Case Study: Transmile Group Berhad

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Abstract

Transmile Group Berhad (Transmile), an investment holding company involved in the provision of air freight, aircraft engineering and maintenance services, pride itself as being a company with stellar performances, operationally and financially as well as its share price. In 2007 however, the company was hit with an accounting scandal with allegation that its revenues and profits had been materially overstated as far back as year 2004. The fiasco had resulted in negative consequences to both the company and its shareholders. Against this backdrop, issues of corporate governance (or the lack of it) and business ethics were raised to the fore. Hence, this case allows for discussions to better understand the aspects of corporate governance and business ethics involving several parties in this Transmile fiasco.

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Prologue

It was supposed to be his usual brunch at Raju’s, that Thursday morning. Sipping his hot tea patiently, he read the newspaper when suddenly a news headline caught his attention: “Transmile faces suspension and de-listing.” Utterly frustrated by the headline, his eyeballs frantically moved on to read through the rest of the news. Instantaneously, he got hold of his broker, Ali through the phone, and had his worst fear confirmed. Transmile’s share price had plunged - on the de-listing news - to a new record low as it closed at RM0.09 a piece.

Slumped in his seat, Kamal lamented over his bad investment in the company but soon realized his over reaction to the news. “The news shouldn’t come as a surprise to me. I should have seen this coming as the share has been heading south for as long as I have owned it”, Kamal thought. Kamal bought a few lots of Transmile’s shares soon after the company announced its unaudited consolidated results for the fourth quarter of the financial year ended Dec 31, 2006 on 15 February 2007, before the price plunged in May of the same year when the scandal started to unraveled.

However, certain questions kept Kamal wondering. Could the scandal be averted? Could he have known something was amiss earlier that could have helped him decide not to buy the share in the first place? “Hey, what happen to the red flags?” he asked himself almost loudly.

Background

Transmile Group Berhad (Transmile) is an investment holding company, which principally involved in the provision of airfreight, aircraft engineering and maintenance services. The company was founded by Gan Boon Aun in November 1993 and was later listed on the Bursa Malaysia Securities Berhad (Bursa Malaysia) on 27 June 1997.

Transmile shareholding as at 28 April 2006 showed a mixture of local and foreign shareholders with the largest shareholder being Trinity Coral Sdn Bhd (19.5%), a company that was part of the diversified international conglomerate, the Kuok Group. The Kuok Group had earlier in March 2004 bought a 28.5% stake in Transmile, via Trinity Coral Sdn Bhd, from Gan and Khudin Mohd for RM282.5mil. In 28 April 2004, Transmile appointed Tun Dr Ling Liong Sik as its independent and non-executive chairman and the outgoing chairman cum executive
director, Gan had been re-designated as director and chief executive officer (CEO) of the company. Other notable shareholders were Pos Malaysia Berhad (17.3%), JP Morgan Chase Bank (USA) (4.4%), Employee Provident Fund (3.9%), GAP Ltd (3.9%), Goldman Sachs International (3.4%) and Gan (2.5%).

Equally impressive were Transmile’s clientele which included some of the household name companies such as the DHL Worldwide Express, United Parcel Service (UPS), Pos Malaysia Berhad, Nationwide Express, Citylink, BaxGlobal and Nippon Express. Operationally, Transmile had maintained regular flights between Peninsular Malaysia and East Malaysia, to countries like China, Thailand, India and to some major cities in the Asia Pacific region.

With a wide range network of operations, Transmile reported increasing revenues and profits since 1998 until 2006. The strong showing in revenue and profit were tracked by its share price which had risen substantially. However, the company was hit with an accounting scandal in 2007. It started when the company failing to adhere to the deadline in submitting its audited annual accounts for the financial year ended 31 December, 2006 to Bursa Malaysia for public release. It was to be within a period not exceeding four months from the close of the financial year, which was on or before 30 April 2007 as required by the Listing Requirements of the Exchange.

Matters took a turn for the worse when its external auditor, Deloitte & Touche via a letter to the Board of Directors (BOD) on 4 May 2007, declined to approve the annual accounts for lacking of certain supporting documents. In response, on 7 May 2007, the BOD appointed Moores Rowland Risk Management to conduct a special audit on issues raised by Deloitte & Touche. It was later found, amongst others, that the revenues and profits had been materially overstated not only in the company’s 2006 unaudited annual accounts but also in the 2004 and 2005 audited annual accounts. With the overstating figures taken into consideration, Transmile’s profits for the effected years had reversed to a loss instead.

