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## DO ORGANISATIONAL CULTURE AND STRUCTURE ENHANCE INTERNAL CONTROL EFFECTIVENESS? EVIDENCE FROM MALAYSIAN SOCIAL COOPERATIVES

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### ABSTRACT

Similar to the private and public sector, internal control in social cooperative plays an important role on the success of the organisation and is a mirror to effective governance. Nonetheless, little is known about the effectiveness of internal control of cooperative in Malaysia, as current practice does not require the organisation to follow any prescribed standard of internal control or to report it in their annual report. Hence, this study will shed some light on the factors that influence the effectiveness of internal control in cooperative. This study examines the impact of the cooperatives' organisational culture, organisational structure and the age of the cooperative on internal control effectiveness. Data was collected using questionnaires, which were distributed to 'Top 100 Cooperatives' for the year 2014. Based on the analysis of the 56 responses received, regression analysis revealed that only organisational culture and cooperative age shows a significant relationship with internal control effectiveness in Malaysian cooperatives.

**Key words:** Internal control effectiveness, cooperative, social enterprises, contingency characteristic

### INTRODUCTION

The establishment and movement of cooperatives globally have been driven by ideas of democracy founded on a socioeconomic philosophy that suggests an expansion of decision-making power from small minority shareholders to a large majority of public shareholders. The formation of a cooperative fulfils the need and demand of economically deprived community by pursuing social and economic goals, involving the provision of services and the community's economic revitalisation (Leviten-Reid and Fairbairn, 2011). The International Cooperative Alliance (ICA) defines the term cooperative as "an autonomous association of person united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise." Cooperative principles are based on the strong orientation towards the general interest of public, in contrast with most traditional private companies. Cooperatives, which pool together their collective resources, assist less fortunate people in reducing the risk of vulnerability and in rising out of poverty. These social problems can be alleviated through a collective approach towards social protection as a practice by cooperative (UN, 2003; Hagen, 2004).

The cooperative is different from traditional private firms and traditional non-profit organisations. They not only combine the social goals of the traditional non-profit organisation with the commercial characteristics of a corporation, but also have a unique ownership and membership structure. The cooperative members have full control over the firm, but not over its profit; cooperatives are allowed to distribute part of the profit, but their assets are normally locked (Hansman, 1996). The cooperative has a multiple stakeholder membership, including its governance, and different actors participate in the production process, including workers, volunteers and customers (Thomas, 2004). Based on its

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principles and structure, a cooperative can be seen as a type of social enterprise, and it represents one of the most developed and successful models of such an enterprise (Borzaga et al., 2014).

Cooperatives have similar requirements to other business organisations in achieving business goals and performance, although they are different in organisational characteristics, thus outlining the need and importance of internal control effectiveness in cooperative organisations. O'Connor (2003) stated several reasons why corporate governance is difficult in cooperatives compared to other organisations. One of the problems is the absence of effective oversight (control) by the owners (directors) of cooperatives. Additionally, compared to directors of public companies, cooperative directors typically have less expertise and thus less incentive in providing effective corporate governance. Understanding that effective internal control is a function of corporate governance, problems within the corporate governance also indicate problems in its internal control. Cooperative without effective internal control can lead to financial misappropriation by the person in charge within the management.

Although the professional literature on internal control has made progress in discussing internal control and its effectiveness, the amount of research within this area is scarce (Jokipii, 2009), particularly on Malaysian cooperatives. There are several studies on internal control in the private sector (e.g. public listed companies and small-medium enterprises), the public sector and non-profit organisations in Malaysia (Fadzil, Haron and Jantan, 2006; Haron, Rahman and Hanid; Ghazali, 2010; Mohamad-Nor, Shafie and Wan-Hussin, 2010; Mohd-Sanusi, Mohd- Omar and Mohd-Nassir, 2015), but studies on internal control and internal control effectiveness within Malaysian cooperative organisations context are very limited. Very little literature focuses on the relationship between organisational culture, organisational structure and the effectiveness of internal control. Hence, this study will examine the influence of cooperative characteristics (organisation culture, organisation structure, environmental factors and organisational age) on the effectiveness of internal control.

