



# Corporate Governance

The Intersection of Public and Private Reform



Center for International Private Enterprise  
United States Agency for International Development



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FROM THE AMERICAN PEOPLE





*25 years* of strengthening democracy through market-oriented reform

Center for International Private Enterprise

# Corporate Governance

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**The Intersection of Public and Private Reform**



United States Agency for International Development





## **The Center for International Private Enterprise**

(CIPE) strengthens democracy around the globe through private enterprise and market-oriented reform. CIPE is one of the four core institutes of the National Endowment for Democracy. For 25 years, CIPE has worked with business leaders, policymakers, and journalists to build the civic institutions vital to a democratic society. CIPE's key program areas include anti-corruption, advocacy, business associations, corporate governance, democratic governance, access to information, the informal sector and property rights, and women and youth.

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*25 years of strengthening democracy through market-oriented reform*

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# Introduction

## The Linkages between Corporate Governance and Development

Successful development efforts demand a holistic approach, in which various programs and strategies are recognized for their important contributions to progress and prosperity. In this regard, linkages between corporate governance and development are crucial.

Corporate governance is traditionally thought of in the framework of large corporations, shareholders, and broad private sector issues in developed economies and some of the major emerging markets. Many of these issues may seem to bear little relevance to broader development concerns, that deal with day-to-day issues of poverty, job-creation, anti-corruption, education, media, and political reform.

Yet, corporate governance and development are strongly related. Just as good corporate governance contributes to the sustainable development prospects of countries, increased economic sustainability of nations and institutional reforms that come with it provide the necessary basis for improved governance in the public and private sector. Alternatively, corporate governance failures can undermine development efforts by misallocating much needed capital and resources and developmental fallbacks can reinforce weak governance in the private sector and undermine job and wealth creation.

The linkages between corporate governance and development are explored further in this publication. The authors focus on several distinct themes.

They highlight the differences that exist in corporate governance frameworks between developed and developing countries. This helps put corporate governance reforms in the context of institutional change in developing countries, stressing the need for structural changes required for good governance to take root in the private sector.

In addition, they explore in detail fairness, transparency, responsibility, and accountability as the core values of corporate governance and core principles of democracy. This is absolutely crucial to understanding the interplay between public and private governance institutions, which should not be analysed in isolation.

The authors also discuss how good corporate governance contributes to combating corruption, which remains one of the greater threats to development around the world. Simply put, good corporate governance makes bribes harder to give and harder to conceal, and it also contributes to the broader climate of transparency and fair dealing.

These and other issues related to corporate governance, job creation, poverty reduction, and democratic reform are discussed in the pages that follow. Many of the arguments often lead to the point that corporate governance cannot exist in a vacuum – it depends as much on the country's overall institutional development as much as it relies on the internal practices of companies. Therefore, in order to strengthen private sector governance, it is imperative that efforts also focus on the reform of the judicial systems, property rights, freedom of information, and other institutions vital to democratic market economies.



# **From Sustainable Companies to Sustainable Economies**

## **Corporate Governance as a Transformational Development Tool**



**Aleksandr Shkolnikov  
and Andrew Wilson**

**Center for International Private Enterprise**



## **Introduction**

For democracy to deliver, reform efforts must focus on improving economic institutions as well as political structures. Despite some impressive growth figures, many fragile democracies continue to face pressing economic problems such as poverty, infrastructure decay, limited access to basic resources, and lack of private sector jobs. Resolving these issues should be on the top of the agenda for everyone involved in the development community. If these economic issues are left unaddressed, they lead to serious widespread dissatisfaction that undermines the legitimacy of governments and leads to reversals from the course of democratic and market reform. Economic issues, such as energy or food shortages, often have political consequences and solutions.

The economic and political landscape of the world has certainly changed over the past several decades. Building on their recent success, whether from export-driven growth or natural

resources, emerging markets are set to overtake developed countries in terms of overall economic wealth in the coming decades. Much of the attention to growth and development in emerging economies, however, has been confined to BRIC countries – Brazil, Russia, India, and China. Although not without their own set of problems of unequal income distribution and poor social conditions, these four countries have certainly redefined the power nexus and are becoming major players in the global arena.

But, what about the rest of the developing world? What prospects do smaller countries have going forward? As dozens of other emerging markets outside of BRIC continue to struggle to attract investment, create jobs, and achieve functional democratic governance, the need for working approaches to reform remains pressing. How can the rest of the world address the socio-economic challenges that persist despite an unprecedented rise in the number of electoral democracies over the past several decades?

Of course, there is no one source of and no one answer to the many of the issues facing emerging economies today. In countries exhibiting strong macroeconomic growth, it is not uncommon to see the benefits out of reach for the poor because of the unequal distribution of income and opportunity. In countries struggling to break out and reduce poverty through sustainable economic means, much of the economic activity remains trapped in the informal sector, where entrepreneurial survival rather than business growth and development best describes the private sector.

Many of the fragile democracies exhibit governments that are seldom accountable to their citizens beyond elections. In such countries, day-to-day decision-making processes remain opaque, unpredictable, and impenetrable for outsiders, while economic systems are being tailored to benefit the insiders.

Corporate governance is a viable solution to many of these problems. Traditionally, it has been viewed as the domain of large companies in developing economies – something of interest to investors and CEOs. However, as experiences of the past several decades show, corporate governance is much more than

that. It helps to clean up the governance environment, exposing insider relationship and injecting values of transparency and accountability in both private and public transactions. Corporate governance is also an effective means of building up a functional small and medium-sized enterprise sector which can be capable of generating jobs and attracting investment – recognized sustainable solutions to poverty. In all, as good governance in the private sector is inseparable from good governance in the public sector, corporate governance can be viewed as one of the important tools to make democracies deliver for all segments of society. This paper explores these linkages in more detail.

## Key Points

- Corporate governance has a much broader application than improving internal company procedures, important in their own right. Corporate governance encompasses a wide variety of tools that also address the environment within which companies operate – i.e. issues associated with the institutional development of countries.
- In addition to attracting investment, improving competitiveness, and managing risks, corporate governance is fundamental to changing the relationship between business and state in many emerging markets. By injecting transparency into the equation, corporate governance helps to remove cronyism, corporatism, and favoritism, instead facilitating an open exchange between the private sector and government.
- By helping countries to attract investment, facilitating institutional reform, reducing opportunities for corruption, increasing competitiveness, and promoting minority shareholders rights protection, corporate governance helps to build a foundation for economic growth, job creation, and private sector-led poverty alleviation.
- There are two types of drivers of corporate governance reform. One set of drivers is associated with failures and collapses. A more proactive set of drivers has much to do with companies' and countries' search for investment, the need to improve competitiveness, and gaining access to regional and international markets. Both have been responsible for increased attention paid to corporate governance over the past decade.

## Reducing Poverty: The New Global Development Agenda

The eight Millennium Development Goals (MDGs), outlined in the United Nations Millennium Declaration in 2000 and embraced by governments, civil society, international institutions, and the private sector in countries around the world, have fundamentally changed the global perception of development. MDGs have brought poverty and inferior socio-economic conditions to the forefront of the development agenda and created a new vision of the world where people at all levels of society benefit from economic growth.

- Corporate governance is applicable to a wide variety of companies, not just large multinationals listed on major stock exchanges. As a means of introducing transparency, accountability, responsibility, and fairness in company decision-making structures, various corporate governance mechanisms can benefit many different companies – including SMEs and family-owned firms not listed on stock exchanges – seeking to build sustainability and remain competitive.
- In many emerging markets, the emphasis must be placed on the enforcement of the existing corporate governance mechanisms. While developing new tools is important, reformers must pay closer attention to the already existing mechanisms and seek ways to ensure that they are consistently implemented and enforced for all market players.
- Although the debate continues on voluntary versus mandatory systems of corporate governance, reformers must seek to integrate the business community in the process of developing corporate governance mechanisms in either one of the systems. Getting the business community engaged in the process early creates a sense of ownership and provides ample opportunities for valuable feedback and effective implementation.
- Ultimately, the creation of corporate governance value systems combined with the strengthening of basic rights and legal institutions contribute to the development of stable and democratic societies.

