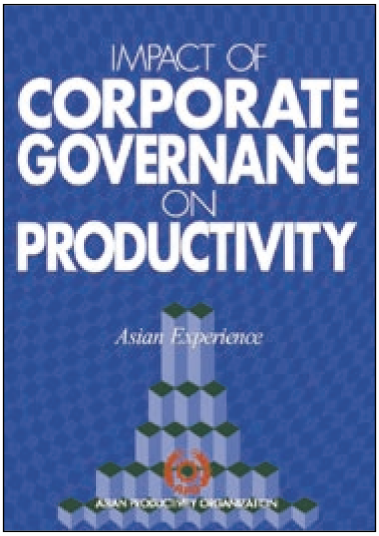
From:

Impact of Corporate Governance on Productivity: Asian Experience

©APO 2004, ISBN: 92-833-7030-9

Report of the APO Basic Research XI on Impact of Corporate Governance on Productivity

Edited by:
Dr. Eduardo T. Gonzalez



Published by the Asian Productivity Organization
1-2-10 Hirakawacho, Chiyoda-ku, Tokyo 102-0093, Japan
Tel: (81-3) 5226 3920 • **Fax:** (81-3) 5226 3950
E-mail: apo@apo-tokyo.org • **URL:** www.apo-tokyo.org

IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY

Asian Experience

ASIAN PRODUCTIVITY ORGANIZATION

IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY

Asian Experience

2004
ASIAN PRODUCTIVITY ORGANIZATION
TOKYO

Report of the APO Basic Research XI on Impact of Corporate Governance on Productivity.

This report has been edited by Dr. Eduardo T. Gonzalez.

ISBN: 92-833-7030-9

FOREWORD

Asia thrives on a diet of constant change. Big new undertakings draw governments and the private sector together in constructive ways. They encourage experimental give-and-take. That is the case with corporate governance, which is increasingly seen as a crucial instrument not just for enterprise reform, but more so for sustained economic growth.

In an Asian context, good corporate governance means unlearning pre-crisis corporate practices, getting concentrated ownership under control, keeping shareholders and consumers satisfied, and keeping stakeholders constantly informed. In a region as varied as Asia, that is not an easy task to do.

Within the Asian Productivity Organization alone, a variegated club of 19, the member countries may share the same corporate governance goals only in general terms. The notion of countries assembling together on a theme as important as corporate governance in different formations is surely inevitable. Some adopt the shareholder model of corporate governance, holding shareholder rights as inviolable; most embrace the stakeholder model, which holds that the interests of the community are as important as those of the shareholders. Yet practically all are still wedded to a relationship-based system, although that has not stopped many from pursuing *avant garde* forms that are more associated with the market-based, at-arms length system. Such is an Asia of diverse groupings, moving in different directions and at different speeds, with many countries hard at work at catching up with the region s leaders. Indeed this is a healthy trend, a source of pluralism and innovation within the region.

Despite the differences, the common ground among the APO member countries seems to rest on a consensus to adopt principles of corporate governance that hew more closely to generally-accepted global benchmarks. Whether widely-held or closely-held (by families), Asia s listed firms are heading toward a convergence that is going to make them better equipped to make their way in the global corporate market.

This globalizing trend is shifting the balance of interests between private owners, shareholders and society at large. Tensions have flared around key public policy concerns. Asian countries face huge challenges when re-designing and implementing corporate policy at all levels. As the policy options for these nations to use corporate governance in support for their broader growth and productivity strategies are being rapidly narrowed down, many experts are questioning the one-size fits all approach to corporate discipline and are advocating a rebalancing of the corporate regime.

Asian nations as a whole will emerge the stronger for all this, if good corporate governance principles encourage them to push harder for national policies that make the firms work better. For those with threadbare institutions, their interests should lie in insisting on policies that keep the costs of business low, barriers to transparency down, and markets accessible.

The world has always wanted to keep investing in Asia. The task now is to keep investors excited about the prospects for corporate reform in the years ahead. Asian firms do want changes in rules every now and then, since it is the only way they can keep up with a constantly shifting global environment.

And change will happen, one way or the other, especially now that economies in Asia are enjoying growth again, although slowly. In order to sustain this momentum, the urgent need is to constantly assess recent developments in corporate governance in the region. As this publication shows, there is more to corporate governance than simply adherence to a code of good conduct: it is the *sine qua non* for improving corporate productivity and performance.

To say that corporate governance reforms only bring uncertainty runs counter to the evidence presented in this book. They are the very engine of stability and continued progress for Asian firms.

The APO is grateful to all contributors in this book for conveying this important message through their research studies. Special thanks are due to Dr. Eduardo T. Gonzalez for editing this present volume. It is our hope that the basic research study on corporate governance with its modest findings will provoke firms and policy makers to undertake corporate governance reforms that will yield business excellence and higher productivity.

Takashi Tajima
Secretary-General

Tokyo
March 2004

TABLE OF CONTENTS

THE IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY IN ASIA: A REVIEW

Dr. Eduardo T. Gonzalez
Development Academy of the Philippines
Philippines

INTRODUCTION

This review describes the major patterns and realities of corporate governance across selected member countries of the Asian Productivity Organization and analyzes how well Asian firms are governed within the context of the typical Asian environment, which includes relatively weak property and shareholders rights, and less capable judicial systems. In turn, the characteristics of governance structures provide the backdrop for looking into the productivity of Asian firms. This report relies on the empirical findings of the basic research conducted by APO on Asian firms in 2002. Ten national experts, Chwo-Ming Joseph Yu (Republic of China), Ramesh C. Monga (India), Hossein Rahmanseresht (Islamic Republic of Iran), Junichi Mizuo (Japan), Young Seog Park (Republic of Korea), Bishwa Keshar Maskay (Nepal), Magdalena Mendoza (Philippines), Chee Leong Chong (Singapore), Lal Balasuriya (Sri Lanka), and Nguyen Thi Bich Hang (Vietnam) joined the research and discussions. This review also drew from recent studies made by various corporate governance analysts.

In many Asian economies (excepting Japan and ROC), companies are closely held by majority shareholders (that is, families, and in some cases, governments), despite being listed on public stock exchanges. On this basis alone, the dominant Asian business model is unlike that found in the US or the European Union. Across Asia itself, important differences mark the quality of corporate governance and the enabling environment for protecting shareholder rights. Hong Kong, Singapore and Malaysia seem to have the edge in preserving significantly high standards in corporate governance, while having fairly mature and capable legal systems to shield property rights. By contrast, Indonesia, Korea, Thailand, and the Philippines are associated with inadequate property right protection and weak enforcement, lax operation of lending institutions and ineffective regulation of the financial sector (Chong Nam, Kang and Kim, 2001). India, on the other hand, boasts of a well-established regulatory framework for more than four decades, and this foundation has enabled the corporate, banking and financial sectors to avoid the weaknesses that have afflicted other Asian countries and impaired fair assessment of credit risk (Kar, 2001).

Thus, to be successful at assessing corporate governance in Asia, one must be heedful of the peculiarities that exist and the institutional hurdles that Asian corporations will have to prevail over. It may not be simply a question of saying that since the Asian financial crisis in 1997-98 exposed the vulnerabilities of Asian firms, the corporate governance model in the region will now have to be scrutinized on how much it deviated from the arms-length, equity market-oriented model (also known as the Anglo-American model), considered in many western corporate circles as the global benchmark. As Khan (1999) argues, such exercise unfairly implies that deviations suggest failure of Asian corporate governance to varying degrees, when what is really needed is an alternative theoretical account of the Asian governance system. On this point, Chong is emphatic that in Singapore, the Anglo-American model is not going to thrive as local business cultures and legal systems will shape the way in which governance ideas are adapted by each company, adding that government ownership will continue to exert a powerful influence over the pace of change, the details of new regulations and the degree of power allowed minority shareholders.

Which model of corporate governance is right for emerging markets is a highly sensitive issue, according to Allen (2000). The OECD explicitly rejected one size fits all when it declared that there is no single model of good corporate governance in the preamble to The Principles of Corporate Governance (which provided the conceptual basis for the APO research). It is a clear recognition that existing legal systems, business cultures and corporate structures are formed in different contexts. More recently, according to Allen, the Global Corporate Governance Forum, formed by the World Bank and OECD, has been torn between promoting developed-country governance standards or allowing emerging markets to be benchmarked against standards which developing countries themselves crafted and were shaped for their conditions.

Yet paradoxically, new corporate governance policies in Asia demonstrate the noticeable influence of developed-country governance standards , especially those relating to the minority shareholder concept. The single biggest catalyst for this change has been the Asian crisis, but other factors also count, such as the expansion of international capital markets in Asia (Allen, 2000). Among Asian countries, the shift is most apparent in Japan, and this is partly induced by the increasing influence of foreign (especially Anglo-Saxon) shareholders. But as Yasui (2001) contends, it is not likely that Japanese corporate governance practices will resemble those of the Anglo-Saxon model in the near future. Legal and regulatory systems, financial market systems, and employment practices in Japan are too different to be successfully converged with those in the Anglo-Saxon countries.

This review will maintain that such convergence is likely to have conflicting impact in Asia—accepted when it least endangers current practices, and resisted when it deviates from them. Such split-level mode, as this review will show, has profound implications on Asian corporate productivity.

ANALYTICAL FRAMEWORK

Following Khan (2001), this review views Asian corporations as socially-embedded organizations servicing the needs of multiple stakeholders in the context of differing Asian governance structures. It is a non-utilitarian approach to explaining the successes and failures of Asian firms. It modifies the standard principal-agent model by recasting the agency problem in terms of more explicit societal objectives.

This way of seeing Asian firms indicates that corporate governance is considered not just in a narrow sense—internal corporate relations out of which decision-making power and accountability are derived—but in its broad sense: extent of control by majority shareholders, rights of stockholders, contractual covenants and insolvency powers of debt holders, and government regulations. The key players, necessarily, are the inside controlling agents (owners and top management) and external agents (financiers such as banks and majority shareholders, government regulators). The agency problem is how to align their interests, to ensure the firm s—and the economy s—growth. That implies aligning not just authorities and responsibilities but likewise the flow of information, incentives and the capacity to act, all of which are necessary preconditions for optimizing the value of the enterprise and raising its productivity. This alignment will involve transaction costs, and other short-run costs (Khan, 1999).

Along these lines, the review examines several corporate governance aspects:

- Concentration of ownership and control
- Voice and exit options for shareholders
- Creditor and debtor relations
- Insolvency mechanisms
- Transparency and disclosure
- Monitoring issues arising from principal-agent problems
- Performance and productivity
- The Asian environment

The first six are the most important elements of corporate governance structure, while performance and productivity can be seen as the most sought-for outcomes. Through an examination of the various strands of corporate governance, and how they are linked to corporate productivity, the review hopes to shed light on what steps are right for enhancing overall corporate performance.

The following suppositions are examined:

- A high level of ownership concentration is no barrier to improved performance (low transaction costs) in the short run, but may hurt in the long run (high agency costs).
- A low level of conflict between inside controlling agents and external financiers will increase firm performance and productivity.
- Increased transparency and accountability will bring about higher performance and productivity.
- The more transparent and consistent, and fairer the regulatory framework, and the more efficient the judicial system is, the better would be business performance.

CONCENTRATION OF OWNERSHIP AND CONTROL

High concentration of ownership and control of corporations is a characteristic shared by most countries in Asia. Family-owned or controlled firms are prevalent in most Asian countries except in Japan. The firms are not widely-held, although outside equity ownership by minority shareholders exists alongside the predominant shares by the family groups.

Ownership by families is more obvious in smaller firms than in larger firms. However, even for large firms in some countries, ownership concentration exceeds 60 percent (Chong Nam, Kang and Kim, 2001). In the Philippines, one sixth of total market capitalization can be traced to the ultimate control of a single family, the Ayalas (Claessens, *et al.*, 1998). Most companies on the Hang Seng Index are companies owned or controlled by tightly held majority shareholders (i.e., families); a quarter of the 450 listed companies in Singapore are controlled by 10 families (Lyngaas, 2002). In Hong Kong, Indonesia, Korea, Malaysia, and Thailand families have control over the majority of corporations (Claessens, Djankov, Fan and Lang, 2000).

More than formal ownership, ultimate control and *de facto* control rights are decisive. Claessens, Djankov and Lang (1998, 1999) note two key characteristics of industrial organization in Hong Kong, Indonesia, Korea, Malaysia and Thailand. These are: a) families have control over the majority of corporations and b) such control is also exercised through the use of pyramid structures, cross-holdings, and deviations from one-share-one-vote rules. They also find that between 25 and 32 percent of cash-flow (control) rights are in the hands of largest block-holder in Thai, Indonesia, and Hong Kong firms. Japanese and Taiwanese firms have the least concentrated ownership, but financial institutions are the main owners of corporations in Japan, controlling around 40 percent of corporations (Claessens, Djankov, Fan and Lang, 2000). In many cases, Japanese banks exercise control as a result of cross-shareholding arrangements (Yasui, 2003). Most Asian firms operate as economic entities within the context of a relationship-based system.

Northeast Asia

In the APO survey on Korean firms, 14 out of 27 firms were found to be in the hands of one to three shareholders; four more had four to five shareholders. The median proportion of shares held by the top shareholder is only 16.2 percent, however. Likewise, the median proportion of shares held by top five shareholders is 31.24 percent. What is prevailing in Korea, according to Park, are large block-holdings, cross-shareholdings among companies, and the issuance of multiple classes of shares with different voting rights, all of which help dominant shareholders retain control of corporate assets far larger than their direct stock ownership would justify. This corroborates the finding of Claessens *et al.* (1999) that even when the formal degree of ownership is low, control can still be exercised through member companies that own stocks.

A classic example of inter-company shareholding among subsidiaries offered by Park is that of the Samsung group, in which Samsung Life Insurance Co. acts as parent company to a pyramidal set of firms. Because cross shareholding is prohibited by the law, *chaebol*s resort to one way shareholding through which they can exercise leverage, with a small investment, over a group of companies. Firms that are not controlled by any founding family are a rarity in Korea, according to Chong Nam, Kang and Kim (2001).

In Taiwan, firms are more widely-held. The APO survey indicates that majority of the firms have more than 10 shareholders, including foreign ones. Twenty-five percent, however, had a single owner, which happened to be government. Except for these two state-owned enterprises, according to Yu, it is managers and employees who own shares in the firms. The law requires companies issuing stocks to share ownership with employees. Taiwanese companies prefer to distribute shares to employees as bonus to solidify the relationship with employees. There are no mutual holding of stocks between the firm and affiliated companies.

Despite this seemingly Anglo-American feature, Taiwanese firms are still considered to be relationship-based. In fact, as T. Yeh (2001) points out, family members also become managers as the business grows, and retain their controlling influence on firm management even when the company has gone public. The Securities and Futures Institute speaks of the family board , because outside shareholders are either members of the controlling family or business associates (SFI, 2001). Family ownership has substantial control over the board decisions and agendas in stockholders meetings (Ko, *et al.*, 1999).

Southeast Asia

Among the respondent firms in the Philippines, controlling shareholders (the top five shareholders) own up to more than 80 percent of shares in 60 percent of the firms. Majority ownership is generally held by two to three shareholder-owners (40 percent of firms). Ten percent of the firms have majority share that is controlled by one shareholder. Twenty percent of respondents, according to the APO survey, indicated mutual holding of stocks between their firms and affiliated companies. For Mendoza, this validates the presence of cross-holding structures among Philippine firms, noted in earlier studies.

An interlocking organization structure of groups of companies enables large shareholders in the Philippines to maintain control and minimize risks while achieving economies of scale and allowing public investors to hold minority shares. Mendoza indicates, citing an ADB study, that large shareholders set up pure holding companies, while going on selective public listing of companies in the group, centralizing management to control companies where it only has minority shareholdings, or holding a portfolio of the companies with different amounts of shareholdings.

In Singapore, the majority shares in the surveyed firms are held mainly by a single individual shareholder-owner. According to Chong, that would be typically the founder, a family, an investment company of the government, or other individuals. Block holders constitute between 50 percent and 80 percent of ownership. Half of the companies are in family hands and almost a quarter are state-controlled. Singapore firms show a high incidence of pyramiding; some 15.7 percent of companies have some cross-ownership. The ultimate owners of block holders are government, corporations and sometimes individuals.

Government-linked corporations (GLCs) are dominant in the Singaporean economy. Up to 70 percent of GLCs are directly and indirectly controlled by the government. Most interlocks, Chong points out, happen between listed subsidiaries and the parents and between competitors in the same industry. The effect of this is restraint in competitive vigor. In addition, since many directors of GLCs are also senior government officials, the state can indirectly monitor corporate activities and policies. Given the perceived need to GLCs as tools for economic development and rationalization of the domestic economy, the government will likely maintain majority ownership through its holding companies.

In Vietnam, a number of subsidiaries of state corporations have been equitized, becoming joint-stock companies (whether publicly-listed or not). Parent corporations, however, are still state-owned, but equitization has at least transformed state capital into stocks which shareholders other than government can acquire. This seems evident in the APO survey results, which indicate that on average, 56 percent of the stocks of the respondent firms are in the hands of the top 10 shareholders, while 43 percent belong to the top five shareholders. Only a quarter of the stocks are in the possession of the top shareholder. Hang admits that financial markets (especially the stock exchange) have not yet developed, making it difficult to trade stocks.

South Asia

In India, majority of the respondents, the largest stakeholder group holds 50 to 65 percent of the shares. Corporate bodies (a mix of independent firms and those owned by business groups, families, and multinationals) are on average substantial blockholders in private enterprises. Some 42.5 percent of all sample companies have equity ownership by insiders in which equity holdings are in excess of 25 percent. Directors and relatives have more than 25 percent equity ownership in 26.6 percent of sample companies. Monga suggests that India is typical of Asian countries in terms of the predominance of insider-dominated family business in stand-alone companies or business groups. The high concentration of corporate holdings, according to Kar (2001), is the outcome of government incentives that have allowed business houses to develop intricate webs of private companies and cross-shareholding.

In half of the companies APO surveyed in Sri Lanka, the top ten shareholders held the major shares. Total shares in only two companies were held by a single shareholder. That may seem to show that in most cases, few individuals or groups have shareholdings enough to exercise control over the company. However, Balasuriya, in an examination of 226 Sri Lankan firms, finds that most of the large companies (both private and publicly listed) have subsidiaries which are controlled by them. Although the Companies Act in Sri

Lanka does not permit a subsidiary to hold shares in its holding company—crossholding of shares are not seen in Sri Lanka—Balasuriya indicates that a chain of holding companies and subsidiaries can nevertheless consolidate control by a few families.

Majority ownership in half of the surveyed Nepalese firms are held by a single shareholder-owner, which holds, on average, 81 percent of the shares. Majority shares in all sample firms are owned by no more than five shareholders, who hold jointly, 63 percent of the shares. Generally, significant family or block ownership characterizes the ownership of Nepalese companies, according to Maskay.

West Asia

The general trend in Asia is also reflected in the APO survey of firms in the Islamic Republic of Iran. A single owner holds majority shares in eight of 20 sample firms. In six firms, two or three shareholders keep most of the shares. In nine firms, the top shareholder holds between 50 and 65 percent of the shares; in another eight firms, the top shareholder holds more than 80 percent.

Blockholdings are the rule in Iran, since according to Rahmanseresht, major stockholders have been banks, foundations, insurance companies, pension funds, and mutual funds. Owner management is prevalent. Parastatal institutions, or *bonyads*, which were created after the Iranian revolution have evolved into conglomerates control a very considerable chunk of production and employment in agriculture, industry and services. *Bonyads* get implicit and explicit subsidies from the government, though this is changing with the current reforms (Alizadeh, 2003).

In all, family-based corporations may be taken as prototypical for the majority of Asian developing economies (Khan, 1999). Even when widely-held firms are prevalent, as in Japan and Taiwan, a relationship-based system involving a small group of insiders holds sway. In Vietnam, these relationships are rooted in two types of networks: one grounded on pre-existing ties of family or friendship, the other on informal channels involving manufacturers of similar kinds of goods. Vietnamese companies employ these networks, to background-check future trading partners and to keep an eye on them afterwards (McMillan and Woodruff, 1998; Malesky, Hung and Anh, 1998). Close links among firms, their banks, and the government have developed through this relationship-based system.

VOICE AND EXIT OPTIONS FOR EQUITY HOLDERS

Are there avenues which ensure that debt holders and equity holders can try exit or voice options to make company management accountable? In a context where a relationship-based system is prevalent, in which controlling shareholding families tend to make crucial corporate decisions on their own, the record is mixed. On the one hand, in the face of weak legal protection, investors do rely on big shareholders control of corporate decisions since it offers them the assurance that their resources will be used in accordance with their interests, and in extreme cases, allows them to prevent diversion of corporate resources without having to deal with legal institutions. As Mendoza suggests, concentrated ownership is a mechanism to protect investors' money in the absence of a strong regulatory environment. On the other hand, because some countries are adopting the Anglo-American model, corporate ownership and control by a few owners intensify conflicts of interest between dominant shareholders/managers and minority shareholders (Chong Nam, Kang and Kim, 2001).

In any case, the rules of the game seem to be dictated by both ownership

Table 1. Protection of shareholders in selected Asian countries

Variables	Description/effect	Japan	Korea	R.O.C.	Singapore	Malaysia	Indonesia	Philippines	Thailand	Vietnam	India	Sri Lanka	Nepal	Iran
One share, one vote	Basic right; some shareholders may waive their voting rights for other benefits such as higher dividends	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Mandatory shareholder approval of major transactions	Protects against abuse by insiders; protection can be enhanced through supra-majority voting		✓	✓	✓	✓	✓	✓	✓	✓	✓			
Mandatory disclosure of connected interests	Protects against abuse by insiders		✓		✓			✓	✓					
Mandatory disclosure of non-financial information	As important as financial information in assessing firm's prospects		✓		✓	✓	✓		✓					
Provision on takeovers legislation	Protects against violation of minority shareholders' rights		✓			✓		✓	✓					
Penalties for insider trading	Protects against use of undisclosed information at the expense of current and potential shareholders		✓	✓	✓	✓	✓	✓	✓	✓	✓			
Proxy voting	Facilitates shareholders control	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
Preemptive rights on new stock issues	Protects against dilution of minority shareholders; prevents insiders altering ownership structure		✓				✓	✓	✓					
Mandatory shareholder approval of interested transactions	Protects against abuse and company asset stripping by insiders		✓	✓	✓	✓	✓	✓	✓	✓	✓			
Right to make proposals at shareholders meeting	Facilitates shareholders control; increased opportunity to prevent biased decisions by insiders		✓		✓	✓	✓	✓	✓	✓	✓			
Right to call shareholder meeting (% of shareholders)	Facilitates shareholders control		✓	✓	✓	✓	✓	✓	✓	✓	✓			
Allow proxy by mail	Facilitates shareholders control		✓		✓					✓	✓			

Sources: World Bank, cited in Chong Nam, Kang and Kim, 2001; APO BRXI Survey 2002; OECD White Paper 2003

distribution and the ability of the legal system to protect shareholder rights. In a skewed system where majority shares are held by a few and the legal system is weak, the payoffs often go to the dominant shareholders. If there is no one share-one vote rule, dominant families can monopolize decision making by preventing minority blockholders from coming out with voting rights. A minority block share at any rate does not confer much leverage on small shareholders. Also, self-dealings often accompany the absence of mandatory disclosure of connected interests, as in Indonesia and Malaysia (Chong Nam, Kang and Kim, 2001).

On paper, many APO member countries do provide legal protection for shareholders (Table 1) in key areas such as mandatory shareholder approval of interested transactions, penalties for insider trading and mandatory shareholder approval of major transactions. One share-one vote and proxy voting are present in practically all countries. The tabulation is based on incomplete information, however, and it is possible that recent reforms have increased the number of shareholder rights in many economies. Indeed, Korea, Thailand and Hong Kong have gone past the other Asian economies by making the appointment of independent directors mandatory. In Korea, cumulative voting now enables minority shareholders to better represent themselves on the board. However, having good laws is one thing, making them work is quite another story (Chong Nam, Kang and Kim, 2001).

A closer look at some institutional arrangements in various parts of Asia reveals, however, substantial shortfalls in shareholder protection.

Northeast Asia

In Japan, a typical board of directors is constituted from middle managers who are regarded as company leaders. This innovation is sustained by a stable and concentrated ownership structure in which cross-shareholdings are particularly prevalent (Yasui, 2003). The outcome, Mizuo points out, is often a situation where the company entrenches itself within its own structure, putting its own interest ahead of its responsibility and accountability to other stakeholders, including shareholders. Since Japanese boards are often oversized, important decisions are made by a limited number of managing directors, who collectively form a *jomu-kai* or a *keiei-iinnkai* (managing directors committee), according to Mizuo. Power is concentrated in *shacho*, who also assumes the role of representative director. Minority shareholders are represented in the board, but are left out in the board s decision-making structure, which also makes it easy to remove the minority representative.

On the bright side, Mizuo acknowledges that firms have introduced changes, such as slimming down the decision-making processes at top levels (Sony, Toshiba, and Shiseido have taken the lead), reducing the number of directors (Examples: Yuaza trading, from 25 directors to five; Shimizu, from 45 to nine; Nichimen, from 26 to nine; NKK, from 34 to seven; and Asahi Breweries, from 40 to nine) and the introduction of outside directors. Shareholder activism has likewise pushed Japanese firms into adopting shareholder-friendly measures such as a more efficient use of funds with share buybacks, introduction of incentive schemes to link compensations of corporate executives to their performance, and improvement of disclosure (Yasui, 2001).

Conflict of interest in South Korea tends not to be between managers and shareholders *per se* but between the dominant owner-managers on one hand and minority shareholders and other investors (domestic and foreign) on the other, according to Park. Episodes of expropriation in South Korea are common. Heavily-indebted firms with minority shareholders often made loan guarantees, or lent money directly, to other companies controlled by the same family. That would be equivalent to the firm borrowing from banks and in turn re-lending to a member company at its own risk. Also, equity participation by connected firms, especially those near dissolution, amounts to an outright transfer of wealth from participating firms to the firm issuing new equities. Judicial relief against expropriation is generally weak, and criminal cases involving breaches of trust by dominant shareholders are exceptional (Chong Nam, Kang and Kim, 2001).

Park suggests that the new Korean Securities and Exchange Act (KSEA) has significantly relaxed the shareholding requirements for exercising minority shareholder rights, including the filing of a derivative suit. But Chong Nam, Kang and Kim argue that lawsuits do not prosper much in Korea because the reward that minority shareholders can get even when they win in the courts is generally very small as in most other countries.

Park notes that many outside directors have recently been appointed by listed companies in Korea as mandated by the new KSEA. Listing requirements now require independent outside directors to comprise at least a fourth of a firm s board of directors. Outside directors must also comprise at least two-thirds of the audit committee. Yet there is apprehension that many of them have ties to management and are not expected to act in the interest of all shareholders (Chong Nam, Kang and Kim, 2001).

In Taiwan, firms started as family businesses, and owners and managers were drawn from family members. Matters changed with public listing, according to Yu, as professional managers were hired to run these firms, reflecting the trend towards separation between ownership and management. Publicly listed firms in Taiwan give shareholders the following rights: to vote according to share, proxy voting, proportionate ownership of firm under any financing plan and to demand independent audit. Minority shareholders are not represented in the board, however. By contrast, non-stockholders (i.e., outside directors) can be appointed as board members, beginning in 2001. Still, independent outside directors, discouraged by business practices, are rarely seen in corporate Taiwan (T. Yeh, 2001).

Statutory protection of shareholders exists through the Corporate Law, according to Yu. But in practice, the law does not mean much. Lawsuits filed by shareholders against disqualified directors, for example, take years to adjudicate. The right to demand independent audit is impaired by the close relationship between firm-auditors and major stockholders, as well as the lack of auditing expertise. The absence of class-action lawsuits and rigid regulation in derivative lawsuits make it difficult for minority shareholders to sue the wrongdoing of directors and firm-auditors. There have in fact been no cases of violation against relevant laws by executives, board members, firm-auditors and accountants yet violations do exist.

Southeast Asia

Firms controlled by families are most likely to have separation between ownership and control in Singapore, and small firms are most likely to have a larger wedge between cash-flow and control rights, regardless of the type of ownership, according to Chong. But large firms have between 20 percent and 30 percent of cash flow rights. Family dominance is still the main cause of expropriation, yet, conflicts of interest appear to be much less serious in Singapore than in the rest of the region.

Singapore grants practically all the major rights to minority shareholders. In addition, most of the surveyed firms have minority representatives to the board (although they can be easily ejected without cause). Chong also concedes that although listing rules require the presence of non-executive directors who are not immediate family members and who do not have financial or business interests in the company, it remains possible for more distant relatives and "grey" directors (such as consultant or lawyer) who have business relationships with the company to qualify as independent directors (and be appointed in the audit committee). Not many of them will actively contradict the incumbent managers/owners.

Boards of directors are seldom distinguishable from management in the Philippines. Concurrency is practiced in many firms, where the board chairman is also the CEO, according to Mendoza. Representatives of minority shareholders sit in the board of most of the companies (67 percent); unlike in other Asian countries, they are difficult to remove without cause.

The Corporation Code mandates the use of cumulative voting in the election of directors. Hence, in practice, few minority shareholders exercise their rights. And while proxy voting is allowed, the practice tends to further consolidate the interest of majority shareholders, Mendoza points out.

Only 40 percent of the firms surveyed appoint outside directors, although the law requires that they should constitute 20 percent of the board (and to a lesser extent, the audit committees) in all firms. Audit committees are present in only 60 percent of Philippine firms.

Despite the equitization in Vietnam, state capital is still dominant, Hang indicates. That means many board members are state personnel. Even for those with less than 25 percent state shares, key personnel in management are still government officials. Malesky, Hung and Anh (1998) find, however, that top Vietnamese managers are more likely to be accountable for changes in the way firms are run than the ministries, although the ministries still call the shots in strategic decisions and through management boards. Firms do not have complete autonomy in staffing decisions. Nevertheless, Hang notes the progress toward giving ordinary shareholders more rights, including one share-one vote, dividends, priority in subscribing to new shares on sale, and share in the company assets in cases of insolvency.

South Asia

Indian corporate regulations stipulate the appointment of non-executive directors to bring external and wider perspective and independence to decision making. Monga observes that the board chairman can come from their ranks. At least three non-executive directors should be in the audit committee, and the chairman can also be an independent director. All companies have audit committees in the board. In fact, state owned enterprises do not have any other committee. In practice, audit committees are voluntary in India, where they have been advocated only in recent years by the Confederation of Indian Industries. It is likely, however, that they will become compulsory in the near future (Allen, 2000).

Such liberal provisions, however, do not seem to have a parallel when it comes to minority shareholders. According to Monga, none of the respondent companies offers the right to maintain proportionate ownership of company under any financing plan and also the right to be member of independent board committees. Minority shareholders are not represented on the board of any of the respondent firms. An important exception is that at least 10 percent of minority shareholders can apply to the Company Law Board for relief of oppression or mismanagement (Kar, 2001). Financial institutions which hold a major share of equity in many Indian companies, according to Monga, are likewise not encouraged to seek board participation.

In majority of the companies surveyed in Sri Lanka, the board of management takes all major decisions. Although it appears that the owners do not play a major part in the decision making process of the companies, as suggested by Balasuriya, in fact they can influence decision making through their power to determine the composition of the board and appoint the CEO.

Minority shareholders seem to have little power in Sri Lanka. Few firms allow proxy voting, and this is confirmed by the APO survey results. Nevertheless, in a related front, Balasuriya reports that a code of best practice has been prepared by the Institute of Chartered Accountants of Sri Lanka (ICASL), to deal with conflict of interest situations, evaluating the effectiveness of audit committees and external auditors, and the adequacy of internal safeguards and controls.

In Nepal, most boards do not adhere to the idea of independent oversight, according to Maskay. To begin with, independence is not legally defined, even though the law makes a distinction between full time directors and non-executive board members. Moreover, non-executives may be family members, or nominees from the government or institutional shareholders. It is also common for such directors to sit on the boards of several corporations simultaneously.

The APO survey reveals that shareholders rights do not practically exist in any of the public enterprises in Nepal and have made little headway even in private firms. Few firms recognize the one share-one vote rule, proxy voting, and the right to demand independent audit. Similarly, minority shareholders are represented only in a handful of boards.

West Asia

In Iran, strategically consequential decision-making authority was kept for owners and major stockholders (opening branches, increase or decrease of capital, and financial decisions, reports Rahmanseresht. Shareholders, however, can count on a number of rights. It is the general assembly of shareholders, for example, which elects the members of the board of directors.

Under the Commercial Code, every limited partner has the right to supervise the firm s business and can also review the account books and legal documents and prepare statement of position for his own use. A limited partner cannot transfer all or part of his shares to a third party without the consent of other partners, and when he does, the said party has no right to supervise and interfere in the firm s business. Also, none of the shareholders or directors can start a similar business for himself or for a third party, or join another firm, which is engaged in the similar business, as a major shareholder.

The country-specific anecdotes indicate that while Asian countries have fairly different corporate governance structures, they do close in on a definitive policy route. The points of convergence include extending shareholder rights, inclusion of independent directors to provide a countervailing force in the board and in audit committees. They have become part of laws and regulations governing companies, listing rules of stock exchanges, or in codes of best practice. Yet most governments in Asia have also shown little interest in addressing the basic contradiction between the new corporate governance principles and the deeply entrenched ownership structure of Asian companies. In essence, they are trying to slip a system of checks and balances into an autocratic corporate framework that leaves real power in the hands of existing owner (Allen, 2000). Dominant shareholders can override the opinions of minority shareholders by vote, and unless they face stiff sanctions, they may conceal information about connected transactions (Chong Nam, Kang and Kim, 2001).

CREDITOR AND DEBTOR RELATIONS

The striking characteristic of Asian corporate finance is bank dominance. Although there are variations in how firms and banks relate to each other in Asia, corporations rely heavily on banks for financing. In this context, creditor banks have primary accountability for corporate monitoring and oversight. In many cases, however, family-based corporations also own major stakes in banks, leading to collusive connections between borrowers and lenders. Such conflict of interest, poor prudential oversight by Asian governments, and perverse incentives (such as explicit or implicit government guarantee) are the major dysfunctions in debtor and creditor relations. Interestingly, Singapore and

Hong Kong banks appear to overcome this flaw, providing acceptable monitoring of relationship-based firms (Chong Nam, Kang and Kim, 2001).

When capital is made available by banks in a situation where contractability (the adequacy of contractual infrastructure) is low, the relationship-based system easily leads to over-investment, according to Park, citing Rajan and Zingales (1998): but neither will an arm s length, market based system work well under this circumstance, since it will have limited ability to recover funds once they are invested.

Northeast Asia

Based on the APO survey, 80 percent of firms in Japan have banks as their major creditors, as reported by Mizuo. The main bank is the principal supplier to the company of various financial services, which include loan extensions, but also payment and settlement operations and underwriting and management of bond issues. It is also the company s key consultant on investments, and a provider as well of firm directors or statutory auditors (Yasui, 2001).

The main bank supplies the discipline for the board under contingent governance, in which the board exercises leeway in usual business situations and the bank intervenes only when the company is in distress. The banks earn sufficient rents through long-term relationships with the client companies, in the forms of excessive deposits, monopolistic handling of employee s salary accounts, high interest rate—all in exchange for assistance in time of extreme need (Yasui, 2001).

Korea and Taiwan have similar setups, although bank monitoring takes on a different course. Park reports that 71 percent of surveyed firms in Korea rely on banks as sources of credit. In Taiwan, according to Yu, on average, 88.75 percent of the firms working capital comes from banks.

Southeast Asia

In 80 percent of the firms surveyed in the Philippines, according to Mendoza, banks are the most common creditors. The loans granted to corporations by banks are normally without collateral, suggesting the close relationship between debtors and creditors—more than 50 percent of firms have dealt with their creditors for more than five years None of the firms surveyed indicated that they faced adverse creditor actions such as collection lawsuit or foreclosure of collateral.

In Vietnam, 14 out of 16 surveyed companies (87.5 percent) have banks as their main creditors. Banks have the right to appraise borrowers' business plan and monitor the use of capital. This is a good mechanism for controlling borrowers' operations and business results, according to Hang.

West Asia

In Iran, likewise, majority of the firms depend on banks for financing. Rahmanserehst adds that external creditors have the ability to add or remove conditions or limitation in the loan agreements.

The more important issue at this point is whether the relationship-based system permits banks to monitor borrowing firms closely and objectively. Khan (1999) contends that that would depend on where the bank is located in the corporate financial organization. If banks are within the ambit of large family businesses, their monitoring will not necessarily be impartial and unbiased.

In the Philippines, affiliation and interlocking ownership between borrowers and creditors compromise the role of creditors as external agents in disciplining firms, according to Mendoza. The antidote is an enforceable regulatory framework. Absent that, nothing has prevented Philippine banks from acting as the cash vault of business groups (Chong Nam, Kang and Kim, 2001). In Nepal, Maskay reports that creditors themselves are poorly governed, as evidenced by weak internal control and inadequate regulatory frameworks. The banks' internal risk-management also appears to be underdeveloped.

By contrast, Taiwanese banks are strictly regulated in their equity shares of listed companies, and are allowed up to only 15 percent of bank s net worth. In Singapore s case, the Banking Act limits the investments of banks in other non-financial businesses to a maximum of 20 percent of their capital base (Woo-Cummins, 2000). As a result, firm owners and major shareholders do not influence banks.

State control and moral hazard

Apart from the collusive effects of firm-bank interlocks, poor monitoring of corporate finance by creditor banks were the results of another skewed incentive structure: state guarantee and influence in credit allocation. Although government control in many Asian countries subsided in the wake of financial liberalization efforts, it retained enough clout to compel banks to supply subsidized credit to firms it favored. In Korea, 15 years after their privatization, banks still function like state-owned institutions, given the fact that the government does not have ownership anymore in commercial banks (Chong Nam, Kang and Kim, 2001).

In India, government continues to own major developmental finance institutions, such as the State Bank of India and the Industrial Development Bank of India, which dominate the country s financial sector and exercise control over Indian corporations through their holdings of both debt and equity. This ensures that the investment priorities of both state firms and many Indian companies remain hostage to the political process (Allen, 2002).

Tacit backing by the state implies that Singaporean enterprises are guaranteed solvency. This results in a greater willingness by banks and non-bank financial institutions to lend money liberally to these enterprises, according to Chong. GLCs, being part-owned (or managed) by the government, have easier access to cheaper funds. This prevents GLCs from being disciplined by a competitive capital market. Similarly in socialist Vietnam, state banks rule 74 percent of the market, making it easier for state companies to reach them. In turn, banks feel more secure dealing with companies having state presence, reports Hang.

In 40 percent of surveyed Philippine firms, the government is the guarantor. Mendoza says this presents a moral hazard problem, as creditors are certain that in case of default, government will ensure that their claims are satisfied. Balasuriya has an analogous report: the implicit and explicit government guarantees of loans and injection of capital during restructuring of government-owned Sri Lankan banks may have weakened the creditors incentive to discipline defaulting borrowers and to identify non-performing loans.

Over-borrowing in many Asian countries was common since subsidies allowed real interest rates to remain below the marginal productivity of capital. Cross-debt guarantees among affiliates of business groups in Korea and Thailand allowed firms to borrow more recklessly, leading to unbearably high leverage and heedless capacity expansion in the corporate sector. Excessive corporate leverage based on implicit risk-sharing by the government created the so-called "too-big-to-fail" hypothesis, which worked as an important exit barrier. In Korea, given the c*haebols*' huge market share and the vertically integrated industrial structure, the social costs of a c*haebol* bankruptcy would be enormous. Bailouts by the government in both the financial and corporate sectors were not uncommon practices in many countries, in the process making worse the already weak market discipline and inducing serious moral hazard problems (Chong Nam, Kang and

Kim, 2001). Vietnamese managers are quite certain that the government will help out their firms out whenever they are in distress and hence often adopt unrealistic strategies for expansion. Vietnamese regulators have yet to enforce a credible hard budget constraint for firms (Malesky, Hung and Anh, 1998).

Yet, despite the problems it poses, bank dominance of corporate finance is probably still the best alternative for developing Asian countries, because an arm s length, market-based system and a more mature institutional and regulatory framework are still too underdeveloped in the region. The banks can be the key agents for external governance. But major reforms are needed. Maskay lists some of these as removing explicit and implicit government guarantees, limiting the shareholdings of non-financial companies in banks and of banks in companies to avoid conflict of interest; setting and enforcing limits on lending by banks to affiliated companies. Governments must not put undue influence on banks; instead they must exercise prudential supervision over them.

CAPITAL MARKETS

Capital markets in Asia, excepting Japan and possibly Hong Kong, are not well-developed, and this predicament is a major factor behind the unstable financing pattern wherein firms rely heavily on banks (of course, bank dominance also hindered the development of capital markets). Capital markets are a crucial mechanism for mobilizing long-term capital, but as Nobel laureate and economist Joseph Stiglitz argues, it takes time to develop the substructures—strong legal institutions and shareholder protection—that will make capital markets work. Only the U.S., the European Union and Japan have succeeded in maintaining strong legal systems around which widely-held corporations are built. As a result, very little investment is financed anywhere in the world by raising new equity, or selling shares of stock in a company (Stiglitz, 2002).

Unlike their counterparts elsewhere, Asian corporations depended mostly on *domestic* bank financing. In turn, this was made possible by high savings rates (30-40 percent in East Asia, in contrast to 18 percent in the U.S. and 17-20 percent in Europe). As Stiglitz points out, the region hardly needed additional funds; its challenge—a daunting one—was investing the flow of savings well.

However, capital market liberalization proceeded in Asia, mainly on the prodding of the International Monetary Fund. In theory, capital markets induce greater efficiency that creates conditions for faster growth. Liberalization enables countries to attract foreign capital, and most importantly, foreign direct investment. But doing away with regulations meant to control monetary flow in and out of the country combined with government guarantees to bring about distorted outcomes. It was short-term loans and contracts—they are no more than wagers on exchange rate movements, and firms cannot make long-term investments to build factories or create jobs using money that can be withdrawn on a moment s notice, according to Stiglitz—which dominated the market and which were easily snatched by banks and firms. There was a mismatch of incentives: it was firms which made the decision to borrow hot money yet it was government which had to maintain the country s prudential standing (by stacking up on its reserves) (Stiglitz, 2002).

With both domestic bank financing and foreign speculative money available, relationship-based businesses transformed into highly leveraged firms. In 1996, Korea had the highest debt/equity ratio of 3.54, followed by Thailand with a ratio of 2.36. Highly leveraged firms in some sectors such as construction had ratios that were twice the national average (Khan, 1999). China, on the other hand, avoided piling up debt, but still managed to receive the largest amount of investment in the region, proving that there were ways other than capital market liberalization to attract funds (Stiglitz, 2002).

By force of circumstance, an arms length system should have come into play; as Park argues, the re-rise in borrowings in Korea in 2000 suggests that it is not easy to curb leveraged management without advancement in the capital market. Even in Hong Kong, which has one of the deepest equities markets in the region, a market-based system has not emerged. Khan (1999) surmises that nonetheless, both the discipline enforced by the Hong Kong stock exchange and the market for shares *somewhat* put a brake on family businesses misallocating bank resources.

Generally speaking, Asia s bourses have neither pried open firms to become widely-held enterprises nor made good progress to become viable sources of capital. In Japan, the top 10 shareholders of the companies listed on the Tokyo Stock Exchange (TSE) First Board—mostly domestic banks and insurance companies—have, on average, 44 percent of the outstanding stocks of a company. In addition, more than 90 percent of the listed companies considered the majority of their stock to be held by stable shareholders (Yasui, 2001). Taiwan might be considered an exception: as Yu reports, it is dominated by individual investors and institutional investors (e.g., firms, banks, mutual funds, retirement funds), but they have yet to play an influencing role. At the end of 2000, only 531 companies were listed on the Taiwan Stock Exchange, with another 300 firms in the over-the-counter market.

Singapore is the regional center for the Asian Dollar Market, loan syndication, foreign currency trading, and bond futures trading on the SGX, and yet, reports Chong, the capital market in Singapore remains thin (there are only about 300 listed companies on the Singapore Stock Exchange or SES), and equity is tightly held among the investors (including government, corporations, individuals and financial institutions). Like Singapore, the securities market in the Philippines is frail and controlled by a few. Mendoza offers some details: of the 246 firms listed in the stock exchange, the top 25 percent already represent 95.9 percent of market capitalization and 96 percent of the trading volume, indicating the tight control of the capital market by a handful of firms. On the average, publicly listed firms have 43,500 shareholders, but the largest single shareholder typically owns 41 percent of the outstanding shares. The top five shareholders own about 65 percent while the top 20 shareholders own 76 percent of shares. Controlling shareholders, defined as the largest five shareholders, own up to 80 percent of the voting shares in seven of these companies.

The Sri Lankan equity market has no active independent shareholders. Unit trusts and other forms of fund management remain too feeble to be influential. Balasuriya reports, however, that between 1996 and 1997, several features have been added: over-the-counter market for trading on unlisted shares, a two tiered system consisting of main board and a second board, and a screen based trading system. Nevertheless, at the end of 2002 the Ceylon Stock Exchange only had 239 companies listed with a market capitalization that was approximately 12 percent of the country s GDP. In Nepal, capital markets are underdeveloped, according to Maskay, and have not evolved into effective vehicles for mobilizing long-term capital. Much of the activity centers on treasury bills and government bonds, although no active secondary markets exist for these instruments. The stock market has 115 companies listed, commanding about 12 percent of GDP, but only shares of only 69 companies are traded. In Iran, at present, the number of listed companies is nearing 350, according to Rahmanserehst, likewise attesting to a thin capital market.

INSOLVENCY MECHANISMS

Most Asian countries are equipped with at least the basic elements of either liquidation, or more commonly, reorganization of the firm.[1] The provisions are found in various fiats: in the Companies Act (Malaysia and Singapore), under a Presidential Decree (the Philippines), and in legislative amendments (Thailand) (Chong Nam, Kang and Kim, 2001). Whether they allow quick and easy exit for failed companies, however, depends on the extent of protection against secured creditors, the depth of judicial intervention, the priority of different claims, among others. It also matters whether dissolution is done formally (and how rigorous the process is) or through informal practices.

Most cases uphold the prior rights of creditors. In Iran, all the insolvent firm s liabilities must be paid out from company assets. f they fall short of the total needed to meet the liabilities, then, the creditors have the right to claim from all partners, according to Rahmanseresht. Yu reports that in Taiwan, the claim rights of creditors are ahead of shareowners when firms face insolvency or bankruptcy, and there are no laws which firms can invoke to protect the owners or shareholders. The board of directors of privately-owned companies in India is the guarantor of the loans advanced by the creditors, according to Monga.

But in many countries the firm s management has the right to file for bankruptcy —which keeps a tight rein on creditors claims against the firm s assets and could possibly tempt owners and managers to strip them (Claessens, Djankov and Klapper, 1999). Countervailing devices, such as court-designated trusteeships, can prevent asset stripping. But in Asia neither expertise nor legal frameworks are present to put trusteeships into service (Stiglitz, 2002). In Indonesia, firms could not be forced through the courts to settle their debts, despite the government s adoption of the so-called London Rules. A vintage bankruptcy law drawn by the Dutch in 1906 can offer creditors only vague protection (Woo-Cummins, 2001). A so-called automatic stay on assets bars creditors in the Philippines, where the code is of French origin[2], from taking any collection action against the firm s assets once bankruptcy has been filed. Their security interest does not establish priority status. The law also rules out creditor-initiated management changes during reorganization (Claessens, Djankov and Klapper, 1999). The Insolvency Law allows Philippine firms to be taken off the hook to enable them to start afresh with property set aside for them from assets to be used as payment to creditors, according to Mendoza.

Bankruptcy filings are more likely in countries with efficient legal institutions, in addition to strong creditor rights. A creditor will compel a firm to accept bankruptcy proceedings and incur the related legal costs only if there is an even chance of recovering his losses quickly. That is, he must first be satisfied not just by ex-ante loan features but also by ex-post judicial efficiency (Claessens, Djankov and Klapper, 1999). In Malaysia, a debtor firm unilaterally can seek relief from creditor actions for a period of up to nine months and leave its creditors without any option to present their case in court (Chong

[1]When an insolvent firm faces *liquidation* (or winding-up), its commercial activities are discontinued and its assets are sold. In *reorganization* (or rescue), its commercial activities are continued while the financial claims of its creditors and shareholders are restructured; it also entails a change in the management and the ownership structure (Chong Nam, Kang and Kim, 2001).

[2]Creditor rights are typically the strongest in countries with English and German origins (Claessens, Djankov and Klapper, 1999).

Nam, Kang and Kim, 2001). In Nepal, Maskay reveals that a lack of capacity in the judiciary to settle insolvency disputes inhibits reliance on them. The bankruptcy rules clearly favor poor performing firms.

At any rate, few Asian firms turned to formal proceedings to resolve insolvency cases, even during the Asian financial crisis in 1997-98. Most countries preferred out-of-court means[3](Chong Nam, Kang and Kim, 2001). Because of the close ownership ties between debtors and creditors—that is, banks can make loans and hold equity in the same or affiliated firm—Asian companies can continue accessing funds through internal markets (thus avoiding dissolution), and creditors can internalize the opportunity costs of bankruptcy proceedings through out-of-court negotiations (Claessens, Djankov and Klapper, 1999). Using a sample of 1,472 publicly traded East Asian firms, of which 644 firms were financially distressed, Claessens, Djankov and Klapper (1999) find through regression analysis that the likelihood of bankruptcy filing is negatively associated with the firm being owned by a bank or affiliated with a business group. In Japan, using firm-level data, they also discover that bank-related firms recover more quickly from financial distress than other firms, and without necessarily using formal reorganization or bankruptcy procedures.

Such relationship-based system, with its heavy need of bank loans for corporate financing, set in motion a vicious cycle, with both banks and troubled firms having incentives for debt rescheduling and avoiding court settlement because of the huge stake thy have in each other through the large amount of debt. But court proceedings are equally to blame, because they tend to be time-consuming and expensive, and were not handled in an efficient manner (Chong Nam, Kang and Kim, 2001).

Chong Nam, Kang and Kim argue that the relatively new informal workout procedures that several Asian governments have introduced are appropriate policy responses to the large cases of financially distressed firms. They include the Jakarta Initiative in Indonesia, the Framework for Corporate Debt Restructuring (Bangkok Rules) in Thailand, the Corporate Debt Restructuring Committee Framework (CDRC) in Malaysia, and the Corporate Restructuring Agreement among financial institutions in Korea. Stiglitz (2002) notes that while insolvency is a slow process, the governments of Malaysia and Korea took an active role, and succeeded within a remarkably short period of time, two years, in completing the financial restructuring of a remarkably large fraction of the firms in distress. But the recourse to informal processes has left the formal insolvency regime unable to make significant progress, and its overall weak disciplinary function has exacerbated even more the concentrated ownership in Asia.

TRANSPARENCY AND DISCLOSURE

In most countries in Asia, accounting standards are set and reviewed by professional and quasi-government agencies. Disclosure rules are mostly regulated by the securities exchange commissions and the stock exchanges. There are local standards, but most firms try to follow the International Accounting Standards (IAS) and the disclosure regulations of the US and UK. But practices vary and enforcement is generally weak, helping grant a

---

[3] *Informal workouts* can be used as an alternative to the formal procedures of the insolvency law regime when the debtor firm and its creditors prefer to conduct negotiation of rescheduling or restructuring with more flexibility. They can be less costly and speedier than the formal procedures which involve the courts. (Chong Nam, Kang and Kim, 2001)

free rein to corporate insiders. The close tieup between firms and banks also suggests that transparency and disclosure standards took a back seat, as bank credit tended to flow to favored firms without the benefit of rigorous risk assessment of the firm s investment projects. In turn, this practice deterred the growth of accounting standards and expertise in credit evaluation in the region (Chong Nam, Kang and Kim, 2001).

Northeast Asia

In Japan, the practice is consolidated accounting, especially for publicly listed companies, and this is mostly in line with the principles of the International Accounting Standard Committee. More than 60 percent of the number of Japanese companies now provide such consolidated reports. According to Yasui (2001), consolidated accounting prevents large, listed firms from dressing up their financial statements by conducting transactions with unlisted group firms.

The APO survey reveals that about 80 of the sample companies follow local auditing standards and only 15 percent follow non-US international standards. An even larger number (86 percent) have external auditors, with 63 percent shuffling them over the last three years. According to Mizuo, the companies reported that the external auditors are fairly independent. When the Commercial Law was revised in May 2002, the idea was to separate the functions of business performance and managerial monitoring. Giant companies, with over Y500 million capital or with more than Y20 billion total debt can opt not to appoint an auditor, if they have at least two or more outside directors, and if they form the audit committee (with the outside directors as members) to act as auditors.

In any case, however, such independent auditors are often ex-employees or individuals coming from group companies and the main banks, and thus may not be so unbiased in supervising the firm (Yasui, 2001). Moreover, reporting lines flow from accountants to the statutory auditors, and because of this, accounting audits, especially in cases of fraud, may not be entertained objectively (Kanda, 2001).

In Korea and Taiwan, all surveyed firms answered that they follow local accounting and auditing standards, and each one has both internal and external auditors. No firm changed its external auditor during the last three years, but hinted that this period was the benchmark for maintaining the independence of auditing. In Taiwan, reflecting the spread-out ownership among firms, the law requires that the CPA auditors be appointed by stockholders, according to Yu.

Southeast Asia

Singapore observes International Accounting Standards rather than FASB standards, but problems in legal support and enforcement of these standards lead to a relatively low quality of publicly available corporate information, according to Chong. The APO survey, nevertheless, reveals that a large number of the firms have external auditors and they have been changed over the last three years (the firms rated the degree of independence of the external auditor from the firm as moderate to very high).

Singapore practices a merit-based philosophy to regulation. Under the rules, transactions are scrutinized by shareholders, rather than by regulatory and quasi-regulatory agencies, such as the Singapore Exchange (SGX). This provides companies the incentive to disclose only the bare minimum required by rules, and no more. As a result, according to Chong, even if corporate financial information is publicly available, there is little benefit from it.

In the Philippines, the Accounting Standards Council (ASC) sets the accounting standards and rules that form the Philippines body of generally accepted accounting principles (GAAP), with 18 out of 37 International Accounting Standards adopted to date, Mendoza reports. All the firms surveyed by APO follow the GAAP, and half of them adhere to international auditing standards. But the downside is long auditor tenure, which trade offs independence for secure terms of office. According to Mendoza, auditor turnover among the surveyed firms is very low. Most external auditing outfits have been associated with their client firms since the firms were established (60 percent).

Under the Securities Code, firms are required to submit financial and non-financial corporate information to the Securities and Exchange Commission and the Philippine Stock Exchange, which act as central registries. The code also provides that such information and reports are accessible to shareholders, investors, creditors and other interested parties. Respondent firms generally observe this rule. But Mendoza cites a recent survey made by the Philippine Institute for Development Studies (1999) which indicated that many firms do not prepare financial reports, and if they do, are not audited.

Vietnam basically follows accepted standards. Besides an internal control system, all firms surveyed by the APO maintain an external independent audit. External auditing firms conduct bi-yearly financial audits, and as Hang finds out, it is the big four auditing firms (KPMG, Earns &Young, Delloit Tomatsu, PWC) which are competing with each other in Vietnam, and can be presumed to be very independent from their client firms.

Most of the asked companies also provide financial information to the stock trading center, banks, and security consulting firms.

South Asia

Accounting standards in India are normally the responsibility of the Institute of Chartered Accountants of India (ICAI). But in 1990, according to Monga, the government repealed the Companies Act, giving itself the authority to prescribe the accounting standards. Accordingly, a government-sponsored National Advisory Committee on Accounting Standards (NACAS) has been set up to review the disclosure requirements under the Companies Act. At least for the moment, Indian companies still appoint external auditors, with very high degree of independence from firms, according to the APO survey.

In Sri Lanka, Balasuriya cites a recent ADB finding which gives fairly high marks to the country s financial management arrangements. Sri Lankan companies follow International Accounting Standards. The APO survey also reveals that all respondent firms have external auditors, who are quite independent. But according to Balasuriya, the accounting rules exclude inter-company transactions between members of a group of companies from being disclosed. Many minority shareholders feel this exclusion allows directors with large financial interests to conceal crucial information on questionable transactions.

All surveyed firms in Nepal follow accounting and auditing standards, often a mix of local and international practices. All also claim to having independent external auditors. But the accounting and legal infrastructure is generally weak and underdeveloped, according to Maskay, adding that the Nepalese Company Act 1997 neither imposes any explicit general standards of care nor specifies that directors and officers be legally obliged to act in the company's interests.

West Asia

In the Islamic Republic of Iran, the choice of accounting standards to follow is left to the management of the company, giving it inappropriate incentives, such as reducing the loan agreements limitations and penalties on late payments. Rahmanseresht indicates that this has made adoption of a country accounting system more important.

Listed companies are legally bound to make their major financial reports public, and in particular, are required to publish financial reports in the official gazette and well-known dailies. Despite this, Rahmanseresht points out that while the firm s higher echelons, as well as creditors and external auditors have ready access to company information, other groups such as unions, and minority shareholders do not enjoy the same privilege.

Clearly, the transparency and efficiency of accounting standards do not vary much in Asia. The mandatory disclosure system has not worked effectively in most countries. Nevertheless, many firms now have relatively higher levels of disclosure than before, and subscribe to international accounting standards. Yet it is hard to conclude that because disclosure is taken increasingly into account, the concentrated ownership structure may be changing, as Kanda (2001) suggests. There are no clear signals that ownership is spreading out, except in Japan and Taiwan. Even there, where the relationship-based system still exists, dispersed shareholders still face collective action problems.

RESOLVING THE PRINCIPAL-AGENT PROBLEM

A relationship-based system that relies on bank financing obviously leads to failures in monitoring. As suggested by Khan (1999), the key governance issue to be resolved is the banks weak capacity to monitor the firms through risk-measurement and risk-assessment. As external finance became dominant in Asia, the separation between owner-managers and external financiers increased the cost of information gathering and processing about family businesses; self-monitoring incentives dwindled and financiers did not have proper incentives to monitor the borrowers at such high costs. Under ordinary circumstances, this could lead to expropriation of minority shareholders unless they took actions by themselves to monitor the corporations. The lack of effective monitoring from the viewpoint of shareholders is likely to result in low productivity, and hence, poor profitability of a firm and lower returns on equity.

Moral hazard also arises from the asymmetry of information between the lenders and borrowers. If the lender does not know much about the investment projects undertaken by firms there is a chance that the borrower will misappropriate the funds through the selection of more risky projects. Misuse is often the result of government-provided guarantees, since the borrowers take no extra risks as they do not bear the full costs of their actions. In turn this breeds relatively more risky borrowers in the financial markets, giving rise to the adverse selection problem (Khan, 1999).

It is apparent then that the relationship-based system in Asia can only work well when external financiers can perform ex-ante monitoring of potential borrowers. This presupposes an environment of strong prudential regulations and legal enforcement, the absence of which will not allow financial institutions to perform risk measurement and management, no matter how well developed their capacities are. But in fact, banks monitoring capabilities in Asia are limited, and this, plus increased agency costs, ironically prevents arms length systems from making an impact in Asia. Ironically, as Khan (1999) indicates, the relationship-based system can still be made to work efficiently when it is accompanied by proper regulations, managerial expertise and market competition—at least to the extent that such reforms lower transaction costs without increasing agency costs further. The capability of banks for collecting and analyzing the data necessary for monitoring the borrowing firms is in short supply in Asia. Capacity building must be seen as an urgent task.

Khan (1999, 2001) points to Hong Kong as an example of a governance system that has succeeded in bridging the gap between ownership concentration and effective monitoring. Relationship-based Hong Kong firms were helped along by Hong Kong

(HKMA), which plays the role of an overseer when it comes to disclosure rules. A strong legal system and adequate sanctions likewise make it worrisome for Hong Kong companies to disobey the provisions of the Banking Ordinance which require them to maintain adequate liquidity, and capital adequacy ratios.

PERFORMANCE AND PRODUCTIVITY

The aim of good corporate governance is to enhance efficiency. If the right quantity of investment were the measure, Asian firms registered impressive growth rates. Khan (2001) observes that between 1988 and 1996, a large sample of listed companies in Korea grew, on average, by 13.6 percent. Thailand s mostly family-based corporations showed an even more impressive rate of capital accumulation over the same period at 13.8 percent per year. Not far behind were Indonesian corporations at 12.7 percent. For Thailand, the Philippines and Indonesia, the returns on assets varied between 8 and 10 percent per year. Malaysia and Taiwan followed closely.

Even in Japan, according to Yasui (2001), the returns were not excessively low, given the generally strong performance of Japanese firms in the growing economy. Khan (1999) adds that this pre-crisis performance enabled Asian firms to diversify, with the motive being to protect and expand family fortunes. Interestingly, Kar (2001) notes that the amount of insider holdings by directors and family members follows a U-shaped relationship with company value in India. Initially, corporate insiders may have an interest in maximizing their own private interests when they have less stake in the company, but paradoxically, as their *holdings increase*, their interest start coinciding with that of shareholders. Using a sample of Taiwanese firms, Yeh, Le and Woidtke (2001) find that a nonlinear relation exists between family control and relative firm performance. Both family-controlled firms with high levels of control and widely held firms have higher relative performance than family-owned firms having low levels of control. They also find that a positive valuation effect exists when controlling families hold less than half of a firm's board seats.

Asian firms also performed well even after the Asian crisis, even with few changes in their ownership structure.

Northeast Asia

Park notes that among Korean firms which were surveyed, the group whose main creditor is a bank shows higher ROE, ROA, gross profit margin, net profit margin and sales growth rate. However, the level of median ROE for Korean firms is far lower than the opportunity cost of capital. Firm value declined because controlling shareholders were maximizing firm size at the expense of profits, a practice that was not checked by creditors.

With the exception of return on net worth, all indicators of performance of SMEs in Taiwan rose in 1999, according to Yu. The same goes for large firms, which tended to outperform SMEs each year. Large firms tended to operate more efficiently (that is, in 1999 the operating expenses were 7.77 percent and 14.96 percent for large firms and SMEs respectively), and their profits were higher (4.11 percent vs. 3.45 percent in 1999). However, the economic downturn in 2000 brought about mixed results—high growth sales but reduced ROE.

Southeast Asia

For Singapore, Chong reports that overall the rate of ROA increased slightly from 5.1

percent in 1999 to 5.8 percent in 2000, especially in the manufacturing, financial and commerce services sectors. Manufacturing had the highest rate of ROA at 10.5 percent, followed by transport & communications (8.7 percent).

Most of the Philippine firms exhibited positive performance in 2001, according to Mendoza. The average value of net income to revenue was 6.24 percent, slightly lower than the aggregate corporate sector average net profit margin of 7.9 percent. The average ROA was 2.11 percent, below the aggregate average of 5.3 percent. The mean ROE stood at 5.97 percent, also below the corporate sector average of 12.6 percent.

In Vietnam the record shows positive growth trend among firms, according to Hang, proof that state ownership does not lower firms performance. State control of capital resources also seems to augur well for Vietnamese firms, at least during the formative stages of the stock exchange. The surveyed firms, however, shows a declining trend: ROS (from 8.6 percent in 1999 to 3.81 percent in 2001), ROA (from 11.48 percent to 4.12 percent) and ROE (from 23.35 percent to 8.3 percent). Hang attributes this to the relative inefficiency of the sample firms.

South Asia

Key performance ratios in India have been steady since 1994; in 2000-2001, the ROA for the corporate sector stood at 18.22 percent while the ROE was at 10.89 percent. Productivity gains were also impressive, according to Monga.

Balasuriya cites a 2002 Central Bank of Sri Lanka report on 480 industrial enterprises, which indicated that factory output grew by 11 percent in real terms and 16.8 percent in normal terms. Output of the private sector industries grew by 10.5 percent in 2000, compared to 5.3 percent in 1999. Private sector industries accounted for 94 percent of industrial production in 2000.

Productivity trends are likewise generally upbeat. Labor productivity has been rising in India at an average rate of 4.66 percent per year during the nineties. Capital productivity has shown a growth rate of 0.51 percent, while total factor productivity grew at the rate of 1.9 percent. In Singapore labor productivity increased 5.9 percent in 2000, dropping slightly across industries in 2001 by 5.4 percent. For Philippine firms, the mean value of revenue per employee, an indicator of labor productivity, and average value added per employee, a measure of value created within the firm, also rose. Monga, Chong and Mendoza reported these, respectively.

What are the most important corporate governance elements affecting productivity? A close look at each of the surveyed countries shows variations. In most, however, ownership concentration and productivity are positively correlated, indicating that other intervening factors are at work in Asian firms.

Northeast Asia

A multiple regression analysis made by Mizuo shows that in Japan, higher ownership concentration and less influence from banks improve the firms performance better. The outcome suggests that an internal self-governance process with respect to corporate management, ethics, social responsibility, and institutional interface will stimulate increased management efficiency. Better monitoring results in higher productivity among Korean firms, according to Park. That translates into firms with outside directors, and with specific disclosure policies.

Southeast Asia

There is some evidence that ROA increases in the as the owner becomes more involved in firm decision making, according to Mendoza. Returns are also positive when the CEO and the boards are more active in company operations and monitoring, which is no accident given the congruence in interest among all corporate insiders. In Singapore, the survey findings show little direct evidence of the link between corporate governance practices and firm productivity, according to Chong. This indirectly suggests that family control has no bearing on productivity.

West Asia

In Iran, too, the survey findings suggest that few owners plus good monitoring equals high productivity. As Rahmanseresht discovers, powerful owners acting as managers, coupled with clear-cut, transparent policies, adherence to consumers rights and shareholder protection are more likely to be associated with high firm productivity. Where two or three shareholders had most of the stock the productivity was the highest. The firms, whose majority holdings were held by ten and more shareholders, productivity was lowest. The analysis also revealed a positive correlation between productivity and the use of external independent auditors.

DOES THE ASIAN ENVIRONMENT MATTER?

It is often argued that common law countries offer the strongest shareholder protection, having efficient judicial systems. Civil law countries, on the other hand, offer much weaker protection, with laws made by legislatures rather than by judges looking at precedent (Woo-Cummins, 2001). Asian countries, however, cannot be simply categorized into either legal tradition. Each one uses a mix of substantive and procedural protection in its laws—the outcome of transplantations that have converted the country s institutions into a legal mosaic.

Japan, Korea and Taiwan come from a civil law tradition, but both Korea and Taiwan augmented these laws with Anglo-American practices that permit lenders to take broader security interests in personal property, according to Woo-Cummins. The result is often a balancing act. Japan, for instance, has long had a bankruptcy law based on French and German civil codes: for upwards of a century, courts give high priority to secured creditors, but a still higher priority to salaries owed to employees. An insolvency law regime may be good for protecting lenders, but governments may also have good reasons to protect other stakeholders, such as workers and customers. Bankruptcies may disrupt an existing social pact among various constituents in society, forcing countries to trade off the rule of law for political stability. In the recent case of the dissolution of the Daewoo *chaebol* in Korea, the government had to compare the interests Ford and General Motors, who wanted to take over Daewoo s automobile business but demanded the right to lay off workers, against the strength of Korea s auto unions (which Kim Dae Jung counted as part of his constituency), and the need to preserve both economic growth and social stability (Woo-Cummins, 2001).

Even if Asia is not a uniform region, Asian governments in varying degrees offer active intervention through administrative guidance, or broad discretion to make, interpret and enforce rules of economic behavior (in spite of urgings from advocates of the rule of law that it ought to come to an end). Asian states are developmental rather than regulatory ; more focused on winning social consensus than conforming to legal procedure (Woo-Cummins, 2001). Khan (2001) argues that in the case of Singapore, the close guidance from government in a competitive environment might help explain the relatively better performance of the corporate sector there.

Although Hong Kong s common law tradition has given it a strong legal infrastructure, regulations accentuate more strongly matters that arise directly from the close ties between majority owners and management, such as related party transactions. The threat of civil liability on the part of directors is thus not as important as in an Anglo-American system (Khan, 1999). Similarly, Singapore and Malaysia are common law countries—both were British colonies—but nothing suggests the rise anytime soon of a well-crafted legal system predicated on the western model. Both operate on an administrative guidance mode. Malaysian laws that at first blush seemed to undergird the power of the judiciary over time were used to entrench rule making by the executive as its economic activism expanded (Woo-Cummins, 2001).

IS CONVERGENCE POSSIBLE?

Despite the enduring presence of Asia s relationship-based structure, it is not a closed system. Listing on overseas bourses, for example, as many Asian companies do, is an exposure trip to Anglo-American disclosure standards. A distinct group of firms may somewhat break away from disclosure norms in their home markets, according to Allen (2000). Khan (2001), however, notes that most companies in Hong Kong are already listed in foreign exchanges, but the most it did was to constrain the power of domestic legislation in regulating the internal affairs of corporations.

Selling equity stakes to foreign investors also allow Asian firms to be laid open to outside influence. The APO survey results confirm the significant presence of foreign shareholders in Singapore, India, Korea, the Philippines and even Vietnam. In Korea, where foreign ownership accounted for 18 percent of total market capitalization in 1998 and is still going up, it is expected to induce firms to pursue shareholders value (Chong Nam, Kang and Kim, 2001). Foreign equity funds and longer term mutual funds are willing to take minority stakes in Asian companies in return for board seats and input into business strategy, while expecting a sizeable return several years hence (Allen, 2002).

But in Japan, despite holding 15 percent of the outstanding shares, foreign shareholders have limited influence. Given that a large portion of stocks are held by stable shareholders, foreign investors have had better chances increasing their share in the market turnover and influencing the stock prices of the large, reputable companies (Yasui, 2001). Allen also points to cases of troubled Asian firms inviting foreign shares merely to avoid bankruptcy. In Malaysia, foreign participation ought to increase if the government finally implements a plan to scrap a controversial, decade-old affirmative action policy that compels companies listed on the Kuala Lumpur Stock Exchange, to set aside at least 30 percent of their stock to *bumiputras*, mainly ethnic Malays. The finance ministry is reportedly fine-tuning the details of this reform package (Jayasankan, 2003).

Quality certifications, which follow western standards, are another entry point to a different norm of corporate conduct. On this score, the APO survey reveals varying patterns. Majority of Taiwanese firms have ISO 9000 or ISO 14000 certifications, as do Iranian companies. Only 30 percent of Philippine firms have either. In Vietnam, ISO 9000 is associated with high-performing firms. In Nepal, both are present, but their impact is not clear.

The ambiguity in the Asian context does not necessarily imply that a relationship-based system cannot evolve toward effective norms of transparency and accountability. If social organization is viewed as complex, fluid, highly contextual network of human relations, the endurance of family business could be the result of a *rational* choice. Its important aspect in Asia is its ability to adapt to and reform (Woo-Cummins, 2001). The challenge for corporate governance reform in Asian countries is to channel the energies and operations of family businesses into structures that are more transparent and consequently more clearly equitable for non-family investors.

As Woo-Cummins (2001) points out, it is not a case of the right goal being achieved by the wrong means, as much as the right goal being achieved by creatively utilizing those wrong institutions that were the sources of past developmental success, like the heritage of administrative guidance, to make progress toward arm s-length, third-party governance.

Asia offers different templates for reform and contrasting examples of pathways toward the transparent and predictable rule of law. In suggesting the various roads to take in Asia, Khan (1999) suggests a cautious case by case approach, where in each case the crucial issues are the type of institutional changes that will be necessary and how feasible these changes are within a given time horizon.

CHALLENGES AND POLICY OPTIONS

In the context of a continuing relationship-based system, the major quandary across Asian countries is the fragility of the monitoring framework and the lack of credible enforcement with regard to risk management. Many crucial problems are still left unanswered, awaiting fresh reform measures—minority shareholder issues, for example, are clearly important. But following Khan (2001), what is central to corporate governance is correcting the weak position of the financiers in the overall economic structure and the lack of capacity of banks to gather and analyze technical and financial information.

Asian banks have to be subjected to both discipline (better prudential regulation) and capacity building (development of expertise for risk evaluation). Many of them are in captive positions due to their reckless lending practices to family based firms. Government has to step in to provide the regulations necessary to promote transparency and correct disclosure, and make sure the banks have the appropriate monitoring instruments.

Barring the families from finessing their own reports requires a well regulated disclosure regime. It also requires removing distorting incentives such as government guarantees. In the Philippines, this translates into reforms in the financial sector that could raise the quality of creditor monitoring, including a review of government s contingent liabilities (which includes sovereign guarantees involving private sector loans), according to Mendoza. Elsewhere it means giving minority shareholders a stake in monitoring and/or reducing direct government involvement in it. Enhancing transparency in Sri Lankan firms requires, according to Balasuriya, that all material related party transactions be specifically approved by shareholders at a general meeting. In Taiwan, Yu argues, the government should refrain from using excessive voting power in the audit bodies of newly privatized banks or SOEs. Controlling shareholders (including banks) of troubled firms should not be exempted from due responsibility for neglect of monitoring. The Korean government, according to Park, should exert effort not to allow the manager/shareholder of *chaebols* to un-align the interests of the firm and shareholders through risky ventures that escape due diligence.

Equally important for reforming the relationship-based system is the need to equip financial institutions with competent professionals who can gather and analyze the relevant information about the firms they bankroll. In Taiwan, Yu suggests providing training courses to firm-auditors to enhance their skills. Balasuriya recommends establishing professional qualifications for public sector accountants and establishing retaining courses in Sri Lanka.

Sequencing the reform measures will yield better results. Reforms in regulation must be accompanied by reforms in participation by shareholders. The states must improve minority shareholders rights to participate *ex-ante* in monitoring and to have easy access to business information by strengthening the legal framework. Access to financial reports can counter information asymmetry and solve the agency problem. In Korea, Park is advocating expanding the categories of corporate decisions requiring shareholder approval to ensure shareholder participation in large acquisition and disposal transactions by the company and its subsidiary or major shareholders, large share issuance transactions by listed companies, and material related party transactions by the company or its subsidiaries.

Yu challenges Taiwanese firms to upgrade the quality of their assessments by switching from local accounting standards to those proposed by the International Accounting Standard Committee. Here, the government should facilitate the quick changeover. In Nepal too, the government should promulgate accounting and auditing requirements based on international standards. An effort has come up in this direction, according to Maskay, through the setting up of the Institute of Chartered Accountants of Nepal (ICAN) under the Nepal Chartered Accountants Act, 1997. Other than setting standards, the Sri Lanka Accounting and Auditing Standards Monitoring Board should monitor compliance with laws and regulations in relation to financial reporting as well as cover investigation of financial fraud, suggests Balasuriya. A credible commitment to reform also requires enforcing penalties for violations involving new accounting and auditing standards.

Although Asian governments need to strengthen the regulatory framework and check the incentives that are embodied in rules in order to come up with a fairly effective monitoring system, in the end it is the meshing of formal institutions with informal relationships that can create the right environment for Asian corporations, and not a one size fits all approach to corporate governance. That is the setting that will improve firm performance and productivity in the long run.

CONCLUSION

This review indicated that ownership concentration in Asian firms is not a hurdle to improved performance since it lowers transaction costs. Most of Asian firms operate as economic entities within the context of trust based on relationships. A low level of conflict between inside controlling agents and external financiers in Asian firms increases firm performance and productivity. But in the long, Asian firms would do well by reforming this relationship-based system and strengthening external monitoring. Increased transparency and accountability bring about more competitive performance and productivity and prevent insiders from having a free rein in the firm s activities. Even under a relationship-based system, Asian firms can remove ambiguities and evolve towards greater transparency and accountability through effective regulation. While Asia is more developmental and consensual rather than regulatory , the more transparent (and certainly, the more consistent) the regulatory framework it can offer, the better it be would be for long-term economic growth and productivity. The challenge for corporate governance reform in Asia is to channel the energies and operations of relationship-based businesses into structures that are more transparent and consequently more clearly equitable for non-family investors. Nevertheless, Asian governments must provide the necessary firm supervision following the lessons in other parts of the region.

REFERENCES

Allen, Jamie (2000). Code Convergence in Asia: Smoke or Fire? Asian Corporate Governance Association. January.

Alizadeh, Parvin (2003). Iran s Quandary: Economic Reforms and the Structural Trap *The Brown Journal of World AffairsWinter/Spring, Volume IX, Issue 2.*

Chong Nam, Il, Yeongjae Kang And Joon-Kyung Kim (2001). Comparative Corporate Governance Trends in Asia, in *Corporate Governance in Asia: A Comparative Perspective*, Organization for Economic Cooperation and Development.

Claessens, Stijn, Simeon Djankov and Leora Klapper (1999). Resolution of Corporate Distress in East Asia. World Bank Policy Research Working Paper No. 2133, June.

Claessens, Stijn, Simeon Djankov, Joseph P.H. Fan and Larry H.P. Lang (2000). Expropriation of Minority Shareholders: Evidence from East Asia. World Bank.

Jayasankaran, S. (2003). Rule Roll-Back. *Far Eastern Economic Review.* August 21.

Kar, Pratip (2001). Corporate Governance in India, in *Corporate Governance in Asia: A Comparative Perspective*. Organization for Economic Cooperation and Development.

Khan, Haider (1999). Corporate Governance of Family Businesses in Asia: What s Right and What s Wrong? Working Paper No.3, ADB Institute, August.

Khan, Haider (2000). Corporate Governance of Family-Based Businesses in Asia: Which Road to Take? ADB Institute.

Khan, Haider (2001). Corporate Governance: The Limits of the Principal-Agent Approach in Light of the Family-Based Corporate Governance in Asia. *Journal of Finance*.

Ko, Chen-en, Kung-Wha Ding, Chi-Chun Liu and Yin-hua Yeh (1999). Corporate Governance in Chinese Taipei. Conference on Corporate Governance in Asia: A Comparative Perspective . Organisation de Coop ration et de D velopement conomiques in co-operation with the Korea Development Institute. Seoul, Korea. March.

Lee, Tsun-Siou and Yin-Hua Yeh (2001). Corporate Governance and Financial Distress: Evidence from Taiwan. Paper presented at the 2001 Asia Pacific Financial Association Conference, Bangkok, Thailand.

Lyngaas, John (2002). Corporate Governance: Will Asia Buy It? *Skyline,* March.

Malesky, Edmund, Vu Thanh Hung, Vu Thi Dieu Anh, and Nancy K. Napier (1998). The Model and the Reality: Assessment of Vietnamese SOE Reform Implementation at the Firm Level. William Davidson Institute Working Paper No. 154.

McMillan, John, and Christopher Woodruff (1998). Interfirm Relationships and Informal Credit in Vietnam. William Davidson Institute Working Paper No. 132.

Organization for Economic Cooperation and Development (2003). White Paper on Corporate Governance in Asia. Asian Roundtable on Corporate Governance, June.

Securities and Futures Institute (2001). Corporate Governance in Taiwan. December.

Stiglitz, Joseph (2002). Globalization and Its Discontents. London: Penguin Books.

Woo-Cummins, Meredith (2001). Diverse Paths Toward the Right Institutions: Law, the State, and Economic Reform in East Asia. Working Paper 18. ADB Institute, April.

Yasui, Takahiro (2001). Corporate Governance in Japan, in *Corporate Governance in Asia: A Comparative Perspective*. Organization for Economic Cooperation and Development.

Yeh, Yin-hua, Lee Tsun-siou and Tracie Woidtke. (2001). Family Control and Corporate Governance: Evidence for Taiwan, International Review of Finance, Vol. 2, 21-48.

Yeh, Tsung-ming (2001). The Corporate Governance in Taiwan. Kansai Gaidai University.

THE IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY: EVIDENCE ACROSS 10 ASIAN COUNTRIES

Dr. Eduardo T. Gonzalez
Development Academy of the Philippines
Philippines

INTRODUCTION

The links between corporate governance and productivity have been largely unexplored. Most existing cross-country studies of corporate governance in Asia pay attention only to the firm ownership structure and internal processes, but not on its impact on productivity and quality. Yet at the heart of corporate governance are asymmetric information issues that can draw attention to agency costs and their consequences on firm productivity. The analysis of informational asymmetries is important in determining what a firm s environment structure (including institutional factors in a particular country) plays in disciplining and monitoring its management, that is, the impact governance patterns can have on firm behavior and quality of outcomes.

Building upon the national experts survey carried out for the *Asian Productivity Organization,* this research was designed to assess the quality of corporate governance across 12 Asian countries all APO member nations from a firm-level perspective. This perspective provides a number of advantages. First, it explores the relationship between different characteristics of firms (such as ownership, control, size, sector, etc.) and their effects on firm productivity and quality of outcomes. Second, it provides an opportunity to investigate in depth the types of services for which firms invest to improve their productivity and efficiency. Third, it provides a micro-economic perspective on the costs and benefits to firms associated with different levels of corporate governance.

The research was designed to push further the empirical frontier in the analysis of corporate governance at the country and firm levels in the APO member countries. In the past, the assessment of corporate governance as a broad catch-all category has not proven to be an effective tool for developing specific and well-targeted policy advice for governments, firms and other important stakeholders in this area. The results of this survey would permit cross-country comparisons on the impact of business practices on productivity.

Defining good corporate governance

For good corporate governance to enhance productivity and promote growth, it should adhere to the principles laid down by OECD (1999). Corporate governance should:

1. Protect shareholders rights;
2. Ensure equitable treatment of all shareholders, including minority and foreign shareholders;
3. Recognize the rights of stakeholders as established by law, and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises;
4. Ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance,

ownership, and governance of the corporation; and

5. Ensure the strategic guidance of the corporation, the effective monitoring of management by the board, and the board s accountability to the corporation and the shareholders.

On the basis of these tenets, the research focused on four key areas of inquiry: ownership, management, social responsibility and institutional interface and their relationship to firm productivity. Ownership in this case is characterized by capital structure, distribution of shares and allocation of shareholder rights, and creditor rights and monitoring. Management concerns include allocation of decisions, internal controls and accountability systems, and managerial quality. Corporate citizenship promotes good business, and is thus also an important area of study. Institutional interface focuses on the quality of institutions and basic services of government, as well as legal frameworks and other institutional factors affecting risk-taking.

By defining corporate governance in terms of a number of distinct dimensions, the research provides a much more detailed and in-depth understanding of the nature of the relationship between corporate governance problems and productivity. Asian countries are at different levels of development, which provides insights into the ties between corporate governance patterns and outcomes, both of which are sensitive to the degree of economic development of the country to which a firm belongs. The differences in the economic, and the ensuing legal and institutional structures, across Asian countries provide a unique opportunity to study variations in prevailing corporate governance patterns.

RECENT FINDINGS

Good corporate governance holds widely-dispersed firm ownership as an ideal.

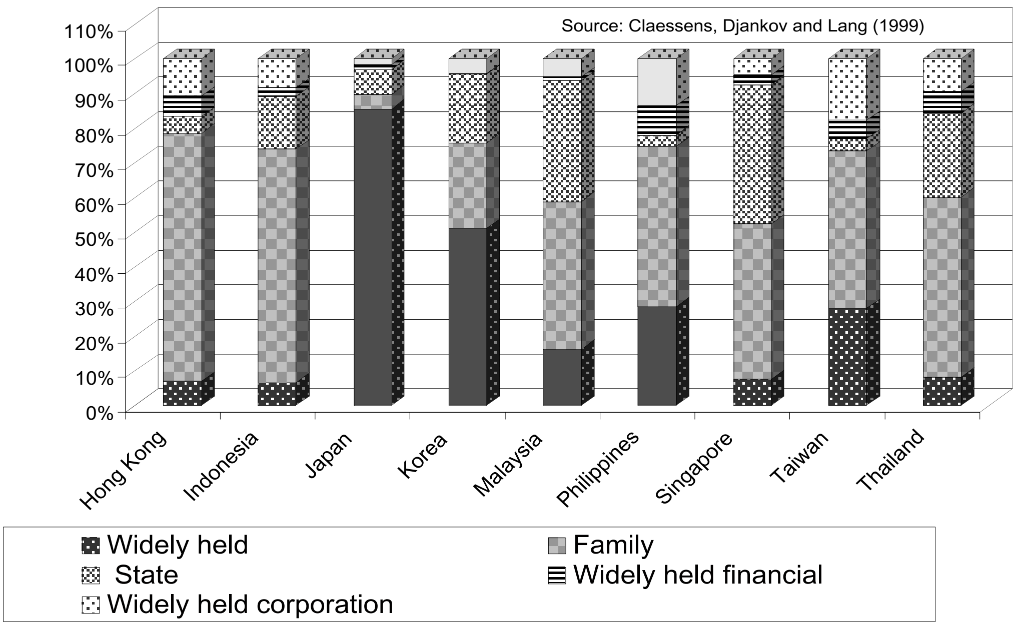


Figure 1. Ownership is family-based in Asia, except in Japan where it is widely held control over companies is seen today as a domain of professional managers, not owners.

The literature on corporate governance often begins from this principal-agent relationship and its associated problems (Claessens, Djankov and Lang, 1999).

East Asian corporations have long been regarded to be an exception to this rule. Claessens, Djankov and Lang, probing ownership control patterns in some 3,000 publicly-traded companies in nine East Asian countries, find that family-based control is prevalent in more than half of the firms in Indonesia, Malaysia, the Philippines, Singapore, Taiwan and Thailand, as well as in Japan and Korea.[1] Significant cross-country differences do exist, however. Ownership in the majority of Japanese and Korean corporations is found to be widely-dispersed, for instance. State-control is significant in Indonesia, Korea, Malaysia, Singapore, and Thailand. Figure 1, which indicates ownership weighted by market capitalization, illustrates these patterns.

Table 1 summarizes the key features of family-based corporate structures in Asia. As suggested by Khan (1999), family control is often associated with less liquid equity markets, weak shareholder and creditor rights, restricted roles for corporate boards, and costly monitoring (since information asymmetry rises with expanded operations). Family-based systems are often a battleground for principal-agent conflicts.

Table 1. Description of family-based system (FBS) of corporate governance

Share of control-oriented finance	High initially, but may vary as family groups get bank and equity financing from outside
Equity markets	Small, less liquid
Share of all firms listed on exchanges	Usually small
Ownership of debt and equity	Concentrated
Investor orientation	Control-oriented for family groups
Shareholder rights	Weak for outsiders
Creditor rights	Strong for close creditors; weak for arm s length creditors
Dominant agency conflict	Controlling vs. minority investors
Role of board of directors	Limited
Role of hostile takeovers	Almost absent
Role of insolvency/bankruptcy	Potentially important
Monitoring of non-financial enterprises (NFE)	Information asymmetry and agency costs rise with the growth of firms, making monitoring more costly.
Self-monitoring	Initially, self-monitoring is effective because of non-separation of owner and management. Later stages present monitoring problems as agency costs rise due to separation of owner-managers and outside financiers.

Source: Khan, 1999

In many Asian countries, control is enhanced through pyramid structures and cross shareholdings. Pyramids are created through subsidiary units. A family-based firm may own shares of companies that usually hold shares of other firms as well. While parent-subsidiary systems make possible scale economies (through shared management and financing), they are inherently risky to the degree that holding firms raise funds through

[1] In this paper, for brevity purposes, the Republic of China is referred to as Taiwan, and the Republic of Korea as Korea.

subsidiaries in order to diversify (Zhuang, Edwards, Webb and Capulong, 2000). Crossholdings, on the other hand, occur when two firms own each other s equity.

Through these structures, effective control in East Asia can be achieved with significantly less than an absolute majority share of the stock, as the probability of being a single controlling owner while holding only 20 percent of the stock is above 80 percent (Claessens, Djankov, Fan and Lang, 1999a).

How owners extend their resources through the use of pyramiding structures as well as through frequent cross-ownership, is shown in Figure 2. Cross holdings are not quite prevalent because they are illegal in most East Asian countries. But pyramids are common, with the incidence in Indonesia, Taiwan and Singapore reaching near or upwards of 50 percent.

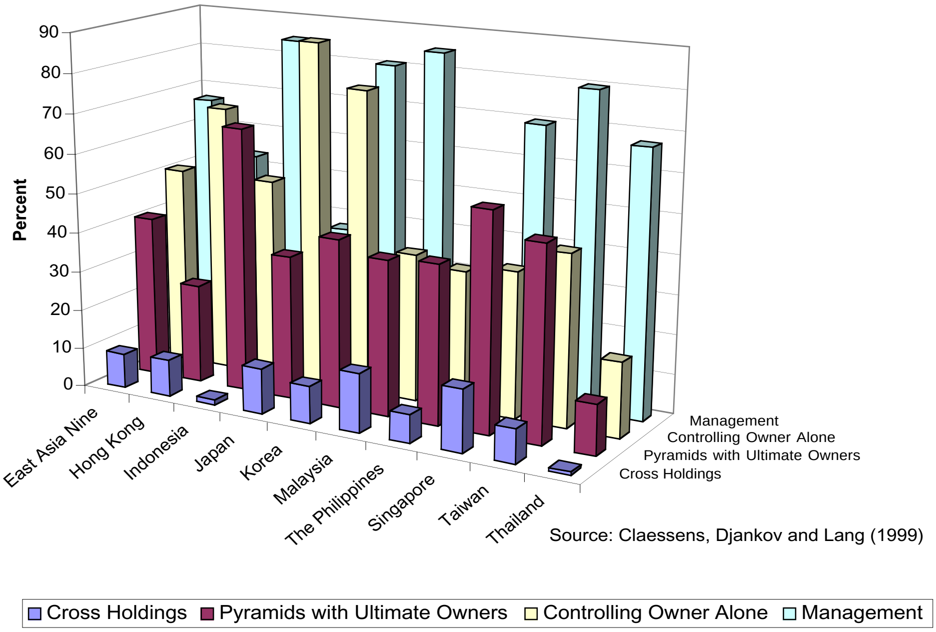


Figure 2. Asian firm have varied ways of maintaining control

Claessens, Djankov, Fan and Lang (1999a), in another investigation, find in their sample that two-thirds of Indonesian firms have stock pyramids, as are half of the firms in Korea, the Philippines, Singapore, and Taiwan. Only 10 percent of the firms (in Singapore, Malaysia, and Japan) have holdings in other firms.

Pyramiding and share crossholding are often practiced on the justification that allocating resources internally is more cost effective, especially in developing economies where external markets are prone to distortions. That may be true, but these practices allow owners to gain effective control of their firms with minimum amount of cash investment. This normally involves decoupling cash-flow rights from control rights.

To distinguish between cash flow and control rights, Claessens, Djankov and Klapper (1999) offer the following example: suppose that a business group owns 11 percent of the stock of Firm A, which in turn owns 21 percent of the stock of Firm B. In this case, the business group effectively holds 11 percent of the control rights of Firm B, which is calculated as the weakest link in the chain of voting rights a detour from the one-person, one-vote rule. In contrast, the business group holds only two percent of the cash flow rights of Firm B, which is calculated as the product of the two ownership stakes along the chain.

Table 2 shows the interplay between cash flow rights and control rights. For example, Thai firms have very high cash flow rights, 33 percent on average, followed by corporations in Indonesia (26 percent), and Hong Kong (24 percent). Cash flow rights are least visible in Japan and Korea. This descending sequence is observed in the cash of control rights. Thai and Indonesian companies have the highest concentration (35 percent and 34 percent, respectively), and followed by Hong Kong firms (28 percent). Again, Japan and Korea have the least concentration of control rights (Claessens, Djankov, Fan and Lang, 1999a).

Table 2. Concentration of cash-flow rights and ultimate control in East Asian corporations (largest control holder)

Cash-flow rights				
Country	Number of corporations	Mean	Standard deviation	Median
Hong Kong				
Indonesia				
Japan				
Korea				
Malaysia				
Philippines				
Singapore				
Taiwan				
Thailand				
East Asia				
Ultimate control rights				
Country	Number of corporations	Mean	Standard deviation	Median
Hong Kong				
Indonesia				
Japan				
Korea				
Malaysia				
Philippines				
Singapore				
Taiwan				
Thailand				
East Asia				
The newly-assembled data for 2,658 publicly-traded corporations (including both financial institutions and non-financial institutions) are collected from Worldscope, the Asian Company Handbook 1999 (1998), the Japan Company Handbook 1999 (1998), the 1997 Annual Reports of the Hong Kong, Jakarta, Seoul, Kuala Lumpur, and Manila Stock Exchanges, as well as with ownership data from the Korean Fair Trade Commission, the Securities Exchange of Thailand Companies Handbook (1998), the Singapore Investment Guide (1998), and IFR Handbook of World Stock and Commodity Exchanges (1997). In all cases, the data are as of December 1996 or the end of the 1996 accounting year.				

Source: Claessens, Djankov, Fan and Lang, 1999

Are the entitlements of shareholders amply protected in Asia? The index of shareholder rights, as adopted in the study of Klapper & Love (2002), is the sum of dummies identifying one-share/one-vote, proxy by mail, unblocked shares, cumulative vote/proportional representation, preemptive rights, oppressed minority, and percentage of shares needed to call an ESM based on Shleifer s (1999) work. The country-level index of shareholder rights for 10 Asian countries is shown in Figure 3, indicating the adequacy of laws on the book (5 is the perfect score). Whether these rights are effectively implemented is another matter, as is the overall quality of the legal environment.

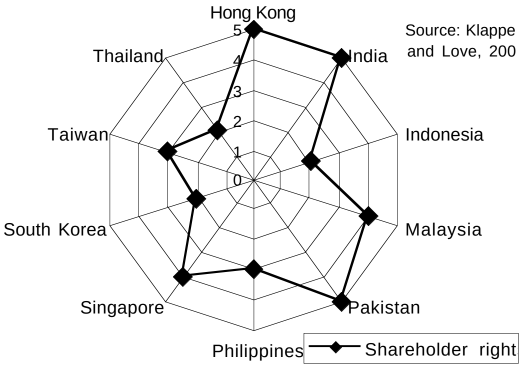


Figure 3: On paper, Hong Kong, India and Pakistan score well in granting shareholder rights

Curiously, minority shareholders are protected, at least on paper, by the legal and regulatory systems of many countries in the region. As documented in (Alba, Bhattacharya, Claessens, Ghosh and Hernandez, 1998), these include a relatively broad set of legal provisions to protect equity investors and secured creditors from abuse by insiders. Shareholder and creditor protection is strongest in Malaysia, Pakistan, and weaker in the Philippines, Indonesia and Sri Lanka. The Philippines scores badly when it comes to shielding the firms secured creditors. In judicial enforcement, however, Indonesia and the Philippines, score below India, Malaysia and Thailand, suggesting that shareholders could not fully avail of their legal protecting mechanisms (see Table 3).

Table 3. Protection of minority shareholders in Asia

	Investor protection (1)	**Creditor protection** (2)	**Judicial enforcement** (3)
India	2.0	4.0	6.1
Indonesia	2.0	4.0	4.4
Malaysia	4.0	4.0	7.7
Pakistan	5.0	4.0	4.3
Philippines	4.0	0.0	4.1
Sri Lanka	2.0	3.0	5.0
Thailand	3.0	3.0	5.9
Average	2.2	0.8	6.1

(1) An index of how well the legal framework protects equity investors. It will equal six when (1) shareholders are allowed to vote by mail; (2) shareholders are not required to deposit share in advance of a meeting; (3) cumulative voting is allowed; (4) when the minimum percentage of share capital required to call a meeting is less than 10%; (5) an oppressed minority mechanism is in place; and (6) when legislation mandates one vote per share for all shares (or equivalent).

(2) An index of how well the legal framework protects secured creditors. It will equal four when: (1) there are minimum restrictions, e.g., creditors consent, for firms to file for reorganization; (2) there is no automatic stay on collateral; (3) debtor looses control of the firm during a reorganization; and (4) secured creditors are given priority during a reorganization.

(3) An index measuring the quality of judicial enforcement ranging from 1 to 10 (best) equal to the average of five sub-indexes measuring: (1) efficiency of the judicial system; (2) rule of law; (3) corruption; (4) risk of expropriation; and (5) risk of contract repudiation.

Source: La Porta et al. (1997 and 1998)

Strong creditor rights, along with strong judicial enforcement, are the institutional ingredients needed to increase the probability that troubled firms can secure legal protection. Bongini, Claessens and Ferri (2000), in a study of bankruptcy codes in Asia, suggest that creditor rights are usually strong in countries with English and German origins and the weakest in countries with a French code. In the Philippines, where the code is of French origin, creditors have zero protection because they are constrained by what is called automatic stay on assets from taking any collection action against the debtor firm s assets once bankruptcy has been filed. To add to a creditor s aggravation, his security interest does not grant automatic priority status, and he is barred from ousting management during reorganization. That is easily contrasted with the strong creditor rights in Malaysia, where the laws are of English origin. In Indonesia, where bankruptcy proceedings follow a Dutch law of ancient vintage, debtors simply could not be forced through the courts to pay their debts. In Korea, lending decisions are based on collateral and cross guarantees among subsidiaries within the big firms (Woo-Cummins, 2001). That suggests the role of pyramiding in potential bankruptcy situations. Table 4 indicates the main features of bankruptcy problems in Asia.

In principle, firms have two ways to deal with financial distress: bankruptcy or out-of-court agreements with creditors and other stakeholders. Claessens, Djankov, & Klapper (1999) find that the preferred approach to settle financial trouble depends on the ownership structure of firms and legal standards and regulatory frameworks of the countries where these firms operate. Using a sample of 1,472 publicly traded firms, of which 44 percent were financially distressed, Claessens *et al.* find that the likelihood of filing for bankruptcy is lower for bank-owned and group-affiliated firms. Among the Asian firms sampled, the percentage of firms with bank ownership is large in Malaysia, the Philippines, and Thailand and relatively small in Indonesia and Korea while group affiliation is prevalent Indonesia and Thailand and less important in the Philippines. In either set up, Claessens *et al.* argue that informational advantages and preferential sources of credit associated with internal markets predispose negotiations outside the courts and limit the use of formal bankruptcy procedures for bank-owned and group-affiliated firms.

Furthermore, they find that the interaction between stronger creditor rights and a better judicial system in the country increases the likelihood of bankruptcy filing. Economics come into play when resolving corporate financial distress. And this greatly depends on ease, expense, and speed of restructuring and or liquidation of the firm via the formal process. As Claessens *et al.* (1999) observe, a creditor will only force a firm to file for bankruptcy and incur the related legal costs if ex-ante loan features and ex-post judicial efficiency indicate an good chance of speedy recovery of losses.

In Table 5, it can be gleaned that Indonesia and the Philippines offer the weakest protection for creditors, and have the least efficient judicial systems. They are thus less inclined to resort to the bankruptcy process. Korea and Thailand, on the other hand, have the most efficient judicial systems and a greater number of firms using formal court procedures as recourse. In the case of Malaysia where bank ownership of firms is large, internal settlement seems to be the preferred mode, despite having a fairly efficient judicial system.

The ownership ties to bank creditors increase the likelihood of renegotiations. Close ownership relations enable distressed firms to access financing through internal markets. Creditors are likewise able to internalize the opportunity costs of filing for bankruptcy through out-of-court negotiations.

In an earlier study on the resolution of firm financial distress in Japanese firms, Hoshi *et al.* (1990) find that the main-bank relationship, which implies both ownership and lending relationships between a bank and a commercial firm, improves a firm s access to capital and promotes corporate investment. In addition, they show that bank-affiliated firms recover more quickly from financial distress than other firms, and without necessarily using formal reorganization or bankruptcy procedures.

Table 4. Main features of the Bankruptcy Codes in Asia

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Country	**Bankruptcy code origination**	**Timetable to render judgment**	**Does management stay in bankruptcy?**	**Is there automatic stay?**	**Do second creditors get priority?**	**Process of liquidation**	**Process of restructuring**
Indonesia	Based on Dutch colonial ordinances promulgated in 1906. The law was amended in August 1998 to establish a special commercial court.	No timetable under old code; 30 working days after a creditor's petition is registered after August 1998.	Yes under the old code; No after August 1998.	Yes under the old code; No after Aug 1998.	Costs of proceedings are paid first, followed by claims on wages and secured creditors.	Not expensive, difficult, inefficient, slow.	Expensive, inefficient, very slow.
Korea	Based on the 1978 U.S. Bankruptcy Code. This excludes provisions for mediation for settling debts without initiating full bankruptcy proceedings.	120 working days after a creditor's petition is registered.	No	No	Secured creditors paid first.	Not expensive, easy, efficient, quick.	Expensive, difficult, efficient quick.
Malaysia	Based on the 1985 British bankruptcy law.	180 working days alter a creditor's petition is registered.	No	No	Secured creditors paid first.	Expensive, easy, efficient, slow.	Expensive, difficult, efficient slow.
Philippines	Introduced in 1909. The law was amended in 1976 to permit debtors to petition the SEC for protection.	No timetable.	Yes.	Yes	Taxes are paid first, followed by wages, cost of proceedings, and secured creditors.	Not expensive, very difficult, inefficient, very slow.	Expensive, very difficult, inefficient, slow.
Thailand	Introduced as part of the 1940 Commercial Code and amended in 1998.	No timetable.	No.	No.	Cost of proceedings are paid first, followed by taxes, wage claims, and secured creditors.	Not expensive, easy, inefficient, slow.	Not expensive, difficult, efficient quick.

Basic source: Asian Development Bank, 1999; compiled by Claessens, Djankov and Klapper, 1999

Economic theory suggests that the bankruptcy process is not necessarily optimal. In the case of East Asia informal settlement is favored to minimize losses on both parties. Informational advantage reduces the need for a third party to settle the problem.

Table 5. Creditor rights, judicial efficiency and filing of bankruptcies

Country	Creditor rights	Judicial efficiency	Number of bankruptcies as % of distressed firms
Indonesia	0	4.5	
Korea	3	7.5	
Malaysia	3	5.5	
Philippines	0	3.0	
Thailand	2	6.5	

Note: Creditor right is the sum of four dummy variables, where the highest score is 4 if timetable for rendering a judgment is less than 90 days, incumbent management does not stay during a restructuring or bankruptcy, there is no automatic stay on assets and secured creditors have the highest priority in payment. While judicial efficiency is the summation of eight dummy variables, where the highest score is 8: expense, ease, efficiency and speed for restructuring and liquidation.

Source: Claessnes, et al., 1999

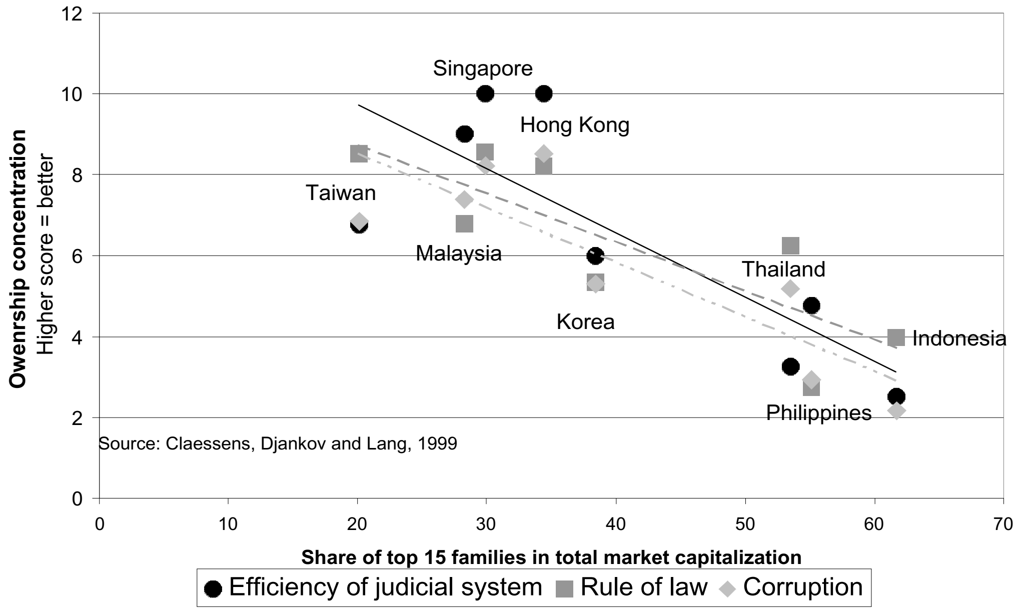


Figure 4. Are Asian judicial systems endogenous?

High ownership stakes can lead to state capture, which refers to the capacity of firms to shape and affect the formation of the basic rules of the game (that is, laws, regulations, and decrees) through private payments to public officials and politicians (Hellman, Jones and Kaufmann, 2000). Corporate clout can put a country s legal institutions in harm s way. In empirical tests, using assorted measures of ownership concentration, Claessens, Djankov and Lang (1999) find that a relatively small number of families have a strong effect on the economic policy of governments. The dominance of most business groups lies in the privileges that they could solicit from the government: exclusive exporting or importing rights, protection from foreign competition for extensive periods of time, including the granting of monopoly power in the local market, procurement of large government contracts, among others.

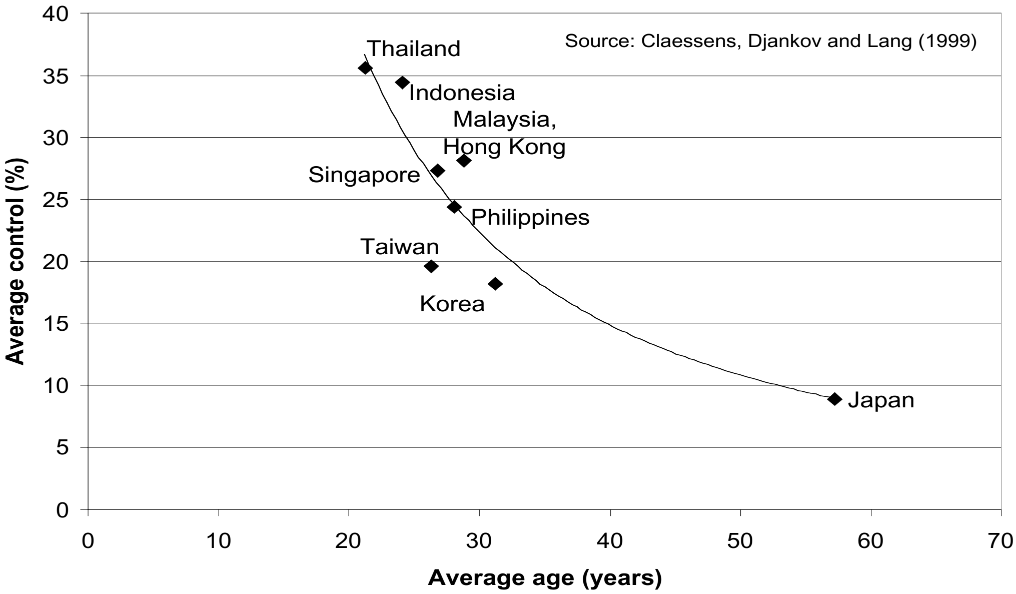


Figure 5. Control eases as Asian firms grow older

Such wealth concentration, and the interlocking links between owners and government officials, casts doubt on the independence of legal institutions in the country. It raises the prospects, according to Claessens, Djankov and Lang, that the legal system may be endogenous to the variety and strength of control over the corporate sector. In a situation of state capture, legal institutions are subverted and less likely to evolve in a manner that promotes transparent and market-based activities. In Figure 4, the higher the share of the top 15 families, the lower the level of efficiency of the judiciary, the weaker the rule of law and/or the higher the judicial corruption. Thailand, Indonesia and the Philippines seem to have the lowest level of legal institutional growth because of heavy ownership concentration in the corporate sector.

On the bright side, ownership concentration generally diminishes with time, as the level of economic and institutional development of the country progresses to a higher level. This negative association is shown in Figure 5, which suggests that owners relax their grip as their firms mature and their countries become wealthy.

Governance and firm performance

Klapper and Love (2002) proffer evidence that the legal system matters less for well-governed firms since firms with better governance have less need to rely on the legal system to resolve governance conflicts. Their study suggests that even though governance is significantly correlated with country-level legal indicators, firm-specific measures are of greater importance than the constraints of country-level laws in determining market valuation.

Credit Lyonnais Securities Asia s (CLSA) corporate governance rankings for 495 firms across 25 emerging markets including Asia became the basis for its own composite corporate governance index. This index is the sum of six categories: discipline,

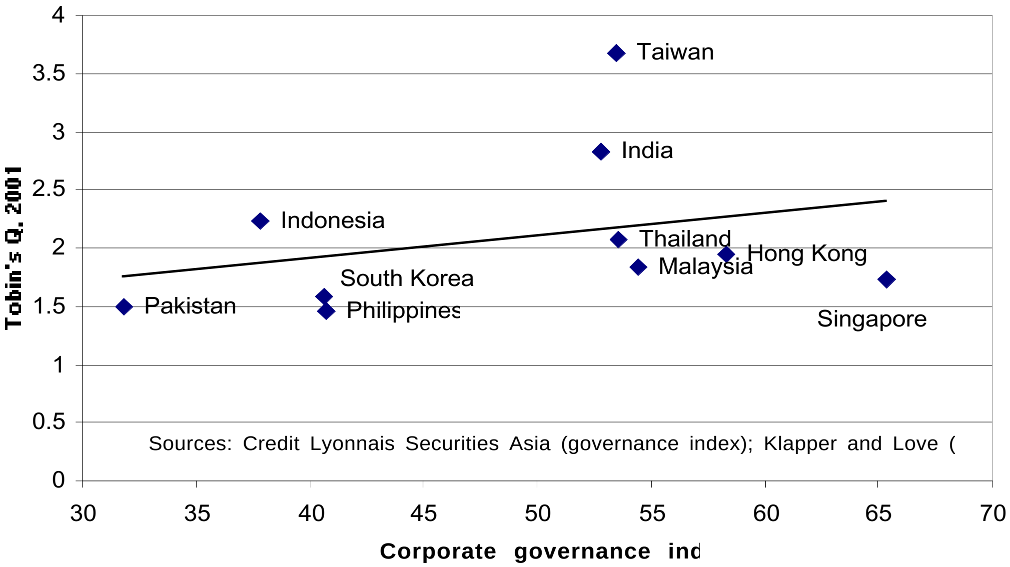


Figure 6. Good governance has a positive impact on the firms market valuation

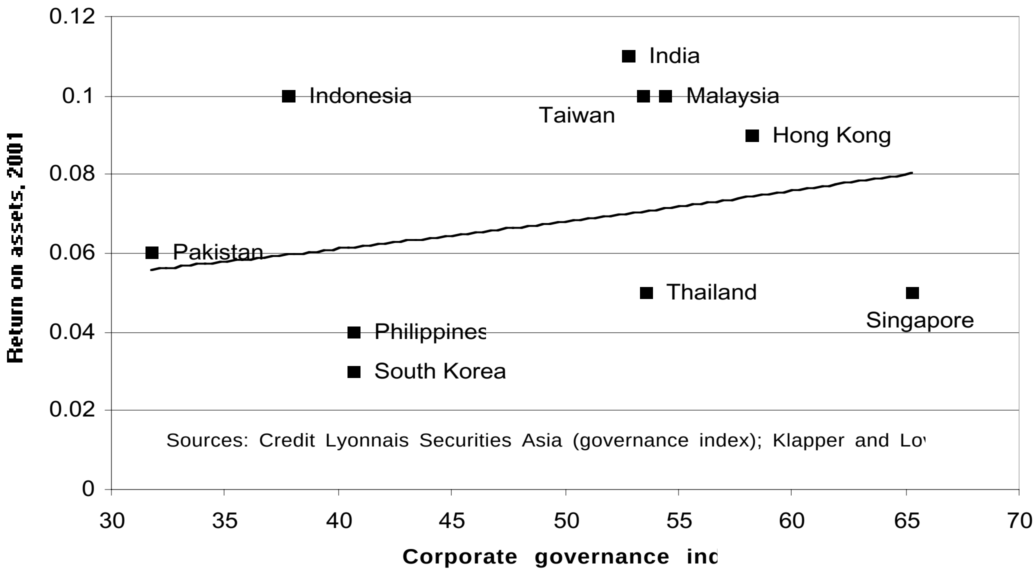


Figure 7. and on ROA

transparency, independence, accountability, responsibility, and fairness. To establish the link between governance and firm performance, Klapper and Love regressed the index of corporate governance with firm-level measures such as Tobin s-Q[2] and return on assets (ROA).

Klapper and Love find that market valuation of firm assets and return on assets are positively correlated with good corporate governance (Figures 6 and 7). A caveat on the results is the likely endogeneity of corporate governance practices. For example, they argue that a growing firm with large needs for outside financing has more incentive to adopt better governance practices in order to lower its cost of capital. These growth opportunities would also be reflected in the market valuation of the firm, thus inducing a positive correlation between governance and Tobin s-Q.

A plausible explanation of the links is that investors in countries with weak legal systems will favor a firm that establishes a good corporate governance framework, no matter how small is the improvement, which enhances market valuation of the firms, decreases the cost of capital and subsequently betters operating performance. It only emphasizes that firm-level investor protection is more important for firm valuation in countries where investor protection from the courts is weaker.

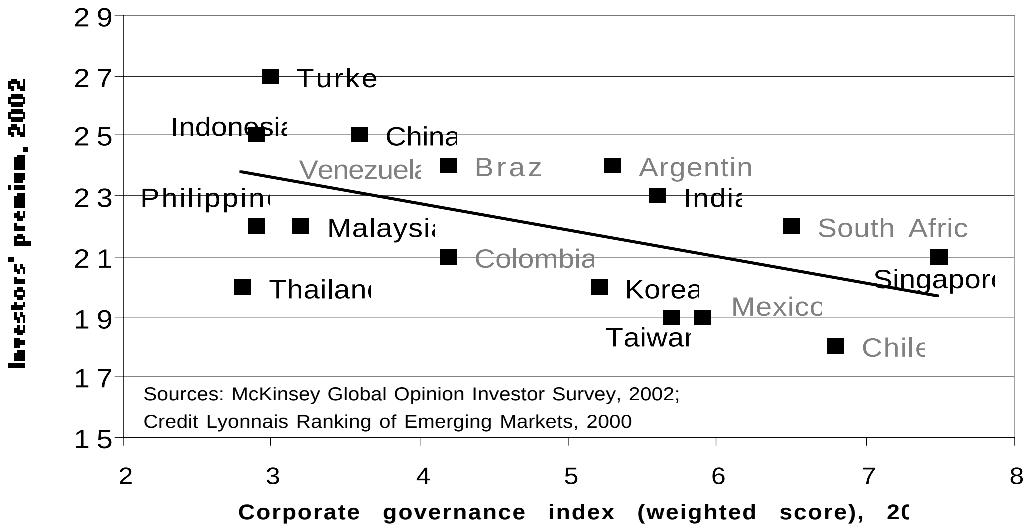


Figure 8. As overall corporate governance improves, there is less incentive for investors to put premium on well managed firms

Premium for better firm-level governance

The 2002 McKinsey Global Investor Opinion Survey shows that the premium investors would pay for a well-governed company[3] varies by country and region. Figure 8 plots the Credit Lyonnais corporate governance index vis- -vis the premium an investment decision maker in a particular country would pay for a company which has set in place good board governance practice. The inverse relationship between the premium

[2] Tobin s-Q is defined as the market value of assets, calculated as book value of assets minus book value of equity plus market value of equity. ROA is defined as net income over total assets.

[3] The attributes of a well-governed company are based on board practices, such as (1) majority are outside directors, (2) outside directors are truly independent, have no ties with management, (3) directors have significant shareholdings, (4) material proportion of directors pay is stock-related, (5) formal director evaluation is in place, and (6) directors are very responsive to investor requests for information on governance issues.

and the corporate governance index may be puzzling but it only suggests that investors value more board improvements in countries with weaker governance. As the enabling environment improves, there is less incentive for investors to put premium on firm-level improvements since the macro-governance environment can already offer them ample guarantees. This is consistent with the assertion of Klapper and Love on the importance of firm-level investor protection (through robust internal safeguards) in markets with weaker legal and regulatory frameworks.

RESEARCH FRAMEWORK AND METHODOLOGY

The research framework was drawn up based on the OECD corporate governance principles. Four key dimensions of corporate governance are examined: (1) ownership structure, (2) firm management, (3) corporate social responsibility, and (4) institutional interface (Figure 9). These four are hypothesized to influence corporate performance in terms of corporate growth and productivity. The governing relationship is described in the heuristic formula below:

Corporate performance (growth + productivity)
= *f*(ownership, management, social responsibility, institutional interface)

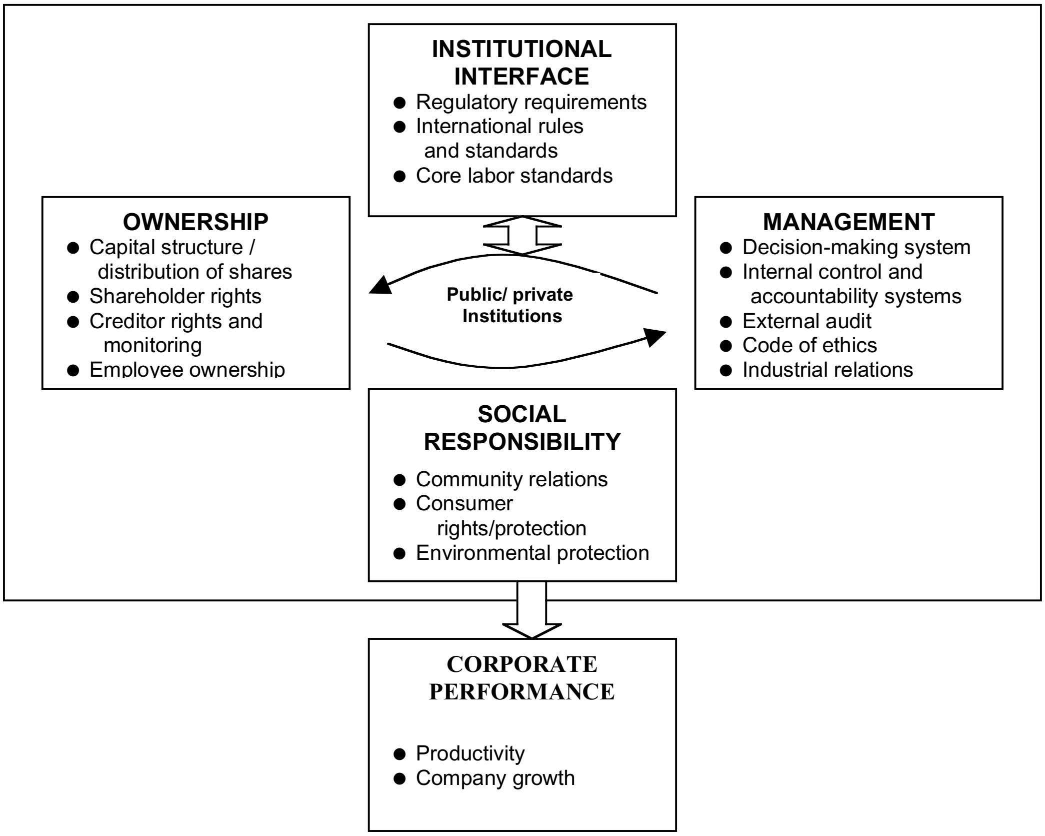


Figure 9. Research framework diagram

The object of the research is to relate firm ownership characterized by capital structure, distribution of shares, and the allocation of shareholder rights, creditor rights and monitoring with firm productivity and profitability. Similarly, it examines how the allocation of decisions, internal controls, and accountability systems, and the quality of management can affect overall firm performance. The framework also assumes that a productive and profitable firm becomes of value to the society. This can only happen if the firm is able to fulfill its social obligations and act responsibly and ethically. The study thus examines how corporate efforts to contribute to the vitality of their communities promote good business. Finally, an attempt is made to ascertain how the quality of institutions and the provision of basic infrastructures and services impinge on firm performance and productivity.

The survey instrument

The questionnaire for the 10 Asian economies was developed by the author with the assistance of the national expert for the Philippines. The survey presented here was implemented during the period January through August 2002 in the following APO member countries: India, Iran, Korea, Japan, Nepal, the Philippines, Singapore, Sri Lanka, Taiwan and Vietnam.

The first part of the questionnaire contains questions on the characteristics of the responding firm covering ownership, area of major activity, number of employees and internationalization (including degree of foreign ownership and level of exports). These questions, in addition to providing information on the responding firm for use in its own right, were used to construct variables on corporate governance. Data on firm-level performance and productivity in terms of revenue, net income, total assets, equity, and employment provide specific estimates of the costs and benefits to firms associated with corporate governance issues.

The survey contains individual modules on the key areas of ownership, management, social responsibility and institutional interface. On productivity, the survey includes questions on firm-level productivity and quality programs and on international standards such as ISO 9000 and ISO 14000. The questionnaire contains about 100 screener and multiple-choice questions. Questions were based on the direct experience of firms.

Firms in each country were asked to rate the quality of public services across a number of dimensions including central government, parliament, the judiciary, utilities, and to evaluate how serious various institutional obstacles are for their business. Questions were asked about the legal system and its ability to protect property and contract rights and the predictability and transparency of policy making.

The survey yielded data from some 200 companies from the 10 countries. This study restricted the sample to firms with sufficient segment and data to construct empirical measures, particularly the productivity measures. For most questions, the results are reported at the cross-country level, though the variation across countries is presented in many cases as well.

A note on the dependent variables used

A number of measures are used in this study alternately as performance and productivity variables. They are the only indicators that can be derived from the restricted sample. More accurate productivity indicators such as output capital ratios cannot be constructed from the available survey data.

- Average return on equity — net income/equity
- Capital productivity 1 — net profit/book value of assets

- Capital productivity 2 —revenue/book value of assets
- Labor productivity 1 —revenue/total compensation
- Labor productivity 2 —value of output/total compensation

These ratios try to capture the corporation s productive capacity to turn assets and value-adding labor inputs into income streams. A higher sensitivity of revenue or net income to assets or to compensation can contribute to productivity and not just performance.

The variables are not deflated with the average annual GDP deflator of each country. Thus the measures are in nominal terms, except where numerator and denominator are both given in currency terms, in which case there was no need to adjust for inflation. When necessary in the course of the research, country currencies were converted to US dollars.[4]

Characteristics of respondent firms

Of some 186 firms which were sampled across 10 APO member countries, a clear majority belong to Japan and Korea, as Table 6 shows. Smaller subsets came from India, Sri Lanka, Singapore and Taiwan.

Table 6. Composition of the sample

Country	Total no. of firms	Legal organization					Firms with foreign equity	Location		
		State-owned enterprise	Gov t controlled corporation, listed	Corporation, listed on stock exchange	Corporation, privately-held	Private/others		Capital city	Other large city	Smaller cities or towns
India	8		2	6			1			
Iran	20	6	2	1	9	3	16	3		17
Japan	58			35	17	6	11	19*	1*	
Korea	38		2	36			16	36	2	
Nepal	12	4	2	2	1	3	4	7		5
Philippines	10	2		3	4	1	6	8	2	
Singapore	8			8			3	8		
Sri Lanka	8			3	1	4	3	5	3	
Taiwan	8		2			6	2	8		
Vietnam	16			16			5	7	1	8
Total	186	12	10	110	32	21	67	101	9	30

*20 samples only

A greater number of corporations in most of the countries are listed on the stock exchange, while a significant number do have foreign stakes. The surveyed firms in

4

Exchange rates to the US Dollar							
		2000	2001			2000	2001
India	Indian rupee	45.7	47.8	Philippines	Peso	44.2	51.0
Iran	Rial		1750	Singapore	Singapore dollar	1.7	1.8
Korea	Won	1130.6	1290.8	Sri Lanka	Sri Lanka rupee	77.0	89.4
Japan	Yen	102.31*	114.47*	Taiwan	New Taiwan dollar	31.2	33.8
Nepal	Nepalese rupee	69.1	73.8	Vietnam	Dong	14168.0	15050.0
Sources: Asian Development Outlook 2002; *Market & data, Economist.com							

Singapore and Vietnam are all publicly-listed, as most are in South Korea and India (Figure 10). In terms of location, a clear majority, if not most, of the firms are located in the countries capital, except most of the corporations in Iran, which are found in smaller cities or towns.

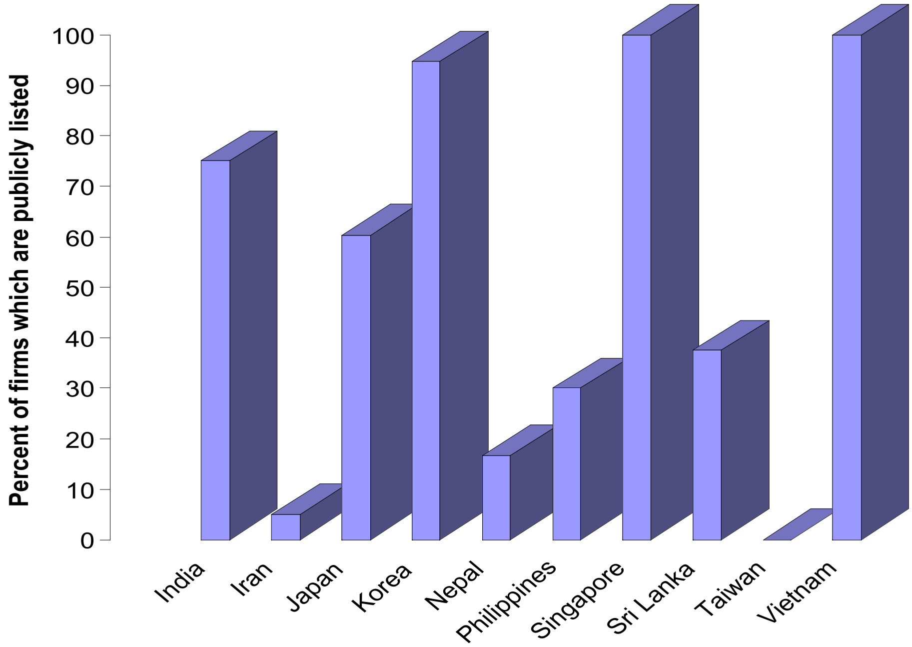


Figure 10. Publicly listed firms dominate surveys in India, Singapore and Vietnam

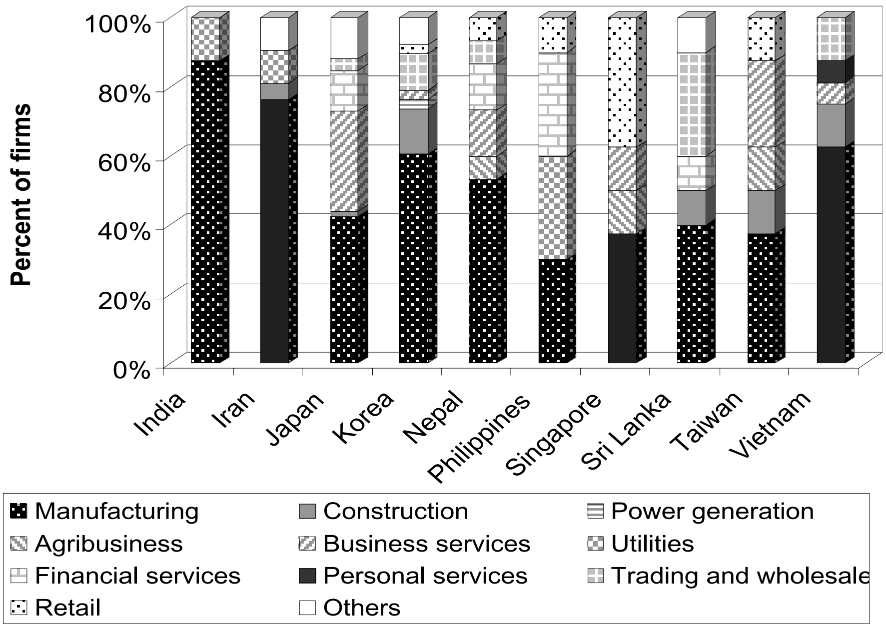


Figure 11. Manufacturing and business services corporations make up the majority

More than half of the respondent firms are in manufacturing, as Figure 11 suggests. India, Iran, Korea and Vietnam have the biggest proportion of manufacturing firms which were surveyed. A fairly large percentage of the surveyed business services firms are found in Japan, and Taiwan. Agribusiness, on the other hand, makes up a good chunk of surveyed firms in the Philippines. Smaller proportions make up the rest of the sectors represented, e.g., agribusiness, retail, power generation, and trading/wholesale.

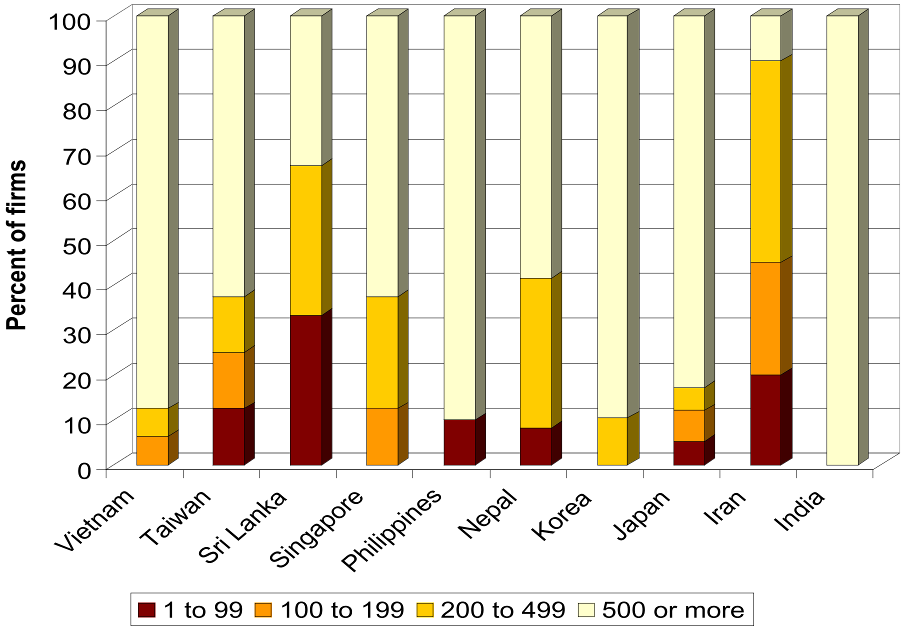


Figure 12. Big firms dominate the survey

Big firms dominate the survey, in terms of the number of employees (Figure 12). With the exception of Iran and Sri Lanka, where a plurality of surveyed firms have between 200 and 499 employees, all countries have respondent firms employing a 500 or more-strong workforce. Respondent corporations in Taiwan and Vietnam all have 500 or more employees, followed closely by India and the Philippines (about 90 percent).

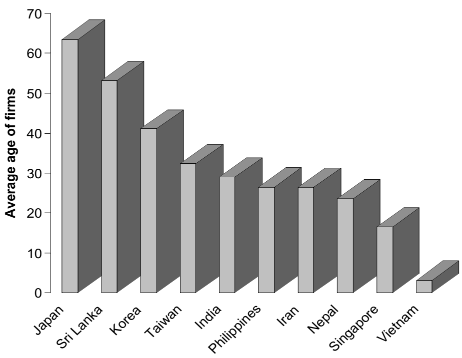


Figure 13. The oldest firms are in Japan, the youngest, in Vietnam

Most of the firms are relatively young (Figure 13). The oldest corporations that were surveyed are found in Sri Lanka. Most of them have existed for more than 70 years. Japanese firms though are on average older (65 years), followed by Sri Lankan firms (53 years) and Korean firms (45 years). They are ahead of the rest by a good number of years. The youngest corporate firms are not unexpectedly found in Vietnam, which is just moving into a market-based economy.

OWNERSHIP STRUCTURE AND SHAREHOLDER PROTECTION

Ownership concentration

Large block-holders are prevalent features of corporations in East Asia, as Figure 14 indicates. Firms owned by one to three owners dominated the survey. All surveyed firms in Singapore belong to this category. This finding validates recent studies on high ownership concentration in Asian countries, regardless of the level of economic development. Japanese and Taiwanese firms, nevertheless have less ownership concentration. Only firms surveyed in Vietnam are more widely held, the shares belonging to mostly individuals.

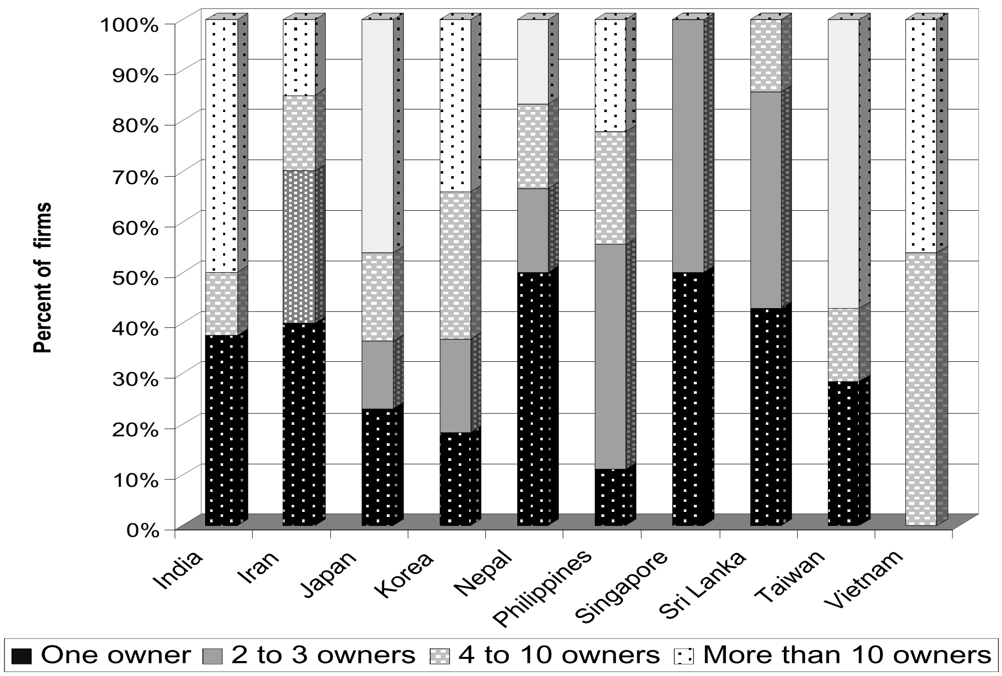


Figure 14. A high degree of ownership concentration

The survey also identified government as the owner with huge stakes in most countries, but there was no attempt to trace the ownership of each company to its ultimate owners and identify those owners by control stake. Past studies have suggested that in each country ultimate control of the corporate sector rests in the hands of a small number of owners or families, through the use of pyramiding, as well as through cross-ownership (less frequently) and the use of shares that have more votes. Asian firms are, on the whole, family-based.

High ownership concentration is often seen in Asia in a favorable light. Investors prefer it to monitor and discipline management, whenever they are not assured of strong legal and regulatory protection against excesses by insiders. But control by a few owners also means that these large shareholders will not have any incentive to move towards better disclosure, as it would loosen their control and diminish benefits. Alba, Bhattacharya, Claessens, Ghosh and Hernandez (1998) suggest that Asian firms, conscious of both developments, are not predisposed to move away from a situation where control rights are generally closely held and managed by majority, often family, interests.

Board of Directors and management separation

Do Asian firms honor the separation of owner from management, a key feature of the modern corporation? Figure 15 seems to suggest so. At first glance, most of the corporate decisions are made by the board and to a lesser extent, the chief executive officer. The owners prevail only in ascertaining the composition of the board and appointing its

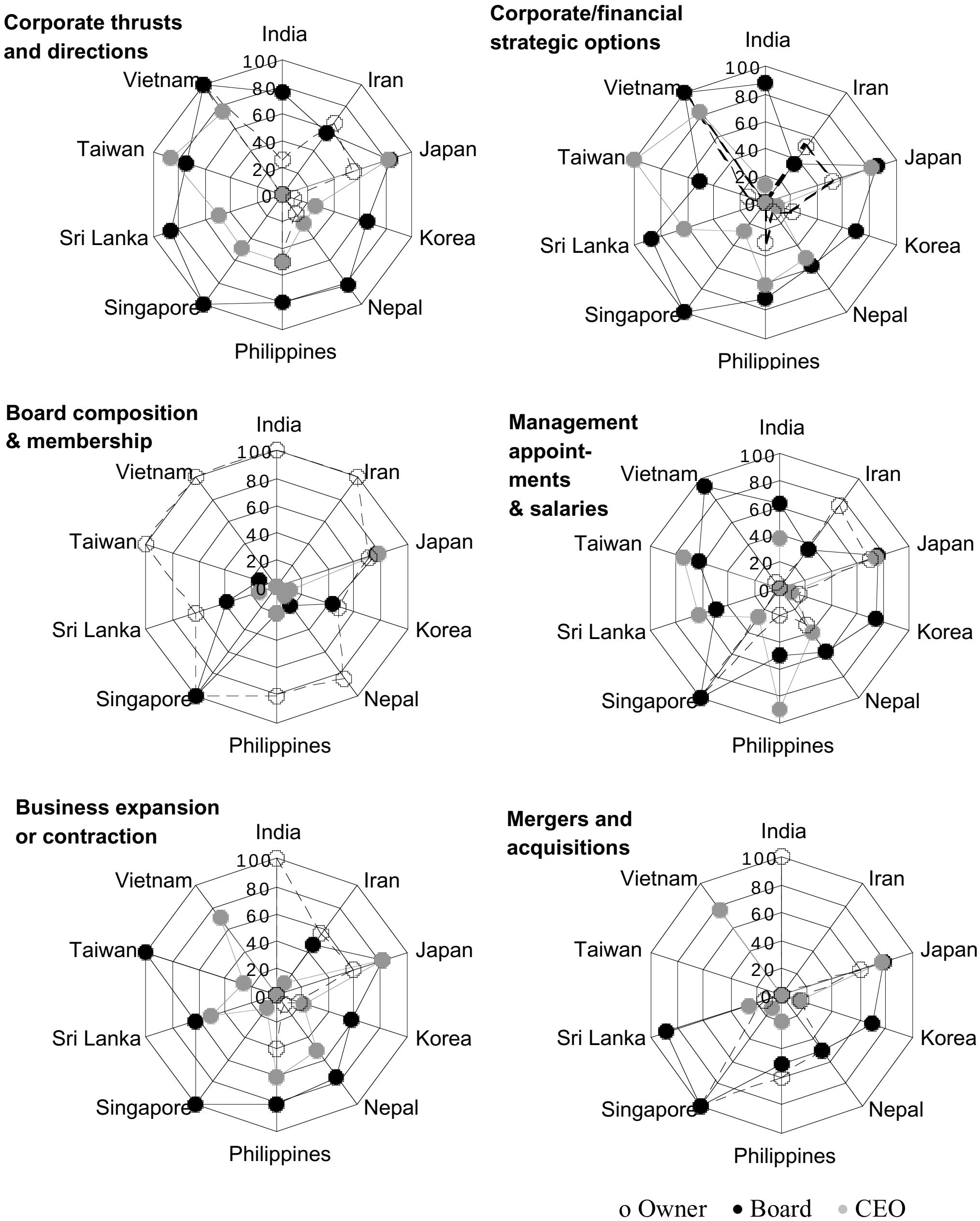


Figure 15. Who calls the shots: owner, board, or CEO?

members. Although firm owners in India decide on business expansion or contraction, and relatedly, on mergers, and those in Vietnam set the corporate pace, controlling stockholders are by and large passive, preferring to delegate to boards the matter of setting directions, choosing financial options, and making executive appointments.

Table 7. A number of rights for minority shareholders

	India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Right to vote according to share	✓		✓	✓		✓	✓	✓	✓	✓
Proxy voting	✓			✓		✓	✓	✓	✓	✓
Right to maintain proportionate ownership of firm under any financing plan							✓		✓	
Right to resolve disputes with the firm	✓						✓		✓	
Right to demand independent audit	✓					✓	✓	✓	✓	✓
Membership in independent board committees							✓			

Source: APO BRXI Survey, 2002
✓ indicates at least 50% of responding firms recognize the right

Separation of management from ownership control is rare in Asia. Claessens, Djankov, Fan and Lang, (1999a), citing various sources, conclude that management of two-third of firms in East Asia is related to the family of the controlling owner, even if managers do not hold much equity themselves. Thus, it is the degree of ownership concentration which determines the distribution of power within the corporation. Large shareholders play an important role in monitoring and disciplining management (Zhuang, Edwards, Webb and Capulong, 2000). The formal separation of management and owners masks the significance of family ties in running Asian companies and in creating entry barriers to outsiders. It aligns the interests of the managers to the controlling shareholder, preventing a possible agency or moral hazard problem. Such collusion may make possible taking on excessively risky projects or paying owners hefty dividends. But managers may not act in the best interests of the minority shareholders.

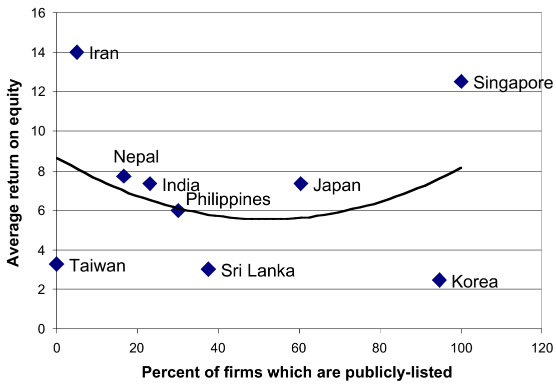


Figure 16. Public listing of surveyed Asian firms: initially negative, then positive impact

Protecting minority shareholders

Asian firms do not lack mechanisms to protect minority shareholders. Table 7 shows the rights of minority shareholders which are offered by firms. According to the survey, Singapore, and to a lesser extent, Taiwan, do have adequate means of insulating minority shareholders from possible expropriation by controlling owners.

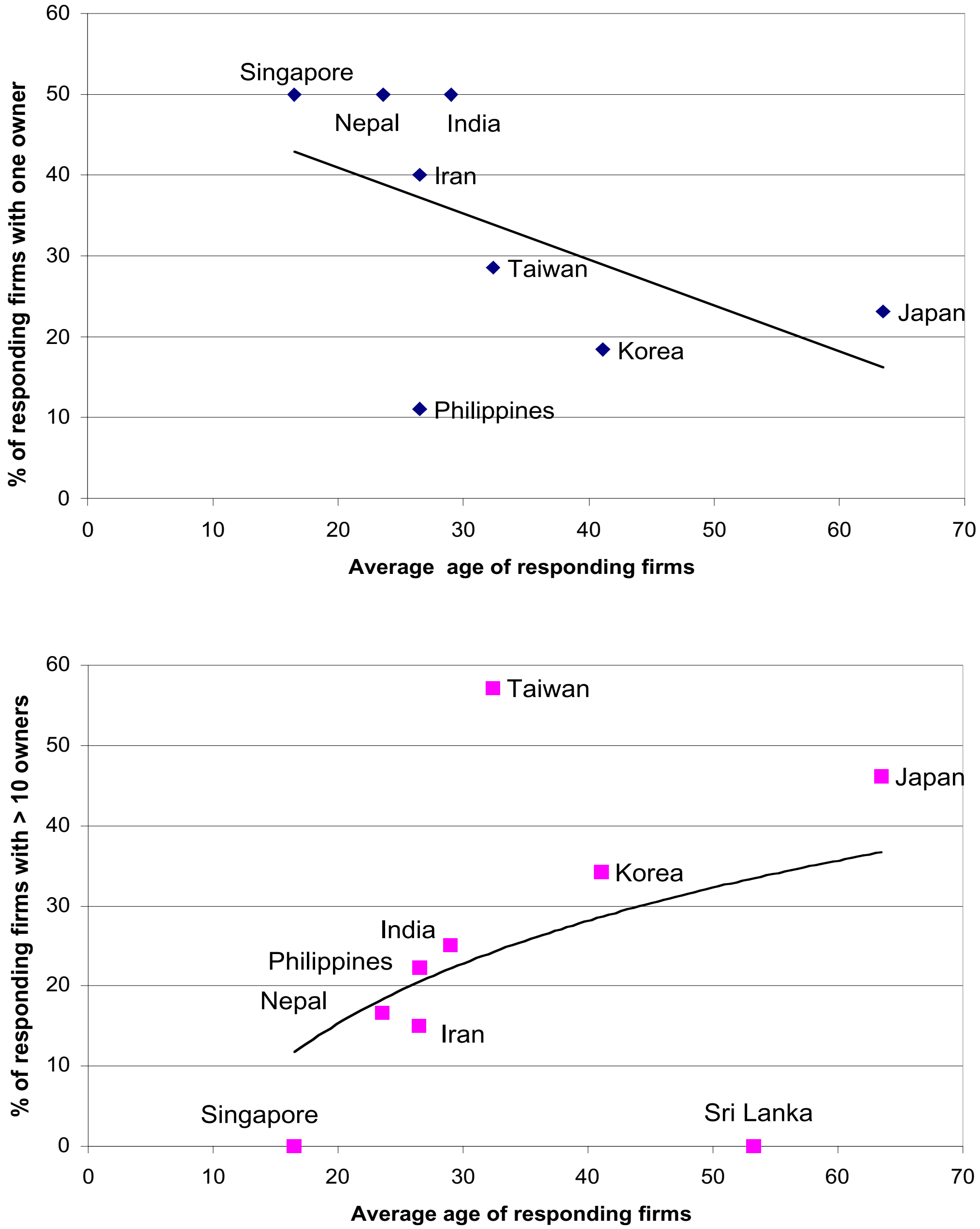


Figure 17. As Asian firms mature, ownership concentration lessens

Even when some rights are missing, such as the right to demand independent audit, many countries (such as India and Vietnam) seem to ensure that at least the right to vote according to share, proxy voting and membership in board committees are accorded to minority investors. But rights are easier put on paper than practiced, and most studies generally find shareholder participation as weak, passive or inadequate. According to Zhuang, Edwards, Webb and Capulong (2000), stipulation of rights is meaningless if excessive power is enjoyed by family-dominated controlling shareholders. Against the power of owners, legal recourse by minority investors is viewed as an exercise in futility.