## **THE DEVELOPMENT OF COOPERATIVES IN MALAYSIA**

In Malaysia, the cooperative movement started in the early 20th century (SKM, 2014). The idea of cooperatives was introduced to solve problems faced by rural farmers, who were oppressed by middle-men or business mediators under the “padi kunca” system, and also to solve problems of indebtedness by low-wage workers and civil servants in the city. In 1922, “Sharikat Bersama-sama Kerja Bantu Membantu” was established in Taiping, Perak; at the same time, the Cooperative Societies Enactment 1922 was enacted to supervise the “sharikat kerjasama”, now known as “koperasi” (cooperatives). In the first year of the movement, six rural credit cooperatives, three civil servants’ cooperatives and two cooperative stores were established (SKM, 2014).

The Malaysian Cooperative Societies Act 1993 (Act 502) defined a cooperative as an organisation built for the purpose of improving its members’ participation in economic and social activities. Owned by a group of individuals, a cooperative is formed based on the cooperative principles: open and voluntary membership, democratic management, limited return based on members’ contributions, a fair distribution of profits, promotion of education on cooperatives and active cooperation among registered cooperatives (SKM, 2014). Today, under the administration of the Ministry of Domestic Trade, Cooperatives and Consumerism (MDTCC) and under the regulation of the Malaysia Cooperative Societies Commission (MCSC), Malaysian cooperatives are regulated by the Cooperative Societies Act 1993 (Akta Koperasi 1993) (ACT 502) and the Malaysia Cooperative Societies Commission Act 2007 (Akta Suruhanjaya Koperasi Malaysia 2007) (SKM, 2014).

The National Cooperative Policy (NCP) was launched in 2002 with the aim of re-developing cooperatives. It was introduced to outline several strategies to be implemented to enable cooperatives to play an active role in business development, along with the public and private sectors. The authority structure of cooperatives was also improved through the NCP between 2002 and 2010 by having cooperatives monitored under the MDTCC and placed under the sole authority of Malaysian Cooperative Societies Commission (MCSC).

The Malaysian government regards cooperatives as a platform for economic development (Othman, Mohamad and Abdullah, 2013). It is taken as a tool in helping to eliminate rural poverty and unequal income distribution, and in enhancing development in both rural and urban areas. As a result of the local government transformation plan, cooperatives have emerged into efficient businesses from being only small and rural, and providing only basic services to their members (Mohamad, Othaman and Mohamad, 2013). The role of cooperatives in uplifting the economic development of rural and urban areas has been described under the New Economic Model (NEM): although on an individual basis cooperatives may seem small, when combined and pooled together, the collective power of cooperatives is very impressive.

### **ISSUES OF MALAYSIAN COOPERATIVES**

Despite the growth in the terms of numbers of cooperative as recorded by MCSC and Malaysia's long history of cooperatives over the past 92 years (Raja-Yusof, Devi, Din, Nordi and Saari, 2002), issues such as the absence of good governance and the weak structure in some cooperatives have typically characterised Malaysia's cooperative movement. These problems have resulted in poor financial performance, poor cash flow and mismanagement and noncompliance with the Cooperative Societies Act 1993 and its related legislation in this sector (Bidin, 2007). These kinds of problems have hindered the movement and the development of cooperatives as inspired by the government.

Issues such as absence of good corporate governance and lack of capital, along with a weak structure, have resulted in poor cash flow and financial performance, mismanagement and financial misappropriation in cooperatives (Bidin, 2007). In Malaysia, an example of an infamous financial scandal involving cooperatives was the Deposit Taking Cooperative, ANGKASA, MOCCIS, Bank Rakyat and the Cooperative Central Bank. The scandal involved a large amount and the loss incurred was reported at more than RM 2 billion. In a statement to the press, Royal Professor Ungku Aziz stressed his disappointment over the scandal and the time it took to settle the investigation.

The scandal was a result of ineffective internal control in the organisation, and created an urgency for regulators to implement better internal control in the organisation. Nonetheless, up to date, it is still not mandatory for cooperatives to implement or to report on their internal control in their annual report.

