

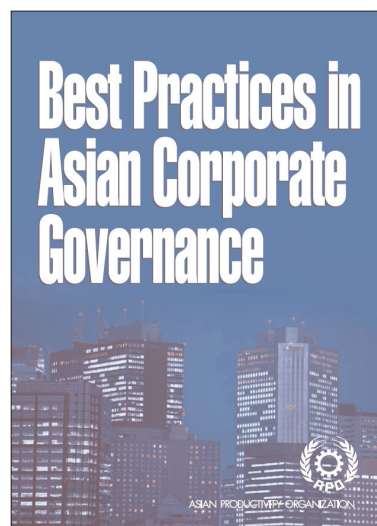
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From:

## **Best Practices in Asian Corporate Governance**

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*A sequel to **Impact of Corporate Governance on Productivity: Asian Experience***



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# Best Practices in Asian Corporate Governance



ASIAN PRODUCTIVITY ORGANIZATION

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## FOREWORD

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This book, written by corporate governance experts in seven APO member countries, is both a sequel to and explores a range of best practice experiences uncovered by its predecessor, *Impact of Corporate Governance on Productivity: Asian Experience*, published by the APO in 2004. The collection of papers in this book seeks to answer the question of how to understand and manage best practice approaches in corporate governance, which too often remain unarticulated. The book illustrates how *praxis*, i.e., translating theory into action, has shaped and reshaped the corporate sector in the Asian countries covered in the essays, making these countries the best they can be in specific corporate governance fields. The APO decided to publish this book to further the cause of corporate governance as a productivity instrument in its member countries. The basic premise is that generating best practice yardsticks by which corporate governance can be gauged helps promote good corporate governance principles and practices.

Corporate governance is not only a method firms use to discipline themselves while remaining profitable. It is also one of the principal ways they “make the society” in which they operate and which in turn “makes” them. If this relationship is obscured, it is because the existing policy and regulatory environment confronts firms with an apparently readymade and opaque organization of means and ends, in which compliance is necessary but over whose purpose the majority of organizations, whether companies or civil society groups, have little or no control. In their individual ways, most of the papers in this publication reflect attempts to regain the power to direct or determine the objectives of business, make the administration of means and ends more transparent, raise the bar of corporate standards, and put restraints on the power of the state to erect needless barriers against the freedom of corporate action.

In Asia, with its complicated business practices, no one country can claim superiority in all facets of corporate governance. But a number of Asian countries have made steady strides in specific aspects, and these are highlighted in this compendium of best practices. The book includes significant advances achieved by the following countries in key corporate governance areas: Malaysia, the general regulatory and institutional environment; India, public enterprise management; Japan, board effectiveness and ownership structure; Singapore, transparency and disclosure; Republic of China, network organizations; Vietnam, equitization; and the Philippines, corporate social responsibility. Considering the context in which the corporate governance efforts of the APO have been formulated—firms are the centerpiece of interventions, but backed up by strong government policies—the essays demonstrate that good governance laws and regulations, on the one hand, and good firm practices, on the other, both result in better performance and higher productivity.

It is impossible to cover more than a fraction of the good corporate governance practices that an increasingly complex Asian corporate sector requires. Readers will note that certain topics are not included: dilution of ownership, ready availability of voice and exit options for shareholders, good creditor and debtor relations, credible insolvency mechanisms, and better productivity and quality management, among others. Similarly, as noted in the introductory essay by the chief expert, it is hard to ignore the make-or-break role of institutions in shaping good governance practices. Each significant absence

suggests a gulf between theory and practice, indicating the need to widen the research agenda on corporate governance.

The APO wishes to thank all the contributors to this book. We are grateful to Dr. Eduardo Gonzalez, the chief expert, for coordinating the research effort and editing this volume. Finally, while not all the contributors share the same views or agree with the inferences drawn from their essays, in a sense the significance of this publication lies not in any particular viewpoint, but in the agreement to discuss a topic common to all Asian countries.

Shigeo Takenaka  
Secretary-General

Tokyo  
May 2007

# **“BEST PRACTICE” BENCHMARKING IN ASIAN CORPORATE GOVERNANCE: A REVIEW**

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## **INTRODUCTION**

Until quite recently, corporate governance in Asia has been a “soft” concept, regarded by many as having little impact on a company’s financial picture or its present cost of doing business. Until recently, there have been few know-hows of benchmarking corporate governance and what they would mean for investors and governments.

Yet experience shows that failings in corporate governance practices have caused financial crises to be blown up at the expense of lenders, investors, and customers. Poor practices and lack of transparency have provided a *carte blanche* for companies to rob their financial stakeholders (shareholders and creditors) of their fair share of the company’s earnings and assets. Indeed, as a direct consequence of the recent spate of corporate excesses, governments have stepped in to offer stakeholders long-term relief.

In Asia, voluntarily or not, governance reform in key areas such as performance criteria, internal processes and measurements is taking place. Companies are having their internal control processes closely checked out. Long-term productivity gains outweigh upfront costs associated with repairing or modernizing internal systems. Process-driven approaches have started to yield benefits in terms of greater value and better business.

Making the shift is not easy. And doing it right still is a vexing problem. Sound corporate governance, after all, is more than about simple compliance with “universal” standards—economic and financial decisions are entrenched in an array of relationships that ties company directors, senior executives, shareholders, money managers, stock analysts, and government regulators. Discovering the right combination of features that can yield high investment returns and robust growth is an elusive quest.

In part, this is due to the fact that reforms are many-sided and call for a mixture of legal, regulatory, and market measures, according to Claessens (2003). This makes for difficult and sluggish progress, as efforts may have to be organized among many constituents, including foreign stakeholders. Changes along legal and regulatory lines must take into account a particular country’s enforcement capacity, which is often a binding constraint. Even as firms face competition and adapt themselves, they must operate within the limits given by the country’s institutional framework.

Claessens further notes the overriding importance of the origin of the country’s legal system in analyzing prospects for reform. What a country started with or acquired as a result of colonization some century or more ago may still have systematic impact on the characteristics of its legal system today, the functioning of its judicial system, the regulation of labor markets, entry by new firms, the evolution of its financial sector, state ownership, among others. Both the origin of its legal systems and a country’s initial endowments are important determinants of the extent of shareholder rights protection.

In short, existing national institutions are rarely sufficient to guarantee the accountability of corporations in designing and implementing corporate governance measures. Indeed, many unresolved issues lie behind catchwords such as global standards,

accountability, transparency, independence of courts, or shareholder protection. To date, the linkages between institutional qualities and countries' more lasting features, including culture, history, and physical endowments have not been widely researched. Broadly speaking, the dynamic aspects of corporate governance reform are not yet well understood (Claessens, 2003). Any failing would suggest roughly that the legal and regulatory system is not performing well, which in turn indicates that its beginnings and evolution are poorly apprehended.

What could fill the gap? The key, it seems, is for Asian corporations to learn from each other. The economic and political diversity in the region—the outcome of differing pre-colonial and colonial histories—ensures that a “one size fits all” approach to governance policies will not work in many Asian markets. Evidently, countries do not adjust with ease and casually accommodate better standards to fit their own circumstances and satisfy their own needs. Further advances in corporate governance must be informed by best practices in each market, even while companies are appraised in terms of compliance with internationally accepted codes of practice. Benchmarking in this sense enables investors to support positive governance standards and developments in each country. More importantly, it enables governments to adopt those standards in the context of the countries' own institutional constraints, make stepwise policy adjustments and avoid an injurious, wholesale locking out of “political economy” factors. Paradoxically, best practice benchmarks are best developed with constrained choices. The ability of corporations to borrow the corporate governance framework from other jurisdictions is limited to the extent that some local enforcement of rules is necessary. Corporate governance needs to be sensitized to the country's policies.

But while “best practice” transfers must pass the “localization” test, they must also give in to the inevitable forces of the global equity marketplace. With companies seeking capital from all corners of the globe, the countries' authorities surely prefer relatively effective practices that they believe will help lift up their corporate sector. To be sure, corporate governance benchmarks appeal more to investors, who will warm to those companies that get it right, but retreat from those who are at the bottom of the league tables. The road ahead is likely to see a greater emphasis on those governance practices that work well both within national settings and across cultural divides.

As a disciplining tool, best practices should give the governments and the corporate sectors in APO member countries the key instrument to keep an eye on firms whose adherence to corporate governance codes are at best shaky, and which have the potential to harm each country's economy. Good governance is Pareto-improving *ex ante*, but for those whom the governance provisions were designed to constrain it usually creates regret *ex post*. Understanding the empirical features of political mechanisms that appear to resist *ex post* political influence therefore should be high on each Asian country's agenda.

## **POSITIVE EXPERIENCES IN SEVEN ASIAN COUNTRIES**

Corporate governance is more than a single pattern of activities in a single domain: best practices abound in every aspect of firm governance, each one attempting to capture its multi-dimensional nature. In this book, best practice benchmarking was made on two levels:

1. Macro-level – general laws and regulations; independent strength of the court system, efficiency of legal and regulatory processes; general considerations affecting the corporate sector, such as ownership patterns, political stability, and global standards. The broad legal framework of the country is highlighted in



terms of the degree to which shareholders are protected and judicial decisions are enforced.

2. Micro-level – best practice standards for governing individual firms or clusters of firms. The best practices include those conventionally associated with board effectiveness, disclosure, leverage, and minority shareholder rights.

This book puts together seven APO member countries' highly positive experiences in corporate governance reforms, specifically on the general regulatory and institutional environment, public enterprise management, ownership structure and board effectiveness, disclosure, management of networked firms, equitization, and corporate social responsibility. A host of measures that, when deftly combined, adapted to institutional contexts, and made responsive to cultural subtlety, should produce what governments, executives, directors, and stockholders, analysts, and regulators all want. Best practices take different forms as they take place within various countries of the region. The essays in this book identify and discuss particular governance issues, clarifying which ones represent good practices. As empirical investigations, they are not expected to clear up the channels through which institutional features alter corporate governance over time, and how these features change. As such, these papers represent only the beginning of a broad research agenda.

### **Malaysia: functioning laws and regulations**

Governance standards are emphasized in regulatory decisions made by the state. Generally, Malaysia has benefited from a good governance regime which involves laws and regulations that provide the triggers for wide-ranging corporate governance reforms. There is evidence that laws and practices in Malaysia which regulate the stock exchange and capital markets have caused firms to perform better. Lending, underwriting, and investment decision-making have generally improved as a result of reforms in regulatory and supervisory processes.

### **India: breakthroughs in the public sector**

Corporate governance standards (particularly micro-standards), although they originated in the private sector of market economies, are applicable to public sector institutions. Much of what governments do in delivering public services involves running major businesses, the operation of public utilities for example. India has had a long history of managing public enterprises. On the one hand India has a complicated range of political, social and economic objectives that its government is trying to achieve through a variety of public sector entities. On the other hand there is the need to practice a culture of openness and integrity at both the political and bureaucratic levels. In recent years, faced with the challenge of balancing service and commercial decision making with accountability, the Indian government started devolving powers to central public sector enterprises. Apparently, *Navratnas* and *Mini-Ratnas*, as they are called, have been effective in delivering effective services while achieving value for money. While much remains to be desired, there are significant improvements in performance reporting by these empowered public sector corporations as part of their accountability processes, as well as in upgrading government auditing and accounting standards.

### **Japan: dilution of ownership and the influence of outside forces**

Japan is struggling to find a middle ground between the arm's-length, market based, Anglo-Saxon model, which is widely practiced in the US and the UK, and its own stakeholder regime. For years, the stakeholder model in Japan seemed to give better

answers to issues of firm performance and productivity. The Asian crisis has prompted a switch to the arm's length model. Markets are now eroding the past dependencies between banks and industry, increasing pressures from shareholders and requiring greater labor mobility. Shareholdings by banks and affiliated firms have been declining. At the same time, foreign ownership in Japanese firms is on the rise. Japan's institutions are making a labored effort to adapt to greater openness to these market pressures and threats of takeovers, being so rooted in mutually reinforcing firm-specific commitments rather than politically-constructed rights and responsibilities. Whether Japanese corporations like it or not, capital markets are changing rapidly to push them toward shareholder-oriented corporate governance practices. And it is foreign ownership that seems to be nagging them toward that direction. The example of the takeover of Nissan by Renault of France illustrates the positive impact of foreign ownership on the performance of a major Japanese car maker, and in a way suggests that it is external forces which would likely force desired changes in Japan's relationship-based system.

#### **Singapore: a credible disclosure regime**

Singapore has championed a disclosure regime that produces credible firm-specific information about publicly traded firms. It has promoted corporate transparency, taken to mean as the widespread availability of relevant, reliable information about the periodic performance, financial position, investment opportunities, governance, value, and risk of publicly traded firms. What best practices there are in Singapore can be measured in the quality of corporate reporting, including the intensity, measurement principles, timeliness, and credibility (that is, audit quality) of disclosures by firms listed domestically. Singapore is a notable exception where the local market has attempted to improve disclosure standards using voluntary mechanisms.

#### **Republic of China: a hybrid model for its networked SMEs**

Creative learning is offering Taiwanese corporations a way forward that will not compromise entrepreneurship and postpone the growth of its enterprise communities, which form the backbone of the island's knowledge-based economy. ROC's medium-sized firms specialize in one segment of the value chain or another, but economy-wide they are interconnected through social and business networks. Taiwanese SMEs, with their distinct network features, likewise are integrated with global meshing structures. State policies fostered a decentralized, predominantly SME-based industry structure. Two corporate practices in ROC that have helped foster the growth of these firms: employee stock bonus and stock cross-holdings. Taiwanese 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. Historically, the stock bonus option helped solidify positive relationships with Taiwan's labor force, while cross-holdings kept Taiwan's companies going as they tried to survive in a highly-competitive information ICT global market. Both conserved precious capital for most firms. They are by-products of the institutional environment, which is a major factor in explaining the rise of networked firms in ROC. Both are necessary but flawed instruments, indicating that corporate governance in ROC would evolve in a manner that takes legacies as a modifiable reality, not as a custom that could readily be cast aside.

#### **Vietnam: substantial progress in equitization**

Corporate governance is as relevant in non-market economies as in market economies. Vietnam has done a lot in this respect. State-owned enterprises are being gradually

converted into limited liability companies, joint-stock companies, partnerships, or private enterprises. Vietnam's equitization program, to be sure, is a long process that will require much time to realize. But best practice lessons from this shift can be of tremendous help to APO member countries which share Vietnam's economic orientation and political tradition, such as Cambodia and Laos.

### **The Philippines: breaking ground in corporate social responsibility**

Philippine corporations tend to externalize many governance functions onto auxiliary associations. The Philippine private sector, for example, has long sponsored the Philippine Business for Social Progress, a non-profit group that implements the corporate responsibility of member companies. It is a measure of the firms' responsiveness to the country's social and welfare challenges. Through PBSP, the country's top companies have focused on diversity, economic empowerment for the poor, and development of human capital. PBSP implements development projects whose criteria include environmental, economic and social sustainability. Social responsibility seems to be a critical element adhered to by member companies.

## **BEST FIT FOR BEST PRACTICE: THE SHAPING FORCES OF LOCALIZATION**

Corporate governance innovations may reflect the shaping forces of local circumstance as much, if not more, than stimulants from abroad. There are two key issues (Page, 2000):

1. Understanding the conditions under which policies or practices operate in the policy exporting country. The perception of how the policy operated in the exporter jurisdiction might be crucially shaped by the policy-maker from outside who seeks to import it.
2. The identification of the policies or practices to be emulated by the importing country, and their application, whether in modified form or not. Both are susceptible to "national" bias. The *lesson-drawing* literature, according to Page, emphasizes how the conditions which might make them work in a similar way can be created in importer jurisdictions.

Here, the context-specific analysis of institutions in the importing country comes into play because more than one set of outcomes can emerge in given circumstances. The desired model may not necessarily be followed. Examining the contextual details helps to clarify why particular institutions emerged in a particular historical setting and how they are maintained (Greif, cited in Helpman, 2004). Arguably, lessons from other country experiences will be learned in ways that reinforce national practices more than they transform them (Bomberg and Peterson, 2000).

A supply-side analysis of the reform effort should reveal how the policy or program component being transferred came about, how it works in practice, under what particular circumstances it succeeded (or failed) in similar settings, and how its sustainability or likely effectiveness in a different context might be assessed (Wyatt and Grimmeisen, 2002). What is required in this case is a detailed and comprehensive description of the object of transfer. The fundamental problem that has afflicted attempts to import a specific set of practices is that they cannot bring along the entire set of assumptions, attitudes and institutions that support the practices. Individual policies, no matter how attractive, cannot be grafted on markedly different blueprints of state-society relations than those in which they evolved (Wilson, 2003).

According to Wyatt and Grimmeisen (2002), if a country's governing authorities are aiming for a copy of the policy in question or any of its components, its scrutiny must be based on a higher level of rigor than those cases where only "inspiration from abroad" is desired. Dolowitz and Marsh (1996) distinguish four such cases that differ according to their similarity with the original: the copy (transfer of the object without much changes), emulation (adaptation of the object to the new context), hybrid/synthesis (combination of elements of) transfer objects from different jurisdictions) and inspiration (transfer of the underlying idea of a transfer object). Where power asymmetries between the importing and the exporting country are too big they can present obstacles to lesson-drawing. The higher the asymmetry, the higher the probability that the lessons learned may provide only a source of policy inspiration but not a basis for copying or synthesis (Wyatt and Grimmeisen, 2002).

It may also be asked, as Page (2000) does, if policy makers tend to import lessons which highlight the benefits and downplay the disadvantages of transfer, and if they are less likely to subject to critical evaluation lessons drawn from one set of countries (say, common law countries like Malaysia and Singapore) than others (say, civil law countries like Japan and Korea)?

In the end, there is the danger that best practice benchmarks may turn out to be inappropriate to the environment obtaining in the importing countries. Corporate governance frameworks are administratively and politically demanding, and have been implemented mainly in advanced economies (IMF, undated). The most rational starting point for cross-national policy transfer would be a study of the patterns of success and failure over time of the policy under consideration (Wyatt and Grimmeisen, 2002).

Any country adopting best practices should ask itself to what extent its situation differs from the sources of innovations in terms of its organizational/institutional setting, its socio-economic environment, its ideological and cultural setting and its financial, human and administrative resources, and how significant any differences are likely to prove (Wyatt and Grimmeisen, 2002). Such demand-side analysis requires one to always keep in mind the importance of contextual perspective.

Institutional reform that ignores the role of local variation is at best inadequate, and at worse harmful (Srivastana, 2004). Perhaps realizing this possibility, the Singapore paper has attempted to depict both "highs and lows" of the disclosure-base regime in the city-state, a warning that replicators must have full appreciation of the peculiarities of the Singaporean disclosure system.

In the Republic of China, two mechanisms can explain why the small but early lead acquired in corporate governance could not gain further ground. The first is that in the past, there was bandwagon in the enterprise community in favor of cross-holdings. The second was a network effect: past politicians and bureaucrats alike observed that this old system of corporate financing had played a big role in the growth of SMEs and stocked up on it; this in turn led other people into a "buy-in" of the process across the years, and so on until there was complete lock-in to the practice. Taiwan's ethnic politics involving the Taiwanese business community and the Mandarin-dominated Kuomintang political elite is at the origin of ROC's path-dependence. Bandwagon and network effect led to a reinforcing pattern, in which bureaucrats "tipped" towards one design. Once this social convention emerged, though, it became permanent because of the huge switching costs involved in modifying it.

Current choices are constrained by the "heritage of institutions accumulated from the past." To North (1990) path dependence stems from numerous organizations "whose survival depends on the perpetuation of those institutions and which hence will devote

resources to preventing alteration that threatens their survival.” Path dependence occurs because transaction costs associated with institutional change are non-trivial and typically serve as deterrents to rapid or jarring change (La Croix and Kawaura, 2005).

But the tables can be turned. Institutions can be effective weapons to deconstruct old ways. The adherence by Vietnam to equitization illustrates North’s notion of a “self-reinforcing mechanism”: Initially, there were *large setup or fixed costs*: start-up costs were appropriated to make the system operational. The second stage had to do with the *learning effects*: government agencies became more adept at giving state enterprises more freedom of action. Then the *coordination effects* kicked in: both the party and the government fostered the same equitization rules and regulations. Finally, *adaptive expectations* made the change permanent: the initial reform efforts led to precedence, which reduced uncertainties about the rules. Once policies are in place, events are more likely to take the form of incremental changes that follow the same trajectory. *Policies create constituencies with an interest in their perpetuation* (italics provided) (Wilson, 2003).

Patterns of transfer are thus mediated by local institutions and governance arrangements which in turn are affected by the country’s political, legal and social context. Existing institutions and governance quality (“context” as used here) have a profound impact on reform efforts. They shape the way the interests of actors are aggregated and shaped. Context also determines the degree of complementarity between new and existing institutions, which ascertains how likely effective and sustainable the institutions will be (Fritzen, 2005).

A common platform of reform ideas could only be translated into common practice if governments were not only functionally equivalent but equally autonomous (Freeman, 1999). Best practices can be “fungible” and can be expected to travel across jurisdictions effortlessly only if they fulfill the following conditions (Page, 2000):

- They are less context-dependent;
- The organizations for service delivery are substitutable;
- The resources available to develop the program are similar;
- The mechanisms by which the program works (the “cause and effect structure of a program”) are simple;
- The scale of change the program produces are small;
- The program covers areas of interdependence between importer and exporter jurisdictions; and
- The values of policy makers are relatively consensual.

Best practice exporters and best practice importers may not be as different as apples and oranges, but the radically different historical backgrounds of public policy development in the countries in the region have shaped varying approaches to corporate governance reform. The structures may be dissimilar: unitary states like the Philippines cannot borrow without great alteration models based on federalism (like those in Malaysia) where devolved powers contrast with the strong authority of a central government and are crucial to the successful functioning of the model.

It is noteworthy that all the essays suggest that even good practices may be flawed instruments—the more reason why importing jurisdictions need to be extra careful about what they are copying or mimicking. Corporate giving and philanthropy in the Philippines do not measure up to the standards of corporate social responsibility. Malaysia’s regulatory standards are world-class, but the country’s “average only” enforcement capacity makes the system vulnerable to regulatory capture. A market-friendly disclosure regime, like the one found in Singapore, may leave not much elbow room for government

to maneuver, in cases where breaches of rules occur (as happened in the China Aviation Oil case). India is still struggling to derive value for money for its public enterprises, despite a half-century headstart. Japan could not rely on domestic reformers and needed external forces (illustrated by Renault's takeover of Nissan) to shake up its lethargic corporate governance structure. The recurring theme in the Republic of China is that cross-holdings and stock bonus system are transitional instruments designed to stabilize the system. The same applies to Vietnam's equitization drive, which is seen as an act of passage to full privatization.

### **ADOPTING BEST PRACTICES IN LIGHT OF INSTITUTIONAL CONSTRAINTS**

Benchmarking allows firms to judge the worth of various aspects of their processes in relation to best practice, usually within their own sector, according to Wikipedia. In practice, benchmarking involves, in stepwise fashion, comparing aspects of performance (functions or processes) with best practitioners; identifying gaps in performance; learning the lessons that those comparisons bring about; looking for fresh approaches and new methods to improve performance; following through with implementing improvements; and following up by keeping tabs on progress and reviewing the benefits. Benchmarking is often treated as a continuous process<sup>1</sup> in which organizations continually seek to challenge their practices.

Of course, approaches are constantly evolving and being updated, in a manner that fit local circumstances and institutions. If done right, benchmarking helps crack through resistance to change by demonstrating the adaptability of other methods of solving problems that can replace poor practices. But important aspects of best practice knowledge are tacit. Translations of concepts into action are held largely in people's minds and are not often easy to document, even in the most codifiable cases. Because tacit knowledge comes about as a result of informal institutions, best practice advocates may not be able to bring in from abroad all the major factors needed for lesson-drawing. Therefore, most best practice programs that are sensitive to institutional dynamics mix together two key elements: explicit knowledge (providing practitioners with solid information, often written down), and methods for sharing tacit knowledge such as communities of practice. A potential user of the best practice can make use of documents to find out if adopting the example is worth pursuing. Then, he or she can engage others who have been involved in instituting changes in the model firms or organizations. Because quality of institutions matters, best practice initiatives are most suitable in organizations where processes have evolved quite well and where a substantial amount of knowledge and experience has been accumulated (NeLH, 2005).

#### **Going about it: a 6-step approach**

Skyrme (2002) recommends a 6-step approach to identifying and adopting best practices. Summed up in NeLH (2005), and summarized below in modified form, the approach emphasizes the importance of "context" in the application and adaptation of the practices.

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<sup>1</sup> The idea of continuous incremental improvements is an originally Japanese management concept for incremental (gradual, uninterrupted) change. Called *kaizen* (literally: change (*kai*) to become good (*zen*)), its key elements include quality, effort, involvement of all employees, willingness to change, and communication. Japanese companies distinguish between radical innovation and continuous improvement (Source: Wikipedia).

1. *Identify users' requirements.* This step looks easy, but it is not unusual for someone given the task of capturing best practices to start by searching for models abroad, when clearly this is a case of putting the cart before the horse. Start by considering where the effort can really add value to the firm. Know specifically what the company's problems are. Check which areas need attention because of poor performance or difficult challenges. Discovering the company's troubled aspects may require a range of research methods that Wikipedia lists down as informal conversations with staff, customers, or suppliers, focus group discussions, surveys, reengineering analysis, process mapping, analysis of quality control variance reports, among others.
2. *Discover good practices.* Look for organizations in similar fields or in other industries which are known to perform highly and produce excellent results, and are thus likely to be sources of good practices. Consult customers, suppliers, internal auditors, financial analysts, and trade associations to determine which organizations are worthy of study. After zeroing in on possible "models", ascertain which parts of their overall approach or methods being used are in actual fact good practice and may be the answer to the company's problems. At this stage it is not necessary to describe the practice in great detail. But the information assembled should allow the company's managers to decide whether the approaches being investigated match the company's needs.
3. *Document good practices.* Best practice descriptions should be recorded in detail. A typical template might include the following:
  - Profile – outline the processes and functions of the best practice organization.
  - Context –here, supply-side analysis would be critically important. How did the program component to be taken up as one's own come about? How does it work in actual practice? Under what particular circumstances has it succeeded (or failed) in similar settings? How might its likely effectiveness in a different context be assessed? Are there differences in the policy environment of the best practice organization that need to be taken into account? More nuanced departures, such as political and cultural variables, should not evade the adopters.
  - Resources – what resources and skills are needed to carry out the best practice? This is another supply-side aspect that should be documented, as the said resources and skills may not be available in the adopting firm.
  - Improvement measures – are there performance yardsticks associated with this practice?
4. *Validate best practices.* A practice is only "good" if there is a demonstrable "good sense" that (other things being equal) significant parts of the innovation being adopted are capable of accommodating the circumstances of the "borrowing" company. In areas where conditions are different, demand-side analysis would shed light on the contextual nature of the proposed best practice transfer. The questions that are important at this juncture include the following: To what degree does its situation differ from the sources of innovations in terms of its organizational/institutional setting, its socio-economic and policy environment, its cultural setting and its financial, human and administrative resources? How significant are any differences are likely to prove? What implementation difficulties will be encountered? It is critical to organize a panel of reviewers comprising internal and external subject experts and peers, who will evaluate a potential best practice against their knowledge of local circumstances.

5. *Apply the innovation.* While a rigorous supply-side and demand-side analysis of best practices is a useful starting point, make sure this is complemented with face-to-face knowledge sharing by the exporting organization. Implementation should bring people together to share specific knowledge and experience. It is through people that deep tacit knowledge is transferred. Personnel exchanges would help too. This is where real value is added. Not only does it help the recipient dig beneath the explicit knowledge and gain more in depth insights, but it can also provide a two-way benefit: the dialogue between the conveyor of best practice knowledge and the recipient can enrich the knowledge of both. Within the adopting firm, involve employees in the transfer process. Ensure that improvement groups or quality circles within the firm meet regularly to discuss ways of improving the process. Organize learning events as well as employee visits to the conveyor firm.
6. *Develop a supporting infrastructure.* To successfully implement a best practice program, ensure that the required infrastructure is in place. This infrastructure is often developed as part of a wider knowledge management strategy. Typically, several generic aspects need attention:
  - The people to facilitate and drive the process through its initial stages, until it becomes embedded in the company's ways of working (e.g., a best practices team, or a network of best practices coordinators).
  - The technical infrastructure for document sharing and databases.
  - The content management infrastructure to ensure that continuous improvement is documented.

Just as there is a social and cultural environment, so is there an internal organizational culture. Both are inextricably intertwined. Do not forget the importance of motivation and culture. The ease with which good practices emerge and are shared depends on how well the culture of the firm is inserted as an integral part of a surrounding whole. Without this acculturation, then good practices will be slow to emerge and spread, as each part of the organization will defend its own way of doing things rather than learning from, and sharing with, others. Focus more on encouraging people to develop and share best practices voluntarily and in a manner that suits the firm's own circumstances. Remember too that best practice is constantly evolving. Build in response mechanisms so that the value of existing best practices is constantly assessed, and feedback is used to create further improvements.

## **THE WAY FORWARD**

To accelerate the rate of best practice transfer over time, the urgent need is to endow local firms the capacity to analyze their own situation and tailor the program to fit the domestic context, rather than simply apply standard models. A few suggestions to make best practices more capable of adapting to the particulars of each Asian country's situation are in order.

### **Best practice benchmarking should not be limited to highly developed economies**

As Mulgan (2003) suggests, many of the best ideas and projects are now coming from smaller economies (such as Singapore and Taiwan). Of course, developed countries have often been particularly innovative, but when set against rigorous benchmarking measures—of competitiveness, innovation, social results or environmental quality—the



smaller countries have not done badly either in recent years. A particular reason to look for a good model in smaller entities is that domestic firms can shape it more than they will be shaped by it, and be less attached to the uncertainties that scale breeds.