So does public listing make sense, in the light of the Asian family-based corporate tradition? If in fact it does dilute ownership, then it is worth a good try in Asia. As Figure 16 indicates, profitability and productivity (measured by the average return on equity) may at first decline because agency costs may rise due to a decrease in monitoring, but eventually it will improve as more ownership dispersal occurs. This is similar to the inverted U-shaped relationship found to exist between high degree of ownership and corporate performance (as ownership rises initially, profitability also rises because of increased shareholder monitoring; but as ownership reaches a plateau, its costs may outweigh the gains, triggering a drop in profitability).

Also on the bright side, as firms mature, major shareholders become more open to investments of other groups, since expansion needs require a wider capital base. Pyramiding and cross holding, of course, will not lead to a dispersion of ownership. But Figure 17 offers some hope that Asian firms eventually move toward the ideal of dispersed ownership (modeled by Taiwan and Japan) and adopt an arms-length attitude toward control (that is, rely more on legal protection and the market for corporate guidance).

CORPORATE MANAGEMENT

Delineating board and CEO functions

Theory suggests that splitting the role of the CEO from the chairman of the board improves the protection of shareholders. Board directors are supposed to monitor managers; if they are one and the same, it may seem that the key problem of aligning the interests of managers and shareholders is solved. (Zhuang, Edwards, Webb and Capulong, 2000). But in fact new agency problems crop up, those linked to accountability and transparency. Boards formulate corporate policy and thrusts; managers are expected to execute them. If this division is blurred, it is hard to determine who is going to be answerable to shareholders. If boards can hire and fire managers, it will be hard to fire an underperforming CEO coming from the ranks of the board itself.

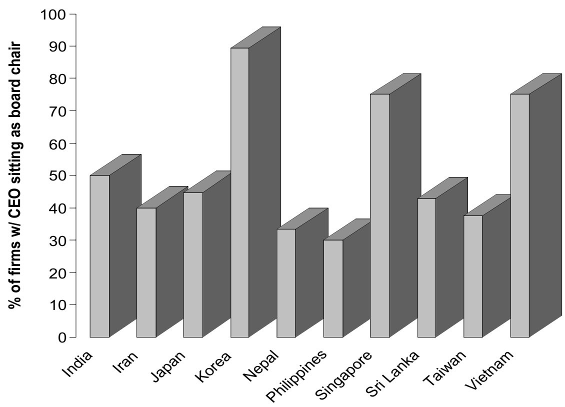


Figure 18. Many board chairmen double as chief executive officers

Professional management is expected to be the counter-balancing force to a family-dominated board. Without this, and given the concentration of ownership in the hands of family groups, the major outcome would be a corporate inability to reverse the firm s weaknesses and adopt corporate governance reforms.

So are Asian firms in trouble because of board chairmen functioning as chief executive officers at the same time, as Figure 18 depicts? If this were true, Korea, Singapore and Vietnam would be prime sources of corporate dysfunctions.

Figure 19 shows typical CEO functions and the board s involvement in them. But the Figure gives no definitive answers. Cross-country differences probably matter. Singapore firms, based on the survey results, are board dominated. There, boards control day-to-day operations, micro-managing even on issues of productivity and quality improvement, and dealing with customers. Yet the fusion of board chair and CEO seems to work well; Singapore has not been singled out as a key source of corporate woes. Korea, on the other hand, is a case that closely follows the prescription above CEOs in the boards underlie some of its weaknesses in accountability and transparency (Zhuang, Edwards, Webb and Capulong, 2000). Yet another case is that of Japanese firms, where boards and CEOs function in equal measure. Arguably, issues of productivity and quality must have champions in the board, but it is hard to see why Japanese boards are also engaged in daily operations.

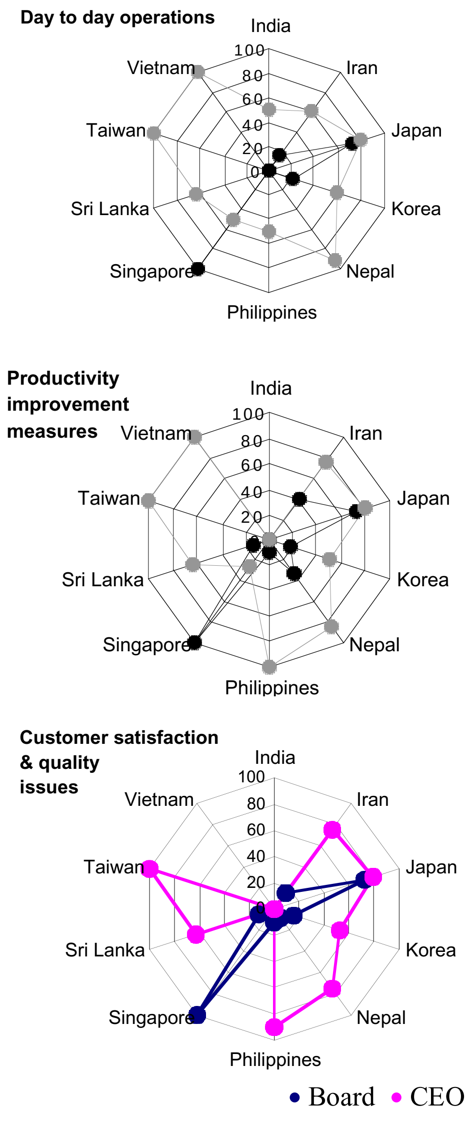


Figure 19. Between the board and the CEO

At any rate, it would be useful to see if indeed, it helps if the board chair is also the CEO. Figure 20 seems to suggest that it does, at least in the case of maintaining good internal controls. For this purpose, a crude measure of looseness of internal controls constructed by adding up the responses to the issue of whether controls are somewhat loose or very loose, and calculating the average was constructed, then plotted against the proportion of firms where the board chair doubles as the CEO.

The scatter plot suggests a negative relationship between loose internal controls and the percentage of firms where the manager is not separate from the board chair. It indicates that a double function would do well in strengthening internal controls. A possible explanation is that fusion rather than separation aligns the interests of both board and manager, in a context where both serve the interests of the controlling shareholder(s). It also reduces the costs of monitoring the workforce who deal with controls, especially on critical tasks such as cash flow, capital expenditure, loan repayment, accounts receivable and aging, inventory, tax payments and payroll.

Thus, the benefit of CEO-board chair mix is that it solves the agency problem since a single person is able to more easily assert control over the firm. Although loose controls are generally not a problem for most surveyed firms, many exhibit a number of soft spots. Table 8 summarizes the areas where problems arise for at least 20 percent (but not more than 49 percent) of the sample firms in each of the countries where the APO survey was conducted. Note that Iran has the most number of areas requiring improvement in control aspects. On the other hand, firms in India, Korea, Japan, Singapore and Taiwan have barely any weak spots. Indeed, although not shown, the survey reveals that Singapore and Taiwan maintain very rigid controls in all key areas.

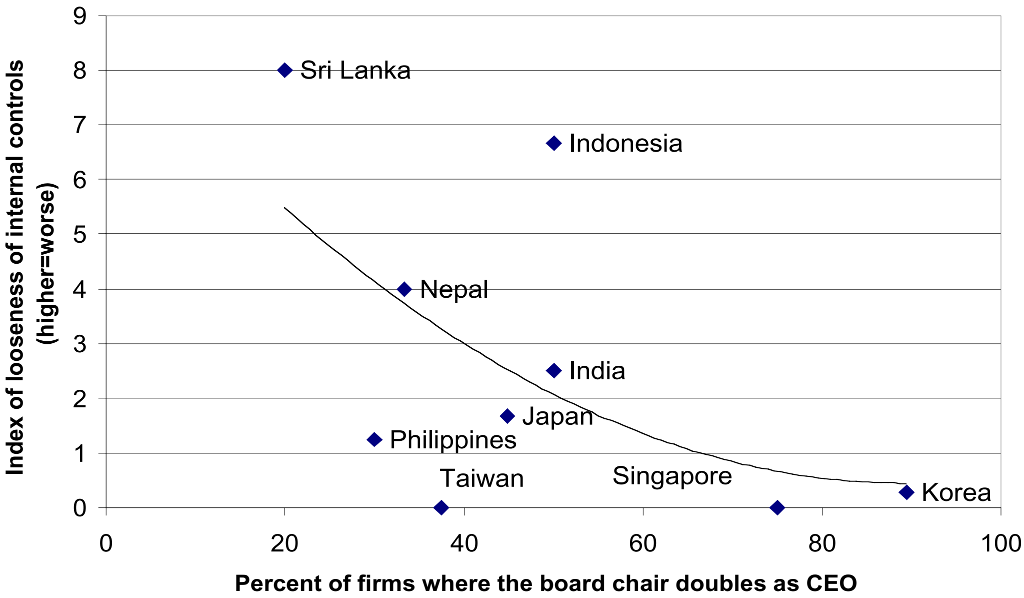


Figure 20. It helps discipline management if the board chair is also the CEO

Table 8. Where loose controls are

	India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Cash flow										✓
Accounts receivable, collection and aging		✓						✓		
Bad debt write off		✓			✓					
Inventory		✓						✓		
Fixed asset acquisition		✓								✓
Research and development		✓				✓				
Capital expenditure		✓								
Tax payments					✓			✓		
Loan repayment										
Payroll										

Source: APO BRXI Survey 2002

✓ represents at least 20% of surveyed firms answering yes

Transparency and disclosure

Effective shareholder control and protection depends significantly on transparency of information. The survey inquired about who has access to material information on the firm s financial health, corporate performance, ownership and governance structures. Without disclosure, minority shareholders will not be able to monitor the status of corporate projects, or challenge risky ventures undertaken by the firm.

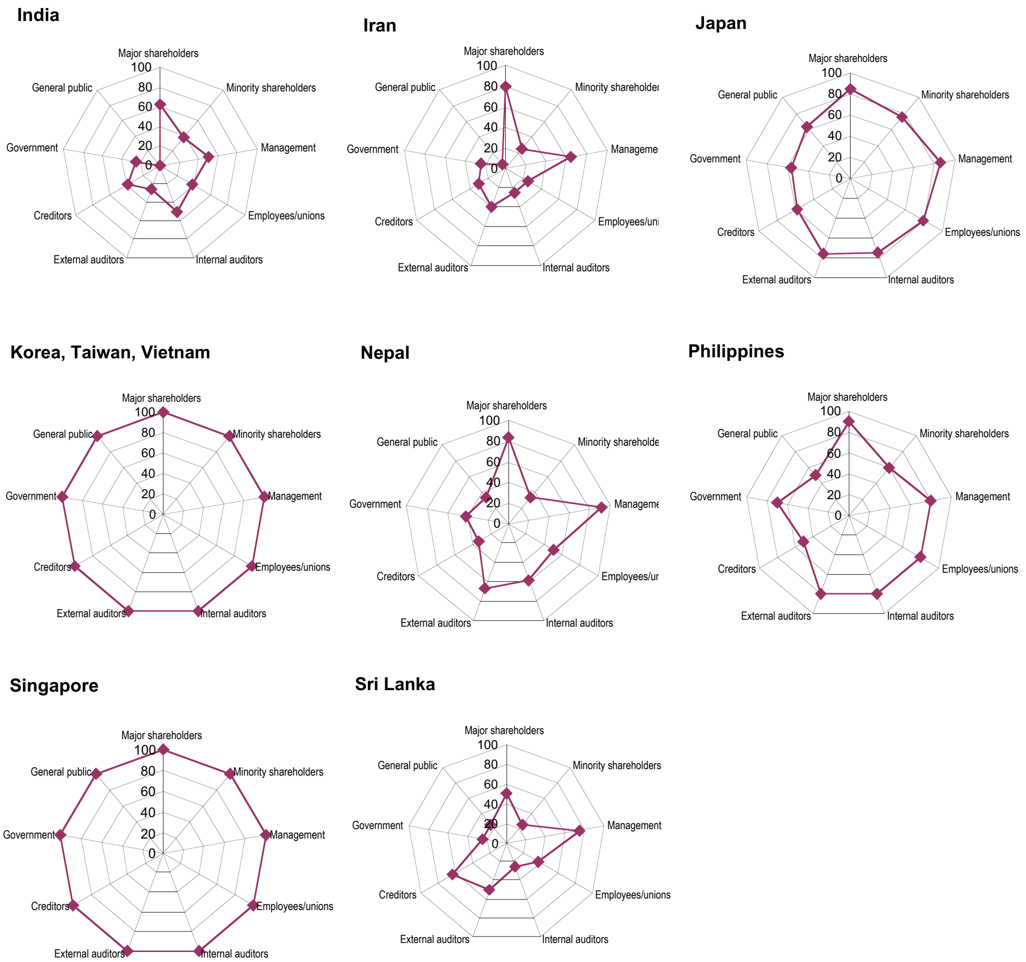


Figure 21. Who has access to corporate information?

Figure 21 shows the patterns of information access in all 10 countries. Firms in Korea, Singapore, Taiwan and Vietnam, all known to have exacting public governance structures, practice full disclosure of information to all their stakeholders, which include major shareholders, minority investors, management, unions, auditors, creditors, government security agencies, and the general public. Not far behind are corporations in Japan and the Philippines which both score fairly in this regard. The rest have withheld information to a significant extent to their stakeholders.

Zhuang, Edwards, Webb and Capulong (2000) suggest that poor transparency and insufficient disclosure appear to stem from a lack of tradition of information divulgence (if owners are unwilling to yield control, why should they share information?) and weak market discipline (firms have little to gain from improving disclosure). State capture may also be at work, in the sense of major shareholders steering the legal and regulatory framework away from transparency and disclosure. Legal and regulatory reform in most Asian countries will likely not be independent of changes in ownership structures and wealth concentration because of the observed endogeneity of the legal systems (Claessens, Djankov, Fan and Lang,1999).

Creditor monitoring and protection

How effectively firm performance is monitored and induced by banks, equity markets, or other mechanisms to act in the best interests of its shareholders is a crucial microeconomic issue in corporate governance (Khan, 1999). Capital markets play a limited role in Asian corporate governance, however. Even if many Asian economies are moving to a market-based regulatory system, markets are still weak to perform signaling and monitoring tasks (Alba, Bhattcharaya, Claessens, Ghosh and Hernandez, 1998) through the pricing, trading and purchase of the corporations securities.

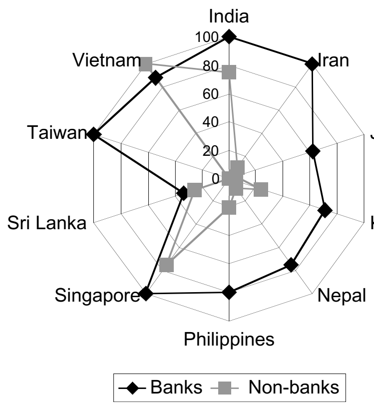


Figure 22. Banks are the favorite creditors of surveyed Asian firms

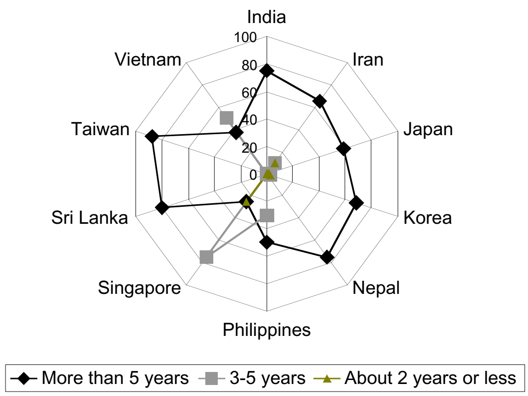


Figure 23. Asian firms prefer long-staying financiers

Banks are thus the main agents which monitor the activities of the corporation, including the task of overseeing management. Many Asian companies maintain cozy relations with banks, which are the providers of debt financing (Figure 22). Unlike the fusion of owners and managers, there is a clear distinction between controlling family owners and external financiers like banks. Information asymmetry between banks and borrowers can thus be a major problem. Adverse selection can occur if banks are unable to identify risky borrowers unless an adequate ex-ante monitoring mechanism is in place. Moral hazard can occur if banks are unable to know the investment options of borrowing firms, raising the prospects that funds can be diverted to risky projects.

To offset both adverse selection and moral hazard, Khan (1999) argues for well-developed risk-measurement capabilities of financiers, which in any case must be well situated to perform monitoring even in the face of controlling shareholders undue intervention.

In Asia, banks have few incentives to oversee corporations because of another moral hazard problem: government guarantees their loans. In addition, their risk management systems are weakly developed, internally undermined by their own relationship-based business practices. Above all, banks are locked in as components of conglomerates, which means they cannot effectively discipline corporations of which they are a part (Zhuang, Edwards, Webb and Capulong, 2000). This is probably the reason why Asian firms prefer keeping their financiers for long periods (Figure 23).

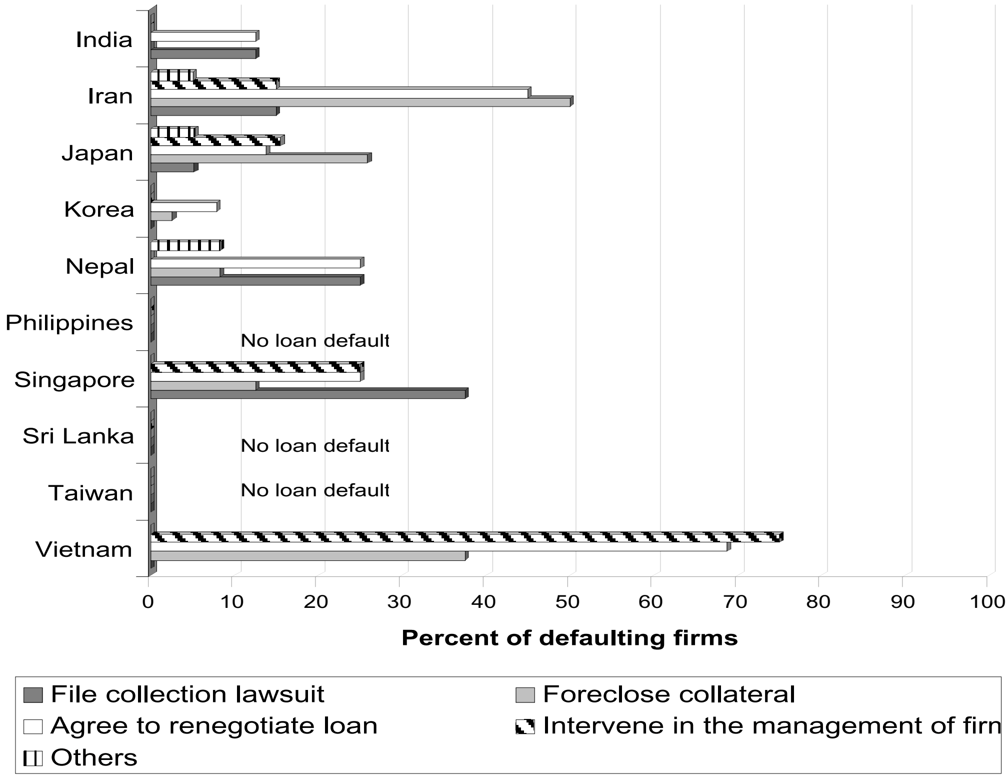


Figure 24. Defaulting firms select a variety of settlements with creditors

In the final analysis, bank-firm relationships serve as substitutes for weak market structures. They thrive better in relationship-based systems (such as those found in Asia) than in arm s length systems in more opaque, legally less efficient environments (Claessens, Djankov and Nenova, 2000).

Are creditors, despite their flawed relationship with borrowers, amply protected? Alternative means exist among Asian firms to deal with financial adversity: besides the use of the foreclosure process, debt rescheduling and management takeover are common (Figure 23). Filing for bankruptcy is not common in Asia because banks with corporate ties (that is, with equity in the same firm) can internalize the costs of conducting bankruptcy proceedings and will likely settle out of court (Claessens, Djankov and Klapper, 1999).

Finally, protection of shareholders is guaranteed by a strong auditing process. External auditors have an important role to play in ensuring that major corporate transactions are above board, and not hostage to the controlling owners interests.

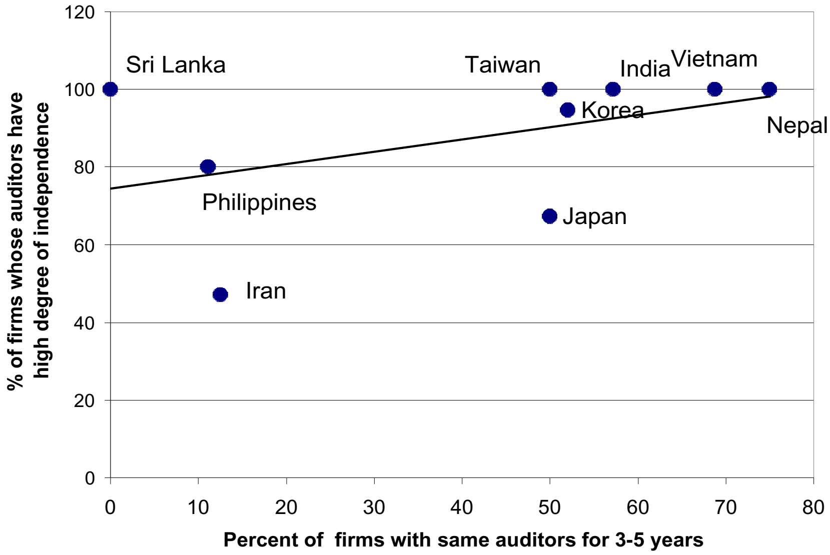


Figure 25. The more firms employ transient external auditors, the more independent the auditors

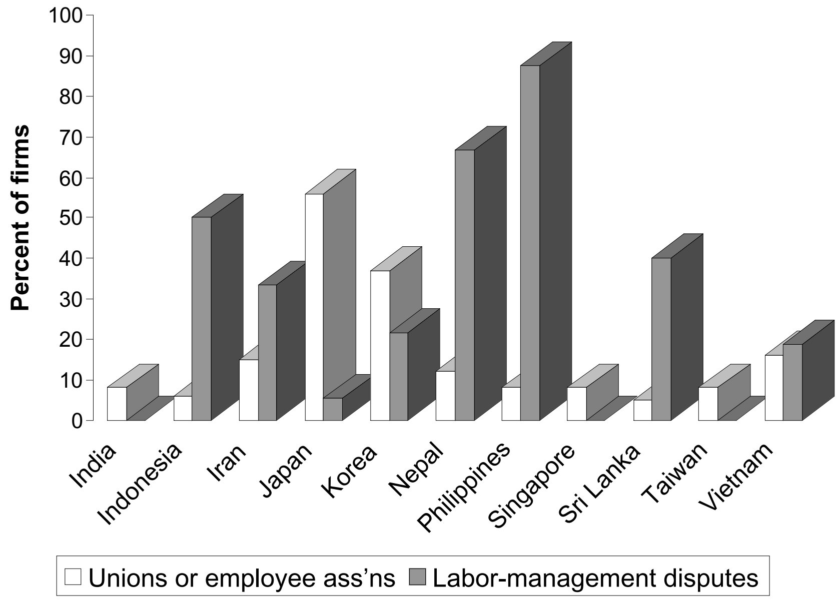


Figure 26. Unions abound in Asian firms, but they are not necessarily the source of internal disputes

Industrial relations

Good corporate governance requires that firms deal not just with owner-management issues but with labor-management issues as well. Organized labor is a key actor in ensuring the viability of firms, so it is important that they become part of the governance reform process.

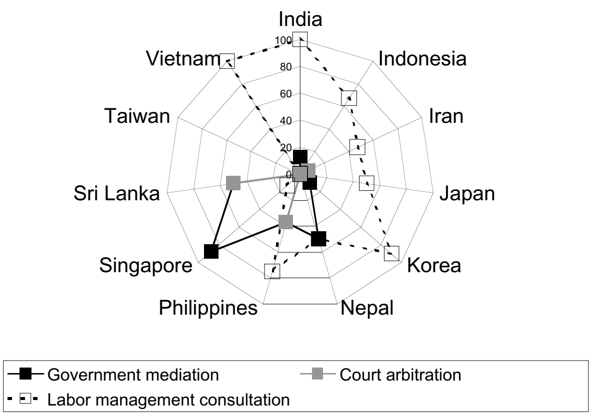


Figure 27. Labor management consultations are the preferred way of resolving disputes

Agency problems also abound in industrial relations. A disgruntled workforce will have incentives to shirk in the absence of rewards and sanctions. Unions and employee associations can help reduce principal-agent problems if they can be encouraged to discipline workers given reasonable assurances of job continuity and if offered acceptable packages of benefits. In Asia, unions are a diminishing, but still important, force. As Figure 26 shows, unions are at least a non-disruptive force in Asia. There is no correlation between labor unions and labor disputes. Figure 27 shows that

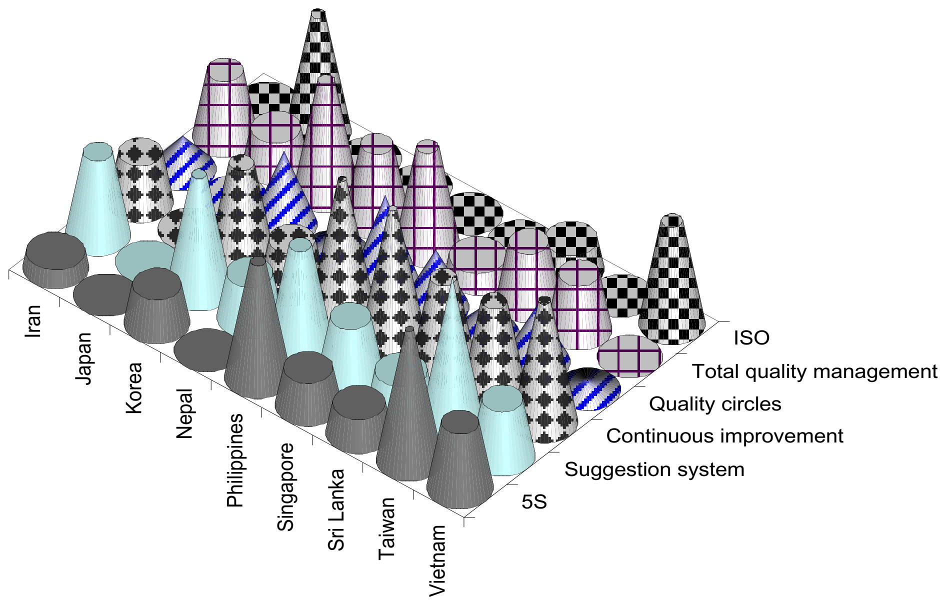


Figure 28. Preferred P & Q programs

increasingly, labor management consultations have become the preferred way to settle labor-management rifts, especially in India, Vietnam, Korea and the Philippines. Only in Singapore is government mediation a dominant practice.

Productivity programs

Another way of engaging employees and management as well is by carrying out productivity and quality programs. In Asia, APO has pioneered the promotion and widespread use of P & Q programs such as 5S, continuous improvement, total quality management, quality circles and ISO. Figure 28 shows the preferred programs in the 10 countries. Continuous improvement is a clear favorite, followed by TQM and to a lesser extent, quality circles.

SOCIAL RESPONSIBILITY

Firms thrive when people have the capacity and desire to consume. To be profitable, companies have to satisfy consumers. But consumers are dispersed individuals who will face collective action hurdles if they are not amply protected.

Consumer protection is often guaranteed by the firm through product warranty and after-sale service, and through mechanisms for handling consumer complaints. The state supplements firm guarantees by enacting consumer protection legislation. In Asia, consumers are by and large protected through these devices. Excepting Iran and Sri Lanka, all countries surveyed have sufficient consumer safety mechanisms (Figure 29).

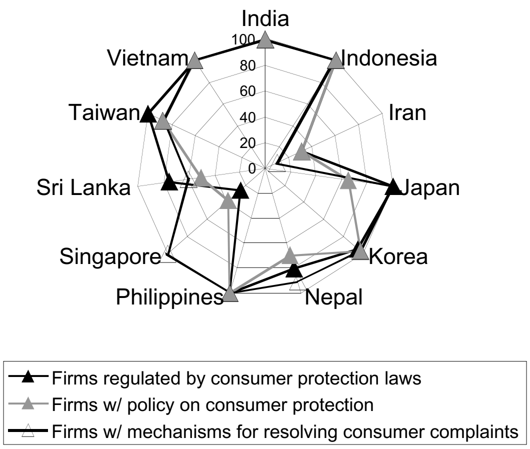


Figure 29. Asian firms generally protect consumers

When differences in price, quality and availability of products and services are negligible, sales and deals are often made on the basis of corporate citizenship practices. Consumers and shareholders increasingly scrutinize and favor companies with solid citizenship practices globally. Shareholder activism and consumer interest would provide incentives for good corporate citizenship.

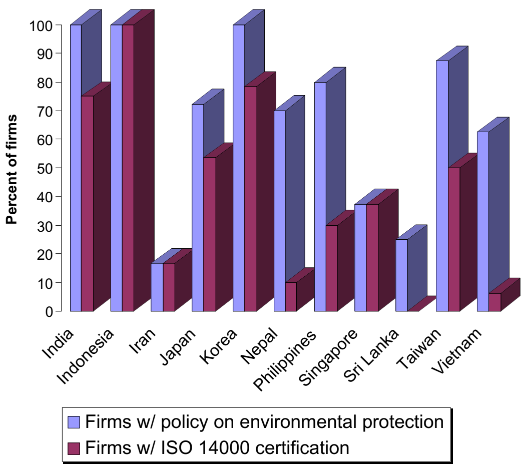


Figure 30. Asian firms are getting to be more environment-conscious

Long-term corporate self-interest dictates the need for actions and investments that are socially and environmentally responsible. Modern firms link social responsibilities strategically with creating and maintaining a climate conducive to long-term business success. It is through core business decisions and operations that corporate resources can be leveraged in protecting the environment and strengthening communities. Environmental protection is steadily becoming a company preoccupation in Asia. The proportion of firms that have at least adopted environmental protection policies is fairly large, as Figure 30 shows. This suggests that Asian firms are beginning to embrace green productivity measures such as ISO 14000.

Table 9. Preferred modes of engagement in community action*

	Leading role	**Voluntary**	**Compliant**
Pollution control		Vietnam	Singapore
Environmental protection	Korea	Nepal	Singapore
		Vietnam	
Product warranty and service	Korea	Vietnam	Singapore
	Philippines		
Control of harmful products	Korea	Indonesia	Taiwan
		Singapore	
		Vietnam	
Community support	Philippines	India	Singapore
Philanthropy		India	Singapore
		Nepal	
		Vietnam	
Support for indigenous groups		India	Taiwan
		Singapore	
Support for working mothers (e.g., day care centers)		India	Taiwan
			Vietnam

*Represent 50% or more of firms

Varying legal and regulatory frameworks yield vastly differing responses and practices in corporate citizenship. As seen in Table 9, the preferred modes of engagement in community action vary as a result of differences in operating environments. Singaporean and Taiwanese corporations do so as a matter of compliance. Acquiescence to state directives is typical in these two countries, and is observed as a matter of course by firms. Indian and Philippine firms practice corporate citizenship on a voluntary basis, or they take leading roles because of a relatively unencumbered political milieu. Vietnamese firms, being the newest companies in the block, may prefer a voluntary mode as a way of gaining experience. Corporate citizenship thus must be locally appropriate, and must lead to locally sustainable solution.

INSTITUTIONAL INTERFACE

Reducing uncertainty at the macro level, such as by encouraging governments to maintain credible and consistent policies, links corporate governance to public governance. For corporate reforms to thrive, an enabling environment is needed. Thus in countries with better public governance structures, shareholders are better able to limit risk-taking by corporations than in countries where they are not sufficiently protected. When there are stronger legal and regulatory tools (including an efficient judiciary) at their disposal, both creditors and shareholders will be able to protect the value of their investments. Corporations with greater use of measures of financial risks are more likely to emerge in

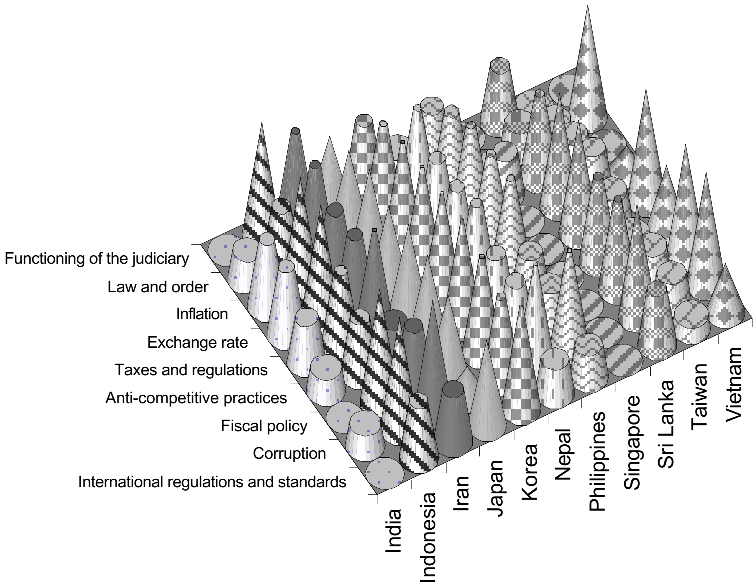


Figure 31. A difficult public governance environment for firms in Iran, the Philippines, Sri Lanka and Vietnam

environments with more developed laws and institutions. To be sure, political transition and uncertainty in some of the countries, such as Indonesia and the Philippines, have led to a sharp erosion in private sector confidence. But delayed and flawed policy responses also contribute to a fall in corporate performance.

Figure 31 graphically portrays the difficulties faced by Asian firms, especially those in Indonesia, Iran, the Philippines, Sri Lanka and Vietnam. To a large extent, the problem areas are corruption, fiscal and monetary policy, taxes and regulations, law and order, anti-competitive practices, and an unresponsive judiciary. Japan s economic slowdown has been attributed as well to archaic policy responses to these problems. Only Taiwan and Singapore seem to have better public governance structures.

Contradictory legal and regulatory traditions, however, may also have something to do with the way firms react to their environments. Countries with a civil law tradition, such as Japan and Korea, build institutions from the vantage point of the power of the state. Countries with common law origins, such as Malaysia, prefer a good system of impersonal exchange, combined with third-party enforcement of the rules of the game

(Woo-Cummins, 2001). Most Asian countries partake of the characteristics of the two systems, also the tendency now is to embrace more and more common law regulations, as they are market-based. Claessens, Djankov and Nenova (2000) identify the advantages of common law: higher efficiency of contract enforcement, stronger legal protection of outside investors rights, for both shareholders and creditors, and faster reaction to new developments.

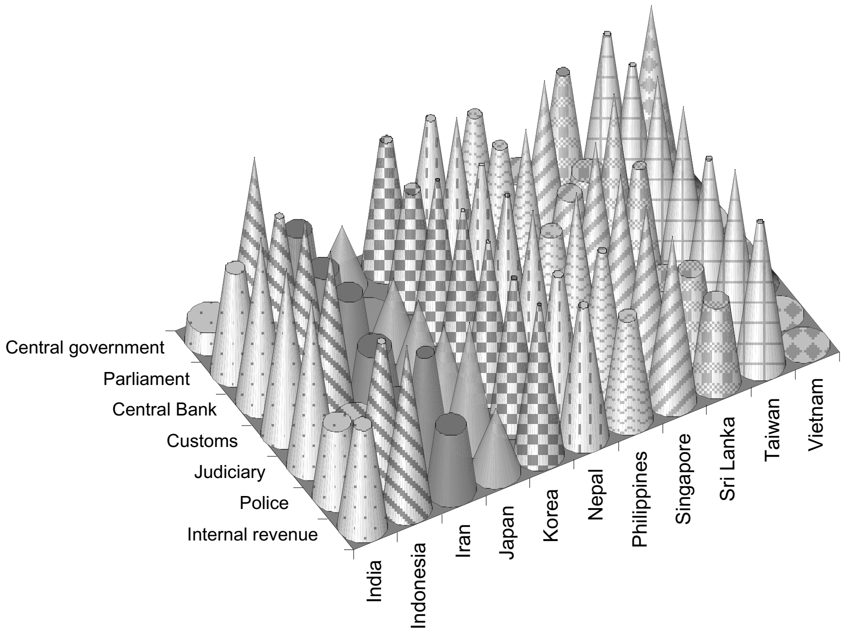


Figure 32. High marks in most countries for quality of government services provided to corporations

Woo-Cummins disputes this, arguing that experience suggests that regardless of legal tradition used, it is administrative guidance which propels countries to particular directions. She cites the case of Malaysia, where an elaborate and sophisticated common law system still posed no barrier to arbitrary decisions by the state (as when a fixed foreign exchange was adapted to mitigate the effects of the Asian crisis). Singapore is another interesting case. Khan (1999) notes its system of corporate governance is influenced by the state through government-linked firms, arguing that the close guidance from government in a competitive environment might also explain the relatively superior performance and governance of the family businesses there.

Thus, regardless of legal origins, Asian countries do prefer government presence in heavier form. Asian firms generally give high marks to the services provided by government institutions, including the central government, parliament, central bank, and even those normally associated as sources of corruption, namely, customs, internal revenue service, and the judiciary (Figure 32). Only in Iran, Vietnam, and to a certain extent, Japan are government services perceived to be weak and unresponsive. (Alba, Claessens and Djankov, 1998) note that the relatively heavy presence of government in capital markets, at least compared to industrial country markets, as well as government ownership and contingent government support (e.g., in large infrastructure projects) may have also consoled investors.

On the other hand, firms also need independence from undue economic and political pressures. If creditors face heavy and arbitrary government intervention, they will lose incentives to monitor. The preference for voluntary action rather than state impositions is evident in Figure 33, at least on the question of enforcing international standards.

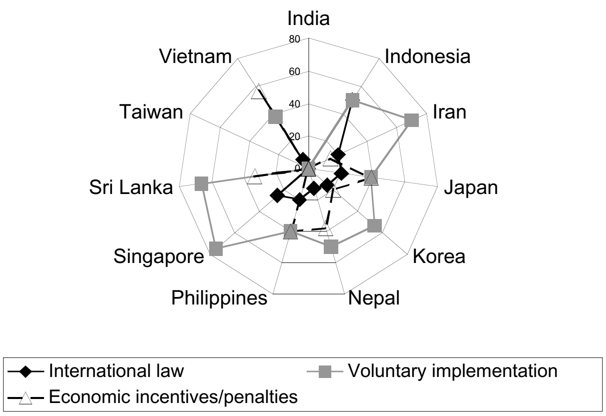


Figure 33. Asian firms prefer voluntary execution of international safeguards

How much are the firms guilty themselves of exacerbating a weak public governance environment? Table 10 itemizes some of the major infractions made by Asian corporations on key governance issues. The violations are not rampant, but the proportion of firms in Iran that do break the rules on labor, consumer protection, and the environment is higher than percentages in other countries. It should be stressed though that these private sector offenses take place in the context of government policies that do not do enough to discourage violations while providing too little regulatory control and insufficient transparency to allow markets to recognize and correct the problems.

Table 10. Corporate infractions in Asia

	Internal revenue code	Environ-mental rules	Labor code	Intellectual property rights	Corporation law	Consumer protection laws	Anti-bribery act
India							
Iran	✓	✓	✓	✓	✓	✓	
Japan	✓						
Korea							
Nepal							
Philippines		✓	✓				
Singapore	No data						
Sri Lanka							
Taiwan		✓					
Vietnam		✓	✓	✓			

✓ represents at least 20 percent of responding firms

IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY

Ownership concentration

The high concentration of resources in the hands of block-holders seems to be beneficial to corporate performance and productivity. Figure 34 suggests that concentrated ownership, to the extent that large shareholders are more easily able to assert control over the directions of the firm, while limiting management inefficiency and excesses, does wonders for both return on equity and labor productivity. This is an agency problem that

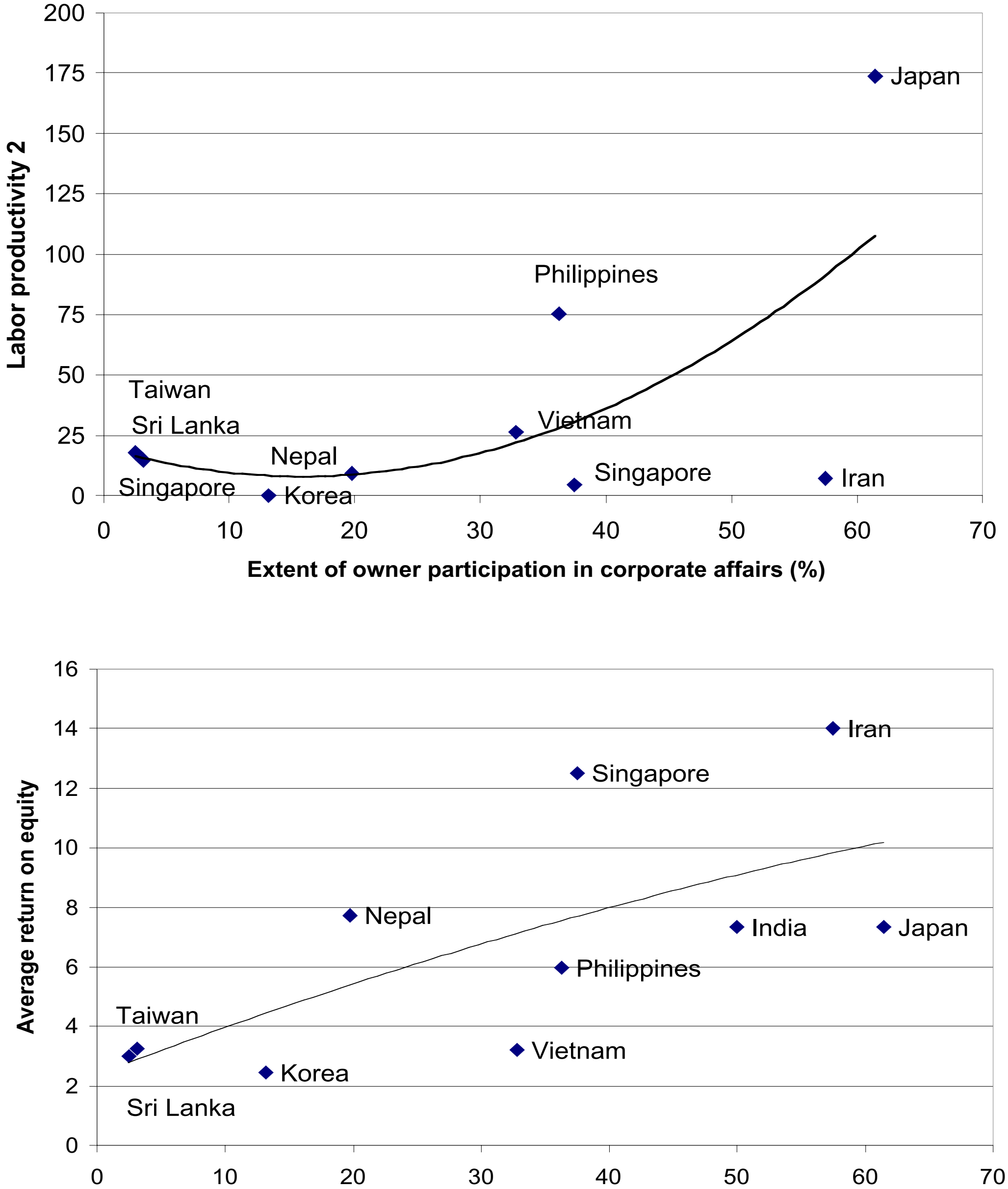


Figure 34. Owner participation in corporate affairs: positive impact

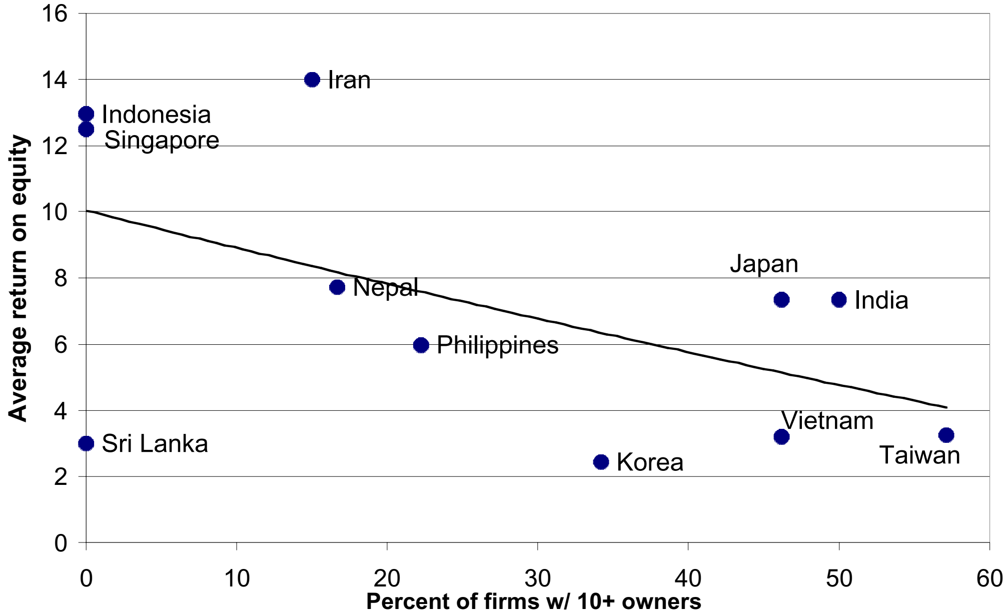


Figure 35. Less ownership concentration: negative impact

ownership concentration is able to solve (Alba, Claessens and Djankov, 1998).

The positive relationship is counter-intuitive, since ownership concentration (and the associated managerial ownership) should lead to falling profitability and firm performance. But the inverted U-shape shape relationship between the degree of ownership concentration and profitability might help explain. It could be that Figure 34 only reflects the upward sloping part of the curve. That is, as managerial ownership rises, agency costs decrease and hence profitability rises. Asian corporations surveyed may not be at the stage where owners start pursuing empire building strategies that lead to declining fortunes. At any rate, managerial ownership can entrench incentives (such as preferential financing) for a while. The U-shape hypothesis might also help explain Figure 35, where dispersion of ownership initially leads to worsening performance.

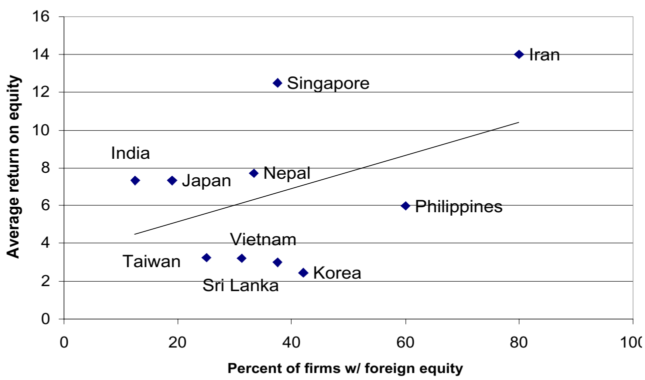


Figure 36. Foreign equity: positive impact

The infusion of foreign equity has a positive impact on labor productivity, as Figure 36 shows. Foreign equity is often made conditional on good corporate governance practices. That is, firms that have more foreign portfolio ownership are perceived to be better governed and less prone to high risks. Controlling families will also be less tempted either to veer from good corporate policies or to influence government to allow regulatory leeway that favors family interests.

Access to information

In the final analysis, corporate governance is all about resolving the information asymmetry between principals and agents. Large owners gain nearly full control and prefer to use corporate information to generate private benefits of control that are not shared by minority shareholders. In this case, profitability and productivity will be significantly lower among corporations in weaker minority rights countries.

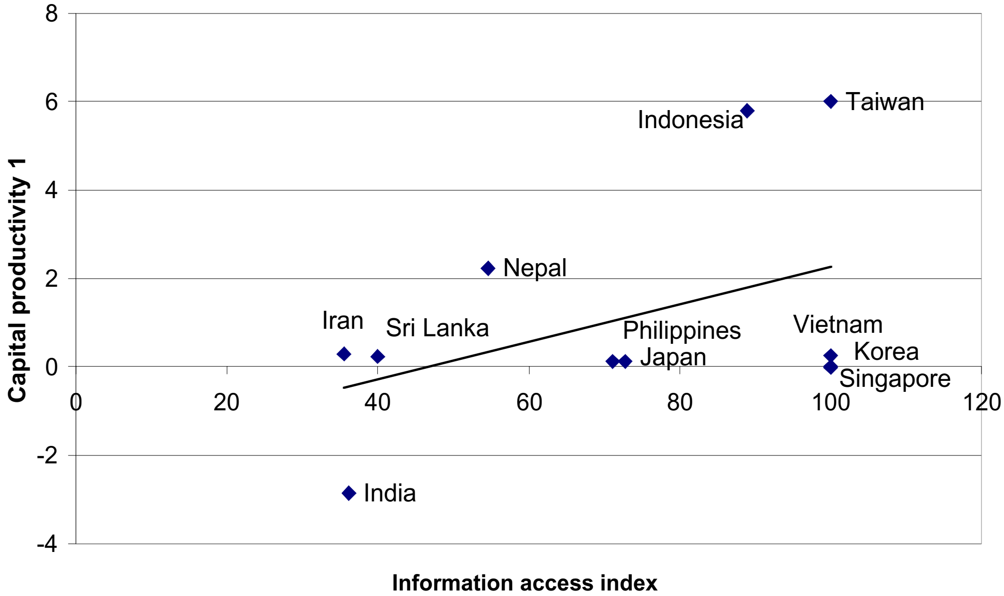


Figure 37. Greater access to corporate information: positive impact

Weak due diligence by external creditors may be in part fueled by poor information access, and this can play a role in building up vulnerabilities. Firms with less creditor protection generally display more risky financing patterns and lower rates of return on assets and equity. Creditors must have the internal capability to properly evaluate credit and other types of risks of borrowers and their projects. To do this effectively, it is essential to gather and analyze the relevant information (cash flow, debt, balance sheet, etc.) about the firms they finance. For banks in developing countries in particular, capabilities for such information gathering and analysis are in short supply (Khan, 1999).

Yet, as Figure 37 indicates, firms can make progress in their ability to attract and use assets productively by opening up, that is, by sharing information and encouraging greater transparency. Where banks and firms are effectively controlled by the same shareholders, increased disclosure is necessary. Of course creditors need to develop more arms-length relationships with firms.

Accounting practices

Asian countries generally follow a dual accounting system, with both local and international accounting standards being widely used. According to Chong Nam, Kang and Kim (2001), Japan is a classic example of how the two accounting systems have

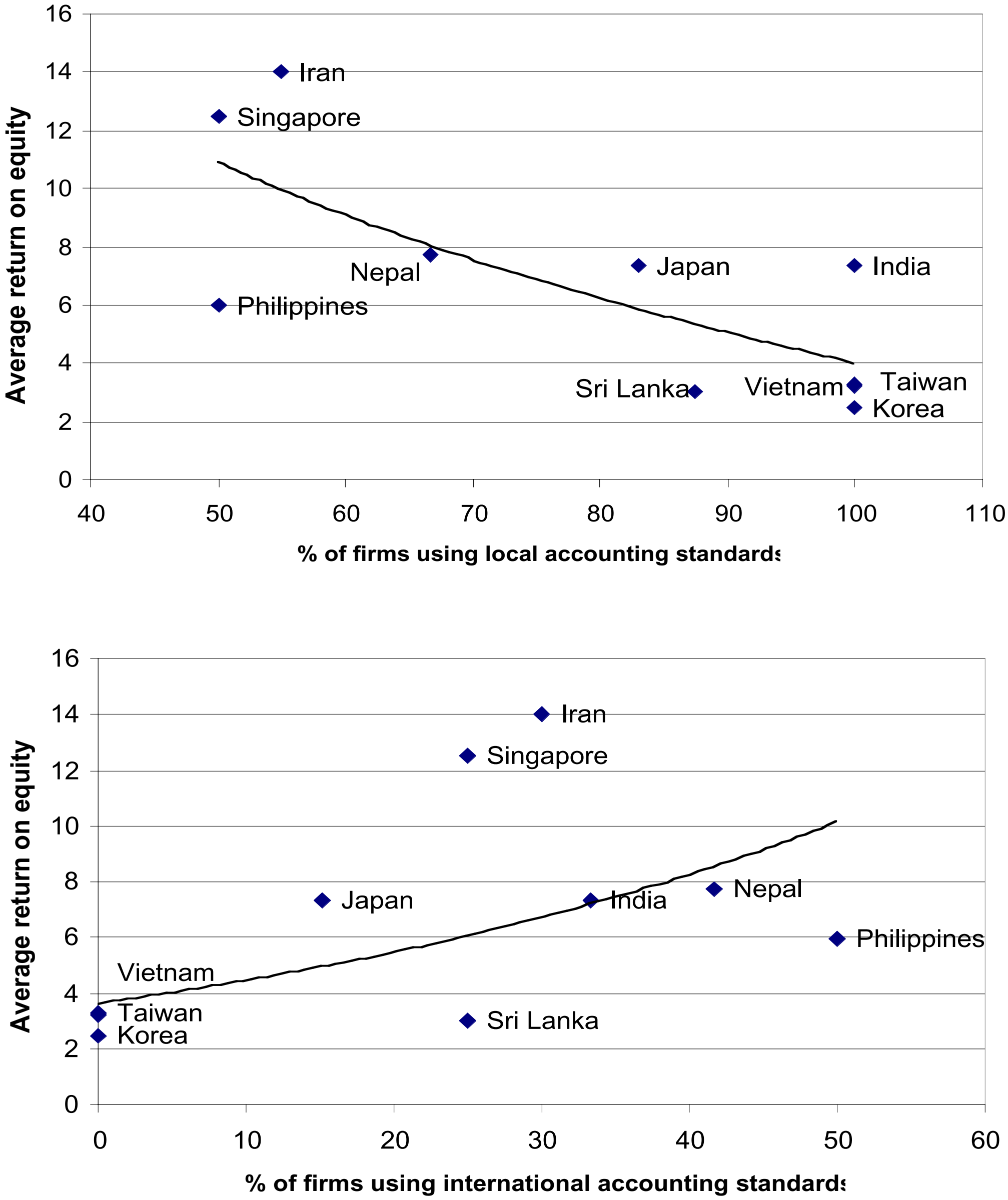


Figure 38. A tale of two accounting standards

blended well together—Japanese companies make use of the dual system without much difficulty. Recent advances in international accounting practices, however, have widened the difference between local and foreign standards, putting increased pressure on Asian firms to include more international elements into their accounting system. Foreign standards in the region are generally consistent with those issued by the International Accounting Standards Committee.

Accounting rules are flouted because of weaknesses in industry self-regulation. Well-qualified accountants are likewise in short supply in the region (Alba, Bhattcharaya, Claessens, Ghosh and Hernandez, 1998). Local standards are perceived to be inferior to international ones, and appear to be partly responsible for the weak governance of firms and poor firm performance. Inadequate standards and rules and lax enforcement have given undue advantage to corporate insiders at the expense of outside shareholders, and have hampered the development of risk assessment skills. Figure 38 seems to suggest that subscription to local standards makes Asian firms worse off, while adoption of international standards leads to dramatic improvements in firm productivity.

Management incentives

Despite the lack of separation of ownership from control in Asian firms, executive compensation seems to play a large role in corporate governance. Salaries linked to performance contracts seem to yield good dividends for the firm and improve their capital

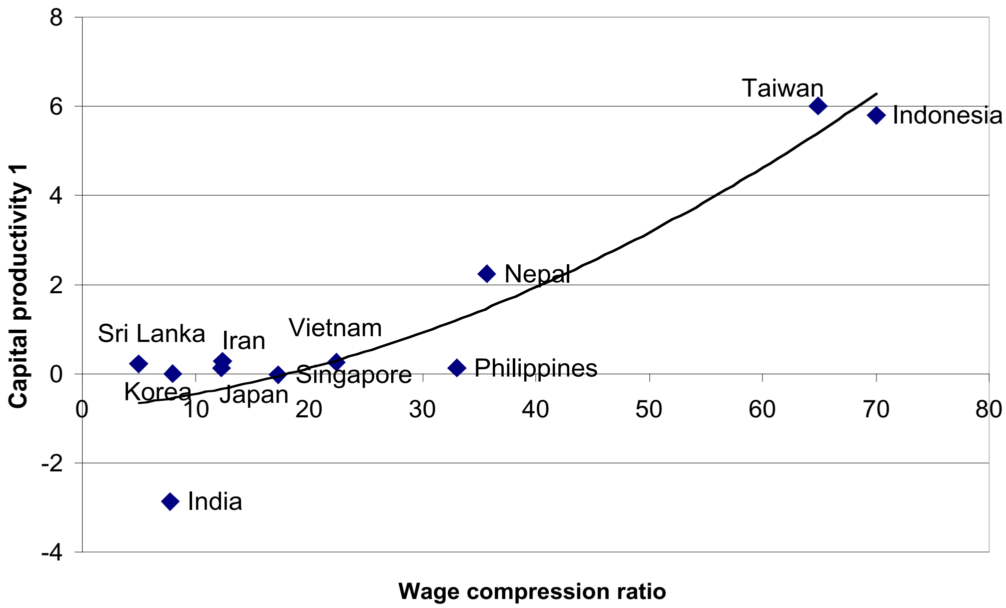


Figure 39. Wage decompression: positive impact

productivity as Figure 39 implies. Here the wage compression ratio measures the highest executive pay as a proportion of the lowest rank-and-file salary. As companies start decompressing their wages, they can expect better performance and higher productivity.

Employer-employee relations

Over the long term, good corporate governance generally calls for strong employer-employee relations, anchored in firm-level institutions such as labor-management councils and unions. The broader the participation of rank-and-file in operational matters, the greater the productivity of firms. But these institutions are a double-edged sword: they can make it hard to change harmful ways as the beneficial ones. Unions in Asia, for example, generally impact negatively on capital productivity (Figure 40) because of their adversarial nature, perceived or real. However, this can be balanced in the long run by judicious managerial exercise in resolving contentious labor-management issues, such as

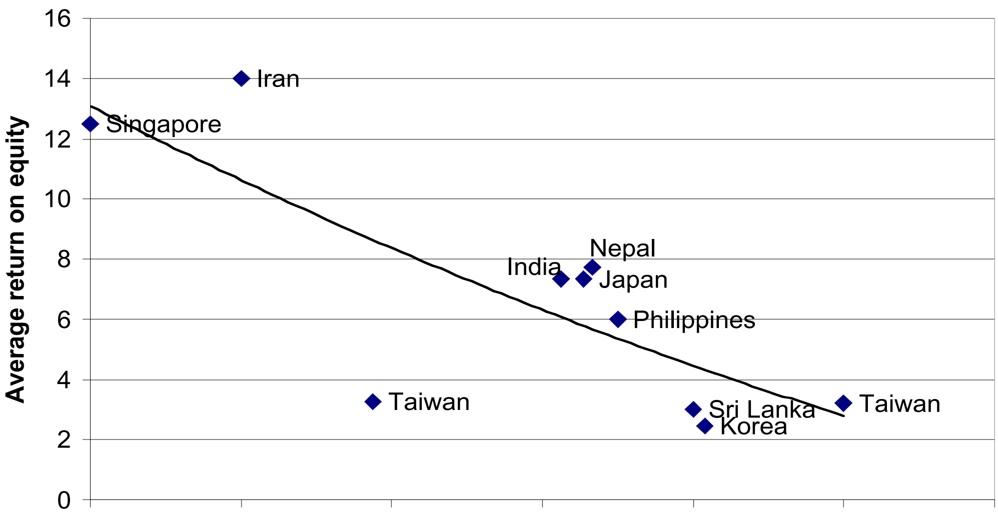


Figure 40. Labor unions: negative impact

wages and benefits (Figure 41).

A motivated staff is essential to an effective firm. Employees can be encouraged to perform better and transform firms into reasonably well-functioning systems. Competitive recruitment and promotion practices as well as better pay will make a big difference in company performance. But in-plant quality enhancing programs yield payoffs as well. Cross-country evidence reveals that continuous improvement programs do impact positively on labor productivity (Figure 42).

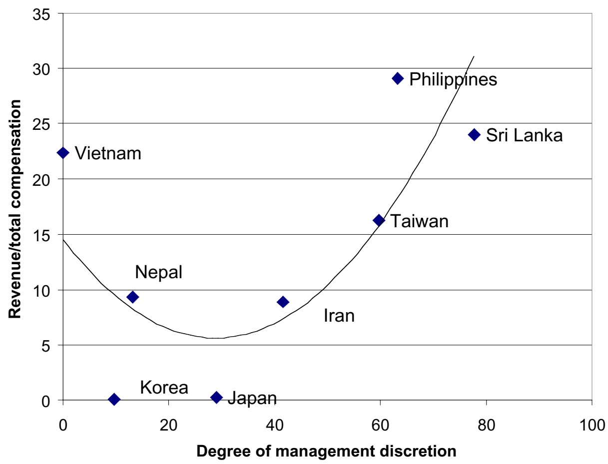


Figure 41. Settling labor disputes: initially negative, then positive, impact

Public governance

Underdeveloped legal and regulatory frameworks are an important explanatory factor of low profitability and capital productivity. They bring about high agency costs. These same institutional weaknesses also facilitate the abuse of minority shareholders. At the macroeconomic level, ill-considered trade and credit policies (which may give incentives to hedge borrowing) as well as ill-conceived exchange rate systems, can be fatal for rising firms.

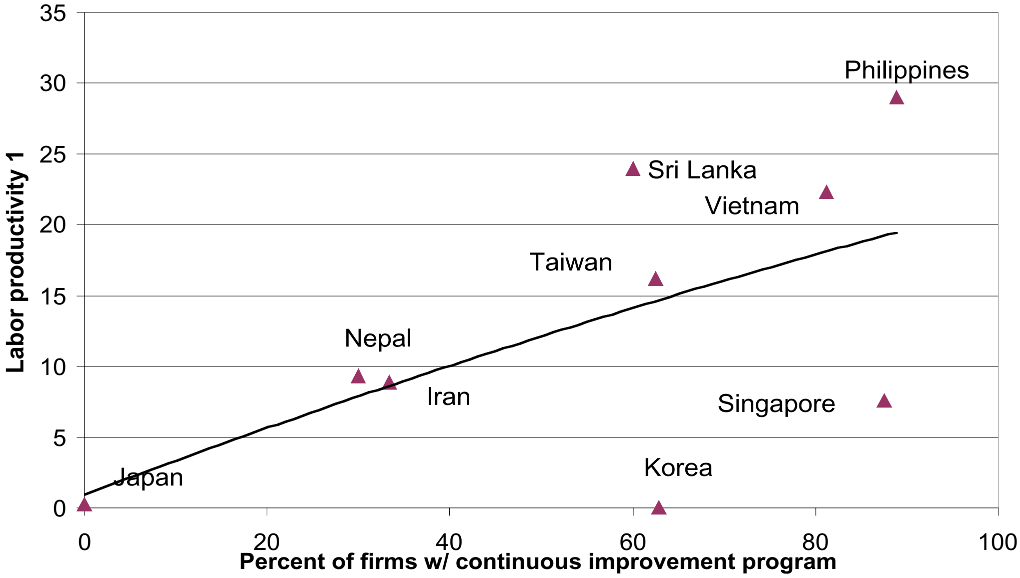


Figure 42. Continuous improvement programs: positive impact

A cautionary note is that legal and regulatory developments may have been impeded by the concentration of corporate wealth and the tight links between corporations and government (state capture), either directly or indirectly. In public choice theory, too elaborate regulatory frameworks make possible bribe extraction and/or make entry less appealing to potential competitors (Djankov, La Porta, Lopez de Silanes and Shleifer, 2001). Regulation becomes an instrument to transfer monopoly rents to private interests. This intertwines with ownership concentration to encourage corrupt trading practices, such as when management and large shareholders expropriate company assets for private gain. Very rigid regulation is, thus, associated with higher corruption and less competition (Claessens, Djankov and Lang, 1999). Figure 43, which shows poor government services negatively associated with capital productivity, validates these commonly-held observations.

When markets are a little weak, as in most Asian countries, it makes economic sense for government to reduce coordination problems and gaps in information. To spur the productivity of firms, government has an array of mechanisms at its disposal, including highly strategic use of subsidies (as in Singapore), or less-intrusive devices such as export promotion and special infrastructure incentives. It is important to recognize that Asian countries, despite policy slippages, have undertaken broad macroeconomic reforms and consolidation and have seen very significant improvements in their overall reform effort.

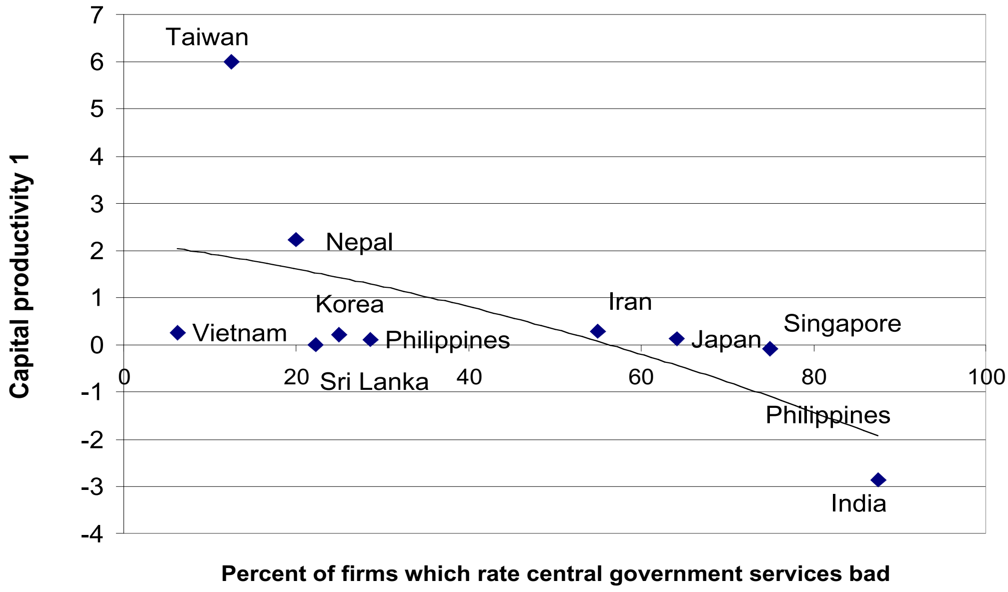


Figure 43. Poor central government services: negative impact

A healthy public governance environment has a favorable effect on labor productivity as well. Reasonable industrial policies protect consumers and workers and bring about service quality. Good infrastructure makes life a little easier for employees. Good industrial policies can also foster innovation. It is the ability of the state to choose wisely among various interventions that can make a difference between productive firms and a moribund private sector.

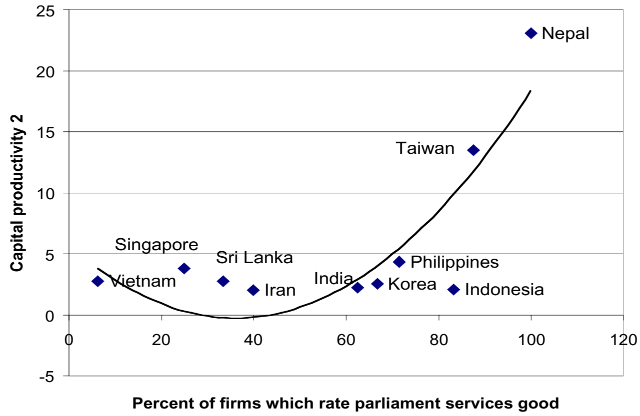


Figure 44. Good parliament services: positive impact

Many Asian countries have parliamentary forms of government, so it is not hard to see why good parliament services have a positive effect on capital productivity. The impact is initially negative (Figure 44), perhaps because laws and resource priorities (which are legislated by parliament) are seen by many as directly favoring powerful constituencies. However, it is also the legislature which passes and oversees reasonably functioning regulatory systems.*

* Figures 20, 26, 29, 30, 31, 32, 33, 35, 37, 39, and 44 include Indonesia. Indonesia joined the earlier phases of the APO study, and had its own partial survey results.

RECOMMENDATIONS AND CONCLUSIONS

Summary of findings

Recalling the objectives of the study, the research intends to help APO member countries understand how governance issues impact on firm performance, and develop policies, strategies, and approaches that can address these issues in the context of the member countries current stage of development. The study hypothesizes that corporate governance is a determinant of firm productivity and growth—that is, ownership structure, corporate management, social responsibility, and institutional interface, affect firm performance.

The study shows a high concentration of ownership in Asian countries, regardless of the level of economic development, but also finds merit in the relationship-based structure. Concentrated ownership, to the extent that large shareholders are more easily able to assert control over the directions of the firm while limiting management inefficiency and excesses, have a positive effect on firm financial and productivity performance. High ownership concentration is often seen in Asia in a favorable light since investors prefer it to monitor and discipline management, whenever they are not assured of strong legal and regulatory protection. But as firms mature, major shareholders become more open to investments, since business expansion necessitates a wider capital base. Asian firms will eventually move toward the ideal of dispersed ownership and rely more on legal protection and the market for corporate guidance as legal institutions become stronger.

The study finds minimal separation of corporate management and ownership control in running Asian firms. The board makes most of the corporate decisions. Many board chairmen double as chief executive officers, solving the problem of aligning principal-agent interests. In general, concurrency helps, at least in the case of maintaining good internal controls, since it reduces the cost of monitoring. But at the same time, it indicates a weak system of checks and balances . Strong external monitoring compensates for this weakness as the study shows more favorable performance for Asian firms with highly independent auditors. But the relationship-based practices, especially in sourcing financing from conglomerates and affiliated banks, somewhat relax monitoring by creditors. Sovereign guarantees on loans also create moral hazard, giving banks few incentives to oversee corporations.

In Asia where insufficient disclosure stems from a lack of tradition of information disclosure, the positive relation between productivity and openness and greater access to information is revealing and may sway firms to break the tradition. Continuous improvement programs do impact positively on productivity. Except for a few countries, productivity enhancement measures, customer satisfaction and quality matters remain to be an off-boardroom issue. Unionism is diminishing, as labor management consultations have become a preferred way to settle labor-management disputes: the presence of adversarial unions generally impacts negatively on productivity. Compensation linked to performance contracts yields good dividends for the firm and improves productivity.

The study likewise finds that varying legal and regulatory frameworks yield different responses and practices in corporate citizenship among Asian countries. Firms generally engage in civic activities to strengthen communities as part of their long-term business strategy. Compliance is evident in countries acquiescent to state directives. Although strong sanctions linked to code of ethics violations impact positively on productivity as well, no concrete relationship was established between firm performance and observance of corporate social responsibility.

Asian countries prefer government presence. Firms give high marks to services provided by institutions such as the central government, parliament, central bank, customs, internal revenue service, and the judiciary. Corruption, fiscal and monetary policy, taxes and regulations, law and order, anti-competitive practices, and an unresponsive judiciary continue to hound corporate Asia. Not surprisingly, a healthy public governance environment has a favorable effect on productivity. On the other hand, poor government service is negatively associated with productivity.

The way forward

There is no doubt that the quality of corporate governance is a determinant of firm performance and productivity. But in Asia, what may be construed as good corporate governance practices (because they translate to positive returns to firms) can be strikingly different from the Western notion of good corporate governance. This does not mean Asian firms should flout the principles of corporate governance laid down by the OECD. It only suggests that cultural nuances come into play even in the protection of the interests of investors and in ensuring that corporate resources are not squandered.

At any rate, within the context of the region s state of economic development and given the peculiar characteristics of ownership structure and management of firms in Asia, measures to improve corporate governance must take into account the following:

- Strengthening the regulatory and legal framework for corporate governance to prevent conflicts of interests without compromising country-specific cost-effective mechanisms to resolve disputes. Asian firms, given their current state of development, cannot afford sweeping reforms. A careful sequencing requires that the first steps should be in strengthening legal safeguards. A gradual process of dispersing ownership would be more acceptable than drastic ownership changes.
- Establishing or enhancing rules to make external monitoring stronger, and providing a counter-balance to related party transactions. In the short term, the more important things are to tighten monitoring and remove moral hazard problems. This can be done through appointment of independent directors, mandatory audit committees in the boards, and prudential regulation of banks.
- Strengthening boards and professionalizing the management of firms. This will require capability building interventions since there are not enough experienced directors in Asia to play the role of seasoned outsiders.
- Improving the quality of accounting and auditing practices, specifically, switching to international standards.
- Enhancing disclosure practices to the extent that minority shareholders are able to access material information about firms governance and performance.
- Promoting greater corporate social responsibility.
- Benchmarking corporate governance quality to promote reforms—adopting a composite measure of corporate governance, and conducting a periodic country-level assessment and cross-country comparisons. Benchmarking should be done against those which succeeded in Asia in blending the features of the Anglo-American model and the Asian business model (for example, against Hong Kong firms).

The Asian context

Which model of corporate governance is right for Asia? Obviously, there is not one system that fits all. It is impractical to impose the corporate governance standards of developed countries on Asian firms since legal and political systems, business cultures and corporate structures widely differ. Asia must craft its own guidelines and shape the corporate governance model in response to its conditions.

Reforms can adapt the principles laid down by the OECD without losing sight of the peculiar needs of the region. Although Asia may not be able to move towards an identical system of corporate governance, it can still have major points of convergence with OECD standards and policy directions.

Some of these principles have been incorporated into laws and regulations governing companies and securities trading, or have been expressed in the listing rules of stock exchanges. Most are now included in codes of best practice developed over the past two years, and may or may not be mandatory.

What are the limits to this convergence? The difference lies in the concept of stakeholder, board structure, regulatory philosophy, legal styles, and political systems. (For instance, while boards are responsible for developing and sustaining relations with stakeholders, they are accountable to the shareholders.)

Timing and sequencing of reforms

Business practice cannot change so fast. Many Asian countries are starting from a fundamentally different base. Like it or not, family-based systems and state ownership of firms (and bank-financed firms) will continue to exert significant influence on the pace of reforms. Hence, Asian firms would do well implementing reforms in an incremental but effective manner rather than through grand measures that are not easily enforceable.

As minority shareholders become more aware of their rights, companies will have no choice but to disclose more information. Form over substance will become less and less acceptable. As governments continue to dispose of assets through privatization, or inject more autonomy into state firms through corporatization, the effects of state ownership will be mitigated. With continuing reforms, the regulatory weaknesses will gradually be replaced by more effective institutions.

The increasing integration of financial markets worldwide is an important catalyst for common governance standards. Asian companies operating internationally will increasingly see greater financial and non-financial disclosure, and accountability to all shareholders, as in their commercial interests. Governments will continue to push corporate governance as a strong fundamental in the development of advanced and attractive securities markets.

Asian governments and local monetary authorities can take a more proactive role in pushing through corporate governance initiatives.

REFERENCES

Alba, Pedro, Stijn Claessens, and Simeon Djankov (1998). Thailand's Corporate Financing and Governance Structures. Working Paper No. 2003. World Bank.

Alba, Pedro, Amar Bhattacharya, Stijn Claessens, Swati Ghosh, and Leonardo Hernandez (1998). Volatility and Contagion in a Financially Integrated World: Lessons from East Asia's Recent Experience. Working Paper No. 2008. World Bank, November.

Bongini, Paola, Stijn Claessens, and Giovanni Ferri (2000). The Political Economy of Distress in East Asian Financial Institutions. Working Paper No. 2265. World Bank, January 1.

Chong Nam, Il, Yeongjae Kang, and Joon-Kyung Kim (2001). Comparative Corporate Governance Trends in Asia, in Corporate Governance in Asia: A Comparative Perspective. Organization for Economic Co-Operation and Development.

Claessens, Stijn, Simeon Djankov, and Larry H. P. Lang (1999). Who Controls East Asian Corporations? Working Paper No. 2054. World Bank, February.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang (1999). Corporate Diversification in East Asia: The Role of Ultimate Ownership and Group Affiliation. Working Paper No. 2089. World Bank, March.

Claessens, Stijn, Simeon Djankov, and Larry Lang (1998). Corporate Growth, Financing, and Risks in the Decade before East Asia's Financial Crisis. Working Paper No. 2017. World Bank, November 1998.

Claessens, Stijn, Simeon Djankov, and Tatiana Nenova (2000). Corporate Risk around the World. World Bank, January.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan and Harry H. P. Lang (1998). Diversification and Efficiency of Investment by East Asian Corporations. Working Paper No. 2033. World Bank, December 1.

Claessens, Stijn, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang (1999a). Expropriation of Minority Shareholders: Evidence from East Asia. Working Paper No. 2088. World Bank, March.

Claessens,Stijn, Simeon Djankov, and Leora Klapper (1999). Resolution of Corporate Distress: Evidence from East Asia's Financial Crisis. Working Paper No. 2133. World Bank, June.

Djankov, Simeon, Rafael La Porta, Florencio Lopez de Silanes, and Andrei Shleifer (2002). The Regulation of Entry. Third Draft. World Bank.

Hellman, Joel S., Geraint Jones and Daniel Kaufmann (2000). Seize the State, Seize the Day State Capture, Corruption and Influence in Transition. World Bank, September.

Hoshi, Takeo, Anil Kashiyap, and David Scharfstein (1990). The Role of Banks in Reducing the Costs of Financial Distress in Japan. *Journal of Financial Economics*, 27: 67-88.

Khan, Haider A. (1999). Corporate Governance of Family Businesses in Asia: What's Right and What's Wrong? Working Paper No.3. ADB Institute, August.

Klapper, Leora F. and Inessa Love (2002). Corporate Governance, Investor Protection and Performance in Emerging Markets. Policy Research Working Paper No. 2818. Washington, DC, World Bank, April.

Woo-Cummins , Meredith (2001). Diverse Paths toward "the Right Institutions:" Law, the State, and Economic Reform in East Asia. Working Paper No.18. ADB Institute, April.

Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong (2000). Corporate Governance and Finance in East Asia. Asian Development Bank.

THE IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY IN THE REPUBLIC OF CHINA

Dr. Chwo-Ming Joseph Yu
National Changchi University
Republic of China

INTRODUCTION

The economic growth of a nation depends on the efforts of citizens, government, various institutions and firms, either state-owned or private-owned. Sustained growth further relies on the growth of productivity. Effective corporate governance increases productivity in the private and public sectors, promotes competitive pressures, and facilitates participation and partnerships both within and outside the nation.

Corporate governance is the system by which state-owned enterprises and business corporations are directed and controlled. It consists of (1) rules that define the relationships among the board, shareholders, mangers, creditors, the government and other stakeholders in a country; and (2) mechanisms that help directly and indirectly to enforce these rules (T. Yeh, 2001). These imply that the study of governance includes ownership structure, shareholder control and protection, creditor monitoring and protection, and rules and procedures for decision-making.

Firms interact with external environment to seek markets, resources or alliances. Thus, government regulations and the perception of the firm s stakeholders affect how a firm can successfully operate to achieve its social and economic objectives. Between the two, the regulatory environment has direct and clear impact.

The objectives of the study are (1) to identify the links between corporate governance, productivity and growth in the context of the economic development of Taiwan, ROC; (2) to analyze how governance issues promote or hinder productivity in an environment characterized by increasing globalization and liberalization; (3) to recommend policies, strategies and approaches suitable to the productivity needs of Taiwan, ROC following a distinctly Asian style of corporate governance.

REVIEW OF LITERATURE AND RELATED STUDIES

Corporate governance is a relatively new topic for researchers in Taiwan, ROC. Studies do confirm that good corporate governance has positive impact on firms, such as reducing financial risks (Lee and Yeh, 2001). This paper reviews those studies and articles published in Taiwan recently that are most related to the issue of corporate governance.

Executive succession is a critical change event for any organization, which may trigger dramatic transformations in an organization s strategy, design, climate and performance (Hsu, 1998). The issue is particularly significant for private rather than publicly listed trade companies because of the nature of ownership in Taiwan, ROC, where over 98 percent of firms are small and medium enterprises (SMEs). Most of Taiwanese SMEs are private firms and are family-controlled.

The external control mechanisms (such as mergers and acquisitions and institutional investors) in the US have reduced agency cost and protected the interests of stockholders. In Taiwan, the lack of external control mechanisms makes corporate governance (i.e., internal control mechanisms) more important (Chu, *et al.*, 1996). Chiang (2002) examines the impact of such external control mechanisms on corporate governance and reveals the following findings: (1) poorly performing firms tend to be the targets of mergers and acquisitions; (2) the larger the number of board members the largest stockholder has, the poorer the performance of an acquired firm; and (3) the larger the number of board members the second largest stockholder has, the better the performance of an acquired firm. Corporate governance does affect the performance of acquired firms.

Jensen and Meckling (1976) argue that when managers own more shares in a firm, their self-interest will be curtailed and firm performance will be better. This is known as the convergence-of-interest hypothesis. Furthermore, for a firm with high growth opportunity, increasing the shareholdings of managers and employing more external board members (i.e., people not working at the firm) can reduce agency costs (Huang *et al.*, 2001). Indeed, Hsu *et al.* (2002) find that the total shareholdings of managers are positively associated with positive returns (true for publicly listed manufacturing firms). The convergence-of-interest hypothesis is also applicable to board members in services firms (Young, 1989; Chiu and Chang, 1991; Tsai, 1991). For example, banks perform better when board members and/or managers have more shares of stocks.

Investigating newly privatized banks, Chen and Huang (2001) find that (1) when the largest stockholder—the government, that is—has more voting rights, cash flow rights, and directors on the board than its share of ownership represents, the performance of the bank is poorer; and (2) when the second largest stockholder has considerable stockholdings and is less controlled by the largest stockholder, the performance of the bank is better.

Yeh, Lee and Woidtke (2001) have a similar finding for family-controlled listed companies: when family members control a large share of a firm but have less representation in terms of board members, the value of a firm increases. Their findings suggest that corporations perform better when non-family members hold half of the board seats. Furthermore, family-controlled firms behave differently in borrowing funds because of non-transparency of financial information (Tu and Chen, 2001).

Lee and Yeh (2001) use variables that include the deviation of control rights from cash flow rights, the percentage of board (supervisors) seats controlled by the largest shareholder, and the percentage of shares pledged for loans by board members and managers. They show that (1) the greater the deviation of control rights from cash flow rights, the higher the proportion of directors and supervisors seats controlled by the largest shareholder and (2) the higher the stock pledge ratio is, the more likely the firm would run into financial distress in the following year.

Some argue that social responsibility is part of business ethics. Managers and employees in Taiwan have recognized the importance of business ethics (Kuo and Wei, 1999). Hong (1997) examines the social charity and environmental protection activities of firms in Taiwan and finds that (1) firms did engage in activities to fulfill their social responsibility; and (2) firms devoting resources for social causes were perceived to have better reputation.

Board members have the most significant impact on corporate governance (Du, 2002) and empirical studies confirm the impact of boards on firms performance (Tu *et al.*, 2002). Accordingly, the following are suggested for strengthening the effectiveness of a board (Lin, 2001):

- The board should be separate from management so that the latter cannot control the former;
- Half of the board members should come from outside the firm and should have

diverse backgrounds;
- Board members should make independent decisions and monitor firm performance;
- When it warrants, the board can ask the chairman to resign;
- Board members should be stockholders;
- The compensation to board members should be mainly in the form of stocks;
- A system should be designed to evaluate the performance of board members; and
- The board, besides speaking for stockholders, should also respond to the calls of stakeholders.

Yeh *et al.* (2002) evaluate the quality of information provided at websites by 555 listed companies. They find that 54.2 percent set up websites; 33 percent reported financial information; and 54.2 percent provided either financial information, information related to stockholders or other important information (such as important announcements, agenda at stockholders meetings and time for releasing financial reports). In general, firms use websites for introducing themselves and products/services and not for building bridges to stockholders.

Standard & Poor s (2002) rated Taiwan, ROC low in terms of corporate governance. Corporate Governance Score (CGS) is based on the scores of each firm for the following components: ownership structure and influence, financial stakeholder relations, financial transparency and information disclosure, and board and management structure and process. The average CGS of Taiwan, ROC is lower than the scores for Sri Lanka, Malaysia, Thailand, China, Korea, Pakistan, India, Indonesia, and the Philippines.

In recent years, the Taiwanese government has taken several steps to enhance corporate governance practices in Taiwan. It has strengthened the independence and authority of the regulatory agency, the Securities and Futures Commission (SFC). It has improved the transparency of financial statements and information disclosures, increased the legal liabilities of board directors and independent auditors, and instituted other reforms (T. Yeh, 2001).

OVERVIEW OF THE CORPORATE SECTOR

In 2000, the total number of firms in the Taiwan, was 1,091,245 in which small and medium enterprises (SMEs) accounted for 98 percent of all firms (Table 1). SMEs employed a total of 7,404,911 persons (on the average with 6.9 employees), accounting for 78 percent of the work force (Table 2). In terms of sales volume, SMEs accounted for 20 percent of export sales and 32 percent of domestic sales (Table 3). Newly established SMEs in 2000 numbered 96,723 which is lower than the 1999 figure by 3.99 percent. But they had more export sales, which grew modestly by 0.32 percent. SMEs have contributed significantly to the Taiwan economy and they are noted for innovation, flexibility, efficiency and their ability to adapt easily and rapidly to changes, especially in international markets (Small and Medium Enterprise Administration, 2001).

With the exception of return on net worth, all indicators of performance of SMEs rose in 1999 as compared to 1998. For large firms all indicators in 1999 showed an increase compared to those in 1998 (Table 4).

Large firms tended to outperform SMEs each year. Tables 5 and 6 show the profit and loss structures for SMEs and large firms. During 1994-1999, the operating costs were decreasing and gross operating profit and current profit were increasing over time for SMEs while large firms did not show such a persistent pattern as that of SMEs. However, large firms tended to operate more efficiently (i.e., in 1999 the operating expenses were

7.77 percent and 14.96 percent for large firms and SMEs respectively); their profit was higher than that of SMEs each year (e.g., 4.11 percent vs. 3.45 percent in 1999). Clearly, SMEs need to improve their control of operating expenses.

Table 1. Number of firms by selected industry

	Total	Agri-culture, forestry & fishery	Manu-facturing	Commerce	Business services	Public & personal services	Others
1996							
All enterprises	1,024,360	11,503	153,845	611,251	39,612	84,263	123,886
SMEs	1,003,325	11,444	150,806	598,266	38,822	83,785	120,202
SMEs share (%)	97.95	99.48	98.02	97.87	98.00	99.43	97.03
1997							
All enterprises	1,043,286	12,887	150,855	629,617	42,227	83,617	124,083
SMEs	1,020,435	12,833	147,507	615,506	41,309	83,076	120,204
SMEs share (%)	97.81	99.58	97.78	97.76	97.83	99.35	96.87
1998							
All enterprises	1,069,116	12,979	148,990	646,842	45,105	86,057	129,143
SMEs	1,045,117	12,933	145,281	632,444	44,108	85,425	124,926
SMEs share (%)	97.76	99.65	97.51	97.77	97.79	99.27	96.73
1999							
All enterprises	1,085,430	12,876	146,719	656,882	47,701	88,975	132,277
SMEs	1,060,738	12,823	142,686	642,196	46,640	88,318	128,075
SMEs share (%)	97.73	99.59	97.25	97.76	97.78	99.26	96.82
2000							
All enterprises	1,091,245	10,722	144,912	658,501	52,266	91,606	133238
SMEs	1,070,310	10,686	141,340	646,312	51,279	91,005	129,688
SMEs share (%)	98.08	99.66	97.54	98.15	98.11	99.34	97.34

Source: Small and Medium Enterprise Administration , 2001

Table 2. Total employment by selected industry (in thousand persons)

	Total	Agri-culture forestry & fishery	Manu-facturing	Commerce	Business services	Public & personal services	Others
1996							
Total	9,068	918	2,422	1,976	233	324	3,195
Government	1,027	8	59	13	1	324	622
Large firms	910	2	384	106	30	n.d.	388
SMEs	7,131	908	1,979	1,857	202	n.d.	2,185
SMEs share (%)	78.64	98.91	81.71	93.93	86.70	0.00	68.39

Table 2. Total employment by selected industry (continued)

	Total	Agri-culture forestry & fishery	Manu-facturing	Com-merce	Business services	Public & personal services	Others
1997							
Total	9,176	878	2,570	1,995	240	323	3,170
Government	1,023	8	60	13	1	323	618
Large firms	956	2	422	108	29	n.d.	395
SMEs	7,197	868	2,088	1,874	211	n.d.	2,156
SMEs share (%)	78.43	98.86	81.25	93.93	87.92	0.00	68.01
1998							
Total	9,289	822	2,611	2,047	260	315	3,234
Government	975	7	55	11	0	314	588
Large firms	1,049	1	467	112	30	0	439
SMEs	7,265	815	2,089	1,924	229	0	2,208
SMEs share (%)	78.21	99.10	79.99	93.99	88.20	0.13	68.27
1999							
Total	9,385	776	2,603	2,130	284	318	3,274
Government	961	7	46	12	0	317	579
Large firms	1,080	2	463	114	39	0	462
SMEs	7,344	768	2,029	2,004	244	1	2298
SMEs share (%)	78.25	98.90	80.37	94.07	86.16	0.17	70.19
2000							
Total	9,486	742	2,652	2,160	313	316	3,303
Government	956	7	42	10	1	315	581
Large firms	1,125	2	488	113	46	0	476
SMEs	7,405	733	2,122	2,037	266	0	2,247
SMEs share (%)	78.06	98.75	80.01	94.30	85.12	0.06	68.03

Source: Small and Medium Enterprise Administration , 2001

Table 3. Export value, domestic sales value by selected industry (in million NT$)

	Total	Agri-culture, forestry & fishery	Manu-facturing	Commerce	Business services	Public & personal services	Others
Direct export							
1998							
SMEs	1,233,136	2,023	539,774	604,555	18,233	47,089	21,462
SMEs share (%)	23.79	40.68	20.46	28.81	23.06	75.34	7.15
1999							
SMEs	1,197,820	1,979	507,826	601,913	17,969	48,006	20,127
SMEs share (%)	21.11	41.38	17.39	26.44	18.69	82.02	6.29
2000							
SMEs	1,369,937	2,177	592,095	678,994	22,290	50,823	23,558
SMEs share (%)	20.03	47.21	15.84	26.54	18.11	82.39	6.65

Table 3. Export value, domestic sales value by selected industry (in million NT$) (continued)

	Total	Agri-culture, forestry & fishery	Manu-facturing	Commerce	Business services	Public & personal services	Others
Domestic sales							
1998							
SMEs	5,674,645	12,518	1,784,169	2,421,993	180,271	134,287	1,141,407
SMEs share (%)	32.30	36.73	35.63	35.56	31.98	33.47	24.02
1999							
SMEs	5,707,292	11,450	1,784,468	2,441,786	185,501	137,800	1,146,287
SMEs share (%)	31.40	30.19	34.66	34.70	29.60	32.10	23.41
2000							
SMEs	6,196,680	12,142	1,947,789	2,699,778	218,025	152,021	1,166,925
SMEs share (%)	32.15	34.72	35.22	35.72	29.88	33.23	23.52

Source: Small and Medium Enterprise Administration , 2001

Table 4. Earning ability of firms, 1998-1999

	1998	1999		1998	1999
SMEs			**Large firms**		
Operating profit	3.05	3.45	Operating profit	3.87	4.11
Return on gross assets	13.04	14.23	Return on gross assets	20.72	21.13
Return on fixed assets	3.72	4.08	Return on fixed assets	3.36	3.98
Return on capital	10.61	12.85	Return on capital	16.57	17.54
Return on net worth	9.65	9.20	Return on net worth	10.77	11.10

Source: Small and Medium Enterprise Administration ,2001

Note: operating profit = current profit/net operating profit; return on gross assets = current profit /gross assets; return on fixed assets = current profit/fixed assets; return on capital = current profit/capital; return on net worth = current profit/net worth

Table 5. Profit and loss structure for SMEs, 1994-1999 (in %)

Year / Item	1994	1995	1996	1997	1998	1999
Net operating income	100.00	100.00	100.00	100.00	100.00	100.00
Minus: operating costs	84.47	84.29	83.43	82.71	80.27	80.46
Gross operating profit	15.53	15.17	16.57	17.29	19.73	19.54
Minus: operating expenses	13.22	13.60	13.00	13.40	15.46	14.96
Net operating profit	2.31	2.11	3.57	3.88	4.23	4.54
Plus: Non-operating income	1.94	1.90	0.88	1.13	0.71	0.59
Minus: Interest expenditure	1.73	1.82	1.93	2.05	1.40	1.25
Minus: other non-operating expenditure	0.41	0.48	0.44	0.62	0.54	0.48
Current profit and loss	2.11	1.71	2.08	2.34	3.00	3.45

Source: Small and Medium Enterprise Administration (2001)

Table 6. Profit and loss structure for large enterprises, 1994-1999 (in %)

Item \ Year	1994	1995	1996	1997	1998	1999
	100.00	100.00	100.00	100.00	100.00	100.00
Minus: operating costs	86.34	87.69	85.84	84.57	86.78	87.30
Gross operating profit	13.66	12.31	14.16	15.43	13.22	12.70
Minus: operating expenses	8.60	8.44	8.92	9.02	8.34	7.77
Net operating profit	5.05	3.87	5.23	6.39	4.87	4.93
Plus: Non-operating income	1.49	1.87	1.20	1.53	1.26	1.06
Minus: Interest expenditure	1.41	1.36	1.83	1.78	1.47	1.30
Minus: other non-operating expenditure	0.46	3.90	4.18	5.56	3.87	4.11
Current profit and loss	4.67	3.90	4.18	5.56	3.87	4.11

Source: Small and Medium Enterprise Administration, 2001

The securities market in 2000 witnessed considerable growth in Taiwan, ROC. By the end of 2000, 531 companies were listed on the Taiwan Stock Exchange (TSE), with total market capitalization of about $256 billion (US$1=NT$32). Some 300 firms were in the over-the-counter (OTC) market, with market capitalization reaching $33 billion (Table 7). The electronics industry has the largest segment in the TSE (accounting for 26.6 percent of the listed firms and 28.9 percent of the registered capital) and in the OTC market (accounting 42.7 percent of the listed firms and 35.6 percent of the registered capital). That highlights the importance of the sector to the economy, as well as the healthy capital growth rates of the TSE listed companies and OTC companies from 1995 to 2000. In general, under the auspices of the Security & Futures Commission, TSE has been efficient in meeting the fund-raising needs of the business sector in Taiwan, ROC.

Table 7. Statistics of publicly-held companies (in billion NT$)

	TSEC listed companies					OTC listed companies		Unlisted companies	
Year	Number	Capital Registered	Growth Rate (%)	Par Value	Market Value	Number	Capital Registered	Number	Capital Registered
1998	437	27,341	29.81	26,966	83,926	167	3,824	1,810	15,188
1999	462	30,862	12.88	30,540	117,873	264	5,148	2,018	16,196
2000	531	36,612	0.17	36,301	81,911	300	6,772	2,257	15,186

Note: In 2000, (a) 16 companies required full delivery and traded under a separate bracket with a total par value of NT$ 52.9 billion; (b) 80 companies were primarily listed with a total registered capital of NT$ 207 billion in 2000; 11 companies were delisted with registered capital of NT$ 43.7 billion in 2000.

Individual investors are very active in the stock exchange market. As shown in Table 8, close to 80 percent of the owners of stocks have less than 50,000 shares of stocks. In fact the number of persons with trading accounts in December 2000 was 6,829,151 (the population was about 22 million). Individual investors in Taiwan, ROC are very active for three reasons: (1) it is very easy to trade: trading offices are conveniently located and the costs of borrowing money to buy or loaning stocks to sell are relatively low; (2) only transactions are taxed; capital gains are not taxed; and (3) the excitement of the stock markets is generally shared by most people, especially housewives. Furthermore, the number of shareholders increased from 5,954,680 in 1991 to 21,958,091 in 2000. The active participation of individual investors in the stock exchange market motivates firms to go public and, at the same time, underlines the importance of the government to provide a legal framework for fair trading. The positive development, as illustrated in Table 9, is that institutional investors (e.g., firms, banks, mutual funds, retirement funds), especially those from abroad, are gradually increasing their representation at the stock exchange market.

Table 8. Ownership analysis of listed companies

Shares	**1991**		**1994**		**1997**		**2000**	
	Number of share-holders	%	Number of share-holders	%	Number of share-holders	%	Number of share-holders	%
1-9999	2,211,627	37.14	3,139,147	39.18	4,303,555	35.05	7,382,079	33.62
10000-50000	3,123,814	52.46	3,717,938	46.40	5,691,511	46.35	10,118,814	46.08
50001-100000	355,392	5.97	621,600	7.76	1,177,095	9.59	2,161,913	9.85
100001-150000	98,550	1.66	183,759	2.29	366,743	2.99	824,913	3.76
150001-200000	52,679	0.88	107,383	1.34	235,692	1.92	434,788	1.98
200001-300000	42,377	0.71	88,390	1.10	178,678	1.46	381,756	1.74
300001-500000	31,930	0.54	67,739	0.85	145,723	1.19	293,040	1.33
500001-1000000	21,146	0.36	46,219	0.58	101,587	0.83	203,702	0.93
1000001-2000000	8,743	0.15	21,275	0.27	42,379	0.35	88,286	0.40
2000001-4000000	3,950	0.06	9,579	0.12	19,238	0.16	36,897	0.17
4000001-6000000	1,439	0.02	2,910	0.04	6,018	0.05	11,141	0.05
6000001-8000000	713	0.01	1,408	0.02	2,586	0.02	5,121	0.02
8000001-10000000	440	0.01	909	0.01	1,680	0.01	3,292	0.01
10000001 (or more)	1,880	0.03	3,885	0.04	6,453	0.03	2,349	0.06
Total	5,954,680	100	8,012,141	100	12,278,938	100	21,958,091	100

Taiwanese companies have tried to raise capital internationally. In 2000, the capital raised by listed companies through global depository receipts and Euro bonds were US$4,030 million (NT$129 billion) and 1,134.5 million (NT$36.3 billion) respectively. These financial instruments were listed or placed in London, New York or Luxembourg. It is clear that listed companies have the credibility and ability to successfully raise capital from international capital markets.

LEGAL AND REGULATORY FRAMEWORK

The regulatory environment of firms is composed of many regulations, such as laws governing the establishment of firms and laws dictating the tax structures. Since publicly listed companies affect many investors, the governance of these companies becomes more important. Hence, a discussion of the activities of the Securities and Futures Commission, which regulates directly these companies, as well as those of the Fair Trade Commission (FTC), which ensures a fair and reasonable competitive order among firms, is in order.

The laws

The Corporate Law and the Securities and Exchange Law form the regulatory framework of corporate governance in Taiwan, ROC. While the Corporate Law sets the rules to protect present and future shareholders and creditors (i.e., the basic principles of governance), the Securities and Exchange Law regulates the disclosure of information. As in other countries, the stockholders meetings and board of directors are two important mechanisms in corporate governance. However, in Taiwan, ROC, the laws also require the appointment of firm-auditors (i.e., internal auditors), in addition to certified public accountants (i.e., external auditors), by stockholders.

The basic regulatory model of corporation in Taiwan has a two-tier structure consisting of the board of directors, supervisor(s) and shareholders. As owners of the corporation, shareholders elect directors and supervisor(s) during the shareholder s meeting. Thus, the Board, with discretionary powers delegated by shareholders, also performs management functions. Shareholders retain their authority over directors through their power to reshuffle those who abuse delegated discretionary power. Supervisors monitor improprieties committed by directors, and also audit the managerial execution of business activities (Securities and Futures Institute, 2001).

Board of directors

The number of board members should be at least three for non-listed companies and at least five for publicly listed companies. The Corporate Law was amended in 2001 in order that outside directors (i.e., non-stockholders) can be appointed as board members. In general, the board is supposed to act in behalf of stockholders when monitoring and guiding the activities of firms. However, the specific duties or rights of the board are defined in the Corporate Law. To prevent opportunistic behavior by board members, the law gives stockholders the following rights: (1) requesting the board to stop unlawful acts; (2) removing disqualified directors; (3) demanding that directors avoid conflict of interest in fulfilling their duties; (4) demanding that directors be independent; (5) filing lawsuits against directors; and (6) demanding that directors hold a certain percentage of shareholdings.

Firm-auditors

Any unlisted company should have at least one firm-auditor while a publicly listed company should have at least three firm-auditors. A firm-auditor fulfills his duties by providing an independent and objective review of the financial reporting process and internal controls and performing an audit of the firm. Firm-auditors should submit audited reports at stockholders meetings. The law stipulates the duties of a firm-auditor as follows: (1) examines all aspects of a firm s operation, such as records, statements, property; (2) acts on behalf of the firm when there are lawsuits between a firm and its directors; (3) convenes a shareholders meeting when deemed necessary or requested by court orders; and (4) maintains independence. The Law also gives stockholders the following rights to monitor firm-auditors: (1) file lawsuits against firm-auditors; (2) remove disqualified firm-auditors; (3) demand compensation for losses or damages resulting from negligence in performing the firm-auditors duties; and (4) demand that firm-auditors hold a certain percentage of shareholdings.

Stockholders meeting

The stockholders meeting is the ultimate decision-making body of a firm. It approves the following (1) appointment of board members and firm-auditors; (2) compensation packages of board members and firm-auditors; (3) revision of company charter; (4) major activities of the firm (such as mergers and acquisitions, raising capital, investing abroad). It also enjoys other rights as indicated by the Corporate Law. Stockholders can vote for others through proxies so that they can put pressure on the board and managers. However, although minority stockholders can ask managers to take certain actions, the requirements are too stringent for these rights to be realized.

Information disclosure

Firms are required to disclose certain information. Publicly-held firms are required to submit reports to the SFC regularly on the following: monthly sales revenues; monthly endorsement and guarantee; monthly capital lending; information about derivative instrument transactions; financial reports for the first and third quarters; half-year financial report; yearly financial report; financial forecasts; changes in share ownership and pledged rights; information about shareholders meetings; matters regarding calls for proxies; annual reports; minutes of shareholders meeting; status of internal audit execution; status of the internal audit execution for companies engaging in derivative instrument transactions; and internal control declaration. Also, firms are required to report non-regular matters, such as incidents sufficient to affect stock prices and stockholders equity, merging with other companies, and others.

Amending laws

Violations committed against the Corporate Law and the Securities and Exchange Law suggest that these two laws have not been able to cope with the changes in business practices. Thus, the Guidelines for Examination of the Listed Securities and the Guidelines for Examination of the OTC Listed Securities were enacted to add teeth to these two laws. In addition, the SFC was given the power to set up new rules/regulations and amend old rules/regulations whenever it is necessary. Disclosure requirements covering various pieces of information (such as those listed above) are already the products of various laws, guidelines and rules/regulations.

Securities and Futures Commission[1]

One important institution in Taiwan, ROC to promote more rigorous corporate governance is the Securities and Futures Commission, organized through the mandates of the Securities and Exchange Law and the Future Trading Law. The SFC is responsible for the development, regulation, and supervision of the capital market and is also the regulator of the futures industry. The statutory mandates of the SFC are to facilitate national economic development and to protect investors' interests. To achieve these goals,

[1]The major sources of information in this section are: (1) 2000 SFC Annual Report, Taipei: The Security and Futures Commission, Ministry of Finance, R.O.C., 2001, and (2) 2000 Major Indicators of Securities & Futures Market, Taiwan District, ROC, Taipei: The Security and Futures Commission, Ministry of Finance, ROC, 2001.

the SFC has laid out four general policy directives:

- To foster the sound development of the capital market and to encourage fund raising through the offering of securities to the investing public;
- To improve the operation of the securities and futures markets and to ensure a fair and efficient market environment;
- To promote the development of the securities services industries and to facilitate the flow of savings into investment; and
- To regulate certified public accountants and to enhance their professional standards.

The SFC aims to constantly enhance the securities market s administration, improve the related regulations in line with international standards, and strengthen the mechanisms of information disclosure and market self-discipline. All these efforts facilitate the process of fund-raising and enhance investor protection. A summary of the activities of the SFC in 2000 is discussed below.

As regards its external supervision function, the SFC relies on the Securities Investors and Futures Traders Protection Law to provide the legal basis for protecting investors. The law was passed by Parliament in July 2002 and enacted in January 2003. The most important part of the law is the enhancement of mechanisms for securities class action. The Securities and Futures Investors Protection Center has also been established in January 2003 to help protect investors rights and interests.

Enforcement of the full disclosure policy

In an effort to achieve a higher standard of transparency so that investors would better understand the business and financial activities of publicly held companies and thus, empower them to make informed decisions, the SFC demands full disclosure in the form of prospectuses and periodical information as well as important information that may affect shareholders interests or stock prices. To enforce the full disclosure policy, the SFC has amended the Rules Governing Acquisition and Disposition of Assets by Publicly Held Companies , the Rules Governing Acquisition of Real Estate from a Related Party by Publicly Held Companies , and the Rules Governing Engagement in Financial Derivatives Transactions by Publicly Held Companies .

Enforcement and investigation of illegal trading

Price manipulation and insider trading are prohibited acts. To maintain the securities trading order and establish justice in the market, the SFC has instituted the following reforms: audit the securities holding of directors, supervisors, managers or shareholders holding over 10 percent of shares of listed companies; subject the staff of the SFC and other related government agencies suspected of insider trading to scrutiny as regards significant market information announced by listed companies; utilize informants, media reports or other sources when illegal trading is suspected. The SFC audits the insiders stock transactions and holding balances of listed companies and over-the-counter companies monthly. If violations of insiders disclosure requirements are detected, insiders are penalized. On the other hand, board directors and firm-auditors of a listed or an OTC company shall hold not less than a specified percentage of its total issued shares. Any person who possesses, either individually or jointly with other persons, more than 10 percent of the total equity shares of an issuer, has to register with the SFC as well. Violations of these obligations are scrupulously investigated. The 2000 figures show the following offenses committed:

- Violation of the requirements of insiders transferring shares: 215 cases;

- Violation of the requirements of declaring shareholding changes: 71 cases;
- Violation of the requirements of maintaining minimum share holdings: 62 cases; and
- Violation of the requirements of tender offer and acquisition large shares: 121 cases.

Regulating the futures market

In order to develop an Asia-Pacific financial center on Taiwan, ROC and provide investors with more channels for risk hedging, the government has actively worked to set up a domestic futures market. Relevant by-laws to the Futures Trading Law have been promulgated continuously to lay a comprehensive legal and regulatory foundation for a domestic futures market.

Regulating accountants

The Attestation System of Certified Public Accountants is a foundation stone for providing credible financial records. To strengthen the CPAs attestation system and provide reliable public information, the SFC has promulgated several procedures (such as Guidelines of Parent and Affiliated Companies: Relationships Reports, Group Management Reports and Consolidated Financial Statement , Rules Governing Fair Presentation of Financial Statements of Publicly Held Companies and Peer Reviews on CPA Firms Practices to enhance the CPAs professional level and quality of accounting information. In 2000, among 12 cases involving misconducts of accountants, nine were punished with suspension of practice, one received a warning, another received a reprimand, and yet another was exempted from administration sanctions.

Promoting internal control

In compliance with the stipulation of the Guidelines for Publicly Held Companies to Establish an Internal Control System and Guidelines for Service Businesses Engaging in Securities and Futures Markets to Establish Internal Control Systems, the SFC has required publicly held companies and service businesses engaging in securities market to establish and implement internal control systems, in order to strengthen their operations and protect investors. Publicly held companies should self-appraise their internal control systems and issue an Internal Control Statement .

Fair Trade Commission[2]

The Fair Trade Law is the basic law of the Republic of China governing business competitive behavior. It is enforced by the Fair Trade Commission as well as by the courts. This law mainly regulates restrictive business practices and unfair trade practices. Regulations on restrictive business practices include controls on monopolies, mergers, concerted actions, resale price maintenance and competition restraints. Unfair trade practices include counterfeiting, false, untrue and misleading advertisements, damaging the business reputation of another, multi-level sales schemes and other deceptive or obviously unfair conducts.

Activities of the FTC

By the end of 1997, 11,893 complaints and applications had been filed with the FTC, which included 8,655 complaints, 69 applications for the approval of concerted act, 1,717

[2] The source of information is: Cases and Materials on Fair Trade Law of the Republic of China, Vol.2, Taipei: Fair Trade Commission, The Executive Yuan, Taiwan, ROC, 2000.

Table 9. Concluded cases of complaints (categorized by regulated act)

Year	Total number of cases	Misuse of monopolistic power	Combinations	Concreted actions	Resale price maintenance	Restrictive competition	Counterfeiting	Misleading acts	Damage to business reputation	Improper multi-level sales	Deceptive or obviously unfair acts	Others
1992	252	6	-	17	1	15	13	86	1	3	5	-
1993	468	16	-	23	2	47	22	118	3	13	39	3
1994	808	24	-	28	3	50	38	209	6	15	91	-
1995	875	16	-	29	2	86	17	233	3	14	109	4
1996	971	16	1	26	5	62	21	248	2	36	144	4
1997	941	17	6	37	2	85	14	255	6	11	111	11
1998	916	12	6	23	4	57	24	234	7	24	125	10
Total	5,231	107	13	183	19	402	149	1,383	28	116	624	32

Source: Statistical Office, Fair Trade Commission

applications for mergers, and 1,432 requests for explanation. Out of the 8,655 complaints filed, a total of 8,197 had been reviewed and concluded by the FTC by the end of 1997. Table 9 shows the distribution of cases by type of regulated acts in certain years. Misleading acts, deceptive or obviously unfair acts and restrictive competition are the three consistently leading violations. While the FTC received 1,296 complaints in 1992, the number increased to 2,697 in 2000, showing its importance in providing a level playing field for competition.

Other services of the FTC

The FTC has set up a service center to provide business firms and individuals with consulting services and to answer questions concerning the Fair Trade Law and FTC s administrative programs. Services provided by the service center include the following categories: orientation on the Fair Trade Law; provision of educational materials, explanation of application procedures, and handling comments and inputs from the public. Its Competition Policy Information and Research Center provides domestic and foreign users with services on competition policy and laws as well as research and training services.

To effectively enforce the Fair Trade Law and to protect consumer interests in light of market liberalization, the FTC has been actively participating in various international cooperation programs, such as those sponsored by the World Trade Organization and the OECD.

CORPORATE GOVERNANCE IN TAIWAN, ROC

Corporate governance in Taiwan can be broken down in four areas, namely: ownership, management, social responsibility and institutional interface.

Separation of ownership and management

Most firms in Taiwan, ROC started as family businesses. As business grows, family members eventually become managers but even when the company has gone public, family members continue to exercise controlling influence on the management of the company (T. Yeh, 2001).

When firms become publicly listed firms, professional managers are likely to be hired to run these firms. The decline in the combined ownership by board members and firm-auditors reflects the trend towards separation between ownership and management (Table 10).

Risks associated with business groups

Firms prefer to grow through setting up new firms, either in related or unrelated businesses. As a result, there are more than 200 business groups in Taiwan. Because some business groups expanded too quickly and into unfamiliar territory, the financial crisis in 1997 hurt them seriously. Its lesson for firms is that that they should concentrate on their core businesses. Its implication on government is that rules regulating intra-group transactions have to be revised frequently.

Table 10. Distribution of combined ownership by board members and firm-auditors for publicly listed firms

% of ownership	As of April, 1985		As of August, 1999	
	No. of firms	% of total firms	No. of firms	% of total firms
0 - 9.99	3	2.68	83	18.28
10 - 19.99	32	28.57	160	35.24
20 - 24.99	21	18.75	42	9.25
25 - 29.99	18	16.07	44	9.69
30 - 39.99	9	8.04	68	14.98
40 - 49.99	10	8.93	31	6.83
50 - 59.99	12	10.71	14	3.08
60 - 69.99	4	3.57	7	1.54
70 - 79.99	1	0.89	4	0.88
80 - 89.99	0	0	1	0.22
90 - 100	2	1.79	0	
Total	112	100.00	454	100.00

Source: Securities and Futures Commission

Dominance of individual investors

Individual investors dominate the stock market in Taiwan, ROC. Institutional investors (e.g., firms, banks, mutual funds, retirement funds, etc.) have yet to play a strong role (Table 11). For example, domestic and foreign institutional investors accounted for only 10.1 percent and 8.3 percent of market transactions, respectively, in 2000. When compared with the situation in developed countries, the presence of institutional investors in Taiwan, ROC is not significant. The passive role they play may be explained by the restrictions imposed by Taiwanese regulatory bodies in terms of shareholding limits or holding period (SFI, 2001).

Taiwan, ROC opened its door to foreign portfolio investment in 1983. A series of policies were taken that allowed firstly the indirect investment of funds raised overseas by domestic investment trust companies, followed by direct investment of foreign institutional investors in 1991 and then finally direct investment of all foreign natural persons in 1996. Foreign institutions, such as banks, insurance companies, fund management institutions and securities firms must apply to become qualified foreign

Table 11. Transactions by type of investor

Year	Qualified domestic institutional investors (%)	Qualified foreign institutional investors (%)	Individuals (%)
1992	3.6	0.3	96.1
1993	5.4	0.5	94.1
1994	5.8	0.7	93.5
1995	6.7	1.4	91.9
1996	8.6	2.1	89.3
1997	7.6	1.7	90.7
1998	8.6	1.6	89.7
1999	9.4	2.4	88.2
2000	10.1	8.3	81.6

Source: Securities and Futures Institute

institutional investors (QFIIs) so that they can invest in the local securities markets. To encourage foreign institutions to invest and to facilitate the sound development of the capital market, the government has gradually lifted the restrictions on QFIIs, such as the investment ceiling and the shareholding ceiling for each foreign investor.

Violation of laws

Although the Corporate Law protects the interests of stockholders, it is not enforced well. Lawsuits against disqualified or unlawful board directors do not prosper in court because the proceedings usually last for years; a close relationship between firm-auditors and major stockholders weakens their independence and the lack of auditing expertise of firm-auditors reduces their ability to identify inappropriate firm activities. Moreover, the absence of class-action lawsuits and rigid regulation in derivative lawsuits make it difficult for minority shareholders to sue the wrongdoing of directors and firm-auditors. The fact is cases of violation of relevant laws by executives, board members, firm-auditors and accountants do exist as revealed in the discussion of the activities of the SFC and FTC. This would indicate that current laws and regulatory agencies are inadequate to establish appropriate monitoring mechanisms for the control of moral hazard.

RESEARCH METHODOLOGY

A case study approach was adopted to examine the relationship between corporate governance and firm productivity. Eight firms, all located in Taipei, are included in the study. Among them, two firms are state-owned enterprises, four firms are publicly listed firms, and two are unlisted companies. Although the firms were chosen through convenient sampling, care was taken so that there was enough variety among them. Two state-owned enterprises, Chinese Petroleum Corporation and Taiwan Sugar Corporation, are the two largest state-owned enterprises in Taiwan, ROC. To reflect diversity, two electronics firms (i.e., Unitech Electronics Co., Ltd and Lunghwa Electronics Co., Ltd), one leading car maker (i.e., China Motors Co., Ltd) and one construction company (i.e., Ruentex Construction & Development Co., Ltd) comprise the publicly listed firms in the sample. And finally two unlisted companies but issuing stocks privately (i.e., Sunsino Ventures Group and Eslite Corporation) are included.

The paper basically argues that ownership, management, social responsibility, and institutional interface affect corporate governance, which in turn affects firm performance. The data were collected through personal interviews based on the country questionnaire. Secondary data, to supplement the primary data, were gathered mainly from corporate annual reports and firms websites.

As already discussed, the regulatory framework in Taiwan, ROC has been revised and enforcement has become increasingly rigorous. Regardless of firm size and nature of industries, all publicly listed firms follow similar rules, especially as far as governance structure is concerned. In addition, state-owned enterprises (SOEs) have to abide by rules specially designed by the government. Their activities are audited by both government-appointed and independent auditors.

CHARACTERISTICS OF RESPONDENT FIRMS

Chinese Petroleum Corporation (CPC)

Funded 100 percent by the Treasury of the Republic of China, CPC was founded in Shanghai in 1946. It moved to Taiwan in 1949 and has since had its headquarters in Taipei. Being a state-owned enterprise, CPC is entrusted by the government with the active exploration, development, refining, transportation, marketing and sales of petroleum and natural gas, and has always served as the core of Taiwan s petrochemical production. CPC s total capital stood at $3.8 billion and had 17,356 employees in 2000. The sales of the company in 2000 reached $13.7 billion although foreign trading accounted for less than one percent of the sales.

CPC has set up a variety of functional units in Taiwan, ROC including Taiwan Petroleum Exploration Division, Kaohisung Refinery, Talin Refinery, Liyuan Petrochemical Plant, Taoyuan Refinery, Exploration & Production Research Institute, Refining & Manufacturing Research Institute, LNG Project & Construction Division, Northern Project & Construction Division, and Taiwan Marketing & Transportation Division, to carry out its diverse operations. Overseas, CPC established liaison offices in Kuwait and Singapore to perform specific tasks concerning crude oil procurement and exploration ventures. With the opening up of a local petroleum market under the deregulation policy, CPC s monopolistic position in Taiwan, ROC is now facing challenges from home and foreign competitors. In particular, the first private naphtha cracker in Taiwan has started its operation in September 2000. CPC is scheduled for privatization in 2004. Therefore, to enhance its competitiveness, CPC has in recent years established business-oriented units for the handling of oil products, lubricants, LPG, solvents and chemicals, refining, petrochemical, security, and telecommunication, respectively.

Taiwan Sugar Corporation (TSC)

Founded in 1946 as a state-owned enterprise, TSC was set up mainly to handle sugar production and exporting. From 1952 through 1964, sugar was Taiwan's leading export commodity and accounted for 74 percent of the nation's total foreign exchange earnings at its peak. Since 1964, however, the influence of the sugar industry has waned as a result of Taiwan's changing economic structure. At present, TSC actively diversifies its business to high-quality agriculture, food processing, bio-technology, logistics & petroleum, tourism, commercial building and housing construction. In 2000, its revenues were $920 million and sources of income were the following: sugar (41 percent); fresh flowers (4 percent); processed foods (12 percent); live hogs (5 percent); construction (10 percent); logistics and petroleum (10 percent); agriculture products (8 percent). The total number of employees was 6,797 and trading abroad accounted for less than one percent of the sales.

Unitech Electronics Co., Ltd

Unitech was established in March 1979 to provide microprocessor applications in the field of automation services and products. In 2001, the firm s capital was $29.06 million; sales were $192.63 million; and the number of employees was 365. The firm gradually shifted its focus from the domestic market to foreign markets. In 2000, foreign sales accounted for 4.2 percent of total sales. At present, Unitech has two major types of business:

- High-tech products channel distribution: in this area, Unitech takes advantage of information technology to integrate core capabilities in distribution, delivery and maintenance. The products marketed are personal computers, notebooks, printers, monitors, scanners, network devices, and others.
- Designing, manufacturing and marketing automatic data capturing products: in this area, it develops, produces and sells auto data capturing products and services worldwide customers to enhance productivity and effectiveness. Products marketed are CCD/laser scanners, barcode decoders, portable date collection terminals and stationary data collection terminals.

China Motors Co., Ltd.

China Motors Corp. began to produce motor vehicles in 1973. With 2,929 employees, sales reached $1.5 billion in 2000. Over the years, the company has focused on manufacturing and marketing cars and is the leading local carmaker in Taiwan. "Harmony, innovation and aiming for excellence is the company philosophy. In recent years, the firm has started exporting parts and producing cars abroad. In 2000, foreign business accounted for 11.5 percent of total revenues.

Ruentex Construction & Development Co., Ltd.

Aiming to satisfy the demand for quality housing and to make effective use of Taiwan s limited land resources, Ruentex Construction & Development was founded in 1977 to engage in land development and construction, leasing and selling of all kinds of housing and commercial buildings, as well as invest in related businesses.

Total quality management has been widely adopted in both the construction and sales processes of the company. The company only serves the domestic market. The number of employees in 2000 was 509 and the total revenues were $119.2 million.

Lunghwa Electronics Co., Ltd

Lung Hwa Electronics Co., Ltd., established in 1973 as a private company, had sales of $54.8 million and 118 employees in 2000. Lung Hwa is one of the leading 3C manufacturers in Taiwan. With 28 years of innovation and creative powers, Lung Hwa is now expanding its products lines, in the process creating two divisions: Electronics Manufacturing Service and Design Manufacturing Service. For EMS, the major products are PCBAs, LCD monitors, digital cameras, PDA and set top boxes. For DMS, the major products are graphic cards, mobile links, LCD monitors and set top boxes.

Lung Hwa has built up long-term partnerships with several major OEM clients. In 2000, foreign business accounted for more than 95 percent of total sales.

Sunsino Ventures Group

Sunsino Development Associate, Inc. was launched in 1994, with the primary objective of rendering support to SMEs in terms of financing advisory, funding requirement, and management consulting. To date, Sunsino, renamed as Sunsino Ventures Group, has invested in over 100 companies in Taiwan, ROC and the US, with investment of over $100 million. In 2000, Sunsino had 35 employees and total revenues of $13.7 million.

Eslite Corporation

Starting as an importer of cooking-wares in 1974, Eslite Corporation has grown into a multi-business firm. Today, the company has four other major businesses: the cultural division, which runs more than 40 book stores; the retailing division, which runs stores; the quality–living division, which runs restaurants and wine cellars; and the industrial equipment division, which sells and services energy-saving and pollution-control equipment. The company has concentrated its efforts in the domestic market. It had 1,200 employees and with sales of $173.6 million in 2000.

SELECTED RESULTS

Ownership

Two firms are 100 percent owned by the government[3] and six firms are considered to be private firms. Among the six, only one unlisted firm has majority shares owned by four to five shareholders and no foreign holdings. All others are widely-held, having more than 10 shareholders and foreign holdings. Although there are no restrictions on foreign ownership, the government has been trying to encourage foreign participation in the capital market for years. Foreign ownership of these firms remains minimal.

As regards the private firms in the sample, the largest shareholders, usually institutional investors, own from 4.85 percent to 36.99 percent of shares. Ownership concentration is lessening in Taiwan, ROC. As a result, there is a persistent movement towards separation of ownership and control. The survey results are consistent with the trend to decentralize ownership in Taiwanese firms.

Except for the two SOEs, managers and employees own shares in the firms. The law requires companies issuing stocks either publicly or privately to offer them to employees. Companies prefer to distribute shares to employees as bonus to solidify employer-employee relationships. But since employees can buy or sell stocks in the stock market, it is difficult to figure out their actual shares in the firm. Estimates of share holdings show that managers have 25 percent or less (mostly in the vicinity of five percent). On the other hand, employees have less than 10 percent (mostly in the neighborhood of five percent).

There are no mutual holding of stocks between the firm and affiliated companies. Major decisions are made by board of directors and managers for all firms. For SOEs, the government is another major decision-maker. For one unlisted firm, the family owner is also a major decision-maker. The control of these firms has not changed in the last three years.

Most of the firms source their working capital from banks. On the average, 88.75 percent of the working capital comes from banks. Only one unlisted firm sources its working capital from the owner. Capital markets contribute 25 percent of the companies working capital, while non-bank financial institutions contribute 13.75 percent.

[3] An SOE is defined as state owned if government owns more than 50 percent of shares.

For publicly listed firms in the survey, shareholders have the following rights: vote according to share; assign their votes (proxy voting); maintain proportionate ownership of firm under any financing plan; resolve disputes with the firm; and demand independent audit. Minority shareholders are not represented in the board.

Banks with no affiliation with the firms are the major creditors of the firms. Only one firm s creditor is a non-bank institution. All firms have had business relationships with banks for more than five years. When dealing with banks, all firms have to offer collateral for loans. In general, over-reliance on stocks as collateral to acquire leverage creates financial risks for some listed companies. When the stock price slumps, borrowers are included to maintain the stock prices in order to avoid providing more stocks as collateral. This prompts them to use whatever sources are available to do so (SFI, 2001).

For short-term loans, credit financing is resorted to. None of the firms had liquidity problems in the past. There are no laws which firms can invoke to protect the owners or shareholders, since the claim rights of creditors are ahead of share owners when firms face insolvency or bankruptcy.

Management

Major shareholders generally decide on board composition and board membership. Once constituted, the board takes care of corporate thrusts and direction, corporate financial strategic decisions, management appointments and executive compensation, declaration of dividends, profit or gain sharing, business expansion/contraction, and mergers and acquisitions. The chief executive officer also deals with corporate thrusts and direction as well as corporate financial strategic decisions. The CEO s major involvement is, however, in day-to-day operations, improving productivity as well as customer satisfaction/quality.

Table 12. The respondent fimrs corporate decisions makers

Type of decision	Owner(s)/ major share-holders	Board	Chief executive officer
Corporate thrusts and direction		✓	✓
Corporate and financial strategic options		✓	✓
Sanctions/rewards for management performance			✓
Management appointments and executive pay		✓	✓
Board composition and membership	✓		
Day-to-day operations			✓
Declaration of dividends		✓	
Profit or gain sharing		✓	
Business expansion/contraction		✓	
Mergers and acquisitions		✓	
Productivity improvement measures			✓
Customer satisfaction/ Quality issues			✓

Firms are run by board chairmen or general managers. Among the surveyed firms, three board chairmen are CEOs and five general managers are CEOs. The typical size of a board is six to 10 members and the tenure of board members in all firms is less than three years. None of the firms has outside directors and no formal committees are formed in the board. Four boards meet less than four times a year, two meet four to six times a year, and two meet more than eight times a year.

The results go against the general requirement that firms adopt an independent directors and supervisors system. Starting 2002, every publicly held company applying for listing should have at least two independent directors and one independent supervisor. This is in consonance with TSE and GTSM listing rules. Henceforth, the annual reports of listed companies should disclose whether their independent directors and independent supervisor have complied with TSE and GTSM listing rules.

In addition, the SFC has spelled out the qualifications of independent directors and independent supervisors in an April 2003 ruling. Under the new requirement, an independent director or supervisor must be an individual who has had more than five years of professional experience and meets the relevant qualifications of independence for the latest year. Under the Company Law, a person is barred from serving as independent director or independent supervisor of over five companies and from representing other institutions as an independent director or independent supervisor.

About 55 listed companies have independent directors and independent supervisors. It is estimated that about 165 listed companies will have both by the end of 2003.The qualification requirement helps to enhance both independence and professionalism of independent directors and supervisors. There are many ways, including through the help of consulting firms or job placement companies, of looking for adequate candidates to serve as independent directors and independent supervisors. The SFI, at the request of SFC, has established a database for independent directors and independent supervisors. This is available at http://www.sfi.org.tw/watch/main.asp.

Although the Taiwanese system stipulates that both supervisors and directors are to be elected by shareholders and only the current shareholders are qualified candidates, in reality there is no supervisory board that is independent from and superior to the managing board. It should be noted that the designated function of Taiwanese directors corresponds to that of the US inside directors, while the designated function of Taiwanese supervisors corresponds to that of the US outside directors. But even as the Corporation Law stipulates that no current employees or directors can serve as supervisors, their family members can (Lee and Yeh, 2001).

Nevertheless, despite the absence of outside directors, and despite the fact that six firms have had the same CEOs for the last three years, five firms rate themselves very high in terms of the degree of independence of management in making operational decisions. As to compensation package, on the average, executive salary is 3.84 times that of the average employee s salary and 6.49 times the wage of the lowest paid employee.

Since all firms in the survey issue stocks, either publicly (if they are listed in the stock exchange) or privately (in the case of unlisted companies), they are required to disclose certain information publicly more than once a year and in fact they all have specific disclosure policies. Most information is publicly available. Thus, shareholders, management, employees, unions, internal auditors, external auditors, creditors, government agencies and the general public can access the information. However, minutes of board meetings are available only to management in order to protect the interests of firms.

The study further shows that firms do not maintain separate books. Instead they follow local accounting and auditing standards. All firms have firm-auditors and external auditors (i.e., certified public accountants). All eight firms have not changed external auditors during the last three years even as these auditors have worked with these firms for more than three years (three to five years in four firms and more than five years in another four firms). The degree of independence of the external auditors is rated very high by four firms and rated high by two other firms.

All firms have a code of ethics for employees in written form and is made known to the rank-and-file. Protecting the interests of firms, customers, stockholders and employees seem to be the common theme of the codes. Five firms have violated these codes and in each case, sanctions have been imposed on the lawbreakers. This is consistent with the trend to establish a corruption-free business culture among Taiwanese firms.

The Taiwan Stock Exchange has developed a Corporate Governance Code for TSE/GTSM listed companies. It requires listed companies to protect shareholders rights and interests, strengthen the powers of the board of directors, respect stakeholders rights and interests and enhance information transparency.

None of the firms have been investigated for allegations of breach of proper financial conduct even as two firms were found to have violated some environmental rules. On the whole, the internal controls on financial dealings are very rigid in the following areas: cash flow, accounts receivable collection and aging, bad debt write-off, inventory, fixed asset acquisition, research and development, capital expenditure, tax payments, and payroll.

All firms have company-wide quality and productivity improvement programs. The suggestion system is the most widely used. Also popular among the firms are 5S, continuous improvement and total quality management.

Three firms have employee unions while five do not have unions. Since mechanisms to discuss employer-employee relations issues are available, there is hardly any dispute between management and employees. Management discretion or discussions with the human resources department settle the following issues: compensation, benefits, tenure, working conditions, company rules and regulations, training and development, and labor standards. In a few instances, collective bargaining and labor-management consultations are resorted to, but in general, the respondents favor the exercise of management choice.

Table 13. Corporate involvement in areas of public concern (% of responding firms)

Areas of public concern	No firm activity	Compliance only	Voluntary response	Takes leadership role
Pollution control	12.50	25.00	37.50	25.00
Environmental protection	25.00	12.50	37.50	25.00
Truth in advertising and in all business activities		50.00	50.00	
Product warranty and service		25.00	25.00	50.00
Control of harmful products		50.00	37.50	12.50
Community support		50.00	25.00	25.00
Lobbying management	25.00	75.00		
Philanthropy	25.00		25.00	50.00
Support for indigenous groups	37.50	50.00		12.50
Stockholder relations		87.50	12.50	
Support for working mothers (e.g., day care centers)	12.50	75.00	12.50	

Social responsibility

The Fair Trade Law and the Consumer Protection Law safeguard the interests of consumers. Seven firms have policies on consumer protection and environmental protection while four firms have ISO 14000 certifications. It would seem that firms have different degrees of involvement for different types of social responsibility activities as shown in Table 13.

Not surprisingly, firms tend to care more for those having direct impact (e.g., product warranty and service) and care less for those having indirect impact (e.g., support for indigenous groups).

Seven firms have mechanisms for receiving consumer complaints. Complaints are solved by responding via the phone, by sending service people over, by coordinating with other departments in the firm, and by replacing products.

Three firms face community actions against them. Direct compensation for damages seems to be the major approach in dealing with the problem. To improve the relationship with communities, firms set up customer-relations departments, participate in social causes and engage in public relations campaigns.

Institutional interface

The overall quality of services delivered by the following agencies are judged to be generally good to slightly good: central government, parliament, central bank, customs, judiciary, police, internal revenue, education, roads, ports, telecommunication, electricity and power, and water. The overall quality of the services provided by the government appears to be acceptable to the eight firms. More firms in Taiwan, ROC are urging the government to improve the quality of infrastructure and the efficiency of government services.

As to the operations and growth of their businesses, most firms rate as either no problem or minor problem the following: the judiciary, law and order, inflation, exchange rate, taxes and regulations, anti-competitive practices, finance, infrastructure, corruption, and international regulations and standards.

Recognizing the importance of strengthening international safeguards, including codes of business conduct, five firms prefer voluntary implementation to other modes. All firms opine that corporate governance affects firm performance and productivity, either to a great extent (six companies) or to a moderate extent (two companies).

GOVERNING RELATIONSHIP

To repeat, the basic argument of the paper is ownership, management, social responsibility, and institutional interface affect firm performance and productivity. This relationship is depicted as

Corporate productivity = f (ownership, management, social responsibility, institutional interface)

The performance of a firm is defined as firm growth and productivity. Growth is measured by the sales growth rate between 1999 and 2000; productivity is measured by gross profit margin, net profit margin and return on equity (ROE). To avoid revealing the true identity of a particular firm, in the discussion below, S1 and S2 (representing the SOEs), P1, P2, P3, and P4 (representing the publicly listed firms) and U1 and U2 (representing the unlisted firms) are used to stand for the eight firms examined. As shown in the upper part of Table 14, the economic downturn definitely has impact on firm performance. All firms, except for P3, experienced sales growth and, except for P4, ROE decreased in 2000. P3 is in the construction industry and this industry usually suffers heavily in recession. P4, with more than 95 percent of the sales from international markets, apparently is able to keep its profit margin through international diversification.

All independent variables (i.e., ownership, management, social responsibility and institutional interface) are measured by multiple indicators. Information was abstracted from these indicators. The idea was to reflect the essence of each independent variable, to make the assessment of its impact on performance much easier (refer to the lower part of Table 14).

Establishing patterns

Ownership

Among the eight firms, the shareholdings are widely distributed for the four publicly listed firms, controlled by a few stockholders for the two unlisted firms and completely owned by the government for the two SOEs. Except for the SOEs which have to take into account the views of the government, board members and managers make the major decisions of firms. These firms grant stockholders the rights as required by law and maintain a normal relationship with creditor banks. The ownership patterns can be characterized as SOE for Ss, large number of shareholders for Ps, and small number of shareholders for Us.

Management

There is division of labor for the types of decisions made by major shareholders, boards, CEOs and COOs. Apparently boards and CEOs are major decision makers. Six to 10 is the typical size of a board and board members meet less than four times which is in line with the law. The independence of management in making operational decision is very high except for S2. All firms have productivity enhancement programs and mechanisms to deal with employees complaints. All firms reveal information regarding finance, performance, ownership structure and governance as required by law and the information is available to all stakeholders, either inside or outside of firms. The external auditors of four firms have been associated with these firms for more than five years and all external auditors perform their duties independently. Expect for U2, the internal controls in financial dealings (such as cash flow, bad debt write off, fixed asset acquisition, capital expenditure, loan payment) are rated rigid or very rigid. Therefore, the pattern of management for these firms in terms of management independence and internal control can be characterized as independent/rigid for S1, P1, P2, P3, P4 and U1; less independent/rigid for S2; and independent/less rigid for U2.

Social responsibility

Since there are laws on consumer rights, most firms have policies on consumer protection. All have policies on environmental protection and mechanisms for receiving/resolving complaints. Although firms do engage in community projects to show their commitments to social responsibility, a compliance-only mindset seems to have been adopted for various areas of public concern (such as community support, support for working mothers, control of harmful products, among others). To summarize, the pattern of fulfilling social responsibility demonstrated by the firms can be characterized as active for P2 and U2, and less active for the remaining six firms.

Institutional interface

Although the overall quality of the services provided by the government seems to be acceptable to the eight firms, S1, P2 and U1 tend to be more satisfied with the quality of infrastructure and the efficiency of government officials. On the other hand, S1, P2 and U1 and satisfied in relation to institutional interface. The other six firms are less satisfied .

Table 14. Summary of information

Variables	S1		S2		P1		P2		P3		P4		U1		U2	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
Sales growth rate (%)	24.5		22.1		36.2		3.1		-25.9		42.8		20.0		15.4	
Gross profit margin (%)	11.5	6.2	15.9	12.9	11.9	9.9	11.8	13.4	24.3	14.0	9.3	9.3	56.3	71.7	23.3	22.5
Net profit margin (%)	6.4	2.4	3.4	(.6)	3.0	2.1	7.5	7.7	-27.8	-21.7	4.7	5.9	47.4	62.7	1.2	1.9
ROE (%)	8.7	5.1	5.3	.6	10.5	8.2	12.8	12.1	-3.24	-1.20	7.1	11.0	18.9	28.3	.9	-7.24
Ownership	SOE		SOE		Large number of share-holders		Large number of share-holders		Large number of share-holders		Large number of share-holders		Small number of share-holders		Small number of share-holders	
Manage-ment	Independ-ent/rigid		Less Independ-ent/rigid		Independ-ent/rigid		Independ-ent/rigid		Independ-ent/rigid		Independ-ent/rigid		Independ-ent/rigid		Independ-ent/less rigid	
Social respons-ibility	Less active/ less satisfied		Less active/ less satisfied		Less active/ less satisfied		Active/ satisfied		Less active/ less satisfied		Less active/ less satisfied		Less active/ less satisfied		Active/ satisfied	
Institution al interface	Active/ satisfied		Less active/ less satisfied		Less active/ less satisfied		Active/ satisfied		Less active/ less satisfied		Less active/ less satisfied		Active/ satisfied		Less active/ less satisfied	

Impact assessment

Ownership

In general, firms with many shareholders tend to perform better. When firms are listed in the stock exchange market, their shares are widely distributed and they are required to disclose operational information to the public. Thus, investors can monitor these firms more effectively.

Management

When the degree of independence of management in making operational decisions is high and when financial controls are rigid, firms tend to perform better. This seems to imply that in giving managers a high degree of independence to make decisions, tight financial controls ensure that a certain balance is maintained.

Social responsibility

P2 and U2 usually get positive coverage in the press for doing something good for society. S1, S2, P1, P3 and P4 also treat their social responsibility seriously. Because U1 invests in other firms, it may fulfill its social responsibility through its investments in these firms. However, judging by the performance of P2 and U2, the relationship between commitment to social responsibility and performance is not clearcut. Probably there are many factors affecting firm performance and the pay-offs to a socially responsible firm will only be seen in the long run.

Institutional interface

Five out of eight firms are less satisfied with the public services. There is a negative, although weak, linkage between the quality of public services and performance: when firms are less satisfied, their performance tends to be lower. Because social responsibility may not be a significant factor affecting firm performance, at least not directly, the model originally presented in the paper can be revised as:

Corporate performance = f (ownership, management, institutional interface).

POLICY RECOMMENDATIONS

Good governance needs the complementarity of two things: (1) rules that define the relationships among the board, shareholders, managers, creditors, the government and other stakeholders in a country; and (2) mechanisms that help directly and indirectly to enforce these rules. In addition to a government s activity, good corporate governance can be strengthened by the managers of a firm making decisions with the interests of stockholders, employees, customers and communities in mind.

This study makes the assertion that the legal and regulatory framework in a country is the foundation of corporate governance. The Corporate Law and the Securities and Exchange Law lay the foundation for corporate governance in Taiwan, ROC. Firms tend to follow laws, especially when they plan to raise capital publicly. A thriving stock exchange market, coupled with rules and mechanisms to ensure transparency and information disclosure, encourages firms to adopt better corporate governance. On the operational side, SFC derives and revises rules to foster the development of the stock exchange market, and FTC monitors firms anti-competitive and unfair trade practices. Laws and regulatory institutions both facilitate the development of capital markets and corporate governance systems. Besides regulating firms behavior, another role of the government is providing high quality public services. Good public services lead to better firm performance, thus, making it easier for firms to commit resources to socially beneficial activities.

The study shows that good corporate governance tends to produce better firm performance—a thinking shared by many shareholders. This is likewise reflected in the independent decision-making of managers, and in the enforcement of rigid financial controls. Thus, there should be a clear delineation of tasks between boards and managers and a monitoring system for each sector should be developed.

Taking into account the findings and results of the debate on corporate governance in Taiwan, ROC, this paper presents the following suggestions to the ROC government.

Promote good corporate governance practices among SMEs

SMEs accounted for 98 percent of all firms in Taiwan in 2000. These firms, due to limited resources and access to information, may not be aware of the importance of corporate governance and how to institute a corporate governance system. Small firms eventually grow; the earlier they start paying attention to the governance issue, the better they can cope with the public scrutiny that ensues when they issue shares to the public. The government should engage in activities to educate SMEs towards a better understanding of corporate governance.

Strengthen the role of the board

Revising the Corporate Law in November 1999 so that outside directors (i.e., with no stock ownership) can be appointed was a good start. The presence of independent directors will generate a more balanced view in board meetings. To make boards more effective, the government should ask boards to form various committees (Yeh et al., 2002). It should also provide training courses to board members and firm-auditors to enhance their managing capabilities. The government should also conduct or sponsor research programs and then offer the public the best practices for corporate governance. To protect outside directors, the government may encourage insurance companies to offer liability insurance to them (Liang, 2002).

Continue initiatives on capacity building for directors and supervisors

The SFI has already established a registration portal and database for potential independent directors and supervisors candidates, and the database is always open for all publicly held companies to use. To make directors and supervisors better fulfill their mandate, SFC appointed SFI to provide orientation and continuous training courses for both new or experienced directors and supervisors. SFI provides practical training courses in the field of company laws, finance and accounting to make the board of directors share a diversity of background, knowledge and experience. After taking these courses, directors and supervisors will know how to read a financial report and have knowledge of company laws and securities laws. These initiatives can be expanded and enhanced.

Encourage more information disclosure

Information disclosure increases transparency. Transparency will further increase the confidence of investors, either domestic or international. International assessments such as Standard & Poor s Corporate Governance Score (CGS) indicate that corporate governance practices need to be improved in Taiwan, ROC. Currently, as required by the SFC, firms have already disclosed quite a number of information. Stakeholders should be given access to the following: transactions among firms in a business group; names of board members, firm-auditors, certified public accountants and managers who have misbehaved; and complaints of minority stockholders. Because timing and accuracy determine the value of information (Shao, 2002), the government may develop a system to evaluate whether companies are seriously revealing the information to the public or not. One challenge for foreigners who would like to participate in the capital market is how to read the financial statements of local firms, which follow local accounting standards. The government should consider the possibility of adopting standards proposed by the International Accounting Standard Committee (Tsai, 2002).

Minutes of board meeting are key information and are useful to investors. Limited assess to them is understandable. However, there should be some means by which stockholders, who are not board members, may examine the minutes of board meetings when some matters concern them.

Other public disclosure enhancement measures may take the following forms: (1) integration and reinforcement of the information disclosure system of the publicly-held companies; (2) establishment of the Publicly-held Companies Information Internet Data Filing System for investors easy reference (the system has been activated on August 1, 2002); (3) publication of an English version of the Market Observation & Post System to assist foreign investors in understanding the financial and business conditions of every publicly held company in Taiwan, ROC (this project has been accomplished in January 2003, and the database contains both timely and special disclosure materials); (4) amendment of Guideline of Annual Report & Prospectus to encourage transparency regarding corporate governance implementation; and (5) introduction of the Information Disclosure Rating System to encourage publicly held companies to improve the contents of financial and operation information, and also to execute voluntary information disclosure. The purpose of the activity is to enhance the transparency of publicly held companies.

Protect minority stockholders

Current laws seem unable to protect the interests of minority stockholders. Although outside directors can be their voice, a better means would be for minority stockholders to speak for themselves. For example, minority stockholders can have their representatives in board meeting to express their views on crucial issues. The revised Corporate Law has also relaxed the rule for filing derivative lawsuit. Any shareholder owning three percent of a company s share over a year may ask a firm-auditor to sue directors. If the firm-auditor fails to do so in 30 days, the shareholder can file the lawsuit himself/herself. The government may also refrain from using excessive voting power in the boards of newly privatized banks or SOEs (Chen and Huang, 2001).

Encourage firms to fulfill corporate responsibility

Although this paper did not verify the relationship between commitments to social responsibility and firm performance, other studies show that firms devoting resources to social causes tend to be perceived positively by the public (Hong, 1977). Besides encouraging firms to continue to be socially responsible, the government may assist firms to adopt the international standards and acquire Social Accountability 8000 certification. (Shieh, 2000).

Promote corporate governance in a stepwise fashion

This study agrees with the SFC s decision not force public companies to quickly adopt corporate governance best practices such as the immediate designation of independent directors, independent supervisors and audit committees. Rather the measures should be introduced in phases to ensure that the law is effectively enforced and to allow all corporations to develop commitment to the law.

Involve self-regulatory organizations

It is important to establish SROs for assisting the authorities to promote the system. SROs such as the Corporate Governance Association can be a valuable partner to the regulatory agencies in achieving the objectives. Establishing the Corporate Governance Best-Practice Principles for Brokers-Dealers , Corporate Governance Best-Practice Principles for Futures Firms , and Corporate Governance Best Practice Principles for Securities Investment Company/Investment Advisers can help securities and futures industries establish their own rules.

The TSE and TAISDAQ have endeavored to develop a code of best practices in Taiwan and have taken into account equal treatment of shareholders, disclosure and transparency, protection of shareholders rights, the role of the board, and the special managerial circumstances that Taiwan, ROC corporations face. The contents of the code include powers of the board of directors and supervisors, and appointment of independent directors and supervisors (SFI, 2001).

CONCLUSIONS

Corporate governance ensures transparency of firms operations and accountability of managers. Since corporate governance protects the interests of stakeholders, a firm with sound governance structure would be trusted and welcomed by the public and regulators.

Internally, instituting a system for good governance would be the responsibility of those people within a firm, such as the board and managers. Externally, organizations interested in firms, such as government agencies and consumer groups, ought to propose rules to ensure that public interests are protected and effective monitoring is done to ascertain compliance with rules and regulations. A firm s governance structure has to adapt to the changes in environment, technology and business practices as well. That is why improving corporate governance is an on-going process and a firm and its stakeholders should always establish benchmarks for the best practices.

Corporate governance does matter. Ownership, management and institutional interface, which reflect corporate governance, affect firm performance. Therefore, the government should institute policies to ensure transparency, information disclosure and accountability. The board of directors, firm-auditors and management of a firm should do their best to increase the value of the firm to its stakeholders. This is the bottom line in corporate governance.

REFERENCES

Chen, J. and Huang, P. (2001). An Analysis on Performance of Public Bank Going Private: The Ownership Structure and Central Agency Problem, *Review of Public-Owner Enterprises*, Vol. 2, No. 3, 69-88.

