

# Independent Directors and Stakeholders Protection: A Case of Sime Darby

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### **Abstract**

In today's ever challenging corporate environment, the unfortunate events of decision making by top management has led major companies to suffer huge losses. This results and mistakes made have given a significant impact to the stake holder's perception and raise a serious questions on the role of board of directors especially the role of independent directors. In today's fast evolving business pace with stiff economic conditions, unethical and misjudgment in business decisions are driving the board's role in corporate governance as an integral element. Hence, corporate governance can be defined as the way listed entities should be operating in accordance with legal framework, rules and regulations that underpin an institution so as to ensure strict compliance with law, sharing and balancing of powers between board of directors and stakeholders. As such, the board with a balance mixture of types of directors, where the independent directors predominate the board's strategy formulation and implementation in the interest of governance is needed. This paper seeks to bring focus to the importance of the role of independent directors in ensuring that the organization runs its operations in the manner where stakeholders especially shareholders and corporate governance is a virtue.

**Keywords:** Corporate Governance, Independent Directors, Stakeholders, Transparency, MSWG, Sime Darby

## 1. INTRODUCTION

Corporate governance has evolved and grown significantly in the last decade. Numerous countries have issued corporate governance codes, and the recommendations of these codes, that typify "good" corporate governance, undoubtedly contributing towards increased transparency and disclosure. With the internationalization of cross-border portfolios, and the financial crises that have occurred in many parts of the world, it is perhaps not surprising that institutional investors in particular look more carefully at the corporate governance of companies. After all, corporate governance goes hand in hand with increased responsibility and accountability. This increased transparency and corporate reputation/financial stability should, of itself, lead to a better flow of foreign direct investment (FDI) and more stable financial markets. Malaysia is no exception to the impact of world economy evolution. As Malaysia falls into the radar screen of investors, public listed companies must indoctrinate strong compliance and greater corporate governance cultures. Furthermore, investment choice is aplenty amidst the capital market liberalization as institutional investors now have the option to invest locally or overseas.

A definition by the Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2000) stated that: "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 realizing long term shareholder value, whilst taking account the interests of other stakeholders". This indicates that corporate governance is not only applied to the shareholders but the other stakeholders as well. Corporate Governance basically needs the unitary board structure for Malaysian companies where it stresses effective in dual role of the board which is leadership and control. It explains that combination of executive directors who well versed in knowledge of business responsible for leadership of the company and independent directors who visualize broader view to the company's activities also a chairman who accepts the duties and responsibilities that the post entails.

In other words, good corporate governance rests with the board of directors, the written description of the way in which the board has applied the principles of corporate governance represents a key part of the process. Paul Krugman (1998) argued that due to structural weaknesses in the domestic financial institutions supported by unsound macroeconomic policy and moral hazard "the written description" of corporate governance has failed. According to IMF (1999), the crisis was infected by the domestic policy weaknesses. This were described by the large current account deficits, concentration of bank loans in real estate development and financing share purchases, weaknesses in domestic financial system, poor governance and risk management, and too much international borrowing in the corporate sector. The World Bank (1998) referred the vulnerability in the banking sector was attributed to poor risk management and excessive lending. Poor risk management was reflected by weak corporate governance and limited investment in risk management technology.

Good corporate governance help to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole. (OECD, 1999). There is different type of reasons to explain the causes, why the year 1997 had faced financial crisis. If you analyze in detail there is a common reason among the above mentioned ideas which is called poor corporate governance. Yes, corporate governance is the most highlighted factor that caused financial crisis. Corporate governance (CG) is one of the hottest topics in business world, indeed in society nowadays. Corporations are formed for a purpose, so do the people who runs the organization. The saying of “everybody has the purpose” will serve this paper as our core discussion. Corporations will not act alone, governance setbacks have been identified as a significant indicator of a purpose failure. The financial scandals and corporate failures have been constant feature in Europe and America and recently in Malaysia involving many establish corporation such as Sime Darby and Kenmark. The days of Enron, Tyco, WorldCom’s and Parmalat have created headlines for wrong purposes/reasons all over the world. Do corporation and the people have served the purpose of being exist?

