



Corporate Boards AND BUSINESS JUDGEMENT

BOARDS OF DIRECTORS ARE PLACED IN CONTINUOUS FOCUS WHENEVER FINANCIAL SCANDALS OR CORPORATE EXCESSES ARE HIGHLIGHTED. THE QUICKENING OF DUTIES OF CARE AND SKILL IN A HYPER COMPETITIVE ENVIRONMENT HAS CREATED A MILIEU OF ANXIETY FOR SERVING DIRECTORS.

Philip TN Koh

Board decisions are often questioned by the public in retrospect. The media scrutinises and queries transactions which were approved months before (in a conditional arrangement), but in a changed economic environment their completion is then contested. For example, Maybank was criticised for its Indonesian venture without due regard for the realism as to the circumstances in which management may have made the investment decisions. Some criticism invokes the mantras of governance without a nuanced application of principle to the real world of decision-making. A successful company requires the spirit of an entrepreneur whilst negotiating the shoals of control mechanisms.

THE “BUSINESS JUDGEMENT” DEFENCE

In an Australian decision which captured the pragmatism of common law, Rogers J observed:

“The courts have recognised that directors must be allowed to make business judgements and business decisions untrammelled by the concerns of a conservative investment trustee. Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate but ephemeral, political insights, a feel for economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against allegations of negligence by the entrepreneur?”

*[Daniels v Andersen
(1995 NSW Supreme Court)].*

The Malaysian Companies (Amendment) Act, 2007 which came into force on 15 August 2007 provides a “safe harbour” defence of business judgement.

A director who makes a business judgement is deemed to meet the [duty of care, skill and diligence] and the equivalent duties under the common law and in equity if the director

- (a) makes the business judgement in good faith for a proper purpose;*
- (b) does not have a material personal interest in the subject matter of the business judgement;*
- (c) is informed about the subject matter of the business judgement to the extent the director reasonably believes to be appropriate under the circumstances; and*
- (d) reasonably believes that the business judgement is in the best interest of the company.*

[Section 132(1B)]

The introduction of this new provision in the Companies Act is to be welcomed. Common law has long affirmed that there should be judicial reticence in substituting a court decision *ex post facto* for that of a Board. Some have doubted the wisdom of a statutory enactment of such a rule, as it was felt the judicial balance on this matter already reflected adequately the principle that the Courts will permit wide deference to commercial judgements of men and women of business. The business judgement rule has however been reflected in wide reform proposals in both the US and the Commonwealth. Directors should pay careful attention to the scope of the rule, as there are several pre-conditions before the protection that is available can be made use of.



PRE-CONDITIONS TO THE BUSINESS JUDGEMENT RULE

The first is that the rule protects decisions that have been consciously made, and where a business judgement has been taken on the matter. Passive rubber stamping of a decision and negligent omission by way of serious failure of oversight and monitoring on the part of a director will negate the application of this safe harbour. The elements of good faith and disinterestedness must also be present, and any evidence of self dealing will also disqualify the application of this defense.

The significance of an informed decision is a cardinal element. The American Law Institute (ALI) acknowledges that there may not be a precise way in which to measure what information is appropriate for sound and informed decision-making. Much of governance lapses come from what economists characterise as asymmetrical information that leads to misjudgements by Boards.

The ALI lists the following as matters which are appropriate for sound decision-making:

- i) the importance of the transaction;*
- ii) time availability;*
- iii) costs for obtaining information;*
- iv) director's confidence in exploring the matter;*
- v) the state of the company's business and the nature of competing demands for the Board's attention.*

In one interesting Delaware decision, the Court held that the Board of Trans Union Corporation were not adequately informed when they approved the cash out merger for the corporation [Smith v Van Gorkom (Del 1985)]. The main defects which persuaded the Court to disentitle the directors of the

protection under the rule and have their conduct castigated as grossly negligent were that the directors:

- *did not adequately inform themselves as to the role of Van Gorkom in forcing the merger and establishing the cash out price;*
- *were uninformed about the intrinsic value of the company; and*
- *approved the merger after only two hours of deliberations without prior notice.*

Further, it appeared that the Board did not seek any further valuation or justification for the sale price and made no inquiries for Van Gorkom's bare assertions of value. The availability of the business judgement rule therefore does not preclude the requirement that a director carries out his evaluative decision-making in a manner that evidences reasonableness and is wholly disinterested for the interests of the shareholders of the company as a whole.

It is incumbent for Boards collectively and directors individually that, in discharging their duties, the intersection of governance duties and strategic oversight be reconciled in a sound business judgement. The presence of the business judgement rule in the Companies Act is a good instance that Courts ought to refrain from second-guessing decisions which have been made in good faith, and which has disclosed independent informed decision-making. Whilst the substance and demands of governance for Boards cannot be compromised, it is important that any finding of negligence and breach of duties must be made within the backdrop of commercial realism that meshes sound principles with pragmatism. ■

Philip TN Koh is a senior partner of Mah-Kamariyah & Philip Koh, Advocates & Solicitors



Are directors responsible for the preparation and fair presentation of financial statements in accordance with International Financial Reporting Standards (IFRS)?

IN THE CONTEXT OF THE MALAYSIAN CORPORATE LAW FRAMEWORK, DIRECTORS ARE RESPONSIBLE FOR THE FINANCIAL STATEMENTS OF A COMPANY AND THIS SHALL BE CITED ACCORDINGLY IN THE AUDITOR'S REPORT.

A key question is frequently debated: “Who is responsible for the financial statements of the company?” Should the responsibility for the financial statements lie with the directors of the company, the management or both?