Chiang, C. (2002). Corporate Governance and Performance of Acquired Firms, unpublished master s thesis, Fu-Jen Catholic University.

Chiu, Y. and Chang, C. (1991). Shareholder Structure, Composition of Board and Firm Performance, *Taipei City Bank Monthly*, Vol. 22, No. 5, 11-32.

Chu, S., Chen, J. and Chen, K. (1996). Family Business, Ownership Pattern and Firm Value. *Chinese Financial Journal*, Vol. 4, No. 1, 56-60.

Du, Y. (2002). Strengthening the Board by working with CEOs. *China Commercial Times*, Nov. 30, 9.

Hong, Y. (1997). Social Responsibility of Taiwanese Firms, *Journal of Commomwealth*, Dec. 1, 124-133.

Hsu, H., Hsieh, K. and Young, C. (2002). Shareholdings of Managers and Firm Performance, Asia Pacific *Journal of Social Science and Technology*, Vol. 2, No. 1, 103-118.

Hsu, M. L. A. (1998). Executive Succession: Review and Suggestions, *Journal of Human Resource Management*, Vol. x, No. x, 39-64.

Huang, H., Chen, L. and Shieh, J. C. P. (2001). The Impact of Growth Opportunity on Managers Stock Holding and The Structure of Board of Directors, *Sun Yat-sen Management Review*, Vol. 9, No. 1, 37-59.

Kuo, T. and Wei, Y. (1999). Perception of Business Ethics in Manufacturing Industries, *Business Finance Quarterly*, Vol. 22, No. 4, 21-30.

Liang, C. (2002). Insuring for Board Members Helps Corporate Governance, *Economic Daily*, Dec. 22, 18.

Lee, T. and Yeh, Y. (2001). Corporate Governance and Financial Distress: Evidence from Taiwan, paper presented at the 2001 Asia Pacific Financial Association Conference, Bangkok, Thailand.

Lin, H. (2001). Empower the Board of Directors for Better Performance, *Management Magazine*, July, 17.

Securities and Futures Commission, (2001). 2000 SFC Annual Report, Taipei: Securities and Futures Commission, Ministry of Finance, R.O.C.

Securities and Futures Institute (2001), Corporate Governance in Taiwan. Taipei: Securities and Futures Institute, R.O.C.

Shao, S. (2002). SFC Deals with the Problems of Faking Financial Data, *Economic Daily*, Sept. 18, 13.

Shieh, F. (2000). Trend towards SA 8000, *Commercial Times*, Sept. 10, 4.

Small and Medium Enterprise Administration (2002). *White Paper on Small and Medium Enterprises in Taiwan, 2001*, Taipei: Ministry of Economic Affairs, R.O.C.

Standard & Poor s (2002). Transparency & Disclosure Study: Non-US Rankings 2001-02, www.standardpoors.com.

Tsai, Y. (1991). The Relationship between Shareholdings of Board Members and Firm Performance, *Reports of Accounting Studies*, 35-37.

Tsai, P. (2002). Our Accounting Standards Should be Compatible with those of the IAC, *Commercial Times*, Nov. 5, 8.

Tu, M. and Chen, Y. (2001). Bank Loans, Capital Structure and Corporate Governance, *Sinopac Financial Journal Quarterly*, No. 15, 43-54.

Tu, Y., Huang, C. and Lin, J. (2002). Board Structure, Firm Performance and Financial Policy: Empirical Analysis of Stock-Listed Firms in Taiwan, *Journal of Management & Systems*, Vol. 9, 345-368.

Yang, J. (1989). The Relationship between Ownership Structure and Firm Value, unpublished master thesis, National Sun Yat-sen University.

Yeh, Yin-hua., Lee, Tsun-siou. and Woidtke, Tracie. (2001). Family Control and Corporate Governance: Evidence for Taiwan, *International Review of Finance*, Vol. 2, 21-48.

Yeh, Y., Lee, T. and Ko, C. (2002). Corporate Governance and Rations System, Taipei: *Businessweekly*.

Yeh, Tsung-ming (2001). The Corporate Governance in Taiwan. Kansai Gaidai University.

THE IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY IN INDIA

R. C. Monga[1]
National Productivity Council
India

INTRODUCTION

India, the largest democracy in the world, has many unique attributes with regard to its socio-economic features. The present socio-economic background evolved from the effects of 300 years of colonialism, to the differential impact of the industrial revolution and the recent liberalization spree. The Indian economy grew at 6.5 percent during the 1990s as compared to 5.7 percent in the 1980s. Since independence, the economy has diversified with the service, manufacturing sector and agriculture accounting for 48 percent, 28 percent and 24 percent, respectively of the gross domestic product (GDP).

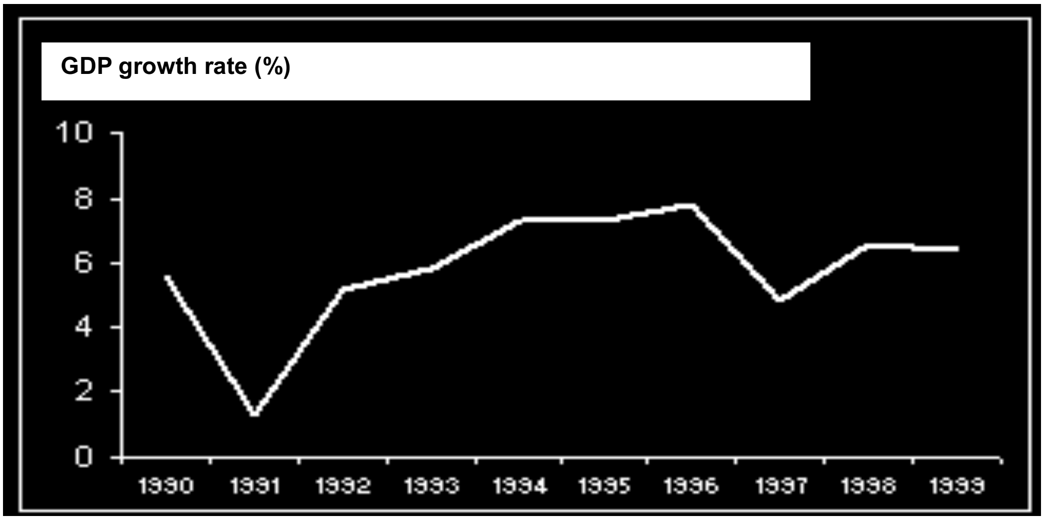
India enjoys comparative advantage in many areas that include information technology, biotechnology, space and nuclear sciences, because of its skills, low wages, and highly educated human resources. However, the economy faces challenges from lack of infrastructure, poverty, unemployment, and illiteracy among others. The country, rich in natural resources, once accounted for about 23 percent of world income that dropped to less than four percent during the later half of twentieth century. Despite the population crossing the 1 billion mark, India was able to increase its share to nearly five percent of world income in the recent past. India is well known for its diversified cultural heritage spread across the 28 states with vivid geographic characteristics. The visible amount of regional and social imbalance and the political differences that always existed in the country have contributed remarkably in molding the institutions the legislature, the judiciary and the executive which form the basic foundations of the market economy.

India offers a large market potential because of its huge size with a GDP of over US$450 billion. It is one of the world s largest economies with a per capita GDP of US$444 (US$2,371 in PPP terms) in 2000. The percentage of investment required to generate one percent GDP growth in India is 4.2 percent. This is typically high when compared to other Asian countries. In 1990-99 India generated a growth rate of 5.8 percent with an investment rate of 24.5 percent. It can be seen from Figure 1 that the economy recorded a positive GDP growth rate during the first half of the 1990s but started showing a negative trend later on. The performance of economy declined to 5.4 percent in 2001 (advanced estimate). The estimated growth rate for the year 2002 is almost the same as that for the year 2001. The board objective of the 10th five-year plan is to achieve an average GDP growth rate of eight percent annually.

It may be noted that the fall in GDP growth rate has occurred while foreign direct investment inflows increased. Infrastructure bottlenecks and slippages in the reform program, among others, were the main reasons for the slowdown of the GDP growth. At

[1]The author wishes to express his sincere thanks to his colleagues S/Sh. Jagdish Kumar, Lovneesh Chanana, and S. Prakash for the assistance provided in data collection, data analysis and presentation of study results.

any rate, India has the potential to attain a growth rate of 10 percent by 2010 (Mckinsey, 2001). McKinsey identified 13 policy changes in removing the critical barriers to economic growth. These changes include removing reservation on products for small industries; rationalization of taxes and excise duties; establishing effective and pro-competition regulation as well as empowering independent regulators; reducing import duties; removing restrictions on foreign investment; reforming property and tenancy laws; and undertaking wider privatization.



Source: CMIE

Figure 1. GDP growth rate, 1990-1999

Low productivity in many sectors still continues to be a matter of concern. The usual approach has been to attribute the main causes of low productivity to labor laws, public policy, infrastructure, and the like. However, in recent studies, the quality of enterprise management has emerged as the most significant factor. It is in this context that this research project assumes importance. Governance is associated with the manner in which power is exercised in the management of economic and social resources. The desired outcome development and the improvement of the quality of life comes when all the stakeholders coordinate and direct their efforts to leverage such resources in the desired direction. The government has to bring about reforms that will make private and public enterprises optimize the allocation and use of resources, and promote competitiveness. As corporate actions influence national and community fortunes and the availability of resources for development and sustenance, there is a need to influence business culture and operations to make them ever more responsible and productive socially.

˚If a clear correlation could be established between corporate governance and corporate performance, then it will lead to wider acceptance and adoption of good corporate governance practices. However, a corporation s ability to create wealth depends on the role given to it by society. And because societies differ in their attitudes towards corporations, the functioning of corporate governance systems varies with different socio-political cultures. A survey was carried out simultaneously in 10 Asian countries_all members of the Asian Productivity Organization_to identify the links between governance, productivity and growth. Drawing from the survey results, this study analyzes the effect of corporate governance on productivity in the liberalized environment of India. The outcome of the study will help developing policies, strategies and approaches that can address corporate governance.

REVIEW OF LITERATURE AND RELATED STUDIES

In India, the idea of corporate governance is relatively new and as such not many researchers have written about it.

Kar (2002) argues that corporate governance in India was not important until recently, given the narrowly-held ownership structure and the macro-economic environment prevailing in the early 1990s, in which private enterprise was allowed restrictive growth. The regulatory framework for the securities market was fragmented as there was no single body mandated with protecting the interest of investors. In the past few years, however, there has been a growing awareness that good corporate governance forms an intrinsic part of a company s best practices and its obligations to the outside world, and more importantly, is crucial to its competitive strategy and long term growth. Kar attributes the change to a number of factors, including India s adoption of macroeconomic reforms, the exposure firms to greater domestic and foreign competition, the growth of capital markets (underpinning the need for better disclosures and better investor service), the growing awareness of investors and investor groups of their rights, the rise of institutional investors and public financial institutions as active shareholders rather than as lenders, the stock exchanges becoming increasingly more self-regulatory and listing as a tool for raising the standards of corporate governance, the setting up of the Securities and Exchange Board of India (SEBI) as the statutory regulatory body for securities.

Dahiya and Gupta (2001) surveyed the state of corporate governance in India, in the context of the liberalization policies that have swept the nation in the 1990s. The two authors narrate the difficulties encountered by India s corporate sector, which has to adjust not just to the pressures from the IMF on Asian countries, but to the reality that when capital markets are liberalized, funds tend to flow to jurisdictions with more developed rules-based governance system. They note that India has made great strides in most aspects of corporate governance, except in the areas of liquidation and bankruptcy and in the delays in the resolution of outstanding cases with SEBI and the courts.

Nevertheless, there have been steady improvements in laws relating to rules-based governance, which India inherited from the British during independence, to keep pace with the changes brought in by liberalization (Sachs, Varshney & Bajpai, 2000).

Also, the Securities and Exchange Board of India has now incorporated corporate governance norms as part of the requirements for listing companies in the stock exchange. SEBI has taken the right step by putting compliance with corporate governance in the book, although many researchers opine that the implementation of the corporate governance norms on a mandatory basis might only serve the purpose of making promoters/management aware of the concept (Vaidyanathan, 2001). As regards the flow of information about material events, Vaidyanathan suggests that much improvement has taken place since SEBI introduced the disclosure requirement two years ago. But that is confined to just reporting an event. Timeliness, breadth and quality of information have been major casualties. Vaidyanathan likewise offers the observation that in spite of the recent hype on corporate governance and having the annual reports or having independent directors on board, there have been numerous instances of companies with a number of independent directors systematically destroying shareholder wealth (Vaidyanathan, 2000).

Does the corporate governance framework in India encourage public participation? Panchali (2002) points out that unlike institutional investors, public shareholders are generally not in a position to influence managerial decision-making. In most of the Indian companies, promoters have the final word over professional managers. He says it is crucial to evolve a system wherein the promoters are forced to bring a set of values that focuses on using public money in the best way by maximizing the interests of all stakeholders.

OVERVIEW OF THE INDIAN CORPORATE SECTOR

The Indian corporate sector is large and highly diversified. As of 2001, about 584,100 companies limited by shares with an estimated aggregate paid-up capital of Rs.3,39,801.06 crores (US$70.062 billion) were at work in the country. These comprise of 1,262 government companies and 582,922 non-government companies with paid-up capital of Rs.89,256.5 crores (US$18.403 billion) and Rs.250,545.1 crores (US$51.659 billion), respectively. After liberalization, the number of foreign companies at work in India has been steadily increasing. As of 2001, there are about 1,213 foreign companies at work in India. A major share of foreign direct investment is in information technology (IT) and related sectors and this has brought with it better corporate culture and improved business practices, even to non-IT organizations.

Characteristics of the corporate sector

After independence, the Indian government adopted a mixed and centrally planned economic model that encouraged both public sector (government-owned) and private sector to accelerate industrialization within the overall framework of industrial policy. During the period 1950-91 that can be called industrial licensing policy regime, many private firms were able to obtain licenses and build highly diversified family-run industrial empires with assistance from public financial institutions. Many of the sectors were reserved for the public sector and some specifically for the small-scale sector. Because of the need to promote rapid industrialization, the public financial institutions provided financial assistance without seriously considering asset quality. This approach led to the development of a wide spectrum of industries, spread all over the country.

The development of the Indian corporate sector can be divided into three distinct phases (Vaghul, 1997). In the first phase, which lasted from the beginning of independence to the late 1960s, the corporate sector was dominated by 20 family groups who started as traders in the pre-independence era and who took a pioneering effort in the industrialization of the country after independence. These family groups developed strong political connections and were able to take advantage of the licensing system to control a large portion of industrial activity.

The second phase of development, from the early 1970s to the mid 1980s, was called the socialist phase. A Monopolies Commission was established during this period and restrictions were imposed on the expansion of the family groups, with a view to broadening the entrepreneurial base of India (Vaghul, 1997). This phase saw the emergence of a new type of entrepreneurs who seized the opportunity and competed effectively with the traditional family groups. Financial institutions also emerged as shareholders in big companies. However, Vaghul (1997) argues that the pattern of growth remained unchanged except that the new groups gradually supplanted the old. As the financial institutions were under the control of the government, theoretically the government controlled a large part of India s private corporate sector.

The third phase in the development of the Indian corporate sector began in 1991 with the liberalization and the globalization of the Indian economy. The sectors in which only public investment was formerly permitted which have been opened to private investment include mining, coal, hydrocarbons, power, air transport, ports, roads, telecommunications and banking. In addition, automobiles and textile production are no longer subject to licensing. The ready-to-wear garment industry, previously reserved for the small-scale sector, has been opened to large enterprises. Today automatic approval of foreign majority ownership is allowed in a number of industries, while for the rest the approval process has been liberalized. With competition, the corporate sector in India is undergoing sweeping reforms. Businesses are being divested, new businesses are being acquired and efforts are being made to scale up operations to international size. Nonetheless, there are no immediate signs of a clear demarcation emerging between ownership and management (Vaghul, 1997).

The corporate sector operated generally on a philosophy of cost of production plus in the protected economy. Since they were not exposed to any serious competition, Indian industries continued with existing technologies and remained insensitive about technological developments and happenings in the global market. This affected the pace of productivity improvement and innovation in the industry (McKinsey, 2001). The relations between business groups and government decision makers affected the allocation of resources. The promoters were able to diversify into unrelated activities with little stake of their own investment but with high control rights. Thus, the overall result was the evolution of poor corporate governance practices.

Liberalization of the Indian economy led to a sharp rise in the number of new companies registered. These companies are concentrated in select industries such as IT, telecommunications, power, financial services, and biotechnology. Many large private firms also responded by adding to their capacity and production increased rapidly often at the expense of higher inventory accumulation.

As part of the industrial policy reforms, financial participation even up to 100 percent depending on the type of industry was encouraged. As a result, many Indian corporations joined hands with global leaders to provide better products and services at competitive prices. Many well-known business houses, which were earlier largely owner managed, restructured and reorganized into professionally managed business entities. While some corporations took positive steps towards adjusting management practices to the needs of time, many firms are still resisting change towards better business practices.

Yet many studies on emerging markets McKinsey has done one and Credit Lyonnaise has done another indicate that companies which have good corporate governance practices are more likely to be favored by investors. Better disclosure norms and better governance help in the valuation of companies. It also gives the company an opportunity to project itself in the external world that it has substance. The adoption of corporate governance practices, in whatever possible manner, has helped Indian corporations transform themselves during this period of globalization of funding. During the 1990s, corporate governance in India grew by leaps and bounds. Certain immediate visible changes are seen, e.g., greater transparency in accounts, appointment of professional managers, and greater sensitivity to shareholder's interest and a closer attention to profits.

Ownership pattern

A survey of a representative sample of Indian corporations shows the pattern of equity ownership in different types of companies in India. It is evident from the survey that corporate bodies are on the average substantial block holders in private companies belonging to business groups, and 42.5 percent of all sample companies have equity ownership by corporate bodies in which equity holdings are in excess of 25 percent. Directors and relatives hold on the average 20 percent of equity ownership in private stand-alone companies and have more than 25 percent equity ownership in 26.6 percent of the sample companies. The relatively high proportion of concentrated shareholding by directors and relatives and inter-corporate holdings is on account of the predominance of family owned business either in the form of stand-alone companies or business groups, a feature that is typical of corporations in many developing countries. Foreign companies, both stand-alones and those belonging to business groups, almost definitely have foreign investors as substantial block holders.

By law, shareholders own the corporations and, ideally, corporate managers should be working on behalf of shareholders to allocate business resources to their optimum use. But as the economy has grown and business units have become even larger, de facto shareholder control has diminished. Ownership has become more dispersed and few shareholders have sufficient stakes to individually influence the choice of boards of directors or chief executive officers. The vast majority of corporate share ownership is for investment, not to achieve operating control of a company (Greenspan, 2002). The CEO sets the business strategy of the organization and strongly influences the choice of the accounting practice.

Equity holdings by non-financial corporations in India, which are primarily inter-corporate cross-holdings, are much higher than those in the developed economies. The participation of the small investor in corporate equity in India is at comparable levels with the US, with India having the largest number of listed companies in the world. Further, data on the 10 largest non-financial corporations reveal that the average concentration of shareholding among the top three shareholders is about 40 percent, which is much higher than in the US and the UK. Block holdings by government institutions are of two types. First are the holdings by institutional investors namely government-sponsored mutual funds and insurance companies, and second are the holdings by development financial institutions. Institutional investors have only equity holdings while development financial institutions typically have both equity and debt holdings in companies.

Transparency and disclosure

During the initial few years of the post reform era, corporate governance in India did not receive much attention. However, there had been steady improvements in laws relating to rules-based governance, which India inherited from the British, to keep pace with the changes brought in by liberalization policies. Currently, the quality of financial and non-financial disclosures, mandated by law, is stronger in India than most developing countries and a number of developed European countries.

The reforms have encouraged the flow of funds to India from many developing countries. When investments take place across national borders, the investors want to be sure that not only is their capital handled effectively, not only does it add to the creation of wealth, but the business decisions are also taken in a manner which is not illegal or involving moral hazard. This has forced the financial institutions and the regulator bodies to strengthen the corporate governance systems and laws in India.

The Companies Act provides for disclosures of financial and non-financial information to all the stakeholders in terms of annual balance sheet and annual report. Of late, the regulator has mandated the disclosure of quarterly financial information by various companies. The companies are now required to provide specific information on corporate governance in their annual reports. However, it is observed that the information provided by most of the companies in their annual reports are often sketchy and is not of much relevance to shareholders and would-be investors. Hence, there is need for a reality check to ensure the quality of information given in the annual reports.

One possible solution to ensure the quality of information is through an electronic filing system which will allow complete access to all filings by issuers of securities to all concerned. A good and encouraging beginning has been made in this domain in India by amending the Companies Act and formulations of the Securities and Exchange Board of India (SEBI) code. The Registrar of Companies in India is also in the process of computerizing the information disclosed by companies. The integration of this system with the regulatory authorities will go a long way in increasing transparency and efficiency. Companies will be in a position to file returns and reports online. Further, the system will ensure that every stakeholder of a company has access to the needed data.

An increasing number of well-informed shareholders are now demanding more transparent and comprehensive disclosures from the companies. They are also becoming assertive of their rights as shareholders. Further, foreign institutional investors whose number is also on the rise expect international standards of corporate governance. As a result, more and more Indian companies are now becoming more transparent in the disclosure of both financial and non-financial information to investors.

A recent Corporate Social Responsibility Survey of more than 100 leading Indian corporations reveals that around 90 percent of the respondents expect to be more transparent in reporting financial information in the near term, whereas 63 percent say they will be more transparent in disclosing non-financial information. What is more, around 88 percent believe that they will benefit from the greater transparency. The survey reveals that nearly 90 percent recognize that there is a paradigm shift occurring wherein investors of the future will demand greater transparency in disclosure of information to better understand companies. More than 70 percent see themselves as entities that earn profits through ethical practice, compliance with regulatory requirements, and with a substantial focus on protecting the environment and improving of employee health and safety (Venkatesan, 2002).

To deter market malpractice, SEBI has been empowered with penal authority. The penalty which SEBI could impose has been raised from Rs.5 lakhs to Rs.25 crores. SEBI has also investigative powers like search and seizure which will enable it to gather evidence. There have been several instances where SEBI s cases had to be thrown out for lack of evidence. The market regulator has also recently amended the regulations dealing with insider trading, underwriting, employee stock option plans (ESOPs) and the abolition of non-delivery period.

°

Use of accounting standards

The Institute of Chartered Accountants of India (ICAI) traditionally specifies the accounting standards for the corporate sector. By amending the Companies Act in 1999, the government of India has empowered itself with the authority to prescribe the accounting standards. The government has also set up a National Advisory Committee on Accounting Standards (NACAS) which will review the disclosure requirements under the Companies Act from time to time. The NACAS will formulate and lay down the accounting standards and accounting policies for adoption by companies under the Companies Act. This is expected to bring in more transparency in the statutory auditing process carried out by external auditors who are certified by the ICAI.

With a view to checking corporate frauds and failures, the government of India is revamping the accounting standards while plugging the loopholes in the norms for mergers and acquisitions, preferential allotment of shares, inter-corporate deposits and related party transactions. Also, stringent norms are being worked out to bring greater accountability on auditors.

Business financing and creditor monitoring

In addition to equity issues and term loans by public financial institutions and banks, public deposits have been a peculiar feature of business finance in India. Companies have been receiving public deposits for a long time in order to meet their medium-term and long-term requirements for finance. The reasons for the popularity of these systems include high interest rates offered by the companies and the cost of deposits to the company is less than the cost of borrowings from banks. India s top most corporation, Reliance Industries, started its operations with public deposits only.

While accepting public deposits, a company has to follow the provisions of the Companies Act and the directions issued by the Reserve Bank of India. The central government requires that no company shall invite a deposit unless an advertisement, including a statement showing the financial position of the company, has been issued in the prescribed form.

Although there has been no specific policy to analyze lending risk practiced by the banks, while granting credit, a commercial bank generally takes into consideration factors such as nature and size of the enterprise, financial soundness of the concern, profitability of the business, quality of management, ability to repay its loan, technical and commercial feasibility of the project, and security offered by the business unit.

Most of the public financial institutions normally reserve the right to appoint their nominee directors on the boards of the assisted companies. The actual appointments for directors, however, are made after mutual consultation among the institutions depending upon the extent of their combined shareholdings, the size of aggregate debt and individual debt, the role of the lead institution, among others. The nominee directors are not to interfere in the day-to-day affairs of the assisted firm. They are also to ensure that, among other things, financial performance, payment of dues to institutions and government, transactions in shares, major expenditures and the like are reviewed during board meetings.

Nevertheless, it has been observed that due to political pressure, state financial institutions usually support existing management. Also, they do not have many senior professionals who can play the role of active directors in the companies where they have invested. Accordingly, institutional investors play a passive role in corporate governance of the companies and act only in extreme cases such as when the company is about to default on its foreign borrowings.

In the post-reform period, India has allowed the entry of private mutual funds and private banks. The entry of new private banks and foreign institutional investors has forced government-owned financial institutions to improve their performance and functioning (else they lose market share). Further, with the acceleration of globalization, it has become imperative for the corporations to seek more and more cross-border sources of funds. Several leading corporations are now entering the international capital market for debt as well as equity. Thus, foreign investment institutions now hold a significant proportion of the equity in Indian corporations.

Performance of the corporate sector

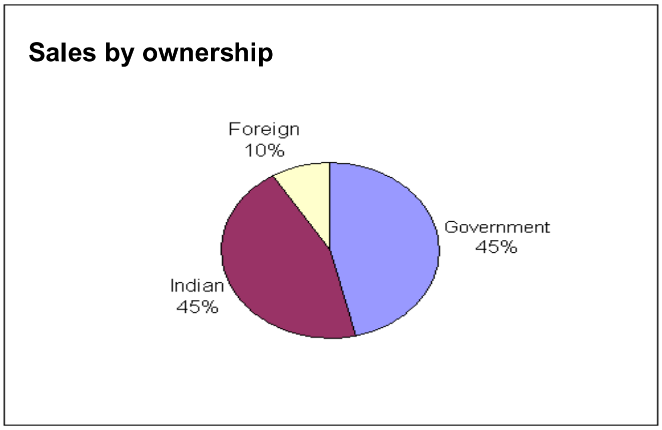
A pattern of growth in total assets of companies characterizes the performance of the corporate sector for the period 1993-2001. The Indian private sector and the foreign private sector grew rapidly during the years 1993-1996. State-owned corporations exhibited higher growth during the period 1997-1999 (Table 1).

Table 1. Growth in total assets by ownership in percent (1993-2001)

Ownership group	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Government	11.3	12.7	11.8	12.9	15.3	14.7	12.8	11.0
Indian private sector	28.4	37.1	23.3	16.7	14.1	9.9	11.9	7.8
Foreign private sector	14.0	24.0	24.3	17.6	16.2	12.5	8.1	15.1

Source: Centre for Monitoring of Indian Economy (CMIE) Survey of Indian Corporate Sector, 2002

The aggregated sales of 10,008 companies surveyed by the Centre for Monitoring Indian Economy (CMIE) was US$266.4 billion (Rs.12917.95 billion) in 2000-01.This was 57 percent of India s GDP in that year. State-owned firms and Indian private companies contributed the bulk of sales as seen in Figure 2.



Source: CMIE, 2002

Figure 2. Sales by ownership, 2000-2001

During the Asian crisis period, the growth of sales, the growth of value of output and net value added dropped appreciably, forcing the companies to defer capital investment decisions, reflected in very slow growth of capital employed from 1998 to 2001 (Table 2). Sales started to pick up only during 1998-1999 and showed robust growth during 1999-2002. This was also the time when the IT sector in India started showing hyper growth. It is interesting to note that even during this slack period, return on sales, return on fixed assets, and return on capital employed were maintained at a reasonably safe level, presumably due to better corporate governance.

In the recent past, Indian corporations have positively revived their performance. Incidentally, it was in the late 1990s that corporate governance also started gaining acceptance by the corporate sector in India. The positive trend of the ratios like PBDIT/capital employed and value of output/capital employed shows that corporations have adapted themselves towards better utilization of capital employed, which happens to be a key focus of corporate governance. Another reason that may be attributed for this improved utilization of the capital employed, could be positive growth of the ratio of internal source/total source of investment. Probably, corporations were adopting better practices while relying more on internal sources of funds.

Table 2. Key indicators of corporate growth

°	1994 -95	1995 -96	1996 -97	1997 -98	1998 -99	1999 -00	2000 -01
Growth in gross sales (%)	27.9	21.0	12.7	6.6	8.8	17.1	17.2
Growth in value of output (%)	28.6	22.3	11.7	6.6	8.8	17.6	15.8
Growth in net value added (%)	28.4	24.6	4.2	4.8	3.8	7.9	10.9
Growth in capital employed (%)	29.0	19.0	16.4	13.6	6.3	3.4	4.6
Growth in total assets (%)	24.6	20.8	15.6	12.4	7.7	7.6	5.7
PBDIT/Gross sales	13.0	13.3	12.5	12.2	11.6	10.9	10.2
PBDIT/Gross fixed assets	26.2	26.7	23.3	20.6	18.4	17.9	17.8
PBIT/Capital employed	22.0	22.0	19.5	17.8	16.7	17.5	18.6
Equity dividend/Equity capital	11.1	11.0	10.5	10.7	11.5	12.7	12.8
PAT/Total assets	4.2	4.2	2.2	1.5	0.7	0.8	1.2

Source: CMIE Survey of Indian Corporate Sector, May 2002
Note: PBDIT = profit before depreciation, interest and taxes

Table 3. Key performance ratios of the corporate sector

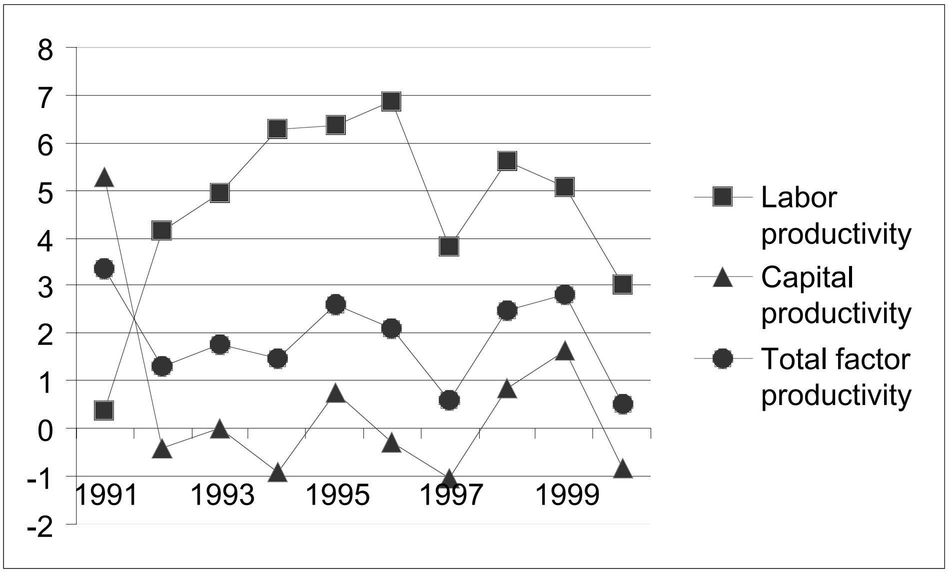
°	1994 -95	1995 -96	1996 -97	1997 -98	1998 -99	1999 -00	2000 -01
PBDIT/Gross fixed assets	**26.2**	**26.7**	**23.3**	**20.6**	**18.4**	**17.9**	**17.8**
Government	17.5	18.3	17.2	15.6	14.6	13.3	13.3
Indian private sector	28.9	28.6	24.0	21.0	18.7	18.5	18.6
Foreign private sector	41.4	42.2	40.2	35.6	27.9	27.4	24.8
Equity dividend/Equity capital	**11.1**	**11.0**	**10.5**	**10.7**	**11.5**	**12.7**	**12.8**
Government	3.9	4.5	4.2	4.8	6.7	8.3	9.7
Indian private sector	14.6	13.1	12.1	12.0	11.7	11.5	11.1
Foreign private sector	29.1	28.5	27.7	26.0	26.2	29.9	27.0
PAT/Gross sales	**4.0**	**4.1**	**2.3**	**1.7**	**0.8**	**0.8**	**1.1**
Government	0.8	1.0	0.2	-0.4	-1.0	-0.9	-0.2
Indian private sector	5.6	5.4	2.9	2.0	1.1	1.2	1.4
Foreign private sector	4.5	4.9	4.6	4.7	3.7	4.3	3.4
Return on equity	19.59	20.23	18.17	16.77	16.02	17.25	18.22
Return on assets	12.21	12.43	11.28	10.52	9.95	10.36	10.89

Source: CMIE Survey of Indian Corporate Sector, May 2002
Note: PBDIT = profit before depreciation, interest and taxes

The ratio of equity dividend/equity capital has also been steadily growing, which can be attributed directly to better overall corporate practices. The trend in return on gross assets as indicated by PBDIT/gross fixed assets indicates a continuous fall during the last six years for all the sectors, firm about 26 percent during 1994-96 coming down to 17 percent in the year 2000-01 (Table 3). It can, however, be seen that the foreign private sector has always maintained above average values while the government sector always lagged behind the average. The Indian private sector performed a little above the average during all these years.

Productivity of the corporate sector

Labor productivity has been growing at an average rate of 4.66 percent per annum during the 1990s. Capital productivity has shown a growth rate of 0.51 percent per annum. Total factor productivity (TFP) has been growing at the rate of 1.9 percent per annum as seen in Figure 3.



Source: National Productivity Council

Figure 3. Labor, capital, total factor productivity growth, 1991-1999

Among the broad economic sectors, mining and quarrying had the highest labor productivity during the 1990s. Labor productivity in the construction sector, on the other hand, declined over the years. The dominant sector in terms of employment_agriculture _which accounted for a little less than two-thirds of the labor force, had very low levels of labor productivity during any year. The relative labor productivity in agriculture worsened during the 1990s. Employment, too, in agriculture exhibited a declining trend during the 1991-2001 period.

At the firm level, a survey conducted on about 250 large private sector companies revealed that during 1996-97 to 2000-01, the share of net value added in output declined from 23.11 percent to 21.32 percent. But the share of transnational corporations among the companies included in the survey shows improved performance during the same period.

Table 4. Growth in gross value added by ownership (%)

Ownership group	1993 -94	1994 -95	1995 -96	1996 -97	1997 -98	1998 -99	1999 -00
Government	5.8	24.2	21.0	13.4	14.5	12.3	13.3
Indian private sector	22.1	33.4	27.5	9.2	6.5	6.2	11.4
Foreign private sector	23.3	20.1	34.2	18.9	9.4	6.9	9.2

Source: Centre for Monitoring of Indian Economy (CMIE) Survey of Indian Corporate Sector, 2002

LEGAL AND REGULATORY FRAMEWORK

The implementation of corporate governance has depended upon laying down explicit codes, which enterprises and the organizations are supposed to observe. India has established many rules that enable enterprises to conduct their business freely and improve their productivity. In recent years, the focus of regulatory agencies has been to put in place a policy environment that enables firms to enhance their competitive advantage and strategies.

The Indian corporate sector normally abides by statutory requirements and various standards. The Narayana Murthy committee on corporate governance has noted with approval that the level of compliance in respect of requirements relating to the board of directors, mandatory constitution of audit committees, and shareholders' grievance committee is very high (Ravindran, 2003). But, at the same time, the committee has noted that many companies are yet to comply with the requirements relating to the constitution and working of remuneration committees, board procedures, and reports on corporate governance.

The responsibility for collection, compilation, maintenance and dissemination of basic statistics on the Indian corporate sector is vested with the Department of Company Affairs (DCA). The DCA has recently introduced a scheme of assigning a unique 21-digit corporate index number (CIN) for registration of companies. The CIN has been designed to help easily identify or group the companies by state, industry (whether listed or not), economic activity, ownership and year of incorporation and will be applicable to all companies registering beginning November 2000. The older companies will also be given the new registration number subsequently.

As many analysts have noted in their research on corporate governance, the most important legal right that shareholders have is the right to vote on important corporate matters such as mergers and liquidations, as well as the right to elect the boards of directors. Among the key legal rights that Indian shareholders have under the Companies Act to make management accountable are proportional voting rights and voting through proxies, and the right to remove a director before the expiry of his period of office by ordinary resolution, subject to certain tenurial clauses like life time employment.

Laws regulating the corporate sector and capital market

The basic law governing the functioning of the corporate world is the Companies Act of 1956 which has been amended about 20 times. The act vests the power to the central government to monitor, regulate and control the affairs of companies. It provides a broad framework for disclosure and reporting to DCA.[2]

The government has passed the Competition Law aimed at tackling abuse of dominance, encouraging meaningful competition, and regulating mergers and demergers of companies in tune with the global practices. A few amendment bills are also under consideration to provide a modern, efficient and time-bound insolvency law, conversion of cooperative business into companies and others. Recently, an amendment has been made to enable companies to buy back their own shares without hassles.

The advisory committee on corporate governance in its report to the Reserve Bank of India (RBI) has observed that the predominant form of corporate governance in India is

[2] All companies are expected to provide information regarding the following in the specified format: employment, important heads of expenditure, overseas operations, foreign collaboration and FDI, foreign assets and liabilities, mergers and acquisitions, capital issues, shareholding pattern, balance sheet abstract and corporate governance practices.

much closer to the East Asian insider model with promoters playing the dominant roles. In this model, a small group of inter-connected shareholders exercise control over management and it is difficult to distinguish between shareholder and management. It has found out that in India this detailed statutory framework of corporate governance has been embedded in the Companies Act and hence the change in governance practices can be brought in only through a repeal of this act.

°Some of the relevant corporate governance codes in India are:

1. CII (1998) Code by the Confederation of Indian Industries;
2. SEBI (1999) Code adopted from the Recommendations of the Kumar Mangalam Birla Committee;
3. Accounting Standards by the Accounting Standards Board of Institute of Chartered Accountants of India (ICAI);
4. New Companies (Amendment) Act-2000 reviewed by the joint Parliamentary Committee; and
5. DC Code suggested by the Disinvestments Commission for PSUs.

The Indian corporate sector normally abides by the statutory requirements and various standards. The most obvious one is financial reporting by the statutory auditor. But the quality and track record of the audit have not been so good and are more tuned to the letter than to the spirit of the law. The financial reports do not contain key performance metrics that can give a sense of what is happening inside the organization. The reason could be that it is a report of an external agent in whose appointment the promoters play a vital role.

°Most of the Indian firms including some of the biggest ones, tend to have different standards and practices for different companies in their fold. Various companies under the same business house have different foreign institutional investors influencing their corporate standards and practices. This trend is now fast changing with the restructuring exercise taken up by various business houses.

Stock exchanges and role of market regulator

Stock exchanges provide an organized market for transactions in securities and other financial instruments. There are 23 stock exchanges in the India, 20 of them being regional ones with allocated areas. Three others set up in the reforms era_the National Stock Exchange (NSE), the Over the Counter Exchange of India Ltd (OTCEI), and the Inter-connected Stock Exchange of India Limited (ISE)_have been mandated to have nationwide trading network. Majority of the stock exchanges have adopted the screen based trading system (SBTS) to provide automated and modern facilities for trading. Online trading and transaction in dematerialized form is also available in most of them.

A major development in the Indian capital market has been the setting up of the depository. The objective of the depository is to provide for maintenance/transfer of the ownership record of securities in an electronic book entry form and scripless trading in stock exchanges thereby reducing settlement risk.

With the aim of raising more capital and to encourage greater participation of people, steps have been taken to improve the working of the stock market. The operations of the capital and financial markets were streamlined by SEBI as companies are now free to approach the capital market after clearance by SEBI. SEBI has the duty to protect the interests of investors in securities and to promote the development of and to regulate the securities market through appropriate measures.[3]

[3] These measures provide for: (a) regulating the business in stock exchanges and securities market, (b) registering and regulating the working of stock brokers, agents, bankers and other intermediaries who may be associated with the securities market in any manner, (c) registering and regulating the working of

The SEBI has formed a group to review implementation of corporate governance standards and recommend steps to strengthen bourses to enhance transparency and integrity of the market. The group would take the stock of corporate governance standards and their implementation by the market participants including listed companies. It has also worked out a code of ethics for directors and functionaries of stock exchanges. In order to ensure better corporate governance, exchanges will have to monitor whether the companies listed on the bourse have set up independent boards of directors and audit committees and also are filing quarterly results with the exchange. New companies will be required to disclose their shareholding pattern on a quarterly basis.

SEBI code of corporate governance

Keeping in view the needed changes and the importance of corporate governance as a tool for investor protection, the SEBI has appointed a committee to draw up a code of corporate governance. The code is to be followed by listed companies, their directors, management, employees and professionals associated with the companies.

SEBI, the market regulator, and the Confederation on Indian Industry (CII), a premier industry association, have also constituted committees to establish guidelines for good corporate governance practices to keep pace with the changes brought in by globalization and to help Indian corporations attain international standards in terms of transparency and integrity in the global market.

The recommendations of the Birla Panel call for changes in the existing law (Birla, undated).[4] For instance, the committee recommends that the board may consist of the following types of directors: promoter directors, executive directors, and non-executive directors. Executive directors (like the finance director or personnel director) are involved in the day-to-day management of the companies while the non-executive directors bring external and wider perspective and independence to decision making. Based on the code, a part of the non-executive directors have to be independent directors, such that they do not have any relationship with the company or its promoters. The percentage of independent directors in the board is defined depending on whether the chairman is executive or non-executive. Although not mandatory, financial institutions are asked to refrain from nominating any directors in the board to avoid potential conflicts of interest.

The code also recommends an independent audit committee to act as a bridge between the board, statutory auditors and internal auditors. The committee is expected to monitor the overall financial reporting process and to ensure compliance with accounting standards and other legal requirements. The audit committee derives its power from the authorization of the board. A separate committee to take care of the remuneration of the directors is also prescribed.

---

collective investment schemes, including mutual funds, (d) promoting and regulating self-regulatory organizations, (e) prohibiting fraudulent and unfair trade practices in the securities market, (f) promoting investor education and training of intermediaries in the securities market, (g) prohibiting insider trading in securities, (h) regulating substantial acquisition of shares and take-over of companies, (i) calling for information, undertaking inspection, conducting enquiries and audits of the stock exchanges and intermediaries and self-regulatory organizations in the securities market, (j) performing such functions and exercising such powers under the Securities Contracts (Regulations) Act. 1956, as may be delegated to it and the Central Government, (k) levying fees or other charges for carrying out the defined purposes under various sections, (l) conducting research for the above purpose.

[4] The 30-page Birla panel report covers recommendations under 11 categories: (1) independent directors, (2) nominee directors, (3) chairman of the board, (4) audit committee, (5) remuneration committee, (6) board procedures, (7) accounting standards and financial reporting, (8) corporate management, (9) shareholders, (10) institutional shareholders, and (11) manner of implementation.

The code also prescribes basic procedural requirements in terms of frequency of meetings, the availability of timely information, sufficient period of notice for the board meeting as well as circulation of agenda items well in advance, and more importantly, the commitment of the members of the board. Accordingly, the board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings. Further, to ensure that the members of the board give due importance and commitment to the meetings of the board and its committees, a director should not be a member in more than 10 committees or act as chairman of more than five committees across all companies in which he is a director.

°The financial reporting and accounting standards have to be upgraded towards international standards. A requirement to be met by all companies is consolidating the accounts of all the subsidiaries in which the company holds 51 percent or more of the share capital has to be given. Companies which are in multiple lines of business, should make available to their shareholders financial reports in each product segment. Regarding the disclosure and treatment of related party transactions and treatment of deferred taxation, the standards issued by the Institute of Chartered Accountants of India (ICAI) have to be followed.°

Although shareholders are the owners of the company, they are not expected to assume responsibility for the management of corporate affairs. The boards of directors, by delegation from the shareholders, are responsible for corporate strategy and operations. Nevertheless, the shareholders are expected to be actively involved in the appointment of directors and have the right to be sufficiently informed about the major decisions concerning fundamental corporate changes or changes in capital structure. There are several other guidelines for keeping the shareholders informed up-to-date about the financial performance and board meetings. Moreover, although financial institutions hold a major share of equity in many Indian companies, it is preferred that these institutes do not seek participation in the board. Instead they may take active interest in the composition of the board and maintain contacts at senior level to exchange views on strategy, performance and management.°

To ensure that companies strictly follow this code for corporate governance, the mandatory provisions are implemented through the listing agreement of the stock exchanges. As this is not a very powerful instrument and the penalties for violation are not stringent, it is recommended to bring the necessary amendments in various existing laws including the Companies Act. The listed companies and companies seeking listing are required to have a separate section on corporate governance in their annual reports.

With the amendments made in the Companies Act, the introduction of Competition Bill 2000, the adoption of new SEBI guidelines and changes in accounting practices suggested by ICAI, corporate governance in India is now moving towards ensuring compliance with the legal and regulatory framework and is geared towards meeting the requirements of majority shareholders. However, experience and research have shown that successful companies ought to adopt a much larger meaning of corporate governance that ensures their long-term survival through meeting the needs of all stakeholders including employees, creditors, and community.

SURVEY IMPLEMENTATION

As mentioned earlier, if a clear correlation could be established between corporate governance and corporate performance, a wider acceptance and adoption of good corporate governance practices can be expected. This study, which was carried out simultaneously in 12 Asian countries including India, endeavors to identify those links.

The primary data for the basic research were collected through structured interviews and detailed questionnaire. The sampling was done on the basis of the area of business as well as the sectoral representation. The sample selected includes public and private sector firms and those listed in the stock exchange. Companies located in different locations across the country are covered in the study. The sample also includes both profitable organizations and troubled firms.

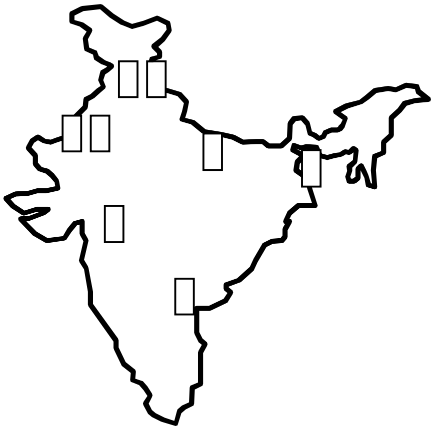


Figure 4. Geographical location of sample firms in India

The sampled companies are Mahanagar Telephone Nigam Limited, KEC Internationa Ltd, Flex Industries Limited, Bharat Heavy Electricals Limited, Samtel Colour Limited, Ballarpur Industries Limited, and Philips India Ltd. Majority of the respondents represent the manufacturing sector.

The average age of the respondent companies is 29 years. About 75 percent of the respondents were established as originally private companies and the rest were established as fully state owned corporations. The average number of employees for the respondents is 21,800. Two state-owned enterprises employ an average of 53,000 employees each, while the private respondents employ an average of 5,700 employees.

The companies surveyed represent different regions in India. The geographic locations of the respondent organizations are shown in Figure 4.

SELECTED RESULTS

°

Ownership°

Capital structure/distribution of shares

The largest stakeholder groups in the respondent companies are the government (25 percent); banks (25 percent); and family (25 percent). The rest are owned by a domestic company (12.5 percent) and others (12.5 percent).

In majority (75 percent) of the respondents, the largest stakeholder group holds 50-65 percent of the shares. In 25 percent of the sampled firms, the percentage of shares owned by the largest stakeholder is 66-80 percent.

°There is no law prohibiting foreign ownership in the country. Yet only one company out of the eight has foreign holding. On the reverse side, four respondents have holdings outside the country. The privately owned companies have a tendency to hold stock in affiliated/mutually-associated companies. The state-owned companies do not hold stocks in mutually associated companies.

Employees and managers hold tiny shares in four out of the eight respondents. The percentage of share holding by employees ranges from 0.3 percent to 3 percent. Managers hold shares in four respondent companies with shareholding from 0.1 to 2 percent.

Shareholders rights°

The Indian Company Law largely determines shareholders rights in India. The following rights are available to shareholders in the respondent companies:

- Right to vote according to share (100 percent);
- Proxy voting (100 percent);
- Right to resolve disputes with the company (50 percent); and
- Right to demand independent audit (50 percent).

None of the respondent companies offers the right to maintain proportionate ownership of company under any financing plan and also the right to be member of independent board committees. Minority shareholders are not represented on the board of any of the eight respondents.

Creditor rights and monitoring

Majority of the respondents (75 percent) have both banks and non-banking financial institutions as their creditors. The remaining (25 percent) has banks only as their creditors. None of the respondents have allowed the creditors any affiliation to the companies. All respondents have more than five years of association with their creditors.

The state-owned companies do not furnish any guarantee to creditor banks for the loans. In private owned companies, the promoters and board of directors have to provide guarantee for the loans advanced by the creditors. The state-owned respondents do not submit any collateral for loans to the creditors. The private-owned respondents submit collateral in the form of personal guarantees by the board/promoters.

The state-owned corporations have not faced any liquidity problems till now. The privately held corporations can use renegotiation of the loan terms as the main instrument in case of liquidity problems. Four out of the eight respondents have never faced any situation wherein action is required on the part of the creditor against loan default. In case of loan default, however, filing a recovery suit and renegotiation of loan payment terms are the instruments resorted to by the creditors. In case of insolvency, there is a bankruptcy law to protect the rights of majority and minority shareholders.

Management

Decision making systems

The pattern of decision-making practices and authorities in sample firms is shown in Table 5. In 75 percent of companies surveyed, decisions on corporate thrusts and directions are made by the board of directors. For the remaining 25 percent, the majority shareholders do this job.

Only one company has indicated that the chief executive officer determines the corporate and financial strategic options. In all others it is the board of directors who does the job. All respondents have stated that the CEO makes all decisions concerning rewards and sanctions for performance. Majority of the respondent board of directors are entrusted with the decision-making authority on management appointments and executive compensation. In three cases the CEO is empowered to do this. The majority shareholders decide the board composition and membership in all the cases. Either the CEO or the chief operating officer (COO) looks after the day-to-day working of the companies. The majority shareholders decide the declaration of dividends in majority (75 percent) of the respondent companies. The board is empowered in the remaining firms. The majority shareholders decide everything about profit or gain sharing, business expansion/contraction, and mergers and acquisitions in all the respondent companies.

Internal control and accountability systems

In 50 percent of the respondent companies, the board chairman is not the CEO of the company. The CEOs of two out of the eight organizations have taken over during the last three years only. Both of them were working with the companies before being appointed as CEO.

Table 5. Allocation of decisions in respondent firms (%)

Type of decision	**Owner(s)/ major share-holders**	**Board**	**Chief executive officer**	**Chief operating officer**
Corporate thrusts and direction	25.0	75.0	0	0
Corporate and financial strategic options	0	87.5	12.5	0
Sanctions and rewards for management performance	0	0	100	0
Management appointments and executive compensation	0	37.5	62.5	0
Board composition and membership	100	0	0	0
Day-to-day operations	0	0	50	50
Declaration of dividends	25	75	0	0
Profit or gain sharing	100	0	0	0
Business expansion/contraction	100	0	0	0
Mergers and acquisitions	100	0	0	0
Productivity improvement measures	12.5	12.5	75	0

In majority of the respondent companies, the size of the board is between six and 12. It is observed that the state-owned enterprises tend to have a larger representation on the board than the privately held companies. The average tenure of the board is three to four years. Board meetings are normally held four to six times per year. For the state-owned enterprises, the board meets more than eight times per year.

All companies have audit committees in the board. The state-owned enterprises do not have any other committee. The other common committees are compensation and investment.

Public disclosure of material information about the company

There is a legal requirement for public disclosure of material information about the companies. All respondents have specific disclosure policies. All material information about the company related to financial performance, ownership structure and governance is required to be disclosed to the general public more than once a year. The access to minutes of board meetings is regulated by the Indian Companies Act.

The surveyed firms have varying policies on disclosure. Not all stakeholders have access to firm information. The key stakeholder groups that have access to material information about the companies are the major shareholders, internal auditors, external auditors, government and creditors (Table 6).

Table 6. Extent of stakeholder access to company information (%)

	Financial information	Firm performance	Ownership	Governance
Major shareholders	100	100	100	100
External auditors	75	25	0	0
Creditors	75	75	100	75
Government (e.g., securities agency)	25	25	25	25
General public	100	100	0	0

Internal controls

The companies show varying degrees of internal controls in different areas (Figure 5). Majority of the respondents exercise rigid or very rigid control over cash flow, accounts receivable, writing off bad debt, loan repayments, inventory and capital expenditure. Control over tax payments is very rigid. Control over research and development is less rigid but considered adequate.

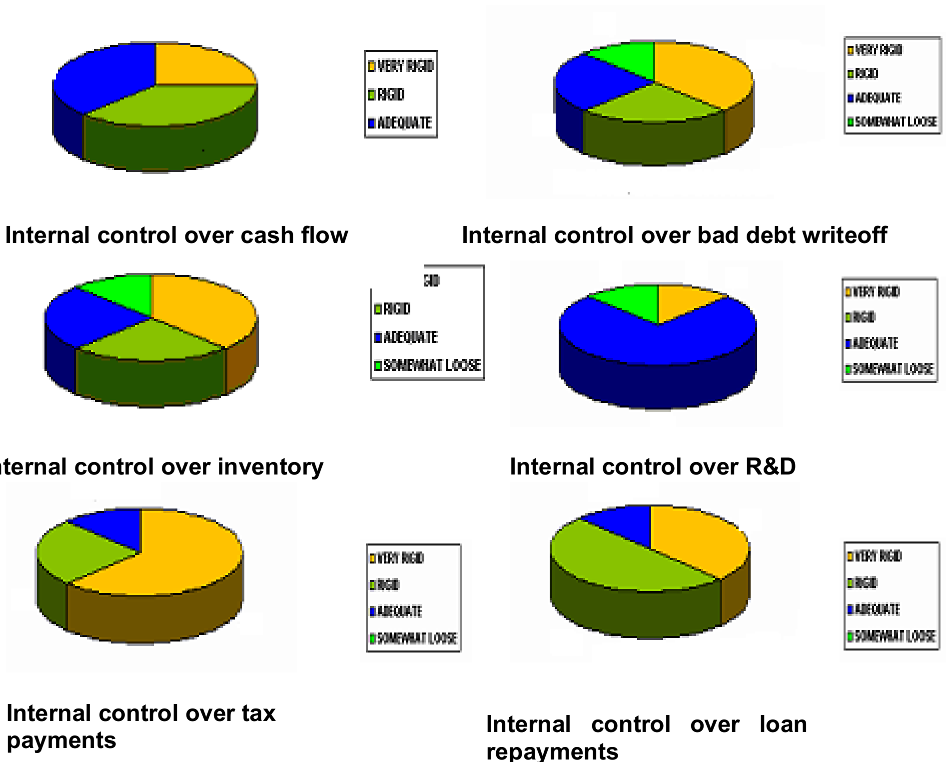


Figure 5. Degree of internal controls

External audit

All the respondent companies appoint external auditors. In half of the respondents, auditors have been associated with the companies for a period of three to five years. In 25 percent of the firms, the same auditors have been there for more than five years. In only one is the auditor been the same since the establishment of the firm.

Code of ethics

All respondent companies have a code of ethics, which is publicized. The instruments for publicity include citizen charter and, governance committees. Only 25 percent of the respondent companies have provisions for penalties for violation of their code of ethics.

No company has received any allegation of breaches of proper standards of financial conduct.

Employer–employee relationship

Employee unions exist in 62.5 percent of the respondent companies. No respondent company has reported any dispute with the union. The mechanisms being adopted by the respondent companies to settle issues are shown in Table 7. Compensation, benefits, and working conditions are often the subject of collective bargaining. Management exercises discretion when it comes to company rules and regulations, training and development, and application of labor standards. Labor management consultation is adopted in some firms to discuss labor issues.

Social responsibility

Community relations

No company has been subjected to any community actions. The important community projects being taken up by the companies include: scholarships, sponsoring medical camps/ health meals, street lighting, slum development, day care centers, adoption of villages, and urban forestation.

When it comes to key social responsibilities, majority of the respondents take voluntary action or leadership role as can be seen in Table 8.

Table 7. Mechanisms adopted to settle issues

Issue	Mechanism	% of respondent firms adopting
Compensation	Collective bargaining Labor management consultation	80 20
Benefits	Collective bargaining Labor management consultation	80 20
Tenure	Collective bargaining Labor management consultation Management discretion	20 40 40
Working conditions	Collective bargaining Labor management consultation Management discretion	40 40 20
Company rules and regulations	Management discretion	100
Training and development	Management discretion	100
Labor standards	Labor management consultation Management discretion	40 60

Table 8. Firm actions on key social responsibilities (% of responding firms)

Areas of public concern	**No firm activity**	**Compliance only**	**Voluntary response**	**Takes leadership role**
Pollution control	0	0	25	75
Environmental protection	0	0	0	100
Truth in advertising and in all business activities	0	0	75	25
Product warranty and service	0	0	75	25
Control of harmful products	0	0	75	25
Community support	0	0	50	50
Lobbying management	37.5	12.5	25	25
Philanthropy	3.5	12.5	12.5	37.5
Support for indigenous groups	0	0	25	75
Stockholder relations	0	0	75	25
Support for working mothers (e.g., day care centers)	75	0	25	0

°All respondents have policy on consumer protection and mechanisms for receiving customer complaints. Likewise, all respondents have policies on environmental protection. Majority of respondents (75 percent) have ISO 14000 certification.

Institutional interface

The rating for quality of services is given in Table 9. The respondents rated the quality of services offered by external agencies from good to poor (Figure 6).

Table 9. Rating the quality of services

Type of service	**% of responding firms**					
	Very Good	**Good**	**Slightly good**	**Slightly Poor**	**Poor**	**Very Poor**
Education		87.5	12.5			
Roads		50.0	25.0			25.0
Ports		25.0	62.5	12.5		
Telecom	37.5	37.5	25.0			
Electricity		37.5	25.0		25.0	12.5
Water			37.5		62.5	

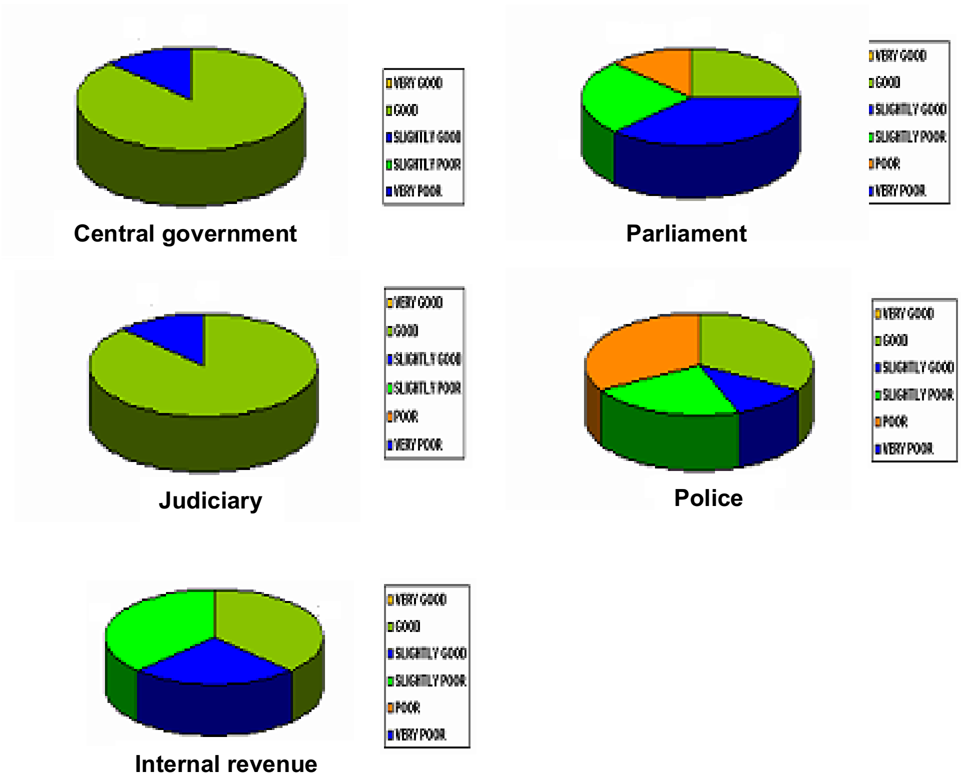


Figure 6. Quality of institutions

GOVERNING RELATIONSHIP

To examine the governing relationship between productivity and corporate governance practices, trends in value added per employee, return on equity (ROE), return on assets (ROA) and sales growth along with profitability ratio were considered. The trends, captured for a period of five years, are depicted in Figures 7, 8, 9, 10 and 11. To identify the best performing firms, the trend rather than comparison of absolute values was used since the respondents deal with different products and technologies.

Out of the seven firms; four recorded productivity growth, one had negative growth and the other two had almost flat growth. The ROE and ROA were negative for two firms. As for sales growth, only one firm recorded positive growth while others showed either negative or zero growth. It must be remembered that period for which the analysis has been carried out was characterized by deregulation and liberalization of the Indian economy during which these organizations were also engaged in restructuring their strategies and operations.

Based upon the limited sample data and observations, some practices emerge as key characteristics of the firms that have exhibited productivity and performance growth. These trends were studied and are discussed below.

Ownership

The firms that were originally established as private companies and were subsequently listed on the stock exchange, those which acquired loans against personal guarantees by promoters, and those which hold stocks in mutually associated companies have shown a tendency for growth during this period. All firms have built long-term relationships with their creditors.

As can be seen also in Tables 10 and 11 below, firms whose majority shares are held by less than 10 owners demonstrate higher labor and capital productivity.

Management

˚A careful study of the corporate governance practices adopted by the participating firms does throw up some evidence about the practices which could have contributed towards achieving better results in the case of high performance firms. These firms largely have relatively active boards with higher tenure, more frequent board meetings, and largely focused on corporate thrusts and financial strategic options. In all higher performance firms (in financial terms), the CEO is also the board chairman.

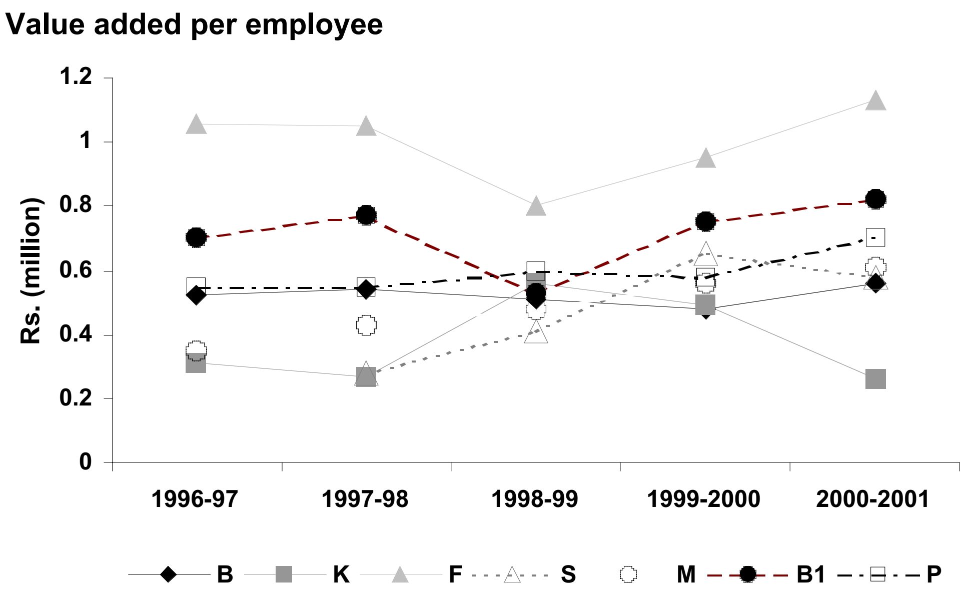


Figure 7. Productivity growth of respondent firms

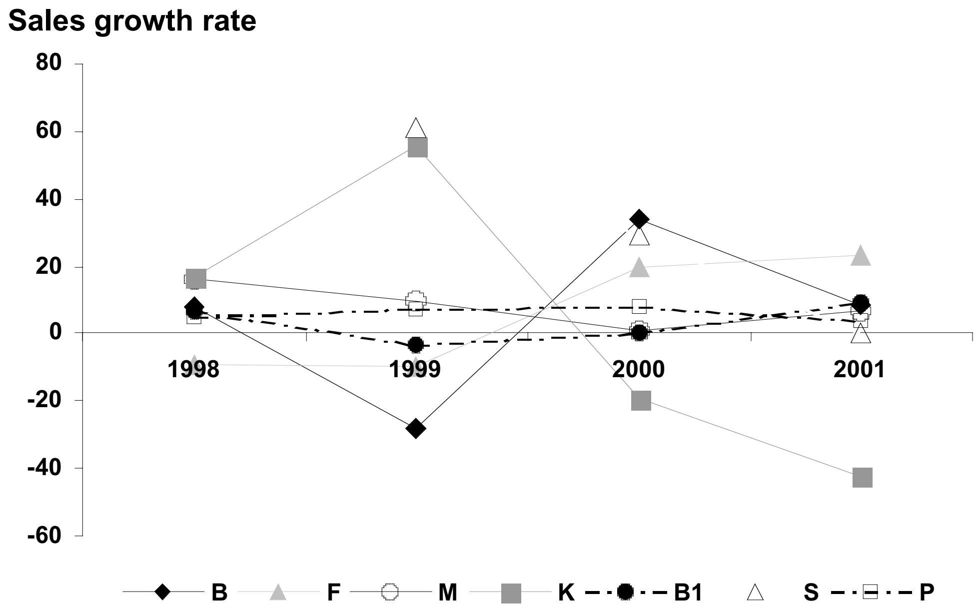


Figure 8. Sales growth rates of respondent firms

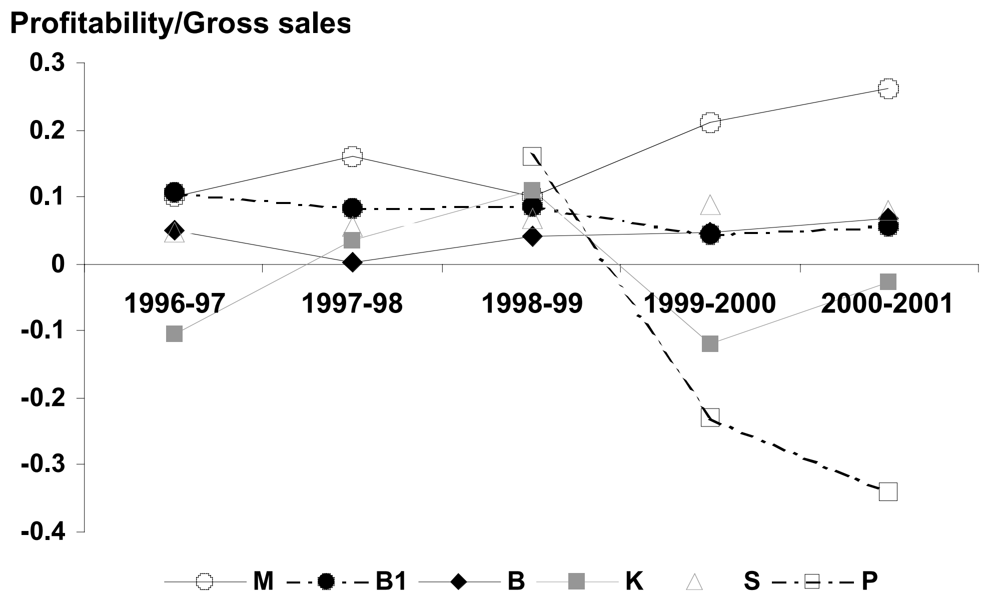


Figure 9. Profitability ratio of respondent firms

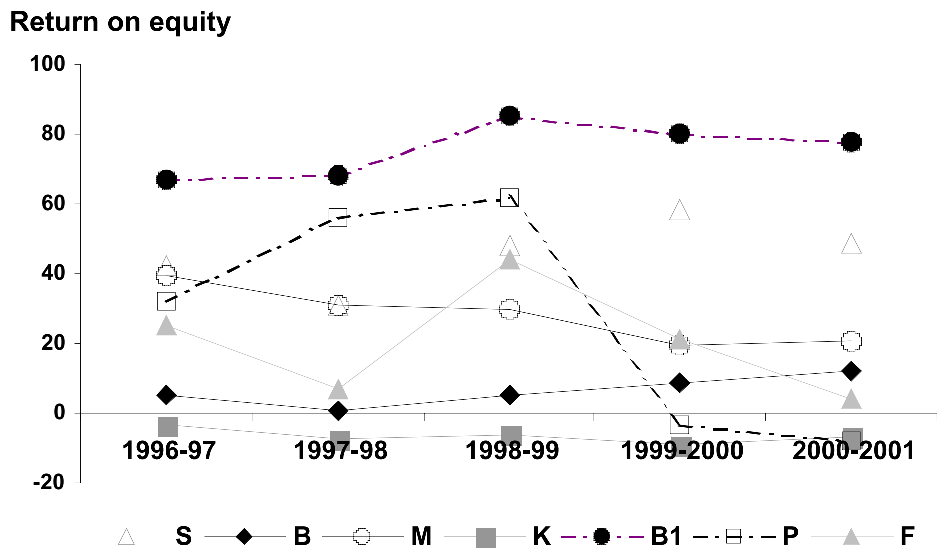


Figure 10. Return on equity of respondent firms

These firms emphasize corporate governance by creating a separate function/cell responsible for implementing corporate governance practices and principles. The cell works directly under the chief operating officer. These firms are more inclined to take penal action for violation of the company code of ethics. These firms have special committees such as shareholders/investors grievance committees. The CEO has not frequently changed in these companies. These firms display more transparency by providing access to material information to number of interest groups.

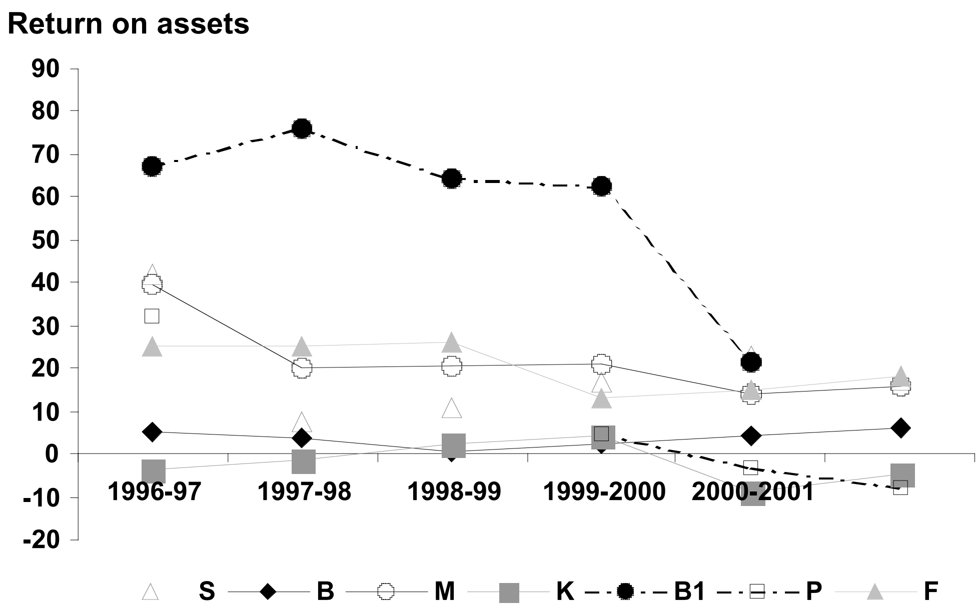


Figure 11. Return on assets of respondent firms

Table 10. Average labor productivity of sample firms
(value of output/compensation)

		Labor productivity	Remarks
Ownership			
Whose majority shares are held by	≥ 10 owners	36.49	
	< 10 owners	100.78	Higher
Financing			
Whose creditors are	banks	63.3	Higher
	non-banks	50.4	
Management			
Whose board chairman is	CEO	10.75	
	non-CEO	139.27	Higher
Which has	unions or associations	25.22	
	no unions or ass ns	110.32	Higher
Social responsibility			
Which undertake	community projects	59.06	Higher
	no community projects	42.65	
Interface with government/international players			
Which rate the quality and efficiency of infrastructure (roads)	good	73.53	Higher
	poor	13.71	
Which rate the quality and efficiency of infrastructure (telecom)	good	63.66	Higher
	poor	3.25	
Whose problem with anti-competitive practices is	moderate/major	13.71	
	minor/none	73.53	Higher

However, labor and capital productivity is higher for the other subset of firms, those with no unions also perform better in terms of labor productivity.

Internal controls

The higher performing firms exercise rigid controls over tax and loan repayments, payroll, cash flow, accounts receivables, and R & D expenditure.

Social responsibilities including interface with external agencies

The high growth companies and those not showing impressive growth rates do not differ much when it comes to factors related to social responsibility and interface with outside agencies. In any case, firms with community projects demonstrate higher labor productivity.

The quality of services affects the productivity of firms. Productivity is higher in firms able to access good infrastructure like roads, telecommunications and power. Productivity is also higher in firms with minor problems with law and order, anti-competitive practices, taxation, and international standards and regulations.

Table 11. Average capital productivity of sample firms
(revenue/book value of assets)

		Capital productivity	Remarks
Ownership			
Whose majority shares are held by	≥ 10 owners	3.76	
	< 10 owners	6.43	Higher
Financing			
Whose creditors are	banks	3.76	
	non-banks	6.43	Higher
Management			
Whose board chairman is	CEO	2.87	
	non-CEO	9.11	Higher
Social responsibility			
Which undertake	community projects	3.67	
	no community projects	5.20	Higher
Interface with government/international players			
Which rate the quality and efficiency of infrastructure (telecom) as	good	5.48	Higher
	poor	1.28	
Which rate the quality and efficiency of infrastructure (power) as	good	7.77	Higher
	poor	1.09	
Whose problem with law and order is	moderate/major	2.87	
	minor/none	9.11	Higher
Whose problem with anti-competitive practices is	moderate/major	1.09	
	minor/none	7.77	Higher
Whose problem with taxes and regulations is	moderate/major	3.76	
	minor/none	6.43	Higher
Whose problem with international standards and regulations is	moderate/major	1.28	
	minor/none	5.48	Higher

POLICY ISSUES AND RECOMMENDATIONS

The dramatic improvement of corporate governance in India owes to a number of events that have transpired in India:

- Economic reforms that allowed the growth of free enterprise and freed private investment opportunities;
- Exposure of domestic private and public sector companies to greater domestic and foreign competition, which has multiplied choices for consumers and compelled increases in efficiency;
- Growing reliance placed by private and public sector companies on capital markets, underpinning the need for better disclosures and better investor service;
- Consequential changes in the shareholding pattern of private and public sector companies;
- Growing awareness of investors and investor groups of their rights;
- Growing importance of institutional investors and public financial institutions gradually asserting and transforming themselves in their new role as active shareholders rather than as lenders;
- Stock exchanges becoming increasingly conscious of their roles as self-regulatory organizations and exploring the possibility of using the listing agreement as a tool for raising the standards of corporate governance; and
- Establishment of a comprehensive regulatory framework for the securities markets with the setting up of SEBI as the statutory regulatory body for the

securities markets, to protect the rights of investors and to regulate the markets.

These are welcome developments, but it should not stop Indian authorities including SEBI, DCA, and professional associations from reviewing rules and regulations in order to implement better corporate governance practices. The working of corporate boards, the role and independence of auditors, the responsibilities of management, particularly of the chief executive officer and chief finance officer, ethics and the corporate social responsibility of business, and above all, the larger institutional framework have emerged as major issues in this regard. Various stakeholders, however, interpret corporate governance differently and focus on just a few of its aspects. To make corporate governance a vehicle for accelerating corporate growth and excellence, a holistic view needs to be adopted.

Role of auditors

The present debate is mostly focused on the role and responsibilities of auditors in withholding/providing right information to various stakeholders and carrying out audit in a professional and ethical manner. The suspected connivance between management and auditors rests on the practice of owners/managers choosing and fixing the fees of auditors. Many times auditors are persuaded to gloss over the questionable practices that management adopts in order to dress up the financial results. It has also been observed that conflict of interest arises when auditing is undertaken by an organization having two wings the consultancy wing that provides non-auditing services and the auditing wing.

By and large, accounting and related standards in India are world class but their implementation and revision in the light of the new economic order are tardy and *ad hoc*. To tackle these issues and to bring in greater transparency, the Institute of Chartered Accountants of India is continuously examining accounting practices and standards. For example, the ICAI observes that changes are needed in the accounting of intangible assets. According to ICAI, the present accounting system is not sufficient to prevent a promoter siphoning off funds in the name of intangible assets like software.

°The Institute of Chartered Accountants of England and Wales has recently finalized a list of recommendations which are worth looking into. For instance, audit partners will be subject to a two-year cooling period before they are allowed to join their audit clients as an employee or director. Audit rotation requirements will also cover all key audit partners. Audit committees will have an enhanced role to play. They will set up policies for awarding non-audit work to the auditing firm and not only recommend the appointment of auditors each year but also fix their remuneration. For greater accountability, fees paid to auditors for non-audit work will be analyzed in the statutory accounts.

°The New Law in the United States also has accountability mechanisms worth mimicking. The Sarbanes-Oxley Act of 2002 stipulates that an audit firm cannot provide certain services such as those relating to book-keeping, financial information system design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing services, management services or human resources, investment advisor or investment banking services, legal services or expert services unrelated to audit, to name a few. However, the directors have the power to exempt on a case-by-case basis the audit firm from such prohibitions. Further, a registered public accounting firm is not permitted to audit a public company where the company s CEO, CFO, controller, chief accounting officer or any person serving in an equivalent capacity, has been employed by the firm and participated in the audit of that company during the one year period preceding the date of the initiation of the audit beside the approval of all audit and non-audit services by the audit committee. It also empowers the comptroller general to review the potential effects of mandatory rotation of registered public accounting firms as auditors of companies and submit a report to the US Congress. It also requires the CEO and the CFO to certify the truthfulness and completeness of the disclosure and financial statements in every annual and quarterly report and include criminal penalties for a false certification.

˚Clearly, the trend is to provide legal safeguards so that no information is withheld regarding the association of the auditing firm with the company from the board or the investors and thus, avoid conflict of interest. However, it need not be emphasized that the real solution would lie in the auditing firms maintaining their professional integrity and through self-regulation.

Constitution and working of the board

Even though the number of members in the board varies from organization to organization, there is no structure/guideline specified for nomination to the board. It would be appropriate to set some guidelines in order to include experts from various functions (e.g., technical, human resources, finance among others) in the board besides the independent directors. The selection of independent board members should also be guided by considerations like how much time they can devote to participate in the discussions of the board. The practice prevalent in Germany to have two separate boards supervisory and management boards is worth considering in this regard.

Primarily, the effectiveness of the board would be determined by the accuracy and comprehensiveness of the information that it receives and the time it devotes to open and detailed discussion of strategic issues. Hence, it is critical to have a good board information system and an evaluation system to monitor the performance of the organization. The information system should go beyond the legal framework and focus on future threats and opportunities. The system should also pay attention to whether each board member is performing the function for which he/she is inducted.

However, one phenomenon generally observed in India is that the CEOs generally collude in the business of not releasing hard-hitting, negative news even to the board with the aim of preventing a short-term fall in the stock prices. The reason for this practice is that often the compensation of the board as well as the CEO is linked to the stock prices. Palepu (2000) suggests that an overvalued stock is as critical as an undervalued stock which could lead to spontaneous bankruptcy (as in the case of Enron). According to Palepu, the CEOs should present a realistic picture to the board to ensure the long-term survival of the company. The board should not hold the CEO responsible for short-term fluctuations in stock prices but for the overall performance of the organization in terms of value addition, quality of the product/service, adherence to various standards and compliance to various laws.

˚Availability of information with respect to the following needs greater attention: strategic review and guidance, and monitoring; selection, compensation and succession policies; risk policy and management; reviewing key executives and board remuneration; transparent board nomination process; monitoring and managing potential conflicts of interests; integration of accounting and financial systems and independent auditing including compliance with the legal requirements; monitoring effective corporate governing policies and practices; establishing appropriate systems of control; overseeing disclosures and communications; and ensuring access to material information of all stakeholders.

Ethics and corporate social responsibility

Although most firms have a publicized code of ethics for management and for various committees, specific provisions for violations of this code are found wanting. Only one surveyed firm reported taking action for such violations. Perhaps there is a need to provide some legal sanctity to such codes. Majority of the surveyed firms do undertake projects and actions that benefit the community. The ethical behavior of the firm depends upon the core beliefs and value systems that its top management sets for it. Sharing as much information as possible with shareholders and communicating and iterating corporate values provides the foundation of corporate governance policy. As Mckinsey (2001) has shown, socially responsible organizations tend to be more profitable in the long run. The SEBI is working on evolving an index to rate the corporations to reflect their practices, actions and commitment relating to social responsibility and ethics.

Role and responsibility of the CEO and CFO

The decision making pattern in a typical Indian firm as indicated by the survey results reveals that the CEO calls the shots when it comes to day-to-day operations and control over cash flow and other operational matters. Organizations with a long serving CEO or empowered CEO have shown growth in terms of productivity and performance. It is also interesting to note that high performing organizations have a separate function/cell working directly under the CEO or COO.

However, the survey also reveals that present actions to promote corporate governance are limited to complying with the legal and regulatory framework. Further research has shown that management dynamism and employees creativity are the two most critical factors that drive performance and productivity in an organization. Therefore, it is very important to broaden the scope of corporate governance to include practices that meet the different and sometimes conflicting expectations of all stakeholders. Keeping a balance between various expectations is the key. If management pays disproportionate attention to shareholders interests, particularly those of majority shareholders, the firm s survival over a long term could be damaged. It has to look beyond disclosures to create trust among all stakeholders. It has to be sensitive to the concerns of society, particularly those relating to the environment. Experience has shown that customers delight is the key to producing business results and employees play the most critical role in achieving customer satisfaction.

The CFO as the custodian of the company s capital has to take on new responsibilities in order to meet emerging business challenges. It is in the best interests of the CFO to ensure that the company follows clear, open and transparent accounting policies and avoids any shortcuts just to achieve good immediate financial results. The CFO and the CEO are expected to do the following: focus on the long term viability of the corporation; manage costs and liquidity; reduce the risk in business; maintain high levels of operating efficiency; lower the cost of capital; disclose timely and accurate information; provide all information required for the effective functioning of the board; maintain high levels of personal integrity; and follow internationally accepted principles and standards for both annual and quarterly reporting.

The Naresh Chandra Committee on Corporate Audit and Governance has come out with comprehensive recommendations. The thrust of the recommendations is on providing a greater role for the independent directors on the company boards, disciplining the auditors, and making the chief executive officer (CEO) and the chief financial officer (CFO) accountable for financial reporting and statements (*The Hindu Business Line*, January 21, 2001). But the need of the hour is lighter laws in tune with global standards, and stricter implementation.

Institutional framework

As explained earlier, government, professional associations, judicial and law enforcement agencies, the securities exchange board, consultants and industrial associations that provide guidance and control for ensuring compliance with and development of corporate governance practices comprise the cornerstone of the institutional framework in India. The Department of Company Affairs, in order to increase surveillance, is considering random scrutiny of accounts by independent auditors. Simultaneously, the policy makers are thinking seriously about the means to improve the quality of audit carried out by external auditors and the audit committee. The audit committee needs to ensure that the annual report or the quarterly report clearly communicates the performance of the organization not only in financial terms, but also in term of key success factors.

With government support (for example, through legislation), professional bodies with greater punitive powers would be ideal in containing frauds and irregularities. The law should penalize auditors if financial irregularities are discovered after the audit exercise. The SEBI is considering many recommendations to improve disclosures in order to make it difficult for companies to commit irregularities. Among others, these proposals include disclosure of loans and advances given to subsidiaries and associate companies in the annual accounts, limited audit of quarterly results and full audit of bi-annual results, risk assessment, and disclosure of qualifications by the auditors. If a company s accounts have been qualified by the auditors, the reasons behind the qualifications and when the company will be able to publish accounts without qualifications should be explained to the stock exchange. SEBI should, in consultation with the government, ensure that no firm audits a company s account for more than three to five years continuously and put in place a system that would enable it to order a special audit (not paid by the company) by a firm other than statutory audit to check the credibility problems facing the audit profession.

One of the issues being discussed for quite a long time is the quality of information disclosed to the public. Major shareholders, internal auditors, external auditors, government and creditors have access to material information about the surveyed companies while access to the minutes of the boards is regulated by the Indian Companies Act. In practice, however, these minutes are available only to the majority shareholders. Disclosure should include financial and operating results, objectives, major shareholding patterns and voting rights, members of the board and key executives and their compensation, risk factors, issues concerning employees and other stakeholders, and governance structure and policies.

Emerging framework of corporate governance

The corporate governance framework in India encourages public participation but unlike institutional investors,[5] public shareholders are not in a position to influence managerial decision-making. The right to vote according to the proportion of shareholding, proxy voting, the right to resolve disputes with company, and the right to demand independent audit do exist in the legal framework. On the other hand, the minority shareholders are not represented in the board. However, the shareholders voice needs to be strengthened further to protect basic minimum rights as follows:

- Basic rights of ownership such as being informed of and participating in decisions to change the company statutes, capital structure or sell the company;
- Right to elect members of the board;

[5] Institutional investors are emerging as a major force and their investment in the capital market has grown from 42 percent in 1991 to 70 percent in 2000. This has an impact on various organizations as they demand good governance and better performance.

- Equitable treatment of all shareholders including minority and foreign shareholding;
- Right to be ensured that members of the board and management disclose all material information regarding their interests in related party transactions;
- Employee share ownership representation on the board, creditor participation in insolvency proceeding; and
- Access to relevant information for the participating stakeholders to assist them in fulfilling their responsibilities.

Experience and research have shown that successful companies adopt a much larger meaning of corporate governance that ensures their long-term survival through meeting the needs of all stakeholders, including employees, creditors, and the community. Participation of suppliers in the improvement process for example, would facilitate exploitation of opportunities for improvement in the value or supply chain. Corporate governance practices should translate into fairness, transparency, and raising the trust and confidence of all stakeholders.

Knowledge has emerged as the major weapon of competitiveness in the present highly complex and global environment. Among all resources, employees who possess the knowledge are the fountainhead of performance and improvement. It is in this context that people building should be seen as the first responsibility of any organization. Transparency and trust would motivate employees to give their best. Workers like to belong to an organization which is well respected in community and is regarded as a good corporate citizen.

It is also time to worry about the intermediaries. In practice the performance and functions venture capitalists, money managers, audit firms, investment banks, have a direct impact on the governance of corporations.

CONCLUSIONS

The concept and practices of corporate governance are still evolving to meet the new challenges. Mere compliance with the existing legal and regulatory framework and protecting the majority shareholders interests alone is not a guarantee for long-term corporate survival. Shareholder value would also depend upon the way employees perform. Corporate governance has to be interpreted in a holistic sense to achieve satisfaction of all stakeholders including employees, shareholders, and the community that will facilitate growth and improve productivity.

Proactive, principled and value-based corporate governance practices would affect productivity in a positive way. A clear demarcation between the role of the board and the executive management is essential for a more effective functioning of the corporation. Nominating a good number of non-executive members of the board, setting up sub-committees presided by non-executive members, providing all relevant and material information, promoting open and detailed discussions in board meetings, laying down clear norms for the selection and rotation of auditors, de-linking compensation (of management and board members) with stock prices, and institutionalizing the continuous monitoring of corporate practices are some of the measures that would strengthen corporate governance.

CEOs and CFOs should ensure disclosure of all relevant, accurate, comprehensive and material information to all stakeholders and board. The annual and other reports should be compiled based upon internationally accepted principles and practices. The CEO should demonstrate commitment to the organizational beliefs and values by his/her actions and maintain high standards of personal integrity. The CEO should focus more on creating value for all.

Finally, the need for a continuous review and strengthening of standards and practices is the missing link in sustaining the gains of corporate governance in India.

REFERENCES

Birla, Kumar Mangalam (Undated). Draft report of the Committee appointed by SEBI on Corporate Governance.

Centre for Monitoring of Indian Economy (2002). Survey of Indian Corporate Sector.

Dahiya, Shri Bhagwan and Desh Gupta (2001). Foreign Investment and Issues of Corporate Governance in India. Department of Economics, M.D. University, India.

Greenspan, Alan (2002). Corporate Governance Gone Astray. *The Hindu Business Line*, April 17.

Institute of Company Secretaries of India (2001). Corporate Governance: Implementation Issues. Chartered Secretary, August, pp 889-890.

Kar, Pratip. Corporate Governance in India, in Corporate Governance In Asia: A Comparative Perspective. Organization for Economic Co-Operation and Development, 2001.

McKinsey (2001). India: Growth Imperative.

Panchali, Jinesh (2002). Institutional Investors and Corporate Governance. *IIMB Management Review*, March.

Palepu, Krishna (2002). The Role of the Board Is Not to Maximize Share Prices: An Interview by Manjari Raman. *Indian Management*, June, pp 18-23.

Ravindran, S. (2003). Murthy Panel Agrees to Level of Compliance. March 20, www.rediff.com

Sachs, Jeffery, Ahutosh Varshney & Nirupam Bajpai (2000). India in the Era of Economic Reforms, April, www.cid.harvard.edu/india.

The Hindu Business Line (2001). Corporate Governance: Broader Issues and Challenges. January 21.

Vaghul, Narayanan (1997). Indian Specialties in Dahiya, Shri Bhagwan and Desh Gupta. Foreign Investment and Issues of Corporate Governance in India.

Vaidyanathan, S (2001). Professionalising Corporate India. *The Hindu Business Line*. January 21.

Venkatesan, Lakshmi (2002). Corporate Social Responsibility in Emerging Economy. *Business Standard*, March 18.

IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY: THE CASE OF THE ISLAMIC REPUBLIC OF IRAN

Prof. Hossein Rahmanseresht
Allame Tabatab ee University
Islamic Republic of Iran

INTRODUCTION

In the past, owners of capital or means of production, owner-managers, and even executives seem able to influence the firm s performance considerably. However, the complexity of ownership and capital structure of corporations in the post-industrial era appears to have undermined the impact of traditional factors on performance.

Corporate governance, which refers to the interplay of major forces bearing on strategic decisions, has emerged as the key element defining the character of corporations and determining their performance. Corporate governance has been defined in both narrow and broad senses. According to a 1997 *Financial Times* article, Corporate governance is defined narrowly as the relationship of a company to its shareholders, or more broadly, as its relationship to society.

The narrow concept is elaborated in OECD (1999). The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.

The broader context involves a wider range of institutions. It includes an efficient public service, an independent judicial system and legal framework to enforce contracts, the accountable administration of public funds, an independent public auditor responsible to a representative legislature, respect for the law and human rights at all levels of government, a pluralistic institutional structure and a free press (World Bank, 1992).

These definitions provide the backdrop for this research.

Given that corporate governance impacts on firm performance then what remains to be seen is which of the constituting elements bear more on productivity.

To be sure, this type of study has been carried out in several countries with different results. Following the structure of similar studies undertaken in some Southeast Asian countries, this paper seeks to add its share to a comparative study on the impact of governance on performance in various countries.

In essence, this study finds that small enterprises with powerful owners acting as managers, who have clear-cut, transparent policies and who recognize consumers rights and relate positively to external stakeholders are more likely to experience high productivity. This thesis is anchored on researches conducted and data gathered.

PAST RESEARCH EFFORTS

Privatization has been regarded as necessary to make the economies of post-soviet Russia, China, some eastern European countries, and other nations in the world more efficient and effective, but governance has been found to complement the efficiency-seeking efforts. According to Mayer (1996), in Eastern Europe, privatization has given way to questions on how private enterprises should be governed. China is experimenting with forms of corporate governance which attempt to blend some of the features of market systems with state ownership of enterprises.

Although governance , albeit under different disguises, has long been recognized (see Chandler, 1966), it has gained wide currency only in the past 25 years. McRitchie (1996) offers some of the reasons for this. Just as the impact of the general aspect of governance capital structure on the firm s performance has been scrutinized (Johnson and Greening, 1999), studies have also been done on the impact of the ingredients of the governance, i.e., managerial incentive schemes (Conyon, Gregg, & Machin, 1995); disciplining and restructuring of poorly performing firms (Franks, Mayer, & Renneboog, 1995); and the reliance on rules of CEO succession (Casio, 1999), to name a few.

Moreover, different empirical methods for investigating governance and performance have been reviewed. Tobin s Q, in particular, has been employed in several of these studies (Morck *et al.*, 1988; McConnell & Servaes, 1990). However, scholars use different empirical methods for governance investigations. Heinrich and Lynn (2001) reviewed and compared several of those surveys employing ordinary least squares, regression models, and the like only to conclude that multi-level approaches produce a better and more precise understanding of the complex phenomenon.

Despite the privatization spree in Iran and the realization of the importance of governance, this has not been taken seriously as a research topic and policy making on governance has been rather impressionistic and half-hearted.

THE ECONOMIC SITUATION IN IRAN

According to the World Bank, social conditions in Iran have improved considerably. This improvement was a result of the activist role of government in extending direct support or assistance. Although government provides subsidies of essential goods and undertakes human resources development programs such as universal access to education and health combined with population growth control, it is also engaged in large untargeted subsidies. One of the major hurdles of Iran as it undergoes transition is to identify appropriate mechanisms to move away from this mode of subsidy and towards targeted subsidies for the genuinely poor. This is expected that in turn can generate public savings which can then be channeled to assist in financing private sector investment to generate productive employment and sustained growth under a regime of social justice (World Bank, 2001a).

Iran s current development priorities and approach are outlined in the Third FYDP (2001-2005) approved by the Parliament in 2000. The development blueprint targets a growth rate of 6 percent per annum during the period with continued emphasis on social development and equity. The plan seeks to increase economic growth potential, raise the living standards of the population, and reduce unemployment. A wide range of structural reforms is in order. While more private investment is needed to boost rapid growth, the plan gives special emphasis to agricultural and rural development, and housing as the key sectors that would fulfill growth with equity goals. Not only do these sectors possess the potential for growth but given their labor-intensive feature (particularly of unskilled and poor workers) they are also crucial in job creation and poverty alleviation schemes (World Bank, 2001a).

The economic reform strategy is aimed at developing a competitive economy by moving toward a market-based allocation of resources, and by undertaking legal and institutional changes to pave the way for the development of private sector participation together with public enterprise sector reform (World Bank, 2001a).

Standard Chartered chief economist Gill James assessed Iran s immediate economic outlook as encouraging. Current strong oil prices and high output levels are expected to support GDP growth of around 5 percent in 2003 (*Economic Review*, April 21, 2003)

Economic growth has averaged five percent a year since 1999. Iran has strengthened its national finances. The fiscal accounts are now nearly balanced. For the past three years there has been a surplus in its current account. It has rebuilt its foreign exchange reserves and brought foreign debt servicing obligation under control. The central bank has also unified the exchange rate system, and successfully launched two eurobonds. But despite the improvements on the macro level, its economy faces enormous challenges. Oil continues to be the driving force of the economy *(Economic Review*, April 21, 2003).

Even so, a gradual approach is prescribed for Iran s economic reform strategy given the complexity of the reform process and the need to avoid undue social disruption (World Bank, 2001a).

Corporate profile

Official economic activities in Iran operate within three legal frameworks: government, private, and cooperatives. Although much effort has been expended in recent years to encourage private and cooperative activities while disfavoring government ownership, government economic activities account for about 75 percent of GNP. Most large corporations belong to government.

On the basis of 1999 statistical data, about 11,000 enterprises with 10 or more workers accounted for 58 billion rials (US $7,250,000) of value-added of the country and created employment opportunities for about 900,000 people in the same year. Average remuneration per labor in 1999 was 16 million rials (US $ 2000) per year. Labor in the coal and refinery industries received the highest salary while workers belonging to the recycling industry had the least..

Most enterprises in Iran are private, joint liability and limited companies. Owner-management is prevalent and most enterprises are in the hands of private owners. Majority of firms rely on banks for financing. Flotation and stock exchange are being boosted to finance private firms. Investment by overseas investors is scant. However, this is being encouraged through legal means. Figure 1 illustrates the capital structure of listed companies. Some 48.69 percent of the firms capital is in the hands of owners-managers. Another 20.59 percent is sourced from investment companies. Although banks account for only 4.64 percent of the firms capital, they are the major financiers of corporate undertakings.

The financial sector is state controlled. Public banks directly administer most of the credit. There are no private banks in Iran (World Bank, 2001a).

At present, the number of the companies being listed in the stock exchange is nearing 350; the process of flotation and moving out of government control is gaining impetus.

Although firms and corporations operate within a strict legal framework and there are different sanctions to make sure that all laws and regulations are observed, listed firms are under stricter surveillance through specific external controls.

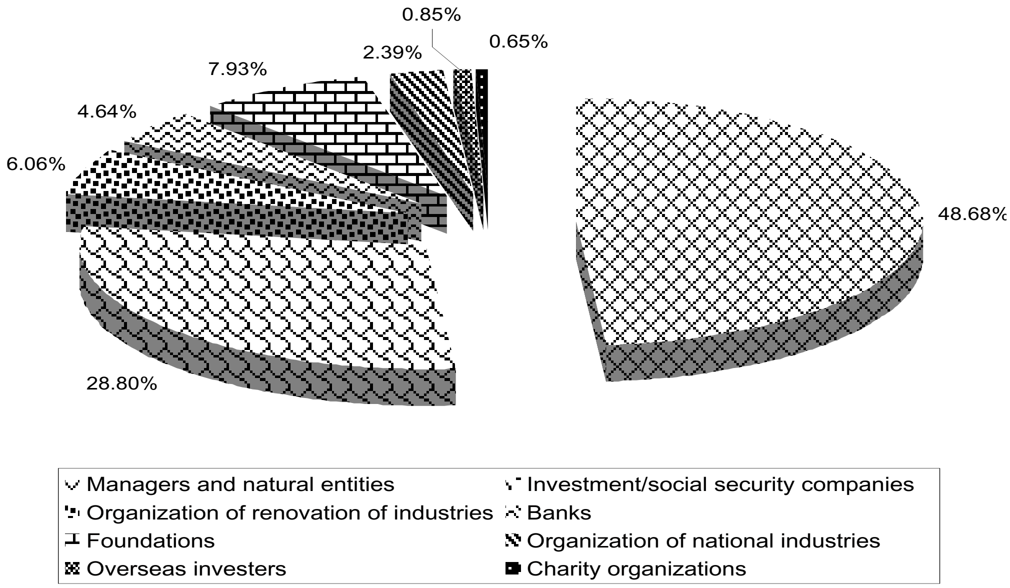


Figure 1. Sources of companies capital

THE REGULATORY ENVIRONMENT

Ownership and capital structure

The Iranian constitution respects private ownership. There are three sectors of ownership in the Iranian economy.

State sector: The state sector includes all large-scale and mother industries, foreign trade, major minerals, banking and insurance, power generation, dams and large-scale irrigation networks, radio and television, post, telegraph and telephone services, aviation, shipping, roads, railroads and the like. All these will be publicly owned and administered.

Cooperative sector: The cooperative sector includes cooperative companies and enterprises concerned with production and distribution, in urban and rural areas, in accordance with Islamic criteria.

Private sector: The private sector consists of those activities concerned with agriculture, animal husbandry, industry, trade, and services that supplement the economic activities of the state and cooperative sectors.

These categories define the limits within which different types of private sector partnerships, in general and in particular, have been authorized thus far. Partnerships in Iran are no different from those found elsewhere. They include limited liability companies, general and limited partner ships, proportional liability partnerships, consumer and producer cooperatives, and joint stock companies.

Of great importance in this study is the *joint stock company:* a company formed for commercial purposes. Its capital is divided into shares and the liability of its shareholders is limited to their shares. There are two types of joint stock firms: the *private joint stock company,* which is registered but not listed, and the p*ublic joint stock company,* which is registered and listed.

In either kind, the shareholder assembly exercises superior power in the organization. It is the assembly s responsibility and duty to choose the board of directors, and to set the annual, semi-annual or quarterly general meeting of the board. The shareholders set the direction of the company for the next few months in the meeting. They also approve or disapprove the decisions emanating from board of directors.

The next level in the joint stock company is the board of directors as chosen by the shareholder assembly. They have specific duties. For example, the directors are responsible to the company or a third party for any infringement of the provisions of the Articles of Association. They are accountable for any errors in their management activities specially where they have distributed fictitious dividend or have not prevented such distribution. The board of directors consists of executives and non-executives.

The next authority is the chief executive officer who is appointed by the board of directors. Internal and independent auditors report to the board of directors. The CEO appoints vice-presidents who choose managers or branch managers who in turn appoint supervisors and shop-floor leaders in branches.

Aside from joint stock companies, there is the civil partnership which is a type of non-registered company that is also legally recognized. Stockholders or shareholders' voting rights are proportional to the number of shares. The general assembly of shareholders elects the members of board of directors, one of whom may be elected as the CEO.

All natural and legal entities enjoying shareholder s status are lawfully entitled to hold shares. Although both private and public joint stock companies have individual natural shareholders, the major stockholders have been banks, foundations, insurance companies, pension funds, and mutual funds. Shareholders normally have the controlling power in the company.

Iranian corporations secure their capital through the following financial resources: owners, shares and bonds, banks and financial institutions.

In order to establish a public company, owners must provide Rls. 5 million. Thus far, to be floated, a company must be non-service (manufacturing) and prove to be financially sound for at least three successive years. Shares and bonds may be traded to persons willing to pay and buy them. Banks and financial (non-bank) institutions, called creditors, extend loans to companies after reviewing their financial and accounting books. As a result, a public company is able to source its capital in several ways.

In corporations, each shareholder has a right to vote. For decision making to be valid in the general meeting, the presence of a number of subscribers who own at least 50 percent of the share capital of the company is required. If this number of shareholder cannot attend the meeting, a second date will be issued. At least 30 days must be allowed between the two dates.

Shareholder control and guarantees

Companies that issue shares and bonds are virtually controlled by their shareholders, who have absolute power to control and choose the board of directors of the company. As stated in The Commercial Code of Iran, in order to form a corporation, all capital in cash must be paid and all contributions other than cash must be delivered and valued. The profits of the company would be shared among partners in proportion to their contribution. One of the most important rights of shareholders is the right to appoint one individual as director by voting. In a corporation, each partner has a number of votes in proportion to the amount of his contribution to the capital and in like manner profits and losses are divided.

To protect shareholders rights and benefits, none of the shareholders or directors can start a similar business for himself or third party, or join another firm which is engaged in a similar business as a major shareholder.

A record of the names, addresses, and the number of shares held by shareholders present in such a meeting, is kept. This record after being certified by the board is kept at head office and may be consulted by any one authorized and wishing to do so. If the board of directors decides to convert its bearer shares into registered shares, it must publish a notice to that effect and grant shareholders a respite of at least six months in which to change their shares for new ones.

Management

Decision making in Iranian companies is top-down. The board of shareholders makes the crucial decisions. Decisions must be made in general meetings of shareholders by voting. A decision is valid if the shareholders who are present own more than half of the shares. A majority, representing at least half of the company s capital, must pass a resolution concerning the company. If at the first meeting a majority has not been obtained, all partners must be called to a new meeting. In this case, a numerical majority can pass resolutions even if this majority does not represent one half of the company s capital.

There are two kinds of decisions: strategic decisions and operational decisions. The first are usually made by the board of directors and/or vice-presidents. These may require the shareholder assembly s approval. For example, opening branches, research and development, increasing or decreasing capital, among others could be considered strategic decisions.

Operational decisions are made at the lower levels. Managers and/or supervisors can make such decisions requiring the above echelons‘ approval according to the arrangements within the company.

Monitoring and disclosure

Owners of a corporation establish business in order to increase their wealth. But not all capital owners make effective managers. Hence, they hire managers to attain for them their goal of increasing their wealth. Managers share the same objective_that of increasing their wealth. Increasing company market share and choosing a reward system for managers are directly related to corporate profits and, the price of stock. Managers are also interested in independent monitoring for the following reasons:

- Some agreements such as Articles-of-Association in large companies would limit the power and activities of the managers;
- Publication of reports from independent monitors/ auditors and legal inspectors and approval of financial reports would showcase the creativity of managers;
- When a dispute arises between owners and managers, independent monitors/ auditors and legal inspectors are there to provide evidence to defend themselves and managers;
- Managers compete with the board of directors of the corporation and with rivals in the market.

There are two different groups who benefit from company disclosure. The first group consists of shareholders; the second group consists of institutions or individuals who extend loan to a company. All concerned have access to financial and other reports needed for decision-making. This information enables them to stipulate their terms of reference. Management has the right to choose an accounting system. But by choosing an appropriate accounting system, managers can reduce the loan agreement limitations and penalties on late payments. Thus, adopting the right accounting system acquires importance since such accounts information will be used for the loan agreement.

The Commercial Code of Iran states that, every limited partner has the right to supervise the firm s business and can also review the account books and legal documents and prepare a statement of position for his own use. This person cannot transfer all or part of his ownership to a third party without the consent of other partners. When he does, the said party has no right to supervise and interfere in the firm s business [codes 147, 148 and 149]. A limited partner who is liable toward third parties, shares the liabilities that the firm has undertaken prior to registration, unless he can establish that the third parties were aware that he was only a limited partner [code 150].

There are two kinds of creditors for corporations—banks and non-bank institutions. Owners, by choosing managers, have control over corporations. But creditors do not have this kind of control. Thus, before extending loans to corporations, creditors demand an examination of their accounting books to assess their capacity to pay the loan. External creditors have the ability to add or remove conditions or limitations in the loan agreements.

Transparent and accountable use of corporate resources

In the Islamic Republic of Iran, the law requires that all registered companies keep at least four books. Transactions must be registered in these books according to the standards set by the legal bodies such as the Ministry of Economy and Finance. These books are used by internal and external independent auditors to be presented to all beneficiaries concerned such as shareholders or stakeholders in general, who may need information for decision-making. Although these books are means to establish accountability of the companies, they are mainly used to check proper financial conduct. To be registered and legally recognized, companies must obtain their legal books from the company registration department, the first page of which is signed and sealed. The books are: journal, ledger, inventory, and copy book.

- *Journal*: in this book, companies are required to enter the daily credits, debits, commercial transactions and commercial bills.
- *Ledger:* it is mandatory for companies to enter, at least once a week, an abstract of all operations extracted from the Journal Book.
- *Inventory:* companies are required to enter and sign annually by 15th Farvardin a complete and detailed statement of all moveable and immovable properties, assets and liabilities for the past year.
- *Copy book:*companies are required to copy in chronological order all letters, telegrams, abstracts of account and invoices sent by the company under its proper date.

There are four groups who control the books. After reviewing these books, independent auditors send a report to shareholders and stockholders. In this report, independent auditors are required to give an explanation of the financial activities of the company in the last year as well as how well the firm has observed the rules and regulations. They must notify the shareholders if the company made profit or not. If not, they should state the reasons. Internal auditors also submit a report to the board of directors. The report deals with the general position of the company. It comes in the form of balance sheets and other financial statements. In order to make decisions, directors need this report. Another group which reviews the books is the Financial Tribunal. It controls the independent auditors and internal auditors. If there are any problems or intentional mistakes, it could send the guilty person(s) to court. The Financial Tribunal or General Auditing Office is actively involved, particularly if government is one of the shareholders. For purposes of transparency and accountability, listed companies, are required to publish their approved financial reports in the Official Gazette and well-known dailies.

Stockholders relations

A stockholder or merchant is a person who is ordinarily engaged in commercial transactions. Stockholders have value for company and corporation. In the company s Article-of-Memorandum mention must expressly be made of the value of non-cash contributions. The relationship of stockholders is governed by the Articles-of-Association. Each stockholder can monitor and supervise the firm s activities and business. He/she may also examine the books and documents.

In cooperatives, all shareholders must accept directors' positions and responsibilities. All the shareholders enjoy the same voting rights regardless of their number of shares.

Dissolution

In case of dissolution of a general partnership, all firm liabilities must be paid out by the firm s assets. If the firm s assets are not sufficient to meet the liabilities, then, the creditors have the right to claim from all partners. The bankruptcy of the corporation does not mean the bankruptcy of shareholders. Also, the bankruptcy of one or more shareholders does not mean the bankruptcy of the corporation.

The proceedings for annulment of the company or its deeds and contracts cannot be heard by the court, if, before lodging of the petition, the cause for invalidation has ceased to exist. After the expiration of one year from the date when the invalidation ceased to exist, should any third party claim damage by reason of invalidation, the court will not admit such claim. To prevent the nullity, a special general meeting is called and the partners (shareholders) are notified of the meeting in accordance with the Article-of-Association. The court from the date of notification will not entertain nullity proceedings, unless the meeting has failed to remove the nullity. If the court declares the company to be invalid the partners responsible for the nullity as well as the board of directors and managers who were in charge and who neglected their duty at the time of the nullity or immediately afterwards, are jointly and severally responsible toward the partners and third parties for damages resulting from the invalidation. The right to prosecute is barred after ten years from the date when the cause of nullity arose; the court will no longer admit such action.

Dividends cannot be reclaimed from shareholders unless the distribution was made without the preparation of a statement of accounts, or contrary to the results shown by such a statement. In such cases, claims for refund can be made within five years only. The period of limitation runs from the date of distribution of such dividends. Whoever issues shares or bonds of a company may be called swindler and is liable to a fine of 500 to 10,000 rials besides having to pay damages to the company or to individuals. According to the Commercial Code of Iran, a swindler is:

- Any person who, with intent to defraud, either claims that shares have been subscribed for, or that the price of shares has been paid or who fraudulently advertise to that effect, or makes fraudulent statements with the object of inducing others to take shares or pay for shares, whether such acts have been effective or not.
- Any person who, with a view to obtaining payment or subscription for shares falsely and fraudulently represents others as connected with a company.
- Any director who, without any statements of accounts, or on the authority of a fraudulent statement, distributes fictitious profits to shareholders.

Non-registered shares are issued in the form of shares payable to bearer. Their holder shall be recognized as the owner unless the contrary is established in accordance with the provision of the law.

As long as a joint stock company has not been formed, cannot be issued. Any shares delivered to a person before the formation of the company shall be null and void, and those who issued it shall be held jointly and severally responsible for any damage incurred by the holders of such stock.

Code 152 states that if the firm dissolved otherwise than bankruptcy, and if the limited partner has not paid the whole or part of his capital, or has withdrawn it after payment, the firm s creditor can sue the limited partner directly, and claim the amount of his capital which was not paid or was withdrawn.

When a company files for bankruptcy, the liquidator should provide the official receiver with a list of its creditors. The official receiver shall authorize the payment of such creditors out of the first money received. If such privilege is contested, the matter shall be referred to the court for settlement. The liquidator may at any time, with authority of the official receiver, redeem the security for the benefit of the bankrupt party, by paying the amount due to the secured creditor. If the pledge has not been redeemed, the liquidator must sell his property under the supervision of the public prosecutor. If after deduction of expenses, the proceeds of sale are more than the debt, the balance shall be paid to the liquidator. If the proceeds of sale are less than the debt, the creditor shall have priority for payment of the balance.

State-owned enterprises

State-owned enterprises which have not been privatized are subject to the following requirements:

- The management of state-owned enterprises should be independent of the policy making function of the concerned ministry. However, the concerned ministry exercises authoritative functions over the state-owned enterprises.
- To ensure diversity of members representing the shareholders, government shareholding representation at the general shareholders meetings of state-owned enterprises is to be entrusted to the Minister-in-Charge, Minister of Economic Affairs and Finance, Head of the Plan and Budget Organization, and two or more ministers selected by the Cabinet, or their representatives (Embassy, 2002).

The Tehran Stock Exchange

The idea of having a well-organized stock market dates back to 1930s. The Bank Melli Iran conducted the initial study, and completed the report six years later in 1936, working out details of the foundation of the Tehran Stock Exchange (TSE) World War II delayed the process for thirty-two years and it was not until April 1968 that the TSE was finally established. In the beginning only government bonds and certain state-backed certificates were traded in the market. But the 1970s saw an increasing demand for capital which in turn caused an increase in demand for stocks.

Economic reforms following the Islamic Revolution expanded public sector control over the economy and reduced the need for private capital. At the same time the elimination of interest-bearing bonds concluded their presence in the stock market. As a result of these events, the stock exchange underwent a period of standstill. TSE was revived in 1989 with the revitalization of the private sector through privatization of state-owned enterprises and promotion of private sector economic activity based on the First Five-Year Development Plan of the country.

The TSE Council is the highest authority in the stock exchange. State officials as well as private sector representatives and specialists are members of the Council. Other constituent organs of TSE are the Acceptance Committee, Arbitration Board and Brokers Organization. The board of directors of the Brokers Organization is the highest policy making authority in TSE and appoints the secretary general as the chief executive officer for a period of two years. TSE is a full member of Federation of Euro-Asian Stock Exchanges (FEAS).

The TSE has an important role in the foreign currency market. As the rial becomes more overvalued at the official rate, the problem of converting rial into foreign exchange becomes more severe. Under this condition, exporters are discouraged from surrendering their export proceeds while government is forced to subsidize those importers who manage to avail of foreign currency at the official rate. To address these problems, the Central Bank of Iran resorted to auctioning some of the foreign exchange turned over to the government by exporters as well as from the government s own oil export proceeds. The auction was done through the Tehran Stock Exchange. Most importers were obliged to source their foreign exchange at the stock exchange. Only a few categories of essential imports were allowed to source their foreign exchange needs from the Central Bank at the much cheaper official rate. Prior to 1997 foreign exchange at the official rate was available to all imports of state-owned enterprises. By 2000 foreign exchange needed for most imports of state-owned enterprises was sourced by auction at the Tehran Stock Exchange. Some capital goods for public infrastructure projects, however, are still imported at the official rate. The unification of the foreign exchange is expected to diminish this allocation system wherein the TSE has played a major role (World Bank, 2001).

In the past few years the number of listed companies has increased rapidly. There are now 290 companies listed in the TSE.

RESEARCH FRAMEWORK

This research singled out the general constituent components of governance: namely, *corporate structure, institutional interface, public responsibilities,* and, *ethics and values* as the independent variables affecting corporate performance.

Productivity is taken to represent *performance* and this dependent variable is used to help show how the foregoing variables affect it. The most important determinants were singled out_individually considered_to show more clearly the influence of each on productivity.

Data for this research were derived from the results of a survey questionnaire administered to sample firms. The survey instrument was the outcome of the workshop on the impact of governance on productivity organized by the Development Academy of the Philippines under the auspices of the APO in Cebu City, Philippines in November 2001. Most of the 20 sample firms came from different industries. Since this was a convenience sampling and the questionnaire could only be completed by the few experts who had no choice but to depend on the data to which they had free access, the analysis may have produced biased conclusions, which might not be easily generalized.

The survey questionnaire was translated into the Persian language and was administered to 20 Iranian firms. Of the twenty firms, one is non-listed and two are listed government corporations, three are private listed and four are private non-listed, and finally five are special ownership firms. Sixteen of the firms are in manufacturing, two are engaged in water and gas services and two are dedicated to educational services.

The dependent variable in this research is productivity, the indicators of which are sales growth, net profit, debt to equity ratio, labor output to wages or number of employees, and TFP (total output to total input).

However, the study extensively used the Malmquist index, which focuses mainly on value added and covers almost all those indicators. The index can provide an easier yet more comprehensive way of covering productivity.

Many recent studies have used data envelopment analysis (DEA) methods to calculate Malmquist indices of total factor productivity (TFP) growth. These methods have two principal advantages over the familiar methods (Coelli, 1996): (a) the measures of TFP change can be decomposed into technical change and technological change components, and (b) no price information is essential.

Fare, Grosskopf, Norris and Zhang (1994) show how one could apply DEA to construct non-parametric production frontiers and then calculate the Malmquist index, which could also be decomposed into managerial, scale and technological components.

The Fare *et al.* (1994) DEA methods have become widely used in recent years. The survey article by Fare, Grosskopf and Russell (1998) makes note of 67 applications of Malmquist DEA methods in 1990s. TFP tops them.

The Malmquist index is defined using distance functions. Distance functions allow one to describe a multi-input, multi-output production technology without the need to specify a behavioral objective, and then calculate total productivity decomposed into three components.

This paper uses this method to calculate productivity which is the dependent variable. Ownership, management, social responsibility, and institutional interface are regarded as the independent variables.

DATA ANALYSIS

Overall productivity level

Using the Malmquist index to measure the level of the sample firms, this paper discovered a slight fall in the level of productivity of the sampled Iranian firms during the period of this research (Table 1). The mean Malmquist index for that period was 0.93.

As regards the impact of technology, management, and scale economy, technology

Table 1. Descriptive statistics of productivity

	N	Minimum	Maximum	Mean	Std. Deviation
ME; Total	20	.54	1.17	.9315	.1729
MME; Management	20	.64	1.20	.9820	.1414
MEE; Scale Economy	20	.81	1.22	.9855	.1114
MTE; Technology	20	.68	1.15	.9700	.1295
Valid N (listwise)	20				

seemed to have affected productivity most severely of the three factors; the other two had lesser effect.

However, in 35 percent of the sample firms, the productivity level was positive but the remaining 65 percent suffered from negative productivity (Figure 2).

Moreover, the two-tailed Pearson correlation between productivity and the general characteristics of the firms displayed little association among age, size, number of labor hours worked and the like.

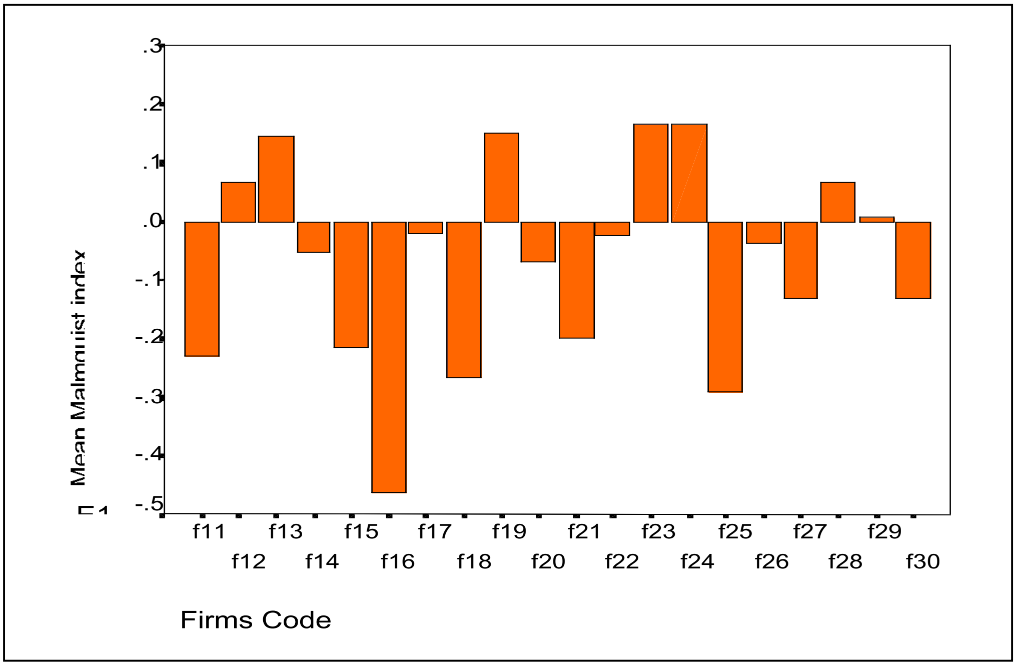


Figure 2: Overall productivity of sampled firms

However, positive and relatively significant correlation was established between exports and productivity. That is, exports made firms productive (Table 2).

Table 2: Correlations between productivity and firm characteristics

Malmquist index	Pearson correlation Sig. (2-tailed) N	1.00 .742 20
Age	Pearson correlation Sig. (2-tailed) N	.077 .746 20
Number of employees	Pearson correlation Sig. (2-tailed) N	-.361 .118 20
Wage bill	Pearson correlation Sig. (2-tailed) N	.028 .916 17
Number of hours worked	Pearson correlation Sig. (2-tailed) N	-.348 .157 18
Export	Pearson correlation Sig. (2-tailed) N	.762 0 20

Ownership and productivity

The analysis indicates that non-PLC private enterprises were the most productive and PLC enterprises were the second most productive. Special ownership firms, PLC government, and government corporations were the 3rd, 4th, and 5th in row (Figure 3).

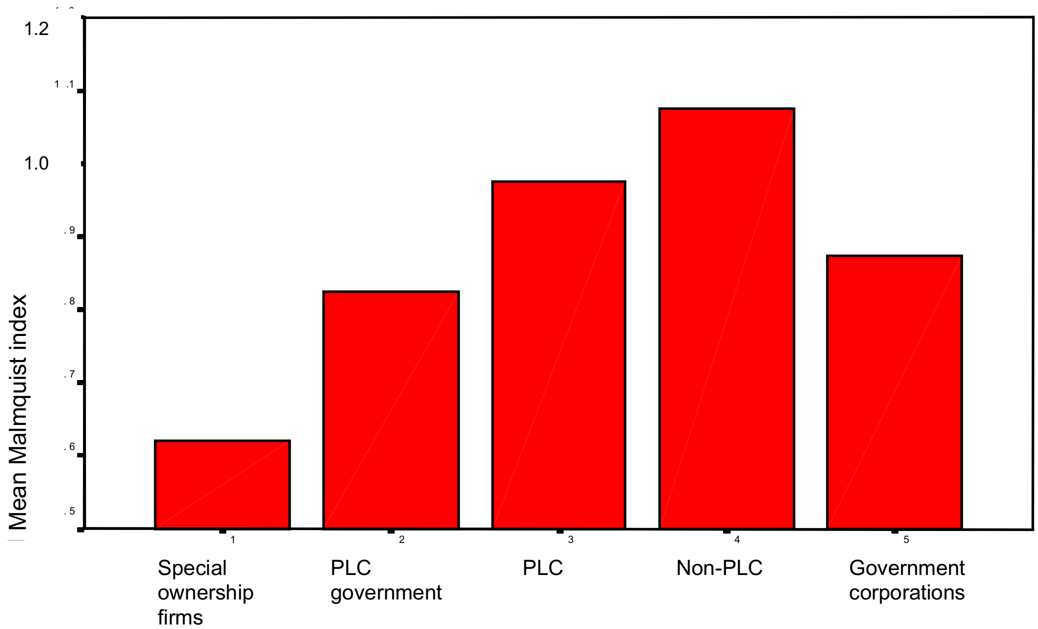


Figure 3. Ownership vs. productivity

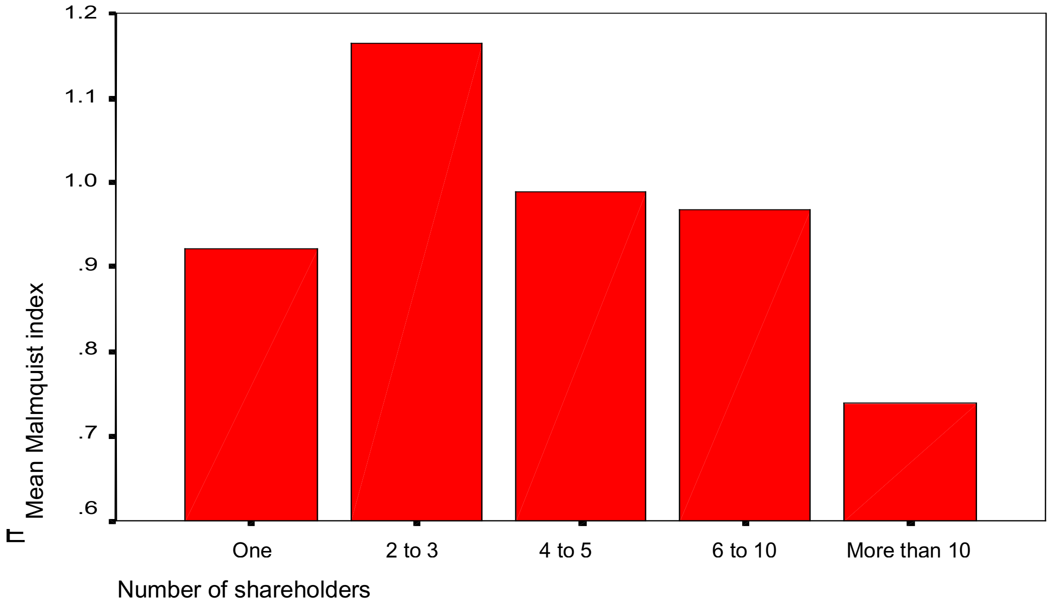


Figure 4. Number of shareholders vs. productivity

Major shareholders made a difference. Where two or three shareholders had most of the stocks productivity was the highest. Four to five major shareholders made their firms less productive than the firms whose stocks were held by two to three shareholders. The firms whose stocks were held by ten and more shareholders were the least productive (see Figure 4).

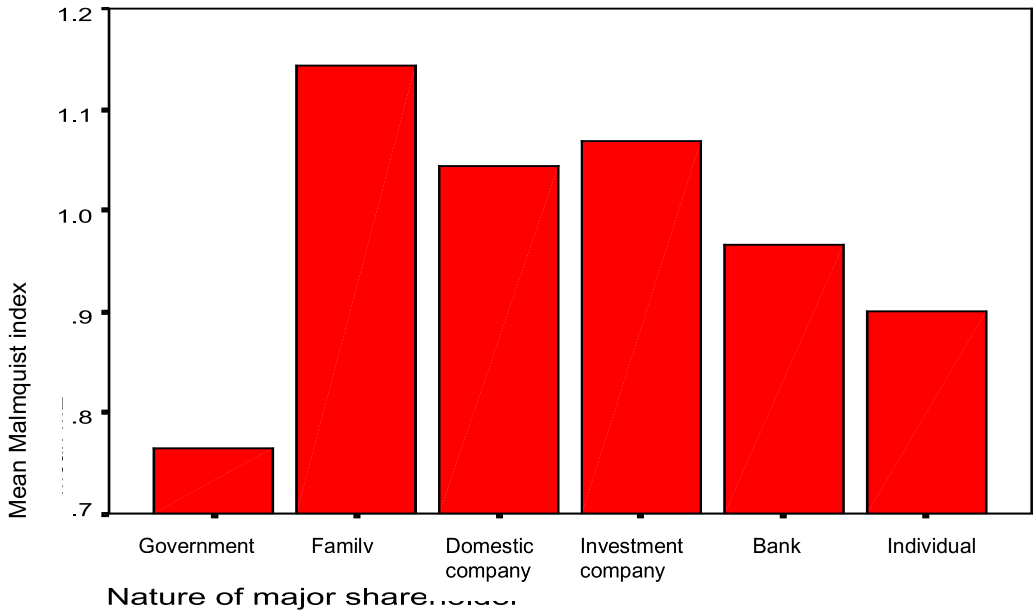


Figure 5. Type of major shareholders vs. productivity

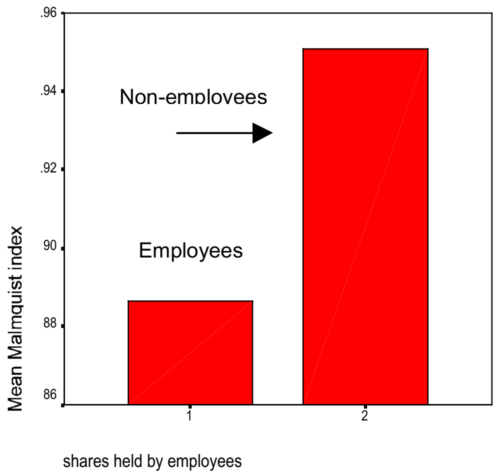


Figure 6. Shares held by employees vs. productivity

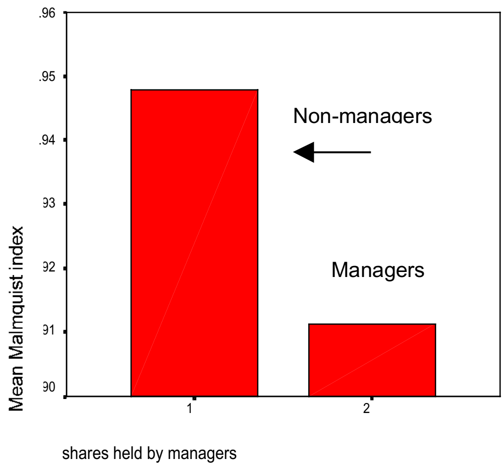


Figure 7. Shares held by managers vs. productivity

The shareholders status shows that if all stocks belonged to just one family, productivity would surge, and the firms whose stocks belonged mostly to insurance and social security organizations were the next in row as to their productivity level. The firms wholly or partly owned by government linger behind (Figure 5).

Although the descriptive analysis of the data indicates that allowing employees and managers to hold stocks in the firm can make them more productive than if it were not the case, the statistical analysis (Figure 6 and Figure 7) does not indicate any significant difference between the two cases (see also Tables 3a and 3b). But it is believed that a larger sample may support or otherwise negate the relatively impressionistic descriptive data analysis.

A positive relationship also exists between the power to make major decisions and productivity. Where there was one shareholder who had the majority decision over strategic issues, productivity was highest. The analysis found that the major shareholding families and investment companies made their companies more productive.

Table 3a. ANOVA: productivity differences in firms with and without employee stocks

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	1.746E-02	1	1.746E-02	.571	.460
Within groups	.551	18	3.060E-02		
Total	.568	19			

Table 3b. ANOVA: productivity differences in firms with and without managers stocks

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	6.623E-02	1	6.623E-03	.212	.651
Within groups	.562	18	3.121E-02		
Total	.568	19			

Management and productivity

The second group of questions considered the different aspects of management and their impact on the firm s productivity. In-depth review of the answers concerning the major stakeholders decision making, span of power and authority indicated that significant strategically consequential decision making was kept exclusive for owners and major stockholders. The board and CEO could make operational decisions regarding productivity, customer satisfaction and quality of the goods and services produced. The owner and major shareholders scarcely concerned themselves with these aspects (Table 4).

Despite this, however, the owners and principal stockholders, the board, CEO, and COO were held responsible for the firm s general and financial performance and ownership structure.

Table 4. Responsibilities for productivity-related decisions
(percent of responding firms)

Type of decision	**Owner(s)/ major shareholders**	**Board**	**Chief Executive Officer**	**Chief Operating Officer**
Corporate thrusts and direction	65.00	55.00		
Corporate and financial strategic options	50.00	35.00		
Sanctions and rewards for management performance	65.00	30.00		
Management appointments and executive compensation	75.00	35.00		
Board composition and membership	100.00			
Day-to-day operations	25.00	15.00	60.00	30.00
Declaration of dividends	70.00	20.00		
Profit or gain sharing	80.00	10.00		
Business expansion/contraction	5.00	45.00	10.00	
Mergers and acquisitions				
Productivity improvement measures	15.00	40.00	75.00	10.00
Customer satisfaction/ quality issues	15.00	15.00	75.00	20.00

Firms which did not use different account books were more productive than those who did although those who used at least two books claimed one of their books had to be submitted to and kept by the Ministry of Economics and Finance. The difference in productivity between the two groups is significant at 91 percent (Table 5 and Figure 9).

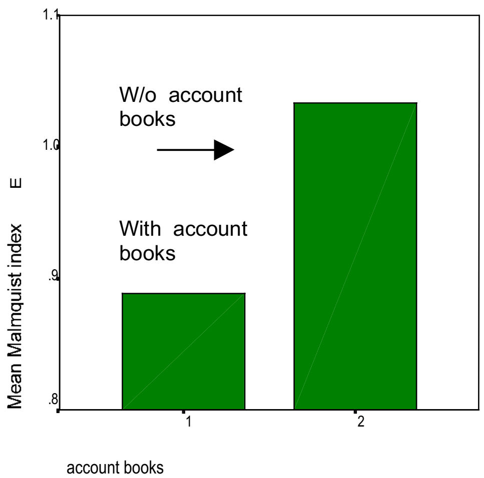


Figure 9. Account books vs. productivity

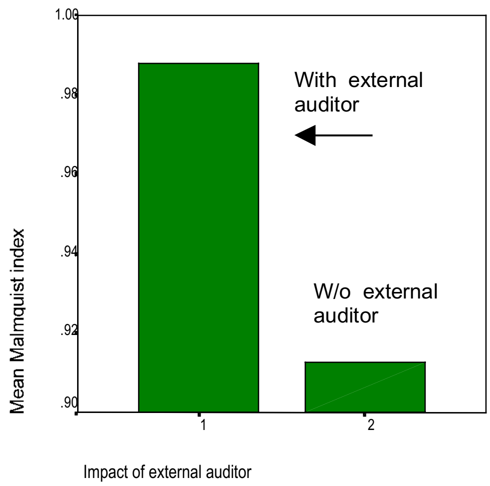


Figure 10. External auditors vs. productivity

Table 5. ANOVA: productivity differences in firms with and without account books

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	8.845E-02	1	8.845E-02	3.318	.085
Within groups	.480	18	2.666E-02		
Total	.568	19			

Table 6. ANOVA: productivity differences in firms with and without external auditors

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	2.123E-02	1	2.123E-02	.895	.001
Within groups	.547	18	3.039E-02		
Total	.568	19			

The analysis shows a positive correlation between productivity and the use of external independent auditors. Firms which had confidence in the ability of their auditors and as such retained them for long periods were more productive than the others. This variable is the most important factor influencing auditing characteristics (Figure 10 and Table 6).

No positive correlation was found between the manager s observation of code of ethics and productivity. The explanations for this observation may be that (i) there are no specifically defined codes of ethics (written circulars to be followed by the managers); and (ii) it is not easy to establish any relationship between something abstract (ethics) and something concrete (productivity). And that it is the government corporations which are mainly expected to observe these codes (Figure 11 and Table 7).

Figure 11. Code of ethics' observance vs. productivity

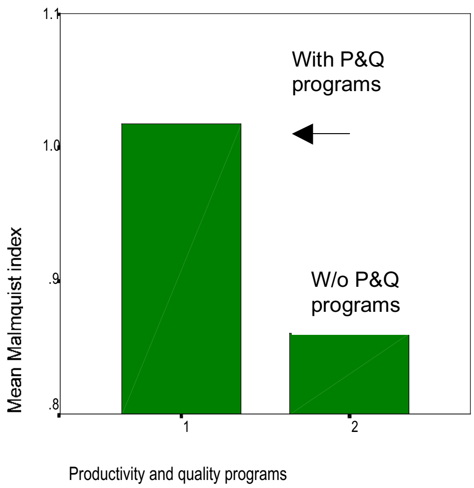


Figure 12. Quality programs vs. productivity

As to allegations made against the firms, failure to enter or delcare proper income or revenue appeared to be the most significant. Failure to observe the labor Law, as well as the Company Law, was the main reason for complaints against firms. Complaints against companies failure to observe intellectual property rights were negligible.

Table 7. ANOVA: productivity differences in firms with and without code of ethics

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	1.329E-02	1	1.329E-02	.980	.002
Within groups	.555	18	3.084E-02		
Total	.568	19			

Table 8. ANOVA: productivity differences in firms with and without P & Q programs

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	.121	1	.121	4.874	.040
Within groups	.447	18	2.485E-02		
Total	.568	19			

Company-wide quality and productivity improvement programs correlate positively with productivity; firms implementing these programs were more productive than firms which did not have such programs. Quality circles (QC) and suggestion systems were singled out as the most valued components of their programs (Figure 12 and Table 8).

Incidentally, quality standards are set by the Institute of Standards and Industrial Research of Iran (ISIRI). Around 5,000 national standards covering exports, imports and domestic production have been established. These benchmarks are based on international standards, or if there are none, on standards adopted by the largest producers of the relevant products, taking into consideration consumer tastes (World Bank, 2001).

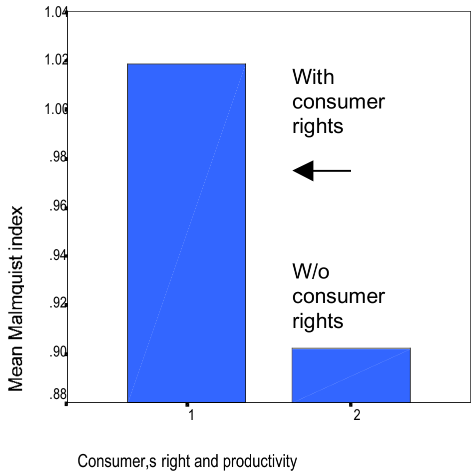


Figure 13. Consumer rights vs. productivity

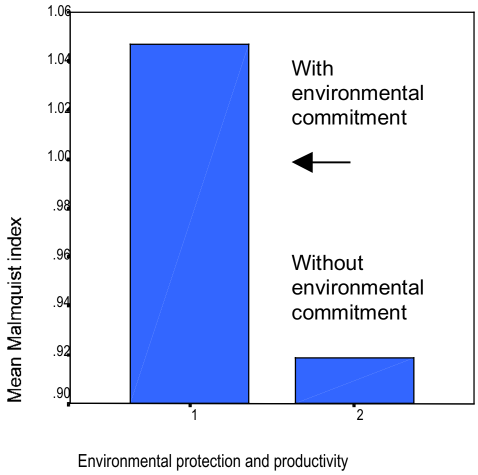
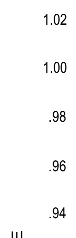


Figure 14. Environmental protection vs. productivity



Social responsibility and productivity

The sample firms responses indicated they do follow rules and regulations concerning consumers rights. However, firms which actively complied with the rules were more productive than the firms which barely complied (Figure 13 and Table 9).

Table 9. ANOVA: productivity differences in firms observing and not observing consumer rights

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	5.101E-02	1	5.101E-02	1.775	.199
Within groups	.517	18	2.874E-02		
Total	.568	19			

Table 10. ANOVA: productivity differences in firms committed and not committed to environmental protection

Mean Malmquist index

	Sum of squares	df	Mean square	F	Significance
Between groups	2.957E-02	1	2.957E-02	.988	.053
Within groups	.539	18	2.993E-02		
Total	.568	19			

As to the relationship between environmental protection and productivity, it was found out that environment-conscious firms were more productive than those who were not. Almost none of the firms surveyed had obtained ISO 14000 certificate (Figure 14 and Table 10). In contrast, more than 400 Iranian companies obtained ISO 9000 and 14000 series certificates. The reason for this is that many companies tend to follow the standards being followed by overseas ventures.

The survey indicated that only a small number of firms established systems for receiving consumer complaints, and the few that did, had no defined mechanisms to process them. There was no meaningful difference in productivity between those that had complaints receiving systems and those that did not have such systems.

Only government organizations showed some degree of willingness to shoulder social responsibilities and even then, only in rare cases. Other organizations fulfilled their social responsibilities only when they had to. Such attitude or behavior had no impact on productivity.

In the main, what these firms offered to their community was establishing day care centers. In addition, government organizations offered a few scholarship grants.

Interface with external stakeholders and productivity

The survey revealed average to relatively weak relationship between productivity and the external regulatory bodies. Most of the firms complained about banks and customs services. Firms that related better with external stakeholders, seemed to be slightly more productive than the firms which related badly with such stakeholders (Table11). Firms with higher productivity seemed to regard the general services of some external stakeholders (in this case, central government) rather satisfactorily (Table12).

Table 11. Descriptive statistics: external stakeholders and productivity

	N	Minimum	Maximum	Mean	Standard deviation
Central government	20	3.00	6.00	4.85	0.9881
Parliament	20	2.00	6.00	4.00	1.3377
Central bank	20	2.00	6.00	3.85	1.1821
Customs	20	2.00	6.00	4.25	1.0699
Judiciary	20	2.00	6.00	4.55	1.1459
Police	20	2.00	5.00	3.15	1.0894
Internal revenue service	20	1.00	4.00	2.80	0.8944
Valid N (listwise)	20				

Table 12. Correlation between central government and productivity

			Malmquist index	Central gov tt
Spearman s rho	Malmquist index	Correlation coefficient	1.000	-.380
		Sig. (2-tailed)	-	.005
		N	20	20
	Central gov t	Correlation coefficient	-.380	1.000
		Sig. (2-tailed)	.005	-
		N	20	20

The firms evaluation of the efficiency of deliverance of external services hover from fair to weak. However, firms with the higher degree of productivity tended to regard such external services (say, education/schooling) more favorably (Table 13 and Table 14).

Table 13. Descriptive statistics: delivery of services and productivity

	N	Minimum	Maximum	Mean	Standard deviation
Education/schooling	20	3.00	6.00	4.55	0.8870
Roads	20	3.00	6.00	4.05	0.7592
Ports	20	3.00	6.00	4.80	0.8944
Telecommunication	20	1.00	6.00	2.75	1.4096
Electricity/power	20	1.00	5.00	2.85	0.8751
Water	20	2.00	5.00	3.50	0.6882
Valid N (listwise)	20				

Table 14. Correlation between education and productivity

			Malmquist index	Education
Spearman s rho	Malmquist index	Correlation coefficient	1.000	-.580
		Sig. (2-tailed)	-	.008
		N	20	20
	Education	Correlation coefficient	-.580	1.000
		Sig. (2-tailed)	.008	-
		N	20	20

CONCLUSION

Because the variables are nominal or ordinal, they have been subjected to discriminant analysis, which leads to these conclusions:

- Ownership has a considerable impact on productivity and private ownership can improve productivity the most;
- The more the owners and major shareholders wield power over strategic decisions, the better the chances of improvement in firm performance;
- If firms have clear-cut and transparent policies in protecting or observing consumer rights, they stand better chances to attain higher productivity.
- Firms enjoying better relationship with external stakeholders are more likely to experience higher productivity.

This study offers no conclusive finding that good corporate governance is essential for rapid growth and productivity or that it is simply correlated with other variables that are harder to measure, such as an efficient institutional environment. The determination is only partial. But common sense also suggests that each piece of a corporate reform package enhances all other pieces: dispersed ownership is unlikely to hinder firm productivity if discipline and transparency are voluntarily practiced. Opportunities for improved efficiency cannot be readily exploited if the regulatory environment is not responsive to corporate needs. Similarly, no modern corporation can function efficiently without an efficient financial sector and a secure legal framework. Iranian firms should lead in the design and implementation of voluntary corporate governance standards along these lines.

REFERENCES

Casio,W. (1999). Institutionalized Action and Corporate Governance: The Reliance on Rules of CEO Succession. *Administrative Science Quarterly*, 44, 384-416.

Chandler, A.D. (1966). *Strategy and Structure*. New York: Double Day & Co., Inc.

Coeli, T. J. (1996). A Guide To DEAP Version 2.1, A Data Envelopment Analysis (computer) Program. CEPA Working Paper. Department of Econometrics, University of New England, Armidal, Australia.

Coli, Tim, Prasads & Battese (1998). An Introduction to Efficiency and Productivity Analysist, Department of Economics, University of Surrey Working Paper.

Conyon, M., P. Gregg. & S. Machin (1995). Taking Care of Business: Executive Compensation in the UK, *Economic Journal*, 105,704-714.

Economic Review (2003), Iran Heads for 5 Percent GDP Growth in 2003 April 21.

Embassy of the Islamic Republic of Iran in Ottawa (2002). Primer on Reorganization of the State-Owned Enterprises, www. Salam Iran- Economy.html

Fare, R., S. Grosskopf, M. Norris, and Z. Zhang (1994). Productivity Growth, Technical Progress and Efficiency Change in Industrial Countries, *American Economic Review*, 84.

Franks, J., C. Mayer and L. Reunboog (1995). The Role of Large Share Stakes in Poorly Performing Companies. Mimeo.

Heinrich, C.J. & L.E. Lynn, Jr.. (2001). Means and Ends: A Comparative Study of Empirical Methods for Investigating Governance and Performance. *Journal of Public Administration and Theory*.11 (1): January, 109-38.

Johnson, R. A. and D.W. Greening (1999). The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance. *Academy of*

Management Journal. 42(5): 564-576.
Mayer, C. (1996). Corporate Governance, Competition and Performance. Paris: OECD, Working Paper No.164.
McConnell, J. and H. Servaes (1990). Additional on Equity Ownership and Corporate Value, *Journal of Financial Economics*.27:595-612.
McRitchie, J. (1996). Ending the Wall Street Walk, Why Corporate Governance Now? A Commentary.
Morck, R., A. Shleifer and R. Vishny (1988). Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics*, 20, 203-315.
World Bank (1992). *Governance and Development*. Washington, D.C: World Bank.
World Bank (2001a). The Islamic Republic of Iran. Document.
World Bank (2001). Trade And Foreign Exchange Polices In Iran: Reform Agenda, Economic Implications and Impact On The Poor. Report No. 22953-IRN. Social and Economic Development Group, Middle East and North Africa Region. November 1.

IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY: THE CASE OF JAPAN

Prof. Junichi Mizuo[1]
Surugadai University
Japan

INTRODUCTION

The "borderless nature" of today's international corporate environment also means the growing importance of a perspective that views corporate activities on the basis of global standards. No longer can one solely concentrate on the mutual interests of shareholders and management alone. Instead, of grave importance to corporate strategy is the establishment of good relations between a variety of stakeholders, both within and outside of the firm. This study specifically focuses on the question of corporate governance, namely, "What should a company do, and for whom?"

Recently, in terms of a company s relationship with its investors, new reform measures have been introduced in Japan. They include more diffused and democratic general shareholder meetings, the elimination of collusive discussions, and attempts to give new life to what have become mere empty hulls of boards of directors. Companies such as Sony, Toshiba, and Shiseido have especially taken the lead in slimming down the decision-making processes at top levels. These efforts have included the introduction of outside directors, and the establishment of distinct differences between directors and company officers who are actually involved in day-to-day company business.

