

CONFLICTS OF INTEREST IN THE GOVERNANCE OF MALTESE CO-OPERATIVES AND THEIR FINANCIAL IMPLICATIONS

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Abstract. The main objective of this paper is to ascertain the major conflicts of interest faced in the governance of the Maltese co-operative movement consisting of three governing institutions and individual co-operatives, as well as the financial implications of such conflicts. Results from personal semi-structured interviews point to a lack of awareness on the deeper meaning of what constitutes a conflict of interest. Furthermore, no clear delineation of roles among the three institutions is as yet present. With respect to co-operatives, results reveal that the majority of conflicts of interest surface within committees of management owing to varying personal/entity interests and the overlapping roles of directorship and management. In the authors' view, at the co-operative level, the need arises for the development of a general Code of Ethics and for better training for those in charge of governance, as well as for skill gap analysis and the formalisation of their relevant policies. On the other hand, at the institutional level, the need beckons for general restructuring, including revisions to the appointment system of the respective governing bodies.

Introduction

Co-operatives were one of the early structures formed with the specific aim of assisting groups of workers that have an entrepreneurial spirit to achieve their aims. In fact, according to Luccock (n.d.) *'No one can whistle a*

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symphony. It takes an orchestra to play it'. The International Co-operative Alliance, the organisation that represents co-operatives and the co-operative movement worldwide, defines a co-operative as: *'An autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.'* (ICA, 1995). Thus co-operatives are distinct from other forms of public or private organisations in that they are democratic structures owned and controlled by their members, whereby each person has one vote. Furthermore, they are guided by a set of seven principles that enable them to put their co-operative and ethical values into practice.

The main objective of this paper is to ascertain the major conflicts of interest faced in the governance of the Maltese co-operative movement consisting of three governing institutions and individual co-operatives, as well as the financial implications of such conflicts. The analysis is based on semi-structured interviews held between October 2010 and March 2011 with 9 representatives of the three institutional bodies—the Co-operatives Board, Koperattivi Malta and the Central Co-operative Fund—as well as with members of the committees of management or professional management of 22 Maltese co-operatives willing to participate in the study out of a total of 52 existing at the time of study. The analysis must therefore be interpreted within the limitations of such response, with the overall position being noted as prevailing as at 31st March 2011. Yet, in this latter context, no significant changes to such position were noted by the authors up to 15 May, 2012.

The Corporate Governance of Co-operatives

Within the Maltese co-operative framework, one finds various hierarchical levels in its governance. With respect to the three above-mentioned governing institutional bodies:

- The role of the Co-operatives Board is to *'register, monitor and exercise supervision over co-operative societies and ensure that they operate in full compliance with the provisions of the Co-operative Societies Act (CSA) of 2001'* (Government of Malta, 2001). Moreover, the Co-operatives Board is to assist and give advice to the Minister responsible on all co-

operative aspects. The Board is appointed by the Minister and is composed of the Chairman, Secretary and between 2 to 6 other members.

- Koperattivi Malta (KM) is a non-political organisation set up by the CSA (2001) and it must *'have at least absolute majority of all primary co-operatives societies'* registered with it as members (Government of Malta, 2001). However, registration with KM is not compulsory. Its Council is made up of a maximum of 9 individuals elected from the member co-operatives. The roles of President, Secretary and Treasurer are then selected from the elected individuals. Its main role is to assist co-operative societies in Malta and to represent and promote the Maltese co-operative movement, both locally and internationally. It also has to provide a variety of services to member co-operatives, including education and training.
- The Central Co-operative Fund (CCF) is imposed by Art 91 of the CSA(2001) and is to be used to promote co-operative education, training and research, and for the general development of the Maltese societies in every aspect of the economy and society. Those co-operatives whose annual audited financial statements show a surplus contribute to the fund to the extent of 5% of such surplus. The CCF committee is obliged to *'exercise a high degree of diligence in administering the funds under its responsibility'* (Government of Malta, 2002). Such a board is composed of 7 members: 2 members elected from the Co-operatives Board, 1 member from *Koperattivi* Malta and the rest are selected from Maltese co-operatives.

Individual co-operatives are categorised into five sectors, namely: producers, workers, consumers, social co-operatives and public sector co-operatives. Within each co-operative, the hierarchical levels are the Supervisory Board (optional), the Committee of Management (COM), Professional Management and Members/Employees.

