

ETHICS AND ACCOUNTABILITY FOR
GOOD GOVERNANCE IN THE PRIVATE SECTOR¹

BY

TAN SRI DATO' SERI (DR) AHMAD SARJI BIN ABDUL HAMID²

The financial crisis that started in 1997, which affected almost all Asian economies, had led to the bankruptcy of several companies, while some were at the brink of bankruptcy. Even though many agreed that the currency speculators were the real culprits behind the crisis, the lesson learnt was that many of the corporate failures were as a result of poor corporate governance. It has been suggested that excessive gearings was the main reason, suggesting a lack of prudence in managing the funds of the companies. Guided by the belief that debt financing is cheaper than equity financing, greed and other human weaknesses encouraged the managers to go for debt financing, and extended their leverages to the maximum. When the economy was attacked by the currency speculators, the economy went into a down turn thus affecting demand. Many companies found that they were unable to service their loans, because of low cash flow and the collaterals, mostly share certificates, had depreciated substantially.

1 : Text of speech at "The International Conference on Good Governance : Perspectives and Practices" at Brunei Darul Salam on 28 September, 2002.

2 : Chairman, Permodalan Nasional Berhad
Chairman, Institute of Islamic Understanding Malaysia

2. There are many other causes for corporate failures such as incidents of conflict of interest, the utilization of company assets to serve a private purpose, and the discovery of false invoices totaling millions of dollars which can be classified as cheating and forgery. At the heart of these problems are the lack of ethics and accountability in managing the companies.

3. Enron, a company in the United States made eye-catching headlines recently with their collapse, stripping away the conglomerate, which only months before, had assets worth over USD65 billion. The collapse had also unravelled the debts which Enron had been hiding for years in its overstated balance sheet and income statements. Its share price came tumbling down from USD85 a share a year earlier to a mere 26 cents a share upon liquidation. As we all know, the "creative" management of its accounts contributed to Enron's downfall. This creativity had misled the public and its shareholders as to the real financial position of the company. Thus, the public trust in the integrity of the management as well as the auditors came crashing.

4. The Enron case shook America, and sent a warning signal to all of us about what could happen if codes of conduct, transparency and good corporate governance practices are ignored by an organisation. In the Enron case, we saw how the auditors themselves, together with the management, colluded in hiding the accounting figures. The lesson learnt

from the Enron case should enhance public awareness of the critical need for good corporate governance.

5. Many cases of corporate failures have shown that good corporate governance could have saved these companies from the rage of disruption and the heavy losses - there could have been greater accountability, expressed through each company's willingness to report to shareholders on its performance frequently, not just each year; and a greater transparency exhibited by the quality and comprehensiveness of financial reporting. Minority shareholders must enjoy more protection than they ever did.

6. Many companies, including some in Malaysia also had in the past represented obstacles to robust standards of corporate governance, namely those which were controlled by a single family, by financial and industrial groups, or by the State. Many had a tradition of being opaque to outsiders and of not allowing outside board members to provide insight of management. Today's board members are appointed not just to look at today's business - but to ensure that there is a business to manage tomorrow. The benefits of a sound corporate governance can be realised if we have the fortitude and foresight to reward those who practise them well and to penalise those who do not.

7. There are three important reasons for improving standards in corporate governance :

- (i) to promote confidence in the investing community;
- (ii) to meet current demand of customers who increasingly want to have firm and an absolute confidence in the business and moral ethics of the companies they deal with; and
- (iii) to ensure that the height of employees' morale and the depth of their commitment is in direct proportion to the quality of governance and respect for leadership.

8. Today, even rating agencies are starting to include governance benchmarks in their indices. Clearly, the rules for doing business are changing. In the end, it is all about quality - hiring quality people, making quality decisions, delivering quality results, demonstrating good business behaviour and managing risks. International money flows in where the regulatory environment is sound. Some banks have made good corporate governance in a company as a pre condition for a loan. It is believed that good governance ultimately result in good company performance.

9. In Malaysia: *"Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other*

stakeholders." The Malaysian Code on Corporate Governance was introduced in March 2000, and is applicable to public listed companies. Among the provisions in the code are :

- (i) that at least one third of the Board named comprise independent non-executive directors;
- (ii) the creation of committees to assist the Board in performing its duties, such as the audit committee, which should include at least one member who is a qualified accountant under the accounting laws; the nomination committee, comprising all non-executive directors, a majority of whom are independent, whose major functions are to recommend candidates to the Board for directorships and assessing the effectiveness of the Board as a whole, the committees, and also the contribution of each individual director through an evaluation process; the remuneration committee, comprising wholly or mainly of non-executive directors, to make recommendations to the board on the remuneration of the executive and non executive directors. There is now a provision which requires a full disclosure of the remuneration of all directors and the Chief Executive Officers of public listed companies.