Consequently, Gan (CEO) and former executives, Khiudin Mohd and Lo Chok Ping were charged by the Securities Commission (SC) with abetting the company in providing misleading unaudited consolidated reports for the 4th quarter of the financial year ended Dec 31, 2006, “an
offence under section 86(b) of the SIA read together with section 122C(c) of the SIA. Gan and Khiudin were also charged under section 122B of the SIA in the alternative.” However, SC later withdrew the charge against Lo, the former chief financial officer of Transmile after he paid a compound of RM700,000. The SC also offered compounds of RM500,000 each to the two non-executive directors of Transmile, Chin Keem Feung and Shukri Sheikh Abdul Tawab, for an offence under section 122B(b)(bb) SIA 1983 for knowingly permitting the making of misleading statements to Bursa Malaysia. Besides SC, Bursa Malaysia also reprimanded Transmile and four of its directors – Gan, Khiudin, Chin and Shukri - for “breaching the Listing Requirements pertaining to timely and accurate disclosures of financial information.” Both Gan and Khiudin were fined RM781,500 each and Chin and Shukri, RM162,600 each.

The Transmile fiasco had sent reverberating shock waves to the investment public. As a result, the share was down to around RM8 from its peak of around RM14 in early May 2007. According to Singapore Business Times, most of the selling came from disgruntled foreign investors. The price drop had resulted in substantial wipe out of its market capitalization.

Source: Thestar.com
The Board of Directors (BOD)

It was stated in the company’s annual reports that the responsibilities of the BOD included “overseeing and monitoring of the performance of management and the business of the Group, setting strategic and succession plans, developing and implementing shareholder communication policy, managing risks and putting in place adequate internal controls and reporting procedures.” In carrying its responsibilities the BOD delegated some of its responsibilities to several agents. The BOD however was still held fully responsible and accountable for the overall conduct and performance of the activities of the company. Nonetheless, Transmile’s BOD had found it convenient to totally leave the business to their agents. Datuk Oh Siew Nam, the alternate director to Kuok Khoon Ho (Kuak Group) confessed: “we left the business entirely to the management because we assumed it would conduct the business with proper corporate governance and keep all directors informed.” In response, the shareholders showed their displeasure of the performance of the directors by voting against paying the directors of the company for their services in 2006 during its annual general meeting.

The Audit Committee

The main objective of the Transmile’s Audit Committee was to assist the BOD in carrying out its statutory duties and responsibilities relating to accounting and reporting practices of company and its subsidiaries. According to the 2005 Annual Report, the Audit Committee also:

- evaluates and monitors the financial reporting process;
- provides assurance that the financial information provided by management is relevant, reliable and timely;
- oversees compliance with laws and regulations and observance of a proper code of conduct; and
- determines the adequacy of the Company’s internal control system.”

The Audit Committee was headed by one Chin Keem Feung during the years when it was found that there were serious accounting issues in Transmile’s financial reports. Together with him in the three-person committee were Shukri Bin Sheikh Abdul Tawab and Khiudin Bin Mohd@ Bidin, an Executive Director of Transmile ever since it was listed publicly in the KLSE. Both Chin and Shukri were the independent non-executives.
Integrity

One way the Audit Committee assisted the BOD in carrying out its statutory duties and responsibilities was by serving as a bridge in the communication network between internal and external auditors and the BOD. Hence, all material matters raised by the internal and external auditors were expected to be reported to the BOD for information as well as further deliberation. However, this was not always the case in Transmile, whereby there were some pertinent information that was not communicated to the BODs. Transmile’s Audit Committee and the top executives had been alerted by Deloitte & Touche on two occasions- 14 February 2007 and 15 February 2007 – of the serious accounting issues found in the company’s unaudited 4th Quarter of 2006 report. Yet, despite knowing the auditor’s concern, the Audit Committee decided otherwise and went ahead to seek the consideration and approval of the BOD for release of the unaudited annual account. In fact, the auditors’ concern was not immediately highlighted to the entire BOD by the top executives and the Audit Committee upon being alerted by the auditors. The unaudited 4th Quarter of 2006 report was released on 15 February 2006, before the due date for submission on 28 February 2007.

