BUILDING A FRAMEWORK FOR CORPORATE TRANSPARENCY

CHALLENGES FOR GLOBAL CAPITAL MARKETS AND THE MALAYSIAN EXPERIENCE

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Recent developments in the global corporate sector have provided useful, albeit sharp, lessons on the importance of transparency, accentuating the fact that cases of accounting malpractice and outright fraud cannot be regarded lightly if there is to be confidence in the capital markets and their integrity.

Fundamentally, disclosure and transparency are vital for a strong corporate governance framework in any capital market and from this, good corporate governance lays the foundation needed for a strong and robust capital market.

Therefore, it is not surprising that following the collapse of Enron and WorldCom and subsequent revelations of poor governance at a string of major corporations, corporate governance and transparency issues have been very much the focus of attention across markets world-wide.

THE NEED FOR A HOLISTIC APPROACH

Corporate transparency is the result of many elements. It is impossible to talk about transparency without also considering the other elements that must partner it, namely sound regulation and enforcement, shareholder activism and professional and ethical management.

Malaysia's own experience of problems with corporate transparency came into greater focus during the 1997-98 crisis. During that time, the combination of slowing demand and volatile markets led to deteriorating balance sheets and a subsequent credit crunch, a particularly severe problem among many companies that were not as well managed or transparent as they should have been. This necessitated the formation of several agencies to clean up the situation, including the National Asset Management Company and the Corporate Debt Restructuring Agency.

Accordingly, it was recognised that meaningful longer-term corporate reform and economic recovery required a corporate governance framework that was:

Figure 1: A Holistic Approach to Building the Corporate Governance Framework: the Malaysian Experience

- Holistic
- Market-based
- Diligently implemented, enforced and reviewed

Thus, the Malaysian corporate governance framework is premised on a broad-based approach, taking into account the various fundamental considerations needed for an effective framework (see Figure 1).

At the root of the framework is the professional and ethical management of companies. This is particularly important because it is the first line of defence against corporate misconduct. The law cannot prescribe all that is ethical, because ethical behaviour requires not only abstinence from doing the wrong thing, but also actively doing the right thing.

While authorities may require independence of directors based on proximity and relationships, they cannot regulate independence of mindset. For instance, when independent directors are beholden to the company or the CEO in ways too subtle to be captured in customary or legislative definitions, they cease to be truly independent. Therefore, the primary driver for accountability and responsibility must be motivated by the values of corporate management itself.

Moving beyond the issue of professional integrity is the role of government and standard-setters in setting the broad framework and principles needed for effective corporate governance. This may include formally articulating prescribed best practices in corporate governance, ensuring the clear formulation and use of accounting standards, and enhancing the role of self-regulatory associations.

Then there are the rules and regulations which would require due compliance by market participants. These are typically embodied in the various legislation, rules and guidelines, which are ultimately enforced by the relevant regulatory agencies.

THE MALAYSIAN EXPERIENCE

Effective planning and implementation have been the key tenets underlying the development of the Malaysian framework for enhanced corporate governance, following from the 1997-98 regional financial crisis.

While efforts to enhance corporate governance had been ongoing even prior to the crisis, these efforts had been largely piecemeal and on an incremental basis. The first comprehensive review of the overall framework was initiated with the formation of a High-level Finance Committee on Corporate Governance by the government in 1998, comprising senior representatives from the private sector, financial industry and relevant regulatory authorities. The committee looked at existing corporate governance practices in Malaysia and made extensive recommendations for improvement in its report, which was released the following year.

The Finance Committee Report also included a proposed Malaysian Code on Corporate Governance. This was finalised in 2000, setting out principles and best practices on corporate governance. The Kuala Lumpur Stock Exchange's (KLSE) revised listing rules now require all public listed companies to provide a mandatory statement of extent of compliance with the Code. The Code recommends, for example, a statement on the state of internal controls and audit committees to be composed of a majority of non-executive directors who are independent.

With the Malaysian economy on track towards recovery following the 1997-98 crisis, efforts were then directed towards drawing up a comprehensive blueprint for the capital market's longer-term development. This saw the release of the Capital Market Masterplan in 2001, which had corporate governance, transparency and disclosure as its key themes.