Although building consensus on MDGs has been a significant accomplishment in its own right, signatories continue to face much greater challenges in actually achieving these goals – according to some UN studies, progress has not been uniform. Despite increased attention and financial commitments, billions of people still live on less than \$2 a day, and many lack access

## Monterrey Consensus

In March 2002, 50 heads of state, over 200 ministers and leaders from the private sector, civil society, and all the major inter-governmental financial, trade, economic, and monetary organizations participated in the International Conference on Financing for Development in Monterrey, Mexico. The conference adopted the Monterrey Consensus, which maps out a strategy for addressing poverty and other most pressing problems facing countries around the world.

*“Our goal is to eradicate poverty, achieve sustained economic growth, and promote sustainable development as we advance to a fully inclusive and equitable global economic system.”*

### Leading Actions:

- Mobilizing domestic financial resources for development.
- Mobilizing international resources for development: foreign direct investment and other private flows.
- International trade as an engine for development.
- Increasing international financial and technical cooperation for development.
- External debt.
- Addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial, and trading systems in support of development.

Throughout the many initiatives captured within these categories, the Monterrey Consensus outlines how democratic governance and market economies can help to reduce poverty around the world. Focusing on the role of the private sector and economic solutions to poverty, the Monterrey Consensus is a fundamentally important document that captures world leaders' commitment to sustainable poverty reduction strategies.

For more, visit:

[www.un.org/esa/sustdev/documents/Monterrey\\_Consensus.htm](http://www.un.org/esa/sustdev/documents/Monterrey_Consensus.htm)

## Corporate Governance Impact

Corporate governance:

- Brings stability to markets
- Strengthens competitiveness (companies and economies)
- Strengthens institutions
- Improves risk mitigation
- Promotes investment, lowers cost of capital
- Weakens corruption
- Strengthens lending
- Promotes reform of state-owned enterprises
- Promotes successful privatization
- Builds transparent relationships between business and state
- Helps to combat poverty

to the most basic public services taken for granted in developed countries. While MDGs have been successful in drawing the world's attention to these problems, the framework outlined in the UN Millennium Declaration has left the field wide open as to which strategies should be implemented to achieve poverty alleviation and to facilitate the development of more prosperous societies.

Building market economies, unleashing entrepreneurship, strengthening governance, promoting investment, securing property rights, and combating corruption are some of the reform priorities that have been identified as key to reducing poverty and moving countries up the development ladder. The UN's own "Unleashing Entrepreneurship" report and the Monterrey Consensus are just two of the many initiatives that have succinctly captured reform issues that countries must address to reduce poverty. Countries' own institutional deficiencies, however, remain a real barrier to implementing many of these recommendations.

## Values of Corporate Governance

Transparency, responsibility, accountability, and fairness – these four concepts are now widely quoted as the key principles of good corporate governance.

The original definition of corporate governance, outlined above, is built around the concept of accountability. It stems from the belief that owners entrust the managers with running their company and they can hold them accountable for any violations of the contract. Accountability, in that sense, requires the functioning of supporting institutions, both internal and external.

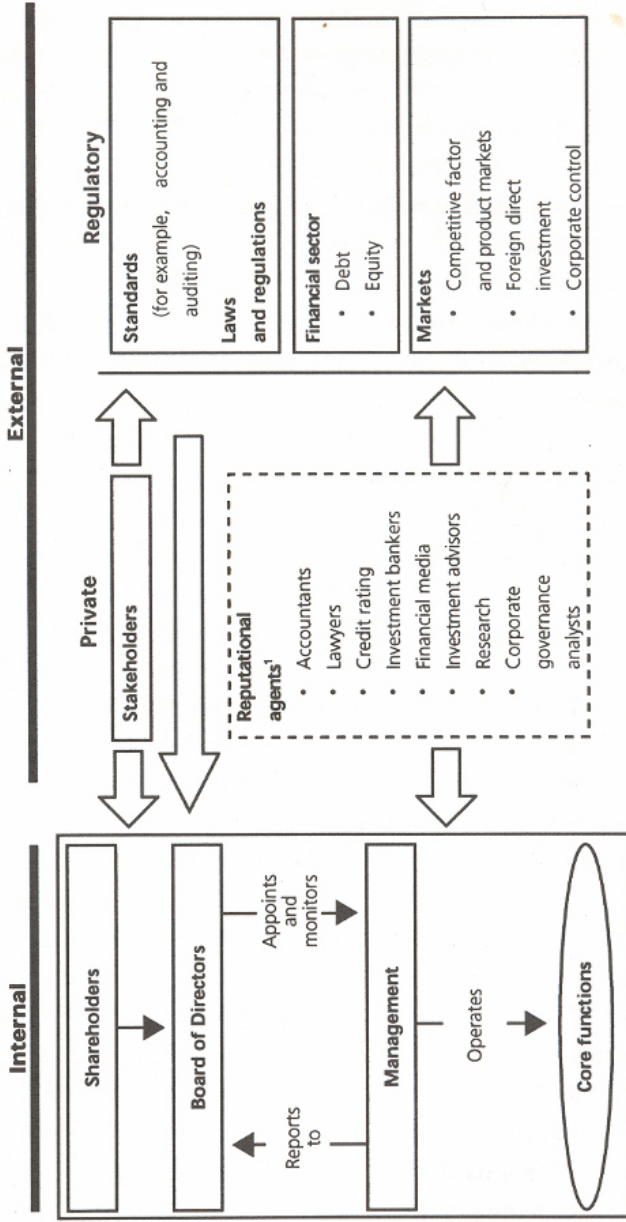
When we speak of transparency in a corporate setting, we focus on the timely and proactive disclosure of financial and other information to shareholders. Such disclosure can be voluntary or mandatory depending on the market and legal environment within which companies operate.

In the corporate governance framework, fairness ensures equitable treatment of minority shareholders, employees, managers, and other agents. Rules and mechanisms of good governance in the private sector seek to eliminate discrimination and establish a clear, predictable environment conducive to long-term investment planning.

The concept of responsibility deals with the integrity of markets and citizen's trust in market institutions and corporations. Responsibility has both internal (owners-managers-employees) and external (business-society) application in the business environment.

Despite notable successes in reducing poverty in some places, we often find that foreign aid does not reach its intended recipients. Corruption continues to rob the poor while anti-corruption programs stall in red tape and bureaucracy. Elites enjoy access to the benefits of trade and investment while regular citizens are left out. Entrepreneurs are forced to operate in the informal sector without access to legal mechanisms to enforce contracts and protect private property. Public funds devoted to building infrastructure and providing public services end up in the pockets of crooked government officials and their cronies. Jobs are not being created to accommodate the burgeoning youth population.

# Mapping a Corporate Governance System



1. *Reputational agents* refer to private sector agents, self-regulating bodies, the media, and civic society that reduce information asymmetry, improve the monitoring of firms, and shed light on opportunistic behavior.

Source: The World Bank

Ultimately, to reduce poverty, reformers must attack the very causes of it – weak institutions that squander resources, undermine fair competition, reward corrupt behavior, and restrict private sector development and job creation. What mechanisms do we have to promote institutional reform? How can we move people up from the bottom of the development pyramid? How can the power of the private sector be best utilized to reduce poverty and improve living standards? These are the questions that countries and the development community continue to answer as the deadline for achieving MDGs quickly approaches.

## **Corporate Governance as a Development Tool**

At a first glance, corporate governance may seem like an odd answer to the questions outlined above. After all, the popular perception of corporate governance is that it is something more applicable to multinational corporations, large stock exchanges, and CEOs rather than average entrepreneurs, SME loans, and job creation. Corporate governance is frequently discussed in the context of complex accounting procedures and disclosure mechanisms and certainly not in the context of poverty alleviation. Yet, a closer look at corporate governance, its broader application, and, most importantly, its institutional underpinnings, underscores its role as an essential component of public governance and private sector development, both of which are recognized poverty alleviation solutions. This paper uncovers some of these linkages.

The conventional view of corporate governance has much to do with separation of ownership and control – issues that arise between owners and managers of corporations. Managers and owners, the theory holds, may have different interests, and fully removed from managing the day-to-day activities of the enterprise, owners need guarantees that managers act in the interest of a company (or its owners) rather than in their own interest. This is where corporate governance comes in – it establishes the mechanisms necessary to ensure proper actions on behalf of managers of a corporation. For example, it helps prevent theft of property or its misuse by management.

## How Does Corporate Governance Affect Development?

- Increased access to external financing by firms, which can lead to greater investment, higher growth, and more employment creation.
- Lower cost of capital and associated higher firm valuation, which makes more investments attractive to investors and leads to growth and employment.
- Better operational performance, through better allocation of resources and better management, which creates wealth.
- Reduced risk of financial crises, a particularly important effect, as financial crises can impose large economic and social costs.
- Better relationships with all stakeholders, which helps improve social and labor relationships and areas such as environmental protection.