The release of the unaudited results that were not qualified was, as described by Oh, a great shock and that the management and Audit Committee had “failed in fiduciary duties to alert the board on the warning raised...” The conduct of the management and the Audit Committee on this matter had also given rise to a suspicion that something sinister was going on. TA Investment Management Bhd chief investment officer Choo Swee Kee suspected that “...there seems to be a conscious effort by the management to cover this up.”

Effectiveness and Independence

There were concerns on the effectiveness and independence of the independent directors in the Audit Committee. The public expects that with the presence of the independent directors, who formed the majority in the committee, the quality of monitoring would be increased. Independent auditors were expected to be able to form independent and objective opinions and judgments. In fact, the Audit Committee was authorized by the BOD to convene meetings with the external auditors, excluding the attendance of executive member(s) of the Audit Committee,
wherever it deemed necessary. However, by releasing the unaudited consolidated results for the fourth quarter of the financial year ended Dec 31, 2006 despite the audit alert, the independent auditors had knowingly permitted the making of misleading statements to Bursa Malaysia, which breached the Listing Requirements of the Exchange.

**Competency**

The Audit Committee was also tasked by the BOD to determine the adequacy of the company’s internal control system. In doing so, the Audit Committee was expected to be more prudent and stringent in its roles of overseeing the internal control system. Prior to 2004, the Audit Committee was assisted by the Internal Audit Department in overseeing the internal control system. According to Transmile’s 2003 annual report, the internal audit department was entrusted with the responsibility of “appraising policies, procedures and management controls of the Group so as to ensure that activities are properly managed and to promote effective controls.”

Beginning from the middle of 2004, Transmile had outsourced its internal audit function to Moores Rowland Risk Management Sdn Bhd, an independent professional firm. However, the scope of auditing had only been on several specific areas as instructed by the Audit Committee. The internal audit was not expanded to some critical areas such as the sales and finance divisions of the company. Hence, it did not cover the review of financial statement. This gave rise to the question why a large capitalized company like Transmile opted to outsource its internal audit works to a third party against the norm of having it done in-house.

**The External Auditor**

**Competency and Due Care**

According to its 2005 Annual Report, the role played by Transmile’s independent external auditors was to “evaluate the overall financial statements presentation and ensure that they are prepared in accordance with statutory requirements.” However, the Transmile’s saga had left considerable concerns among the public of the role played by the company’s external auditor, Deloitte & Touche. The Minority Shareholders Watchdog Group (MSWG), for example, urged the regulator to scrutinize the role
played by the external auditors and take speedy action to bring those at fault to task. The concerns especially came when the special audit had confirmed that, amongst others, the revenues and profits had been materially overstated in the company’s 2006 unaudited annual accounts released to Bursa Malaysia on 15 February 2007 as well as the 2004 and 2005 audited annual accounts of which Deloitte & Touche was the auditor. The special audit indicated that sales attributed to over 20 companies since 2004 were confirmed to be either fictitious or unsubstantiated. The failure by Deloitte & Touche to detect the material errors in 2004 and 2005 had cast doubts on the auditor’s competence and due care.

Deloitte & Touche however dismissed the concerns on several points. In an interview with the Business Times, Chaly Mah Chee Kheong (Mah), Chief Executive Officer, Deloitte & Touche Asia-Pacific explained that the audit was governed by the concept of materiality: “We only check based on samples randomly picked, generally a bias towards large items which are material, because there are so many transactions. It is almost impossible for auditors to check on every single transaction.” He further explained the difficulty that auditors faced in the course of doing their auditing was that “in instances where there is collusion between employees in an organization, worse still with vendors who are outside the organization, it becomes extremely difficult for both internal and external auditors to detect,” Mah also argued that public are putting much responsibility on the external auditors when, in fact, “the primary responsibility of ensuring proper internal control systems and accurate accounting records lies with the directors and management of a company,”. He further defended Deloitte & Touche role by saying that “I don’t believe we have done a bad job as far as Transmile is concerned. At the end of the day, it was our stringent audit processes that led us to discover the accounting irregularities. If our quality of work were really that bad, we probably would not have discovered them.”