As a result of these concerted efforts, a wide range of corporate governance initiatives were subsequently implemented. Figure 2 provides an overview of some of these initiatives, although this is by no means an exhaustive list.

With regard to the financial reporting framework in Malaysia, before 1997 the promulgation of accounting standards rested primarily with the two main accounting associations (the Malaysian Institute of Accountants and the Malaysian Association of Certified Public Accountants), which issued accounting standards based on IAS for adoption by their members.

However, the Financial Reporting Act 1997 saw the establishment of the Malaysian Accounting Standards Board (MASB) and the Financial Reporting Foundation (FRF), with the latter exercising oversight authority over the former. This marked an important milestone in the development of the local financial reporting framework and has been cited as the first such statutory framework for accounting standard-setting and compliance in the region.

The Act provided an institutional financial reporting framework in line with those in mature jurisdictions, including an independent standard-setting structure with representation from all major stakeholders; the users of financial reports, regulators and the accounting profession. Importantly, legal status was also accorded to the accounting standards issued by MASB, with enforcement powers exercisable by specified authorities.

Compliance is required by all auditors, public companies and wherever companies provide financial statements under laws administered by the Securities Commission, Companies Commission and the Central Bank. This is significant as in most jurisdictions this is left entirely to the profession. CEOs and directors are legally responsible for ensuring their financial statements are in accordance with MASB standards. In addition, the Companies Act 1967 requires the directors responsible for finance to make a statutory declaration on the correctness of their financial statements. The stock exchange also requires compliance by listed companies with standards set by MASB, through its listing rules.

At the same time, the accounting associations are still responsible for ensuring compliance of the standards by their members and have disciplinary powers for breaches. Auditors are required to certify that the company has complied with approved accounting standards. To assist the boards of directors of public-listed companies in the effective discharge of their responsibilities in relation to the internal audit function, the Institute of Internal Auditors Malaysia also released Guidelines on the Internal Audit Function in July 2002.

Table 1 provides a brief comparison of some of the various corporate transparency initiatives in selected East Asian markets (see overleaf).

Figure 2: Selected Corporate Governance Initiatives in Malaysia

Professional management of companies

– Mandatory accreditation programme for directors (2001)
– Regulatory reforms to encourage participation of non-executive directors
– Strengthened rules on Related Party Transactions
– Release of Guidelines on Internal Audit Function (2002)
– Change in management teams in several companies

Shareholder activism

– Minority Shareholders Watchdog Group formed (2000)
– Ongoing education and awareness programmes
– Increase in minority shareholder awareness and actions

Enforcement

– SC's enforcement capacity enhanced
– Increased emphasis on enforcing accountability of principal officers/controlling stakeholders, incl. enhanced compounding powers & powers to impose civil penalties, e.g. for insider trading
– Since 1999: Number of prosecutions initiated by SC increased by over 150% compared to the total number over the preceding six years (1993-98), including the first insider trading conviction

Transparency & disclosure

– Quarterly reporting by PLCs required from 1999
– Financial Reporting Act 1997: established the Financial Reporting Foundation & Malaysian Accounting Standards Board (MASB)
– Cited as the first such statutory framework for accounting standard-setting & compliance in the region
– Accounting standards have always been based on IAS
– Compliance with MASB standards is mandated by law, & enforced by relevant agencies

CHALLENGES FOR EMERGING MARKETS

International literature and studies generally agree that emerging markets face particular challenges in developing corporate transparency. The 1999 Report of the Asia-Pacific Economic Cooperation (APEC) Collaborative Initiative on Corporate Governance, for instance, identified the following factors as having compounded the severity of the 1997-98 Asian financial crisis:

- High degree of family ownership as opposed to institutional investors;
- Minority shareholders and institutional investors are generally passive, preferring exit over voice;

- Many boards and audit committees were not effective oversight mechanisms;
- The ethics of full and timely disclosures were not fully entrenched in many Asian corporations, resulting in perceptions of a dichotomy between 'insiders' and 'outsiders;'
- Inadequate enforcement systems, especially the inability to respond swiftly against misbehaving corporations.