Corporate governance has been defined with many definition and thoughts but for the researchers of this paper, corporate governance is simply a virtue of good deeds. Corporate governance is concerned with duties and responsibilities of a company’s board of directors in managing the company’s strategies and policies with sustaining and excellent relationship with shareholders and the other stakeholders. Pass (2004) further added that full time executive directors have acquired substantial powers in respect of the affairs of the company they are paid to run on behalf of shareholders. However with substantial powers comes together with responsibilities and accountabilities, executive directors may not always had the best interest of shareholders and stakeholders interest, instead they create the scene of conflict of interest.

## **2. LITERATURE REVIEW**

In the past 2 decades independent directors becoming more globally recognize and prevalent. In reality independent directors have been associated with the roles of overseeing, monitoring and achieving proper CG and accountability in companies. Independent directors must be independent of the corporate management in order to fulfill the oversight role and protect shareholders interest as well as the other stakeholders’ preferences. Pass (2004) played the role of independent directors as an important guarantee of integrity and accountability of companies. The integrity and accountability will comes together with the ability if independent directors to see the weakness and opportunities for the companies. Regan, Donnell, Kennedy, Bontis and Cleary (2001) further conclude that the evolving understanding of governance is increasingly being informed by not only considerations of accountability and transparency, Stiles and Taylor (2001) argued that independent directors should be able to oversee issues relating to risk and related strategy. In view of this Cadbury Committee Report (1992) “ code of best practice ” had made an important recommendation that Non Executive Director should bring an independent judgment to bear on issues of strategy, performance, resources including key appointments and standards of conduct.

Stakeholder's has a belief and so do the independent directors, the extent to which the independent directors belief put in is a priority and it is vital. This will explain the proposition or role of directors that should act independently in executing management decision. The decision making by the independent directors must be an ethical process and the decision making is not be influenced by any other conflict interest. In recent years the area of responsibility and accountability of an independent directors are much debated by corporate scholars. The main aim of this paper is to examine strategic responsibility and the role of the independent directors with focusing on transparency and ability to act accordingly to corporate governance requirements. Demirbas and Yukhanaev (2011) have clearly concluded that the roles of independent director are strategically important as its represent the shareholders interest in which they provides strategic direction to control over company's manager. In view of this, it is an expectation from stakeholders especially from shareholders that independent directors will diligently observe and monitor or have supervision of the organization's operations and management for the benefit of good corporate governance as expected by the shareholders. It is important that the independent directors are able to balance and understand the interest of shareholders and the management decision. Melkumov (2009) have further supported that effective boards of directors have been pivotal pillars in ensuring the appropriate maintenance of corporate governance standards, conceptualization and systematic, monitoring of strategic corporate development.

There are several distinct benefits that an independent director can bring to a company, ranging from long-term survival to improved internal controls. One of the important roles is overseeing the establishment and maintenance of a strong control environment, and in overseeing the procedures of evaluating a system of internal accounting control, is particularly important. Financial statement is a significant element in good corporate governance which measures performances of the business. Independence directors so called trustee of the organization shall manage to provide annual report to stakeholders must be transparent. Usually the conflict of interest happens in this field where the independent directors should ensure that the financial information accurate and satisfy all the stakeholders in the organization. Indeed as an independence director, he/she must strengthen the responsibilities of audit committees, and improving the quality of financial and shareholders disclosures. According to William H, cited in Borowski I, (1984) the former chairman of the Securities and Exchange Commission is the person who probably more than anyone else placed the independent director at the heart of the accountability system. To accomplish this objective, he has proposed a course of action primarily addressing itself to reforming the processes and structure of the corporate board.

Stakeholders and shareholders agree that effective corporate governance requires the following principles, which is listed with examples of their implementation:

- Transparency: Full disclosure of financial and non-financial information
- Accountability: Ensuring that management is effectively overseen (and, where necessary, replaced) by appointing an independent and competent governing body
- Fairness: Equitable treatment of investors
- Responsibility: Ensuring the corporation fulfills its proper role in society