Members of the COM are users, owners and controllers of the society and the COM is vested with the conduct and management of the affairs and business of the co-operative (Government of Malta, 2001). On the other hand, the function of the Supervisory Board is to ensure that co-operative affairs are conducted in accordance with the provisions of the Act, the

Statute and the resolutions and decisions adopted at the general meetings. From the replies of respondents, it emerged that the majority of co-operatives have opted to do away with the Supervisory Board and adopted instead a single-tier system of corporate governance with the Committee of Management managing the whole affairs of the society.

In some co-operatives, the COM may appoint a person or persons as full-time professional manager/s responsible for implementing strategies approved by the COM.

The COM approves all members that are admitted in a society. Munkner (1982) describes the position of a member as having a dual capacity - as a member of the co-operative group, and as user of the services and facilities of the co-operative. A member has the right to one vote in the AGM, irrespective of the number of shares paid. Apart from members working in a co-operative, there can be both voluntary as well as paid employees engaged by the COM. Even though employees do not have a voting right, it is their duty to abide by the society's principles and values and work towards common goals.

Conflicts of Interest Defined

For the purpose of this paper, a working definition of conflict of interest (COI) is the following:

"A conflict of interest arises when the personal or professional interests of a member who is authorised to take decisions have the potential to be at odds with corporate and societal values."(amended from Brown, 2008).

In situations involving a group of people, conflicts of interest (COIs) are common, and can hardly be avoided. In fact, from the study, the perception of the majority of respondents is that while in general everybody states that they try to avoid conflicts of interest, the reality is different in that one accepts them 'as part of human nature'. Yet, all this is tied up with the 'individual's moral values and ethics'. Overall, personal interests and financial gains were identified as the most common sources of conflicts.

In reality, conflicts of interest can be mainly categorised into pecuniary and non-pecuniary interests (OECD, 2003). Pecuniary interests involve an actual or potential financial gain that may arise from a member who has decision-making power, including improved employment or post-employment prospects, gifts or hospitality, financial rewards and business referrals. Non-pecuniary interests do not have a direct financial component, but still have financial implications, and may arise from personal or family relationships or involvement in social or cultural activities. A COI may also be looked at it in simpler terms as it is generally a situation in which someone in a position of trust has competing professional or personal interests that strongly colour one's perceptions, making the individual incapable of taking decisions objectively.

Risks of Conflicts of Interest

Conflicts of interest carry a number of risks, including that board members may be held liable if prudent management of an organisation's resources is not exercised. Higuera (1996) mentioned that a 1974 court decision in the USA, known as *'The Sibley Hospital Case: Trustees & their loyalty to the Institution'* confirmed that board members can be held legally liable for COIs because they constitute a breach of fiduciary responsibility. Olear (2008) states that nothing undermines a community's faith in their leadership faster than impropriety and self-dealing amongst the board and management team.

According to Brown (2008), if COIs are not dealt with, risks can go beyond financial penalties and remedies. The lasting effect of ignoring COIs is reputational. Individuals on the governing body could be tainted with the ethical aspects of the matter, and both personal and corporate reputations could be ruined for a lasting period of time.

Should Conflicts of Interest be Regulated?

According to Campbell and Houghton (2005), ethical behaviour does not simply mean conforming to legal and professional rules, but is indeed a

culture of '*doing the right thing*'. However it is inevitable that individuals are faced with ethical decisions and COIs. Thus it is fundamental that both internal and external regulatory frameworks and measures are engrained in the culture of co-operatives.

In an ideal scenario, COIs should be avoided at all costs. Since within any community enterprise certain COIs are inevitable, one needs to know how to deal with them in a constructive manner. Both extremes of a complete regulatory framework, or complete self-regulation, are considered to be inappropriate. The majority of respondents stressed that a general Code of Ethics (COE), with a set of rules, needs to be established. Regulation cannot cover every possible situation, yet it would serve as a solid base for the identification and minimisation of instances of COIs. The way in which such a COE is to be drafted needs to leave enough space for self-regulation. Such a COE will also best form part of the CSA(2001), in order to strengthen regulation in this respect, since there is only one clause regulating such an important matter.

More tools within all levels of the co-operative movement need to be developed for the appropriate management of COIs. Disclosure policies need to be drawn up consisting of a detailed questionnaire or statement, with a regular review and update. Full and accurate prior disclosure, followed by abstention from decision making on matters in which conflicts may potentially exist, will probably be the best practice. Decisive action should always be taken on the merits of each case even if this entails suing for damages in serious cases. Whilst such structures may initially be costly to implement, their contribution to the financial stability of the system should in the long-term outweigh costs, promoting informed decisions within a stronger framework—this also eventually leading to the strengthening of liquidity, profitability and investment.