Mossberger and Wolman (2001) point out that assessing variations in policy environment can be a formidable challenge, requiring extended knowledge and analytic thinking. To “bound” the need for knowledge and analysis, there is a need to pay attention not just to the state-of-the-art models but to “most similar” ones. It is obvious that in searching for promising approaches it is critical to look beyond the large western nations (Mulgan, 2003). Furthermore, there often is an enormous gap between a company’s practices and those that represent the absolute best. It would take a quantum leap to reach their level. It would be better to make incremental changes (Feltus, 1994).

### **A regional best practice network could help solve common problems.**

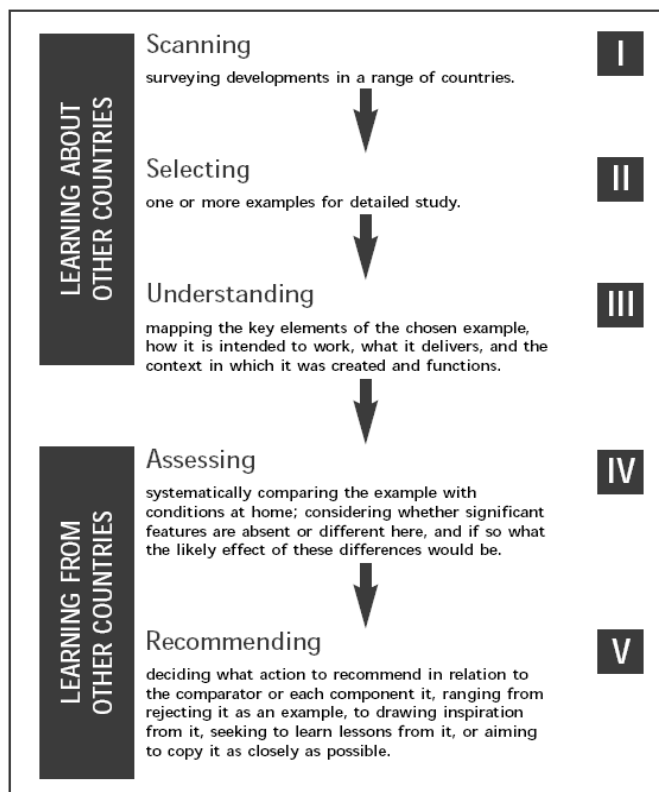
Asian companies should rely increasingly on networks of technical experts in similarly situated countries, who have distinctive but interdependent interests, and who are striving to solve similar problems (Cliff, Walt, and Nhatave, 2003). Regional networks allow policy adopters to operate beyond the domestic context. As Stone (2001) points out, when there is an aspiration for best practice transfer, networks are the means for agencies and organizations to project their ideas into programmatic thinking across states and within global or regional build alliances, share discourses and construct consensual knowledge. From this basis, best practice entrepreneurs can work to shape innovations, “brokering” their ideas to potential beneficiaries.

A participatory process of policy learning, with considerable cross-border exchanges fueled through professional contacts is second nature to best practice communities. Networks have extraordinary capacities for innovation, managing risk, building trust, facilitating joint action and gathering information in a manner that flows around and between geographical, legal and institutional barriers (Stone, 2001). Likewise, they can mobilize resources for collective action in the solution of common problems (Cliff, Walt, and Nhatave, 2003). On hindsight, the best practice programs illustrated in this book would have evolved better, if they went through a best practice community, and if the transfer, as Cliff, Walt, and Nhatave (2003) argue, was not a linear, top-down process, but occurred in a series of policy loops over a long period. Of course, the central assumption of network analysis is that stakeholders are dependent on one another and have incentives to share resources, bargain, and agree (Bomberg and Peterson, 2000). The downside of networking is if it triggers a wave-like pattern of reforms being blindly adopted. That is, an innovator country starts a bold reform which appeals to other countries which, more or less follow the example. At this juncture, it is the behavior of others rather than local conditions that drives reform. In effect control is transferred to the group in general and the innovator in particular (CRC, 2005).

Policy networks can help improve the quality of good practices by establishing a strong information base. A worthy undertaking in this regard is the International Comparisons in Policy Making Project, established by the Centre for Management and Policy Studies (CMPS) in the UK. The project promotes the use of international examples where relevant, ease access to reliable information about international experience, and increases the capability of practitioners to learn useful lessons from that experience. It has developed a brief, robust and evidence-based guidance to help various stakeholders engage successfully in best practice program transfer and avoid the most common causes of transfer failure (Wyatt and Grimmeisen, 2002).

**There is no substitute for the right method of interpreting experience from abroad.**

Asian corporations should subscribe to a systematic approach that will assist them make sense of experience in foreign countries, understand what factors have made a program successful in its place of origin, and deal effectively with differences in social, economic, political or institutional conditions that might stand in the way of successful adoption. Of course, it goes without saying that companies should also have the right disposition—an inclination to look abroad as a natural and automatic part of the best practice process; and the right knowledge as well, of where to find relevant and reliable information about good initiatives abroad, and links to the appropriate communities of practice. It is axiomatic that good formulation requires achieving an optimum balance between innovation and learning lessons, from observation of what others do (Wyatt and Grimmeisen, 2002).



Source: Wyatt and Grimmeisen (2002)

Figure 1. Discovering innovations

The figure at the right suggests a good method for investigating foreign innovations that have the potential to be emulated. Taken from Wyatt and Grimmeisen (2002), the steps to be followed are described below.

*Phase 1: Mixed scanning*

- “Broad survey of the field”
- Selection of the most apt and potentially helpful comparator for detailed study
- Acquiring, analyzing and interpreting information, including first-hand field investigation to generate true learning about the practice in question.

*Phase 2: Prospective evaluation*

- Detailed comparison of the knowledge gained about the policy and its context—including such factors as “its institutional and structural setting, the national political culture, public opinion, relationship to other policies, and the country's level of economic development, wealth and economic structure”—with corresponding aspects of the domestic policy environment. The critical activity here is the assessment of the implications for a successful transfer of any significant observed differences.
- Conclusions to be drawn from all the preceding analysis and reflection about what to do or what action to recommend.

On the supply-side, policy makers need to know what questions to ask in order to establish a clear understanding of how the practice came into being in its home place, how it was shaped by its social, economic, political and institutional setting, and how and how well it works in reality. On the demand-side, they need also know the comparable aspects of the situation in their own country—a process of reflection and self-examination. The method is intended to spread a net as widely as possible to capture data that might be relevant, and to enable both the simple model and the complex context to be mapped (Wyatt and Grimmeisen, 2002).

**It is important to take a long-term perspective.**

To understand how policies are transferred, it is essential to take a long-term perspective. Best practice transfer takes place over extended time periods. The briefer the episode of transfer, the more likely an innovation is likely to be viewed as foreign import. Over time the innovations become “domesticated” as local institutions and policies shape their development (Page, 2000).

Lesson-drawing is especially relevant for developing countries where there is a tendency to embrace the most *avant garde* reforms. True reform is gradual; basic institutions must be in place before advanced methods are tried. It is essential to gain a deepened appreciation of the challenges that must be overcome in a new program on a sound basis. A country can move very far by taking one step at a time (Schick, 2001).

All things considered, best practices highlight diversity (in every country history, culture, and institutions are unique) and sharing (knowledge, experiment, experience). To paraphrase Mulgan (2003), best practice transfer means scanning the world to identify the promising innovations and the crucial lessons. It means making use of a network of contacts as channels for learning. And it means developing skills to distinguish the paper accounts of best practices from their reality. What still matters most is the ability to exercise judgment since international learning is no substitute for judgment.

In the end, international comparisons are perhaps best viewed not as platforms on which decisions are forged, but more as pressure for a reframing of best practice problems and potential solutions (Wyatt and Grimmeisen, 2002). A “confluence” between “best practice” ideas from abroad and local governance arrangements would be the best way to make corporations an effective instrument of growth and development in the Asian region.

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# NETWORKED FIRMS IN THE REPUBLIC OF CHINA: TOWARD A HYBRID SHAREHOLDER MODEL

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## INTRODUCTION

Corporate governance has been considered as a comprehensive system to promote the integrity of the securities market. The ultimate goal of this system is to protect shareholders' rights and interests. Corporate governance ensures transparency of firms' operations and accountability of managers. Because corporate governance protects the interests of stakeholders, a firm with sound governance structure would be trusted and welcome by the public and regulators.

But sound corporate governance depends as much on the existing institutional environment as on newly-prescribed rules and codes. Firms respond to their institutional environment through a process of "isomorphism", recreating on their internal workings the constraints imposed by external institutions. At the very least, firms employ formal and informal "rules of the game", which govern inter-firm relationships and bind the behaviors of these firms, which in turn influence organizational processes and decision making (Ahlering and Smallman, 2001). Formal rules set general guidelines for behavior, but they cannot cover all eventualities. Players operating within a particular formal institutional context, such as corporations, develop norms and procedures that expedite their work or address problems not anticipated by formal rules (Helmke and Levitsky, 2004). The aim of such interventions is to cut down on transaction costs, reduce instability, boost certainty and enhance communication (Ahlering and Smallman, 2001). In the context of the new institutional theory, corporate governance is thus concerned with identifying the role and contribution of both new and established institutions in economic performance and firm productivity.

It is in such context that this paper argues that the Republic of China is moving toward a hybrid corporate governance model, one that blends new rules with the widespread use of norms and practices that reinforce and stabilize networks of firms. How Taiwan, ROC is effectively adapting the stakeholder model to capital market and shareholder pressures, and strong employee voice may contribute to a new hybrid model of a more "enlightened" shareholder-value. The premise here is that Taiwan, ROC does not have the option to simply return to its "old" stakeholder model, because many of its key features have eroded under the pressures of internationalization and liberalization. On the other hand, creative learning may offer the island economy a way forward, such as widening the definition of its enterprise communities and placing the rights and responsibilities of stakeholders on a more public footing. The appropriation of innovative organizational and corporate governance approaches in Asian companies is necessary to bring their industrial structures in line with the development of their comparative advantage (Zhang, 2000).

There is no single model of good corporate governance and the effectiveness of different corporate governance systems is influenced by differences in countries' legal and regulatory frameworks, and historical and cultural factors, in addition to product and factor markets (Aguilera & Jackson, 2003; Maher & Andersson, 1999). Moreover, there is often a

need for substitutive institutions in cases where formal rules are new and cannot be routinely enforced. For firms requiring quick response time, conventional practices achieve what formal institutions are designed, but are slow, to achieve, or where new corporate governance structures are weak or lack authority (Helmke and Levitsky, 2004). Taiwanese hi-tech firms, the lynchpin of ROC's economic progress, illustrate this case. As Woo-Cumings (2001) suggests, such unofficial conventions may postpone system convergence toward plausible rule-of-law practices, but that does not necessarily mean that they cannot evolve toward effective norms of transparency and accountability.

In this paper, we examine two corporate practices in ROC that have helped foster the growth of hi-tech firms: employee stock bonus and stock cross-holdings. The stock bonus option helped solidify positive relationships with Taiwan, ROC's labor force, while cross-holdings tided over Taiwanese companies as they tried to survive in a highly-competitive IT global market. Both conserved precious capital for most firms. Both are necessary but flawed instruments. The purpose of this paper is to substantiate and explore the reasons behind these findings in the context of the institutional environment in Taiwan, ROC, so that other member economies can draw some lessons. They will be scrutinized against the backdrop of Taiwan, ROC's transition to a knowledge-based economy.

## **ROC'S SHIFT TO A KNOWLEDGE-BASED ECONOMY**

The transition to a knowledge-based economy is currently in steady progress in Taiwan, ROC. The island has come out as one of the biggest computer hardware producers in the world in recent years. The Taiwanese government's strategy in the last few years has been to develop Taiwan, ROC into a "Green Silicon Island" which would combine a knowledge-based economy and a just society with a sustainable environment. On the basis of the island's comparative advantage, the government's principal goals under this strategy are

- to speed up the commercialization of new inventions and the development of new market niches through mechanisms that (a) encourage innovation, (b) nurture start-ups, and (c) promote the application of IT technology and the Internet; and
- to review basic infrastructure, laws and regulations, labor supply, and government administrative procedures, fine-tuning as necessary with a view to supporting the development of knowledge-intensive industries and narrowing the "digital divide". Knowledge intensive industries usually mean those industries that create value in products through innovation (Yang, 2002).

Toward these ends, an inter-ministerial coordinating agency, the National Information Infrastructure Special Committee, was set up under the Executive Yuan in 1994 (Zhang, 2000).

Speed, flexibility and innovation are *sine qua non* in the knowledge-based economy. KBE firms that are just setting out, or quickly growing, are already selling to global markets almost from their inception. Established companies are compelled to reinvent their operations in order to stay competitive in the new game. The new KBE has significantly altered the organization of production, market structures, occupational choices, among others (Chen, Chen and Liu, 2001). Their continued advance will depend on a good institutional environment—*better legal frameworks and enforcement*, particularly relating to the protection of intellectual property, the security of commercial information, and privacy safeguards for consumers and companies. That suggests generating framework conditions to support progress in more advanced knowledge-based activities (Zhang, 2000).

At the same time, Zhang also indicates the need for scaling down excessive government interventions in order to further the self-sustainable development of knowledge-based industries which are dynamic and responsive to market conditions and which are developed in line with Asian comparative advantages. Corporate governance is at the heart of these changes.

Yet while there is a felt urgency to rethink corporate governance, an equally compelling need is to accommodate a middle way that will not compromise entrepreneurship and stall the growth of SMEs, which form the backbone of the KBE. As we shall see, Taiwanese firms, most of which are small-scale and family-based, are being shaped by historical legacies as much as by a new legal framework that carries the “at arms’ length” model being sponsored by OECD and other multilateral bodies.

### **Origins of the network of family-based enterprises**

Today’s Chinese-descent entrepreneurs, according to Miozzo and Tylecote (2001), grew out of a South Chinese merchant class that settled in Hong Kong, Malaysia, Singapore and Taiwan, determined to have as little as possible to do with the state, and to rely first on family capital and loyalties, second on the ties of locality, kinship and friendship. In Taiwan, ROC, before and after the Communist take-over in China, this class, the most dynamic element of the Chinese economy, dedicated to self-improvement and self-enrichment, dominated the Chinese-speaking populations the island. Accordingly, a large number of small businesses flourished, aided by family and co-operative savings and supported by bank credit. They employed family members who also worked on the land. The companies, linked by kinship, trust and locality, developed a good degree of specialization and coordination (Miozzo and Tylecote, 2001).

From this multitude of family-based firms, a flexible decentralized network of small and medium-sized firms focusing on export trade in consumer goods developed. Taiwanese firms of course could not make patient large-scale investments and accordingly could not often make technological jumps. But even if they are not vertically linked, it proved possible for SMEs to move steadily and indeed rapidly up-market in a range of mechanical and electrical/electronic niches, from bicycles to computers. Taiwan, ROC progressively integrated into the global production system by targeting sequentially industrial sectors with higher levels of value added, by increasing the skill and technology intensity of manufacturing exports and by reducing their natural resource and unskilled labor-intensive industries<sup>1</sup> (Miozzo and Tylecote, 2001).

### **Role of Taiwanese firms in the global and local value chains**

In effect, this progression enabled ROC to change its export structure, retreating from textiles and advancing into non-electrical machinery and transport equipment, and finally into the electronic industry. The shift highlighted the dynamic role of the smaller firms in the export sector, moving up the value chain without either much control or much support

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<sup>1</sup>The competence needed to produce capital goods was mechanical, and involved skills in metal-working (e.g., the working of iron and steel). The advent of electrical technologies did not require a skill shift: they remained closely related to mechanical technology. It was normal for machines to have electro-mechanical components. Electronic technologies of course grew out of electrical technologies, and in due course began to replace electro-mechanical controls on machinery. It was a natural chronological succession for late-developing countries to move from mechanical, then electrical sectors (combining both) and lately, electronics. The technologies are also alike in certain circumstances. Machines and consumer durables are all made up of a number of components which need to be assembled. They are thus highly responsive to a division of the production process among a rather large number of producing firms (Miozzo and Tylecote, 2001).



from government. The Taiwanese firms initially concentrated on production, depending on US and Japanese partners for the technology and the marketing, including brand names. They became subcontractors of American multinationals or medium-sized Japanese firms, and suppliers of international commercial networks (through Japanese trading companies and American department stores) (Miozzo and Tylecote, 2001). As in Korea, dependence on foreign providers of technology has been carefully managed so that it would not be permanent. Despite its relatively small magnitude, in qualitative terms, foreign direct investment has been important, as it has been in Korea, to develop certain key industries and has been used in conjunction with a national technology system.

It is not surprising thus that the Taiwan, ROC's market is SME-dominated. The successful specialization in IT by Taiwanese firms followed the same effective coupling and close alignment between the evolution of the SMEs, with their distinct network features and local network dimensions, and the global IT production networks of leading foreign computer firms. The basic ingredient in Taiwan, ROC's success in IT is not just a question of developing networks but of integrating locally and nationally emerging networks with global meshing structures. This has given rise to a historical conjuncture between the global demand network and Taiwan, ROC's supply-oriented system of innovation, including its manifestation in locally concentrated networks. Taiwan, ROC is a major source of, and is heavily dependent on, foreign companies' original equipment manufacturing (OEM) and original design manufacturing (ODM) (Kim and von Tunzelmann, 1998). Taiwan, ROC's IC industry is organized by industrial networks with strong connection to global technology centers like Silicon Valley (Chen, Chen and Liu, 2001). As long as their networking relationships with brand marketers are secure, the Taiwan-based firms remain in the driver's seat in terms of profit distribution within internal organizations, and coordination of R&D and manufacturing (Chen, Liu, and Shih, 2003).

ROC's horizontal network was aided in part by the personal computer. The IBM PC, which became the dominant platform in the 1980s, had vertically disintegrated innovation and opened the doors for "open architecture"—any firm could add hardware or software components to an IBM-compatible PC, which could be sourced externally through global production networks. This revolution lowered entry barriers, and the new horizontally-segmented system meant that many Taiwanese companies were able to compete in fast-growing market niches throughout the production chain. The PC industry's attributes of (a) a complex knowledge base (requiring technology-product design and commercialization), (b) high opportunity conditions (encouraging external network developments), and (c) low appropriability conditions (encouraging entry) played into the hands of Taiwanese firms' strategy of imitation and production differentiation. It is worth noting that in its effort to integrate its exportable products into the global value chain has, Taiwan, ROC relied mainly on its own capabilities to design products that meet the fast-moving needs of leading-edge global companies. The network was forged by a combination of in-house experience, learning and development, with a wide variety of external sources of information and advice available through formal and informal networking. The system could have not gotten ahead so rapidly had it not been for Taiwan, ROC's typical Chinese entrepreneurial culture (Kim and von Tunzelmann, 1998). Taiwan, ROC's major sectors today are characterized by this vertical disintegration (Chen, Liu, and Shih, 2003). ROC's IC industry, for instance, typically comprises of small firms, each one specializing in a narrow range within the value chain, such as IC design, mask production, foundry service, and packing and testing, in contrast to the dominance of vertically integrated conglomerates of Korea and Japan (Chen, Chen and Liu, 2001).

### Small is beautiful

In all these, it should be remembered that the network features of innovation and production in Taiwan, ROC have been the product of political circumstances. It was the singular Taiwanese ethnic politics and the ruling Kuomintang party's ideological views on restraining private capital that promoted the bias against big private business firms in Taiwan, ROC (Kim and von Tunzelmann, 1998). Generally, domestic firms in Taiwan, ROC would have been bigger were it not for government resistance. Large-scale enterprises are state-owned. State-owned enterprises continue to dominate the capital-intensive sectors, like steel making, which were, in any case, too large-scale for family capitalism to handle (Miozzo and Tylecote, 2001).

Public enterprises have served to consolidate the power of the Mainlander bureaucracy from the beginning. But it has a positive flipside: nurturing large-scale capital in Taiwan, ROC would have endangered the fragile but broad distributive coalition encompassing SMEs, farmers, state-sector employees, labor, and broadly defined consumer and household savers. The outcome of this unique ethnic politics involving the Taiwanese business community and the Mandarin-dominated Kuomintang political elite, according to Kim and von Tunzelmann (1998) was the creation of a multitude of extra-firm, industry-wide support organizations, as well as public bodies that conduct research, disseminate technology and provide market intelligence to the private sector. This investment in linkages and network organizations evened off the frailness caused by the small size of companies. State policies fostered a decentralized, predominantly SME-based industry structure and the beefing up of ties and networks by subsidizing public R&D and network organizations (Kim and von Tunzelmann, 1998). Whilst specializing in one segment of the value chain or another, IC firms in Taiwan, ROC are interconnected through social and business networks (Chen, Chen, Liu, 2001).

The speed of diffusion of market and technological knowledge in inter-firm networks was greatly enhanced by the considerable coming and going of people among firms of different sizes and ownership structures in Taiwan, ROC, creating informal inter-firm linkages. The geographically concentrated networks likewise encouraged a "virtual just-in-time system" of supplier relations to emerge, characterized by arm's length and constantly shifting "spot contracting" among suppliers who enter and exit firm networks easily. These compensate for the usually fragmenting competitive forces of pure markets. Otherwise, Taiwan, ROC's system might easily have been overwhelmed by its hyper-competitive and hyper-entrepreneurial system. The exchange of information about needs, techniques, and technology among buyers, suppliers, and related industries has happened at the same time as active rivalry was being maintained in the industry (Kim and von Tunzelmann, 1998).

Corporate governance-wise, Taiwanese firms are loosely knit, with no unified management structure. In lieu of a formal system of command, a highly flexible management arrangement in each business group relies on networks generated by personal and trust-based relationships. Typical of this kind of corporate governance is the Acer Group which adopts a client-server management organization structure similar to computer networking models. This grants Acer the power to source valuable high-tech components and peripherals internally and externally, lowering costs and raising efficiency, while supplying leading-edge products to a strong worldwide distribution network at competitive prices. Modular manufacturing within the network has led to a very fast inventory turnover, which gives firms like Acer a substantial advantage for market competition in the PC industry, where time-to-market speed and cost-competitiveness count for so much. It can be said that Taiwanese firms compete on the *collective* basis of the industry network (Kim and

von Tunzelmann, 1998).

Taiwanese corporate governance is essentially embedded in the island's social capital, derived from the network of relationships in the network of firms. Managers of these firms possess strong social interaction ties, develop trusting relationships, and share common values and norms. In more ways than can be recorded, social capital increases the efficiency of the actions of individuals (both transmitters and recipients of knowledge) and reduces the probability of opportunism as well as the need for costly monitoring processes, and hence, the costs of transactions. It also eases the exchange of resources, and, thus, the value-creating activities of the firm (Lau, Lu and Makino, 2002).

## **THE STOCK BONUS SYSTEM**

The importance of personal relationships and authority in Chinese family businesses means that jobs and skills are not rigidly defined and formalized, and so, the relationship with labor can be rather co-operative, as long as the firm does not expand too far (Miozzo and Tylecote, 2001). In a political economy sense, this has guided the ROC good corporate governance system: management's responsibility to protect the legitimate rights and interests of shareholders means giving due consideration to employees as share subscribers. It will be noted that the government draws heavily on the OECD Code of Corporate Governance, but most especially on the following objective: *Emphasizing the balance of rights and obligations among interested parties, including shareholders, employees, clients, upstream and downstream companies, banks and creditors.*

### **How the stock option works**

Industrial relations in Taiwan, ROC have been sweetened by the remarkable adoption of stock options for corporate workers. The Corporate Law allows firms to distribute share subscription warrants and stocks to employees, in the following manner:

"...Upon adoption of a resolution by a majority of the directors present at a meeting of the board of directors attended by two-thirds or more of the total number of directors of the company, enter into a share subscription right agreement with its employees whereby the employees may subscribe, within a specific period of time, a specific number of shares of the company. Upon execution of the said agreement, the company shall issue to each employee a share subscription warrant."

"...The percentage of surplus profit distributable as employees' bonus shall be definitely specified in the articles of incorporation...."

"...The bonus distributable to the employees under the article of incorporation may be paid either in the form of shares newly issued for such purpose or in cash."

"A company may, by a resolution adopted by a majority of the shareholders present who represent two-thirds or more of the total number of its outstanding shares of the company, have the whole or a part of the surplus profit distributable as dividends and bonuses distributed in the form of new shares to be issued by the company for such purpose."

Furthermore, a public listed company can distribute stocks at face value to employees instead of cash for bonus. The motivating effect for employees is stronger for issuing stocks than for cash and stock options when the stock exchange market is booming (see Table 1 for a comparison). For example, if the bonus of an employee is worthy of NTD20,000 and the face value of a stock is NTD10 per share, the company can distribute 2,000 shares to the employee. If the public traded price is NTD12 per share, the employee can get NTD24,000 by selling the stocks, which is NTD4,000 more than getting the cash bonus directly. That is

why employees in general prefer to have stock bonus, instead of cash bonus, for a growing economy such as Taiwan, ROC. Table 1 also indicates that stock bonus will not be preferred by the employees when the stock price of a company is lower than its face value.

In 1993, the value of cash bonus was NTD2.1 billion but the market value of stock bonus was NTD8.8 billion (i.e., four times of cash bonus); in 2002, the value of cash bonus was NTD7 billion but the market value of stock bonus was NTD72.4 billion (i.e., ten times of cash bonus) (Commercial Times, 2004). This shows how popular the stock-bonus system is in Taiwan, ROC.

Table 1. A comparison among stock bonus, cash bonus and stock options

	<b>Stock bonus</b>	<b>Cash bonus</b>	<b>Stock options</b>
Type of reward	2000 shares NTD10 per share	NTD20,000	10,000 shares Exercising price: NTD10 per share
Market price (1) Per share	NTD 12	Irrelevant	NTD 12
Total cost	Irrelevant	Irrelevant	Buying with NTD100,000
Total revenue	Selling for NTD24,000	Irrelevant	Selling for NTD120,000
Net gains	NTD24,000	NTD20,000	NTD20,000
Market price (2) Per share	NTD 8	Irrelevant	NTD 8
Total cost	Irrelevant	Irrelevant	NTD 0, no action
Total revenue	Selling for NTD16,000	Irrelevant	NTD 0, no action
Net gains	NTD16,000	NTD20,000	NTD 0

Source: Securities and Futures Institute

What serves to distinguish the stock-bonus is that the Taiwanese GAAP (Generally Accepted Accounting Practices) requires companies to expense only the par value (usually NTD10) of such shares in the income statement. The employee bonus shares do not entail a lock-in period and are subject to virtually no capital gains taxation. So the employees can (and probably most of them do) sell these shares soon after they receive them, pocketing the difference between the market price and par value (Singhai, 2002).

This system of stock-bonus is different from that of stock option adopted by American firms. In the stock-bonus system, employees receive stocks by paying face value of stocks and usually the face value is much lower than the market price; in the stock-option system, employees can decide either exercise options or not and the price of options reflect the true value of stocks, to some extent. Issuing stocks to employees with lower prices shows the willingness of a firm to share profits with employees and the concern of a firm for its employees. This creates the loyalty to a firm and strong identity with a firm (Hung, 1997).

The stock-bonus system is a widely accepted innovation by Taiwanese firms. In the 1980s, Acer Computer Inc. was the early adopter of the system because Stan Shih, the founder, is a firm believer of sharing stocks with employees. Other firms then followed suit: United Microeconomics Inc. adopted the system in 1984 (Huang, 1998); most firms planning to get listed at the stock exchange market implemented the system to keep key

employees and to create the identity of employees to firms (Chen, 2002). It has been argued that the salaries in Asian firms were too low to attract high caliber employees and the stock-bonus system effectively provides incentives to attract them (Chen, 2002). However, some foreign investors and analysts question this practice. First, it dilutes the equities held by investors, mainly the public. Singhai (2002) calls the stock bonus as excellent example of managers exploiting specific loopholes in accounting practices to expropriate shareholders. Second, it is not required to report the practice in the income statements and thus investors are not able to assess the impact on investors. International pressure has pushed some Taiwanese firms to modify this practice. On the other hand, the merits of the stock-bonus system seem to be appreciated by some foreign firms. For example, American Express and Amazon.com started to distribute stocks to employees as bonus (Yang, 2003).

To firms, giving bonus by stocks, instead of cash, has its reasons. First, cash can be kept within a firm for further investment. The cost is lower than raising capital through other means. Second, it can be an effective means to retain employees and recruit new employees, especially when competing with other firms. During the booming of high-tech industries, issuing bonus stocks is popular among high-tech firms in the R.O.C. Some executives even claim that it is a must for motivating employees and innovations.

Mediatek's case, however, took the practice to an extreme. In April 2002, the Mediatek management announced that it would be granting 18 million shares (4.1 percent of total outstanding shares) to employees at the par value of NTD10 apiece as bonus for the past year. This price reflected a 98 percent discount to the prevailing market price of NTD447 (NTD626 adjusted for a 40 percent stock-dividend announced simultaneously). The NTD8.1bn imputed value of the employee bonus shares was 1.25 times the entire net profit of NTD6.7bn earned by the company in FY2001. However only NTD180 million (18 million x NTD10) required to be expensed. Before the October 2001 listing of Mediatek, employees had already been granted 12.3 million shares in 2000 and 12.5mn shares in 1999. That effectively diluted the owners every year to pay executive compensation, the excessiveness of which was highlighted by the high market value of the compensation relative to the profit-after-tax for the company.