### **INTERNAL CONTROL EFFECTIVENESS IN COOPERATIVES**

Generally defined, internal controls are process employed by the board and management to prevent and mitigate fraud, to warrant reliable financial reporting and to stay compliant with rules, law and regulations. From the board to the lower-level employees, all are responsible for the internal controls impacting their jurisdiction. Sponsoring Organisations of the Treadway Commission (COSO, 1992, p. 1) defined internal control as "a process, effected by an entity's Board of Directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories; effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations." As a process, internal control is dynamic in nature, with constant changes in the organisation's environment (internal and external), resulting in a cycle where, as past threats are mitigated, new risks will arise.

Internally, internal control helps organisations ensure the reliability of reports, such as financial reports; helps compliance with laws and regulations; encourages and promotes operational efficiency and effectiveness; and most importantly helps in reducing risks (COSO, 1992). Internal control also helps management deal with external opportunities and threats such as the competitive environments, economic volatility and shifting demands and supplies (COSO, 1992). The purpose of internal control is to reduce risk and error and to enhance accountability, as it provides a system of checks and balances, with the potential for reducing theft and fraud. It can also help identify potential areas of errors. In evaluating the effectiveness of internal control, although it depends on subjective judgment, COSO (1992) outlined that effectiveness is determined by meeting three categories of objectives of internal control: effective and efficient organisational operations, reliable reports and compliance with laws and regulations.

Generally, if the organisation's internal control is free from material control weaknesses and reasonable assurance regarding the achievement of its objectives is provided, internal control is deemed effective (Pfister, 2009). Effective internal control exists when board and management obtain reasonable assurance that achievement on efficiency and effectiveness of operation is gained, and it is crucial for the management to be aware of the level at which these achievements are earned (Pfister, 2009). In addition, board and the management are reasonably assured that internal financial reports and statements are reliably produced. All information in the financial reports needs to be carefully constructed and free from material errors for it to be reliable. Finally, the management and board must have reasonable assurance that the organisation as a whole has complied with the laws and regulations pertaining to the organisations' operations.

### **CONTINGENCY THEORY**

The theoretical foundation of this study is premised on contingency theory. Donaldson (2001) defined contingency as "any variable that moderates the effect of organizational characteristics on organizational performance." Klaas (2001) outlined that organisational viability depends on different contingencies such as organisational structure, organisational climate, technology and culture. Thus, it explains how the contingency theory enables a researcher to originate systematically factors in predicting or explaining expected situations (Badara, 2013; Umanath, 2003). The main context of contingency theory is that the success of any management control initiative (e.g., internal control and internal control effectiveness) depends on the contingencies of the company.

Additionally, Hui and Fatt (2007) state that two theories (industrial organisation and resource based theory) discussed in the research argue that a good fit between a firm's internal characteristics and external forces is crucial to the effectiveness of a strategy. A good fit means tailoring controls to organisations' characteristics to make them unique, as this will result in better effectiveness in control (Fisher, 1998; Jokipii, 2009, Ninlaphay Ussahawanitchakit and Boonlua, 2012). Ninlaphay et al. (2012) argue that organisational ability to adapt to internal control system in times of facing external or internal changes is crucial in determining whether the system fits the organisation, and is thus capable of promoting its effectiveness.

A specific proposition of contingency theory is that the dependent variable and two or more independent variables' relationships are hypothesised and empirically tested (Drazin and Van de Ven, 1985; Badara, 2013). Organisational ability in adapting to internal control systems may be analysed by empirically testing the relationship of organisational contingencies (contingency characteristics and organisational culture) and the effectiveness of the system. In this study, components of contingency theory such as organisational structure, environmental factors and organisational culture will be utilised in explaining

organisational contingencies that could influence the effectiveness of internal control in cooperative organisations.

## RESEARCH HYPOTHESES

### Organisational Structure

Organisational structure fairly affects elements in internal control, which directly affects effectiveness of internal control and provides a base for the overall internal control system (Standards for Internal Control, New York State Government, 2007). Some of the line-up of organisational structure characteristics in an overview by Vroom (2002) are standardisation, differentiation and coordination, formalisation, centralisation, and configuration.