Corporate governance systems vary in how they achieve these goals, but by focusing on one group in this case employees we can further develop the notion of how a stakeholder group can strengthen the corporate governance system. Such is the level of principles needed by organizations to convince their stakeholders that the management means more than just making exorbitant profits. By that basis, the stakeholder model is appropriate as it brings together the entire network that makes an organization functional and contains elements that forges the need for directors to make decisions based on stakeholder needs and not just a certain party. Stakeholder model is a managerial model. It is a way of dictating how a company manages to run, the stakeholder model advocates a more pluralist/widely approach to business which merely admits that the profit oriented interests of shareholders aren't the only interests which are relevant to the running of a company. Introducing value creation for all stakeholders broadens the framework of management bringing us closer to a more realistic economic maximization which generates new co-operative capabilities and overcoming some conflicts. The central idea is that an organization's success depends on how well it manages the relationships with key groups such as creditors, employees, owners, suppliers, communities, and others that can affect the realization of its purpose. In the case of employees it is an input of human capital particularly of long term employees who have worked to consolidate specialist skills attributable to the company to assist with maintaining a successful business. In view of this, the development of industrial relations issues has been widely spoken from the aspects of corporate governance. For instance, issues that arise include employees' rights to just wages, to participate in hiring and firing policies, removal of discrimination in working conditions, honesty, product quality and customer satisfaction. This establishes that there are more than just economic issues that should be taken into account by managers on a corporate governance journey under the stakeholder model. It should be remembered that 'companies do not exist just to satisfy the needs of their owners but they have a much wider range of responsibilities towards stakeholders who affect or are affected by the company's actions, and who set moral expectations to companies and to their managers.

Stakeholder's movement contains a prescription for corporations to pursue ends that go beyond the single interests of shareholders and means that Directors are to care for the interests of others involved in the company activity. In doing so, shareholders long term interest are also benefited: increasingly consumers prefer to buy products from companies they trust, suppliers are interested in business partnerships with companies they can rely on; employees rather work for companies they respect; large investment funds favor socially responsible firms and most respected NGOs prefer to cooperate with companies conciliating their investment interests with Community goals. In addition to the above, Freeman and Phillips (2002) has further illustrated that the stake of suppliers is that they derive income from goods supplied to the company. The stake of owners is principally economic in the sense that they are relying on their shares in the company to produce a profit. The stake of the community is the need for a clean environment and boost to the economy through the provision of jobs and production of goods. Finally, the stake of creditors is that the business continues to perform well to ensure that the debts owed to the creditor are satisfied. Therefore, the manager's job is to maintain the support of all of these groups, balancing their interests, while

making the organization a place where stakeholder interests can be looked after over time. It indicates that every stakeholder mentioned above holds stakes in the company.

Since different types of capital contributors and other stakeholders have different types of utility functions from the firm, the conflicts of interest that develop and the agency problems they cause are dissimilar. The utility function of different classes of stakeholders also varies and the degree of alignment of interests with those agents in the firm who control the major decisions is also different. This gives rise to conflicts among stakeholders and these “incentive” conflicts have become known as agency (principal–agent) problems. Unhindered, each class of stakeholders will pursue its own interest, which may be at the expense of other stakeholders. Kose, J. and Senbet, L. W. (1998)

The public outcry on Sime Darby especially the substantial shareholders and The Minority Shareholder Watchdog Group( MSWG) has raised conflicting questions over Sime Darby nearly RM 1 billion loss from cost overruns in the group’s energy and utilities division. It was revealed that Sime Darby would have to book RM964 million in cost overruns from three projects in Qatar and the Bakun hydroelectric dam. Figure 1 shows a summary of failures by large corporations and the issues that they failed at. Among the significant issue is the cost overrun that should be disclosed as Sime Darby has a reputation locally and internationally. In addition , question was asked why there were no attempt to prevent the overrun cost in the appropriate time when there was a sign of losses in which question was whether if the independent directors could play a bigger role and devote more attention in overseeing the governance of Sime Darby. It is well accepted that shareholders invest at Sime Darby because of its success in plantation business in which have contributed 70% of the group’s net profit in 2009 and why instead focusing in the core business, Sime Darby venture into the unfamiliar business territory.

### **3. SIME DARBY FIASCO**

Sime Darby Bhd., Malaysia’s second- biggest company by market value, removed Ahmad Zubir Murshid as chief executive officer after holding him responsible for cost overruns on projects in Qatar and the Bakun hydro-electric dam. Sime may need to book 964 million ringgit (\$302 million) in losses in the second half of this financial year, the Kuala Lumpur-based company said in a statement today. Azhar Abdul Hamid, head of Sime’s plantations unit, was named acting CEO. The company ended Ahmad Zubir’s six-year tenure as losses mounted on engineering and construction projects, seven months after it formed a taskforce to investigate an unprofitable energy and utilities unit. The 100-year-old company, the world’s biggest palm-oil producer, has diversified into businesses ranging from cars and shipbuilding to property development. Malaysia's Sime Darby Berhad, the world's largest listed palm oil producer, posted its first quarterly loss on Thursday due to massive losses from its energy division.