The Mediatek employee share bonus issue brought to everyone's attention a practice that had long existed across the whole breadth of the local electronics sector. The investment community, particularly the foreign institutional investors and brokers, began focusing on the practice very closely, generating a slew of analyses on its dilutive impact. The theme has constantly come up as a key concern about the market in recent months (Singhai, 2002).

In the context of agency theory, however, Sheu and Yang (2005) suggest that insider stock ownership relates positively to firm performance. They used total factor productivity as the relevant performance measure and classified insiders into executives, board members and blockholders. Using a five-year (1996–2000) panel data of 333 Taiwanese listed electronics firms, they observed that total insider ownership remains steady while the executive-to-insider holding ratio increases significantly. In terms of the effect on total factor productivity, neither the total insider ownership nor the board-to-insider holding ratio shows any influence on productivity. However, productivity first decreases then increases with the executive-to-insider holding ratio, forming a U-shaped relationship. The results indicate that stock ownership of top officers in high-tech firms should be encouraged to enhance productivity.

In a more recent study by Chen (2006), using a switching simultaneous-equations model, evidence indicates that the patterns of the relation between managerial ownership and firm performance are markedly different across ownership regimes. The model includes a multinomial logit for the firm's choice among three regimes of large-block ownership,

which can be argued as the choice among different degrees of controlling-minority structures, and three simultaneous-equations systems of managerial ownership and performance for each ownership regime. The paper argues that the choice of ownership regimes is the firm's endogenous decision as a reflection of the firm-specific organizational and transactional characteristics, and hence the impact of managerial ownership on performance diverges across firms belonging to different regimes.

### **Proliferation of individual investors**

Interestingly, the stock bonus scheme has been associated with the proliferation of individual investors in Taiwan, ROC. A previous study (Yu, 2004) on corporate governance in Taiwan, ROC found that individual investors actively participate in the stock exchange markets and thus there is a wide distribution of stocks by individual investors. In fact, it can be said that the laws conspired to generate an interlocking system (involving the stock exchange and brokerage firms) favorable to individual investors. Many of these investors are corporate employees who exercise their rights to stock option.

Table 2. Trading volume and value in the ROC: 1992 – 2004

Unit: NTD Million / Million Shares					
Year	Volume	Value	Daily average-volume	Daily average-value	Company listed
1992	107,595	5,910,079	379	20,835	267
1996	350,739	12,907,561	1,218	44,818	461
2000	630,868	30,526,566	2,328	112,644	831
2004	987,574	23,875,366	3,950	95,501	1163

Source: Taiwan Stock Exchange Corporation (2005), p. 69.

Active participation by investors is essential to a vibrant securities market. Securing more active investor participation would be of high strategic importance to stock exchange markets. Over the years, not only the companies listed at the stock exchange market, but also the trading activities have been growing steadily in the ROC, as illustrated by the following numbers (Table 2): the daily average volume increased from 379 million shares in 1992 to 3,950 million shares in 2004; the daily average value increased from NTD20,835 million to NTD95,501 million in 2004. The number of domestic individual shareholders has continued the trend of increasing and reached more than 26 million in 2004, which was 3 millions more than that of 2002 (Table 3). In terms of the shares registered, close to 80 percent of all individual shareholders owned less than 50,000 shares. Because the unit of stock transaction in the stock exchange markets is 1,000 shares, this means that many investors do not hold large quantity of stocks—a sign that many are employees with share subscriptions.

Most of the investors in the stock exchange markets have been individual investors. For example, in 2004, domestic individual investors accounted for 48 percent of total investors, domestic corporations and institutional investors accounted for 35 percent, and foreign investors accounted for 15.8 percent (Table 4). Similar to several emerging stock markets, the Taiwanese stock markets had historically set several limitations on foreign investment. As foreign investment increased, however, the government has gradually adopted a more flexible attitude to open up the stock markets for participation by foreign investors. For example, the review process for investment by foreign investors in domestic stocks has been changed from the 'permit' system to the 'registration' system. As a result, foreign investor participation has increased gradually in Taiwan, ROC.

Table 3. Domestic individual share-ownership by size of holding in the ROC, 2002–2004

<b>Shares Registered</b>	<b>2004 No. of persons</b>	<b>%</b>	<b>2003 No. of persons</b>	<b>%</b>	<b>2002 No. of persons</b>	<b>%</b>
Below 10,000	10,697,181	39.8	10,307,335	38.9	8,972,288	37.7
10,001-50,000	10,483,414	39.1	10,586,663	40.0	9,955,987	41.8
50,001-100,000	2,734,993	10.2	2,661,748	10.1	2,347,009	9.9
100,001-150,000	951,398	3.5	1,015,763	3.8	916,704	3.9
150,001-200,000	600,896	2.2	553,955	2.1	466,664	2.0
Above 200,000	1,381,578	5.2	1,346,484	5.1	1,158,608	4.9
Total	26,849,460	100	26,471,947	100	23,817,260	100

Source: Taiwan Stock Exchange Corporation (2005), p. 53.

Table 4. Share-ownership by types of investors in the ROC, 2002–2004

Unit: Percentage

<b>Year</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
<b>Domestic investors</b>			
Government	5.02	6.23	6.73
Financial institutions	4.41	4.37	3.76
Trust fund	1.48	1.19	0.98
Corporations	21.35	22.38	22.37
Other juridical persons	2.83	2.96	3.40
Individuals	48.01	50.17	50.70
<b>Foreigners</b>			
Trust fund	6.96	4.19	4.57
Financial institutions	0.38	0.27	0.28
Juridical persons	8.07	6.06	5.96
Individuals	0.37	0.70	0.52
Share buy-backs	1.12	1.48	0.73
Total	100.00	100.00	100.00

Source: Taiwan Stock Exchange Corporation (2005), p. 63.

In terms of the total investor accounts kept by securities brokerage firms, bearing in mind that the population was about 22 million, the numbers over the years are (TSEC, 2005): 12,869,344 in 2002; 13,053,178 in 2003; and 13,720,461 in 2004. Excluding those who are under 20 and over 65 years of age, the population was 14,389,248 in 2003. Comparing this number with the number of the investor accounts, it implies that most adults participate in the stock exchange market and some adults like employees probably own several accounts with different securities brokerage firms for stock transactions.

Apart from the law permitting share subscription among employees, two other sets of laws explain the large number of individual investors in Taiwan, ROC.

The laws that require public listed companies to distribute equity holdings include:

- The Securities and Exchange Act, which stipulates that firms may be required to disperse their shares when issuing new shares to raise capital.
- The Taiwan Stock Exchange Corporation Criteria for Review of Securities Listings

which stipulates that, when an issuing company applying for the listing of its stock, the company has to satisfy the following condition: “Dispersion of shareholdings: The number of holders of registered share certificates shall be 1,000 or more. Among them, the number of shareholders holding 1,000 shares to 50,000 shares shall not be less than 500, and the total number of shares they hold shall be 20 percent or greater of the total issued shares, or at least 10 million.”

This regulation has motivated companies to *increase the number of stockholders before going to be public*.

The laws regarding stock exchange markets also contribute to the phenomenon. For stock transactions the government only levies transaction tax on the sale side of each transaction (i.e., 0.3 percent of traded value) and capital gains are exempted from tax. Investors can gain by stock transactions frequently and thus increase the turnover rates of stocks. Investors can also transact through pecuniary financing and securities financing. Pecuniary finance represents loans to investors for the purchase of securities and such loans are secured by the securities purchased by the investors; securities finance represents securities lent to investors by securities brokerage firms and the investors' deposits for borrowing securities are held by these firms as collateral.

Although there are many types of securities, such as bonds, warrants, Taiwan depository receipts, etc., transaction in stocks accounted for the lion share of trading value. For example, stock transactions accounted for 98.75 percent of the trading value in 2004 (TSEC, 2005). Brokerage commissions, charged from investors for stock transactions, are the major source of revenues for stock brokerage firms.

Security brokerage firms make it very convenient for individual investors to buy or sell stocks. Investors have to open accounts personally at security brokerage firms. However, security brokerage firms usually have branches conveniently located close to investors. Securities brokerage firms, by setting up branch office nation-wide (154 firms with 1048 branches in 2003), are the main intermediaries for stock transactions (accounting of 94.0 percent of total trading value in 2003) (TSEC, 2005). People can trade at the main or branch offices, through phone calls or fax, or trade on-line.

Because the bonus of brokers at security brokerage firms is usually based on the volume of businesses conducted through them, to increase their bonus, brokers tend to encourage their clients to engage in more transactions.

Individual investors conduct stock transactions by themselves and, if they buy mutual funds, they prefer to buy foreign mutual funds, instead of local mutual funds. Although over 40 securities investment trust enterprises sell mutual funds, which theoretically provide a better choice to individual investors for risk diversification, the expertise and professionalism of these firms are questioned by investors. The feeling of the public is that, these firms sometimes manage mutual funds not for the interests of investors, but for earning commission. Individual investors trust more of their own capabilities and judgments, instead of relying on institutional investors.

In addition, investors in the ROC have two characteristics:

1. Love of betting: Gambling is very much part of Taiwan, ROC's culture. People gamble on anything and everything -- outcomes of baseball games, the fluctuations of the stock market and the results of elections, including which candidates and parties will win and also the margin of victory (Taipei Times, 2004). The fluctuations of the stock prices generate excitement to investors (Lee, 2005) and they prefer to experience the excitement by themselves.
2. Discretionary investing: The securities investment trust enterprises and securities investment consulting enterprises were permitted to accept consignment for



discretionary investment for customers in 2000. However, to manage personal investment portfolio, the investors in Taiwan, ROC have already familiarized with stock transactions. That is the reason why, unlike in other developed countries, the business of consignment for discretionary investment for customers in Taiwan, ROC has been growing slowly.

## **CROSS-HOLDING OF STOCKS BETWEEN FIRMS**

In ROC, cross-holding and pyramid linkages are allowed but now require mandatory disclosure (Singhai, 2002). Cross-holding of stocks between firms is a sensitive issue for corporate governance. But for firms, cross-holding generates some advantages managerially and strategically. First, cross-holding can alleviate the threat of take-over so that the management can focus on running of firms (Chen and Hong, 2003). Second, cross-holding can be a way to form alliance with upstream or downstream firms so that stable relationships can be maintained and competitiveness can be enhanced (Huang, 1999). In a largely networked agglomeration of firms, cross-holding can provide a solidarity instrument. Third, cross-holding can stabilize the stock prices of involving firms when needed. Some executives felt that it makes business sense to own the stocks of subsidiaries but have to be careful for subsidiaries to own the stocks of parent firms (Huang, 1999).

As discussed above, Taiwan, ROC's industrial structure is organized predominantly around small and medium-sized family enterprises. SME-based systems of production are frequently regarded as being pliant but often constrained by deficiencies in one or other functional respect—sometimes in finance, sometimes in technology, sometimes in marketing, and so on. Yet Taiwan, ROC's success equals that of South Korea, whose industrial growth was built almost entirely on large, horizontally diversified and vertically integrated business conglomerates (*chaebols*) (Kim and von Tunzelmann, 1998). Absent economies of scope, small firms can only retreat to very particular niche markets (Chen, Chen and Liu, 2001), indicating reliance on inter-firm financing.

Another advantage of cross-holdings is, by investing in subsidiaries which are in emerging or growing industries, or operating in new geographic markets, parent firms enjoy higher returns and eventually benefit to the stockholders of parent firms (Huang and Chou, 2004). For example, Deutsch Bank reported that the consolidated income increased by 158 percent and the return on assets increased from 5.8 percent to 9.1 percent for the 20 largest investing Taiwanese firms in China. However, the same report also indicated that the consolidated debt ratio also increased from 29 percent to 44 percent. This shows that, by diversifying into new businesses or areas, firms may incur higher risks and thus lead to even poorer performance. Therefore, firms with many subsidiaries may either perform highly above or below market average (Hong, 2003).

Hi tech industries often have a greater level of risk than other industries, particularly enterprises in the start-up phase, which needs seed capital to finance product development and marketing. R&D expenditures account for a high percentage of their total funding requirements. Consequently, newly established enterprises have difficulty securing loans from traditional financing institutions, including banks, and they often depend on personal capital (Yang, 2002). Arguably, cross-holdings take on this greater risk, but they also have the prospect of earning higher returns. Also, financial institutions in Taiwan, ROC are not competitive and capital markets are underdeveloped. Most SMEs, which dominate Taiwan, ROC's industrial structure, lack the liquidity and economies of scale to list on either the Taiwan Stock Exchange or the OTC. Hence, SMEs usually cannot use capital market funds to expand the scale of production or improve competitiveness (Yang, 2002). The

government has been studying the "Second Board Market" system for smaller firms, especially high-tech and small and medium firms (SMEs), to be traded on the OTC Exchange so that they can raise funds more easily and efficiently. It has asked the OTC Exchange to relax listing procedures and requirements for such companies.

Notwithstanding the benefits, cross-holding of stocks between firms generate some problems for corporate governance. For example, in Taiwan, ROC, under certain conditions (such as less than 50 percent of ownership), firms need not report the operations of affiliated firms and submit consolidate financial information (Hong, 2003). This may mislead the public in making investing decisions.

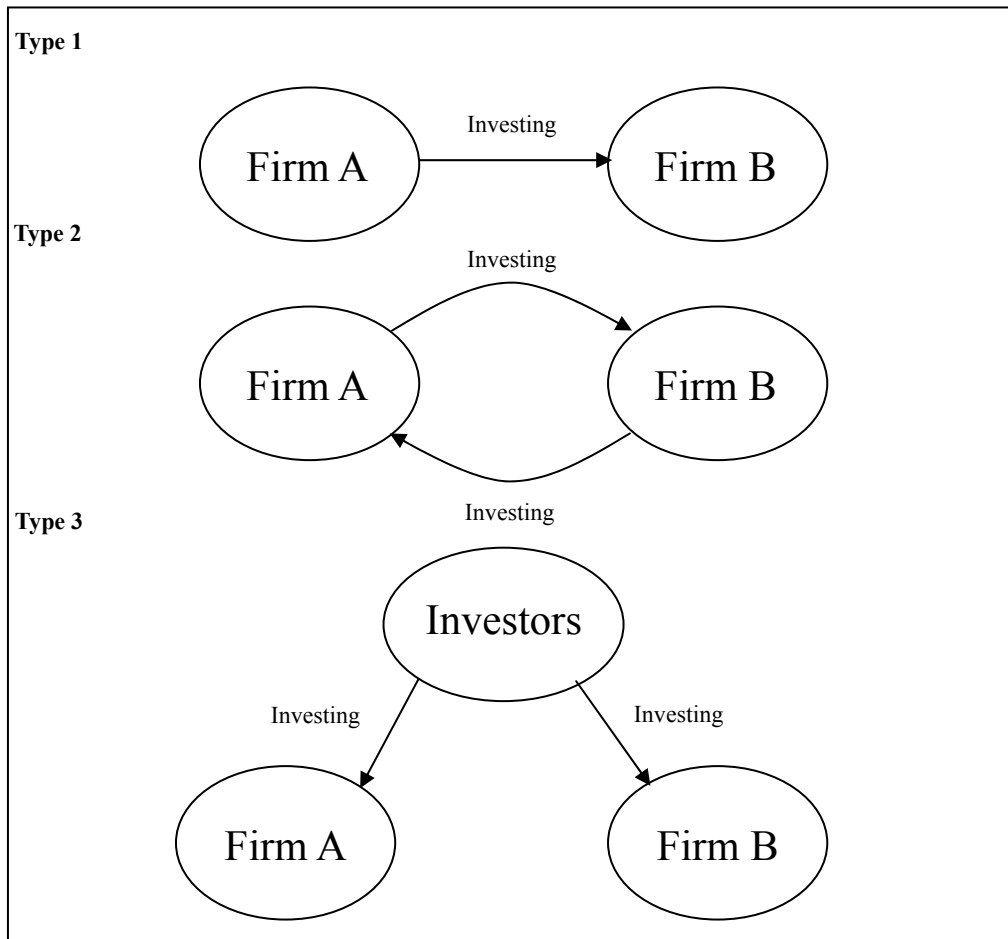


Figure 1. Relationships between firms

Yu's study examined Type 2 relationship only and Types 1 and 3 were not included. Yu's study (2004), which found no mutual holding of stocks between the firms examined and their affiliated companies, needs to be interpreted with caution. There are three ways two firms can be related (Figure1):

- Type 1: one firm owns the equity of another firm, i.e., two firms having controlling and subordinate relationship between them;

- Type 2: two firms own the shares of each other, i.e., two companies having made investment in each other; and
- Type 3: one firm's major investors own significant shares of another firm, i.e., two firms are related due to common investors.

The discussion in this section will take a more comprehensive view and include all of three types of relationship in Taiwan, ROC. As it stands, the regulations are more clear for Types 1 and 2 relationships and vague for Type 3 relationship.

The regulations on cross-holding of stocks in Taiwan, ROC are different for the financial sector and other sectors. The financial sector in Taiwan, ROC has been engaging in a series of reforms. To consolidate the sector the Financial Holding Companies Act was passed in 2001. This Act allows financial institutions to form holding companies, which are not permitted for manufacturing firms, and to own controlling share of other firms in the financial sector (i.e., Type 1 relationship). Firms have reacted actively to the Act and, as a result, more than ten domestic financial groups have obtained approvals from the Ministry of Finance and have already listed on the Taiwan Stock Exchange. Thus, the Act requires and encourages financial institutions to own controlling stocks of other firms in the financial sector. However, the regulations for firms in other sectors on cross-holding are more restrictive.

For non-financial companies, the Corporate Law specifies the following for Type 1 relationship:

“A company which holds a majority of the total number of the outstanding voting shares or the total amount of the capital stock of another company is considered the controlling company, while the said another company is considered the subordinate company.”

“If a company has a direct or indirect control over the management of the personnel, financial or business operation of another company, it is also considered the controlling company, and the said another company is considered the subordinated company.”

“Where two companies are holding one half or more of the total number of the voting shares or the total amount of the capital stock of each other's company, or having direct or indirect control over the management of the personnel, financial or business operations of each other's company, they shall have the status of the controlling company as well as the subordinate company to each other's company.”

“In case a controlling company has caused its subordinated company to conduct any business which is contrary to normal business practice or not profitable, but fails to pay an appropriate compensation upon the end of the fiscal year involved, and thus causing the subsidiary company to suffer damages, the controlling company shall be liable for such damages” and “if the responsible person of the controlling company has caused the subordinated company to conduct the business described in the preceding paragraph, he/she shall be liable, jointly and severally, with the controlling company for such damages.”

“A subordinate company of a listed company shall, at the end of each fiscal year, prepare and submit a report regarding the relationship between itself and its controlling company indicating therein the legal facts, funds flow and loss and profit status between the two companies” and “The controlling company of a listed company shall, at the end of each fiscal year, prepare for submission a consolidated business report and consolidated financial statements of the affiliated enterprises involved.”

The Law regulates more stringently for controlling-subordinate relations than for share mutual-holding relationships. For Type II relationship the Corporate Law specifies that:

“Where a company and another company have made investment in each other’s company to the extent that one third or more of the total number of the voting shares or the total amount of the capital stock of both companies are held or contributed by each other, these two companies are defined as mutual investment companies.”

Regardless of share ownership, the voting power of mutual investment companies is limited to 1/3 (Wang, 2003) and mutual investment companies are required to reveal the relationships in financial statements. However, if the mutual ownership is less than 1/3 of the equity, both firms have more freedom of operations and face less reporting requirements.

Cross-holdings create governance challenges. In recent years, several public listed companies in Taiwan, ROC went bankruptcy to the surprise of the regulators and investors. A typical arrangement blamed for this works as follows (Figure 2) (Chou, 2005):

1. A Taiwanese firm sells products to foreign firms, with or without its ownership.
2. The Taiwanese firm receives payments in the form of account receivables. However, in reality, no deal was done between the two parties.
3. The transaction increases the revenues of the Taiwanese firm and may lead to higher stock prices. Furthermore, the firms can use account receivables as collateral to borrow money from banks

A more sophisticated arrangement than that depicted in Figure 2 is the case of Procomp Informatics Ltd., a maker of chips used in communications and networking equipment. The top management of Procomp was found to have illegally manipulated the company's stock while leveraging NTD6.3 billion in frozen assets to raise more capital. Procomp had used part of the funds as collateral for bank loans granted to its foreign associates, which agreed to buy euro convertible bonds issued by the company. Procomp had also authorized these banks to use the funds to buy financial derivatives while selling fake account receivables to banks. The banks later froze Procomp's savings since its receivables could not be realized. The Financial Supervisory Commission (SFC) accused that Procomp had worked with five of its Hong Kong-based sales agents, suspected were paper companies, to increase its account receivables so that its stock prices could be boosted (Huang, 2004). Four of the five agents had never registered in Hong Kong and the other had been making deals with Procomp two years before it became a Hong Kong-registered company in 2003. Therefore, the top management might have violated article 171 and 174 of the Securities Transaction Law, which carry a maximum penalty of 10 years and seven years, respectively, as well as civil and criminal laws.

This kind of arrangement makes it difficult for accountants to audit. Accountants have to clarify the nature of paper companies or real companies which companies are doing businesses with. Though publicly listed companies are required to report the information about overseas subsidiaries with controlling ownership, it is difficult to check the validity of the information submitted. In addition, firms need not incorporate the operations of affiliates with non-controlling ownership. No wonder Mr. Wei of Deloitte Taiwan, a member of Deloitte Touche Tohmatsu, claimed that “From now on we will be more cautious in selecting our clients.... We may turn down clients with low stock prices, high debt ratio and those clients whose management teams have questionable decisions” (Lin, 2005).

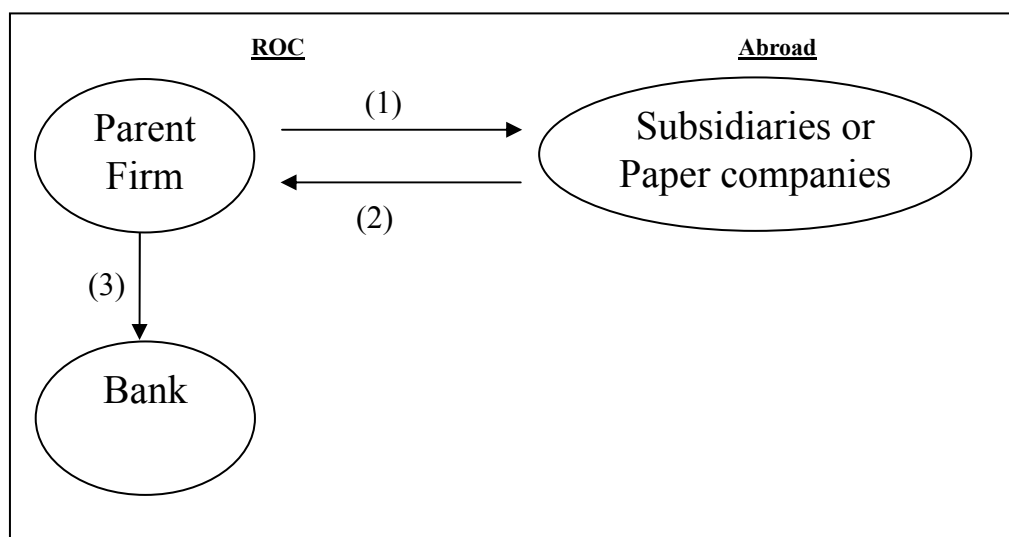


Figure 2. Foreign affiliates and fake transactions

Another problem associated with cross-holding is the manipulation of stock prices. If an affiliate buys its parent firm's stocks, the stock prices will go up so that the parent firm can borrow more money from banks and to raise capital from the public easily (Chen and Hong, 2003). This negative aspect was voiced by the public and demanded for government regulations (*Commercial Times*, 1999; *Economic Daily*, 2003). Owing to this hidden risk of cross-holding among affiliated corporations, a subordinate company shall not redeem or buy back any of controlling company shares, nor accept any of them as collateral under amended Company Law (Securities & Futures Institute, 2004). However, firms have ways to get around the regulation. A typical scheme works as follows (Figure 3):

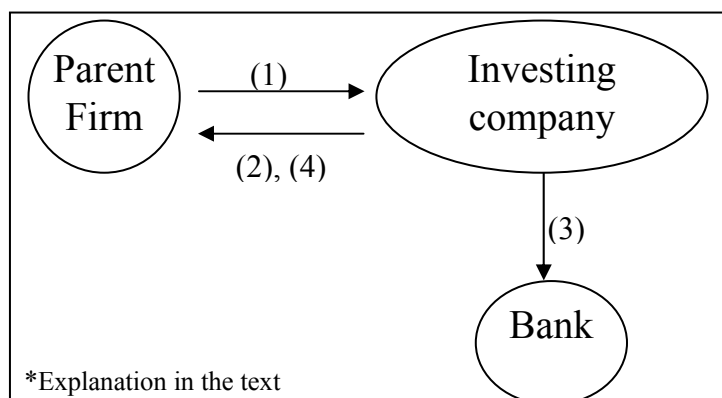


Figure 3. Manipulating stock prices of the parent firm

1. The major investors of a firm (i.e., the parent firm) set up an investment company and the main activity of the company is investment.

2. The investment company buys the stocks of the parent firm which boosts up the stock prices of the later.
3. Using the stocks of the parent firm as collateral, the subsidiary (i.e., the investment company) borrows money from banks.
4. The money can be used for investment or buying more stocks of the parent firm. If the parent firm runs well, the stock prices can be maintained high; if the parent firm does not run well, the stock prices will go down and, when the prices fall to certain levels, the banks will ask for loan repayment from the investment company. The banks may sell the stocks of the parent firm to get the payment and this leads to further reductions of the stock prices. Eventually the stock prices of the parent firm will go down to the extent that the parent firm and the investment company both file for bankruptcy.

For the problems created by cross-holding, depicted in Figures 2 and 3, in addition to demanding accountants to be more thorough in auditing, there are several suggestions (Chou, 2005):

- Hold management responsibilities for unlawful or cheating behaviors;
- Set up hotlines by government agencies for tips for cheating behaviors, typically from investors or inside-employees;
- Implement better corporate governance (e.g., setting up audit committee and appointing independent directors) so that more efforts can be devoted to the clarifying of the needs and nature of setting overseas subsidiaries, and examining the transactions between parent firms and their affiliates; and
- Implement more effective internal control systems and make reports to appropriate bodies, not to CEO.

Basically more effectively in designing and implementing corporate governance, which relies on boards and management teams to perform their duties and the government to provide a better legal framework, is demanded to protect the interests of the investors.

Cross-holdings breed the agency problem, which occurs when the desires or goals of the principal and agent conflict, and it is difficult or expensive for the principal to verify that the agent has behaved improperly. For example, in a firm with dispersed *ownership* (*cash flow rights*) and *control* (*voting rights*), managers may over-diversify to reduce their employment risk and increase compensation. However, owners can mitigate such indirect expropriation by instituting an effective and responsible board of directors as a monitoring mechanism and by entering into incentive-based performance contracts with the managers (Singhai, 2002).

However, the agency problem tends to be far more complicated when control of a firm is concentrated in the hands of a single shareholder (individual, family, or business group). The threat of expropriation is further exacerbated when such large shareholders manage to gain *control* disproportionately higher to their *ownership*. Control in excess of ownership can be achieved with the help of cross holdings between companies, through pyramidal holding structures, or by issuing more than one class of shares with differential voting rights (Singhai, 2002).

In light of the situation, the government amended relevant regulations to restrict companies from creating investment vehicles to hold the shares of the parent companies. The government has also strengthened mechanisms to monitor the usage of funds by listed companies obtained through cash offerings.

Clearly, these are only small victories, and leave plenty of scope for follow-up measures like an indirect deterrent like inter-corporate taxation to discourage pyramids and cross-ownership (Singhai, 2002). All things considered, the progress of hi-tech firms in

Taiwan, ROC should lead them to pathways that would eventually end up in hybridization: networks that will incorporate the best features of employee share subscriptions and “at arms length” shareholding.

## **CONCLUSION**

Existing legal systems, business cultures and corporate structures are formed in different contexts and may effect how corporate governance systems are designed and implemented in different countries (Gonzalez, 2004). The evidence provided in the paper suggests that the institutional environment seems to be a major factor in explaining the rise of networked firms in Taiwan, ROC.

Countries differ in their institutions and cultural orientations. Institutions, including both formal rules (e.g., laws and regulations) and informal rules (e.g., conventions and norms) (North 1990), affect political, social and economic behaviors and relationships in a country. Studies have shown that culture affects the behaviors of human, such as attitude towards work, social capital and management dynamics (Isobe, et al., 2004).

The basic premise of the institutional theory is that firms’ tendencies toward conformity with predominant norms, traditions, and social influences in their internal and external environments lead to homogeneity among firms in their structures and activities, and successful firms are those that gain support and legitimacy by conforming to social pressures (Oliver, 1991, 1997). From an institutional view, firms operate within a social framework of norms, values, and assumptions about what constitutes appropriate or acceptable economic behavior. Therefore, economic choices are constrained not only by the technological, informational, and income limits but also by socially constructed limits (Oliver, 1997).

Institutional context refers to rules, norms, and beliefs surrounding economic activities that define or enforce socially acceptable economic behavior (Oliver, 1997). Similar to firms, the behaviors of individuals are influenced by both formal and informal institutions. The investing behaviors in the stock exchange markets in Taiwan, ROC and the cross-holding of stocks between firms reflect the influence of institutional factors, either directly or indirectly. Specifically, the paper dealt with two by-products of the institutional environment, namely the stock bonus given to employees and stock cross holdings among hi-tech firms. In the process, the paper found that share subscriptions are but part of the regulatory structure that favors individual investors. The other laws regarding public listed companies, stock exchange markets, and issuing stocks to employees, the characteristics of stock brokerage firms and behaviors of individual investors all contribute to the wide distribution of stocks by individual investors. Cross-holdings are, to put it bluntly, a necessary instrument, and that is why the government has allowed the practice, although the laws are designed to regulate the cross-holding of stocks between firms so that misbehaviors can be avoided. Some firms have developed several mechanisms (e.g., setting up paper companies and investment companies and faking transactions) to manipulate the legal framework. Continued improvement of the laws and implementing practices related to the corporate governance system is a must.