Otley (1980) states that a mechanistic structure (more centralised, vertically differentiated and formalised) will increase predictability of work behaviour by reducing variability, and thus may facilitate organisations' internal control. It was later found in the results that organisational structure has a statistically significant positive effect on internal control effectiveness. Erserim (2012) on the other hand finds no significant relationship between centralisation and managerial accounting practices, but finds formalisation to have positive relationship with managerial accounting practices. Additionally, Jokipii (2009) finds no significant results for organisational structure towards internal control and its perceived effectiveness. Thus the following hypotheses are built:

*H1a: There is a positive relationship between cooperative's organisational structure (centralisation) and the effectiveness of internal control.*

*H1b: There is a positive relationship between cooperative's organisational structure (formalisation) and the effectiveness of internal control.*

### Environmental Factors

Environment factors include forces outside organisation that could potentially affect performance (Robbins, 1998). As all environmental elements (i.e., government regulations and competitors) combine and conspire, an unpredictable environment will be produced to a lesser or greater extent (Lashley and Lee-Ross, 2003). Lashley and Lee-Ross (2003) also list some popular techniques in analysing environmental factors, such as SWOT analysis (strengths, weaknesses, opportunities and threats), PEST analysis (political, economic/environmental, social and technological factors) and mnemonics (all appropriate variables are considered).

Chenhall (2003) emphasises the external environment as a powerful contextual variable. Specific external risks may arise towards the industry within which the organisation operates (AICPA, 2006); for example, using technology to ensure efficient organisational operation, or political factors that may impact the organisation (Gupta, 2013; Mahara, 2013), having an impact on the effectiveness of internal control.

*H2: There is a positive relationship between environmental factors and the effectiveness of internal control.*

### Organisational Culture

Organisational culture is a shared values, assumptions and beliefs that exist in the environment of an organisation, which produces a behavioural norm in solving problems (Schein, 1990; Owens, 1987) and guides behaviours within the organisation (Heris, 2014; Ahmad, 2012). Organisational culture influences behaviour and attitudes within an organisation, as it acts as a system of social control, and the values and beliefs that construct culture portray the organisational internal environment (Aycan, Kanugo and Sinha, 1999; MacIntosh and Doherty, 2010), making organisational culture an organisational contingency.

Previous research findings found a significant positive relationship between internal control, internal control effectiveness and organisational performance, and organisational

culture (Aydin and Ceylan 2009; Pfister, 2009). Aydin and Ceylan (2009) state that organisational commitment and employee satisfaction will aid in organisational effectiveness; for example, employee satisfaction will increase involvement in the organisation and thus facilitate organisational effectiveness.

Although reports on direct positive relationships between organisational culture and internal control effectiveness are fairly limited, large significant findings on organisational culture positive relationships with internal control and organisational performance have made the researcher's point in discovering a relationship between organisational culture and internal control effectiveness relevant. Thus, the following hypothesis is constructed:

*H3: There is a positive relationship between organisational culture and the effectiveness of internal control.*

## **RESEARCH METHOD**

### **Design and Research Instrument**

This paper employs quantitative methods by using a questionnaire adopted from prior literature on internal control effectiveness by Jokipii (2009). Questions were also adopted from prior literature on organisational culture by Aftab, Rana and Sarwar (2012). The questionnaires were prepared in booklets and were bilingual (in English and Bahasa Malaysia), and were distributed in both languages separately. The questionnaire was designed in four (4) sections. Section A covered demographic information of respondents: the gender, age and position in the cooperative organisation of each respondent. Section B required respondents to answer questions on the characteristics of cooperatives, namely the cooperatives' years of operation, their organisational structure in terms of both centralisation and formalisation, and environmental factors.

Section C focused on the organisational culture of the organisation. The section consisted of 31 statements which explained four dimensions of organisational culture. As previously mentioned, these dimensions from Denison's Framework of Organisational Culture comprise of four traits: involvement, consistency, adaptability and mission. Lastly, Section D consisted of statements that represent the effectiveness of internal control in the organisation. It was elaborated under three elements: operational efficiency and effectiveness, reliability of information and compliance with laws and regulations.

The questions of every section, except the demographic section, operational years and centralisation (organisational structure) section, were built on a four-point Likert Scale. The respondents needed to select their most appropriate responses to each statement: whether they strongly agreed (SA), agreed (A), disagreed (D) or strongly disagreed (SD). The questionnaire is included in the Appendix section.