*Source: Stijn Claessens "Corporate Governance and Development" Global Corporate Governance Forum Focus I Publication, [www.gcgf.org](http://www.gcgf.org)*

From this simple concept, corporate governance extends into many areas of creating sustainable business. How do boards of directors actually function? What is the role of the board of directors? How do you define the rights of stakeholders? What mechanisms are available to prevent the abuse of minority shareholders' rights? What are the key disclosure mechanisms and which areas of company operations should not be disclosed to the general public?

But such a narrow view of corporate governance – as a tool only useful for large corporations, with many shareholders and powerful managers, listed on stock exchanges in developed countries – is increasingly questioned by reformers and business communities around the world. Weak corporate governance, for example, has been linked to the inability of countries to attract investment, financial collapses, persistent corruption, failures of privatization, weak property rights, and many other development challenges countries around the world face. As such, many economies are warming up to the idea that good corporate governance is essential to their overall health. Companies are

beginning to look at corporate governance as something that can give them a competitive edge. The challenge remains, however, in channeling this increased attention into reforms that actually improve governance practices.

## **What Is Corporate Governance: Defining the Framework**

The broader applicability of corporate governance is captured well in the chart on page 17. This World Bank chart illustrates both internal and external mechanisms that make up an effective corporate governance framework. The traditional structure of corporate governance captured on the left side of the chart addresses conventional issues: the relationship among shareholders and between shareholders and the board of directors, the relationship between the board and managers, board composition procedures, management operation, etc. All these different parts, important in their own right, make up the internal, or governance, function of a corporation.

Within a company, whether publicly-held or not, corporate governance provides directors the tools they need to ensure efficiency, accountability, and sound decision-making. Strengthened reporting requirements demand improved accounting procedures and stronger internal control systems, which in turn provide managers and directors the tools *they* need to control expenditure and gauge revenue. By increasing the transparency, quality, and regularity of financial reporting, managers can be held more accountable for the decisions they make and the performance that results. Poor performance or activities that divert company resources into non-profitable activity can be quickly identified and remedied.

The increased accountability of corporate directors through the duties of care and loyalty required by good governance means that strategic decisions affecting performance and risk are made with greater care and consideration for owners. What duty of care and duty of loyalty mean is that directors should make best-informed decisions in the interest of a company. As seen in recent years, the markets, shareholders, and regulators have increased their scrutiny of director performance, creating demand for qualified directors and institutions that can provide them with training, information, and networking opportunities.

Boards themselves are becoming more sophisticated in the way they control risk factors with independent audit and executive compensation committees becoming commonplace, and board composition increasingly turning to the appointment of independent directors to ensure transparency and accountable decision-making. In many emerging markets, however, the integrity of independent directors often comes into question, as their decisions may still be influenced by dominant shareholders. Yet, these newly effective boards drive internal reforms that enhance efficiency, control risk, and represent shareholder interests more fairly.

Much more important for developing countries, although it has been long unrecognized as such, is the right side of the chart that captures the external mechanisms that help complete the corporate governance framework. Broadly speaking, both the private side and regulatory side make up what can be called an institutional framework where corporate governance is implemented. Just as this institutional framework affects corporate governance mechanisms and its enforcement, at the same time, it is itself influenced by corporate governance.

This circular relationship between internal company practices and the institutional environment in which companies operate has not always been recognized. In trying to strengthen corporate governance in emerging markets, many efforts in the past focused on the left side of the chart – building up internal company practices. However, as it has become evident over the last decade, internal company practices are inseparable from the environment in which these companies operate. While institutions in developed economies may be established or functional, they are weak. In some emerging markets seeking to improve governance within the private sector, institutions are missing altogether. Addressing these institutional deficiencies along with internal company practices is crucial to the success of corporate governance reforms.

How does this relationship between institutions and intra-company governance mechanisms work? How does corporate governance strengthen institutions?

Corporate governance regulation and enforcement relies on the development of an inter-related web of public and private institutions, regulations and rights that underpin the four basic values of corporate governance – transparency, accountability, fairness, and responsibility. Without the guarantee of these institutions, the market-building benefits of good internal corporate governance become tenuous. However, if functioning well, their benefits have far-reaching impact, increasing investor confidence and providing business the legal basis needed to take risk and to grow.

At its most basic level, a well-developed corporate governance system ensures the rule of law is applied to all companies and that the property rights of shareholders, and the broader rights of other stakeholders (lenders, suppliers, and employees, etc.) are defined and protected. The foundation of these protections is a well-functioning court system capable of adjudicating commercial law as well as exercising true independence in the protection of property rights.

Building on this foundation are a variety of public and private institutions that define corporate governance practice and enforce its implementation. Stock exchanges, through their listing requirements, and securities markets, with regulators and enforcement actions, form the front line of external control. These institutions also guarantee property rights through providing share owners an efficient exit mechanism from ownership, an important element in attracting investment.

This frontline is backed by a group of secondary private institutions such as shareholder rights organizations, corporate governance institutes, and directors' associations, which help build the infrastructure for advocacy, professional standards, and self-regulation. These organizations not only serve to build skills, but are the breeding grounds for new values systems that can help transform corporate behavior and performance.

Ultimately, the creation of these value systems, combined with the strengthening of basic rights and legal institutions, contribute to the development of stable and democratic societies. Good corporate governance requires sound public governance,

viable civil society, and an active and independent media which can monitor boardroom actions. By extension, it requires good corporate citizenship on behalf of companies who must respond to the broader concerns of their stakeholder community, and operate in a responsible and transparent fashion. Moreover, the same values described above – transparency, accountability, responsibility, and fairness – also underpin democracies, and by strengthening corporate governance one also provides tools to make democracies work.

For countries where the institutions described above do not exist or are weak, corporate governance provides an avenue for bringing institutional reform issues to the forefront and to begin addressing them. It should be noted that even in systems that possess weak external institutions, strong internal corporate governance provides value for companies and is worth pursuing as an end in itself. Academic research has indicated that investors in high-risk emerging markets with poor public governance, will pay a higher premium to invest in well-governed companies that offer improved financial information as well as better protection for minority shareholders.

## **Corporate Governance Application in Emerging Markets**

As noted above, corporate governance is applicable to all companies, not just large multinationals. The principal-agent problem, which lies at the core of governance issues, is present not only in large corporations (managers acting or not acting in the interest of shareholders) – it is also present in any type of a business entity where owners are not the ones managing an enterprise. Simply put, corporate governance can help to ensure that agents (managers) act in the best interest of principals (owners) regardless of the size of the company.

### **Family firms**

Corporate governance is also applicable to family firms, which are prevalent in Asia and the Middle East and North Africa, as well as in Latin America. While family firms are not traditionally associated with the conventional model of governance failures as owners and managers are one and the same, governance issues in family firms are proving to be of

major concern in issues of attracting investment and ensuring sustainability in the second and third generation of owners. For example, without clarified rules for management and decision-making, how can you resolve disputes among different owners

## **Benefits of good corporate governance in family-owned firms**

- Increased professionalization in company management.
- Higher degree of formalization of the work processes.
- Improvement of the decision-making process of top management.
- Clearer separation of roles between representatives of the ownership (directors) and of management (chief executive officer and other executives).
- Better management of the risks associated with the investment and improvement of internal controls.
- Increased ability to attract and retain talented personnel.
- Admission of independent board members and their active participation in committees.
- Better criteria for the evaluation of performance and for a system of compensation for executives (establishment of measurement of added value).
- Development of better accounting practices and managerial instruments.
- Better perception of the corporate roles by the investors.
- Increased access to capital.
- Increase in liquidity and volume of shares traded.
- Possibility of wider diversification of assets by the controlling shareholders.
- Greater precision in share-pricing.
- Increase in the number of international issuances for the raising of funds, mostly through debt securities.

