



SELF-REGULATING CORPORATE GOVERNANCE

RASHIDAH ABDUL RAHMAN
NORMAH OMAR

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UN DR. MAHAATHIR MOH

SELF-REGULATING CORPORATE GOVERNANCE

*Rashidah Abdul Rahman
Normah Omar*

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e-mail: upena@salam.uitm.edu.my

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*To our parents, our husbands and our children.
May the light always shine from their eyes.*





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Preface

Much effort in recent years has been devoted to the formulation of ever more elaborate and complete rules of corporate governance. Many countries have adopted their existing or established sophisticated and extensive new legal texts and regulations, often imported from developed market economies. In addition to laws and regulations, more informal codes of conduct have been adopted. Besides international efforts, such as the corporate governance principle of organizations like OECD, the Malaysian Code of Corporate Governance (MCCG) came into effect in 2000, and revised in 2007. These sets of rules, whether international or national, are all remarkably similar. Yet there are still many concerns regarding the effectiveness of corporate governance rules in transition and developed countries, as well as many developed countries. In great part this is because rules and regulations are not enforced and more so, studies have shown that companies are just ticking a series of boxes to indicate that they are complying with their prescribed best practices. Further, in spite of the many regulations and enacted rules, it is apparent that many corporate scandals still occur.

In the absence of a well-functioning enforcement environment, *Self-Regulating Corporate Governance* discusses the importance of self-regulation within the company. Self-enforcement mechanisms involve efforts of individual firms to potentially improve their commitment power to overcome investors' concerns of getting a return in their investment and also to balance the rights and interests of other stakeholders (i.e., management, the corporation, shareholders, creditors, employees and other stakeholders). The high-quality corporate governance self-enforcement mechanisms at firm's level should be able to generate trust between the organizations and stakeholders. The Corporate Governance Scorecard (CG Scorecard)

template developed in this publication is to facilitate the implementation of self-regulate corporate governance within the corporations.

However, the CG Scorecard template which is premised on 13 basic corporate governance principles and 33 best practices dimensions of the MCCG itself may not bring improvements in governance. Thus, we also provide in the book some indicators such as Strong Spiritual and Ethical Culture, Spiritual-Principle-Centered Leadership, Transparency, Whistle-Blowing Policies and Effective Communication in strengthening the companies' internal structure and culture before implementing self-regulation at the firms' level. Excellence in governance in the respective organization will evolve from continued self-inspection, obsession with conceptual integrity and more rigorous definitions of spiritual values.

We believe that people nowadays find that there is more to an organization than profits alone. Money as the single bottom line is increasingly a thing of the past. In a post-Enron world, spiritual values and ethics are an urgent concern. The hottest buzz today is about a "triple bottom line", a commitment to "people, planet, profit". Employees and the environment are seen as important as economics. Hence, we promote organizations with corporate conscience and culture built around spiritual ethical set of moral principles and values to self-regulate corporate governance. We also acknowledge the fact that leadership from the top is the single most important factor in creating and maintaining a spiritual ethical climate in any organizations. While many speak in terms of "ethical", "moral" or "principled" leadership, what we have introduced in this publication is a spiritual leadership that goes beyond some minimum ethical standards of the day. All we need to do is to look around at the companies that are doing the best during the recent economic downturns. The most successful ones are those with high employee and customer loyalty, brought about by a strong management team that focuses on treating everyone fairly, offering win/win situations, and setting the example of "do unto others"; in other words, companies that embody a spiritual leadership model.

Managing the spiritual ethical climate of an organization is not easy given the myriad influences, both internal and external. Spiritual corporate ethics programs will not eliminate unethical conduct, nor will they resolve all of the perplexing conflicts of ethical values that arise in various

social and economic arenas today. Nevertheless, the efforts of spiritual principle-centred management to strengthen spiritual ethical climate in their organizations will have real benefits for employees, for the performance of the firm, for the society at large. By legitimizing the discussion of spiritual ethical considerations in business, by standing up for spiritual ethical values despite short-term costs, by giving serious considerations to problems of conflicting values, managers and executives can contribute to strengthening self-regulating corporate governance in their organizations and to building trust in business.

