

# GOVERNANCE

Promoting good corporate governance in development finance institutions



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CG REPORT

## Investing in Good Governance

Investors say they highly value corporate governance. And they put their money where their mouths are.

- Well-governed firms in Korea traded at a premium of 160 percent to poorly governed firms, a study by Korean researchers found.
- An ABN/AMRO study showed that Brazil-based firms with the best corporate governance ratings garnered 2004 P/E ratios that were 20% higher than firms with worst governance ratings.
- A study of Russian firms showed that a worst-to-best improvement in corporate governance predicted an astronomical 700-fold (70,000%) increase in firm value. The study's sample size was small (21 firms), so it's unlikely that such a huge increase would occur in larger, more representative sample. However, the study still demonstrated a correlation between improved corporate governance and firm value.
- A study of S&P 500 firms by Deutsche Bank showed that companies with strong and improving corporate governance outperformed those with poor or deteriorating governance practices by about 19% over a two-year period.
- A Harvard/Wharton study showed that if an investor purchased shares in US firms with the strongest shareholder rights, and sold shares in the ones with the weakest shareholder rights, that investor would have earned abnormal returns of 8.5 percent per year.
- In 2002 Mackinsey survey, institutional investors said they would pay premiums to own well-governed companies. Premium averaged:
  - 30% in Eastern Europe and Africa
  - 22% in Asia and Latin America

Source: www.ifc.org

**"It is not possible to create and run an island of good corporate governance in a sea of poor or underdeveloped public governance."**

--- Arthur M. Mitchel  
General Counsel, Asian Development Bank

CORPORATE DIRECTION

## Where Do We Go From Here?

Effective, holistic governance is more complex than simply adopting a checklist of "best practices". There are, however, areas that can be probed to uncover the direction in which a company should be pointed. These areas can be determined by answering the following questions:

- ⇒ What are the company's primary activities?
- ⇒ What is the company's stage of development?
- ⇒ What is the company's ownership structure and how will it evolve?
- ⇒ Where has the company raised capital, and where it will raise capital in the future?
- ⇒ Is there a controlling shareholder(s)? How big is the company (revenues, employees, locations)?
- ⇒ Where is the company's head office?
- ⇒ Where does the company carry on business?
- ⇒ Where does it sell products?
- ⇒ What are the human capital needs of the company?
- ⇒ How positive is the company's relationships with its stakeholders?

### CORPORATE GOVERNANCE (CG) FACTS

- ⇒ Only 25% of US companies separate the roles of chairman and CEO compared with at least 50% for companies in other developed economies.
- ⇒ Swiss boards have the highest percentage of independent directors (81%) – Germany, Austria and Japan all have less than 10%.
- ⇒ Only 4% of companies in Japan have audit committees comprising a majority of independent directors compared to over 95% in the U.S.A, Canada, the Netherlands, Luxembourg, the UK and Ireland,
- ⇒ Only 22% of companies in Singapore and 25% of companies in Hongkong have a meaningful codes of ethics.

Source: www.eiris.org

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## Making SOE More Competitive, Efficient and Transparent

The OECD has approved new Guidelines on Corporate Governance of State-Owned Enterprises (SOE) to give concrete advice to countries on how to manage more effectively their responsibilities as company owners.

The Guidelines aim to help make SOEs more competitive, efficient and transparent. The Guidelines call on governments to:

Ensure a level-playing field for SOEs competing with the private sector by

- Clearly separating the state's ownership role from its regulatory role
- Allowing more flexibility in capital structures while making sure that state-owned enterprises face competitive access to finance

Become more informed and active shareholders by

- Simplifying the chain of accountability through centralising or more effectively coordinating shareholding responsibilities within the state administration
- Reducing political interference in day-to-day management
- Introducing a transparent nomination process for boards, based on competence and skills

Empower boards by

- Clarifying their mandates and respecting their independence
- Separating the role of Chairman and CEO and giving boards the power to appoint CEOs Systematically monitoring the board's performance.

Improve transparency by

- Strengthening internal controls
- Carrying out independent, external audits based on international standards
- Disclosing any financial assistance from the state
- Producing aggregate performance reports

## Sources of Corruption

Corruption is rampant to companies that do not employ good corporate governance; it makes them stand in the brink of downfall. Below are Daniel Kaufmann's ( Senior Manager for Governance, Finance and Regulatory Reform at the World Bank Institute) sources of corruption:

- ⇒ Issuing licenses, permits and border-crossing documentation, banking licenses.
- ⇒ Implementing price controls.
- ⇒ Blocking new firms and investors from entry and providing monopoly power.
- ⇒ Awarding public procurement contracts.
- ⇒ Granting subsidies, soft credits, tax exemptions, and allowing tax evasion.
- ⇒ Imposing foreign-exchange controls.
- ⇒ Allocating real state.
- ⇒ Selectively enforcing socially desirable regulations.
- ⇒ Maintaining obscure or secret budgetary accounts by government officials.

## Principles of Good Corporate Governance

[www.shareholders.com](http://www.shareholders.com) enumerates 10 principles of good corporate governance, as follows:

- ⇒ Lay solid foundations for management oversight
  - ⇒ Promote ethical & responsible decision-making
  - ⇒ Safeguard integrity in financial reporting
  - ⇒ Make timely and balanced disclosure
  - ⇒ Respect the rights of shareholders
  - ⇒ Recognize and manage risk
  - ⇒ Encourage enhanced performance
  - ⇒ Remunerate fairly & responsibly
  - ⇒ Recognize the legitimate interest of shareholders.
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