*Source: Brazilian Institute of Corporate Governance (IBGC) "Corporate Governance in Family-controlled Companies: Outstanding Cases in Brazil." The findings are part of the study of corporate governance practices of 15 largest family-owned firms in Brazil.*

in the second and third generations, when their numbers can multiply significantly? How can you assure investors that mechanisms are in place to ensure that their funds are spent

## Governance risks in family-owned firms

- Imbalance between the growth of the company's profitability and family growth: the geometric increase of family size and the family's needs in relation to the company may compromise growth and investment in projects that are crucial for the long-term success of the organization.
- Transition between generations and succession plan: the replacement of leadership and the entry of new generations into family-controlled companies is a critical moment, creating situations which may generate internal conflicts and a decrease in management quality.
- Separation of interests between company and family: the discussion of family affairs in the company (and vice versa) and the lack of criteria in the separation between family and corporate assets may be harmful to the organization.
- Maintenance of professionalism under certain situations: long-term family dynamics (personal relationships and the emotional history involved) could influence business-related decisions. Additionally, it may be harder to exercise authority and market practices among relatives.
- Nepotism: the automatic promotion of an individual based on family relationships may undermine meritocracy in the work environment, causing the flight of talented personnel and an increase in personal rivalry between members of top management.
- Rivalry between generations and siblings: the coexistence of different generations in the same company may bring about disputes for self-assertion and power. Additionally, an attempt on the part of different partners to promote their respective family-branch or the influence of in-laws, coming into play as time goes by, may have negative impacts on the company.

*Source: Brazilian Institute of Corporate Governance (IBGC) "Corporate Governance in Family-controlled Companies: Outstanding Cases in Brazil." The findings are part of the study of corporate governance practices of 15 largest family-owned firms in Brazil.*

efficiently on the needs of a company and not on the personal needs of the family-owner? Studies have shown that better governance standards do improve sustainability and financial performance of family firms over time.

### **State-Owned enterprises**

Corporate governance is also important for state-owned enterprises (SOEs). Not only do good governance practices increase productivity in and competitiveness of SOEs, they also help to ensure that public funds invested in these enterprises are not mismanaged and are spent effectively. By creating more transparent and economically viable SOEs, corporate governance also helps to ensure that services are actually delivered to the public. Further, as state enterprises often provide a bulk of employment in some emerging markets and a variety of essential public services, good governance helps to prevent failures with devastating social impact. In many countries, corporate governance has been used as a means of not only improving the efficiency of SOEs, but also as a mechanism to improve their attractiveness to investors, thus increasing state income from privatization.

In many developing countries, state-owned enterprises make up a disproportionate segment of the economy and suffer from a myriad of management and performance issues that limit their effectiveness and the role they are expected to play in generating growth. Often, these enterprises are found in “strategic sectors” such as infrastructure or trade, where their inefficiencies limit the private sector’s ability to contribute to economic development. Working with unclear strategies and multiple lines of accountability, manager decision-making within SOEs becomes hostage to politics and conflicting bureaucratic interests, resulting in a situation where multiple agencies and ministries vie to influence SOE management while ultimate accountability for decision-making is non-existent. By their non-transparent nature, SOEs are often plagued by political patronage, corruption, and waste, which limits their ability to modernize and build responsive and efficient programs of work.

## CIPE Strategy for Corporate Governance Reform

### *Initial Assessment*

- Assess corporate governance failures, challenges, opportunities, etc.
- Rate country standards vs. international best practices
- OECD principles/guidelines and local realities

### *Outreach and Education*

- Identify stakeholders
- Build awareness: business leaders, policymakers, society
- Create broader public demand for reform
- Public education campaigns

### *Develop and Institute Corporate Governance Mechanisms*

- Develop corporate governance codes and internal control mechanisms
- Foster shareholder activism
- Improve regulatory and enforcement frameworks
- Create corporate governance networks including regulatory bodies, business leaders and organizations, and other civil society groups

### *Capacity-Building, Enforcement, and Follow-up*

- Training and certification programs for managers and directors
- Establishment of Institutes of Directors
- Create corporate governance ratings systems for investors
- Training for financial intermediaries
- Broader legal and institutional enforcement: ex. judicial systems

Corporate governance in the SOE sector focuses first and foremost on making the state an effective owner, by establishing clear and simple lines of political and social accountability, improving board selection and quality, and contributing to the development of clear corporate strategies that reward efficiency and professionalism. By improving transparency, internal controls, and reporting, corporate governance practices reduce corruption and self-dealing.

By introducing good governance values to the state-owned sector, corporate governance creates clear lines of accountability that directs the state's ownership role through a single state ownership bureau that translates the political and social demands of state ownership to a qualified board of directors. In turn, this independent board translates policy into strategic decision-making that guides management responsible for implementation.

Lines of accountability for SOEs thus become clearer and easier to track to their policy roots in government and ultimately to the voter, who makes the ultimate performance determination during elections. By using corporate governance to strengthen lines of accountability and performance, companies not only improve governance – they also improve incentives for democracy to function.

### **Small and medium-sized enterprises (SMEs) and the financial sector**

Within the framework of economic development, access to credit is often cited as one of the biggest challenges facing private enterprise, especially in economies where capital markets are underdeveloped and banks serve as a key source of capital for growing businesses. However, local banks often are a poor source of affordable credit, and they themselves can be sources of economic risk, as was evident during the Russian financial crisis of 1998. Insider lending, often leading to default, is a major source of risk in many emerging markets where weak legal frameworks and poor central bank oversight allow bad loans to be made. When this is combined with a business community where poor governance practices at the company level serve to hide the true financial condition of loan recipients, risk levels often drive interest rates to unattainable levels.

As such, in many emerging markets, corporate governance has the potential of being an effective risk mitigation tool in the financial sector. U.S. Federal Reserve Basel II guidelines, for example, have pushed for more responsible behavior from banks to increase preparedness for failures and to ensure proper evaluation of risks. Yet, the same guidelines fall short of identifying the mechanisms for achieving these goals. Corporate governance, in this regard, fills the void and can be viewed as

an effective tool to strengthen bank stability and profitability and, more importantly, it can be used to successfully evaluate the risk of failure in making loan decisions.

By requiring better financial information from companies before making loans, banks can encourage the adoption of sound accounting systems and regular reporting even in economies dominated by family-owned and closely-held companies. In this light, the banking sector can promote good governance in economies where companies do not naturally rely on stock exchanges to raise capital.

In addition, corporate governance plays an important role in state-owned or state-dominated banks by helping to ensure that economic decision-making trumps political considerations in extending loans. This process works similarly as described above for SMEs – more transparency and accountability in board composition, decision-making, and disclosure forces banks to put economic considerations above political favors.

Within banks, improved board governance starts through greater transparency in loan decision-making, wherein directors and related parties must disclose lending relationships. In other words, high-risk insider lending can be contained through duty of care and loyalty. Extending the concept of risk management through board guidance and better supervision of management lending practices, potential loss-making and insider lending can be curtailed, thus improving overall loan performance and reducing the cost of credit.

As a result, corporate governance promoted within and through the banking system can contribute to economic stability through better bank oversight, as well as improve risk management and drive down the cost of capital – thereby generating growth.

## **Transforming Business-State Relations**

Corporate governance plays an important role in transforming business and state relations. As financial crises in Asia and Russia have shown, a murky relationship between government officials and private sector companies can undermine the economy and

lead to economic collapse. The lack of transparency in business-state interactions often leads to preferential legal and regulatory treatment, asset stripping, wasting resources, and corruption that undermines the competitiveness of national economies while benefiting a few insiders. Corporate governance helps to address these problems and is an effective solution to corporatism, cronyism, and favoritism.

Privatization is a good example of the corporate governance solution. Within SOEs scheduled for privatization introducing good corporate governance can play an important role in preparing companies for the new challenges brought about by private ownership.

When examining the legacy of privatization in transition economies during the 1990s, much of the corruption, shareholder abuse, and self-dealing that resulted can be directly tied to the failure of the state to establish and require effective governance mechanisms within privatizing firms. Asset stripping, share dilution, and the “tunneling” of capital by the owner/managers were features of the “wild west capitalism” that afflicted many former communist economies and did much to discredit early popular notions of capitalism and democracy. Corporate governance, therefore, has a crucial role to play not only in readying firms for privatization, but in preventing the potential market mayhem that can occur when firms privatize without effective internal controls, reporting mechanisms, and shareholder protections.

Instituting sound internal corporate governance measures into state-owned firms prior to privatization is crucial to ensuring a smooth transition to private ownership both prior to and after the privatization process. Good internal accounting and controls contribute to effective evaluation and can enhance value by reducing investor costs associated with transitioning accounting practices and building internal control systems. Establishing a model of board governance and management accountability prior to privatization also facilitates a smooth transition to private ownership/governance models.