Rashidah Abdul Rahman, PhD
Professor of Accounting and Corporate Governance
Deputy Director, Accounting Research Institute
Faculty of Accountancy
Universiti Teknologi MARA
Email: shidah@salam.uitm.edu.my

Normah Omar, PhD
Professor of Management Accounting and Corporate Governance
Director, Accounting Research Institute
Faculty of Accountancy
Universiti Teknologi MARA
Email: normah645h@salam.uitm.edu.my



Introduction

Recent empirical research confirms that companies with demanding governance standards achieve higher market valuations. Due to the complexity of specific corporate governance matters there is a rising need for a systematic and quantitative evaluation approach for corporate governance. This book, 'Self-Regulating Corporate Governance' elaborates a range of issues associated with corporate governance and how companies are responding to those issues and using self-regulation efforts to build and sustain greater value. Particularly the focus of this book is to assess whether self-regulation by firms is adequate to ensure sound corporate governance or whether regulation by statute is needed.

The controversies surrounding corporate governance have increased immeasurably since the Asian financial crisis (1997/8), the US corporate failures (2001/2) and the collapse of stock markets around the world. "Corporate Governance" became a favourite buzzword after the infamous Enron episode where thousand of employees lost their employment, retirement benefits and saving plans while corporate officers ran off with the company wealth, making an ugly dent in the history of the Corporate Sector in USA. This corporate and market failure has led to more strenuous demands for corporate governance regulation and monitoring. Suddenly corporate governance has transformed from an interest of an elite of business people and investors, to a concern of general public anxious about the security of their superannuation fund investments.

The passage in the US of legislation addressing the problems at Enron and WorldCom prompts us to ask rules work best to secure good corporate governance. Should Malaysia follow suit with a raft of criminal sanctions

or should we retain a substantial portion of self-regulation within the respective corporations? It is important to begin a discussion of the subject by attempting to clarify the basic concepts in **Chapter 1**.

Governance in general has to do with the issue of allocation of power on the one hand (what powers and to whom) and the issue of the exercise of power on the other (the question of how power is exerted, processes and procedures, accountability and responsibility). Meanwhile, companies are usually seen as a framework for co-operation where contracts are incomplete, and in this context the relevant aspect of power relates to decisions that determine future returns and their distribution across claimants on the firm. Accordingly, corporate governance has to do with the way in which decisions over claims are taken in a company (powers of managers and shareholders) and with the corresponding issue of accountability and transparency with respect to decisions taken. These issues are often determined by company law, as well as securities laws, accounting rules and practices, history and politics.

The definitions on corporate governance above imply that important elements of any governance system include compliance and accountability. Implicitly, an extension of these definitions should include the ethics of an organisation and the tone set by top management and the board as the integral parts of establishing a culture that promotes open and honest communication between all parties involved in governance and an accountability system that ensures compliance. As such, **Chapter 2** highlights some indicators including principles and procedures that promote Strong spiritual and Ethical Culture, Spiritual-Principle-Centered Leadership, Transparency, Whistle-Blowing Policies and Effective Communication (including Stakeholder Voice) in strengthening the companies' internal structure and culture before implementing self-regulation on good corporate governance. In fact, the factors function in a mutual-causal manner, encouraging and facilitating deeper levels of each as they interact. The relationship existing between and among these factors serves as a catalyst for reinforcing the ethical commitment of the spiritual leadership, strengthening the governance process and driving greater transparency into the communication of both.

Chapter 3 of this book focuses on the development of corporate governance codes around the world and in Malaysia. In articulating an

effective country-level corporate governance framework, the OECD Principles of Corporate Governance (2004 at page 29) proposes that the corporate governance framework should typically comprised elements of *legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices*. For Malaysia, the corporate governance framework is supported by the elements of legislation (i.e. provisions contained in the Securities and Companies Acts); regulation (i.e. SC guidelines and listing requirements by Bursa Malaysia) and self-regulatory arrangements, voluntary commitments and business practices, (i.e. the code of corporate governance and industry best practices). Unlike the legislation and regulatory elements that are more structured, the self-regulatory or voluntary governance infrastructure remains informal. This book therefore propagates the use of self-regulating corporate governance scorecard that could be utilized by business organizations to assess their corporate governance reporting and practices.