### **Participants and Procedures**

The targeted respondents for the study were the management of cooperatives, comprising of the cooperatives' Board Members (Ahli Lembaga Koperasi), executives and non-executives, as the responsibility for internal control lies in each individual in the organisation (Pfister, 2009). Questionnaires were distributed by mail to the selected samples – the cooperatives listed in the Top 100 Cooperatives for the year 2014. Mail was addressed to respected cooperatives as this was the most effective way to reach the respondents and in an attempt to receive more valid responses to the questions. Out of 100 distributed questionnaires, 56 were returned by the respondent. The response rate was equal to 56%.

## **RESULT OF THE ANALYSIS**

### **Respondent Demographic**

**Table 1:** Descriptive Analysis of the Participants' Demographic Factors

No.	Item	Overall N = 56		
		Frequency	Percent	
1	Gender	Male	25	44.6
		Female	31	55.4
2	Age Distribution	Up to 35 years old	19	33.9
		36 to 50 years old	25	44.6
		51 to 65 years old	10	17.9
		66 years old and above	2	3.6
3	Position	Board Member (ALK)	9	16.1
		Executive	33	58.9
		Non-executive	14	25.0
4	Cooperative Distribution	Age Up to 35 years	25	44.6
		36 to 70 years	20	35.7
		71 years and above	11	19.6
5	Cooperative Region	Pahang	14	25.0
		Wilayah Persekutuan Kuala Lumpur	13	23.2
		Johor	10	17.86
		Others	19	33.94
6	Cooperative Functions	Credit	23	41.1
		Consumer	14	25.0
		Agriculture	7	12.5
		Others	12	21.4
7	Total Assets of Cooperative – Average		RM 53,848,723	

A total of 56 responses were received for analysis. Distribution of gender among respondents shows a total of 25 respondents were male and 31 respondents were female, which accumulated to 44.6% and 55.4% respectively. Despite indicating a balance gender distribution in cooperative organisations' management, a small gap in percentage between genders shows that there was equal willingness to support the study by responding to the questionnaires. Age distributions shows that most respondents were between the ages of 36 to 50, at a rate of 44.6%. The second highest age group were respondents aged up to 35 years old (at 33.9%). Additionally, respondents' positions were assessed. The highest response rate was received from executives within cooperative organisations, which accumulated to 58.93% of total responses.

As also shown in the table, 44.6% of responses came from cooperatives established up to 35 years ago, which recorded the highest percentage, compared to 35.7% from cooperatives established 36 to 70 years ago and 19.6% from cooperatives established 71 years ago or more. Most responses came from cooperatives in Pahang (25% of total responses). The second and third highest response rates came from cooperatives in Wilayah Persekutuan Kuala Lumpur and Johor, at 23.2% and 17.9% respectively, while another 33.9% came from other regions or states. Credit cooperatives recorded the highest responses received among cooperative functions, with 41.1% of total responses. Consumer cooperatives and agriculture cooperatives recorded 25% and 12.5% respectively, while 21.4% came from cooperatives with other functions. The average total assets from all responses were recorded at RM 53,848,723.

### Test of Hypotheses

To determine the relationship between the independent and dependent variables, multiple regression analysis was used. Hypothesis 1a examines whether there is a significant positive relationship between cooperative's organisational structure (centralisation) and the effectiveness of internal control. The expectation is that the more centralised the organisational structure, the more improved the effectiveness of internal control. Based on regression analysis, the result in Table 2 shows that there is no significant influence between centralised organisational structure and effectiveness of internal control ( $t = -.310$ ,  $p = .758$ ). Even the direction of relationship is also negative; thus Hypothesis 1a is not supported. For Hypothesis 1b, it is claimed that a more formal organisational structure would eventually improve the effectiveness of internal control. Based on the results presented in Table 2, it is shown that there is a significant positive relationship between formalised corporate structures and the effectiveness of internal control ( $t = 1.445$ ,  $p = .155$ ). Hence, Hypothesis 1b is supported. On the other hand, Hypothesis 2 is not supported, as the results in Table 2 show there is no significant positive relationship between environmental factors and the effectiveness of internal control ( $t = .464$ ,  $p = .644$ ). Meanwhile, Hypothesis 3 examines whether the organisational culture will significantly influence the effectiveness of internal control. It was expected that an increase in the organisational culture would significantly improve the effectiveness of internal control. Based on the results in Table 2, the proposition of Hypothesis 3 is supported, with a t-value equal to 2.442 and a p-value equal to .018.