The conglomerate recorded a loss of RM 308.6 million in the three months ended March 31 compared with a net profit of RM 150.6 million in the same period in 2009. Third-quarter energy unit losses wiped out contributions from its mainstay plantations business, it said. The company, which was formed by a merger in 2007, said it would miss its target for a net profit of 2.5 billion ringgit for the year. Authorities in Malaysia will investigate possible graft at Sime Darby after



the palm oil giant said it would post its first ever loss when it announces its third-quarter results on Thursday. Zamri Mohamed Iderus, Sime Darby general manager for marine and international projects, was the first person hauled to court for abusing his position in a wider investigation by the anti-graft agency into losses in the company's energy and utilities arm, said prosecutor Anthony Kevin Morais. The losses were widely expected after Sime removed its chief executive following an internal probe that revealed losses in four projects under its troubled energy and utilities arm. But investors were unnerved and the problems sparked demands for a thorough probe to ensure transparency and public accountability. Complaints about corruption were among key public grievances that caused the National Front ruling coalition to suffer its worst results ever in general elections last year following five decades in power. Prime Minister Najib Razak has since pledged to take tougher steps to combat graft.

The essential role of the board of directors is to ensure that all the organization matters must be in transparent manner, in order to guide effective decision making which Sime Darby failed to do so. In this case, Rita also has mentioned that minority shareholders were expecting the board to be fully accountable and conduct a forensic investigation and make its findings transparent to shareholders in a prompt manner. Figure 2 depicts forms of financial fraud methods that companies have engaged in previous years. Prime minister has added that the board deals with issue in a transparent manner, "in line with good corporate governance principles". It shows that Sime Darby had not practiced good corporate governance principles in its organization. So where is the role of independent directors in Sime Darby? Indeed Sime Darby is one of the important growth engines for Malaysia and they must have accountability and transparency in order to satisfy all the major shareholders for example Permodalan Nasional Berhad.

(Sourced: The Star, May 2011)

#### **4. Suggestion**

Stakeholder theory has been categorized into three aspects, i.e. normative, instrumental. And descriptive, based on their different research approaches (Donaldson and Preston 1995). There are two types of stakeholder theory – the normative theory and the instrumental theory. While the former emphasizes "intrinsic value" in stake holding and views stakeholders as "end", the latter is only interested in how stakeholders' value can be used for improving corporate performance and efficiency and regards stakeholders as 'means'. Indeed, corporate governance is not science, but an art, as William Allen (2001), the former chancellor of Delaware Chancery Court in the US, suggests. For him, good corporate governance may have good effects on long term corporate financial performance. However, the definition of good standards of governance cannot be just measured by scientific precision. 'Corporate governance functions only through human action, which in itself is affected by a high number of changing, interacting variables' (Allen 2001). Any single model or structure identified and developed on corporate governance might not work well for all organizations at all times. Corporate governance needs to be flexible, adaptable, and innovative. Therefore, our model is a rhetoric that is workable and explicable in practice which can better explain the idiosyncratic workings of local corporate governance scenario. Although there is a dispute between the shareholder and stakeholder perspectives common to the model is the notion of profit maximization, increasing market value, and economic rationality and efficiency. It is thus apparent that corporate governance

debates are focused entirely on pure economics, and ignores the basic fact that corporate governance is a social process, which cannot be isolated from social and non economic factors such as power, legislation, social relationships, and institutional contexts (Roy 1997).

As we champion good corporate governance, the disputes between the two parties are eliminated and the responsibilities of the parties do not end economically, but to steer towards a more ethical path that constitutes the entire social obligations. Stakeholder model has been praised for overcoming the narrow view which says that the company's sub purpose is to maximize economic value for shareholders. Introducing value creation for all stakeholders broadens the framework for management, bringing it closer to a more realistic economy optimum, generating new co-operative value creation capabilities and overcoming some conflicts. As long as the focus remains on economic value, any solutions adopted will be insufficient because the processes of capturing that value will always be liable to conflicts of all kinds. If the amount of economic value generated in the company increases, some will wonder why they cannot have a bigger share and if they can't why they shouldn't appropriate the share of others especially the minority shareholders. As such, criticisms leveled against the stakeholder model are justified. Therefore, the conceptual model in this paper proposes a new framework in which bridging the gap of minority shareholders is vital. Thus, the proposed conceptual model is better exercised through internal control mechanism rather than external market such as corporate boards acting as representatives of all the important stakeholders in the corporation especially the minority shareholders. To further strengthen the governance of