Further, a collaborative study between UiTM and MSWG is also highlighted in **Chapter 4** where a Corporate Governance Scorecard (CG Scorecard) has been developed that fulfills the key goals defined by analysts and investors: It has a standardized format, can be applied efficiently, and enables self-assessments by companies as well as sector-specific comparisons. The CG Scorecard was developed to assess the level of corporate governance compliance of one hundred (100) selected public listed companies (PLCs) with the corporate governance principles and best practices.

In assessing the average scores for the four attributes of corporate governance, the results in **Chapter 5** indicate that the compliance score is highest for Accountability and Audit (78.54%), followed by matters relating to Shareholders (75.4%), Directors (72.75%), and Directors' Remuneration (43.30%). Further analysis shows that there is high compliance with an average of over 90% in relation to companies having met the requirement of having disclosure on re-election, providing transparent information with external auditors, internal audit department, appointments to the board, in providing separate independent access to company secretary's services and allowing directors to take independent professional advice, and also in providing appropriate disclosure on special business in their AGM's notice.

However, the findings in this study indicate that there is still room for improvement in areas such as disclosure and the level and make-up of Directors' Remuneration, in establishing other specialised committees besides Nomination and Audit Committees, and disclosing information on the relationship between the Chairman and CEO, as the average CG scores reported on these areas are less than 50%. The results also show that the CG scores are much lower for the "As in spirit" compared to those in the "As in form" categories. PLCs are expected to be keen on enhancing corporate governance within their organizations. It is important that they should report (in full) items categorised under the "As in form" and "As in spirit". Rather than applying the box ticking system, whereby companies can just check off a series of boxes to indicate that they are complying with their prescribed best practices, board of directors need to be committed to embrace spiritual and ethical values in a business context which include integrity, honesty, accountability, quality, cooperation, service, intuition, trustworthiness, respect, justice, and service.

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This book is written for a general not an academic audience. In learning about self-regulation, we experienced a journey around the globe, peeking into places we had never heard of, and finding to our surprise that self-regulation truly begins with oneself. We are grateful to the many people who have helped us throughout the development of this text.

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We thank God for blessing us with a marvellous and supportive family: our husbands and children, whose gifts of conversation and critique are of inestimable value and whose life and love continue to be our greatest inspiration. Without their constant prayers, our book would have been a more difficult journey.

Conceptual Clarification



For the global economic system to function as it should, investors, employees, consumers, and the general public must have confidence that they will benefit from it and from the work of corporations that support it. More than often, that confidence has been severely shaken. In July 1997, the world awoke to an alarming wave of selling that was devastating currencies and stock markets in financial markets across Asia, Latin America, and Europe. Massive waves of capital fled into safe heavens as investors lost faith in previously booming developing economies. A series of bankruptcies began. As the meltdown continued over the following months, Malaysian Prime Minister then Dato' Seri Mahathir Mohamad charged George Soros and other international investors with sucking the wind out of our country's economy. The Asian financial crisis lasted three years, spilling over to Wall Street and Western economies.

Western politicians, economists, and media identified emerging economy corruption, nepotism, and favoritism, along with poor corporate governance as the major sources of vulnerabilities that led to the economic meltdown during the Asian financial crisis in 1997. Lack of disclosure by companies, commercial banks, and even central banks had fanned the crisis. Malaysia was one of the five worst affected countries (others being Indonesia, Republic of Korea, Philippines and Thailand), all suffered, in varying degrees, from over-capacity, poor quality of investments, excessive exposure of debt, especially unhedged short-term foreign debt.

