How to clean up

China Aviation Oil (Singapore) Corporation Ltd
Creditors' Meeting
8 June 2005

China Aviation Oil is, in some ways, Singapore's Enron but the list of accounting scandals is growing. From ACCS to Citiraya, among others, we take a look at how it all went so wrong, where the weakest links are and what can be done.

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Handcuffed and unshaven, Chen Jiulun sat in the packed Subordinate Court 26 last Thursday morning, dressed in a short-sleeved light-brown chequered shirt. Next to the chief executive officer and managing director of China Aviation Oil (CAO) was finance head Peter Lim Tiong Sun, wearing a crumpled polo shirt. In contrast, chairman Ju Changbin — also president of parent China Aviation Oil Holding Co (CAOHC) — and non-executive directors Gu Yanfei and Li Yongji looked smart in their dark business suits, flanked by a phalanx of lawyers and other aides, occasionally smiling and chatting. During the recess in the application for bail, the entourage had McDonald's for lunch, bought from an outlet in nearby People's Park.

After months of high drama, Thursday's action was an anticlimax of sorts. However, for investors of the once high-flying China-based company, and creditors who just the day before acceded to a debt-repayment scheme in which they would get 56.6 cents on each dollar, the arrests offer little comfort in what has been the biggest scandal to hit Corporate Singapore since Barings. In some ways, CAO could turn out to be our own version of Enron, the energy firm whose collapse triggered an overhaul of corporate governance in the US.

Jet fuel importer CAO listed on the Singapore Exchange in December 2001. Helmed by the high-profile, 44-year-old Chen, it became one of the hottest stocks around, tripling in value between the middle of 2003 and the first quarter of 2004 as sales soared and the company embarked on an acquisition trail. But towards the final quarter of last year, whipsawed by trading problems due to a breakdown in its accounting system, CAO's share price dipped sharply.

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$700 million was wiped off CAO’s market capitalisation between early October and late November. In the last few weeks, a sorry picture of fraud, concealment of material information, suppression of internal controls and insider trading has unfolded.

Yet, the CAO debacle didn’t happen in isolation. It was the latest in a year-long string of governance lapses in many Malaysia-listed companies.

Citiraya Industries, a recycler of electronic waste, revealed it had amassed liabilities of $110.2 million and is also being investigated by the authorities. On a smaller scale, Greatronic Ltd said its Malaysian subsidiary was being investigated for fraud and for inflating its accounts. Meanwhile, another private education company, Auston International Group has said it overstated profits for its financial years 2002 and 2003.

Ironically, almost all these companies were stock market darlings. Their management were hailed as models of business enterprise. Tan, who founded ACCS and was CEO until his departure last month, was named the Ernst & Young Emerging Entrepreneur of the Year last year.

How did it all go so wrong? What happened to the internal controls, risk management systems, and layers of checks and balances that were supposed to kick in — at a time when disclosure requirements and governance awareness have never been higher? Whether it was the chairman of the board, directors, CEO, chief financial officer, external auditors, internal auditors, audit committee members, independent directors or management — somewhere along the line, why weren’t questions raised when lapses were detected? What were the guys on audit committees — now a must-have for all public-listed companies — doing? What about the board and the external auditors, both of whom are responsible to the shareholders of the company? How could they sign off on accounts each year, only to come back later and say the numbers were all wrong?

Weak links

Boards that lack teeth. Independent directors who are too ingratiatingly independent. A charismatic CEO or management that overrules internal controls. A culture that doesn’t push insiders to blow the whistle when the rot starts to surface. These are some of the weak links in what is otherwise a fairly decent governance environment. Much of the regulation was already in place and the hurdles were high but it has ultimately been a case whereby “too many people were simply not doing their jobs”, says associate professor Mak
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Yuen Teen, who is co-director of the Corporate Governance and Financial Reporting Centre at the National University of Singapore (NUS) Business School,

While highly charged COA was a drama involving fraud, hiding information and dishonestly selling new shares in the company, it was also a case where non-action played a part in the company's downfall. As the report by special auditor PricewaterhouseCoopers (PwC) concluded: "If anyone at any level had independently asked more questions, or delved a little deeper, or even sought to understand the position fully, the situation might well have been averted.