In 2001, the Asian Productivity Organization (APO) initiated a cross-country survey on corporate governance to help its member countries, including Japan, understand how governance issues impact on productivity and growth, and develop policies, strategies, and approaches that can address these issues. This paper is the outcome of the APO research. It seeks, on the basis of primary data, to construct the relationship between corporate governance (including ownership, management, social responsibility, institutional interface) and productivity. The study looks at corporate governance issues that affect growth and productivity performance of sample firms in the context of the current stage of development of the Japanese economy. The corporate governance standards that are used in this study are grouped into four categories: ownership, efficiency of the company, management legality, and corporate ethics.

OVERVIEW OF THE JAPANESE CORPORATE SECTOR

Before the war, Japanese industries were dominated by *zaibatsu* companies held by a limited number of wealthy families. After the war, those family shares were taken away and distributed among the general public. *Zaibatsu*s were broken up into hundreds of small companies. Although the former *zaibatsu*-affiliated companies later formed

[1] The national co-expert for this research is Takaya Seki, Head of Research, Japan Investor Relations and Investor Support Inc. The members of the research team are Kenji Okabe, Associate Professor of Surugadai University, Koji Kudo, Associate Professor of Chiba University of Commerce, Toru Nozaki, Chief Assessor of Japan Quality Award Committee. Assistant members are Tetsutoki Shiozawa, Researcher of Surugadai University and Chizuko Ueda of Rikkyo Graduate School.

industrial groups bearing the same names, they are not bound by any single stockholding company which used to control the group companies, and their ownership distribution is widely diversified.

There are some signs of changes recently. Today s Japanese companies are characterized by seniority and lifetime employment, company-based labor unions, and management consisting almost entirely of insiders.

These features are crucial to Japanese corporate governance. Companies have long adopted a pyramid-like hierarchy, with the company president (*shacho*) at the helm. Since the Japanese Commercial Code requires directors to take charge of execution of business as well as overseeing other directors, a typical board of directors consists of both officers in charge of particular units of corporate divisions and those who are not. Japanese boards are often oversized. Important decisions are made by a limited number of managing directors, who collectively form a *Jomu-kai* or a *Keiei-iinnkai* (managing directors committee). Power is concentrated in the *shacho*, who also assumes the role of representative director. The *shacho* calls the shots on strategy, budget and nomination of other board members and officers.

It is also uncommon for anyone working in a large Japanese company to change jobs from one company to another. The absence of an effective labor market also makes it difficult to find another job. Under these circumstances, a typical board of directors consists entirely of internally trained employees. This situation also provides a rational goal for the employee to commit his/her entire life to a single company. But this has also resulted in the company entrenching itself within its own structure, and putting its own interest ahead of its responsibility and accountability to other stakeholders, including shareholders.

Role of the corporate sector in the economy

When the Japanese securities market reopened after the war in 1949, individual investors held more than 60 percent of all shares listed on stock exchanges. But as the stock market developed its size, capitalization and volume of trading, the relative percentage of stocks owned by individuals fell dramatically. Several reasons may be cited: (1) aggressive efforts taken by large-sized companies to engage in cross-shareholding; (2) growth in products such as investment trusts; (3) the ageing of Japanese population and spread of pension schemes; and more recently; and (4) the internationalization of the market and increase of foreign shareholders. The table below indicates how Japanese shares have been distributed across the years (1950-2001) among various kinds of investors.

Table 1. Distribution of Japanese shares among different kinds of investors

Shareholder distribution (%)	**1950**	**1960**	**1970**	**1980**	**1990**	**2000**	**2001**
Government, Local Government	3.1	0.2	0.6	0.4	0.3	0.2	0.2
Banks, Trust Companies	12.6	30.6	15.8	19.9	25.5	27.5	28.5
Life and Casualty Insurance	na	na	13.7	16.1	15.8	10.9	10.2
Other Financial Institutions	11.9	3.7	3.4	3.8	3.4	1.4	1.4
Other Business Corporations	11.0	17.8	23.9	26.2	30.1	21.8	21.8
Foreign Shareholders	0.0	1.3	4.9	5.8	4.7	18.8	18.3
Individual Shareholders	61.3	46.3	37.7	27.9	20.4	19.4	19.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Tokyo Stock Exchange

In Japan, corporate governance is characterized by the existence of corporate shareholders who hold shares in order to maintain stable but exclusive business relationships. The practice is often referred as *keiretsu*. Liberated from hostile shareholders, corporate executives are able to concentrate on business strategies on a long-term basis.

The separation of company ownership and management, discussed in modern capitalist theory, is also apparent in Japan. The break-up of *zaibatsu* groups and the institutionalization of the stock market both contributed to the separation. Dispersion of shares previously held by the *zaibatsu* families helped the number of individual shareholders to grow. But at the same time, companies had to prepare themselves against the threat of unfriendly takeover, particularly by foreigners. In the 1960s companies started to look for stable shareholders and began cross-holding of shares. The move led to the formation of *keiretsu* groups as seen today. These events transformed the shareholding structure of Japanese companies. Banks, life insurance companies and *keiretsu*-affiliated companies became major shareholders, while individuals shares fell to about one-fifth of total shares. Although Japan s Anti-Monopoly Law puts ceilings on how much of a particular company s stock financial institutions are allowed to hold, multiple interlocking relationships enable financial institutions to collectively tighten their grip on the company s major shareholdings.

Shares held by corporate sectors represent so-called cross shareholdings among industrial groups. A typical cross-shareholding follows this pattern: while ABC Corporation holds five percent of ABC Bank shares, ABC Bank holds, say, three percent of ABC Corporation shares.[2] In a narrower sense, cross-shareholdings are confined to the traditional industrial groups such as Mitsubishi, Mitsui and Sumitomo. However, cross-shareholding is also prominent among newer companies seeking relationships with banks. Reciprocal shareholding has been shown to be undesirable because it could not secure a sound equity level for the corporation. Today cross-shareholding is on the decline.

On the bright side, foreign shareholding has increased. Foreign investors are buying Japanese stocks. US and European institutional investors represent a large portion of foreign shareholders who have introduced many new ideas into the Japanese market, including the promotion of an investor relations program. The recent growth in interest in corporate governance by Japanese companies owes much to the influence of foreign shareholders.

Privatization

Government s stake in publicly traded Japanese industries is relatively insignificant as seen in the previous table. Large holdings are noted in NTT, JT, and railway companies. These companies were privatized during the 1980s and the government intends to sell its remaining shares. There are intensive discussions on privatizing or selling government stakes in natural resources, postal services and highways. That should improve the efficiency of government entities in these sectors.

Financial reforms

In post war Japan, banks assumed a major role in the reconstruction of principal industries by contributing long-term finance. The Japanese public was also encouraged,

---

[2] A large portion of stocks held by banks represent cross-shareholdings. The ratio of pension fund and investment trust is on a steady rise recently.

through various measures by the government, to save its earnings. Banks were heavily regulated by government authorities.

Banks gradually lost their influence when manufacturing firms (particularly power and automobile companies) made breakthroughs in the international markets. Those companies, with rich cash accumulated through aggressive expansion, no longer relied on banks for their ongoing operations. The growth of the capital market also contributed further to the erosion of bank influence. However, the most devastating factor which hit banks was the accumulation of bad loans after the collapse of the bubble economy and the persistent recession thereafter. Non-performing loans haunt Japanese financial institutions and the government is still struggling to overcome the problem.

As a result, Japanese banks experienced an unprecedented scale of reorganization during the last decade. By 2002, only one out of 19 major banks which existed in 1992 survived the shakeup.[3]

The continuing recession is putting added pressure on companies. Lifetime employment and seniority are facing the most serious threat ever. Employees collectively are losing their bargaining power. Strategic relationships between management and employees are gradually replacing the traditional ones. Dismantling cross-shareholdings and reviewing the current employment system will have a potentially huge impact on Japanese companies. The result will drastically change corporate governance and the firms relationship with stakeholders.

CORPORATE GOVERNANCE IN JAPAN

Corporate governance in Japan is an insider-oriented system (Sheard, undated). Main banks and large parent firms play a major role in this insider-based system. Japanese corporations typically maintain interlocking shareholding relations with key business transaction partners. By building up corporate control coalitions among trusted business partners, Japanese corporations are able to suppress the operation of a competitive takeover market. By holding back the external takeover market, main banks and parent firms are able to perform rescue operations from within, as opposed to putting their fate on external agents through arms-length monitoring.

The main bank is the heart of the system (Kang and Stultz, 1997). A firm s main bank is a large shareholder that provides the firm with loans and diverse financial services. It helps the firm access capital markets by providing financial guarantees and underwriting the firm s securities. It monitors the firm s management and intervenes at times of poor performance.

This system of corporate governance has both strong and weak points, according to Sheard. On a positive note, the Japanese system, by shutting out direct external capital market influences, provides a high degree of managerial stability and autonomy. This facilitates the buildup and maintenance of valuable long-term relationships with employees, suppliers and customers. Moreover, the system helps to economize on various forms of monitoring and intervention costs since shareholders (who are transaction partners) do not have to expend inordinate resources collecting information. The system

[3]Only Sumitomo Trust remains unchanged. Five major financial groups emerged from the reorganization: Mizuho Financial Group (1999), Mitsubishi Tokyo Financial Group (2000), Sumitomo Mitsui Banking Corporation (2000), UFL Group (2000), and Resona Group (2000). Not included in the above five major financial groups are Chuo and Mitsui Trusts which merged in 1998, and three major banks (Long-term Credit Bank, Nippon Credit Bank and Hokkaido Takushoku Bank) which went out of business between 1997 and 1999.

of interlocking shareholdings among firms maintaining continuous business relationships with one another results in a diffuse mutual monitoring system with inherent, though low-key, checks and balances. Furthermore, the system allows certain social costs, such as training costs and unemployment costs, to be internalized by firms.

Kang and Stultz (1997) add that the bank-centered corporate governance system has advantages over the capital market-centered system. In the latter, banks play a role in disciplining management. But the main difference between the two mechanisms of corporate control is that main banks can get a continuous flow of confidential information that allows them to assess the firm s performance better. Information asymmetries play a crucial role in decision-making. In the capital market centered system, outside investors do not have access to information that management has. Investors are forced to assess management based on publicly available information.

On the other hand, Sheard also argues that the system is seen to be inherently non-transparent and discriminatory between insiders and outsiders. It has weak external accountability and, lacking a diverse mix of competing subsystems and mechanisms, it becomes susceptible to system-wide failure such as the bubble . A second weakness is that, while the system served Japan well in the high-growth period—when a clearly defined technology gap existed, when firms faced abundant investment opportunities, when macro and micro economic goals were closely aligned—it does not appear to be as functional when uncertainty is high at both the economy-wide and individual firm level about whether, where, and how to invest. Sheard further notes that the Japanese system tolerates too low a level of corporate restructuring. Because the system is geared to providing a high level of managerial autonomy and suppressing an active takeover market, positive incentives and means to effect restructuring are lacking.

However, Kang and Stultz (1997) have shown in their paper that bank dependence affected firms adversely during the 1990 to 1993 period in Japan when bank balances were weak. This evidence points to an important cost of bank finance, namely that a firm can be constrained in investing in valuable projects because the bank it relies on to provide financing cannot do so and because, as a result of its reliance on banks, it does not have good financing alternatives.

Of late, corporate governance has become the focus of policy debate and public discussion in Japan. The experience of the bubble economy and its aftermath and a series of scandals involving corporations have raised questions about the adequacy of Japan's system of corporate checks and balances and the integrity of capital market controls. This is the subject of on-going corporate governance reforms in Japanese firms.

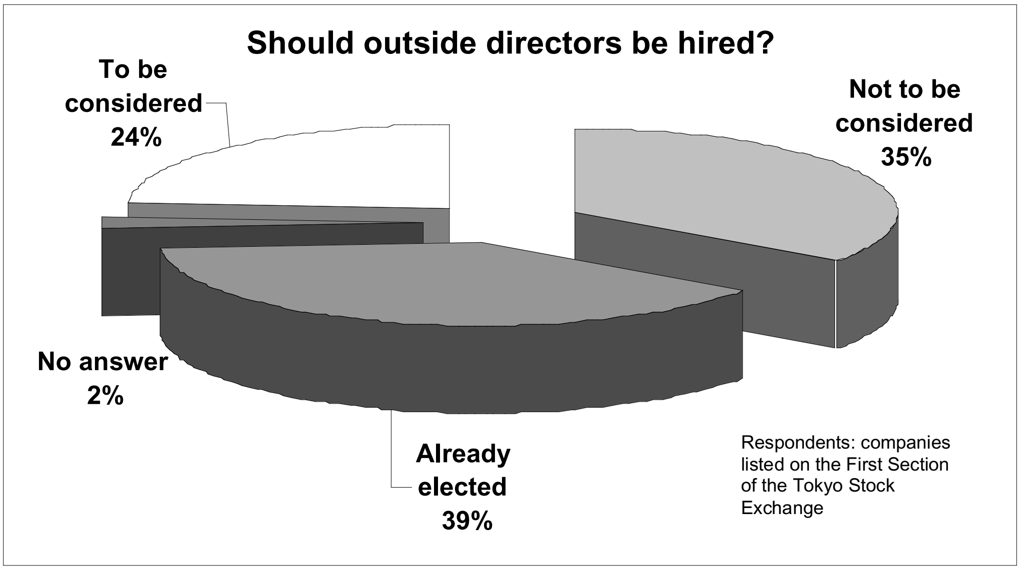
Board of directors

In the Japanese system, the corporate governance function rests with board of directors who are elected to represent the shareholders (Suzuki, *et al.*, 1998). The board of directors is the primary overseer of the company, monitoring managers to ensure that they maximize long-term corporate value to shareholders. Suzuki *et al.* raise some concerns on the accountability and authority of the board of directors. In practice, according to them, the board of directors is composed principally of an in-house director loyal to the *sacho* rather than to the shareholders, which is inconsistent with its governance roles. Most members of the board of directors are executives who have successfully climbed the corporate career ladder and who are actually recognized as employee representatives.

Furthermore, Suzuki, *et al.* observe that the roles of directors and managers have not been clearly defined. The distinction between the governance role of directors and the management role of managers is complicated by the existence of a separate board of auditors, whose role is to audit the activities of management. This means that the board of directors is not necessarily equipped with sufficient authority and capability for the governance of the firm. The board of directors does not actually have real decision-making power since the important decisions are actually made by the management board or the board of managing directors. The board of corporate auditors is only able to carry out *ex post facto* auditing and tends to be remote from the actual decision making of the board of directors.

One of the reforms being introduced in Japan is the establishment of a system of outside directors. At present, however, there is a short supply of independent directors in Japan. The Japanese government is also seeking to strengthen the powers of external corporate auditors in order to address the perceived shortcomings of the traditional cross-shareholding system with regard to the board of directors, and to prevent corporate misconduct.

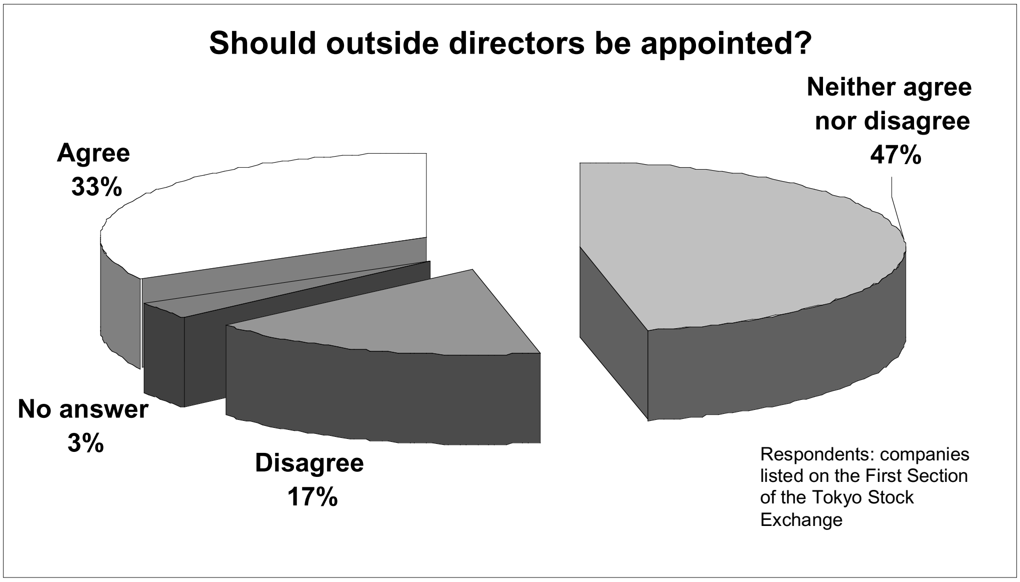
A recent study shows the sentiment of Japanese firms regarding the introduction of independent directors. Here, outside directors is defined as people who have not been executives or employees of the corporation or its subsidiaries. As can be seen in Figure 1, more than 60 percent of corporations listed on the first section of the Tokyo Stock Exchange are already hiring and or considering hiring outside directors.



Source: *Japan Economic Newspaper,* 16 June 2001

Figure 1. Acceptability of outside directors in Japanese firms

Four of the corporations electing outside directors, represented by Hoya and Squaresoft, are controlled by over a half of outside directors. According to the Tokyo Lawyer Committee Corporation Law division, companies which hire outside directors expect them to: (1) ensure rationality in general managerial decision, provide beneficial information in personal managerial decision; (2) judge the usefulness of business decision; (3) ensure efficient management and audit with high validity; and (4) function as an audit of management legality (TLCCL, 2001).



Source: *Japan Economic Newspaper,* 16 June 2001

Figure 2. Appointment of outside directors

Not all firms favor this move. According to Figure 2, companies who said "agree" are twice as many as those who said "disagree," regarding the appointment of outside directors. However, the notable fact is those who answered "don t know" come up to almost 50 percent. Some of the reasons cited for not hiring outside directors are that: (1) there are no appropriate candidates; (2) it is enough to hear the outsiders opinion, or there are other ways to get outsiders' opinions; (3) the benefits are unclear; and (4) it takes extra work because outside directors not familiar with companies operations.

The midterm trial plan in the Amendment to the Commercial Law proposes to require the appointment of more than one outside directors for large companies with a capital of over · 500 million or with a total debt of · 20 billion or more. On the other hand, those who "disagree" such as the Federation of Economic Organizations insist "it is not right for government to be concerned with this nor to oblige things in order to streamline management."

At any rate, many companies in Japan are reducing directors, for the purpose of energizing the board and making the decision more smooth and speedy. For example, within the period 1998-2001, Yuasa Trading Co., Ltd reduced its directors from 25 members to five, Shimizu Corporation from 45 to nine, NKK from 34 to seven, Nichimen Corporation from 26 to nine, and Asahi Breweries from 40 to nine.

Executive officers system

"Executive officers" are persons who conduct business, although they are not directors and therefore not members of the board. In general, they are given the same amount of salaries and other fringe benefits as directors. According to the survey of *Japan Economic Newspaper* on June 16, 2001, companies which have already adopted the executive officer system (EOS) reached 35.7 percent, and those which were willing to adopt the system made up 14.1 percent. But 49.7 percent of companies were unwilling to take up the system. EOS appeals to companies which think that business operation and management should be performed separately. However, the EOS does not exist in Japan s Commercial Law.

It is natural for corporations to hesitate to introduce a position which is not existing in current laws. Furthermore, the EOS has not been established as essential in Japan. Again, according to the Tokyo Lawyer Committee Corporation Law division, the reasons why the EOS has not prospered are many: (1) there are not many existing directors, (2) the legal status and basis are unclarified, (3) the allotment of responsibilities between directors and executive officers is unclear, and (4) the number of interlocking directors would only increase.

Despite these vacillations, Japanese companies are gaining consciousness about corporate governance. Their main concern is management focused greatly on shareholders , followed by structural reform of the board of directors and absolute disclosure of information . Ownership related problems such as unwinding of cross shareholdings and eliminating M & A market are paid less attention (Kikuchi and Hirata, 2000). Japanese firms rank shareholders first among the stakeholders considered essential for a corporation. Next in importance are customers. Employees are ranked third.

LEGAL AND REGULATORY FRAMEWORK

Laws regulating the corporate sector

There are over two million business organizations in Japan formally registered as companies. Of these, however, the vast majority are joint-stock corporations of extremely small organizational scale. At present Japanese laws recognize four basic corporate forms: (1) unlimited partnerships (g*omei-kaisha*), (2) limited partnerships (g*oshi-kaisha*), (3) joint-stock companies (*kabushiki-kaisha*) and (4) limited liability companies (y*ugen-kaisha*). Among these the largest group is the *kabushiki-kaisha* type of companies.

A *kabushiki-kaisha* can be established by even one individual, by preparing appropriate articles of incorporation. The minimum capital requirement is 10 million yen. Companies are required to hold at least one regular general shareholders meeting each year to decide on matters of highest importance to company operation. A *kabushiki-kaisha* is required to appoint a minimum of three directors, elected by shareholders. Directors collectively form the board of directors. Each individual director has the power to execute business. The board oversees the activities of its members. Beside directors, a company is also required to appoint corporate auditors. In large-sized companies, including publicly traded companies, corporate auditors collectively form the board of corporate auditors. The responsibilities of corporate auditors are to supervise the execution of business and to oversee financial reports. Majority of corporate auditors must be appointed from outside.

A director is immune from any loss he may have caused, if he can prove that he was executing the business faithfully. However, if there is a clear fault by a director in executing his responsibility, he is subject to a suit by shareholders, referred to as a derivative suit.

A shareholders meeting must be held in order to elect directors and to make important decisions at least once a year, within three months of the end of the business term. It is often the case that most shareholders meetings in Japan are ceremonial, as companies usually collect the necessary votes to pass resolutions before the meeting is held. About 70 percent of shareholders meetings are held at the same time, or the same day of the year, preventing a shareholder with more than one kind of stock from attending all the meetings in which he or she has interest.

The Company Law has undergone substantial changes since 1993. The most recent amendment passed in May 2002 relates to corporate governance and includes objectives to diversify managerial means and streamline management. With this amendment, a large sized company can adopt a unitary board structure similar to US companies, if it decides to establish three board committees: nominating, auditing and compensation. Each of the three committees must have majority drawn from outside directors. By selecting this new structure, the company can abolish the traditional board of corporate auditors.

Revised commercial law

Changes with regard to corporate governance have been introduced in the Commercial Law which was revised in May 2002. Its fundamental idea is to separate the functions of business performance and managerial monitoring. In other words, there should be a mechanism to ensure the transparency and accountability of corporate management. Concretely speaking, big companies, with over · 500 million capital or with more than · 20 billion debt in total, need not appoint an auditor, if they can meet the following two conditions: (1) appointment of at least two or more outside directors and (2) existence of the following committees in the board of directors, each of which consists of more than three members who are mostly outside directors:

- Nomination Committee, which selects the candidates for directors;
- Audit Committee, which plays a role as auditors; and
- Reward Committee, which decides on rewards to directors and executive officers.

A company that retains the committee system must have executive officers whose function is directed toward business performance. Chief executive officers, not former chief executive directors, should manage. The board of directors still has the right to decide basic management policy as well as declare dividends,[4] but the company now entrusts executive officers with the authority to decide on important business matters such as issuing bonds or new stocks. Moreover, the term of directors has been shortened from two years to a year. Such separation improves monitoring (by directors) and streamlines decision-making (by executive officers), the end result of which is overall corporate efficiency and maximization of shareholders profit.

In the case of a company which continues to maintain auditors, it is the board of executive directors which is authorized to handle business decisions, such as selling fixed assets. The board also decides on payments of compensation for losses by its action, although payments cannot go beyond six times the annual income of chief executive officers and four times that of executive officers.

A company can choose of its own will, whether to become a new company that organizes committees or to continue to have auditors. In the case of a committee-driven setup, there are some worries about the shortage and low quality of outside directors in Japan, doubts that outside directors can be involved in decision making for management, and even hesitation to at least try the new system. Nevertheless, companies like Aeon and Orix have released their auditors and adopted the new style of corporate governance controlled by outside directors, based on the Revised Commercial Law.

What led to the revision of the law were corporate scandals in Japan in recent years and the need to attract and keep huge investments in the Japanese market by foreign corporate and private investors, typified by CalPERS (California Public Employees Retirement System) as a result of the globalization of the capital market. The new law

[4] For companies with auditors, a general meeting of shareholders holds the right.

mimics the United States style of corporate governance, and in that sense, it can be interpreted as an intention of maximizing shareholders value.

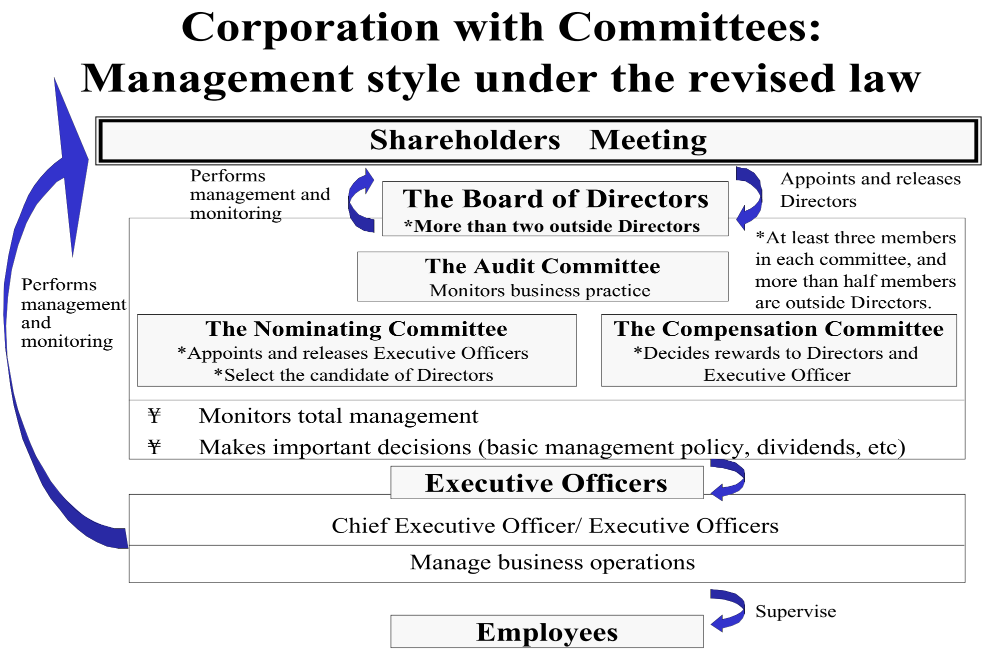


Figure 3. Corporate governance in a firm with committees

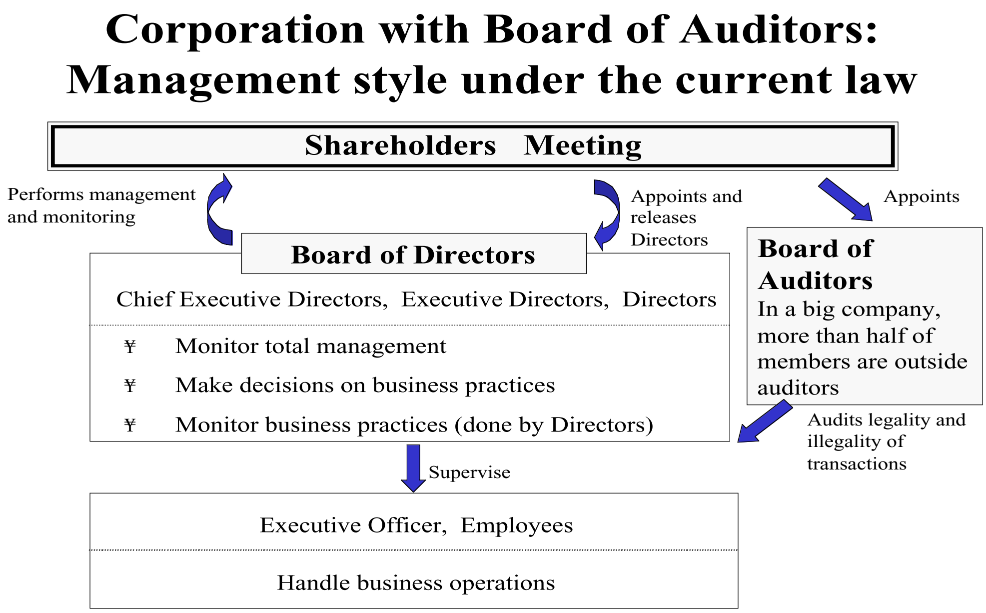


Figure 4. Corporate governance in a firm with an auditors board

However, judging from the fact that the United States style of corporate governance has given rise to scams such as Enron and WorldCom, further reforms are needed in various aspects to include not only ownership and efficiency of decision-making, but also legal and ethical dimensions.

Transparency and disclosure

Japan adopts a dual system of disclosure: one is framed by the Commercial Code (Law No. 48 of 1899, as amended) and the other by the Securities and Exchange Law (Law No. 25 of 1948, as amended). The scope of information to be disclosed is carefully delineated in law, and the key information that is made public is accounting and financial data. Such periodic disclosure, however, has at least two flaws (Kanda, 1999). First, there is a time lag between the date when disclosure documents (typically the firm's financial statements) are prepared and the date when they are actually disclosed. Second, there is no obligation for the company to update the information supplied in the financial statements even if something happens after they are prepared and become public. Certain important events must be disclosed in a special report (known as an "8-K" report in the US), but this exception is not comprehensive. As such, stock exchanges and other self-regulatory organizations usually require "timely disclosure," by which the company is required to reveal pertinent information more often (and sometimes in more detail) than is required by law. But to rectify these two flaws, a supplemental scheme is needed (Kanda, 1999).

Regulations governing the capital market including stock exchange

Apart from laws regulating the corporate sector, the most important regulation governing the capital market in Japan is the Securities and Exchange Law (SEL), first enacted in 1947. The SEL was modeled after the US Securities Act of 1933 and the Securities Exchange Act of 1934. The purpose of the law is to provide an appropriate environment for the sound development of the Japanese economy and the protection of investors by making sure that listed securities would be traded in the securities market under a system that is in principle both fair and strict.

The main areas covered by SEL are as follows: registration statement, continuing obligation to file information by the issuer, disclosure of information filed, guaranteeing the fairness of the information filed, tender offering, disclosure of large volume holding, securities companies, association of securities dealers, stock exchange, prohibition of unfair trading, and prohibition of insider trading. A securities and exchange surveillance committee was established to help in regulating the stock exchange.

SEL underwent a series of reviews during the last few decades. In 1990, the SEL was revised to include introduction of disclosure requirements for large-volume holdings of stock and other securities, and modification of regulations governing tender offers. The revision was effected to enhance the fairness and transparency of the Japanese stock market at a time when domestic securities companies were becoming increasingly internationalized.

A more recent amendment of the SEL includes prohibition of unethical compensation and other unsavory practices carried out in securities transactions. The new regulations include prohibition of discretionary accounts, prohibition of stock loss compensations and revision of penal system.

The latest amendment effected in 2001 includes various measures for listed companies to disclose information electronically. Although a listed company is not required to file information electronically at this time, investors are now able to view on line information disclosed by many companies.

SURVEY IMPLEMENTATION

The foregoing discussions have shown some features of the corporate governance system in Japan and its effects on corporate financing and control. This study looks into the impact of corporate governance practices on productivity. The underlying proposition is that good corporate governance promotes improved productivity and competitive pressures. Corporate governance includes: (1) making determinations regarding company behavior; (2) adjusting and fine-tuning the relative relationship with stakeholders; (3) monitoring management activities and results; and (4) promoting social responsibility, business ethics and institutional interface with the society and local community.

In administering the survey in Japan, the questionnaire was framed following APO research guidelines. Two hundred sixty-seven companies were chosen at random, based on the book list of Nikkei Company Information. The survey questionnaires were sent on 1 February 2002 to which 58 companies responded by the end of February.

Majority of the 58 respondent companies are Japanese, with headquarters in Japan. Eleven are foreign affiliated, of which seven have US partners. Half of the respondent companies are publicly traded with their shares listed in the nation s stock exchanges or traded over-the-counter. Those companies have diversified shareholders among individuals, foreigners, corporations and various financial institutions.

Despite government s efforts to set up industries nationwide, major industries are still concentrated in the Tokyo, Osaka and Nagoya areas. Respondent companies, reflecting this condition, are likewise found in these areas. But they are well diversified. The average number of employees is about 7,500 in the sampled companies.

This paper attempted to come up with an analysis of findings in four main categories: ownership, management, social responsibility, and institutional interface. Here the dependent variables are company growth and productivity while the independent variables are ownership, management, social responsibility and institutional interface.

SELECTED RESULTS

Ownership

Capital structure/distribution of shares

As shown in the survey, most minority shareholders are excluded in board meetings making it easy to remove the minority representative. As a result, minority shareholders cannot exert a large influence on management. But in Japan there is a system in which everyone who has one share can sue the board members in the court. Hence, the board cannot just ignore the minority shareholder.

Table 2. Are minority shareholders represented in the Board?

	% of companies
Yes	7.3
No	85.3
Responding firms	70.7

If ownership is highly concentrated the audit function may be diluted. In effect, corporate infractions may occur frequently. There, the role of corporate auditor is very important.

As shown in Table 3, most companies source their capital from financial institutions. Therefore, most of the firms capital is generated from the capital market.

Table 3. How long has the firm dealt with its major creditors? (% of firms)

Creditor	About 2 years or less	3-5 years	More than 5 years
Bank	2.8	0	97.1
Non-bank	16.6	0	83.3
Others			100

Table 4 shows that a single shareholder has more than 80 percent of shares in roughly 14 percent of the surveyed firms in Japan. The top five shareholders have up to one half of the total shares in 60 percent of the firms. Only about a fourth of the firms can be considered widely-held. The table also indicates that Japanese companies engage in cross shareholding—the holding over of each other s stocks by companies and financial institutions.

Table 4. What is the proportion of shares held by shareholders? (% of firms)

	50% or less	Between 50-65%	Between 66-80%	More than 80%
Top 1 shareholder	78.4	3.9	3.9	13.7
Top 5 shareholders	60.0	12.0	10.0	18.0
Top 10 shareholders	53.0	10.2	10.2	26.0

Domestic companies and banks own 60 percent of the respondent companies, but foreign companies and individuals are holding 20 percent. Most of the firms are under the control of domestic companies and banks, which get to own more of the firms by converting their own non-performing loans into shares (Table 5).

Table 5. Type of owners which have the largest stake in the firm

	% of firms		% of firms
Government	0	Investment company	1.8
Family	1.8	Bank	20.7
Domestic company	39.6	Individuals	11.3
Foreign company	13.2	Others	11.3
% of responding firms		91.4	

About 78 percent of employees own shares but the proportion of shares they own is only 2.2 percent whereas the proportion owned by managers is 8.4 percent. They are small compared to the proportion of shares owned by domestic companies and financial institutions. It is no surprise, therefore, that Japanese companies get their instructions or direction from domestic companies and financial institutions.

Shareholder rights

Decision-making in the companies is done through the board meetings. Most of shareholders invoke their rights. As shown in Table 6, close to 60 percent of respondent firms recognize proxy voting. Minority shareholders exercise their rights through the power of attorney.

Table 6. Shareholder rights existing in the firm

	% of firms
Right to vote according to share	94.5
Proxy voting	59.4
Right to maintain proportionate ownership of firm under any financing plan	5.4
Right to demand independent audit	8.1
Membership in independent board committees	2.7
Responding firms	63.8

Minority shareholders can participate in board meetings if they are allowed by board members.

Creditor rights and monitoring

For 84 percent of the respondent firms, the creditors are banks and private companies, as shown in Table 7. Most of the respondent companies have close relationships with banks and private companies. Because of this dependence, if banks cannot supply capital, the companies are confronted with a management crisis. In many cases, Japanese companies face bankruptcy or insolvency due to the excess demand for bank capital.

Table 7. Who are the creditors of the firm?

	% of firms
Banks	80.0
Non-bank institutions	4.4
Others	68.8
Responding firms	77.6

Table 8. Who guarantees loans made by the firm?

	% of firms
Government	5.2
Private owners	52.6
Others: Firm	42.1
Responding firms	32.8

In 52 percent of the firms, private owners guarantee the loans made by the firms. Individual guarantees involve real estates and stocks as security for the payment of debt. But falling prices of real estates and stocks in Japan have put a limit to individual owner loan guarantees.

Most of the respondent firms have long association with their creditors as shown in Table 9. More than 90 percent of companies have loans with banks for over five years, and are thus assured of long-term capital.

Table 9. How long has the firm dealt with its major creditors? (% of firms)

Creditor	About 2 years or less	3-5 years	More than 5 years
Bank	2.8	0	97.1
Non-bank	16.6	0	83.3
Others			100

Management

Decision making system

The types of decisions made and the involvement in the decision making by the owner/major shareholders, board, CEO, and COO vary. Owner/major shareholders are not involved in many types of decisions. In less than 50 percent of firms are owners heavily involved in decision-making. When they are relatively highly involved, they make decisions on management appointments, executive compensation, board composition and membership, and declaration of dividends.

The board and CEO make decisions on issues that include corporate trusts and direction, corporate and financial strategic options, sanctions and rewards for management performance, board composition and membership, declaration of dividends, profit or gain sharing, business expansion/contraction, merger and acquisitions.

Japanese boards are quite active as decision-makers. The frequency of board meetings is very high and about 94 percent of corporate boards meet more than seven times a year. Boards meet 14 times a year on average. This is partly the reason why 45 percent of the corporate boards do not include outside directors and about 90 percent of corporate boards include less than two persons apart from the director.

For the COO, there are few types of decisions made. Many Japanese companies do not recognize the job description of COO, and the responses as regards COOs are 20-30 percent less than the other columns as seen in Table 10. COOs mainly focus on day-to-day operations and corporate and financial strategic options. The decisions related to productivity improvement and customer satisfaction/quality are delegated to the operating team in the company.

Table 10. Depth of involvement in decision making (by parameter*)

Type of decision	**Owner**	**Board**	**CEO**	**COO**
Corporate thrusts and direction	43	90	92	37
Corporate and financial strategic options	42	91	91	64
Sanctions/rewards for mngt. performance	49	87	90	56
Executive appointments and compensation	65	84	80	46
Board composition and membership	62	82	86	46
Day-to-day operations	22	62	70	60
Declaration of dividends	61	90	82	49
Profit or gain sharing	57	91	82	49
Business expansion/contraction	50	92	90	58
Mergers and acquisitions	55	88	83	55

Note: Parameters are calculated by the number of company replies on depth of involvement as follows: deeply involved=2, moderately involved=1, no involvement=0.

As the results above suggest, it is most likely that almost all decisions are made by management players including the board, CEO and COO. The level of independence of management is relatively high. Seventy percent of companies say their management has high independence; the rest indicate their managers are moderately independent of the major shareholders. No company claims to have low managerial independence. Most likely, conflicts between owners and management teams are not high in Japan. Historically, owner(s)/ major shareholders entrust management teams with business decisions with the least interference. The owners involvement in decision-making is likely related to their interests as described above.

It is interesting to note that 79 percent of CEOs have worked in the same company prior to being appointed. The board size is different across companies with 13 members as average size. Tenure of the board is seven years on average. Very few committees are present within the board and 69 percent of companies say they have no board committee at all.

Management compensation

Some companies tie executive compensations to company performance but others do not. Generally though, Japanese corporate management teams enforce compensation cuts in times of low business performance. The average CEO compensation as a percentage of the average employee salary is 650 percent and no CEO has 1200 percent or more (Table 11). That would indicate a reasonable wage compression ratio.

Table 11. Wage compression (% of firms)

Range	0-400%	401-800%	801-1200%	1201-1600%	>1600%
Using average employee salary	30.7	38.4	30.7	0	0
Using lowest employee salary	23.0	7.6	15.3	30.7	23.0

Internal control and accountability system

There is a legal or regulatory requirement for public disclosure of material information about listed companies. About 76.5 percent of the companies have a specific disclosure policy. Most companies disclose information on corporate finances, corporate performance, ownership structure and governance two times (39 percent) or four times (43 percent) a year. Only 12.5 percent of companies do not disclose any information because they are not listed and no request has been made on them.

A fairly large group of people can access material information. They include major shareholders, minority shareholders, management, employees, unions, internal auditors, external auditors, creditors, government, and the general public. Major shareholders, minority shareholders, and management can access the minutes of the board meetings. But 60 percent of companies do not disclose to minority shareholders.

Companies have very rigid to moderate internal controls as a shield against misuse of cash flow and to monitor, accounts receivable collection and aging, bad debt write-off, inventory, fixed asset acquisition, research and development, capital expenditure, tax payments, loan repayment, and payroll (Table 12). But research and development is not rigidly monitored.

Table 12. Degree of internal control (% of responding firms)

	Very rigid	**Rigid**	**Adequate**	**Some-what loose**	**Very loose**
Cash flow	33.3	41.1	23.5	0.9	0
Accounts receivable collection and aging	36.1	42.5	19.1	2.1	0
Bad debt write-off	29.7	38.2	31.9	0	0
Inventory	26.0	34.7	34.7	2.1	2.1
Fixed asset acquisition	34.6	36.7	28.5	0	0
Research and development	18.1	27.2	50.0	4.5	0
Capital expenditure	36.7	36.7	24.4	2.0	0
Tax payments	38.7	28.5	32.6	0	0
Loan repayment	41.8	34.8	23.2	0	0
Payroll	37.5	29.1	33.3	0	0

About 65 percent of companies have corporate wide quality and productivity improvement programs. These include TQM, six sigma, ISO, the Japanese quality award program, EVA, balanced scorecard, and TQC.

External audit

About 80 percent of the companies follow local auditing standards and only 15 percent of companies follow international standards. Fewer companies follow the American standard. About 21 percent of the companies maintain separate books for various groups such as owners, managers, tax agency, auditors, and creditors. A large number of companies (86 percent) have external auditors and 63 percent of them have changed auditors over the last three years. The degree of independence of the external auditor from the company ranges from very high to moderate.

Code of ethics

About 72 percent of the companies have a code of ethics to govern the behavior of managers and employees (and some of owners as well) and 62 percent of them disclose their codes to the public. Many of them maintain sanctions or penalties for violating the code and some employees and middle managers have had those sanctions. Seven percent of the companies have received complaints and investigated allegations of breaches of standards of financial conduct. Very few companies have received complaints about or have been accused of violating the following: internal revenue code (9 companies), environmental rules (2), labor code (4), intellectual property rights (1), anti-bribery act (1), and others (5).

Employee-employer relations

Companies employ mechanisms on employer-employee relations. About 66 percent of companies have an employees union or association and this is the main mechanism to solve issues between management and employee such as compensation, working conditions, company rules and regulations, labor standards and benefits. Despite the strong presence of unions, there have been almost no disputes between management and employees during the last three years. Only three companies (5.4 percent) have experienced disputes, which were settled through labor management consultation.

Table 13. What mechanism is usually used to solve employee-employer issue?

	Collective bargaining	Labor management consultation	Management discretion	Others
Compensation	53	87	89	14
Benefits	32	88	75	12
Tenure	10	36	82	12
Working conditions	43	101	82	15
Company rules and regulations	45	101	79	15
Training and development	3	47	93	15
Labor standards	41	87	77	15

Note: The parameters were calculated based on the response and weights assigned as follows: highly related=3, related=2, moderately related=1, not so related=0, and not related= -1.

Social responsibility

Community relations

In the sphere of community relations, many Japanese corporations have launched social contribution activities in the 1990s, in an attempt to be good corporate citizens, as shown in Table 14. For example, in community support and philanthropy , majority of firms answered that they do voluntary response or take leadership role .

Table 14. Characteristics of the firm's role in areas of public concern
(% of responding firms)

Areas of public concern	No firm activity	Compliance only	Voluntary response	Takes leadership role
Pollution control	14.0	28.0	38.0	20.0
Environmental protection	12.9	18.5	37.0	31.4
Truth in advertising and in business activities	5.6	35.8	32.0	26.4
Product warranty and service	3.8	25.0	36.5	34.6
Control of harmful products	10.4	29.1	37.5	22.9
Community support	11.7	35.2	27.4	25.4
Support for older people	15.6	29.4	39.2	15.6
Philanthropy	11.5	26.9	32.6	28.8
Support for cultural activities	26.4	32.0	22.6	18.8
Shareholder relations	4.0	42.0	42.0	12.0
Support for working mothers	24.0	56.0	14.0	6.0

So far, Japanese corporations have been characterized as employees communities . They practice lifetime employment and seniority which sustains the employees community. In the 1980s those who studied Japanese management often had high praises for this communal aspect of Japanese firms. They thought that it made a significant contribution to Japan s economic upturn after World War II.

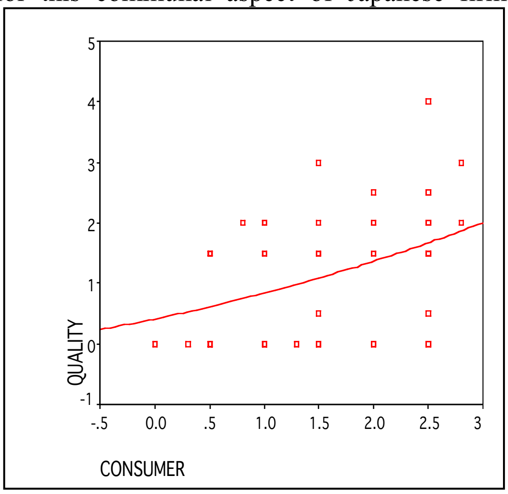


Figure 5. Quality consciousness vs. awareness of consumer rights

Now Japanese corporations are beginning to reach out to external stakeholders including local communities. They have made themselves more open. But the transition has not been smooth. Recently, some corporations, including the largest electric power company, were found to have carried out business illegally for years, indicating that the closed character of the Japanese corporation still dominates the corporate landscape.

Consumer rights protection

As to consumer protection, the interesting point here is whether a firm s awareness of consumer rights would means higher quality consciousness. So far, Japanese corporations have been famous for their product-quality consciousness. But they have not always been conscious of relating quality consciousness to consumer protection. However, consumer satisfaction (CS) has long been recognized in Japan and in 1994 the Product Liability Law was passed. At present, Japanese corporations are slowly changing their attitude, as the APO survey suggests. For example, when asked whether there are in-firm regulations on consumer protection, majority of Japanese large corporations which were surveyed say they are now conscious of consumer rights.

Indeed, as Figure 5 shows, the relationship between quality-consciousness and awareness of consumer rights is positive. And as Table 15 shows, the two factors are significantly correlated.

Table 15. Correlation between quality consciousness and consumer rights awareness

	QUALITY	CONSUMER
QUALITY Pearson s coefficient of correlation N	1 . 58	.425* .001 58
CONSUMER Pearson s coefficient of correlation N	.425*> .001 58	1 . 58

*1% level; QUALITY=quality consciousness, CONSUMER=consumer rights awareness

Environmental protection

Japanese corporations have adopted ISO 14000 much earlier than other countries. As of January 2002, 8169 Japanese companies have gained ISO 14001 certification, the highest among more than 40 countries.

Japanese corporations have been criticized for their anti-environmental activities in the course of Japan s rapid economic growth but they seemed to have learned their lesson as Table 16 suggests. A notable fact is that activities such as green transactions have been prevailing and many companies have been doing environmental business, after discovering that it pays to be friendly to the natural environment.

Table 16. What are the firm s activities concerning environmental protection?

	% of firms
Declaring environ-mental statements	40.7
Acquiring certification of ISO 14001	53.7
Publishing environ-mental reports	42.6
Disclosing environ-mental activities in the web	38.9
No activity	27.8
Others	14.8

Finally, many firms go beyond social obligations to support community activities or people who need care in the community. But support for working mothers is rather poor. Japan is not known for being friendly to women and this research makes it clear it is an urgent issue.

Institutional interface

Regulatory framework

First, on the service quality of public institutions, companies rate the level of the service quality of public institutions center slightly good to slightly poor (Table 17). This shows that the Japanese business sector appreciates governmental and judicial systems only moderately.

Table 17. Rating of overall quality of services delivered by government agencies (% of responding firms)

	Very good	Good	Slightly good	Slightly poor	Poor	Very poor
Central government	0	12.8	23.0	48.7	12.8	2.5
Central bank	0	11.1	30.5	44.4	11.1	2.7
Customs	0	17.5	30.0	42.5	7.5	2.5
Judiciary	0	18.9	32.4	35.1	10.8	2.7
Police	2.5	25.0	45.0	20.0	5.0	2.5
Internal revenue	0	11.1	27.7	50.0	8.3	2.7
Local government	0	14.6	21.9	36.5	24.3	2.4

Next is the assessment of industrial infrastructures. The ratings range from good to slightly good (Table 18). This shows that Japanese business appreciates industrial infrastructures rather highly. With respect to government s economic policies, the scores are spread out widely from no problem to major problem (Table 19). But it should be noted that Japanese firms regards anti-competitive practices and taxes and regulations problematic to business or economic growth.

Table 18. Rating of overall quality and efficiency of the public services (% of responding firms)

Type of service	Very good	Good	Slightly good	Slightly poor	Poor	Very poor
Education/ schooling	0	10.0	30.0	32.5	20.0	7.5
Roads	2.5	22.5	27.5	35.0	7.5	5.0
Ports	2.9	20.5	32.3	35.2	5.8	2.9
Telecommunication	2.5	30.7	33.3	25.6	5.1	2.5
Electricity/power	5.1	38.4	43.5	7.6	2.5	2.5
Water	2.5	38.4	41.0	12.8	2.5	2.5

Table 19. How problematic are the following for the operations and growth of firms? (% of responding firms)

	No problem	Minor problem	Moderate problem	Major problem
Exchange rate	2.0	27.0	37.5	33.3
Taxes and re regulations	2.0	18.7	27.0	52.0
Anti-competitive practices	8.5	14.8	34.0	42.5
Fiscal policy	4.2	29.7	42.5	23.4
Corruption	29.5	43.1	13.6	13.6
International regulations/standards	8.1	16.3	44.8	30.6

International rules and standards

On international quality standards, Japanese corporations generally follow international quality and environmental standards excepting Social Accountability 8000 (Table 20). Thus, the urgent issue is how to encourage Japanese corporations to look more closely at the societal aspects of business activities and appreciate social accounting properly.

Table 20. International quality standards adopted by firms

	% of firms
ISO 9000 series	70.3
ISO 14000 series	78.4
SA 8000	0
Others	8.1

Core labor standards

Japan is well known as for experiencing few labor disputes. As the survey shows, very few companies (5.4 percent) have experienced disputes between management and employees during the last three years. That is because the prevailing form of labor union in Japan is the so-called in-house union . In reality labor unions have been powerless to arrest recent large-scale dismissals. This suggests that even if majority of Japanese firms have labor union(s), it does not necessarily mean that employees have strong and independent power.

Productivity and governance

To check whether corporate governance and productivity are correlated, the average expansion rate for five years of return on equity (ROE), representing both productivity and growth rate from 1996 to 2000 was calculated. Featured differences appear between 17 companies with more than 10 percent of average expansion rate and 13 companies with negative growth as seen in Table 21.

Table 21. Differences of companies with 10% average expansion rate and negative growth

	Companies with more than 10% average expansion rate	Companies with negative growth
Share rate of stock owned by employees	3.4%	1.4%
Share rate of stock owned by directors	7.1%	0.5%
Members of the board of directors	12.5 members	13.9 members
Members of outside directors	1.2 members	0.7
Frequency of the board meeting	13.9 times/year	12.3 times/year
Companies with specific disclosure policy	81.2%	66.6%
Companies with code of ethics	76.4%	61.5%
Companies with ISO accreditation	100%	80%

Clearly, companies with high performance also have a high share rate of stock by their own employees. In other words, by owning company stocks, employees become more aware of management participation which in turn can lead to productivity improvement. Similarly, companies with high performance have a high share of stocks by their directors. That is, these directors tend to be more responsible in management, resulting in improved productivity.

Table 21 shows that companies with high performance have fewer board of directors members. With less members, prompt decisions can be implemented. But less does not necessarily mean no outsiders. Outside directors provide multiple points of view to the company. The presence of outside directors not only translates into high performance; it also maintains the transparency and the independence of the board. High performing companies also hold few—and very likely more efficient—meetings of board of directors. They also tend to have positive and transparent attitude towards the disclosure of corporate information and to work on business ethics positively.

GOVERNING RELATIONSHIPS

In determining the governing relationships between firm performance and productivity, on the due hand, and corporate governance elements, on the other, the following sequence was observed: first, the productivity and performance measures (dependent variables) were defined; second, the governance measures (independent variables) all derived from the survey results were constructed; third, correlation analyses among all variables, dependent and independent, were done to determine which variables have significant relationships with each other.

In this study, corporate performance and productivity is measured by the following five factors:

1. The mean rate of growth in sales profit from 1996 to 2000 (represented by SALES);
2. The mean rate of net profit in these five years (NET PROFIT);
3. The mean rate of ROE in these five years (ROE.GR);
4. ROE average profit in these five years (ROE.AVE); and
5. ROA average profit in these five years (ROA.AVE).

The main determinants of corporate governance are sorted out in seven patterns. Ownership concentration suggests that few shareholders influence the firm s activities and its performance. This pattern of governance is labeled SHAREFEW and is the cumulative numerical score drawn from the questions or shareholdings in the APO survey questionnaire[5]. FOREIGNCAP is the overall score of all firms on survey questions related to foreign holdings. The other patterns are constructed similarly. The seven patterns are:

1. SHAREFEW in which a small number of shareholders has much influence;
2. FOREIGNCAP in which foreign capital has much influence;
3. DIRECTORS in which firm s directors have much influence;
4. BANKS in which banks have much influence;
5. EMPLOYEES in which employees or labor unions have much influence;
6. CROSSHOLD in which cross-holdings have much impact.
7. CREDITORS in which creditors have much influence.

Preliminary results suggest that only a few governance patterns have certain influence on firm performance and productivity. Table 22 charts the correlations between performance and productivity and these seven patterns of governance. It can be seen that EMPLOYEES and SALES are in negative and significant relationship, CREDITORS and NETPROFIT are in negative and significant relationship, SHAREFEW and ROA.AVE

[5] For example, in the following survey question, the scores for a participating firm is counted as follows:

Is the majority ownership in your firm held by					
	1 shareholder?	2 to 3 shareholders?	4 to 5 shareholders?	6 to 10 shareholders?	More than 10 shareholders?
Score	1.5	1.0	0.5	0.5	0.0

Details of the scoring process and outcomes are available upon request from the author.

are in positive and significant relationship, and BANKS and ROA.AVE are in negative and significant relationship.

Ownership concentration and performance

A U-shaped relationship exists between the degree of ownership concentration and corporate profitability. As Table 22 shows, only ROA.AVE is significantly correlated with SHAREFEW. Other performance or growth indices do not show any significant relationship with ownership concentration. The scatter diagram of ROA.AVE and SHAREFEW certainly shows a U-shaped relationship (Figure 6). As regards other ownership patterns, Figure 7 shows that EMPLOYEES has significant relationship with SALES. In Figure 8, CREDITORS is shown to be highly correlated with NETPROFIT while in Figure 9, BANKS is significantly associated with ROA.AVE.

Table 22. Correlation between governance and performance components

	SALES	NET PROFIT	ROE.GR	ROE.AVE	ROA.AVE	FOREIGNCAP	S.HAREFEW	DIRECTORS	BANKS	E.MPLOYEES	CROSSHOLD	CREDITORS
SALES	1	.545**	.486**	-.059	.086	.047	.241	.198	.108	-.329*	.262	.186
Pearson s	.	.000	.003	.731	.605	.761	.114	.198	.484	.029	.086	.227
N	44	44	35	37	39	44	44	44	44	44	44	44
NETPROFIT	.545**	1	-.333*	-.051	.120	-.092	-.104	-.053	-.120	.188	-.207	.383**
Pearson s	.003	.	.048	.759	.460	.543	.493	.725	.426	.210	.167	.009
N	44	46	36	38	40	46	46	46	46	46	46	46
ROE.GR	.486**	-.333*	1	.349*	.163	-.181	.108	.066	-.173	-.311	.141	-.142
Pearson s	.003	.048	.	.037	.374	.291	.531	.703	.313	.065	.411	.410
N	35	36	36	36	32	36	36	36	36	36	36	36
ROE.AVE	-.059	-.051	.349*	1	.108	-.044	.030	-.048	-.076	.140	-.024	.026
Pearson s	.731	.759	.037	.	.543	.795	.859	.773	.650	.403	.884	.876
N	37	38	36	38	34	38	38	38	38	38	38	38
ROA.AVE	.086	.120	.163	.108	1	-.158	.352*	.045	-.305*	-.256	-.040	-.288
Pearson s	.605	.460	.374	.543	.	.317	.022	.777	.050	.101	.802	.065
N	39	40	32	34	42	42	42	42	42	42	42	42
FOREIGNCAP	.047	-.092	-.181	-.044	-.158	1	.372**	.176	.446**	.079	.766**	.174
Pearson s	.761	.543	.291	.795	.317	.	.004	.186	.000	.555	.000	.191
N	44	46	36	38	42	58	58	58	58	58	58	58
SHAREFEW	.241	-.104	.108	.030	.352*	.372**	1	.181	.152	-.051	.384**	-.052
Pearson s	.114	.493	.531	.859	.022	.004	.	.173	.254	.704	.003	.700
N	44	46	36	38	42	58	58	58	58	58	58	58
DIRECTORS	.198	-.053	.066	-.048	.045	.176	.181	1	.377**	.453**	.228	.213
Pearson s	.198	.725	.703	.773	.777	.186	.173	.	.004	.000	.085	.108
N	44	46	36	38	42	58	58	58	58	58	58	58
BANKS	.108	-.120	-.173	-.076	-.305*	.446**	.152	.377**	1	.257	.481**	.454**
Pearson s	.484	.426	.313	.650	.050	.000	.254	.004	.	.051	.000	.000
N	44	46	36	38	42	58	58	58	58	58	58	58
EMPLOYEES	-329*	.188	-.311	.140	-.256	.079	-.051	.453**	.257	1	.141	.091
Pearson s	.029	.210	.065	.403	.101	.555	.704	.000	.051	.	.289	.497
N	44	46	36	38	42	58	58	58	58	58	58	58
CROSSHOLD	.262	-.207	.141	-.026	-.040	.766**	.384**	.228	.481**	.141	1	.088
Pearson s	.086	.167	.411	.844	.802	.000	.003	.085	.000	.289	.	.511
N	44	46	36	38	42	58	58	58	58	58	58	58
CREDITORS	.186	.383**	-.142	.026	-.288	.174	-.052	.213	.454**	.091	.088	1
Pearson s	.227	.009	.410	.876	.065	.191	.700	.08	.000	.497	.511	.
N	44	46	36	38	42	58	58	58	58	58	58	58

- 5%level **1%level

Relationships among governance patterns

Since the seven types of governance also mutually affect each other, there was a need to check the interference of each factor on the others. Correlations are seen among the explanatory variables (see Annex Table 1). Those factors that significantly affect each other are: (1) FOREIGNCAP and SHAREFEW, (2) SHAREFEW and BANKS, (3) DIRECTORS and BANKS, (4) DIRECTORS and EMPLOYEES, (5) SHAREFEW and CROSSHOLD, (6) BANKS and CREDITORS, among others.

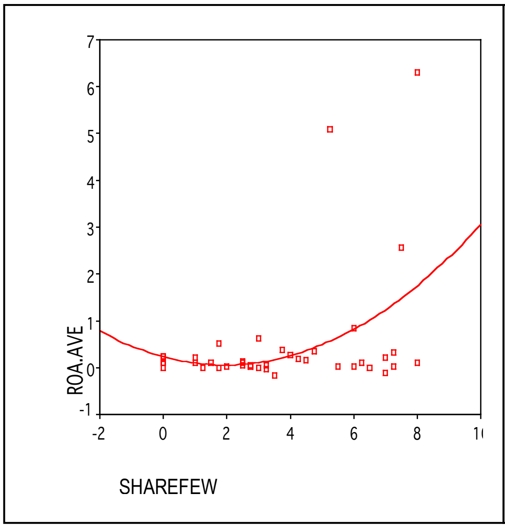


Figure 6. SHAREFEW vs. ROA.AVE

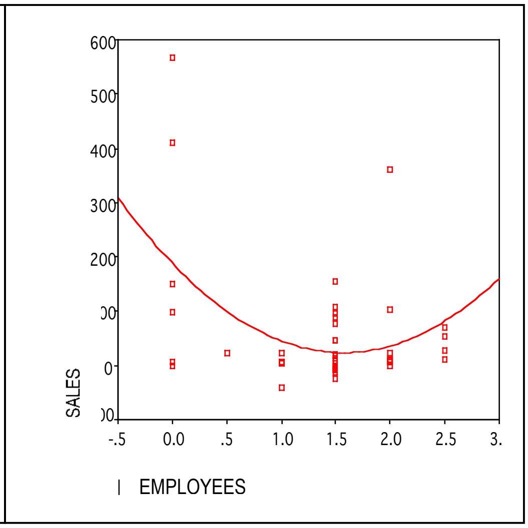


Figure 7. EMPLOYEES vs. SALES

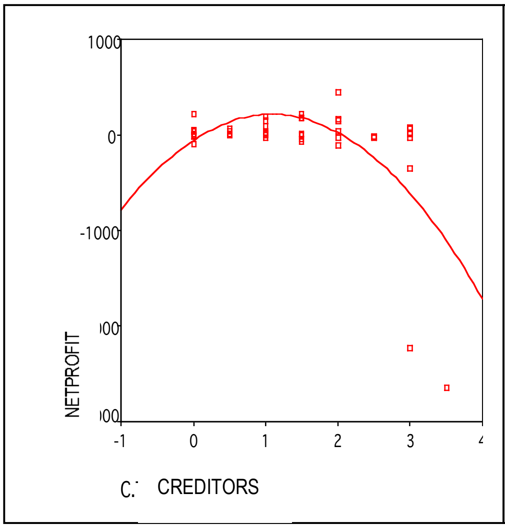


Figure 8. CREDITORS vs. NETPROFIT

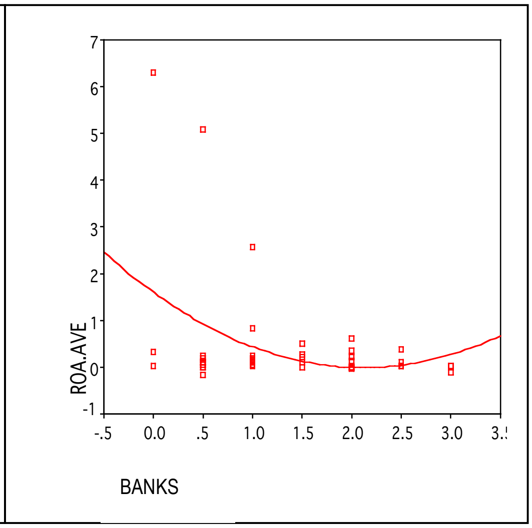


Figure 9. BANKS vs. ROA.AVE

The initial choice of SHAREFEW, EMPLOYEES and CREDITORS as explanatory variables means that FOREIGNCAP, BANKS and CROSSHOLD (from (1), (2) and (5)), and DIRECTORS, BANKS and CROSSHOLD (from (3) and (4)) have to be excluded because of their high correlation with the determinants. The use of BANKS, which has significant relationship with ROA.AVE, would preclude using CREDITORS in the same equation or grouping.

Relationships between governance and performance

Mean rate of growth in sales profit and governance patterns

Preliminary results coming from Table 22 suggest that only EMPLOYEES has significant relationship with SALES. EMPLOYEES, along with SHAREFEW and CREDITORS (all are not correlated with each other) are regressed against SALES. Table 26 shows that any of these patterns of governance do not contribute to firm performance and productivity (5 percent level). That puts Figure 7 in doubt.

Table 23. Results of the multiple regression analysis of SALES and governance patterns

Dependent variable: **SALES**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	64.410	54.919		1.173	.248
SHAREFEW	9.046	6.902	.193	1.311	.197
EMPLOYEES	-47.147	24.814	-.280	-1.900	.065
CREDITORS	19.792	15.638	.183	1.266	.213

Mean rate of growth in net profit and governance patterns

Again, in Table 22, only CREDITORS is significnantly correlated with NETPROFIT. CREDITORS, SHAREFEW and EMPLOYEES are the explanatory variables in the regression shown in Table 24, which indicates that CREDITORS significantly and negatively affects firm performance (1 percent level). That means that the more creditors exert influence on the firm, the worse the firm performs. Figure 8 is thus validated.

Table 24. Results of the multiple regression analysis of NETPROFIT and governance patterns

Dependent variable: **NETPROFIT**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	102.601	240.903		.426	.672
SHAREFEW	-21.118	30.052	-.100	-.703	.486
EMPLOYEES	114.024	110.202	.148	1.035	.307
CREDITORS	-186.215	68.048	-.383	-2.737	.009

Average ROA and governance patterns

SHAREFEW and BANKS are significantly associated with ROA.AVE in Table 22. Regressing SHAREFEW, BANKS and EMPLOYEES (note that BANKS has taken the place of CREDITORS) against ROA.AVE yields Table 25. SHAREFEW and BANKS significantly influence corporate performance (1 percent level). It suggests that higher ownership concentration and less influence from banks make the firm perform better. The regression outcome validates Figures 6 and 9.

Managers control and performance

Large Japanese corporations have been known to adhere to a social consensus in which managers and employees share a common fate. The development of the cross-holdings system after the World War II reduced the power of individual shareholders, providing a favorable environment for in-house managers. It can be said that Japanese firms have experienced the so-called managerial revolution in a Japanese way.

Table 25. Results of the multiple regression analysis of ROA.AVE and governance patterns

Dependent variable: **ROA.AVE**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	.738	.518		1.425	.162
SHAREFEW	.182	.073	.362	2.508	.017
EMPLOYEES	-.219	.251	-.127	-.869	.392
BANKS	-.474	.212	-.321	-2.234	.031

To check the relationship between the managers power of control and the firm s performance, managers control (represented by MANAGERS) was constructed out of several survey questions on management.

First the relationship between DIRECTORS and MANAGERS has to be established. The predicted result is a close relationship. Table 26 shows significant relationship between the two determinants. Thus, MANAGERS can be the index of managerial power thrust.

Table 26. Correlation between DIRECTORS and MANAGERS

	DIRECTORS	MANAGERS
DIRECTORS	1	.408**
Pearson s coefficient of correlation	.	.001
N	58	58
MANAGERS	.408**	1
Pearson s coefficient of correlation	.001	.
N	58	58

**1% level *5% level

That provides the basis for finding the relationship between MANAGERS and performance. Annex Table 2 shows that MANAGERS has no connection with any of the firm s performance and productivity indices. It suggests that managers independence from shareholders has little relevance to firm performance.

Disclosure and performance

The firm s disclosures policy is now being debated in Japan. Various pressures are being put on firms to open themselves to their stakeholders. According to business common sense such policy would increase cost and therefore decrease profit. Those who agree on the basis of enlightened self-interest say such policy has potential to increase profit, because the firm could gain praise from community or civil society and the firm could stretch sales or could employ good people. To test these two arguments, a disclosures score (DISCLOS) is tallied from the appropriate survey questions.

Annex Table 3 shows that DISCLOS significantly relates only to the average growth rate of sales profit and the relationship is negative. What the result means is that disclosures policy and performance of the firm have little connection. The enlightened self-interest theory does not find support in this study.

Ccorporate ethics and performance

What applies to disclosure also applies to corporate ethics. That ethics pay is also based on the enlightened self-interest hypothesis . Again, to test the hypothesis, corporate ethics was measured from relevant survey questions (for example, the APO survey questionnaire asks whether the firm has a code of ethics). The overall score of each firm is represented by ETHICS.

Annex Table 4 shows however, that ethics has no connection with any of the firm s performance indices, suggesting that corporate ethics is not relevant to firm growth and productivity. Thus none of the rival theories is validated.

Quality and productivity programs and performance

Next a quality score (QUALITY) was tallied from the questionnaire (for example, a relevant survey question asks whether the firm has company-wide quality and productivity improvement programs).

Again, there is no connection between quality and performance as Annex Table 5 indicates. It suggests that P & Q has no impact on firm performance.

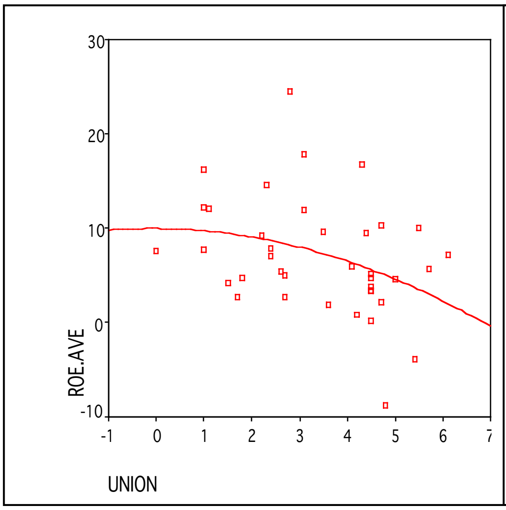


Figure 10. Management-employee relations vs. ROE

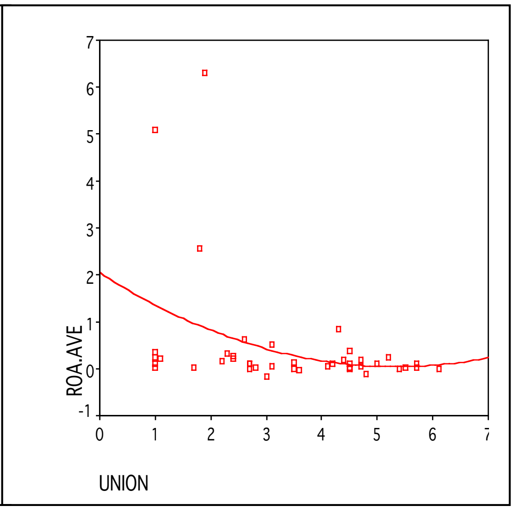


Figure 11. Management-employee relations vs. ROA

Management-employee relations and performance

If employees organize themselves, would the firm be affected badly? When the firm tries to suppress its employees, would people lose work motivation and would the performance of the firm get worse? A management-employees relations score (UNION) was derived from the questionnaire (for example, it asks whether there is an employee association or union in the firm). A higher score is given when employees organizations seem to be independent from management.

Annex Table 6 shows that management-employee relations significantly relate to ROE.AVE and ROA.AVE and the direction of the relationship is negative. That suggests that the more employees organizations are independent from management, the more the firm s performance deteriorates.

Consumer protection and performance

Consumer protection (CONSUME) was also measured (for example, a survey question asks whether there are laws or regulations on consumer protection) but Annex Table 7 shows that it does not relate with any of the firm performance indices.

But as seen before, the relationship between quality-consciousness and awareness of consumer rights is significant and positive. Hence, consumer protection exerts at least a positive influence on quality-consciousness.

Relationship between environmental consciousness and performance

Survey questions such as: What kind of environmental protection does the firm have? led to the construction of ENVIRON, or an environmental consciousness index.

The relationship between environmental protection and performance is shown in Annex Table 8. Environmental protection activities significantly relate to SALES, ROE.GR, and ROE.AVE and all the relationships are negative. The result is counter-intuitive. The more the firm engages in environmental activities, the more its performance drops.

Japanese corporations may have learned their lesson from Japan s industrial pollution but here, it cannot be said that it pays to be green .

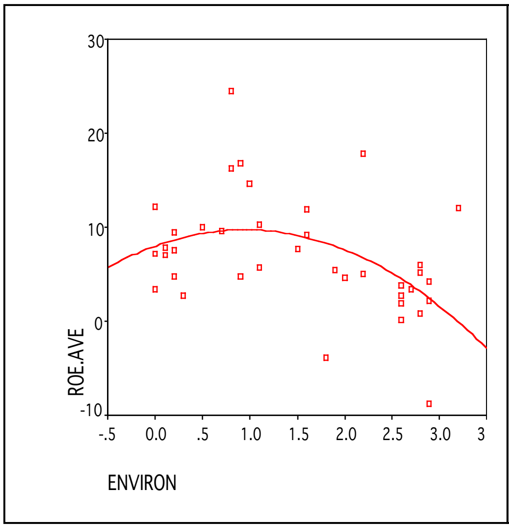


Figure 12. Environmental protection vs. ROA.AVE

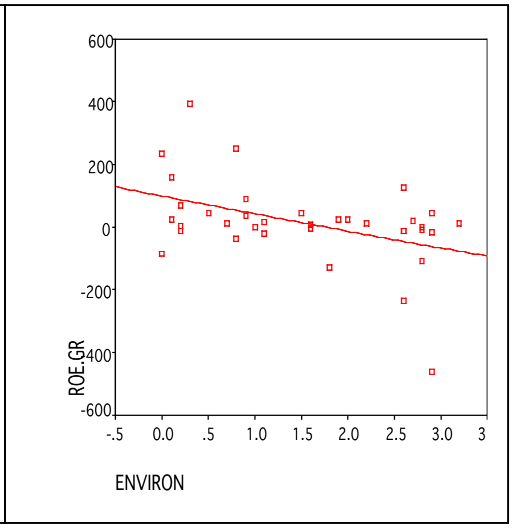


Figure 13. Environmental protection vs. ROA.GR

Community relations and performance

This issue is on corporate philanthropy . A community relations score (COMMUN) was used to test the issue. Annex Table 9 shows that COMMUN has no connection with any of the firm s performance indices. Corporate philanthropy or enlightened self-interest hypothesis again finds no support in this research.

International standards and performance

Does adherence to international standards affect firm productivity? Annex Table 10 unfortunately shows that international standards (represented by GLOBALSTAND) have no connection with any of the firm s performance indices. Perhaps local standards would suffice for Japanese firms at this time.

Overall governance variables and performance

Because new explanatory variables were introduced—after finding the links between firm performance and the seven governance patterns—it was necessary to check whether correlation exists among them and between them and the seven patterns (see Annex Table 11). Two combinations came from the correlation analysis, each set being composed of variables not correlated with each other. The first combination consists of MANAGERS, UNION, and COMMUNITY as well as SHAREFEW, CREDITORS and BANKS. The second combination consists of MANAGERS, ENVIRON and CONSUME as well as SHAREFEW and BANKS.

Accordingly, further statistical tests were conducted to validate the links between these governance variables and firm performance. The first set of multiple regression analyses, based on the ownership-performance nexus (Annex Tables 12, 13, 14 and 15), show the following results:

- No explanatory variables contribute significantly to SALES,
- Only CREDITORS affects NETPROFIT significantly (and negatively),
- Only UNION affects ROE.GR and ROA.AVE significantly (and negatively),
- SHAREFEW affects ROE.AVE significantly (and positively), and
- BANKS affects ROA.AVE significantly (and negatively).

The second set, based on variables other than ownership-related predictors (Annex Tables 16, 17, 18 and 19), show that

- None of the variables relate to SALES and NETPROFIT
- Only ENVIRON impacts on ROE.GR and ROE.AVE significantly (and negatively),
- SHAREFEW significantly affects ROA.AVE (and positively), and
- BANKS significantly affects ROA.AVE (and negatively).

Due to space limitations, these tests are not shown here.[6] However, the regression analyses generally show the robustness of the previous outcomes. It must be emphasized though that except for these variables, altogether no strong relationship has been found between corporate governance and firm performance and productivity.

SUMMARY AND CONCLUSION

This section summarizes the results of the study.

Owner/major shareholders in Japan are not deeply involved in the decision making process since major decisions are done by the board and the CEO. In Japanese companies

[6] The detailed correlation and regression results and analyses are available from the author.

the level of responsibility of COO is less and many companies do not indicate the kind of decisions made by the COO. The level of management independence is relatively high and conflicts between owners and management teams are few in Japan. Historically, owner(s)/ major shareholders entrust management teams with the all business decisions.

Most companies disclose financial information, and information on ownership structure and governance twice or four times a year. Only a small numbers of companies do not disclose any information because they are not listed and no request has been lodged from their stakeholders or the general public.

Many companies in Japan employ moderate to very rigid internal controls to protect themselves against abuses but employ few internal controls for research and development. Japanese companies tend to invest on research and development aggressively for future business.

There are a number of mechanisms employed by the companies to discuss employer-employee relations issues. Labor management consultation is the basic instrument to solve issues between management and employees such as compensation, working conditions, company rules and regulations, labor standards and benefits.

The nature and content of social responsibility of for-profit-organizations have changed because the demands of society have changed over time. Recently, stakeholders have begun to judge corporations on the basis of participation in civic affairs. Along this vein, Japanese corporations seem to have attempted to be good corporate citizens, but it remains to be seen whether significant progress will be made.

Some illegal actions of well-known corporations show that it is not easy to achieve a balance between business and ethics. An emergent issue is the need to create many non-profit organizations or other interfaces to enable citizens to check corporations more effectively. The point is that external stakeholders, such as civil society, should exercise their watchdog function on corporations.

Japan is now facing the worst economic downturn in years yet little is heard from Japanese firms on the need to reform governmental and judicial systems. On paper, business society in Japan appears to be satisfied with government s economic and industrial policies. Japanese citizens are by nature not faultfinders, although what to an outsider are moderate views may in reality be already quite critical . That is to say, even a mild criticism of government policy may mask a strong desire to change it.

As earlier mentioned, Japanese management-labor relations appear peaceful on the surface but have significant structural problems. The in-house union system is a mirror image of the corporate organization. Often the hierarchy of a corporation is reflected directly in the hierarchy of the labor union. Voices of ordinary working people are easily suppressed through the union structure.

This study has demonstrated various results of linkages between performance and governance variables. The hypothesis is that the more good corporate governance practices are adopted, the better firm performance becomes. But this hypothesis could not be confirmed in Japan. A key problem lies perhaps in the choice of explanatory variables. The governance variables may not have been suitable for Japanese conditions. Regression analysis shows that few significant linkages exist, suggesting that other forces are at work within the real-world context in Japan.

It is sometimes difficult to hypothesize that corporate governance variables such as social responsibility deeply influence corporate performance. Although recent trends indicate that firms imbued with corporate citizenship perform better than traditional profit-oriented firms, it could be that Japan has not reached a social stage which would make social responsibility a necessary condition for survival and profitability.

The persistent underperformance of the economy in the last decade is often referred to as the lost ten years , and efforts to reverse the trend include better corporate governance. Despite many problems associated with the introduction of and the specification for best practice in Japan, a significant improvement has been made during the past several years thanks to the attempts by the government, academic professional organizations, regulatory bodies and above all, the companies themselves to benchmark Japanese corporate practices against global standards.

There is a long way to go before the goal is attained. There are areas yet to be modernized, such the role of directors vis- -vis the implementation of internal control system. The roles of institutional investors in corporate governance are still unclear. Above all, there is yet no clear proof of whether good corporate governance will actually promote the performance and enhance the value of companies.

This study indicates that companies feel the need to adopt a set of disciplines to demonstrate that they are trustworthy. There are strong signs that companies are determined to communicate with various stakeholders, above all with shareholders to discuss corporate governance. International interest on corporate governance is certainly being felt in Japan.

Such external factors can stimulate an internal self-governance process in regard to corporate management, business ethics, social responsibility, and institutional interface. Hopefully, this will in turn stimulate increased management efficiency.

As a necessary condition for good corporate governance in the 21st century, company transparency, as well as total openness in ownership, management and corporate responsibility will surely be of utmost importance. The latter condition social openness will lead to the idea of a corporation as a quasi- public organ endowed with societal presence. And that means that transparency and public accountability will be a *sine qua non*. The outcome can only be better firm performance.

REFERENCES

Fukao, Mitsuhiro (1999). Japanese Financial Instability and Weaknesses in the Corporate Governance Structure. Paper presented in the OECD Corporate Governance In Asia: A Comparative Perspective, Seoul, March 3-5.

Japan Economic Newspaper (2001), June 16.

Kanda, Hideki (1999). Disclosure and Corporate Governance: A Japanese Perspective. Paper presented to Organization for Economic Cooperation and Development Conference on Corporate Governance In Asia: A Comparative Perspective, Seoul, March 3-5.

Kang, Jun-Koo and Rene M. Stultz (1997). Is Bank Corporate Governance Approach Worth It? June 17.

Kikuchi, Tadao and Mitsuhiro Hirata (2000). International Comparison of Corporate Governance, *Bunshindo*, May.

Sheard, Paul (undated). Japanese Corporate Governance in Comparative Perspective.

Suzuki, Tadao et al. (1998). Corporate Governance Principles: A Japanese View. Prepared by the Corporate Governance Committee, Corporate Governance Forum of Japan, May 26.

Tokyo Lawyer Committee Corporation Law Division (2001). Actual Condition of Appointing Executive Officer and Outside Executive, A Separate Volume of Commercial Law No. 243. A Society for the Research of Commercial Law, October.

ANNEX

Annex Table 1. Correlation between governance patterns

	FOREIGNCAP	SHAREFEW	DIRECTORS	BANKS	EMPLOYEES	CROSSHOLD	CREDITORS
FOREIGNCAP	1	.372**	.176	.446**	.079	.766**	.174
Pearson s coefficient	.	.004	.186	.000	.555	.000	.191
N	58	58	58	58	.58	58	58
SHAREFEW	.372**	1	.181	.152	-.051	.384**	-.052
Pearson s coefficient	.004	.	.173	.254	.704	.003	.700
N	58	58	58	58	58	58	58
DIRECTORS	.176	.181	1	.377**	.453**	.481**	.213
Pearson s coefficient	.186	.173	.	.004	.000	.000	.108
N	58	58	58	58	58	58	58
BANKS	.446**	.152	.377**	1	.257	.141	.454**
Pearson s coefficient	.000	.254	.004	.	.051	.289	.000
N	58	58	58	58	58	58	58
EMPLOYEES	.079	-.051	.453**	.257	1	.141	.091
Pearson s coefficient	.555	.704	.000	.051	.	.289	.497
N	58	58	58	58	58	58	58
CROSSHOLD	.766**	.384**	.228	.481**	.141	1	.088
Pearson s coefficient	.000	.003	.085	.000	.289	.	.511
N	58	58	58	58	58	58	58
CREDITORS	.174	-.052	.213	.454**	.091	.088	1
Pearson s coefficient	.191	.700	.108	.000	.497	.511	.
N	58	58	58	58	58	58	58

*5% level **1% level

Annex Table 2. Correlation between MANAGERS and performance

	SHAREFEW	SALES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
MANAGERS	1	-.109	.166	-.033	-.223	.000
Pearson s coefficient	.	.482	.269	.847	.178	.998
N	58	44	46	36	38	42
SALES	-.109	1	-.545**	.486**	-.059	.086
Pearson s coefficient	.482	.	.000	.003	.731	.605
N	44	44	44	35	37	39
NETPROFIT	.166	-.545**	1	-.333*	-.051	.120
Pearson s coefficient	.269	.000	.	.048	.759	.460
N	46	44	46	36	38	40
ROE.GR	-.033	.486**	-.333*	1	.349*	.163
Pearson s coefficient	.847	.003	.048	.	.037	.374
N	36	35	36	36	36	32
ROE.AVE	-.223	-.059	-.051	.349*	1	.108
Pearson s coefficient	.178	.731	.759	.037	.	.543
N	38	37	38	36	38	34
ROA.AVE	.000	.086	.120	.163	.108	1
Pearson s coefficient	.998	.605	.460	.374	.543	.
N	42	39	40	32	34	42

* 5% level **1% level

Annex Table 3. Correlation between disclosure policy and performance

	DISCLOS	SALES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
DISCLOS	1	-.434**	-.028	-.199	-.199	-.262
Pearson s coefficient	.	.003	.852	.245	.245	.094
N	58	44	46	36	36	42
SALES	-.434**	1	-.545**	.486**	-.059	.086
Pearson s coefficient	.003	.	.000	.003	.731	.605
N	44	44	44	35	37	39
NETPROFIT	-.028	-.545**	1	-.333*	-.051	.120
Pearson s coefficient	.852	.000	.	.048	.759	.460
N	46	44	46	36	38	40
ROE.GR	-.199	.486**	-.333*	1	.349*	.163
Pearson s coefficient	.245	.003	.048	.	.037	.374
N	36	35	36	36	36	32
ROE.AVE	-.199	-.059	-.051	.349*	1	.108
Pearson s coefficient	.245	.731	.759	.037	.	.543
N	36	37	38	36	38	34
ROA.AVE	-.262	.086	.120	.163	.108	1
Pearson s coefficient	.094	.605	.460	.374	.543	.
N	42	39	40	32	34	42

* 5% level **1% level

Annex Table 4. Correlation between ethics and performance

	ETHICS	SHARES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
ETHICS	1	.067	-.056	.080	.053	.173
Pearson s coefficient	.	.667	.771	.644	.754	.274
N	58	44	46	36	38	42
SHARES	.067	1	-.545**	.486**	-.059	.086
Pearson s coefficient	.667	.	.000	.003	.731	.605
N	44	44	44	35	37	39
NETPROFIT	-.056	-.545**	1	-.333*	-.051	.120
Pearson s coefficient	.771	.000	.	.048	.759	.460
N	46	44	46	36	38	40
ROE.GR	.080	.486**	-.333*	1	.349*	.163
Pearson s coefficient	.644	.003	.048	.	.037	.374
N	36	35	36	36	36	32
ROE.AVE	.053	-.059	-.051	.349*	1	.108
Pearson s coefficient	.754	.731	.759	.037	.	.543
N	38	37	38	36	38	34
ROA.AVE	.173	.086	.120	.163	.108	1
Pearson s coefficient	.274	.605	.460	.374	.543	.
N	42	39	40	32	34	42

* 5% level **1% level

Annex Table 5. Correlation between P & Q and performance

	QUALITY	SALES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
QUALITY Pearson s coefficient N	1 . 58	-.055 .722 44	-.232 .121 46	.164 .341 36	.122 .467 38	-.284 .069 42
SALES Pearson s coefficient N	-.055 .722 44	1 . 44	-.545** .000 44	.486** .003 35	-.059 .731 37	.086 .605 39
NETPROFIT Pearson s coefficient N	-.232 .121 46	-.545** .000 44	1 . 46	-.333* .048 36	-.051 .759 38	.120 .460 40
ROE.GR Pearson s coefficient N	.164 .341 36	.486** .003 35	-.333* .048 36	1 . 36	.349* .037 36	.163 .374 32
ROE.AVE Pearson s coefficient N	.122 .467 38	-.059 .731 37	-.051 .759 38	.349* .037 36	1 . 38	.108 .543 34
ROA.AVE Pearson s coefficient N	-.284 .069 42	.086 .605 39	.120 .460 40	.163 .374 32	.108 .543 34	1 . 42

* 5% level **1% level

Annex Table 6. Correlation between management-employees relations and performance

	UNION	SHARES	NET PROFIT	ROE.GR	ROE.AVE	ROA.AVE
UNION Pearson s coefficient N	1 . 58	-.178 .247 44	.112 .460 46	-.292 .084 36	-.340* .037 38	-.339* .028 42
SHARES Pearson s coefficient N	-.178 .247 44	1 . 44	-.545** .000 44	.486** .003 35	-.059 .731 37	.086 .605 39
NETPROFIT Pearson s coefficient N	.112 .460 46	-.545** .000 44	1 . 46	-.333* .048 36	-.051 .759 38	.120 .460 40
ROE.GR Pearson s coefficient N	-.292 .084 36	.486** .003 35	-.333* .048 36	1 . 36	.349* .037 36	.163 .374 32
ROE.AVE Pearson s coefficient N	-.340* .037 38	-.059 .731 37	-.051 .759 38	.349* .037 36	1 . 38	.108 .543 34
ROA.AVE Pearson s coefficient N	-.339* .028 42	.086 .605 39	.120 .460 40	.163 .374 32	.108 .543 34	1 . 42

* 5% level **1% level

Annex Table 7. Correlation between consumer s relations and performance

	CONSUMER	SHARES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
CONSUMER	1	-.196	.067	-.135	-.092	-.255
Pearson s coefficient	.	.202	.658	.431	.585	.103
N	58	44	46	36	38	42
SHARES	-.196	1	-.545**	.486**	-.059	.086
Pearson s coefficient	.202	.	.000	.003	.731	.605
N	44	44	44	35	37	39
NETPROFIT	.067	-.545**	1	-.333*	-.051	.120
Pearson s coefficient	.658	.000	.	.048	.759	.460
N	46	44	46	36	38	40
ROE.GR	-.135	.486**	-.333*	1	.349*	.163
Pearson s coefficient	.431	.003	.048	.	.037	.374
N	36	35	36	36	36	32
ROE.AVE	-.092	-.059	-.051	.349*	1	.108
Pearson s coefficient	.585	.731	.759	.037	.	.543
N	38	37	38	36	38	34
ROA.AVE	-.255	.086	.120	.163	.108	1
Pearson s coefficient	.103	.605	.460	.374	.543	.
N	42	39	40	32	34	42

* 5% level **1% level

Annex Table 8. Correlation between environmental protection and performance

	ENVIRON	SHARES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
ENVIRON	1	-.386**	-.038	-.435**	-.380*	-.264
Pearson s coefficient	.	.010	.801	.008	.019	.091
N	58	44	46	36	38	42
SHARES	-.386**	1	-.545**	.486**	-.059	.086
Pearson s coefficient	.010	.	.000	.003	.731	.605
N	44	44	44	35	37	39
NETPROFIT	-.038	-.545**	1	-.333*	-.051	.120
Pearson s coefficient	.801	.000	.	.048	.759	.460
N	46	44	46	36	38	40
ROE.GR	-.435**	.486**	-.333*	1	.349*	.163
Pearson s coefficient	.008	.003	.048	.	.037	.374
N	36	35	36	36	36	32
ROE.AVE	-.380*	-.059	-.051	.349*	1	.108
Pearson s coefficient	.019	.731	.759	.037	.	.543
N	38	37	38	36	38	34
ROA.AVE	-.264	.086	.120	.163	.108	1
Pearson s coefficient	.091	.605	.460	.374	.543	.
N	42	39	40	32	34	42

* 5% level **1% level

Annex Table 9. Correlation between communities relations and performance

	COMMUN	SHARES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
COMMUN Pearson s coefficient N	1 . 58	-.117 .448 44	-.047 .758 46	.240 .159 36	.159 .339 38	-.105 .510 42
SHARES Pearson s coefficient N	-.117 .448 44	1 . 44	-.545** .000 44	.486** .003 35	-.059 .731 37	.086 .605 39
NETPROFIT Pearson s coefficient N	-.047 .758 46	-.545** .000 44	1 . 46	-.333* .048 36	-.051 .759 38	.120 .460 40
ROE.GR Pearson s coefficient N	.240 .159 36	.486** .003 35	-.333* .048 36	1 . 36	.349* .037 36	.163 .374 32
ROE.AVE Pearson s coefficient N	.159 .339 38	-.059 .731 37	-.051 .759 38	.349* .037 36	1 . 38	.108 .543 34
ROA.AVE Pearson s coefficient N	-.105 .510 42	.086 .605 39	.120 .460 40	.163 .374 32	.108 .543 34	1 . 42

* 5% level **1% level

Annex Table 10. Correlation between international standards and performance

	GLOBALSTAND	SHARES	NETPROFIT	ROE.GR	ROE.AVE	ROA.AVE
GLOBALSTAND Pearson s coefficient N	1 . 58	-.101 .516 44	-.024 .873 46	-.100 .561 36	-.241 .145 38	-.191 .227 42
SHARES Pearson s coefficient N	-.101 .516 44	1 . 44	-.545** .000 44	.486** .003 35	-.059 .731 37	.086 .605 39
NETPROFIT Pearson s coefficient N	-.024 .873 46	-.545** .000 44	1 . 46	-.333* .048 36	-.051 .759 38	.120 .460 40
ROE.GR Pearson s coefficient N	-.100 .561 36	.486** .003 35	-.333* .048 36	1 . 36	.349* .037 36	.163 .374 32
ROE.AVE Pearson s coefficient N	-.241 .145 38	-.059 .731 37	-.051 .759 38	.349* .037 36	1 . 38	.108 .543 34
ROA.AVE Pearson s coefficient N	-.191 .227 42	.086 .605 39	.120 .460 40	.163 .374 32	.108 .543 34	1 . 42

* 5% level **1% level

Annex Table 11. Correlation table for all governance variables

	FOREIGNCAP	SHAREFEW	DIRECTORS	BANKS	EMPLOYEES	CROSSHOLD	CREDITORS	MANAGERS	DISCLOS	ETHICS	QUALITY	UNION	CONSUMER	ENVIRON	COMMUN	SOCIAL	INTER.N
FOREIGNCAP	1	.372*	.176	.446*	.079	.766*	.171	-.160	.125	-.017	-.005	.139	-.047	-.085	.017	.251	.223
Pearson s coefficient	.	.004	.185	.000	.555	.000	.191	.231	.349	.900	.972	.296	.726	.526	.902	.057	.092
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
SHAREFEW	.372*	1	.181	.152	-.051	.384*	-.052	-.198	-.101	.001	.098	.067	-.039	-.215	.180	.237	.224
Pearson's coefficient	.004	.	.173	.254	.704	.oo3	.700	.137	.451	.995	.464	.616	.770	.106	.177	.073	.091
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
DIRECTORS	.176	.181	1	.377*	.453*	.228	.213	.408*	.588*	-.239	.228	.309*	.298*	.127.	.309*	.264*	.175
Pearson s coefficient	.185	.173	.	.004	.000	.085	.108	.001	.000	.071	.085	.018	.023	344	.018	.046	.188
N	58	58	58	58	58	58	58	58	58	58.2	58	58	58	58	58	58	58
BANKS	.446*	.152	.377*	1	.257	.481*	.454*	.049	.381*	-	.205	.028	.157	.098	-.067	.257	.239
Pearson s coefficient	.000	.254	.004	.	.051	.000	.000	.712	.003	.274*	.123	.833	.239	.466	.615	.051	.070
N	58	58	58	58	58	58	58	58	58	.037 58	58	58	58	58	58	58	58
EMPLOYEES	.079	-.051	.453*	.257	1	.141	.091	.258	.628*	-.096	.298*	.336*	.486*	.369*	.398*	.066	.211
Pearson s coefficient	.555	.704	.000	.051	.	.289	.467	.051	.000	.473	.023	.010	.000	.004	.002	.623	.112
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
CROSSHOLD	.766*	.384*	.228	.481*	.141	1	.088	-.162	.129	.110	.003	.115	-.040	-.215	.002	.182	.015
Pearson s coefficient	.000	.oo3	.085	.000	.289	.	.511	.225	.336	.409	.985	.392	.767	.105	.988	.171	.909
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
CREDITORS	.171	-.052	.213	.454*	.091	.088	1	-.070	.275*	-.170	.301*	.108	.169	.203	-.052	.310*	.105
Pearson s coefficient	.191	.700	.108	.000	.467	.511	.	.603	.037	.202	.022	.176	.204	.127	.700	.018	.435
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
MANAGERS	-.160	-.198	.408*	.049	.258	-.162	-.070	1	.388*	-.215	.147	.141	.127	.249	.127	-.027	.179
Pearson s coefficient	.231	.137	.001	.712	.051	.225	.603	.	.003	.105	.269	.293	.341	.060	.342	.842	.179
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
DISCLOS	.125	-.101	.588*	.381*	.628*	.129	.275*	.388*	1	-.120	.433*	.349*	.523*	.526*	.379*	.166	.433*
Pearson s coefficient	.349	.451	.000	.003	.000	.336	.037	.003	.	.370	.001	.007	.000	.000	.003	.213	.001
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
ETHICS	-.017	.001	-.239	-.27*	-.096	.110	-.170	-.215	-.120	1	-.27*	.020	.141	-.159	-.037	-.030	-.197
Pearson s coefficient	.900	.995	.071	.037	.473	.409	.202	.105	.370	.	.037	.882	.292	.232	.783	.823	.139
N	58	58	58.2	58	58	58	58	58	58	58	58	58	58	58	58	58	58
QUALITY	-.005	.098	.228	.205	.298*	.003	.301*	.147	.433*	-.27*	1	.067	.425*	.514*	.405*	.075	.527*
Pearson s coefficient	.972	.464	.085	.123	.023	.985	.022	.269	.001	.037	.	.617	.001	.000	.002	.576	.000
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
UNION	.139	.067	.309*	.028	.336*	.115	.108	.141	.349*	.020	.067	1	.270*	.343*	.141	.254	.214
Pearson s coefficient	.296	.616	.018	.833	.010	.392	.176	.293	.007	.882	.617	.	.404	.008	.291	.054	.106
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
CONSUMER	-.047	-.039	.298*	.157	.486*	-.040	.169	.127	.523*	.141	.425*	.270*	1	.546*	.517*	.059	.337*
Pearson s coefficient	.726	.770	.023	.239	.000	.767	.204	.341	.000	.292	.001	.404	.	.000	.000	.661	.010
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
ENVIRON	-.085	-.215	.127	.098	.369*	-.215	.203	.249	.562*	-.159	.514*	.343*	.546*	1	.309*	.129	.517*
Pearson s coefficient	.526	.106	.344	.466	.004	.106	.127	.060	.000	.232	.000	.008	.000	.	.018	.335	.000
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
COMMUN	.017	.180	.309*	-.067	.398*	.002	-.052	.127	.379*	-.037	.405*	.141	.517*	.309*	1	-.091	.285*
Pearson s coefficient	.902	.177	.018	.615	.002	.988	.700	.342	.003	.783	.002	.291	.000	.018	.	.497	.030
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
SOCIAL	.251	.237	.264*	.257	.066	.182	.310*	-.024	.166	-.030	.075	.254	.059	.129	-.091	1	.119
Pearson s coefficient	.057	.073	.046	.051	.623	.171	.018	.842	.213	.823	.576	.054	.661	.335	.497	.	.375
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58
INTER.N	.223	.224	.175	.239	.211	.015	.105	.179	.433*	-.197	.527*	.214	.337*	.517*	.285*	.119	1
Pearson s coefficient	.092	.091	.188	.070	.112	.909	.435	.179	.001	.139	.000	.106	.010	.000	.030	.375	.
N	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58	58

*5% level **1% level

Annex Table 12. Results of the multiple regression analysis of SALES and governance variables

Dependent variable: **SALES**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	58.837	92.604		.635	.529
SHAREFEW	14.141	7.847	.302	1.802	.080
BANKS	-7.541	23.413	-.056	-.322	.749
CREDITORS	26.972	18.928	.249	1.425	.163
MANAGERS	2.806	17.385	.027	.161	.873
UNION	-16.788	11.368	-.228	-1.477	.148
COMMUN	-19.908	36.678	-.083	-.543	.591

Annex Table 13. Results of the multiple regression analysis of NETPROFIT and governance variables

Dependent variable: **NETPROFIT**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	200.020	396.863		.504	.617
SHAREFEW	-33.373	33.219	-.159	-1.005	.321
BANKS	57.258	100.085	.095	.572	.571
CREDITORS	-219.455	81.886	-.451	-2.680	.011
MANAGERS	15.599	73.349	.033	.213	.833
UNION	59.701	48.222	.181	1.238	.223
COMMUN	-104.322	158.094	-.096	-.660	.513

Annex Table 14. Results of the multiple regression analysis of ROE.GR and governance variables

Dependent variable: **ROE.GR**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	-12.222	116.277		-.105	.917
SHAREFEW	13.484	10.271	.238	1.313	.200
BANKS	-37.115	34.423	-.233	-1.078	.290
CREDITORS	7.418	27.151	.060	.273	.787
MANAGERS	13.832	22.652	.117	.611	.546
UNION	-36.127	15.605	-.409	-2.315	.028
COMMUN	64.301	43.441	.249	1.480	.150

Annex Table 15. Results of the multiple regression analysis of ROE.AVE and governance variables

Dependent variable: **ROE.AVE**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	10.020	5.314		1.886	.069
SHAREFEW	.221	.468	.086	.472	.640
BANKS	-.743	1.449	-.102	-.513	.612
CREDITORS	.354	1.119	.063	.317	.754
MANAGERS	-.782	.988	-.144	-.792	.435
UNION	-1.441	.673	-.366	-2.141	.040
COMMUN	2.302	1.992	.192	1.156	.257

Annex Table 16. Results of the multiple regression analysis of SALES and governance variables

Dependent variable: **SALES**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	86.999	80.983		1.074	.290
ENVIRON	-37.743	19.755	-.345	-1.911	.064
SOCIAL	2.232	13.664	.028	.163	.871
CONSUMER	-9.010	26.246	-.059	-.343	.733
SHAREFEW	3.718	8.098	.079	.459	.649
BANKS	18.859	21.853	.140	.863	.394
MANAGERS	-2.036	17.248	-.019	-.118	.907

Annex Table 17. Results of the multiple regression analysis of NETPROFIT and governance variables

Dependent variable: **NETPROFIT**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	-88.685	363.072		-.244	.808
ENVIRON	-62.653	94.022	-.129	-.666	.509
SOCIAL	-36.720	59.887	-.103	-.613	.543
CONSUMER	80.499	121.030	.119	.665	.510
SHAREFEW	-10.522	37.834	-.050	-.278	.782
BANKS	-56.680	97.361	-.094	-.582	.564
MANAGERS	65.683	77.656	.140	.846	.403

Annex Table 18. Results of the multiple regression analysis of ROE.GR and governance variables

Dependent variable: **ROE.GR**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	175.383	97.639		1.796	.083
ENVIRON	-52.010	23.438	-.412	-2.219	.034
SOCIAL	-29.409	14.732	-.329	-1.996	.055
CONSUMER	-1.811	32.273	-.010	-.056	.956
SHAREFEW	4.629	9.541	.082	.484	.631
BANKS	-23.796	24.885	-.150	-.956	.347
MANAGERS	1.593	19.326	.013	.082	.935

Annex Table 19. Results of the multiple regression analysis of ROE.AVE and explanatory variables

Dependent variable: **ROE.AVE**

Model	Non-standardized coefficient		Standardized coefficient	t	*P value*
	B	Standard error	Beta		
1 (fixed number)	.493	.744		.662	.512
ENVIRON	-2.599E-02	.218	-.022	-.119	.906
SOCIAL	-4.289E-03	.136	-.005	-.032	.975
CONSUMER	-.258	.283	-.155	-.910	.369
SHAREFEW	.197	.082	.391	2.401	.022
BANKS	-.479	.224	-.324	-2.134	.040
MANAGERS	.141	.164	.130	.859	.396

ASSESSING THE IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY AND GROWTH IN KOREA

Prof. Young Seog Park
School of Business Administration
Sogang University
Republic of Korea

INTRODUCTION

Corporate governance in Korea was unheard of until the East Asian financial crisis struck in 1997 and drew attention to it.

According to the World Bank (1999), rapid and unsustainable buildup of investment in fixed assets financed by excessive borrowings brought about the crisis in Korea. This over-investment resulted in poor profitability as reflected in low and declining returns on equity and on capital employed. Other findings of the World Bank report point to several conclusions.

First, corporations in Korea tried to defy financial "laws of gravity" that can be ignored only at the risk of financial distress. Such business practice reflects a lack of financial discipline. Second, Korean corporations have not adopted global standards on creating shareholder value. In an era of increasing capital mobility, disparities underlying returns on equity and risk involved with capital employed cannot be sustained in the long run. Third, the poor operating and financial performance in Korea suggests a need for systematic corporate restructuring.

Just a few years ago, it was fashionable to decry the short-sightedness of the American financial system—the tendency of US financial markets to ignore longer-term corporate prospects while focusing heavily on quarterly earning reports. There were repeated calls for the US to adopt new laws that would permit financiers to take a longer view of their investment, and to move toward the more relationship-based investing model that prevailed in Japan. Now the talk is all about the virtues of "the market", the importance of competition and disclosure, and the horrors of crony capitalism.

Why did these relationship-based financial systems, which have been credited with fueling the miraculous growth of East Asia implode suddenly? Rajan and Zingales (1998) provide answers to this question. Based on previous academic researches, they illustrate the pros and cons of both the relationship-based system and the arm's length Anglo-Saxon system. Although relationships may increase or preserve value, in some cases, particularly when contracts are hard to write or enforce, they also have a downside in that they do not rely on price signals. The consequence has been a widespread and costly misallocation of resources. Rajan and Zingales conclude that two dimensions are important in determining whether relationships work well in an environment relative to arm's length transactions. The first is the extent of adequacy of the contractual "infrastructure" ("contractability" for short) in that environment. The second is the availability of capital for investment opportunity. When there is little available capital relative to opportunities and contractability is low, a relationship-based system is better than an arm's length system. On the other hand, when there is high contractablity and relatively abundant capital, an arm's length system works better. When the ratio of capital to opportunities is low but contractability is high, both systems work reasonably well, although in most developed economies the arm's length system tends to supplant the relationship system over time. Finally neither system works well when capital is relatively abundant and contractability is low. The relationship system easily leads to over-investment while the arm's length system has limited ability to recover funds once these are invested.

Until the end of the 1980s, the East Asian economies were overwhelmingly relationship-based systems. During the onset of liberalization, the volume of profitable investment opportunities greatly exceeded the available capital. The capital shortage in turn prompted a momentous change in the environment: namely the opening up of the economies to capital flows—a development that coincided with the increased desire of western banks and fund managers for international diversification.

A flood of foreign capital poured into these countries at a time when the institutional infrastructure was not adequately developed to permit direct contracting between these sources of capital and borrowers. Not only did the foreign lenders not always know whether their funds were being deployed appropriately, they also did not have the institutional safeguard to protect their investment. Therefore, they took the second best route. They kept their loans and investment short term so that they could pull out at any indication of trouble. Short-term financing was the cheapest way for the countries to obtain large amount of capital. Both sides were happy provided the economies continued to go well. Then, suddenly prospects changed. Once some foreign arm's length capital started to pull out, it did not make sense for any to stay in. And that was how the crisis started.

The inconsistency between the financial system and the contractual environment lies at the core of the inevitability of East Asian crisis. Once the infrastructure of high contractability is established, the arm's length system will work better than the relationship system in the sense that the arm's length system performs well regardless of the level of capital to investment opportunity ratio. Currently, East Asian countries are in the process of institutionalizing contractability. They are setting up institutions such as exchanges and custodial services. Monitoring systems such as rating agencies, auditors, and supervisory authorities are being established or strengthened. Accounting standards and disclosure laws are being improved. There are also efforts to polish bankruptcy and contract laws to make these more effective. Under the arm's length system with contractual infrastructure, there is much to be done by the investment bank as a provider of vehicle to allocate funds with utmost transparency. However, that is not the end of story. The next hurdle is overcoming the incompatibility of the market mechanism with the current corporate governance system.

Corporate governance may be defined in various ways depending on how the firm is viewed. According to John and Senbet (1998), corporate governance is a mechanism by which stakeholders of a corporation exercise control over insiders and management such that their interest is protected. Prowse (1998) defines corporate governance as rules, standards, and organization in an economy that govern the corporate owners, directors and managers. Using a narrow definition, Shleifer and Vishny (1997) identify corporate governance as ways in which suppliers of finance to corporations assure themselves of getting return on their investment.

This paper defines corporate governance as the system by which corporations are directed and managed. It specifies the relationship and distribution of rights and responsibilities among the providers of capital, the board, managers and other stakeholders (employees, consumer, the community and the state) of the corporation. The outcomes of the interplay of these actors are strategic decisions that provide direction to the corporation.

Much of the literature on corporate governance focuses on the principal-agent relationship between shareholders (the principals) and managers (the agents) that stems from the separation of ownership and management in publicly owned corporation of the kind that prevails in the US and the UK in which no single shareholder owns more than a small fraction of a corporation s stock. More important, however, is the fact that outside the US and the UK, the corporation with widely dispersed ownership is not the rule but the exception. What prevails in Korea are corporations with concentrated ownership, i.e., large block-holders who directly control managers. Also widespread are cross-shareholdings among companies and the issuance of multiple classes of shares with different voting rights, all of which help dominant shareholders control corporate assets in a manner that is considerably greater than what their direct stock ownership would justify. Therefore, the key potential conflict of interest in Korea tends not to be between managers and shareholders *per se* but between the dominant owner-managers on one hand and minority shareholders and other investors (domestic and foreign) on the other. This conflict of interest is commonly referred to as the expropriation problem , as opposed to the agency problem that applies to the principal-agent relationship between shareholders and managers.

The Korean style of corporate governance tends to maximize sales rather than maximize the value of the firm as put forth by neoclassical economic theory. This is because the manager/shareholder of a Korean *chaebol* could monopolize the private utility at the expense of minority shareholders.

A key element in improving economic efficiency is corporate governance. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining these objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

The purpose of this study is to understand how governance issues impact on productivity and growth in Korea, and to develop policies, strategies and approaches that can address these issues. Specifically, this study identifies the link between corporate governance and productivity and growth it suggests policy recommendations based on survey findings and results.

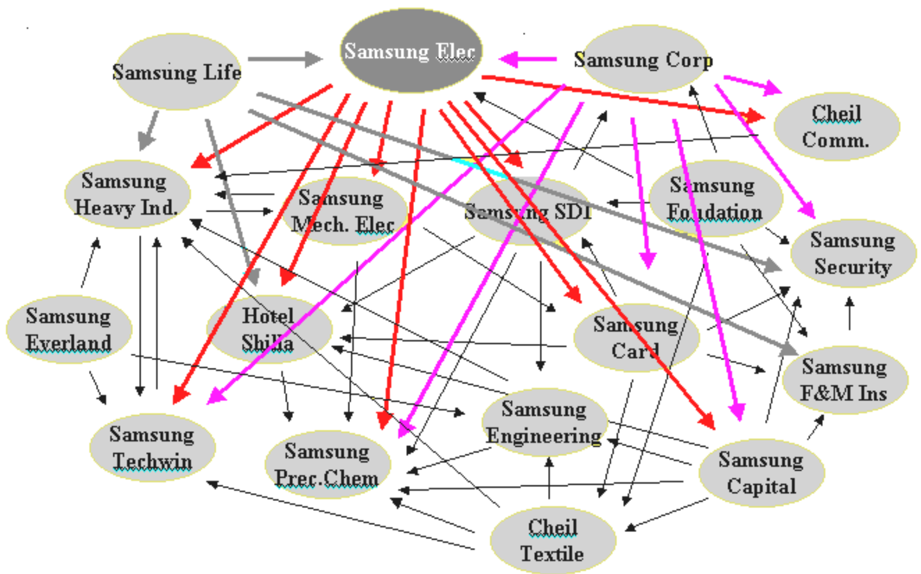
This report is organized as follows. After the introduction, the overview of the corporate sector follows. It covers the characteristics of the corporate sector, its role and performance. Next, the legal and regulatory framework is established. It reviews the laws governing the corporate sector and the regulations governing the capital market including the stock exchange. The next section describes the survey instrument (i.e., a background on the questionnaire and structure of the questionnaire) and the survey implementation and methodology. It presents how the firms were sampled and the variables were chosen. Then the characteristics of respondent firms are described. The findings, based on four key areas of corporate governance ownership, management, social responsibility and institutional interface and how these four areas of corporate governance impact on growth and productivity of firms form the centerpiece of the study. The concluding part provides general and specific policy recommendations.

OVERVIEW OF THE CORPORATE SECTOR

Characteristics of the corporate sector

The Korean Fair Trade Act defines a business group as a group of companies, whose business activities are controlled by an identical person. A large scale business group is called a *chaebol*. The most important elements characterizing *chaebols* are as follows.

First, they are conglomerates of many companies clustered around the parent company. The parent company is usually controlled by a single family owner and the companies hold shares in each other. *Chaebols* have a history of substantial concentration of ownership. One reason for this controlling power is inter-company shareholding among subsidiaries. Figure 1 shows the structure of equity ownership in the Samsung group. In this group, Samsung Life Insurance Co. acts the role of a parent company, giving rise to a pyramidal equity ownership structure. On the other hand, one can also easily come up with circular equity ownership as in the Hyundai group. In Korea, cross shareholding is prohibited by law, but one way shareholding (as shown in Figure 1) is not.



Source: Jang (2001)

Figure 1. Inter-company shareholding of the Samsung group

Table 1 shows that the 30 largest *chaebols* comprised a total of 624 separate public and private companies in 2001. It also shows that the number of subsidiaries of these *chaebols* increased considerably since 1993 and peaked at 819 in 1997. However, after the financial crisis, the number of subsidiaries declined drastically due to corporate restructuring.

Second, the group firms are diversified and vertically integrated. For example, the Samsung group has member firms in the electricity, heavy machinery, chemicals, financial and other industries. These affiliated firms do much of their lending and borrowing within their group. Using an internal capital market, the industrial groups can make it possible to invest in strategically important projects by shifting funds within a *chaebol*. Theoretically, *chaebols* can utilize the synergy effect, including the economies of organizational size as well as the usual economies of scale . Since *chaebols* are engaged in many different lines of business, they can reduce uncertainties and risks through sharing of information and diversification. This could ensure their stable growth and enhance their investment abilities.

Table 1. Number of subsidiaries of the 30 largest *chaebols*, 1993-2001

Year	Number of subsidiaries	Average number of subsidiaries per chaebol
1993	604	20.1
1994	616	20.5
1995	623	20.8
1996	669	22.3
1997	819	27.3
1998	804	26.8
1999	686	22.9
2000	544	18.1
2001	624	20.8

Source: The Fair Trade Commission

Third, the cross payment guarantees among affiliated firms help *chaebols* to finance projects through bank loans and corporate bonds. The cross payment guarantees, along with cross shareholdings, link member firms to each other and reduce the member firms risk of financial distress and bankruptcy by creating an internal capital market among the firms within *chaebols*. To expand internal capital markets, *chaebol* firms also increased their ownership of non-bank financial intermediaries in the 1980s when the government pushed for the financial market liberalization policy.[1]

Fourth, *chaebols* are more centralized than Japanese *keiretsu* and are more akin to the American and European conglomerates the early 1900s. *Chaebols* have strong central staff whereas many *keiretsu* in Japan have no central staff at all. Where Japanese conglomerates operate more through informal networking, their Korean counterparts have formal structures and centralized control. Therefore, major strategic and financial decisions are made at the group level instead of the individual firm s board meeting. In many ways, the relationship between firms belonging to the same *chaebol* and the decision-making committee is exactly the same as that of a division of a large firm and a board of directors. Using a survey of *chaebols*, Kook, Park, and Lee (1997) show that *chaebols* follow a group-oriented decision-making process.

On the other hand, there are many negative assessments of organizational structures and practices of *chaebols*. For example internal capital and product markets that might be of help to *chaebols* ultimately lead to the decline of social efficiency. Also, the strong financial links through mutual payment guarantee among their subsidiaries could cause the bankruptcy of one marginal subsidiary to trigger a chain of bankruptcies for the entire *chaebol*.

Under this structure, there is a severe conflict of interest problem between the manager-owner and the minority shareholders of *chaebol* firms. For example, a negative NPV[2] project, which would be rejected in the case of a stand-alone company, can be undertaken by a firm when this project can generate greater amount of positive NPV for other firms in the same *chaebol*. This investment decision might be good for the owner, but an owner s interest is pursued at the sacrifice of that of the minority shareholders of the firm which undertakes the negative NPV project.

[1] See Shin and Park (1998) for detailed analysis of internal capital markets.

[2] NPV= net present value.

Performance of the corporate sector

One of the basic principles in financial markets is high risk-high return and low risk-low return. This makes sense because investors ask for risk premium as a reward for bearing more risk. According to this principle, on average, low risk taking bond investors should earn higher return than high risk bearing stock investors.

Table 2 presents the average returns and standard deviation of annual returns of stock and bond investments. During the period 1926-1999, large cap common stocks yielded 11.2 percent while small firm common stocks generated 12.4 percent, which is consistent with high risk high return and low risk low return. Also this principle holds between stocks and bonds. A high risk taking stock investor earns more than low risk taking bond investor on average. In Table 2, based on finance literature, the standard deviation of annual returns is used to measure the level of risk for each investment.

Table 2. Distribution of stock and bond annual returns in the US, 1926-1999 (in %)

	Geometric average	**Arithmetic average**	**Standard deviation**
Common stocks (S&P500)	11.2	13.2	20.3
Small firm common stocks	12.4	17.4	33.8
Corporate bonds	5.8	6.1	8.6
Government bonds	5.3	5.7	9.2
Treasury bills	3.8	3.8	3.2

Sources: Stocks, Bills and Inflation 2000 Yearbook, 2000 Ibbotson Associates

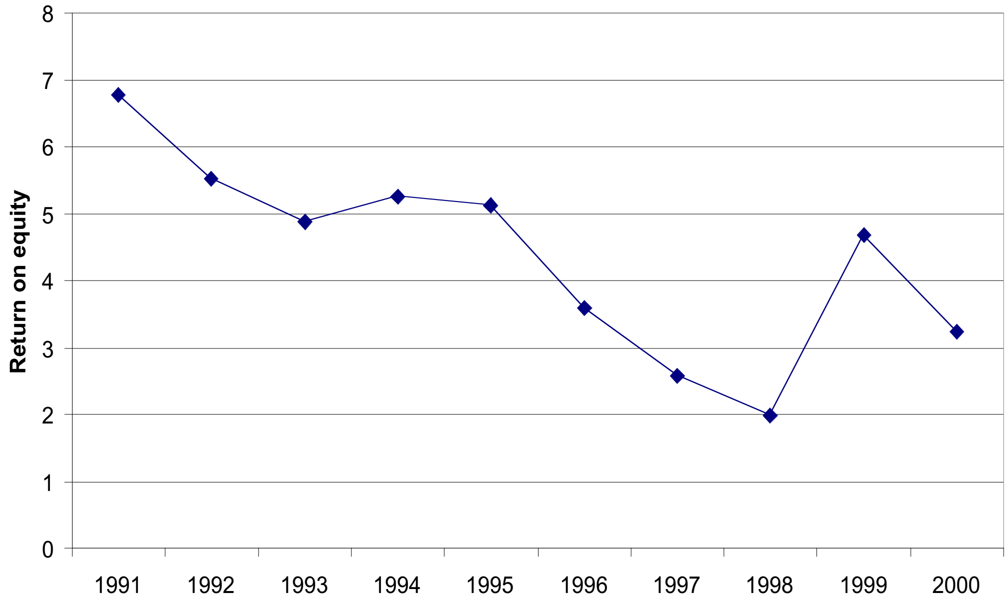
According to Table 3, the annual average return from corporate bond investment in Korea was 15.93 percent during the period 1980-2001 (13.7 percent during 1990-2001). On the other hand, higher risk taking investment, i.e., stock investment, gave rise to only 12.77 percent (3.32 percent) during the period 1980-2001 (3.32 percent during 1990-2001). This means that in Korea, low risk investment (corporate bond investment) offered higher return than high risk investment (stock investment) which was the reverse of what happened in the US. Therefore, the lesson that the rationality of financial market investment teaches to the stock investor is that the buy and hold strategy is not a good rule to follow in the Korean stock market. A rational stock investor in Korea will not follow the basic principle of investment, i.e., diversification.

Table 3. Average return of stock and corporate bond investment in Korea (in %)

	1980-2001	1990-2001
Corporate bond (3 year)	15.93	13.70
Stock	12.77	3.32

Sources: Bank of Korea (corporate bond return); KIS-FAS database (stock return)

Why did the stock investment not give enough return for companies bearing more risks? The study of 351 Korean non-financial firms which were listed during the period of 1999-2000 (Figure 2) shows that the median ROE for sample firms was as low as 2.36 percent in 1997 and that the Korean firms median ROE declined monotonically before the crisis. ROE received in 1999 but again it slid down in 2000.



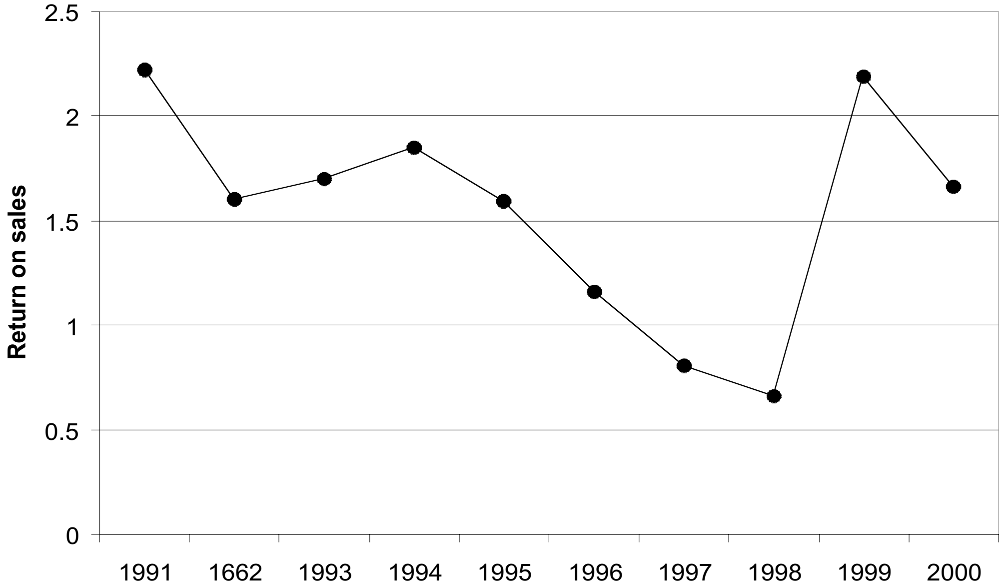
Source: Korea Stock Exchange

Figure 2. ROE of Korean firms

Since the average CD interest rate in 1990s was 12 percent, the level of median ROE for Korean firms in the 1990s was far lower than the opportunity cost of capital. Therefore, Figure 2 indicates that many Korean firms destroyed the value due to low profitability. Managers and controlling shareholders were maximizing firm size at the expense of profits, a practice that was not checked by creditors, internal control mechanism, or capital market discipline. This has been the crux of the corporate governance problem in Korea. Further, banks as major creditors (which had governance problems of their own) failed to monitor or exercise the control rights generally afforded to lenders via loan agreements.

In order to further investigate factors behind the low ROE, a look at the return on sales (ROS)[3] and asset turnover ratio during the same period is necessary. Figure 3 shows the pattern of ROS for Korean firms. Like ROE, ROS continuously declined until 1997. The excess competition from over-capacity is to be blamed for the low ROS of Korean firms. The firms maximizing their size suffered from over-investment and had to dump products into the market at a low_and sometimes below zero_margin. Also, due to the advance of globalization, competition with the global market players worsened the situation.

[3] ROS is calculated by dividing net income by sales. ROS indicates how large the profit is compared to t he amount of sales after paying out all cost including cost of goods sold, selling and administrative expen se, interest expense and taxes.



Source: Korea Stock Exchange

Figure 3. ROS of Korean firms

Figure 4 shows the trend of asset turnover ratio of Korean firms before and after the crisis. It shows that Korean firms have suffered from over-investment in the 1990s. Even after the crisis when the margin has recovered owing to low interest rate and low debt equity ratio imposed by the government the total asset turnover ratio did not show any significant recovery. Actually, severe over-investment has impact not only on profitability but also on total asset turnover ratio, lowering both in a more direct way.

Summarizing the above results, it can be said that low profitability and low asset turnover ratio caused by over-investment are behind the sliding ROE before the crisis. Consequently, the stock market that reflects the fundamentals of real side did not provide stock investors enough long-term average return to compensate for their bearing more risk when they chose to invest in stocks.

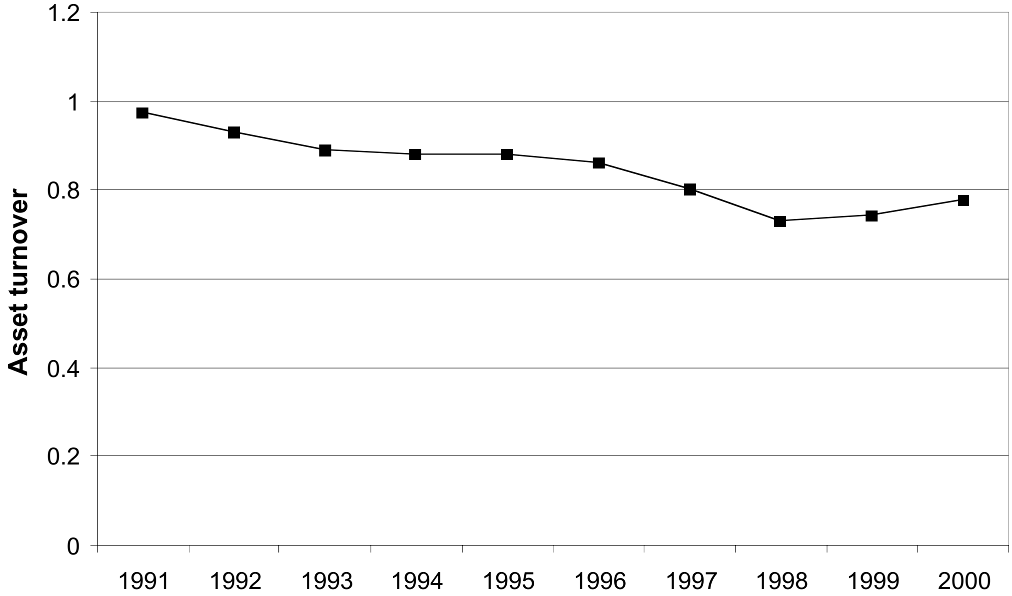
Changes in Korean firms after the crisis[4]

Since the 1997 crisis, the management style of Korea's top 30 business groups has changed in both positive and negative ways. On the positive side there is an increase in operating cash flows and internal funds even while the operation cycle has been shortened. On the negative side, the interest coverage ratio has not improved much, indicating that the companies are still exposed to excessive leverage. Consequently, credit risk is still a problem for Korean firms.

The financial crisis brought about changes in all dimensions of corporate finance. Right after the crisis, the cash-strapped Korean companies fought to survive by securing liquidity in the short-term, which was high on cost and low on efficiency. Then, they made an attempt at various restructuring measures. An analysis of how Korean companies

[4] This section was summarized based on Park (2001).

have responded to such rapid changes in the management environment is in order.[5] The main data used in the analysis was the companies' cash flow statements. The analysis revealed the following changes in the companies' management style.



Source: Korea Stock Exchange

Figure 4. Total asset turnover ratio of Korean firms

Increased cash flow

Since the currency crisis, Korean companies have made extensive restructuring efforts to overhaul their high cost, low profit structure and improve cash flow. As a result, the companies' cash flow has noticeably improved. During the pre-crisis period between 1995 and 1997, the average ratio of operating cash flows to sales was 4.2 percent, but that increased to 8.6 percent between 1998 and 2000.

The companies may be turning out profit on paper, when operating cash flows are actually negative. This means that unless they can collect accounts receivable, the companies have to carry the burden of providing their own working capital. They need to have at least positive operating cash flows to avoid bankruptcy while in the black. The fact that operating cash flows are improving since the financial crisis signifies that the profitability of the large business groups has improved and the pressure to generate own working capital is gradually lessening.

Less labor cost

Korean companies resorted to layoffs and wage cuts to improve cash flow and reduce costs after the crisis. Through such restructuring in human resources, the top 30 business

[5]This analysis includes 125 listed non-financial companies that belong to the top 30 business groups. The 125 companies 49 belong to the top 5 business groups and the remaining 76 companies belong to the to p 6 to 30 business groups.

groups gradually reduced the share of labor cost in the total production cost. The average ratio of labor cost to manufacturing cost during the pre-crisis period (1995-1997) was 10.7 percent, but after the crisis it was down to a range between 2.5 percent to 8.2 percent. Labor cost is likely to continue to decline. Korean manufacturers are moving their production lines offshore to China and Southeast Asia where labor is cheap, in a bid to raise competitiveness in production cost.

Shorter operation cycle

Since the crisis, the traditional businesses have tried hard to enhance the operation efficiency of the value chain by adapting e-business to the actual workplace in such forms as information sharing system and ERP system. In the top 30 business groups, the operation cycle (made up of average inventory processing period and receivables collection period) has shortened from an average of 117 days during the pre-crisis year (1995-1997) to 95 days after the crisis. The operation cycle in the top 5 business groups dropped from 116 days to 87 days and in the top 6 to 30 business groups, from 199 days to 100 days.

Reduction in inventories

Thanks to development in information and telecommunications and e-commerce, the top 30 groups now have a much less inventory burden. The average ratio of inventories to sales was 10.0 percent during the 3 years prior to the financial crisis, but fell to 7.8 percent after the crisis. In the top 5 business groups, the ratio dropped from 8.3 percent during 1995 and 1997 to 6.2 percent during 1998 and 2000 while in the top 6 to 30 businesses the ratio fell from 11.4 percent to 9.5 percent over the same period. The reduction in inventories is quite helpful in improving operating cash flows.

Increased dividends and share repurchases

The participation of minority shareholders in overseeing management has been expanding significantly since the crisis. Moreover, investors now put more emphasis on market information such as share prices and market value of listed shares than they do on assets and sales figures when evaluating a company s profitability and future growth. Amid the changing management environment, the affiliates of the large business groups are becoming more shareholder-focused, increasing dividends and share repurchases, and strengthening industrial relations activities.

The top 30 business groups paid out a total of 1.8 trillion won in cash dividends between 1995 and 1997. The amount increased to a total of 4.2 trillion won between 1998 and 2000. For the top 5 business groups dividends paid rose from 1 trillion won to 3 trillion won while that for the top 6 to 30 groups the increase was from 0.8 trillion won to 1.2 trillion won. In addition, the average dividend per share increased from 251 won (1995-1997) to 284 won (1998-2000) in the top 30 business groups. Share repurchases increased from 1.2 trillion won (1995-1997) to 6.5 trillion won (1998-2000) in the 30 business groups.

Increased divestitures and equipment investment falls

The large business groups increased their divestitures of assets and equipment to improve capital structure. Divestitures more than doubled from 23.1 trillion won (1995-1997) to 66.9 trillion won (1998-2000). The ratio of divestitures to sales rose from 3.6 percent to 6.7 percent over the same period.

In the top 30 business groups, the ratio of equipment investment to sales fell from an average of 9.5 percent per annum (1995-1997) to 4.6 percent (1998-2000). The ratio fell by a greater extent in the top 6 to 30 business groups than it did in the top 5 groups. After the financial crisis, accessing external funds became hard, thus making it almost impossible for businesses to make aggressive investments. Furthermore, Korea's potential growth capability and its ability to sustain high growth are now in doubt. And, the sharp slowdown in the US economic growth has created much uncertainty about undertaking investments, actively.

Rise in internal financing and low borrowings

Internally raised funds are growing. Internal funds in the top 30 business groups increased from 36.8 trillion won (1995-1997) to 39.1 trillion won (1998-2000). Internal funds fell as low as 4 trillion won in 1998, immediately after the crisis, but rose to 20 trillion won in 1999 and 15 trillion won in 2000. The average ratio of internal funds to sales rose from 4.4 percent between 1995 and 1997 to 5.5 percent between 1998 and 2000.

Interest bearing borrowings of the top 30 business groups shrank from 139.3 trillion won at the end of 1997 to 122.3 trillion won at the end of 2000. Borrowings rose as high as 140.6 trillion won at the end of 1998, but dropped significantly to 114.7 trillion won in the following year before turning upward again in 2000.

Low interest coverage ratio

The top 30 business groups' average interest coverage ratio between 1995 and 1997 was 1.2, but after the financial crisis the ratio was down to 1.1. In 1997, the number of firms with an interest coverage ratio of less than one, or without ability to meet financial obligations, was 41. The number was still the same in 2000. However, the interest coverage ratio of the top 30 business groups dropped to as low as 0.9 in 1998 and gradually increased to 1.4 in 2000. Interestingly, the top 5 groups maintained an average interest coverage ratio of 1.3 before and after the crisis, but the average interest coverage ratio of the top 6 to 30 business groups dropped from 1.2 before the crisis to 1.0 after the crisis. It is possible to expect a gradual improvement in the interest coverage ratio once the high-interest bonds issued at the end of 1997 and early 1998 are refunded, thus reducing the companies' financing costs. However, no big improvement is likely, because the sluggish domestic demand and export could make sales and operating profit at a low level, and because corporate borrowings are rising again.

Credit risk

The management style of the top 30 business groups in Korea has changed since the crisis and it is particularly uplifting that the conditions of internal funds and operating cash flows have improved. However, it is disappointing that the interest coverage ratio is only around 1.4. It means that Korean business groups are still facing credit risk. Also, the uptrend again in borrowings in 2000 suggests that it is not easy to curb leveraged management without significant progress in the capital market. Besides, if the decline in equipment investment were actually a result of a lack of vision or assurance about which industries would lead the Korean economy in the future, then, such a change could have an adverse effect on the economy.

LEGAL AND REGULATORY FRAMEWORK[6]

Laws regulating the corporate sector

As part of the restructuring of the Korean economy after the crisis, the IMF and the World Bank put great emphasis on improving the corporate governance of Korean firms. Consequently, there have been dramatic changes in Korean laws and regulations dealing with corporate accountability and transparency, protection of investors, and shareholder democracy. Specifically, the Korean Commercial Code (KCC), the Korean Securities and Exchange Act (KSEA), the Korean Banking Act (KBA), and other related laws are undergoing important changes to reflect the new corporate governance policy adopted by the Korean government after consultation with the IMF and the World Bank. Most importantly, both the KCC and the KSEA have undergone three substantial changes since 1998.

Since its inauguration in 1998, the new government has embraced many reform measures aimed at improving the corporate governance of c*haebols*. *Chaebols* were required to make the financial structure improvement agreement with their main banks and, according to that agreement, all 30 *chaebol* groups were required to lower the average debt-to-equity ratio to less than 200 percent by the end of 1999. Interest payments on debt in excess of 500 percent of the debt-to-equity ratio would not be recognized as a tax deductible expense. For the top 30 *chaebols*, any new cross debt guarantee among affiliated companies was prohibited and all existing ones was to be cleared by March of 2000.

The bankruptcy laws were revised to expedite the bankruptcy process and to provide quick and easier exit for failed companies. The limits on foreign stock investment were removed and the regulation that suppressed hostile takeover in the market was abolished. The c*haebol s* excessive diversification of business line was discouraged. Also, business swaps among chaebols were encouraged to let them concentrate their resources on specialized business areas. Tax laws were revised to provide incentives to the companies that sell off their assets as part of restructuring efforts.

The Korean government has also taken several steps to enhance transparency and to strengthen management responsibility. In order to increase transparency, the top 30 *chaebols* are now required to disclose the consolidated financial statements starting 1999.

The KCC and the KSEA have been revised to strengthen minority shareholder rights. The February/May 1998 amendments to the KSEA significantly relaxed the shareholding requirements for exercising minority shareholder rights, including the filing of a derivative suit. The January 2000 amendments of the KSEA went further in favoring the shareholders of large securities firms by relaxing such requirements to one-half the requirements applicable to regular listed companies. In practice, however, the exercise of minority shareholder rights is still relatively rare. A recent survey by the *Korean Daily Economic Newspaper* showed that only 10 Korea Stock Exchange (KSE) listed companies had experienced the derivative suit in the past three years.

Recently the Class Action Bill was adopted in Korea but with some restrictions attached. The bill provides that (1) class action suit shall be restricted only to those claims pertaining to fraudulent accounting and disclosure; (2) only those companies with assets exceeding two trillion Korean won shall be subject to class act suits; and (3) a class in a class action suit must get prior approval from a court.

---

[6] This section was summarized based on Kim (2002).

The January 2000 amendments to the KSEA also introduced the outside director system into the statute, which, thus, far had only been required through the listing rules of KSE. Listing requirements now require the listed companies to have independent outside directors to constitute more than one fourth of its board of directors. Another rule is that certain large listed companies with total assets in excess of 2 trillion won must have more outside directors than the number of manager-directors. The rule also stipulates that the number of outside directors in such firms must be at least three. Listed companies are also required to institute the auditor selection committee with outside directors comprising at least two-thirds of the committee. The penalties on the company and the auditors committing accounting manipulations have become stiffer.

The cumulative voting system was introduced as a default rule in the October 1998 amendments to the KCC. So far, it has been a regular practice for Korean firms to opt out cumulative voting through charter provisions. However, under the March 2001 amendments to the KSEA, shareholders of a large listed company with total assets in excess of 2 trillion won as of the end of the most recent business year who own more than three percent of the voting shares issued would not be allowed to exercise their voting right over three percent of such voting shares when opting not to vote cumulatively. The new rule rectifies such practices as opting out of cumulative voting through charter provisions and rendering the cumulative voting a true default rule in many circumstances.

Under the pre-amendment KCC, a company could issue new shares of stock to a third party other than its shareholders regardless of the purpose of such issuance of the new shares. The July 2001 amendments to the KCC, however strengthen the existing shareholders preemptive right. The new KCC provides that the issuance of new shares to a third party by overriding the existing shareholders preemptive right is allowed only when necessary to achieve the objective of the company s management, such as introduction of new technology and improvement of financial structures.

Regulations governing the capital market including the stock exchange

The Korean government has recognized the role of the market for corporate control in disciplining poorly performing corporate managers. Several regulatory reforms to allow and promote hostile takeovers and to open the market to foreign investors began before the 1997 crisis and were hastened by it. Recently, these efforts have reached completion.

The opening of the domestic market for corporate control was an actively discussed policy issue in Korea beginning in late 1996. However, even after the basic ceiling of ten percent for individual ownership for listed Korean companies was abolished in April 1998, foreigners acquisition of Korean shares remained highly restricted. Most Korean companies wanted to delay the internationalization of the domestic market for corporate control. However, the opening of the M&A market to foreigners became a sudden reality with the 1997 agreement between the Korean government and the IMF. Korea practically agreed to allow the hostile acquisition of Korean companies by foreigners.

This change was incorporated in the February 1998 amendments to the Law of Foreign Investment and Foreign Capital Inducement. By the end of July, the percentage of foreign investors in KSE-listed companies had risen further to 31.7 percent. Also, the generally revised Korean Banking Act weakened the ceiling on bank ownership. Foreign investors can acquire shares in Korean banks up to 10 percent without the approval of the Korean government.

The market for corporate control is emerging in Korea. In fact the number of contested corporate acquisition activities and proxy battles gradually increased in 1996 and 1997 until the 1997 crisis pushed the trend toward friendly acquisitions and restructuring. In 1997 alone, 11 tender offers were launched in the Korean securities market; some of those offers were hostile. When the Korean economy rebounds, foreign investors can find many attractive acquisition targets in the restructured and internationalized Korean capital markets. Thus, foreign companies have launched 26 (as of August 2001) tender offers in the Korean securities market. The Korean government will continue to focus on the role of an active market for corporate control in improving the corporate governance of Korean firms.

Traditionally, creditors such as banks do not interfere with the management of the borrowing company. The covenants in loan agreement and bond indentures are very loose, simple and not strictly enforced. Banks themselves are poorly governed and bank management has little incentive to monitor borrowers. As for the bond issues, underwriting securities firms act also as trustees. Thus, there is the usual conflict of interest problem and the trustee does not have the incentive to strictly enforce the covenants. In fact, bond indentures are only a few pages long in Korea compared to a few dozen pages found in advanced bond markets.

SURVEY IMPLEMENTATION AND METHODOLOGY

The underlying proposition of this research is that good corporate governance promotes improved productivity and competitive pressures. On the basis of the characteristics of good corporate governance, a framework was drawn up consisting of four key areas: ownership, management, social responsibility and institutional interface. These key elements of corporate governance are presumed to affect the corporate performance in terms of corporate growth and productivity.

The governing relationship can be described as

Corporate performance (growth + productivity) =
f(ownership, management, social responsibility, institutional interface)

Here the dependent variables are company growth and productivity and the independent variables are ownership, management, social responsibility and institutional interface.

In order to analyze the impact of corporate governance on productivity and growth, a detailed survey by the Asian Productivity Organization was conducted at the firm level. The survey was initiated in Korea in February 2002 and was completed in April 2002. The top 300 largest KSE listed firms in terms of capitalization were contacted for an interview with preferably the corporate finance officer or any other executive in charge of investor relationship. Out of 300 firms, 38 firms participated in the survey. Publicly available financial data were gathered from the database of the Association of Listed Companies rather than from individual companies in order to minimize the risk of reporting figures from heterogeneous perspectives.

How do the important areas of corporate governance impact on growth and productivity? The key is to find out any empirical relationship between corporate governance *and* the productivity and growth of Korean firms. The measures of productivity that were used are ROA, ROE, gross profit margin, net profit margin, and sales growth rate and asset growth rate. Since the survey was done in 2002, the study relied on 2000 financial numbers (year 2000 has the recent figures available). Any significant result is reported whether consistent with the research hypothesis or not.

Characteristics of respondent firms

A brief description of the characteristics of the sample is shown in Table 4. All surveyed firms are located in Seoul and all firms are listed in the Korea Stock Exchange.

Table 4. Characteristics of sample firms

		Frequency		%	
Industry distribution	Manufacture	23		60.53	
	Construction	5		13.16	
	Power generation	1		2.63	
	Business service	1		2.63	
	Trading and wholesale	4		10.35	
	Retail	1		2.63	
	Others	3		7.89	
		yes		no	
Foreign firm has a financial stake		16(43.24%)		21(56.74%)	
Firm have holdings or operations in other count		23(63.89%)		13(36.11%)	
Exporting firm		32(84.21%)		6(15.79%)	
	Mean	Standard Deviation	Minimum	Median	Maximum
Proportion of export	0.3853	0.0525	0.003	0.3634	0.97
		Frequency		%	
Major shareholder	Government	2		5.26	
	Family	8		21.05	
	Domestic company	12		31.58	
	Foreign company	1		2.63	
	Individual	14		36.84	
	Others	1		2.63	
	Mean	Standard Deviation	Minimum	Median	Maximum
Number of regular employees	3,863.21	5,701.60	200	1,999	26,333
Total compensation budget	140,336million	241,697million	5,622million	64,130milliom	1,246,393milliom
Number of hours actually worked	2,453	250.25	2,160	2,448	2,868
Value of output	4,310million	7,796million	0	1,504million	40,620million
Value added	695million	1,213million	19million	292million	5,756million
Book value of fixed assets	3,691million	10,080million	136million	1,171million	61,721million
Gross profit margin	0.2274	0.2224	0.0243	0.1528	0.9993
Net profit margin	0.0283	0.06	-0.0969	0.0208	0.165
Return on equity	0.0245	0.2048	-1.1066	0.0423	0.2016
Return on assets	0.0112	0.0218	-0.0499	0.0097	0.0623

Note: Total compensation budget, value of output, value added and book value of fixed assets are in Korean won.

Two of the respondents are government-controlled firms and the rest are private corporations listed in the Korea Stock Exchange. Twenty-three firms (60.5 percent) are from the manufacturing industry, five firms (13.1 percent) belong to the construction industry, and four firms are engaged in trading and wholesale business. There are 16 firms (43.24 percent) in which foreign firms have a financial stake and 24 firms (56.74 percent) in which no foreign company has a stake. The largest company in terms of the total number of regular employees has 26,333 employees whereas the smallest company has 200.

SELECTED RESULTS

Ownership

Ownership concentration may be viewed from different perspectives. When ownership concentration is referred to in the context of how much of the ownership and shareholding is in the hands of a single person, most Korean listed firms can be said to be narrowly held. Most founding families are still the largest shareholders. Moreover, a pyramidal structure of corporate ownership is prevalent.

Kim (1992) and Kim, Chang, and Kim (1995) find a U-shaped pattern of relationship between the degree of ownership concentration and financial performance in Korea. Both studies use Tobin s Q for financial performance and discover that the U-shaped relationship was similar to that found in the US.[7]

The Korean Commercial Code does not permit direct cross-shareholding. This means that companies A and B cannot hold each other s shares at the same time. Although cross-shareholding is not allowed in Korea, endless shareholding is not against the law. Thus, a pyramiding share ownership is observed in which a *chaebol* controls a group of companies with a smaller investment using leverage effect.[8]

For the 34 listed firms which responded in APO survey, the median proportion of shares held by the top shareholder is 16.2 percent and the maximum proportion of shares held by the top shareholder is 52.2 percent whereas the minimum is 3.00 percent. The median of proportion of shares held by the top five shareholders is 31.24 percent, the maximum proportion is 71 percent and the minimum proportion is 7 percent. These numbers confirm the fact that share ownership of Korean firms is highly concentrated. Individual shareholders and families have the largest stake in 14 firms (36.8 percent of the sample) and eight firms (21.1 percent) firms, respectively.

Some 73.7 percent of the firms claim it is the board of directors that make major decisions concerning the firm s present direction while 13.1 percent say it is the managers who control the firm. For all firms there have been no changes of top managers or directors who control the firm since three years ago.

For all listed firms, shareholders have the right to vote according to share, to do proxy voting, to maintain proportionate ownership of the firm under any financing plan, to resolve disputes within the firm, and to demand independent audit. As to minority shareholder they are represented in the board only in one firm.

Out of the 38 firms, 84.2 percent were originally established as private firms, 10.5 percent were originally government owned and later privatized firms, and 5.3 percent were originally joint ventures.

No law prohibits foreign ownership in Korea and this policy has had favorable results. Figure 5 shows there is a positive relationship between foreign share ownership and revenue growth rate. It partially supports the hypothesis that foreign owned firms are more efficient.

---

[7] Mork, Shleifer, and Vishny (1988) find a U shaped relationship between share ownership concentration and firm performance.

[8] See Figure 1 for pyramiding share ownership. The author has not found any direct cross shareholding.