<b>Companies</b>	<b>Accountability</b>	<b>Transparency</b>	<b>Responsibility</b>	<b>Fiduciary</b>
Sime Darby	Denial of losses even though informed by external auditors	Failure to disclose overrun costs	Poor business decision making	Possible graft and abuse of power/position
Enron	Inside info of company hidden and investors advised to buy shares	Use of non-transparent financial statements	Overstating profits primarily due to accounting manipulations	
Transmile		Overstatement in the consolidated revenue		
Lehman Brothers	High level of leverage causing gains in short term but increases long term risk			Availability of innovative mortgage options causing standards to deteriorate
Parmalat		Failure to disclose information on directors' shareholding structure	Holding position in management as well as in board of directors	Abuse of power/position. CEO duality

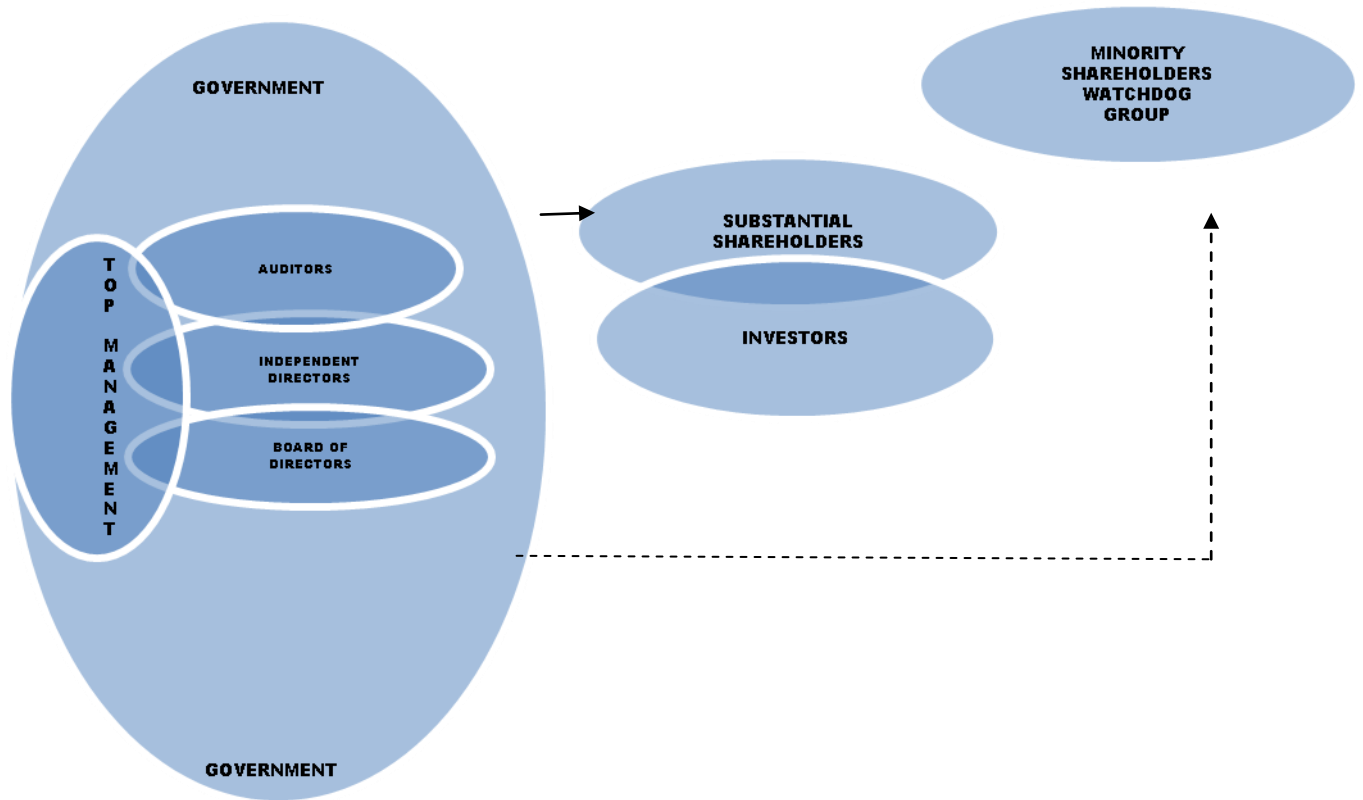
corporations and recognition, it is suggested that Minority Shareholders Watchdog Group (MSWG) be given board representation in Government Linked Companies (GLC) on how the appropriate minority shareholders should be treated in respect to other major stakeholders. This will ensure a level playing field for stakeholders who participate in companies to enjoy the wealth maximization.