In cases of voucher or IPO forms of privatization, good corporate governance is important in balancing shareholder

expectations and rights with the needs of majority owners seeking to restructure and reorganize firms. Additionally, improved transparency and good board/stakeholder relations help negotiate conflicts that may occur as a result of these efforts. The values of fairness, accountability, responsibility, and trust that are hallmarks of good corporate governance are central to developing privatization models that ensure value, ease the privatization transaction, protect stakeholder and shareholder interests, and allow for more efficient post-privatization restructuring.

## **Corporate Governance as an Anti-corruption Tool**

No longer silently accepted or regarded as a taboo subject in many developing countries, corruption has emerged as one of the bigger barriers to democratic development and economic growth. Linkages between high corruption levels and bad governance, as well as higher poverty, higher inequality, and poor public services are rarely questioned. In all, from a political perspective, corruption destabilizes political institutions and leads citizens to question the legitimacy of democratic institutions marred by bribery and extortion.

From an economic perspective, corruption leads to lower investment levels, a larger informal sector, higher costs of doing business, and uncertainty in contracting.

Consider the typical corruption dilemma from the private sector viewpoint – although corruption is bad for business, individual companies that engage in corruption receive a short-term advantage. Taking into the account the damaging effects of corruption on the overall economic health of an economy, the question becomes, “How do you set up a system that makes it hard for companies to engage in corruption, even if corruption seems desirable for those individual companies?” The issue becomes solving a collective action problem – shaping incentive structures in a way that the private sector commits to responsible business practices, exposes corrupt behavior, and does not allow corruption to become part of doing business.

The reforms to do this can come from many different directions. On the government side, there can be checks and

balances systems, reform procurement codes, the implementation of independent audits, legal reform, the simplification of tax codes, using e-government systems, and concentrating on enforcement of existing rules and regulations. Yet, there are reforms we can also implement on the part of the private sector, limiting, as outlined above, its ability to engage in corruption.

One such reform is corporate governance. Consistent with the view of corruption outlined above, corporate governance reduces the number of corruption opportunities by making bribery harder to conceal, positioning it not only as an immoral but also illegal behavior with personal costs to those who provide bribes, and outlining internal penalties for violation. Effective corporate governance means that transparency values are present, investors receive timely and relevant information, decision-making is not done behind closed doors, decision-makers are held accountable for their actions, and managers act in the interest of a company – not their personal interests. The bottom line is that effective corporate governance makes it hard for companies to provide bribes or other company resources to government officials in exchange for services.

As a corruption-fighting tool, corporate governance reduces the scope for corporate employees and directors to engage in self-dealing and or corrupt practices with public and private counterparts on a number of levels. On the level of values, corporate governance's focus on a director's duty of care and loyalty rule out self-dealing and provide sanctions for directors who place their own personal interest and gain above those of the company. On a more practical level, tightened internal controls and financial reporting allow managers and directors to ensure that transactions with suppliers and vendors, as well as dealings with government officials, remain above board and free of corruption and self-dealing.

The role of the independent director as prescribed by good governance standards also reduces the probability of self-dealing through peer scrutiny. This can be reinforced through independent director participation in the board audit committee, which provides an independent guarantee of an audit's credibility.

One example is the Business Principles for Countering Bribery (BPCB) developed by Transparency International with the help of business leaders and non-governmental organizations. The principles address political and philanthropic contributions, gifts, hospitality, and even facilitation payments, the topic that has generated some heated debates in regards to corruption. Implementing the principles requires that boards of directors take formal responsibility for their actions, effective whistle-blowing channels exist, internal control measures are embedded in decision-making, formal accounting procedures set up that check for bribery, and there is internal communication and training.

## **Conclusion**

The broader view of corporate governance, as a set of mechanisms that deals with institutional reform and not just company-level changes, suggests that it is one of the integral components of successful development strategies. Corporate governance is fundamentally central to building competitive economies, reducing the private sector side of corruption, promoting property rights, and creating jobs and wealth – all of which are components of successful poverty alleviation efforts. The development community must take a closer look at how corporate governance can be used as a tool to improve public governance and promote democratic and market-oriented reforms.

Ultimately, however, efforts to promote corporate governance must take into account the drivers of reforms – both positive and negative. On the negative side, drivers of corporate governance are most frequently associated with financial failures and corporate scandals.

This set of drivers suggests a reactive approach to corporate governance reform. A more proactive approach is associated with positive drivers, which include search of investment, increased competitiveness, and efforts to combat corruption. Seen in this light, corporate governance can be used as a tool to spur broad-based reforms in the areas of investment and company laws,

property rights protection, enforcement mechanisms, accounting and tax laws, judicial reform, and others.

While the international community has many different corporate governance tools ready for implementation, reformers must avoid the temptation of copying successful initiatives from elsewhere. Successful institutional reforms require building local capacity and commitment to reform efforts, not transferring policies from one set of books to another. Seeking access to capital and entry into global markets, the private sector in many emerging markets can become a true leader in corporate governance reform, allowing the benefits of transparency, responsibility, fairness, and accountability to spread across society and help millions to escape poverty.



# Getting Emerging Economies Up To Standard

**Philip Armstrong**  
Global Corporate Governance Forum



In emerging economies, guaranteeing investor confidence and encouraging private sector growth are no small tasks. Structural and political obstacles impede emerging economies' ability to codify transparent business practices. Corporate governance, if implemented carefully and correctly, can expand confidence in the private sector while promoting local and foreign investment.

## Emerging Versus Developed Economies

There are many differences in corporate governance issues between developed and emerging economies, foremost of which is the issue of structure. Many emerging economies have state-owned or state-controlled commercial enterprises that dominate the economy and therefore have a significant effect on attracting investment, financing growth, and establishing reliable business practices in a developing country.

Most developed markets do not exhibit such significant levels of state ownership and control. Capital markets are well-established in developed economies, including a set of active

investors, a well-informed media, and properly run pension funds that fulfill their fiduciary role. Developed markets tend to interpose on governance issues from different perspectives, giving the idea and implementation of corporate governance greater weight in comparison to emerging economies. Developing countries, in contrast, may have governance rules in place, but enforcement is inconsistent and selective, with the degree of adoption dependent on the dominant business or political interest in the country. The unreliable enforcement of corporate governance standards, compounded by a lack of external actors influencing governance, creates the perception that corporate governance is part of an arbitrary process in emerging economies – fueling the notion that corporate governance is negotiable.

Due to this sense of negotiability, emerging economies face tremendous challenges in prosecuting corporate malfeasance – the judiciary is usually ill-equipped to handle corporate and commercial terms and standards. Even in developed markets, prosecution can be a difficult process. For example, in the United States it took six years to get to the point where the Enron case could be effectively prosecuted. In developing markets, however, the same process can stretch 20 to 25 years, which represents a major commitment of public resources, while corruption may continue to impose costs on a country and its citizens.

## **Building Confidence In Local Investment**

Developing countries need not forego good governance because they have weak institutions, they can overcome these difficulties by cultivating a trustworthy atmosphere for local investment. Governance can reflect the general integrity of society, encompassing how people behave towards each other, how they respect contracts, and how they respect the quality of services rendered for payments received. With its emphasis on fairness and equality, this concept directly links to democracy and in turn bolsters economic development. The process of establishing and building companies, and internalizing fair business practices, has as much to do with attracting investment and financing growth, as with dealing with the interests and equitable treatment of shareholders. People are more willing to place money at risk in a market sustained by governance and investment security.

While investment requires more than just good governance, the way governments manage resources influences investment. Especially in emerging economies the goal is to attract and retain local investors, and at the same time to prevent capital flight. Corporate governance helps people determine how much they trust the places they put their money. While adding a component of governance (public or corporate) to the business environment encourages foreign investment flows, governance is primarily about encouraging internal growth from internal resources – although foreign and domestic investors tend to desire stability and predictability, no matter the country of origin.

## **South Africa Success Story**

South Africa has set a good example for implementing corporate governance codes in developing markets – though its successes may not be easily replicable. Corporate governance in South Africa emerged and developed at the intersection of politics, business, and political transformation. The private sector took on an important role in South Africa’s political transformation by changing its own structures, from the boardroom to management to human talent and capital.

State-owned corporations (SOEs) were at the epicenter of this transformation because of their positive public reputation. State-owned corporations in South Africa have maintained a social dividend. They responsibly and productively provide services to consumers and effectively utilize tax-payer dollars. Sound, yet transparent political relationships are important at this level and during the transformation SOEs achieved political and social objectives through economic delivery. Their business practices had to be seen as part of the solution instead of the problem in this political transformation. Many South African businesses, for example, have volunteered to actively engage with politicians trying to understand private and public sector objectives and challenges.