The ROC government has implemented a number of reforms (such as amending the Company Law to further regulate cross-holding of shares) and measures (e.g., requiring firms to strengthen internal audit and internal control systems) in recent years to strengthen corporate governance in Taiwan (Yu, 2004). In late 2003, the government further adopted the recommendations of the Task Force for Reforming Corporate Governance to strengthen corporate governance (Executive Yuan, 2003). For example, Securities Investors and

Futures Traders Protection Law has been enacted to protect the interests of investors. Public awareness as well the initiation of the government on corporate governance will lead to a better investing environment for investors and more responsiveness to stakeholders by firms in the ROC. But in the end, it must be said that institutions as well as their history matter, and corporate governance in Taiwan, ROC, whether we like it or not, would evolve in a manner that takes tradition as a modifiable given, not as a convention that could readily be discarded.

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# **CORPORATE GOVERNANCE IN INDIA: LESSONS FROM THE PUBLIC SECTOR**

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## **PERSPECTIVES**

The debate on corporate governance in the public sector is of recent origin. Much of what governments do in delivering public services involve running major businesses, the operation of public utilities for example: water, electricity, roads, transport. In India, various forms of businesses managed by state-owned enterprises have total assets that run into billions, and they are not insignificant by any standard. Indian taxpayers, as the ultimate owners of these businesses, have the right to expect them to perform to best practice. That requires having good corporate governance systems in place.

However, as Whitfield (2003) points out, governments do more than simply operate utilities. If private sector businesses bear upon the community and the economy, many public sector activities have a more direct and immediate influence. Health, education, social welfare, and the justice/legal systems all redound directly to the community's and society's benefit. Governments are trying to achieve through a variety of public sector corporations a complicated array of political, social and economic objectives. Much more so than the private sector, the public sector is faced with the challenge of reconciling service and accountability with commercial decision-making.

Corporate governance in the public sector is much more complex because it also raises important questions about government monopoly, ownership concentration, regulatory capture, redistribution and the wide scope of public sector activities in India, among others, which would need to be considered for evolving a suitable corporate governance framework and practice. The Standing Committee on Public Enterprises, the apex organization of public corporate sector in India took the initiative in the mid-nineties to encourage debate and focus attention on these issues, particularly those affecting central public sector enterprises, that is, firms owned by the central government of India (SCOPE, 2004).

The tradeoffs are increasingly important in the context of liberalization where government is expected to relinquish its control over a wide range of public sector activities. The clamor for the privatization of SOEs has gained ground in the last decade, although its success has rather been episodic, marked by gradualism throughout the 1990s and acceleration in more recent years. As Karayalcyn (undated) notes, it is not easy for the state to simply give up control of the SOE sector because of its major role as an instrument of redistribution, especially for countries undergoing adjustments induced by IMF and World Bank policies.

Indeed, given this institutional vacillation, there are economic reasons (in addition to political reasons) for government control in corporate governance as a second-best response in developing countries like India. As Qian (2000) argues, state ownership and control may have comparative advantages over private control in an imperfect institutional environment, such as when there is ineffective rule of law in securing property rights, poorly functioning capital market, and a lack of acceptable taxation and fiscal institutions.

Likewise, even if government ownership and control are inefficient, there are still economic arguments for delaying privatization of existing state firms, such as a lack of a social safety net, inadequate legal framework for corporate governance, and the absence of regulatory institutions for special industries. Arguably too, where the private sector is reluctant to invest its energy and resources (true in many cases for public goods and in areas where there are large externalities), SOEs are the only implementing instruments available to governments. Seen this way, SOEs and private enterprises are complementary to each other.

This paper attempts to examine corporate governance issues in the context of challenges peculiar to the public sector in India and draw lessons that could be of use in similarly situated countries. It discusses the broad trends of initiatives that are in progress in the central public sector enterprise, keeping in mind the basic principle enunciated by the Organization for Economic Cooperation and Development: the legal and regulatory framework for state-owned enterprises should ensure a level-playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions (Isaksson, 2005). The chief aim of the public enterprises is to maximize productive exploitation of the valuable resources invested in them with effective governance and transparency (Jain, 2004).

## **TWO VIEWS OF CORPORATE GOVERNANCE**

There are two views of corporate governance that prevail in various settings today. A narrow view is particularly prevalent in the USA and UK and is largely focused on promoting and protecting the interests of shareholders. It is tilted towards complying with legal and other rules and practices prescribed for the purpose of preventing any wrongdoing and presenting the correct picture to the shareholders. The major focus of this view is on enhancing shareholder value. Its key concepts—disclosure, transparency, accountability, audit, among others—are geared toward protecting the rights of minority shareholders. Because it considers the outside market as its source of discipline and its corrective mechanism, this particular view is very internally-focused: its principal chore is to define and delineate relationships amongst the company's management, the board of directors, its shareholders, and auditors so that no conflict of interest arises. The principal-agent relations provide a broad governance framework for formulating company policies and monitoring performance. However, experience has shown that maximization of shareholder value alone may place undue emphasis on achieving results that benefit a few at the cost of other stakeholders in society.

The broader view treats corporations as socially embedded organizations servicing the needs of multiple stakeholders in the context of varying 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 matters, according to Gonzalez (2004), has several ingredients: extent of control by majority shareholders, rights of stockholders, contractual covenants and insolvency powers of debt holders, and government regulations. The key players are not simply the inside controlling agents (owners and top management) but external agents (financiers such as banks and majority shareholders, government regulators) as well. The agency problem is how to line up their interests, to avoid divergence and ensure the growth of both the firm and the economy.

Mere compliance with the existing legal and regulatory framework and protecting the majority shareholders' interests exclusively is not a guarantee of long-term corporate

survival (Monga, 2004). It is a necessary, but not a sufficient, condition. The very first order of business for corporate governance is the commitment of people in the organization (Vittal, 2002). The values of transparency and integrity must percolate down within the organization to enhance employees' belongingness, and outside it. The broader view therefore is to consider the best interests of wider set of stakeholders including employees, customers, and the community. Building trust with both internal and external stakeholders that is essential for achieving holistic better performance. This view regards companies as a social institution rather than merely a vehicle for shareholder value creation.

That does not mean that countries like India should be entirely on their own in crafting their corporate governance principles, even granting that these principles must pass the "localization test"—the extent to which they could imbibe India's legal and political systems, business cultures, and corporate structures. The reforms, in the context of the broader stakeholder perspective, can adapt the principles laid down by the OECD without losing sight of peculiar needs of the nation. Although India should move towards the stakeholder model, it can still have major points of convergence with OECD standards and policy directions as well as those developed in the Cadbury Report in the UK and the Sarbanes-Oxley Act in the US. Many of these shareholder model features, like open disclosure regimes, broad ownership, stock exchanges, accounting standards, risk management and regulatory mechanisms are in place already in India. Most companies are honoring the rights of shareholders to participate, question, vote and influence decisions, as Reddy (2004) points out, but in a departure from the US-UK model, they are engaging stakeholders more intently.

In the end, what matters is that India is able to get the best out of these two approaches. Both shareholder and stakeholder values must be entrenched in the organizational culture, and supported by appropriate mechanisms and systems.

## **CORPORATE GOVERNANCE INITIATIVES IN INDIA**

Soon after independence, India, like most underdeveloped economies, was caught in a low-income-level trap, which occurred at low levels of physical capital, both productive and infrastructural, and was maintained by low levels of accumulation and by Malthusian population growth. That implied a powerful case for government activism as a way of breaking out of the trap. Accordingly, the Government of India adopted a model of economic development that could be best described as "mixed economy". The state operated from the "commanding heights" and aimed at the highest level of socio-economic good for the largest number (Dewan, 2004a).

This development paradigm, a "big push" of sorts, accorded a strategic position to the public sector in the economy. It was in line with the first Industrial Policy Resolution of 1956 which sought to achieve a self-reliant economic and social growth. The private sector was also encouraged to prosper, but played second fiddle to the public sector.

It was the policy of mixed economy that initiated the creation of large number of SOEs. The policy was to address the aspiration of a new nation towards quick industrialization. The basic argument has been that Indian industrialization has to be anchored on the core sectors that were highly capital intensive with long gestation periods. Since the private sector of the nascent economy was not strong enough to invest in such sectors, state initiative was imperative. Later, the policy got mixed up with trade union pressure for nationalization of many enterprises. By the last decade of the last century SOEs in India were spread over from core sectors like steel, power, and machinery to

many consumer goods that included even bakery products (Nath, 2004).

The reversal of fortunes for SOEs occurred in the eighties, which saw a gradual opening up of the Indian economy. But it was in 1991 when the Government of India decided to give a further impetus to accelerate the process of liberalization and opening up of the economy, which boosted the chances of private enterprises. Yet, according to Nair, although India's growth accelerated, this performance could not be sustained in later years. The average growth rate during the five-year period 1997-02 was only 5.4 percent as against the targeted 6.5 percent (Nair, 2003). However, economic growth rate picked up later, to more than 8 percent during the years 2004-05 and was expected to slow down to around 6.5 percent beginning 2006. The erratic economic behavior suggested that the reform was not simply about "getting the price right" but "getting the institutions right".

Realizing that good governance plays a crucial role in developing an efficient economy, the Indian government embarked on a course that put emphasis on corporate behavior. A 2004 study of the World Bank recognized this effort and acknowledged a marked improvement in corporate governance in India (*Economic Times*, 16 May 2005).

Several major corporate governance initiatives have been launched in India since the mid-nineties. The first was by the Confederation of Indian Industries (CII), India's largest industry and business association, which came up with the first voluntary Code of Corporate Governance in 1998. The confederation was driven by the conviction that good corporate governance was essential for Indian companies to access domestic as well as global capital at competitive rates. The code focused on listed companies. While this code was well received and some progressive companies adopted it, it was felt that under Indian conditions a statutory rather than a voluntary code would be more purposeful. Consequently, the second major initiative in the country was undertaken by the Securities and Exchange Board of India (SEBI) which envisaged that corporate norms would be enforced through listing agreements between companies and the stock exchanges. In early 2000, the SEBI board incorporated new regulations into Clause 49 of the Listing Agreement of the Stock Exchanges. This clause has been further revised in 2002, and again, in 2004. Clause 49 lays down guidelines for composition of the board including the number and qualities of independent directors, remuneration of board members, code of conduct, and the constitution of various committees (including audit), disclosures, and suggested contents of annual reports.

Likewise, the government has taken initiatives to rationalize and simplify the Companies Act. The objective was to make the law more business friendly, bring greater clarity and accountability to roles of directors, strengthen penal provisions against fly-by-night companies and safeguard the interests of shareholders. Proponents of the amendments also toughened the eligibility criteria for independent directors: having a relative with pecuniary or material relationship with the company is a disqualification, which is not the case with the listing agreement; and the number of independent directors was set at one third of the total size of the board. Recognizing the advent of high technology, the government recommended allowing board meetings by electronic means such as video conferencing. The reforms are expected to reduce compliance costs and raise the levels of transparency in corporations. Also launched was an e-governance project which seeks to put all information on the website that can be accessed by companies anytime.

These actions were to be applicable to both private and public sectors, but it was left to SCOPE to examine issues relating to central public sector enterprises. SCOPE initiated studies on the role of government directors and non-government directors on boards of public sector enterprises, action strategies for sick central public sector enterprises, and

comparative performance of public and private sector organizations. To recognize the contribution of public enterprises, it launched the SCOPE Awards for Excellence and Outstanding Contribution to the Public Sector Management in 1996-97. In 2002, a SCOPE Centre for Excellence in Corporate Governance was established. Its aim is to promote and inculcate good corporate governance practices among public enterprises as a means of enhancing their competitiveness. The center would act as a repository of excellence in corporate governance practices. It would promote awareness of existing regulations, facilitate appropriate policy formulations by the government, and encourage professional governance of public enterprises by fully empowered boards.

### **THE PUBLIC SECTOR IN INDIA: GAINS AND PITFALLS**

At the time of independence, building an industrial base required huge investments which the private sector was not prepared to make. Private firms did not have the resources and competence given the poor state of financial markets at that time. The “mixed economy” approach gave the state the sole responsibility to build strategic industries that included defense, railways, river valley projects, atomic energy, and to play the dominant role in support industries such as steel and iron, coal, civil aviation, shipping, fertilizer, road transportation and machine tools.

Over the years, the scope of the public sector expanded and both the central and state level governments established public undertakings in practically all spheres of economic activity that included manufacturing and operations in oil and gas, telecommunication, coal, textiles, nuclear power, banks, and financial services. The Government also took over sick private sector industries ostensibly to protect, inter alia, the interest of workers. As a result, public sector enterprises covered even more sectors such as petroleum, basic metals, and non-ferrous metals.

Starting with five enterprises with an investment of Rupees 29 Crores (USD67 million) in 1950-51, the central public sector enterprises (CPSEs) have expanded to 230 operative enterprises by 31 March 2004 with an investment of Rupees 3,049,209 Crores (USD811 billion). The combined turnover/operating income in 2003-04 of these enterprises was Rupees 5,860,144 Crores (USD1,334 billion). The top 10 enterprises contributed 72.71 percent of the turnover of all enterprises. Of these 230 enterprises, 140 were profit making, 88 were losing and 2 registered no loss/no profit. According to the Public Enterprises Survey conducted in 2003-2004, the following were the salient features of the performance of CPSEs during those years:

- Annual net profit increased by 64.10 percent (607.17 percent over the last decade) while investment increased by 4.04 percent.
- Return on equity share capital was 44.62 percent and earning was Rupees 4.46 per share of Rupees 10 as against Rupees 2.89 in the previous year.
- The turnover/ operating income increased by 9.53 percent.
- The contribution to the national exchequer by way of dividends, interest income, corporate tax, excise duty, custom duty, and other duties went up by Rupees 7158 Crores (USD16 billion), that is, from Rupees 81,926 Crores (USD191 billion) in 2002-03 to Rupees 89,025 Crores (USD207 billion) in 2003-04, or an increase of 8.74 percent, thereby helping in the mobilization of funds for financing the needs of planned development.
- Central public sector enterprises paid Rupees 15,283 Crores (USD37 billion) as dividend as compared to Rupees 13,768 Crores (USD32 billion) in the previous

year, or a growth of about 11 percent. The dividend payout ratio went down to 28.74 percent from 42.50 percent in the previous year.

- Export earnings were Rupees 34,893 Crores (USD81 billion)—a growth of 21 percent from Rupees 26,296 Crores (USD67 billion) earned the previous year. The earnings played a major role in easing the balance of payments by promoting import substitution and exports.

Given the scope of economic activities that they cover, it was inevitable that some of the public sector enterprises would be saddled with excess manpower, which resulted in low productivity. Some 242 CPSEs employed about 1.766 million employees in 2003–04 as compared to 1.866 million in the previous year. Government had initiated a voluntary retirement scheme in public sector enterprises during 1998 to help them shed excess manpower and to improve the age-mix and the skill-mix of employees. At the same time, training and retraining of employees were strengthened to bring about overall productivity improvement. By 31 March 2004, more than half a million employees have availed of the voluntary retirement scheme which was initiated in 1998. The compensation per employee was Rupees 248,691 (USD578) in absolute terms.

To their credit, the public enterprises have helped in development of backward regions, the provision of public utilities, technological development, the development of managerial competencies, and the generation of jobs. As an instrument of development, the SOEs helped in reducing poverty, narrowing regional disparities and building the foundation of a strong industrial base. They have been the forerunners in trying out and implementing superior management practices in the Indian environment, namely strategic management, total quality management, ISO9000, knowledge management, productivity management, quality circles, and so on (Khader, 2004).

However, counterfactual evidence suggests that the state enterprises could have done more, were it not for inefficiencies inherent in the public bureaucracy. Scholars are agreed that state firms were stymied by diverse and often contradictory expectations from the very beginning. While the CPSEs were expected to run on commercial lines, in practice they functioned as a policy tool of the government. Due to the very nature of the relationship between the CPSEs and the government, inefficiencies crept into their functioning, leading to a spate of criticisms on count of time and cost overruns in project implementation, lack of modernization and technology upgrading, overstaffing, low efficiency, and profitability (Dewan, 2004b).

Governance-wise, SOEs paid little attention to opportunity costs of investment (the moral hazard problem). They were burdened with insider governance; direct monitoring (and meddling) by line ministries; administratively determined or politically negotiated prices, inputs, and production levels; and poor, idiosyncratic, and opaque accounting. Finance-wise, SOEs underperformed (shirking) because of soft budget constraints, direct state financing, and state control over domestic savings and capital markets. As an industrial organization, each SOE existed as a monopoly or single franchise, viewing competition as wasteful, and mistaking firm interest for public interest. It was like a social contract embedded within the firm. From a policy standpoint, SOEs were a confused lot, supplying multiple functions (social safety net, job generator, supplier of public goods). It was therefore difficult to measure and enforce compliance (Victor, 2003).

It is no surprise that today, there appears to be a sea change in public expectations over SOEs. Current thinking now heavily tilts toward commercial results and long-term viability.



## **THE REFORMS AND SOME POSITIVE CONSEQUENCES**

In July 1991 the central government announced a new industrial policy, which included a series of measures to unshackle Indian industry from myriad administrative and legal controls, limit the role of the public sector to eight core areas and selectively open the rest for private participation. The core areas included arms and ammunition and other defense equipment; atomic energy; coal and lignite; mineral oils; mining of iron ore and other minerals; atomic energy and railway transport. Since then, many measures have been taken that included abolishing of industrial licensing, de-reservation of some items manufactured by small industries and the public sector, advancing foreign direct investment, wider access to foreign funds and technology, removal of restrictions on imports, financial sector reform, introduction of product patents, increased focus on building infrastructure, and corporate governance. However, many bottlenecks remain. The reform process still continues and issues relating to infrastructure development, rightsizing the government, reorientation of the civil service, fiscal deficit, labor markets, and public sector reform are being addressed.

As regards public enterprises, starting with the idea to sell public sector equities, the government has considered various approaches that included restructuring, disinvestment and privatization. The broad components of the new policy are as follows:

- Investment through strategic sale and privatization
- Selling shares to the public
- Restructuring and reviving potentially viable SOEs and closing down poorly-performing ones
- Giving workers protection through labor reform
- Empowering boards and stakeholders
- Promoting mergers and acquisitions.

The new United Progressive Alliance (UPA) was established in 2004 and issued a Common Minimum Program (CMP) containing the following specific points:

- Commitment to a strong and effective public sector whose social objectives are met by its commercial functioning. This is to be tempered by the need for selectivity and strategic focus.
- Full managerial and commercial autonomy to successful, profit-making companies operating in a competitive environment.
- Generally, profit making companies to be retained in the public sector. All privatization will be considered on a transparent and consultative basis.
- Retention of existing *Navaratna* companies in the public sector, while these companies raise resources from the capital market.
- Revitalization of somewhat sick public sector companies. However, chronically loss-making companies will be sold off or closed after all workers have received their legitimate dues and compensation. The UPA will induce the private sector to take care of turning round companies that have potential for revival.
- Resistance to the re-emergence of any monopoly that only restricts competition.
- Use of privatization revenues for designated social sector schemes.
- Public sector companies and nationalized banks to be encouraged to enter capital market to raise resources and offer new investment avenues to retail investors.

The government has also announced the establishment of a Board for the Reconstruction of Public Sector Enterprises to guide the government policy with regard to SOEs. The Board will advise government on measures to be taken to restructure central

SOEs including those in which disinvestment or closure or sale is justified in national interest. Such moves, according to Dewan (2004c), remove the policy uncertainty vis-à-vis the SOEs. All things considered, the thrust now would be on increasing competition and monitoring monopoly situations that may restrict it. With managerial autonomy and empowerment of boards, SOEs would be fully equipped to face up to global competition and would emerge as strong global players.

Since the launch of the reforms, the CPSEs have been taking initiatives to adjust to new economic realities and many of them were quite successful. An ET-CMIE survey (*Economic Times*, 12 September 2003) revealed that unlisted companies, led by CPSEs, outperformed the listed companies in terms of profit and sales, during 2002. These CPSEs were hailed by the media as the “hidden jewels” of India. Bombay Stock Exchange data have shown also that the public sector index increased by 3.2 times as against the BSE-500 which increased by 2.1 times in the period from February 1999 to August 2004 (Dhawan, 2004). Several public enterprises in India are publicly listed and actively traded with thousands of individual investors owning shares alongside the government (Reddy, 2004). Likewise, worthy of mention is a SEBI 2003 corporate governance report which indicated that stock analysts had clearly established a positive correlation between good corporate governance and SOE financial returns. Recent events suggest that many public enterprises are not only dominating the Indian scene—the market capitalization of public enterprises as proportion of the total market cap (estimated at about 20 percent of the Bombay Stock Exchange) is probably among the highest in the world—but have become important players in the markets for mining, oil, gas, earthmoving, steel, banking, engineering, and heavy electricals competing with Fortune 500 MNCs (Reddy, 2004).

Successful and profit making SOEs have been promised “full managerial and commercial autonomy” operating in a competitive economy. The key was to restructure relations between the government and SOEs so that the SOEs enjoy the desired autonomy and accountability and remain free from political interference. To limit the role of the government to policy direction, the following steps have been taken with respect to SOEs: performance contracting and the creation of *Navratnas* and *Miniratnas*.

### **Performance contracting**

In an attempt to bring the right balance between accountability and autonomy, the government of India carried out a system of performance contracting by entering into a Memorandum of Understanding with each SOE that has not been referred to the Bureau Industrial Finance Restructuring and is not insignificant in size, beginning in 1988. The MOU defines clearly the relationship of the SOE with the government and delineates their respective roles. It is a freely negotiated performance agreement between government as owners of public enterprises and the SOEs. The enterprises commit to meet the targets set in the agreement at the beginning of the year. The performance targets are measured on a five-point scale for all crucial parameters like production, sales, profits, among others. The MOU covers both financial performance as well as non-financial ones. The contents of these MOUs include the agreed mission and objectives of the SOE, commitments, the level of assistance to be given by the government, monitoring and evaluation parameters, and rewards for good performance. Starting with four CPSEs in 1987–88, the number of SOEs covered by MOUs has gone up to 96 in 2003–04, out of which 53 were rated as excellent and 23 as good.

Specifically, the MOUs lay down procedures based upon the guidelines issued by the Department of Public Enterprises. These guidelines are refined every year and for the year 2005-2006 cover the following:

- *Mission and objectives:* SOEs should take note of new opportunities that may have emerged during the year. The objectives should be comprehensive and related to the mission of the enterprise and listed in order of priority, and include both quantitative and qualitative aspects, commercial and non-commercial aspects, static as well as dynamic aspects of the operations and approved by the SOE Board.
- *Exercise of autonomy:* SOEs can exercise self-direction through the delegation of financial powers relating to capital expenditure, joint ventures, strategic alliances, organizational restructuring, creation and winding up of posts, and human resource management. SOEs can specify other areas in which further autonomy and financial powers are desired, but they have to justify how these additional powers will stimulate the growth of the enterprise.
- *Performance appraisal:* The MOU lists down performance evaluation parameters and targets that keep in mind strategic objectives, profitability, productivity and growth. Critical aspects such as modernisation, technology upgrading, mergers and acquisitions, diversification, organizational restructuring, manpower rationalization, employee skilling and others having bearing on the long term competitiveness of the SOE are considered. Due emphasis is placed also on project implementation, R & D, occupational safety, environmental protection, customer satisfaction, quality improvement, and corporate plan updating. However, criteria relating to any “social (or, non-commercial) obligation” unless it is mandated by the government are not to be included. The weights for static financial parameters such as profitability, and for dynamic parameters such as quality are 50 percent and 30 percent, respectively. Sector specific parameters that include macro factors that are beyond the control of the enterprise, and enterprise specific parameters which are important from the viewpoint of the society (such as environmental protection) are given 10 percent each. However, these parameters and weights would vary depending upon the nature of the enterprise. The guidelines also specify that the targets should be realistic, growth oriented and significantly higher than targets and achievements of the previous year.
- *Government commitments:* The assistance requested of government should be relevant and related to agreed performance targets. These obligations should have direct bearing on the functioning of the enterprise and their impact must be measurable.
- *Action plan:* The implementation plan should indicate timelines for meeting the SOE objectives, frequency of monitoring to be done by the Board and the Administrative ministry, and parameters for the annual evaluation to be done by the Department of Public Enterprises.

Since the SOE budget has implications on performance targets, the negotiation meetings are deliberately scheduled after the budget presentation to central authorities. The appropriateness of the parameters and weights and the soundness of the targets, as well as the commitments of the government are examined in detail at the negotiation meetings. The MOUs are finalized thereafter. After approval, these are signed by the CEOs of the SOEs and the Secretaries of the supervising ministries.

The evaluation of the MOU-covered enterprises is done at the end of the year. When the performance exceeds the targets, the enterprise is ranked as “excellent” and when the targets are just met, the enterprise gets a “very good” rating. When the targets are not met, the enterprise is rated either “fair” or “poor”.

Good performance is rewarded through a performance incentive system. The incentives are mostly non-monetary. The MOU system in India does not have any monetary incentive system yet for the top management, but high-performing staff and workers receive monetary rewards. The Department of Public Enterprises guidelines permit 5 percent of profits to be allocated to employees as performance linked bonus. However, the government is considering an incentive package for CEOs and Executive Directors of SOEs as suggested by a group of experts on empowerment of central public sector enterprises. The package could include performance linked bonuses, hassle-free foreign trips and greater freedom to take commercial decisions.

The non-monetary part consists of MOU Awards for excellent performance, instituted by the Department of Public Enterprises. These awards are presented only to those enterprises whose performance gets an “excellent” score. On the basis of the audited results for year 2002-03, 46 were rated as excellent. Additional criteria were set to identify the top 10 enterprises: the net profit of the current year should be higher than the net profit of the previous year, and the enterprise has no recent record of losses. These enterprises receive the Prime Minister’s Shield and the rest are awarded merit certificates.

The full power of the MOU is yet to be realized. Its internalization by the SOEs is the most crucial issue at this time. A study conducted by Vithal (2001)<sup>in</sup> 10 enterprises on MOU “systems” that needed to be “interiorized” by management and staff—for instance, corporate plans and the budgetary system, infrastructure, and training—revealed that out of some 15 systems, only four are attended to by the enterprises. The Vithal study made several conclusions:

- Public enterprises do not look at the MOU as an opportunity to link the enterprise with emerging strategies in the wake of liberalization. Indian enterprises need to achieve international competitiveness and therefore should incorporate international level benchmarking in their targets.
- Very few enterprises carefully monitor the link between actual performance and MOU targets, although some enterprises have linked the MOU to their Strategic Business Units in a more direct manner.
- Attention needs to be given to dysfunctions in budgeting and setting targets. A serious observation by one particular enterprise is that the MOU targets fixed around September vary to a great extent with their performance budget targets fixed in February, which are more realistic.

### **Formation of *Navratnas* and *Mini-Ratnas***

In 1997, Government started the process of devolution of powers to central public sector enterprises by granting them the status of *Navratnas* and *Mini-Ratnas*. In Hindi (Indian language), they mean new jewels and little jewels, respectively. It is useful to discuss the *Mini-Ratnas* first. All SOEs that have earned profits continuously in the last three years, have pretax profits more than Rupees 30 Crores (USD69 million) in at least one of the three years and have positive net worth are known as Category I *Mini-Ratnas*. SOEs that have made profits continuously for the last three years, but have lower pre-tax profits than category I *Mini-Ratnas*, and have positive net worth are classified as Category II *Mini-Ratnas*. Furthermore, only those SOEs which have not defaulted in the repayment of loans and interest payments and do not depend upon the government for budgetary support or guarantees are eligible for this status. It is the administrative Ministries which decides which category to confer to the eligible SOEs.

*Mini-Ratnas* are allowed to incur capital expenditure on new projects, and purchase new equipment without government approval up to 300 Crores (USD690 million) (for

Category I firms) and 150 Crores (USD345 million) (for Category II firms). Their Boards have also been delegated powers to establish joint ventures, subsidiaries in India and overseas offices subject to certain ceilings. They can also enter into technology joint ventures/strategic alliances, obtain technology know-how by purchase or other arrangements, structure and implement schemes relating to personnel and human resource management, and rationalize the SOE through voluntary or compulsory retirement schemes.

Mini-*Ratnas* can exercise enhanced delegation of powers after broad basing the board by inducting at least three non-official directors in the board while ensuring that the number of non-official directors is increased to one third of the total strength of the board at the earliest time. These non-official directors are selected through a search committee whose members include the SOE chairperson, the Secretary of the Department of Public Enterprises, the Secretary of the administrative ministry, and some eminent non-official(s).

*Navratnas* are higher category SOEs which Mini-*Ratnas* can graduate into. Mini-*Ratnas* Category I which obtained “excellent” or “very good” MOU ratings in three of the last five years and a “composite score” of 60, are eligible for the *Navratnas* status. The composite score is based on six performance indicators that include net profit to net worth, manpower cost to cost of production/services, PBDIT to capital employed, PBDIT to turnover, earning per share, and inter-sectoral performance (net profit to net worth) relative to the sector to which the SOE belongs.