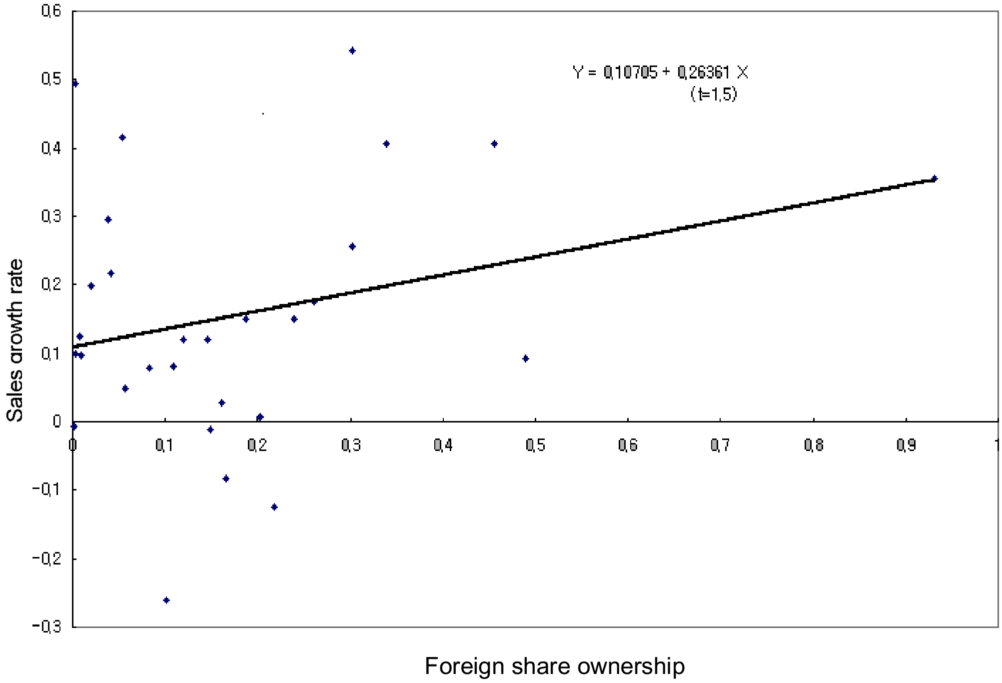


Figure 5. Foreign share ownership vs. sales growth rate

Figure 6 shows how the gross profit margin changes according to the proportion of export out of total sales. The relationship is negative. From the viewpoint of Korean firms, the foreign product market is more competitive the higher the proportion of export out of total sales the lower the gross profit margin. When firms export they are under severe pressure to compete. This could be a positive factor in the long run although in the short run there is a squeezing effect on firms.

In 70.3 percent of the firms, employees own shares. The median of the proportion of shares owned by the employees is 4.4 percent while the maximum proportion of shares held by employees is 17.0 percent. The minimum is 0.01 percent. Managers own shares in 8.4 percent of the surveyed companies. The median of proportion of shares owned by managers is 7.8 percent and maximum proportion of shares they hold is 46.2 percent. Again, the minimum is 0.01 percent.

This paper hypothesizes that labor productivity is higher if there is an employee ownership scheme. Figure 7 and Figure 8 show a positive relationship between employee share ownership ratio *and* asset growth rate and sales growth rate. Under a governance system where the majority shareholder/manager prefers growth in firm size rather than maximization of profitability, positive relationships ensue as can be seen in the charts.

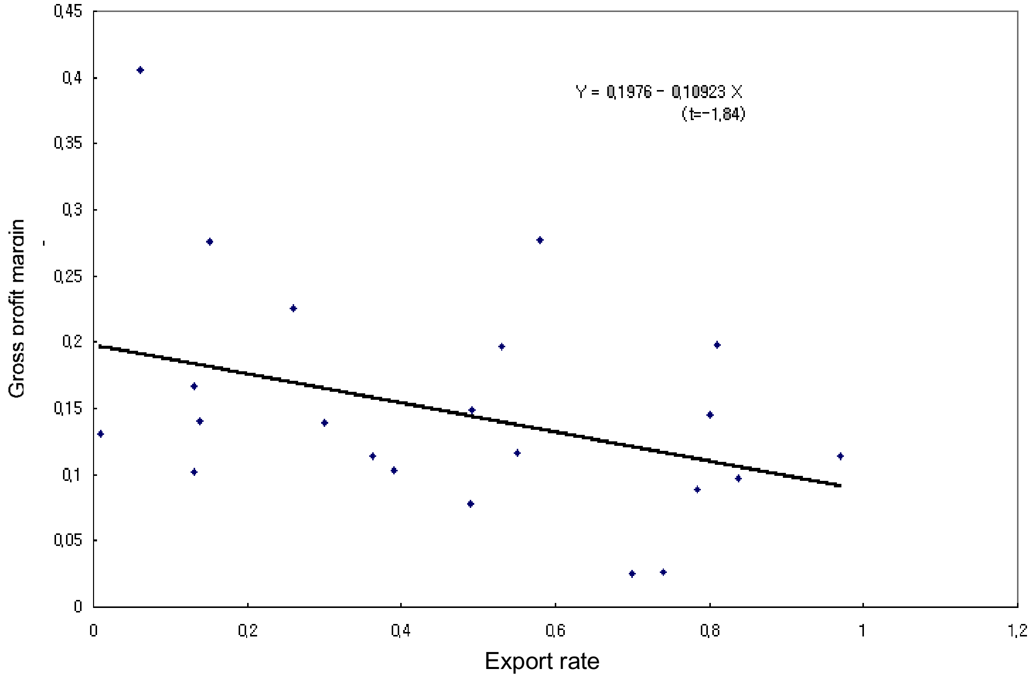


Figure 6. Ratio of export vs. gross profit margin

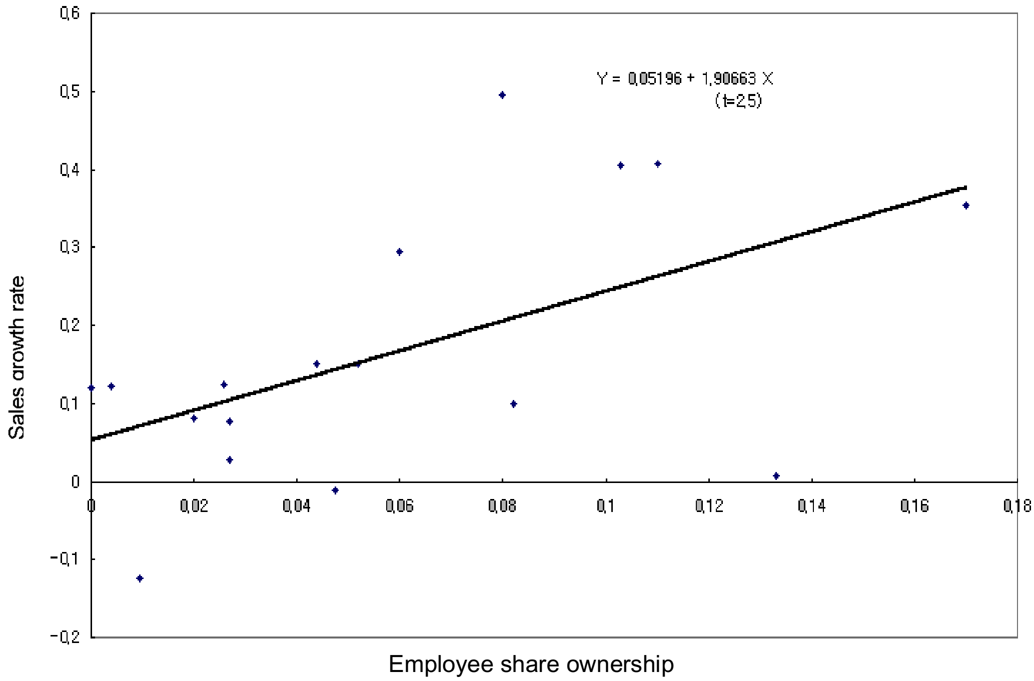


Figure 7. Employee share ownership vs. sales growth rate

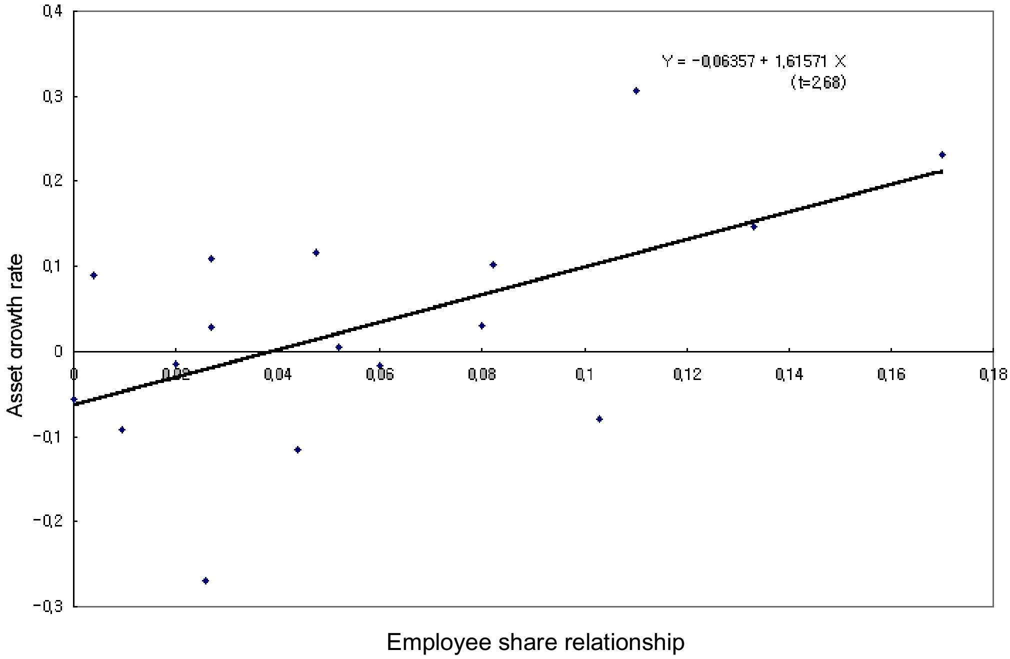


Figure 8. Employee share ownership vs. asset growth rate

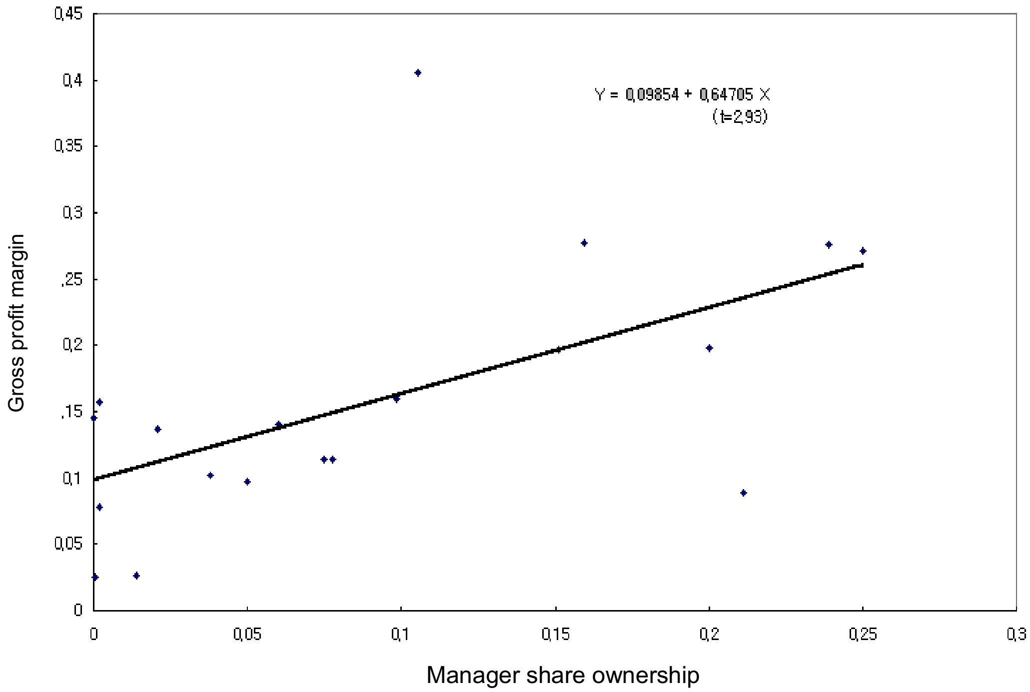


Figure 9. Manager share ownership vs. gross profit margin

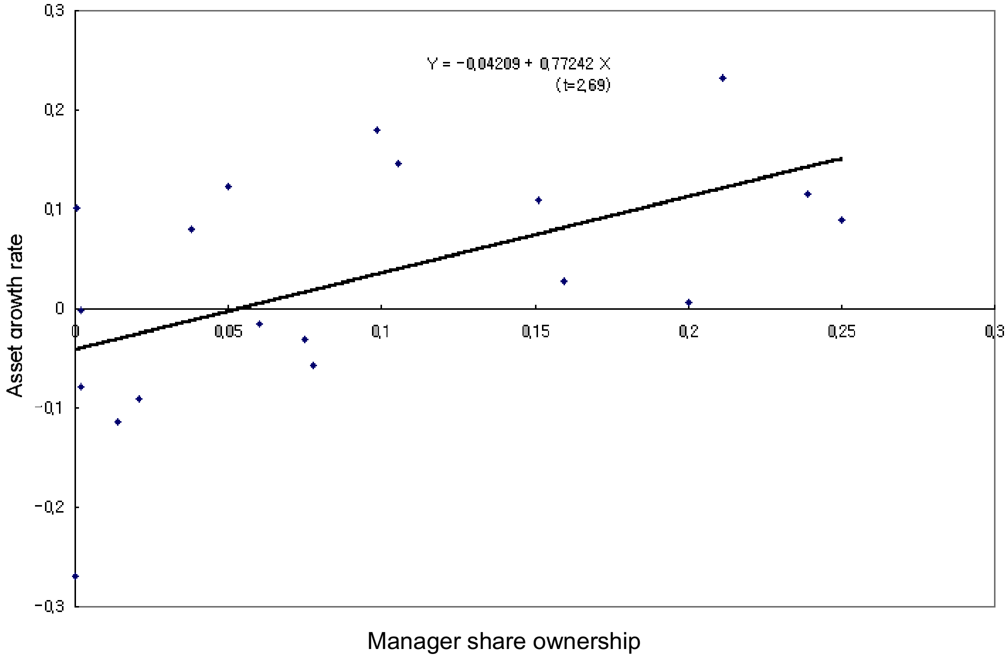


Figure 10. Manager share ownership vs. asset growth rate

Similar relationships exist among managers share ownership, and growth profit margin and asset growth rate. When managers own shares of the company, there is incentive compatibility between shareholders and managers, and a positive relationship is expected. Figure 9 and Figure 10 show that managers share ownership has a positive impact on gross profit margin and asset growth rate.

Banks are the main creditors of 71.1 percent of the firms surveyed. When the firms were asked whether external creditors ask for collateral for loans, 61.8 percent answered yes while 38.2 percent answered no . In 25.7 percent of the companies, the creditors are affiliated with the firm. Of the firms whose creditors are affiliated, 55 percent identified banks as their creditors while 45 percent identified their creditors as non-bank financial institutions.

Figure 11 compares the profitability and growth of two groups: firms with banks as creditors and firms with non-bank as creditors. As expected, the group whose main creditors are banks shows higher ROE, ROA, gross profit margin, net profit margin and sales growth rate. Only in asset growth rate does the non-bank group rate better than the bank group.

When the creditors are part of the conglomerates, there is distortion of incentives. Figure 12 shows how that applies to Korean firms. The group in which creditors are affiliated with the firm experiences less productivity and less growth.

Management

Corporate governance deals with the manner by which firms are directed and controlled and by which accountability for corporate decisions and management actions are established. Who decides on corporate thrusts and direction in Korean firms that were sampled?

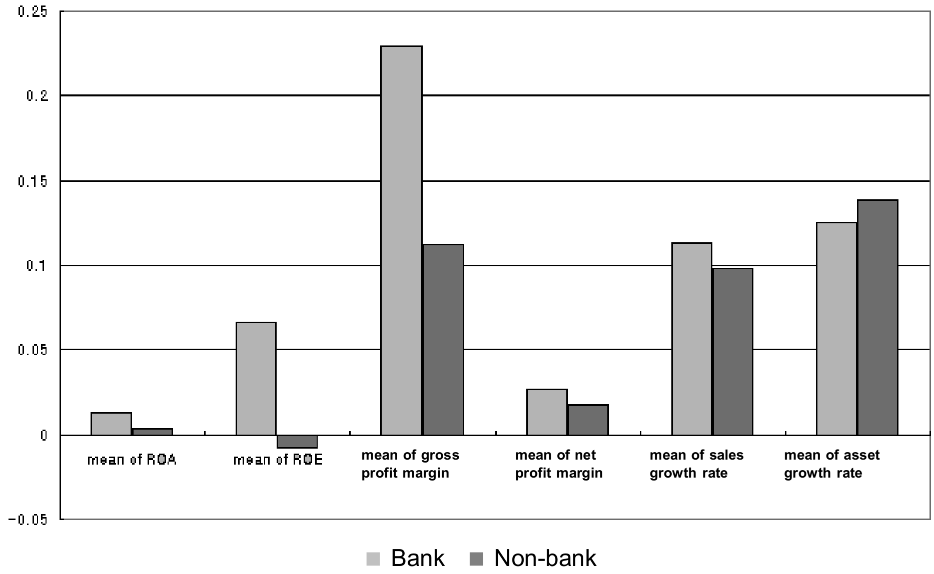


Figure 11. Main creditor and firm performance

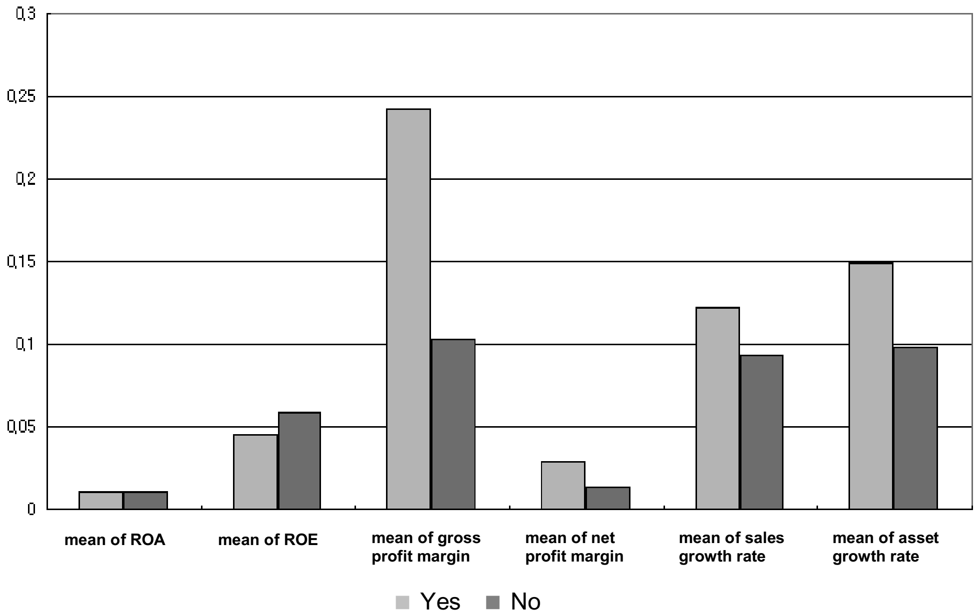


Figure 12. Creditors affiliation and firm performance

Some 7.9 percent of the firms indicate the majority shareholders do, 65.8 percent point to the board, and 26.3 percent acknowledge the chief executive officer (CEO) as the one in charge. About 21.1 percent say major shareholders take care of corporate and financial strategic options. On the other hand, 68.4 percent claim that the board handles corporate and financial strategic options. For 11.5 percent of the firms, these functions rest with either the CEO or the chief operating officer (COO). In most of the firms, sanctions and rewards for management performance are decided by the board.[9]

Major shareholders call the shots when it comes to board composition and membership. In 47.4 percent of the surveyed firms, board composition is mainly decided at the level of the major shareholder. But in 42.1 percent of the firms, the board decides on its own composition. Regarding day-to-day operations, decisions are made by either the CEO or COO in 78.9 percent of the firms. The declaration of dividends is generally made by either major shareholders or board. According to the survey, decisions on profit or gain sharing, business expansion/contraction, mergers and acquisitions rest with the board while decisions on productivity improvement measures and customer satisfaction/quality issues are done at the management level.

Concurrency is widely practiced among the firms surveyed. In 89.5 percent of the firms, the board chairman is also the CEO. In 87.9 percent of the companies, the current CEO has worked in the company prior to his appointment. The median of the executive compensation as a percentage of the average total employee compensation is 3.3 percent and its maximum is 60 percent (the minimum is 0.5 percent).

As to how executive compensation affects profitability and growth, the paper came up with conflicting empirical findings. The total compensation of CEO divided by average total employee compensation was used as a measure of executive compensation. As shown in Figures 13, 14 and 15, negative relationships exist between executive compensation and profitability (ROA, ROE and net profit margin). On the other hand, a positive relationship exists between executive compensation and sales growth rate as shown in Figure 16.

Boards assume major roles in the management of the firms surveyed. Most firms (71.1 percent) have boards of 6 to 10 members. Within the firm s board, there are many firms (91.2 percent) with an audit committee but only a limited number of firms have other committees on share options, compensation, nominations and investment. In 81.6 percent the firm s board has appointed outside directors. Some 84.2 percent conduct board meetings more than 8 times a year. About 59.5 percent indicate that the average tenure of the board is 3 years or less and for 35.1 percent of the firms, the average tenure of the board is 4-6 years.

Does tenure of the board determine productivity and growth? The group whose board has an average tenure of 4-6 years exhibits better productivity and growth than the group less than 3 years (Figure 17). There are no clear explanations why the group with a longer board tenure performs better than the group with shorter board tenure.

Figure 18 indicates that firms with outside directors perform better than firms without outside directors except when reckoned in terms of net profit margin and asset growth rate.

---

[9] Twenty-nine firms said that the board decides management performance evaluation system.

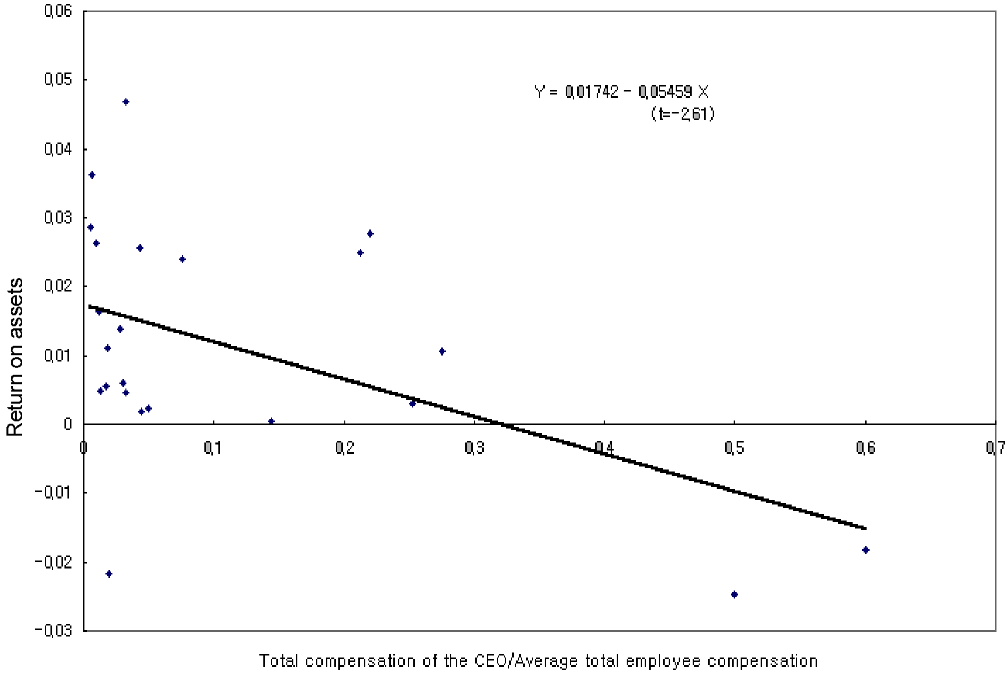


Figure 13. CEO compensation vs. ROA

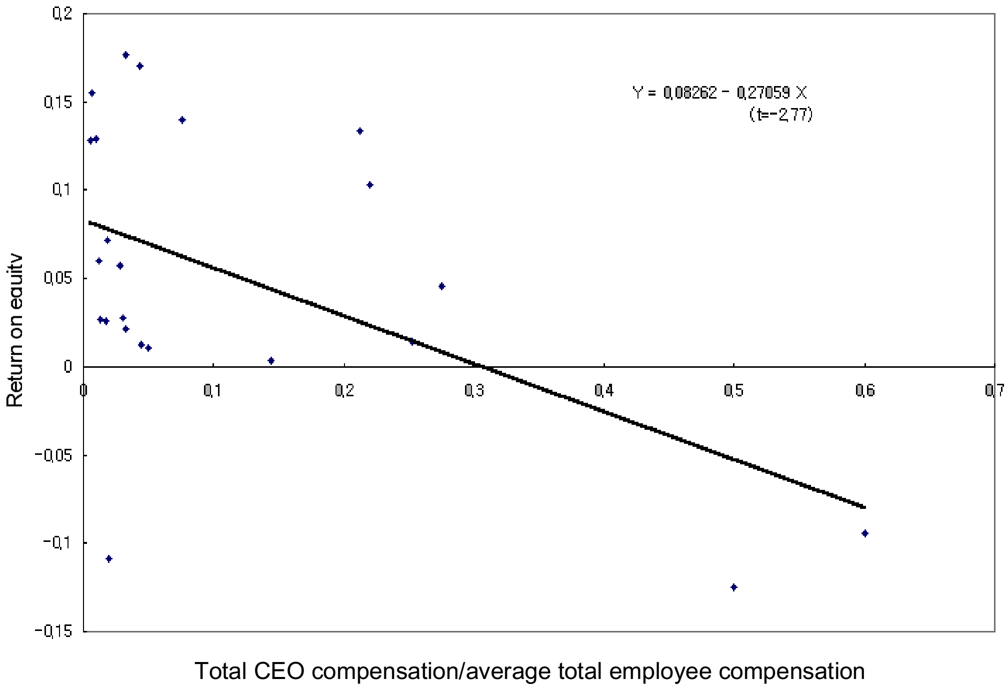


Figure 14. CEO compensation vs. ROE

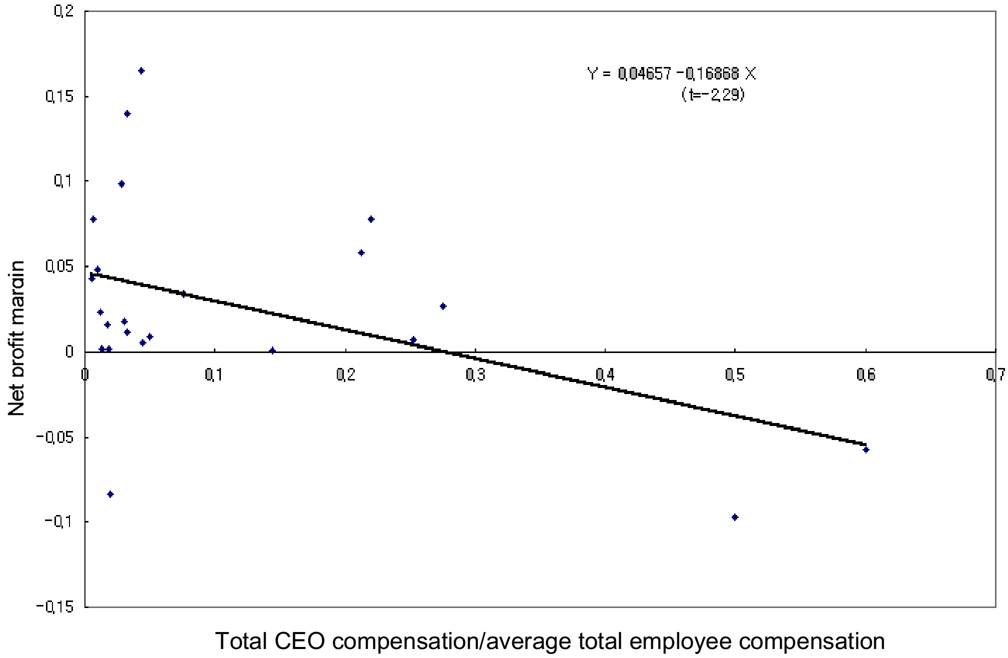


Figure 15. CEO compensation vs. net profit margin

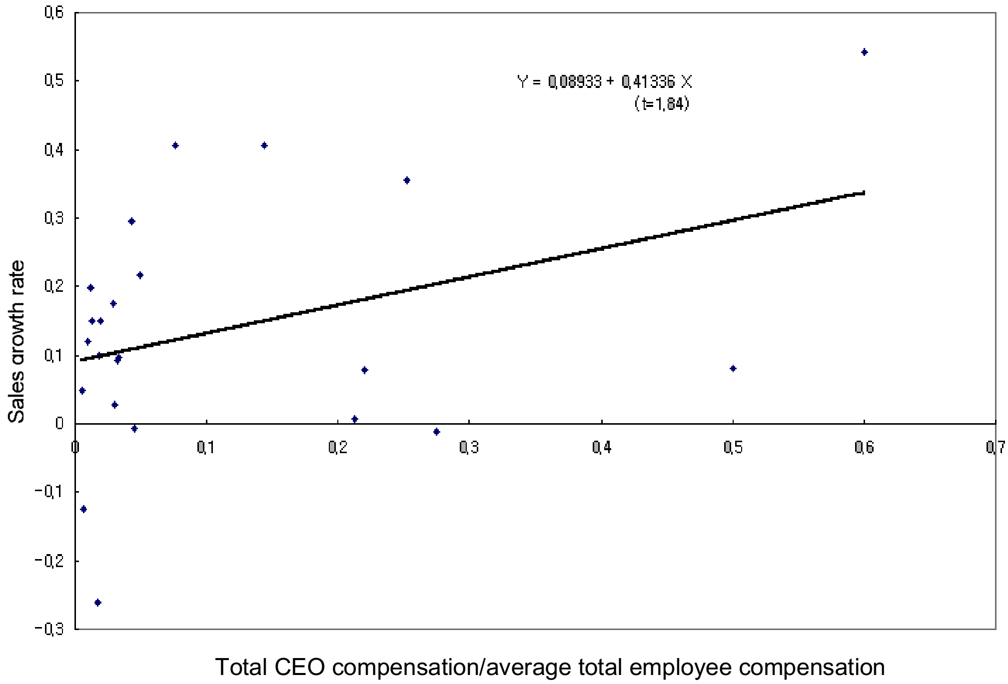


Figure 16. CEO compensation vs. sales growth rate

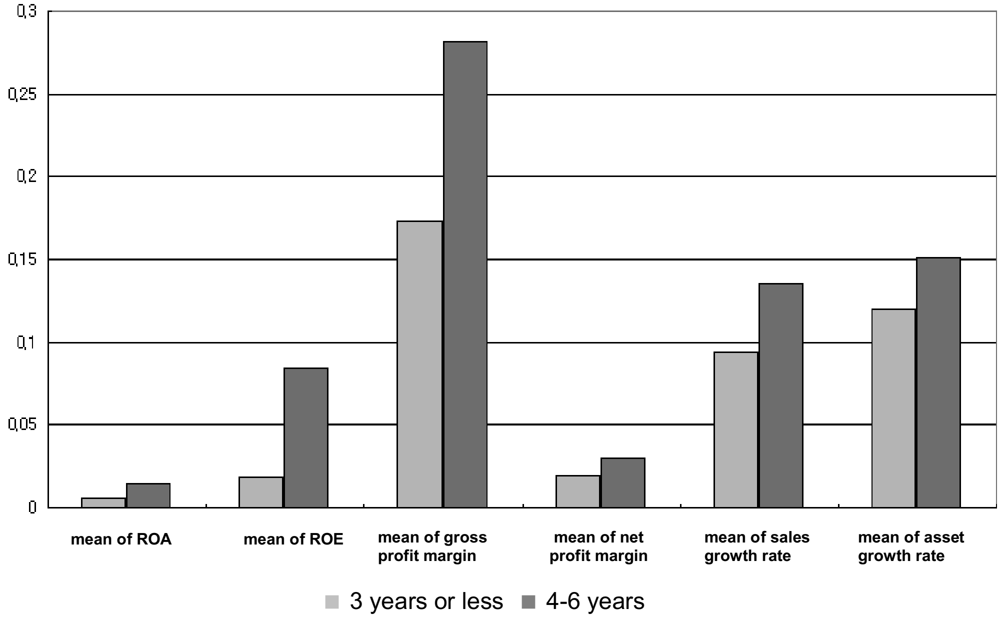


Figure 17. Average board tenure and firm performance

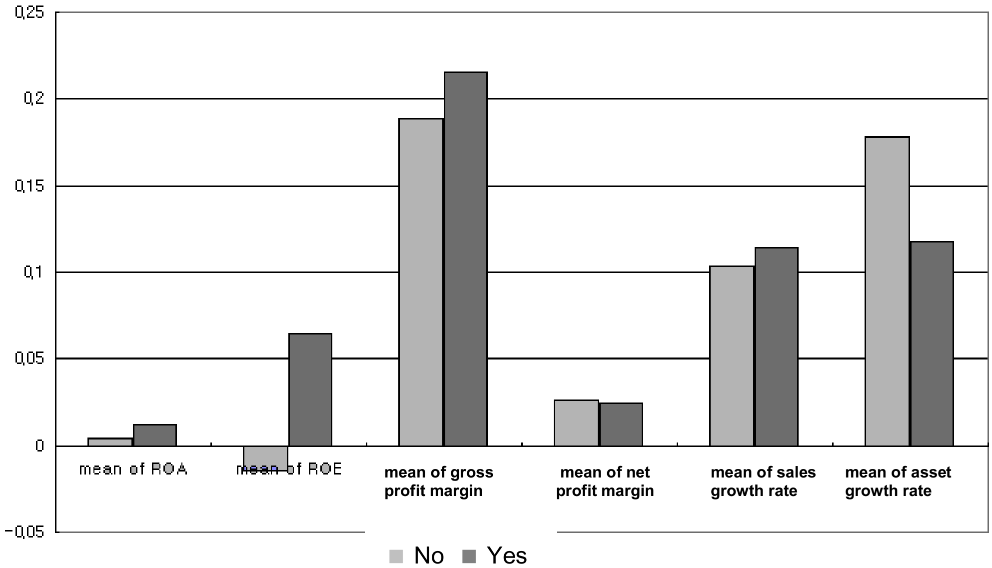


Figure 18. Outside directors and firm performance

The paper also looked into the degree of independence of management in making operational decisions as a determinant factor in financial performance. Around 52.7

percent report a high degree of independence; 29.0 percent indicate a moderate degree of independence. Firms with managerial autonomy very high or high degree of management independence outperform those moderate , as shown in Figure 19.

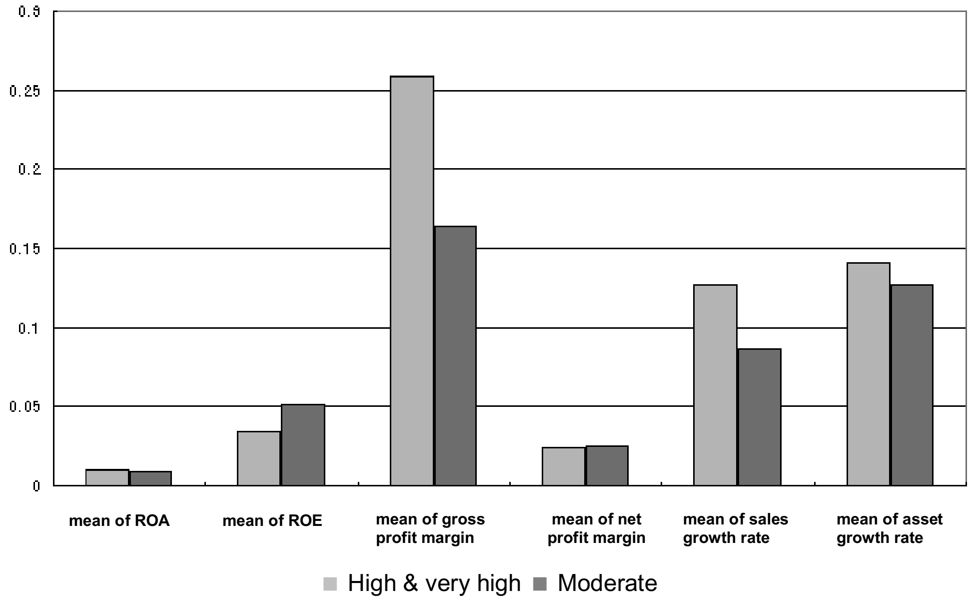


Figure 19. Degree of management independence and firm performance

There has been a change of CEO in the last three years, in 71.1 percent of the firms. As shown in Figure 20, firms that have had a change of CEO show higher sales growth rate and asset growth rate. Figure 20 also shows that new CEOs stress growth more than profitability. On the other hand, this can be interpreted as firms having low profitability are likely to change their CEOs.

Korean firms tend to employ very rigid internal controls as shown in the survey. Most firms give either very rigid or rigid response to questions on the nature of internal controls the firm has instituted. Such internal controls cover cash flow, account receivables collection and aging, bad debt write-off, inventory, fixed asset acquisition, research and development, capital expenditure, tax payments, loan payments and payroll.

Korean firms are also sensitive to the issue of breach of standards of financial conduct. Almost all firms (94.7 percent) claim to have a code of ethics that governs the behavior of owners, managers, employees and shareholders. Of these, 84.2 percent say their code is publicized. There are also sanctions or penalties for violation of the code of ethics as indicated by 80.6 percent of the firms. So far, however, no firm has sanctioned the board chairman, board directors, CEO, COO or managers for violations. Only 26.3 percent have a record of sanctions or penalties for Code violation by employees. On the other hand, 89.5 percent have received complaints and investigated allegations of breach of standards of financial conduct.

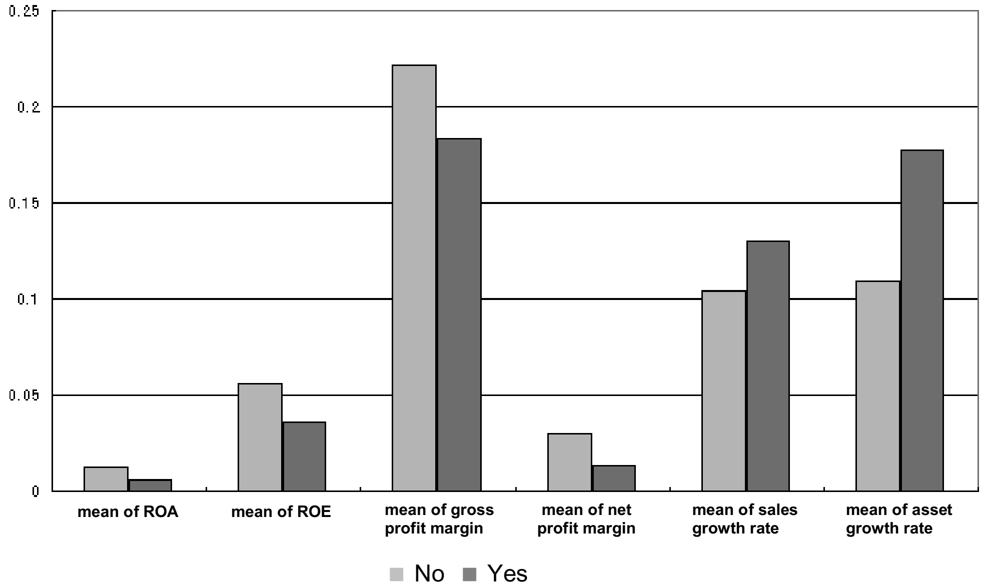


Figure 20. CEO change and firm performance

In Korea there is a legal or regulatory requirement for public disclosure of material information about the firm. Hence, all firms answered yes to this question. However, only 59.5 percent have a specific disclosure policy. The Korea Stock Exchange Law mandates listed firms to disclose financial information and records of firm performance quarterly and the ownership structure and governance whenever needed. All firms comply with this requirement. Thus, stakeholders have access to the above material information.

In all the surveyed firms, shareholders, whether majority or minority, have access to the minutes of board meetings. All firms also follow local accounting and auditing standards and do not maintain separate books.

It may be instructive to note that firms with a specific disclosure policy are more productive and growth oriented than those without such policy. Figure 21 shows the relationship between the existence of a specific disclosure policy and productivity and growth.

All surveyed firms have an external auditor. About 24.3 percent have changed their external auditor in the last three years while 75.7 percent have not. In 52 percent, the current external auditor has been associated with the firm for three to five years; in 48 percent the current auditor has been associated with the firm for more than five years. As to the degree of independence of external auditor, 71.1 percent answered very high and 23.7 percent answered high .

On the assumption that long association means poor monitoring, it is expected that firms which have retained their external auditor in the last three years would be characterized by lower productivity and growth. Figure 22 shows that firms who changed their external auditor during the last three years do better due to tight monitoring.

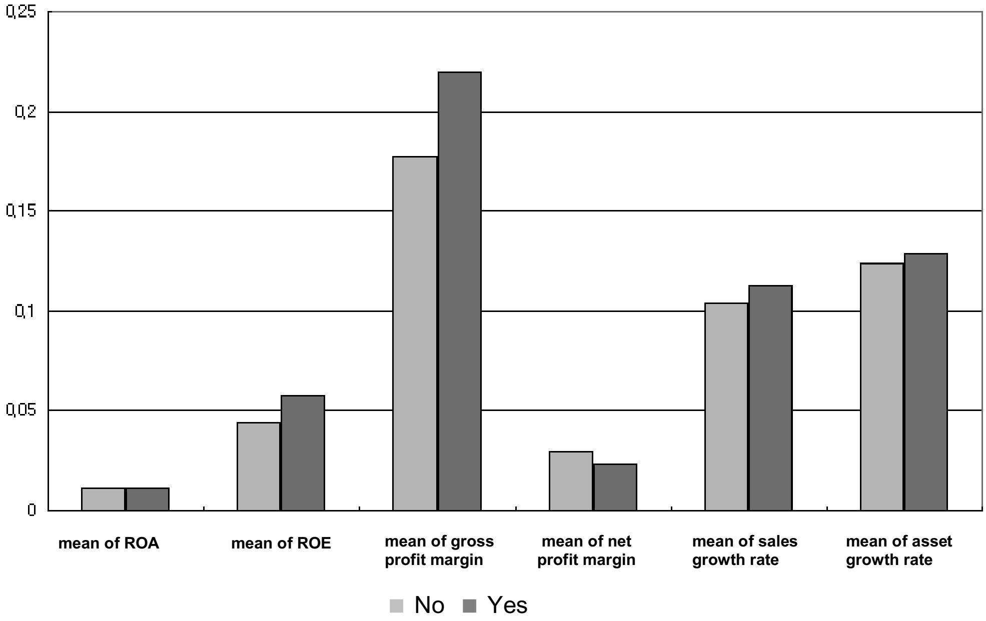


Figure 21. Existence of disclosure policy and firm performance

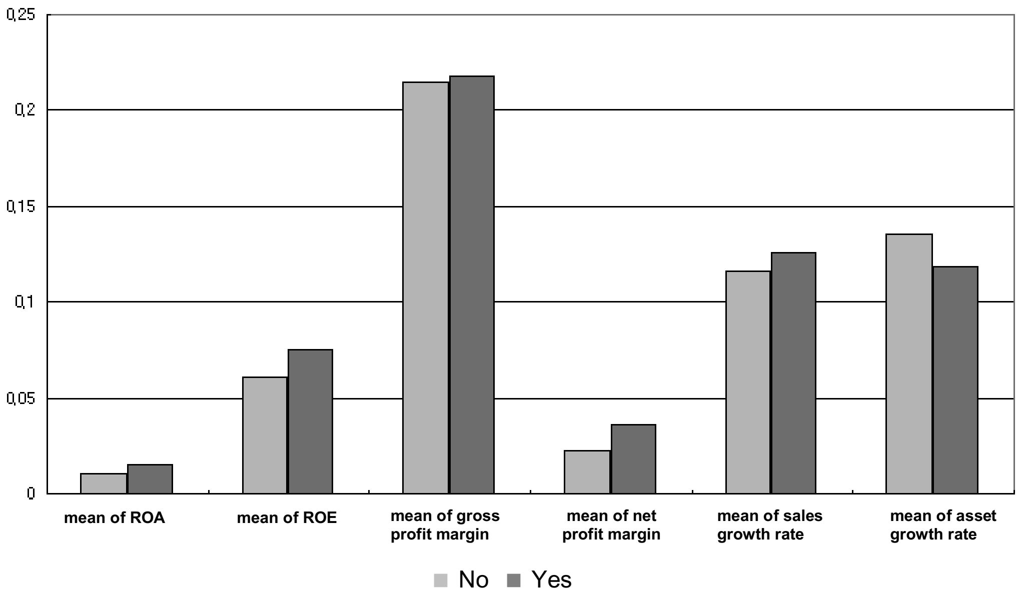


Figure 22. Change of external auditor and firm performance

Figure 23 compares the financial performance of two groups_those with longer association with the external auditor and those with shorter association. It appears that the group with longer association exhibits higher growth but low profitability.

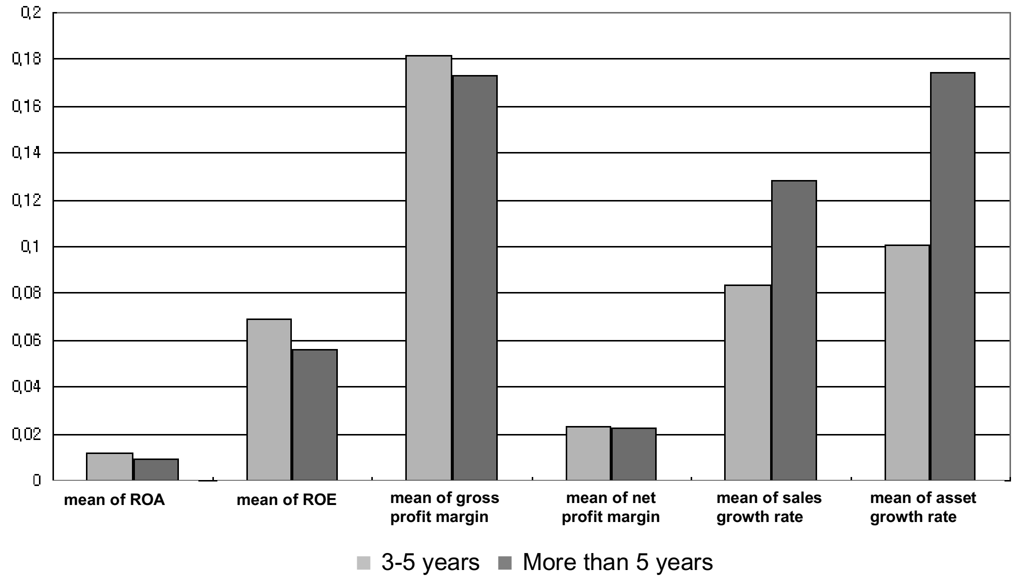


Figure 23. Tenure of current external auditor and firm performance

Company-wide quality and productivity improvement programs exist in 97.3 percent of the firms. The survey results indicate that the most widely adopted productivity improvement programs are the suggestion system, quality circles, and total quality management (TQM). Only 16.22 percent of the firms have adopted the six-sigma program.

Employee unions or associations are found in 81.6 percent of the firms but only 21.6 percent have experienced disputes with employees in the last three years. All firms indicate that the disputes were settled by labor management consultation. Some 84.9 percent of the firms claim they have their own mechanisms to discuss employer-employee relation issues.

Figure 24 compares the productivity and growth of firms with an employee union or association with that of firms with no employee organization. Firms with an employee union outperforms those without in every measure. This means that the existence of a labor union is a critical factor for sound corporate governance in Korea. Figure 25 shows that firms which experienced labor disputes in last three years perform far better in profitability than firms without disputes. However, when growth rates are compared the result is reversed.

Social responsibility

As many as 94.7 percent of the firms claim there are laws or regulations on consumer protection and 100 percent indicate that they have a policy on consumer protection.

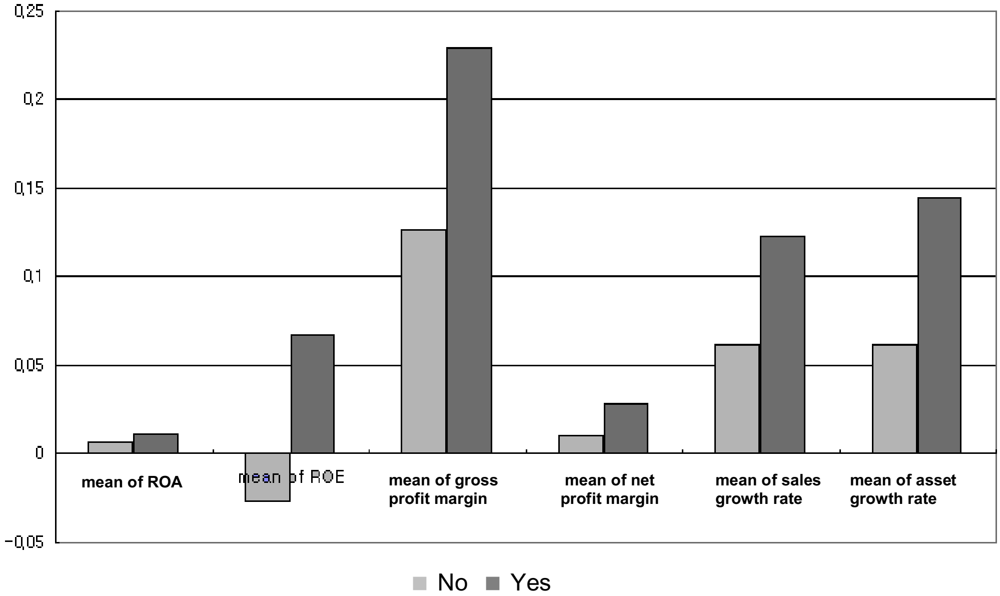


Figure 24. Existence of employees union and firm performance

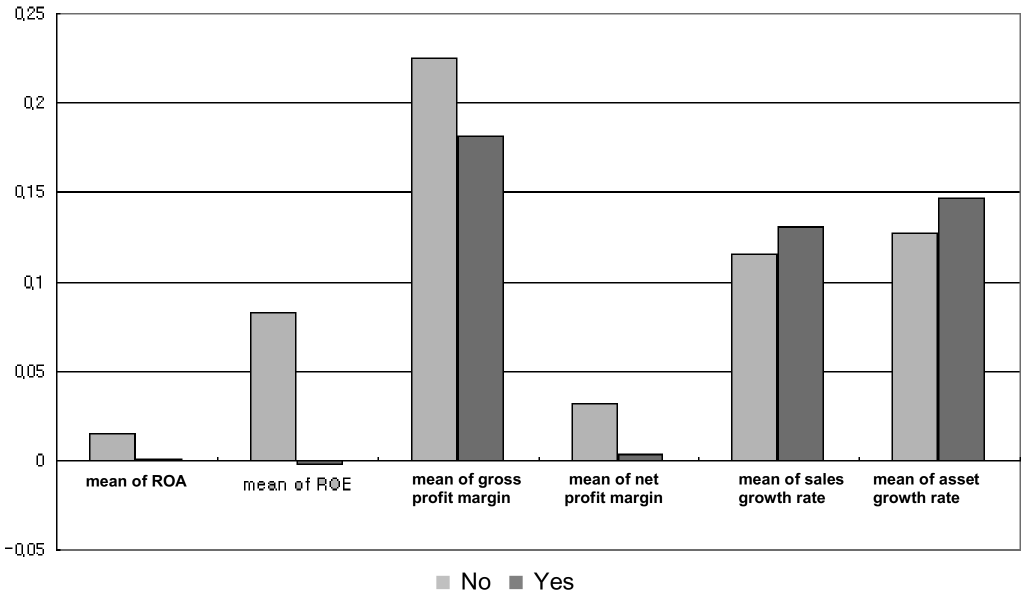


Figure 25. Disputes between management and employees and firm performance

All firms have a policy on environmental protection but 78.4 percent have received ISO 14000 certification. The survey shows that firms supporting environmental standards demonstrate better performance in all dimensions. According to Figure 26, firms with ISO 14000 certification show far better productivity and growth than firms that do not have ISO 14000 certification.

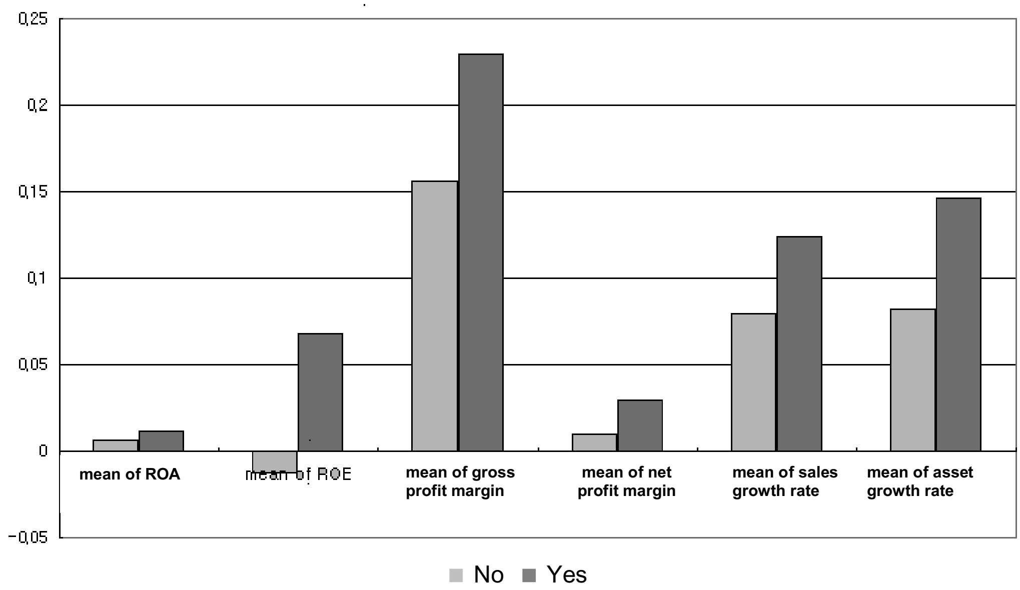


Figure 26. Existence of ISO 14000 certification and firm performance

Most firms are also doing voluntary work or taking leadership role in various consumer protection and environmental protection issues. Almost all firms (97.3 percent) indicate they have mechanisms for receiving consumer complaints. Some 10.53 percent indicate there has been community action filed against them during the last three years. 75 percent have resolved their conflict with the community.

Interface with external stakeholders

Most of the surveyed firms rate the quality of national services (such as central government, central bank, judiciary, police and internal revenue) as either good and slightly good. However, they rate parliament as worse compared to other services. Regarding the quality of facilities such as education/schooling, roads, ports, telecommunication, electricity and water, most of the surveyed firms rate them good or slightly good .

To evaluate the effect of the overall quality of services delivered by the following_central government, parliament, central bank, customs, judiciary, police and internal revenue_on firm performance, a scale of 1 (very good) to 6 (very poor) is adopted.

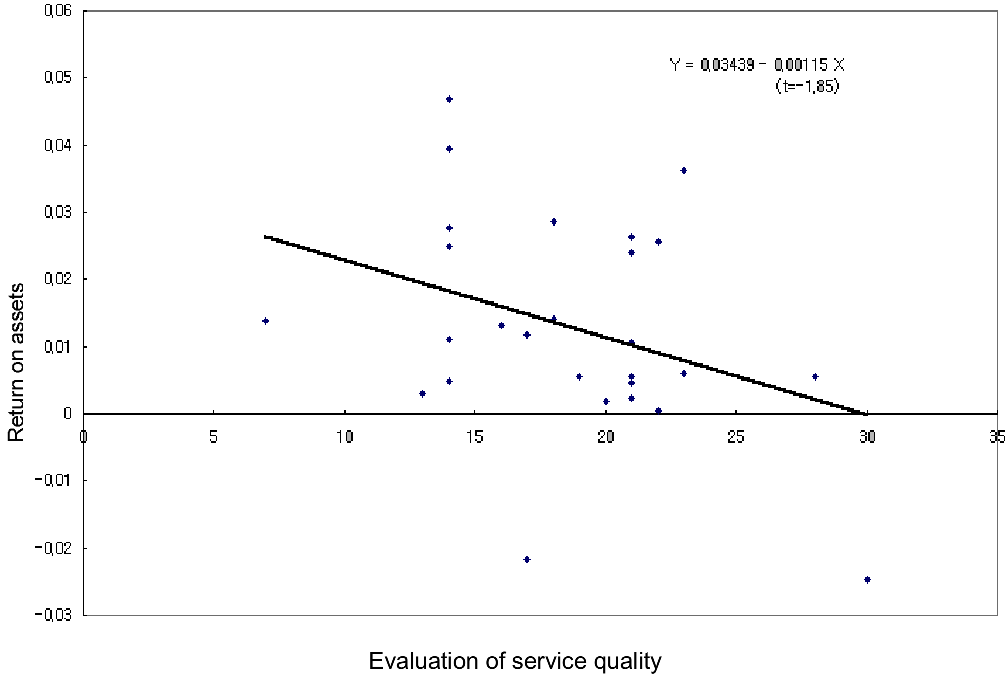


Figure 27. National service quality vs. ROA

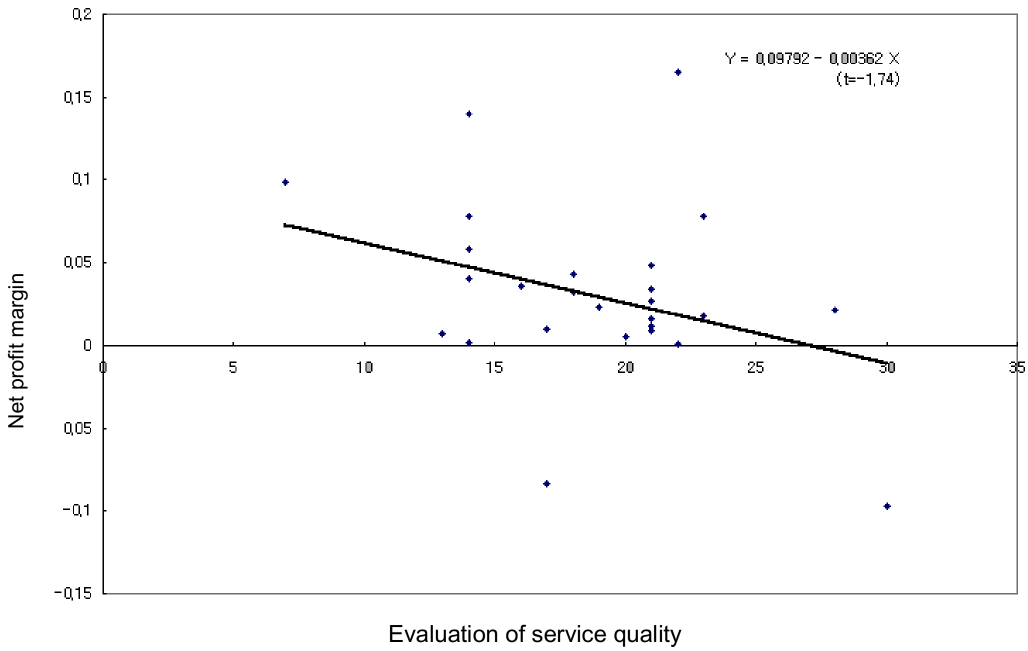


Figure 28. National service quality vs. net profit margin

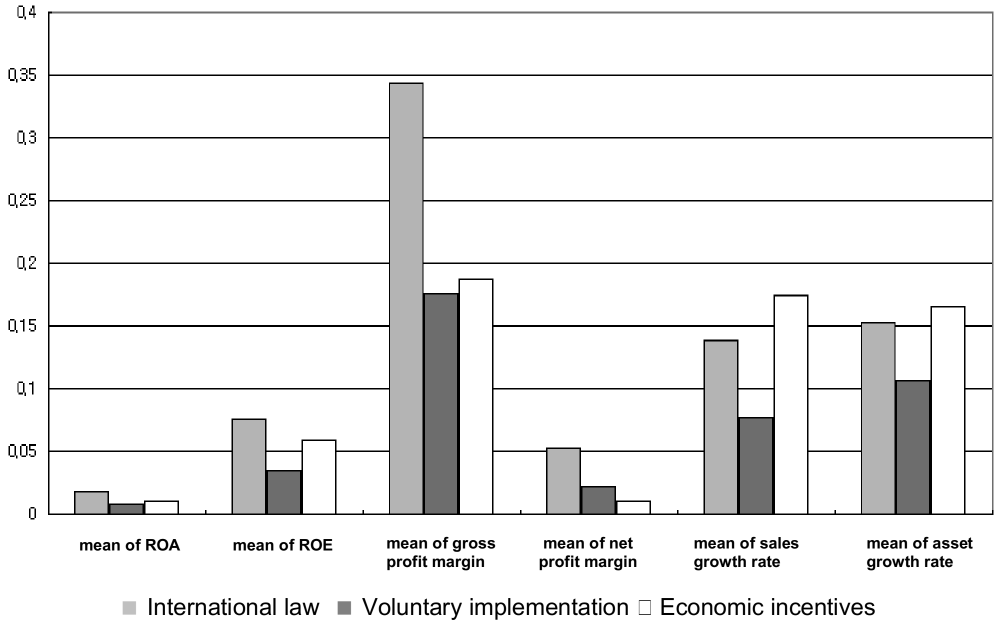


Figure 29. Preferred approaches to strengthening international safeguards and firm performance

.

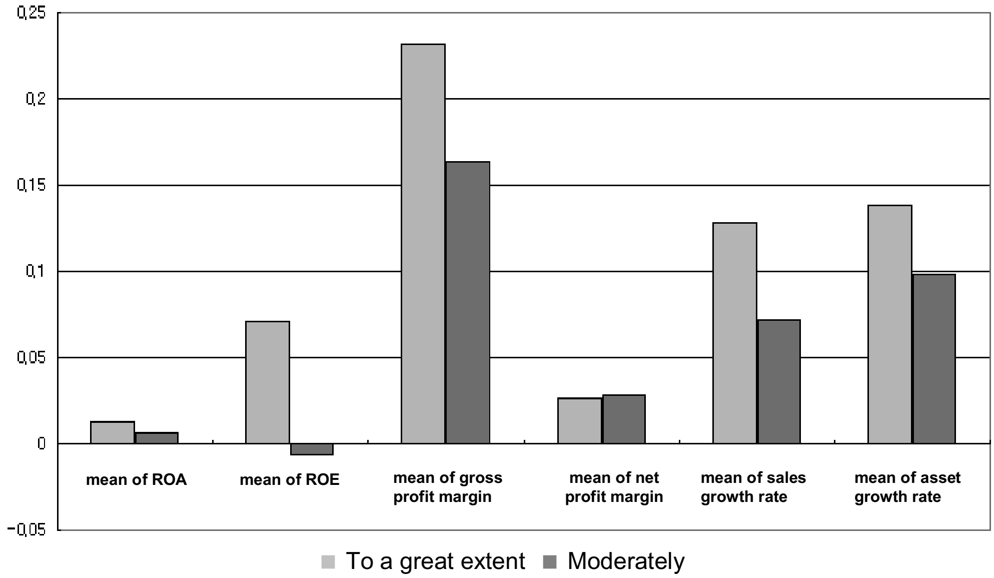


Figure 30. Firms opinion on the impact of corporate governance on performance and productivity and actual firm performance

For each surveyed firm, the scores are summed up to come up with the firm s evaluation of national service quality. The higher this number, the lower the firm s evaluation of overall quality of services. Figure 27 shows that there is a positive relationship between evaluation of national service quality and ROA. There also exists a positive relationship between national service quality and net profit margin (Figure 28).

As to the preferred approach to strengthening international safeguards, including codes of business conduct, 60 percent prefer voluntary implementation . On the other hand, 17.1 percent prefer international law while 22.9 percent prefer economic incentives/penalties. Generally firms which choose international law show better performance than firms voluntarily implementing and economic incentives/penalties.

To what extent does the corporate governance of the firm affect its overall performance and productivity? According to the surveyed results, 71 percent of the firms think corporate governance affects the firm s overall performance and productivity to a great extent while 21.1 percent think it affects performance only moderately.

A comparison was done on the financial performance of those firms that say to a great extent and those which say moderately. The former have better productivity and growth than the latter. It would seem that firms which consider corporate governance issues seriously have a better governance system which leads to better performance

POLICY RECOMMENDATIONS

The empirical findings lead this paper to conclude that firms with corporate governance exhibit better productivity and growth. To ensure that corporate governance works in a positive way, the study recommends to the Korean government the following policy improvements.

One, the Korean government should make every effort not to allow the manager/shareholder of a *chaebol* to enjoy the private utility while he/she manages the firm. It is not an easy task for market forces including investment banks to change the corporate governance system in Korean corporations in a short period of time. However, competition in the product market and constant pressure from financial markets would push Korean companies to adopt global standards on corporate governance. This is where the best hope lies for restoring long-term growth in the Korean economy.

Two, the board of directors should be empowered and the presence of independent outside directors should be strengthened. This paper argues that the role of the board should be more clearly defined by providing an explicit list of corporate actions requiring decision by the board. Also, the right of directors to have access to all corporate information necessary to perform their tasks should be expanded and clarified. Further steps should be taken to ensure the effectiveness of independent directors.

Three, shareholder rights should be enhanced. The categories of corporate decisions requiring shareholder approval should be expanded and clarified to ensure shareholder participation in (1) large acquisition and disposal transactions by the company and its subsidiary or major shareholders, (2) large share issuance transactions by listed companies, and (3) material related party transactions by the company or its subsidiaries.

Four, in order to more effectively protect investors, the Korean government should improve the transparency and accountability of firms. All listed firms should be required to report any material information regarding their business operations regularly to their stakeholders.

Five, efforts should be geared toward encouraging mergers and acquisitions, including contested takeover bids. Utilizing the market for corporate control as a vehicle to force Korean firms to follow best practices for corporate governance is a good strategy. Another alternative is to let institutional investors be involved in corporate governance. After all, institutional investors have an important role to play in bringing Korea s new corporate rules to work in the marketplace and in shaping the further evolution of Korean corporate governance standards.

REFERENCES

Jang, H. (2001). Profile of Director: The Case of Korea, 3rd Asian Roundtable on Corporate Governance, OECD

John, K. and Senbet, L.(1998). Corporate Governance and Board Effectiveness, Journal of Banking and Finance, Vol. 22

Kim, H. (2002). Toward the Best Practice Model in a Globalizing Market: Recent Developments in Korean Corporate Governance, *Yearbook Law and Legal Practice in East Asia*, Vol. 5

Kook, C., Park, Y. and Lee, J. (1997). Investment Decision and Cost of Capital of Korean Conglomerate, *The Korean Journal of Finance*, Vol. 13

Morck, R., Shleifer, A. and Vishny, R. (1988). Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics*, Vol. 26.

OECD (1999). OECD Principles of Corporate Governance.

Park, S. (2001) Shifts in Korean Firms after Crisis, *Korean Economic Briefing*, Vol. 11

Prowse, S. (1998). Corporate Governance: Emerging Issues and Lessons from East Asia, *Word Bank Working Paper*

Rajan, R. G. and Zingales, L. (1998). Which Capitalism? Lessons from the East Asian Crisis, *Journal of Applied Corporate Finance*, Vol. 11

Shin, H. and Park, Y. (1998). Financing Constraints and Internal Capital Markets: Evidence from Korean Chaebols , *Journal of Corporate Finance*, Vol. 5

Shleifer, A. and Vishny, R. (1997). A Survey of Corporate Governance, *Journal of Finance*, Vol. 52

World Bank (1999). The Republic of Korea and the World Bank: Partners in Economic Recovery. Korea Country Management Unit. East Asia and Pacific Region. February.

.

DOES CORPORATE GOVERNANCE AFFECT PRODUCTIVITY? EVIDENCE FROM NEPAL

Dr. Bishwa Keshar Maskay
Center for Development and Governance
Nepal

INTRODUCTION

Corporate governance has been the buzzword in Nepal in recent years. With the advent of economic liberalization and public limited companies being listed in the stock exchange, a felt need for better corporate practices has emerged. The failure of several companies to offer their shares to the public has also brought this matter into the limelight. A methodological and comprehensive study of the governance of public sector and private sector enterprises has thus become a necessity. This study is a modest attempt to bring to the surface aspects associated with the governance of Nepalese firms and their impact on productivity.

There are major challenges that the country faces with regard to good corporate governance that need to be addressed adequately. This study highlights these challenges and proposes measures to cope with them. The following are what Nepalese firms need today:

- More efficient allocation of the reduced flows of investment;
- Establishing more stable corporate financing structures that are less prone to future external shocks;
- Re-capitalization of viable companies and financial institutions;
- Gaining the confidence of local and international private investors and lenders;
- Deepening domestic equity markets; and
- Improving management practices, particularly those associated with risk management, among financial and corporate institutions.

Defining corporate governance

A *Financial Times* (1997) article defines corporate governance as a continuum of relationships: in a narrow sense, it refers to the relationship of a company to its shareholders; but in a broad sense, it represents the company s relationship to the wider society. A too narrow view of the concept, however would treat it as a fancy tool for directors and auditors to handle their responsibilities toward the shareholders, while a much broader view would hold corporate governance as something synonymous with shareholder democracy (Maw *et al.*, 1994:1).

To Mathiesen (2002), the corporate governance concept is a tool to secure, or motivate to secure, efficient management of corporations through the use of incentive mechanisms such as contracts, organizational designs, legislation, among others. But this tool is being used only to assess or measure the financial performance of the firms, and thus has inherent limitations.

Not unlike these perspectives, corporate governance is defined in this study as a set of rules that define the relationships between a company's management and its board of directors, shareholders and other stakeholders. These rules help set up mechanisms of attaining good governance. In the broader sense, good governance is an important requirement to achieve multiple purposes: for gaining overall market confidence, for attaining efficiency, for attracting international capital allocation, for renewal of countries' industrial bases, and ultimately for enhancing their overall wealth and welfare. Globalization and liberalization policies also play a decisive role in creating the demand for good governance. A corporate governance system is expected to provide protection to shareholders and creditors and to assure them of getting return on their investment.

Productivity in Nepal

Productivity takes place in an environment where there is a constant urge to find cheaper, easier, quicker and safer means of manufacturing a product and providing services, according to the National Productivity and Economic Development Centre (NPEDC, 1999). The primary objectives of productivity are improvement in the quality of workforce, products and services, and the effective and efficient use of human, capital, and technological resources.

Productivity as a concept is a dynamic one in that it involves constant changes, strongly influenced by the technology developments. This implies that what is considered a better product today may not remain so tomorrow due to improvements in technology. For Nepal, labor productivity measurement is more compelling than the measurement of capital productivity since labor is more abundant than capital. Improvements in labor productivity will certainly help boost the targeted rate of growth.

OBJECTIVES OF THE STUDY

The study seeks to answer, among others, the following questions: Does the pattern of ownership structure affect corporate governance? Does the manner in which firms are governed have impact on the firms' productivity? Through what channels do shareholders exert their influence on the management and consequently on firm performance? The study provides insights on the functioning of the firms, which in turn are used in suggesting parameters for policy formulation and the development of strategies and approaches to translate policies into action.

Specifically, the study seeks to:

- Identify the links between governance, productivity and growth in the context of the current stage of development of the firms;
- Analyze how governance issues promote or hinder productivity in an environment characterized by increasing emphasis on globalization and liberalization; and
- Recommend policies, strategies, and approaches suitable to the productivity needs of firms.

The key analytical categories constructs used for the analysis of the status of the Nepalese enterprises are:

Corporate structure: ownership and capital structure, decision-making systems shareholder control and guarantees granting of corporate rights and allocation of responsibilities, and credit monitoring and protection.

Institutional interface: policy environment, interaction with domestic and international bodies/entities.

Interface with the public: community relations, environmental concern, and consumer protection.

Corporate ethics and values: corporate conduct, and transparent and accountable of corporate resources.

METHODOLOGY AND DATA SOURCES

The 12 Nepalese enterprises included in the APO survey are a sampling of government-owned enterprises, listed firms and unlisted companies. Government-owned organizations are the most dominant type of business operation in Nepal. The public sector enterprises represented in the survey are four companies from the manufacturing sector and one each from the trade and finance sectors. Among the listed companies, one each comes from the manufacturing, transport and finance sectors. Of these three companies, two are joint venture enterprises with foreign collaboration. All three companies representing the unlisted enterprises are from the manufacturing sector, and two of these are joint venture undertakings with foreign collaboration.

The sample represents roughly three percent of the entire universe of enterprises in Nepal. Although sweeping generalizations cannot be made on the basis of just 12 enterprises, the findings do shed light on several governance dimensions and aspects of public and private enterprises in Nepal.

In queries where responses are sought on scales (e.g., 1-3, 1-4, 1-5, etc), *t*-tests are used for comparing the groups of enterprises. The financial data of five years reported by the enterprises, on the other hand, are converted into index numbers, then treated as raw scores to be subjected to statistical analyses. Wherever possible (i.e., where there are responses in adequate number), comparisons are made between the public sector enterprises and the private sector enterprises, and between the listed companies and the unlisted companies.

Secondary information was gathered from publications, progress reports, profit and loss statements and balance sheets of the enterprises. The top-level management personnel of the enterprises were interviewed to extract important pieces of information, which normally are obtained through questionnaires. Financial data based on standard analytical categories (value of output, value added, capacity utilization, return on equity) were obtained specifically for this study since some enterprises have not disclosed their financial statements in their annual reports.

REVIEW OF LITERATURE

The efficiency of the existing corporate governance mechanisms in advanced market economies has been the subject of debate. For example, Jensen (1989, 1993) has argued that the internal mechanisms of corporate governance in US corporations have not worked well. He advocates a move from the current corporate form to a much more highly levered organization, similar to a leveraged buyout (LBO). On the other hand, legal scholars, including Easternbrook and Fischel (1991) view the US mechanisms and the legal system in a favorable light.

Many of the more prominent empirical studies on the relationship between managerial ownership and enterprises performance express a particular mathematical connection between managerial ownership and corporate performance. Mathiesen (2002) notes a number of mutually contending hypotheses in these empirical studies and any hypothesis can be associated with an indefinite number of explanations. For example, some studies hypothesize that corporate performance is an increasing function of managerial ownership. The underlying explanation is the need to align incentives. But other studies also suggest that it is a decreasing function, putting the burden on management entrenchment and the need to conserve capital. In another instance, corporate performance can be a non-monotonous function of management ownership. But the reverse is also possible: managerial ownership is an increasing function of corporate performance, on the basis of the insider-reward or insider-investment argument.

Using pooled, cross-sectional longitudinal models in the study on the relationship between family ownership of public corporations in the US, Kang (2000) finds out that there is a positive association between family ownership of the public corporation and the corporation s performance—more so if a family member has some stakes in the non-CEO chairman of the board of directors—and that association is stronger if the family member holds the single largest share of the firm and a family member holds a non-CEO chairman position.

King s study (2001) has come up with the following explanation: companies that deliver value to all stakeholders produce superior financial performance, and sustainable companies are those that serve all stakeholders and produce better aggregate performance than their peers.

The findings by Nagar *et al.* (2000) have profound implications for the Asian relationship-based system:

- Models of governance developed for large public companies with dispersed ownership control are not, and cannot be, automatically applicable to closely-held companies.
- The allocation of ownership rights serves as a mechanism to resolve shareholder conflicts in closely-held companies.
- The presence of a hired manager without an ownership stake exerts no significant impact on the performance of companies. This finding confirms the assumption that the major agency problem that closely-held companies face is the conflict among shareholders, and the conflict between the manager and the shareholders.

Agrawal and Knoeber (1999), on the other hand, indicate that the size of the board and the proportion of outside directors on the board are negatively related to the performance of the companies. The magnitude of both relations is non-trivial.

In a cross-sectional time-series study carried out in the US, Kang (2000) suggests that the presence of an activist investment company investor as the single largest shareholder produces a credible threat of voicing against the company, if things go wrong. Such a situation serves also as an important monitoring role in corporate governance, and coalitions of activities of activist shareholders may overcome collective action problems. Dalton *et al.* (1998) provide empirical proof that the separation of CEO and board chairman has no effect on firm performance.

A similar study conducted by Bhagat and Black (2000) reports the following:

- Low profitability firms respond by increasing board independence, but this strategy does not work. Firms with more important boards do not necessarily produce improved profitability, thus challenging the conventional wisdom that speaks highly of board independence.
- There is weak evidence of a correlation between board size and firm performance.
- There is evidence of a positive relationship between past performance and CEO ownership. However, there is lack of evidence that the CEO s share ownership translates into improved future firm performance.
- There are some indications that stock ownership by outside directors correlates with improved firm performance.
- Evidence is poor with regard to belief that monitoring of the firm activities by outside blockholders has an effect on firm performance.

- There is evidence that slow growth in sales and assets (not in operating income) leads to board independence, while there is lack of evidence that a higher level of board independence leads to faster growth.

For Core *et al.* (1999), firms with weaker governance structures have greater agency problems. In firms characterized by agency problems, CEOs receive greater compensation. Firms having agency problems perform less productively. The importance attached to the employment of outside directors and their ownership stakes appears misplaced.

Corporate governance experts have analyzed the relationships among product market competition, ownership structure, and corporate performance:

- Product market competition has a positive and significant impact on performance.
- Firms with relatively dispersed and relatively concentrated ownership have higher productivity growth than firms with an intermediate level of ownership concentration.
- This correlation between concentration of ownership and productivity growth is not explained by the type of the controlling shareholder.
- Product market competition and good governance tend to reinforce each other rather than act as substitutes.
- Competition has no significant effect on performance of firms with poor governance; but it has a significant positive effect on performance of firms with good corporate governance.

As to the contribution of employees skills in improving production to the extent of creating new wealth, the lessons are:

- A good corporate governance system needs to take care of the interest of all parties concerned that make risky investments, including employees.
- The priority given to shareholder return may have worked reasonably well in earlier times, but not anymore in today s high-tech companies.
- The specialized skills and efforts of employees are critical ingredients in creating new wealth.
- Unless corporate governance mechanisms take account of interests of employees and protect their firm-specific investments, firms risk slowing down productivity and economic growth.

All things considered, the contextual factors do play significant roles, implying that no single equation will be applicable on a universal scale.

There are only a few studies on corporate governance and productivity conducted in Nepal. Andenas *et.al.* (1999) are concerned with financial reporting and corporate governance in Nepal. The study focuses on transparency, accountability and enforcement. Adam Smith Institute (1999) identifies, for policy suggestions and legislation, some key issues that need to be addressed in order to improve the performance of state enterprises in the country.

OVERVIEW OF THE ECONOMY

The macroeconomic situation

Nepal's macroeconomic trends show a mixed picture, especially since Nepal has undergone a major shift towards greater market orientation in the early 1990s. Until a few years following this shift, the economy recorded an impressive growth rate resulting in an improvement in macroeconomic stability. However, this could not last long. The following tables show the growth of the economy during the last plan period.

Table 1. Indicators of performance of the Nepalese economy

	GDP in FY 2002/01 (NRs. billion)	% GDP	Annual growth rate (% p.a., at constant prices)
			1997/98-2000/01
GDP at factor cost	392.53	95.9	5.03
Agriculture sector	144.42	36.7	3.20
Non-agriculture sector	248.11	63.3	6.30
GDP at producers' price	409.25	100.0	4.93
Gross domestic investment	78.46	20.0	11.1
Gross domestic savings	65.67	16.7	14.0
Trade balance (1999/2000)	-55.34	14.0	-6.5

Source: Economic Survey 2000/01, Ministry of Finance

To improve on the modest GDP targets of the past plans, the Ninth Plan (1997/98-2001/02) came up with an ambitious target of six percent annual average GDP growth. The growth rate during the first four years of the Ninth Plan were 3.44, 4.47, 6.44 and 5.80 percent respectively through the fiscal years 1997/98 to 2000/01, averaging an annual growth rate of only 5.03 percent.

The agriculture sector still carries more than a third of the entire value-added activities of the Nepalese economy. Table 2 indicates that during the Eighth and Ninth Plans, the agriculture sector achieved around three percent growth as against the target of 3.7 and 4.0 percent respectively, putting a negative impact on the overall growth. On the other hand, the non-agriculture sector, regarded as the modern sector, grew by six percent annually during those periods; however, this growth fell short of the seven percent level achieved during the Seventh Plan period. The service sector, which accounts for two-fifth of the GDP, is slowly taking the place of the agriculture sector in terms of GDP contribution, with a growth of around six percent per annum during the Eighth Plan periods. However, the response of manufacturing activities to GDP in terms of contribution and growth is rather slow, with little traceable positive trend.

The growth of the industrial sector (which contributes a fifth of GDP), which includes also mining and construction, has undergone wider fluctuations in the Eighth and the Ninth Plan periods, achieving a lower level of growth than the target of 12.4 percent and 7.7 percent, respectively. Although the growth rate of 6.5 percent during the eight plan period cannot be regarded less satisfactory. The 4.5 percent growth rate during the first four years of the ninth plan period is a reflection negative internal and external business and political developments. On the other hand, the rise in industrial index by 16 percent per annum during the first four years of the Ninth Plan has aroused some hope.

Table 3 shows value-addition, employment and productivity in the key sectors of the economy. Both Tables 2 and 3 indicate that labor productivity in the agriculture sector is very low, a clear sign of overcrowding and low capital employment. Productivity in the industrial sector is also relatively low, reflecting the fact that most of the industries are in the cottage and small sectors with less capital intensity and high labor application.

Table 2. Performance of the economy by sector

	GDP composition and sectoral growth	
	1993-'97	1998-2001
Sectoral contribution to GDP (in %)		
Agriculture	41.2	38.7
Non-agriculture	58.8	61.3
Industry	21.8	21.8
(Manufacturing)	9.2	10.0
Services	37.0	39.5
Sectoral growth (% per annum)		
Agriculture	3.0	3.2
Non-agriculture	6.3	6.3
Industry	6.5	4.5
(Manufacturing Index)	5.5	16.1
Services	6.1	6.6
Gross Domestic Product	4.9	5.0

Source: Industrial Development Perspective Plan —Vision 2020, Draft Report, MOICS/UNIDO, 2002 and various issues of *Economic Survey*, Ministry of Finance

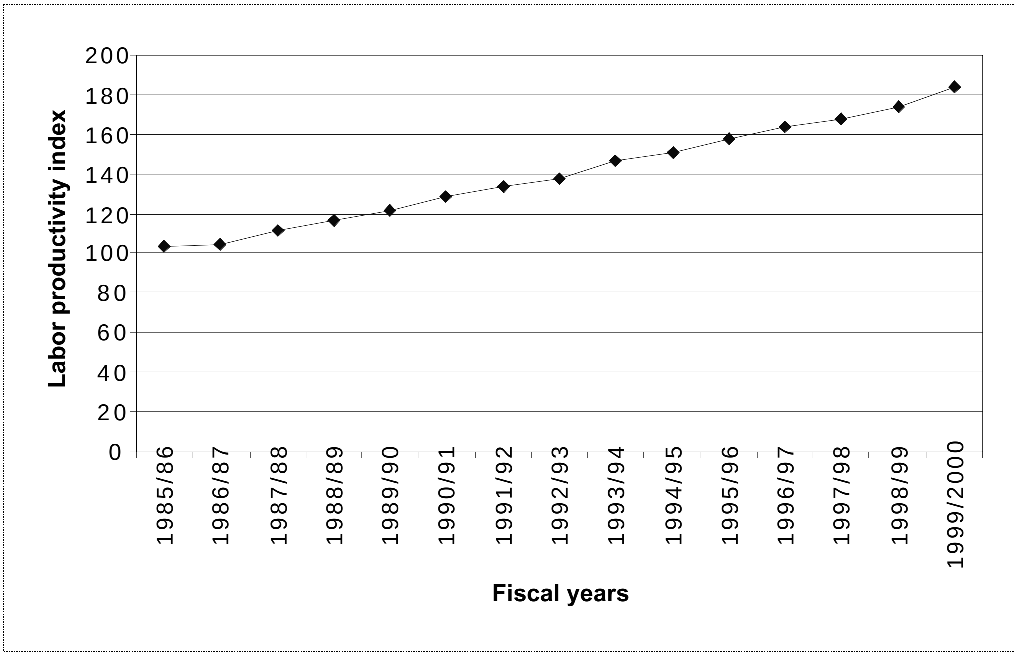
On the other hand, the service sectors including telecommunication, transport, and power require more capital concentration than labor, which naturally raises the value addition per worker. The Census of Manufacturing Establishments (1996/97) shows that the industrial sector employed 0.9 million (9.8 percent) out of the total work force of 9.5 million in 1996/97 in which the employment generated by the sector stood at 0.18 million, i.e., 20 percent of the industrial labor force and 2.4 percent of the total labor force.

Table 3. Output, employment and productivity by key economic sector

Sector	Value added FY 1998/99			Labor force employed		Value added per worker	
	USD million	NRs. million*	Percentage of GDP	Million	Percentage of total	NRs. thousands	Percentage of average
Agriculture	1,906	130,084	40.1	7.2	76.1	18,067	52.7
Industry	998	68,113	21.0	0.9	9.8	75,681	213.5
Services	1,849	126,194	38.9	1.3	14.0	97,072	277.0
Total	4,754	324,391	100.0	9.5	100.0	34,146	100.0

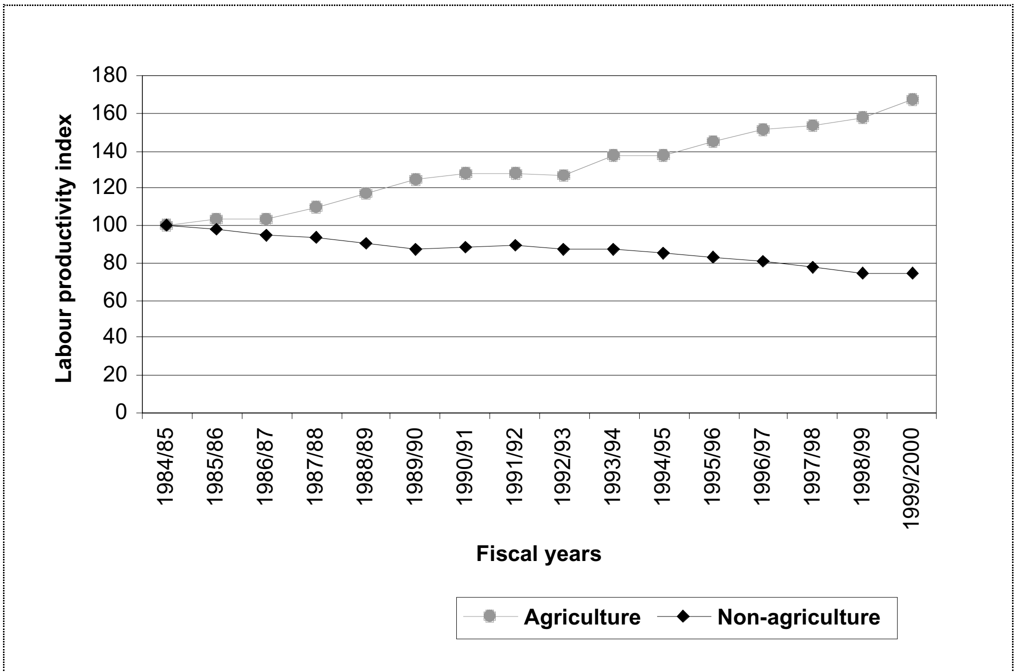
*A conversion factor of NRs. 68.25 for a US dollar is used.
Source: Nepal-Public Expenditure Review, World Bank, 2000

Below are presented the national labor productivity index (Figure 1) and agriculture and non-agriculture sector productivity indices (Figure 2). These graphs are based on the data reported by NPEDC (2000).



Source: NPEDC

Figure 1. National labor productivity index



Source: NPEDC

Figure 2. Agriculture and non-agriculture sector productivity indices

In Figure 1 the trend depicts a consistent increase in national productivity over the years. Figure 2 shows the growth rate in productivity of the agriculture sector (comprising fishery and forestry) and the non-agriculture sector. It indicates that whatever positive growth rate occurred in national productivity is the almost exclusive contribution of the agriculture sector. Thus, improvement in the productivity of the non-agriculture sector (where most of the Nepalese corporations are) is a matter of paramount importance for enhancing the productivity of the national economy.

PROFILE OF NEPALESE LISTED COMPANIES

Nepal has a small equity market, commanding about 12 percent of GDP, and is featured by a low five percent of liquidity. The number of listed firms is 115, which is less than one percent of all companies and 10 percent of the public limited companies. Of the 115 listed companies, shares of 69 companies are traded. Table 4 shows the decreasing percentage of listed companies being traded, which dropped from 70.5 percent in 1996/97 to 62.7 percent in 1999/2000.

Table 4. Percentage of listed companies traded, 1996/97 —2000/01

	1996/97	**1997/98**	**1998/99**	**1999/00**	**2000/01**
No. of companies listed	95	101	107	110	115
No. of companies traded	67	68	69	69	67
Percentage	70.5	67.3	64.5	62.7	58.3

Source: NEPSE

Further, the NEPSE index does not show an encouraging prospect about the ratio of turnover to market capitalization. The ratio shows a fluctuating trend. This ratio was 3.25 percent in 1996/97, increased to 6.38 percent in 1998/99 but went down to 2.68 percent in 1999/2000. It again reached 5.06 percent in 2000/01. Sector-wise the details are as follows:

Market capitalization was Rs.12,698 million in 1996/97, and reached Rs.46,349.4 million in 2000/01. Market capitalization on GDP was 11.81 percent by the end of FY 2000/01. The market capitalization of the banking sector as a proportion of total market capitalization was the highest (67.39 per cent) as compared to other sectors.

Table 5. Percentage of turnover to market capitalization, FY 1999/2000

Sectors	**Market capitalization** (NRs)	**Annual turnover** (NRs)	**%**
Commercial bank	31235.21	1923.07	6.16
Finance company	3077.17	254.67	8.28
Insurance company	2178.47	46.08	2.12
Hotel	2969.85	22.35	0.75
Manufacturing & processing company	5971.97	67.07	1.12
Trading company	616.98	4.48	0.73
Others	299.76	26.44	8.82
Total	46349.41	2344.16	5.06

Source: NEPSE

The total number of listed companies under different sectors is as follows:

Table 6. Sector-wise details of listed companies

Sectors	1996/97	1997/98	1998/99	1999/00	2000/01
Commercial bank	8	9	9	10	10
Finance & insurance company	25	28	32	34	39
Hotel	2	2	3	3	3
Manufacturing & processing co.	34	36	37	37	37
Trading company	22	22	22	22	22
Others	4	4	4	4	4
Total	95	101	107	110	115

Source: NEPSE

The industrial activity of the country is concentrated in a small number of powerful families who own and control about 27 percent of total private sector assets in the country. In addition, a number of enterprises are still in the public sector and operate at a very low efficiency level. Nepal's incremental capital output ratio (ICOR) stands at around five percent.

Most of the enterprises are running below their capacity to utilize the human and physical resources they own. The reality is that capacity utilization among the firms is less than 50 percent on average. According to Pant (2001), the capacity utilization of a cigarette factory and a cement factory that were considered as the best performers was calculated as a bare 33 percent and 48 percent, respectively, in 1997. Pant states candidly that human resource development is a neglected management function among the state-owned enterprises (SOEs).

THE LEGAL AND REGULATORY ENVIRONMENT

Government regulations affecting business

The regulatory framework of the Nepalese capital market has more or less been guided by the following acts, regulations and guidelines:

- Securities Exchange Act, 1983
- Securities Exchange Regulations, 1993
- Company Act, 1997
- Commercial Bank Act, 1974
- Finance Companies Act, 1986
- Foreign Exchange (Regulation) Act, 1962
- Foreign Investment and Technology Transfer Act, 1992
- Securities Listing Bye-Laws, 1996
- Membership of Stock Exchange and Transactions By-Laws, 1998
- Issue Management Guidelines, 1997
- Securities Allotment Guidelines, 1994
- Securities Registration and Issue Approval Guidelines, 1995
- Auditors Act, 1974
- Nepal Chartered Accountants Act, 1997.

The new Company Act, passed by Parliament in 1996, sharpened the distinction between public and private limited liability companies and effective deregulated private limited liability companies. It also streamlined the approval systems for company actions by the Office of Company Administration, and clarified the reporting responsibilities of public limited liability companies and the rights and responsibilities of shareholders, management, and boards of directors. The Act puts the minimum number of owners of limited liability companies at two (IRIS, 2003).

The Company Act does not impose any explicit general standards of care for company managers nor does the statute specify that directors and officers be legally obliged to act in the company's interests. In Nepal, common law precedents do not cover this gap in legislation (ADB, 1999). The government has undertaken some reform measures. The budget speech of the Finance Minister for FY 2001-2002 states that to reform the managerial, accounting and financial systems of public enterprises, separate strategic and organizational planning will be prepared so that they can run at healthy conditions. Public enterprises will be converted to private companies, the number of their board representatives will be curtailed, the functions and duties of board members and manager will be ascertained and professionalism will be reinstated (MOF, 2000/01).

The Office of the Registrar registers all companies. The approval of the Registrar is needed to restructure the company, change the authorized capital of the company, operate newly registered company, change the location of the registered office of the company, and merge companies. The companies are required to submit to the board of directors an annual report, audit report and balance sheet, the resolutions passed in the annual and special general body meetings and the names of the members of the board of directors. The office has the duty to enforce many provisions of the Company Act. The registrar has the power to call special general meetings. It also has the authority to monitor, investigate, supervise, direct and order the companies to abide by the company law, rules, memoranda, articles of association and other instruments of corporate governance. The registrar may impose fines up to Rs.5,000 on any company or its directors, managing directors, managers, and other officers. In a compulsory liquidation process, the registrar has the key role to play.

Shareholders: According to the Company Act, 1997, shareholders meet at least once a year at either the annual general meeting or the extraordinary general meeting. No person may participate and vote in the general meeting in his/her capacity as a shareholder either in person or by proxy on discussions to be held in respect to any terms and conditions signed or to be signed between him/her and the company. A shareholder is entitled to attend the general meeting and cast vote or nominate another shareholder of the company to cast proxy vote on his/her behalf.

In order to make the size of shareholders manageable, the Securities Exchange Board (SEBO) reviewed the existing allotment limit and amended the 1994 Share Allotment Guidelines which prescribe the allotment ceiling. Before the amendment, the allotment limit was a minimum of 50 shareholders per Rs.100,000 of issued capital. After the amendment, the limit has been changed to a minimum of 50 shareholders per Rs.100,000 of issued capital, if the issued capital is up to Rs.50 million; and a minimum of 20 shareholders per Rs.100,000 of issued capital, if the issued capital is more than Rs.50 million.

Accounting standards: Poor accounting and auditing standards enabled some institutions to present a far better picture than what the financial health actually was. In view of this, the Nepal Rastra Bank issued new accounting policy directives following international accounting standards and Generally Accepted Accounting Principles (GAAP). Various disclosure requirements together with other regulatory and supervisory frameworks have helped make the share values of commercial banks stocks more realistic (*The Weekly Telegraph*, May 28, 2003).

Reform measures have been undertaken aimed mainly to promote greater transparency, and to bring changes to accounting and auditing standards, financial reporting systems and disclosure requirements. SEBO, with suggestions from the Asian Development Bank, has prepared a new draft of Securities Act. The proposed act tries to clarify the right of investors to demand for compensation, if any loss or damage occurs due to misinformation of corporate bodies at the time of public notice. Provisions have been made to discourage insider trading of securities and to make it mandatory for the listed companies to audit their books of accounts only by those auditors who are recognized by SEBO. In order to improve the financial reporting standard, SEBO, with consultancy services from the Institute of Chartered Accountants of Nepal (ICAN), is developing uniform financial reporting formats for implementation. SEBO has also submitted to the Ministry of Finance a concept paper on the Implementation Plan for Setting up Standards of Accounting and Auditing Practice. It has also published a booklet on Provisions of Disclosure for Listed Companies by incorporating the provisions made in the Securities Act, the Securities Exchange Regulation and other by-laws and guidelines.

It is generally accepted that Nepal should promulgate accounting and auditing requirements based on International Accounting Standards and International Auditing Standards. An effort has been made in this direction through the setting up of ICAN under the Nepal Chartered Accountants Act, 1997. The objective is to ensure compliance with the International Accounting Standards, the International Auditing Guidelines and the guidelines received from the International Federation of Accountants. A parallel move requires firms to prepare their accounts in conformity with the accounting standards prescribed by ICAN.

Disclosure: Statutorily, all companies have to prepare audited annual accounts. These reports are first submitted to the board for approval, then to all shareholders, and finally to the Office of the Company Registrar. The listed companies are required to submit their annual report along with their financial statement to the SEBO within four months after the expiry of the fiscal year as well as their semi-annual report within 60 days after expiry of each six month period. The most substantive financial disclosures of companies are stated in the annual reports, particularly the balance sheet, profit and loss account, and their relevant schedules all containing data for the current and the previous fiscal years. The quality of financial disclosure in the annual accounts is determined by the Office of the Company Registrar, the Ministry of Industry, Commerce and Supplies, SEBO, (which mandates special disclosure requirements for listed companies) and ICAN (the body authorized to define the parameters of Nepalese accounting standards). The listed companies are expected to prepare their financial statements based on General Accepted Accounting Practices and in accordance with the provisions of the Company Act of 1997. Any information affecting trading at the stock exchange in respect of an increase or decrease of fixed assets, or an agreement with a person or organization affecting the organization, shall have to be immediately submitted to SEBO and NEPSE.

With the aim of educating the listed companies regarding information disclosure and thereby improving their transparency in the market, SEBO has published a booklet with the title Provision of Disclosure for Listed Companies by incorporating appropriate provisions made in the Securities Exchange Act, the Securities Exchange Regulations, and other by-laws and guidelines.

While the Company Act specifies punishments for non-compliance of financial disclosures, in most instances, the maximum penalty is either fine, which does not exceed Rs.20,000 or imprisonment for a term not exceeding two years, or both.

Financial institution: The latest attempt for improving the performance of the banks is particularly focused on revising the core capital; classifying loans; provisioning and limiting individual or sectoral loan sanctions; and upgrading the existing domestic banking system to the international standard, by making the accounting and financial statements more transparent. Among other measures, the new directives have introduced provisions related to risk minimization, good institutional governance, inspection reporting, and banking investment on shares and government securities (*The Kathmandu Post*, October 7, 2001).

The banks and financial companies can play a key role as agents for external governance. But, some major reforms are still required to fulfill this role, which include removing explicit and implicit government guarantees in favor of the banks; limiting the shareholdings of non-financial companies in banks and of banks in companies to avoid conflict of interest; setting and enforcing limits on lending by banks to affiliated companies, directors and related interests. There is also a need to strengthen capacities for regulation and supervision of banks and financial institutions including the Nepal Rastra Bank. The banks and financial companies should apply international standards of capital adequacy, financial accounting, reporting and disclosure standards. When all is said, it is imperative that the NRB monitors with seriousness compliance with all measures adopted by the banks. Finally, the NRB should assure strict compliance with these standards within its own ranks.

Insolvency: The liquidity laws and procedures are generally ineffective in protecting the creditors as well as in disciplining the borrowers. In the case of banks and development financing institutes, the government has recently presented a Loan Recovery Bill to the Parliament for enactment.

Industrial relations: Provisions have been made to protect the rights and interests of the employees and laborers of industrial establishments which employ ten or more laborers. The new regulations provide for the formation of a Minimum Wage Determination Committee. The regulations also envisage a tripartite Central Labor Advisory Committee having representation from management and laborers to ensure cordial relations in the industrial establishment.

The Nepal Stock Exchange

The Nepal Stock Exchange has been operating in its current form since 1993. It has 115 companies listed, although of these, the 10 commercial bank shares accounted for over 75 percent of turnover in 2000/01. In a typical day, only 25 to 30 listed stocks actually trade. NEPSE is regulated by the Securities Board, which has recently launched a five-year strategy to define its role more clearly and improve its effectiveness as a regulator.

Under the provisions of the Securities Listing By-Laws 1996, which came into effect in the beginning of fiscal year 1996/97, companies are categorized on the basis of the following criteria:

- Companies with paid up capital worth Rs.20.0 million and having shareholders not less than 1,000 in number;
- Companies that have a book value of shares not less than the paid-up capital;
- Companies that have been profitably operating for three preceding consecutive years; and
- Companies submitting their fiscal report within six months of closing of the fiscal year.

Companies listed in the stock exchange fulfilling the above criteria are classified under Category A while others are classified under Category B. During FY 1999/2000, 26 listed companies were classified under Category A.

While registering some initial successes, the Nepal Stock Exchange (NEPSE) has little daily trading activities and only in a few selected cases does it issue shares mainly the financial institutions shares.

Nepal's stock market is primarily a retail market. The local institutional investors' base is small and foreigners are not permitted to purchase shares in the local stock market. Also, investors located outside Kathmandu do not have good access to NEPSE because no broker has a branch office outside the capital. The trading activity of the companies is low mainly because few companies pay dividends and adhere to relatively transparent accounting standards. Also, some companies have apparently become insolvent but have not actually been de-listed. This is an apparent consequence of the absence of a bankruptcy law in Nepal. Nearly all the listed companies are majority owned by their promoters. At present, there is only one corporate debenture listed on the NEPSE. The vast majority of shares remain illiquid.

The Nepal stock market experienced the most interesting phenomenon in 2000/2001 when the stock exchange rose sharply in terms of turnover as well as capital investment. The market price of shares of commercial banks skyrocketed but in most cases prices were not propped up by their respective balance sheets. Inadequate knowledge about the share market led to this kind of situation (*The Weekly Telegraph*, May 28, 2003).

As regards capital market supervision, the Securities and Exchange Commission (SEC) was established with a 26 percent government share, 36 percent share owned by the Nepal Industrial Development Corporation (NIDC), and 38 percent share owned by NRB, the central bank of Nepal. As conceived then, the role of SEC was to facilitate and promote the growth of the capital market by acting as a broker, an issuer of securities, a market maker for government-floated bonds, and a registering and clearing point for securities exchange transactions. These multiple roles prescribed for SEC, although elegant, resulted in the slow development of the stock exchange market. In 1993, the government split apart the regulation and the brokerage functions by privatizing the latter. As provisioned by the new Securities Exchange Act of 1993, SEBO was established to formulate policies and regulations, prescribe terms and conditions for the stock exchange operations, carry out inspection function, and do the registration of securities. The amendments mandated that the market intermediaries get registered with SEBO before doing primary and secondary securities business and to report to SEBO their financial and trading activities. During the past eight years, SEBO approved 81 public issues amounting to Rs.3116.26 million. The total public issues included 60 issues of ordinary shares, 15 issues of right shares, 3 issues of preference shares and one issue of debenture (SEBO, 2000/2001).

The capital markets in Nepal are very much underdeveloped. A corporate bond market is almost non-existent. Much of the activity centers on treasury bills and government bonds, although no active secondary markets exist for these instruments. Much of the trading revolves around financial institution stocks. It is generally recognized that the capital markets have yet not been effective vehicles for mobilizing long-term capital in Nepal. Although the creation of the capital market immediately attracted the interest of the retail investors, in size and maturity it has not kept pace with the growth of the private sector.

Overall, capital markets have so far not been playing any significant role for long-term financing such as capital expansion. Individuals and institutions prefer to deposit savings in banks and in fixed-interest government securities, even at very low interest rates, than they would if the market were working properly. Long-term savings that should be invested in the capital market are going into short-term schemes. This is due to the overall weak governance structure, poor accountancy standards and weak disclosure of financial information. This situation offers limited investor protection; it also reflects an undeveloped institutional investor base. The institutional strengthening of the regulator, SEBO and the NEPSE will be required not only to avoid further confidence crisis due to market irregularities, but also to lay the foundations for a more diversified, resilient, and market-led financial sector.

SEBO has drafted a new Securities Act, which has been reviewed by international experts commissioned by the Asian Development Bank. This proposed act envisages strengthening the SEBO, and also incorporates provisions related with the Central Depository System (CDS) of securities, transfer agent and full range of the brokerage firm. It also ensures the right of the investors to demand for compensation, if any loss or damage occurs due to misinformation of corporate bodies at the time of public notice. Further, provisions have also been made to discourage insider trading of securities and to make it mandatory for the listed companies to audit their books of accounts only by those auditors who are recognized by SEBO. SEBO has initiated to develop uniform financial reporting formats in consultation with ICAN. The SEBO has also submitted to the Ministry of Finance a concept paper on the Implementation Plan for Setting up Standards of Accounting and Auditing Practice.

This situation can be improved only by providing the investors with timely and reliable information related to the financial position of the listed companies to help them in making reasonably correct analysis of financial prospects and providing them proper guidance for sensible investment. According to the latest information, less than 60 percent of the listed companies submitted their financial statements for 1999/2000. Among the defaulters are several major companies whose shares are being traded regularly. Moreover, the contents and the style of presentation of the financial statements differ from company to company.

In Nepal, brokerage firms do not manage portfolios on behalf of their clients. Their role is limited to advising clients as to whether a particular stock is a good investment or not, based on an analysis of company reports and any other information they may have access to about the company or the sector concerned.

Consumer protection: The Consumer Protection Act was enacted in 1998 with the objective of maintaining the health of consumers, offering facilities and economic benefits, maintaining the quality of goods and services, controlling the inflation caused by monopoly and unfair trade practices, making arrangements to establish institutions for facilitating consumer complaints, and redressing grievances. This act aims at protecting the rights of the consumer as well as restricting unfair trade practices. The provisions mentioned in the act can help protect the interest of the consumer and also foster a competitive business environment. Consumer protection regulations have been enforced since September 1999. However, the enforcement aspects of both (the Act and the regulations) have remained far below expectations.

RUNDOWN OF CORPORATE GOVERNANCE IN NEPAL

Ownership and capital structure

The study considers three different ownership structures: state owned public enterprises, listed companies and unlisted private limited companies.

Performance is considered related to an institution's ownership because the incentives for managers to efficiently allocate resources might differ under different ownership arrangements. If the owners do not have the incentives or capability to monitor the activity of the enterprise is management, then agency problems and subsequent costs are thought to increase. It is expected that joint venture organizations will be relatively efficient because the modality of corporate governance that they adopt is generally of international standards. In terms of efficiency, the state owned organizations are generally thought to be inferior to privately owned firms.

There is concentration of corporate ownership in Nepal. Significant family or block ownership characterizes Nepalese companies. In family-owned enterprises, the major shareholder completely dominates the corporate decision-making process, while the voice of minor shareholders is largely ignored.

A bright spot is the new opening for foreign ownership. The ceiling on foreign equity ownership by operating joint venture commercial banks has been increased from 50 percent to two thirds of total shares.

External finance, mostly bank loans, dominates corporate financing. In the public sector, a large portion of corporate capital is composed of loan capital, particularly, external loans. This accounts for about four times that of the total share investments. Clearly, the poor financial health of public enterprises has posed a serious budgetary pressure. According to Ministry of Finance estimates (2000/01), equity investment in public enterprises for FY 1999/00 amounted to Rs.1373 million and was expected to reach Rs.1,080 million in FY 2000/01. In FY 1999/00, the loan capital investment amounted to Rs.5,945 million and this figure was expected to increase to Rs.9,390 million in FY 2000/01. In FY 1999/00, net return on capital employed from public enterprises amounted to 2.9 percent.

Enterprises were too leveraged with debt financing. During good times, the leverage would not be a problem; but during crises, it could create a serious problem not only for the firms themselves but also for the financial institutions providing loans to these enterprises.

Management in the enterprises

Because of the relationship-based system in Nepal, most boards do not satisfy any of the conditions that accompany the principle of independent oversight. Although there is a clear distinction between full time directors and non-executive board members, there is no legal definition of independence. Moreover, the non-executives are family members or nominees from the government or institutional shareholders. It is common for prominent persons to serve on the boards of several corporations simultaneously.

Management shares very little substantive information with the outside directors. Most of the nominee directors fail to understand that they are fiduciaries of the company. Their major interest is directed to avoiding undue exposure by the firms as well as any risky decision that may have adverse consequences to the organization. Moreover, in majority of cases, they bring with them little specialized knowledge of any aspect of corporate work and, hence, contribute very little. Most Nepali companies are driven by their management and not by their boards. Given the non-commercial objectives of the principal, most chief executives of public enterprises quickly adopt the line of least resistance. Important organizational changes are not made, wages are not linked to productivity, and redundant workers are not retrenched. To some extent, the concentration of family-based ownership structures tends to hinder sharing of information about company affairs. Data about risky dealings are kept away from shareholders.

The executive director or general manager is in charge of the company's daily operations. In some public enterprises, the general manager is a board member and also function as board secretary. The controlling ministry selects the board directors and the general manager. The board is the most important organization in a firm, controlling the selection of senior staff members and fixing the compensation of employees. The board consists of five to 13 members including the chairperson.

Public enterprises suffer from frequent political interference and frequent changes of board members and of chief executive officers. Appointments of CEOs in public enterprises are almost entirely restricted to bureaucrats and political nominees who have little or no experience in commercial business. Thus, there is little room for utilizing the commercial potential of public enterprises. The boards include a representative from the line ministry and another from the finance ministry. But the director from the line ministry dominates and others do not play any significant role.

Listed and unlisted public companies are formed in a more democratic manner. They can nominate board members and choose senior officers. They hire professional managers. The board members are represented according to their shareholding. Board members in public enterprises are paid according to their attendance in the board meetings.

Management changes are often regarded as a chronic problem of public enterprise management. From a theoretical perspective, it is known that incentive and contracting problems create inefficiencies in enterprises owned by the state. This is because managers in state-owned enterprises pursue objectives that differ from those pursed in private firms (a political view) and they have to face less strict monitoring (a management view). In state-owned enterprises, the organizational objectives that the managers hold are often distorted, and the budget constraints they face also are softened. The soft-budget constraint emerges from the fact that bankruptcy is often not a credible threat to managers of public enterprises, for they live on the assumption that the government will bail the enterprises in the event of real financial distress.

The lack of hard budget constraint and managerial incentives as well as the monopolistic attitudes and behavior on the part of the managers, have contributed to operational inefficiency and large-scale corruption in the public sector enterprises.

Shareholder control and guarantees

Because of the dominance of family-based controlling shareholders and the lack of effective mechanisms that could provide checks and balances, there is ineffective mechanism in safeguarding the interests of all shareholders. The mechanism for participation by minority shareholders in corporate decision-making is weak, and legal protection for shareholders is inadequate. Family-owned groups have little tradition of transparency and disclosure practices. Further, disclosure requirements have been undermined by inadequate accounting standards and weak implementation of these standards, besides the failure to impose penalties for fraudulent financial reporting.

The legal mechanism does not work well for some companies. If a majority of the company's shares is held by a few people whose economic interests are linked (a family group, for example), the majority will tend to elect themselves as directors, appoint themselves as officers, and run the business as they see fit. Periodic review of management performance by the shareholders remains a legal reality but lacks practical significance.

Minority protection is a problem when owner-managers solicit funds and then abscond or mismanage the company. A legalistic overview of sections 126-132 of the Company Act would suggest that minority shareholders are well protected by legal remedies. But the legal reality is different. Practically speaking, minority shareholders do not have easy access to legal protection in Nepal. The courts in Nepal are ill-equipped to deal with business problems. Judges and lawyers have not been trained to analyze the kinds of legal issues generated by a capital market. Summary process and quick resolution of disputes are the necessary ingredients of a developing market system. Delay and indecision are typical in legal disputes in Nepal. Judges should be further educated to respond to new demands, but that is a long-term solution (ADB, 1999).

Transparency and disclosure

Poor disclosure of information is one of the impediments for gaining investors' confidence at a high level. The issuers publish over-optimistic forecasts of future profits and they often fail to publish annual accounts or hold annual general meetings, and even pay no dividends. A look at the following data gives the impression that, despite the gradual increase in the number of listed companies over the years, the proportion of them making public statement of their financial status (hence being transparent to some extent) has decreased.

Table 7. Companies submitting financial statements

	1995/96	1996/97	1997/98	1998/99	1999/00
Number of companies listed	89	95	101	110	115
Number of companies submitting financial statements	65	69	58	68	67
Percentage	73	73	57	62	58

Source: SEBO

A document published by the Ministry of Finance, Targets and Performances of Public Enterprises , has observed the difficulty in pre-estimating the financial position of public enterprises for two reasons: financial statements are not prepared on time and accounts are not audited internally and externally on a regular basis. As a consequence of these irregularities, the government is not getting a fair return on the investments made in the public enterprises. Among the reforms proposed are the inclusion of professional people on the boards of directors with special tenure and specific duties and responsibilities, and the introduction of a system that ensures preparation of financial statements within six months from the end of the fiscal year and completion of the audit within nine months of the fiscal year. Public enterprises and development boards will also be strictly prohibited from creating long-term liabilities beyond their financial capacity.

Credit monitoring and protection

Poor protection of creditors rights creates space for managerial discretion of power. In the hands of an inefficient management it can create problems through highly risky investments, which raise the cost of credit and debase the disciplining role of debt, eventually ruining the health of the financial sector. Creditors, in general, have little input into the companies' management and decision-making. Their role in corporate governance is weak. In Nepal, creditors themselves are poorly governed. Weak internal control and inadequate regulatory frameworks for the banks and other financial institutions explain this. The banks' internal risk-management system also appears to be underdeveloped. The implicit and explicit government guarantees of loans and injection of capital during restructuring of government-owned banks may have further weakened the creditors incentive to monitor and discipline bad borrowers and to identify non-performing loans. For example, despite the liberalization of financial sector, Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), the two state-owned commercial banks, still command the majority of the market shares to the extent of about 50 percent in deposits and 58 percent in lending. The government has off-loaded significant amounts of its shares in NBL. In 1998, the government sold 10 percent of its shareholding to the general public, reducing its own share to 41.1 percent, whilst increasing that of the general public (which now includes business houses with seats on the bank s board) to 58.9 percent. It is estimated that about 25-30 percent of this bank s lending portfolio is non-performing. The bank is technically insolvent, primarily as a result of experiencing high levels of bad debts. The bank has an estimated negative net worth of between NRs 6 to 10 billion, and requires a further NRs 1.6 billion to restore adequate capital to its balance sheet. The RBB is included in the government s list of companies to be privatized. Recently, Nepal Rastra Bank (NRB), Nepal s central bank, has selected international consultants to manage and operate both the commercial banks—NBL and RBB—under a contract. The decision of the government to hand over the management of these two banks to a foreign banking agency is an attempt to revive their ailing financial positions.

Additionally, NRB has designed and implemented some regulatory norms to promote competition and avoid concentration of economic power in the form of single borrower limit. The primary objective of fixing a ceiling on the loan and facilities that can be disbursed by a commercial bank to a single group, a firm or a company, is to enforce prudential commercial norms on the banks. This was done for the purpose of minimizing concentration of risk encountered by commercial banks. Accordingly, the banks may extend a fund-based loan to a customer or a group of customers having mutual relations up to a maximum of 25 percent of its primary capital; and in the case of non fund-based or off-balance sheet items, the amount may not exceed 50 percent of the primary capital loans like guarantee and commitments (MOF, 2000/01).

The financial institutions, mainly the banks, tend to have weak governance, partly reflecting the underdevelopment of enforcement tools such as information transparency in the wider economy. But this is also as a result of the inherent susceptibility of financial institutions to problems in the financial sector. Government involvement exacerbates the situation. Additionally, the traditional financial institutions tend to be financially and operationally weak, with high incidence of non-performing loans, inefficient operations, a weak service culture, and lack of commercialism.

The accounting and legal infrastructure that supports the financial sector also tends to be weak and underdeveloped. Accounting standards are usually outdated and enforced ineffectively. Bankruptcy legislation is often lacking. The poor capacity of the courts to settle business disputes inhibits reliance on them. Other infrastructure-related weaknesses include the lack of credit information bureau and antiquated payments systems. The Nepali financial sector exhibits most of these characteristics.

Given the dominance of public sector banks and a relative lack of skills up-grading opportunities, there is now a critical need to support a strong capacity-building effort in the financial sector. To this end, the development of a banker s training center to upgrade the skills base of the staff operating in the commercial banking sector will turn the financial sector around.

Banking supervision practices in Nepal do not comply with the Basle Core Principles. Regulations on banking activities, in many cases, are inadequate, too lenient and inconsistent. Enforcement of regulatory instruments is particularly loose. Most of the regulations allow for long delays in correcting non-compliance, do not set mandatory financial or legal penalties, and do not prescribe actions to be taken by the banking authorities. Regulations relating to multifarious banking aspects such as internal control and audit, interest rate risks and foreign exchange transactions, concentration of credit exposure, capital definition, liquidity, loan classification and provisions, single borrower limit, and accounting policies need to be revised and upgraded to meet international standards. Also, the state-owned banks are generally considered to be outside the scope of NRB s regulatory powers.

Prior approval of the NRB is required under the Foreign Investment and One-Window Policy before any investment is accepted from foreigners in the financial sector or other sectors. There are also considerable indirect barriers to investment such as those relating to inadequate infrastructure and legal and accounting systems. Restrictions on investment in the financial sector mean that no foreign financial institution has been allowed to open a wholly owned branch in Nepal. Most of the large multinational financial institutions prefer not to participate in joint ventures, and as a result, they have stayed away. Foreign insurers, securities dealers, investment bankers, and other financial sector intermediaries have similarly been unable to obtain licenses to do business in Nepal other than in joint partnership arrangements. The experience of foreign (overseas) ownership of Nepali banks to date has been mixed.

The lack of national accounting standards has made it difficult to assess inter-company financial performance. Even the reports of the same company are not always comparable from one year to another. This situation has made it difficult for regulating agencies to establish their effectiveness. Different agencies including tax authorities seek additional information in different ways. The companies have to furnish additional information to them, a task that the companies do with much reluctance and inefficiency.

MAJOR SURVEY FINDINGS AND OBSERVATIONS

Characteristics of the enterprises

Altogether, twelve enterprises are represented in the sample—six from the public sector enterprises (PUSEs), and six from the private sector enterprises (PRSEs). Of the six PRSEs, three are listed on the stock exchange and the other three are not listed. The selected enterprises are shown in Table 8. For brevity s sake, the enterprises are given short names throughout the study.

Of the 12 enterprises, only two PRSEs have holdings or operations in other countries. Only one PUSE sells its services outside the country; while three PRSEs export their products. However, only two of the four PRSEs have reported the proportion of sales exported (54 percent and 90 percent, respectively).

Table 8. Enterprises represented in the sample

Public sector enterprises (PUSEs)	Short name
1. Janakpur Cigarette Factory	Janakpur
2. Nepal Oil Corporation	N Oil
3. Hetauda Cement Limited	Hetauda
4. Rastriya Banijya Bank	RBB
5. Dairy Development Corporation	DDC
6. Royal Drugs Limited	Royal
Private sector enterprises (PRSEs)	**Short name**
7. Nepal Lever Company (listed)	N Lever
8. Necon Air Limited ((listed)	Necon
9. Nabil Bank (listed)	Nabil
10. Dabur Nepal Limited (not listed)	Dabur
11. Surya Tobacco Limited (not listed)	Surya
12. Nepal Lube Company (not listed)	N Lube

The PUSEs originated much earlier than the PRSEs. PUSEs came about in the 1960-1970 period and the PRSEs in the 1980-1990 decade. Seven out of the 12 enterprises are located in the capital (four PUSEs and three PRSEs), and the rest in three other districts outside the Kathmandu Valley. The main activity areas of the selected enterprises are cigarette production (2), banking (2), sale of petroleum and petroleum products (2), drug production (2), cement production (1), and production of dairy products (1), aviation services (1), and production of several kinds of commodities (1).

Financial performance profile of the enterprises

The enterprises were requested to provide five years data on their financial status.[1] The data on a few variables of some enterprises cover only 2-4 years. But there is a need to compare the enterprises. Therefore, to facilitate the comparisons, the reported financial data are converted into index numbers by assigning the base year amount the value of 1.00 and converting the subsequent years amounts as ratios of the base year amount. By doing so, a common unit of measurement is established. The enterprises are not equal in an *absolute sense*, but they are made equal in a *relative sense,* and hence made comparable.

Table 9. Longitudinal financial data of enterprises (in index numbers)

Description of variable	Enterprise type	Base year	2nd year	3rd year	4th year	5th year	Growth rate
Value of output	PUSE	1.00	1.23	1.42	1.48	1.82	0.0201
	PRSE	1.00	1.66	2.09	2.71	2.92	0.0550
	TOTAL	**1.00**	**2.89**	**3.51**	**4.18**	**4.74**	**0.0751**
	(Listed)	1.00	1.90	2.74	3.15	3.16	0.1218
	(Not listed)	1.00	1.46	1.53	2.33	2.72	0.1051
Value added	PUSE	1.00	1.21	1.42	1.53	1.92	0.0264
	PRSE	1.00	2.06	3.07	4.32	4.69	0.1086
	TOTAL	**1.00**	**3.27**	**4.49**	**5.85**	**6.61**	**0.1349**
	(Listed)	1.00	2.33	3.65	4.74	5.25	0.3931
	(Not listed)	1.00	1.58	2.04	3.56	3.70	0.1398
Book value of fixed assets	PUSE	1.00	0.99	0.91	0.89	0.85	-0.0053
	PRSE	1.00	0.53	0.63	0.61	0.63	-0.0185
	TOTAL	**1.00**	**1.52**	**1.54**	**1.50**	**1.48**	**-0.0238**
	(Listed)	1.00	0.37	0.35	0.31	0.28	-0.0820
	(Not listed)	1.00	2.12	3.44	3.67	4.25	0.1557
Capital expenditure s for fixed assets	PUSE	1.00	0.40	0.16	0.24	0.17	-0.0897
	PRSE	1.00	8.96	2.68	1.93	1.61	0.0242
	TOTAL	**1.00**	**9.35**	**2.84**	**2.17**	**1.78**	**-0.0655**
	(Listed)	1.00	9.02	2.69	1.83	1.62	0.0327
	(Not listed)	1.00	2.74	1.49	11.63	0.78	-0.0483
Gross additions to fixed assets	PUSE	1.00	0.64	0.53	0.63	0.65	-0.0172
	PRSE	1.00	2.34	2.63	1.11	1.70	0.0267
	TOTAL	**1.00**	**2.98**	**3.16**	**1.75**	**2.34**	**0.0095**
	(Listed)	1.00	2.07	1.52	1.08	1.03	0.0031
	(Not listed)	1.00	2.45	3.12	1.13	1.99	0.0710

[1] The original combined data showing absolute amounts of the four groups (PUSE, PRSE, listed and not listed) are with the author.

Table 9. Longitudinal financial data of enterprises (in index numbers) (continued)

Description of variable	Enterprise type	Base year	2nd year	3rd year	4th year	5th year	Growth rate
Working capital *	PUSE	1.00	1.15	1.04	1.22	1.96	0.0227
	PRSE	1.00	1.07	1.32	1.65	2.16	0.0393
	TOTAL	**1.00**	**2.21**	**2.36**	**2.88**	**4.12**	**0.0620**
	(Listed)	1.00	0.76	0.51	0.69	0.88	-0.0131
	(Not listed)	1.00	1.80	3.28	3.98	5.27	0.1807
Revenue or receipts	PUSE	1.00	1.23	1.42	1.48	1.82	0.0201
	PRSE	1.00	1.43	1.68	2.11	2.37	0.0351
	TOTAL	**1.00**	**2.66**	**3.10**	**3.59**	**4.19**	**0.0552**
	(Listed)	1.00	1.42	1.75	2.00	2.20	0.0539
	(Not listed)	1.00	1.47	1.54	2.36	2.74	0.1059
Operating costs	PUSE	1.00	1.28	1.45	1.51	1.83	0.0204
	PRSE	1.00	1.55	1.86	2.36	2.65	0.0397
	TOTAL	**1.00**	**2.83**	**3.31**	**3.87**	**4.48**	**0.0600**
	(Listed)	1.00	1.63	2.14	2.39	2.57	0.0650
	(Not listed)	1.00	1.47	1.53	2.33	2.73	0.1056
Capacity utilization	PUSE	1.00	0.91	1.02	1.05	1.03	0.0017
	PRSE	1.00	1.21	1.21	1.28	1.11	0.0072
	(Listed)	1.00	1.22	1.13	1.29	1.23	0.0206
	(Not listed)	1.00	1.20	1.42	1.26	0.82	-0.0386
Gross profit margin	PUSE	1.00	0.37	0.12	6.09	8.67	0.0746
	PRSE	1.00	1.09	1.17	1.34	1.27	0.0121
	(Listed)	1.00	1.11	1.12	1.24	1.24	0.0213
	(Not listed)	1.00	1.05	1.29	1.58	1.36	0.0315
Net profit margin	PUSE	1.00	1.47	-0.05	-34.29	-46.47	-8.4940
	PRSE	1.00	1.49	1.89	2.10	1.85	0.0284
	(Listed)	1.00	1.52	1.94	2.15	1.89	0.0502
	(Not listed)	1.00	1.00	0.94	1.17	1.03	0.0030
Return on equity	PUSE	1.00	-3.08	0.07	0.58	-0.25	-0.7500
	PRSE	1.00	1.25	1.98	1.90	1.11	0.0048
	(Listed)	1.00	1.25	2.37	2.45	1.50	0.0346
	(Not listed)	1.00	1.24	1.48	1.22	0.61	-0.0535

Note: The base year is given the value of 1.00.
*Total current assets investment at any given time.

Two sets of comparisons are carried out: (a) comparisons between the PUSE and PRSE groups, and (b) comparisons between the listed companies and the unlisted companies among the PRSEs. The indices are treated as raw scores and the statistical values are computed to do the comparisons. Following this, tests of mean difference are carried out to determine the significance of the observed differences. Below are presented the results of the tests (t-tests for independent samples). Table 10 presents the several sets of comparisons on the 12 financial variables.

Table 10. Status of enterprises on defined financial variables: tests of significance of mean differences

I. Public sector enterprises (PUSEs) versus private sector enterprises (PRSEs)

Name of variable	Firm type	N	Mean	Std deviation	t-value
A. INPUT VARIABLES					
Book value of fixed assets	PUSE	30	1.1960	0.2687	-1.56
	PRSE	25	1.9420	1.1178	
Capital expenditures for fixed assets	PUSE	18	1.2916	0.5666	-2.45*
	PRSE	20	2.4467	1.4500	
Gross additions to fixed assets	PUSE	23	1.1927	0.2686	-2.15*
	PRSE	20	1.8168	1.0390	
Working capital	PUSE	30	1.2393	0.3008	-1.68
	PRSE	20	1.7488	0.9168	
Composite: Input variables	**PUSE**	**101**	**0.9074**	**0.4471**	**-2.61**
	PRSE	**85**	**5.2014**	**15.1879**	
B. OUTPUT VARIABLES	PRSE	20	1.9420	1.1178	
Value of output	PUSE	25	1.2916	0.5666	-2.95*
	PRSE	15	2.4467	1.4500	
Value added	PUSE	30	1.1927	0.2686	-2.92*
	PRSE	25	1.8168	1.0390	
Revenue or receipts	PUSE	30	1.2393	0.3008	-2.66*
	PRSE	25	1.7488	0.9168	
Operating costs	PUSE	20	1.0060	0.0757	-2.47*
	PRSE	15	1.2780	0.4219	
Capacity utilization	PUSE	20	1.0060	0.0757	-2.47*
	PRSE	15	1.2780	0.4219	
Composite: Output variables	**PUSE**	**135**	**1.1944**	**0.3415**	**-5.83***
	PRSE	**100**	**1.8385**	**1.0657**	
C. PROFITABILITY VARIABLES					
Gross profit margin	PUSE	30	-1.0187	11.3464	-1.05
	PRSE	20	1.1635	0.1760	
Net profit margin	PUSE	28	-3.0552	11.8579	-2.18*
	PRSE	22	1.9518	2.3556	
Return on equity	PUSE	28	-2.5607	7.793825	-3.04*
	PRSE	21	2.4457	3.4010	
Composite: Profitability variables	**PUSE**	**86**	**-1.2441**	**10.3740**	**-2.74***
	PRSE	**63**	**1.9287**	**2.3775**	

N represents the number of years for which the data are reported, which vary from one enterprise to another.
* Indicates that the observed mean difference is significant at the .05 level.

Table 10. Status of enterprises on defined financial variables:
tests of significance of mean differences (continued)

II. Listed companies versus unlisted companies

Name of variable	Firm Type	N	Mean	Std deviation	t-value
A. INPUT VARIABLES					
Book value of fixed assets	Listed	15	0.9180	0.5902	-2.33*
	Not listed	10	2.0290	1.4310	
Capital expenditures for fixed assets	Listed	15	20.7327	32.3121	2.00*
	Not listed	5	3.5280	4.5924	
Gross additions to fixed assets	Listed	10	1.2080	1.0050	-1.26
	Not listed	10	2.6610	3.5128	
Working capital	Listed	10	1.0180	0.5318	-2.18*
	Not listed	10	3.0560	2.9052	
Composite: Input variables	**Listed**	**50**	**6.9404**	**19.5408**	**1.50**
	Not listed	**35**	**2.7171**	**2.9655**	
B. OUTPUT VARIABLES					
Value of output	Listed	10	2.3480	0.2687	1.70
	Not listed	10	1.5360	1.1178	
Value added	Listed	5	3.3940	0.5666	1.67
	Not listed	10	1.9730	1.4500	
Revenue or receipts	Listed	15	1.9687	1.2413	1.01
	Not listed	10	1.5890	0.6210	
Operating costs	Listed	15	1.8733	1.0750	0.92
	Not listed	10	1.5620	0.6156	
Capacity utilization	Listed	10	1.3470	0.4866	1.11
	Not listed	5	1.1400	0.2337	
Composite: Output variables	**Listed**	**55**	**2.0282**	**1.2489**	**2.10***
	Not listed	**45**	**1.6067**	**0.7356**	
C. PROFITABILITY VARIABLES					
Gross profit margin	Listed	10	1.1360	0.1431	-0.69
	Not listed	10	1.1910	0.2080	
Net profit margin	Listed	13	2.4715	2.9789	1.52
	Not listed	9	1.2011	0.4278	
Return on equity	Listed	12	3.2975	4.3448	1.56
	Not listed	9	1.3100	0.6483	
Composite: Profitability variables	**Listed**	**35**	**2.3731**	**3.1623**	**2.11***
	Not listed	**28**	**2.3725**	**0.4429**	

N represents the number of years for which the data are reported, which vary from one enterprise to another.
* Indicates that the observed mean difference is significant at the .05 level.

Significant differences between the PUSE and PRSE groups

In nine out of the 12 defined financial variables, the observed mean differences between the PUSE and PRSE groups are found to be significant, all differences being in favor of the PRSE group. Also, the PRSE group is found to hold higher level status on the composite on all the three classified variables. These 12 cases of significant mean difference are as follows:

Variables in which the difference is in favor of the PRSE group

The input, output and profitability variables whose significant mean difference favors the PRSEs are the following:

Input variables: capital expenditures for fixed assets, gross additions to fixed assets, and composite of input variables;

Output variables: value of outputs; value added, revenue or receipts, operating costs, capacity utilization, and composite of output variables; and

Profitability variables: net profit margin, return on equity, and composite of profitability variables.

Significant differences between the listed and unlisted companies

The observed mean differences between the listed companies and the unlisted companies are fewer in number. In only three out of the 12 variables, the observed differences are found to be significant, one being in favor of the listed companies and two being in favor of the unlisted companies. However, in all the three classified variables, significant differences are found to exist in favor of the listed group. These six cases are mentioned below:

Input variables

- Book value of fixed assets - difference in favor of the unlisted;
- Capital expenditures for fixed assets - difference in favor of the listed; and
- Working capital - difference in favor of the unlisted.

Output variables

- Composite of output variables - difference in favor of the listed.

Profitability variables

- Composite of profitability variables - difference in favor of the unlisted.

Correlation between classified variables

A matter of greater significance is the extent of mean difference between the three broad categories of variables: input variables, output variables, and profitability variables. While the above findings relate to the status of the four groups of enterprises in each of the twelve defined variables, the findings stated below are related to the status of these four groups in these three classified variables:

PUSEs versus PRSE:. The status of the PRSE group is found markedly above the status level of the PUSE group in all the three classified variables. This means the PRSE group is in a better position than the PUSE group in terms of three indicators of financial performance.

Listed companies versus unlisted companie:. In two classified variables output variables and profitability variables it is the listed group of companies that command better position far above that of the unlisted group. But on one count, viz., input variables, it is the unlisted group of companies that have a status far above that of the listed group of firms.

The correlation matrix (Table 11) depicts inconsistencies about the assumed relationships between inputs and outputs, inputs and profitability, and outputs and profitability. At the aggregate level (when all enterprises are taken), a high relationship is found to exist between input and output, but between outputs and profitability and between output and profitability, the relationship is terribly weak. The inconsistencies are found also at the disaggregated level. In the PUSE group, there is no evidence that these relationships hold: they are low and even negative in some cases. The assumed relationships are found to exist in the PRSE group as well as in the listed companies group. In the unlisted companies group, one relationship is moderate (input/output relationship), while two relationships are low and one even negative. One prime reason for the disparities in the relationships is the style of management and governance of financial matters of the enterprises. As the data indicate, the PUSEs have low profile on this aspect, and so do the companies that are not listed on the stock exchange.

Table 11. Relationships among input, output, and profitability variables

Enterprise type	Input and output	Input and profitability	Product and profitability
All enterprises	Positive and high	Positive but low	Positive but low
PUSE	Positive but low	Negative and low	Negative and low
PRSE	Positive and high	Positive and high	Positive and high
Listed	Positive and high	Positive and high	Positive and high
Unlisted	Positive but moderate	Negative and low	Positive but low

Analysis of the financial status of the enterprises: a summing up

These analyses of the financial performance of the 11 enterprises should be interpreted cautiously. The findings cannot be generalized for two reasons: (1) the sample size is small, and (2) some irregularities have been noted in the financial data supplied by the enterprises. However, the findings offer some indications about the financial performance of the Nepalese enterprises.

- The degree and direction of association between the input factors, output performance, and the profitability gains in the Nepalese enterprises may not turn out as theorized (or as expected).
- If the present corporate culture among the public sector enterprises continues, the PUSEs may be performing poorly with regard to output increases or improvement and to the expected level of profits.
- In contrast, the private sector enterprises, particularly the listed companies, may produce evidence of higher level relationships amongst the three indicators of financial performance.

Ownership of the enterprises

Distribution of shares

All six PUSEs are owned by the state and thus represent the one-shareholder model of ownership. The case of the PRSEs is different. Two enterprises have two to three shareholder/owners; another two enterprises have four to five shareholder-owners; and the remaining two have more than 10 shareholder/owners. The distribution of shareholding in the five PRSEs is shown in Table 12.

In the private sector, it is customary to offer some shares of the firm to both employees and managers as a means to promote organizational or institutional loyalty to the firm. In this respect, only three enterprises are found to have provided this facility. But the shares given seem to be extremely nominal from less than one percent to five percent of the total shares for the employees. In the case of managers, the shares range from less than one percent to 46 percent. The mutual holding of stocks between the enterprise and their affiliates is found to be practically non-existent among the six PRSEs.

Table 12. Shareholding by major owners (%)

Enterprise	Top 1 shareholder	Top 5 shareholders	Top 10 shareholders
Nepal Lever	80.0	-	-
Necon Air	19.6	50.2	58.8
Nabil Bank	50.0	70.0	70.0
Dabur Nepal	100	-	-
Nepal Lube	40.8	68.0	83.0

Rights of shareholders

Shareholders rights practically do not exist in any of the PUSEs. However, they are recognized in four of the six PRSEs. All four grant the right to vote according to share or the right to exercise proxy voting. Three give the right to demand independent audit of the firm. One honors the right to maintain proportionate ownership of the firm and another grant the right to membership on independent committees. Similarly, minority shareholders are represented on the board of governors only in four PRSEs; they have provisions which make it difficult to remove the minority representative(s) from the board without any legitimate cause.

Sources of working capital and conditions of loans

Depending on the sector (industrial or financial) where they belong, the sources of funding of the 12 enterprises are quite varied. The government guarantees the loans taken by the PUSEs in most cases. In the case of PRSEs, the guarantees come from the Board of Governors or from proprietors, shareholders or private owners. The external creditors demand collateral for the loans. When faced with liquidity problems, the enterprises either liquidate assets like treasury bills, solicit deposits from other banks, or seek further loans. In such cases, the firms either face a collection lawsuit, or enter into renegotiation of the loan.

Management

Decision-making

The type of control over decision-making slightly varies between PUSEs and PRSEs, and it has not changed during the last three years. In one PUSE, control rests solely with the government; in three PUSEs, it remains with the board of directors; and in two PUSEs, control is exercised by two and even three levels of authorities, e.g., by government, board of directors, and managers.

Among the major issues for decision-making, the important ones are: (1) corporate thrust and direction (2) corporate and financial strategic options (3) appointment of executives (4) determination of board composition (5) declaration of dividends and sharing of gains (6) business expansion/contraction and (7) productivity improvement initiatives. The decision-making power on these matters is located in one level of authority in some cases, and in more than one level of authority in a few cases. Overall, the owners/major shareholders in the PRSEs exercise decision-making in more areas than their PUSE counterparts. In the case of the PUSEs, this power virtually rests with government agencies. The second level authority to make decisions is the board which is present in both types of enterprises. The chief executive officer and the chief operating officer enjoy some decision-making power in a restricted number of cases.

Committee work as a participatory mode of firm management is not popular in either PRSEs or PUSEs. Majority of the enterprises do not do any kind of committee work.

The board in both PUSEs and PRSEs is generally composed of 5-10 members, but the tenure of the board varies to some extent: three years or less in PUSEs and 4-6 years in the PRSEs. The board chairman acts also as the CEO in three PUSEs and in one PRSE. The board in both types of enterprises does not generally appoint outsiders as directors. The frequency of the board meetings varies, more than eight times a year in the PUSEs and less than four times to more than eight times a year in the PRSEs.

Status of the chief executive officer

The PUSEs are in a better footing than the PRSEs with respect to the appointment of the CEO. Four of the current CEOs in the PUSEs are experienced insiders as against two in the PRSEs. During the past three years, the CEOs have been changed in all six PUSEs, but in only three PRSEs. On executive compensation as a percentage of the average employee salary, the proportions range from 1.14 percent to 200 percent in the PUSEs, and from 24.24 percent to 1000 percent in the PRSEs.

Transparency and information disclosure

All enterprises are legally required to make the material information about the firm public. Two PUSEs and one PRSE are found to have ignored this obligation. Do the enterprises have their own policy on public disclosure of information? One PUSE does not have such a policy, and so do two PRSEs. Enterprises that disclose their material information generally do so once a year.

Not everybody has access to material information of the enterprises. The information is available mostly to the major shareholders, management and the internal and external auditors in both types of enterprises. But the PRSEs are found to be more open than the PUSEs in providing access to other stakeholders, such as minority shareholders, employees, unions, and the general public. Overall, information related to the firm s financial transactions and performance is made accessible more often than information related to the firm s ownership structure and governance style.

The minutes of the board s meeting are often treated as confidential information especially among the PUSEs. In the PRSEs, the minutes are accessible to interested stakeholders, including minority shareholders.

Accounting and auditing systems

The enterprises follow mostly local standards with regard to accounting and auditing. Three PRSEs adhere to the local standards while another three PRSEs follow the international standards. Some PUSEs mix some elements of developed country standards with elements of the local systems. Only one PUSE has maintained separate account books, but three PRSEs keep separate books to meet the demands of management, the tax agency, auditors and creditors.

All PUSEs and PRSEs report having external auditors. Auditors in four PUSEs have been changed during the past three years. Four of the six PRSEs have been employing the same external auditor in the last 3-5 years, and two PRSEs have not changed the external auditor since the time of their establishment. Both PUSEs and PRSEs claim that the degree of independence of their external auditors is high/very high.

Code of ethics

A code of ethics is assumed to guide the behavior and attitudes of owners, managers, shareholders, and employees. All PUSEs and PRSEs report having such a code in their organization. Eight of the 12 enterprises (5 PUSEs and 3 PRSEs) have their code published and disseminated among the stakeholders. The code is found in PUSEs more than in PRSEs. Additionally, six PUSEs and four PRSEs have reported that they have received and investigated allegations or breaches of proper standards of financial conduct. The complaints are generally associated with infractions of the internal revenue code, environmental rules, labor code, corporation law, and consumer protection laws.

Internal control systems

The enterprise chiefs were requested to characterize the nature of internal controls within their firms seen as a means to protect shareholders against the misuse of the firm s money in ten different areas involving significant financial transactions. These areas are: (1) cash flow, (2) accounts receivable collection and aging, (3) bad debt write-off, (4) inventory, (5) fixed asset acquisition, (6) research and development, (7) capital expenditures, (8) tax payments, (9) loan payments, and (10) payroll. The surveyed enterprises report no significant variations, generally speaking, except in fixed asset acquisition, where control in the PRSEs is stricter than in the PUSEs.

Employer-employee relations

In five PUSEs and three PRSE, there is an employee union. During the past three years, there have been disputes between management and employees over several issues, including improvement of working conditions for the employees. All these disputes have been settled using various approaches. Disputes in the PUSEs are settled through government arbitration, although mutual discussion between management and employees is often attempted in 5 PUSEs and 3 PRSEs. In the PRSEs, the conflicts are usually resolved through negotiations and sometimes through collective bargaining.

Nine conflict-ridden issues were identified in the APO survey: (1) compensation, (2) benefits, (3) tenure, (4) working conditions, (5) company rules and regulations, (6) training and development, (7) labor standards, (8) productivity improvement programs, and (9) productivity gain sharing. Management discretion is the popular way of resolving issues in the PRSEs particularly on training and development of employees, productivity improvement programs, and productivity gain sharing. In the PRSEs, the predominant way is collective bargaining, particularly on benefits to employees, followed by management discretion, especially on training and development.

Quality and productivity improvement

Ten of the 12 enterprise chiefs (five in each group) have adopted measures for improving the quality of their products/services and the productivity of their firm. The PUSEs have launched more quality and productivity programs compared with the PRSEs.

On whether or not there are commitments to abide by international quality standards, only two PRSEs are found not to have ISO 14000 certification but different ones: ISO 9002 and ISI 9006, respectively.

Four PUSEs prefer different approaches with regard to observing international safeguards like the Codes of Business Conduct (COBC) two favor enforcing the COBC through economic incentives/penalties, one prefers enforcing it as a law, and one favor implementing it on voluntary basis. In contrast, three PRSE CEOs prefer voluntary implementation, while one PRSE CEO prefers imposing economic incentives and sanctions.

Social responsibility of the enterprises

Consumer protection

Only eight out of the 12 enterprise CEOs (four from each group) are aware that laws protecting the consumer rights exist in the country. Of the eight, four PUSEs and three PRSEs have some kind of policy on protection of the environment.

Ten of the 12 enterprises (four PUSEs, all PRSEs) report having a mechanism to receive and resolve consumer complaints. There were several complaints lodged in PRSEs (but none in the PUSEs) during the past three years as regards the services delivered by the firms.

The strategies for addressing the complaints include: (1) rectifying the defects/deficiencies in the firm; (2) giving compensation to the affected person/group in genuine cases; (3) forming an investigation committee to probe into the issues raised in the complaint; (4) introducing improvement in the firm s services; and (5) holding discussions with the person/group making the complaint. Not surprisingly, all the 12 enterprises report not having any kind of community action against them during the last three years.

Community action

In areas of wider public concern pollution control, philantrophy, support for indigeneous groups the role played by both PRSEs and PUSEs is just compliance in most cases and voluntary action in a few cases; none claims to have taken any leadership role.

Only two PUSEs and three PRSEs have done community development or welfare projects within the last three years. These projects include water supply, financial support to VDC/local schools, construction of rural roads, health services, skill generation, and income generation.

Interface with external stakeholders

Rating the quality of public services

The quality of services of external institutions determines the working environment of the enterprises. Overall, the PUSEs have rated the services of the following agencies at a level significantly higher than the ratings given by PRSEs: (1) central government, (2) parliament, (3) central bank, (4) customs office, (5) judiciary system, (6) police department, and (7) internal revenue office.

The same applies to the quality and efficiency of certain sectoral services such as education, roads, ports, telecommunication, electricity/power supply, and water supply public goods that the enterprises have to use recurrently. In this case also, the PUSEs have rated the quality of these services at a level higher than the scores given by PRSEs. On two other counts, the mean difference in the ratings is statistically significant. This is reflected in education and water supply, the services which the PUSE chiefs have rated higher.

Assessment of national problems

Statistical analysis indicates that PUSEs and PRSEs differ in their perceptions about the seriousness of national problems that have the potential to affect the smooth operation and growth of their business. These problems include the judicial system, law and order, inflation, exchange rate, taxes and regulations, anti-competitive practices, fiscal policy, corruption, and international regulations and standards. The PUSEs perceive that the judicial system, the law and order situation, and fiscal policy do not seriously affect their business, but the PRSEs believe otherwise. Also, the PUSEs indicate no effect when all problems are considered as a block.

As regards the extent to which they think the style of corporate governance of their firms has affected overall performance and productivity, both PRSEs and PUSEs irrespective of what style of corporate governance prevails feel there is nothing about the governance aspects of their firms that could seriously affect corporate productivity. As other indicators suggest, however, the reality is something different than what they have claimed.

RELATIONSHIP BETWEEN GOVERNANCE AND PRODUCTIVITY

A decisive positive relationship is clearly observed between good governance and productivity in the PUSEs and PRSEs that have been studied. Those companies which have given the decision making authority to the top management, and those which exhibit greater frequency of meetings of the board of directors, have higher productivity. Transparency and informative disclosure, too, are generally found to have contributed to better firm performance.