One of these challenges, for both public and private entities, is the HIV and AIDS epidemic, an issue that directly affects corporate governance in South Africa. While companies invest in their human capital, that capital is diminished by HIV and AIDS. The epidemic affects firm-financed health systems, impacts

pension planning and reflects poorly on boards of directors. South African companies must continue their innovative cross-sector approach to address these challenges as part of their good governance and economic sustainability efforts.

## **What Does Corporate Governance Mean For Companies?**

Companies in emerging markets may generally view corporate governance as a good business decision and recognize its value, but sometimes for the wrong reasons. They see it as something that can decrease inherent business, such as investment risk, and can build trust by building credibility in historically well-governed markets.

Yet, corporate governance should be implemented and viewed as part of day-to-day operations, synchronized with how the business is conceived and strategically oriented. Corporate governance is not just a compliance issue, such as an audit, a misconception that has compromised its importance. Its value is also challenged by the rush of new government standards and regulations.

Amidst so many standards and ideals, some feel that businesses have lost sight of what governance was about in the beginning: introducing exemplary practices and behavior in the board room that take a company beyond the minimum legal requirements. Corporate governance should be a tool for boards to measure performance and effectiveness of their operations, providing a transparent way to report results to shareholders.

In some cases, corporate governance has mutated into a checklist of ideals that companies either embrace or reject. In these situations, corporate governance becomes alienated from the global context, rendering it practically irrelevant. Multinational corporations (MNCs) use corporate governance as a type of risk management by which they protect themselves from exposure in harsh business environments. In developed markets, the compliance approach to corporate governance has worked for MNCs because active investors and a well-informed media keep track of companies' performance and hold them accountable. By contrast, emerging markets lack these external checks, leaving governance to be more integrated into business

strategy as a way to establish and distinguish credibility, and to raise capital or take on debt to finance growth. Since capital and debt flow from developed markets that are sensitive to risky investments in emerging markets, building credibility becomes vital to fostering investment.

Though global context is vital, companies must keep in mind that if corporate governance is implemented simply to address certain external standards and obligations, the approach comes from the wrong angle. Corporate governance should be implemented because of its continuous constructive and substantive benefits to a company, including a more positive public image.

## **Consistency and Ethics in Corporate Governance**

There are important linkages between the institutional environment, governance capabilities, corporate governance promotion, and compliance. Successful corporate governance entails effective and consistent enforcement of regulations and discipline in observing laws and internal regulations. There must also be a rapid, fair, and effective punitive system in place, with the ability to make decisions public and reasonably discernable to those without legal expertise – in partnership with independent media.

On the institutional side, there must be supporting structures to guide companies in corporate governance and to mitigate any situations where regulators and companies are pitted against each other. Auditors, chambers of commerce, institutes of directors, the media, employees at every level of the company and investors serve as important voices in the decision-making process concerning governance.

Regulators in emerging markets feel helpless without a balanced external legal framework. Laws are difficult to enact and enforce because of tedious legislative processes. Even worse are nominally voluntary codes of governance that cause resentment and conflict between businesses and regulators because they are in fact disguised mandatory instruments to force businesses to act in certain ways. This disingenuous policy sours the environment for future compliance to truly voluntary

and higher standards of governance. Companies that resent regulators and shun existing laws will probably not follow future laws based on past experiences. In this context, the ideals of corporate governance become negotiable once more.

The basic principles of governance highlight their role as a tool to combat corruption. The board, appointed by shareholders, should establish standards, policies, and control systems to uphold ethical practices at all levels of business. While cultures and business environments differ from market to market, standards should be the same, and should be mandatory. Ethics are not a negotiable part of business. Choices and negotiations in standards affect the quality of work and success of the company. Board directors and managers are responsible for upholding the quality of services and products and have responsibilities to maintain and grow the assets of the business, and are held accountable when standards are compromised.

## **The Transition to Responsible Corporate Governance**

As developing markets reform their systems of corporate governance, they must take into account several factors complicating the process. One nuance is the dichotomy of corporate governance and political governance, exemplified by state-owned enterprises. These publicly-owned businesses are run with certain characteristics of the private sector model, but political influence is expected, and often unconstructive. State-owned enterprises are usually structured to deliver a product or service to society, a commitment that is illustrated by board conduct. During privatization there is an intermediate step of corporatization that can weaken a state-owned enterprise. The best way to prepare for the privatization process is by implementing sound corporate governance practices before the process begins. In developed markets, privatized firms can survive far better than in emerging markets, where privatized companies in distress will likely flounder.

Corporate governance codes must also be adaptable to the business environment where they work. For example, codes have been adapted to fit the dynamics of family-owned firms so that in emerging economies, where family-owned firms are likely to be in their first or second generation, families know best how

to adapt standards of governance to accommodate the fact that all the firm's actors are related. In Africa, society tends to see firms as having a greater role within the community than merely the production of profits for shareholders, creating tension and sensitivity around the issue of corporate citizenship and leaving the development of corporate governance at a standstill.

## **Current Trends and Future Considerations**

While developed markets cultivate more sophisticated systems of governance, emerging market leaders focus merely on improving current systems. There is concern that auditing firms (and their comprising mergers) and corporate collapses in developed markets have negatively affected emerging markets. Debates over U.S. and British systems of governance also impact regulation design in emerging markets.

Lately, there has also been interest in moving back to state-owned enterprises implementing corporate governance, reprising the issue of political governance. Another consideration concerns interested investors – are they more active at home or in emerging markets? And do they exhibit consistency in their behavior in both locations? As institutions increasingly invest around the world, cross-border voting issues become more important as leaders wait to see which international regulatory systems will survive.

Confidence and consistency in implementing policies of corporate governance should triumph at any level. The public and private sectors must work together to ensure that policies are non-negotiable, trustworthy, streamlined, and effective processes and that corporate governance creates a constructive environment for investment and growth.



# Corporate Governance: The Russian Experience and Beyond

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## Internal Operation of Companies: The Russian Experience

The major difference between corporate governance in emerging versus developed economies is ownership. In emerging economies ownership is usually concentrated in the hands of company founders who retain great control over their firms, even when the firms become public. While founders play a primary role in decision-making, regardless of their formal status, the boards of these companies serve in an advisory capacity instead of a controlling one. These boards approve only major transactions, deal with legal issues, and relations with external parties. It is the controlling shareholders and company founders who decide on strategic issues in emerging economies. A silent agreement exists between the board and controlling shareholders to maintain the status quo.

As a result, independent directors in emerging economies usually are not a majority of the board. Additionally, unlike

developed economies where, at a minimum the board members have the authority to appoint the CEO with full rights to take over, in an emerging economy like Russia, controlling shareholders have the ultimate power. CEOs have to manipulate rules and relationships to have any amount of authority to lead the company in the right direction. There is widespread opinion that founders, as the owners of the companies, bear the main risks and therefore have the right to make the final decision.

There are some occasions of controlling shareholders abusing their authority. However, they usually realize that it is not in their best interest to abuse their power. These abuses should be evaluated according to the standard of internationally accepted best corporate governance practices. One power-abusing controlling stakeholder does not necessarily imply that his firm poses a higher risk to investors than other firms.

The ownership structure of Russian companies represents yet another difference between emerging and developed economies. In emerging economies, there is usually one controlling shareholder, several groups of minority shareholders, and a concentration of minority holdings. The controlling shareholder usually holds 52 to 55 percent of the company, while shareholders of investment funds usually hold another 20 to 25 percent. Thus, shareholders representing up to 80 percent of a company's outstanding shares are either the owners of the stock or have permanent authority to represent their interests. The remaining shares are in the hands of anonymous small retail investors. As a result of the ownership share concentration, decision-making often breaches any understanding between the controlling shareholder and various investment funds.

As in many developed economies, board members who represent special interests sit on company boards in emerging economies. However in Russia, unlike developed economies, it takes very little authority to nominate someone to the board. If one member has enough votes, he or she can elect anyone to the board without consulting existing board members. Therefore, minority shareholders often conflict with controlling shareholders over boards, board members, and other issues wrought by myopia, a lack of legitimate business strategies for small holders, and out-of-control selfishness.