10. The internal control framework has also been strengthened. Internal control now has a wide definition which includes both financial and non-financial matters such as efficiency, value for money, legal and regulatory compliance issues. Directors are requested to include in the Annual Report, a report on the *"state of internal control"* of the public listed company. The Kuala Lumpur Stock Exchange requires public listed companies to make the following disclosures in their annual reports :-

- (i) A narrative statement of how it has applied the 13 principles set out in Part 1 of the Code.
- (ii) A statement on the extent of compliance in respect of the 33 best practices set out in Part 2 of the Code.
- (iii) A Director's Responsibility Statement in respect of the preparation of the annual audited accounts; and
- (iv) A Statement on Internal Control

All these mean that the personal reputations of company executives and board members are put on the line. All board members have to attend mandatory courses on corporate governance.

11. The Listing Requirements of the KLSE has set out the continuing disclosure requirements that apply to all listed companies unless otherwise specified in the Requirements. Therefore, all listed companies are required to disclose and announce to the public all material information necessary for informed investing and take reasonable steps to ensure all who invest in securities enjoy equal access to such information. It is also important that the disclosure of all pertinent information be made available to the public in a timely manner, to ensure that investors could make the correct investment decision. This will also assist the market to reflect the true value of a company, thereby enabling investors to make an informed judgement about the quality of management and corporate strategies.

12. The KLSE has also imposed that all listed companies are required to submit quarterly results, on a consolidated basis, complete with balance sheets, profit & loss statements and explanatory notes. This is done as soon as the figures have been approved by the board of directors. All these reports and disclosure are now being made readily available for public viewing and retrieval via the KLSE website. Therefore, information available to the public will be more timely and accurate.

13. However, some practices of directors may give rise to conflicts of interest. The practice of conducting businesses in competition with the company, for instance, or the practice of interested parties

voting on transactions, is an obvious conflict of interest. These practices could undermine confidence in the capital markets.

14. The common law stipulates that directors cannot enter into a contract with his company without disclosing the fact that he is a party at interest. For example, the Companies Act prohibits a director from entering into substantial property transactions with a company without the approval of shareholders, and a disclosure of interest.

15. In addition, the Listing Requirements of the Kuala Lumpur Stock Exchange (KLSE) requires a company to make an immediate announcement or disclosure to the KLSE on any related party transactions entered by the company. It also sets out the procedures/requirements of announcement to be complied with by the company, depending on the quantum of the related party transaction. The disclosure by the related party is required mainly to ascertain whether there is a conflict of interest in the transaction to be entered by the company. This will facilitate voting procedures, where in the event the director/major shareholder is deemed interested in the said transaction, the director/major shareholder must abstain from voting on the resolution.

16. Just being in business is associated with some degree of risk. In fact, if the goal is to make profit, then risk should not be avoided in many cases, only to be managed properly. Indeed in Islam, Muslims are taught to accept the business principle of *no gain without risk*. Business risk management would have to be a regular agenda at board meetings. A

business entity must be able to identify, measure, control and monitor these risks that could threaten the assets and earnings of the organisation and therefore, provide the right balance and control. If a company is to minimise risk, it must try to *integrate* compliance requirement with risk management programme, wherein both factors are considered in every process, function, task, and action that are performed by the company, no matter how small the process, function, task or action may be.

17. Thus, total integrated compliance and risk management should include complying with rules regulations, corporate policy, productivity practices, efficiency practices, quality control, training and education, human resource management, the corporate mission statement, the strategic plan, the business plan, the budget contingency planning, ethical behaviour, and profit requirements. Using this expanded definition, it becomes clear that compliance is not just relating to government regulations anymore. It encompasses virtually everything that the company does. Compliance is all about doing things right. When compliance and risk management are integrated in this manner, the company will minimise its risk and will be managed effectively. In Malaysia, risk management is enshrined in the Malaysian Code of Corporate Governance. It is imperative for the Board of a company to establish a structured risk management process in order to identify the principal risks and to ensure the implementation of appropriate systems to manage these risks.

18. In today's competitive global market, customers are placing increasing importance on quality in the purchasing judgement. Therefore, there is the pressure for companies to become ISO 9000 certified in order to ensure a transparent and orderly process of work. ISO 9000 series certification unquestionably brings significant benefits to companies when a sound and easily acknowledged quality management system is implemented. The attainment of such recognition would further enhance the corporate standing of the companies, since continuous auditing will have to be carried out.