**Figure 1: Summary of concept failures of large corporations**

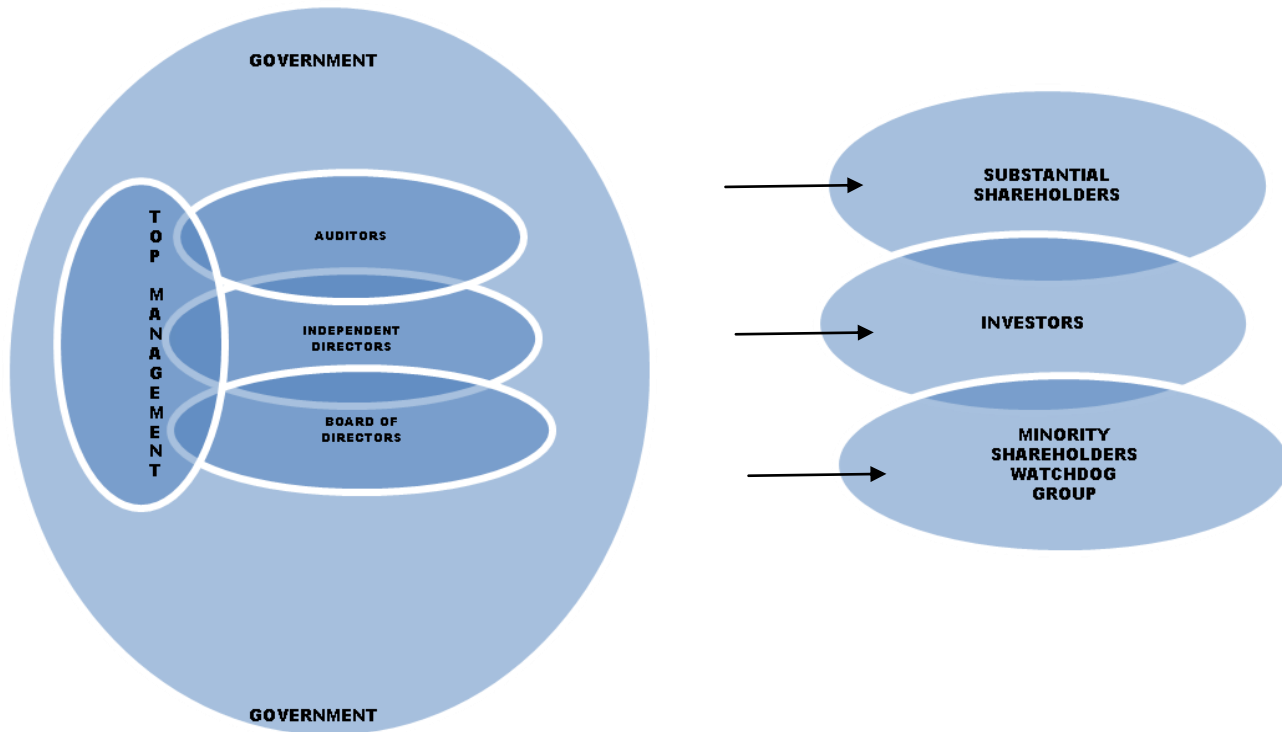
<b>Methods used to misstated financial statement</b>	<b>% of the 347 fraud companies using fraud method</b>
Improper revenue recognition	61%
Overstatement of assets	51%
Understatement of expenses/liabilities	31%
Misappropriation of assets	14%
Inappropriate disclosure	1%
Other miscellaneous techniques	20%
Disguised through the use of related party transactions	18%
Insider trading also cited	24%

**Source: The committee of Sponsoring Organizations of the treadway commission**

**Figure 2: Financial Fraud Methods**



**Figure 3: Conceptual model-Relationship gap between MSWG and other stakeholders**



**Figure 4: Proposed Conceptual model-Relationship gap between MSWG and other stakeholders**

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