The Government has enhanced the autonomy and the delegation of powers to *Navratnas* to support their effort to become global giants in line with the Common Minimum Program. The CMP stipulates that the *Navratnas* would be retained in the public sector with freedom to raise resources from the market. *Navratnas* can incur capital expenditure without any monetary ceiling, enter into technology joint ventures, create and wind up all posts including and up to those of board level directors, undertake human resource development and training, develop voluntary retirement schemes, raise debt from domestic capital markets and from borrowings from international markets subject to government guidelines, and establish financial joint ventures and wholly owned subsidiaries in India and abroad subject to ceilings of Rs.200 Crores (USD470 million) in any one project limited to five percent of their net worth and 15 percent of the net worth of the SOEs in all joint ventures put together.

*Navratnas* are required to have a transparent and effective system of monitoring and a firmly established audit committee. They must seek no financial support from government or have contingent liability. Their new powers can be exercised only after they restructure their boards. Four non-official directors of an impeccable stature and background must sit on each SOE board. This number should be higher for those SOEs which have more functional directors. The number of non-official directors must be equal to at least one third of the Board.

An apex committee headed by the Cabinet Secretary in the case of *Navratnas* and an inter-ministerial committee headed by the Secretary of the Department of Public Enterprises in the case of Mini-*Ratnas* would undertake the performance review of the performance of the SOEs, including whether to elevate, or divest them of, their current status. So far experience suggests that consistent improvements in the overall performance of the SOEs amply demonstrate the fact that further grant of operational autonomy could only be beneficial to the economy (Dewan, 2004a).

## THE NEED FOR MORE CHANGES

Clearly the antecedent conditions relating to the functioning of the Central Public Sector Enterprises (CPSEs), on account of both internal and external factors, do not exist any longer (Dewan, 2004b). CPSEs have to be prepared for meeting the challenge of global competition and achieving commercial goals, more than ever before. They must respond proactively to the market dynamics by making decisions faster and taking bona fide commercial risks. More changes are necessary in the following areas: public sector management; intergovernmental relationships, particularly involving Parliament and regulatory agencies; and internal organizational management.

### **An end to public policy equivocation**

Despite many studies and efforts, the government has no clear policy on which objectives—commercial or social—SOEs should focus their energies on. Empirical findings have indicated that budgetary support and off-budget subsidies for SOEs, as well as price fixing based on political and social considerations, often tend to distort costs, making it difficult to decipher real commercial performance. Target groups would have been better off had such subsidies been given directly to them. Often, it is the shareholders themselves, including government, who pay the price. For instance, a forced takeover of a sick company or a product line or a dictated pricing formula or control would impinge on the shareholder value (Reddy, 2004).

Part of the reason is prolonged attachment to something that has already elapsed. According to Sahai (2004), for the first twenty years, the public sector did not make any profits, and no one raised any objection. The basic economic infrastructure that was laid was due mainly to the contribution made by SOEs. Within a few decades, from the status of a colonial country, India emerged as the tenth most industrialized country of the world. With new economic and social conditions, however, appeal to this kind of reasoning no longer holds, as SOEs are now expected to compete against private sector and produce economic results.

But SOEs continue to be guided by ambiguous public policy which only creates uncertainties about their role and responsibilities. The ambiguity is attributable to changes in government. As Ghuman (1999) observes, there is a close link between government change and the type and aims of specific reforms, with each phase co-existing with the tenure of the government. But policy vacillation sends the wrong signals to SOE management, which tends to take refuge in this vague policy environment to justify its otherwise non-tenable and costly decisions. This is not to say that SOEs should stick to purely commercial objectives. By their very nature, SOEs have to fulfill public policy goals. Research has also shown that firms that pay more attention to what is called triple bottom line, that is, economic, social and environmental performance generates higher economic returns in the long term. Striking a balance between commercial and socio-economic objectives is the key. An end to policy uncertainty means laying down in very clear language the SOEs terms of engagement. As OECD advises, any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations, and disclosed to the general public (Isaksson, 2005). Likewise, related costs should be covered in a transparent manner.

To be more transparent means developing disclosure policies for the satisfaction of stakeholders. Again, the OECD suggests that the state ownership policy should fully recognize the state-owned enterprises' responsibilities towards stakeholders and request

that they report on their relations with stakeholders. In this respect, the government, the coordinating or ownership entity and SOEs themselves, in their pursuit of important public policy objectives, should recognize and respect stakeholders' rights established by law or through mutual agreements (Isaksson, 2005). To be more transparent also means there should be mechanisms by which enterprises are forced to debate openly, directives or choices that affect shareholder value or the long-term sustainability of the public sector enterprises. While the dominant shareholder (government) will have its rights in pursuing its thinking, decisions have to be cleared through the authority of the shareholders (Reddy, 2004). In this regard, the state and state-owned enterprises should recognize the rights of all shareholders and ensure their equitable treatment and equal access to corporate information. They should develop an active policy of communication and consultation with all shareholders, and facilitate the participation of minority shareholders in shareholder meetings in order to allow them to take part in fundamental corporate decisions (Isaksson, 2005). Externally, the aim of performance information is to aid stakeholders and management in drawing informed conclusions about operations from what is provided in published documentation, thus providing a sound basis for decision-making (Whitfield, 2003).

Thus, a clear, stable and conducive macro-policy environment is the felt need of the hour. SOEs embody national assets that should not be subjected to a particular political party's policies and programs. Therefore, the government should come out with a policy paper that includes among others (a) areas in which the public sector enterprises would be allowed to function based on commercial grounds, (b) laying down clearly the social objectives and functions of SOEs, (c) establishing clearly the rules for privatization,<sup>1</sup> and (d) ensuring fair treatment of SOE shareholders and stakeholders.

### **Government role: policy guidance, not dominance**

Necessarily, public sector enterprises have to work under the aegis of government, their major shareholder. Article 12 of the Indian constitution provides the foundation for this control. In practice, government control has led to SOEs being managed in a manner similar to how the public bureaucracy functions. Besides the administrative ministry which exercises direct supervision over the SOEs under its wings, the Department of Public Enterprises provides overall guidance for all state firms. It functions as coordinating agency and issues guideposts for their effective management. It also conducts in-depth studies, monitors and evaluates their performance, appraises proposals for their restructuring, and approves joint ventures with private sector partners.

The key question is whether under the changed economic context, they can continue to function under bureaucratic style systems, which include multiple controls exercised by various government agencies, in order to deliver commercial results that are expected of them.<sup>2</sup> The current "backseat driving" by Indian bureaucrats and politicians, in a context

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<sup>1</sup> A recent Federation of Indian Chambers of Commerce and Industry (FICCI) survey on disinvestment concluded that 75 percent of restructuring required for repositioning SOEs could be achieved without privatization (Khader, 2004).

<sup>2</sup> Interestingly, Jawahar Lal Nehru, who was responsible for making the public sector a pillar of Indian economic strength, presaged the dilemma to be faced by Indian SOEs when he said after independence: "The way a Government functions is not exactly the way that business houses and enterprises normally function...When one deals with a plant and an enterprise where quick decisions are necessary, this may make a difference between success and failure. I have no doubt that normal governmental procedure applied to a public enterprise of this kind will lead to the failure of that enterprise". But the essence of this message seems to have been lost over the years and was never translated into practice.

where SOEs are treated as an extended arm of the government, is the core issue. Bureaucrats exercise oversight powers without any accountability while the Chief Executive Officers are held responsible for the SOEs' poor performance. (In truth, if all major decisions by SOEs require prior approval, advice, guidance or concurrence of the government, management cannot be held accountable for the results.) The long-term interests of the enterprise are sacrificed in favor of vested interests of entrenched politicians. The influence of government over management is often subtle and not transparent: it is generally expected that wishes or "orders" are complied with without question. Such meddling occurs on top of explicit restrictions found in the SOEs' articles of association, issuances by the Bureau of Public Enterprises, central government guidelines and directions, the procedures for scrutinizing investment funding, choice of projects, wage policy, and all other regulations which are common to both the public and private sectors.

That Government is a major shareholder in public sector enterprises raises typical issues of control that are also prevalent in private firms which do not have diversified ownership. But there is a crucial difference. In SOEs, the representatives of government as the dominant owner are only fiduciaries with relatively short tenures that could hamper accountability. In both the cases the structure and practice of monitoring, control, and superintendence seem to go beyond the typical corporate governance mechanisms, to direct control over management (Reddy, 2002). This contravenes what OECD suggests: The state should act as an informed and active owner and lay down a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is executed in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness (Isaksson, 2005).

Arguably, government as major shareholder has rights which cannot be denied. But the state as an active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities, according to OECD, include

- Being represented at the general shareholders meetings and voting the state shares;
- Establishing well structured and transparent board nomination processes in fully or majority owned SOEs, and actively participating in the nomination of all SOEs' boards;
- Setting up reporting systems allowing regular monitoring and assessment of SOE performance;
- When permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control organs; and
- Ensuring that remuneration schemes for SOE board members foster the long-term interest of the company and can attract and motivate qualified professionals (Isaksson, 2005).

Khader (2004) contends that what is more important is not who owns the company but how much freedom is given to the management. The separation of management from ownership can be achieved by restructuring the existing practice of handpicking the chairman, and by empowering the boards with more authority and withdrawing government intervention. This is consistent with OECD's prompting that the government should not be involved in the day-to-day management of SOEs; instead it should allow them full operational autonomy to achieve their defined objectives. The state should let defer to SOE boards and respect their independence (Isaksson, 2005).



De-linking SOEs from the control of the Ministry officials and functionaries would create enough space for the SOEs to function effectively and focus on performance rather than “conformance”. Stronger measures must also be adopted. For instance, there should be a clear separation between the state’s ownership function and other state functions that may influence the conditions for SOEs, particularly with regard to market regulation (Isaksson, 2005). Article of 12 of the constitution, is fundamentally wrong and is inconsistent with the principles of the setting up SOEs as corporate entities (Ahluwalia, 2004) and should be amended. To really free the SOEs from government control, this anomaly has to be set right and public sector employees should be categorized separately from the government employees.

### **Streamlining review and audit mechanisms**

Presently, various government authorities carry out the review and audit of the performance and accounts of the SOEs. These include the Parliamentary Standing Committee, Internal Audit, the Controller and Auditor General of India, the Chief Vigilance Commission besides the Department of Public Enterprises and administrative ministries. Presently, chartered accountant firms are appointed by the SOE boards to carry out audits besides the audit committee and the internal audit wing of the enterprise. The existence of specific state control procedures does not substitute for an independent external audit, according to the OECD (Isaksson, 2005). Indeed, the number of coordinating and supervisory roles might yet increase in the name of governance (Raj, 2002). There is a need to rationalize and optimize these multiple review mechanisms.

As result of these multiple appraisals, the SOE management tends to take decisions that avoid, rather than manage, risks. Yet risk-taking is an essential component of the commercial operation of any commercial undertaking. To rationalize audit, a framework must be established on an integrated whole-of-public sector approach on a consistent and comparable basis. It must take a holistic approach to managing strategic, operational, compliance and financial risk. Government must simplify the review procedure and generate uniform standards that must be followed by review authorities.

### **Empowerment of boards**

Given the need and importance of corporate governance, the debate has shifted to more substantive issues that include board constitution and empowerment. As the OECD maintains, the state should let SOE boards exercise their responsibilities and respect their independence (Isaksson, 2005). A focus on board composition makes the board autonomous with powers to take critical financial and strategic decisions requiring real time response (Dewan, 2004c). To give a good example, Ramchandran (2004) narrates that Indian Oil Corporation, with an independent, competent, and educated Board at the helm, was able renegotiate the terms of setting up two prominent projects, Paradip and Panipat Refineries, when it was learned that they were not yielding reasonable returns.

A truly effective board with sufficient independence and competent directors could act as cushion and insulate the SOE from the vagaries of ministry officials and political functionaries. Restructuring the relations between the government and the SOEs would create the needed space for the boards to balance the “performance” criteria better with “conformance” requirements (Reddy, 2002). The board and the CEO must articulate the concerns of the SOEs from a long-term perspective. The government for its part should limit itself to policy formulation and evaluation, and devolve the desired autonomy in order to empower boards. Such devolution should cover all areas that are necessary for the board to respond proactively to the changes in the market place. The time has come to go

beyond the CPSEs and bring the other public sector corporations in the ambit of corporate governance.

#### *Composition of the board*

Normally, the SOE board comprises of full time functional directors (not exceeding 50 percent of the Board), representatives of the administrative ministry (not more than one sixth of the actual strength and in no case more than two), non-official part time directors (at least one third of the Board) and sometimes workers representatives<sup>3</sup>. The Public Enterprises Selection Board (PESB) has been mandated to recruit, select and promote Chief Executives and functional directors, normally from within or outside the SOE for a term of three years that can be renewed till they reach the age of superannuation. The recommendations of the PESB have to be cleared by the appointments committee of the Cabinet. Generally, additional or joint secretaries of the concerned department are nominated as representative of the Ministry. With frequent transfers in the Ministry, the individual nominees also keep on changing. All such appointments are further subject to clearance by the Central Vigilance Commission. The administrative ministry, the Department of Public Enterprises and PESB have been vested with powers to nominate non-official directors. The SOE board does not have any role or authority for such appointments, hence cannot do any succession planning or safeguard the quality of members.

Clause 49 of the listing agreement with SEBI is applicable to all listed SOEs. The following are its salient features as far as composition of the Board is concerned:

- The board of directors shall have an optimum combination of executive and non-executive directors with not less than 50 percent of the board comprising of non-executive directors.
- If the board chairman is a non-executive director, at least one third should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors. An independent director is one who does not have any material pecuniary relationship or transactions with the company, its promoters, directors, senior management, holding company, subsidiaries and associates which may affect the independence of the director. If any person related to promoters or occupying management position at the board level or at one level below the board, has been an executive of a company in the previous three years or has been a partner or an executive during the preceding three years, or is a material supplier, service provider, or customer, or a lessor or lessee and is a substantial share holder (owning at least 2 percent of the of voting block) cannot be an independent director of the board.

A review undertaken in 2003 of corporate governance in 18 listed and 6 unlisted public sector enterprises revealed that many SOEs have not complied with the provisions of Clause 49. Some key posts in the board remained unfilled for a long time. Attendance of non-executive directors was not regular in a significant number of SOEs. As result, the audit committee was not properly constituted in most SOEs. This is a common finding with respect to both listed and unlisted SOEs. The annual general meeting was not attended by a significant number of both executive and non-executive directors (Report

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<sup>3</sup> If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence (Isaksson, 2005).

No. 4 of 2003 (SOEs)). It appears that many board members do not find the work of the board stimulating enough or take it part of their routine job. In such a situation, a board would find it difficult to take an independent view and render sound decisions, which may put at risk the long term interests and viability of the SOE.

Public enterprises have argued that the government's representatives be declared as part of the independent directors. But these official directors represent the dominant shareholder and they are in any case full-time salaried bureaucrats. Fortunately, the SEBI has rejected such arguments. As a result, all well known SOEs (among them, the Oil and Natural Gas Commission, the Indian Oil Corporation, the Gas Authority of India, and the National Thermal Corporation—all *Navratnas*) have started looking for independent directors. Yet in the final analysis, a key issue is not the number of independent directors, nor their affiliations, but their quality. The appointment of independent directors who have the requisite experience, attitude, and knowledge of the market place is essential to make an objective assessment of the strategies and performance of the SOEs.

At present most of the central SOEs are managed by a CEO designated as chairperson and managing director, which violates the tenet that there should be a separation between board and management. Ideally, the boards of SOEs should be composed so that they can exercise objective and independent judgment. Good practice calls for the Chair to be separate from the CEO (Isaksson, 2005). But it has been a practice that has evolved in order to avoid a worse result—political nominees being appointed as chairperson. The government has earlier rightly decided that Members of Parliament cannot be appointed to the boards of the central SOEs. To attract talent and right kind of people, the compensation system along with a credible scheme of reward and punishment for the board members needs to be overhauled. Capacity building of board members would be crucial for the effective functioning of the board. SCOPE is in an excellent position to take this course of action. Besides training, accreditation of board members would help in the process of choosing the right board members. While waiting for a good accreditation system, a national roster of qualified candidates could be considered.

#### *Responsibilities of the board*

Undoubtedly, the primary responsibility of the board is to ensure the SOE's prosperity in the long run. The key question is what should the board be doing in the face of reduced budgetary support from the government so that the SOE survives? Merely having the right board constitution is not going to ensure survival, even if it provides the right starting point. Recent studies have shown that board constitution has a very limited ability to explain managerial decisions and firm valuation.

Therefore the primary responsibility of the board should be to build value. The OECD has laid down the key mandate of SOE boards: to have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. More specifically:

- The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably.
- SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity. They should have the power to appoint and remove the CEO.
- When necessary, SOE boards should set up specialized committees to support the full board in performing its functions, particularly in respect to audit, risk

management and remuneration. SOE boards should carry out an annual evaluation to appraise their performance (Isaksson, 2005).

*Roles that cannot be abandoned*

SOEs in a developing country like India, where markets and institutions are at a nascent stage, have to play larger-than-life roles. One traditional role that cannot yet be abandoned by SOEs is that of harbinger of industrial efficiency. To be sure, Indian SOEs have been plagued with the woes of Russian types of socialist system, but they can augment private sector initiatives in areas where it is weak. If in 1950's steel manufacturing has been the higher productive sector and the nation was lacking in private initiatives and capabilities in that sector, state intervention to promote private initiatives and augment both capability building and utilization has been appropriate. Once that is achieved, SOEs have to move out of the sector. What is true then is still dead on target today (Nath, 2004).

As choice SOEs are divested—only nuclear power, defense and railroads were left in the strategic category while everything else was eligible for privatization—those which remain in government hands must still pick up the slack. The experiences in Eastern European countries and the former Soviet Union have shown that market institutions do not develop spontaneously once SOEs are privatized. The consensus now is in favor of establishing an institutional framework conducive to promoting competition before privatizing firms (Kapur and Ramamurti, 2005). Given this situation, the Indian government has introduced a duopolistic market ownership structure, in which private companies would be allowed to get license and operate in competition with SOEs. The government also set up joint ventures between domestic and foreign companies. An obvious example is the joint-venture strategy in the telecommunications sector. To promote a competitive environment in which local players are not at a disadvantage, the strategy clearly favored giving Indian telecom companies exposure to expertise (so that they could gain experience) and acquiring it through technology transfer (Dash, 2003).

Deregulation of sectors in which Indian SOEs operated preceded privatization. Airlines, telecommunications, power, and all manufacturing sectors (e.g., oil, petrochemicals, steel) were deregulated in some measure long before SOEs were privatized. But in 2002, several years after deregulation, SOEs were still dominant in many of these sectors. Today that is still the case. But deregulation has a salutary effect on SOEs. Again, a competitive framework seemed to have resulted from deregulation (rather than from outright privatization). It did force internal reforms in SOEs. Competition put pressure on SOEs to lower costs, which, in turn, reinforced moves to right size the SOE workforce. Labor union support for the downsizing was obtained by making the schemes voluntary, with generous compensation package for early retirees. Voluntary retirement schemes (VRS) gradually spread to SOEs in nearly all sectors and have become an important instrument for all large organized sector employees, in both public and private sector enterprises. A policy of gradualism also gave government time to make policy reforms in areas such as price controls and subsidies, as raising prices or ending cross subsidization are easier done over time than carried out immediately. In the Indian case, this point is exemplified by the petroleum sector, where it took almost a decade to loosen up a system of administered prices under which some products were under-priced (kerosene, diesel) and others were overpriced (gasoline, aviation turbine fuel) (Kapur and Ramamurti, 2005).

## **CHALLENGES**

In view of the significant contribution of the public sector and the dominant role it would continue to play in the Indian economy, improving corporate governance in SOEs has assumed a sense of urgency. Considering the values at stake, it is only reasonable that governments develop their expertise as owners and improve the governance of their enterprises. But while the gains are apparent, practicing corporate governance of state-owned enterprises is a complex task. One paramount challenge is to find the right balance between the government's duty to be an active owner, while desisting from making undue political interference in the management of the company. Another challenge is to make sure that the government does not distort competition in the way it uses its regulatory and supervisory powers (Isaksson, 2005). Given those contexts, what are the lessons to be learned in the Indian public sector?

Considering the various forms, nature and levels of performance of public sector enterprises, a selective, gradual and flexible approach for implementing corporate governance practices is prudent. Besides, even if there are "universal" elements present in various codes and standards, what is more important is how to develop broad policies into more specific outcomes and outputs. The conditions "on the ground" in which the SOEs operate need to be taken into account in formulating an effective corporate governance framework. In all cases, corporate governance must pass the localization test.

Sector characteristics and past performance ought to be considered in determining which SOEs can be granted more autonomy. Devolution of powers may be considered in areas such as capital expenditure, strategic alliances, joint ventures, and internal operations. The key is to find out which ones have an impact on the competitiveness of SOEs even while the role of government is to be confined to policy making. A level playing field can result from restructuring the relations between government and SOEs. The formulation of a clear and stable policy environment would create condition for exercising such devolved powers.

The ownership rights of the government should be exercised with caution so that the capacity of SOEs to function along commercial lines is not impaired, even while they meet the public policy objectives of the government. The government should limit its role to policy formulation and laying down strategic objectives. The government's influence over the SOE should be exercised through a transparent board nomination process.

Legal instruments such as the Company Law should be repealed to make them more market friendly. Initiatives for accelerating use of information technology such as allowing board meetings by video conferencing should be strengthened. These reforms would reduce compliance costs while enhancing the SOEs' effectiveness and level of transparency.

Besides complying with the legal requirements, the board should focus on developing a work culture based on the fundamental values of corporate governance and an understanding of the expectations of various stakeholders. Formulating and enforcing a code of ethics and conduct is another area that deserves attention of the board. This code should encompass areas that include conflict of interest, responsiveness to workers, concern for value of public assets, non-abuse of official position and continuous improvement through professionalism.

Performance indicators should be developed. The government must require both outcome indicators (measures of effectiveness, in terms of the contribution of the relevant SOE outputs to the achievement of both commercial and social outcomes) and output

indicators (measure of efficiency, in terms of the price, quantity and quality of the final output).

If properly carried out, these recommendations should go a long way to ensuring that SOEs behave in an accountable and professional manner that enhances value creation.

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# **CORPORATE GOVERNANCE IN JAPAN: FLEXIBLE ADOPTION OF SHAREHOLDER- ORIENTED PRACTICES**

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## **INTRODUCTION**

Before the 1990s, corporate governance in Japan had never received much attention from a public policy or managerial perspective. One of the reasons for this lack of interest is that Japanese firms adopted the “stakeholder” model of corporate governance in which shareholders were simply treated as one of the stakeholders and their interests were not given priority. This stakeholder model is based on the Japanese industrial system that has been characterized by its tight network of suppliers, buyers, and financial institutions, which is often called *keiretsu*. Many networks exist in Japan, and are known for their extensive cross-shareholdings among group members, affiliated firms and banks (Abegglen and Stalk, 1985; Gerlach, 1992; Sheard, 1994).

In addition, large portions of Japanese stocks have been, and continue to be, owned by “stable” shareholders. These investors own the stocks of affiliate companies not just to gain financial returns (Abegglen and Stalk, 1985). Rather, because these Japanese institutional shareholders are a company’s business partners, cross-shareholdings and stable ownership are expressions of business goodwill, information exchange and mutual monitoring. They provide the foundation for formalizing long-term business relationships (Clark, 1979). Gerlach (1992) reports that as high as 70 to 75 percent of shares owned in Japan belong to the “affiliated stable investors” category, defined as long-term, *keiretsu*-or business- affiliated holders of shares. Consequently, managers of Japanese firms have not paid much interest to the concerns of financial investors who bought, sold, and held shares purely for financial purposes (Charkham, 1994).

Further, investors in Japanese stocks had enjoyed higher returns from their stock investments than they would have gained from other investment alternatives because of the high performance of the Japanese economy which pushed up the stock markets. Investors in Japanese stock markets achieved a nominal return of 17.9 percent or a real return of 11.7 percent during the period between 1962 and 1986 (Aoki, 1989). Thus, despite the lack of priority given to the financial interests of stock investors, there was no strong motivation for those stock investors to care much about how Japanese firms were “governed.”

During the 1990s, however, this situation began to change. Corporate governance started to figure more conspicuously in private sector dealings in Japan for several reasons. First, it became apparent that the traditional governance system in Japan, which was based on main bank monitoring, was no longer effective (Aoki, Patrick, and Sheard, 1994). In the past, Japanese banks played an important monitoring role for their client firms. But due to their own problems as well as to changes in the external environment, Japanese banks ceased to play an effective governance role, especially for large corporations. Second, it is now widely believed that the risky and unwise investment decisions made by many Japanese firms during the “bubble” economy period in the late 1980s were due to the fact



that Japanese managers were not properly monitored by anyone, including banks. After the bubble economy burst, many stock investors suffered huge investment losses. Investors blamed poor governance practices of Japanese firms for the significant drop in share prices (Watanabe and Yamamoto, 1992).

Third, as the growth rate of the Japanese economy “stabilized” at relatively low rates compared to those in the boom years (the 1970s and 1980s), Japanese firms needed to shift their focus on growth and market share to in order to achieve higher profitability and returns (Yoshikawa, 1995). This shift now requires Japanese firms to change their policy on the distribution of interests among the stakeholders. That is, they have to value more highly their own shareholders. If a firm tries to please all stakeholders, whose interests often clash, the outcome is sub-optimal allocation of resources which leads to the sacrifice of firm profitability. Since the corporate governance system affects how senior managers make their resource allocation decisions, there is a growing interest in how Japanese firms should be governed. Today Japanese firms are under strong pressure to shift their focus to shareholders’ interests and firm profitability.

In reaction to these challenges, there have been some changes in corporate governance practices of Japanese firms as well as in regulations. But an important question here is whether these changes are appropriate or adequate to deal with the current governance crisis that Japanese firms are facing. Indeed, many Japanese companies are resisting the shift. In their favor, there persists a skeptical view that this changeover to shareholder-oriented corporate governance is not desirable for Japanese firms (e.g., Itami, 2000). It is often argued that the competitive advantage of Japanese firms lies in their employees’ commitment to their employer firms and in firm-specific know-hows. Hence, there is apprehension that switching to a shareholder model may erode Japanese firms’ long-term competitiveness. This chapter discusses how Japanese firms have responded to these challenges.

This chapter is organized in the following order. The first part presents the traditional corporate governance system based on main bank monitoring in Japan. The discussion touches on the characteristics of the main bank system and its current problems, and canvasses the key findings of a number of empirical studies on the effectiveness of main bank monitoring. The second part reviews recent changes in the ownership structure of Japanese firms, to the extent that they affect corporate governance practices. The third part examines the recent boardroom self-improvements initiated by Japanese firms. The impacts of such ownership changes and corporate-led governance reforms on firm performance are considered in Part 4. The fifth part appraises critically the recent changes in Japan’s commercial code that pertains to corporate governance. Part 6 goes over the practical implications of these changes to other countries. Finally, the case of Nissan is presented in the concluding part. This case is selected to show some best practices that have emerged from the changing environment since the 1990s.

## **TRADITIONAL GOVERNANCE SYSTEM IN JAPAN**

### **Monitoring by the main bank**

A main bank relationship is conventionally defined as a long-term relationship between a debtor firm and a main creditor bank. That is, the firm borrows the largest part of its loans from this bank. The main bank relationship is not characterized by bank loans alone, however. Main banks often hold shares in their client firms and take care of the firms’ cash management accounts. Further, market participants and government regulators perceive the role of the main bank as keeping an eye on its client firms and even

intervening in the management of these firms if required (Aoki, et al., 1994). The main bank's surveillance role unquestioningly has been taken for granted for decades in Japan.

A key feature of the main bank system is that the bank and its client firms share information intensively. This implies that the bank is often intimately involved with strategic and financial planning of its client firms, a situation which provides the bank with unique access to its clients' critical information that other investors usually do not have. Further, through their cash management accounts, the main banks can monitor their client firms' cash movements. According to Sheard (1989), the main bank is able to play the screening and monitoring functions that credit rating agencies or investment analysts usually play in the US context.

These monitoring and information-screening functions are also facilitated by directors dispatched by banks to their client firms. Because of its status as one of the largest shareholders as well as debt providers, the main bank often has representation on the board of its client firms. A bank-dispatched director is frequently one of a few outside board members in Japanese firms (the board is usually dominated by insiders and former employees). Sheard (1997) reports that about a quarter of board members of listed Japanese firms are outsiders, of which 20 percent are dispatched by banks and about 64 percent are transferred from non-financial firms. Hence, on top of regular contacts, the main bank enjoys board-level access to critical information of its client firms.

Main bank monitoring is largely a confidential matter between the bank and its client firms. The exercise of the bank's control rights due to its shareholdings and loan exposure becomes visible only when its client firm is in deep financial trouble. Since the bank can detect its client firm's problems at a relatively early stage by constantly keeping an eye on the firm's credit profile and cash management practices, it can deal with financial troubles before they become more serious. When the main bank catches sight of the firm's financial woes, it can devise a series of steps to rescue the firm, often in consultation with the firm's management. As much as possible, the main bank tries to prevent a situation where the firm's financial crisis is open to easy view. But if public exposure is unavoidable, the bank oftentimes dispatches its senior executive(s) to keep tabs on the management and board of the firm. Banks, especially main banks, have a strong incentive to allow their client firms to recuperate quickly and without much fanfare because of their large loan exposures. If its rescue effort does not help the firm to recover, the bank sometimes finds a merger partner.

### **Empirical findings on main bank monitoring**

There are a number of empirical studies that examine the effect of main bank monitoring on firm performance and policies. Gerlach (1992) investigated the relationship between capital structure and profitability of Japanese firms for the period 1976-1985 and found that borrowing from the main bank was positively associated with profitability of its client firms. This result supports the view that the main bank did play positive monitoring role, although counterfactual evidence might suggest that the firm might have been better off with a more independent surveillance arrangement.