DIRECTORS' DUTIES AND RESPONSIBILITIES UNDER THE LAW

In the context of the Malaysian corporate law framework, the duties and responsibilities of the company directors in Malaysia are clearly stated in the Malaysian Companies Act 1965 (Act). Under the Act, company directors are responsible for the management of their companies and have a fiduciary duty to act in the best interest of their companies.

DIRECTORS' RESPONSIBILITY FOR FINANCIAL STATEMENTS UNDER THE COMPANIES ACT 1965

The Act expressly imposes the responsibility for the preparation and fair presentation of financial statements on directors. However, management is not defined in the Act and such impositions have not been made on them.

- Sections 166A(3), 166A(4), 166A(5), 167(1), 167(1A), 169(1), 169(3), 169(5), 169(15), 169(16) of the Companies Act are some of the key references that state that company directors are responsible for the maintenance of accounting and other records, as well as the tabling of the audited financial statements at a general meeting of members of a company.
- Sections 166A(3), 166A(4) and 166A(5) state clearly that the directors of a company shall ensure that the accounts of the company (including consolidated accounts, where applicable) laid before the annual general meeting are in accordance with the applicable approved accounting standards.
- Section 167(1) requires the company directors and managers to ensure proper maintenance of accounting and other records to enable them to be conveniently and properly audited. Section 167(1A) requires accounting entries and other records to be properly documented within sixty days of the completion of the transaction.
- Sections 169(1) and 169(3) require the directors of a company to table at the annual general meeting a profit and loss statement for the period and a bal-

ance sheet to which the profit and loss account relates. Section 169(5) requires directors of each company to prepare a resolution signed by no fewer than two of the directors attesting to the profit or loss of the company for the financial year and the state of affairs of the company's affairs as at the end of the financial year. Section 169(15) on the director's statement requires directors to state that the profit and loss account and the balance sheet (including consolidated accounts, where applicable) give a true and fair view of the results and state of affairs of the company and that the accounts of the company are in accordance with applicable approved accounting standards. A director or where the director is not primarily responsible for the financial management of the company, the person responsible is required by Section 169(16) to state his opinion in the statutory declaration on the correctness or otherwise of the balance sheet and the profit and loss account (including the consolidated accounts, where applicable).

Apart from the above-mentioned key sections, there are other references in the Act which indicate or imply that directors

are responsible for the financial statements. Other paragraphs in the Companies (Amendment) Act 2007 further elaborate on the powers, duties and liabilities of directors as officers of the company.

There is a general statement in Sections 131B(1) and 131B(2) as to the functions and powers of directors. For the purpose of Section 132, Section 132(6) interprets “director” to include the chief executive officer, the chief operating officer, the chief financial controller or any other person primarily responsible for the operations or financial management of a company, by whatever name called.

In Section 132(1C), directors, in exercising their duties, may rely on information given by employees or professional advisors or other directors or directors’ committees provided their reliance is made in good faith and the directors have made an independent assessment of the information.

Section 132 (1F) provides for the delegation of powers of the board to officers and others but delegating such management function to others and relying on others does not absolve the directors from being accountable for the affairs of a company.

REQUIREMENTS OF INTERNATIONAL STANDARDS ON AUDITING

The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) establish high quality auditing, assurance, quality control and related services standards for the use of all professional accountants. The International Standards on Auditing (ISA) issued by the IAASB are adopted as the basis for the Malaysian approved auditing standards which are issued by the Malaysian Institute of Accountants (MIA), the regulatory body overseeing the accounting profession in Malaysia.

The ISA 700 (Revised) “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” effective for auditor’s reports dated on or after 1 July 2008 clarifies, among other things, the duty and responsibility of man-

agement and auditors relating to the financial statements in the auditor’s report.

The following are pertinent extracts of the Malaysian Approved Standards on Auditing ISA 700 (Revised):

Management’s Responsibility for the Financial Statements (paragraph 28, 29 and 31)

..... PARAGRAPH 28

The auditor’s report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes:

- Designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- Selecting and applying appropriate accounting policies; and
- Making accounting estimates that are reasonable in the circumstances.

PARAGRAPH 29

Financial statements are the representations of management. Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. For example, in the case of financial statements prepared in accordance with IFRS, management is responsible for preparing financial statements that fairly present the financial position, financial performance and cash flow of the entity in accordance with IFRSs. To fulfil this responsibility, management designs and implements internal control to prevent or detect and correct misstatements, whether due to fraud or error, in order to ensure the reliability of the entity’s financial reporting. The preparation of the financial statements requires management to exercise judgement in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgements are made in the context of the

applicable financial reporting framework.

PARAGRAPH 31

The term management has been used in this ISA to describe those responsible for the preparation and fair presentation of the financial statements. Other terms may be appropriate depending on the legal framework in the particular jurisdiction. For example, in some jurisdictions, the appropriate reference may be to those charged with governance (for example, the directors).

Although, the reference to “management” in ISA 700 is a generic reference within the ISA definition, appropriate and



due consideration should be given to those ultimately responsible for the preparation of financial statements in the respective jurisdiction, which in Malaysia’s case, are the directors.

To conclude, in the context of the Malaysian corporate law framework, the directors are responsible for the preparation and fair presentation of the financial statements notwithstanding that reliance could be placed by them on information and professional or expert advice provided by any officer of the company. Therefore, the parties responsible for the financial statements are the directors and this shall be cited accordingly in the auditor’s report. ■

.....
This article was contributed by MIA’s Audit and Assurance Standards Board (AASB).