**Integrity and Independence**

Other than competence and due care, there was also concern about Deloitte & Touche independence. Deloitte & Touch have enjoyed a long-term relationship with Transmile, stretching more than a decade. “We have been serving them for a number of years, even before their initial public offering” said Mah. The long-standing relationship could
however to a certain extent pose the familiarity threats. Familiarity, could negatively affect auditors’ independence of mind and therefore their auditing quality. As Prabhat Kumar, the chief consultant at Alliance IFA (M) Sdn Bhd explained, “when auditors go for a job, there’s a presumption in their minds that everything is in good faith.”

Deloitte & Touche was also said to have quoted its client an audit fee, which was comparatively too low. This could be Deloitte & Touche’s strategy to continue secure auditing assignments from Transmile. Yet, from another point, it could be seen as fear of losing the client, especially with the intense competition from the other audit firms. According to Teck Heang Lee and Azham Md. Ali of The Accountants Today, evidence of low audit fees by Deloitte & Touche could be found in the case of Transmile where in 2006 and 2005, the fees were RM150,000 and RM73,000 when revenue were RM655.8 million and RM356.4 million respectively. However, when the audit was taken over by KPMG in 2007, the fees shot up to RM280,000 while the revenue dropped to RM616.2 million. The practice of setting the fees so low could compromise the principle of competence and due care as auditors might be in difficulty to perform their duties satisfactorily.

The release of the unaudited annual accounts for 2006 to Bursa Malaysia which was made despite the auditor’s concerns over the accounting issue had breached the Listing Requirements of the Exchange and was an unfortunate event for the company, but how Deloitte & Touche responded to this was what that matters. The Section 99E of the Securities Industry Act stated that, “if an auditor is of the professional opinion that there has been a breach of securities laws or rules of the exchange or any matter which may adversely affect the financial position of the listed company, the auditors must immediately submit a written report on the matter to the Securities Commission.” There could be a tremendous pressure on the auditor not to report to the authority as per requirement of the Section 99E since the audit committees which played a role in selecting auditors, determining their remuneration, dismissal or retention could be implicated if found guilty.

Deloitte & Touche had held regular discussions with the management and the audit committee to address the accounting issues when they were first discovered, but was to no avail. Finally, on 4 May 2007,
via a letter, Deloitte & Touche informed the BOD that they declined to approve the annual accounts as they had not been able to obtain “relevant supporting documentation from the management on certain transactions relating to trade receivables and related sales and additions to property, plant and equipment so as to enable them to satisfy themselves on the fairness or validity of those transactions.”

Transmile was not the only case that had affected Deloitte & Touche’s reputation, but also those of NasionCom Holdings Bhd and Ocean Capital Bhd, of which it was the auditor. Both companies were reprimanded by the Securities Commission for submitting inflated revenue figures in their financial statements. Later, Deloitte & Touche was replaced with KPMG after many years. However, KPMG was already an auditor for a few companies owned by Robert Kuok namely the Hong Kong listed Keck Seng Investments and Shangri-La Hotels (Malaysia) Bhd. KPMG was also offering other non-audit work like due diligence and corporate tax advisory services to PPB Bhd, a company also owned by Robert Kuok. Thus, again there could be issues of possible conflict of interests and independence of auditors.

The Research Analysts

Transmile had always been one of the favorite companies for investors and analysts alike. Its share price had risen by 428.3% since 2003 and analysts had always maintained bullish views on Transmile. Key points that were usually highlighted by analysts were, Transmile’s strong growth in earnings; its five year pact with DHL, as its strategic partner; its landing rights in various cities around Asia, freedom rights out of Hong Kong and China to the US; its increasing capacity including the four long haul and fuel efficient MD11 planes freighters; and the company’s strong and reputable shareholders such as The Kuok Group and Pos Malaysia. In order to encourage a better understanding of the company’s performance and latest developments, Transmile had also conducted several briefing sessions to interested fund managers and analysts and “one to one” dialogue sessions upon request.