The Financial implications

When a co-operative experiences any type of COI, proper corporate governance may be seriously undermined if this is not dealt with appropriately, with negative consequences on the financial stability of the

society. While varying financial implications are involved in any business activity, COIs clearly tend to give rise to strategic and operational activities which result in adverse financial ones as indicated in Table 1 below. In this context, the study indicates that individual awareness of such financial effects of a COI, such as unprofitability, risky business and arrangements with third parties of low credibility often comes about when these have actually been realised.

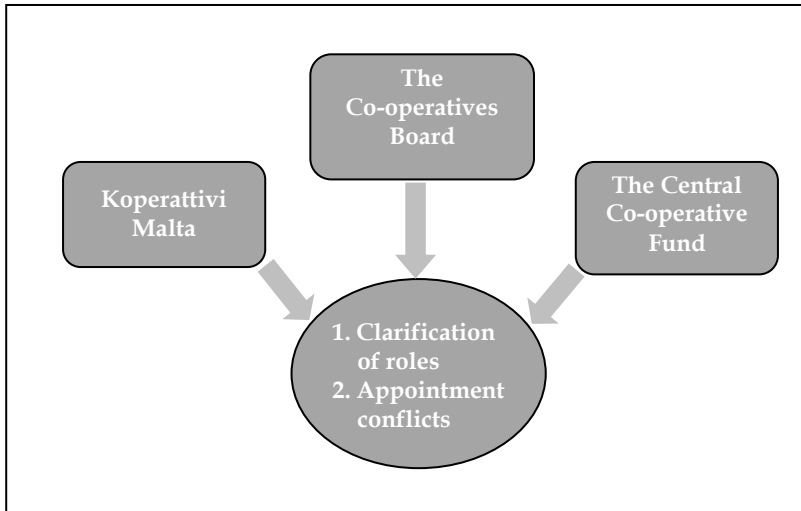
Table 1
Financial Implications of Strategic and
Operational Activities Resulting from COI's

Strategic Activities	• Inefficient use of time, resources and money
	• Erroneous decisions on short and long term capital investments
	• Biased decisions taken
	• Negative impact of agreed strategies and objectives
	• Undermining of effective internal controls
Operational Activities	• Questionable business ventures with third parties of low credibility
	• Trading in markets which do not allow profitable return on investment
	• High risk of insider trading
	• Engaging in risky business agreements that can have serious repercussions on the operational viability of the co-operatives if the venture fails
	• Loss of contracts due to negative reputation
	• Pricing frauds
	• Proper tendering systems not observed with potential risk of not benefitting from the most advantageous offers or services
	• Excessive consultancy fees

Towards a Better Institutional Framework

Through this study, the main issues identified as needing specific intervention in the three institutions are highlighted in the figure below. As shown in Fig 1, analysis revealed that the current roles of these institutions are not clearly defined and that the current appointment system of the board/councils is also leading to real and perceived COIs, sometimes leading also to resource wastage and inter-institutional disputes.

Figure 1
Issues Identified as Possibly Leading to
Institutional Conflicts of Interest



Individual co-operatives need to look up to the three institutional bodies in order to function properly and prosper. If the relationship amongst the institutions is not strong and appropriate, co-operatives tend to perceive them negatively and thus be also adversely affected. In all communities, the strength lies in their leadership and the intra-relationships governing them.

One consideration is whether the Co-operatives Board is to retain its current structure and regulatory role, or transform itself into a Co-operative Authority with stricter monitoring powers and a more active role in the development of new legislation and policies. Such transformation would result in the regulator being in a better position to inspect and ensure compliance with co-operative regulation and principles, and hence to utilise better the full powers already provided in the current legislation.

The relevance and adequacy of the appointment systems have been widely discussed. Clearly, the Board needs wider representation of the various parties concerned in the movement. The fact that Board members are appointed by the responsible Minister, with the majority having to pass through a steep learning curve each time that there is a Ministerial change, has been considered a great disadvantage. Probably, a more balanced and stable alternative would be to have equal representation of government, KM and individual co-operatives, together with an Opposition member.