Kaplan (1994) examined the relationship between firm profitability and director transfer from the main bank. His study found that banks were more likely to dispatch directors to firms that recorded losses. This finding suggests that Japanese banks would intervene in management to secure their loans whenever their client firms were in financial troubles. Similarly, Kaplan and Minton (1994) studied the relationship between the appointment of a bank director and poor firm performance and low stock price. They

found that the director's appointment was highly correlated with these poor performance measures.

Kang and Shivdasani (1995) looked at the relationship between non-routine executive succession and firm performance and found that those firms with the strong main bank ties were more likely to experience executive succession when a firm experienced poor performance. Morck and Namamura (1999) investigated the director transfer from banks to their client firms under poor firm performance. They found that banks were more likely to dispatch directors when their client firms had cash flows and liquidity problems if these firms had no main bank relationship. When the firms borrowed under a main bank relationship, the creditor banks tended to send in directors not only when the client firms had cash flows and liquidity problem, but also when their stocks were performing poorly. In terms of firm restructuring, however, they found that banks tended to impose greater pressure on firms that were outside any main bank relationship. This suggests that the main bank might not play an effective disciplinary role when their client firms needed restructuring.

The findings of these studies generally suggest that the main banks did their job (adequately or even excessively) of monitoring their client firms. However, these studies used data in the 1970s and 1980s when the main bank's monitoring power was still relatively strong. The studies' findings may no longer be relevant to the 1990s' situation. In fact, the evidence today suggests that the main bank no longer plays an effective governance role.

Table 1. Summary of empirical findings on main bank monitoring

<b>Author(s) (Year)</b>	<b>Independent variables</b>	<b>Dependent variables</b>	<b>Support for main bank monitoring</b>
Gerlach (1992)	Bank borrowing from main bank	Profitability	Support
Kaplan (1994)	Earnings, stock returns, sales performance	Top executive turnover, directors from banks	Support
Kaplan & Minton (1994)	Earnings, stock performance	Appointment of bank directors	Support
Sheard (1994)	Bank borrowing, top bank loan share	Bank executive on the board	Support
Kang & Shivdasani (1995)	Firm performance	Non-routine top executive succession	Support
Morck & Nakamura (1999)	Cash flows, liquidity, stock performance	Appointment of bank directors	Support

### **A weakening main bank system**

The foundation on which the main bank system was based has changed as early as the 1980s when the domestic bond market was gradually deregulated. Japanese firms began to use the domestic capital market to raise funds. Since the mid-1980s, due to low interest rates, Japanese firms started to issue a large amount of equity convertible bonds in the domestic bond market. The booming stock markets also pushed Japanese firms to issue equity-warrant bonds in the Euromarket. These moves gnawed at the reliance of Japanese firms on bank loans. For example, during the 5-year period from 1985 to 1989, the ratio of bank and insurance firm loans to total debt borrowing of Japanese firms declined from 77 percent to 52 percent (Miyazaki, 1992). This trend shows that when Japanese firms began to use capital market financing more actively, it chipped away the bargaining power of

Japanese banks vis-à-vis their client firms. These changes in corporate finance practices of Japanese firms led Japanese main banks to lose their power to monitor their client firms.

In addition to the increasing bargaining ability of Japanese firms, Japanese banks were weakened by moral hazard problems. After the burst of the bubble economy, large amounts of loans extended by Japanese banks turned into bad debts because their borrowers spent those loans on inefficient and unprofitable projects. These non-performing loans have impaired the balance sheet of Japanese banks substantially. This problem led some banks to go bankrupt and others to merge with their competitors.<sup>1</sup> As a result, Japanese banks could not easily provide financial recovery support to their client firms that are in financial distress. At the same time, large amounts of bad debts suggest that Japanese banks did not play a proper screening and monitoring role when they extended these loans. This raised a credibility problem on the banks' ability to play an effective governance role.

Further, the recent accounting change, which requires Japanese firms and banks to use market value rather than book value in disclosing the extent of their long-term stockholdings, forced them to report unrealized capital losses when the stock prices of their holdings declined. Because of this, corporate and bank shareholders have started to reduce their shareholding positions in other firms (*Nihon Keizai Shimbun*, 22 September 2000). For example, stable shareholdings by banks in total outstanding shares in Japan decreased from 15 percent in 1987 to 5.9 percent in 2003 (NLI Research Institute, 2004). Also, cross shareholdings between banks and other firms have been declining. In fact, since the mid-1990s, the banks' stable and cross-shareholdings have steadily decreased (Figure 1). Smaller shareholding positions should also reduce Japanese banks' bargaining power vis-à-vis their client firms.

At the same time, the corporate scene began to see the rising importance of market investors as a monitoring mechanism due to the changing share ownership structure in Japanese firms. While the monitoring power of Japanese banks has declined, it appears that some stock market investors, especially foreign ones, have started play a more active role. In other words, market investors in stock markets may have started to fill the governance gap left by Japanese banks. How does the changing ownership structure since the 1990s impact on corporate governance in Japanese firms? The next section provides some answers.

## CHANGING OWNERSHIP STRUCTURE

As discussed earlier, many Japanese firms have been linked through extensive cross-shareholding arrangements with their main banks, business partners, and client firms. Also, a large portion of Japanese stocks are owned by "stable" investors (Sheard, 1994). It is often argued that stable investors own their shares primarily to cement and grow stable business relationships rather than to earn a return on their stock investments (Charkham, 1994; Kester, 1991). It is also suggested that they own shares in other firms to ensure constancy in earnings and sales so that they can protect the interests of important stakeholders including employees, management, business partners such as banks, suppliers, and other affiliated firms (Caves and Uekusa, 1976; Nakatani, 1984). Because of these characteristics, Japanese corporate governance is often seen as stakeholder-oriented as

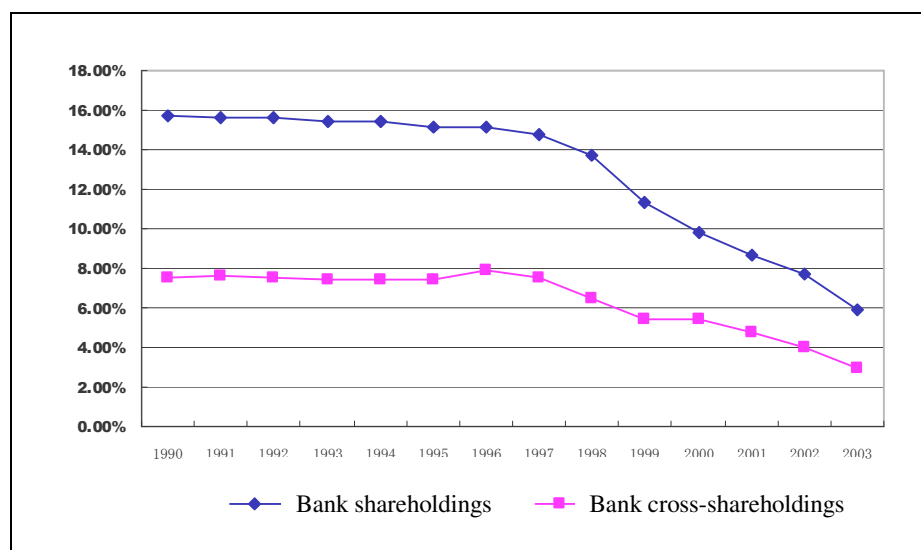
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<sup>1</sup> In fact, major Japanese banks have been consolidated into the four major financial groups (i.e., Mizuho, Sumitomo-Mitsui, Tokyo-Mitsubishi, and UFJ), and it is expected that there will soon be only three major groups if UFJ is successfully merged with Tokyo-Mitsubishi.

opposed to shareholder-oriented (Buhner, Rasheed, Rosenstein, and Yoshikawa, 1998; Weimer and Pape, 1999). Since these stable investors do not aim at maximizing the investment return on their shareholdings, they do not impose much pressure on managers to improve firm performance (Charkham, 1994; Kester, 1991). However, although these domestic shareholders still hold large block positions in Japanese firms, there have been significant changes in ownership structure.

Since the mid-1990s, foreign ownership of Japanese firms has been rising, climbing to about 22 percent of all listed Japanese shares in March 2004.<sup>2</sup> Globalization of stock investment by international institutional investors, especially from the US and Europe, and relatively cheaper Japanese equity prices after the collapse of the bubble economy led foreign investors to a buying spree of Japanese stocks (Nitta, 2000). The steady rise of foreign ownership (Figure 2) is one of the most conspicuous changes in ownership structure since the 1990s.

Foreign investment in Japan tends to be dominated by institutional investors from the US and the UK. Recent data show that US and UK investors held 41.8 percent and 30.9 percent of total foreign shares respectively in 2003.<sup>3</sup> Each foreign investor usually holds only a small block of shares. However, they tend to trade shares more frequently than domestic institutions. Recent official trading data show that foreign investors accounted for over 30 percent of the total trading in the three major stock exchanges (Tokyo, Osaka,



Note: Percentage of bank shareholdings includes cross-shareholdings  
Source: *Kabushiki Mochiai Bunpu Chosa 2003*, NLI Research Institute

Figure 1. Bank shareholdings (total and cross shareholdings)

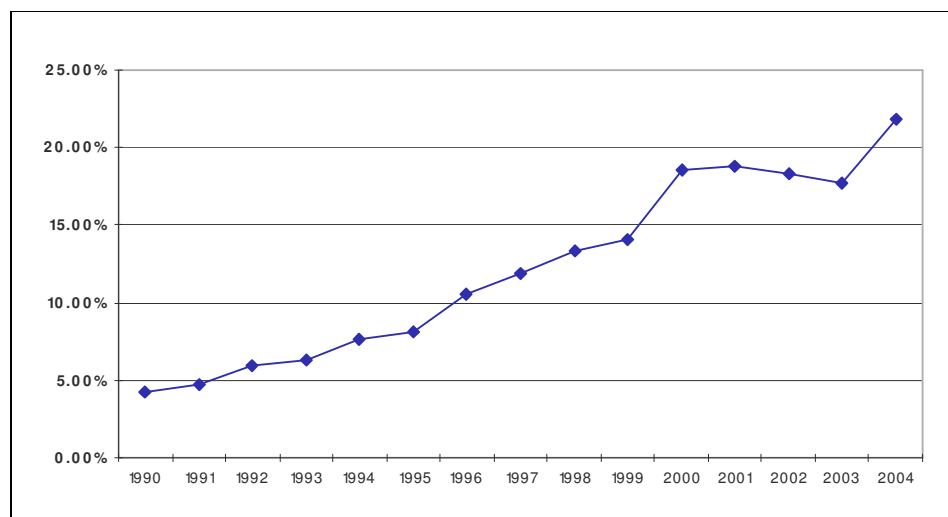
Nagoya) in Japan (Table 2).<sup>4</sup> These data indicate that the foreign investors' relatively smaller stakes are traded very many times at short intervals. Since foreign investors attempt to reduce their investment risk through international portfolio diversification, they

<sup>2</sup> Kabushiki Bunpu Chosa (Stock distribution survey), 2004.

<sup>3</sup> Bank of Japan, 2004.

<sup>4</sup> Fact Book, 2004. Tokyo Stock Exchange.

need to constantly adjust their shareholdings according to any changes in the global capital markets.



Source: *Kabushiki Bunpu Chosa 2004*, Association of Stock Exchanges

Figure 2. Foreign ownership in Japanese firms

Foreign investors are those who buy, sell, and hold shares primarily for investment purposes, as opposed to business relationship purposes. The main investment objective of foreign investors is a high investment return because, unlike stable domestic investors, they only have arm's-length financial relations with firms in which they own shares (Kikuchi, 1999; Sheard, 1997). This means that they are under no constraint, unlike domestic stable investors, to reduce their expectations for maximization of investment return in order to maintain business relationships with firms in which they hold shares.

Table 2. Transaction shares by investment sectors

Year	Foreigners	Banks	Business Firms
1999	27.9%	13.5%	3.5%
2000	29.1%	15.7%	2.4%
2001	34.7%	13.2%	1.7%
2002	31.7%	11.1%	1.9%
2003	31.4%	10.8%	2.1%

Source: *Fact Book 2004*, Tokyo Stock Exchange

Another noticeable trend in ownership structure since the 1990s, corollary to the emergence of foreign owners, is the decline in stable ownership and cross-shareholdings among affiliated firms and banks. Table 3 shows that stable shareholdings among listed Japanese firms went down to 24.3 percent of the market value of all outstanding shares in 2003, from a high 45.6 percent in 1990 (NLI Research Institute, 2004). During the same period, cross-shareholdings decreased from 18.1 percent to 7.6 percent.

These changes in ownership structure suggest that Japanese firms are under greater pressure to accommodate the needs of more return-oriented foreign investors. Because of their arms'-length relationship with firms in which they own shares (which motivates them to look for higher investment returns), foreign investors are more likely to demand that Japanese firms disclose more corporate information. Unlike affiliated domestic investors, they do not have other means to gather such information. In order to maximize their investment returns, foreign investors need as much information as possible to assess the investment prospects of a firm (Yoshikawa and Linton, 2000). In addition, internationally active institutional investors may pressure Japanese firms to adopt global standards of corporate disclosure (Useem, 1998). Hence, those Japanese firms that have sizable foreign owners may have to place greater focus on shareholders' interests.

Table 3. Stable and cross shareholdings

Year	Number of Firms	Stable Shareholdings	Cross-Shareholdings
1990	2078	45.6%	18.1%
1991	2107	45.6%	17.9%
1992	2120	45.7%	17.8%
1993	2161	45.2%	17.6%
1994	2214	44.9%	17.4%
1995	2279	43.4%	17.1%
1996	2341	42.2%	16.3%
1997	2389	40.5%	15.1%
1998	2433	39.9%	13.3%
1999	2487	38.0%	10.9%
2000	2602	33.1%	10.4%
2001	2688	30.2%	9.0%
2002	2674	27.2%	7.9%
2003	2690	24.3%	7.6%

Percentage of stable shareholdings includes cross-shareholdings

Source: *Kabushiki Mochiai Bunpu Chosa 2003*, NLI Research Institute

Indeed, more recent evidence indicates that an increasing number of Japanese firms are slowly adopting more shareholder-oriented practices—such as a greater number of outside directors on the board and greater information disclosure to investors. They are intended to serve the interests of shareholders, rather than satisfy important stakeholders' varied concerns (Yoshikawa and Phan, 2001). A key factor that drives these firms to adopt more shareholder-oriented policies is a shift in ownership structure. The effects of these ownership changes on performance and corporate practices are discussed later.

## RECENT TRENDS IN BOARDROOM REFORM

In Japan, as in many other countries, the board of directors is legally responsible for the management of the corporation. The Japanese board, however, does not delegate its management duties to executive officers (Heftel, 1983). In part, this is because Japanese boards are often composed of only executives and former employees (Abegglen and Stalk, 1985; Charkham, 1994). Unlike an American board, the Japanese board does not define its primary role as that of monitoring top management (Charkham, 1994; Heftel, 1983).

In recent years, however, the rising view that a more shareholder-oriented approach to corporate governance should be adopted in Japan (Kikuchi, 1999; Wakasugi and Yanai, 2000; Watanabe, 1994) has put more pressure on Japanese boards to consider changes. Moreover, falling profits and rising public demand from such interest groups as domestic pension funds and the Japan Corporate Governance Forum emphasize the need for the Japanese board to play a more effective monitoring role of management (*Nihon Keizai Shimbun*, August 14, 2001; *Nikkei Business*, October 25, 1999; Watanabe, 1994). The widespread call to improve the effectiveness of board monitoring continued after the 1997 Asian economic crisis, which exposed the weaknesses of corporate governance in Asian countries. Newspaper and journal articles demanding corporate governance reforms are now quite common. Further, as discussed earlier, foreign owners have mounted pressure on Japanese firms to improve their corporate governance practices as well (Useem, 1998).

Facing these changes in business environments, some Japanese firms started to reform their boardroom practices. The first such boardroom self-improvement was initiated by Sony Corporation in 1997. Sony reduced the number of board members and separated the roles of executive officers and directors. This practice has gradually been adopted by many other Japanese firms. From the late 1990s to 2000, for example, Orix Corporation, Toshiba, Nissan Diesel, and NEC restructured their board by reducing the number of directors and allowing the CEOs to part ways with the directors. A survey conducted by *Nihon Keizai Shimbun* in 1999 reported that 36 percent of the respondents in the survey had made the roles of the board members and executive officers distinct from each other. The separation often results in the reduction of the board size since many directors are also executive officers (*Nihon Keizai Shimbun*, June 13, 1999). Many firms reportedly adopted this practice in order to improve the quality of decision-making and the effectiveness of monitoring (Aoki, 2004).

A number of firms also started to appoint outside directors on their boards. For example, the same survey reported that over 38 percent of Japanese firms had outsiders on their boards in 2001 even though they were not legally required to do so (*Nihon Keizai Shimbun*, 16 June 2001). However, many outsiders on the Japanese boards are not independent but affiliated directors who often come from banks, associated firms, and government agencies. While these changes in boardroom practice may show the increased emphasis on corporate governance in the Japanese boardroom, less clear is their impact on shareholder wealth creation.

## IMPACTS OF OWNERSHIP CHANGE AND BOARDROOM REFORM

### Impact of foreign ownership on firm performance

There are a growing number of studies that examine the effect of foreign ownership on firm performance and corporate practices. Nitta (2000) examined the effect of foreign ownership on various measures of firm performance for the period between 1988 and 1997 and found that foreign ownership was positively associated with stock index, return on assets, return on equity, and earnings. Similarly, Yoshikawa and Phan (2003) found that the foreign ownership change during 1997–1999 was positively related to return on assets and stock return index in 2000. A survey conducted by the Ministry of Finance and Tokyo Stock Exchange also found that firms with large foreign ownership had higher return on equity.<sup>5</sup> However, a study by Gedajlovic et al. (2005) did not find any relationship between foreign ownership and return on assets during the period between 1996 and 1998.

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<sup>5</sup> <http://www.mof.go.jp/singikai/henkaku/top.htm>



Hence, while we have some empirical evidence to show that foreign ownership is positively associated with firm performance, we still need some caution to conclude.

### **Impact of foreign ownership on investor relations and restructuring**

There are also studies that investigated the relationship between foreign ownership and corporate practices. Yoshikawa and Gedajlovic (2002) examined the effect of foreign ownership on the quality of investor relations practices of Japanese firms and found a positive relationship. Similarly, Yoshikawa and Linton (2000) found a positive association between foreign ownership and the quality of investor relations practices. These are consistent with the view that since foreign investors have only arm's-length relationship with a firm in which they hold shares, they demand greater information disclosure through better knowledge of how investor relations are done.

Other studies investigated the relationship between foreign ownership and restructuring. Ahmadjian and Robinson (2001) studied the effects of various institutional factors and foreign ownership on downsizing, which is defined as a decrease in the number of permanent employees, of Japanese firms for 1990–1997. They found that firms with larger foreign ownership were more likely to downsize. Yoshikawa, Phan and David (2005) investigated the effect of foreign ownership on employee wage payments for the 5-year period between 1998 and 2002 and found that foreign ownership reduced wage payments when firm performance was low. These findings suggest that foreign investors promote firm restructuring. Table 4 shows a summary of studies that examine the impacts of foreign ownership.

### **Impact of boardroom reform on firm performance**

Since boardroom changes in Japanese firms started only in the late 1990s, there are not many empirical studies that look at the performance implications of such reforms. However, based on the few existing studies, the recent boardroom reforms initiated by Japanese firms do not appear to have any positive effects on firm performance. One study (Yoshikawa and Phan, 2003) examined the effects of the ratio of outside directors, the separation of the board members and executive officers, and the reduction of board size. It found that these reform measures have no impact on return on assets or stock returns. However, this study did find that participation of outside directors in strategic decision-making was positively related to stock returns. Another study also investigated the effect of the introduction of the executive officer system (separation of the board members and executive officers) and found that such reform has no positive influence on firm performance (Aoki, 2004).

There may be various reasons why boardroom reform has no impact on firm performance. Implementation woes would be one of them. Although many firms claim that directors and executive officers have parted company through boardroom reform, there are still many instances where the CEO is concurrently a director (Aoki, 2004). Hence, in actual practice, the separation has not taken place in many firms.

In addition, newly appointed executive officers who were former directors often felt that they were demoted. Consequently, they may have been demoralized. Further, the board of directors has been seen traditionally as the highest echelon within a firm that employees can aspire to reach. Therefore, the reduction of board size also means that it becomes more difficult for employees to reach that status. Lastly, those studies examined the effects of the boardroom reforms only after a relatively short period of time and therefore it is possible that the effects of such reforms have not been reflected yet in the performance measures.

Table 4. Summary of empirical findings on impacts of foreign ownership

Author(s) (Year)	Dependent variable(s)	Support for positive Impact
Nitta (2000)	Stock index, ROA, ROE, earnings	Support
Yoshikawa & Phan (2003)	ROA, stock return index	Support
Ministry of Finance & Tokyo Stock Exchange	ROE	Support
Gedajlovic, Yoshikawa & Hashimoto (2005)	ROA	No support
Yoshikawa & Linton (2000)	Investor relations	Support
Yoshikawa & Gedajlovic (2002)	Investor relations	Support
Ahmadjian & Robinson (2001)	Downsizing	Support
Yoshikawa, Phan & David (2005)	Employee wage payments	Support when firm performance is poor

Another reason why the reforms did not improve firm performance is that many Japanese firms may have been using the separation of directors and executive officers as a means to present a cosmetic change. From an institutional theory perspective, attempts to reform corporate governance can be seen as a way to gain undisputed credibility in the eyes of the shareholders and the public. The institutional theory framework argues that organizations will try to incorporate norms in their institutional environments so that they can gain legitimacy, resources, stability, and enhanced survival prospects (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). This organizational behavior can be described as a process of isomorphism, which is induced by institutional pressures and expectations. Theory suggests that such pressures and expectations force organizations to demonstrate conformity because organizations compete not only for economic resources but also for political power and institutional legitimacy (Dacin, 1997; Suchman, 1995). Conversely, breach of such an expectation would damage legitimacy and even deny the organization access to resources needed for survival.

It appears then that Japanese public expectations on corporate governance practices changed after the collapse of the bubble economy and the continued poor performance of Japanese firms throughout the 1990s. During this period, there has been growing demand for greater transparency and more attention paid to the interests of shareholders from such groups as domestic and foreign institutional investors, shareholders' rights groups, and the stock exchanges (Watanabe, 1994). The rising institutional pressures to improve corporate governance practices can be seen from numerous developments as follows:

- 1993: The Japan Investor Relations Association was established to promote better information disclosure to investors and shareholders by listed Japanese firms.
- 1994: The Japan Corporate Governance Forum (JCGF) was created by businessmen, scholars, and media to promote a stockholder-oriented corporate governance system in Japan.
- 1995: *Keidanren* or the Japan Federation of Economic Organizations issued a statement that stressed the importance of improving information disclosure by Japanese firms to stimulate the growth of equity transactions in the domestic stock markets.
- 1998: JCGF issued the Corporate Governance Principles. The revised JCGF principles were issued in 2001.

- 1999: OECD issued its own Corporate Governance Principles. The revised OECD principles were issued in 2004.
- 2003: The Tokyo Stock Exchange (TSE) required all listed firms to disclose their policies on corporate governance. TSE also issued the Principles of Corporate Governance for Listed Companies in 2004 (see Appendix 1 on the responsibilities of board of directors, auditors, board of corporate auditors, and other relevant group(s)).

From an institutional theory perspective, it can be argued that Japanese firms started to pay more attention to their corporate governance practices because of the rising public expectation for corporations to deal with the governance issue. Thus, recent boardroom reforms may be motivated not primarily by economic necessity but by mounting institutional pressures. If that is the case, those boardroom reforms initiated by the corporate sector are not likely to improve firm performance because they are being implemented to conform to institutional expectations.

However, along with the changing ownership structure, these shifts in institutional expectations have been nudging Japanese firms to switch over from a stakeholder-centered model to a more shareholder-oriented governance framework (Figure 3). In order to provide more flexibility to push for a shareholder model for Japanese firms, the Commercial Code was revised in 2002.

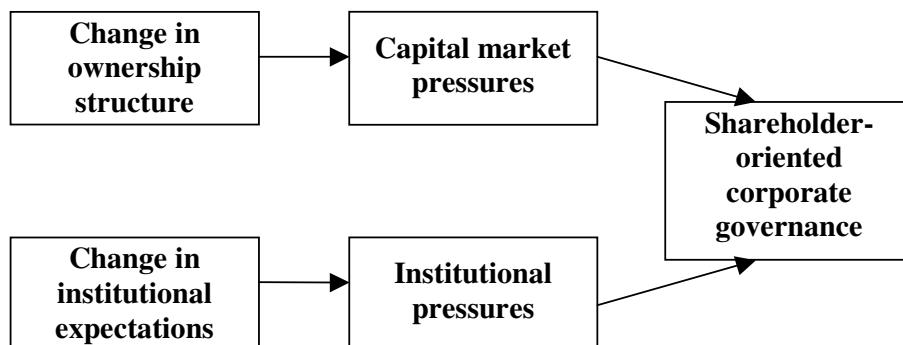


Figure 3. Transition from the stakeholder model to the shareholder model

### RECENT REVISION OF THE COMMERCIAL CODE

The most recently revised Commercial Code, which took effect in April 2003, provides large Japanese firms with two choices in terms of their internal corporate governance structure. They can either go for the auditor system or the committee system.

In the auditor system (which is the traditional system), the board of directors (*torishimariyaku-kai*) and the board of statutory auditors (*kansayaku-kai*) call the shots for Japanese firms. Statutorily, the board of directors is responsible for strategic policy making and overseeing top management decision-making. The board of statutory auditors is responsible for monitoring the board of directors. That is to say, “they guard the guardians.” However, a majority of board members are insiders come from the ranks of

employees (Charkham, 1994). Because it is dominated by insiders, it is often argued that the Japanese board has no incentive to effectively monitor the company. After all, in most Japanese firms, a directorship is seen as a reward for those employees who survive a long internal competition (Gerlach, 1992). Records will show that employees who did not excel enough to become a director are often appointed as statutory auditors (Heftel, 1983). Japanese board culture often views board members as *de facto* managers and thus subordinate to the CEO. Thus, the board of statutory auditors as an oversight body is often seen with skepticism.

Since April 2003, Japanese firms have been allowed to choose another system—the committee system, so called because it is based on the existence of committees within the board. This system is similar to the system adopted by listed US firms. In this committee system, the board of directors is responsible for monitoring the management and an executing role is delegated to executive officers. Hence, there is a clear legal separation between monitoring and execution functions. The executive officer system initiated by some Japanese firms in the late 1990s has similar objectives, although it is an informal internal system and hence executive officers have no legal status. However, the committee system and the executive officer system share the same problem. As it happened under the executive officer system, the committee system also allows directors to be concurrently appointed as executive officers. Hence, in practice, the separation of directors and executive officers is not guaranteed.

In addition to board-management separation, the board of directors is required to have the following three committees under the committee system; i.e., nominating committee, audit committee, and compensation committee. The committee system is the most significant departure of this system from the traditional mode. Each committee consists of at least three directors of which a majority has to be outsiders. These committees have the following functions:

- Nominating committee – appointment and termination of directors;
- Audit committee – monitoring of directors and executive officers; appointment and termination of accounting auditors;
- Compensation committee – policy and decisions regarding compensation of directors and executive officers.

The presence of outside directors in the committees is designed to strengthen the monitoring capability of the board. If implemented properly, this feature enhances the effectiveness of the company's internal governance mechanism. However, in the first year after the revised Commercial Code became effective, only 36 firms out of over 1500 firms in the first section of the Tokyo Stock Exchange (where most of the large firms are listed) adopted this new system. Even in the second year in 2004, the number of firms that adopted this system had increased to only about 70. Thus, despite its intent to improve the monitoring of management by outside directors, the committee system has not yet spread widely among Japanese firms.

Those who are critical of the committee system often mention the difficulty of finding suitable outsiders who can serve as board members in the Japanese context where the executive labor market is not as developed as in the US. Some are also skeptical that outsiders who may not be very familiar with businesses of a firm for which they serve as independent directors can effectively play a governance role. This argument is based on the belief that those who monitor the management should have industry expertise as well as some managerial experience. Without those attributes, it is argued that outside directors are not very useful.

Others contend that since directors can concurrently serve as executive officers, the functions of strategic decision-making and execution of strategy may not be clearly separated. Hence, at least in this regard, the new system is not much different from the traditional governance system in Japanese firms. The independence of outside directors is another issue that is often raised as a problem (Yano, 2004). According to the Commercial Code, outsiders are defined as those who have never worked for a company or its subsidiaries for which they serve as a director. This means that those people who have business or professional relationships with a firm as well as managers and employees of the firm's parent company are seen as outsiders. In fact, most of the outside directors of Japanese firms are from banks and affiliated or parent firms. Thus, it is argued that independence needs to be included in the criteria to select outside directors to avoid any conflict of interest (Yano, 2004).

In addition to these problems, the most important reason why the committee system has not become popular among Japanese firms lies in the reluctance of Japanese executives to let the outsider-dominated committees to decide their appointment/termination as well as remuneration and also to monitor their strategic decisions. As long as the corporate sector shows strong resistance, it would be extremely difficult to impose a system in which outside directors have the authority to decide the fate and perquisites of directors and top executives. Hence, if Japanese executives have an option not to use this system, it is likely that many of them will not choose it. Company executives cannot be expected to initiate good corporate governance practices because they do not always have a strong incentive to do so. What makes it possible then for Japanese firms to adopt good corporate governance practices?