Advocacy

On 15 February 2007, the company released its unaudited 4th Quarter of 2006 report. Both local and foreign analysts, agreed with it by giving
positive assessments on the company’s prospect and lofty target prices. These, despite the fact that profit growth were unusually high – a common general red flag for financial statement fraud. One of the leading local research houses was rating Transmile’s share as a “strong buy” with an expected total return exceeding 20% in the next 12 months, underpinned by the reported net profit growth of 110.5%. An analyst explained that this was mainly due to the increase in aircraft capacity in 2006, contributed by the arrival of four MD-11s in September 2005. Curiously enough, the research house’s own estimate on the Transmile’s profit wasn’t that far off, but merely by 1.5% than that of Transmile’s own inflated figure. Other analysts were not bad either in their estimates, with Transmile’s figures were just 4.6% above consensus. This gave rise to suspicion that the analysts could have gotten wind of the information from insiders in Transmile.

**Due care**

While many analysts were focused on the earnings and company’s prospects, there were other indicators that could have a material effect on the investors’ decisions to invest in the company but were largely missing from many analysts’ reports. Despite being a strong growth company, Transmile had not really been able to turn its sales into cash. Transmile’s trade receivables had been building over the years with trade receivables for 2006 were reported at RM381.2 million, which was a 243% jump or RM270.1 million more than the previous year, while growth in 2005 was 5% and 2004, 46.1%. With revenue recorded increase of 80% or RM439.1 million during the same year 2006, receivables accounted for much more of the company’s revenue growth. Since trade receivables could have influence on the profitability reported, it would be prudent for analyst to be on the alert as these trade receivables could easily be re-classified as doubtful debts.

The cash flows from the operation activities substantially dropped from RM161.2 million in 2005 to RM18 million in 2006, which resulted in the company not having sufficient fund from its operating activities to service the interest payments of existing debt which stood at RM36.5 million. The shortfall had been financed by its cash flow from financing activities. Given the substantial drop in the operating cash flow and the level of debts, question lingered over the sufficiency of the future cash flow...
from the operation activities to service the interest payments of the debts. The drop also gave rise to concerns on its ability to finance its future growth as seeking funds maybe more expensive in the future. Transmile’s cash and bank balances as at year-end 2006 stood at RM417 million. Of this amount, only a meager RM18 million came from its operating activities while much of it, RM260.7 million was from the previous year and RM287 million from the issuance of new shares.

**Integrity**

With such favorable assessments by the analysts, the influence on the share price went without saying, as “when research houses are upbeat on a stock, most others tend to follow suit. And when investors are buying into a counter, others too think it must be a good idea. It is called the unconscious herd instinct,” says a seasoned investor. However, by May 2007 as the irregularities of the 15th February figures became clearer, many of these analysts were quick in downgrading their recommendation to “sell”. One of the earliest to react was JP Morgan Securities analyst Lucius Chong who drastically cut his target price on the stock to RM6.25 from RM19.40. Meanwhile, investors, being true to their herd instincts, followed suit. Few however chose to remain on the contrary by holding on to the shares.

While many analysts were jolted by the Transmile’s tumble, investors were irked at them as it was just a few months ago that they had been generously positive with their assessments. Analysts’ assessments, however, were not without any disclaimer. The assessments were actually intended for information purposes only and not to be construed as an invitation to buy or sell the shares referred. Hence, investors were supposed to seek financial advice regarding the appropriateness of investing in the share assessed by the research house in its report. In coming up with their assessments, analysts too relied on the publicly available information obtained from sources believed to be reliable but had not been independently verified by them, thus no guarantee as to its accuracy, completeness or correctness.

**The Lingering Questions**

Transmile’s saga had left many with unanswered questions, among others were?
1. Who were the main characters and what are the ethical issues concerning every character?
2. How was the corporate governance in Transmile?
3. The BOD and the Audit Committee were to be considered as the safeguard to protect the shareholders’ interest in a company. In this case, have these group failed to uphold its fiduciary and moral obligation? How? Why?
4. What were the causes of the conflict of interest on the part of the BOD and the Audit Committee?
5. How objective and independent have the external auditor been?
6. How have the research analysts been in terms of their role of advocacy vs objectivity?

Epilogue

Transmile case happened during the time where the financial world had already seen some spectacular corporate failures due to ethical issues. Companies like Enron, Arthur Andersen, Lehman Brothers and many more which were once household names and the darlings of the business world, had crumbled with their names now being uttered not without the perceptions of distrust and disbelief. One would assume that with these failures being exposed, repeat of such scandals anywhere would be remote since all interested parties would be more vigilant and red flags would be raised when it matters. Oh, how far this is from truth for poor Kamal.

References