On the other hand, Koperattivi Malta (KM) is one of the contributors to this lack of clarity in roles, as it has no specific roles entrenched within the Co-operative Societies Act 2001. Furthermore, the current nomination process to the AGM and consequently to Council needs to be looked into. Nominating individuals on the basis of two delegates per co-operative may not be entirely just. Probably, a wider and more direct representation could be achieved leading to better awareness, understanding and acceptance. One way may be having delegates nominated directly and separately by all co-operative members in each sector, with the number of nominations being proportionate to the total number of members in each sector. Wider representation would hopefully lead to more enthusiasm on the nomination process to the Council itself. It is important that emphasis is placed on the independence of council members, particularly in the context of ongoing business relationships, as these will be perceived negatively owing to possible COI implications. However, this will not necessarily preclude a Council member from being a '*supplier of services*' provided that a scrupulously independent tendering process is conducted.

With respect to the Central Co-operative Fund (CCF), the appointment of its Board, with potential concurrent membership of both the KM and the

CCF, can evidently cause uneasiness within the institutional bodies, as well as with co-operatives vis-à-vis the institutions.

The principal consideration is the perceived COI arising from the fact that the majority of individuals on the CCF Board are also allowed to form part of the KM Council. As a result, the same individuals may wear different hats for different occasions, such as with their dual role in the presentation and approval of projects. This may easily be perceived as not conducive to the optimal allocation of funds. Of course, this does not mean that the CCF Board membership would necessarily exclude a member or two sitting concurrently on the KM Council. Such representation may be important for informed decisions to continue to be made. However such person/s, if any, cannot be allowed to participate in conflicting situations such as project presentation and approval. Funds approved by the CCF are also to be monitored by the CCF within a stricter regulatory framework. For example, quarterly reviews may be established whereby financial performance is evaluated against these budgets with corrective action being required immediately when the latter are not being achieved.

In deciding on the future of the CCF, a number of alternatives were proposed in order to ensure the elimination of COIs. This involves changing the present set-up by way of KM/CCF amalgamation, or by the introduction of a Board of Trustees composed mostly of independent members. Probably, the latter alternative involving trustees would be a superior alternative because while leading to less bureaucracy, KM/CCF amalgamation would necessitate a formula to cater equitably for the financing of non-KM member entities, unless KM membership first becomes compulsory for all Maltese co-operatives.

Coordinating the Entities into a Better Framework

The clarification and differentiation of the major roles of the three institutions, including the elimination of any present overlapping need to be emphasised for them to achieve the strength necessitated by the movement. It has already been proposed that the regulatory role would

better under the responsibility of a Co-operative Authority with wider powers and representation of the various stakeholders.

This Authority may be ultimately responsible for a Fund trust run by five trustees appointed by the Authority in agreement with KM. A legal requirement will be imposed, whereby all trust members would be unrelated and independent from any dealings within the co-operative movement and at least three would be professionals with sufficient expertise in commercial banking and, possibly, co-operatives, such as commercial lawyers, accountants and bankers. The Chairman would be chosen by the trust members from amongst these professionals. The Co-operative Authority might also elect an Internal Audit Unit to monitor the approval and usage of the CCF funds. Fund trustees need to have their own executive team working independently from that of the Authority.

On the other hand, as the statutory arm of the co-operative movement, KM would also be statutorily regulated with possible changes to the system of election to council as referred to earlier. It would have its own support unit composed of, say, a lawyer, accountant, and professional consultant/s - such as industrial psychologist and/or other relevant professional. This could provide services to all KM-affiliated co-operatives and their members, while also being open to non-affiliated co-operatives at a charge. Services would typically include feasibility studies for new projects, management, skills and social audits. Hopefully, such changes would contribute to better and more independent monitoring, more operational effectiveness, and meaningful investment appraisals.

Conflicts of Interest within Individual Co-operatives

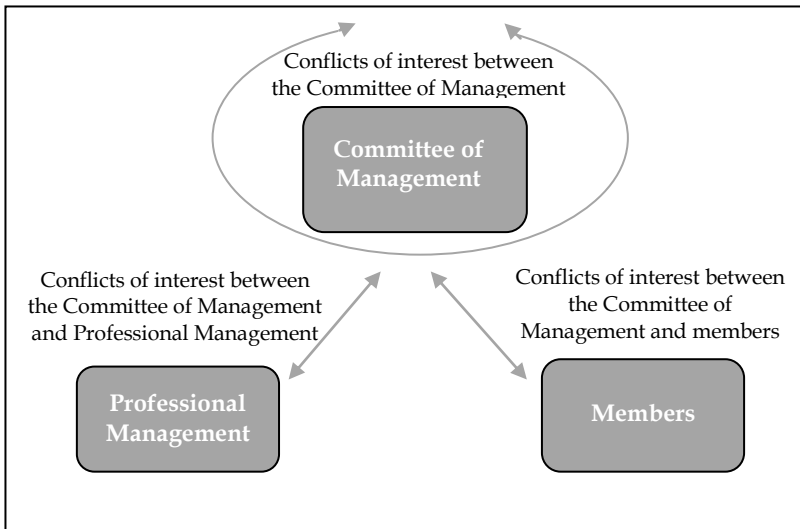
Figure 2 identifies the three areas in which such COIs within individual co-operatives will now be discussed.