## **TOWARD GOOD GOVERNANCE: A DISCUSSION**

### **Summary of the recent changes**

In the post-war period, the main banks had been playing an important governance role in Japan. Since Japanese firms did not have easy access to capital market financing for a long time, bank loans were the only source of capital for many of them. Further, as Japanese firms needed a large amount of capital to finance their growth during a high economic growth period, they did not have much bargaining power vis-à-vis banks. Under these circumstances, banks could effectively monitor their client firms. However, since the 1980s, the monitoring power of banks started to decline due to the deregulation of financial markets and the bad debt problem of Japanese banks. This left a gap in corporate governance of Japanese firms. However, changes in external environments began to fill this gap to some extent.

Broadly speaking, there have been two important changes in external environments that affected corporate governance practices of Japanese firms. First, there were significant changes in ownership structure. As discussed earlier, shareholdings by domestic stable shareholders such as banks and affiliated firms have been declining. At the same time, foreign ownership in Japanese firms has been increasing. Since Japanese managers had been shielded (they still are to some extent) by domestic stable investors from any outside pressures and threat of takeovers, these changes would have an important impact. Further, as foreign investors have an impersonal relationship with firms and are primarily interested in financial returns. Japanese managers have been under greater pressure to focus on investment returns. Hence, rapid changes in the capital markets are to pushing Japanese firms toward shareholder-oriented corporate governance practices.

Second, institutional expectations on corporate governance practices of Japanese firms have been changing as well. There is growing public pressure on Japanese firms to improve their governance practices. Demand-side changes such as this prompted some Japanese firms to restructure their boardroom practices. Since the late 1990s, a large number of Japanese firms reduced the size of their board and separated the role of directors and executive officers. This can be seen as an attempt by the corporate sector to fill the governance gap.

In addition, the recent revision of the Commercial Code provides Japanese firms with an option to utilize outside directors to play an active governance role through the committees. Hence, Japanese firms now have more flexibility to improve their corporate governance practices. However, the number of firms that adopted the system based on the committees controlled by outside directors is still very small. A key reason is the difficulty of finding appropriate outsiders to fill positions on the board as discussed earlier. Also, many Japanese executives are reluctant to be monitored by outside directors. Hence, it may take a long time before the revised Commercial Code becomes an effective corporate governance instrument.

Further, the performance implications of the boardroom reforms initiated by the corporate sector are not clear. At least, the empirical studies (Aoki, 2004; Yoshikawa and Phan, 2003) indicate no positive impact of such reforms on firm performance. It is possible that firms initiated boardroom reforms not out of economic necessity, but merely as a concession to mounting external pressures. This may have led to the weak implementation of the separation of directors and executives officers, which in turn made sure the internal check and balance mechanism of Japanese firms would show little if any change.

The only positive force that seems to have some impact on firm performance is foreign ownership. It would be difficult to expect that Japanese firms will change their corporate governance practices voluntarily, unless they are compelled to do so by external forces. After all, effective governance reforms usually reduce the power of top executives, because other directors, often outsiders, have the authority to decide appointment, reappointment, and remuneration of top executives. Hence, it is a big challenge to ensure observance of good corporate governance practices without any compelling force, whether external or regulatory.

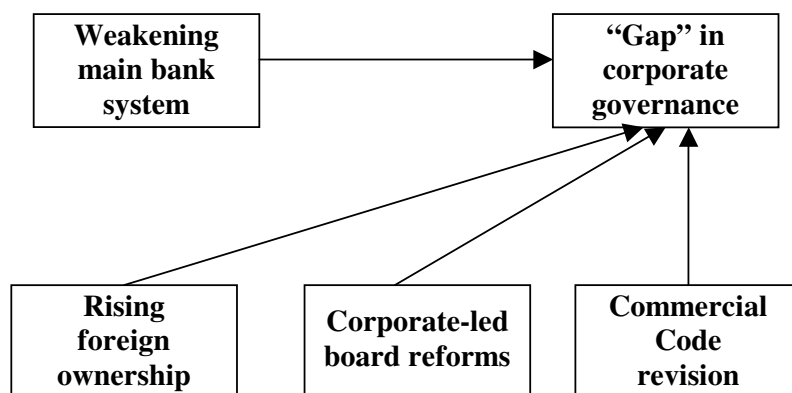


Figure 4. Recent changes in corporate governance

To recap, the declining effectiveness of corporate governance based on the main bank monitoring has been in part “solved” by rising foreign ownership, boardroom reforms initiated by the corporate sector, and the recent change in the Commercial Code (Figure 4). However, although many Japanese firms have adopted some reform measures, such measures have not led to improvements. Further, the monitoring of management by outside directors has not been deeply established among Japanese firms. In order to improve the internal monitoring mechanism of Japanese firms, there must be further advances in key areas. Table 5 shows the concrete reform measures implemented by and available to Japanese firms and the problems associated with each measure.

Table 5. Reform measures and problems

Corporate-initiated measures		
Measure	Objective	Problem
Separation of directors and executive officers	Effective managerial monitoring and strategy execution	Poor implementation: concurrent appointment of director and executive officer
Reduction of board size	Effective discussion and efficient decision-making in the board	Lower morale: switching status from directors to executive officers seen as demotion
The committee system		
Measure	Objective	Problem
Separation of directors and executive officers	Effective managerial monitoring and strategy execution	Poor implementation: concurrent appointment of director and executive officer
Committees dominated by outsiders	Effective managerial monitoring by outsiders	Lack of qualified outsiders; concern over effectiveness of outsiders without any business knowledge

### Desirable further advances

In order to generate further changes in Japanese corporate governance, two critical issues need attention.

First, since top executives do not always have an incentive to improve the internal monitoring mechanism, external pressure must be brought to bear on Japanese firms as a whole. Compulsion may come from capital markets or regulatory authorities. As discussed, foreign investors have been an emerging force for better corporate governance practices in the firms they invested in. However, although their shareholdings in Japanese stocks have been increasing, their stakes are still relatively small compared to domestic institutions. Thus, at this stage, it is important that domestic institutional investors such as pension funds and other investment funds impose greater pressure on Japanese firms to improve their governance practices.

However, because the concept of fiduciary duties of institutional investors is not clearly defined in Japan, domestic institutional investors have not been very active as good corporate governance agents. One of a few exceptional cases is the Pension Fund Association (*Kosei Nenkin Kikin Rengokai*), which started to impose some pressure on Japanese firms through proxy votes. In its proxy vote guidelines, the association states that “the objective of the firm is the maximization of shareholders’ interests over a long term, and such objective is not in conflict with the interests of other stakeholders such as employees, business partners, and local communities as the objective can only be achieved

by establishing cooperative relations with those stakeholders.”<sup>6</sup> The Fund has likewise positively assessed the corporate governance system based on the outsider-dominated committees.

The guidelines also emphasize the following characteristics of the board:

- Executive and monitoring functions should be separated; the role of the board is the monitoring of management for the interests of shareholders.
- The board should have the appropriate size that allows effective discussion and efficient decision-making.
- At least one third of the board members should be “independent” outsiders.
- The CEO and chairman of the board should be separated.

Since institutional investors are managing other people’s (customers or other beneficiaries) money, they need to be made responsible for monitoring governance practices of firms in which they hold shares. Without an enhanced vigilance by institutional investors, good corporate governance may not be easily achieved.

Another issue is regulation. The new Commercial Code should have disallowed the auditor system and enforced only the committee system. As long as Japanese executives are given a choice, it is only natural that many of them would opt for the system that requires less stringent monitoring. To make Japanese firms adopt the committee system, enforcement will have to be done either by a relevant government agency or the stock exchanges. If there is apprehension about the availability of suitable outside directors, it may be possible to be flexible on the requirement at the initial stage. At the same time, some infrastructure development efforts may have to be done in terms of director training and education.

### **Key lessons for other countries**

An important lesson that governments in other countries can learn from the Japanese experience is that self-initiated improvements do not always lead to better firm performance. Evidence shows that boardroom reforms opened up by many Japanese firms, e.g., the separation of directors and executive officers, have not so far yielded superior firm performance. It should be clear that corporate top executives are generally reluctant to give up much of their power and let outsiders set the standards and monitor their performance. This is not a country specific issue, as it can happen in any country. Corporate governance reforms in the US and UK were mainly advanced by institutional investors despite resistance by top executives. Hence, effective monitoring of management will have to be forced from outside.

In this respect, market investors and/or government and stock exchanges can turn matters around. In countries where the ownership structure is not concentrated and market investors, i.e., foreign or domestic institutional investors, have a relatively large presence, capital market pressures can make a strong difference. However, those institutional investors must be accountable to the beneficiaries of pension funds and must always act to protect their customers. In countries where family owners or government agencies are large shareholders, it may not be possible to expect institutional investors to play an active role. In such an environment, government regulations or stock exchange rules are the only force that can change corporate governance practices of firms.

In enforcing a rigor in monitoring, however, it is also important to pay attention to a country’s infrastructure and labor market. In some settings, it would be difficult to find a large number of qualified *independent* outside directors. Where capital markets are not

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<sup>6</sup> Kosei Nenkin Kikin Rengokai, Shareholders’ Proxy Vote Guidelines, 20 February 2003, p. 2.



well developed and ownership is highly concentrated in family owners or affiliated group firms, many potential candidates for outside directors may be connected with such owners and firms. Hence, outside directors are to be a strong monitoring force, the training of current and potential directors is essential in order to increase the pool of qualified, independent directors. Without this pool, it is not possible to establish a good committee-oriented board.

Notwithstanding the slow progress of corporate governance in Japan, there are worthy examples of good practices that have emerged through all the difficulties that have characterized the period of reform. One such case is Nissan Motor Corporation which experienced a major change in its ownership structure after it faced financial crisis in the late 1990s. How does a corporate giant in distress restructure its operation and restore its profitability? Nissan is an exemplar when it comes to answering this question.

### **THE CASE OF NISSAN: EXTERNAL FORCES MATTER**

One of the best cases in which a sea change in ownership structure, mostly by foreign investors, brought about best practices in corporate governance and management involves one of Japan's biggest automaker, Nissan Motor Corporation. Nissan was experiencing its largest ever losses in the late 1990s. Its domestic market share, which peaked at 34 percent in 1974, declined to below 19 percent in 1999. Nissan's global market share also declined from 6.6 percent in 1991 to 4.9 percent in 1999. Between 1991 and 1999, the company had just one profitable year. There were several factors, both environmental and firm specific, that could be attributed to Nissan's historically poor performance.

#### **Major problems that Nissan faced in the 1990s**

Arguably, the downfall of Nissan and many other Japanese firms during the 1990s came when Japan's bubble economy came crashing down. Many Japanese firms expanded rapidly in foreign markets as well as in different business sectors in the 1980s, most especially during the "bubble" period in the late 1980s. However, many of them were saddled with large debts that they could not pay after the bubble broke open in the early 1990s. Despite this dramatic fall in the macro environment, Japanese firms found restructuring extremely difficult, because they were caught in the middle of conflicting economic needs and traditional obligations. They needed to cut costs to reduce excessive capacities and manpower, but at the same time they had to carry the burden of lifelong employment for their employees. Thus, many Japanese firms, including Nissan, simply delayed implementing the necessary restructuring measures.

Traditional Japanese business practices had caused another nightmare for Japanese firms. As discussed earlier, many Japanese manufacturing firms are often interlinked through traditional supplier relationships. This *keiretsu* system of cross-shareholdings among group member firms was devised during Japan's rapid economic growth period in the 1950s and 1960s. This shareholding arrangement was initially aimed at preventing hostile takeovers, especially by well-capitalized foreign competitors. In the manufacturing sectors (including automobile), this process fostered long-term relationships between major car manufacturers and suppliers, and *keiretsu* member firms usually worked very closely on product development and also promoted and protected the business interests of each other.

Like many manufacturing firms, Nissan was deeply embedded in this process. Senior management had the obligation to buy from its group partners, sometimes even at a premium as suppliers of Nissan were not as competitive as those of Toyota Motor

Corporation, Japan's number 1 automaker. Thus, close relationships with its suppliers became a liability to Nissan. However, it was extremely difficult to break the *keiretsu* ties in Japan as the companies in the same group were implicitly bound to support each other. As a consequence, Nissan had to incur \$22 billion in debt and higher supplier costs.

In addition to Nissan's close ties with its suppliers, the company's cozy relationship with its banks allowed it to pile up a huge amount of bank debts. Because of its historical ties with the main banks and its huge presence in the Japanese automobile industry—Nissan used to be second only to Toyota—it was relatively easy for Nissan to borrow bank loans despite its poor performance (Nikkei Business, 2000). This led to a lack of financial discipline and large interest payments. The core of the internal problem Nissan was facing then was, in part, due to traditional Japanese business practices.

Another source of difficulty, which also stemmed from one of the characteristics of Japanese management, was that employees tended to concentrate on their narrow responsibilities within their own department or section (Nikkei Business, 2000). Cross-departmental communication rarely took place at Nissan. This situation created a lack of coordination among different departments and little sense of responsibility for overall corporate performance. Further, there was little sense of crisis among Nissan's employees despite the fact that the company's problems were widely reported by the media in the 1990s.

Ironically, the Japanese production systems were still superior and many of their vehicles were ranked ahead of the competition in quality and reliability, despite recent progress in quality management by automobile manufacturers in the US and Europe. But Nissan's senior executives could not make good use of superior quality management to respond to the crisis. Because of the tradition of lifetime employment and seniority based system, Japanese firms found it difficult to remove managers and employees who were not up to par in maintaining Japan's total quality management system.

Finally, there was a lack of focus on profitability. Nissan had been selling its products at low prices to maintain market share, which led to low profit margins. In other words, sales figures were more important than profitability. When Nissan's market share was declining, it relied on incentives to entice customers to purchase their products. In the US, for example, leased vehicles were often given artificially high residual values so that customers could lease their cars at lower monthly payments. Although this put more Nissan vehicles on the road, the company could not make much profit from this practice.

### **The French connection: strategic alliance with Renault**

In the late 1990s, faced with limited growth opportunities in the European market, Renault was looking for opportunities to grow elsewhere, possibly through alliances (Magee, 2003). However, Renault was also concerned that an alliance with a stronger firm or competitor could put the company in a weaker position. Senior executives at Renault believed Nissan was the company that was most suitable for Renault to form an alliance.

The strengths of Nissan and Renault were considered complementary and therefore, each firm was could be a good alliance partner to the other. Nissan had its strengths in the reliability of its products, strong engineering, and superior manufacturing capabilities. Renault's strengths were its innovative design, good cost management, product planning and marketing capabilities. In terms of markets, Nissan's presence was strong in Asia and North America, whereas Renault's market strength lied primarily in Europe and South America (Magee, 2003).

Although Renault and Nissan agreed to work closely in many areas through this alliance, the agreement also allowed both companies to maintain their separate identities

and hence avoid any negative effects that might arise from a full merger. Renault was very careful not stage its alliance with Nissan as a French takeover of one of the major Japanese automobile companies.

In this alliance, Renault injected \$5.4 billion cash in exchange for 36.8 percent equity stake in Nissan and 22.5 percent stake in Nissan Diesel, Nissan's close truck manufacturing affiliate. Renault also acquired Nissan bonds with detachable warrants that could increase Renault's equity stake to 39.9 percent after four years, and 44.4 percent after five years. This was a significant move for Renault as its investment in Nissan was huge, but it was also a quiet critical decision for Nissan as it chose to have a foreign firm as its largest shareholder.

In addition to its cash infusion, Renault also appointed three executives to Nissan's board of directors. Carlos Ghosn, executive vice president at Renault was appointed as Nissan's chief operating officer (COO). Patrick Pelata, senior vice president, vehicle development of Renault, was appointed as Nissan's executive vice president of product planning and strategy. Thierry Moulouguet, senior vice president, capital expenditure controller of Renault, was named managing director and deputy chief financial officer of Nissan. Nissan personally requested Renault to transfer Carlos Ghosn to the Japanese carmaker, as he believed that Ghosn was the right person to restructure Nissan.

Nissan's ownership structure once consisted of shareholders who were its business partners, suppliers, and banks. Its board consisted of mostly insiders with a few outsiders from the company's main banks. Through this alliance, the ownership and board structure of Nissan changed dramatically.

While Renault was providing all the financial resources to Nissan initially, Nissan was given the option to hold equity stake in Renault at a later date. Renault and Nissan set up the cross-company teams to investigate additional synergies that could result from the alliance between them in areas such as joint manufacturing and purchasing.

## **TURNAROUND STRATEGY**

### **Cross-functional teams**

After Ghosn took over as COO at Nissan, the cross-functional teams (CFTs) were formed. The mandate of those teams was to identify Nissan's internal problems and make recommendations that could solve these problems. The CFT's proposals went directly to Ghosn and a newly formed executive committee. The CFTs were designed in such a way that employees from different departments and sections could work together so that different perspectives could help to solve problems. The CFTs at Nissan were empowered by senior executives of the company and given wide-ranging and yet very specific tasks.

The formation of the CFTs was based on Ghosn's strong belief that "the solutions to Nissan's problems were inside the company." The CFT concept was implemented because it would force employees from different departments to overcome narrow departmental boundaries and encourage information sharing with people in other departments. Ghosn selected middle managers from different departments and operational regions, such as North America, Europe, and other overseas markets, in order to break functional and geographical barriers (Magee, 2003).

Ghosn formed nine CFTs, each team consisting of approximately 10 members. These team members were selected from Nissan's middle management group, usually with specific line responsibilities such as marketing and finance. While the size of the CFTs varied from 10 to 50, it was expected that there would be varied inputs from different perspectives, yet each team was not so large to prevent active interactions among team

members and move the project forward rather quickly (Nikkei Business, 2000). Although the CFTs had no direct decision-making authority, they operated directly below the executive committee. And the executive committee had responsibility to decide which CFT recommendations to accept and implement.

The nine CFTs had the following focus areas: business development, purchasing, manufacturing and logistics, research and development, sales and marketing, general and administrative, finance and cost, phase-out of products and parts complexity management, and organization (Magee, 2003). The first specific mandate assigned to the CFTs was to review Nissan's overall operations and develop recommendations within three months on how Nissan could restore profitability and ensure future growth.

Based on the recommendations proposed by the CFTs, the Nissan Revival Plan (NRP) was announced in October 1999. The main objective of this plan was to cut costs immediately and thereby save a large amount of expenses and also to establish long-term growth opportunities which would allow Nissan to regain profitability. The NRP aimed to (1) reduce operating costs by 1 trillion yen in global purchasing, manufacturing, and general administrative costs, (2) cut numbers of parts and materials suppliers in half, (3) reduce net debts from 1.4 trillion yen to less than 700 billion yen by FY 2002, (4) create new product investment and rollout, (5) reduce the number of employees globally by 21,000, (6) reduce the number of assembly plants in Japan from seven to four, and (7) reduce the number of manufacturing platforms in Japan from 24 to 15 (Magee, 2003; 85).

### **Plant closures and employee reduction**

Nissan had over 148,000 employees worldwide before the NRP was implemented. Because of declining sales, many of Nissan's manufacturing plants were operating only at around 50 percent capacity. Therefore, plant closures and employee reduction were inevitable. However, these measures must be dealt with very carefully especially in Japan, as employee morale may be negatively affected given the traditional practice of lifetime employment among large Japanese firms. Nissan offered to transfer all employees at the plants that were to be closed to other positions in different locations (Nikkei Business, 2000). Also, job reduction was achieved mainly by natural attrition. Hence, although several plants were closed down, massive layoffs common in the US industry were avoided.

### **Overhaul of *keiretsu* supplier relationships**

As purchasing costs accounted for about 60 percent of Nissan's total operational costs, it was imperative for Nissan to cut these costs. Hence, the company planned to reduce them by 20 percent over three-year life of the NRP. To achieve this, the number of parts and materials suppliers with which Nissan has transactions was cut from more than 1,100 suppliers in 1999 to 600 or fewer by the end of 2002 (Magee, 2003; 88). In this process, Nissan sold most of shares it owned in its *keiretsu* member firms. These parts and material suppliers had traditionally been members of the Nissan *keiretsu*, and they were tied through cross-shareholdings and director transfers within the group. Therefore, this move was seen as quite drastic not only by the group suppliers that were affected by this plan, but also by the business community (Nikkei Business, 2000). However, the company believed that Nissan could not afford to keep supporting all its group suppliers. The company's new position on its supplier relationship was that only suppliers that worked in the best interests of Nissan could be its partners. And those suppliers that helped Nissan to achieve its objectives were to be rewarded with more business. This implies that Nissan no

longer purchased from uncompetitive suppliers just because they were Nissan group members.

### **Treasury operation reform**

Reduction of its treasury operation costs was another important objective of the NRP. Before the NRP was implemented, Nissan dealt with 200 Japanese and foreign banks globally. It was because the company was structured globally as separate regional entities and each overseas entity had its own banking relationships in its region. Under the NRP, Nissan reduced the number of banks it dealt with to only 15. With this consolidation of its global banking relationships, Nissan was able to reduce its financial operational costs from 90 billion yen in 1999 to 24 billion yen.

### **Human resource management reform**

Another functional area which required restructuring at Nissan was human resource (HR) management. However, along with the dramatic reduction of *keiretsu* supplier relationships, the restructuring of human resource management practices within the company was another tough issue to deal with, especially given that the traditional labor practices among Japanese firms tended to value long-term employment and seniority. Nissan's new HR structure under the NRP established a global human resource department in its Tokyo headquarters which worked closely with regional committees in the different operational areas worldwide.

One of the major changes in Nissan's HR practices was that the company eliminated the seniority-based promotion system, which had been the traditional scheme used by many Japanese firms. In yet another major shift, Nissan started to implement a clear performance-based compensation scheme. Under this scheme, employee salary payment reflected performance of each employee and bonus pay was tied to the NRP's success for all employees. These changes imply that seniority no longer guarantees higher pay. As for executive pay, Nissan's key executives now receive warrant bonds and incentive pay based on their performance.

Many senior executive positions were consolidated as it was deemed that those positions were redundant in the global structure of the company. For example, in the regional operations groups, which no longer hold treasury and purchasing authority under the NRP, the position of president was abolished (Magee, 2003). The objective of this change in management structure was to establish a headquarters function in Nissan's Tokyo office so that there were clear management lines running from top executive levels in Tokyo to North America, Europe, and other overseas markets. Further, Ghosn made the management structure much more streamlined than it was in the past, making Nissan a very flat organization.

### **New product development**

The NRP included not only cost cutting measures and organizational restructuring but also other measures that enhance competitiveness in Nissan's products. Rebuilding its brand as well as commitment to research and development investments were also important objectives. Nissan planned to introduce 22 new models globally during the 3-year life of the NRP. Nissan cut down its new model development time by reducing the number of platforms that it used. Today it takes 30 to 50 percent less time to develop a new model from an existing platform than to develop a model from an entirely new platform (Magee, 2003). Hence, this measure aimed at accelerating the pace of Nissan's product rollout.

To enhance its designing capability, Ghosn hired Shiro Nakamura as Nissan's chief designer from another Japanese automobile manufacturer, Isuzu Motor. After the new chief designer joined Nissan, Ghosn approved the renovation plan to completely remodel the company's technical center in Japan despite Nissan's poor financial position as he believed that new product launches would help revive the company's profitability.

### **Focus on profits**

Ghosn made it very clear that Nissan should never strive for market share at the expense of profitability and that its products should be sold profitably or not sold at all. Nissan had been offering large incentives to customers to sell its products for long periods of time, because the company cared more about market share. The company's new initiative was aimed at establishing market presence with attractive new products and clear brand identity, which would enhance profitability. However, sales figures are also important in automobile industry as a company with large sales can enjoy the economy of scale. Hence, Nissan started to focus on market presence with its attractive products, which in turn should lead to a bigger market share (Magee, 2003).

## **TURNAROUND IN FINANCIAL PERFORMANCE<sup>7</sup>**

Through various measures implemented under the NRP, Nissan's financial performance improved substantially as can be seen from the charts below.

Operating profit fell from 199 billion yen in 1996 to 87 billion yen in 1997, with a slight improvement to 110 billion yen in 1998. However, it then decreased again to 83 billion yen in 1999. Furthermore, its profit margin declined sharply from 1998 to 1999 by 11.92 percent. After 1999, there was a rising trend in the operating profit and its operating profit margin (Figure 5). It rose from 83 billion yen in 1999 to 825 billion yen in 2003. It was a remarkable 894 percent improvement in the operating profit.

Other performance indicators of Nissan show healthy improvement as well. In 1999, the return on equity (ROE) was -126.4%. It meant that the company did not earn any profit from the investments of its shareholders. Right after the alliance with Renault, Nissan recovered the next year and achieved an ROE of 30.2 percent. It continued to generate good profit and reported 38.4 percent ROE in 2002 and 36.4 percent in 2003 (Figure 6).

Similarly, the return on assets (ROA) also hit its low in 1999 with ROA of -11.5 percent. It shows that the company did not utilize the assets efficiently to generate profits but in fact made losses. But from year 2000 onwards, ROA had an increasing trend.

In terms of net sales, Nissan's sales hit an all time low of 5,977 billion yen in 1999 with a 9.16 percent decrease from 1998. From 1999 to 2003, the net sales had picked up by 24 percent, the largest increase of 10.21 percent from 2001 to 2002 (Figure 7). Improvement in sales has been less dramatic than changes in profitability measures. However, the company has been gradually improving sales figures lately.

The total debt to equity ratio is one of the gearing ratios used to measure the amount of long-term liabilities that a business has as compared to its capital employed. From the chart (Figure 8), it can be seen that from 1996 to 2000, Nissan had been relying heavily on debts, with a total debt to equity of 123 percent in 1996, 294 percent in 1999 and 146 percent in 2000. It can be noted that debts were significantly reduced as the ratio decreased

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<sup>7</sup> All the financial figures were collected from Nissan's annual reports.

from 146 percent in 2000 to 99 percent in 2001 and lastly 84 percent in 2003. It suggests the company's conscious effort to reduce its heavy reliance on debt financing.