Insights into the first two characteristics can be shed by reference to corporate Asia's historical context, where modern Asian corporate growth (with the exception of a few Japanese multinational companies) is a relatively recent phenomenon, emerging only after World War II. This is in contrast with Europe, which had flourishing capital markets even in the 17th century.

Table 1: Comparison of Key Corporate Transparency Initiatives for Listed Companies in Selected East Asian Markets

Country	Malaysia	Singapore	Korea	Hong Kong
Code on corporate governance	2000	2001	1999[1]	1993[2]
Quarterly reporting	1999	2003	2000	None
Disclosure-based reporting framework	Yes	Yes	Yes	Yes
Independent accounting standard-setting board	1997	2002	1999	None[3]
Internal Audit Guidelines for PLCs	2002	None[4]	None	None

1. Code of Best Practice for Corporate Governance
2. Code of Best Practice on minimum board practice
3. HK's accounting standard setting board is a committee that is part of the HK Society of Accountants
4. The Code of Corporate Governance recommends the adoption of the Institute of Internal Auditors' standards

The Asian miracle itself was founded essentially upon the dynamic efforts of Asian entrepreneurs who helped build their domestic economies in the post-war period. There was heavy reliance on the banking system and a relatively high degree of paternalism from the state, which essentially prescribed export policies that strongly encouraged growth in the manufacturing sector.

While close relationship between Asian firms with the state or with family groups gave rise to strong synergies which helped fuel the early stages of development, the Asian crisis highlighted concerns that such relationships create opportunities for serious conflicts of interest and engender imprudent risk-taking at the expense of minority and public shareholders.

As Asia moves towards greater global competition, against firms that subscribe to global standards of corporate governance and management, it is clear that many aspects of the old paradigm need to be rethought. A key competitive distinction between Asian and Western firms is that the latter have already garnered considerable experience in developing and leveraging on superior financial and managerial expertise. Going forward, there is a need for a pragmatic approach of learning from the varied models and experiences of the various economies and building a domestic model based on lessons learnt.

However, it should be recognised that no one solution fits all. In addressing specific governance concerns to the particular economy, there is also a need to ensure that existing strengths (such as the spirit of entrepreneurship and hard work that are the hallmarks of Asian success) are not sacrificed in the process of imposing reforms.

Figure 3 shows the key areas that emerging (particularly Asian) markets may wish to address in developing their corporate governance frameworks.

For developing regulatory and disclosure frameworks, appropriate mechanisms to ensure proper accountability are essential. Clearly, without robust accounting, disclosure and enforcement mechanisms firms can only meet the information standards demanded by international investors by volunteering such information.

In building a strong compliance and enforcement framework, emerging markets also need to align their standards and underlying principles more closely with modern, internationally-accepted principles. This means continuous benchmarking against international best practices in accounting, disclosure and corporate governance, while bearing in mind the specific needs and conditions unique to the individual market in question.

Undeniably, this is an issue that is not unique to developing markets. Even developed countries recognise the value of international harmonisation. The recent landmark agreement between the US and the International Accounting Standards Board to begin work on eliminating the major differences between their rules illustrates the importance attached to creating a set of global standards that would make it easier to compare financial results across borders.

Emerging markets tend to be characterised by a certain degree of shareholder passivity as well. This is often pervasive among both minority retail as well as institutional shareholders. This has been, in part, due to incomplete knowledge among shareholders on their rights, as well as perceptions that legal recourse is uncertain, cumbersome and potentially expensive.