Conflicts of Interest within the Committee of Management

The original Co-operative Societies Act 1974 allocated specific managerial roles and authorities to the COM based on the requirement of a two-tier

system of corporate governance with a Supervisory Board responsible for the direction of the co-operative. However, since this Board was made non-mandatory by the CSA 2001, most co-operatives have functioned with a COM only, performing also the function of the higher Board.

Figure 2
Conflicts of Interest within Individual Co-operatives



Given also the common absence of a manager, this committee is also trying to balance the dual responsibilities of providing long term direction and the day-to-day management of the business. This paves the way for possible COIs owing to unclear direction/management roles, at times creating internal conflicts and even squabbles that lead to negative consequences on the finances of the co-operative. The Act needs therefore to be amended to clarify the role of a Committee of Management now performing the function of a mixed Board of Directors. This may lead, for example, to the creation of Audit Committees.

Furthermore, currently, the law does not specify any qualifications required by members to form part of the COM. As membership of the co-operative society is a legal requirement for election to the COM, there is a strong possibility of a skills gap being created with the COM. This may necessitate the employment of a manager to support such skills, which may involve significant costs.

The issue may be tackled in various ways. Compulsory membership of the co-operative for election to the COM in the CSA 2001 may be removed. Furthermore, the appointment of a manager may be made compulsory for co-operatives of a certain size. Finally, regular skill gap analysis may be carried out by the proposed support unit of KM and either specific training given to fill the resulting gaps or co-option to the Committee of one or two professionals could be permitted by law to supplement such committee.

Conflicts of interest between the Committee of Management and Professional Management

Findings indicated that COIs may arise when professional managers take over the management of the co-operative: they may abuse of their discretionary position to give priority to their financial and personal interest. Of course, this is not invariably so: ethical managers may bring innumerable advantages, with better informed decisions in the relevant field, whilst in the process contributing to a better informed and coherent committee.

In most situations, professional managers participate in COMs but have no voting rights. One may consider the possibility of responsabilising such managers by requiring them to form part of the COM, with direct voting rights to exercise in the final decision-making process. In considering the statutory option to dilute the Committee of Management with non-co-operative members such as managers or, as previously suggested, with relevant professionals, the danger of there being too many non-members who may be detached from the interests of members must also be kept in mind. For this reason, the majority of COM seats probably still need to be retained for co-operative members.

Conflicts of interest between the Committee of Management and Members

The principal COI in this area mainly emerged between the short and long-term interests of the members in deciding on fund distribution. The vision of well-intentioned management may focus on securing the continued existence of the co-operative, while members may press for the immediate distribution of surpluses. Energies are thus wasted in directing resources into areas that are not synchronised with the business, management and financial strategies of the co-operative, this having clear negative consequences. In co-operatives, such a conflict is particularly prevalent in view of the statutory ineligibility of members to have prior-year surpluses distributed to them. The removal of this restriction, while controversial, would incentivise members to have co-operative surpluses invested for future growth. Of course other possible solutions may be studied.

Conclusion

Overall, most COI's at all levels are subtle and discreet and the study revealed that they are not being easily identified or handled once they surface. Furthermore, both institutions and co-operatives generally perceive COIs limitedly in situations of direct pecuniary gain and insufficient emphasis is as yet given to other deeper instances which may ultimately have even wider financial and corporate governance implications.

It is also clear that conflicts of interest tend to be a clear symptom of inadequate corporate governance. Mitigating the existence of COIs will help develop the capacity and capability of the governing bodies to be more effective, minimise the substantial negative financial implications associated with them and enable the individual co-operatives to address better stakeholder expectations.

Institutions have an important role to play and their sole mission needs to be directed towards promoting co-operative principles and values. Once such inspirational values are seriously reinforced amongst members, the concern related to COIs will be substantially minimised. Such values

should even inspire others to form part of the co-operative community and, as Antoine de Saint-Exupery (n.d.) stated:

'If you want to build a ship, don't drum up people together to collect wood and don't assign them tasks and work, but rather teach them to long for the endless immensity of the sea.'

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