Table 13. Average capital productivity (revenue/book value of assets) of sample firms

		Capital productivity	**Remarks**
Ownership			
Whose majority shares are held by	≥ 10 owners	1.9760	
	< 10 owners	4.8558	Higher
Financing			
Whose creditors are	banks	4.5521	Higher
	non-banks	4.4791	
Management			
Whose board chairman is	CEO	3.6448	
	non-CEO	4.9814	Higher
Whose minority shareholders are	represented in the board	5.8200	Higher
	not represented in the board	3.1129	
Whose board has	audit committee	5.2694	Higher
	no audit committee	3.9491	
Whose board has	outside directors	3.1290	
	no outside directors	4.9378	Higher
Which has	disclosure rules	5.1625	Higher
	no disclosure rules	2.3428	
Whose accounting standards are	local	3.5785	
	international	6.4507	Higher
Which has	unions or associations		Higher
	no unions or ass ns		

Table 13. Average capital productivity (revenue/book value of assets) of sample firms (continued)

		Capital productivity	Remarks
Social responsibility			
Which has	consumer mechanism	4.9424	Higher
	no consumer mechanism	3.8990	
Which undertake	community projects		Higher
	no community projects		
Interface with government/international players			
Which rate the quality and efficiency of education as	good	5.8417	Higher
	poor	2.8539	
Which rate the quality and efficiency of roads as	good	4.8790	Higher
	poor	3.3348	
Which rate the quality and efficiency of telecom as	good	4.8836	Higher
	poor	4.3108	
Which rate the quality and efficiency of power as	good	4.9337	Higher
	poor	3.1434	
Whose problem with the judiciary is	moderate/major	6.6988	Higher
	minor/none	6.0973	
Whose problem with law and order is	moderate/major	5.5580	Higher
	minor/none	2.5741	
Whose problem with anti-competitive practices is	moderate/major	5.1201	Higher
	minor/none	4.5040	
Whose problem with taxes and regulations is	moderate/major	3.8487	
	minor/none	6.4175	Higher
Whose problem with fiscal policy is	moderate/major	5.1278	
	minor/none	7.4596	Higher
Whose problem with international standards is	moderate/major	3.3953	
	minor/none	7.5486	Higher

PRSEs make better use of international standards of accounting and auditing. And this has been shown to have positive impact on productivity in the companies investigated. PRSEs have the tendency to retain established auditors for 3-5 years. In contrast, PUSEs are found to be changing auditors too frequently the reason why there have been slippages in regular monitoring and continuity of purpose.

Table 13 summarizes the relationship between corporate governance and capital productivity irrespective of the nature of the enterprises.

SUMMARY OF FINDINGS AND CONCLUSIONS

A recapitulation of empirical findings and observations, is as follows:

- The twelve enterprises subjected to scrutiny on the input, output and profitability dimensions (productivity dimensions) exhibit wide differences.
- There is a downward trend in the indicators of financial performance, viz., inputs, outputs, and profitability across the enterprises.
- Most of the enterprises are not managed well. There are several management lapses among the enterprises. On many counts, the PUSEs seem to have better

standardization the PRSEs.

- The policies of the government with regard to the regulation and development of the enterprises are uncertain, unstable, and non-transparent. Government is unable to influence management behavior in the enterprises in a direction that would promote the interest of shareholders and investors, as well as of the larger public.
- Management in Nepalese enterprises is hardly participatory. Participation of the stakeholders and those who should be involved and immersed in organizational activities does not prevail. If bossism predominates inside the enterprises, bureaucratization hangs over them (from the government). Enterprise development cannot be expected to take place in such a constrained environment
- Training and retooling is an effective strategy for raising the efficiency and productivity of the organization. This aspect has remained quite neglected in Nepalese enterprises. If enterprises are found to be inactive in initiating creative programs of human resources development, references to raising productivity would be idle talk.

RECOMMENDATIONS

For resolving persisting problems in enterprise development and the promotion of corporate governance, the following measures are essential:

General recommendation

The Nepalese government needs to provide all possible assistance to the enterprises, but at the same time it should establish a strong system to monitor and regulate the behavior and activities of the enterprises, and to evaluate their performance against regional and international benchmarks until the time when self-regulation can be the norm, that is, when the corporate sector is able to take care of itself.

Specific recommendations

Ownership: The government should implement policies to broaden the share ownership structure and ensure the rights of shareholders, specially the minority shareholders. Also, the government needs to mandate all enterprises to allot some portion of the total shares to employees as a productivity incentive and to ensure employee loyalty to the organization.

Management: It is essential that the decision-making process in the enterprises be made transparent and participatory to ensure the effectiveness of corporate decisions as well as to increase the performance level of all involved in the enterprises. It is also essential that the enterprises institute practices of internal control and accountability, such as external auditing of the accounts, supplemented by observance of a code of ethics that the enterprises may formulate for themselves. The government should establish some minimum performance thresholds that the enterprises should meet.

Social responsibility: The goal of enterprises is not merely to make money (or profit). As part of the larger society, they do have social or public responsibilities and should be publicly held responsible if they cause certain negative externalities because of their activities. A factory that emits pollution cannot be considered immune from social obligations arising from the harm that its pollutants inflict on the community. Protection of consumer rights also comes under social obligation. Then the government should at least make it mandatory that the enterprises spend a part of their regular budget in projects directed at promoting the well-being of the people and institutions around them.

Initiatives for self-improvement: Enterprises have to improve their performance and productivity in order to be able to compete with others, both within and outside the national boundaries. Given the phenomenal improvements in the technology of production, marketing approaches, mode of governance including the involvement of workers in management, the enterprises are increasingly exposed to global compulsions to enhance their performance and productivity. In such a context, no enterprise can remain indifferent to the necessities of improving itself, continuously. The challenge to today s enterprises is to build their capabilities in order to compete more effectively and to face risks more ably. Only learning organizations survive in a highly liberalized environment. Additionally, the government needs to arrange opportunities for training and retraining of enterprise managers. But government alone cannot do, and should not try to do, everything for the enterprises.

Awareness raising on the advantages of good corporate governance: A vital aspect of helping the enterprises help themselves is to raise their consciousness of good corporate governance and its consequences on firm performance, growth and productivity. This should be an all-embracing activity that involves owners, mangers, trade unions, shareholders, entrepreneurs and other stakeholders. A quantum leap to high productivity is the sum of significant, inspired steps in good corporate governance.

REFERENCES

Adam Smith Institute (1999). Corporate Governance of State Enterprises in Nepal.

ADB (1999). Financial Sector Reform Private Sector Governance "The Real Opportunity for Economic Growth", Asian Development Bank.

ADB (1999). Financial Sector Regulation and Governance in Nepal, Asian Development Bank.

Agrawal, Anup and Charles R. Knoeber (1999). Outside Directors, Politics and Firm Performance: Working Paper, Current Draft.

Andenas, M., K. Stevenson and B. Welling. (1999). Transparency and Enforcement in the Corporate Sector in Nepal, Asian Development Bank.

Bhagat, Sanjai and Bernard Black (2000). Board Independence and Long Term Firm Performance, Working Paper No. 143, Columbia Law School Center for Law and Economic Studies.

Core, John, Robert Holthansen and David Larcker (1999). Corporate Governance, Chief Executive Officer Compensation and Firm Performance, *Journal of Financial Economics*.

Dalton, Dan R., Catherine M. Daily, Alan E. Ellstrand and Joverthan L. Johnson (1998). Meta-Analytic Reviews of Boards Composition, Leadership Structure, and Financial Performance, *Strategic Management Journal*.

Easternbrook, F. D. and Fischel (1991). The Economic Structure of Corporate Law, Harvard University Press, Cambridge, MD.

IRIS (2003). Nepal: Economic Liberalization and Microenterprise Support. IRIS Project: Nepal Regulatory Reform. University of Maryland. www.iris.umd.edu/adass/proj/closed/nepal.asp

Jensen, M. (1989). Active Investors, LBOs and the Privatization of Bankruptcy, *Journal of Applied Corporate Finance,* Vol. 2, 35-44.

Jensen, M. (1993). The Modern Industrial Revolution, Exit and The Failure of Internal Control Systems, *Journal of Finance*, Vol. 48, 831-880.

Kang, David L. (2000). Family Ownership and Performance in Public Corporation: A Study of the US Fortune 500, 1982-1994, Working Paper No. 00-051, Harvard Business School.

Kang, David L. (2000). Family Ownership and Performance in Public Corporations: A Study of the U.S. Fortune 500. 1982-1994, Working Paper No. 00-049, Harvard Business School.

Kang, David L. (2000). The Impact of Activist Institutional Investors on Performance in Public Corporations: A Study of the U.S. Fortune 500. 1982-1994

King, Michael J. (2001). Sustainability Advantaged or Disadvantaged? Do organizations that deliver value to all stakeholders produce superior financial performance? *The Journal of Corporate Citizenship*.

Manandhar, N. & P. Bajracharya. 2000. Privatization in Nepal, Privatization in S. Asia, Minimizing Negative Social Effects through Restructuring Edited by Joshi, G., South Asia Multidisciplinary Advisory Team (SAAT), International Labour Organization (ILO), New Delhi, India.

Mathiesen, Henrik (2002). Managerial Ownership and Financial Performance, Ph.D. Dissertation. Department of International Economics and Management, Copenhagen Business School, Unpublished.

Maw (1994). Quoted in What is Corporate Governance? (http://www.encycogov.com/WhatIsGorpGov.asp)

MOF. Budget Speeches, 1998/99 - 2001/02, Ministry of Finance, Kathmandu, Nepal.

MOF. Targets and Performances of Public Enterprises, 1996/97-1999/2000, Ministry of Finance, Kathmandu, Nepal.

MOF. Economic Survey 1999, 2000, 2001. Ministry of Finance, Kathmandu, Nepal.

Nagar, Venky, Kathy R. Petroni and Daniel Wolfenzon (2000). Ownership Structure and Firm Performance in Closely-held Corporations: Working Paper, University of Michigan.

Nepal Stock Exchange (1998). Financial Statements of Listed Companies, Vol. IV, Kathmandu, Nepal.

NPEDC (1999). Kathmandu Productivity Measurement: Macro Level. National Productivity and Economic Development Center, Kathmandu, Nepal.

Pant, D.P. (2001). Nepal Country Paper: Public Sector Productivity Enhancement, Strategies, Programs and Critical Factors, Asian Productivity Organization, Tokyo, Japan.

Security Exchange Board, 2000/01. Annual Report.

The Financial Times, 1997 and June 21, 1999.

The Kathmandu Post. October 7, 2001.

The Weekly Telegraph (2003). Corporate Governance and Financial Sector Reform in Nepal. Kathmandu, 28 May. www.nepalnews.com

World Bank (2000). Nepal Public Expenditure Review —Vol. 1: PER Overview —The Main Report, Washington D.C., USA.

LINKAGES BETWEEN CORPORATE GOVERNANCE AND PRODUCTIVITY IN THE PHILIPPINES

Magdalena L. Mendoza
Development Academy of the Philippines
Philippines

INTRODUCTION

Good corporate governance augurs well for business and for the economy. Effective corporate governance promotes the efficient use of scarce resources both within the company and the larger economy thereby stimulating growth.

Never has corporate governance been considered as a priority concern until the 1997 Asian financial crisis identified failings in corporate governance as one of the factors that contributed to it. Although it certainly was not the major cause of the Asian crisis, weak corporate governance amplified the downturn and hampered the decisive economic recovery of affected countries. The crisis brought to the fore the structural weaknesses of the corporate sector such as concentration of ownership, underdeveloped capital markets, and less than adequate regulatory framework for investor protection. The issue of corporate governance, however, is not confined to Asia. Transparency and accountability scandals hit no less than big and well-established corporations in the United States.

Corporate governance, which deals mainly with the relationship and distribution of rights amongst the providers of capital, is part and parcel of a country s overall enabling environment. A key corporate governance issue is the protection of investor[1] interests. Shleifer and Vishny (1997) ask how providers of capital could be assured that corporate managers would provide them with ample return and would not expropriate or use their money to finance poor projects. In other words, corporate governance is about how the management of a firm can create value and share the gains with investors and stakeholders. Governance structures such as product market institutions, labor market institutions, capital market institutions, and the judiciary are also instrumental in promoting investor interests.

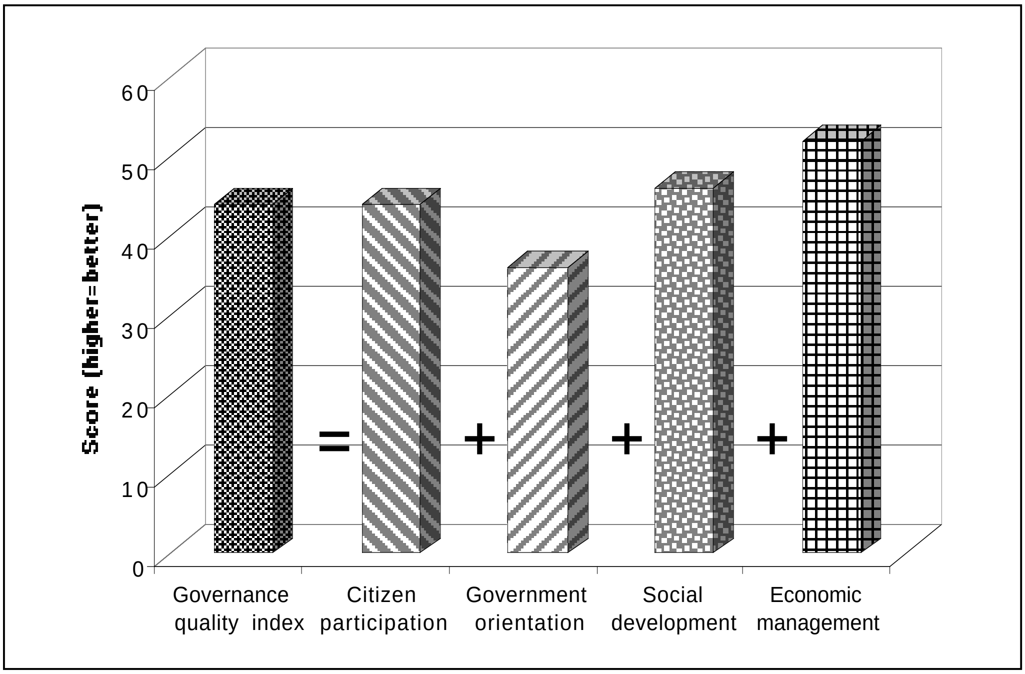
Over the years, the Philippine government has attempted to strengthen the market institutions in the country. It established new rules to level the playing field, and implemented major structural and economic reforms to stimulate productive ventures and generate employment. The government also introduced a comprehensive legal framework of corporate governance to attract more private investment and further develop the capital market.

The broad reforms put in place by the Philippine government earned a fairly good rating, seen from the prospective of economic management, specifically its outward orientation, central bank independence, and debt management (Huther & Shah, 1998). But these were not a sufficient condition to vitalize the country s economic activities. Economic management is after all only part of the country s overall governance quality assessment.[2] Equally important are political stability, citizens participation, human

[1] The term investor is used to refer to financiers (shareholders, creditors), workers, suppliers, and other stakeholders of a firm.

[2] Governance quality is a composite index constructed by Huther and Shah (1998) consisting of citizen participation, government orientation, social development, and economic management. The Philippines

development and matters that the normally associated with good government—reliability of the courts, bureaucratic efficiency, and absence of corruption. The Philippines also demonstrated good performance in social development orientation and citizen participation. It is in government orientation where it took a beating because of widely perceived bureaucratic and judicial weaknesses (Figure 1). The GRICS II[3] survey conducted by the World Bank between 2000-2001 revealed similar observations: the Philippines ranked only average in terms of government effectiveness and regulatory quality (Figure 2).



Source: Huther and Shah, 1998

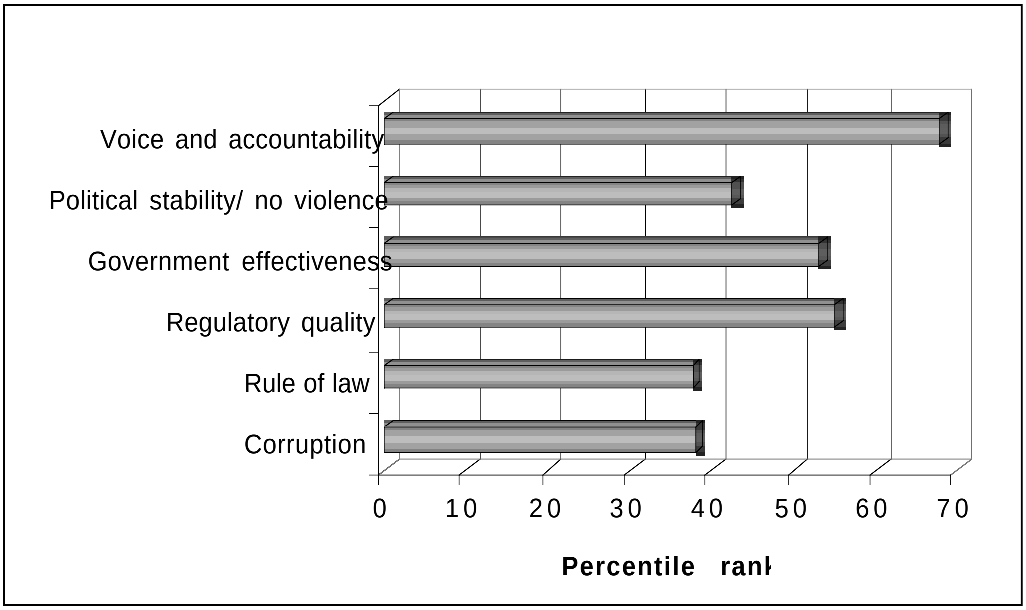
Figure 1. Governance rating for the Philippines

Apparently, the general concern about the Philippines is not the lack of but the quality of regulations. A recent World Bank review, while acknowledging the presence of fair universal corporate standards and codes in the Philippines, spotted poor compliance particularly on disclosure of corporate information, and the weakness of some institutions to enforce laws and discipline the market (World Bank, 2001).

---

was rated fair , with an index of 44 on a scale of 0 to 100—100 being the highest score. Economic management is a measure that combines outward orientation, central bank independence, and inverted debt to GDP ratio. Social development orientation consists of human development and egalitarian income distribution while citizen participation indicates the degree of political freedom and political stability. Government orientation characterizes judicial efficiency, bureaucratic efficiency and absence of corruption.

[3] The World Bank Governance Research Indicators Country Snapshot (GRICS) II, 2000-2001 was conducted by non-governmental organizations, commercial risk rating agencies, and think-tanks during 1997 and 1998, and during 2000 and (up to mid-) 2001. The rating used a scale of 0 to 100 percent, where the percentile rank indicates the percentage of countries worldwide that rate below the selected country.



Source: World Bank GRICS II

Figure 2. Philippine governance rating by GRICS II

The Philippine corporate sector thrived and grew under this environment. The set-up also nurtured a corporate structure where single shareholders have dominant control of corporate resources. Along with few other Asian economies, the Philippines has been criticized for high concentration of firm ownership. The top 15 families in the Philippines control over 50 percent of total market capitalization of the country (Claessens, Djankov and Lang, 1999).

It is easy to attribute such wealth concentration to Spanish and American legacies that handed economic and political power in the hands of a few elite families,[4] who were naturally adept in making sure government policies worked in their favor. Investors, faced with weak legal safeguard, also relied on ownership concentration to protect their money. According to the World Bank (2002), big shareholders control of corporate decisions provides investors with the assurance that their resources would be used in accordance with their interests, and in extreme cases, allow them to prevent diversion of corporate resources without having to deal with legal institutions.

Apart from the protection of the interests of investors, corporate governance deals with the manner by which firms are directed and controlled and by which accountability for corporate decisions and management actions is established. It also includes the laws and regulations as well as common and voluntary practices that enable firms to attract capital, perform efficiently, and meet both legal obligations and societal expectations_things every good company strive for.

Earlier studies offer evidence that better corporate governance is highly correlated with better operating performance (Klapper & Love, 2002). Does the relation stand in the case of productivity? This is the subject of the Asian Productivity Organization (APO)

---

[4] The top 5.5 percent of all land-holding families own 44 percent of tillable land in the Philippines. On the political governance side, only 60 to 100 political clans control all elective positions in the Philippines (FTACI, 1998)

research on the impact of corporate governance on productivity, which hopes to contribute to the current discourse on productivity and governance, corporate responsibility and citizenship, and economic policy and firm competitiveness. Twelve APO member countries including the Philippines are covered by the study.

This component of the study attempts to identify the links between corporate governance, productivity and growth in Philippine firms in the context of the country s current stage of development. The paper is organized as follows. The first section provides an overview of the study. A review of related literature on corporate governance and productivity is given next, followed by a discussion on the development of the Philippine corporate sector. The succeeding section discusses the legal and regulatory framework of corporate governance in the Philippines. The methodology of the study and the characteristics of respondent firms are described next. The paper then presents the results of the survey, explores the governing relationships between corporate governance and firm performance, and suggests ways to improve corporate governance in the Philippines.

REVIEW OF RELATED LITERATURE

The Cadbury Report[5] defines corporate governance as the system by which firms are directed and controlled. The system consists of: (1) a set of rules that define the relationships between shareholders, managers, creditors, the government, and other stakeholders; and (2) a set of mechanisms that help directly or indirectly to enforce these rules (ADB, 2000).

For Gregory (2000), corporate governance may not guarantee improved corporate performance at the individual company level, as there are too many other factors that impact on performance. But it should enable the company to respond rapidly to changes in business environment, crisis and inevitable periods of decline. It should help guard against managerial complacency and keep managers focused on improving firm performance, making sure that they are replaced when they fail to do so. Although it may not prevent corruption, effective governance should make it more difficult for corrupt practices to develop and take root. It would also make it easy to monitor incidence of effective governance and check on the power of the relatively few individuals within the corporation who control large amounts of shareholders money.

Gregory takes stock of the current situation in many developing and emerging market nations, and points out that most have not yet fully developed the legal and regulatory systems, enforcement capacities and private sector institutions required to support effective corporate governance. Reform efforts in these countries tend to focus more on the fundamental framework. Reform needs vary, but often include (1) stock exchange development; (2) creation of systems for registering share ownership; (3) enactment of laws for basic minority shareholder protection from potential self-dealing by corporate insiders and controlling shareholders; (4) education and empowerment of a financial press; (5) improvement of audit and accounting standards; and a change in culture and laws against bribery and corruption as accepted ways of doing business.

The firm is not a passive spectator while reforms are carried out. Hellman, Jones, Kaufmann and Schankerman (2000), using survey data from the transition economies, have assembled cross-country evidence on state capture—the efforts of firms to shape and

[5] The Cadbury Report is widely recognized as having laid the foundation for corporate governance. It was a pioneering assessment of the financial aspects of corporate governance in 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in the United Kingdom.

influence the underlying rules of the game (i.e., legislation, laws, rules, and decrees) through private payments to public officials. Key state institutions can be captured by private interests to skew the policy-making process in favor of particular firms and render the operation of government non-transparent. Firms can use their political influence to distort both the legal framework and the policymaking process in an effort to gain concentrated rents with detrimental consequences for the economy and society at large.

In some Asian countries, the links between government and business are extensive. The concentration of wealth, and the important direct and indirect channels through which the government can play an active role in business activity and businessmen may lure rent-seeking politicians into unduly favoring big business. It would also raise the possibility that the legal systems in some Asian countries may be endogenous to the forms and concentration of control over the corporate sector as Claessens, Djankov, and Lang (1999) suggest. The theory of Claessens, *et. al.* says that if the role of a limited number of families in the corporate sector is large and the government is heavily involved in and influenced by business, the legal system is less likely to evolve in a manner that will protect minority shareholders and promote transparent and market-based activities.

They find that to some extent, the correlations between the share of the largest 15 families in the Philippines in total market capitalization, on the one hand, and the efficiency of the judicial system, the rule of law, and corruption, on the other, are very strong. They suggest that it can also be construed the other way, that is, the ownership structures of individual firms are a function of the level of institutional (judicial and legal) development where these firms operate.

Ownership concentration works both ways. When ownership is concentrated, large shareholders could play an important role in monitoring management. On the other hand, when ownership is dispersed, shareholder control tends to be weak because of poor shareholder monitoring. Morck, Shleifer and Vishny (1988) find an inverted U-shaped relationship between the degree of ownership and corporate profitability interpreted as follows. As ownership concentration rises from a very low level, costs decrease due to increased shareholder monitoring. Hence, profitability rises. When ownership concentration rises to a certain limit, its costs outweigh its benefits, leading to a fall in profitability.

Concentrated and family-based ownership also works to preserve high industry concentration and dominance of large firms that somehow weaken competition. Competition, efficiency, and productivity growth are positively related. According to the World Bank (WDR, 2001/2002), the benefits of competition do not depend on having a large numbers of firms. Studies show that technical efficiency falls with increased market concentration in industrial countries such as Australia, Canada, Japan, the United Kingdom, and the United States. Below a certain level of concentration, technical efficiency also falls. A related study of firms in transition economies showed that competition from one to three rivals is important in explaining innovations such as a firm s decision to launch new products. Those firms with more than three competitors perform better than monopolists, but their advantage is only half as great as those facing one to three competitors. Competition can substitute for strong shareholder control in firms in raising productivity growth. Greater competition raises productivity growth in a firm with no dominant external shareholder, while competition has no positive impact on productivity performance in the presence of a dominant outside shareholder.

Saldana (2001) zeroes in on the large, family-based ownership structure of companies as the dominating factor in Philippine corporate governance. That is not necessarily a flaw, according to Saldana, but the country s history of economic, policy, and legal environment, and the relatively weak external control agents, suggests that the relationship based system is a structural weakness that curbs future growth and leads to inefficiencies in corporate investments and financing. He lists a few reasons why this is so. Large shareholders tend to pursue a financing policy characterized as trading-on-equity, resulting in further dominance. Corporate groups with affiliate banks do take advantage of access to financing and economies of investments and operation in related industries. That reduces the capacity of banks to be effective external control agents. Then, too, the regulatory framework for corporate governance, a modified US-oriented Corporation Code, is inadequate in the context of these conditions. It is not surprising that Saldana sets his sights on reviewing the regulatory framework to address weaknesses in Philippine corporate governance, specifically in improving disclosure of actions by large shareholders, reforming the legal basis for the operation of investment funds and venture capital funds, adopting rules to increase the supply of securities in the stock market, and enhancing external audit standards.

Klapper and Love (2002) go further by exploring the differences in firm-level governance mechanisms, their relationship with the country-level legal environment, and the correlations between governance and performance. They find that (1) firms in countries with weak overall legal systems have on average lower governance rankings; (2) firm-level governance is correlated with variables related to the extent of the asymmetric information and contracting imperfections that firms face, which they proxy with firm size, sales growth (proxy for opportunities) and intangibility of assets; (3) firms that trade shares in the US have higher governance rankings, especially firms in countries with weak legal systems; (4) good governance is positively correlated with market valuation and operating performance; and (5) this relationship is stronger in countries with weaker legal systems.

Thus, firm-level corporate governance matters more in countries with weak shareholder protection and poor judicial efficiency. Furthermore, the legal system matters less for the well-governed firms, which is plausible because firms with better governance will have less need to rely on the legal system to resolve governance conflicts. Klapper and Love also suggest that firms in countries with poor investor protection can improve their corporate governance, which may improve their performance and valuation.

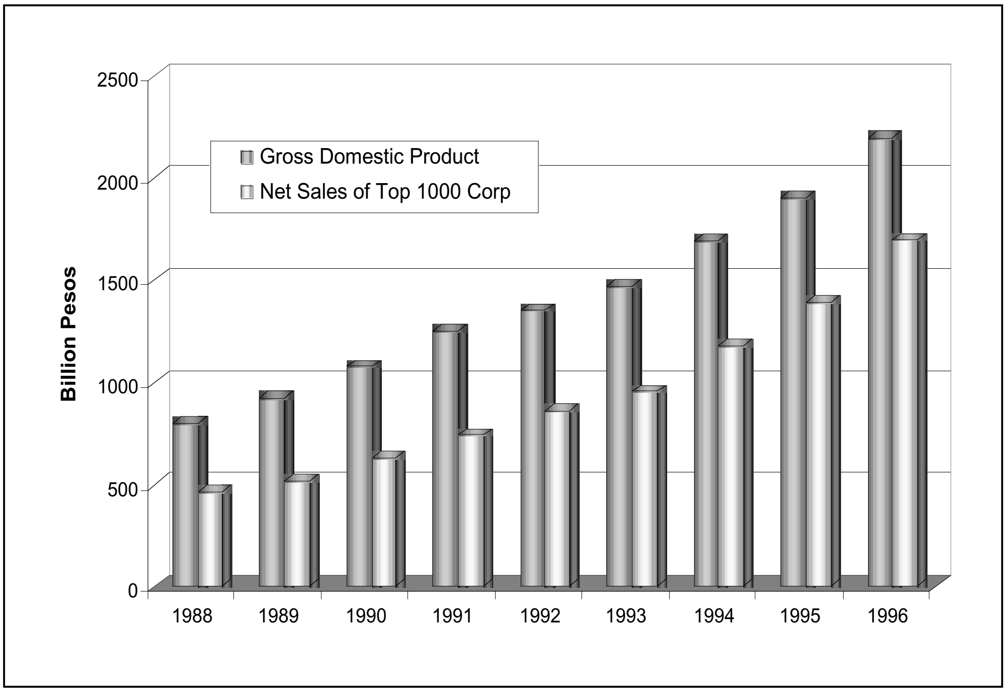
OVERVIEW OF THE PHILIPPINE CORPORATE SECTOR

Corporate sector profile and performance

The Philippines is an example of a largely market-based and services-oriented economy. Its service sector contributes about half to domestic production. The industry sector contributes about a third while the agriculture sector pitches in about a fifth. The country s informal sector is sizeable. But its corporate sector leads the economic activities.

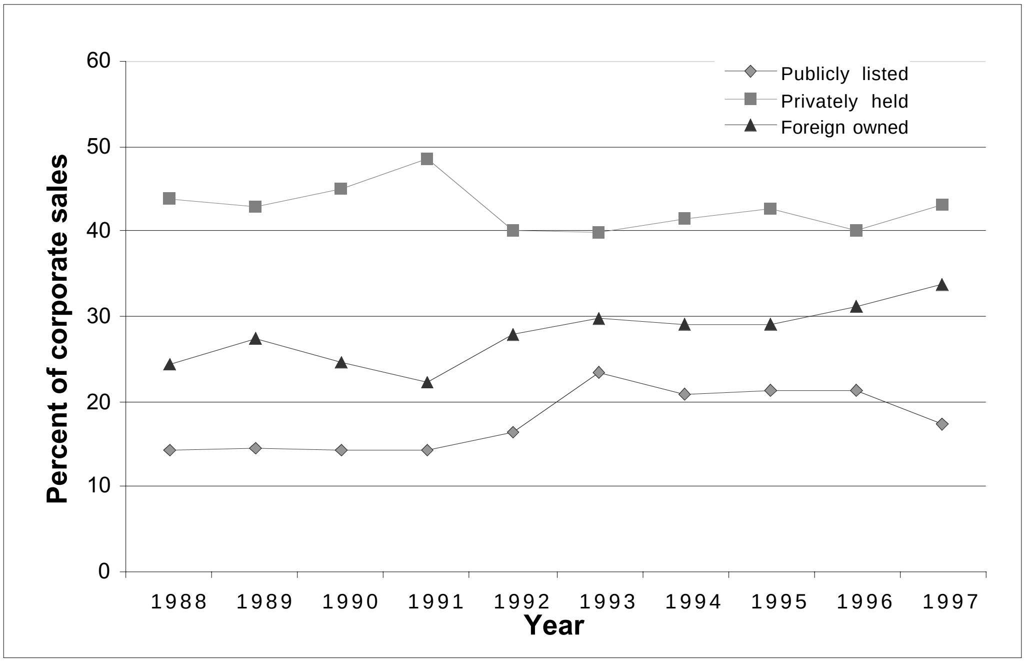
As of 2000, there are approximately 233,438 active stock corporations in the country. The biggest and most active of these are the country s top 1000 corporations, whose performance also reflects that of the Philippine economy (Figure 3). (From 1988-1996, the country s GDP grew at the same pace as the growth of the country s top 1000 corporations.) Four types of corporations operate in the Philippines: private, foreign, publicly listed, and government owned. Among the top 1000, privately held corporations constitute the largest group in terms of total assets and sales. The foreign-owned firms are the second largest and the most profitable. Publicly listed companies have a small but growing share (Figure 4).

Emerging from a protectionist environment, the Philippine corporate sector grew as a result of structural and economic reforms instituted by the government (e.g. privatization,



Source: Saldana (2001)

Figure 3. Net sales of corporate sector vs. GDP



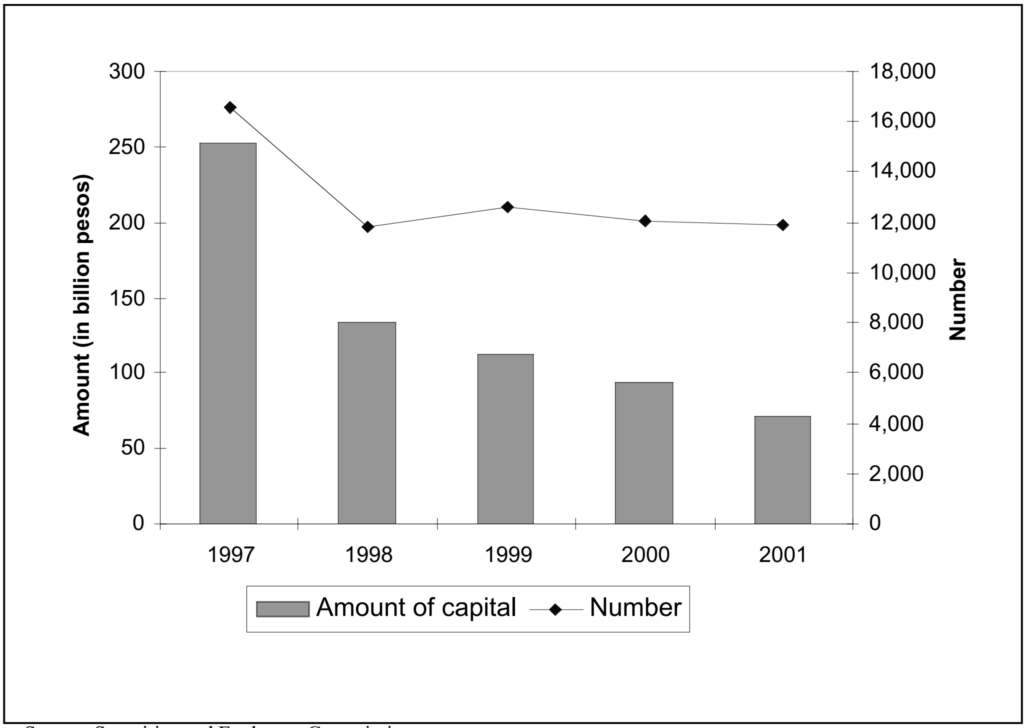
Source: Saldana (2001)

Figure 4. Corporate sector performance by ownership, 1988-1997

deregulation, and market liberalization). In the late 1980s, the Philippine government shifted economic management toward reliance on markets and introduced policy reforms to reduce tariffs, quantitative restrictions, and import licensing requirements. In 1991, Congress passed the Foreign Investments Act to open foreign equity investment in many areas. In the mid-1990s, the government moved to privatize many state-owned corporations and accelerated structural reforms by deregulating of the oil industry, telecommunications and air transportation. It was at about the same time that the country s accession to GATT/WTO took place. Later, initiatives focused on the reform of the banking sector, the power sector, and the judiciary.

The Philippine corporate sector was in a fairly sound financial position (compared to its counterparts in the region) when the Asian crisis erupted in 1997. Nevertheless, it was slower to recoup and is yet to recover from the global economic downturn in 2000 and from another external shock in 2001.

New investments came in 2001 about 11,908 new domestic stock corporations were formed as a consequence. But this was almost the same number of new entrants in the market that came in during each of the previous years (Figure 5). That suggests that while domestic investments as well as foreign direct investments were flowing mainly to wholesale and retail trade, real estate and financial intermediation, the manufacturing sector was losing its grip on both domestic and foreign investors.

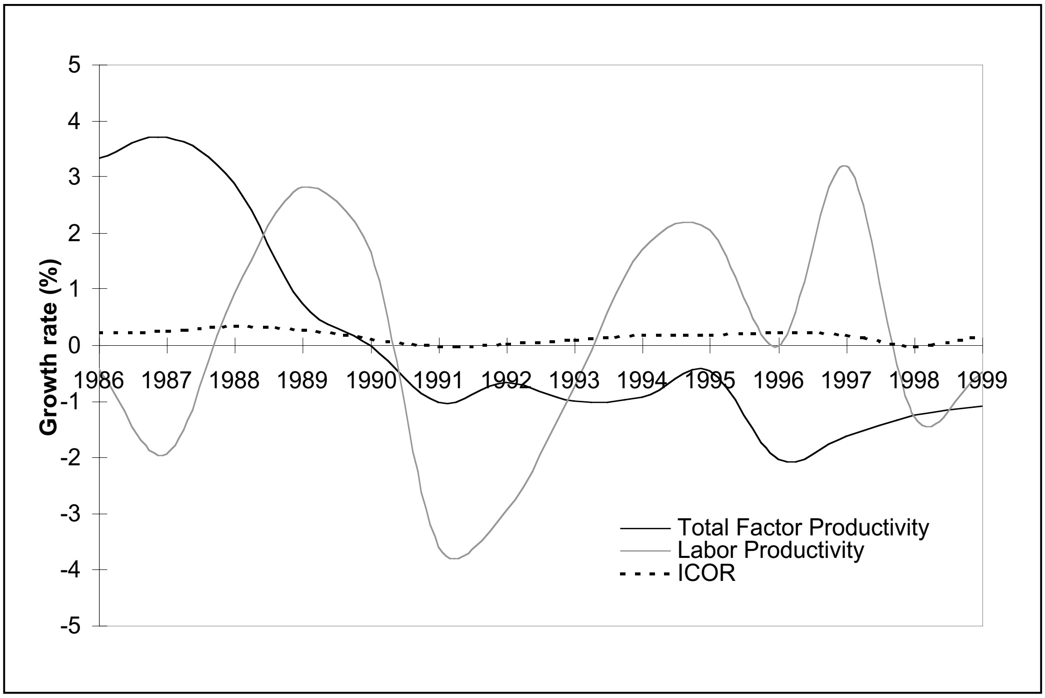


Source: Securities and Exchange Commission

Figure 5. Newly registered domestic stock corporations, 1997-2001

Productivity performance

As a whole, the productivity of Philippine firms continue to lag behind its Asian counterparts. Despite private sector-led and market-based development, the country s



Source: PCP Annual Report 2000

Figure 6. Total factor productivity performance

productivity did not improve much to invigorate the economy. From 3.31 percent in 1986, the country s total factor productivity (TFP)[6] increased to 3.7 percent in 1987, a hint that economic recovery occurred after the People Power revolution in 1986. Growth in productivity decelerated to 2.99 percent in 1988 then continuously declined due to political instability, reaching a negative point in 1990. Slight improvements were achieved in 1992 and 1995 but these gains were completely eroded in 1996. TFP recovered in 1997 and showed an increasing trend since then but the growth rate remained negative.

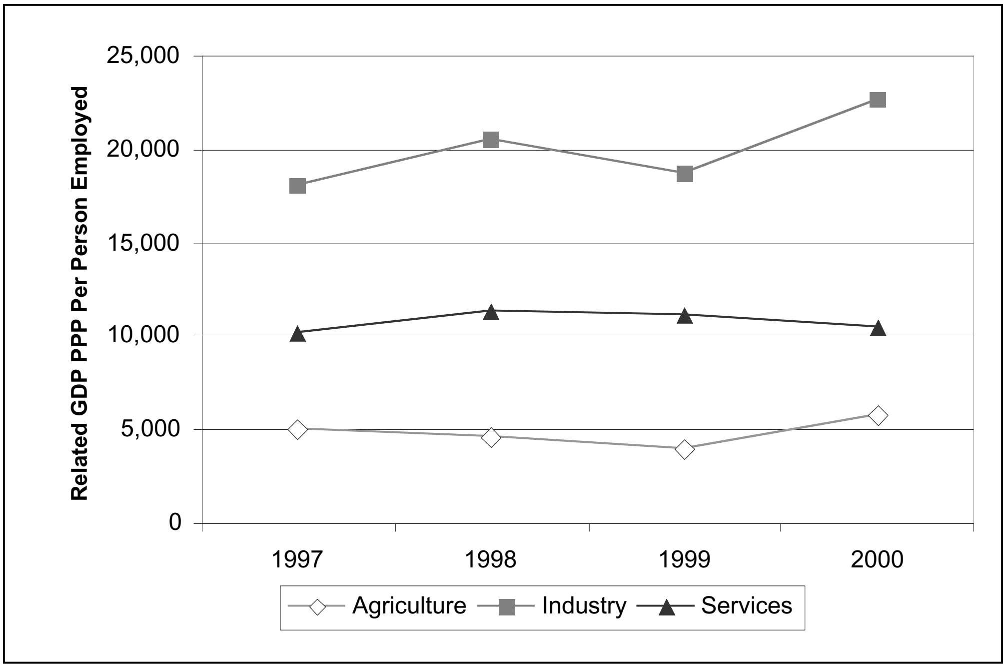
Efficiency in the use of human resources can explain the TFP trend. Figure 6 shows that the country s capital productivity, measured by incremental-capital output ratio (ICOR),[7] was in hiatus during the same period. The fluctuation in the TFP can thus be attributed to the roller-coaster growth of labor productivity.

Sectoral productivity performance is also wanting. Of the economic sectors, it is industry that is pulling up the country s level of productivity but it is not able to raise it high enough since the sector has a small contribution to the GDP. Agricultural productivity is low a dismal situation for an economy with a large percentage of population subsisting primarily on agriculture. The services sector is fast emerging as the country s major employer yet its productivity performance has been stagnant for years (Figure 7).

---

[6] TFP measures the growth arising from technical progress and technical efficiency. It is measured by the residual between the growth of the economy and the weighted sum of the growth of the primary factor inputs —labor and capital (Medium-Term National Action Agenda for Productivity, 2000-2004).

[7] ICOR is the inverse of incremental-capital output ratio (ΔGDP/I) (Philippine Council for Productivity, 2000).



Source: World Competitiveness Yearbook

Figure 7. Sectoral productivity performance

One would have expected improved economic productivity when in the 1990s, the Philippine government shifted gears and fast-tracked structural reforms to liberalize trade, allowed the entry of foreign direct investments, and deregulated business. True enough, these reforms stimulated business activity and growth trickled down to reduce poverty levels. But proved inadequate to boost overall productivity.

The Philippine Council for Productivity ascribes the low performance to the following factors: inefficiency in product markets (e.g., poor market linkages), lack of a sound competition policy; poor quality and inadequacy of infrastructure (e.g., transportation, power and communication); low private investment in research and development; high cost of doing business; mismatch in labor skills; and recently corruption and poor governance quality (MNAAP, 2001). The agenda to strengthen corporate governance is embodied in the country s Medium Term Philippine Development Plan 2001-2004. The intent is to reform corporate governance and uphold corporate responsibility to create a healthier business environment as a step to improving corporate performance. The country s blueprint for enhanced productivity and competitiveness, on the other hand, is contained in the Medium Term National Action Agenda on Productivity.

The stock market

The Philippine Stock Exchange is the country s facility for secondary trading of shares of publicly listed companies. About 246 firms are listed in the stock exchange, each firm with an average market capitalization of PhP10.4 billion. As of 2000, the total market capitalization of these companies is PhP2.577 trillion representing 77.5 percent of the country s GDP. The top 10 percent of the listed firms account for 88.65 percent of the market capitalization and 81 percent of the trading volume. The top 25 percent of the firms represent 95.9 percent of market capitalization and 96 percent of the trading volume, indicating the tight control of the capital market by very few firms. On record, the largest and most liquid companies are: the Philippine Long Distance Telephone Company (telecommunications), the Ayala Corporation (real estate and banking), San Miguel Corporation (food and beverages), Metropolitan Bank (banking), and SM Prime Holdings (real estate).[8]

On the average, publicly listed firms have 43,500 shareholders. The largest single shareholder of these listed companies typically owns 41 percent of the outstanding shares. The top five shareholders own about 65 percent while the top 20 shareholders own 76 percent of shares. The Phisix, a 30-stock composite index, is the stock exchange s main barometer. Companies in the index account for about 70 percent of total market capitalization. Controlling shareholders, defined as the largest five shareholders, own up to 80 percent of the voting shares in seven of these companies. The shareholding pattern of listed firms attests to the concentration of ownership of firms in the Philippines.

Since it peaked in mid-1990s, the Philippine stock market has not fully recovered from the financial shock of 1997, a price manipulation scandal in 1999, and market uncertainties brought by the September 2001 terrorist attack in the US. The average value of daily trades in the country s stock exchange reached PhP3.1 billion in 1999. In 2000, the value of trading in the stock market was approximately PhP1.43 billion per day. The stock market reached its new ten-year low in 2001. Efforts are underway to restore confidence and activate trading in the stock market, e.g., through legislative measures such as the Securitization Act, revision of the Investment Company Act, and a Corporate Recovery Act.

LEGAL AND REGULATORY FRAMEWORK

The Philippines has a comprehensive legal framework for corporate governance and capital market regulation. Two sets of legislation principally govern corporate activities the Corporation Code and the Securities Regulation Code. The basic laws governing the establishment, ownership and management of business in the country are found in the Corporation Code. The country s first corporate code was enacted in 1906—the Corporation Law Act No. 1459. The regulatory framework adopted in this code was patterned after the American corporate law.[9] It was supplanted in 1980 with *Batas Pambansa* No. 68, known as the Corporation Code of the Philippines. The Corporation Code is a compilation of important judicial rulings, administrative regulations, and recognized rules on corporate practices. It specifies the minimum information to be indicated in the articles of incorporation and provides the basic constitutional structure for the organization, operation, and dissolution of corporations.

The Securities Regulation Code, the country s principal law on securities, was also patterned after several US securities acts. The Securities Code is designed to prevent the exploitation of investors through the sale of unsound or fraudulent securities. The law

[8] Data on the stock exchange were taken from the report prepared by Saldana (2001) for the World Bank.

[9] Accordingly, when the Philippines passed to the sovereignty of the United States, there was no entity in the Spanish Law exactly corresponding to the notion of the corporation in English and American Law such that when the Philippine Bill was approved in July 1, 1902, the US Congress inserted provisions which were intended to control the lawmaking power of the Philippine Islands in the matter of granting franchises, privileges and concessions. Under the guidance of these provisions a general law was enacted authorizing the creation of corporations in the Philippines.

requires full and accurate disclosure of all material information concerning the issuer and the securities it proposes to trade. It also prescribes the rules and regulations of the country s stock market.

The main agency responsible for the implementation of these codes is the Securities and Exchange Commission (SEC). The SEC was established in 1936 by virtue of the Commonwealth Act No. 83 or the Securities Act. Its major functions include registration of securities, analysis or every registered security, evaluation of the financial condition and operation of applicants for security issue, screening of applications for broker s and dealer s license and supervision of stock and bond brokers as well as stock exchanges. The Commission has already gone through several changes. In 1976, Presidential Decree No. 902-A expanded the Commission s mandate to include absolute jurisdiction, supervision (regulatory), and control (adjudicative) of all corporations.

SEC was reorganized in 2000 through Republic Act No. 8799 known as the New Securities Regulation Code. Under the new code, SEC is tasked to focus on the regulation of the securities market. Its quasi-judicial functions such as the resolution of intra-corporate disputes, suspension of payments, and private damage actions were transferred to the courts. With all its powers, SEC was unable to completely regulate the corporate sector in the past. Firms were able to skirt the requirements of the Commission and avoid scrutiny. SEC was also perceived to have been ineffective in preventing firms to continue trading after they had become insolvent and in rehabilitating distressed companies. The new regulation vested SEC with powers to provide additional protection to investors, define prohibited market practices, monitor and take action against abusive market practices, promote self-regulation by market participants, manage systemic risks in the brokerage industry, and investigate and enforce disciplinary proceedings against market participants (World Bank, 2002).

Aside from observing SEC regulations, publicly listed firms are also required to comply with the listing requirements of the Philippine Stock Exchange. PSE is responsible for ensuring that the listed companies follow the rules of disclosure and fair treatment of investors. It has the power to impose sanctions on any company that fails or erroneously discloses material information that affects the rights and benefits of investors. Also as a result of the stock manipulation scandal in 1999, the PSE was demutualized in 2000 and reorganized as a stock corporation that is 100 percent owned by its 184 member-brokers. It is now a private entity entrusted to provide and ensure a fair, efficient, transparent and orderly market for the buying and selling of securities in the country.

Other relevant laws governing corporations in the Philippines are the Insolvency Law and the General Banking Law. The Insolvency Law provides for an equitable distribution of insolvent debtors properties among creditors. It allows debtors to be discharged from their liabilities to enable them to start afresh with property set apart for them from assets to be used as payment to creditors. The jurisdiction for insolvency proceedings including suspension of payments for individual debtors is lodged with the regular courts. The General Banking Law has provisions that affect corporate finances. The important ones concern the capacity of officers of corporations to assume positions as members of the board of directors of banks; limits on ownership of banks by non-financial corporations; limits on lending by banks to corporations; and rules on lending to directors and other insiders.

With the abovementioned regulatory framework, one would expect a highly disciplined corporate sector. But the review of the Observance of Standards and Codes (ROSC) (World Bank, 2001), while acknowledging the presence of fair universal corporate standards and codes, noted poor levels of disclosure, lax enforcement of the minimum requirements for governance, and relatively weak institutions to enforce regulations. The weaknesses in the system were highlighted when local practices were benchmarked against the OECD corporate governance principles. Governance flaws lay in the areas of basic shareholder rights, and disclosure of material information coupled with the relatively free rein that controlling shareholders and managers might have in matters involving risk management. Examples of such practices are managers not making available information with reference to material foreseeable risk factors, and preparation of information that are generally not in accordance with high standards of accounting, disclosure, and audit.

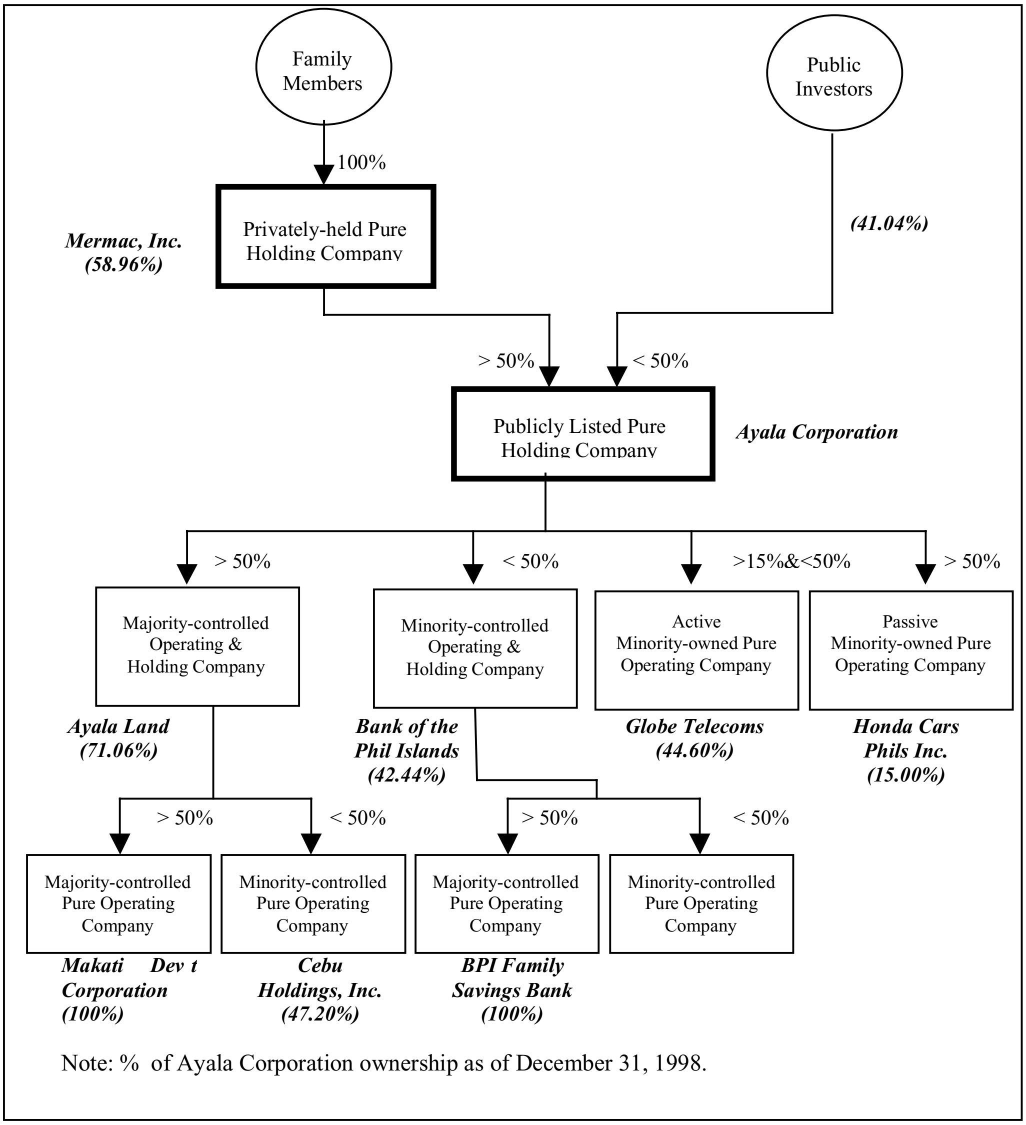
Recent closures and mishaps in established Philippine firms are illustrative. One Philippine bank was forced to service billions of withdrawals within a span of two weeks brought by its downgrading from a universal bank to a thrift bank as a result of its failure to meet increased capitalization requirements. The bank, together with its subsidiary and an affiliate investment company, was placed under receivership. Another case was a local sugar mill that dealt with audit issues surrounding lost inventory. False reporting was allegedly resorted to in an attempt to make the company appear more efficient. To make matters worse, the firm auditing the company admitted that its reports on the company were based on false figures presented by the company officials (Benito & Del Rosario, 2002). The most distressing of these mishaps, however, was a stock manipulation scandal that involved a leisure company with foreign tie-up. Investigations of the case uncovered insider trading in the stock exchange. The scandal led the Philippine government to institute swift reforms in capital market regulation. Tougher measures are expected in the area of corporate monitoring and control.

These, plus other critical issues were addressed in the implementing regulations of the revised securities code which adopted many of the practices recommended by the International Organization of Securities Commissions (IOSCO). The Philippine government also adopted the Guidelines for Good Corporate Governance Practices endorsed by the Asia-Pacific Economic Cooperation (APEC) in October 2002. These guidelines stress the importance of fairness, transparency and accountability. The Code of Corporate Governance addresses issues dealing with the board of directors; board committees such as audit, nomination and compensation; the auditors; and the disclosure and transparency of the corporations. The Code requires public companies to have independent directors, at least two or 20 percent of the members of the board, whichever is lesser, and mandates the formation of an audit and compliance committee, a nomination committee, a compensation committee, and a risk management committee, none of which is currently required nor specifically encouraged in either SEC registration or listing requirements. The Code also requires each corporation to document its corporate governance rules and principles in a manual and to put in place a performance evaluation system for the board and top management. The SEC has also amended the Special Accounting Rules, to conform to International Accounting Standards (IAS).

Corporate sector control

The Philippines has most of the legal instruments needed to discipline the corporate sector but the rules are often challenged by the interlocking nature of corporate control. Claessens, Djankov, and Lang (1999) observe the tendency among Philippine corporations to have interlocking directorates and management boards, whereby members of one family serve on the board of companies controlled by other influential companies. An inter-corporate organization structure of groups of companies enables large shareholders in the Philippines to maintain control and minimize risks while achieving economies of scale and allowing public investors to hold minority shares. Large shareholders achieve control by setting up pure holding companies, going on selective public listing of companies in the group, centralizing management to control companies where it only has minority shareholdings, or holding a portfolio of the companies with different amounts of shareholdings (Saldana, 2001). The widely known conglomerates having this style of ownership are the Ayalas and the Lopezes.

The Ayala Corporation Group, Mermac, Inc. is the family-owned pure holding company that holds 58.96 percent of the publicly listed pure holding company of the group, Ayala Corporation. Public investors hold a minority share of Ayala Corporation. Ayala Corporation holds sufficient number of shares in two holding companies and two operating companies. Ayala Corporation s majority-and minority-controlled operating companies are also holding companies. The Lopez Group is an example of corporate

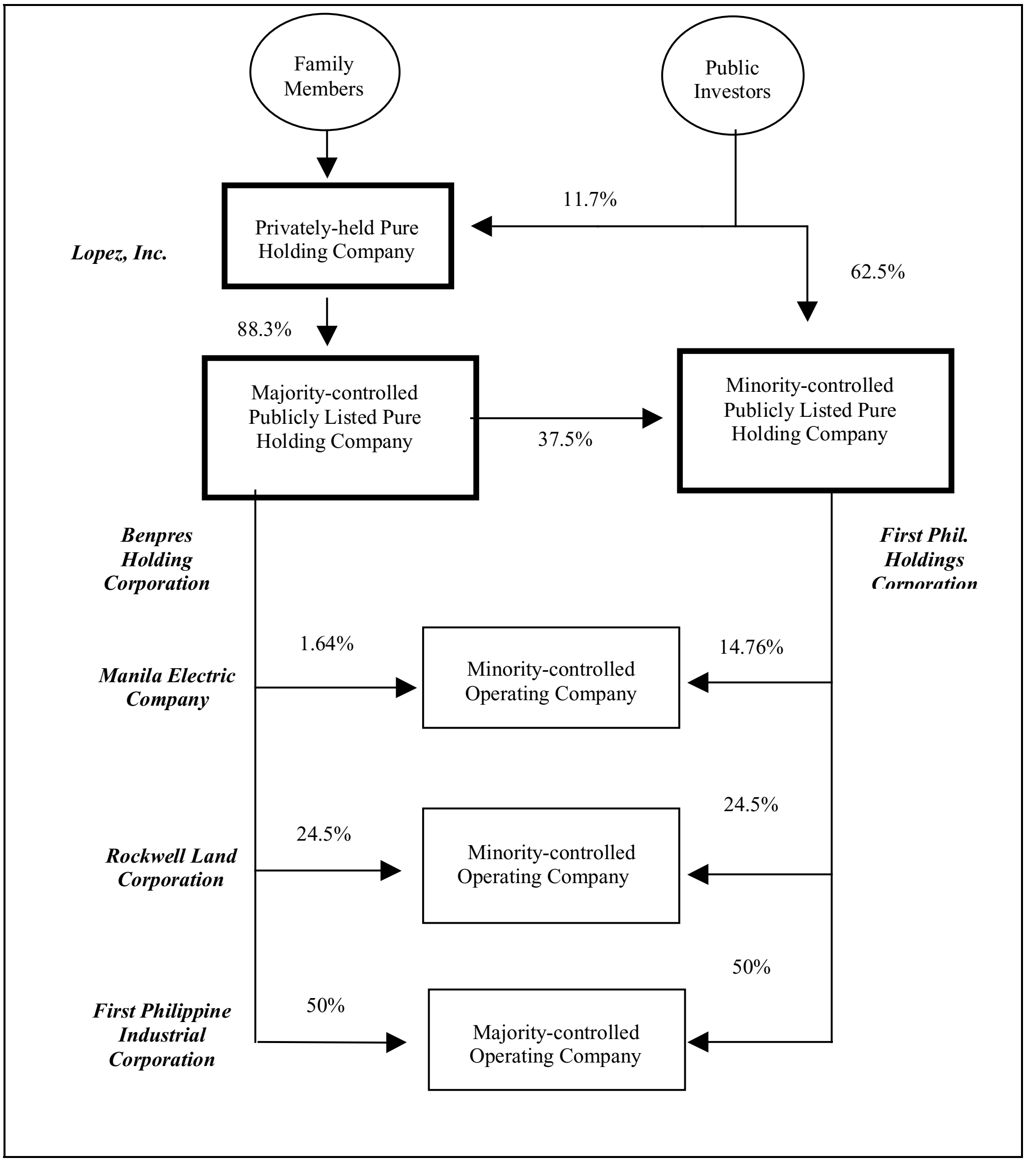


Source: Claessens et al. (1999) and Saldana (2001)

Figure 8. Corporate shareholder control structure using Ayala Group as example

the Lopez Group are generally large and minority-controlled. The Manila Electric Company, Rockwell Land, and the First Philippine Industrial Corporation are indirectly held by a majority-controlled holding company, Benpres Holdings, and a minority-controlled holding company, the First Philippine Holdings Corporation. The Lopez family owns a significant proportion of shares of these companies if these indirect shareholdings are summed up and attributed to the beneficial owners (Saldana, 2001). Figures 8 and 9 illustrate the structures of these two groups.

Cross-shareholding structures such as these as are critically viewed as a means to expropriate the wealth of minority shareholders and control the economy. But the issue seems to be a minor domestic concern compared to the stability exuded by these



Source: Saldana (2001)

Figure 9. Cross-holdings in groups of companies using the Lopez Group as example

conglomerates and their contribution to the domestic economy and generation of employment. For instance, family-based corporations played a major role during the boom period of the East Asian miracle due to their economically efficient use of limited entrepreneurial abilities and management flexibility. Government certainly helped these family ventures through industrial policies and investment. But the government-business nexus in many cases also economized on transaction costs arising from the low level of development of legal systems (Khan, 1999).

At some point, however, these family ventures expanded beyond the point where finances and technology could develop from the internal resources of the family groups and had to rely on external financing. With owners unwilling to share control of the firm with outside shareholders and family-based companies having an underdeveloped capacity for effective monitoring by the financiers, the undesirable situation arose. Khan (1999) concludes that family based system works well only when (1) self-monitoring is practiced or (2) when outside financiers are able to monitor adequately, which can happen only when there is either *de facto* control of major shareholders over management, or when risk-measurement and -management capabilities of financial institutions are well-developed.

Certainly, questions will arise when few families effectively dominate the economy and have strong influence on government policies, for example by encoding built-in advantages in laws and regulation.

SURVEY METHODOLOGY AND PROFILE OF RESPONDENTS

While effective regulations can discipline firms, it is high returns to business productivity and profitability that motivate firms to enhance good corporate practices. This research explores the links between corporate governance and performance. The underlying proposition of the study is that good corporate governance enhances productivity and promotes the growth of the firm. Good governance includes, among other things (OECD, 1999):

- Protecting shareholders rights;
- Ensuring equitable treatment of all shareholders, including minority and foreign shareholders;
- Recognizing the rights of stakeholders as established by law, and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises;
- Ensuring that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the corporation; and
- Ensuring the strategic guidance of the corporation, the effective monitoring of management by the board, and the board s accountability to the corporation and the shareholders links.

With these principles in mind, four key dimensions of corporate governance are examined: (1) ownership structure, (2) firm management, (3) corporate social responsibility, and (4) institutional interface. These four are presumed to influence corporate performance measured in terms of corporate growth and productivity. The governing relationship is described in the heuristic formula:

Corporate performance (growth + productivity)
= f(ownership, management, social responsibility, institutional interface)

The object of the study is to relate firm ownership characterized by capital structure, distribution of shares, and the allocation of shareholder rights, creditor rights and monitoring with firm productivity and profitability. Similarly, it examines how the allocation of decisions, internal controls, and accountability systems, and the quality of management can affect overall firm performance. The framework also assumes that a productive and profitable firm becomes of value to the society. This can only happen if the firm is able to fulfill its social obligations and act responsibly and ethically. The study thus examines how corporate efforts to contribute to the vitality of their communities promote good business. Finally, an attempt is made to ascertain how the quality of institutions and the provision of basic infrastructures and services impinge on firm performance.

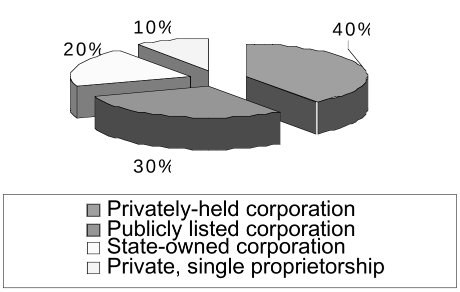
A survey was conducted which covered 12 APO member countries including the Philippines. About 25 Filipino firms were invited to join the survey but only 10 firms responded positively. These include three publicly listed corporations, five private firms, and two government corporations. The survey questionnaire was fielded to the firms. In more than half of the respondent firms, structured interviews were conducted. The key informants were a chairman of the board, a vice-chairman of the board, a chief executive officer, a vice-president, senior officers, corporate secretaries and human resource managers. Additional information about the firms was gathered from published reports and records of the Securities and Exchange Commission.

Basic information about the firms was readily available but financial and operational data were not easily obtained. The survey limited the indicators for dependent variables, e.g., company growth and productivity to sales, net income, return on assets, return on equity, labor productivity and value added productivity. These data were derived from published financial statements since the respondents were reluctant to directly provide them. The analysis of governing relationships was somehow constrained by the small number of respondents but many of the results confirm findings of earlier studies and the prevalence of certain corporate practices.

CHARACTERISTICS OF RESPONDENT FIRMS

Legal organization

Most of the respondent firms are from the private sector: 30 percent are publicly listed while 40 percent are privately held corporations and 10 percent under single proprietorship. About 20 percent of the respondent firms are state-owned enterprises (Figure 11).



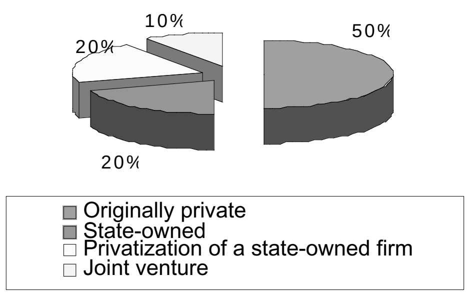


Figure 11. Legal organization of firms

Figure 12. Origin of firms

Firm origin

About 50 percent of the firms were originally private, 40 percent were established by the state and 10 percent established through joint venture with a foreign firm. Twenty percent of the respondent firms were set up through privatization of a state-owned enterprise (Figure 12).

Age of firms

Some 40 percent of the firms have existed for less than 10 years while the rest have been in operation for more than 10 years. The youngest firm surveyed has been operating for four years while the oldest has been in business for 74 years (Figure 13).

Foreign stakes

The respondent firms have various degrees of internationalization. About one to three foreigners have investments in 60 percent of the respondent firms. Japanese have investments in 30 percent of the respondent firms. Indonesians have stakes in 20 percent of the respondents. Other foreign shareholders include the British, Dutch, French, and American at 10 percent each.

Main area of activity

Some 30 percent of the respondent firms are in the manufacturing sector, another 30 percent in utilities, yet another 30 percent in financial services and 10 percent in retail trade (Figure 14). About 60 percent of the respondent firms sell their products or services outside the country, with the proportion of exports ranging from five percent to 90-100 percent.

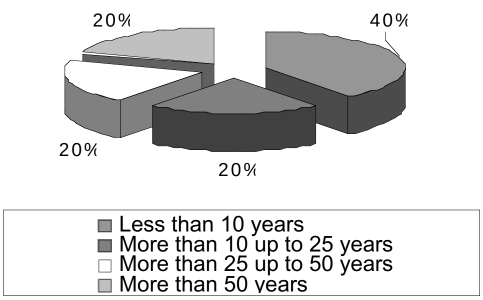


Figure 13. Age of firms

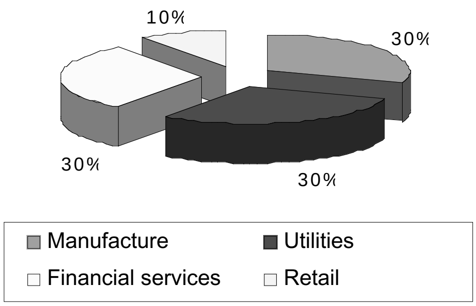


Figure 14. Main area of activity of firms

Geographical location

Most (80 percent) of the surveyed firms are based in Metro Manila, although half of the respondents have operations nationwide. About 20 percent of respondent firms are located in cities outside Metro Manila.

Firm performance

Most of the firms exhibited positive performance in 2001. The average value of net income to revenue is 6.24 percent, slightly lower than the aggregate corporate sector average net profit margin of 7.9 percent (Saldana, 2000). The mean value of revenue per employee, an indicator of labor productivity, stood at PhP14.23 million. Average value added per employee, a measure of value created within the firm, was PhP2.4 million. The average return on assets (ROA) was 2.11 percent, below the aggregate corporate sector average of 5.3 percent. The mean return on equity (ROE) stood at 5.97 percent, also below the corporate sector average of 12.6 percent (Table 1).

Table 1. Firm performance data

	Mean	Minimum	Maximum
Total number of employees	3046	62	13279
Working hours per year	2287	2000	2824
Average compensation per employee (In million pesos)	0.48	0.11	0.88
Revenue (in million pesos)	28979	568	88427
Net income to revenue (In percent)	6.24	0.70	14.64
Labor productivity (Revenue per employee in million pesos)	14.23	0.79	70.24
Value added productivity (value added per employee in million pesos)	2.40	0.28	6.31
Return on assets (in percent)	2.11	1.11	3.04
Return on equity (in percent)	5.97	2.66	10.55

SELECTED SURVEY RESULTS

Corporate ownership and capital structure

Composition and concentration of ownership

The ownership structure is defined not only by the distribution of equity with regard to votes and capital but also by the identity of the equity owners.[10] The two key aspects of corporate ownership structure are composition and concentration. Ownership composition refers to parties who hold and control the shares of the firm. A shareholder can be an individual, a family, a holding company, a bank, an institutional investor, or a non-financial corporation (ADB, 2000).

In 46 percent of the surveyed firms, the largest stakeholders are holding companies. Government has stakes in 18 percent of the firms and foreign companies have investments in another 18 percent. A family has the largest financial stake in nine percent of the respondent firms while individuals have the biggest stake in another nine percent of the firms (Figure 15). It should be noted that large shareholders in the Philippines are able to attain firm control by setting up holding companies. Holding companies perform central management, investment, and financing functions for a group of companies and as such, strategic decision-making is maintained in the hands of controlling shareholders. Within the existing regulatory framework, the scheme reduces risks and promotes economies of scale.

Two to three shareholder-owners generally hold majority ownership in 40 percent of respondent firms. In 20 percent of firms, four to five shareholder-owners and in another 20 percent, more than ten shareholders hold the majority. Only a minority of the surveyed firms are widely-held. In 10 percent of the firms, only one shareholder controls the majority share (Figure 16). The table below shows the percentage share of top

[10] Source: Encyclopedia Corporate Governance (2001).

shareholders of respondent firms.

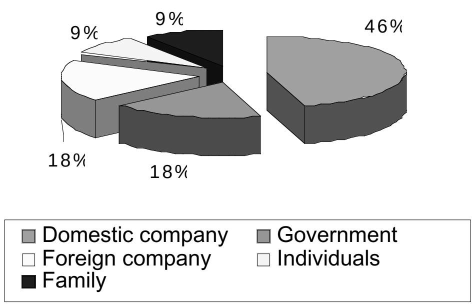


Figure 15. Owners with the largest financial stake

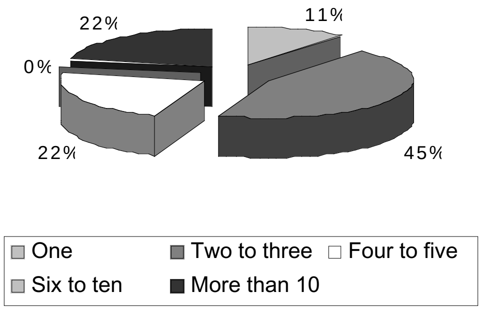


Figure 16. Shares held by major owners

Controlling shareholders (defined as the top five shareholders) own up to more than 80 percent of shares in 60 percent of the firms. Twenty percent of respondents indicated mutual holding of stocks between their firms and affiliated companies. These results strongly support earlier studies of Claessens *et al.* (1999) and Saldana (2001) about cross-holding structures among Philippine firms.

Table 2. Share of top shareholders

Firm	Percentage share of top shareholder
1	80 percent of shares owned by top two shareholders
2	Shares owned by individuals
3	Top one shareholder owns 26.84 percent of common shares Top five shareholders own 85.78 percent
4	Top one shareholder owns between 66-80 percent Top five shareholders own more than 80 percent
5	Top one shareholder owns between 50-65 percent Top five shareholders own more than 80 percent
6	Top one shareholder owns 54 percent Top four shareholders own 94 percent
7	Top one shareholder owns 59 percent Top two shareholders own 99 percent
8	Top one shareholder owns between 50-65 percent
9	Shares owned by family
10	Government owned

Public listing allows some dilution of control in 30 percent of the respondent firms that are listed in the stock exchange. But minority shareholders still have a weak voice. In one of the publicly listed firms, the top shareholder owns between 50-65 percent of the shares, which means that the control of the firms still resides with the dominant shareholder. In another firm, the top two shareholders own about 80 percent of the shares. In the third firm, the number one shareholder owns about 24 percent of common shares while its top five shareholders own 85 percent of common shares. Such arrangement does not differ from the ADB (2000) study finding that the largest single shareholder of a publicly listed corporation typically owns 41 percent of the outstanding shares; the top five shareholders (65 percent); and the top 20 shareholders (76 percent).

Employee ownership scheme

The managers own shares in 50 percent of the firms. Managers can own shares through executive stock option plans. The employees own shares in 40 percent of the respondent firms. The scheme is often provided through an employee stock option plan. Under this plan, the proportion of shares normally allocated to employees is about six percent. Although considered a minority, managers own shares in 50 percent of the firms. Employees also own shares in 40 percent of the firms. The proportion of shares owned by managers and employees as disclosed by two of the respondent firms is about six percent. In the case of these two companies, management and employees are able to buy company shares through a stock option plan. For the other companies, management and employees can avail of stocks on their own via the stock market. While employee ownership schemes are known to enhance employee motivation and affiliation with firms, it is not so popular among the respondent firms.

Shareholder protection

Sound corporate governance ensures that shareholders can actively participate in, and exert influence on, corporate decision-making through legal protection of rights of shareholders. The Corporation Code of the Philippines guarantees the rights of shareholders to elect, remove and replace directors, vote on certain corporate acts, subscribe to the capital stock of the corporation; obtain information about the company, receive returns on investment, appoint auditors and dissent on certain decisions of the board. Many of these shareholder rights are articulated by respondent firms but in practice, few minority shareholders exercise them.

The following shareholder rights are generally observed by the respondent firms: right to vote according to share (100 percent), proxy voting (100 percent), right to resolve disputes with the firm (33 percent) and right to demand independent audit (67 percent). Other rights as provided in the Corporation Code, e.g., appraisal rights when there are major changes in the company, pre-emptive rights to maintain shareholders proportionate ownership of the company, and right to review transactions involving potential conflict of interest between shareholders and management, are generally not observed.

About 67 percent of the publicly listed firms also provide for representation of minority shareholders in the board. Minority representatives, according to respondent firms, are difficult to remove without cause. Their actions are obviously constrained by the Corporation Code that mandates the use of cumulative voting in the election of directors. Although directors may be removed with or without cause, the Corporation Code prohibits removal without cause if it will deny minority shareholders representation in the board. In such cases, removal of directors requires an affirmative vote by two-thirds of the outstanding capital. In practice, however, as Saldana (2001) argues, minority shareholders are highly vulnerable to the expropriation of their interests by controlling shareholders and management because of poor compliance, weak enforcement and loopholes in the existing corporate laws. Few minority shareholders exercise their rights. And while proxy voting is allowed, the practice tends to further consolidate the interest of majority shareholders. There are also reports that very few shareholders exercise their appraisal rights and demand inspection of corporate books including minutes of board meetings.

Creditor monitoring and protection

As providers of short-term financing, creditors have some control rights in firms. Creditors can influence the major decisions of firms and through a variety of controls, discipline firms that default on debt payments or violate debt contracts. The effectiveness of debt as a mechanism of corporate governance depends on the quality of monitoring, on how difficult it is to renegotiate and on the extent to which creditors rights are enforceable in courts. The survey results show that debt does not seem to be a very effective mechanism to discipline firms.

A Philippine Institute of Development Studies (PIDS) survey of Philippine industries, conducted before the Asian financial crisis, showed that income from sales and loans from banks were the main sources of short-term and long-term financing of Filipino firms (Lamberte, 1999). The APO survey result shows that the sources of financing of firms have not changed much. In 80 percent of the firms, banks are the most common creditors. Others source credit from non-bank institutions, multilateral and bilateral institutions, suppliers and individuals.

Based on the PIDS study, banks usually require collateral when firms borrow for 12 months or longer. Few firms provide collateral when they borrow for less than six months. Of those required to present collaterals, they mainly come in the form of land, buildings, machineries and equipment. In some cases, banks require their borrowers to have guarantors for their loans, especially if they cannot present an acceptable collateral or if their collateral is inadequate. In this case, the stockholders serve as guarantors.

The results of the survey further support this practice. Only in 50 percent of the respondent firms would external creditors ask for collateral for loans, whether working capital or capital expenditure. For others, loans were normally given without collaterals. None of the firms surveyed indicated that they faced adverse creditor actions such as collection lawsuit or foreclosure of collateral. This could be due to the fact that more than 50 percent of the firms have dealt with their creditors for more than five years. The other 40 percent have dealt with their creditors for less than five years. The long association and dealings may have locked in the confidence of firms to their creditors.

Although 30 percent of respondents have not encountered any liquidity problem, 40 percent of the respondents indicated that they could easily renegotiate with their creditors on loan repayment in case they face such problem. Other firms resort to trading or selling securities (10 percent), floating bonds (10 percent), infusing equity (10 percent), or securing additional loans (10 percent). These are shown in Table 3.

About 60 percent of the firms have not defaulted on loan payments. For those who did, the situation is not tight since creditors normally do not initiate adverse action, especially when they are affiliated with the firms. As the survey reveals, 30 percent of the respondents obtain credit from creditors (usually banks) affiliated with the firm. The other explanation for lax creditor action may be the fact that the country has an Insolvency Law which owners and creditors can invoke in case of bankruptcy. A third reason may be the nature of guarantee provided by borrowing firms. In 30 percent of firms, it is the private owners who guarantee the loans. While in 40 percent of the firms, the government is the guarantor. In the latter case, creditors have fewer incentives to monitor since the government provides sovereign guarantee. Moral hazard arises as creditors are certain that in case of default, government will ensure that their claims are satisfied.

There is no doubt that the quality of creditor monitoring and the effectiveness of creditor control depend on the nature of the relationship between creditors and borrowers. As it is, affiliation and interlocking ownership between borrowers and creditors compromise the role of creditors as external agents in monitoring and disciplining firms.

Table 3. Type of creditors and nature of monitoring

Firm	Type of creditor	Is the creditor affiliated with firm?	Who guarantees loans?	Do creditors ask for collateral?	What is the action of firm when faced with liquidity problem?	What is the action of creditor in cases of default?
1	Bank	No	None	Yes	Renegotiate loan payment	No default
2	None	No	Gov t	Yes	Trade/sell securities	Not applicable
3	Bank, non-bank	Yes	Gov t	No answer	Renegotiate loan payment, bonds	No experience
4	Bank	Yes	Private owners	Yes	Equity infusion, additional loans	Not applicable
5	Bank, supplier	Yes	n.a.	No	Loans	No action
6	Bank, ODA	No	No answer	Yes	No liquidity problem	No default
7	Bank	No	Private owners	No	Renegotiate loan payment	No action
8	Bank, non-bank, individuals	No	Gov t	No	Renegotiate loan payment	No action
9	Bank	No	Private owners	Yes	No experience	No action
10	ODA	No	Gov t	No	No liquidity problem	Not applicable

Corporate management

Decision making system

The distribution of power between management and shareholders is a key corporate governance issue. When ownership of the firm is separated from management, a critical concern is how to effectively monitor managers and how to exercise control so that the managers will act in the best interest of the shareholders. The common answer to this issue is the system of the board of directors. Firms generally have big boards (between six and 15), with low turnover. Appointment of independent directors, though required by law, is not faithfully observed.

The Philippine Corporation Code provides for a unitary board of directors composed of at least five but not more than 15 members elected by shareholders. The Board is authorized to exercise all the corporate powers of the corporation, conduct the corporate business, and control and hold the properties of the corporation subject to limitations provided by law. The responsibilities of the Board are derived from the Corporation Code, the Securities Code, the General Banking Law (in the case of banks), articles of incorporation, and by-laws of the corporation. These instruments provide the board with control over management by virtue of its authority to: (1) select, appoint and remove corporate officers, (2) determine executive compensation, (3) set strategic directions and policies, and (4) delegate authority to management.

Being the top decision-making body in the firm, the board of directors is the source of authority of the managers to run its operations. It is thus expected to set the goals and objectives of the firm and to ensure that they are achieved. In this regard, the board of directors ought to monitor not only the firm s financial health (e.g., sales, profits, rate of return on investment, stock prices) but a wide range of strategic performance measures (e.g., quality, customer satisfaction, employee turnover, level of intellectual capital, product development, regulatory and environmental compliance).

Among the respondent firms, it is the board of directors that controls the firm and makes major decisions concerning its direction (Figure 17). Shareholders select directors. Board size ranges from 6 to 15 in 80 percent of firms. In 10 percent of respondents, the size of the board is five or less. And in another 10 percent, the board size is more than 15, a digression from the Corporate Code. Forty percent of the firms appoint outside directors, a good external monitoring practice that is only half-heartedly observed in the Philippines (the law mandates the appointment of independent directors in all firms). The appointment of independent directors underscores the need to protect minority shareholders and not just the controlling shareholders.

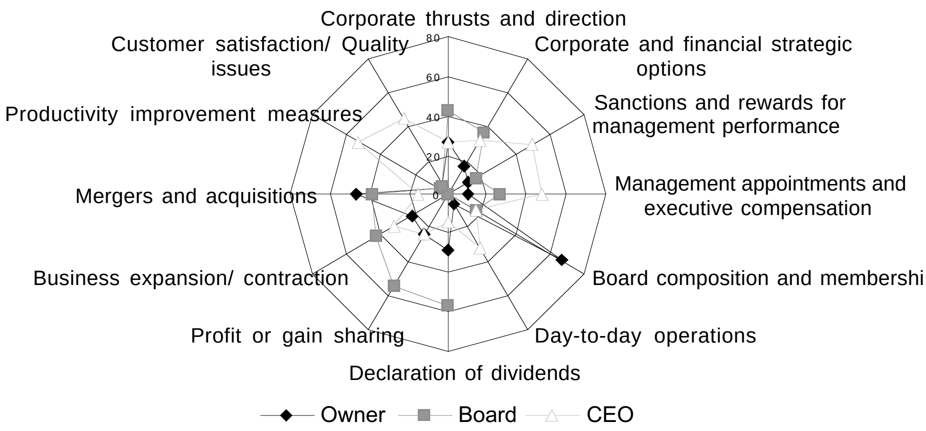


Figure 17. Decision allocation in firms

Respondent firms have active boards. In 50 percent of the firms, the boards meet more than eight times a year. In 40 percent of the firms, the average number of meetings is four to six times a year. In 10 percent of the firms, the board meets less than four times a year. Boards control and get involved in the management of the firm resources through independent committees. Audit committees are present within the boards of 60 percent of the firms. Other committees set up by the boards of these firms cover the following concerns: investment (40 percent), compensation and remuneration (20 percent), financial (10 percent), technical (10 percent), trust (10 percent), human resource (10 percent), and governance (10 percent). Although the corporation code prescribes having a nominations committee, the practice is uncommon among the respondent firms.

Boards in Philippine firms also have low turnover, a practice that is both advantageous and disadvantageous to the management of the firm. The average tenure of the board director is four to six years for 40 percent of the firms, three years or less for the other 30 percent, seven years or more for the other 30 percent of firms. This appears consistent with the board responsibility of guiding the strategic decisions of the firm. Nevertheless, a very low turnover may influence the quality of monitoring by the boards.

Boards of respondent firms are vested with powers to control and manage all businesses of the firm except where shareholder consent is required. Owners or major shareholders often decide on the composition of the board and on matters pertaining to mergers and acquisition. In some firms though, major shareholders still control decisions on corporate thrusts and directions, declaration of dividends, profit or gain sharing, and corporate financial and strategic options. Boards generally take care of declaration of dividends and profit or gain sharing, setting of corporate thrusts and directions, and business expansion or contraction. Boards also decide on corporate and financial strategic options, management appointments and executive compensation, mergers and acquisitions. Chief executive officers generally decide on productivity improvement measures, sanctions and rewards for management performance, management appointments and executive compensation, customer satisfaction and quality issues. Day-to-day operations and decisions on customer satisfaction and quality issues are the domain of the chief operating officer.

Nonetheless, the management of respondent firms has high (40 percent) to very high (40 percent) degree of independence in making operational decisions. Only 20 percent of the firms indicate that management has low to very low independence in making operational decisions.

Minimal separation of boards of directors from management also seems to be the common practice. Concurrency is practiced in 30 percent of the firms, where the chairman of the board also serves as the CEO. Low turnover of CEOs is also observed. In 30 percent of the firms, the CEO has not been changed in the last three years. Appointing insiders is also customary. Most CEOs (50 percent) have worked with the company prior to being appointed.

In any case, one must bear in mind that while the ownership structure is critical, the overall performance of firms will depend on the quality of management. Firms with competent and efficient boards of directors and CEOs will certainly have better chances of growth and survival.

Internal control and accountability system

Internal management and control is the foundation of accountability and integrity within the firm. Transparency[11] through regular disclosure of both financial and non-financial information about the firm is a hallmark of good corporate governance. The survey shows strong internal system of accountability of most firms (Figure 18). Controls are strict for cash flow, fixed asset acquisition, capital expenditure, payroll, loan repayment and accounts receivable. In a number of firms, internal controls for bad debt write off, capital expenditure, accounts receivable, tax payments, and research and development are even more rigid. Inventory control is less rigid and in some cases, control of research and development is somewhat loose.

Transparency and disclosure requirements improve accountability in firms. By and large, the level of accountability and quality of disclosure depend on accounting and auditing standards and the financial reporting system employed by firms. The good news is all firms surveyed follow the GAAP. On top of this, half of the firms follow international auditing standards, while a tenth adopt the US GAAP.

A general weakness observed among the surveyed firms is the limited disclosure of material information and the less than adequate channels for disseminating information to stakeholders although rules on disclosure are provided for in the Securities Regulation

[11] Transparency is associated with the quality of being open in all transactions and the ability to provide easy access to relevant and material information in a timely manner.

Code and in the listing rules of the PSE. Under the Securities Code, firms are mandated to submit financial and non-financial corporate information to SEC and PSE, who act as central registries. The Code also provides that such information and reports are accessible

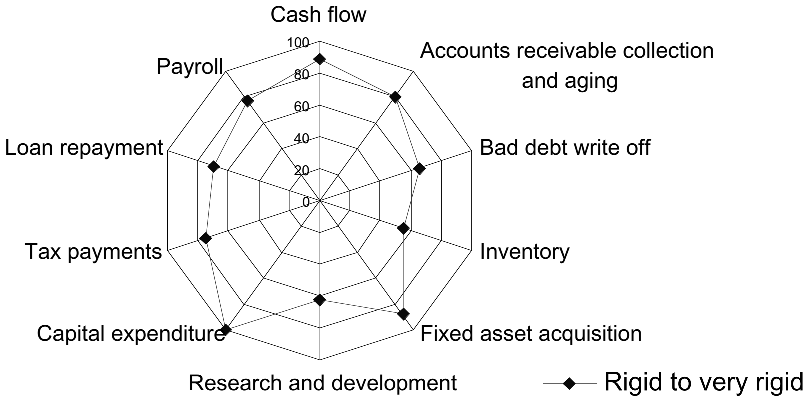


Figure 18. Degree of internal control

to shareholders, investors, creditors and other interested parties. Respondent firms generally observe this rule. Except for one, all respondent firms have a specific disclosure policy on material information about the firm. Annually, financial information is disclosed by 60 percent of the firms while the rest (40 percent) do it more frequently. In 50 percent of the respondents, information on firm performance is made available more than once a year. Information on ownership structure is made available once a year in 60 percent of the firms while that on governance is released annually in 50 percent of the firms. In some firms, information on governance and ownership structure is not disclosed. Material information about the firms is accessible to stakeholders in varying degrees.

Information on firm performance is generally more open (Figure 19). Minutes of board meetings are accessible to minority shareholders in 50 percent of the firms.

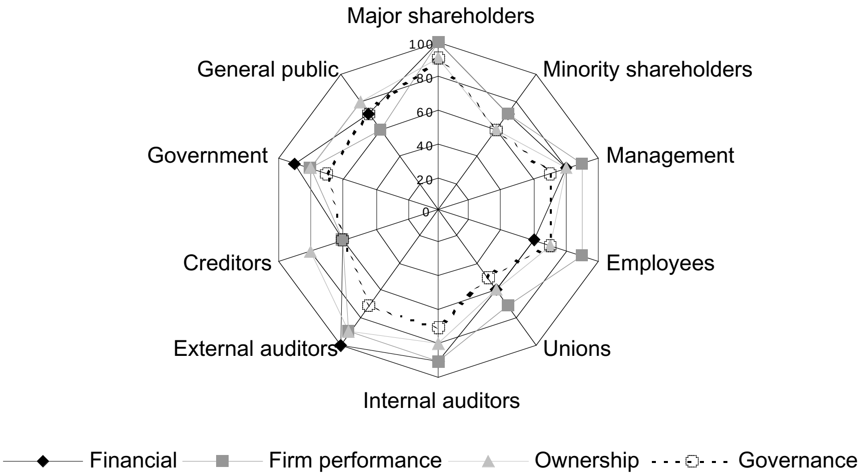


Figure 19. Disclosure of firms

As a rule, corporate laws give shareholders the right to inspect records of firms and minutes of board meetings. However, a corporation can refuse such a request by claiming confidentiality or possible improper use of information.

External audit and monitoring

Strong internal and external audit systems are important in ensuring the integrity of material information about the firm especially financial reports. Financial reports (such as income statement and balance sheet) are key instruments in determining a firm s financial health and quality of management. The value of financial statements is enhanced if certified by an independent or external auditor.

All of the respondent firms have external auditors. Fifty percent of respondent firms claim that their external auditors have very high independence. For 30 percent, external auditors have high independence while for 20 percent external auditors have moderate independence. The practice of long auditor tenure, however, may compromise the independence of firm audits. Auditor turnover among the surveyed firms is very low. In 90 percent of the firms, there has been no change in the external auditors. For 60 percent of the firms, the same external auditors have been associated with them since they were established (60 percent). In 20 percent of the firms, the same auditors have been contracted for more than five years. In 10 percent, the current auditor has been around for three to five years. In 60 percent of the respondent firms, external monitoring is compensated through the existence of board audit committees.

While there are institutional mechanisms in external monitoring and disclosure through submission of annual reports and financial statements (to SEC in order to update firm registration, to the Board of Investments to avail of tax incentives, to stockholders as required by law, to the Bureau of Internal Revenue for income tax purposes), these have been undermined by inadequate accounting and auditing standards. In the case of 30 percent of respondent firms, separate books are maintained for owners, management, tax agency, auditors and creditors. The Accounting Standards Council (ASC) sets the accounting standards and rules that form the Philippines body of generally accepted accounting principles (GAAP), with 18 out of 37 international accounting standards adopted to date. The ASC seeks to address concerns on the preparation of financial information and disclosures that are not in accord with high standards of accounting.

The PIDS (1999) survey revealed that some firms, especially small ones, do not regularly prepare balance sheets and income statements, and if they do, the financial statements are not audited by an external firm. The proportion of firms having audited financial statements is lower for small firms (about 80 percent) than for large firms (94 percent). Ninety-two percent of exporting firms maintain audited financial statements, whereas only 80 percent of non-exporting firms do so. The rigor involved in competing in the international market is perhaps one of the compelling reasons for exporters to engage external auditors.

Moreover, Philippine banks require loan applicants, especially business enterprises, to submit financial statements as part of the documents needed to evaluate the creditworthiness of their borrowers. Whether they accept audited or unaudited financial statements is another matter. Results show that despite the fact that 87 percent of the total sample respondents of PIDS study declared that their financial statements are audited by independent auditors, only 65 percent of them said that they typically need audited financial statements to apply for and receive a bank loan. As expected, large firms reported higher proportion (70 percent) than small firms (59 percent) being required to submit audited financial statements when applying for a loan. The difference is smaller between exporters (67 percent) and non-exporters (62 percent).

Ethical conduct

Corporate codes of conduct are sets of ethical standards in business dealings. The good news is that all of the respondent firms have a code of ethics which provide sanctions and penalties for misbehavior. In 90 percent of the firms, the code is publicized. The code appears to be communicated and in effect as 78 percent of firms indicated that they have received and investigated allegations of breaches of proper conduct. So far, most of those sanctioned for violating the code are managers (44 percent) and employees (44 percent). The rest are board directors (12.5 percent) and chief operating officers (12.5 percent).

Accountants and auditors of firms are covered by separate professional codes of ethics. Recently, the SEC issued a code of ethics for corporate directors. The survey however was not able to check firm compliance with these external codes of ethics. Nevertheless, the Enterprise Survey conducted by the Social Weather Stations among Filipino managers in 2003 can give clues on the ethical conduct of the business sector. In the survey, enterprise managers indicate a high prevalence of dishonest business practices, with only 35 percent saying that all companies in their sector issue receipts; only 18 percent saying that all in their sector keep only one set of accounts; and only 11 percent saying that all in their sector pay taxes honestly. Fifty-seven percent claim that most, if not all, companies in their sector use bribes to get public sector contracts, while 30 percent admit that most, if not all, in their sector use bribes to get private sector contracts (SWS, 2003).

Employee-employer relations[12]

The survey reveals a rather peculiar employer-employee relations in which unions serve as main employee counterpoint to management, and management generally exercising discretion to settle disputes.

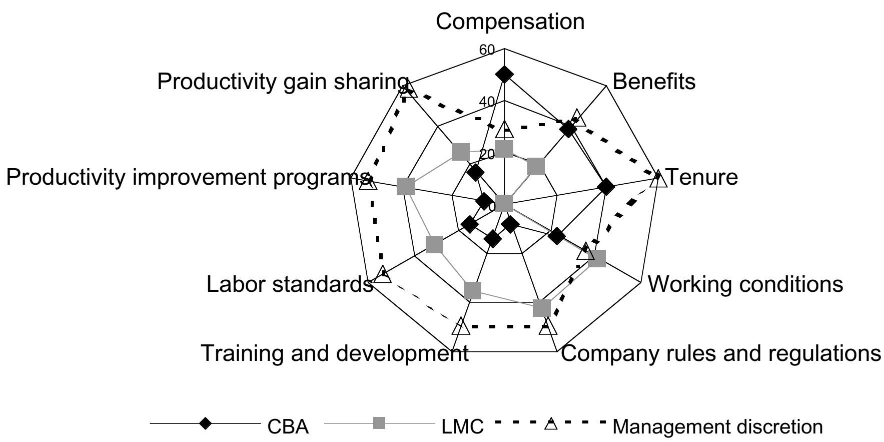


Figure 20. Preferred approaches to settle disputes

[12] Employer-employee relations traditionally fall under industrial relations.

Seventy percent of firms have unions. Many (70 percent) are not spared from disputes between management and employees. All of these disputes, however, have been settled using varied approaches. About 50 percent of disputes were settled through labor management consultation. Seventeen percent of the disputes were settled through government mediation and the other 17 percent, through court mediation.

Firms generally use collective bargaining and labor management mechanisms to resolve industrial relations disputes. CBA is the preferred venue to discuss compensation, tenure, benefits and working conditions. Other prefer to discuss company rules and regulations, and working conditions through labor management consultation. But in most of the firms, settlement of the aforecited issues including productivity improvement programs, gain sharing, training and development, and benefits are at the discretion of management (Figure 20).

Many firms have programs for productivity improvement: 80 percent have continuous improvement; 70 percent employ 5S; 60 percent have suggestion scheme and total quality management; 50 percent have quality circles; 30 percent have total productive maintenance program; and 20 percent have adopted just in time and environmental management programs. Only 30 percent of the firms have ISO certification.

Corporate responsibility

A firm s social responsibility refers to its obligations to protect and enhance the society in which it functions (Van Fleet, 1988). In pursuit of value creation and good return on investments, a firm commands tremendous financial resources and necessarily exploits resources and in doing so significantly affects the community where it operates. Firms are thus expected to behave as good corporate citizens by fulfilling social obligations as dictated by government regulations and being directly responsible to employees, shareholders, customers, suppliers, and the community in terms of fair labor practices, environmental protection, consumer protection and guarantee of safety and health.

All the respondents belong to the socially oriented firms in the country (Figure 21).

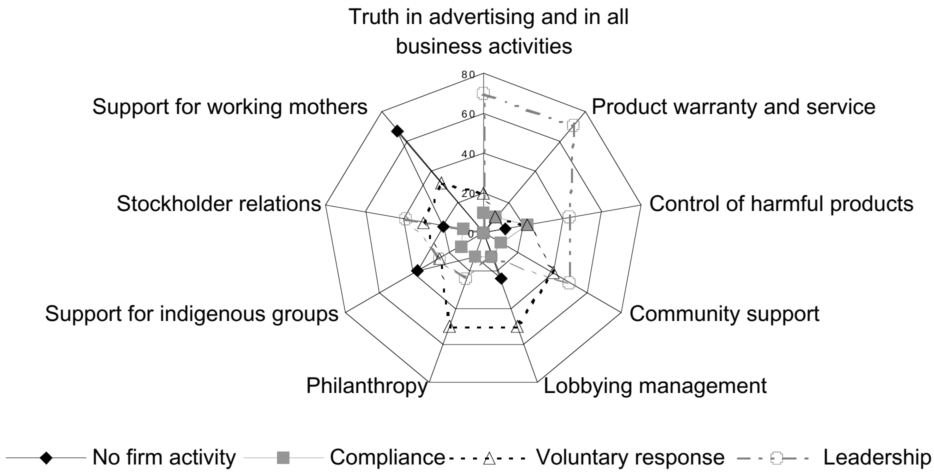


Figure 21. Firm practices of social responsibility

As a whole, the stance of firms is to assume leadership roles in the areas of truth in advertising and product warranty and service. Eighty percent of the firms have their own policies on consumer protection besides Republic Act No. 7394 known as the Consumer Act of the Philippines. All firms have mechanisms for receiving consumer complaints. The common means to resolve them are through customer service (33 percent), direct approach (17 percent), 48 hours policy (17 percent), and through the corporate affairs office (17 percent).

Some firms assume leadership role in environmental protection; other companies do it for compliance purposes. Eighty percent of firms have specific policy on environmental protection and about 30 percent of firms go to the extent of obtaining ISO 14000 certification. These firms are mainly in the power, utilities and manufacturing sectors. The rest of the respondent firms have given ISO 14000 certification lower priority since this is not a critical concern of firms in the financial sector.

In the area of community support, many firms endeavor to take leadership position. Firms usually support education, medical outreach, and social welfare projects. Philanthropy and lobbying management is voluntary. Firms have limited activity to support working mothers and indigenous groups. Nevertheless, despite proactive and voluntary efforts to strengthen community relations, 40 percent of the firms have done community action during the last three years.

Institutional interface

In governance, the key role of the private sector is to utilize the country s resources in order to generate jobs and create wealth. Government supports this role by creating an enabling environment and by providing the rules and institutions that govern economic activities.

By and large, corporations are subject to the laws, regulations and conditions of the countries in which they operate. But to make sure they grow and survive, a country must provide sound governance fundamentals: fair rules, business protection, adequate services and stable environment. Firms are oftentimes adversely affected by the weakness of a country s rules and institutions. The APO survey shows that exchange rate, inflation, taxes and regulations are among the major issues facing firms in the Philippines. Corruption, law and order and the functioning of the judiciary are only a moderate problem. Fiscal policy is a minor problem. Anti-competitive practices and international regulations and standards pose not much of a problem (Figure 22).

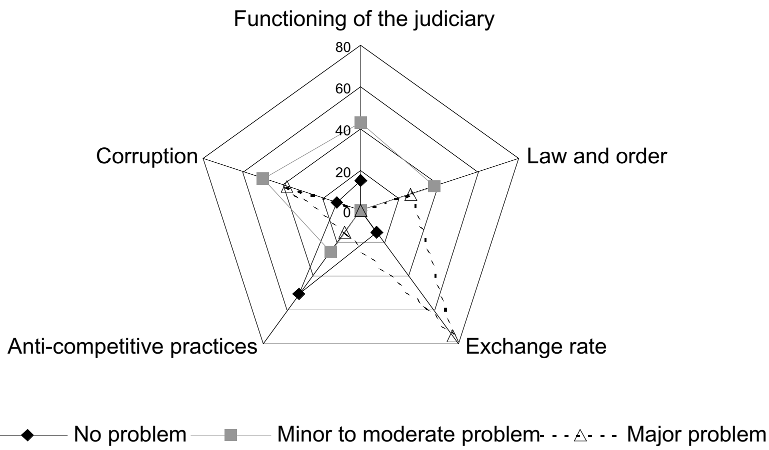


Figure 22. Political and economic concerns

The quality of dealings of firms with government is generally good, except in some areas (Figure 23). Many firms express satisfaction with the services of the central bank, rating it good (62.5 percent) or very good (37.5 percent). The judiciary is rated good (50 percent) or very good (16.7 percent). The quality of services delivered by the central government is considered slightly good (28.6 percent) or good (42.9 percent). Some 14.3 percent though think it is very poor. The legislature is also rated slightly good (28.6 percent) or good (42.9 percent). Customs is perceived to be good (42.9 percent) while the police is rated slightly good (66.7 percent).

In terms of quality and efficiency of basic services, telecommunication, electricity and power are rated slightly good (37.5 percent) or good (37.5 percent). The surveyed firms split their scores on the quality of roads and ports with some saying these services are very poor. Education and water service are rated slightly good. The favorable ratings might be due to recent government efforts to improve basic services, e.g., curriculum changes in basic education, allowing players from the private sector in the area of power generation, and construction of more roads, ports and other transportation and communication facilities.

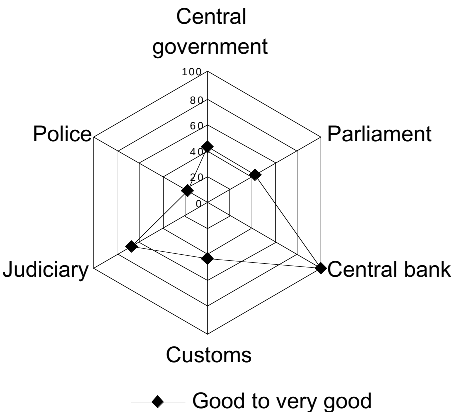


Figure 23. Satisfaction with public institutions

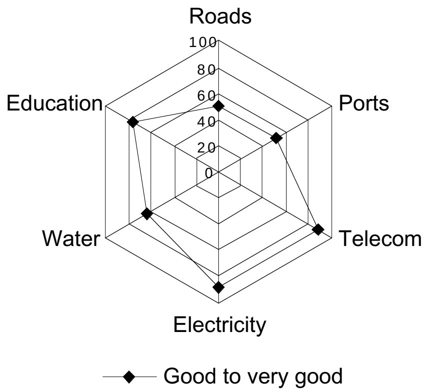


Figure 24. Satisfaction with basic services

With regard to strengthening international safeguards including codes of business conduct, 40 percent go for voluntary implementation, while another 40 percent prefer economic incentives. Twenty percent think it should be done through international law.

GOVERNING RELATIONSHIPS

In this study, the underlying proposition is that good corporate governance enhances productivity and promotes growth. Fair treatment and adequate protection of shareholders raise investors confidence_a necessary condition to sustain the flow of capital. Strategic guidance and effective management of the firm are also important to ensure that wealth is created and resources are not squandered.

Off hand, 70 percent of the respondent firms believe that corporate governance affects to a great extent the overall performance and productivity of the firm. Twenty percent think it is only to a small extent.

A recent empirical study showed some correlations. Klapper and Love (2002) used recent data on firm-level corporate governance rankings across 14 emerging markets and find that there is wide variation in firm-level governance across countries in their sample and that the average firm-level governance is lower in countries with weaker legal systems. These are the findings: Governance is correlated with the extent of asymmetric information and contracting imperfections that firms face. Better corporate governance is highly correlated with better operating performance and market valuation. Firm-level corporate governance provisions matter more in countries with weak legal environments. These outcomes suggest that firms can partially compensate for ineffective laws and enforcement by establishing good corporate governance and providing credible investor protection.

Firm performance and ownership

When ownership is concentrated, large shareholders could play an important role in monitoring management. On the other hand, when ownership is dispersed, shareholder control weakens due to poor shareholder monitoring. Morck, Shleifer and Vishny (1988) find an inverted U-shaped relationship between the degree of ownership and corporate profitability interpreted as follows. As ownership concentration rises from a very low level, costs decrease due to increased corporate monitoring. Hence, profitability rises. When ownership concentration rises to a certain limit, its costs outweigh its benefits, leading to a fall in profitability.

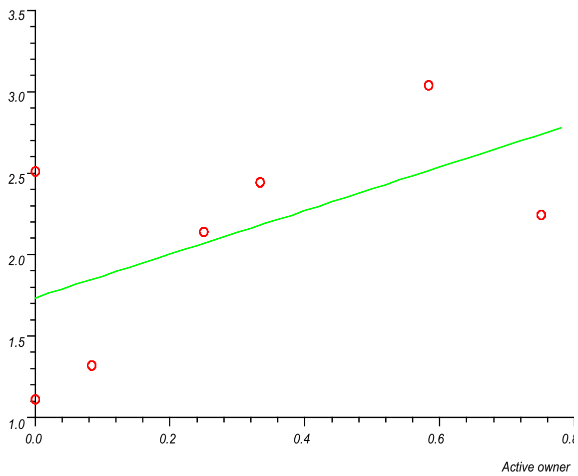


Figure 25. Active owners vs. return on assets

The assumption was somewhat difficult to establish among the respondent firms given the sample limitations. Nevertheless, some relationship was discerned between firm efficiency and governance. For instance, there is some evidence that return on assets (ROA) increases (*correlation coefficient (r) = 0.574344*) as the owner becomes more involved in firm decision-making (Figure 25). ROA, computed as the ratio of net income to total assets, emphasizes efficiency in the utilization of assets. As Morck, Shleifer and Vishny (1989) found out earlier, it is not surprising to expect higher efficiency in a firm s operations when the owners themselves make decisions and ensure that the firm s resources are being optimized and used wisely. Too much intervention from owners though may cripple management flexibility and ability to generate reasonable returns on investment as the cost of owner monitoring may increase unreasonably.

Firm performance and management

Boards are the ones primarily responsible for the governance of the firm. To ensure good governance of the firm, boards are expected to establish the firm s directions, strategies, policies and procedures that will guide the activities of the company. As agents

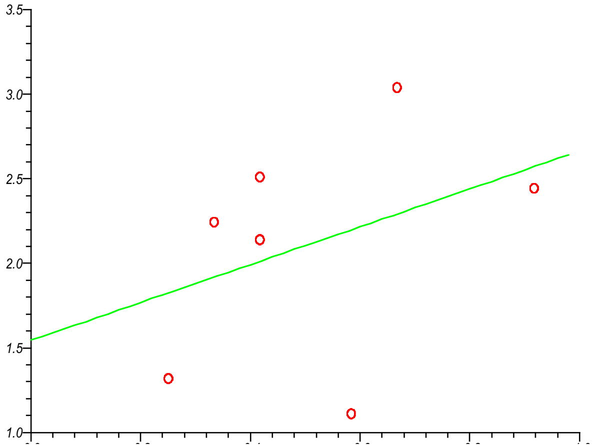


Figure 26. Active board vs. return on assets

of shareholders, boards ought to monitor management s performance and attainment of business objectives including customer satisfaction, low employee turnover, product development, regulatory and environmental compliance. Hence, a firm can expect better performance with active boards.

The good news from sampled firms is that as their boards get more involved in setting corporate thrusts and directions and in monitoring firm performance, the returns improve as well. That is, ROA increases as boards become more active (*correlation coefficient (r) = 0.374973*). (Figure 26). That means, the more active a board is, the higher the assurance the owners get that the firm is being directed in their best interest. The result is not an isolated case. An active and efficient board of directors is the first line of defense of companies in times of economic difficulty. Based on *Business Week* s ranking of best and worst boards in 1996, the stocks of companies with the best boards outperformed those with the worst boards by two to one. When the Philippine economy slowed down in 2000, studies also showed that companies with the best boards retained much more of their value at 51.7 percent compared with -12.7 percent for the worst board companies (Benitez and del Rosario, 2002).

Evaluation of active CEO

While the board sets the overall direction, it is management which directs the efficient and effective utilization of the firm s capital and material and human resources in pursuit of its business goals. In that case, the best place to gauge corporate performance would be in the office of the chief executive. Generally, it is the CEO who orchestrates the firm s resources and directs its course to create value within the firm. Hence, the more dynamic and competent the CEO, the more wealth can be generated by the firm. As shown in Figure 27, firm

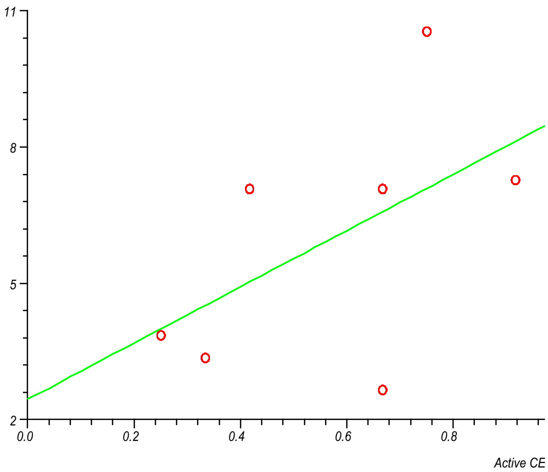


Figure 27. Active CEO vs. return on equity

performance has positive association with the extent of CEO involvement in the management of the firm. In this case, ROE increases steadily (*correlation coefficient (r) = 0.534766*) as the CEO becomes more active in company operations and decision-making.

It must be noted however that in 30 percent of the sample firms, the CEO is concurrently chairman of the board. Under such a set-up, the power and influence of the CEO over its internal and external stakeholders are enormous.

Firm productivity and quality improvement

In a market characterized by globalization and tougher competition, traditional management is pass . By and large, firms possess intrinsic technology to create value from its resources. Yet it can do better with the adoption of approaches that raise labor, material, energy, and capital productivity and with the application of technologies that enhance customer s satisfaction with product and service quality.

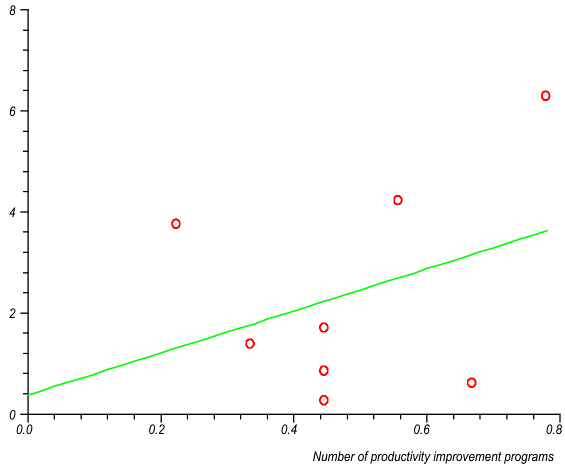


Figure 28. Value added productivity vs. number of productivity programs

Productivity and quality improvement programs range from simple housekeeping like 5S and quality circles to more sophisticated approaches like total quality management, automation and just-in-time production. Basic approaches are effective in raising consciousness and in creating a quality work environment. Higher levels of productivity can be expected from the application of more advanced programs. The results confirm this when labor productivity was cross checked with the number of productivity improvement programs of the sample firms. (Figure 28). Undeniably, value added productivity increases as the number of productivity and quality interventions employed by the sample firms increases (*correlation coefficient (r) = 0.346335*). The positive results could be attributed to the synergistic effect of productivity and quality programs embraced by the firm.

Managing employee-employer relations

Labor problems are merely symptoms of bad management. A healthy and cooperative relationship between management and employees is a sure sign of good corporate management. It indicates that the firm is able to meet its responsibility towards its own human resources and align their objectives with that of the firm. The stability resulting from good employee-management relations provides shareholders the assurance that both labor and management can concentrate on achieving the goals of the firm.

Labor contracts are the most common instruments used by firms to set the terms of employment and hammer a good work and compensation agreement with employees. But no contract is perfect. And in case of changes being introduced by the firm, difference of opinion between management and employees are inevitable. Several procedures (either

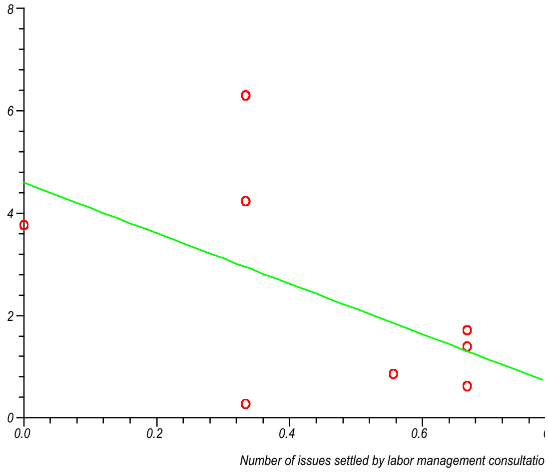


Figure 29. Value added productivity vs. number of productivity programs

consensual or confrontational) are available to settle issues between management and employees. The most popular are collective bargaining and labor management consultation. Management and union officials reach agreement on wages, benefits, working conditions, separation, and other policy issues through collective bargaining which results in a mutually binding contract. Labor management consultation uses dialogue with employees on matters concerning mainly quality of work and labor productivity.

Collective bargaining is widely criticized for being confrontational. Labor management consultation (LMC), as the name suggests, is argued as a soft approach as it is more consensual. Thus, it is expected to produce better results. But that is not always the case. As can be seen in Figure 29, value added labor productivity decreases as LMC is employed to address employee issues. On the other hand, labor productivity is on the rise when collective bargaining is used to settle labor issues (Figure 30).

The findings run counter to other countries experience with labor management consultation. It is said that LMC has been the driving force of productivity improvement in Japanese industry. Although LMC is quite Asian in its approach and, thus, expected to be closer to the Filipino culture, the predominance of CBA only confirms the generally adversarial industrial relations that prevail over indigenous values such as consensus. With labor focused on rights-based contracting, there is greater vigilance and monitoring of company s financial performance. Surprisingly, labor productivity drops as employees are given more access to performance data in sampled firms (Figure 31). This goes to show that while transparency and disclosure enhance internal and external monitoring,

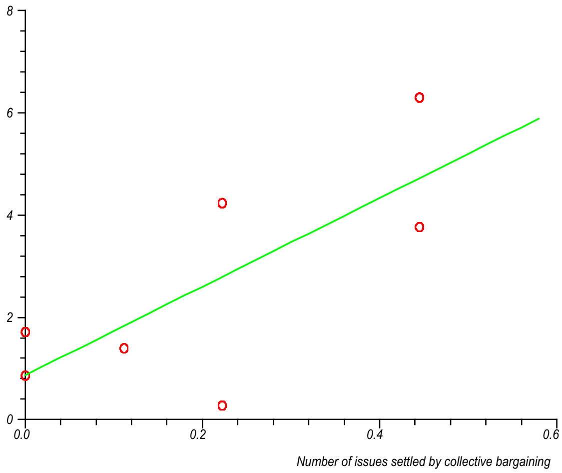


Figure 30. Value added productivity vs. use of collective bargaining

other forces are at work within the firm.

In summary, the exercise on governing relationships provides some evidence that good corporate governance, proxied by allocation of decisions between owners, board and CEO and the manner by which the resources and operations of the firm are managed, affect financial viability and productivity. Active owners, efficient boards and competent managers enhance the financial standing of the firm. Productivity measures enhance value creation within the firm but principles like LMC and disclosure lead to unexpected results. Given the study limitations, it should be noted that the associations established are true for the sampled firms but are neither conclusive nor generalizable.

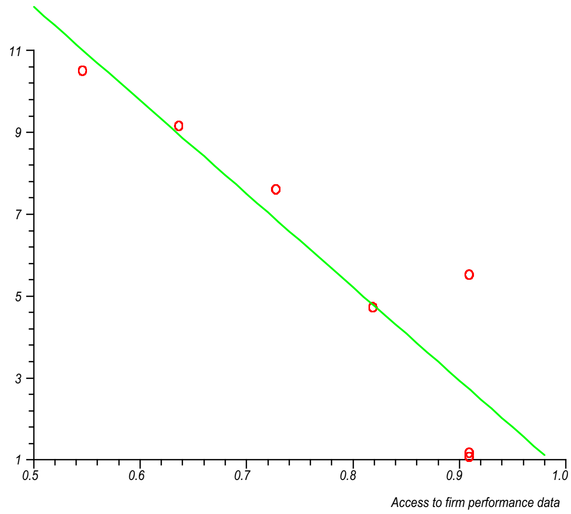


Figure 31. Labor productivity vs. access to firm performance data

CONCLUSION AND RECOMMENDATIONS

The study has indicated peculiar manifestations of corporate governance in Philippine firms. To start with, the country has more than adequate rules and institutions that provide a comprehensive legal framework for corporate governance and capital market regulation. These rules meet universal corporate standards and with strong enforcement, one would expect a highly disciplined corporate sector. Yet the country has its own share of serious corporate misconduct that fortunately paved the way for swift and tough reforms in corporate regulation. Philippine firms are also criticized for poor compliance with universal rules on disclosure of information and quality of monitoring. Both the government and the private sector have initiated action to address these issues through revision of the corporation and securities code, adoption of a code on corporate governance, and strengthening of institutions charged with corporate monitoring and regulation. A big issue raised by international organizations is concentration of ownership in Philippine firms, manifested through high proportion of shares by a single shareholder and the use of cross-shareholding structures. While it tends to perpetuate the concentration of economic (and political) power to a very small segment of the Philippine society, the issue seems to be of minor domestic concern. In a situation where the capital market is underdeveloped and the legal framework is somewhat imperfect, the practice minimizes investors risks. This corporate setup promotes economies of scale and maximizes returns on investments both considered as productivity concerns of a developing economy like the Philippines. An important policy implication of this finding is that although the task of reforming investor protection laws and improving judicial quality is difficult, improving corporate governance at the firm-level is a feasible goal. Specifically, firms can reduce their cost of capital by establishing credible investor protection provisions, by using provisions in their charters to improve corporate governance. (Klapper and Love, 2002)

While there are areas for improvement, the study indicates general observance of corporate governance principles in the Philippines. Philippine corporate laws provide shareholders with adequate rights although minority shareholders are still unable to exercise these rights. In practice, majority shareholders will always expropriate minority shareholders (and independent directors) for as long as the latter remain bystanders in firm governance. Full exercise of the rights by minority shareholders, however, has a long way to go due to the information asymmetry between majority and minority shareholders and the absence of an impetus for collective action on the part of minority shareholders. Nonetheless, raising the accountability of boards (which act in behalf of both majority and minority shareholders) can help correct this state of affairs within the immediate term.

Principal-agent relationships govern corporations as much as other entities. In a corporate environment, the board is the principal, and management its agent. The basic task of the principal (in this case the board) is to coordinate the activities of its agent (management) in order to succeed in promoting stakeholders interests. There are of course problems associated with such principal-agent relations (Andvig, 2000). The first is a potential conflict of interest or divergent objectives between the principal and the agent. The second has to do with imperfect information (the agent possesses more information than the principal). The third is related to the difficulty of establishing an incentive structure that aligns the goals of both the principal and the agent. The corporate management structure and practices examined in this study in part reflect how Philippine firms deal with these problems.

In Philippine firms, the general practice involves low turnover and minimal separation between the board and management. This is obviously a convenient way to align objectives and share information, which are serious concerns only for as long as firms do not possess well-disciplined boards (which, the study shows, tend to enhance firm performance). Unity of purpose and consistency of directives are promoted under this setup, but at the same time, it is vulnerable to control of majority shareholders through the appointment of chairman and CEO. Corporate monitoring by external creditors, the presence of independent directors, and quality external auditing, can offset this problem. But while firms adhere to generally and internationally accepted accounting practices, there is lax creditor monitoring and limited disclosure of information on firm performance. Reforms in the financial sector can raise the quality of creditor monitoring. The current review of government s contingent liabilities (which includes sovereign guarantees involving private sector loans) will hopefully put the situation in check. Recent regulations that require greater disclosure of information will have rough sailing due to the wariness of firms to share information that they believe can put them in harm s way.

In the area of management, the study has surfaced typical practices of Philippine firms in the allocation of decisions: key strategic directions emanate from the board while operations, quality and productivity matters, and employee relations reside with management. In a country where unions are quite active, firms constantly face challenges from workers. The common approaches in labor management relations are collective bargaining and labor management consultation. Curiously, management discretion is preferred over consensus in dispute resolution. This might be something cultural and peculiar to industrial relations in Philippine firms. Philippine firms tend to adopt Western management styles, which are supposedly less autocratic and more participatory. Yet, the value orientation of Filipino workers makes them more predisposed to accept authority and hierarchy.

As far as rules and institutions are concerned, the study confirms that the outward orientation of government is a necessary but not a sufficient condition to develop the corporate sector. What is more important to the development of the domestic capital market is good legal framework and sound corporate governance. Furthermore, while effective regulations can discipline firms, it will be good returns to business, i.e., higher productivity and profitability that will motivate firms towards better corporate governance. In other words, an arms-length approach is as much needed as a regulatory approach.

In the light of the above findings, several interventions are in order to strengthen corporate governance in Philippine firms. APO can start the advocacy on corporate governance and productivity. What would be needed at this stage are as follows:

- *Education and exposure of the Board of Directors*: Since boards play a very critical role in the governance of firms, boards need to be made more conscious of their responsibilities. One way to do this would be to organize a forum for corporate directors in APO member countries and expose them on corporate management practices of successful firms in Asia.
- *Improving the quality of external auditing*: Considering the value of good external monitoring, APO intervention may be needed to help raise the integrity of external auditing. Some programs along this line could be the adaptation of quality assurance (e.g. ISO-type accreditation) for auditing systems and of material information such as those contained in financial statements.
- *Benchmarking corporate governance quality*: APO can develop an Asian version of corporate governance quality index, do a periodic country-level measurement and assessment, and promote benchmarking of good corporate governance practices.
- *Promotion of corporate codes of conduct*: APO can support the APEC initiative to make countries adopt of a corporate code of conduct. A model corporate governance code can be developed and adapted by firms.
- Finally, APO can conduct advocacy programs to promote the interests of minority shareholders, social responsibility of firms, and greater transparency of corporate activities.

REFERENCES

Andvig, Jens Chr., Odd-Helge Fjeldstad, Inge Amundsen, Tone Sissener and Tina Soreide (2000). Final Report on Research on Corruption: A Policy Oriented Survey commissioned by NORAD; Chr. Michelsen Institute (CMI) & Norwegian Institute of International Affairs (NUPI).

Asian Institute of Management (2001). The Board of Directors, *Managing Corporate Governance in Asia*, Vol. 2, July 2001, AIM Center for Corporate Responsibility, Makati City, Philippines.

Benitez, Rene B. and Juan Carlos del Rosario (2002). Global Problem of Corporate Governance: The Philippines Response at www.KWR.Advisor@kwrintl.com

Claessens, Stijn, Simeon Djankov and Harry H.P. Lang (1999). *Who Controls East Asian Corporations?* World Bank Working Paper No. 2532, The World Bank and the University of Chicago.

Encyclopedia Corporate Governance (2001).

Free Trade Asia Consulting, Inc. (1998). Promoting the Competitiveness of Philippine Industries Through Competition Policy at http://www.policy.com.ph

Gregory, Holly (2000). The Globalisation of Corporate Governance, Global Counsel, September and October.
Huther, Jeff and Anwar Shah (1998) cited in Gonzalez, Eduardo T. and Magdalena L. Mendoza (2002). Anti-Corruption Initiatives in the Philippines: Breakthroughs, Limits and Challenges. A case study prepared for the World Bank.
Hellman, Joel S., Geraint Jones, Daniel Kaufmann, and Mark Schankerman (2000). Measuring Governance, Corruption, and State Capture: How Firms and Bureaucrats Shape the Business Environment in Transition. World Bank Working Paper No. 2312.
Juzhong Zhuang, David Edwards, David Webb, Ma. Virginita Capulong (2000). *Corporate Governance and Finance in Asia: A Study of Indonesia, Republic of Korea, Malaysia and the Philippines, and Thailand,* Volume One. Asian Development Bank.
Khan, Haider (1999). Corporate Governance of Family Businesses in Asia: What s Right and What s Wrong? Working Paper No.3, ADB Institute, August.
Klapper Leora F. and Inessa Love (2002). Corporate Governance, Investor Protection, and Performance in Emerging Markets. World Bank Policy Research Working Paper No. 2818.
Lamberte, Mario B., Cesar Cororaton, Marge Guerrero and Aniceto Orbeta (1999). Results of the Survey of Philippine Industry and the Financial Crisis. Philippine Institute for Development Studies.
Morck, R., A. Shleifer and R. Vishny (1988). Management Ownership and Market Valuation: An Empirical Analysis, *Journal of Financial Economics,* Vol. 26.
Philippine Council for Productivity (2000). Annual Report.
Saldana, Cesar G. (2001). The Philippines, *Corporate Governance and Finance in Asia: A Study of Indonesia, Republic of Korea, Malaysia and the Philippines, and Thailand.* Juzhong Zhuang, David Edwards, Ma. Virginia Capulong (editors). Volume Two. Asian Development Bank.
Saldana, Cesar G. (2001). Corporate Governance Environment and Policy: Their Impact on Corporate Performance and Finance in the Philippines, in *Corporate Governance in Asia: A Comparative Perspective*. Organization for Economic Cooperation and Development.
Securities and Exchange Commission (2001). *Annual Report: Managing Through Times of Change and Adjustment.*
Securities and Exchange Commission (2002). SEC Memorandum Circular No. 2 Series of 2002. Manila, Philippines.
Shleifer, Andrei and Robert Vishny, 1997. A Survey of Corporate Governance, *Journal of Finance*, 52: 737-783.
Social Weather Station (2003). 3rd Survey of Enterprises about Public Sector Corruption, October 2002 to February 2003.
Van Fleet, David D. (1988). *Contemporary Management*, Houghton Mifflin Company.
World Development Report 2001/2002. The World Bank.
World Bank (2001). Report on the Observance of Standards and Codes. Corporate Governance Country Assessment of the Republic of the Philippines by Cesar Saldana.
World Bank (2002). *Philippines: An Opportunity for Renewed Poverty Reduction.* A World Bank Development Policy Review.

CORPORATE GOVERNANCE IN SINGAPORE: ISSUES, OPTIONS, AND IMPACT ON FIRM PRODUCTIVITY

Dr. Chee Leong Chong
National University of Singapore
Singapore

INTRODUCTION

Singapore has an open trade policy which is clearly reflected in its total trade figures of more than two-and-a-half times its GDP. Data from the 1990 input-output tables also show imports comprising some 55 percent of total expenditure and 60 percent of exports. Singapore has practically no exchange controls on the inflows and outflows of foreign currency funds and has a very liberal policy towards foreign direct investment (FDI). As to restrictions on share ownership, the only limitations for foreigners are a 40 percent cap in onshore banks and a three percent maximum cap in a local media company. Ownership policies in key sectors are regarded as more open than those of developed nations.

Compared to the US and UK, however, corporate governance in Singapore is still underdeveloped in both theory and practice. Ownership is highly concentrated. This, when combined with a weak takeover market, tends to tip the scale in favor of owner-managers to the detriment of minority shareholders. Unlike in Japan and Germany where a strong bank-based monitoring mechanism is fairly common, there is a lack of either a market or structural governance mechanism in Singapore to discipline erring managers.

The Singapore corporate governance system is more or less patterned after the US-UK model. However, unlike in the US and UK, the capital market in Singapore is rather small. The Singapore Stock Exchange has only about 300 listed companies and equity is closely held among investors which include government, corporations, individuals and financial institutions. Another feature is the lower quality of publicly available corporate information due to the lack of strict accounting standards (Singapore subscribes to International Accounting Standards rather than FASB standards) and legal structure and poor enforcement of these standards.

There is, too, the high concentration of ownership among company management and large shareholders which has the potential to violate the principle of decision management and ratification, and could result in the expropriation of wealth from minority shareholders to large shareholders.

The predominance of government-linked corporations (GLCs) is one major feature of the Singapore corporate sector. The government invests in corporations through three holding companies: MND Holdings, Singapore Technology Holdings, and Temasek Holdings. Government directly and indirectly controls up to 70 percent of some GLCs and indirectly controls a smaller percentage of major non-GLCs in the banking, shipping, and technology sectors through intercorporate equity shares between GLCs and non-GLCs.

Towards the end of the 1980s, GLCs comprised 69 percent of total assets and 75 percent of profits of all domestically controlled companies in Singapore. In the 1990s, the government embarked on a privatization program, which resulted in the dispersal of equity of these companies. Still, the government continues to hold majority ownership, through its holding companies (Temasek Holdings, MND Holdings, and Singapore

Technologies) in these GLCs.

Thus, a study of corporate governance in Singapore must necessarily include an understanding of the role and governance structures of GLCs. In many ways, these companies play a formidable role in the domestic economy and lead others in the practice of management.

In Singapore, inter-firm competition is somewhat diluted by cooperation and coordination in corporate ventures that represent unrelated diversification strategies. This is particularly the case for GLCs which not only pursue economic but also social objectives such as those related to promoting the development of Singapore. For example, the regionalization of such GLCs as Keppel Corporation has often been achieved in tandem with other companies including in many cases competitors.

This is also seen in the distribution of interlocking directorates. A high percentage of interlocks exist not only between listed subsidiaries and the parents but also between competitors in the same industry. One effect is the moderation of competition. Another effect is government s indirect control and monitoring of corporate activities and business policies since many directors of GLCs are also senior government officials.

It would seem that government is facilitating governance through GLCs, but this approach may spawn some problems. One, the appointment of government officers to senior management and board positions within GLCs may not necessarily bring in the best persons to run corporations that form an important part of the economy. Two, government appointed senior managers may be so sensitive to signals sent by government especially when the signals are not profit but socially oriented that their response may be in conflict with the commercial objectives of the enterprise. Three, there could be less pressure for GLCs to pay dividends.

Unlike other blockholders, who may simply facilitate the takeover of poorly-performing firms, government is expected to get involved in these GLCs for the long haul in the higher interest of the nation. This makes GLCs even more protected in a market for corporate control that to begin with is already quite weak. Compared to non-GLCs, GLCs are also likely to have easier access to sources of capital. That is because lenders perceive government to be morally and legally responsible for their liabilities, implying that with state backing, the enterprise will not be allowed to go under. This explains the readiness of banks and non-bank financial institutions such as insurance companies to provide loans to these enterprises. Moreover, GLCs are able to raise funds much more cheaply—by up to four percentage points lower—than others.

The Minister of Finance noted that since GLCs are awash in cash they usually do not need to raise bonds or resort to bank borrowings (*Business Times*, August 23, 1997). This is said to reduce the potential discipline to which a GLC will be exposed in a competitive capital market. GLCs have drawn criticism for excessive diversification (*Straits Times*, May 15, 1998, p.52). In a competitive market, any wealth-decreasing diversification would be penalized by investors. However, the reduced exposure to market discipline as a result of reduced exposure to takeovers and access to cheap capital on account of tacit government guarantee may make GLCs less efficient than other private companies.

Foreign ownership has limitations ranging from 20 to 49 percent imposed by statutes on banking and news media industries. In other cases, these restrictions are adopted *motu propio* by the firms themselves through amendments to their Memorandum and Articles of Association (M&A). Foreign ownership limitations are justified by strategic (i.e., defense) and national interests.

Where foreign shareholdings have reached the statutory or self-imposed limit, shares are traded in separate local and foreign tranches. In general, foreign shares trade at a significant premium over local shares, provoking a debate over whether firms should remove foreign shareholding limits or not. Evidence suggests that the use of foreign shareholding limits to prevent companies from falling into foreign control imposes capital costs on the company. Recently, however, some companies, such as those within the Singapore Technologies (ST) Group, have responded to this debate by increasing their foreign shareholding limits. In addition, companies such as the ST units and Singapore Press Holdings have merged their foreign and local shares.

The adoption of foreign ownership limits, whether statutory or self-imposed, can facilitate managerial entrenchment. The imposition of a foreign ownership limit prevents control of the firm from being passed to the hands of foreign investors. It also reduces the ability of foreign investors to acquire large stakes in these firms. In turn, this curtails the potential monitoring that can be provided by large foreign investors. Where the firm has dual listings of foreign and local stocks, the foreign stocks tend to trade at a substantial premium over the local stocks. This reduces the vulnerability of the firm to takeovers.

Since the last Asian economic crisis, corporate structure and governance have been under scrutiny. It has been pointed out that close relationships between government and big business incur both positive and negative effects. On a positive note, business risk and transaction costs from unpredictable government policies are reduced. On a negative note, there are more opportunities for corruption and wasteful resource allocation, including real estate and stock market bubbles.

Despite the increasing demand for corporate governance, transparency and accountability which have made it difficult for the state to favor big business, there has been limited success in tearing down the old structures. Big business continues to dominate while government s ability to enforce policies continues to suffer.

Even so, Singapore has been widely known as among the best in Asia when it comes to disclosure and corporate governance for which commentators have attributed the relative robustness of the Singapore economy during the recent financial crisis. In the Price Waterhouse Coopers (PWC, 1997) survey of companies, respondents rated corporate governance in Singapore as better than Taiwan, Malaysia, Hong Kong, and Japan; but not as good as Australia, UK and US. A more recent PWC (2000) survey of institutional investors ranked Singapore as second only to Australia among principal markets in the region, in the areas of auditing and compliance, accountability to shareholders, disclosure and transparency and board processes. This rating is important in as much as 76 percent of Asian CEOs consider corporate governance as a key factor in attracting foreign capital and investments and eight out of 10 Asian CEOs view it to be an important consideration in selecting business partners.

Given the globalization of business and Singapore s aim of becoming an international financial center, the Singapore government has identified meeting international standards of disclosure and corporate governance as extremely important. Hence, in December 1999, the government announced the establishment of the Corporate Regulation and Governance Policy Committee jointly chaired by the permanent secretary of the Ministry of Finance and the managing director of the MAS. The policy committee in turn established private sector-led review committees in three areas: (a) company legislation and regulatory framework, (b) disclosure and accounting standards, and (c) corporate governance.

Companies are also concerned with addressing the "value gap", which is the difference between what CEOs and what investors consider as important in assessing their companies value. One solution to narrowing the "value gap" is a more transparent disclosure of financial and non-financial information to stakeholders. Only 47 percent of Asian CEOs consider themselves transparent in disclosing financial information; only 26 percent regard themselves transparent when it comes to non-financial information. These figures are significantly less than those in other regions.

Corollary to this is the issue of corporate social responsibility. Eighty percent of Asian CEOs rate acting responsibly towards stakeholders as the most important factor to influence the development of their company s social reputation. Creating value for their shareholders is ranked second by 78 percent of Asian CEOs while 73 percent of Asian CEOs rate corporate social responsibility as vital to the profitability of any company.

REVIEW OF LITERATURE

In corporate governance, when the only goal of the corporation is to maximize long-term shareholder wealth, the finance approach has been principally used. The problem with the separation of ownership from control is that individuals charged with making the operating decisions that affect shareholder wealth—the managers—may methodically conduct themselves in ways inimical to the interests of the owners. This is why there are many legal, regulatory and procedural proposals presented to provide solution to this principal-agent problem.

The main contention of the finance approach is that governance—the rules and institutions by which agents are constrained to act—matters to corporate performance. Good governance should equate to the maximization of long-term shareholder wealth. Yet most studies fail to establish the connection. Typical is the conclusion of Karpoff *et al.* (1995), after studying 866 shareholder initiated proxy proposals, that even the most successful proposals do not substantially change their target firm s policies or stock values.

While this result is generally confirmed in other studies, some authors find a link between performance and certain governance features. Among these is a study by Gordon and Pound (1991) in which they were able to identify corporations with fewer anti-takeover governance measures in place who outperformed corporations with more anti-takeover initiatives. This leads to the conclusion that removal of anti-takeover measures should enhance performance, but that is just the evidence Karpoff, *et al.* fail to find.

While a link between specific shareholder initiatives and corporate performance is yet to be clearly established, there appears to be a growing body of evidence that institutional pressure on underperforming companies can spell a difference in corporate performance. This pressure often comes in the form of a proxy proposal or a request for a change in corporate governance (splitting the CEO and the chair is a popular vehicle)—but everyone involved understands that performance *not* governance is the real concern.

A number of institutional investors, such as CalPERS and associations such as the Council of Institutional Investors (CII), have systematically targeted underperforming companies with the explicit goal of improving shareholder value. Studies by Nesbitt (1994) and Opler and Sokobin (1995) find excess returns at firms that have been targeted as part of these larger programs that are primarily informal and *ad hoc* and, until 1992, conducted almost entirely by press release. What may be happening here is that management is responding to general pressure from activist investors by redoubling their efforts to satisfy these shareholders desire for performance.

What are the governance implications? Specific institutional changes in the board of directors may not be as important as general rule changes that empower institutions to bring pressure to bear on underperforming companies. As these studies suggest, such measures may allow, for example, institutions to consult with one another, to coordinate the approaches they adopt towards a particular underperforming company, and to communicate directly with management in ways that will not entail expensive, restrictive proxy mechanisms and potentially expose institutions to large liabilities.

In addition to casting the principal-agent problem in a broader context, many commentators cast corporate governance in general and monitoring in particular in a wider political context. Grundfest (1990) notes that agency problems are not only inefficiencies to be corrected, but also entitlements to be allocated by a political process. The conclusion is that monitoring by institutional investors is an inherently political process in which the rules of the game are determined by state legislatures, and the regulations of key federal agencies like the Securities and Exchange Commission. In this context, important policy issues in corporate governance are likely to be external to the boardroom and are likely to deal with the rights and restrictions placed on owners (institutions) in their attempts to influence the economic performance of corporations.

A number of studies on corporate governance in Singapore are worth mentioning.

Khan (2003) cites several reasons why Singapore corporations, including family-owned and controlled corporations, survived without serious harm the Asian financial crisis. According to him, the financial markets were quite efficient; government displayed skillful management and major domestic players cooperated with one another in an open and competitive market structure. However, this should not be taken to mean that Singapore would soon embrace an equity-based governance structure despite the fact that Singapore has adopted reforms in auditing and accounting. Kahn believes that banks, with government oversight, will be the ones that will closely monitor Singaporean firms.

Tan (2003) believes that corporate governance remains a crucial issue even if Singaporean firms remain family-based, and avoid a complete separation of ownership and control. According to him, the controlling shareholders dominance can be manifested through informal channels, including through transactions with related parties, and trading with related parties at less than arms-length terms. He believes tight rules do not necessarily close the gap between governance and performance. On the contrary, if a corporation is too dependent on rules, business costs may increase considerably and performance may suffer on account of the rules stifling effects. He argues against the conflict of interest theory, by maintaining that the controlling shareholders can put pressure on directors and top management to deliver the goods and strive for better corporate productivity. In his view, what Singapore needs is not more tightening of corporate governance rules but the development and promotion of board practices and control measures that can pinpoint and supervise conflict of interest situations effectively.

What is the status of corporate governance reforms in Singapore vis- -vis detection and prevention of material accounting irregularities? Based on a sample of more than 100 listed Singaporean firms in 2002 (after the Singapore Code of Corporate Governance took effect), Yao and Wai (2003) collated board and audit committee data, and found that there is a high percentage of independent directors as well as separation of CEO from board chair; there is room for improvement in the accounting and financial expertise of audit committees (39 percent) which is not at par with recommendations of the Singapore Code (at least 66 percent). Audit committee activity via meetings held and percentage attended can be further expanded.

Yao and Wai (2003) also conducted a study on the extent of earnings management and the accounting/financial expertise of the audit committees for Singapore companies from 1998 to 2002. Earnings management is measured by the extent of income-increasing or income-decreasing discretionary accruals that management can construct in the financial reports that affect the neutrality of accounting earnings, and reflect the earnings trend desired by management. With earnings management, the real economic performance of the company can be hidden from the scrutiny of stakeholders. Their analysis shows that with high accounting/financial expertise on audit committees, managers would have fewer opportunities to manage earnings. When audit committees have poor accounting/financial skills the extent of earnings management on profits before tax can hit as much as 10 percent or higher.

THE APO SURVEY

This survey report is part of an APO research study on corporate governance which seeks to examine the relationships among four key areas of corporate governance: ownership, management, social responsibility, and institutional interface as well as its relationship with overall firm performance and productivity.

The survey instrument is a key input to the research. It makes use of a questionnaire of 101 items divided into five parts: basic information about the firm, ownership, management, social responsibility, and interface with external stakeholders.

The governing relationship may be described as follows:

Corporate performance (growth + productivity) =
f(ownership, management, social responsibility, institutional interface).

Participants to the study were drawn from a sample of 420 Singapore-listed companies, comprising 309 mainboard companies and 111 SESDAQ companies. Eight firms were finally selected based on completion of data and willingness to take part in the study.

Primary data were elicited from the questionnaire and interviews were conducted with the consent of the board chairmen and the CEOs of the sample firms.

The survey findings were based on a small but purposive group. Thus any generalized statement must be treated with caution. Some of the aggregated information may only serve as general guides to the likely relationships between variables. It would be inappropriate to appraise the extent of the relationships between the variables.

CHARACTERISTICS OF RESPONDENT FIRMS

Eight firms participating in the survey are listed in Table 1.

Table 1. Participating firms

	1	2	3	4	5	6	7	8
Origin	SIN	SIN	SIN	SIN	SIN	SIN	SIN	SIN
Ownership	CL	CL	CL	CL	CL	CL	CL	CL
Main area of activity	Mfg	Retail	Retail	Retail	Agri-Business	Business services	Mfg	Mfg
Number of employees	243	845	877	641	218	139	5462	4000
Internationalization	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Number of majority shareholders	2	1	2	2	3	1	1	1

Note: SIN —Singapore; CL —Corporation, listed on a stock exchange

The sample firms are Singapore in origin and at present are located in Singapore. They are listed corporations in the mainboard of the Singapore Stock Exchange (SGX) with three coming from the manufacturing sector; another three from retail services; one from business services and the remaining one from agribusiness. These firms source their working capital from the capital markets.

The average employee size of the sample firms is 1,533 but two manufacturing firms have the largest workforce of 5,462 and 4,000 employees. The business services firm has the smallest number of employees at 139. Except for the retail firm and the business services organization, the firms export their products. All firms have individual owners who make important decisions regarding the company s directions through the stocks that they hold. Four companies have one majority shareholder while three have two major shareholders. Only one company has three major shareholders. Three have foreign companies (Hong Kong, Malaysia, US) holding financial stakes.

The firms in the APO survey have company-wide quality and productivity improvement programs such as 5S, suggestion system, continuous improvements, quality circles, TQM, TPM, JIT and six sigma.

PERFORMANCE OF SAMPLE FIRMS

To verify the performance of the surveyed firms, various indicators were chosen and five-year trends were examined. The indicators include value of output, revenue/receipts, gross profit margin, and return on equity. These were the more common financial ratios used to check the financial performance of the firms.[1]

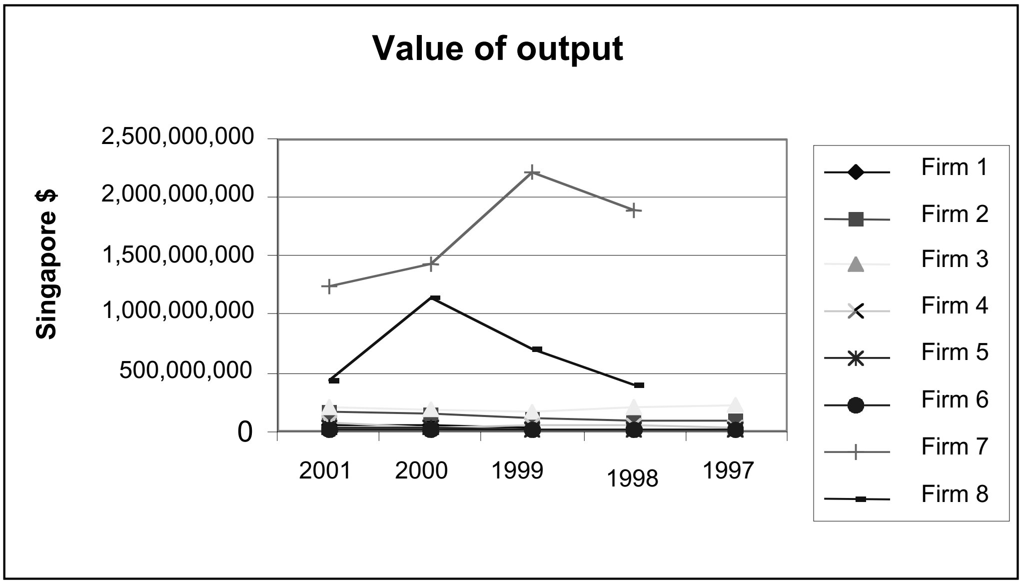


Figure 1. Value of output of respondent firms

[1] In the preceding table and succeeding graphs, the companies can be identified as follows: 1- Mfg Integration Tech Ltd, 2- Osim Int Ltd, 3- C.K. Tang Ltd, 4- Eu Yan Sang Int Ltd, 5- Qianhu Corp Ltd, 6- Eng Wah Org Ltd, 7- Creative Tech Ltd, and 8- Chartered Semicon Mfg Ltd.