The study by the Asian Development Bank (2000) suggest that ineffective boards of directors, weak internal controls, poor audits, lack of adequate disclosure and lax legal enforcement characterize corporate

governance in many Asian countries, including Malaysia. These weaknesses appear to owe much to the highly concentrated ownership structure, characterized by significant family control and interlocking shareholdings among affiliated firms, which may have left insiders with excessive power to pursue their own interests at the expense of minority shareholders, creditors and other stakeholders. The high concentration of ownership reduces the effectiveness of some important mechanisms of shareholder protection, such as the system of the board of directors, shareholder participation through voting during shareholder meetings, and transparency and disclosure.

As such much effort in recent years have been devoted to the formulation of ever more elaborate and complete rules of corporate governance – from financial reporting and internal controls to how a corporation selects, trains, and evaluates its board of directors.

Looking at this topic and the interest it has generated of late, it is important to ask and attempt to answer a number of questions. These include:

1. Why is there much emphasis in regulating the activities of public listed companies in Malaysia?
2. What is corporate governance?
3. What is self-regulation and why is it now being promoted?
4. Why building trusts between the corporations and stakeholders is important in raising the standard of practice among the public listed companies in Malaysia?

An attempt is made in this book to answer some, if not all of the above questions and point attention to what must be a collective effort to raise the standard of practice in the Malaysian public listed firms. It is thus important to begin a discussion of our subject with an attempt to clarify the basic concepts we shall be using in this book. The following sections will elaborate the definitions for Corporate Governance, Statutory Regulation, Self-Regulation and the role that ethics play in the boardroom while highlighting the importance of thinking ethically in an era of investigative reporting.

WHAT IS CORPORATE GOVERNANCE?

The agency or moral hazard problem that could exist not just between shareholders and managers, but also between controlling and minority shareholders, between shareholders and creditors and between shareholders and other stakeholders arises because of external financing. A firm approaching outside markets for finance, resulting in the separation of ownership from control faces a serious of commitment problem: how can the investors be assured that the management will choose the right projects, exert sufficient effort, adequately disclose relevant information, and ultimately repay investors? In the complete absence of credible commitment, outside investors will assume the worst-case scenario, i.e., the management will use all opportunities to defraud investors or in other ways not live up to its promises. Shleifer and Vishny (1997) pose the governance question as one on how investors could ensure the manager would provide them with ample return and would not expropriate money or use the capital provided to finance poor projects.

Besides balancing the rights and interests of multiple stakeholders problem (the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders), corporate governance is in great part about mitigating this commitment. Firms can try to employ a variety of commitment mechanisms to overcome investors' concerns. A sound corporate governance system - refers to the structures and processes for the direction and control of companies - should provide effective protection for shareholders and creditors such that they are not denied the return to their investments. It includes the set of policies and procedures which a company adopts for achieving its objectives.

From the perspective of the OECD Principles and the Malaysian Code of Corporate Governance, the concept of corporate governance is two fold:

1. Corporate governance encompasses the relationships and ensures patterns of behaviour between different agents in a limited liability corporation the way not only managers and shareholders but also employees, creditors, key customers and communities interact each other to form the strategy of the company – the behavioural side of corporate governance

2. Corporate governance also refers to the set of rules that frame these relationships and private behaviours, thus shaping corporate strategy formation. These can be the company law, securities regulation, listing requirements, and can also be private, self-regulation or self-governance. This is the normative side of corporate governance, that is, it is concerned with how managers should act.

The first concept of corporate governance on the relationships between different agents in corporations, as outlined above, boils down to a monotonic (emphasizes maximization of shareholder wealth) versus a pluralistic (emphasizes stakeholders interest) view. Abdul Rahman and Omar (2007) describe this concept at length in their book titled ‘CSR-Based Corporate Governance’. They argue that firms will be more successful in achieving their primary objective of enhancing shareholder wealth when they respond to signals of significant moral preferences with capital, consumer, and labor markets relevant to the firm.

Thus, corporate governance encompasses the entire mechanism of the functioning of a company and attempts to put in place a system of checks and balances between the shareholders, directors, auditors and the management. In its normative sense, it prescribes a code of corporate conduct in relation to the stakeholders both external as well as internal. Therefore corporate governance is a system whereby the companies can be controlled and administered. Besides ensuring transparency it is a mechanism which keeps a check and control over the corporate dealings, with a prime objective of ensuring accountability of these companies with those directly involved.