The way Mak sees it, "If you sit on a board and don't ask questions, or if you're not as bad as the people who hid information or engaged in fraud, but does that mean you've done your job as a director? I don't think so." In his mind, the big question now is whether action will be taken against people "once the dust has settled" when they should have been probing, asking the right questions or taking steps to remedy a situation in time.

Aside from the issue of ineffective boards, the one palpable link between the string of recent scandals that was listed in 2001 or later — just as Singapore moved to a market-driven environment. "In the late 1990s, we moved to a disclosure-based regime and with that, we relaxed the way companies go public," says Mak. However, that meant companies started to go for an initial public offering earlier than ever, sometimes before their business models were proven and quite often before governance processes and internal controls were developed. Mak feels that in the past, entrepreneurs used to build up their businesses more before they turned them into public companies.

Moreover, even as Corporate Singapore lurched towards the new regulatory regime, which offered more transparency and more responses to cover-up (let the buyer beware), some of the lines were still being drawn. Companies were only legally required to adopt the city-state's Financial Reporting Standards for the financial years beginning 2003, a pretty recent development.

On top of that, there has been a corporate version of performance anxiety as shareholders clamour for better returns with excessive increases in offer prices. "We must not overlook the incredible stress on operational results," says Leong Kwong Sin, associate professor of accounting at Singapore Management University (SMU).

The pressure to keep profits growing and keep "delivering shareholder value" can skew attitudes towards risk-taking or suppress the disclosure of liabilities to keep the numbers looking robust.

Watchdogs, not bloodhounds

Look no further than the most common problem of late: overstatement of revenue and profit numbers. While COA's case involved complicated derivative trading and options which few seemed to know how to value, problems that cropped up at companies like Informatics, Auston and ACCS seem far more elemental. After all, properly recognising revenue is very basic accounting.

More worryingly, in some cases, the irregularities went back two or three years. Why didn't the audit committee, the internal auditor — or for that matter, the external auditor — pick it up?

"That's a legitimate question," says Mak of NUS, an accounting don himself. However, as SMU's Leong points out, there is a limit to the ability of auditors to detect all bad practices and fraud. For their part, auditors say management has the primary responsibility of ensuring that financial statements are true and fair.

"If management seeks to override internal controls, suppress information or weave complex webs over transactions which they do not want their external auditors to detect, there is very little that an external auditor can do," says Joseph Alfred, technical manager of the Association of Chartered Certified Accountants Singapore. Auditors are "watchdogs", not "bloodhounds", he adds.

Unclear reporting lines, inadequate segregation of duties, non-compliance with procedures and the lack of a whistle-blower programme are some factors that prevent the discovery of fraud, says Gautham Banerjee, executive chairman of PwC in Singapore. However, they are also factors under the control of the company. Factors such as management fraud, collusion between parties and forgery are "uncontrollable" and it is up to the company to institute a good governance culture to minimise this.

"Risk management is the responsibility of the board and the company and not the auditors," Banerjee stresses.

Enough regulation already

All this has happened not for the lack of roles. Listed companies have to adhere to the Companies Act, the Securities and Futures Act and the SGX Listing Rules. Three years ago, the Code of Corporate Governance (CGC) was introduced as a best-practice guide for companies. Among others, it advocates companies segregate the role of chairman and CEO to ensure an appropriate balance of power within a company, and that audit committees be made up mostly of non-executive, independent directors. The audit committee should have explicit authority to investigate matters within its terms of reference and review the independence of the external auditors annually, it adds.

However, the CGC isn't enforceable and is merely a guide. Should it be made compulsory? Most experts think not.
"I believe we are moving in the right direction in pushing for more transparency, not just of facts and figures but also of processes and procedures," says Leong of SMU. He also points out there is now greater participation of the investment community through groups such as SIAS. Indeed, the Investment Management Association of Singapore feels that "the current regulatory regime adequately protects investor interest". As its executive director, Andrew Kwek says: "What happened at CAO was the result of failure at every level... and this type of situation would be difficult to police in any circumstance. It is important that we do not overreact and end up with too onerous regulations."