## Implementing Good Governance

Countries with poor or no corporate governance standards in place have multiple ways to establish them. Although pressure from investors is becoming more important in the push for governance standards, government authorities remain the driving force in corporate governance improvement.

Portfolio investors introduced corporate governance to Russia when they pressed foreign companies operating in the country to go beyond simple corporate law. They succeeded in persuading only with the largest companies to adapt to international best practices. Since their investments were merely speculative, their interest in promoting corporate governance was short-term.

With time, Russian companies decided to form their own standards of governance, hoping to improve their initial public offering or to raise capital from international investors. Further incentives to develop internal governance came from a growing interest in mergers and acquisitions and by investigations initiated against Russian companies by regulatory authorities abroad. This change led to the perception of corporate governance as a tool to attract investment, rather than improve operations. As a result, internal control and risk management fell under the broad category of management instead of an independent program.

Despite initial perceptions, corporate governance initiatives improved company performance, although data collection in emerging economies is particularly difficult. For example, purchasing goods and services for a company was once subject to many abuses. Strict procedures, standards, and transparency mechanisms could be implemented to fight these abuses and their effectiveness measured. Reports should be made periodically to ensure a business adheres to its own standards in purchasing goods and services. A parent company's oversight of its' subsidiary also needs regular supervision. During the ongoing process of oversight and analysis a parent company can develop more complex strategies for managing subsidiaries, streamline their activities, and reduce abuses by management.

Lastly, risk management is another important aspect of governance that requires the regular attention of directors.

Qualified managers should supervise the monitoring process themselves, which becomes easier as controlling shareholders gradually pull away from management activities.

## **Making Corporate Governance Work**

### **Corporate Governance as a Tool to Fight Corruption**

Corporate governance can be seen as an anti-corruption tool. Through transparency standards in purchasing goods and services, a company can and must avoid paying kickbacks to develop business. Also, companies should be aware that more government involvement in the economy often means more opportunities for corruption. Therefore, a company board should analyze and evaluate contracts between their firms and governmental entities.

To limit corruption, boards should ensure that an internal audit is independent from company executives. In addition, the board should have regular communication with auditors. Those found at fault through internal audit should be dismissed from their positions only with the approval of the board. In addition, shareholders should be duly informed of the benefits of transparency. They should know that the burden of corruption is carried by everybody, regardless of the industry or size of the company. Shareholders also suffer from the corruption of executives, parent companies, and subsidiary companies.

Business associations should be encouraged to make anti-corruption programs a permanent fixture on their agenda and report their anti-corruption efforts regularly. In addition, businesses should report to investors annually on how they have improved their anti-corruption procedures (including specific rules associated with these procedures), how they adhere to them, and how the board monitors the effectiveness of anti-corruption tools.

Finally, more analysis of corporate governance as an anti-corruption tool would be helpful. Even though separate surveys exist on each topic, there is no comprehensive, combined data set comparing a company's implementation of corporate governance practices and its anti-corruption efforts' effectiveness.

## **Transparency Improves National Institutional Environment**

Good corporate governance improves the national institutional environment in many ways. Transparency helps investors to understand a company's performance, the prospective benefits of investment and possible risks. As a result, investment decision-making becomes more effective, efficient, less expensive, and less time-consuming for investors. In addition, transparency helps government regulators identify violations, helping to protect investors. Preliminary analysis of major business decisions shows that corporate governance improves the quality of decision-making.

## **Corporate Governance in State-Owned Companies**

There are still many obstacles to implementing corporate governance within state-owned enterprises. Governmental officials have little incentive to change and no systematic approach to control or monitor performance of the managers they appoint. These government officials, as supervisors and board members, face temptation to accommodate CEOs and top managers at the expense of government interests. To overcome this obstacle, the government should establish a clear program with regard to state-owned enterprises. It has to determine the status of state-owned enterprises, and which should be privatized short-term, middle-term, or long-term. The government program should begin with instituting standards of transparency and reasonable, public selection criteria for government-appointed directors. The promotion of government officials, who work as government-appointed directors, must be linked to their performance against pre-established criteria. Finally, the government should introduce basic components of good corporate governance before the process of privatization begins.

## **Corporate Governance Reform**

For countries looking to initiate corporate governance reform, a few key points come to mind. They must incorporate principles of international corporate governance into national law, which government regulators should be able to enforce. Governments should also develop internal governance control standards and

publicize the evident benefits of internal governance. Lastly, government leaders should encourage the introduction of good corporate governance within the national financial infrastructure and in doing so set an example for companies to improve their corporate governance practices.

An important consideration is that corporate governance is different for family-owned companies. However, regardless of these differences, standards designed for public firms continue to be forced upon family-owned companies. Unfortunately, many international organizations and financial institutions still support the application of these ill-fitting standards. It is crucial to understand that family-owned firms are driven by the spirit of their founders resulting in inherently different organizational structures. If inappropriate standards are imposed upon them, it may stifle their entrepreneurial spirit, and as a result, their entire business.

There are also generational changes and trends in corporate governance that need attention to keep companies competitive. As competition grows and companies become more complex, there is a constant necessity for new business ideas and better risk management. Companies must stay current despite the succession of their founders, and regularly bring new faces to the board. Tangible improvements can be seen at holding shareholders' meetings around Russia, in the dissemination of corporate information to shareholders, and in the transparency of board elections and performance records. However, these positive changes have been spreading very unevenly in Russian business community and are most concentrated in large companies.

The impact of corporate governance has reached beyond individual company performance. There is a great urgency among Russian companies to introduce good corporate governance. This rush to implement new corporate governance standards is caused by the behavior of portfolio investors, the superfluous attitudes of rating agencies, and by the business media. Investors can also demand good corporate governance and encourage its development, through incentive or award systems for further company improvements. Good corporate governance standards are now established and well-recognized as an ideal to which companies aspire.

# Applying Modern Practices in the Latin American Business Community

Andres Bernal



## Introduction

Corporate governance is growing as one of the more important aspects of business conduct and development. The concept helps explain proper business management and governance practices and offers recommendations on the best path towards success within any company's business culture. A recent trend in the corporate governance field is its application to non-listed privately-owned companies, many of which are closely-held entities, such as family enterprises.

In closely-held companies, corporate governance refers to the introduction of professional and transparent practices in business management. Common corporate governance practices include financial and non-financial disclosure to stakeholders, the protection of minority shareholders' rights, and the establishment of effective mechanisms to strengthen management and control of marketplace strategy

From the business view point, corporate governance practices contribute to a company's increased performance and sustainability in two ways. First, through formalization of the decision-making process, so that those inside and outside the

company can determine how decisions are made, who makes them, and who can be held accountable. Second, corporate governance minimizes potential conflicts between various owners via proper planning and communication between key company stakeholders.

Corporate governance is different in its application across the globe and it varies according to the degree of economic development of a country. The differences between corporate governance in developed and emerging economies are often reflected in the ownership structure, level of ownership concentration, the competence of the judicial system, and the development of an entrepreneurial culture in a given country. A great discrepancy exists between the entrepreneurial vision within the business community of a developed country and that of an emerging economy. Additionally, business education plays an important role in addressing corporate governance problems in any economy. Educational programs that share and promote ideas, knowledge, and vision facilitate an efficient dialogue to further develop the surrounding environment for implementing good corporate governance.

### **Real benefits of good corporate governance**

Bavaria, the largest brewery in Colombia, the second largest in South America and the tenth largest in the World, was the biggest private company in Colombia until just a few years ago. Two factors drove the growth and success of this company in the global market: international commercial expansion and new sources of international financing, both were due to improved corporate governance. Bavaria's commitment to self-regulation, helped by the International Finance Corporation as one of its investors, led the company to new levels of growth and efficiency. The company's directors developed a long-term plan for financing, acquisitions and corporate governance. The changes implemented by the company's directors fostered domestic and international investor confidence in the brewery's operations. The investor's confidence led to more favorable lending terms that enabled Bavaria to expand faster, turning the company into a global competitor in the industry. Recently, the brewery merged with SAB Miller in the biggest corporate transaction in the history of the Colombian market.

In this sense, corporate governance is the new international language of business, and often forms the basis for dialogue between companies, lenders, and investors. It does not matter where a company is located – the principles of fairness, transparency, and efficiency should apply to every company all over the world, if growth and sustainability are the main objectives.