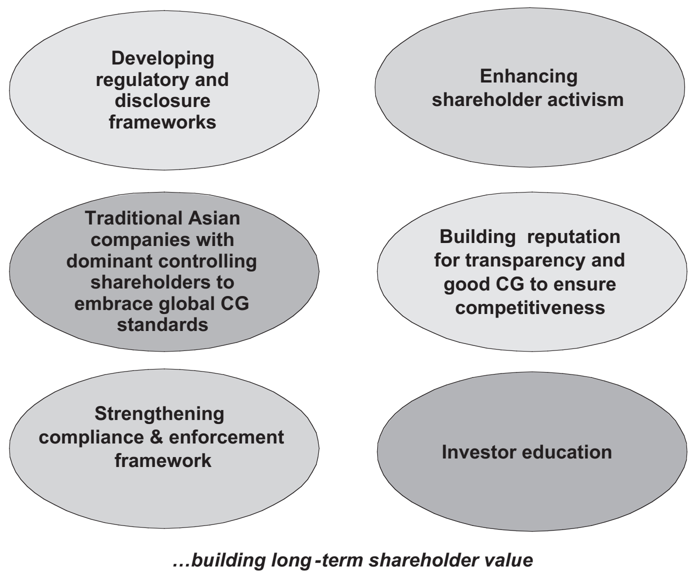
For example, an Egon Zehnder International survey in 2000 found that most companies that had been the target of shareholder activists in the preceding three years had been primarily from Australia, North America and, to a certain extent, Europe. The largely emerging-market regions of Latin America and Asia recorded the lowest incidences of shareholder activism, with all the Asian respondents reporting zero shareholder activism activity targeted at their companies during those three years.

Having a reputation for good corporate governance is critical for emerging companies and markets in nurturing their future competitiveness. Investors discount the value of companies operating in markets with a poor reputation for corporate governance. This also affects the market value of honest companies in these markets. The potential damage to the market's reputation (and hence, attractiveness to global investors) is all the more acute for developing countries, where often even a small number of core companies constitute a significant portion of their markets.

This is important given that country risk often forms a basis for international investors' investment decisions. For instance, McKinsey's Global Investor Opinion Survey on Corporate Governance (2002) showed that the average premiums investors would be willing to pay for well-governed companies from markets in emerging regions such as Eastern Europe/Africa (30%), Latin America (22%) and Asia (22%) were markedly higher than those for Western Europe (14%) and North America (13%). Such results point to the special challenges faced by the developing world in building up their corporate transparency frameworks.

Finally, the nascent level of investor sophistication is often an area where emerging markets share common ground. Training and awareness tend to be fairly long-term efforts, which require time to bear fruit. This points to the need for holistic awareness and education strategies, such as collaborative curriculum development with local universities and targeted education programmes for specific investor groups.

Figure 3: Key Challenges for Emerging Markets



CONCLUSION

More broadly, there are also challenges that must be faced by corporations around the world irrespective of whether they reside in emerging markets or not. Confidence in the corporate sector has been severely strained since Enron's collapse. With each new revelation of corporate misconduct and financial restatements across a broad range of corporations and markets, the goodwill built up by businesses during the boom of the past decade has eroded a little more, exacerbating investor uncertainty.

In addition, corporate mismanagement and accounting malpractice lead to economic costs. They engender a loss in stock market wealth, lower premiums for companies and raise borrowing costs. From the broader perspective, they can discourage foreign investment, which if left unaddressed, may compound a decline in the value of the local currency.

Achieving high levels of corporate transparency and governance is a collective effort. This calls for discipline on three fronts: by the regulators, the market and self.

Regulatory discipline is fundamental to corporate transparency. Authorities can initiate the rules and enforce them within their powers. They can also promote education and awareness on the importance, responsibilities and channels for exercising corporate governance.

This must be accompanied, however, by shareholder activism and collective market discipline. Whether this occurs by means of exercising one's voting power, selling the stock of a poorly governed company, or simply the results of negative publicity, it can have a powerful effect on the decisions and values of that company. This role may involve independent shareholder watchdog groups, investment analysts, media and NGOs oriented towards ethical investments.

Finally, there must be self-discipline on the part of the companies, market intermediaries, exchanges and relevant industry organisations. Companies should work at maximising shareholder value on a sustainable basis, while ensuring fairness to all stakeholders. Corporate leaders must have strong ethical standards, recognise their responsibility to stakeholders and the society they operate in, and practise openness and accountability. Self-regulatory organisations and front-line regulators such as exchanges and industry or professional associations must also recognise that they constitute an important line of defence against breaches of their rules or codes of conduct.

In today's globalised environment, investors can easily switch their investments across companies and markets. Corporate governance acts as a mode of brand differentiation. Thus, a reputation for high standards of corporate governance and transparency is all the more important for emerging economies that are still forging their reputation in the global investing community, where typically not as much resources are devoted to comprehensive coverage of smaller markets. In short, good corporate governance is not a luxury; it is a necessity.

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