Still, some elements of the CGC can be made enforceable, says Mak of NUS, citing attendance at board meetings as one disclosure that should be mandatory. The CGC recommends that annual reports contain information on the number of board meetings held in the year, as well as the attendance of every board member at those meetings and meetings of specialised committees established by the board.

Meanwhile, the SGX is beefing up its listing rules. Chief among the proposals is a requirement for listed companies to have two independent directors on a continuous basis and not just at listing.

On internal controls, the SGX is also asking boards and CEOs to confirm each year that responsibilities for staffing internal control functions are explicitly assigned and that channels for reporting significant risk and internal control matters to the board and CEO are clearly specified. It is also making issue managers disclose their sponsorship of newly listed companies for two years instead of one year after the company lists.

**Encourage whistle-blowing**

However, what is missing on the regulation front is legal protection for whistle-blowers, which is now entrenched in countries like the US, UK and Australia. Conscientious insiders should be encouraged to uncover bad practices in companies, without fear of repercussions by powerful CEOs. In April, the Association of Bankers in Singapore (ABS) said that a policy on whistle-blowing will be incorporated in a proposed new code of conduct. The ABS advocates companies set up internal programmes that guarantee confidentiality and protection to bank staff who reveal wrongdoings by their colleagues. Mak of NUS feels that the authorities should go a step further and enact a separate whistle-blowing Act that covers not just companies, but public-sector organisations and non-governmental organisations.

However, all is not lost. In a rare governance triumph, Sesdaq-listed New Lakeside recently showed that there is hope. The three independent directors of the China-based apple-juice maker called for a special audit of the company’s accounts after a shocking half-year loss and ambiguity over accounting standards. The special audit revealed irregularities in sales, cost of goods sold and receivables and resulted in the ouster of the CFO. The managing director was also terminated but was reinstated after an appeal. Notably, one of the three independent directors, who is also New Lakeside’s non-executive chairman, is Alan Yeo, the 74-year-old former chairman of drinks company Yeo Hap Seng.

Vigilant independent directors can make a difference. But in today’s high-stakes corporate world peppered by celebrity CEOs, everyone along the chain — from the directors, the management team and those further down the line with a role in internal risk management and internal controls, to external parties like auditors and regulators — will need to play their part and assume responsibility for their actions as well as their inaction.

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**Little legal remedy for shareholders**

When investments sour, a resounding chorus of caveat emptor erupts. Still, what recourse do shareholders have under the law against directors or management that appear to be in breach of their duties? Very little.

"It’s actually very tough for shareholders to take any action," says Loh Lih Luh, assistant professor at the National University of Singapore Business School’s Department of Business Policy.

Under Section 216A of the Companies Act, shareholders of private companies can apply to the court for permission to file a civil suit called a “derivative action” against the directors of a company for breach of their duties.

However, there are several hurdles to cross, a key one being that the action to be taken must be in good faith and in the interest of the company (as opposed to the interests of the shareholder).

Additionally, the shareholder must give due notice to the directors and allow them to defend their ground. If they fail to respond within 14 days, only then will the permission to take action on behalf of the company be granted.

And to reiterate, such action can only be taken against the directors of unlisted companies. For listed companies, legal recourse is even more difficult, says Loh. Shareholders can take a "common law derivative action" but will have to prove the incidence of fraud on the minority shareholders.

Most of the time, such action fails, she adds. However, it’s worth noting that even in the US, derivative or class action is used more as a tool to prod the company or the directors towards an out-of-court settlement.

Winning is rare, yet this hasn’t deterred several minority shareholders from taking action, bolstered in part by lawyers incentivised by the "contingency fee system" in the US in which lawyers get a cut of the settlement proceeds.

So, should Singapore look at bequeathing shareholder rights under the law? Loh has mixed feelings. Legal action, which is often costly, should be a last resort, she says. "Frankly, it is the lawyers who gain," says the legal don.

Moreover, it may not always be in the interest of shareholders to seek damages. Shareholders, who are only entitled to what’s left of a company after all creditor demands have been met, may be better off ensuring that a company survives and continues as a going concern instead of dissolving into the graveyard of bankruptcy.  

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