## **Corporate Governance as a Tool for Broader Institutional Development**

Somewhat related to the issue of business sustainability, corporate governance can also be an effective anti-corruption tool. Proper corporate governance leads a company to implement more democratic and inclusive principles of corporate decision-making, by which all decisions are focused on creating and preserving value. Having anti-corruption policies is not just politically correct, it is also good business practice for a company interested in long term growth. Good standing in the community is a related benefit. Around the world, more and more importance is given to corporate citizenship. Stakeholders are interested in having business relations with companies that do not involve reputational risks that can also be sustained over time.

Corporate governance also helps to modernize institutional environments. It facilitates the discussion on major issues, such as property rights, by using a technical, pragmatic, and economic approach to decide the issue. In some countries, conversations about ownership, property rights, or state-owned enterprises (SOEs) have become polarized “left-right” political discussions. Under these circumstances, good corporate governance practices can ease the dialogue by removing the issue from the political context and taking a non-partisan approach to settle the matter. As a concept, corporate governance represents transparency, ethics, efficiency, balanced powers, and accountability – regardless of political goals or affiliations. Additionally, corporate governance spawns a dialogue between the government and the private sector, which increases the interaction of various sectors of society and strengthens democracy.

## Corporate Governance in State-Owned Enterprises

For SOEs, the common difficulty in implementing corporate governance is distinguishing between the “owner’s” interests (which are often government interests) and the SOE’s vision and strategy. Governmental interests are often unpredictable and volatile because they depend on elections and political trends. Efforts to implement corporate governance in SOEs must recognize this factor: if there is no true commitment from the government, corporate governance will be very limited. There must be a solid understanding among all involved parties on their roles and their commitment to corporate governance values, especially if an SOE is not going to be privatized entirely. More importantly, there must be a plan in place to address the risks of having new governments that may have different political views on the place and role of SOEs.

Introducing corporate governance invariably adds value to SOEs – therefore corporate governance principles should be implemented before any steps toward privatization are taken. In the case of Ecopetrol, the Colombian petroleum company, good corporate governance practices were instituted before it entered the process of issuing shares to private investors. In order to create a better business environment for investment, Ecopetrol worked with Confecámaras and CIPE on a project to create a corporate governance code in order to consolidate and improve their corporate practices. Three years after implementing the corporate governance code developed under the project, Ecopetrol has decided to go public.

### Corporate governance in state-owned companies

Empresa de Interconexión Eléctrica S.A. (ISA), the company responsible for energy distribution in Colombia, was entirely state-owned until 1998, when it decided to open up its ownership and sell 20 percent of its shares to the public. Privatization was preceded by the implementation of corporate governance practices in order to create trust within the investor community. Now, ISA has more than 120,000 stockholders and has opened new business operations in 10 countries in Latin America.

To implement corporate governance practices in SOEs, governments should start with a public-private understanding that recognizes corporate governance as a competitiveness policy. The role and responsibility of academia and the media are crucial factors. From the beginning, both groups should be engaged in the corporate governance debate. Universities should work to promote an understanding of governance problems at the local level. Every economy has to address different corporate governance problems. For this reason, it is imperative to diagnose and understand local issues rather than simply importing “best practices” from other markets. Meanwhile, the media has to do its part by promoting an entrepreneurial culture, and providing companies and investors with timely and accurate information.

After getting a grasp on local conditions, reformers should develop strategies to resolve specific problems. Some of the drivers of corporate governance – privatization, capital markets, anti-corruption, family business, building capacity, internationalization – represent different ways to achieve implementation, and might also provide useful starting points.

## **Corporate Governance in Family-Owned Businesses**

For family-owned businesses, representing the vast majority of companies in the world, understanding corporate governance is just as important. While the challenges faced by large and small family firms may be very different from those faced by other types of firms, every business entity should have a clear set of rules indicating how a business is governed.

The biggest challenge for a family business is competitiveness. Family businesses are not excluded from or immune to market forces, and will fail if they are not competitive. While some suggest that the biggest challenge for family businesses is succession planning or the family decision-making process, business decisions should be market-oriented and not family-related.

Even in closely held companies, like family businesses, there is a public interest that needs to be protected. Many economic conditions depend on family businesses, especially in emerging economies and the developing world. Corporate governance

## Corporate Governance in Bloom

Wayuu Flowers, which cultivates and exports roses, is a young family business with 15 years of experience working in the competitive Colombian flower export industry. In 2004, CIPE and Confecámaras conducted a project aimed at improving corporate governance within Wayuu Flowers. Three years after the project ended, the company is not only exporting roses to three new international markets, it is also one of the leading companies in the Colombian rose industry. Wayuu implemented governance practices to formalize the relationship between the family-owners and the company, introduced a professional board of directors and implemented a reporting system to keep shareholders well informed of company developments.

is not just made up of laws or regulations – it is a system of values. Consequently, improving business governance in a family business is vital for social and economic progress and balanced growth in many emerging markets around the world.

## Conclusion

In Colombia, there is clear interest in good corporate governance from family businesses and SOEs, as well as from other business entities such as co-operatives and non-profit organizations. The broader impact of

corporate governance in Colombia has been the start of a broad dialogue about the principles of transparency, efficiency, and accountability.

The dialogue has had a positive effect on society as a whole, as the private sector's perspective has been given a more important role. The private sector used to be very critical of the government's problems in relation to corruption, lack of transparency, and inefficiency, but the private sector failed to evaluate itself based on these same criteria.

A public discussion on corporate governance has allowed a general re-thinking of core institutional values strengthening the economy and contributing to further business and institutional development, better conditions for investing, and better social conditions overall.

In order to truly prosper in the developing world and take advantage of the dynamic forces in emerging markets, it has become essential to understand the importance of corporate governance in the public and private sectors as a tool to improve economic growth and to attract investment. Properly implemented corporate governance helps cultivate the growth and transparency that is often the difference between robust development and stifling control.

Currently, the resistance to corporate governance exists only among the world's largest SOEs – which can handle global scrutiny and stunt the economic development of entire countries. For most other companies and business entities, the choice has become clear – reform and adapt, for the benefit of the company, its employees, the nation and the entire global business community.



## Afterword

Chris Pierce



Effective corporate governance establishes a system that guides the relationship between owners, managers, and various stakeholders, clarifying what directors and managers are expected to do and how to do it. Its processes inject transparency into the decision-making process, which is precious to shareholders, potential investors, regulators, customers, suppliers, and any other stakeholders who may be affected by a company's actions.

On a company level, corporate governance is an effective anti-corruption tool, whereby its mechanisms ensure that the whole process of providing corrupt payments or gifts is exposed and, therefore, becomes unsustainable. Corruption is the enemy of efficiency and creates problems beyond legal repercussions and ethical issues by increasing the cost of doing business. For companies to prosper in the national and global marketplace, they must pay greater attention to reducing their own susceptibility to corruption. Corporate governance initiatives introduce mechanisms that reduce corruption, not only on a legal basis, but also in terms of establishing an ethical business culture. In the process of creating sound systems of corporate culture, corruption will become an unacceptable behavior.

Corporate governance must be evaluated not only in terms of rights, but also in terms of responsibilities. Directors, for example, have duties to the company, to the shareholders, to the stakeholders, and to the communities in which their companies operate. The shareholders have a duty to behave responsibly – in relation to their attendance at general meetings, voting, and the use of their influence within the organization.

Developed markets, where shares can be traded quickly and transparently, provide many institutions, such as the increased sophistication and transparency of communication with shareholders. While in developed markets there is a significant volume of information and communication with shareholders, the information available to shareholders in developing markets is often less sophisticated and less voluminous – leading to more opacity. Additionally, companies in developed markets are required through the listing authorities or through government regulation to give information to shareholders – in many developing countries these mechanisms are weak or absent altogether.

On an international level, we should recognize that every emerging market has a unique history and legacy that influences the behavior and attitudes of the private sector. The development of corporate governance standards, processes, and procedures is indisputably linked with the development of democracies in every emerging market and since corporate governance is the catalyst around which the most efficient marrying of capital and entrepreneurial organization can exist, it has become an absolutely crucial element on the development agenda.

In corporate governance, we talk about the four core principals of transparency, accountability, fairness, and responsibility. Democracy is built on these same principles. Democratic principles are value driven and come from within a society, as opposed to being prescriptive regulatory measures imposed upon citizens. We expect politicians to behave in a particular manner in terms of acting in the public's interests, to have appropriate values, and to carry out their duties and obligations in terms of public service. Citizens, as shareholders too, must exercise their rights, intelligence, personal initiative, and responsibility.

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