19. The heightened focus on corporate governance has produced a positive impact in the corporate world. This is much in evident from the questions raised by the stakeholders at the companies' annual general meetings. There has not been any survey conducted to find out the true importance of good corporate governance - a survey which can establish the real financial and other benefits of corporate governance, as well as to find out the answers to questions such as : (i) do well governed companies have a lower cost of capital and easier access to new capital? (ii) is there a positive correlation between good governance practices and attractiveness to shareholders? From the track record of many hitherto profitable companies which have failed due to poor accountability and unethical practices, there emerge the question : how else do we manage success ?

20. Public Listed companies in Malaysia are drafting their code of business conduct and ethics. Some have incorporated them in their annual

reports. To provide an example, a public listed company in Malaysia in its 2002 annual report, among others, stipulates in its Business Code as follows : "*Employees shall endeavour to protect, at all times, the Group's integrity and its reputation, and its dealings with any person shall not offer, give or promise gratification of any kind to any employee of the person as a means of persuading that person to do or refrain from doing anything relating to a business transaction between the Company and the person.*" Three important points in its Code of Ethics are as follows :

Conflict of Interest

Employees shall avoid possible conflicts of Interest which can make possible any personal gain at the expense of the Group.

Insider Trading

Employees shall not either by themselves or through their relatives or/agent be engaged in insider trading ie the buying and selling of the Company's securities where the aim is to secure personal profit except for dealings in respect of options under and pursuant to the Company's Employees Share Options Scheme in force at the material time.

Disclosure and Use of Company's Information

Employees are prohibited from disclosing, communicating or disseminating information outside the normal requirements of their job, unless prior approval of the Company is obtained.

Al-Ghazali says that ethics is, "*a study of certain religious belief (I'tiqadat) and of rightness and wrongness of action for the purpose of practice and not for the sake of mere knowledge. The main purpose of ethics is to influence actual conduct. All good actions should aim at the improvement of the soul so that it may attain well-being in the hereafter. Moral acts are not distinguished from religious acts. The more religious an individual is, the more moral he will also be.*" The greatest challenge is to ensure that ethical values are practised. There is a gap between practice and knowledge. In fact, Islam propagates the notion of "*ethics for profits*". Unethical conduct could result in divestment and financial loss to companies. Ethics, which is sometimes referred to as *akhlaq* in Islam, is important to ensure that everybody abides by the rules prescribed by the *shariah*. Islam does not view the conduct of individuals only as a worldly affair. A tradition from the Prophet says : "*A truthful and trustworthy merchant (will be gathered in the Day of Resurrection) with the Prophets, the truthful and the martyrs*".

21. The Institute of Islamic Understanding Malaysia, with the cooperation of SIRIM, are spearheading the promulgation of Islamic series of standards to strengthen the ethical, accountability and performances of companies. If these management standards are

established, Malaysia will be the pioneers in this field. The principles and criteria for the formulation of the Islamic series of standards are as follows :-

Principle One is Management which is based on trust, accountability and trustworthiness; the role of leadership to provide the directions; to encourage consultation (mushawarah); there should be internal audit, muhasabah, and continuous improvement; there should be transparency and material evidence; that management is also based on brotherhood (ehsan), and not just contractual relationship;

Principle Two is compliance with the national and international laws, so long as they are in line with the syariah law; there should be adherence to the objectives of the company as well as its internal rules and regulations;

Principle Three is client's management, where a clients charter be drawn up; observance of the Consumer Protection Act; and with responsibility to disclose the facts about the company's goods and services.

Principle Four is human resource management, where an employee's charter be drawn up; observance of the Industrial Relations Act/Labor Laws; and finding measures to create employee satisfaction, and inculcating a sense of belonging, to the company.

Principle Five is relationship with the Environment, principally to observe the Environment Protection Act, product liability law, and the protection of public interest (maslahah)

Principle Six is relationship with the public when the company should demonstrate social responsibility, support public interest (maslahah), practise transparency to avoid misleading information; the company should formulate a policy on competition.

Principle Seven is desian of products and services, when the company should introduce Islamic acceptable products, undertake innovation, research and development, and provide quality assurance, and;

Principle *Eight* is on *process management*, to develop efficiency, reduce wastage, install quality control and assurance, promote time management and effective communication.

22. It is hoped that the Islamic series of standards of management will be introduced next year. With the adoption of these standards, there will be better ethical behaviour and greater accountability in the management of companies.