Creative Tech and Chartered Semicon appear to have higher output than that of the other six firms. On the whole, the other six firms appear to have quite similar output values.

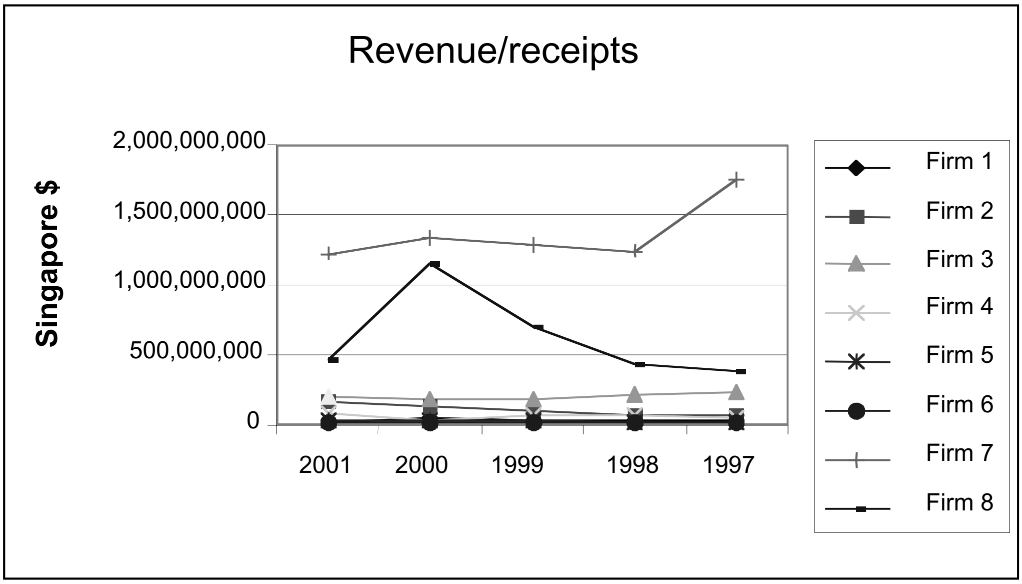


Figure 2. Revenue/receipts of respondent firms

Creative is performing much better than the rest in terms of revenue/receipts,[2] followed by Chartered Semicon.

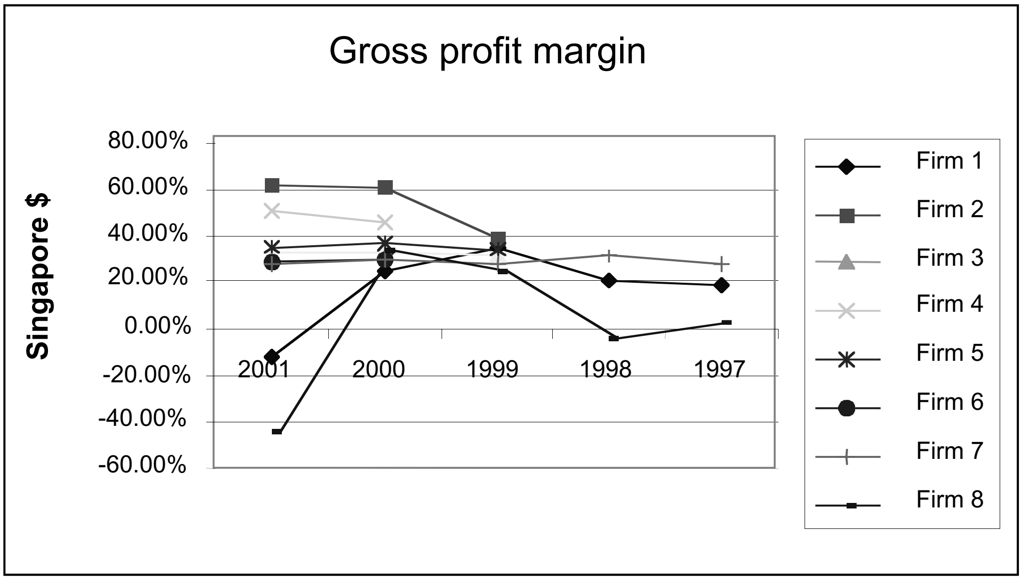


Figure 3. Gross profit margin of respondent firms

---

[2] Revenue/receipts are inflows of assets from selling goods and providing services to customers, including the reduction of liabilities from selling goods and providing services to customers.

The gross profit margins[3] of Chartered Semicon and Mfg Integration Tech appear to be decreasing.

For the return on equity, Chartered Semicon and Creative Tech are performing worse than the other six firms.

OVERVIEW OF THE SINGAPORE CORPORATE SECTOR

The Singapore corporate sector is made up of two key sectors: the financial sector and the non-financial sector. The financial sector accounts for 11.6 percent of the total number of companies in the corporate sector and accounts for 65 percent of the total assets. Due to a consolidation of the financial sector, the number of new companies formed had decreased by 33.1 percent. The non-financial sector is diverse and comprises six key sectors: manufacturing, construction, commerce, transport and storage, insurance services, and real estate and business services. Of these, commerce is the largest (40.4 percent by active companies) while insurance services is the smallest (0.7 percent). In terms of assets, manufacturing, commerce, and real estate and business services are the three largest non-financial subsectors.

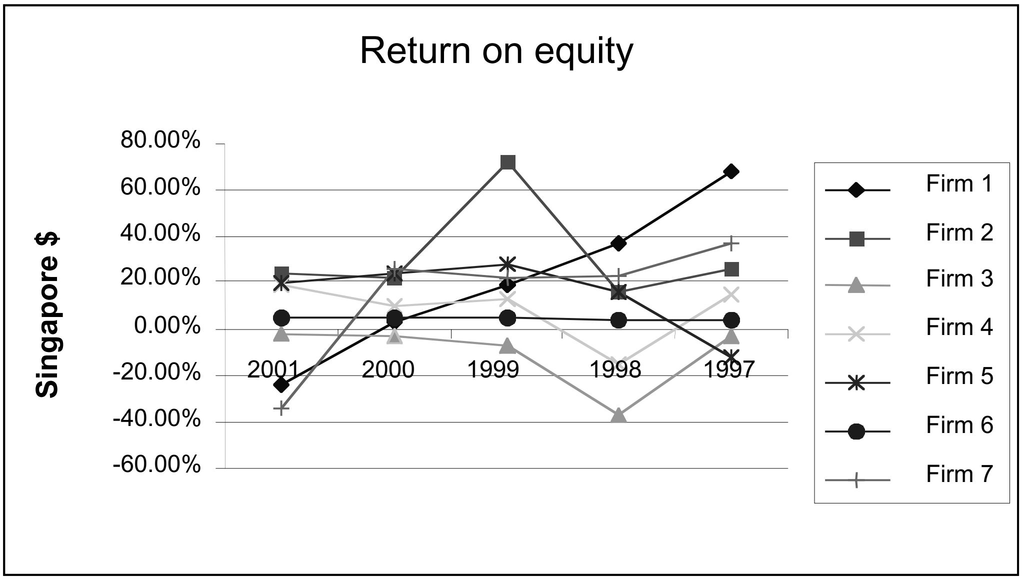


Figure 4. Return on equity of respondent firms

Overall, about 20 percent of the companies in the corporate sector are foreign-owned, with the largest foreign-owned in the financial sector (26.1 percent). In terms of assets, 57 percent are foreign controlled.

Specifically, the commerce sector composed of around 54,400 establishments employed about 349,700 workers. Operating receipts received by the sector totaled US$266 billion in 2000, 24 percent higher compared with the previous year. Operating surplus rose by 6.9 percent to reach US$0.71 billion. The sector generated total value

---

[3] Gross profit margin is the ratio of gross profit to net sales. It indicates the relationship between net sales revenue and the cost of goods sold.

added of US$15.5 billion, representing a growth of 11 percent over that of 1999.

The wholesale trade sector had some 32,500 establishments in 2000, providing jobs to about 190,000 workers. The sector collected total operating receipts of US$248 billion, a rise of 25 percent compared to 1999 figure. Operating surplus rose by 5.6 percent to reach US$4.6 billion. The sector fared well in terms of value added, recording a growth of 5.1 per cent from US$9.3 billion in 1999 to US$9.8 billion in 2000.

There were 18,400 establishments in the retail trade sector in 2000, employing 85,600 workers. Total operating receipts received by the sector amounted to US$16.0 billion, 10 percent higher compared to the 1999 figure. Operating surplus grew by 9.1 percent to reach US$0.8 billion in 2000. The sector s value added of US$4.1 billion represented a growth of 29 percent.

There were 196 establishments in the hotel industry in 2000, a marginal increase of 1.6 per cent over the previous year. Compared to 1999, the overall employment size of 26,100 workers was down by 2.9 percent. Operating receipts received by the hotel industry rose by 12 percent to reach US$1.4 billion in 2000. Total operating surplus stood at US$350 million, a growth of 23 percent over that of 1999. The industry generated value added of US$0.8 billion in 2000. This was 13 percent higher compared to the previous year.

The catering trade consisted of some 3,400 establishments in 2000. Total employment size grew by 1.6 percent or about 48,200 workers in 2000. Operating receipts amounted to US$2.1 billion, a growth of 8.4 percent over the previous year. The industry s operating surplus totaled US$204 million in 2000, representing a rise of 3.0 percent. Total value added generated was US$0.8 billion in 2000, an increase of 7.5 percent.

In 2000, there were some 57,900 establishments employing 517,900 workers in the services sector. Compared with 1999, total operating receipts of the sector rose by 10 percent to reach US$76.0 billion. The sector recorded total operating surplus of US$22.4 billion in 2000, which meant a growth of 14 percent. Value added of the sector amounted to US$27.8 billion, which was 12 percent higher than the preceding year s.

The business services industry, comprising some 17,100 establishments, engaged a total of 148,900 workers in 2000. The industry registered total operating receipts of US$13.4 billion in 2000, or a growth of 13 percent over 1999. Operating surplus rose by 10 percent to reach US$1.8 billion. Also, the industry did well in terms of value added, recording a substantial growth of 15 percent from US$5.3 billion in 1999 to US$6.1 billion in 2000.

There were 6,100 establishments in the real estate industry in 2000, employing a total of 38,800 workers. Total operating receipts collected by the industry declined by 13 percent from US$11.4 billion in 1999 to US$9.9 billion in 2000. Total operating surplus also fell by 1.7 per cent compared to 1999. However, value added of the industry, which stood at US$4.3 billion, showed a positive growth of 2.8 percent.

The community, social and personal services industry comprised 12,900 establishments in 2000 and employed about 106,400 workers. The industry s operating receipts totaled US$6.2 billion, 12 percent higher than that in 1999. Total operating surplus generated by the industry amounted to US$0.9 billion, representing a growth of 5.5 percent. The industry also registered an increase of 9.3 percent in value added, from US$3.2 billion in 1999 to US$3.5 billion in 2000.

Characteristics of the corporate sector

With robust economic expansion the number of companies, their equity and assets posted moderate growth in 2000; profitability and operating efficiency also improved. As of end of 2000, there were 93,590 active companies, an increase of 2.5 percent over that of 1998. In 2002, there was a slight decline to 93,238. While the growth in 1999 was higher than that of 1998 (1.6 percent) which saw a larger number of companies winding up their operations during the economic downturn, the growth was significantly lower than the average annual growth of 13 percent between 1990 and 1997. From 1999 to 2002, there was a decline of 0.4 percent. Construction registered the biggest growth (34.1 percent), followed by the transport sector (4.4 percent). The manufacturing sector saw the biggest decrease (10.5 percent).

Over the past few years, the industrial distribution of the corporate sector remained relatively static. The financial and business sector accounted for about 32.3 percent while the non-financial sector, 67.4 percent. The commerce sector had the largest number of companies, accounting for 40.4 percent of all the active companies in 1999 followed by the real estate and business services sector, comprising 21 percent of the total number of companies.

From 1995 to 2000, there was a rapid increase in the growth of new companies—a hefty 37.5 percent in 2000, which was the highest level recorded in a decade. All industries saw increases in company formation, with the transport and communications industry posting the largest increase at 122 percent.

Table 2. Number of active companies by industry (as of year-end)

	Total 1999	1999 as percent	Total 2002	Percent change
Financial sector & business services	30,478	32.6	29,802	-0.2
Non financial sectors	63,112	67.4	63,436	0.5
Manufacturing	9,140	9.8	8,199	-10.3
Construction	6,051	6.5	8,114	34.1
Commerce	37,806	40.4	35,295	-0.7
Transport & storage	6,513	7.0	6,800	4.4
Other	3,602	3.9	5,028	39.5
Total	**93,590**	**100.0**	**93,238**	**-0.4**

Source: Singapore Department of Statistics

However, with the economic slowdown of 2001, company formation decreased by 23 percent. All the major industries experienced declines in company formation topped by the transport and communications sector. It shrank by 49 percent in 2001 after achieving a record growth of 122 percent in the previous year. Web hosting services, software consultancy and IT development were among those with fewer newcomers. During the same period, company closures increased by 5.5 percent (5,593 in 2001, up from 5,303 in 2000). Among the industries, financial and business services, and transport and communications sectors registered the largest cessation increases of 15 and 11 percent, respectively.

A company is foreign-controlled if more than half of its paid up shares is owned by foreign investors (Table 3). In 1999, about one in five companies was foreign-controlled. In terms of number, there were 19,050 foreign-controlled companies, representing a marginal decline compared to 19,358 in 1998. In contrast, the number of domestic companies increased from 71,925 in 1998 to 74,540 in 1999.

There was a substantial presence of foreign-controlled companies in all the major sectors except in the construction sector where only 7.0 percent of the companies were foreign-controlled. Insurance and financial services sectors had the largest presence of foreign-controlled companies; they constituted 27 percent and 26 percent of the total companies in the two sectors.

Table 4 shows that of the US$278.9 billion shareholders equity, US$124.7 billion or 45 percent was concentrated in the financial services sector although the sector only accounted for 12 percent of the companies. The manufacturing sector held 16 percent while 15 percent went to real estate and business services.

Of the total shareholders equity in 1999, two-thirds (or US$182.9 billion) belonged to local-controlled companies and the one-third (or US$96.4 billion) to foreign-controlled companies. The bulk of the shareholders equity held by local-controlled companies was concentrated mainly in financial services (48 percent), followed by real estate and business services (19 percent). As to foreign-controlled companies, the shareholders equity was also concentrated in the financial services sector (39 percent) although the share in manufacturing (35 percent) was also equally significant.

Table 3. Number of active companies by control (as of year-end)

	Domestic		**Foreign controlled**		**Foreign-controlled as % of total**	
	1998	**1999**	**1998**	**1999**	**1998**	**1999**
Total no. of companies	71,925	74,540	19,358	19,050	21.2	20.4
Distribution of companies (%)						
Financial sector	10.0	10.7	16.1	14.9	30.2	26.1
Non financial sectors	90.0	89.3	83.9	85.1	20.1	19.6
Manufacturing	10.4	9.8	6.9	9.6	15.2	19.9
Construction	9.0	7.6	2.3	2.2	6.4	7.0
Commerce	39.8	39.0	45.0	45.8	23.3	23.1
Transport & storage	7.1	6.6	6.8	8.3	20.5	24.2
Insurance services	0.6	0.6	1.1	0.9	31.8	27.0
Real estate & business services	19.3	21.9	20.7	17.5	22.4	17.0
Others	3.8	3.8	1.1	0.8	7.0	5.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**21.2**	**20.4**

Source: Singapore Department of Statistics

The share of foreign-controlled companies to total shareholders equity in the corporate sector rose further to 35 percent in 1999 from 33 percent in 1998. Clearly, the manufacturing sector was dominated by foreign investors since three-fourths of shareholders equity in manufacturing belonged to foreign-controlled companies. The other sectors with substantial share of equity owned by foreign-controlled companies were commerce (52 percent) and insurance services (44 percent).

Table 4 shows that of the US$314 billion in company assets, nearly 50 percent belonged to the financial services sector. The sector accounted for only 12 percent of companies and 45 percent of shareholders equity, but a disproportionate 65 percent share of assets because of the large and highly liquid assets of banks.

About 54 percent of assets held by local companies were in the financial services sector. Another 18 percent were in the real estate and business services sector. Of the assets held by foreign-controlled companies, an even higher proportion of 75 percent belonged to the financial services sector. The manufacturing and commerce sectors

Table 4. Amount of shareholders equity by industry (US$M) (as of year-end)

	Total 1999	Total 2000	Percent change
Financial sector	124,398.2	149,048	19.8
Non financial sectors	154,075.3	165,128	7.2
Manufacturing	44890.5	55,043	22.6
Construction	2,205.0	1,887	-14.4
Commerce	25,450.6	27,364	7.5
Transport & storage	25,836.4	24,848	-3.8
Insurance services	2,697.0	2,516	-6.7
Real estate & business	41,637.6	45,921	10.3
Others	11,525.9	7,549	-34.5
Total	**278,973.54**	**314,176**	**12.6**

Source: Singapore Department of Statistics

Table 5. Amount of shareholders equity by control (US$M) (as of year-end)

	Total 1999	Total 2000	Percent change
Domestic	182,715.9	201,765	10.4
Foreign-controlled	96,257.7	112,412	16.8
Total	**278,973.54**	**314,177**	**12.6**

Source: Singapore Department of Statistics

Table 6. Total assets by industry (US$M) (as of year-end)

	Total 1999	Total 2000	Percent change
Financial sector	813,877.8	915,125	12.4
Non financial sectors	430,140.2	456,876	6.2
Manufacturing	92,562.3	109,760	18.6
Construction	24,430.9	24,696	1.1
Commerce	97,827.2	104,272	6.6
Transport & storage	55,238.9	58,996	6.4
Insurance services	19,679.3	23,324	18.5
Real estate & business services	115,719.9	122,108	5.5
Others	20,681.5	15,092	-27.0
Total	**1,244,017.9**	**1,372,000**	**10.3**

Source: Singapore Department of Statistics

accounted for 9.6 percent and 8.2 percent, respectively of assets owned by foreign-controlled companies.

In 2000, foreign-controlled companies held 57 percent of the total assets of US$1,372 billion in the corporate sector although they accounted for only one-fifth of all companies. In the manufacturing sector, 70 percent of the total assets belonged to foreign-controlled companies. Foreign-controlled companies also accounted for more than half of the assets in the financial services (64 percent), commerce (59 percent) and insurance services (52 percent) sectors.

Table 7. Total assets by control (US$M) (as of year-end)

	Total 1999	**Total 2000**	**Percent change**
Domestic	539,965.9	587,824	8.9
Foreign-controlled	704,052.0	784,176	11.4
Total	**1,244,017.9**	**1,372,000**	**10.3**

Source: Singapore Department of Statistics

The rate of return on total assets (ROA) and the rate of return on total equity (ROE) were used to assess the performance of the corporate sector. ROA is computed by dividing pre-tax net profits in the current year (before deducting interest payments) by the average of total assets at the beginning and end of that year. It measures company profitability, indicating the rate of return that companies have earned on the capital provided by the shareholders after accounting for payments to all other capital suppliers.

Table 8. Rate of return on equity (ROE) by control (as of year-end, in percent)

	Domestic companies		**Foreign controlled companies**		**Total**	
	1999	**2000**	**1999**	**2000**	**1999**	**2000**
Financial sector	13.1	13.2	5.0	8.5	10.6	11.8
Non financial sectors	8.7	9.6	15.2	18.7	11.2	13.5
Manufacturing	4.7	14.6	16.7	20.0	13.7	18.7
Construction	-8.4	8.3	-1.3	7.1	-6.4	7.9
Commerce	3.5	3.3	16.7	21.3	10.2	13.4
Transport & storage	15.1	14.8	8.6	30.2	14.4	17.1
Insurance services	19.3	24.2	17.0	15.9	18.1	20.0
Real estate & business services	9.7	6.9	10.5	5.6	9.8	6.7
Others	4.9	7.3	-97.1	n.a.	4.4	5.1
Total	**10.7**	**11.4**	**11.4**	**14.9**	**11.0**	**12.7**

Source: Singapore Department of Statistics

In general, foreign-controlled companies proved more profitable than domestic ones. Foreign-controlled companies in the non-financial services sector such as manufacturing and commerce were consistently more profitable than local ones. Foreign-controlled companies in these sectors registered double-digit rate of ROEs (non-financial: 18.7 percent, commerce: 21.3 percent) whereas their respective local counterparts only managed single-digit rate of ROEs (non-financial: 9.6 percent, commerce: 3.3 percent). Higher operating efficiency and a more diversified market for their products and services may have contributed to their higher profitability. However, in the construction, and transport and communications sectors, local companies enjoyed higher profitability than foreign-controlled firms.

Table 9 indicates that the operating efficiency of companies improved slightly in 2000 compared with a year ago. Overall, the rate of ROA went up slightly from 5.1 percent in 1999 to 5.8 percent in 2000. Significant improvements in the rate of ROA were registered in the manufacturing, financial and commerce services sectors. On the other hand, the rate of ROA in the insurance services, and real estate and business services sectors declined.

Manufacturing had the highest ROA rate of 10.5 percent, followed by transport and communications (8.7percent). Construction and insurance services registered the lowest at 1.2 percent and 2.8 percent, respectively.

Table 9. Rate of return on assets (ROA) by control (as of year-end, in percent)

	Domestic companies		**Foreign controlled companies**		**Total**	
	1999	**2000**	**1999**	**2000**	**1999**	**2000**
Financial sector	5.6	6.1	4.7	5.5	5.0	5.7
Non financial sectors	4.3	4.6	6.6	*7.9*	5.2	6.0
Manufacturing	3.0	7.0	10.2	12.0	7.9	10.5
Construction	-0.5	1.2	0.1	1.1	-0.3	1.2
Commerce	2.4	2.4	5.5	6.8	4.1	4.9
Transport & storage	9.5	8.4	4.2	9.3	8.2	8.7
Insurance services	3.4	3.6	2.7	2.2	3.0	2.8
Real estate & business services	4.7	3.9	4.9	3.2	4.7	3.8
Others	3.6	4.6	-8.2	-24.1	3.2	3.2
Total	**5.0**	**5.4**	**5.2**	**6.1**	**5.1**	**5.8**

Source: Singapore Department of Statistics

Table 10. Financial leverage ratio in the corporate sector

	Domestic companies		**Foreign controlled companies**		**Total**	
	1999	**2000**	**1999**	**2000**	**1999**	**2000**
Financial sector	3.4	3.2	14.4	13.2	6.8	6.2
Non financial sectors	2.7	2.7	*2.8*	*2.7*	2.7	2.7
Manufacturing	2.6	2.4	1.8	1.8	2.0	1.9
Construction	8.7	9.7	9.0	8.3	8.8	9.2
Commerce	3.3	3.5	4.0	3.9	3.6	3.7
Transport & storage	1.8	1.9	4.4	4.2	1.1	2.3
Insurance services	5.8	6.8	6.4	7.4	6.1	7.1
Real estate & business services	2.9	2.6	3.2	3.1	2.9	2.7
Others	1.7	2.1	11.4	-7.9	1.8	2.4
Total	**3.0**	**2.9**	**7.1**	**6.7**	**4.5**	**4.3**

Source: Singapore Department of Statistics

Overall, foreign-controlled companies with a ROA of 6.1 percent were more efficient than their local counterparts which had a ROA of 5.4 percent in 2000. Foreign-controlled companies in manufacturing and commerce were consistently more efficient than their local counterparts. The gap in manufacturing between the two groups was largest at 5 percentage points (foreign-controlled: 12 percent; local-controlled: 7 percent). In the transport and communications sector, domestic companies became less efficient than their foreign counterparts. In 2000, the ROA of local companies in the sector was 8.4 percent whereas that of foreign-controlled ones stood at 9.3 percent.

The financial leverage ratio (FLR) measures the access of companies to capital from related companies and international capital market. FLR refers to the proportion of total assets over total equity. Overall, foreign-controlled corporations had a higher FLR (7 times) compared to local-controlled ones (3 times). The disparity was most apparent in the financial services sector where the FLR of foreign-controlled companies was 14 times compared to 3.4 times for their local counterparts. In the other sectors the difference was not significant.

Role of the corporate sector in the economy

In general, the services producing industries contributed more to the GDP, accounting for 1.8 times that of the goods producing industries. The gap widened in 2001 as there was an increase of 1.3 percent in the former but a decrease of 12.7 percent in the latter. In 2001, the contribution from the goods producing industries decreased by 12.7 percent as compared to 2000. The largest decrease was in manufacturing which was 16.3 percent. Among the services producing sectors the business services saw the largest increase at 4.1 percent. These figures confirmed the huge impact of the corporate sector on the GDP. The largest contributors were manufacturing, followed by commerce and financial services.

Foreign-controlled companies have a substantial presence in Singapore. While by far fewer in number than local companies they, however, accounted for some 42 per cent of GDP. On the other hand government-linked companies (GLCs) were estimated to have contributed 12.9 percent to GDP in 1998. Although this was substantially lower than what was widely perceived, the amount was not insignificant. It amounted to more than a quarter of domestic companies estimated contribution of 46.0 per cent to GDP. Their contribution to Singapore s GDP will most likely decline given the government s intention to reduce its investment in GLCs.

Table 11. GDP by industry (US$M)

	2000	2001	2002Q1
Goods producing industries	32,714.2	28,594.6	6,595.6
Manufacturing	25,247.7	21,161.7	4,896.2
Construction	5,852.9	5,537.1	1,280.5
Utilities	1,493.4	1,784.5	390.6
Other goods industries	120.1	111.4	28.2
Services producing industries	63,115.5	63,994.2	15,984.1
Wholesale & retail trade	15,684.2	14,945.4	3,651.4
Hotels & restaurants	2,467.7	2,466.8	593.7
Transport & storage	10,445.5	10,170.3	2,575.9
Financial services	11,384.6	11,834.5	2,952.8
Business services	12,679.9	13,213.8	3,143.1
Other services industries	10,453.5	11,363.5	3,067.2
Total	94,051.9	90,267.8	21,917.9

Source: Singapore Department of Statistics

Singapore s outward-oriented development strategy pays off handsomely with its strong economic performance. Over the years, Singapore s exports have evolved from labor-intensive to higher capital-and skill-intensive products, such as electronics and chemicals. The significance of services sector to the Singapore economy also grew, as shown by the increasing share of the financial and business sectors of the economy.

In Singapore, the corporate sector is recognized as the engine of the economy while government s role is to provide a stable and conducive environment for private initiatives to thrive and flourish. The macroeconomic policies are aimed towards long-term investment in the economy. Fiscal policy is directed primarily at promoting long-term economic growth, rather than distributing income. Over the years, Singapore has achieved a high level of foreign reserves as a result of its healthy fiscal position and consistent budget surplus and is reputed to have the strongest sovereign credit rating for long-term foreign-currency debt in Asia.

Its longer-term economic strategies and policies are constantly under study to make them more adaptive to changing priorities and situations. At present, measures are being put in place to develop Singapore as a world-class financial center. For example, the domestic banking and insurance industries are undergoing liberalization for stronger foreign participation. Moreover, Singapore has also adopted a more consultative approach in the development and its supervision of the financial sector, and has put more emphasis on risk-focused supervision rather than regulation. Various initiatives have also been introduced to give fund managers greater access to domestic funds, widen the debt market and refit corporate governance.

Productivity performance of the corporate sector

All industries experienced a decrease in labor productivity in 2001. The decrease of 5.4 compared to an increase of 5.9 in 2000 showed the impact of the economy on performance. The goods producing industries saw a drop from an increase of 9.2 in 2000 to a decrease of –9.1 in 2001, a drastic 201.1 percent drop from 1999. The largest drop was in manufacturing, —216.4 percent. The decrease was lesser in degree for the services producing industries at –3.6. Among the services producing industries, wholesale and retail, and business services had the steepest drop.

Table 12. Changes in labor productivity by industry
(compared with the same period in the preceding year)

	2000	2001	2002Q1
Goods producing industries	9.2	-9.1	0.7
Manufacturing	11.6	-13.5	-0.3
Construction	-0.5	0.2	-1.1
Services producing industries	3.2	-3.6	-1.3
Wholesale & retail trade	10.9	-6.2	-3.5
Hotels & restaurants	6.5	-4.4	-4.4
Transport & storage	3.5	-1.3	4.8
Financial services	-3.5	-3.8	-2.0
Business services	-2.7	-6.7	-1.2
Total	*5.9*	-5.4	-0.6

Source: Singapore Department of Statistics

The first quarter of 2002 saw some slight improvement. The manufacturing sector seemed to have picked up as indicated by the 0.3 decrease in labor productivity, while construction appeared to have gotten worse. For wholesale and retail trade, the decrease in 2001 got bigger. Only the transport and storage sector registered positively in the services producing industries (Table 12).

BREAKDOWN OF LISTED FIRMS BY OWNERSHIP CONTROL

Based on a study by Claessens, Djankov and Lang (2000), the listed firms are examined. The concentration of voting rights is critical since it enables owners to determine dividend policies, investment projects, personnel appointments, and other related matter. Corporations can be classified into widely-held and those with controlling owners. A widely-held corporation is one which does not have any owners with significant control rights. Owners are further divided into four categories: families, the state, widely-held financial institutions such as banks and insurance companies, and widely-held corporations.

Table 13. Control of publicly traded companies in Singapore

	Corporations with ultimate owner			
Widely held corporations	Family	State	Widely held financial	Widely held corporation
1.4	52.0	23.6	10.8	12.2

Source: Claessens, Djankov and Lang , 2000

The distribution of ultimate control among the five ownership groups identified is shown in Table 13. About 52 percent of companies are in family hands and almost a quarter (23.6 percent) are state-controlled which are mainly GLCs. The limits to the share of ownership that banks can have in other companies greatly restricted the role of widely-held financial institutions.

To further examine the ownership structure, the following categories of ownership structure are used:

- Own=20 percent control is the average minimum percent of the book value of common equity required to control 20 percent of the vote;
- Pyramids with ultimate owners (when companies are not widely-held) where the controlling owner exercises control through at least one publicly-traded company,
- Cross-holdings where the company has a controlling shareholder and owns any amount of shares in its controlling shareholder or in another company in her chain of control,
- Controlling owner alone where a second owner who holds at least 10 percent of the stock does not exist, and
- Management where the CEO, board chairman or vice-chairman are from the controlling family.

Singapore companies show a high incidence of pyramiding in which shareholders who own a majority of the stock of one corporation in turn holds a majority of the stock of another (Table 14). In cross-holdings patterns where a company further down the chain of control has some shares in another company in the same business group, 15.7 percent of companies have some cross-ownership. Around thirty seven percent of Singapore firms have single ultimate owners.

Table 15 shows the separation of ultimate cash-flow and control rights of corporations in the hands of the largest controlling holder, for all companies where the largest control holder has at least 5 percent of the vote. The corporations exhibit considerable cash-flow rights at an average of 20.19 percent. One fourth of them have more than 30 percent of the cash-flow rights with the largest block-holder, while a quarter of the companies have only

Table 14. Means of enhancing control in corporations

	Singapore (percentage of total)	**East Asia**
Own=20%con	20.00	19.76
Pyramids with Ultimate Owners	55.0	38.7
Cross holdings	15.7	10.1
Controlling owner alone	37.6	67.8
Management	69.9	57.1

Source: Claessens, Djankov and Lang , 2000

20 percent of the cash-flow rights with the largest block-holder. The concentration of control rights in the largest block-holder is similar to the concentration of cash-flowrights. The separation of ownership and control is quite high, with the typical large control holder having 10 ultimate votes for each eight direct shares held.

Table 15. Separation of cash-flow and voting rights

	Mean	Standard Deviation	Median	1st Quartile	3rd Quartile
Cash-flow rights	20.19	10.82	20.00	13.27	29.66
Voting rights	27.52	11.12	29.35	18.52	41.12
Ratio of cash-flow to voting rights	0.794	0.211	0.800	0.600	1.000

Source: Claessens, Djankov and Lang , 2000

Table 16 examines whether the separation of ownership and control varies significantly by type of owner and by firm size. To look at the separation of ownership and control across different sizes of firms, market capitalization is used as a proxy to identify the largest twenty, the median fifty, and the smallest fifty companies in each country sample. The first group of companies is also the largest twenty companies in their respective stock markets.

Table 16. Separation of ownership and control across type of the largest controlling shareholder and company size

Category	**Family**	**State**	**Widely held financial**	**Widely held corporation**
All firms	0.722	0.685	0.956	0.944
Largest 20	0.604	0.794	n.a	n.a.
Middle 50	0.693	0.659	1.000	1.000
Smallest 50	0.768	0.655	1.000	0.907

Source: Claessens, Djankov and Lang , 2000

The results show several interesting patterns. In Singapore, family-controlled firms have moderate separation of ownership and control. Firms controlled by widely-held financial institutions have lower separation (0.956). State-controlled firms show the most separation among all types of firms (0.685). As for the pattern across company size, the largest firms display the most separation of ownership and control. The findings suggest that firms controlled by families are most likely to have separation between ownership and control. Small firms are most likely to have larger wedge between cash-flow and control rights, regardless of the type of ownership. Families and state seem to use mechanisms to separate ownership and control in large firms.

Table 17. Concentration of family control

Average Number of Firms per Family	Percent of total value of listed corporate assets that families control			
	Top 1 Family	Top 5 Families	Top 10 Families	Top 15 Families
1.26	6.4	19.5	26.6	29.9

Source: Claessens, Djankov and Lang , 2000

To look at issues of market entry, access to financing, and government policy, the concentration of control of corporate assets in the hands of one or more family groups is important. In Singapore, the largest number of companies controlled by a single family is about 1.26 on average.

The APO survey results corroborate these findings on family ownership and control. The majority ownership in the respondent firms is principally held by one individual shareholder-owner. This is typically the founder, a family, investment company of the government, and other individuals. The proportion of shares held by the top shareholder is from 50 to 65 percent. That held by the top five shareholders as well as the top 10 shareholders is between 66 and 80 percent. Two of the firms also have mutual holding of stocks between them and affiliated companies. Three years ago, the firms were family owned, individually owned, or ran by a board of directors. They were originally private and limited liability companies.

LEGAL AND REGULATORY FRAMEWORK[4]

Singapore has shifted from a predominantly merit-based philosophy of regulation towards a predominantly disclosure-based philosophy of regulation. In the former, the merit of transactions is largely determined by regulatory or quasi-regulatory bodies such as the Monetary Authority of Singapore (MAS) and the Singapore Exchange (SGX). Strict rules governed what companies can or cannot do, hence, the role of disclosure is limited. In the latter, the merit of transactions is largely determined by shareholders which requires a high level of disclosure and monitoring by shareholders rather than regulators. The shift from a merit-based to a disclosure-based philosophy not only changes the role of regulators, but also requires fundamental changes in areas such as legal and regulatory framework, accounting and auditing standards, codes of best practices, as well as in the role of third-party watchdogs such as the news media and investors associations.

[4] Most of the discussions in this section were drawn from the 2001 Corporate Governance Committee Report.

Ownership

Substantial shareholders

Under the Companies Act (s.201), the directors report must disclose the interests of each director in the shares of the company (or its related companies). These interests include both direct and deemed interests. Under the Companies Act (s. 88), all listed companies must maintain a register of substantial shareholders, defined as shareholders with an interest in 5 percent or more of the voting shares of the company. The SGX listing rules also require the disclosure of substantial shareholders and their direct and deemed interests, and the names and holdings of the top 20 shareholders of the company. However, there are several limitations with the disclosure of interests in voting shares. Since the disclosure of the top 20 shareholders relates to direct interests only, the disclosure often includes many nominee shareholders. Thus, the identity of the beneficial shareholders is not known.

Although the disclosures of substantial shareholders include direct and deemed interests, under the Act, more than one shareholder can have deemed interests in the same shares. Hence, there are often significant overlapping substantial shareholders interests reported, leading to cumulative substantial shareholdings of more than 100 percent of the shares of the company. More significantly, substantial shareholders often include investment holding or other private companies, and often it is not easy to determine the controlling shareholders of these companies. In short, control over voting rights is not very clear.

Foreign ownership

As of June 30, 1998, there were a total of 31 companies in the Singapore Stock Exchange (SGX) that had imposed restrictions on foreign ownership. As mentioned earlier, foreign ownership limits were imposed by statute in the banking and news media industries but in other cases, these restrictions were initiated by the firms themselves through amendments to their Memorandum and Articles of Association (M&A). Strategic considerations (i.e., defense) and national interests justify the imposition of foreign ownership limits in certain areas. Where foreign shareholdings have reached the statutory or self-imposed limit, shares are traded in separate local and foreign tranches. In general, foreign tranche shares trade at a significant premium over local shares. This has provoked a debate as to whether firms should remove foreign shareholding limits or not.

The adoption of foreign ownership limits, whether statutory or self-imposed, can facilitate managerial entrenchment. Foreign ownership restrictions prevent control of the firm from being passed to the hands of foreign investors. It also reduces the ability of foreign investors to acquire large stakes in these firms, thereby reducing the potential monitoring that can be provided by large foreign investors. It can also lessen the susceptibility of firms to takeovers. Where firms have dual listings of foreign and local stocks, the foreign stocks tend to trade at a substantial premium over the local stocks. The law requires the mandatory takeover (triggered when an investor acquires more than 25 percent of the voting stocks) to be done at the highest price paid by the acquirer for the stocks over the last 12 months. If the acquisition is done solely through the purchase of local stocks, then the highest price paid is not likely to be higher than the prevailing foreign price. This means that foreign stockholders are unlikely to sell their stocks to the acquirer. To the extent that foreign stockholders exercise some control over the firm s voting rights, the fact that transfers of restricted stocks have to be approved by the firm basically precludes a takeover of the firm.

The government has recently removed the statutory 40 percent foreign shareholding limit for banks. Because of this change, the five local listed banks have merged their foreign and local shares. The market apparently has reacted positively to this development. However, the five percent limit on shareholding by a single party in banks remains, and this five percent limit applies to nominee interests. Institutional investors holding nominee interests cannot acquire shares above the limit for banks. Large institutional investors are thus discouraged from investing in these companies. The restriction cuts incentives to participate in the corporate governance of these companies. There is now considerable empirical data worldwide pointing to the positive role unaffiliated institutional shareholders (such as pension and mutual funds) play in corporate governance.

While recent changes in disclosure requirements, board structure and committees for banks are likely to improve the governance of banks in Singapore, there is the view that allowing institutional investors (including foreign institutional investors) to hold greater stakes in banks would result in more substantial improvements in the corporate governance of banks. Several other companies, such as those within the Singapore Technologies (ST) Group and NOL have raised or removed their foreign shareholding limits. Moreover, companies such as the ST units and Singapore Press Holdings have merged their foreign and local shares. This is a positive development as large foreign institutional investors can become more actively involved in corporate governance of Singapore companies.

Buybacks of shares

Another development in corporate governance in Singapore is the legalizing of share buybacks. Where a company has excess cash and insufficient investment opportunities, share buybacks can be an effective instrument for company management to return excess cash to shareholders. This can therefore reduce the free cash flow problem. Since the legalization of share buybacks more than a year ago, 11 companies have initiated share buyback programs. According to a recent report, seven of these companies have experienced increases in stock prices (above the average price at which the shares were bought back).

Employee share option schemes

In recent years, many Singapore companies have adopted employee share option schemes (ESOS) as a way to compensate directors, managers and employees. However, most companies issue options only to senior management and directors, although there have been several instances wherein stock options were also provided for lower-level employees. Six of the surveyed firms have employee-owned shares. The proportion of shares held ranges between 15 percent and 25 percent. In seven of the firms, managers own shares of the companies. The amount of shares owned ranges from a low of five percent to a high of 30 percent.

Stock options can be an effective tool for drawing together the interests of managers/employees and shareholders and forging a stronger link between pay and performance, and thus play an important corporate governance function. It has been noted though, providing proper incentives through stock options requires a well-designed ESOS. The recent US experience indicates stock options can be contentious; often they lead to an inflation of executive compensation. Further, questionable practices such as repricing options can diminish the incentive effects associated with options.

Since the cost of options are not required to be reported as compensation expense in the income statement, companies often regard stock options as being costless and as a means for shifting compensation expense off the income statement, by substituting it for cash compensation. To be sure, stock options are not without cost because they lead to a dilution of earnings per share and shareholders interests.

Preventing abuse in the use of options requires transparency in the determination of option award and disclosure of the cost of options. In Singapore, ESOS are subject to rules in the SGX Listing Requirements (Practice Note No. 9h) and the Companies Act 1990. The Companies Act (s. 201) requires the number and class of shares for which options are issued, date of expiration of the options, and basis upon which the options may be exercised to be disclosed in the directors report. The maximum expiration term of options is 10 years.

The SGX rules relate to matters such as exercise price, expiration terms, vesting periods, total size of the scheme, number of options issued to particular individuals, participation in ESOS, and administration of the ESOS. In general, options are issued at market price. However, options may be issued at a discount of up to 20 percent provided they have a minimum vesting period of two years and are approved by shareholders. Controlling shareholders and their associates who are directors or employees may participate in the ESOS provided it is approved by independent shareholders for each person. Award of options to controlling shareholders, awards to employees receiving in aggregate five percent or more of the options, and aggregate number of options to be made available for grant have to be approved by independent shareholders. For main board companies, the number of shares available under the ESOS must not exceed 15 percent of the issued share capital. There are limits set on the proportion of options that may be issued to controlling shareholders and to each individual participant. A board-level committee administers the ESOS.

In the annual report, the name of each participant who is a director, controlling shareholder or who receives five percent or more of the total number of options available must be disclosed, together with the number and terms of options, aggregate number of options issued since commencement of the ESOS, aggregate number of options exercised since commencement, and aggregate outstanding options.

In Singapore, the use of vesting schedules, whereby only a portion of the options issued can be exercised each year, and other features such as indexing of the exercise price are rare occurrences. There appears to be a need for directors to pay more attention to the design of ESOS, how option awards are determined, and adequate disclosure of the determination and cost of options.

Management

Shareholder rights

Shareholders have the right to participate in and to be adequately informed on major corporate developments. Companies should be encouraged to welcome the views and inputs of shareholders, and to respond to investors' concerns (CGC, 2001). The Companies Act of 1990 serves as the main legal infrastructure for protecting the rights of shareholders. In the Articles of Association, firms are permitted to issue shares with different entitlements on voting, dividends and return of capital. Section 64 requires ordinary shares to carry one vote per share. Shareholders rights also include voting by proxies, although cumulative voting for directors is not permitted (Mak and Phan, 2001).

In Singapore, shareholders find it easy to institute civil right of action for insider trading and to obtain compensation for losses from insider trading. Aggrieved shareholders can file civil actions for damages and penalties for insider trading even without first securing a criminal conviction. In addition, the time bar has been raised from two to six years. Since civil actions require a lesser burden of proof than criminal actions, the rights of minority shareholders are protected. Even so, unearthing proofs entail costs and this will likely pose as an impediment to effective civil actions for insider trading violations.

The shareholders of the surveyed firms have several rights, including right to vote according to shares, proxy voting, right to maintain proportions ownership of firm under any financing plan, right to resolve disputes within firms, right to demand independent audit and have membership in independent board committees. Seven of the firms have minority shareholders represented in the board. These firms need not exert any effort to remove without cause, minority representatives.

Roles of board of directors

Section 157 of the Companies Act requires directors to be honest at all times and to be reasonably diligent in performing their duties. In addition, directors are also subject to common law and equitable rules established by cases. Directors have three major categories of duties fiduciary duties, duties of skill, care and diligence and statutory duties. However, apart from these broad duties and responsibilities of directors established by statute and case law, the responsibilities of boards of directors are relatively vague. The SGX BPG is silent on board responsibilities. Indeed, the PWC (1997) survey of companies listed the clearer definition of responsibilities of directors as the most important area requiring improvement.

In the APO survey of companies, however, the kinds of decisions made by the owner/major shareholders, board, CEO, and COO vary. The owner/major shareholders decide on sanctions and rewards for management performance, management appointments and executive compensation, board composition and membership, and matters related to mergers and acquisitions.

The board makes decisions on a wide range of matters which include corporate thrusts and direction, corporate and financial strategic matters, sanctions and rewards for management performance, management appointments and executive salary, board composition and membership, day-to-day operations, declarations of dividends, profit or gain sharing, business expansion/contraction, mergers and acquisitions, productivity improve measures, and customer satisfaction/quality issues.

The types of decisions made by CEOs differ across the firms. Most of the CEOs set the corporate thrust and direction, administer sanctions and rewards for management performance as well as handle the day-to-day operations. On the other hand, the COO seems to focus on three areas: day-to-day operations, productivity improvement measures, and customer satisfaction/ quality issues.

As to the board of directors, it is mainly responsible for monitoring management on behalf of shareholders. To perform this role effectively the board must enjoy some measure of independence from management. Two indicators of this are the separation of the CEO and chairperson roles, and the inclusion of non-executive, especially independent, directors. In both the PWC (1997) and PWC (2000) surveys, these two areas were identified as requiring improvement. It should be noted that in most of the firms surveyed by APO, the board chairman is also the CEO.

The PWC (1997) survey reported that 17 percent of companies had two non-executive directors; 23 percent had three, and 60 percent had more than three. However, non-executive directors appeared to be valued more for their contacts, rather than for their independence *per se*. This raises questions as to the criteria set for selecting directors. In the case of the separation of the CEO and chairperson roles, 37 percent of the companies indicated that they already split these roles. In the APO survey, the board appoints outside directors in all cases. The degree of independence of management in making operational decisions ranges from high to moderate.

Appendix 1A of the SGX listing rules requires companies applying for listing to have at least two non-executive directors who are independent and free of any material business or financial connection with the issuer. Since the Companies Act (s. 210B) requires listed companies to have an audit committee of at least three members, with a majority being independent, listed companies are also required to have at least two independent directors on the board. Specifically the act, through its audit committee requirements, considers the following directors to be non-independent: executive directors of the company or any related corporation; a spouse, parent, brother, sister, son or adopted son or daughter or adopted daughter of an executive director or of any related corporation; or any person having a relationship which would, in the opinion of the board of directors, interfere with the exercise of independent judgment in carrying out the functions of the audit committee (s.201B(2)). Section 201B(10) further defines a non-executive director as "a director who is not an employee of and does not hold any other office of profit in the company or in any subsidiary or associated company of the company in conjunction with his office of director and his membership of an audit committee". Although both the listing rules and the act require two directors who are non-executives of the company or its related companies, who are not immediate family members, and who do not have "material" financial or business interests with the company, it is still possible for more distant relatives and "grey" directors who have business relationships (such as consultant or lawyer) with the company to qualify as independent directors.

It would seem that the boards of Singapore companies do not exhibit the three features said to be indicative of ineffective boards, i.e., being too large (among the surveyed firms, the board size is on average six to 20 and the tenure of the board in most firms is seven years or more), dominated by executive directors and having unitary leadership (Jensen, 1993). However, the more liberal definition of independence in Singapore compared to countries such as US may chip off some of the effectiveness of the board in monitoring management. Moreover, since the disclosure of directors background in annual reports, including director independence, is spotty across companies and often vague, it is difficult for investors to properly gauge the quality of the board or its independence. Another damper on the effectiveness of Singapore boards in monitoring management is the fact that new directors are typically nominated or proposed by existing directors, who are often themselves either controlling shareholders or who are affiliated to controlling shareholders. Other problems include the difficulties involved in removing ineffective directors and appointing new ones due to the large stakes held by directors, family members and passive shareholders; the lack of cumulative voting which may help minority shareholders appoint their own directors; and the weak market for corporate control which results in few board changes even when corporate performance is poor. Until recently, boards of local companies almost never had a foreigner.

Because of the heavy concentration of stock ownership, the practice of using nominee (or representative) directors is prevalent. This often contributes to the problem of conflicts of interests, as directors are required by the law to represent all shareholders. In addition, nominee directors can potentially obscure the decision-making process in the boardroom on account of their own agenda.

Recently, the government introduced new requirements for the composition of the board of directors for banks. Majority of the board of directors of local banks must be Singapore citizens or permanent residents, and must have a majority of independent non-executive directors. In addition, where the bank is not a subsidiary of another bank incorporated in Singapore, the board of directors must have a majority of directors who are not substantial shareholders of the bank and are independent of the substantial shareholders of the bank. Where the bank is a subsidiary of another bank incorporated in Singapore, the board of directors must have a majority of directors who are not substantial shareholders of the parent bank and are independent of the substantial shareholders of the parent bank. In addition, the candidate must be fit and proper for the position and be the best and most qualified candidate nominated for the office, taking into account the candidate s track record, age, experience, capabilities and other relevant factors.

Board committees

Under the companies act, all listed companies in Singapore are required to have an audit committee of at least three members. The majority of the members must be independent directors, and the chairman must be a non-executive director. The SGX listing manual also requires listed companies to have an audit committee. The best practices guide provides that a majority of audit committee members, including the chairman, should be independent of management. A director can be considered as independent if any relationship he may have would not likely affect his exercise of independent judgment. In the PWC (1997) survey, 44 percent of the companies indicated that the audit committee was primarily responsible for ensuring an effective system of internal control. Further, 23 percent indicated that the audit committee was primarily responsible for detecting fraud. The APO survey revealed that a firm s board has various committees. All have an audit committee and a compensation/remuneration committee; others have a share options committee, and an investment committee.

Apart from the audit committee, other board committees are not required by either statute or listing rules. But recently, local banks were required to form a nomination committee and a compensation committee. The nominating committee must be composed of five board members to be approved by the MAS. This committee is responsible for identifying individuals and reviewing nominations by the board or shareholders for the following positions: board membership, the executive committee of the board, the compensation committee, the audit committee, the chief executive officer/deputy chief executive officer/president/deputy president/chief financial officer. None of the sample firms in the APO survey has a nomination committee.

Also, under the SGX Practice Note No. 9h, companies having an ESOS have to form a board-level committee, and identify the members of this committee in the annual report. Not surprisingly, therefore, the next most common committee disclosed by companies in the annual report is the compensation committee, including the committee responsible for the ESOS (or its equivalent). However, the functions of the compensation committee in Singapore may be more restricted than in other countries, because they are often formed to administer the ESOS as required by SGX rules.

In the PWC (1997) and PWC (2000) surveys, the introduction of remuneration (compensation) and nomination committees were both identified as areas requiring improvement in Singapore.

Role of external auditor

The external auditor is another important element in the system of corporate governance. He/she provides the stamp of credibility to the financial statements prepared by management. Besides, mandatory annual audits can have statutory effects on management actions and accountability. The effectiveness of the external auditor as a corporate governance mechanism is dependent on the quality of the auditor (independence and expertise), the quality of the audit (audit planning, procedures and communication), and the enforcement of standards by a regulatory body.

In Singapore, a public accountants board was set up under the Accountants Act of 1987 (revised 1998) to register and regulate public accountants who include external auditors.

Applicants for registration must fulfill the requirements in regard to professional examination, post-examination experience, pre-registration course on ethics and professional practice subjects (no examination), and proficiency in local laws. The board is also empowered to regulate the professional conduct and ethics of public accountants and to hold disciplinary inquiries and mete out punishments when necessary. In this regard, the board has issued a Code of Professional Conduct and Ethics, which lays out fundamental principles and more specific principles on pertinent issues such as independence, use of designatory letters, advertising, fees and confidentiality. Under the code, a public accountant or his firm cannot be appointed as an external auditor of a company if:

- he or his immediate family holds a significant beneficial interest, directly or indirectly, in shares of the company (significant = 5 percent or more for public companies and 20 percent or more for private companies); or
- for the year immediately preceding prospective appointment, he was an officer or employee of the subject company, or was a partner of such person(s); or
- he has a direct or indirect material financial interest in the company.

The above requirements of the code are specific and fairly stringent in setting minimum benchmarks for the (appear to be) independence of external auditors. In contrast, Section 8 of the Code of Ethics for Professional Accountants put out by the International Federation of Accountants (IFAC) though similar in spirit to the Singapore code lacks specification of thresholds. However, the IFAC Code does provide a more comprehensive listing of situations that are becoming more common occurrences and which may impair (actual) auditor independence, such as provision of other services to audit clients, materiality of fees, former partners and long association of senior personnel with audit clients. The IFAC Code has not been adopted by the ICPAS of which all Singapore public accountants are members. Instead the ICPAS has its own Code of Professional Conduct and Ethics, which is almost identical to the statutory code applicable to public accountants.

In the APO survey many firms have external auditors who have been changed over the last three years. The degree of independence of external auditors from firms has been rated from moderate to very high.

Creditor rights and monitoring

The creditors of sampled firms are banks, non-bank institutions, and other institutions. Most of these creditors are not affiliated, except for one that is a non-bank institution. The loans made by the firm are guaranteed by the private owners. The government was never a guarantor in any of the firms.

Most of the firms had dealt with the major creditor banks for three to five years and two had dealt with the bank creditor for more than five years. For the non-bank institution, the period ranged from three to five years. In almost all cases, the external creditor asked for collateral for loans, whether working capital or capital expenditure. When the firm is faced with liquidity problems, the usual response is to renegotiate the loan repayment. In cases of loan default, the bank takes actions like filing of collection lawsuit, renegotiation of loan, intervention in the management of firm and even foreclosure of collateral. If a firm faces insolvency or bankruptcy, the firm by law can invoke its right to protect the owners or shareholders.

Institutional interface

The regulatory framework is constantly being reviewed in light of the dynamic business environment. According to the APO survey, there is a high degree of satisfaction and on the whole a perception of a somewhat good quality of services provided by the central government, parliament, central bank, customs, the courts, police, and internal revenue service. The quality and efficiency of education/schooling, and roads were regarded well. However, the quality of telecommunications, electric power and water was perceived poorly.

The functioning of the judiciary, law and order, taxes and regulations, and fiscal policy for the operations and growth of the business pose no problem. Adherence to international rules and standards does not appear to be problematic for the operations and growth of the business.

Only the exchange rate and the inflation seem to be problematic.

As to securities legislation, regulations have been codified and a single securities regulator, the Singapore Exchange (SGX), is responsible for enforcing all aspects of securities law and regulation (including disclosure obligations) and prescribing accounting rules. The PWC (2000) survey identified areas for improvement: improved education on existing rules; clarification and simplification of existing rules; and, improved enforcement of existing rules.

Governing the capital market through the stock exchange

Singapore is a capital center for the Asian dollar market, loan syndication, foreign currency trading, and bond futures trading on the SGX. As Singapore develops into a mature and sophisticated market, a predominantly disclosure based system of regulation has been adopted by the market so as to become a market driven securities market with greater transparency and a higher standard of disclosure. This market friendly regulatory regime reduces the cost of capital and avoids the cost of missed opportunities from delays. It also lowers moral hazard, encourages innovation and business flexibility.

The regulations are distinct from the core company law and are composed of three tiers primary legislation, secondary legislation, and non-statutory. The transparency and certainty of statutory rules facilitate compliance by companies and reduce the need for the securities regulator to exercise discretion, except where it possesses information that is not available and cannot be made available to the public. Secondary legislation is more flexible than primary legislation in that it can be amended without a bill introduced in Parliament, and yet carries the force of law. The advantage of non-statutory rules is that they can be drafted broadly and amended expeditiously to whatever is suitable given the particular circumstance.

There is a security regulator that enforces all aspects of securities law and regulations, including disclosure obligations. This is the Singapore Securities Exchange. It operates a securities exchange and promotes the growth of the securities market. It acts as a conduit between market participants and government, giving feedback to government departments to promote growth. Among its functions are to approve listing applications, conduct market surveillance, monitor continuing disclosure, promote corporate governance and enforce its listing manual. Where a breach of the law is suspected, the matter is referred to the securities regulator for investigation and enforcement.

Legal disclosure obligations expressed in the form of a general test plus checklist, is used to prescribe a high standard of disclosure that is enforceable, while retaining flexibility in specifying minimum disclosure items in checklist regulations. The disclosure requirement is in the form of a general test in primary legislation supplemented by checklists in secondary legislation. The general disclosure test includes both prospectus and continuing disclosure where all information that investors and their professional advisers need to make an informed investment decision is made available. In fact, the prospectus checklist for local and foreign issuers is substantially similar to the proposed International Disclosure Standards on prospectus disclosure with appropriate modifications to suit local requirements.

SGX is vested with authority to prescribe accounting rules for companies that are listed or have made public offers of securities in Singapore and for public offering documents. Foreign companies that do not prepare their financial statements in accordance with the standards prescribed are urged to redo their financial statements using the prescribed accounting standards. However, the securities regulator may grant exemptions and allow locally incorporated companies that are listed or are making public offers to comply with prescribed accounting standards other than the Singapore accounting standards.

The government also considers it important to develop regional corporate financing activities done in regional securities markets by professionals, and to develop a regional private venture capital market that is Singapore-based. Technology is being explored to raise the efficiency of securities market transactions and thereby enhance the mobilization of funds for capital formation.

To enhance performance and adopt new technology, the SGX was formed from a demutualized and new listing of the existing Singapore Stock Exchange, so as to align the securities and derivatives products. However, the operating environment had been a tough one for SGX as indicated by the thin listings in Table 18. While efforts had been made to increase the number of listings, the poor economic situation presented a tough challenge. Overall, for the capital markets, the derivatives market continued to perform well while difficulties in the securities market persisted.

Table 18. Securities markets and number of listed companies

Securities markets	End 2000	End 2001	End 2002
Total SGX mainboard listings - includes new listings	388 59	386 18	385 15
Total SGX SESDAQ listings - includes new listings	92 24	101 96	116 17
Total SGX listings (mainboard + SESDAQ)	480	492	501

Source: Singapore Stock Exchange

Disclosure of information

The disclosure of information is covered by several chapters and appendices in the SGX Listing Rules. Chapter 9 requires immediate reporting to the SGX of any information necessary to avoid the establishment of a false market that would likely materially affect the price of the company s securities, including appointment or resignation of directors and senior management, appointment of special auditors, appointment of auditors, general meetings, acquisitions and disposals, winding up, and earnings and dividends. It also requires semi-annual and annual reports. Chapter 9A requires shareholder approval and immediate announcement of interested party transactions. Chapter 12 requires companies to disclose to the SGX, shareholders and other security holders, as soon as practicable, any material information that is necessary for them to appraise the position of the group. This is deemed necessary to avoid the establishment of a false market in the securities which might be reasonably construed to materially affect the market activity or price of the securities. Examples of events that may require disclosure include joint ventures, mergers and acquisitions, declaration of dividends, earnings announcements; stock splits, litigation, and tender offers.

Singapore companies generally comply only with the minimum information requirements and would not volunteer to go beyond those specified by the Companies Act, the Singapore exchange listing rules and best practices guide (BPG), and other requirements. Unfortunately, at present, the corporate governance disclosure requirements are rather sparse. In particular, although the Singapore Exchange has introduced a BPG (which is non-mandatory), it deals only with two aspects of corporate governance audit committees and dealing in securities by directors. Disclosure of compliance with the BPG is only required for audit committees. Further, although the BPG specifies that companies should provide sufficient disclosure of their corporate governance processes and activities, there are no specific guidelines on what should be disclosed. At present, there is no equivalent in Singapore of the UK Combined Code used by the London Stock Exchange or the Toronto Stock Exchange Corporate Governance Guidelines, although the Singapore Institute of Directors has produced a draft code patterned after the combined code.

A survey of corporate governance disclosures in 150 SGX-listed companies revealed that only six companies did not make corporate governance disclosures. Thirty-three companies (22 percent) incorporated their corporate governance disclosures in the directors report, while the remaining companies (74 percent) included a separate statement of corporate governance. However, as the following subsections indicate, most companies do not go beyond the minimum requirements in the BPG in their corporate governance disclosures. Although there is a legal or regulatory requirement for public disclosure of material information about the firm, most firms in the APO survey do not have a specific disclosure policy. Most of the firms disclose financial information, information on firm performance, ownership structure and governance annually. Only a handful disclose their financial information and firm performance information twice a year.

The PWC (2000) survey identified more guidance on corporate governance and activities in the BPG as an area requiring improvement. In the same survey, 38 percent of institutional investors saw the need for considerable improvement in the corporate governance regime in Singapore, while another 54 percent opined that some improvement was needed. Interestingly, in the PWC (1997) survey of companies, 17 percent felt considerable improvement was needed while 63 percent felt some improvement was needed. It would seem institutional investors are less satisfied than companies are with the state of corporate governance in Singapore. Following one of the recommendations of the CFC, the Committee on Corporate Governance is in the process of developing a Code of Best Practices.

In the PWC (1997) survey, 20 out of 75 respondents (27 percent) did not have a formal policy for the release of price sensitive information, although six have some formal controls in place. Only 18 companies (24 percent) had publicized their policy to all staff. However, formal announcements were found to be well controlled. In the APO survey, information on finance, firm performance, ownership and governance are made available to a large group of people. These include major shareholders, minority shareholders, management, employees, unions, internal auditors, external auditors, creditors, government and the general public. The major shareholders, minority shareholders and management have access to the minutes of the board meetings.

As regards financial reporting, as noted earlier, SAS are identical to IAS in most cases, although there are occasional deviations and omissions. A notable departure from IAS is the Singapore accounting standard dealing with extraordinary items. It still follows the previous IAS. As a result, companies commonly treat items such as profits from the sale of investments or assets as extraordinary, and banks usually treat loan provisions as extraordinary rather than operating items. In addition, it is not unusual for companies to change their accounting policy for such items in order to manage their reported operating profits. Because of these practices financial statements cannot be compared over time and across companies.

In the PWC (1997) survey, 77 percent of companies reported having an internal audit function or share one with a related company. Seventy-one percent of these companies outsource this activity. In two-thirds of these companies their internal audit function reports solely to the audit committee, whereas in 13 percent, the internal audit function reports to both the audit committee and executive management. This is different from the common practice in the US of the internal audit function reporting to both the CEO and the board of directors, usually through the audit committee. The PWC (1997) survey indicated that, in terms of primary responsibility for ensuring effective internal control, the most important was the audit committee, followed by the CFO, executive directors and then the chairman and/or CEO. In terms of detecting fraud, the CFO was the most important, followed by the executive directors and then the audit committee.

The firms in the APO survey have very rigid to moderate internal controls as protection measures against misuse of cash flow, accounts receivable collection and aging, bad debt write-off, inventory, fixed asset acquisition, research and development, capital expenditure, tax payments, loan payments and payroll.

Auditing standards

The board also has the authority to prescribe the standards, methods and procedures to be followed by public accountants but up to now, the Board has not issued any such standards. Instead, both the board s code and ICPAS code require public accountants to observe the professional and technical pronouncements of the ICPAS with regard to external auditing.

ICPAS (more specifically, its predecessor the Singapore Society of Accountants) issued Statements of Auditing Guideline (SAG) and Statements of Auditing Practice (SAP) in the early 80s. SAGs are guidance statements on generally accepted auditing practices and on the form and content of audit reports. SAPs deal with the detailed work or acts which the auditor has to carry out in accordance with the guidelines set out in the SAGs. The SAGs and SAPs are based on the International Guidelines on Auditing and Related Services issued by IFAC. The firms in the APO survey follow a mix of accounting and auditing standards—local, international, and standards of a specific developed country. All the firms maintain separate books for the owners.

Following IFAC, the SAGs were codified in 1997 and are now referred as the Singapore Standards on Auditing (SSAs) to better describe their authority. However, the SSAs are strictly professional and not legal pronouncements failure to comply is a disciplinary matter and not a legal violation. At present, there are 31 SSAs, 27 SAPs and one Exposure Draft for a SSA that are equivalent to their international counterparts. Given the increasing globalization of business and investments, this equivalence is a welcome feature. It is seen to enhance the international credibility of the external audit as a corporate governance tool in Singapore. Foreign investors will most likely have confidence in the audit reports on listed Singapore companies because the market for external auditing services is dominated by the Big Three in Singapore.

Mergers and acquisitions

Although friendly mergers occur from time to time in Singapore, the takeover market is hardly active in Singapore. Hostile takeovers rarely happen and when they do, auctions seldom take place because of the secrecy rules just described. This is mainly because of high ownership concentration among families and government, and traditional tight controls by the SGX and other regulatory agencies. Thus, an important corporate governance mechanism in developed markets such as the US and UK hardly exists in Singapore.

The Securities Industry Council has recently announced a review of the Takeover Code. The purpose is to make takeover rules clearer, more certain, and less expensive. Part of the proposals in the consultation paper is to retain the current UK model for regulating M&A activities, whereby shareholders rather than directors have the right to decide on the offer. One of the major specific changes proposed is the raising of the mandatory bid threshold (for equal price offer to all shareholders) from 25 percent to a higher level.

The overall intent of the proposals is to improve the efficiency of the market for corporate control in Singapore which should be welcomed. Parallel to this, however, should be the adequate protection of minority shareholders rights. Given the significant concentration of ownership among families and government for Singapore companies, it is unlikely that M&A activities can occur without the support of these large blockholders. Where management and directors of these companies are related to or nominated by these blockholders, hostile takeovers that may involve the displacement of existing boards and management are unlikely to occur. It is unlikely that the proposed changes to the Takeover Code will have a marked impact on the incidence of M&A activities in Singapore, especially those that are disciplinary in nature. Therefore, the role of the market for corporate control as a disciplinary mechanism would likely remain weak in Singapore.

Social responsibility

Social responsibility is viewed as a comprehensive set of policies, practices and programs that are integrated into business operations, supply chains, and decision-making processes throughout the company wherever the company does business and includes responsibility for current and past actions as well as future impacts. The issues that represent a company s social responsibility focus vary by business, by size, by sector and even by geographic region. In its broadest sense, it typically includes issues related to: business ethics, community investment, environment, governance, human rights, marketplace and workplace. Stakeholders including shareholders, analysts, regulators, activists, labor unions, employees, community organizations, and the news media are asking companies to be accountable not only for their own performance but for the performance of their entire supply chain. All of these are taking place in an ever more complex global economy with continuing economic, social and environmental inequities.

From the survey, the findings on social responsibility are as follows:

Community relation: There have been community action against the firms during the last three years. Most of these have been resolved amicably through the firms offering to do something for the community. These range from providing scholarships, jobs, amenities, and getting their employees to be involved in community projects.

This is consistent with the response from all firms that community support is by compliance only. Some firms are proactive in philanthropy while a small number do not have any activity.

Consumer rights protectio: Generally, there are no or little laws or regulations on consumer protection. A majority of the firms do not have a policy on consumer protection. However, all the firms have mechanisms for receiving consumer complaints through questionnaire, e-mail addresses, and hotlines.

Environmental protection: Most of them do not have a policy on environmental protection or ISO 14000 certification. A compliance only mindset is adopted for environmental protection areas. In terms of pollution control, most of the firms are either in compliance or taking a leadership role.

Code of ethics: Half of the firms have a code of ethics while the other half do not. For those that have, the code is publicized. There are sanctions or penalties for violating the code but to date, none of the firms had violated the code. The firms also have not received and investigated any allegations of breaches of proper standards of financial conduct nor violations of internal revenue code, environmental rules, labor code, intellectual property rights, corporation law, consumer protection laws or anti-bribery act.

Employee-employer relations: None of the firms have an employee union or association. In the last three years, there have been disputes between management and employees which were settled by government mediation and labor management consultation. Mechanisms exist for the discussion of employer-employee relations issues. Tenure and labor standards issues are settled by collective bargaining. Productivity improvement programs and productivity gain-sharing issues are resolved by labor-management consultation. Most of the other issues are settled by management discretion.

A growing body of data quantitative and qualitative demonstrates the bottom-line benefits of socially responsible firms. These benefits are: better financial performance, reduced operating costs (arising from initiatives aimed at improving environmental performance such as reducing emissions of gases that contribute to global climate change or recycling initiatives that cut waste-disposal costs and generate income by selling recycled materials), enhanced brand image and reputation, stronger sales and customer loyalty, increased productivity and quality (efforts to improve working conditions, lessen environmental impacts or increase employee involvement in decision-making often lead to increased productivity and reduced error rate), increased ability to attract and retain employees, less regulatory oversight (companies that demonstrably satisfy or go beyond regulatory compliance requirements are given more free reign by both national and local government entities), and access to capital.

Links with productivity

Overall, there seems to be consensus, based on the APO survey, that corporate governance will only moderately affect the overall performance and productivity of the firm. Seventy-five percent of the firms surveyed believe so, and only 25 percent indicate that good corporate governance translates into high corporate productivity.

Some relationships, however, appear well established. Table 18 shows that export firms appear to have higher capital productivity than those producing for the domestic market. In terms of capital structure/distribution of shares, firms whose top shareholder-owner has less than half of the companies shares perform better when compared to those with more than 50 percent. This would suggest that even a mild dispersal of ownership helps in promoting productivity. Foreign shares also help in disciplining firms so that they can attain higher productivity.

Firms whose creditors are banks tend to perform better than firms whose creditors are non-banks.

Table 18. Average capital productivity (revenue/book value of assets) of sample firms (% of responding firms)

		Average capital productivity	Remarks
Firm type			
Whose products are	exported	3.736	Higher
	not exported	0.619	
Ownership			
Whose percent share of top shareholder is	≥ 50 percent	1.041	
	< 50 percent	4.872	Higher
Which have	foreign shares	4.179	Higher
	no foreign shares	1.899	
Financing			
Whose creditors are	banks	3.725	Higher
	non-banks	0.648	
Management			
Whose board chairman is	CEO	3.512	Higher
	non-CEO	1.290	
Whose minority shareholders are	represented in the board	1.606	
	not represented in the board	4.306	Higher
Whose external auditor has a tenure of	3-5 years	3.278	Higher
	more than 5 years	0.709	
Which have	code of ethics	1.432	
	no code	4.480	Higher
Which prefer implementation of rules on the basis of	voluntary action	1.764	
	compliance or lead role	4.149	Higher

Separation between board and management, as well as minority representation in the board, does not necessarily bring about higher productivity, as Table 18 shows. As previously discussed, safeguards within Singapore are adequate to offset any agency problem associated with a relationship-based structure including a relatively short company stint for external auditors, which is actually favorable to higher productivity.

But what is surprising is that surveyed firms which profess not to have any code of ethics are more productive than those which profess to have. The fact remains though that firms which prefer compliance rather than voluntary action have higher performance. This probably indicates that there are enough legal sanctions outside the firm to withstand the lack of explicit internal ethical standards. It may also be that Singaporean firms adhere more to a *balanced approach* in which companies may depart from specified corporate governance best practices as long as they observe appropriate disclosure. This is in contrast to a *prescriptive approach* in which companies are required to adopt specific corporate governance practices. Although a prescriptive approach may be appropriate in certain circumstances, for example where capital markets are undeveloped, such an approach is inconsistent with the disclosure-based philosophy to regulation that Singapore is moving towards. In this manner, company flexibility is preserved (Corporate Governance Committee, 2001). Nonetheless, more empirical data is needed for any definitive assessment.

POINTS OF CONVERGENCE AND DIVERGENCE

Some points of convergence with qualitative data are worth mentioning, although Singapore companies may not be necessarily moving towards identical systems of governance. They include:

- Enhancing shareholder value as *the* or *a* primary focus of companies, and upholding or extending shareholder rights. This is accepted as a fundamental prerequisite for the development of capital markets.
- The need for non-executive and independent non-executive directors to provide an outside view on strategic direction and to counterbalance the executives on the board or to help strengthen the supervisory board vis- -vis the management board in two-tier systems.
- The usefulness of board committees responsible for audit, nomination and compensation and comprising a majority of independent directors.
- The importance of higher levels of information disclosure from listed companies and readiness in subscribing to international accounting standards.
- Allowing or encouraging institutional investors to act as a check against management and a lever for enhancing board independence.

Some differences are also observed. One difference involves the stakeholder concept. Most companies openly subscribe to this principle as part of their corporate governance. Only two among the surveyed firms recognize the social function of corporations, but still do not emphasize stakeholders within the governance context. Most of the companies look to legislation to protect employees, creditors and customers. One company encourages boards to be responsible for relations with stakeholders , but stresses that they are accountable to the shareholders .

A second difference concerns board structure: whether companies have single-tier or two-tier boards. Most companies have the former even though the majority agrees that the two-tier structure enhances board independence.

The differences in philosophy and board structure already introduce complications as regards the possible convergence in corporate governance. Further, the impact of Anglo-American ideas is not likely to become pronounced due to the lack of independent directors and director training, a tendency towards form over substance , government ownership, and regulatory weakness.

Most companies have displayed little interest in addressing the basic contradiction between the new corporate governance principles being espoused and the deeply entrenched structure of their companies. While a system of checks and balances is being introduced, real power resides in the hands of the majority shareholders. The cultural terrain in which companies operate is ignored. For example, even though these companies appoint new independent directors and form independent board committees, there is no guarantee that boards will in practice become any more independent (especially if these directors are nominated and appointed by the existing board, not nominated and elected by the general shareholders). Hence, not many will actively contradict the incumbent CEOs.

The study also shows that while attitudes have changed towards corporate governance among market regulators, government officials and professional associations, business behavior has not except in cases where it needs to. Corporate governance in Singapore cannot be expected to ape the Anglo-American model since local business cultures and legal systems will shape the way in which ideas are adapted by each company. Government ownership will continue to exert a powerful influence over the pace of change, the details of new regulations and the degree of power that will be allocated to minority shareholders.

However, this current state will have to struggle with the internationalization of finance that is fueling a demand for common standards. Companies operating internationally will increasingly see greater financial and non-financial disclosure, and accountability to all shareholders, as their commercial interests grow. The government will have to push for corporate governance as fundamental to the development of advanced and attractive securities markets. Groups of shareholders will learn to exercise their rights creating a profound impact on the status quo.

POLICY RECOMMENDATIONS

General recommendations

Corporate structures are the "internal" mechanisms of corporate governance, influencing relationships within the firm among managers, shareholders, creditors and the company board. In Singapore, laws and customary practices of the local business community define these internal relationships. Alternative forms need to be explored since the study reveals an isomorphism of an atypical form among the Singapore companies. This lock-in to a model might only serve as a barrier to further developmental work.

The ownership concentration sets the parameters of control exercised by the majority shareholders and the balance of powers and interests between shareholders which affect the policies as well as communication within the firm. One way to enhance the set-up is to fix a minimum number of shareholders to more than the present three.

The structure of corporate decision-making as well as the granting of corporate rights and allocation of responsibilities determine the nature and scope of the goals, strategies, and motivations to be embraced by the firm. This will have a huge impact on productivity.

Shareholder control and guarantees are based on attributes, such as the composition, representativeness, independence and qualification of board members, as well as the existence of sub-committees (headed by non-executive or independent directors) on audit, nomination and remuneration. These are all to ensure that the board can perform as an effective oversight body on behalf of shareholders.

Disciplinary instruments imposed on the behavior and performance of firms rely on the effective enforcement of laws and regulations. If firms merely wish to comply there is probably the need to explore the various factors that underpin the lack of proactive stance and a poor understanding of corporate management and governance practices.

Government regulations affecting business include accounting and auditing standards that determine the type, detail and quality of information disclosed. Hence, the priority is to ensure that an appropriate system is in place to facilitate the choice of standards and quality of regulations.

Specific recommendations

Corporate governance can be improved in Singapore. The key areas would be in the disclosures made by listed firms, the creation of a single regulator with wide powers to regulate the capital market, the ability of investors (especially minority shareholders) to take civil action against insider trading, and greater flexibility in using share option schemes to pull together the interests of shareholders and management of companies. In many cases, lapses in financial reporting (and, by implication, an audit failure) are involved whenever there is a business failure . These will also have to be addressed by better communication and education.

However, based on the review of corporate governance practices and disclosures and this study, corporate governance in Singapore needs to undergo further changes in order to reach the level of standards in more developed economies such as Australia, US and UK. The following are some of the possible changes that may be considered:

- Developing a comprehensive code of corporate governance that encompasses both principles and best practices. At present corporate governance disclosures in annual reports are unsatisfactory because most companies continue to disclose only the minimum information required to comply with laws, regulations and standards. Such a code may be patterned after codes developed overseas, but adapted to the unique characteristics of the Singapore environment, including the dominance of government-controlled and family-controlled companies, the weak market for corporate control, and the absence of active institutional investors who can develop their own codes and actively participate in corporate governance. The proposed code should strike a balance between accountability and enterprise. Corporate governance guidelines that are voluntary, but which require disclosure and explanations of non-compliance, are generally preferred to detailed listing rules, laws and regulations that mandate a "one size fits all" approach to corporate governance.
- Strengthening the regulatory and institutional framework, including a more effective enforcement of company and securities laws, listing rules, codes of best practices, and accounting and auditing standards. This would require not only rewriting laws, rules, codes and standards, but also strengthening the institutions responsible for enforcing them (e.g., companies and securities regulator, and accounting profession). This is especially important given the shift towards a disclosure-based philosophy to regulation, where shareholders are expected to take a more active role in evaluating the merit of transactions and in enforcing their rights.
- Encouraging the development and robust participation of private sector institutions and third-party watchdogs, such as institutional investors, investment managers and shareholders associations, news media, and institutes of directors. Market forces, rather than regulation, provide the incentive for improving corporate governance in Singapore in the long run.
- Even though there have been some concerns about the lack of separation of ownership and management among Singapore companies, effort to control the shareholding structure of companies, for example by restricting ownership by particular shareholders, is an effective mechanism for improving corporate governance.

In addition, improving the efficiency of the market for corporate control and a continuing push toward liberalization of markets will further enhance the role of external corporate governance mechanisms.

CONCLUSION

A number of factors are precipitating some global convergence in corporate governance practices. First, globalization and liberalization lead to the integration of financial markets, prompted by the recognition of both investors and issuers of the benefits from international diversification. In turn this has led to a greater global push for sound corporate governance practices. For example, CalPERS, the third largest pension fund in the world, has developed its own global governance principles, which it strongly advocates among its investee companies. Globalization of products and services markets, and liberalization of these markets, also create pressure for others to adopt sound management practices to improve efficiency.

Second, there is a certain degree of convergence in companies and securities laws and regulations worldwide. Many Asian countries are moving towards US-style securities regulations and enforcement. There is also increasing impetus for the adoption of international accounting standards, with many influential inter-governmental and regulatory agencies calling for the speeding up of acceptance of these standards. At present, the International Accounting Standards Committee (IASC) has largely completed its development of core international accounting standards, which are now being considered by the International Organization of Securities Commissions (IOSCO).

Third, major inter-governmental bodies such as the OECD, the World Bank, IMF, and ADB are pushing for corporate governance reforms in Asian economies. These reforms often accompany "rescue" packages offered by the World Bank, IMF and ADB. The OECD has developed a set of Principles of Corporate Governance, and together with the World Bank, has initiated a Global Corporate Governance Forum to push for the adoption of these principles. These principles have support at the ministerial level among OECD and many non-OECD countries.

Finally, technology is also likely to accelerate the convergence through the ability to use the internet to trade international securities, disseminate corporate information, disseminate proxy voting advice and decisions, and voting.

In the future, corporate governance in Singapore will be influenced by this global convergence, as Singapore develops further into an international financial center and Singapore companies become increasingly international.

There are a number of barriers to improvements in corporate governance in Singapore. First, it remains to be seen whether adequate protection to minority shareholders can be provided by current and proposed securities and company legislation, and the general legal framework in Singapore. Ownership will likely remain heavily concentrated with significant ownership by executives (and their families). This violates the separation of decision management and decision control and leads to the inefficient sharing of risks. With significant concentration of ownership among individuals who are either managers or relatives of managers (especially for smaller listed companies), matters such as related party transactions and insider trading will continue to generate concerns.

Second, the impact of global convergence will be most keenly felt by larger companies that operate internationally and access international financial markets. Smaller listed companies have little need to access capital markets, either domestically or internationally. Although poor corporate governance may translate to poor share price performance, these companies may continue to adopt minimal, rather than internationally acceptable, corporate governance practices. Further, there is hardly any threat of hostile takeovers given the prevailing customary practices in Singapore.

Third, the continued participation of the government in many private sector firms reduces the exposure of these firms to competitive markets and creates moral hazard problems through implied performance guarantees. It is doubtful that Singapore will give up its significant equity in private sector firms since government-owned companies serve as tools for economic development and rationalization of the domestic economy. If the government continues to own significant equity in these firms, there is an urgent need to improve the accountability, management and monitoring of these government-owned companies. Temasek Holdings Limited, the government holding company for GLCs in Singapore, has acknowledged concern with monitoring of GLCs. It has signalled a more active future role in the governance of GLCs, including greater scrutiny of diversification plans, closer vetting of board appointments, and encouraging the separation of the role of CEO and chairperson in GLCs. However, it remains to be seen whether these changes will lead to improvements in the governance of GLCs.

Fourth, the shift towards a disclosure-based regime, which emphasizes greater disclosure and shareholder monitoring, implies significant changes in the corporate governance environment. This will require significant changes in the way accounting standards are conducted and accounting rules are enforced (including the need for a strong independent accounting body), stronger securities regulations and enforcement, greater shareholder activism (especially by institutional investors), and participation of other third-party watchdogs such as analysts and the financial press.

Finally, a major problem is that under the merit-based philosophy to regulation that was practiced in Singapore, the emphasis was on compliance with rules and regulations set by regulatory and quasi-regulatory agencies. Under this environment, companies were conditioned to disclose the bare minimum as required by rules and regulations, and no more. Since the merit of transactions was frequently determined by regulators rather than by shareholders, there was little benefit to be derived from companies disclosing more to shareholders.

Moving to a disclosure-based philosophy to regulation requires both companies and shareholders to undergo a significant change in orientation. Companies must be prepared to disclose more, and shareholders must be prepared to exercise their rights and participate more actively in corporate governance. Recent surveys indicate that companies favor minimal disclosure, and as of now, there has been no active institutional investors or investors associations able to effectively participate in corporate governance. There is danger that inertia will cause companies to comply with the rules (as they did in the merit-based environment) rather than respond to the market demand for disclosure and good corporate governance (as required in a disclosure-based environment). It can be argued that the merit-based approach to regulation practiced in Singapore for so long simply mirrors its cultural, social and economic milieu (including the significant concentration of ownership among government and families). Although a disclosure-based philosophy to regulation is the right path to take, and appears inevitable given the globalization of markets, much remains to be done if a corporate governance environment comparable to international standards were to be established soon.

REFERENCES

Claessens, Stijn; Djankov, Simeon, and Lang Larry (2000). The Separation of Ownership and Control in East Asian Corporations. *Journal of Financial Economics.*

Corporate Governance Committee (2001). Report of the Committee and Code of Corporate Governance. Singapore: March 21.

Gilson, Ronald (1995) in "Cooperate Governance and Economic Efficiency: When Do Institutions Matter?," unpublished paper, Columbia and Stanford Universities, Schools of Law and Business.

Gordon, Lilli A. and John Pound (1991) "Governance Matters: An Empirical Study of the Relationship Between Corporate Governance and Corporate Performance," John F. Kennedy School of Government, June mimeo.

Grundfest, Joseph A. (1990). "Subordination of American Capital," *Journal of Financial Economics* (vol. 27).

Hawley, James P. (1995). "Political Voice, Fiduciary Activism and the Institutional Ownership of US Corporations: The Role of Public and Non-Corporate Pension Funds," *Sociological Perspectives*, vol. 38, no. 3.

Karpoff, Jonathan M., Paul M. Malatesta, and Ralph A. Walkling (1995). "Corporate Governance and Shareholder Initiatives: Empirical Evidence," mimeo, August.

Khan, Haider A. (2003). Corporate Governance in Singapore and Hong Kong: What Can the Other Asian Economies Learn? CIRJE-F-228. Faculty of Economics, University of Tokyo.

Mak Yuen Teen and Chng Chee Kiong (2000), "Corporate Governance and Disclosures in Singapore: An Update", OECD/ADB/WB Second Roundtable on Corporate Governance, Hong Kong China, May.

Mak, Yuen Teen and Phillip H. Phan (2001). Corporate Governance in Singapore: Current Practice and Future Developments, in Corporate Governance in Asia: A Comparative Perspective. Paris: Organization for Economic Cooperation and Development.

McConnell and Servaes (1990). "Additional Evidence on Equity Ownership and Corporate Value," *Journal of Financial Economics,* vol. 27.

Monks, Robert A. G. and Nell Minow (1995). *Corporate Governance*. Basil Blackwell, Inc.: Cambridge, Massachusetts.

Nesbitt, Stephen L. (1994). "Long-term Rewards From Shareholder Activism: A Study of the "CalPERS Effect" „*Journal of Applied Corporate* Finance, Winter.

OECD Economic Surveys: Germany 1995. Organization for Economic Cooperation and Development.

OECD Economic Surveys: Italy 1995. Organization for Economic Cooperation and Development.

Opler, Tim C. and Jonathan Sokobin (1995). "Does Coordinated Institutional Activism Work? An Analysis of the Activities of the Council of Institutional Investors," August, mimeo.

Pound, John (1993). "The Rise of the Political Model of Corporate Governance and Corporate Control," *New York University Law Review*, vol. 68, no. 5, November.

PriceWaterhouse Coopers (2000). "Corporate Governance: 1999 Survey of Institutional Investors".

Spencer, Stuart *1995 Board Index: Board Trends and Practices at Major American Corporations*.

Singapore Department of Statistics: Singapore s Corporate Sector, 1999-2000.

Tan, Frankie. (2003). Corporate Governance redefined. Tan Leng Cheo & Partners, MSI, Singapore.

Tan Wee Liang (2000), "Corporate Governance in Singapore - An Overview". United Nations Development Programme.

The Economist (1994) "Corporate Governance,", special supplement, January 29.

Yeo, Gillian and Lee Kin Wai. (2003) Does Corporate Governance Work? *Business Times,* Singapore, 1 September.

Yeo, Victor C. S. and Pearlie M. C. Koh (2001). "Country Report on Singapore", OECD/ADB/WB Third Roundtable on Corporate Governance, Singapore, April.

Williamson, Oliver E. (1979). "Transaction-Cost Economics: The Governance of Contractual Relations, " *Journal of Law and Economics* ,Vol. XXII, No. 2, October.

Williamson, Oliver E. (1993). "Organization Form, Residual Claimants, and Corporate Control," *Journal of Law and Economics*, Vol. XXVI, June.

Williamson, Oliver E. (1979). "On the Governance of the Modern Corporation," *Hofstra Law Review*, Vol. 8, No. 1, Fall.

THE IMPACT OF CORPORATE GOVERNANCE ON PRODUCTIVITY IN SRI LANKA

Prof. Lal Balasuriya
University of Moratuwa
Sri Lanka

INTRODUCTION

Sri Lanka is at a critical juncture in its history. A long-drawn civil war is nearing its end. In this context, there is need to take a close look at the institutions that will govern post-conflict Sri Lanka. An important part of the country s institutional structure is that which relates to corporate governance. Every element of corporate governance that is influenced by the institutional environment in Sri Lanka, as it is being carried out now, will have profound impact on its economic and social development.

A critical evaluation of corporate governance in Sri Lanka today would identify areas to be corrected or improved, and remedial measures that will impact on the functioning of both the state and the corporate sector. Whereas the state creates a conducive political, economic and legal environment, the private sector spurs economic activities and generates jobs. Corporate governance issues do affect growth, firm performance and productivity. Hence, this study makes a case for improved corporate governance.

A survey of Sri Lankan firms was carried out between January and April 2002 under the guidelines given by the Asian Productivity Organization (APO). Specifically the study seeks to (1) identify the links between governance, productivity and growth in the current stage of development; (2) analyze how governance issues promote or hinder productivity in an environment characterized by increasing globalization and liberalization; and (3) recommend policies, strategies and approaches suitable to the productivity needs of Sri Lankan firms, following a distinctly Asian style of corporate governance.

REVIEW OF LITERATURE

A prominent feature of the Asian corporate sector is the predominance of family run firms, the informal nature of stakeholder relationship, and the legal and economic diversity of the region. According to the OECD, in Asia, approximately two-thirds of listed companies and substantially all private companies are family run. A particular characteristic of the Asian companies is the tendency to establish large interlocking networks of subsidiaries and sister companies that include partially owned publicly listed companies. While there is an advantage for profit making and better investment, such organizations can lead to inequitable treatment of shareholders. The challenge for corporate governance reforms in Asian countries is to encourage the dynamism and growth of family businesses, while channeling their energies and operations into structures that are more transparent and consequently, more clearly equitable for non-family investors (OECD, 2003).

Koeke and Renneboog (2003) look into the impact of corporate governance and product market competition on total factor productivity growth in two developed economies. In Germany, which embraced a bank-based governance system, productivity grows faster in firms controlled by financial institutions (in particular, banks and insurance companies) and intense competition reinforces this beneficial impact. Furthermore, the importance of the creditors (mostly banks) for productivity growth is particularly significant in firms which experience financial difficulties or are in financial distress. On the other hand, UK, which is a market-based governance system, does not find any evidence that creditors play a disciplinary role. Still, there is strong evidence that shareholder control (by insiders, private outsiders and financial institutions) leads to substantial increases in productivity in poorly performing firms. There is also evidence that product market competition is a substitute for block-holder control in the UK.

Grosfeld and William (2001) find a U-shaped relationship between ownership concentration and performance. Firms with relatively dispersed ownership (no shareholder with more than 20 percent of voting shares) and firms, in which one shareholder has more than 50 percent of voting shares, have higher productivity growth than firms with an intermediate level of ownership concentration. This correlation between concentration of ownership and productivity growth is not explained by the type of the controlling shareholder. Product market competition and good corporate governance tend to reinforce each other rather than substitute for each other. Competition has no significant effect on performance for firms with "poor" governance; on the contrary, it has significant positive effect in the case of firms with "good" corporate governance.

There is a dearth of corporate governance literature on Sri Lanka. But two studies dealing with privatization of state enterprises are worth mentioning.

Ranaraja (2001) examines briefly the consequences of privatizing public enterprises in Sri Lanka, detailing the cases of a manufacturing enterprise supplying industry (Ceylon Oxygen, Ltd.) and a large public utility (Sri Lanka Telecom). Both enterprises operated in a non-competitive and monopolistic environment prior to privatization. They have been privatized by the sale of the majority of shares to a single foreign investor with a large presence in overseas markets.

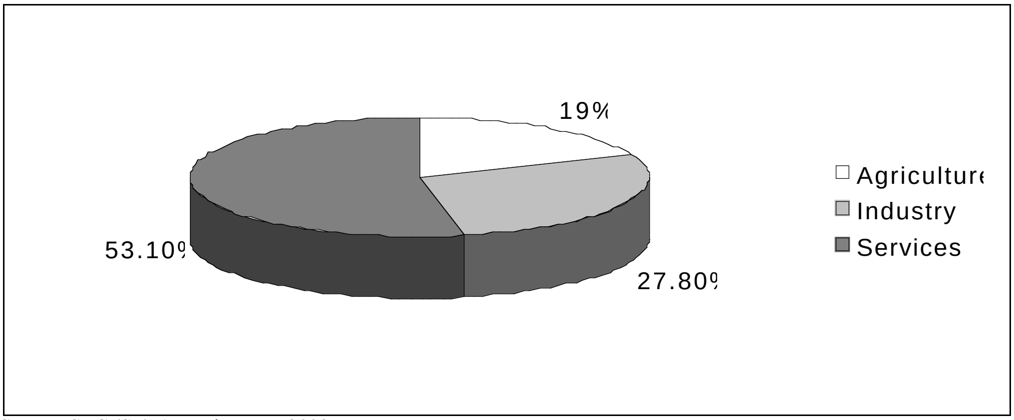
Ranaraja finds that at the time of its privatization, SLT had been recording modest growth both in revenue and profitability. But, after privatization, performance has increased considerably, especially revenue generated by rental charges and domestic call charges due to upward tariff revisions. However, operating costs have also increased simultaneously. SLT s productivity, measured by the subscribers or direct exchange lines per employee, fault clearance efficiency, and a number of new connections per staff, also posted phenomenal increases after privatization.

In the case of Ceylon Oxygen, annual revenue has, since privatization, quadrupled, despite the emergence of several competitors to the company. Ranaraja notes that this revenue growth can only be attributed to better operational activities and more efficient selling and distributing, as the investments made by the company could not necessarily have had such an immediate impact. Using the most commonly used productivity measure, value added per employee (net output per employee per annum), the study also indicates that it has increased by more than 1250 percent since 1987, due to both the reduction in the number of employees and improved performance in terms of sales/turnover.

Kar (2003) takes the opposite view: privatization of SOEs might bring more harm than good—the involvement of the private sector does not necessarily improve efficiency, while raising the costs of services to the poor. Neither the multilateral agencies nor the Sri Lankan government has provided adequate evidence explaining why every SOE would necessarily be better run if transformed into a private company. Kar points out that past experiences in Sri Lanka have demonstrated that privatization can often lead to corruption, large-scale job losses, especially in a context where government is not able to provide an adequate social safety net or resources for job retraining.

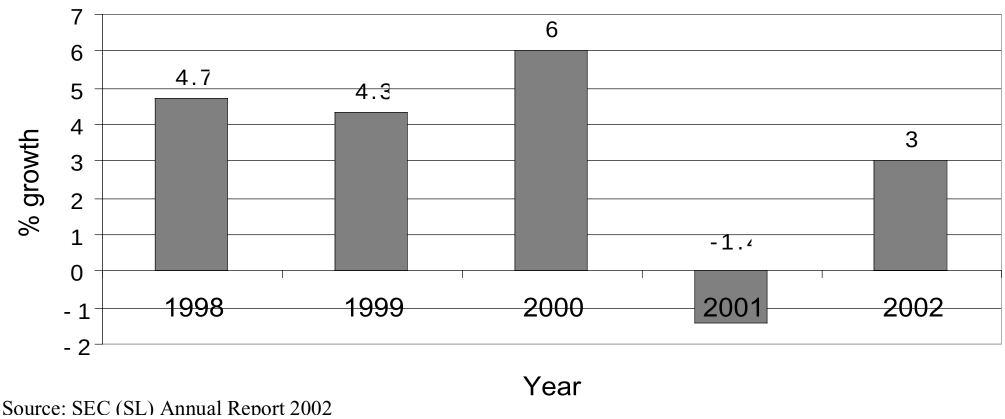
THE SRI LANKAN ECONOMY

With the cessation of hostilities, improved business confidence, decline in the rate of inflation and interest rates and stability of exchange rates, the performance of the Sri Lankan economy showed signs of recovery in 2002. The GDP grew by 2.7 percent during the first two quarters and by 5.3 percent in the third quarter which was the highest recorded since 2000. The service sector which accounts for more than half of GDP (Figure 1) grew by 8 percent, the industry sector which contracted during the first half of the year grew by 3.1 percent and the agricultural sector grew by 1.2 percent in the third quarter of 2002 (Figure 2).



Source: SEC (SL) Annual Report 2002

Figure 1. Percent share of economic sectors, 2002



Source: SEC (SL) Annual Report 2002

Figure 2. GDP annual growth rates, 1998-2002

Prior to this, Sri Lanka suffered a deep economic slowdown. The economy recorded a negative growth rate of -1.4 percent in 2001 (Figure 2), the first since the country gained independence. This deceleration was partly a response to the slowing down of the world economy, which led to a decline in exports from Sri Lanka and partly due to several local factors. The terrorist attack on the Katunayake airport increased the insurance levies on shipping, resulting in an adverse effect on all exports such as tea, rubber garments, among others including influx of tourists to the country. A prolonged drought, which led to power cuts adversely affected industry, as well as a reduced agricultural output, further deepening the economic crisis.

The growth of the economy at 4.3 percent during 2000 fell far behind the growth rate in the region and that of countries with similar development aspirations. Most of the growth came from the services sector of the economy.

Civil war was not without costs. Increases in military purchases up to the year 2001 also drew heavily on the country's foreign exchange reserves that resulted in the depreciation of the SL rupee. At that time the country spent over Rs60 billion a year on the war. This was equal to the total income earned from exporting tea and rubber—the country s two main sources of income—in a year.

The floating of the Sri Lankan rupee benefited companies exporting products, but was not sufficient to offset the rise in the cost of imported raw material and food products.

The finance minister in his budget speech in 2002 proposed several reforms in taxation, expenditure and public debt management. Accordingly, several taxes were abolished and GST and NSL were consolidated into a single VAT. The overall budget deficit in 2002 was estimated to rise approximately to 8.9 percent of GDP in comparison with the original target of 8.5 percent of GDP. This was the result of the current account deficit declining by 2.3 percent of GDP due to a significant shortfall in revenue and expenditure on interest payments. As in the previous year, the government s outstanding debt stock is expected to increase to 57.3 percent of GDP at a rate faster than the rate of growth in nominal GDP. The privatization program is expected to raise Rs21 million. This will mainly be from the divestiture of Sri Lankan Insurance Corporation and the sale of the balance shares of Sri Lanka Telecom. The privatization program continues in 2003.

Sri Lanka possesses a competitive edge in terms of market infrastructure, technology and literacy. Many of the shortcomings in the market, such as lack of an active local investor base, the lack of free flow of information, inadequate levels of liquidity, low market confidence, anomalies in the risk reward structure and the inadequacy of knowledge of market intermediaries would have to be addressed initially from the point of view of improving institutional framework and infrastructure (CSE, 1998).

OVERVIEW OF THE CORPORATE SECTOR

Role of the corporate sector in the economy

The Industrial Production Survey 2002 of the Central Bank of Sri Lanka, which covered 480 industrial enterprises (excluding the Board of Investment industries, tea and rubber processing, coconut and small industries, all of which were covered separately) indicated that factory output grew by 11 percent in real terms and 16.8 percent in nominal terms, resulting in an implicit price deflation for the year 2000. Public sector industries, which contributed 12 percent, grew by 24.1 percent, while private sector industries, which contributed 88 percent, grew by 10.5 percent during the year. This impetus for growth in industrial output in 2000 came from textile, apparel and leather products; chemical, petroleum, rubber and plastic products; and food and beverages and tobacco products.

Output of private sector industries grew by 10.5 percent in 2000, compared to 5.3 percent in 1999. Private sector industries accounted for 94 percent of industrial production in 2000. Output growth in BOI industries was estimated at 14 percent in 2000, compared to 5.7 in the previous year. Output in the non-BOI sector grew by 6.2 percent, compared to 5 percent in 1999. The Industrial Production Survey 2000 of the Central Bank indicated an expansion of production capacity by 46 percent in the non-BOI sector.

Employment in the BOI and non-BOI industrial sectors increased by 12.5 percent and 2.9 percent, respectively. Labor productivity in the non-BOI industries increased by 3.6 percent during the year.

The installation of automated systems and the adoption of modern technology in recent years in Sri Lanka helped improve labor productivity, through reduction of human error, lower wastage and improvement of personal motivation. The adoption of better management techniques, training in skills development and a reduction of excess labor also contributed to the improvement of labor productivity. So did improvements in the working environment in factories and welfare facilities, especially in the apparel, food, beverages and tobacco industries.

On the whole the year 2000 was marked by the overall decline in share prices in capital markets. Only two sectoral price indices improved over the year namely: the chemical and pharmaceutical sector, which increased by 3.4 percent; and the stores and supplies sector, which increased by 6.5 percent. Of the fourteen sectoral price indices, which recorded decreases, the construction and engineering sector index was the biggest loser, declining by 37.9 percent. Other sectors, which fell significantly were diversified holdings (29.8 percent), hotel and travel (28.4 percent), banks, finance and insurance (28.3 percent) motors (27.3 percent), manufacturing (22.4 percent), plantation (21,5 percent), investment trusts (19.8 percent), trading (19.3 percent), and footwear and textiles (17.8 percent).

Although most of the sectoral indices declined during this year, in terms of market capitalization, eight of the top 10 companies recorded improvements in profit for the first quarter of 2000, compared to the same period in 1999. Plantation sector companies also recorded improvements in cumulative profits during this period, while many other companies recorded declines in cumulative profits at the end of the third quarter. The declining trend has however reversed in 2002.

Plantation output contributes approximately 3 percent of the country's GDP and the three main crops—tea, rubber and coconut—account for over 90 percent of plantation production. Due to the drought condition that prevailed in the country, tea and coconut production recorded negative growth in 2001. Rubber production remained almost static during the first ten months of the year.

In the domestic agricultural sector, paddy production dropped by about 9.4 percent in the *yala* production and 3.8 percent in the *maha* production during the year 2001 as the extent of land under cultivation was reduced due to the drought that hit the country that year. Rubber production in Sri Lanka declined by 3.5 percent due to bad weather conditions and there was a reduction of about 25 percent in the price of rubber in the year 2001.

An eight-year record-breaking spell in national tea production was halted in 2001 due to the drought and changes in the weather pattern. In contrast, global production increased during 2001 due to good harvest in Kenya and North India. The decline in national production was 10.5 m.kgs, while global production increased by 58 m.kgs. This increase in global production was seen as the main cause for the decline in the prices at the Colombo tea auction, particularly for the teas from the higher elevation.

Statistics presented at a workshop on Capital Market Advancement (SEC, 1998) indicated that the contribution by the corporate sectors to the capital market was minimal, notwithstanding the various incentives given by the government. Capital structures in many domestic companies, both listed and unlisted, suffered from an asset-liability mismatch and indicated without ambiguity the need for long term finance either through debt or equity, both of which could be provided only through a mature and developed capital market. It was noted that the main issue affecting the Sri Lankan capital market was the absence of a perceivable long-term economic policy, which resulted in short term investment and savings by investors, especially non-corporate investors.

Table 1. Corporate plantation sector statistics

	1996	1997	1998	1999	2000	2001	2002
Price earning ratio		8.1	14.6	3.4	2.6	10.5	2.4
Price-to-book value		0.9	3.3	0.9	1.2	0.5	0.6
Dividend yield		5.7	2.9	17	14.1	7.9	9
Sector capitalization (Rs Mn)	1220	3320	8584	3886	6033	5320	5889
% Total Mkt Cap	1.1	3	6.4	3.7	6.2	6.3	3.6

Source: CSE Handbook - Plantation Sector

Characteristics of the corporate sector

Sri Lanka s corporate sector mainly consists of government owned corporations, corporate entities jointly owned by the government and other shareholders, public listed companies (and groups of companies), and private companies (and groups of companies).

Companies fully owned by the government have boards of management appointed by the minister in charge of the sector. They are subject to government financial and administration regulations. Some companies are partly owned by the government and partly by private institutions. In some cases, they come with public share holdings (quoted in the stock exchange).

Private companies are regulated by the Companies Act No. 17 of 1982. They have to conform to certain restrictions (e.g., they cannot exceed 50 shareholders other than employees owning shares; they cannot offer shares to the public). The same law oversees publicly listed companies which have listing in the Colombo Stock Exchange (CSE). Companies limited by shares must have a share capital. Companies limited by guarantee and unlimited companies may or may not have a share capital.

Most companies are registered as limited liability companies. A registered company may be a public company or a private company. There are about 36,000 registered private companies and about 2,160 registered public companies in Sri Lanka (ADB, 2002), but only 238 are listed in the CSE (CSE, 2002). Despite the privatization program, 75 commercial enterprises and 115 statutory bodies remain wholly government owned.

In Sri Lanka, private companies (and groups of companies) are mainly held by a single owner or families. There is no documented evidence to show the extent of family ownership. However, in most cases, few individuals or groups have a shareholding sufficient to exercise control over the company. An analysis of 226 companies whose information is listed with the stock exchange shows that in most listed companies, few individuals held the majority of shares, giving controlling interest. In at least 48 companies, a single person held the majority shares. In at least 33 companies, two persons held the majority. In at least 31 companies, the majority was held by three persons and in at least 19 companies; four persons held the majority. Most of the large companies (both private and publicly listed) have subsidiaries, which are controlled by them. Some of the subsidiaries of publicly listed companies are themselves publicly listed companies (Figure 3).

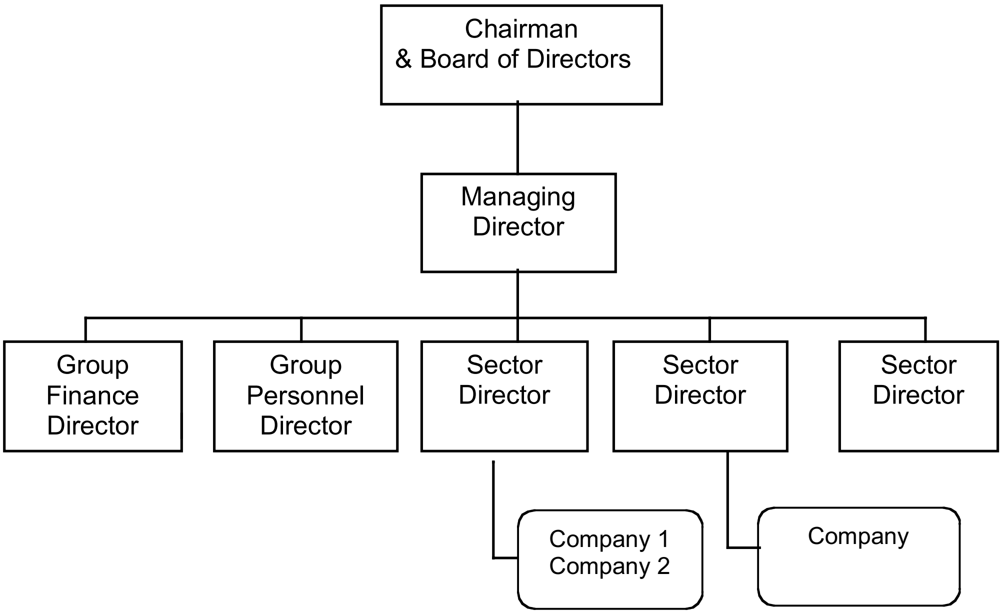


Figure 3. Typical corporate structure of a group

The Companies Act in Sri Lanka does not permit a subsidiary to hold shares in its holding company (section 29 of Act No. 17 of 1982). Therefore, cross holding of shares between holding companies and subsidiaries is not seen in Sri Lanka. However, a chain of holding companies and subsidiaries is possible, and is seen in Sri Lanka.

There could be a number of companies carrying on business in each sector. Each sector director would therefore be responsible for the supervision of the activities of a number of subsidiaries. Depending on the group, the sector director would be the managing director of each of those companies, or there could be other managers appointed as managing directors. If the sector director is the managing director, there could be a general manager appointed to each of the companies.

Many of the publicly listed companies have subsidiaries in which the directors of the holding company have significant shareholdings. Some of the subsidiaries purport to perform management services, computer services and similar types of services. Because of the significant financial interest of the directors in these subsidiaries, it is possible for the boards of the holding companies to make decisions in favor of the subsidiaries to the detriment of the other shareholders of the holding company. As accounting standards (both Sri Lanka and international) do not require disclosure of inter-company transactions, the directors could avoid disclosure of these related party transactions on the basis that they are within the exclusion, though it is doubtful that the standards are intended to permit non-disclosure of such transactions. Non-executive directors are often not effective in controlling such practices, as the board appoints them.

The Sri Lankan equity market does not have active independent shareholders. Unit trusts and other forms of fund management have not developed to a significant degree sufficient to influence the decisions of the management. There is only one rating agency, and that, too, entered the market quite recently.

As shareholdings of most companies are concentrated in few shareholders who are also directors, the directors are able to make decisions which are favorable to themselves and unfavorable to minority shareholders. Therefore, the minority shareholders are largely at the mercy of the directors, and it is unlikely that the market forces would change the situation.

Minority shareholders who participate in general meetings often feel that they do not have a significant voice at these meetings. There is little shareholder participation in important decisions, and in particular on material related party transactions

In the plantation sector most companies have delegated management to other companies in which directors of the plantation company are the shareholders and directors. The delegated company enjoys substantial management fees. Most minority shareholders feel that this arrangement is disadvantageous to the company and its shareholders and have been done to benefit the directors.

Company legislation as well as accounting standards requires disclosure of related party transactions. However, Sri Lanka accounting standards as well as international accounting standards on which the Sri Lanka standards are based, exclude inter-company transactions between members of a group of companies from this disclosure requirement. Many minority shareholders feel that the directors of companies use this exclusion to avoid disclosing transactions with companies of the group in which directors have large financial interest.

LEGAL AND REGULATORY FRAMEWORK

Laws regulating the corporate sector

Companies Act No. 17 of 1982

This Act, as amended by Act No. 13 of 1991 is the main law governing companies in Sri Lanka. It provides for the incorporation of companies, their status as body corporate, their main statutory requirements, their management, and administration, and their liquidation. Both private and public companies are required to file their balance sheets with profit and loss accounts with their auditor s reports and director s report. People s companies are allowed provided that the maximum shareholding of a single shareholder or through a member of his family does nor exceed 1/10 of the paid up capital of the company. The registrar of companies is empowered to call upon a private company to be converted into a public company in the interest of the national economy.

Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995

This Act provides for the formulation and statutory recognition of Sri Lanka accounting standards and Sri Lanka auditing standards, and a means of monitoring compliance with the standards by a statutory board, the Sri Lanka accounting and auditing standards monitoring board.

Miscellaneous legislation

Other laws, which relate to the administration and governance of companies are: Companies (Donations) Act No. 26 of 1951, Companies (Special Provisions) Act No. 19 of 1974, Foreign Companies (Special Provisions) Act No. 9 of 1975, and Conversion of Public Corporations or Government Owned Business Undertakings into Public Companies Act No. 23 of 1987.

Audit committee

The committee regularly reviews, with management and internal and external audits, the effectiveness of internal controls, management of business risks and other matters raised in regular reports submitted to the committee. The Code of Best Practice on Audit Committees, a major corporate governance initiative by the Institute of Chartered Accountants of Sri Lanka (ICASL), covers the areas of role, object and composition of an audit committee. Under the code, the audit committee must evaluate conflict of interest situations, and assess the adequacy of the safeguards which are in place, and review and evaluate factors related to the independence of external auditors.

Directors' responsibilities

The directors are responsible for ensuring (1) that the company keeps sufficient accounting records for disclosure, with reasonable accuracy, (2) the financial viability of the company, and (3) that the financial statements comply with the Companies Act and the Sri Lanka accounting standards (SLAS). They are also responsible for taking reasonable steps to safeguard the assets of the company and to have proper regard to the establishment of an appropriate system of internal control for the prevention and detection of fraud and other irregularities.

Regulations governing the capital market including the stock exchange

The stock exchange in Sri Lanka, which was formalized in 1986, is one of the oldest in the world with a history of share trading of over 100 years, mainly catering to the plantation sector. The Colombo Stock Exchange (CSE) is a company limited by guarantee, established under the Companies Act No. 17 of 1982 and is licensed by the Securities and Exchange Commission (SEC). The CSE is a member of the World Federation of Stock Exchanges (FIBV) and a member of the South Asian Federation of Exchanges (SAFE). The Securities and Exchange Commission (SEC) and the Colombo Stock Exchange (CSE) are leading agencies in the effort to raise capital in the modern capital market for Sri Lanka s economic development. In 1996, over the counter market for trading on unlisted shares was introduced. In 1997, a two-tiered system consisting of a main board and a second board for listing of companies was introduced. In 1997, the SEC and CSE installed a screen based trading system.

At the end of 2002, the exchange had 239 companies listed with a market capitalization of over 160 billion rupees (over US$1.7 billion). The market capitalization was approximately 12 percent of GDP of the country. Market price earnings ratio was 12.1 times. Currently 19 business sectors are represented on the exchange (CSE, 2002).

Foreign investment in the stock market is freely permitted. Investment in shares in Sri Lanka and repatriation of proceeds take place through the Share Investment External Rupee Accounts (SIERA) opened with commercial banks. A special scheme exists for Sri Lankans who are non-residents to remit money for investment in Sri Lanka through an account titled Rupee Account for Non-resident Sri Lankans (RANSI). All incomes from investment such as interest, dividends are not subject to exchange control regulations and may be remitted abroad through a RANSI account. There are no taxes imposed on transactions except for a 15 percent withholding tax on dividends on shares for non-residents.

Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987

Two laws, the Security Council Act No. 36 of 1987 and the Security Council (Amendment) Act No. 26 of 1991 were enacted for the regulation of the securities market and for the protection of shareholders and investors. These acts created the Securities and Exchange Commission which is a mechanism to advise the government on the development of the securities market and to implement government policy with respect to the securities market.

Accounting standards

All listed companies and large private companies are statutorily required to follow Sri Lanka accounting standards. Sri Lanka accounting standards (SLAS) are based on international financial reporting standards (IFRS) [formally known as International Accounting Standards (IAS)]. However, there is a growing gap between SLAS and IFRS due to the slow pace at which standards are adopted, due to pressures from the corporate management on the Institute of Chartered Accountants to defer adoption of standards.

Adopted standards are subject to an effective monitoring process by an independent statutory body, Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB). The accounts of companies are audited by chartered accountants under Sri Lanka auditing standards. The audits of listed companies, large private companies and commercial public corporations, and commercial public corporations are monitored by the SLAASMB.

SURVEY IMPLEMENTATION

Initially, when a sample survey was conducted with a CEO of a company, it was realized that the CEO needed to consult other members of the company, especially the CFO (chief financial officer) or the accountant, to obtain further data. Therefore, it was decided to compile the questionnaire into booklet form, which could be then given to the CEOs to be completed with the help of the other officers of the company.

Next, each CEO was personally interviewed and the questionnaire was handed over after the enumerator explained its purpose and the procedure for completing it.

CHARACTERISTICS OF RESPONDENT FIRMS

Three companies surveyed are limited liability companies. Three are listed in the stock exchange. Four are privately owned. One is a branch of a foreign bank. One company is a corporation listed in the stock exchange. Most of the large companies (both private and public listed) have subsidiaries, which are controlled by them.

The main areas of activities of the eight companies surveyed are in trading, manufacture, financial services, freight forwarding, and construction and engineering.
Foreign companies have financial stakes in three of the companies. One of the foreign companies is a Japanese company and the other two are UK companies. Only one company has holdings or operations in other countries. In three firms surveyed, the chairman of the board is also the CEO. Comparison of the performance of such firms shows a mixed record (Table 2).

Table 2. Comparative performance of sampled firms

Firm	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Return on equity	15%	9.00 %	5.39 %	(30) %	17.80 %	(14) %	13.38 %	20%
Board Chairman also the CEO?	No	Yes	No		No	Yes	Yes	No

In three of the eight companies surveyed, the top ten shareholders hold the major shares. Total shares in two companies are held by one shareholder and one company is a branch of a foreign bank. This pattern is somewhat similar to the general pattern in the Sri Lankan corporate sector.

SELECTED RESULTS

Ownership

In the survey, the three public listed companies show returns on equity of 15 percent, nine percent and 13 percent, respectively, while the foreign owned bank and a private limited company show low returns and negative return respectively (Figure 4). The two privately owned companies with one shareholder each, show high returns on equity.

In 50 percent of the companies surveyed the employees hold shares, but less than 5 percent of total shares.

Only the three public listed companies surveyed allowed proxy voting, indicating that in the others, minority shareholders have little power in deciding on the selection of directors.

There is no law prohibiting foreign ownership of shares. Foreign ownership of shares is common among listed companies and three of the eight companies surveyed have foreign financial stakes in their firms.

In general, it appears that in the companies surveyed, the members of the board and the owners guarantee the loans.

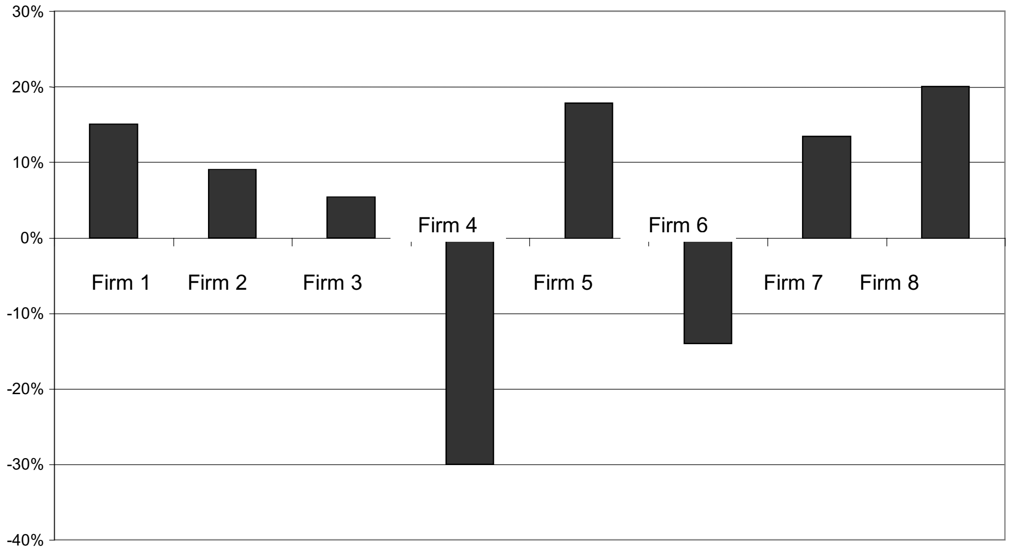


Figure 4. Return on equity

Management

The survey yielded no surprising patterns (Table 3). The board of directors carries out management of companies in Sri Lanka. The CEO is in charge of the day-to-day operations of the company, and guides the board in strategic and other important decisions. These characteristics were confirmed by the survey. In five companies the CEO seems to be the one taking decisions on corporate thrust and direction, financial strategies, rewards for management performance and appointments and executive compensation. Owners and shareholders do not play a major part in the decision making process of the companies, except in five companies where the owners and shareholders decide on the composition of the board and membership. In one company the owners and shareholders decide on mergers and acquisitions. The board of management and the CEO appear to have independence in decision making on major issues. The COO and senior managers make decisions on customer satisfaction, quality issues and productivity improvement measures.

In most private companies, the CEO is also the chairman of the company. The same feature is seen in some of the public listed companies, while in others the CEO and chairman are different. The survey results confirmed this in half of the firms.

All companies surveyed except one have external auditors, with a very high rate of independence given to the auditors. All companies surveyed except three maintain separate books for the management and/or auditors. Two companies maintain separate books for executive salaries.

Four of the eight companies surveyed revealed that they have audit committees and/or compensation/remuneration or investment committees working directly under the board.

Table 3. The decision system in sampled Sri Lankan firms (% of responding firms)

Type of decision	Owner(s)/ major share-holders	Board	Chief Executive Officer	Chief Operating Officer
Corporate thrusts and direction		87.50	50.00	
Corporate and financial strategic options		87.50	62.50	
Sanctions and rewards for management performance		75.00	62.50	12.50
Management appointments and executive compensation		50.00	62.50	
Board composition and membership	62.50	37.50	12.50	
Day-to-day operations			62.50	75.00
Declaration of dividends		87.50		
Profit or gain sharing		87.50		
Business expansion/ contraction		62.50	50.00	
Mergers and acquisitions	12.50	87.50	25.00	
Productivity improvement measures		12.50	62.50	62.50
Customer satisfaction/ quality issues		12.50	62.50	62.50

Social responsibility

Consumer protection laws in Sri Lanka are limited to specific areas. There are no generally applicable consumer protection laws in Sri Lanka. Some firms take effective steps towards environmental protection, while others do not. Most firms have not sought ISO 14000 certification. None of the firms surveyed have received ISO 14000 certification.

Only 50 percent of the companies surveyed have policies on consumer protection and only two companies have a policy on environmental protection. Three of the eight companies surveyed have community projects.

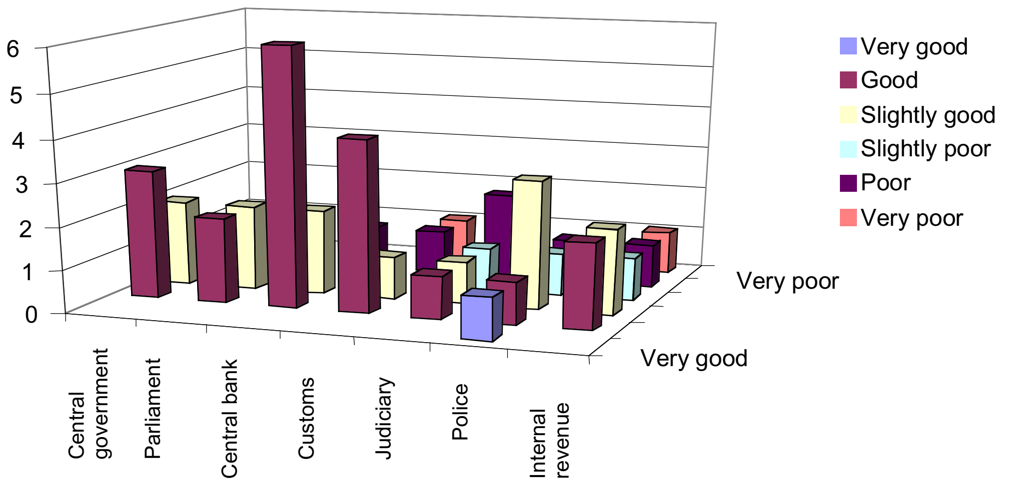


Figure 5. Quality of services by external stakeholders

Institutional interface

The companies surveyed indicate moderate satisfaction or dissatisfaction over the services of the central government, central bank, customs, judiciary, port and water (Figure 5). The companies indicate a low level of satisfaction over the services of the judiciary, police, inland revenue, roads and electricity, the worst being electricity. The companies express satisfaction over the services of telecommunication. They have widely divergent levels of satisfaction in the services of parliament and education.

Corruption and exchange rate were identified as the major problem areas, which affect business operations and growth. The least problem area in relation to business operations and growth is international regulations and standards.

GOVERNING RELATIONSHIPS

The following relationships (Table 4) between a number of corporate governance elements and productivity-measured as net profit/book value of assets-were derived from the survey data.

Ownership: A negative relationship exists between the degree of concentration of ownership and corporate productivity among the sampled firms. This suggests that dispersing ownership has a favorable impact on the efficiency of the firms. Higher participation, which allows minority shareholders to challenge the power of concentrated ownership, results in better performance. This runs counter to the usual finding that widely held firms in Asia are at a disadvantage because the presence of minority shareholders increases monitoring costs and could lower productivity.

Financing: Banks as creditors seem to have a beneficial effect on firm productivity. In theory, if creditors are part of the conglomerate (e.g., affiliated banks) there is distortion of incentives to discipline the firm. Hence, there is lower monitoring cost. Close relationships between owners and financiers also lower the agency costs, putting less constraints on firm resources. In the Asian model (relationship based), to offset poor enforcement of governance rules, external creditors and their ability to enforce agreements have to be relied upon.

Table 4. Average capital productivity (net profit/book value of assets) of sample firms

		Capital productivity	Remarks
Ownership			
Whose top shareholder owns	≥ 50 percent of shares	-0.2019	
	< 50 percent of shares	0.2481	Higher
Financing			
Whose creditors are	banks	0.2339	Higher
	non-banks	-0.6740	
Management			
Whose board chairman is	CEO	0.1419	
	non-CEO	0.2244	Higher
Whose board has	audit committee	0.2591	Higher
	no audit committee	-0.4050	
Whose board has	outside directors	0.1932	Higher
	no outside directors	-0.5723	
Which has	disclosure rules	0.2250	Higher
	no disclosure rules	-0.3891	
Whose accounting standards are	local	-0.0602	
	international	0.1824	Higher
Which has	unions or associations	0.1511	Higher
	no unions or ass ns	-0.2611	
Social responsibility			
Which has	consumer mechanism	0.1570	Higher
	no consumer mechanism	-0.4819	
Which undertakes	community projects	0.2409	Higher
	no community projects	-0.4819	
Interface with government/international players			
Whose interface with central government is	good	-0.0988	
	poor	0.1824	Higher
Whose interface with customs is	good	-0.2462	
	poor	0.3368	Higher
Whose interface with internal revenue service is	good	-0.2586	
	poor	0.2481	Higher
Whose interface with judiciary is	good	0.1447	Higher
	poor	-0.2604	
Whose problem with anti-competitive practices is	moderate/major	-0.1502	
	minor/none	0.1447	Higher
Whose problem with corruption is	moderate/major	0.13.28	Higher
	minor/none	-0.0519	
Whose problem with international standards and regulations is	moderate/major	-0.2770	
	minor/none	0.1631	Higher
When quality standards are	present	0.1063	Higher
	absent	-0.2013	

Management: Here, there are no unexpected outcomes. Efficiency considerations favor separation of board and management. Conversely, when there is high conflict between owners and managers, managers will invest less effort in managing the corporate resources, resulting in lower productivity. If there are systems of internal control, such as audit committees to ensure regularity of transactions, the firms are less vulnerable to mismanagement, and higher productivity should ensue. An external director who is not affiliated to an owner means higher accountability, and better use of company resources.

Disclosure also brings about better productivity. Corporations which observe transparency, i.e., prepare financial reports and submit them to stockholders and security agencies, are less likely to indulge in corrupt or wasteful practices.

Sri Lankan firms use local accounting standards, but as Table 4 indicates, they do not bring levels of productivity as high as those using international standards. If the corporation follows international accounting standards it would mean more transparency and hence more productivity. The presence of unions or employees associations also yields high productivity levels. In this case, unions act as a whip that could bring workers into line with the productivity goals of the company.

Social responsibility: It pays to offer customer friendly products and services to consumers. The pay-offs are sustainable business, increased productivity and sustained profitability. Closer community ties also lead to increased productivity. High quality and availability of products often result in sales and deals that are based on solid corporate citizenship practices.

Interface with stakeholder: The results here are counter-intuitive. Companies that rate central government, customs, and internal revenue service as good have lower productivity levels. Only the relationship with the judiciary yields a positive score for company performance, suggesting the high confidence of firms in the ability of judicial processes to adjudicate corporate cases justly and fairly. On the other hand, the poor productivity outcomes may mean that although many of the sampled firms are satisfied with progress in governmental efforts, a host of unfavorable regulatory processes, statutory restrictions, and low standards of transparency and disclosure, still affect corporate performance negatively.

In general, the results of the survey conform to the hypothesis that good corporate governance results in good performance, and provides a better assurance of productivity.

POLICY RECOMMENDATIONS

The issues that surfaced during the study and subsequent discussions with corporate sector personnel indicate that much could be done to improve good governance in the Sri Lankan corporate sector. Indeed, there is room for improvement on policy on disclosure, formatting and reporting of company data.

General recommendations

Concentrations of major shareholding, directors undue involvement in management companies which are subsidiaries are some of the key issues which prompted the following general recommendations:

1. While it will take time for Sri Lankan companies to be more widely held, in the meantime, it is necessary that steps are taken to ensure that the financial interest of minority shareholders is protected, and shareholder rights and transparency of related party transactions are enhanced. The legal and regulatory framework should ensure that non-controlling shareholders are protected from exploitation by insiders and controlling shareholders.
2. An effective board will need to adopt clear-cut risk policies, clearer monitoring and corporate performance standards, and better ways of overseeing major capital expenditure, corporate acquisitions and divestures. The board must take responsibility for an independent review of transactions involving managers, controlling shareholders and other insiders.
3. Corporate leaders should adhere strictly to the requirements for maintaining the integrity of financial reporting systems, including independent audit.

4. Corporate governance indicators must be constructed to better assess board effectiveness, its performance, accountability and transparency.

Specific recommendations

Some specific recommendations arising from the study include the following:

1. At least one director should be appointed by the minority shareholders, the appointment of which shall be on an annual basis, in all listed companies.
2. All material related party transactions should be specifically approved by shareholders at a general meeting.
3. Transactions with subsidiaries, in which directors and senior officers have a financial interest, should be specifically identified as related party transactions.
4. The role of the Sri Lanka Accounting and Auditing Standards Monitoring Board should be enhanced. It should include monitoring compliance with laws and regulations in relation to financial reporting other than accounting standards and auditing standards (for example, financial reporting requirements of the Companies Act, rules of the Colombo Stock Exchange, and in relation to banks, the financial reporting requirements specified by the Central Bank). It should also cover investigation of financial fraud.

In the public sector, corporate governance is better served if government adopts the ADB recommendations to rectify gaps, mostly in the accounting and auditing area (ADB, 2002). This means increasing the number of qualified, skilled and motivated accountants. It recommends establishing professional qualifications for public sector accountants and establishing retaining courses. Other recommendations include enhancement of director accountability and mandatory continuing professional education of chartered accountants.

Another effort that may offer some relief from poor corporate governance is the publication of the Handbook on Corporate Governance by the Institute of Chartered Secretaries and Administrators. The handbook covers almost all aspects of corporate governance such as the functions of the board of directors, appointment and election of directors, director remunerations, internal control, risk management, the role of the company secretary, among others. Prior to that, the Institute of Chartered Accountants of Sri Lanka, has developed a Code of Best Practice on Corporate Governance in 1997. This code sets out the best governance practices and structures that should be in place.

Responsibility to shareholders

The corporate entity's governance policies should balance the interests of managers, employees, shareholders and other company stakeholders. While ensuring participation it should protect the interest of other stakeholders and their right to information. The corporate entity should respect the right of shareholders to submit proposals to a vote and to ask questions at annual meetings. As regards directors and employees behavior, the company should observe a code of best practice or else it should have its own comprehensive corporate code.

Responsibility to employees

The corporate entity should set a standard governing its employment practices and industrial relations. It should include respect for employees' rights to freedom of association, and free collective bargaining. It should adopt a non-discriminatory stance towards employment and should strive to value employees and their contributions in every sector of its operations. It should recognize the necessity of providing essential social infrastructure support such as child care, elder care and community services which would allow workers, especially women who have traditionally done this role as unpaid labor, to participate as employees.

Responsibility towards customers, suppliers and contractors

The corporate entity should ensure that its products and services meet customer requirements and product specification standards. It must be committed to fair marketing and trading practices, which protect customers and ensure the safety of all products. It should use its purchasing power to encourage good corporate citizenship among its suppliers.

Responsibility to the environment

A corporate entity should adopt high environmental standards and ensure that these standards are implemented regardless of whether these are mandated by law or not.

Responsibility to the national community

Large corporations in Sri Lanka which have partnerships with governments and community leaders have come to realize that investing in the well being of their communities is not just an act of charity. Rather this is becoming necessary for their long-term survival as it ensures brand loyalty, improves employee potential and enhances the long-term sustainability of their investment. Above all it helps create a stable society.

Responsibility to the local community

The corporate entity should engage in political and economic undertakings in the communities especially since it is the principal employer. The employees should be encouraged to participate in local community activities and organizations. It should be sensitive to local culture in its decision making process, while rejecting cultural practices which tend to denigrate human beings on the basis of gender, caste, class, culture or race. Altogether, it should strive to contribute to the long-term sustainability of the local communities in which it operates.

REFERENCES

Asian Development Bank (2002). Diagnostic study of Accounting and Auditing Practices in Sri Lanka.

Central Bank of Sri Lanka (2000). Annual Report.

Colombo Stock Exchange (2002). Handbook of Listed Companies.

Grosfeld I., and Tressel T.William (2001). Competition and Corporate Governance: Substitutes or Complements? Evidence from the Warsaw Stock Exchange. Davidson Institute, Michigan, WDI Working Paper No. 369.

Kar, Debayani (2003). The IMF-World Bank Plan for Sri Lanka: Will it Help or Hinder South Asian Success? Center for Economic and Policy Research, April 10.

Koeke J. and L. Renneboog (2003). Discussion Paper No. 89. Tilburg University, Center for Economic Research: http://ideas.repec.org/p/dgr/kubcen/200289.html

Organization for Economic Development and Cooperation (2003). White Paper on Corporate Governance in Asia. Asian Roundtable on Corporate Governance, June 10.

Ranaraja, Shyamali (2001). Case Study of Privatized Public Enterprises —Sri Lanka, July.

Securities & Exchange Commission of Sri Lanka (1998). Report on the Capital Market Advancement Workshop, July.

Securities & Exchange Commission (2002). Annual Report.

CORPORATE GOVERNANCE AND ITS IMPACT ON PRODUCTIVITY IN VIETNAM

Nguyen Thi Bich Hang
Vietnam Productivity Council
Vietnam

INTRODUCTION AND LITERATURE REVIEW

In a fast changing business environment, to achieve sustainable development and competitiveness in a borderless marketplace, each individual organization must set an appropriate strategy. Enhancing corporate governance is one main focus that an organization needs to take into consideration. But why is corporate governance important for the development of business? How does this issue influence business performance? What can be done to enhance governance to achieve higher productivity? All these questions have different answers in different countries even in different organizations.

A number of researchers have paid attention to the issue of good corporate governance and good governance in Vietnam. But the very important question of linkage between good governance and productivity remains unanswered. Most studies show that there is a need to reform the enterprise sector in Vietnam to achieve good corporate governance.

Without doubt, state-owned enterprises (SOEs) are the main focus due to the fact that this sector, being its main pillar, plays a very important role in Vietnam s economy. Diehl (1998) discovers that the formal institutions in Vietnam are still supportive of SOEs despite budgetary constraints undermining this support. The SOE reform is still tentative and is based on many different government directives. This is probably a result of fears of the political and economic consequences of mass privatization. However, the evolution of efficient informal institutions may have eased the difficult process of building a new governance structure for SOEs. Moreover, codes of conduct and informal business relations may lead to highly competitive markets notwithstanding official interventions favoring SOEs. Thus, for the analysis of the economic adjustment process, not only state interventions and changes in the legal environment need to be considered but also the evolution of informal institutions. For SOEs to have higher performance, managerial autonomy must be allowed, a code of conduct for SOE directors adopted and employer-employee relationship improved.

Gates (1997) and Tam (2000), exploring the financial stability and strengthening of the financial sector in Vietnam, conclude that profound restructuring of the state-owned enterprise sector is critical. According to these authors, the main concerns in implementing enterprise reform are developing transparent and simplified divestiture methods, dealing with excess labor, resolving the bad debts of many of the companies, and providing effective governance of state-owned enterprises while these remain under majority government ownership. They also highlighted the fact that most managers in SOEs in Vietnam, being of engineering rather than accounting or business administration background, gave effectiveness of governance structure less importance.

Two other studies of Macmillan and Woodruff (1998) and Malesky, Hung, Anh and Napier (1998) once again focus on SOE reform and inter-firm relationship to promote trade in Vietnam. They find that strong bilateral relationships exist among many firms.

These relationships are embedded in two types of networks: one based on pre-existing ties of family or friendship, the other on communication among manufacturers of similar kinds of goods. Private firms use both of these networks to investigate potential trading partners before dealing with them and then to monitor them once they start to transact. The punishment for nonpayment of a debt can be bilateral (the creditor refuses to continue to deal with the debtor) or communal (other firms are told of the bad debt and blacklist the debtor). McMillan and Woodruff measure the amount of trade credit the firm grants to the partner as an indicator of a firm s trust in its trading partner. They find that the cost of finding alternative trading partners facilitates trade credit. Search costs are undoubtedly higher in Vietnam s transition economy, which lacks information-generating market infrastructure, than in industrial economies.

Malesky and others (1998) focus on the implementation of enterprise reform at the firm level and how these reforms have changed the behavior of state enterprises. However, it must be noted that the state sector in Vietnam has traditionally accounted for a very small portion of GDP compared with that in Eastern Europe, the former Soviet Union, or China. In 1996, for instance, Vietnam s state sector produced only 29 percent of GDP, mostly through manufacturing and other industries. The heavy indebtedness of the state sector, however, underscored the need for reforms in state enterprises. Accordingly, earlier reform of state enterprises included the liquidation or merger of many small and unprofitable companies (5,000 of 12,000 state enterprises were eliminated in 1989) as well as the combination of many surviving state enterprises into larger business groups or conglomerates. Other well designed reform laws such as those governing the introduction of corporate governance plans, enterprise autonomy, better accounting standards and internal management practices, and more competition called for more effective implementation.

Malesky *et al.* (1999) propose six key steps to successful reform: (1) granting enterprises autonomy and eliminate bureaucratic centralism; (2) imposing strict budgetary discipline; (3) introducing both foreign and domestic competition; (4) allowing prices to reflect market scarcity; (5) creating management boards and restructuring the management hierarchy; and (6) adopting new management techniques. Some of these recommendations seem inappropriate to the current situation but their studies anyway highlighted very important points.

With two recent papers, Ngu (2002) illustrates that reform measures appear to have positive effects on enhancing the SOE economic performance. This is reflected by the average annual TFP (total factor productivity) growth rate of 3.05 percent over the whole period studied and of 4.22 percent and 5.37 percent during the partial and full reform periods, respectively. This resulted from dramatic changes in macro-economic policies. SOEs have the right to decide what, how and for whom to produce and where to source inputs and market their outputs. They are allowed to do business freely with one another and with non-SOEs, including foreign partners in the form of a joint venture or a business contract. They are also allowed to hire and fire employees and set wages, within policy guidelines. However, they have to preserve and develop the capital that government has entrusted them with and to pay taxes and other levies as stipulated in the laws. All after-tax profits belong to SOEs. They have almost total freedom to use their capital: they can invest using their own funds to increase fixed capital and dispose unnecessary fixed capital except for big projects or important equipment where approval must be sought from the finance authority. In spite of these achievements, many problems remain to be solved. While SOEs are enjoying greater autonomy than before, their behavior has not been effectively controlled. The weak management and control mechanisms enable SOEs to exploit public property. Meantime, the SOE sector is still seen to be less competitive and inefficient relative to private enterprises. The latter issues need to be addressed by the on-going SOE reform process in Vietnam.

In sum, the studies conducted so far pay attention on improving the SOE sector for better performance. These studies mention some aspects of corporate governance but none of them examines its impact on productivity. This paper empirically explores this linkage. With the aim of clarifying the impact of corporate governance on productivity in Vietnamese cases, this study argues that good governance criteria should be set for Vietnamese enterprises so that they can better perform. All businessmen should be well aware of the four aspects of good corporate governance, namely: ownership, management, social responsibility and institutional interface.

The sample of the study was carefully chosen. Initially, the number of publicly-listed and non-publicly listed companies were equal. The non-publicly listed companies were recently equitized. They, therefore, have very limited disclosures with respect to financial and other information which prevent any effective analysis of their performance. As a result, all 16 respondent companies are publicly-listed ones.

OVERVIEW OF THE ECONOMY AND THE CORPORATE SECTOR

Brief overview of the Vietnamese economy

VIETNAM IN BRIEF

Political regime: Socialist Republic
Population: 80 million
Area: 330,000 km^2
GDP growth: average 6 %/year
GDP per capita: $ 406 ($1860 PPP)
Geographical zone: South East Asia
Official language: Vietnamese
National birthday: 2 September 1945

Since the adoption of the Doi Moi or renovation policy for transition to a market economy in the late 1980s, Vietnam has been one of the fastest growing economies in the world. The average annual growth rate in the last decade was over six percent despite the slowdown since 1998. Inflation has been low and stable since 1992. Between 1991 and 2000, Vietnam s GDP doubled. Agriculture, covering 40 percent of GDP, grew at slightly over four percent, while industrial value-added increased rapidly at an average rate of 11.2 percent per year, albeit from a very low base. However, in the first quarter of 2003, the value of agricultural exports increased by 33 percent, which shows the positive signal in agricultural development. The services sector expanded at a little more than seven percent each year. The benefits of these reforms to Vietnam s economy and society and its people have been significant, especially in late 1990s. Domestic savings increased from a negligible figure to 25 percent of GDP in 2000. People s living standards have improved. According to the official statistics of the government, the proportion of poor household (based on Vietnam s poverty line) has declined from over 30 percent to 11 percent. According to internationally comparable poverty criteria, the level of poverty fell from 70 percent in the mid 1980s to 37 percent today.

The deceleration in agriculture was more than offset by a strong performance in industry and construction. On the back of strong performance from manufacturing and construction, growth in industry was estimated at 9.7 percent in 2001. In fact, growth reached 14.6 percent at the end of 2001 and increased to 15.1 percent in the first quarter of 2003. Manufacturing is estimated to have increased by 9.2 percent while construction recorded a robust performance of 13 percent due to the implementation of infrastructure projects, urban development projects in major cities, particularly Hanoi and Ho Chi Minh City, and a real estate boom. Within industry generally, the foreign-investment subsector grew at its lowest rate in recent years, at 12.1 percent. Non-state activities grew by 20.3 percent in 2001, partly due to the vigorous impact of the Enterprise Law, which streamlined administrative procedures for doing business. The law abolished 145 out of 400 licenses in 2000, and Government Decree No. 30 issued that year required 60 licenses to be abolished in 2001. Registration requirements were also simplified. As a result, the number of private enterprises surged in 2000 and 2001. In the improved business environment, capital investment also increased.

In 2001, services sector growth was estimated at 4.4 percent. Wholesale and retail trade maintained its modest improvement of 3.3 percent. Real estate services were the leading area, strengthening by an estimated 8 percent due to the buoyant real estate market. The easing of procedures for issuing land-use certificates, the granting of permission to buy land to overseas Vietnamese, and recognition of Vietnam as one of the safer countries in the region all promoted land transactions. As a result, land prices in major urban centers such as Hanoi and Ho Chi Minh City increased by three or four times during the year.

Table 1. Main economic indicators of Vietnam from 1999 - 2003

Item	1999	2000	2001	2002	2003
GDP growth	4.7	6.1	5.8	6.2	6.8
Gross domestic investment/GDP	22.2	23.9	25.9	26.8	28.0
Gross domestic savings/GDP	26.3	25.5	27.4	27.1	27.8
Inflation rate (consumer price index)	0.1	-0.6	0.8	3.0	4.0
Money supply (M2) growth	39.3	39.0	23.2	25.0	26.0
Fiscal balance*	-2.8	-3.0	-4.9	-5.4	-6.5
Merchandise export growth	23.2	25.2	6.5	8.5	12.0
Merchandise import growth	1.1	34.5	6.0	10.0	13.0
Current account balance/GDP	4.1	1.6	1.5	0.3	-0.2
Debt service ratio	12.8	11.2	10.2	8.3	6.8
*excluding grants and including net lending					

Source: ADB Asian Economic Outlook, 2004

During 1998 and 1999, economic growth declined to around four percent a year due partially to the East Asian crisis and in part to the internal loss of momentum as the first round of reforms ran its course. Total investment fell from around 30 percent to around 20 percent of GDP due to the collapse in foreign investment. In 2000, Vietnam ranked 53rd in world competitiveness out of 58 economies being evaluated by the world economic forum. In 2001, Vietnam dropped to 60th position out of 75 countries being ranked.

Despite all these achievements, Vietnam remains a poor country with a low average income per capita ranking (estimated at around US$ 420 in 2001). There are still many shortcomings and constraints which are currently preventing rapid development including, *inter alia,* an ineffective and uncompetitive economy, low domestic savings and low purchasing power. In addition, the change of economic structure is slow and both unemployment and underemployment remain high. The urban unemployment rate is around seven percent and rural underemployment about 30 percent. There are many additional problems with respect to investment structure and the tendency of government to subsidize and protect SOEs still persists. Moreover there are many obstacles in the investment and business environment. There has been not enough substantial change in the reform and development of the state sector, particularly with regard to state-owned enterprises (SOEs). Therefore, foreign and domestic private investors confidence remains rather weak.

During the last few years the government made several attempts to overcome these difficulties. The New Enterprise Law, put into effect in January 2000, removed several bureaucratic steps and eased the often complicated registration procedures for new enterprises. So far, it has been very successful. More than 10,000 new enterprises were registered or established in 2000 alone. Also the Ho Chi Minh City Stock Exchange Center opened.

However, economic globalization and international integration are complex processes, especially for developing countries such as Vietnam with its low level of development and its economy in transition. Therefore, the government is currently drafting new legislation, including a law on competition and monopolies, and amending the Commercial Law, the ordinance on most favored nation status in regard to national treatment and self-protection, stipulations on anti-dumping and other similar issuances justifying the protection of certain businesses from international competition.

Characteristics of the corporate sector

A very important point characterizing Vietnamese business sector is the transition from command economy to market economy. Before 1986, there were only state-owned enterprises, which were considered as uniquely legitimate sector. Under command economy government controlled all business activities from production to distribution. Companies themselves could not interfere in their own businesses. But after the *Doi Moi* , the situation changed dramatically. Other sectors, especially the private sector, were encouraged to actively participate in the economic development. The following business types currently can be found in Vietnam:

- State-owned enterprises (SOEs);
- Enterprises of political organizations or socio-political organizations (kind of state-owned but belonging to the communist party);
- Private enterprises (including limited liability companies, partnership, private enterprises and small household businesses); and
- Foreign capital enterprises (either joint ventures or 100 percent foreign capital invested companies).

Under the legal system, the above-mentioned businesses are either classified as limited liability companies with two or more members, one-member limited liability companies, joint-stock companies, partnerships or private enterprises.

SOEs, which are still bound by the Law on SOEs, gradually are to be converted into relevant above-mentioned classifications. The SOEs' equitization process is one of the efforts to change state ownership. It is a long process and will take time. There are currently many kinds of SOEs: (1) central state corporations (big corporations under the direct control of the Prime Minister), (2) ministerial corporations (big corporations under the control of ministries, consisting of many member companies such as Vietnam Textile and Garment Corp., Vietnam Construction Import-Export Corp.), (3) enterprises belonging to the Communist Party as earlier mentioned, and (4) provincial enterprises. A number of companies belonging to state corporations have been equitized and became joint-stock companies (either publicly-listed or not). This has brought about some unique characteristics in their relationship with their "mother" state corporations.

Performance of the corporate sector

In fact, the corporate sector plays a vital role for the Vietnamese economy, both in terms of incomes and employment generation. However, there is no complete, systematic and updated research on productivity of the corporate sector. Some corporations have calculated their productivity but generally in terms of labor productivity but not total factor productivity. So far, it is impossible to measure the productivity performance of the whole sector. This survey targeted joint-stock companies for the following reasons:

- This sector reveals all the elements of management in the market economy in Vietnam. Although the country has adopted market mechanisms for more than 10 years, management practice may be uneven across companies;
- A number of SOEs (a major part of the Vietnamese economy) will be converted into joint-stock companies in the near future (under the equitization process). Thus, a study in this sector may give some insights for the process in this sector.