With an R<sup>2</sup> value of 0.400, cooperative age, formalisation, environmental factors and organisational culture shares 40.1% variance with internal control effectiveness. This indicates that the variation in internal control effectiveness can be explained by these variables. From the results, it can be concluded that the model can significantly predict the dependent variable (internal control effectiveness) at  $p < 0.001$  with F-ratio 6.680.

**Table 2: Multiple Linear Regression**

	B	Std. Error	t	Sig.
(Constant)	1.688	.381	4.436***	.000***
Centralisation (Organisational Structure)	-.014	.044	-.310	.758
Formalisation (Organisational Structure)	.099	.069	1.445*	.155*
Environmental Factors	.049	.106	.464	.644
Organisational Culture	.298	.122	2.442**	.018**
Cooperative Age	-.003	.017	-2.011**	.050**

R = .633<sup>a</sup>

R<sup>2</sup> = .400

Adjusted R<sup>2</sup> = .341

P = .000<sup>a</sup>

a. Predictors: (Constant), Organisational Culture, Cooperative Age, Formalisation, Centralisation, Environmental Factors

Notes: Significance is based on a two-tailed test; \*\*\* represents significant at .001 level, \*\* represents significant at .05 level and \* represents significant at .10 level

## DISCUSSION AND CONCLUSION

The practice of internal control within credit cooperatives is not fully implemented, although a high level of awareness was recorded in the responses. This was due to the cooperative management, which did not feel confident that there would be enough funds allocated for the implementation of internal control, or to acquire competent people to assist in its implementation. Additionally, it was found that, compared to non-performing cooperatives, performing cooperatives have larger time allocation for control activities, which also

indicates the importance of internal control effectiveness for cooperatives' performance. All of this has raised questions on the cooperatives' ability to implement effective internal control.

To determine whether the internal control system fits the organisation to promote effectiveness, organisations need to be able to adapt. The need for effective internal control may vary depending on each organisational context (Jokipii, 2009). Standardised internal control, such as COSO, also suggest that internal control effectiveness depends on organisational characteristics. The effectiveness of internal control is tested to be influenced by organisational characteristics (organisational structure, organisational culture) and also environmental factors. This could indicate that effectiveness of internal control relies heavily on these characteristics. Both organisation structures in terms of formalisation and organisational culture influence the effectiveness of internal control. This indicates that a more formal organisational structure, such as having formal written policies and procedures, will improve the effectiveness of internal control.

Formal organisational structure will work, perhaps by directing and informing the lower-level employees formally on the do's and don'ts that would direct the organisation towards more effective internal control. Over time, these formal organisational structures, which inform the tone from the top, would provide unique capabilities for cooperative to remain competitive in the market. On the other hand, the results also indicate that all four dimensions of organisational culture impact on cooperatives' internal control effectiveness. For example, if cooperatives provide a culture of involvement, which makes the employees feel they are a part of the team and can see the importance of their work in achieving organisational goals, cooperatives could also improve their internal control effectiveness. Involvement serves as an important dimension in explaining commitment and capability development by employees (Ahmad, 2012). Similarly, a highly consistent culture will lead organisations to be effective (Davenport, 1993). Adaptability, culture and mission are also important within cooperatives to improve internal control effectiveness.

A major limitation to this study was the low response rate from the questionnaire survey via mail. Future studies may consider conducting interviews, as they may provide a better understanding of current views and practices of internal control and internal control effectiveness within cooperative organisations. Interviews may also provide deeper perceptions of cooperative organisations' contingency characteristics, organisational culture and internal control effectiveness. Although previous studies of the relationship between these variables have been carried out primarily on profit organisations, when tested in the context of the cooperative, the results from this study could provide an avenue for more exploration in future on the factors that can influence the effectiveness of internal control. Additionally, the usage of the four-point Likert scale in this study might cause normality problems; it is recommended for future studies to expand the scale. Due to data limitations, exploration on types of cooperative that place great concern on internal control effectiveness cannot be done; future studies may therefore expand the research sample and obtain more information, so that comparisons between each cooperative function might be made. Despite the limitations, it is hoped this study will enhance the understanding of internal control and internal control effectiveness literatures, particularly for cooperatives in Malaysia.

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