Corporations around the world already know that potential or actual shareholders want a healthy triple bottom line: good fiscal performance, a corporate social investment program that works and environmental sensitivity. Good governance of companies and financial markets is not just a question of efficient allocation of capital to investment projects. It is a question of widest social importance. Lost investments corporate collapses are invariably accompanied by large-scale job losses and loss of supplier contracts. This means that good governance and regulation assists not just for investors and markets but is a public good that confers benefits more widely. Companies with good corporate governance standards attract investors.

Corporate governance as may be elicited from this definition is therefore not only about ensuring accountability but also about achieving business prosperity. Various survey results in the early 2000s indicated that the investment community was willing to pay more for a company with strong and effective corporate governance policies. For example, a survey conducted by the Economist Intelligence Unit (2001, p. 2) indicated that more than 80 per cent of European and US institutional investors said they would pay more for companies with good governance. The 2002 Investor Opinion Survey by McKinsey (2002) found that institutional investors said they would pay very high premium for well-governed corporations. These premium range from 12% for the United Kingdom, 21% for Malaysia, 25% for Indonesia, 27% for Turkey, and 38% for the Russian Federation. In its 2001 and 2002 corporate governance reports Credit Lyonnais (CLSA) also found that corporate governance is robustly correlated to both financial performance and stock valuation. These are obviously powerful incentives for corporations to search for quantitative tools in strive for better governance.

The companies that emphasize corporate governance and transparency will, over time, generate superior returns and economic performance and lower their cost of capital. The opposite is also true: companies weak in corporate governance and transparency represent increased investment risks and result in a higher cost of capital. Events of the last few years, including those at Enron, Worldcom, and others, support this statement, as does a growing body of academic research and financial market surveys. And while the spotlight started with U.S. companies, however this is not just a U.S. problem. Similar corporate debacles have occurred recently in Canada, Germany, Italy, Sweden, Switzerland, South Korea, the Netherlands, Australia and even Malaysia.

For emerging market countries like Malaysia, improving corporate governance can serve a number of important public policy objectives. Good corporate governance reduces emerging market vulnerability to financial crisis, reinforces property rights, reduces transaction costs and the cost of capital, and leads to capital market development. Weak corporate governance frameworks reduce investor confidence, and discourage outside investment. Also, as pension funds continue to invest more in equity markets, good corporate governance is crucial for preserving retirement savings.



Dr Rashidah Abdul Rahman is a professor in corporate governance and financial reporting. She is currently the Deputy Director of the Accounting Research Institute (ARI), Faculty of Accountancy, Universiti Teknologi MARA, Shah Alam, Malaysia. With research interest in corporate governance, waqf governance, intellectual capital, financial reporting, corporate ethics, environmental reporting, and mergers and acquisitions, she has presented and pub-

lished various articles in these areas. She has also published several research papers in internationally refereed journals. She sits on the Editorial Board of Malaysian Accounting Research Journal and has reviewed articles for both local and international journals. She has been an external examiner for post graduate students both at the local universities and abroad. Among her publications include books titled 'Effective Corporate Governance', and 'Corporate Governance in Malaysia: Theory, Law and Context'. Her books and research work have won several national and international accolades.



Dr Normah Haji Omar is a professor in management accounting and corporate governance. Currently she is the Director of the Accounting Research Institute (ARI), Faculty of Accountancy, Universiti Teknologi MARA. Basically, Dr Normah focuses her research interest in management accounting and corporate governance-related topics. As a proponent of applied research, Dr Normah has conducted a lot of collaborative works with government

agencies, professional bodies, regulators, non-government organizations and the private and corporate sectors. In the corporate governance area, Dr Normah has successfully completed various projects which include among others, three research titles that have won many national and international accolades: Corporate Governance Reporting Scores (a collaborative research with MICG, RAM and Biz Aid Technologies), Corporate Governance Scorecard (with MSWG) and CSR-Based Corporate Governance (with MICG).