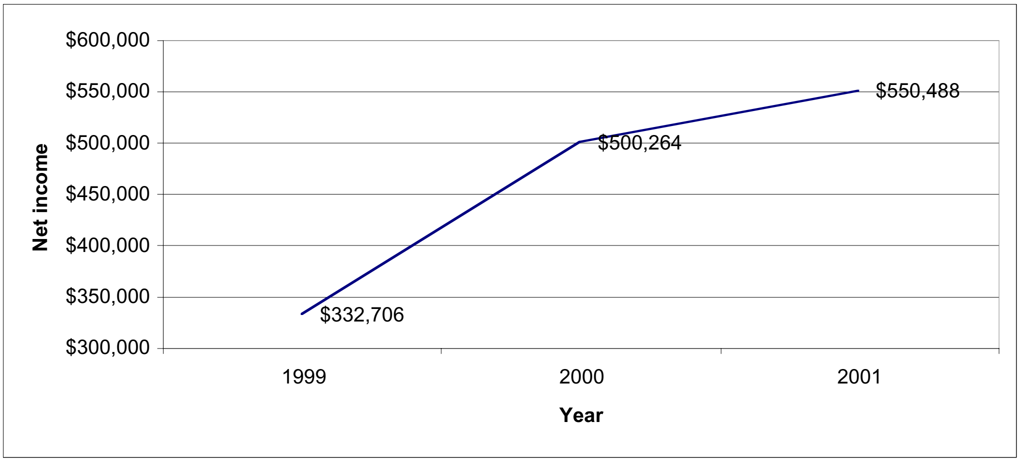


Figure 2. Growth of net incomes of sample firms

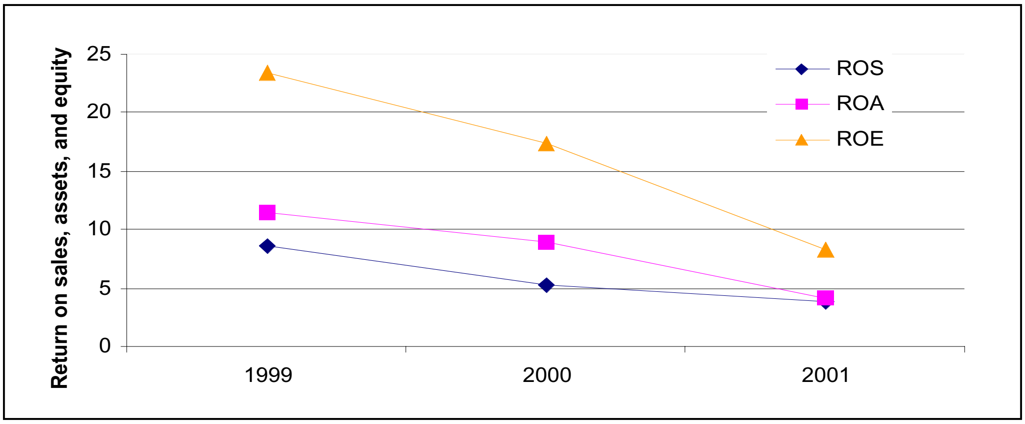


Figure 3. ROS, ROA and ROE of sample firms

As mentioned earlier, there are no figures relating productivity and performance of the corporate sector in Vietnam. So far, data were taken of all 16 publicly-listed companies to highlight some indicators of net incomes, growth, ROS, ROE and ROA. Figure 2 shows that the median net income for sample firms is increasing annually.

Although there is positive growth in terms of net incomes, Figure 3 shows a negative trend for some productivity indicators. All ROS, ROA and ROE declined annually demonstrating inefficiency and low productivity of the sample firms.

Equitization process

Equitization plays a very important role in the restructuring process in the corporate sector in Vietnam. In a demand economy, the government leads all economic activities. SOEs were the only sector running business. Even when Vietnam began to follow a market economy path, SOEs remained the leading sector. It means that the government holds the most important business areas. Some of these are monopolies e.g., telecommunication, petrol, electricity and water. Because only one-third of SOEs ran profitably, and under the pressure of economic integration in the region and the world, SOEs must be restructured to be more competitive. Accordingly, the government has formed a Corporate Restructuring Committee (CRC) to monitor the process.

Equitization transfers state capital to different owners via stocks. Companies can sell stocks to their employees and outside partners. Equitization leads to management changes within a company. Thus, managers who are incompetent to manage the company have to resign. Shareholders can control their company's operations and put pressure on management through internal control mechanisms. However, this process has been taking place very slowly due to the following reasons:

- Resistance to change—a number of companies which feared being transformed into joint-stock firms tried to slow down the process;
- Some policies/regulations issued by the CRC and by provincial authorities are not consistent. Thus, equitized companies face difficulties in speeding up the process;
- The financial markets (especially the stock exchange market) are not yet developed so it is not easy to trade stocks to others. Some companies sold only half of their stocks and cannot come back to their original status (*Saigon Economic Times*, May 1, 2003).

LEGAL AND REGULATORY FRAMEWORK

Laws regulating the corporate sector

On September 12, 1999 the National Assembly adopted for the first time a law on enterprises. Before that, regulations relating to the corporate sector were covered by different legal documents, i.e., law on state-owned enterprises, law on companies, Decree No.66/CP of the government on small businesses, law on encouragement of foreign invested companies (FICs), law on private enterprises and some other governmental decrees and ministerial decisions.

So far, 5,600 SOEs have been lined up for ownership change as follows. About 2,000 companies will be converted into limited liability companies. Another 2,000 will be changed to joint-stock ones. The rest will be merged or dissolved (*Vietnam News Agency*, April 22, 2002). Except for the law on SOEs and the law on FICs, the law on enterprises has replaced all other regulations mentioned above. This law prescribes the establishment, management, organization and operation of enterprises of various types: limited liability companies, joint-stock companies, partnerships and private enterprises. State-owned enterprises and enterprises of political organizations or socio-political organizations, upon being converted into limited liability companies or joint-stock companies, will be subject to this law. Government will stipulate the rules and procedures for such conversion.

Following are some elements of the legal system regulating joint-stock companies.

Regarding types of shares, corporations must have ordinary shares[1] and may have preferred shares.[2] Preferred shares will include the following types: (a) voting preferred shares, (b) dividend preferred shares, (c) redeemable preferred shares, and (d) other preferred shares stipulated in the charter of company. Only organizations authorized by the government and founding shareholders may hold voting preferred shares. The voting preferred of founding shareholders is valid only for three years from the date the company is granted the business registration certificate. After that period, the voting preferred shares of founding shareholders will be converted into ordinary shares. Each share of the same type gives its holder the same rights, obligations and interests. Ordinary shares cannot be converted into preferred shares. Preferred shares may be converted into ordinary shares by decisions of the general assembly of shareholders.

Ordinary shareholders have the right to:

1. Attend and vote on all matters which fall under the jurisdiction of the general assembly of shareholders; each ordinary share carries one vote;
2. Receive dividends at the rate decided by the General Assembly of Shareholders;
3. Be given priority in subscribing for new shares offered for sale in proportion to the number of ordinary shares each shareholder holds in the company;
4. Upon dissolution of the company, receive a part of the remaining asset, in proportion to the number of shares held in the company after the company has paid its creditors and shareholders of other types; and
5. Other rights stipulated in the law on enterprises and the charter of the company.

A shareholder or a group of shareholders holding more than 10 percent of the ordinary shares for a continuous period of six months or more, or holding a smaller percentage as stipulated in the charter of the company, will have the right to:

1. Nominate candidates to the board of management and the control board (if any);
2. Request the convening of a meeting of the general assembly of shareholders; and
3. Have access to and receive a copy or extract of the list of shareholders entitled to attend meetings of tire general assembly of shareholders.

Regulations governing the capital market including stock exchange

The stock market opened officially in Vietnam quite late due to a number of reasons. In fact, the preparation for a stock market took place only in the beginning of the 1990s. The establishment of the State Security Commission was done by a government decree (75-1996/N_-CP) on November 28, 1996. The commission was given authority to administer all activities relating to the stock market: to promulgate relevant regulations; to register security companies; to handle registration for issuing bonds, shares, among others. The first stock exchange center was established in Ho Chi Minh City in 1998 by a decision of the prime minister (Decision number 127-1998/Q_-TTg on 11 July 1998). On the same day, the government issued a decree (48-1998/N_-CP) regulating the operation of the center, stock transactions, and other requirements to do business in the center. After that, a number of legal documents were issued by the State Security Commission regarding the status of publicly-listed companies.

[1] Owners of ordinary shares are called ordinary shareholders.
[2] Owners of preference shares are called preference shareholders.

Table 2. Regulations relating to the stock exchange market

No.	Regulations	Related contents	Date issued
1.	Law on Enterprises	Joint-stock companies & general requirements on stocks issuance	June 12, 1999
2.	Governmental Decree 75 –1996/N_-CP	Establishment of the State Security Commission (SSC)	Nov 28, 1996
3.	Governmental Decree 48 –1998/N_-CP	Regulations on stocks and stock exchange market	July 11, 1998
4.	Prime Minister's Decision 127-1998/Q_-TTg	Establishment of the Stock Transaction Center (STC)	July 11, 1998
5.	Governmental Decree 01 –2000/N_-CP	Regulations on issuance of government bonds	Jan 13, 2000
6.	Decision of the SSC 04 -1999/Q_-UBCK	Regulations on STC membership, information disclosure and stock transactions	Mar 27, 1999
7.	Circular 02/2001/TT-UBCK of the SSC	Regulations on issuance of shares and bonds to public	Sep 28, 2001

Vietnam s policy is to open the economy in a careful manner. This includes the development of the stock market. For a country under a command economy for a long time, properly managing the operations of the stock market required a transition period to adapt to the changed environment. On the other hand, the development of this area needs a systematic development of the legal framework, banking system, corporate sector and other economic infrastructures. According to the assessment of economists and business experts, Vietnam still lacks a lot of conditions, especially a legal system for the smooth running of the stock market. A large number of business activities relating to this area are handled in an *ad hoc* manner. Recently, the SSC issued a template statute for publicly-listed companies. This was developed under a project on enhancing corporate governance sponsored by the Asian Development Bank. The project was to study some bench markings from other developed countries and to build a template statute. The statute is compulsory for companies wishing to register for publicly-listed status. The template statute is considered a breakthrough in good corporate governance. The statute covers almost all aspects of management, information disclosure and other issues. It has encouraged more and more companies to become publicly listed companies.

In sum, regulations relating to joint-stock companies and the stock market have been improved to encourage more public listing as well encourage arm's length monitoring of companies. But, beside them, what is needed is a complete system that would support the smooth running of businesses.

THE SURVEY INSTRUMENT

Following the APO s guidelines, the study focuses on four key areas of governance: ownership, management, social responsibility and institutional interface. To provide a quantitative approach for these issues, primary data were gathered through structured interviews with chairmen of the boards, CEOs, board members or corporate secretaries, using a detailed questionnaire. The original questionnaire was re-designed to gain the most appropriate information from different companies in Vietnam. Based on the results of this survey, the impact of governance on productivity is thoroughly analyzed.

In terms of content, the questionnaire embraces a list of key elements, which are presumed to affect corporate performance in terms of growth and productivity. First, the focal points are ownership characteristics. This area examines the distribution of shares, the capital structure, and the shareholder rights. In addition, the role of creditors and the effects of employee ownership scheme are also pointed out.

In the area of management, the questionnaire deals with the decision-making systems of various companies, the internal control and accountability standards. Some questions on the external audit, code of ethics as well as employer-employee relationship are raised as well.

The third area is social responsibility with focus on community relations, the consumer rights and the environment protection. Finally, the questionnaire inspects the institutional interface by looking at the underlying regulatory framework, the national or international rules together with the core labor standards.

To enrich the discussion, additional information about the corporation was gathered from other sources such as external auditors, chambers of commerce, and corporation websites. From this perspective, the data sample comprises 16 companies.

Variables

Although there are a great number of other factors influencing the corporate performance such as the turbulence of the socio-economic situation, the tariff policy, and the reform of the financial market, this research just takes into account the four areas mentioned above. The dependent variables are company growth and productivity while the independent variables are ownership, management, social responsibility and institutional interface.

The governing relationship or the correlation between these variables could be described as:

Corporate performance = f(ownership, management, social responsibility, institutional interface)

Hypotheses

The following hypotheses are proposed so that an empirical test is implemented more efficiently. The study focuses on several factors that are considered to be the core characteristics of Vietnam s corporate sectors.

Hypothesis 1 - Ownership concentration: The lower the level of state ownership, the easier the decision-making process, the higher the company profits.

Hypothesis 2 - Employee ownership scheme: If shares are distributed to employees, they would become more concerned about company performance and monitoring, and the company s productivity will be improved.

Hypothesis 3 - Conflict of interest: The lower the level of conflict of interest between owners and managers, the more effort managers can spend on managing the corporation, resulting in the growth of the corporation.

Hypothesis 4 - Disclosure of financial information: If the firm frequently discloses financial information to stockholders, securities agencies and the public, the transparency of the accounting system will be enhanced, thus bringing about increased productivity.

Hypothesis 5 - Consumer rights and public responsibility: If the company is concerned about consumer rights and environmental standards, the higher the standards it will strive for. As a result, the image of the corporation will be improved.

Hypothesis 6 - Interface with external stakeholders: The more independent the decision-making processes is and the more transparent the regulatory framework is, the better business performance the company would achieve.

CHARACTERISTICS OF RESPONDENT FIRMS

Origin, date of establishment

All 16 respondent firms are publicly listed. One is privately originated (Tribeco) but most are state originated (accounting for 93.75 percent of the sample). Some of the state originated enterprises have been "equitized". Equitization took place only recently due to changes in the economic structure and the policy of the Vietnamese government to reform SOEs. Most of them—about 80 percent—were equitized between 1998-2001, at about the time of founding of the stock exchange in Vietnam. There were six companies founded as joint-stock companies before 1999. The rest (10 companies) were founded as joint-stock companies on or after 1999.

Financial data in this survey were collected for three years, from 1999 to 2001. The financial analysis was based only on data available after equitization. This fact somewhat affected the result of the analysis because those companies which became joint-stock companies after 1999 might have had unstable business performance after the changeover.

Ownership

Of the 16 respondent companies, only one (6.25 percent of the sample) has no state capital representation. For the rest, the shares of the state account for a considerable part Table 3 shows the allocation of shares, which comprise of four groups: state's shares, employees' shares, outsiders' shares (Vietnamese but outside the company) and foreigners' shares.

Vietnam s legal system allows foreign shareholders to own a maximum of 30 percent of shares. The participation of foreign and outside investors would make governance more transparent.

Geographic location

As Ho Chi Minh City (HCM) is the most dynamic and developed business city of Vietnam with a stock trading center, the majority of publicly-listed firms are located in this city. In this surveyed sample, seven companies (REE Corp., TRANSIMEX, Saigon Hotel, Gemadept, BTC, Tribeco and GILIMEX) out of 16 are HCM-based and account for 43.75 percent of the total sampled. The other firms are located elsewhere in the country. No firm is located in Hanoi, Vietnam s capital. Three of them are in the northern part (CANFOCO, HAPACO and Bimson PC) and one (DANAPLAST) is based in Danang, the city in the central region. The rest (LAFOOCO, SACOM, AGIFISH, Cienco and BIBICA) are located in HCM s adjacent provinces, where Vietnam s main industrial zones are based.

Table 3. Allocation of shares in studied companies

Company	State's share	Employees' share	Outsiders share	Foreigners share
Halong CANFOCO	30.65%	43.78%	0.00%	25.57%
REE Corp.	25.10%	23.91%	25.99%	25.00%
HAPACO	1.27%	49.25%	49.48%	9.99%
LAFOOCO	30.00%	16.43%	23.57%	30.00%
SACOM	49.00%	8.70%	42.30%	
TRANSIMEX	10.00%	63.00%	22.00%	5.00%
Saigon Hotel	38.86%	32.32%	28.82%	
DANAPLAST	31.50%	27.33%	41.17%	
BIBICA	3.54%	30.63%	65.83%	
BimsonPC	55.26%	5.32%	39.42%	
Gemadept	15.75%	39.43%	44.82%	
Tribeco	0.00%	32.90%	67.10%	
BTC	19.04%	28.11%	52.85%	
GILIMEX	10.00%	55.00%	35.00%	
AGIFISH	20.00%	30.88%	42.70%	6.42%
Cienco	49.98%	8.82%	41.20%	

Main area of activity

Eight sectors were covered in this survey. The service and food sectors represent the highest number of companies: 31 percent (five companies) for the food sector and 25 percent (four companies) for the service sector. The chart below Figure 4 indicates the proportion of each sector.

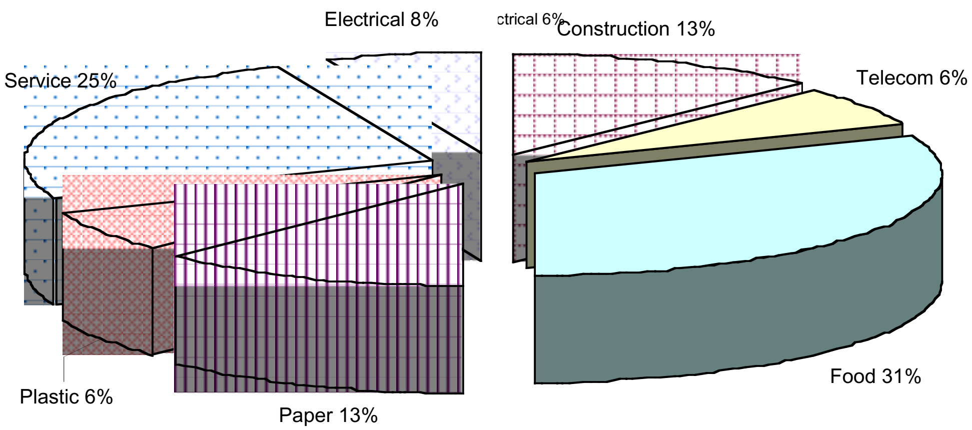


Figure 4. Distribution of the sample firms by sector

Internationalization

Six companies, accounting for 37.5 percent, export their products. The remaining 10 serve the domestic market only. However, whether they export or not, all face the same competitive pressure. Those exporting have to compete in the international market where competition is fierce. The firms serving the domestic market have to compete not only with local firms but also with foreign companies. Thus, the pressure to be more competitive, to more quickly respond to customer requirements and to more efficiently and effectively use resources bear down dramatically on all companies.

Control of firm decisions

Following the legal and regulatory framework, especially the law on enterprises, the decision-making process of 16 firms in the sample has some common characteristics. Firstly, the control board plays the most significant role, in terms of the following rights and duties:

1. To inspect the reasonableness and legality of the management and administration of business activities;
2. To evaluate the annual financial reports of the company; to check every specific issue relating to the management and administration of the company;
3. To report to the general assembly of shareholders (a) on the accuracy, truthfulness and legality of the manner by which vouchers, books of account, financial reports and other reports the company make and keep are prepared; and (b) on the honesty and legality of the management and administration of the business operation of the company;
4. To recommend changes and/or improvement in the organizational structure and in the management and administration of the business operation of the company.

Another common feature is the structure of the board. In all of the 16 companies the chief executive officer sits as member of the control board. However, due to the individual firm s particular nature and situation, control of decision-making is not entirely the same among them. The size of the board and the degree of independence of the external auditors differ among the firms.

Size of the board

A board usually consists of seven members. This is true for medium to large enterprises or joint ventures. Only two companies have an 11-member board. The size of the board continues to be debated on. It is argued that the smaller the board size, the less complicated the decision-making process and the more productive the corporation is. The opposite view argues *for* a larger sized board with stratification and specialized tasks for each member resulting in an improved performance of the board as a whole. It is hard to argue *for* or *against* the size of the board in this sample due to the differences in scales, business activities and sectors under which each of the companies operates.

Degree of independence of the external auditors

As defined in the law on enterprises, annual financial reports must be verified by independent auditing organizations before submission to the general assembly of shareholders for consideration and approval. In the sample, the degree of independence of the external auditors fluctuated among these companies from moderate to very high levels. In general, this shows the degree of importance of the role of external auditor in the companies operation.

SELECTED RESULTS

Ownership

The survey result shows that 54 percent of the companies have six to ten owners and the rest (46 percent) have more than ten owners. In the sample, the top shareholder holds, on the average, 24.86 percent of the company share while the top five shareholders hold, on the average, 43.31 percent. Table 4 indicates the value of shares in each case.

Table 4. Proportion of shares held by top shareholders in sample firms

	Top 1 shareholder	Top 5 shareholders	Top 10 shareholders
Number of respondents	16	16	16
Maximum % of share	55.26%	67.20%	78.22%
Minimum % of share	10%	29.10%	44.21%
Average	24.86%	43.31%	56.18%

Going back to Table 3, it is clear that the state owns more the 30 percent of the shares in seven out of 16 companies (44 percent). Among them, Bimson PC has the highest proportion of state-owned shares (55.26 percent). And most of state-owned firms, as will be shown later, yielded good business returns.

In fact, to evaluate the impact of state ownership on corporate performance, financial data alone are not enough. Other characteristics that should be taken into consideration include the following.

The psychological factor: In general, the majority of Vietnamese still think that it is safer to have the presence of the state in economic activities. People fear that the private sector will not be able to take responsibility whenever negative changes occur. They therefore consider the presence of state ownership as necessary, especially in the situation where the legal framework for the financial market is still insufficient.

The presence of the state in board: Most of joint-stock companies are equitized in a way that state capital remains an important part. And evidently many of the members of the board are state personnel. Even in companies that are less than 25 percent state-owned, the CEO and key personnel in the management board are state personnel.

Better relationship with financial institutions: According to recent statistics, only 34 private domestic banks in Vietnam lend to SMEs and control just 15 percent of all lending to Vietnamese companies. Meanwhile, state banks have 74 percent of the market. Moreover state companies seem to find it easier to deal with state banks while banks in general feel more secure dealing with companies having state presence.

Employee ownership scheme

Employees own all 16 companies in varying degrees. In 12 companies (75 percent), at least 20 percent of the shares belong to employees. The median proportion of shares held by employees is 30.19 percent. Most respondent companies find that the participation of their employees as shareholders is an important factor for the development of the companies. Employees feel more responsible because they are also owners of their company. As shareholders, employees have the right to attend the general assembly of shareholders, according to the law on enterprises, and participate in the decision-making process involving important matters in their company.

Share acquisition by company employees differs from one company to another. Some companies allow their employees to buy, on credit, shares from the state capital portion. These shareholders have to pay interest for acquired shares which they are not allowed to sell to others. This policy, on one hand, enhances employees morale and sense of responsibility and, on the other, keeps employees from leaving.

Foreign ownership

There is no law prohibiting foreign ownership in Vietnam. But it is limited to a maximum of 30 percent as earlier mentioned. There are only five companies in the sample having foreign shareholders (CANFOCO, REE, LAFOOCO, TRANSIMEX and AGIFISH). All of them have high growth rates of revenue and profits. In their own assessment, the presence of foreign partners in their companies is an advantage both in terms of management and markets. The Vietnamese can learn from their foreign counterpart modern managerial experiences and knowledge. Besides, in terms of technological transfer, the foreign party has the ability to help companies acquire modern technologies. But more importantly the foreign partners are the ones who provide the export market for the company, a market contributing a considerable part in the financial performance of the company. However, as the legal framework for foreign investment in the stock exchange remains insufficient, foreign participation remains limited.

Creditor monitoring

Fourteen out of sixteen studied companies (87.5 percent) indicated that banks are their main creditors, although all answered that non-banking institutions are also major creditors of theirs. Nearly 43 percent of them have dealt with banks for more than five years and 81.3 percent of them have dealt with non-banks for three to five years. Actually, the banking system plays a vital role in Vietnam. As creditors, banks have the right to appraise the borrowers' business plan and monitor the use of the loan. This is a very good mechanism for keeping an eye on borrowers' operations and improving business results.

Fourteen companies (87.5 percent) answered yes to the question "Does the external creditor ask for collateral for loans?". All the companies renegotiate loan repayment when faced with liquidity problems.

Management

According to the law on enterprises, the decision-making system in joint-stock companies can be briefly described as follows.

The general assembly of shareholders: This assembly consists of all shareholders who may vote and is the highest decision-making body of a joint-stock company. It has the following rights and duties: (a) to decide the types of shares and total number of shares of each type to be offered for sale; (b) to decide the rate of annual dividend for each type of shares; (c) to elect, remove or dismiss members of the board of management and members of the control board; (d) to decide the reorganization and dissolution of the company; (e) to change the company s charter; (f) to approve annual financial reports; (g) to adopt the direction of development of the company; and (h) to decide the sale of assets having values equal to or larger than 50 percent of the total value of assets recorded in the accounting books of the company.

The board of management: The body managing the company has full authority to make decisions in the name of the company on all issues relating to the objectives and benefits of the company, except for issues that fall under the jurisdiction of the general assembly of shareholders. It has the following rights and duties: (a) to decide the development strategies of the company; to decide sales of new shares within the allowed number of shares of each type which may be offered; (b) to make decisions on mobilizing additional funds in other forms; (c) to make decisions on investment plans; (d) to decide on daily business operations; (e) to appoint, dismiss or remove the director (or general director) and other key managers of the company; (f) to make decisions on the salaries and other benefits of such managers; (g) to decide on internal managerial structure; and (h) to report to the general assembly of shareholders on the financial and operational performance of the company and recommend the dividend rates to be paid and other benefits stipulated by the charter. The board of management approves decisions by voting at meetings, obtaining written comments or otherwise as stipulated in the charter of the company. Each member of the board of management has one vote.

Director (general director) of the company: Appointed by the board of management, the director of the company manages the day-to-day operation of the company and is responsible to the board of management for the exercise of his/her delegated powers and the performance of his/her assigned tasks. He/she has the following powers and duties: (a) to decide on all issues relating to the day to day operation of the company; (b) to organize the implementation of the board of management s decisions; (c) to organize the realization of business plans and investment plans of the company; (d) to propose plans on the organizational structure and internal management rules of the company; (e) to appoint, remove or dismiss management personnel in the company except those whose appointment, removal or dismissal is the prerogative of the board of management; and (f) to make decisions on salary and allowances (if any) for employees of the company, including managers who may be appointed by the director (general director).

Control board: A joint-stock company with more than 11 shareholders must have a control board composed of three to five members. At least one member must be a professional accountant. The head of the control board must be a shareholder. The rights and duties of the control board are: (a) to evaluate the annual financial reports of the company; (b) to check specific issues relating to the management and administration of the activities of the company; (c) to consult the management board prior to the submission of reports, conclusions and recommendations to the general assembly of shareholders; (d) to report to the general assembly of shareholders on the accuracy, truthfulness and legality of the manner in which vouchers, books of account, financial reports and other reports of the company are kept and made, and on the honesty and legality in the management and administration of the business operation of the company; and (e) to recommend changes and/or improvements of the organizational structure, management and administration of business operation of the company.

The majority of joint-stock companies issue their own charter. The control board performs internal control of business activities, to find and prevent all possible deviation and any sign of corruption or illegal actions of management. Besides an internal control system, all sample firms maintain an external independent auditor. External auditing firms are responsible for the conduct of bi-yearly financial audits. They are third parties and very highly independent from their auditors.

Internal power-sharing

The survey results show that there are many areas where power overlaps. All the 16 studied companies agree that aside from the CEO, both major shareholders and the board of directors must decide on corporate thrusts and direction and strategic options (75 percent and 81 percent of respondents, respectively). Ninety four percent of them said that decision on management appointment and executive compensation should belong to the board and only one company said it should be the major shareholders’. Table 5 shows the proportion of surveyed companies responding to the question on internal decision- making rights. Clearly, there is a big difference between regulations stipulated by the law on enterprises and actual practices. Based on in-depth interviews, some executives explained that they did not break the law but it should be more flexible with regard to decision-making practices as it depends on some other elements like characteristics of business and corporate culture.

Table 5. Internal decision-making rights (% of respondent firms)

Type of decision	Major Share-holders	Board	CEO
Corporate thrusts and direction	100	100	12.5
Corporate and financial strategic options	100	100	18.8
Sanctions and rewards for management performance		87.5	
Management appointments and executive compensation	6.2	93.8	
Board composition and membership [(1)]	100		
Day-to-day operations			31.2
Declaration of dividends		100	
Profit or gain sharing	56.2		
Business expansion/contraction			6.2
Mergers and acquisitions		25.0	12.5
Productivity improvement measures			31.2
Customer satisfaction/Quality issues			31.2

[(1)] Board composition and membership are issues of owner(s)/major shareholders and/or general assembly of shareholders. Generally, owners or major shareholders propose the composition and membership of the Board and then the general assembly of shareholders votes to adopt.

Twelve of sixteen (75 percent) surveyed companies have their CEO sitting as chair of the board at the same time, with tenure of four to six years. Their boards have six to 10 members. The others (25 percent) have 11 to 15 members. Only one company (6 percent) accepts appointment of outside director. As regards the degree of independence of management in making operational decisions, all 16 companies reported it as high. Seventy five percent of CEOs have been working for their companies prior to appointment.

The median of CEO compensation as a percentage of the average employee salary is 2.48 percent (maximum, 7.62 percent; minimum, 0.63 percent). The median of the firms wage compression ratio is 22.44 percent (maximum, 33.33 percent; minimum, 13.33 percent).

Disclosure of information

According to Decision 04-1999/Q_-UBCK of the chairman of the State Security Commission, publicly-listed firms have to disclose the following information to the public:

- Financial reports, including balance sheet, profits and loss statement, financial report explanation.
- Other information relating to any change in business activities, such as merger or acquisition, dividend declaration, business objective changes, legal violations, investment decisions involving more than 10 percent of total capital, investment in other stocks of more than 10 percent of the total value of the company s stocks and any decision that may be harmful to shareholders.

Most of the joint-stock companies have their own policy for information disclosure. Out of the 16 studied companies, four companies (25 percent) issue quarterly financial reports. These four companies achieve high growth rates in revenue and profits. An assessment of the responses shows that the more transparent the financial report, the better the performance of the corporation. The reason given was that management would be under greater pressure, when performance information is disclosed, to make all business decisions accurate, prompt and effective. Moreover, disclosure of information allows shareholders to follow and participate in the adjustment of the firms business direction whenever applicable.

Nine companies (56 percent) disclose their financial information yearly although they usually informally provide audited financial reports bi-yearly. The mentioned four provide their information to the public, internal shareholders and other stakeholders quarterly. Most of the surveyed companies provide their information through the following channels: stock trading center (to the public), capital providers (banks), security consulting firm (including external auditor) and internal bodies (business functions, branches).

The disclosed information is generally called White Statement and includes the following: (a) business environment analysis; (b) current and forecast demands, targeted markets, main competitors information and brief business direction; (c) risks analysis; (d) financial indicators and business performance during the most recent two years; (e) organizational structure, lists of board members, management, and list of main shareholders; and (f) policies regarding employment and work system.

As regards the right to access to minutes of board meetings, companies are unanimous: only management can have access to the minutes.

Industrial relations

All the 16 surveyed companies have never faced serious conflicts between labor and management. Only three companies (19 percent) had small disputes and these were settled peacefully. Following the Vietnamese Code of Labor, all business organizations having more than 11 employees have to establish a labor union to protect labor rights. This requirement is strictly followed by SOEs. Thus, for equitized companies, the labor union is necessarily present. The labor union serves as a linkage between employees and employers.

Most respondents stress the fact that after equitization and after being publicly listed, employee morale and incomes have improved. They underscore the fact that with the move from purely SOEs to joint-stock companies, employees now feel they are also owners.

Many companies have announced their human resource management policy but not a code of ethics. Issues like relationship with stakeholders, employees and other stakeholders are sometimes governed by a charter and closely tied to the legal system in cases involving violence. Only two companies (12.5 percent) reported having a code of ethics and both of them have publicized it. Both of them also said there had been violation of the Code but did not indicate any sanctions.

Other issues

All the 16 studied firms have an external auditor. Eleven of them (69 percent) have been associated with the current auditor for three to five years; the rest (31 percent) have more than five-year relationship and none of them changed auditors during the last three years. All of them also confirmed the high independence of their external auditors. An accounting and auditing procedure has been established in Vietnam. All the big four auditing firms (KPMG, Earns &Young, Delloit Tomatsu, PWC) now have businesses in Vietnam.

Regarding internal control, Table 6 shows the degree of control over misuse of cash flow, accounts receivable collection and aging, bad debt write off, inventory, fixed asset acquisition, R & D, capital expenditure, tax payment, loan repayment, and payroll.

Table 6. Internal control (% of responding firms)

	Rigid	**Adequate**	**Somewhat loose**
Cash flow	12.50	62.50	25.00
Accounts receivable collection and aging	37.50	56.25	6.25
Bad debt write off	18.75	56.25	25.00
Inventory	50.00	31.25	18.75
Fixed asset acquisition	31.25	31.25	37.50
Research and development	68.75	31.25	
Capital expenditure		87.50	12.50
Tax payments	62.50	37.50	
Loan repayment		100	
Payroll		100	

Asked about company-wide quality and productivity improvement programs, the respondents gave quite positive answers as shown in Table 7.

Table 7. Quality and productivity programs (% of responding firms)

5S	43.75
Suggestion system	37.50
Continuous improvement	81.25
Quality circles	6.25
Just in time	6.25
Other: GMP	6.25
Other: HACCP	12.50
Other: ISO 9000	62.50
Other: ISO 14000	6.25

Social responsibility

With the objectives of expanding the market and satisfying global consumer demand, the adoption of environmental standards and customer care have become vital requirements for the companies sustainable development. In fact, all 16 companies in the sample recognize the importance of the issue and refer to them as duties in their business strategies. For instance, BIBICA points out that Customer care is the centerpiece of all promotion programs and future development. Another example is REE Corporation. The benefit to the customers is increased through the implementation of the quality management systems and ISO 9000. DANAPLAST also has an environmental protection program. All of them have policies on consumer rights protection.

Regarding the regulatory system on consumer rights protection, a sub-law was enacted in 2001 by the Standing Committee of the National Assembly. It has not played a full role though due to a number of reasons. Firstly, a customer-driven culture within Vietnamese community is still limited. Secondly, the Consumer Rights Protection Association—the official organization for consumer protection—has not played its role actively. So far, the protection of customers rights is dependent on the awareness of individual companies. On surface, most joint-stock companies pay attention to this issue and declare it in their White Statement and other public statements as well as in their vision/mission statements.

Many of the publicly-listed firms maintain very good community relations. Six out of the 16 surveyed companies (38 percent) maintain regular donations to charity organizations. Many of them have given financial assistance to flood victims in the southern provinces. The decision to pursue such activities generally gets the support not only of the board of management but also of shareholders.

Environmental protection has caught the attention of the surveyed companies. Ten of the 16 (62.5 percent) have issued environment protection policy although only one was awarded an ISO 14000 certificate. Several reasons account for the very modest number of ISO 14000 certified companies in Vietnam. The investment for an environmental management system (EMS) is quite expensive, both in terms of consultation and certification. In addition, the need for an EMS is not as urgent as in other businesses. Some respondents claim that even though they are not ISO 14000 certified, environmental issues are always taken into consideration in their decision-making process. They strictly follow the legal requirements for environmental protection and are always conscious of the image of an eco-friendly organization providing green products.

Institutional interface

Most of the respondent firms complain about the bureaucracy in Vietnam. Many administrative procedures seem to be inappropriate to business activities but are still part of the legal system. Since the respondents judge the matter as quite sensitive, they prefer not to comment about these in detail. All of them expressed a desire to reform the administrative system to make it more transparent, accountable and supportive of business development.

Exporting companies often complain about customs procedures. Aside from the lack of regulations, the behavior of many custom officials is seen as bureaucratic. Table 8 shows the evaluation of respondents on the performance of public services:

Table 8. Performance of public services (% of responding firms)

	Very good	Good	Slightly good	Slightly poor	Poor	Very poor
Government		37.5%	56.2%	6.3%		
Tax officials			6.3%	25.0%	68.7%	
Customs				37.5%	50.0%	12.5%
Judiciary			6.3%	56.2%	37.5%	
Police				31.3%	68.7%	

These results show that except for government service, which 37.5 percent of the sampled firms evaluated as good, other public service sectors were rated quite poorly. The main reason for lower performance rating is the time and money wasted in transacting business in these sectors.

Besides public services, a number of other services, especially infrastructure, are still in poor condition resulting in lower productivity of Vietnamese businesses. Table 9 highlights quality rating in these services.

On training and education, most of the respondents remarked that the system in Vietnam is still theoretical and less practical. So when new graduates are recruited, they still have to be retrained for a considerable period of time. Expecting a brighter future, respondents (37.5 percent) gave good evaluation for the training and education system.

Table 9. Quality of public services (% of responding firms)

	Very good	Good	Slightly good	Slightly poor	Poor	Very poor
Education/training			37.5%	37.5%	25.0%	
Roads			12.5%	50.0%	37.5%	
Telecommunication				18.8%	68.7%	12.5%
Electricity			6.3%	37.5%	56.2%	
Water				31.2%	62.5%	6.3%

On the transport system, focus was given to the road system and the traffic situation. The degradation of roads has, for instance, resulted in high operating cost increases. Moreover, the traffic system in Vietnam no longer fits the present needs for development. Traffic jams are now a major challenge in most main roads which leads to wasted time for all concerned.

Other services, telecommunication, electricity and water are all state-monopolized services. As a result, the quality of these services is rated as very poor. The cost of telecommunication is very high. International telephone charge is the highest in the region; internet access is limited and expensive. Power and water services prices are fixed by the state, leaving enterprises with no other choice of providers.

GOVERNING RELATIONSHIP

In this section, four aspects of governance (ownership, management, social responsibility and institutional interface) are analyzed in relation to productivity and growth indicators.

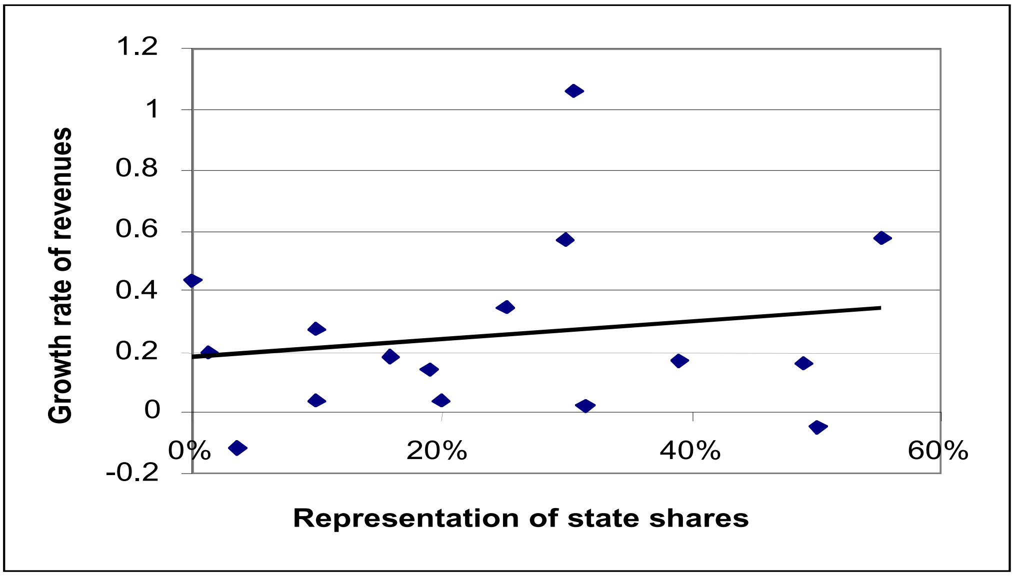


Figure 5. Representation of state share and its link to growth rate of revenues

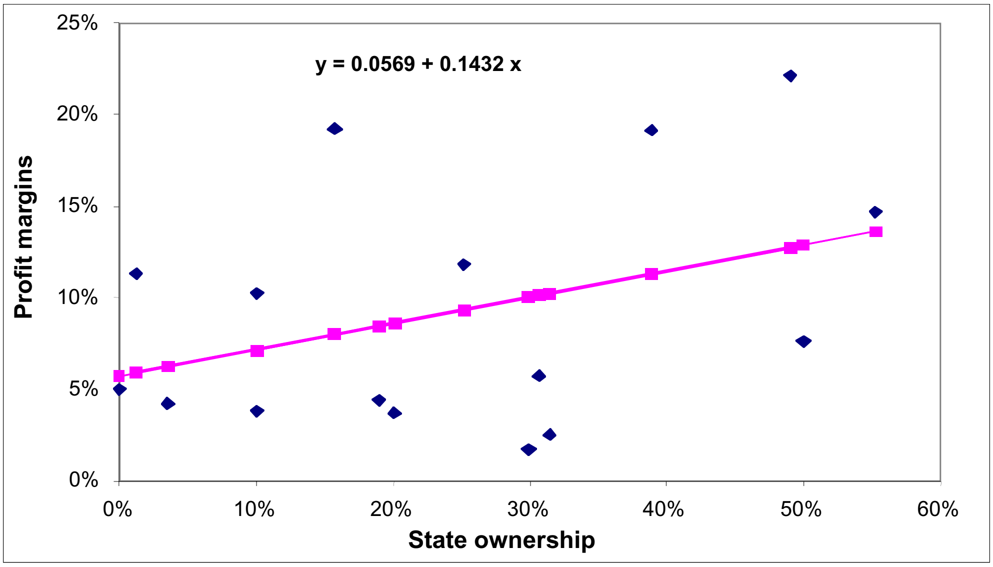


Figure 6. Relationship between state ownership and profit margin

Figure 5 and Figure 6 dispute the hypothesis that high state ownership will lower the firms performance. Both trends are positive. Conversely, the presence of state capital is somehow considered as a facilitating factor for companies accessing capital resources. As this paper argued at the outset, publicly-listed firms need the presence of the state.

But when state representation is plotted against ROE and ROA in Figure 7 and Figure 8, a declining trend appears, indicating increasing growth but declining productivity.

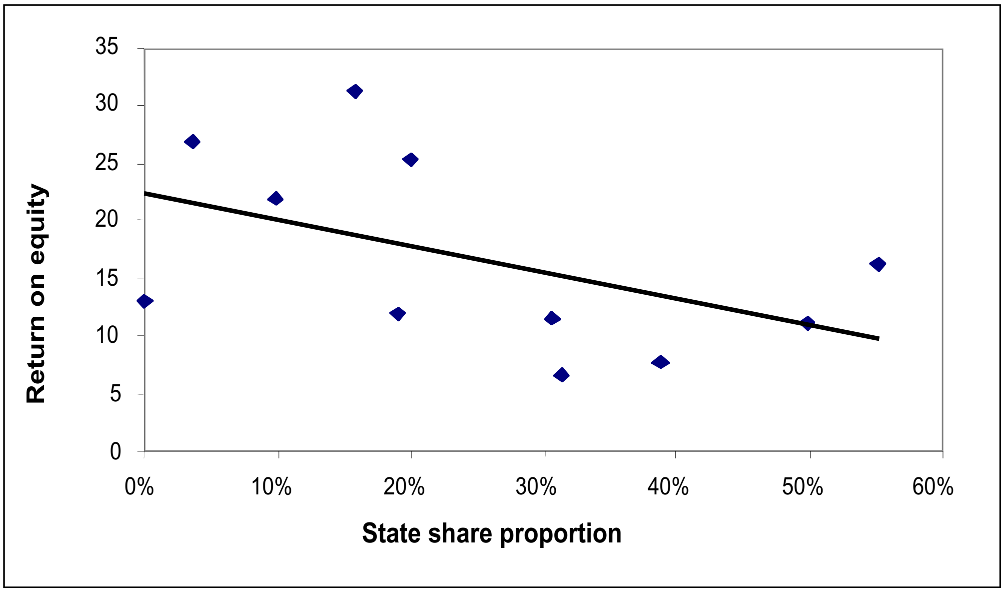


Figure 7. Relationship between state ownership and ROE

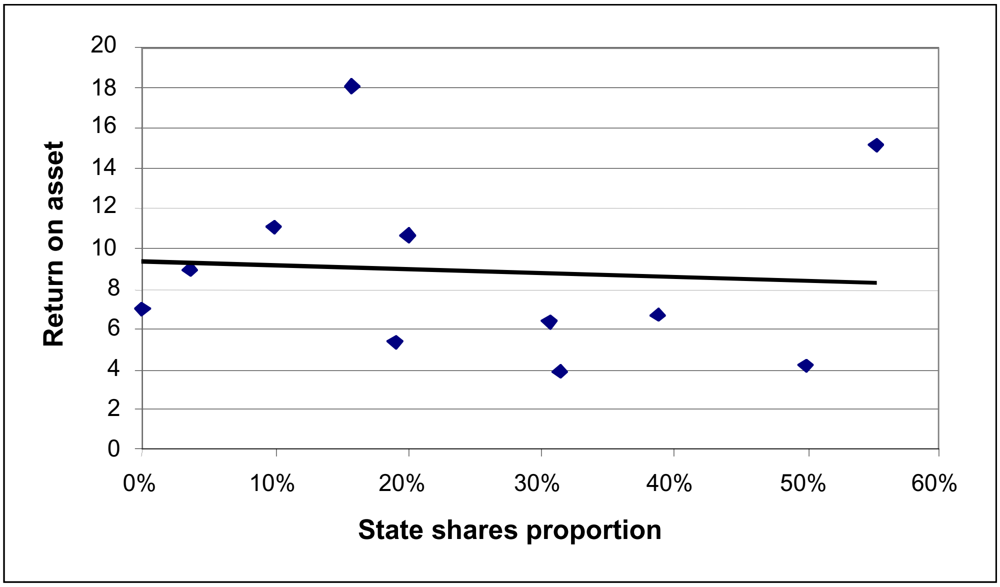


Figure 8. Relationship between state ownership and ROA

However, the participation of employees in ownership schemes would be a good motivator for higher growth. Assessments of respondent companies show that employees become more responsible and motivated to be a part of their company.

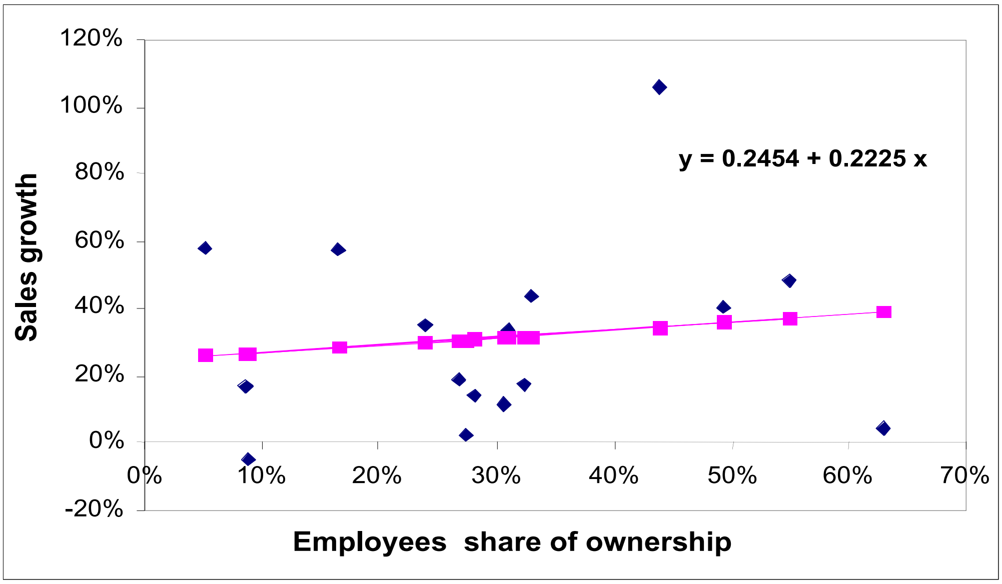


Figure 9. Relationship between employees ownership and sales growth

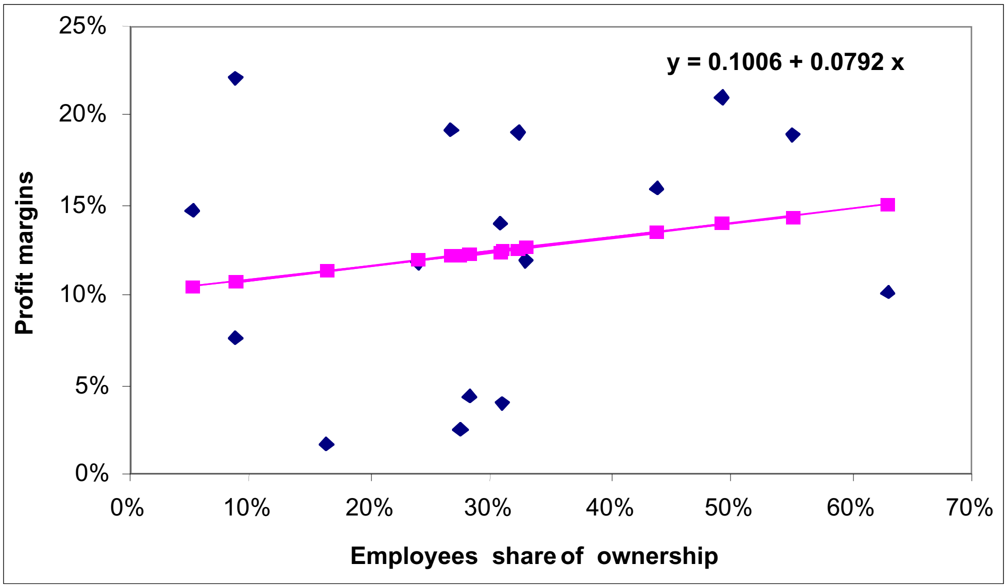


Figure 10. Relationship between employee ownership scheme and profit margin

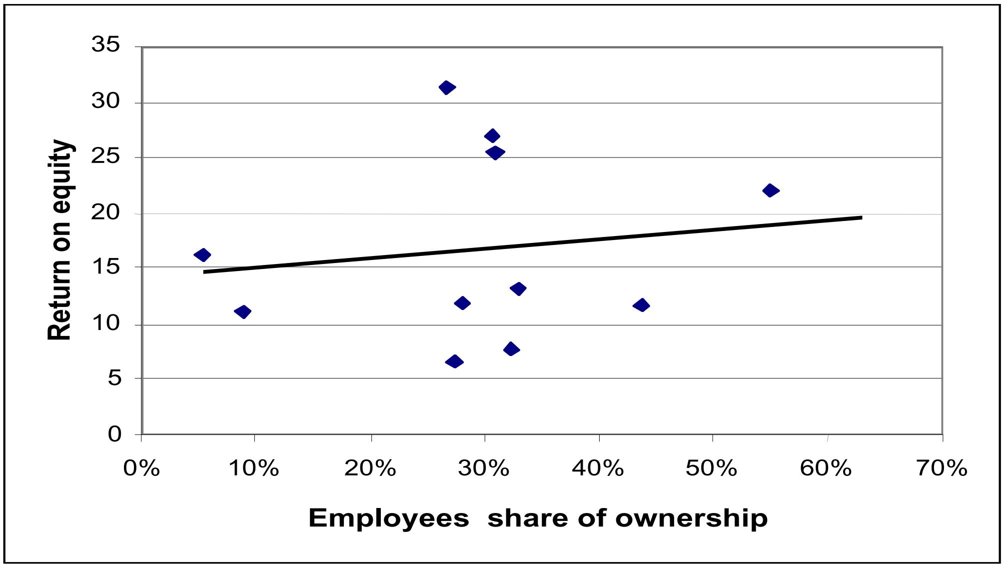


Figure 11. Relationship between employee ownership scheme and ROE

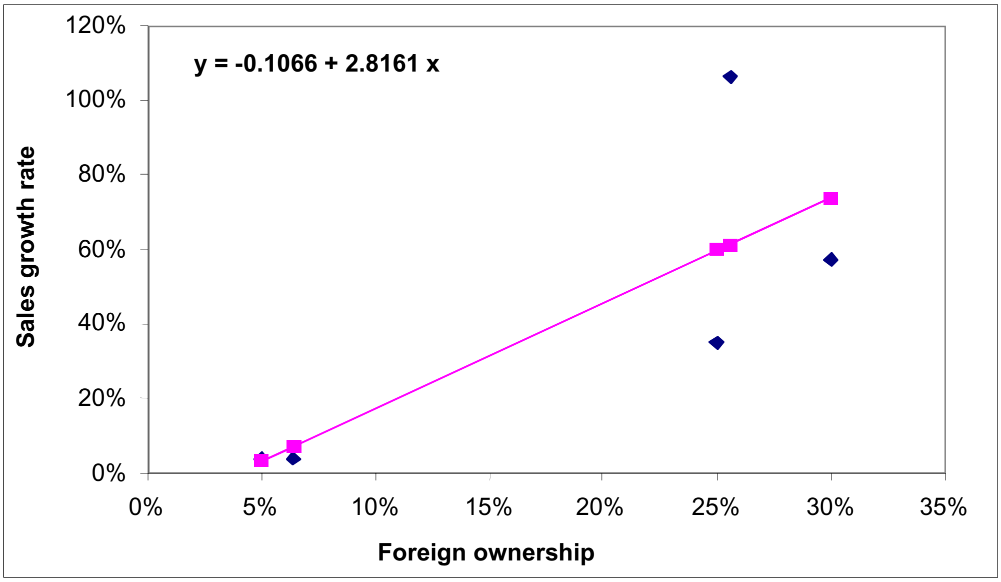


Figure 12. Relationship between foreign participation and sales growth

Thus, their involvement in improving productivity would be enhanced. It is linked to performance achieved in all surveyed companies. All of them have high growth rates of revenue and profits. That is why there has been no big conflict between employer and employees resulting in higher productivity. If shares are distributed to employees, they would become more concerned about company performance and monitoring, and the company s productivity will be improved. Figures 9 and 10 below show the relationship between employee ownership scheme and sales growth and profit margin. Both show an uptrend confirming the positive impact of employee participation in business on productivity and growth.

Figure 11 also confirms the positive association between employees proportion of shareholdings and return on equity.

Another element that should be taken into consideration is foreign ownership. All the companies in the sample achieved considerable growth in revenue and profits. Foreign partners often bring with them modern management skills and experience. In addition, they may be a good connection to international markets. Preliminary assessment suggests that the more Vietnamese companies deal with foreign partners, the more they can learn from them, which would result in improved managerial skills and experiences. Thus, productivity can be improved. Figure 12 shows the impact of foreign participation in business on sales growth rate.

Figure 13 highlights the relationship between proportion of shares held by the top shareholder and ROE. The inverse relationship may be explained by the fact that the role of top shareholder within Vietnamese firms is not significant in decision-making.

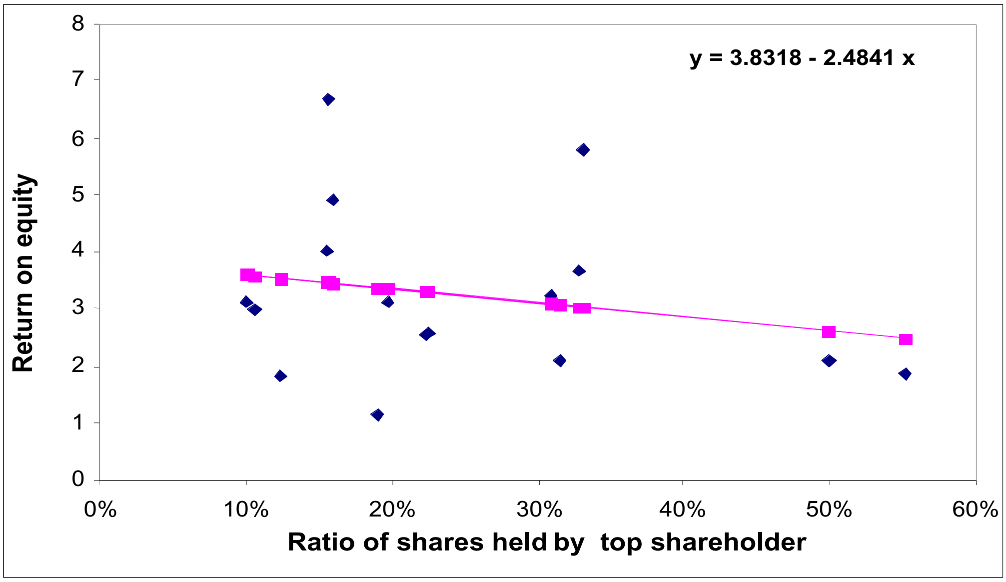


Figure 13. Relationship between ratio of share held by top shareholder and ROE

The majority of Vietnamese publicly-listed companies have been equitized. Nevertheless, the state still has high ownership in these companies. In Vietnam s corporations, almost all owners are also managers of the companies. The separation of ownership and control therefore is not clear. Figure 14 shows the relation between two groups: one, where the board chairman is also the CEO and two, where it is not. Only one criterion, sales growth rate, highlights the advantage of board chairman being also the CEO.

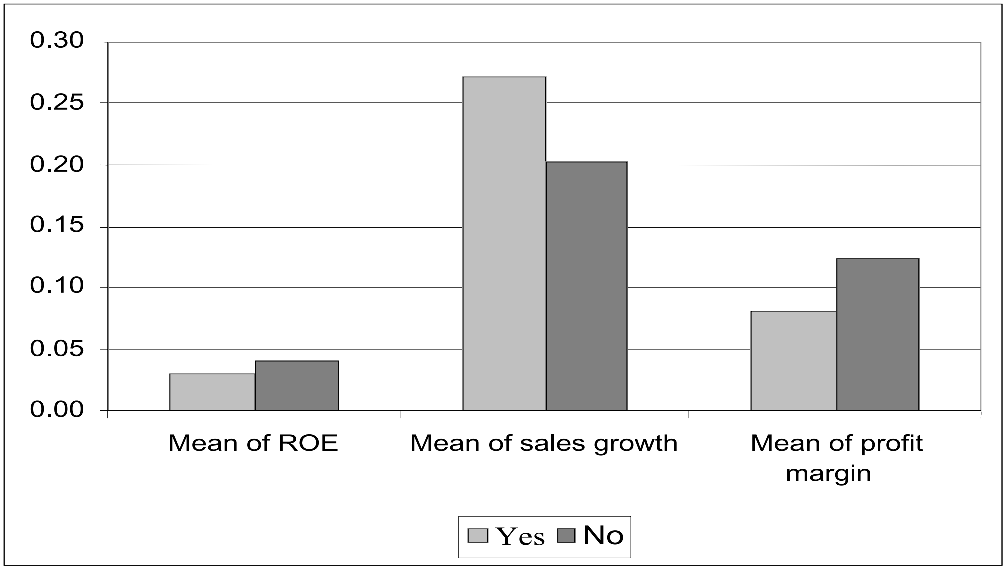


Figure 14. Board chair/CEO split and firm performance
(yes indicates board chair=CEO)

The relationship between executive compensation (the quotient of total CEO s compensation by the average total employee compensation) and performance indicators was also investigated. Figures 15 and 16 show that ROE and profit margin are directly proportional with executive compensation. But with sales growth rate, executive pay varies inversely as shown in Figure 17.

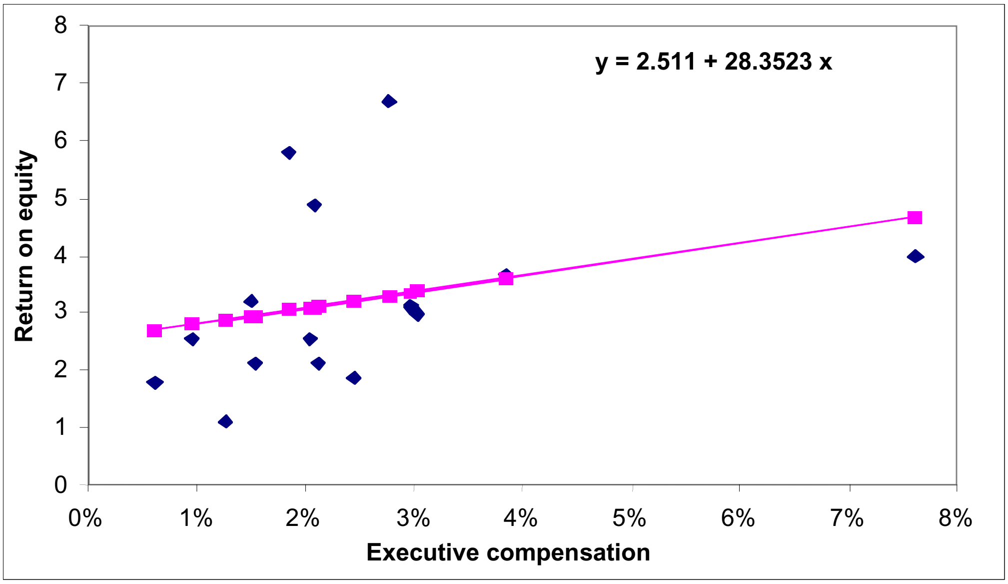


Figure 15. Relationship between executive compensation and ROE

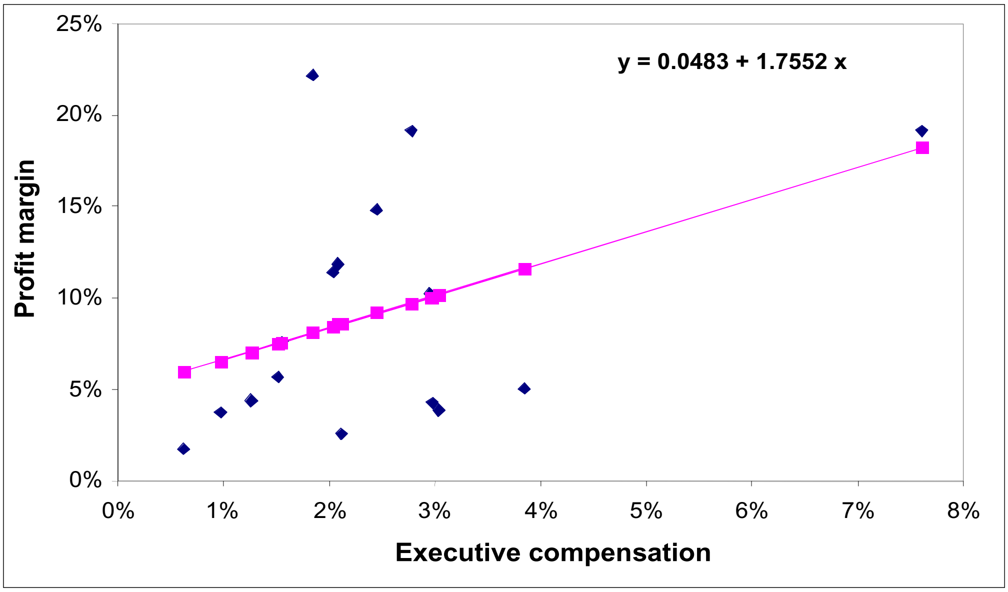


Figure 16. Relationship between executive compensation and profit margin

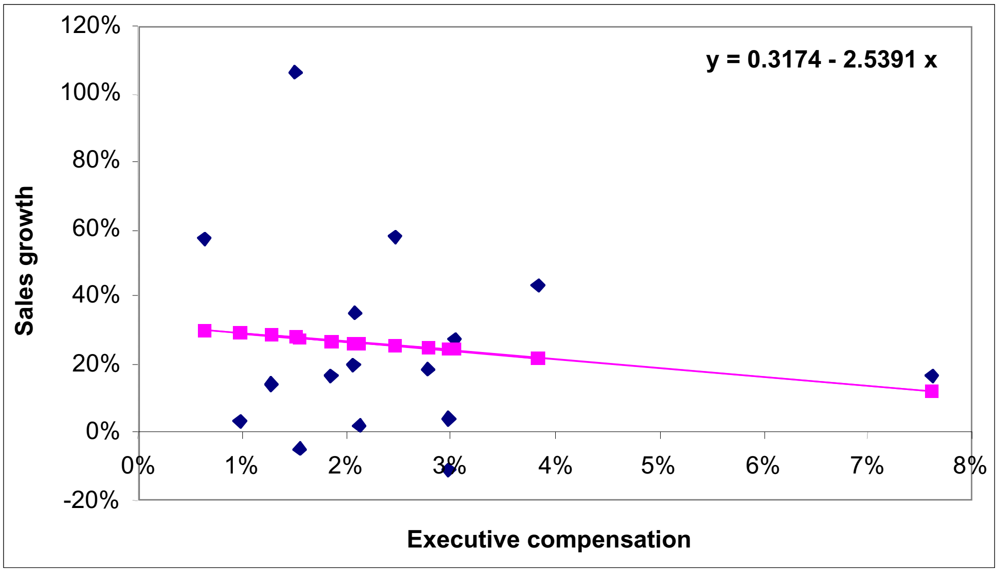


Figure 17. Relationship between executive compensation and sales growth rate

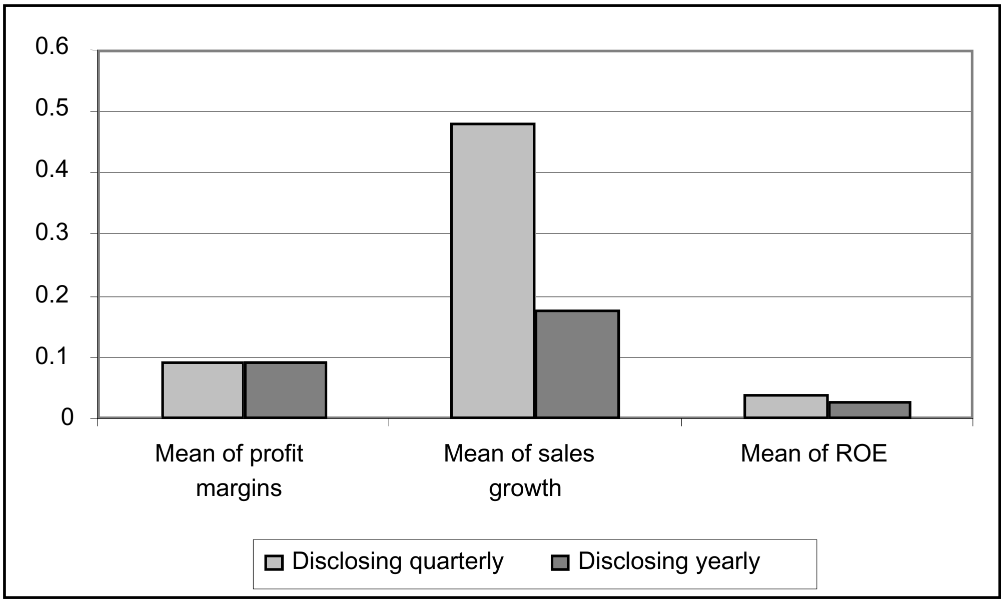


Figure 18. Relationship between frequency of disclosure and performance

Another point is that the more transparent the disclosure on corporate finance, performance and governance, the more the management is pressured to perform more efficiently and effectively. Since all stakeholders have access to companies information, they can encourage the companies to make the right decisions. All the surveyed firms have information disclosing policy but only four companies have a policy to disclose their financial information more frequently (quarterly). The others do it yearly. Figure 18 compares these two groups. The four firms with quarterly disclosures are better than the rest. Hence, firms frequently disclosing financial information to stockholders, securities agencies and the public, bring about increase in productivity.

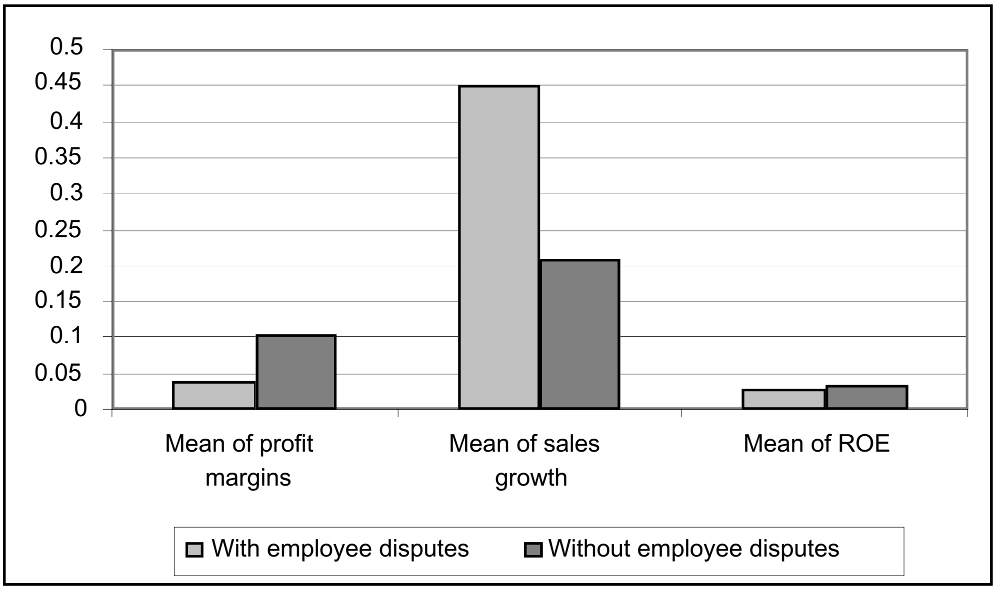


Figure 19. Industrial relations and firm performance

Industrial relations also remain an important aspect of good governance and better performance. The effectiveness of management systems is expressed not only in financial terms but also in the achievement of human resource development. When employees are energized to their full potential then productivity will be greatly improved. The survey findings show that firms having disputes during the last three years have less profit margin and less ROE (even with higher sales growth) than firms without disputes. This is illustrated in Figure 19.

Almost all surveyed companies pay attention to customers, environmental protection and social accountability. And the more they are concerned with these issues, the more they become accountable to the market and the more their image improves. The findings of the study show that firms that implement company-wide quality programs (such as ISO 9000, 5S, suggestion scheme and others) have higher levels of performance. Figure 20 shows the comparison between firms implementing quality management system such as ISO 9000 and those that do not. All performance indicators are higher for companies that are concerned with quality issues.

Environmental protection leads to higher productivity and growth. Firms which have adopted an environment protection policy produce better profit margins and higher sales growth rate than those without one (Figure 21). Similarly, Figure 22 shows that firms with ISO 14000 certification demonstrate better productivity and growth than firms without it. This clearly suggests that better performance in all dimensions is the outcome for firms which support environmental protection and implement environmental management.

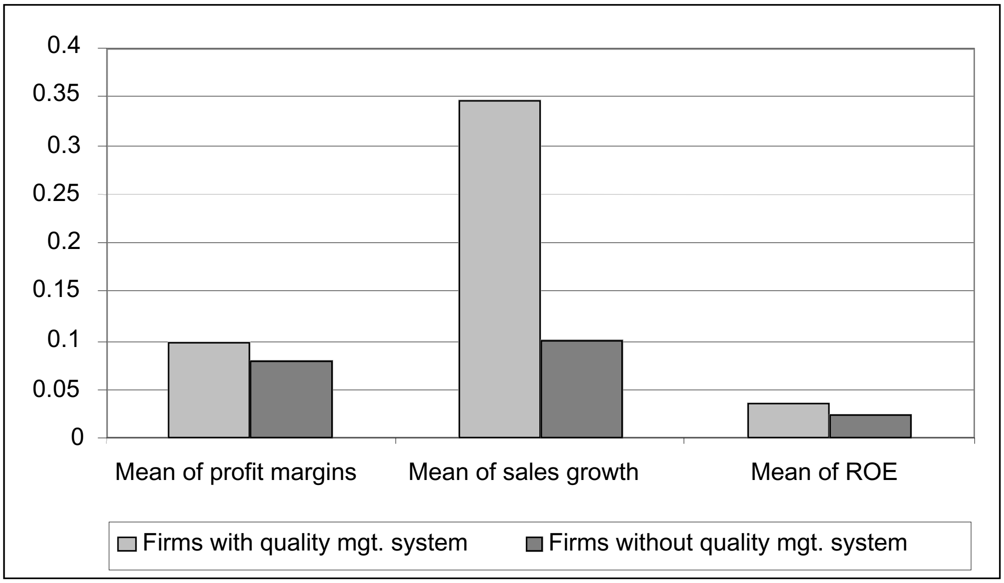


Figure 20. Quality management systems and firm performance

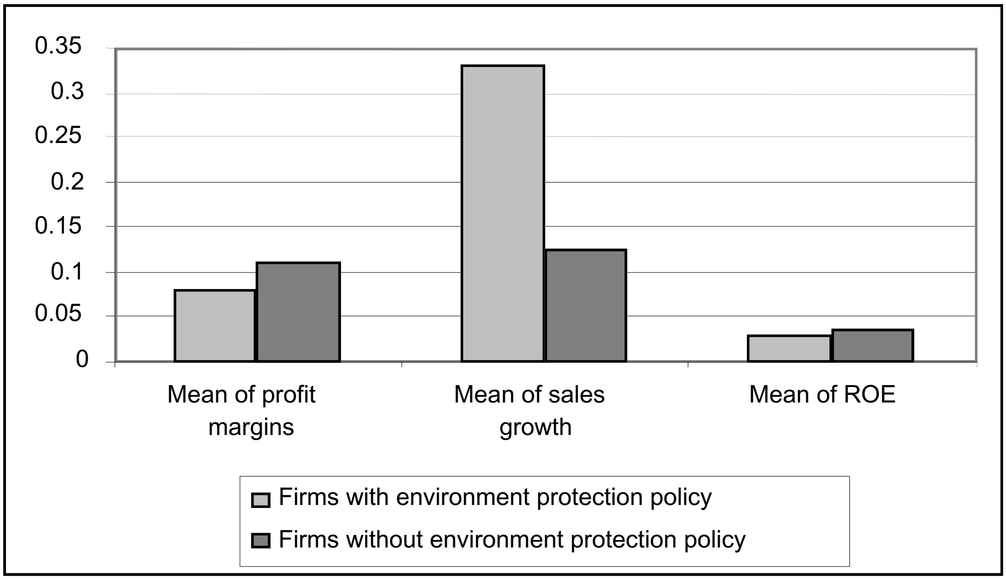


Figure 21. Relationship between environment protection policy and firm performance

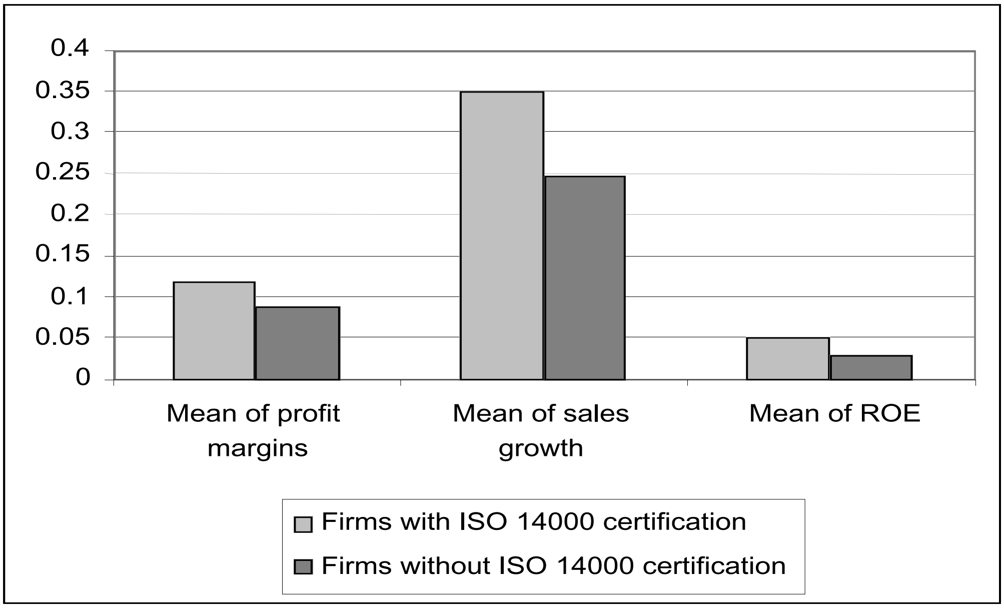


Figure 22. Performance comparison of firms with and without ISO 14000

External factors play an important role in the development of companies. Surely, the lack of regulatory framework is the main obstacle for the development of organizations. Institutional bottlenecks bring about waste of time and effort. Bad public services are also obstacles to the improvement of productivity. High cost of public services lowers profits.

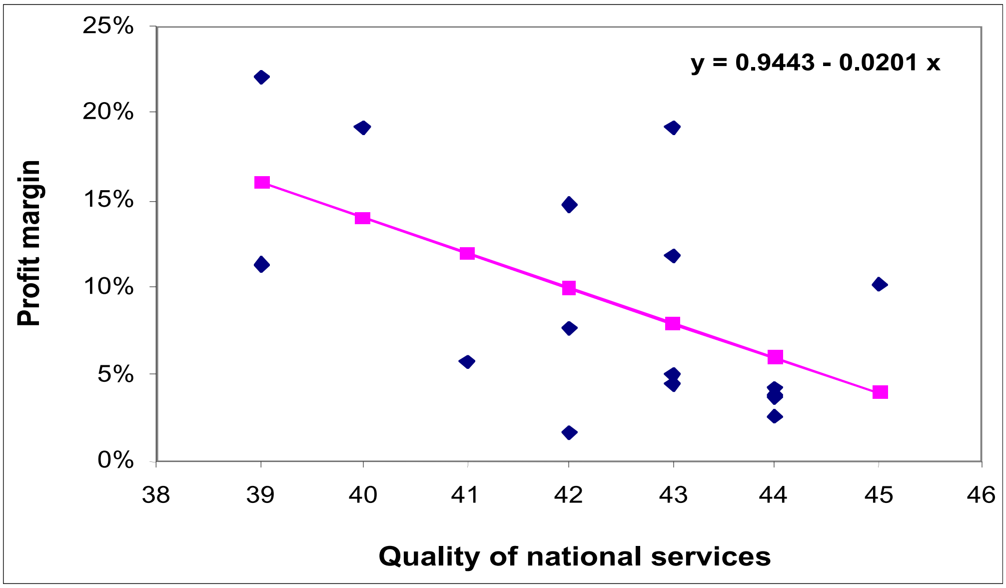


Figure 23. Relationship between profit margin and quality of national services

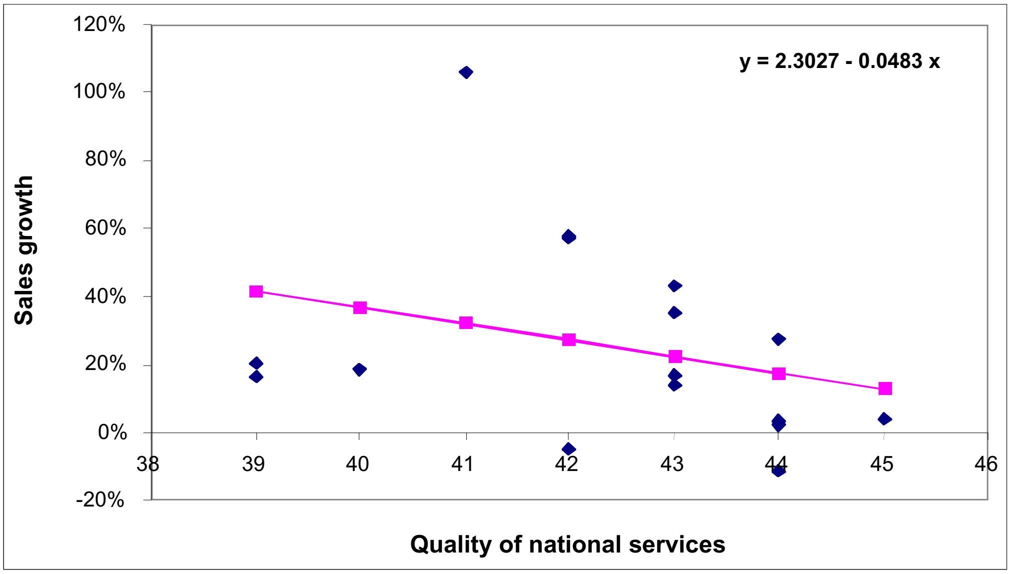


Figure 24. Relationship between quality of national services and sales growth

The assessment of quality of national services made by the surveyed companies are converted to points system with a scale of 1 to 6 with 1 for very good and 6 for very poor . The points are then added for each company. This means that the higher the number the lower is the quality of national services. Figures 23, 24, and 25 show negative relations between the quality of national services on the one hand and profit margins, sales growth and ROE on the other. These results demonstrate that national services have considerable impact on the performance of the firms in all dimensions.

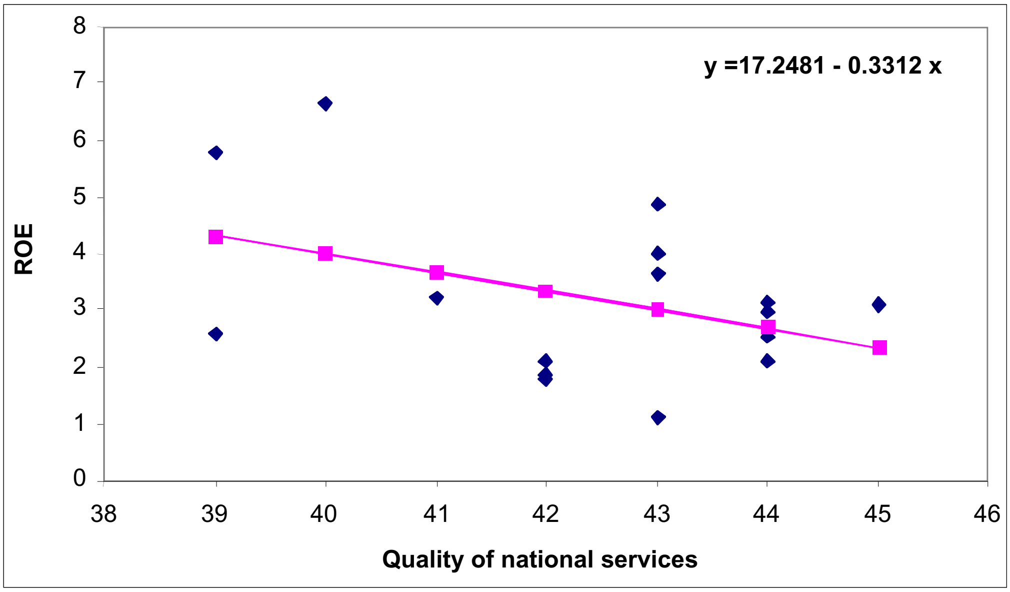


Figure 25. Relationship between quality of national services and ROE

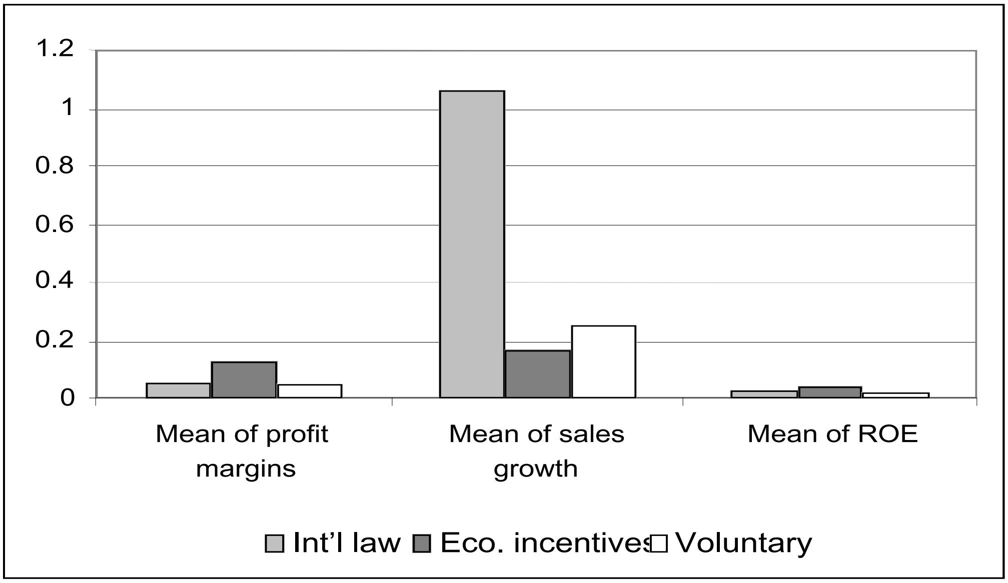


Figure 26. Preferred approaches and firm performance

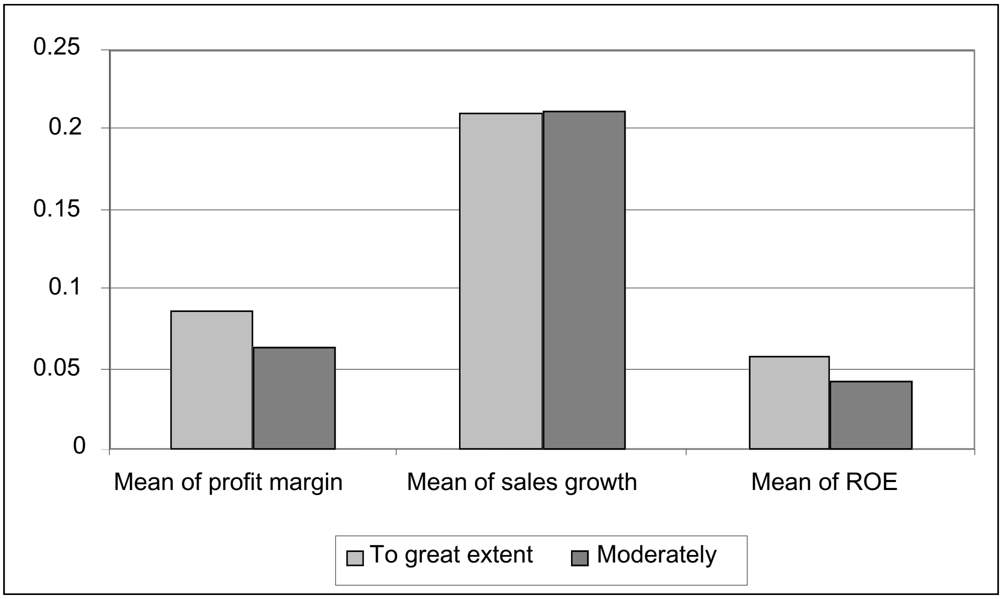


Figure 27. Evaluation of corporate governance s impacts on productivity and firm performance

Regarding the preferred approaches to strengthen international safeguards, the study indicates different results as illustrated in Figure 26. For firms choosing international law as the preferred approach, sales growth remains very high but for those choosing economic incentives/penalties, profit margin and ROE are even higher.

As to the final question regarding the companies evaluation of corporate governance impact on productivity and performance, Figure 27 shows that the group of firms which replied to a great extent have higher performance than those which replied moderately . This demonstrates that most Vietnamese firms are becoming more and more aware of the value of corporate governance on their performance.

RECOMMENDATIONS

The corporate sector in Vietnam, which is in the initial stage of development, is coping with big challenges. To overcome the shortcomings and enter a new era of development, modernizing the corporate sector is vital. The results drawn from the survey show that companies performing good corporate governance have a higher level of performance, both in terms of productivity and growth. Following are some recommendations to promote and maintain good corporate governance towards better performance for Vietnamese businesses.

Legal and regulatory framework development

A powerful legal framework is one of the most important factors in maintaining a stable political and socio-economic environment. Despite efforts by legislative and administrative agencies, Vietnam s legal system has to overcome many shortcomings. Firstly, the state has not yet completed the establishment of a comprehensive legal system to synchronize all the law making, law implementation, legal education and legal dissemination activities. Secondly, reform related to the organization, structure and operational mechanism of the courts and other law enforcement agencies have not gained the desired speed. Coordination between relevant agencies and the qualifications of enforcement officials is still limited.

Good corporate governance requires a legal system that clearly defines and effectively enforces legal rights and creates a fair playing ground for corporations. Enhancing bankruptcy and foreclosure laws, developing and implementing regulations, strengthening the judicial system and procedures should be accomplished effectively.

Vietnam s stock markets include a proportion of amateur traders who often invest without professional background on rules and market regulations. Therefore, legal education and professional training should be another main task. Another investor group consist of foreigners who are still hesitant to invest in Vietnam s stock market. One of the reasons is their uncertainty over foreign ownership limitation. The solution may be the establishment of a complete electronic database for Vietnam’s laws and regulations, and making them available to the public through the internet. This approach can provide foreigners with a further understanding of Vietnamese system, reduce the ambiguity about Vietnam s business environment while speeding up the completion of the comprehensive legal system.

To enhance the efficiency of information dissemination and improve the law making process, it is crucial to develop new administrative procedures based on transparency and simplicity. In striving to reform the administrative procedures, the government should introduce national standard formats for all forms required to be submitted by people and businesses; and reinforce the capacity of agencies directly involved in the legal documentation process. This standard information system will help to improve the issuance of legal documents.

Banking and financial sector reform

Together with the legal and administration reforms, the establishment of a healthy national financial system will boost sustainable economic growth, and also improve corporate governance. This can only be obtained by advancing financial mobilization, as well as allocation policy instruments to ensure equity, stability and dynamism in accordance with socialist market economy features. It will make possible internal strength build-up, attract a larger inflow of foreign financial resources and realize a more efficient management of the national resources pool.

Combined with sound macroeconomic management, financial sector restructuring will hasten the pace at which market confidence and robust economic growth are restored. Financial and corporate sector restructuring needs to be closely linked and should proceed in tandem with each other. The tasks for the banking and financial sector could be as follows:

- Develop strategies for restructuring/improving the banking system and non-banking financial institutions;
- Bring in new management/improve the level of existing management;
- Establish specialized institution restructuring agencies;
- Develop asset management/disposition function;
- Remove barriers to foreign investors;
- Limit government-led solutions; and
- Introduce incentives for banks to restructure.

Corporate sector restructuring

The government should establish a suitable environment for corporate restructuring; facilitate both formal and informal debt workouts; and introduce an effective legal, regulatory, accounting, and institutional framework. It should be noted that the transformation of the corporate sector could only be done with prompt response and support from other sectors.

The government should implement a broad and complex agenda for corporate restructuring. The first step should be to eliminate legal and regulatory obstacles to corporate restructuring. The obstacles include tax and policies that impede corporate reorganizations, mergers, debt-for-equity swaps, and restrictions on foreigners participation as holders of domestic equity and investors in domestic banks.

The next step will be the establishment of a policy framework that facilitates out-of-court settlements. Given the costs and risks associated with even the most developed bankruptcy systems, out-of-court settlements are considered efficient.

Finally, the government should introduce effective bankruptcy procedures, which need to be legally enforced. These procedures should prevent non-viable firms from continuing to absorb credit where a creditor can recover the maximum value of the claims of the insolvent debtor corporation. Moreover, the presence of an effective bankruptcy system will create the appropriate incentives for creditors and debtors to reach out-of-court settlements.

In summary, the corporate sector reform has to accomplish the following tasks:

1. Establish enabling environments for corporate restructuring
    - Legal: remove obstacles to equitization and mergers; ease off on debt equity swaps
    - Simplification of tax administration
    - Flexible labor market

2. Strengthen out-of-court mechanisms
    - Basic voluntary framework in place
    - Adequate incentives for all parties
3. Strengthen bankruptcy and foreclosure systems
    - Improved quality of bankruptcy law
    - Improved judicial capacity and enforcement
    - Better foreclosure and insolvency procedures
    - Rapid build up of supervisory capacity
4. Upgrade the legal, regulatory and organizational framework for financial supervision
5. Ensure the independence of the supervisory authority
6. Strengthen prudential rules governing risk management in private financial institutions.

Other recommendations

Enterprise autonomy: Making enterprises autonomous means allowing them to set prices and select the appropriate mix of inputs and outputs without ministry or other government intervention

Competition: Removing long-standing monopoly control and prices through an influx of foreign and domestic players, which can be implemented by dismantling import or investment licenses, output quotas, control over prices, and other interventions that give certain firms advantages over others. Competition will encourage enterprises to engage in customer-focused decision-making. A competitive labor market for skilled staff and managers must also be developed.

New management techniques: If other reforms are achieved, management can begin to act independently and focus on improving productivity by adopting modern management techniques such as promoting a shared vision, encouraging innovation, promoting internal and external employee education programs, and streamlining internal processes.

CONCLUSIONS

From the analysis above, some guidelines on good governance for Vietnamese publicly-listed companies can be drawn as follows:

Ownership and management

- The participation of employees as investors plays an important role to make management more transparent, efficient and effective as well as to motivate employees to contribute more to the growth of the company. Foreign participation is also important in terms of acquiring new knowledge and experience, both in management and markets.
- All strategic decisions of fundamental importance to the company should be approved in shareholder meetings.
- Auditors should be independent of management and elected by the shareholders. External auditors should be carefully chosen—they must not be affiliated with the audited company.
- The board should decide the remuneration of company directors. Remuneration principles should be published in the annual report and the remuneration of the

directors and the board members should, to a reasonable extent, depend on the company s profitability and share price development.

Information disclosure

- All publicly-listed companies should, in the annual report, inform stakeholders about their strategy and financial goals. They should publish quarterly information on insiders (directors, members of the board, and majority of shareholders) who have been trading shares in the company.
- News having more than marginal influence on the share price should immediately be communicated—including an evaluation of the consequences for the company.

Social responsibility

- Primary focus should be given to the protection of consumers rights. To maintain customer loyalty, the firms should deliver quality products/services that satisfy customers needs and expectations. Vietnamese companies should also protect the environment by producing eco-friendly products and services.
- Firms must actively participate in social activities such as charity donations.
- Implementing international standards such as ISO 14000, SA 8000, OHSAS 18000 and others should be seen as a major commitment to social responsibility.

Besides the efforts made by the company themselves, macro elements play a considerable role. Public services could be improved with less bureaucracy, a clarified legislation system and an enhanced infrastructure. The government remains as the key player that can facilitate a favorable business environment.

REFERENCES

Asian Development Bank (2001). Developing Asia and the World, *Asian Development Outlook 2002,* www.adb.org

Asian Productivity Organization (2001). Corporate Performance Assessment, Tokyo, Japan.

Diehl, Markus (1998). The Role of Institutions in the Economic Transition Process: the Reform of SOEs in Vietnam.

DVFA (2000). Scorecard for German Corporate Governance, Germany.

Gates, Carolyn L. (1997). Enterprise Reform in Vietnam: Issues, Theory and Empirical Evidence.

General Statistic Office (2001). Yearbook 2000, Hanoi.

Gordon Walker and Mark Fox (2002). Corporate Governance Reform in East Asia, *Corporate Governance,* Vol. 2, No. 1, pp. 4-9, MCB University Press.

International Monetary Fund (IMF) (2002). Vietnam: Selected Issues and Statistical Appendix, *IFM Country Report No. 02/5,* www.imf.org

Malesky, Edmund, Vu Thanh Hung, Vu Thi Dieu Anh and Nancy K. Napier (1998). The Model and the Reality: Assessment of Vietnamese SOE Reform Implementation at the Firm Level.

McMillan, John, and Christopher Woodruff (1998). Interfirm Relationships and Informal Credit in Vietnam.

National Assembly (2000). Law on Enterprises, Hanoi.

Ngu, Vu Quoc (2002). The SOE Reform in Vietnam: Process and Achievements and A Model of the Behaviour of Vietnamese SOE's during the Reform Period.

OECD (1999). OECD Principles of Corporate Governance, Paris.

OECD. (2000). Corporate Governance in OECD Member Countries: Recent Development and Trends, Paris.

Saigon Economic Times (2003), "Restructuring SOEs: Still Difficult", Vol. 19, May 1, p. 34.

Stilpon, Nestor (2001). International Efforts to Improve Corporate Governance: Why and How, OECD.

Tam, Le Minh (2000). Reforming Vietnam s Banking System: Learning from Singapore s Model.

Updated Information on Vietnam Stock Exchange Market, www.stockmarket.vnn.vn;

United Nations Development Program (2000). Good Governance and Sustainable Human Development, www.undp.org

United Nations Development Programme (2001). Modernizing Governance in Vietnam, www.undp.org.vn

Vietnam Economic Times, Stock Exchange Market section, www.vn-economy.com.vn;

Vietnam News Agency (2002). State Ownership Transfer . April 22.

Vinten, Gerald (1998). Corporate governance: an international state of the art, *Managerial Auditing Journal*, Vol. 13 No. 7. pp. 419-431, MCB University Press.

Wayne, Taylor D. (2000). Facts, Myths and Monsters: Understanding the Principles of Good Governance, *The International Journal of Public Sector Management*, Vol. 13, No. 2, pp. 108-124, MCB University Press.

World Bank (2001). Vietnam Development Report 2002, www.worldbank.org.vn

APO Survey on Corporate Governance in 10 Member Countries
Quick reference tables

Basic information about the responding firms

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Average age		33.5	26.47	63.49	41.1	23.58	26.50	16.5	53.25	32.38	3.19
Number of employees (mean)	Regular	21800	236.5	15711	3863	1012.5	2764	1533	219	3636	811.06
	Casual	450	96.11	3795.4	419	138.13	403		92	137	214.29
Number of actual hours worked by employees per year (mean)		2532	1720.7	1970.4	2453	1314.4	2287	3303	1920	2374.4	1902
Percentage of responding firms											
Total number of employees	1 to 9			3.45							
	10 to 49		5.00						33.33	12.50	
	50 to 99		15.00	1.72		8.33					
	100 to 199		25.00	6.90				12.50		12.50	6.25
	200 to 499		45.00	5.17	10.53	33.33		25.00	33.33	12.50	6.25
	500 or more	100	10.00	82.76	89.47	58.33	80.00	62.50	33.33	62.50	87.50

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
What is the legal organization of the firm?											
Percentage of responding firms	State-owned enterprise	25.00	31.58			33.33	20.00				
	Government controlled corporation, listed	75.00	10.53	60.34	5.260	16.67				25.00	
	Corporation, listed on a stock exchange		5.26	29.31	94.74	16.67	30.00	100	42.86		100
	Corporation, privately-held		47.37			8.33	40.00				
	Private		15.79	3.45		25.00	10.00		57.14	75.00	
Does any foreign company have a financial stake in your firm?											
Percentage of firms answering yes		25.00	100	19.64	43.24	33.33	60.00	37.5	37.50	25.00	31.25
If yes, what is the nationality of this foreign company?											
Percentage of responding firms	American			12.50	50.00		10.00	33.33			
	European	12.50		1.79	18.75	50.00	30.00		66.67	12.50	20.00
	Japanese				25.00		30.00		33.33	12.50	
	Other Asian				6.250		20.00				
	Others				12.50	50.00					80.00
Does your firm have holdings or operations in other countries?											
Percentage of responding firms		25.00	15.00	75.44	63.88	16.67	60.00	87.50	12.50	62.50	0

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Does your firm sell its products or services outside the country?											
Percentage of firms answering yes		12.50	68.42	43.64	84.21	41.67	60.00	75.00	37.50	62.50	37.50
If yes, what is the proportion of sales exported?											
Percentage of sales exported		17.00	17.00	16.80	38.53	74.00		72.33	37.00	22.54	61.42
How would you best describe your organization s main area of activity?											
Percentage of responding firms	Manufacture	87.50	80.00	43.10	60.53	66.67	30.00	37.50	50.00	37.50	62.50
	Construction		5.00	1.72	13.16				12.50	12.50	12.50
	Mining										
	Power generation				2.63						
	Agribusiness					8.33		12.50		12.50	
	Business services			29.31	2.63	16.67		12.50		25.00	6.25
	Utilities	12.50	10.00				30.00				
	Financial services			12.07		16.67	30.00		12.50		
	Personal services										6.25
	Trading and wholesale			3.45	10.53	8.33			37.50		12.50
	Retail				2.63	8.33	10.00	37.50		12.50	
	Others		10.00	12.07	7.89						

Ownership

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Who holds the majority ownership in your firm?												
Percentage of responding firms	One shareholder-owner		37.50	40.00	23.08	18.42	50.00	11.11	50.00	42.86	28.57	
	2 to 3 shareholder-owners			30.00	13.46	18.42	16.67	44.44	50.00	42.86		
	Four to five		12.50	10.00	7.69	10.53	16.67	22.22			14.29	
	Six to ten			5.00	9.62	18.42				14.29		53.85
	More than ten		50.00	15.00	46.15	34.21	16.67	22.22			57.14	46.15
Which of the following best describes the type of owners which have the largest stake in your firm?												
Percentage of responding firms	Government		25.00	30.00		5.26	50.00	20.00			25.00	66.67
	Family		25.00	5.00	1.89	21.05		10.00			12.50	
	Domestic company		25.00		39.62	31.58		50.00		66.67	25.00	
	Foreign company		12.50		13.21	2.63	25.00	20.00		16.67		
	Investment company				1.89		8.33			16.67		
	Bank			15.00	20.75		8.33					
	Individuals		12.50	35.00	11.32	36.84		10.00		16.67	37.50	33.33
	Others			15.00	11.32	2.63	8.33					
Is the proportion of shares held by												
Percentage of responding firms	Top share-holder	Between 20-49%			68.97	31.58	16.67			12.50	62.50	93.75
		Between 50-65%	25.00	45.00	3.45	36.84	8.33	30.00	25.00	12.50		6.25
		Between 66-80%			3.45	31.58	8.33	10.00	12.50	12.50		
		More than 80%		40.00	12.07	5.26	58.33			25.00	25.00	
	Top 5 share-holders	Between 20-49%			51.72	15.79						81.25
		Between 50-65%	25.00	10.00	10.34	18.42	8.33		12.50			12.50
		Between 66-80%	12.50		8.62		16.67		37.50	12.50		6.25
		More than 80%		5.00	15.52	7.89		50.00		12.50		
	Top 10 share-holders	Between 20-49%			44.83	7.89						50.00
		Between 50-65%	25.00		8.62	2.63	8.33		12.50		50.00	31.25
		Between 66-80%	12.50		8.62		8.33		37.50	12.50		18.75
		More than 80%			22.41		8.33	10.00	12.50	12.50		
Do the employees own shares in the firm?												
Percentage of firms answering yes			12.50	33.33	78.18	70.27	25.00	40.00	75.00	62.50	75.00	100
If yes, what is the employees share?												
Percentage of firms with at least 20% share			0	30.00	0	0	66.67	0	66.67	37.50	75.00	75.00
	Maximum % of share			12.00			50.00		25.00	6.00	10.00	63.00
	Minimum % of share			3.00			5.00		15.00	2.00	4.00	5.32
	Average share (%)		38.00	8.00	2.20	4.40	21.67		20.00	4.00	5.83	30.19
Do the managers own shares in the firm?												
Percentage of firms answering yes			12.50	55.00	83.64	78.38	25.00	50.00	75.00	50.00	87.50	6.25
If yes, what is proportion of shares owned by managers?												
Percentage of firms with at least 20% share			Negli-gible	33.33	0	24.14	33.33	0	57.14	37.50	14.29	6.25
	Maximum % of share			100		46.20	46.00		30.00	5.00	25.00	2.00
	Minimum % of share			3.00		1	0		5.00	2.00	1.00	2.00
	Average		1.05	30.00	8.40	7.80	15.67		15.00	2.33	7.29	2.00
Is there mutual holding of stocks between this firm and affiliated companies?												
Percentage of firms answering yes			62.50	60.00	43.40	78.95	90.90	20.00	25.00	25.00	0	

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Which of the following best describes the control of the firm, where control means making major decisions concerning the firm s present direction?											
Percentage of responding firms	Family		5.00		10.53				12.50	12.50	
	Government		20.00		2.63	25.00				25.00	
	Domestic company			9.62							
	Bank		5.00	1.92							
	Individual owners	25.00	30.00	3.85				100			
	Investment company			1.92		8.33			25.00		
	Foreign company		5.00	5.77							
	Board of directors	75.00	20.00	42.31	73.68	83.33	100		50.00	100	100
	Managers		5.00	17.31	13.16	25.00			25.00	100	
	Workers										
	Others		15.00	17.31							
Three years ago, who controlled the firm?											
Percentage of responding firms	Family	25.00	5.00	2.04	10.53		10.00	66.67	14.29	12.50	
	Government		20.00		2.63	25.00				25.00	31.25
	Domestic company			16.33							
	Bank		5.00	6.12							
	Individual owners		30.00	4.08							
	Investment company			2.04		8.33			14.29		
	Foreign company		5.00	6.12							
	Board of directors	75.00	25.00	36.73	73.68	83.33	90.00		57.14	100	68.75
	Managers			38.78	13.16	25.00			14.79	100	
	Workers		15.00	8.16							
	Others			18.37							
How was the firm established?											
Percentage of responding firms	Originally private	75.00	50.00	91.23	84.21		50.00	87.50	50.00	75.00	
	State-owned	25.00	35.00		12.5	50.00	20.00			25.00	93.75
	Privatization of a state-owned firm			1.75	12.5	8.33	20.00		12.50		
	Joint venture		10.00	1.75	5.26	33.33	10.00				6.25

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Check which shareholder rights exist in the firm (if publicly listed).											
Percentage of responding firms	Right to vote according to share	100	15.00	94.59	100	100	100	100	100	100	100
	Proxy voting	100		59.46	81.08	100	100	100	100	100	100
	Right to maintain proportionate ownership of firm under any financing plan			5.41	21.62	25.00		100		100	
	Right to resolve disputes with the firm	50.00			29.73		33.33	100	33.33	100	37.50
	Right to demand independent audit	50.00		8.11	45.95	75.00	66.67	100	66.67	100	100
	Membership in independent board committees			2.70	18.92	50.00		100		100	
Are minority shareholders represented in the Board?											
Percentage of responding firms		0	60.00	7.32	2.63	41.67	20.00	87.50	0	0	100
If yes, how easy is it to remove without cause the minority representative?											
Percentage of responding firms	Very easy	n.a.	33.33					12.50	n.a.	n.a.	
	Somewhat easy			33.33				87.50			43.75
	Somewhat difficult				100						56.25
	Very difficult		66.67	66.67		60.00	100				

Financing

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Who are the creditors of the firm?											
Percentage of responding firms	Banks	100	100	80.00	71.06	75.00	80.00	100	75.00	100	87.50
	Non-banks	75.00	10.00	6.67	23.68	8.33	20.00	75.00	25.00		100
	Others		15.00	68.89	5.26	41.67	50.00	50.00	75.00		
Are any of the creditors affiliated with the firm?											
Percentage of responding firms		25.00	45.00	63.64	25.71	8.33	37.50	12.50	25.00	0	0
If yes, which ones are affiliated?											
Percentage of responding firms	Banks	25.00	42.86		71.43		66.67		100	n.a.	n.a.
	Non-banks		42.86		14.28		33.33	100			
	Others		14.29		14.28	100					
Who guarantees loans made by the firm?											
Percentage of responding firms	Government	25.00	30.00	5.26	3.33	33.33	57.14				
	Private owners	75.00	40.00	52.63	30	8.33	42.86	100	33.33		
	Others		35.00	42.11	66.67	50.00			66.67	100	
If government is guarantor, what is the proportion of loans that it guarantees?											
Percentage of responding firms		25.00	20.00		2.63	100	10.00	n.a.	n.a.	n.a.	n.a.
	Maximum %		100			100					
	Minimum %		30.00			100					
	Average	100	65.00	100		100	100				
How long has the firm dealt with its major creditors?											
Percentage of firms: Bank	About 2 years or less		10.00	1.72	2.63			25.00	12.50		
	3-5 years		10.00		2.63		30.00	75.00		25.00	50.00
	More than 5 years	75.00	65.00	58.62	68.42	75.00	50.00	25.00	75.00	87.50	37.50
Non-bank	About 2 years or less			1.72						25.00	
	3-5 years		5.00		2.63						81.25
	More than 5 years	25.00	10.00	8.62	42.11	8.33	10.00		37.50		18.75
Others	About 2 years or less				2.63	8.33	10.00				
	3-5 years		5.00					12.50			
	More than 5 years		10.00	6.90	7.89	33.33	20.00		50.00		
Does the external creditor ask for collateral for loans, whether working capital or capital expenditure?											
Percentage of firms responding yes		12.50	80.00	38.10	61.76	72.73	55.56	87.50	62.50	100	100
What does the firm do when faced with liquidity problems?											
Percentage of responding firms	Renegotiate loan repayment	25.00	68.42	2.33	73.53	44.44	40.00	100	50.00	n.a.	100
	No action	75.00	10.53		2.94	11.11	30.00				
	Others		21.05	83.72	23.53	44.44	50.00		62.50		
Do the firm s creditors take action in cases of loan default?											
Percentage of firms responding yes		0	90.00	100	30.00	66.67	0	87.50	20.00	n.a.	100
If yes, what actions do the creditors take?											
Percentage of responding firms	File collection lawsuit	n.a.	16.67	6.25		75.00	n.a.	42.86		n.a.	
	Foreclose collateral		55.56	31.25	25.00	25.00		14.29			42.86
	Agree to renegotiate loan		50.00	16.67	75.00	75.00		28.57	100		78.57
	Intervene in the management of firm		16.67	18.75				28.57			85.71
	Others		5.56	6.25		25.00					
If the firm faces insolvency or bankruptcy, is there a law which the firm can invoke to protect the owners or shareholders?											
Percentage of firms responding yes		100	38.89	100	84.85	50.00	80.00	100	100	0	100

Management

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
What types of decisions are made by the following?												
Percentage of responding firms	Owners/ major share-holders	Corporate thrusts and direction	25.00	65.00	55.17	7.89	16.67	50.00				100
		Corporate and financial strategic options		50.00	51.72	21.05	8.33	30.00			12.50	100
		Sanctions and rewards for management performance		65.00	58.62	2.63	8.33	20.00	100			
		Management appointments and executive compensation		75.00	70.69	15.79	33.33	20.00	100			6.25
		Board composition and membership	100	100	70.69	47.37	83.33	80.00	100	62.50	100	100
		Day-to-day operations		25.00	31.03			10.00				
		Declaration of dividends	25.00	70.00	68.97	15.79	16.67	40.00				
		Profit or gain sharing	100	80.00	67.24	7.89	16.67	30.00			12.50	56.25
		Business expansion/ contraction	100	55.00	58.62	18.42	8.33	40.00				
		Mergers and acquisitions	100		60.34	15.79	50.00	60.00	100	12.50		
		Productivity improvement measures	12.50	15.00	31.03			10.00				
		Customer satisfaction/ Quality issues		15.00	31.03			10.00				
Percentage of responding firms	Board	Corporate thrusts and direction	75.00	55.00	84.48	65.79	83.33	80.00	100	87.50	75.00	100
		Corporate and financial strategic options	87.50	35.00	86.21	68.42	58.33	70.00	100	87.50	50.00	100
		Sanctions and rewards for management performance		30.00	81.03	73.68	58.33	30.00	100	75.00	25.00	87.50
		Management appointments and executive compensation	37.50	35.00	77.59	76.32	58.33	50.00	100	50.00	62.50	93.75
		Board composition and membership			77.59	42.11	16.67	20.00	100	37.50	12.50	
		Day-to-day operations		15.00	72.41	21.05			100			
		Declaration of dividends	75.00	20.00	81.03	81.58	50.00	80.00	100	87.50	100	100
		Profit or gain sharing		10.00	81.03	84.21	66.67	70.00	100	87.50	100	
		Business expansion/ contraction		45.00	80.03	57.89	75.00	80.00	100	62.50	100	
		Mergers and acquisitions			77.59	68.42	50.00	50.00	100	87.50		
		Productivity improvement measures	12.50	40.00	72.41	18.42	33.33	10.00	100	12.50		
		Customer satisfaction/ Quality issues		15.00	72.41	15.79	8.33	10.00	100	12.50		

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
What types of decisions are made by the following?												
Percentage of responding firms	Chief Executive Officer	Corporate thrusts and direction			82.76	26.32	25.00	50.00	50.00	50.00	87.50	75.00
		Corporate and financial strategic options	12.50		81.03	7.89	50.00	60.00	25.00	62.50	100	81.25
		Sanctions and rewards for management performance	100		82.76	10.53	41.67	90.00	50.00	62.50	100	
		Management appointments and executive compensation	62.50		75.86	7.89	41.67	90.00	25.00	62.50	75.00	
		Board composition and membership			79.31	10.53	8.33	20.00		12.50		
		Day-to-day operations	50.00	60.00	79.31	57.89	91.67	50.00	50.00	62.50	100	100
		Declaration of dividends			77.59	2.63	25.00	20.00			12.50	
		Profit or gain sharing			68.97	5.26	16.67	30.00			12.50	
		Business expansion/ contraction		10.00	81.03	21.05	50.00	60.00		50.00	25.00	68.75
		Mergers and acquisitions			75.86	13.16		20.00		25.00		75.00
		Productivity improvement measures	75.00	75.00	79.31	50	83.33	100	12.50	62.50	100	100
		Customer satisfaction/ Quality issues		15.00	79.31	52.63	75.00	90.00	12.50	62.50	100	
Percentage of responding firms	Chief Operating Officer	Corporate thrusts and direction			60.34			10.00			12.50	None
		Corporate and financial strategic options			58.62	2.63	8.33	30.00			25.00	
		Sanctions and rewards for management performance			60.34	7.89		40.00		12.50	25.00	
		Management appointments and executive compensation			46.55			30.00				
		Board composition and membership			48.28			0				
		Day-to-day operations	50.00	30.00	60.34	21.05	25.00	100	100	75.00	50.00	
		Declaration of dividends			48.28		8.33	0				
		Profit or gain sharing			48.28			0			12.50	
		Business expansion/ contraction			56.90	2.63	8.33	10.00			12.50	
		Mergers and acquisitions				2.63		0				
		Productivity improvement measures		10.00	60.34	31.58	8.33	70.00		62.50	25.00	
		Customer satisfaction/ Quality issues		20.00	60.34	31.58	50.00	90.00		62.50	25.00	

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Is the Board Chairman also the Chief Executive Officer?												
Percentage of firms responding yes			50.00	40.00	50.00	89.47	33.33	30.00	75.00	42.86	37.50	100
What is the average tenure of the board?												
Percentage of responding firms	3 years or less			60.00	7.89	59.46	41.67	30.00	25.00	33.33	100	
	4-6 years		100	15.00	47.37	35.14	16.67	40.00		50.00		100
	7 years or more			25.00	44.74	5.41	16.67	30.00	75.00	16.67		
What is the size of the firm s board?												
Percentage of responding firms	5 or less			70.00	22.41	7.89	8.33		37.50	42.86	12.50	
	6 to 10		75.00	30.00	25.86	71.05	91.67		50.00	57.14	62.50	75.00
	11 to 15		25.00		15.52	7.89			12.50		12.50	25.00
	More than 15				36.21	13.16					12.50	
What committees are present within the firm s Board?												
Percentage of responding firms	Audit		100	58.33	8.16	93.94	41.67	66.67	100	80.00	None	100
	Share options			16.67	2.04	9.09			50.00			
	Compensation/ remuneration		50.00	16.67	16.33	15.15	8.33	22.22	62.50	60.00		
	Nomination				16.33	42.42	8.33					
	Investment		12.50	16.67	10.20	18.18	8.33	44.44	37.50	20.00		
	Others			33.33	75.51	30.30	16.67		37.50	20.00		
Does the firm s Board appoint outside directors?												
Percentage of firms responding yes			100	70.00	45.28	81.58	16.67	44.44	100	85.71	0	6.25
How frequent does the Board meet?												
Percentage of responding firms	Less than 4 times a year			35.00		2.63	8.33	10.00	50.00	14.29	50.00	
	4-6 times a year		75.00	35.00	6.12	5.26	8.33	40.00	50.00	14.29	25.00	100
	6-8 times a year					7.89	8.33	0				
	More than 8 times a year		25.00	30.00	93.88	84.21	75.00	50.00		71.43	25.00	
What is the degree of independence of management in making operational decisions?												
Percentage of responding firms	Very high		100	15.00	31.48	13.16	25.00	40.00		37.50	75.00	
	High			25.00	38.89	52.63	41.67	40.00	50.00	37.50	12.50	100
	Moderate			15.00	29.63	28.95	25.00	0	50.00	25.00	12.50	
	Low			30.00		0		10.00				
	Very low			15.00		5.26	8.33	10.00				
What is the firm s wage compression ratio?												
Percentage of responding firms			37.50	100	22.41	18.42	58.33	30.00		37.50	100	100
	Maximum		714.0	1000		9	1000	12.3	25	312.0	1000	33.33
	Minimum		10.00	200		156	3	10.53	10	120.5	350	13.33
	Average		262.3	435	12.3	13	173.5	12.3	17.25	111.0	649.2	22.44
Is there a legal or regulatory requirement for public disclosure of material information about the firm?												
Percentage of firms responding yes			100	50.00	100	100	75.00	88.89	100	42.86	100	100
Does the firm have a specific disclosure policy?												
Percentage of firms responding yes			100	40.00	76.47	59.46	81.82	88.89	25.00	42.86	100	100
How frequently does the firm disclose the following information?												
Percentage of responding firms	Financial information	Once a year +	100	25.00	60.34	100	25.00	40.00	25.00	37.50	100	25.00
		Once a year		50.00	5.17		66.67	60.00	75.00	12.50		56.25
		Not at all		25.00	12.07		8.33			12.50		
	Firm perform- ance	Once a year +	100	35.00	60.34	100	25.00	50.00	25.00	25.00	100	6.25
		Once a year		35.00	5.17		58.33	40.00	75.00	50.00		75.00
		Not at all		25.00	12.07		8.33			12.50		
	Ownership structure	Once a year +		10.00	60.34	100	8.33	10.00		12.50		
		Once a year	100	40.00	5.17		50.00	60.00	100	37.50	100	
		Not at all		50.00	12.07		25.00			25.00		
	Governance	Once a year +		10.00	60.34	97.37	8.33	20.00		12.50		
		Once a year	100	30.00	5.17		50.00	50.00	100	50.00	100	
		Not at all		60.00	12.07		16.67	10.00		12.50		

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Who has access to the firm s material information?												
Percentage of responding firms	Major shareholders	Financial information	100	85.00	84.48	100	91.67	100	100	50.00	100	100
		Firm performance	100	80.00	84.48	100	83.33	100	100	37.50	100	100
		Ownership structure	100	80.00	84.48	100	75.00	90.00	100	37.50	100	100
		Governance	100	35.00	84.48	100	58.33	90.00	100	25.00	100	100
	Minority shareholders	Financial information		35.00	75.86	100	33.33	70.00	100	25.00	100	100
		Firm performance		25.00	75.86	100	33.33	70.00	100	12.50	100	100
		Ownership structure		20.00	75.86	100	25.00	60.00	100	12.50	100	100
		Governance			75.86	100	16.67	60.00	100		100	100
	Management	Financial information		65.00	86.21	100	91.67	80.00	100	75.00	100	100
		Firm performance		65.00	86.21	100	91.67	90.00	100	87.50	100	100
		Ownership structure		40.00	86.21	100	58.33	80.00	100	50.00	100	100
		Governance		10.00	86.21	100	41.67	70.00	100	75.00	100	100
	Employees	Financial information		45.00	79.31	100	58.33	60.00	100	12.50	100	100
		Firm performance		25.00	79.31	100	50.00	90.00	100	50.00	100	100
		Ownership structure			79.31	100	16.67	70.00	100	37.50	100	100
		Governance			79.31	100	25.00	70.00	100	25.00	100	100
	Unions	Financial information		20.00	58.62	100	66.67	60.00	100	12.50	100	100
		Firm performance		10.00	58.62	100	50.00	70.00	100	25.00	100	100
		Ownership structure			58.62	100	16.67	60.00	100	37.50	100	100
		Governance			58.62	100	25.00	50.00	100	12.50	100	100
	Internal auditors	Financial information		60.00	74.14	100	83.33	90.00	100	50.00	100	100
		Firm performance		25.00	74.14	100	58.33	90.00	100	50.00	100	100
		Ownership structure		5.00	74.14	100	33.33	80.00	100	50.00	100	100
		Governance			74.14	100	33.33	70.00	100	12.50	100	100
	External auditors	Financial information	75.00	55.00	75.86	100	83.33	100	100	62.50	100	100
		Firm performance	25.00	40.00	75.86	100	66.67	90.00	100	50.00	100	100
		Ownership structure		10.00	75.86	100	50.00	90.00	100	62.50	100	100
		Governance		10.00	75.86	100	50.00	70.00	100	25.00	100	100
	Creditors	Financial information	75.00	60.00	58.62	100	50.00	60.00	100	12.50	100	100
		Firm performance	75.00	30.00	58.62	100	33.33	60.00	100	25.00	100	100
		Ownership structure	100	5.00	58.62	100	16.67	80.00	100		100	100
		Governance	75.00		58.62	100	16.67	60.00	100	12.50	100	100
	Government (e.g., securities agency)	Financial information	25.00	25.00	56.90	100	58.33	90.00	100	37.50	100	100
		Firm performance	25.00	25.00	56.90	100	41.67	80.00	100	12.50	100	100
		Ownership structure	25.00	25.00	56.90	100	25.00	80.00	100		100	100
		Governance	25.00	10.00	56.90	100	25.00	70.00	100		100	100
	General public	Financial information	100	15.00	63.79	100	33.33	70.00	100	25.00	100	100
		Firm performance	100	5.00	63.79	100	33.33	60.00	100	25.00	100	100
		Ownership structure		5.00	63.79	100	8.33	80.00	100	12.50	100	100
		Governance			63.79	100	16.67	70.00	100		100	100

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Who has access to minutes of board meetings?											
Percentage of responding firms	Major shareholders	100	70.00	66.04	94.74	41.67	80.00	100	42.86		
	Minority shareholders			39.62	94.74	25.00	60.00	100			
	Management		100	84.91	97.37	58.33	90.00	100	28.57	100	100
	Others			22.64		25.00		100	57.14		
What accounting and auditing standards do the firm follow?											
Percentage of responding firms	Local standards	87.50	55.00	83.02	100	66.67	60.00	50.00	87.50	100	100
	International standards		30.00	15.09		41.67	50.00	25.00	25.00		
	Developed country standards (e.g., US GAAP).	12.50	15.00	13.21		8.33	10.00	25.00			
Does the firm maintain separate books?											
Percentage of firms responding yes		100	30.00	20.75	0	25.00	33..33	100	50.00	0	
If yes, for whom are they maintained?											
Percentage of responding firms	Owners		16.67	60.00	n.a.	66.67	100	100	100	n.a.	n.a.
	Management			50.00		100	100				
	Tax agency	25.00	83.33	60.00		66.67	66.67				
	Auditors	25.00		30.00		66.67	66.67		50.00		
	Creditors	25.00	33.33	30.00		33.33	66.67				
Does the firm have an external auditor?											
Percentage of firms responding yes		100	52.94	85.96	100	100	100	75.00	87.50	100	100
If yes, has the firm changed its external auditor during the last three years?											
Percentage of firms responding yes		100	0	57.45	24.32	33.33	10.00	83.33	0	0	
If there has been no change, how long has the current external auditor been associated with the firm?											
Percentage of responding firms	3-5 years	62.50	12.50	50.00	52	75.00	11.11			50.00	68.75
	More than 5 years	25.00	87.50	45.00	48		22.22		42.86	50.00	31.25
	Since firm was established	12.50		5.00	0	50.00	66.67	12.50	57.14		
What is the degree of independence of the external auditor from the firm?											
Percentage of responding firms	Very high	100	5.88	28.57	71.05	75.00	50.00	66.67	62.50	75.00	100
	High		41.18	38.78	23.68	25.00	30.00		37.50	25.00	
	Moderate		11.76	30.61	2.63		20.00	33.33			
	Low		17.65	2.04	2.63		0				
	Very low		23.53		0		0				

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Does the firm have a code of ethics?											
Percentage of firms responding yes		100	45.00	71.93	94.74	100	100	50.00	14.29	100	12.50
If yes, is it publicized?											
Percentage of firms responding yes		75.00	44.44	64.86	84.21	66.67	90.00	100	100	100	100
Are there sanctions or penalties for violations of the Code of Ethics?											
Percentage of firms responding yes		62.50	54.55	61.54	80.56	88.88	100	100		62.50	100
Has anyone been sanctioned for violating the code of ethics?											
Percentage of responding firms	Board chairman							None	None		
	Board directors		50.00	14.81			11.11				
	CEO		33.33			12.50				20.00	
	COO		16.67		10.53		11.11				
	Managers		33.33	66.67	36.84	25.00	88.89			40.00	
	Employees			85.19	52.63	87.50	88.89			80.00	
	Internal auditor		33.33								
	Others			7.41							

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Does the firm receive and investigate allegations of breaches of proper standards of financial conduct?											
Percentage of firms responding yes		0	65.00	7.27	89.47	83.33	77.78	0	57.14	0	
Has the firm received complaints about or accused of violating the following?											
Percentage of responding firms	Internal revenue code	None	55.00	39.13	2.63	16.67		None			
	Environmental rules		10.00	8.70	7.89	16.67	42.88			25.00	25.00
	Labor code		35.00	17.39	2.63	16.67	85.71				50.00
	Intellectual property rights		25.00	4.35							50.00
	Corporation law		35.00			16.67					
	Consumer protection laws		65.00	4.35	2.63	16.67					
	Anti-bribery act			4.35		8.33	14.29				
	Others			21.74	21.05				12.50		

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Characterize the nature of internal controls within the firm to protect against misuse of the following.												
Percentage of responding firms	Cash flow	Rigid	62.5	80.00	65.52	94.74	66.67	80.00	87.50	62.50	100	12.50
		Adequate	37.5	10.00	20.69		16.67	10.00	12.50	37.50		62.50
		Loose		10.00	1.72							25.00
	Accounts receivable collection/aging	Rigid	87.50	55.00	63.79	89.47	41.67	80.00	75.00	37.50	87.50	37.50
		Adequate	12.50	5.00	15.52	5.26	41.67	20.00	25.00	37.50	12.50	56.25
		Loose		40.00	1.72					25.00		6.25
	Bad debt write off	Rigid	62.50	40.00	55.17	84.21	33.33	60.00	87.50	37.50	87.50	18.75
		Adequate	25.00	15.00	25.86	7.89	25.00	30.00	12.50	62.50	12.50	56.25
		Loose	12.50	45.00			25.00					25.00
	Inventory	Rigid	50.00	45.00	48.28	78.95	16.67	50.00	87.50	50.00	75.00	50.00
		Adequate	50.00	35.00	27.59	15.79	41.67	40.00	12.50	25.00	25.00	31.25
		Loose		20.00	3.45					25.00		18.75
	Fixed asset acquisition	Rigid		60.00	60.34	84.21	33.33	80.00	87.50	87.50	100	31.25
		Adequate		40.00	24.14	10.53	50.00	10.00	12.50	25.00		31.25
		Loose										37.50
	Research and development	Rigid	25.00	30.00	34.48	73.68	50.00	50.00	87.50	37.50	75.00	68.75
		Adequate	75.00	10.00	37.93	18.42	33.33	20.00	12.50	37.50	25.00	31.25
		Loose		60.00	3.45	2.63		10.00		12.50		
	Capital expenditure	Rigid	50.00	40.00	62.07	78.94	50.00	90.00	87.50	75.00	87.50	
		Adequate	50.00	40.00	20.69	15.79	16.67		12.50	25.00	12.50	87.50
		Loose		20.00	1.72							12.50
	Tax payments	Rigid	87.50	60.00	56.90	84.21	41.67	60.00	75.00	50.00	100	6.25
		Adequate	12.50	30.00	27.59	10.53	33.33	20.00	25.00	25.00		37.50
		Loose		10.00			8.33			25.00		
	Loan repayment	Rigid	87.50	85.00	56.90	78.95	50.00	70.00	75.00	62.50	100	
		Adequate	12.50	15.00	17.24	15.79	33.33	30.00	25.00	25.00		100
		Loose								12.50		
	Payroll	Rigid		75.00	55.17	81.58	50.00	70.00	75.00	62.50	100	
		Adequate		10.00	27.59	13.16	33.33	20.00	25.00	25.00		100
		Loose		10.00						12.50		

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Does the firm have company-wide quality and productivity improvement programs?											
Percentage of firms responding yes		100	45.00	68.52	97.3	90.91	90.00	100	75.00	100	100
If yes, what are they?											
Percentage of responding firms	5S	50.00	11.11		25.71		77.78	25.00	20.00	87.50	43.75
	Suggestion system	25.00	55.56		77.14	30.00	66.67	37.50	20.00	100	37.50
	Continuous improvement	37.50	33.33		62.86	30.00	88.89	87.50	60.00	62.50	81.25
	Quality circles	37.50	22.22		48.57	10.00	55.56	37.50	20.00	37.50	6.25
	Total quality management	37.50	44.44	24.32	74.29	50.00	66.67	12.50	40.00	37.50	
	Total productive maintenance	50.00			40	10.00	33.33	12.50		62.50	
	Just in time	50.00	22.22		28.57		22.22	12.50			6.25
	Six sigma	62.50	22.22	2.70	34.29			37.50			
	Others			78.38	17.14	10.00	22.22		20.00		87.50
Is there an employees union or association within the firm?											
Percentage of firms responding yes		62.50	20.00	65.52	81.58	66.67	70.00	0	62.50	37.50	100
During the last three years, have there been disputes between management and employees?											
Percentage of firms responding yes		0	33.33	5.36	21.62	66.67	100	100	25.00	0	18.75
If yes, were the disputes settled?											
Percentage of firms responding yes		n.a.	80.00	100	75	100	100	100	50.00	n.a.	100
If yes, how were the disputes settled?											
Percentage of responding firms	Government mediation	n.a.			10	25.00	37.50	87.50	50.00	n.a.	
	Court arbitration		25.00		0		37.50		50.00		
	Labor-management consultation			50.00	90	25.00	75.00	12.50			100
	Others		75.00	50.00		50.00					

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Are there mechanisms employed by the firm to discuss employer-employee relations issues?												
Percentage of firms responding yes			100	30.00	100	84.85	81.82	100	100	100	100	100
If yes, what are they? What kinds of issues are settled by each?												
Percentage of responding firms	Compensation	Collective bargaining	87.50	5.00	23.50	17.86	8.33	70.00		12.50		
		Labor management consultation	12.50	15.00	36.70	32.14		30.00		25.00	25.00	18.75
		Management discretion		5.00	35.50	3.57	16.67	40.00	75.00	50.00	50.00	
	Benefits	Collective bargaining	87.50	5.00	19.70	7.14	25.00	60.00			12.50	
		Labor management consultation	12.50	40.00	40.80	28.57	25.00	30.00		37.50		
		Management discretion		45.00	33.60	7.14	16.67	70.00	75.00	50.00	37.50	
	Tenure	Collective bargaining	12.50	5.00	12.70	10.71	8.33	40.00	12.50	12.50		
		Labor management consultation	37.50	20.00	26.80	14.29				12.50		
		Management discretion	50.00	55.00	52.90	14.29	41.67	60.00	75.00	62.50	37.50	

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Percentage of responding firms	Working conditions	Collective bargaining	37.50	5.00	19.80	14.29	8.33	40.00		12.50	12.50	
		Labor management consultation	37.50	20.00	41.10	32.14	33.33	70.00		12.50	25.00	12.50
		Management discretion	25.00	50.00	33.10	7.14	25.00	60.00	75.00	62.50	75.00	
	Company rules and regulations	Collective bargaining			24.90	7.14	8.33	10.00				
		Labor management consultation		25.00	49.80	25	16.67	50.00		12.50	12.50	18.75
		Management discretion	100	30.00	18.00	14.29	33.33	60.00	75.00	62.50	25.00	
	Training and development	Collective bargaining			8.50	3.57	8.33	20.00				
		Labor management consultation		15.00	29.00	53.57		50.00		25.00		
		Management discretion	100	40.00	54.00	14.29	66.67	70.00	75.00	50.00	62.50	
	Labor standards	Collective bargaining	37.50		20.70	10.71	8.33	20.00	12.50		12.50	
		Labor management consultation		20.00	38.80	25	25.00	40.00		25.00	12.50	18.75
		Management discretion	87.50	45.00	33.90	10.71	25.00	70.00	75.00	37.50	75.00	
	Productivity improvement programs	Collective bargaining				3.57	8.33	10.00		12.50		
		Labor management consultation				28.57	16.67	50.00	12.50	25.00		
		Management discretion		55.00		17.86	41.67	70.00	75.00	37.50	75.00	
	Productivity gainsharing	Collective bargaining				7.14	8.33	20.00		12.50		
		Labor management consultation		5.00		17.86	16.67	30.00	12.50	25.00	12.50	
		Management discretion		50.00		14.29	41.67	70.00	75.00	25.00	75.00	

Social responsibility

	India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Are there laws or regulations on consumer protection?										
Percentage of firms responding yes	100	25.00	100	94.74	80.00	100	25.00	71.43	100	100
Does the firm have a policy on consumer protection?										
Percentage of firms responding yes	100	10.00	64.82	97.37	70.00	100	37.50	57.14	87.50	100
Does the firm have a policy on environmental protection?										
Percentage of firms responding yes	100	10.00	53.70	100	10.00	80.00	37.50	28.57	87.50	62.50
Does it have an ISO 14000 certification?										
Percentage of firms responding yes	75.00	5.00		78.38	0	30.00	37.50	0	50.00	6.25

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Characterize the firm s role in the following areas.												
Percentage of responding firms	Pollution control	No firm activity		25.00	12.07	5.26	8.33	10.00		25.00	12.50	
		Compliance only		45.00	24.14	5.26	16.67	30.00	62.50	37.50	25.00	
		Voluntary response	25.00	10.00	32.76	36.84	50.00	10.00	12.50		37.50	87.50
		Takes leadership role	75.00	10.00	17.24	47.37	16.67	40.00	25.00	25.00	25.00	12.50
	Environ-mental protection	No firm activity		15.00	12.07	5.26	8.33			25.00	25.00	
		Compliance only		35.00	17.24	5.26	8.33	40.00	75.00	12.50	12.50	
		Voluntary response		15.00	34.48	31.58	66.67	20.00	12.50	25.00	37.50	100
		Takes leadership role	100	25.00	29.31	52.63	8.33	40.00	12.50	25.00	25.00	
	Truth in advertising and in all business activities	No firm activity		15.00	5.17	5.26	8.33			25.00		
		Compliance only		30.00	32.76	15.79		10.00	62.50	12.50	50.00	
		Voluntary response	75.00	10.00	29.31	39.47	25.00	20.00	25.00	25.00	50.00	100
		Takes leadership role	25.00	35.00	24.14	34.21	41.67	70.00	12.50	25.00		
	Product warranty and service	No firm activity		10.00	3.45	2.63	25.00	10.00		25.00		
		Compliance only		10.00	22.41	7.89	8.33	10.00	75.00	25.00	25.00	
		Voluntary response	75.00	35.00	32.76	34.21	25.00	10.00	12.50		25.00	56.25
		Takes leadership role	25.00	35.00	31.03	50	33.33	70.00	12.50	25.00	50.00	43.75
	Control of harmful products	No firm activity		10.00	8.62	2.63	25.00	10.00		37.50		
		Compliance only		20.00	24.14	5.26	8.33	20.00	25.00	25.00	50.00	
		Voluntary response	75.00	25.00	31.03	28.95	33.33	20.00	75.00		37.50	100
		Takes leadership role	25.00	25.00	18.97	57.89	25.00	40.00		25.00	12.50	
	Community support	No firm activity		5.00	10.34	2.63	16.67			12.50		18.75
		Compliance only		30.00	31.03	15.79	8.33	10.00	100	25.00	37.50	37.50
		Voluntary response	50.00	20.00	24.14	42.11	41.67	40.00		25.00	37.50	43.75
		Takes leadership role	50.00	20.00	22.41	36.84	25.00	50.00		25.00	25.00	
	Lobbying manage-ment	No firm activity	37.50	10.00		13.16	66.67	20.00		25.00	25.00	
		Compliance only	12.50	25.00		31.58	16.67	10.00	87.50		75.00	
		Voluntary response	25.00	20.00		36.84		40.00	12.50	12.50		
		Takes leadership role	25.00	30.00		10.53	8.33	10.00		12.50		
	Philanthropy	No firm activity	37.50	20.00	10.34	2.63	16.67	10.00	12.50	50.00	25.00	18.75
		Compliance only	12.50	25.00	24.14	15.79	16.67	10.00	75.00		12.50	31.25
		Voluntary response	12.50	15.00	29.31	55.26	58.33	40.00	12.50	12.50	12.50	50.00
		Takes leadership role	37.50	20.00	25.86	18.42		20.00		25.00	50.00	
	Support for indigenous groups	No firm activity		15.00		2.63	41.67	30.00		50.00	37.50	
		Compliance only		10.00		15.79	8.33	10.00		12.50	50.00	
		Voluntary response	25.00	25.00		34.21	33.33	20.00	100	12.50		
		Takes leadership role	75.00	40.00		39.47	8.33	20.00			12.50	

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Characterize the firm s role in the following areas.												
Percentage of responding firms	Stockholder relations	No firm activity		20.00	3.45	2.63	25.00	20.00		37.50		
		Compliance only		25.00	36.21	21.05	16.67	10.00	100	25.00	75.00	62.50
		Voluntary response	75.00	30.00	36.21	47.37	16.67	30.00		12.50	25.00	31.25
		Takes leadership role	12.50	15.00	10.34	23.68	33.33	40.00		12.50		6.25
	Support for working mothers (e.g., day care centers)	No firm activity		5.00	20.69	7.89	58.33	60.00	100	37.50	12.50	6.25
		Compliance only		15.00	48.28	34.21	16.67			25.00	75.00	68.75
		Voluntary response	25.00	15.00	12.07	34.21	16.67	30.00			12.50	25.00
		Takes leadership role	75.00	55.00	5.17	18.42						

	India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Does the firm have mechanisms for receiving consumer complaints?										
Percentage of firms responding yes	100	10.00	100	97.28	90.91	100	100	62.50	87.50	100
Has there been any community action against the firm, during the last three years?										
Percentage of firms responding yes	0	10.00	12.50	10.53	60.00	0	100	0	37.50	0

Interface with external stakeholders

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Could you please rate the overall quality of services delivered by the following agencies?												
Percentage of responding firms	Central government	Good	100	45.00	24.14	73.68	66.67	50.00	25.00	75.00	87.50	93.75
		Poor		55.00	43.10	21.05	16.67	20.00	75.00	12.50	12.50	6.25
	Parliament	Good	62.50	40.00	25.86	63.16	83.33	50.00	100	50.00	87.50	6.25
		Poor	37.50	60.00	44.83	31.58		20.00		25.00	12.50	93.75
	Central Bank	Good	100	40.00	25.86	86.84	75.00	80.00	50.00	87.50	100	
		Poor		50.00	36.21	7.89	8.33		50.00	12.50		
	Customs	Good	100	20.00	32.76	89.47	75.00	40.00	100	62.50	100	
		Poor		45.00	36.21	7.89	8.33	30.00		25.00		100
	Judiciary	Good	100	10.00	32.76	86.84	83.33	60.00	100	12.50	87.50	6.25
		Poor		55.00	31.03	7.89			0	62.50	12.50	93.75
	Police	Good	62.50	65.00	50.00	84.21	66.67	50.00	100	62.50	100	
		Poor	37.50	35.00	18.97	10.53	16.67	10.00	0	25.00		100
	Internal revenue	Good	62.50	40.00	24.14	86.84	66.67	50.00	100	50.00	87.50	
		Poor	25.00	60.00	37.93	7.89	16.67	10.00	0	37.50	12.50	

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
Could you please rate the overall quality and efficiency of the following services?												
Percentage of responding firms	Education/ schooling	Good	100	10.00	27.59	60.53	66.67	60.00	100	50.00	100	37.50
		Poor		90.00	41.38	34.21	16.67	20.00		37.50		62.50
	Roads	Good	75.00	25.00	36.21	81.58	58.33	40.00	100	12.50	87.50	50.00
		Poor	12.50	75.00	32.76	13.16	25.00	40.00		75.00	12.50	50.00
	Ports	Good	87.50	10.00	32.76	81.58	25.00	40.00	12.50	62.50	100	
		Poor	12.50	90.00	25.86	13.16	58.33	40.00	87.50	25.00		
	Tele-communication	Good	100	85.00	44.83	94.74	75.00	70.00		75.00	87.50	
		Poor		15.00	22.41		8.33	10.00	100	12.50	12.50	100
	Electricity/ power	Good	62.50	65.00	58.62	94.74	66.67	70.00		37.50	100	6.25
		Poor	37.50	15.00	8.62		16.67	10.00	100	50.00		93.75
	Water	Good	37.50	45.00	55.17	94.74	58.33	50.00		50.00	100	
		Poor	62.50	50.00	12.07		25.00	30.00	100	37.50		100

			India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
How problematic are the following for the operations and growth of your business?												
Percentage of responding firms	Functioning of the judiciary	No/minor problem	100	20.00	34.48	39.47	66.67	40.00	100	62.50	100	100
		Moderate/major problem		70.00	48.28	55.26	16.67	30.00		25.00		
	Law and order	No/minor problem	100	25.00	24.14	18.42	16.67	30.00	100	62.50	87.50	
		Moderate/major problem		65.00	58.62	76.32	66.67	50.00		25.00	12.50	100
	Inflation	No/minor problem	100	30.00	17.24	10.53	33.33	20.00	62.50	12.50	75.00	100
		Moderate/major problem		40.00	63.79	84.21	50.00	60.00	37.50	75.00	25.00	
	Exchange rate	No/minor problem	87.50	30.00	24.14	7.89	33.33	20.00	100		62.50	75.00
		Moderate/major problem	12.50	45.00	58.62	86.84	50.00	60.00		100	37.50	25.00
	Taxes and regulations	No/minor problem	75.00	5.00	17.24	5.26	25.00	20.00	100		75.00	
		Moderate/major problem	25.00	40.00	48.28	89.47	58.33	70.00		100	25.00	100
	Anti-competitive practices	No/minor problem	62.50	60.00	18.97	5.26	41.67	50.00	100	25.00	87.50	43.75
		Moderate/major problem	37.50	30.00	62.07	89.47	41.67	30.00		62.50	12.50	56.25
	Fiscal policy	No/minor problem	75.00	35.00	27.59	13.16	41.67	40.00	100	12.50	75.00	
		Moderate/major problem	25.00	40.00	53.45	81.58	41.67	20.00		87.50	25.00	100
	Corruption	No/minor problem	25.00		55.17	23.68	8.33	10.00	100	25.00	75.00	
		Moderate/major problem	75.00	70.00	20.69	71.05	75.00	70.00		87.50	25.00	100
	International regulations and standards	No/minor problem	62.50	35.00	20.69	7.89	58.33	50.00	100	50.00	87.50	56.25
		Moderate/major problem	37.50	30.00	63.79	86.84	25.00	20.00		37.50	12.50	43.75

		India	Iran	Japan	Korea	Nepal	Philippines	Singapore	Sri Lanka	Taiwan	Vietnam
What international quality standards have been adopted by the firm?											
Percentage of responding firms	ISO 9000	100		70.27	100	66.67	20.00		75.00	100	100
	ISO 14000	75.00		78.38	18.75		10.00			50.00	10.00
	Others			8.11	15.62	33.33			37.50		30.00
What is your preferred approach to strengthening international safeguards, including codes of business conduct?											
Percentage of responding firms	International law		15.00	20.41	17.14	12.50	20.00	25.00	33.33	37.50	6.25
	Voluntary implementation		70.00	38.78	60.00	50.00	20.00	75.00	16.67	62.50	37.50
	Economic incentives/penalties		15.00	38.78	22.86	37.50	40.00		50.00		56.25
To what extent do you think does the corporate governance of the firm affect its overall performance and productivity?											
Percentage of responding firms	To a great extent	87.50	25.00	54.90	71.05	55.56	70.00	25.00	75.00	75.00	68.75
	Moderately	12.50	45.00	27.45	21.05	44.44	10.00	75.00	12.50	25.00	31.25
	Little		20.00	15.69	5.26		10.00				
	Not at all		10.00	1.96	2.63		10.00				

LIST OF CONTRIBUTORS

Chief Expert

Dr. Eduardo T. Gonzalez
President
Development Academy of the Philippines
P.O. Box 12788
Ortigas Center, Pasig City
Metro Manila, Philippines

National Experts

Republic of China

Dr. Chwo-Ming Joseph Yu
Professor
Business Administration
National Changchi University
64, Chi-Nan Rd., Sec.2
Taipei

India

Mr. R. C. Monga
Deputy Director General
National Productivity Council
Institutional Area, Lodi Road
New Delhi - 110003

Islamic Republic of Iran

Dr. Hossein Rahmanseresht
Professor
Strategic Management and Organization Theory
Faculty of Management
Allame Tabatab ee University
P.O. Box 15815/3487
Tehran

Japan

Prof. Junichi Mizuo
Professor of Business Administration
Faculty of Economics
Surugadai University
698 Azu Hanno
Saitama Prefecture.

Republic of Korea	**Dr. Young Seog Park** Professor School of Business Administration Sogang University Shinsu-dong 1, Mapo-ku Seoul
Nepal	**Dr. Bishwa Keshar Maskay** Chairman Center for Development and Governance Bisnu Niwas 101-3 Kha Khichapokhari Kathmandu
Philippines	**Ms. Magdalena L. Mendoza** Vice-President Development Academy of the Philippines San Miguel Avenue, Ortigas Center Pasig City, Metro Manila
Singapore	**Dr. Chee Leong Chong** Director NUS-SPRING Centre for Best Practices NUS Business School National University of Singapore 1 Business Link BIZ 2 Building Basement Singapore 117592
Sri Lanka	**Prof. Lal Balasuriya** Dean Faculty of Architecture University of Moratuwa Katubedda, Moratuwa
Vietnam	**Ms. Nguyen Thi Bich Hang** Director Directorate for Standards and Quality Vietnam Productivity Center Hoang Quoc Viet Street Nghia Do, Cau Giay Hanoi