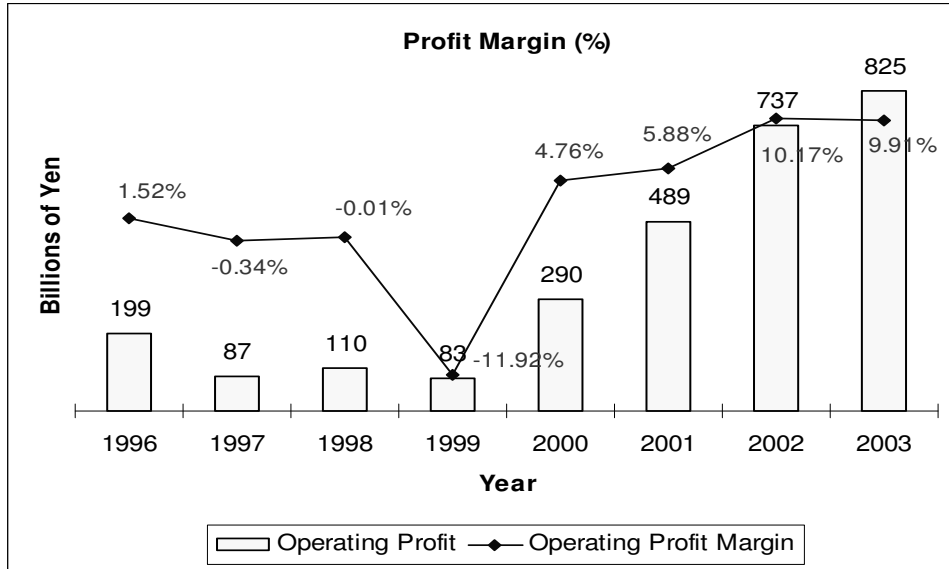


Figure 5. Nissan's operating profit and profit margin

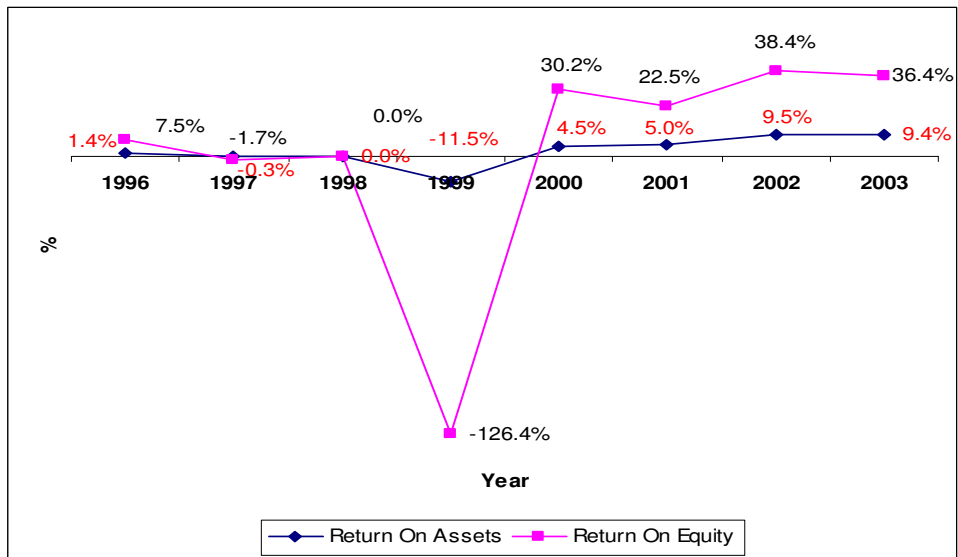


Figure 6. Nissan's ROA and ROE

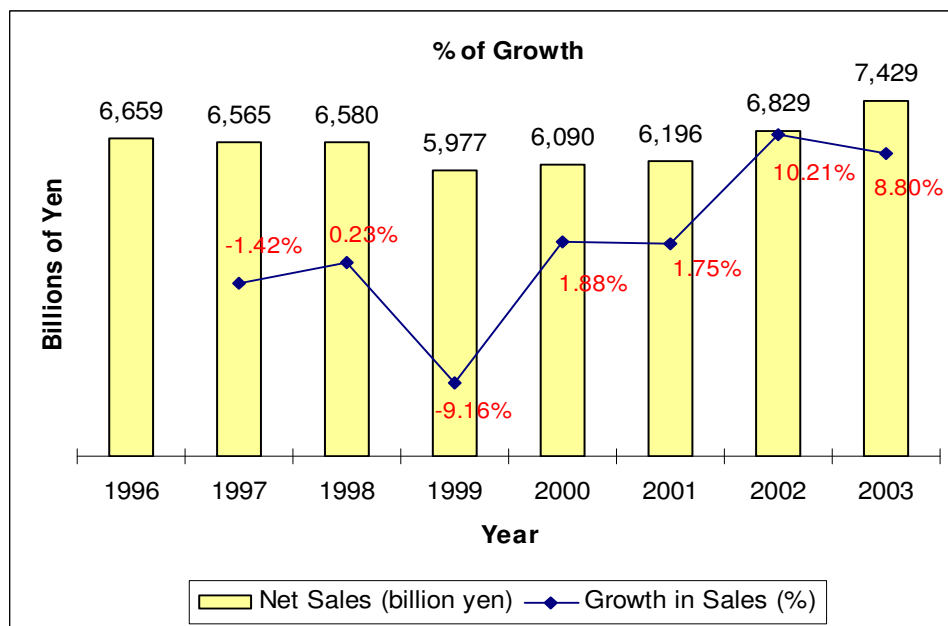


Figure 7. Nissan's sales and sales growth

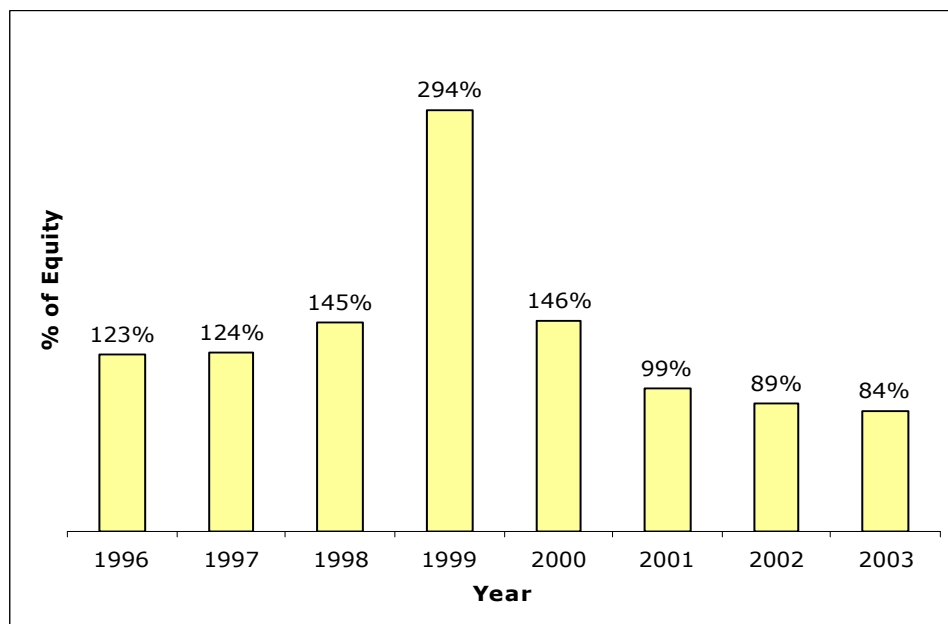


Figure 8. Nissan's debt-equity ratio

### Ownership-led reform and best practices



The case of Nissan presents one of the good examples of how a striking change in ownership structure and top management and the board could bring about various best practices in corporate governance and management. Nissan was suffering from declining sales, rising losses, and poor brand image during the 1990s. It had problems in its relationships with suppliers, financial cost control, human resource management, and organizational focus. Yet, it had not been able to resolve these problems on its own until it formed an alliance with Renault.

Once the alliance was formed, however, the company quickly implemented various restructuring measures in areas ranging from purchasing, finance, product design and human resource management. Such measures, now the wellspring of good practices, include cross-functional interactions among different departments to identify company wide problems, centralized and performance-oriented supplier relationships, consolidated global treasury operation, more efficient new product development operation with a smaller number of platforms, performance-based employee pay, and clearer lines of global management responsibilities with less hierarchy. Surprisingly, Nissan managed to implement all these changes in three years after the NRP was announced in 1999. And various financial indicators showed immediate improvement.

Nissan's best practices mentioned above may never have emerged without the compelling changes triggered by its French connection. However, it also implies that for a firm to implement best practices during a relatively short period of time, drastic changes in corporate governance is needed. An incremental change in corporate governance may not be able to overcome resistance from stakeholders who will be the losers in the reform. Hence, the case of Nissan provides both optimism and pessimism in terms of the ability of Japanese firms to implement best practices.

What lessons can the corporate sector in other countries learn from Nissan's experience? One instructive lesson is that to push through best practices within a company requires a strong impetus, especially from top management. While all the changes Nissan implemented under the NRP appear to be quite reasonable, the company failed to implement any of them before it formed an alliance with Renault. Its old corporate governance structure did not force top management to make tough decisions and follow through such decisions. It is easier, if not easy, to come up with good measures. It is much more difficult to actually implement them. And that requires strong support from and commitment by the top management team and the board. Therefore, the implementation of good management practices requires a strong corporate governance structure.

In the end, it should be emphasized that a firm does not always need to find a strong alliance partner in order to carry out desired changes. But it will need all the courage it can muster in order to utilize the power of institutional and foreign investors to initiate corporate governance reform.

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## Appendix 1

### **Principles of Corporate Governance for Listed Companies – Responsibilities of Board of Directors, Auditors, Board of Corporate Auditors, and Other Relevant Group(s) (Tokyo Stock Exchange, 2004)**

Corporate governance for listed companies should enhance the supervision of management by the Board of Directors, Auditors, Board of Corporate Auditors, and other relevant group(s), and ensure their accountability to shareholders.

The legal framework or basis for corporate governance permits the choice of a corporate auditors system or committees system. In either system, the Board of Directors, Auditors, Board of Corporate Auditors, and other relevant group(s) should evaluate whether the management has been accurately and efficiently executing business pursuant to their strategic guidance on strategies, and prevent the occurrence of conflict of interest between the company and the management by reflecting on such evaluation prior to the election or discharge of management or the execution of decisions on compensation, and thereby fulfill their appropriate supervision responsibilities.

# **CORPORATE GOVERNANCE IN MALAYSIA: REGULATORY REFORM AND ITS OUTCOMES**

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## **INTRODUCTION**

Malaysia is ranked number 1 in Asia for having the most rules and regulations for corporate governance, on the basis of a survey conducted by independent brokerage and research house CLSA Ltd. The survey conducted in 2005 took into account three factors: adaptation to international generally accepted accounting principles, political and regulatory environment, and international mechanism and corporate governance culture (StarBiz, 07/July/2006). Malaysia also scored well in 2004, according to a corporate governance survey of blue-chip companies, which ratings agency Standard & Poor's helped conduct. Hong Kong's leading newspaper, *The Standard*, said moreover that good governance rankings only told part of the story. The majority, if not all, of the publicly listed companies have complied dutifully with regulations and requirements judging by the amount of disclosures, adopting non-independent directors and faithfully reporting their corporate governance practices every year (ACCA, 2004).

In a research conducted for Nottingham Business School's Malaysia campus in 2003, researcher Zalila Mohd Toon indicated that Malaysia seemed to be making a great deal of progress promoting the development of sound corporate governance systems and practices, and had in fact stolen a lead over the US in its drive for higher standards of corporate governance (IR on the Net.com, 2003).

Reportedly among the Malaysian firsts in corporate governance are the following:

- First to have a comprehensive code for corporate governance in March 1999
- First to have mandatory training for directors of listed companies
- First in the region to set up an accounting standards board, the Malaysian Accounting Standards Board (MASB)
- First to revamp listing requirements in the region
- First in the region to set up a Minority Shareholders Watchdog Group
- The establishment of the Malaysian Institute of Integrity (Bursa Malaysia, 2006).

But, as Zalila also suggested, even if there exists a good regulatory framework, an even stronger enforcement regime is required (IR on the Net.com, 2003). Malaysia did better than Thailand, the Philippines and Indonesia in terms of enforcement, but needed to do more to improve compliance with corporate governance (StarBiz, 07/July/2006). Overall, however, regulators seemed to have driven reform well in emerging markets, including Malaysia, Brazil and China (McKinsey, 2001).

## **THE NEED FOR GOOD REGULATORY STRUCTURE**

Corporate governance is a system of checks and balances designed to produce efficient corporations that deliver long-term value. That system must insinuate itself *between* an explicitly defined governance mechanism *and* the practice and adoption of it by agents of the firm. According to Koh and Soon (2004), the Asian financial crisis

uncovered gaps between rule and compliance: the existence of clearly defined governance framework did not causally bring about effective practice. Various stakeholders were unconvinced that their participation would bring about net benefits over their abstention or over the costs of disregarding it. To bridge the gap, corporate governance not only entails greater transparency and market discipline; it must also induce a proper balance in the regulatory framework that acts as a stick as well as a carrot, i.e., inflicting disincentives for deviation from norms and bequeathing incentives for compliance.

Good regulations are needed to prevent the expropriation of shareholders by managers and to ensure the efficient management of companies. They are necessary too in order to attract the capital for large and worthwhile projects. Malaysia was among those countries which succeeded in building up many large firms that their countries needed for economic development funded by many economic agents; however, in the years leading to the Asian crisis, it failed to put in place a sound governance mechanism that could effectively solve the problems that were associated with ownership and control (Nam and Nam, 2005).

Accordingly, reform has focused on advancing the acceptance of such practices as greater disclosure, improved shareholder rights, and board reform. McKinsey (2001) warns, however, that the corporate context should be viewed as part of a much wider governance model that relies heavily on an institutional context that considers efficient equity markets and dispersed ownership as key elements. Together, these circumstances frame the “market model” of corporate governance with which international fund managers are most comfortable. Such arm’s length model depends upon checks and balances between management, boards, majority and minority shareholders and the enforcement of shareholder and creditor rights.

The change has not been easy for Malaysia. The corporate and institutional context in emerging markets differs in a clearly noticeable manner. Typically, corporate governance practices are made to fit the needs of core shareholders. Equity markets are less developed and consequently ownership is more concentrated. A distinct—and internally consistent—“control model” of corporate governance is in operation (McKinsey, 2001). In this “relationship model”, governance is exercised by controlling block-holders. Minority shareholder rights are frail. Independent board directors are only nominally independent. Relationship-oriented companies and markets lack effective risk oversight, have ineffective means for shareholders to evaluate or influence management, and may be perceived as brushing aside outcomes of firm underperformance. But the Malaysian government made the decision to shift to a more open model early on.

## **REFORMS IN THE MALAYSIAN LEGAL AND REGULATORY FRAMEWORK**

### **Post-crisis increase in regulation**

Prior to the financial crisis in 1997, Malaysia had already put in place a relatively high standard of corporate governance based on a strong common law system along with a corporate law regime from the British and has largely “localized” the developments in other Commonwealth countries. Moreover, the Kuala Lumpur Stock Exchange listing rules evolved a number of provisions that provided for checks and balances to enhance transparency and accountability. It introduced the requirement for independent directors on boards of publicly listed companies in 1987 and the establishment of audit committees in 1993 (Khoo, 2003).

Table 1 is a snapshot of the legislative framework for regulating firms prior to 1997 financial crisis, when Malaysia took steps to strengthen corporate governance.

**Table 1: The Legislative Framework**

1965	The Companies Act (CA)	Governs all aspects of company law. Contains provisions on minimum levels of disclosure to the public, rights and obligations of the directors and shareholders.
1973	The Securities Industries Act (SIA)	This Act was subsequently repealed and replaced by a similar Act in 1983. The Act provides more specific regulations on the securities industry and to protect investor interests. Amongst its provisions are the licensing of dealers, powers to curb excessive speculation, insider trading and market manipulation, and enhancement of supervision and control of the industry.
1987	Malaysian Code on Take-overs and Mergers	The code was enacted under the Companies Act to regulate corporate takeovers and mergers.
1989	Banking and Financial Institution Act (BAFIA)	The Act provides for the licensing and regulating of the activities of all types financial institutions including money broking services. The Bank Negara Malaysia (BNM) is the custodian of this Act.
1991	The Securities Industry (Central Depositories) Act (SICDA)	The Act governs the maintenance and operation of a central depository system.
1993	Securities Commission Act (SCA)	The Securities Commission (SC) was established as a regulatory body for the capital market.
1993	The Futures Industry Act (FIA)	Provides for the establishment of futures exchanges and regulation of the trading in futures contract.
1995	SCA	Amendments were made which marked the first move of the regulatory regime towards a disclosure based regime
1997	The Financial Reporting Act (FRA)	The Act was to bring the financial reporting in step with international standards and for effective enforcements. The Financial Reporting Foundation (FRF) and the Malaysian Accounting Standards Board (MASB) were established to set reporting and accounting standards.

Source : Adapted from Securities Commission

Corporate law in Malaysia is primarily set out in the Companies Act 1965 (Act 125) which is based on the British Companies Act 1948 and the Australian Uniform Companies Act 1961. Major subsidiary legislation of the Companies Act 1965 includes the Companies Regulation 1966 and the Companies (Winding-Up) Rules 1972. In respect of publicly listed companies the following legislation and also regulatory directives apply: the Securities Industries Act 1983 and the Securities Commission Act 1993.

The Companies Act, administered by the Registrar of Companies sets out the fundamental rules governing procedures for incorporation, the basic constitutional structure and the cessation of existence of companies. The Companies Act imposes minimum requirements on the way in which corporations are incorporated consistent with the Malaysian contractualist system of company law where the control structure is left to be determined by the promoters and the company through the Memorandum and Articles of Association of a company.

### **Code of Corporate Governance**

The Asian financial crisis highlighted the weak corporate governance practices in Malaysia: washy corporate financial structures; over-leveraging; poor disclosure and accountability; a complex system of family control; and above all, unenforceable or no effective laws to protect small investors; assets shifting; conglomerate structures that were perceived to be given preferential treatment; allegations of cronyism; lack of transparency and unclearness in the regulatory processes; and weaknesses in the credit evaluation

processes by the banks. It was against this backdrop that the Malaysian government ushered in the Malaysian Code of Corporate Governance in 2000. The Code was the product of an elaborate study and recommendations made by the high level Finance Committee which was formed in 1998 precisely to improve corporate governance practices in Malaysia (Khoo, 2003).

A good feature of codes is the evolutionary way in which they influence the aspirations and expectations of society that are eventually reflected in the country's legal doctrines. The attention generated by the various Codes of Best Practices has had an impact on evolving judicial interpretations of directors' duties.<sup>1</sup> As it is, the Code acts as a valuable guide to boards by clarifying their responsibilities and providing prescriptions to strengthen the control exercised by boards over their companies.

The Malaysian Code espoused a hybrid approach, navigating between prescriptive and non-prescriptive models. The prescriptive model sets standards of desirable practices for disclosure of compliance. The London Stock Exchange, for instance, sets best practice benchmarks against which compliance by listed companies are measured. The Non-prescriptive model requires actual disclosure of corporate governance practices. The Australian Stock Exchange adheres to this model. This approach goes against the grain of letting Individual companies determine their own set of objectives based on their needs and those of the directors' (Khoo, 2003). The Code, according to Khoo, allows for a more creative and pliant manner of raising standards in corporate governance in contrast to the more conventional "black-and-white" regulatory response. The idea, as the Code itself indicates, into allow companies to apply these flexibly and with common sense to the varying circumstances of individual companies. The Code essentially aims to encourage transparency through timely disclosure of adequate, clear, and comparable information concerning corporate financial performance and corporate ownership (World Bank, 2005). That way, the investing public can make informed decisions on the performance of the companies.

Steps have also been taken to achieve transparency of ownership. Amendments to the Securities Industry Central Depositories Act in October 1998 now prohibit persons from hiding behind their nominees by introducing the concept of authorized nominees and prohibiting global accounts (an authorized nominee may only hold securities for one beneficial owner in respect of each account) and by requiring a beneficial owner of securities to make a declaration that he is the beneficial owner of the securities (Koh and Soon, 2004).

On corporate governance itself, the Code aims to set out "principles and best practices on structures and processes that companies may use in their operations towards achieving the optimal governance framework. These structures and processes exist at a micro level which include issues such as the composition of the board, procedures for recruiting new directors, remuneration of directors, the use of board committees, their mandates and their activities" (Khoo, 2003). As a reform instrument, the thrust of the Code should lead to the following outcomes: fair treatment of all shareholders and protection of shareholder rights, with particular focus on the rights of minority shareholders; increased accountability and independence of the board of directors; better regulatory enforcement, and promotion of training and education at all levels to ensure that the framework for corporate governance is supported by adequate resources (World Bank, 2005).

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<sup>1</sup> See for example the Australian case of *Daniels v Anderson* (1995) 37 NWSLR 438 which is a clear instance of directors being increasingly held to a higher standard of care.



### **Adoption of international accounting standards**

Malaysia has adopted, as early as the late 70s, accounting standards that are generally consistent with those issued by the International Accounting Standards (IAS) Committee. The approved accounting measures constitute the Malaysian Generally Accepted Accounting Principles (GAAP). They incorporate both IAS and the Malaysian Accounting Standards (MAS). MAS cover topics not dealt with in IAS, as well as domestic standards meant specifically to address particular features of the Malaysian environment.

By the beginning of 1998 Malaysia had adopted 25 of the 31 extant IAS standards. Of the remaining six IAS standards, two deal with the accounting treatment of inflation, which are therefore not material, and a third is on accounting for business combinations for which MAS standards exist. The fourth is on computing earnings per share for which a MAS standard has been available from 1984. For the fifth, on accounting for financial institutions, BNM has drawn up its own standard format of financial reports. The sixth is on disclosure and presentation of financial instruments for which the domestic standard came into force in 1999. As at November 2002, the MASB has issued 30 new accounting standards since its formation in 1997. These standards cover more accounting issues than before the crisis and require greater disclosure by firms (Liew, 2006).

To carry out its own due process so as to satisfy itself that the standards are appropriate and reflect the input of its constituency, MASB embarked on a program to review all extant accounting standards for consistency with the latest developments in International Accounting Standards, statutory and regulatory reporting requirements, and to evaluate the practical aspects relating to the application of the accounting standards. That MASB has been a little cautious in adopting some of the revised IAS standards may be explained by its desire to go through a thorough due process in order not to run ahead of its constituency.

### **A merit-based disclosure regime**

Until 1995, Malaysia had used a merit-based regulatory regime in deciding on the suitability of a company for listing. The pricing of new issues was usually based on the need to protect the interest of minority shareholders.<sup>2</sup> From 1995, a disclosure-based regulatory regime began to be implemented on a phased basis. Good corporate governance based on transparency and the exit route is critically dependent on a country's accounting, auditing, financial reporting and disclosure standards and practices. These standards and practices are examined at some length in this section.

To increase transparency, the Malaysian regulatory framework requires disclosure and dissemination to potential and existing investors of timely, accurate and material information on corporate performance, affairs and events. Such disclosures are mandated at the initial public offering ("IPO") of the securities and thereafter on a periodic or continuous basis depending on the information disseminated.

With respect to the periodic disclosure and reporting requirements, a listed company is required to publish:

- Quarterly reports not later than two months after the end of each quarter of a financial year. Quarterly reporting has been in effect since 1998.
- Income statements for the current quarter and cumulatively for the current financial year-to-date of the immediately preceding financial year.

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<sup>2</sup> The need to promote certain special interests also led to the use of this regime. The fixing of new issue prices often at levels well below market prices, led to massive over-subscription, harmed issuers and in fact restricted the size of new issue activity.

- The printed annual report together with the annual audited financial statements as well as the auditors' and directors' reports (issued to the shareholders) within a period not exceeding four months after the close of the financial year of the listed company.
- Explanations for any differences between the audited accounts and any forecasts, projections previously made.

In addition, the company must issue the Directors' statement on internal controls (in effect since 2001), disclose the Directors and CEOs interests in PLCs, and report on the extent of its compliance to the Code (also in effect since 2001). The last is a mandatory disclosure requirement. Companies are required by the KLSE listing requirements to include in their annual report a narrative statement of how they apply the relevant principles to their particular circumstances. The disclosure makes it possible for investors and others to adequately assess the companies' performance and governance practices and respond in an informed way (Khoo, 2003).

Under the Bursa Malaysia's continuous disclosure requirements, a listed company is required to make immediate public disclosure of all material information concerning its affairs, except in exceptional circumstances. The company is required to release the information to the public in a manner designed to ensure fullest possible public dissemination.

A listed company is likewise to make disclosures, in particular to the Bursa Malaysia Securities Berhad and the market, whenever it

- receives notices of substantial shareholders or changes in substantial shareholders;
- changes directors, company secretary, chief executive officer or auditors;
- proposes to amend its Memorandum & Article of Association;
- acquires shares in an unquoted company which results in the latter becoming a subsidiary or disposes shares in an unquoted company which results the latter ceasing to be a subsidiary;
- acquires more than 5 percent of the paid up capital of another listed company;
- sells any shares in another company which would result in the latter ceasing to be a subsidiary, or where its shareholding falls below 5 percent if the other company is a listed entity;
- any application filed with court to wind up the company or any of its subsidiaries or major associated companies;
- undertakes a revaluation of its assets and/or those of its subsidiaries (unless it is in the ordinary course of business and in accordance with the Guidelines of the SC);
- proposes an acquisition or disposal whether involving the issue of new securities or otherwise where the percentage ratios are equal to or exceed 25 percent;
- purchases or sales of securities within the preceding 12 months, being equal to or exceeding 5 percent of the consolidated net tangible assets;
- proposes to allot shares to its directors or to implement an employee share option scheme; and
- registers any deviation of 10 percent or more between the profit after tax and minority interest stated in a profit estimate or the announced audited or unaudited accounts.

### **Revamped KLSE listing requirements**

The Listing Requirements require a statement from a listed company to be made up to a date not earlier than six weeks from the date of issue of its annual audited accounts and indicating the date of such statement and setting out

- the names of substantial shareholders and their equity interest,
- the number of holders of each class of equity securities and voting rights attached to each class,
- the number and percentage distribution of shareholders by size of shareholding of each class,
- a statement of the percentage of the total holding of the 20 largest holders of each class of equity securities, and
- the names of the 20 largest holders of each class of equity securities and the number of equity securities of each class held.

The listing manual also requires the shareholding spread to be set out in a particular format at a date no earlier than 6 weeks from the date of the issue of the audited annual accounts.

The Listing Requirements require the following disclosures about all directors and executive officers in the prospectus for any new issue of shares:

- Their business experience in the past 5 financial years or the principal business of the corporation they are employed in;
- Any other directorships held;
- The nature of the family relationship between the directors and executive officers;
- Aggregate remuneration paid or distributed to directors for all services rendered to the company or its subsidiaries during the last financial year;
- Details of all options (to subscribe for securities) that were received or exercised during the last financial year;
- Particulars of all sanctions or penalties imposed on the directors; and
- Particulars of material contracts involving the interests of directors or executive officers.

A listed company is required to make a public announcement, send a circular and seek the approval of shareholders on all material<sup>3</sup> related party transactions with the following disclosures:

- The date of the transaction, the parties thereto and a description of their relationship, and the nature and extent of the interest of the related party in the transactions;
- Particulars and purpose of the transactions;
- The total consideration, together with the basis of arriving at the consideration, and how it is to be satisfied;
- The effects of the transaction on the company including any benefits which are expected to accrue to the said company as a result of the transaction;
- An opinion by an independent corporate adviser, as to whether the transaction is fair and reasonable so far as the shareholders are concerned, which opinion must set out the key assumptions made and the factors taken into account in forming that opinion;

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<sup>3</sup> A transaction is deemed as material if its value exceeds five percent of any one of a select set of variables such as profits, equity, market capitalization and assets.

- A statement by the directors (other than any director who is a related party in respect of the transaction) that the transaction is fair and reasonable so far as the shareholders are concerned, and that, if applicable, the directors have been so advised by an adviser; and
- A statement that the related party will abstain from voting on the relevant resolution.

### **Related party disclosures**

More pertinently, related parties transactions are now subjected to a host of control mechanisms under the Listing Requirements. This may be compared with the international accounting standard on related party disclosures which has been adopted as an approved accounting standard in Malaysia. It requires firms, through their financial statements, to give disclosures about certain categories of related parties.

In broad terms, such standard requires the following disclosures:

- Related party relationships where control exists is required to be disclosed irrespective of whether there have been transactions between the related parties;
- If there have been transactions between related parties, the reporting enterprise is required to disclose the nature of the related party relationships as well as the types of transactions and the elements of the transactions necessary for an understanding of the financial statements; and
- Items of similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Specifically, under the standard, attention is focused on transactions with the directors of an enterprise, especially their remuneration and borrowings, because of the fiduciary nature of their relationship with the enterprise. In addition, one other IAS (Information to be Disclosed in Financial Statements) calls for disclosure of significant inter-company transactions and investments in and balances with group and associated companies and with directors. Yet another IAS (Consolidated Financial Statements) requires in such statements a list of significant subsidiaries and associated companies, and, for unconsolidated subsidiaries, intra-group balances and the nature of transactions with the remainder of the group. An IAS on Unusual and Prior Period Items and Changes in Accounting Policies requires disclosure of unusual items. The following are examples of situations where related party transactions may lead to disclosures by a reporting enterprise in the period which they affect:

- Purchase or sales of goods (finished or unfinished),
- Purchase or sales of property and other assets,
- Rendering or receiving of services,
- Agency arrangements,
- Leasing arrangements,
- Transfer of research and development,
- License agreements,
- Finance (including loans and equity contributions in cash or in kind),
- Guarantees and collaterals, and
- Management contracts.

Still under such standard, disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the parent and subsidiaries as a single reporting enterprise.

Transactions with associated enterprise accounted for under the equity method are not eliminated and therefore, require separate disclosure as related party transactions.

### **Mandatory director training for listed companies**

All directors of publicly listed companies now are required to attend a mandatory training program known as the Mandatory Accreditation Program (MAP). The curriculum covers topics on corporate governance, duties, responsibilities and liabilities of directors, risk management and the legal framework, amongst others. In addition to MAP, the Listing Rules require companies with financial year end of 31 December 2005 onward to disclose in the annual report the training attended by directors apart from the MAP (World Bank, 2005).

### **Limits to insider trading, dealings by directors and substantial shareholders**

The ability of company insiders to expropriate company assets for their own benefit was blocked off when the Securities Industry Act 1983 was amended to address weaknesses in insider trading rules in Malaysia. It is noteworthy that insiders are no longer defined as persons with fiduciary duties or who owe a duty of confidentiality (that is, directors, advisers, managers and agents) but include all persons who have in their possession price-sensitive information. Three offenses are now identified: the Trading offense, the Procuring Offense and the Tipping offense. In banking there is already a strict set of insider trading rules which sets out the requirement for directors to be scrupulous in avoiding conflict of interest situations. Banking institutions are also guided by rules on related party transactions (Koh and Soon, 2004).

Table 2. Post-crisis regulatory reforms

1998	The formation of the High Level Finance Committee to conduct a detailed study on corporate governance and to make recommendations for improvements.
1998	Amendments were made to the SICDA with the view to enhance transparency in share ownership amidst other improvements.
1998	The Malaysian Institute of Corporate Governance was established to look into the improvements for corporate governance practices in Malaysia.
1999	A new Malaysian Code on Takeovers and Mergers was introduced.
1999	Directors and CEOs were required to disclose their interests in Public Listed Companies (PLCs)
1999	PLCs were required to submit Quarterly Reports (available to the investing public) on their results and financial position.
2000	The establishment of the Malaysian Code on Corporate Governance.
2000	Amendments were made to the SCA further streamlining the regulatory by making SC the sole regulator for fund raising activities and the corporate bond market.
2001	The KLSE issued its revamped listing requirements which included new sections on corporate governance and continuing disclosure requirements.
2001	Establishment of the Minority Shareholders Watchdog Group to further protect minority shareholders' interests and to promote shareholder activism.
2001	Directors of PLCs were required to undergo training - Mandatory Accreditation Program
2001	The Audit Committee must have a member who is financially trained.
2001	The Malaysian Capital Market Masterplan was launched to further streamline and regulate the capital market and to chart the course for capital market for the next 10 years.
2001	The Financial Sector Masterplan was launched to chart the future direction of the financial system over the next 10 years and outlined the strategies to achieve a diversified, effective, efficient and resilient financial system.
2002	Internal Audit guidelines for PLCs was issued to assist the Directors of PLCs.
2003	Directors of PLCs were required to acquire 48 points of continuing professional education annually.

Source: Khoo (2003).

## **PROGRESS IN MALAYSIAN CORPORATE GOVERNANCE: A MOVING TARGET**

### **No regulatory capture**

A key failing that surfaced during the 1997 financial crisis was the equivocalness over the autonomy of regulators, jurisdictional boundaries and the transparency of the regulators. To address this problem, the SC has been made the sole regulator for the fund raising activities and the corporate bonds market in the Capital Market master plan and with the amendments made to the SCA in July 2000. As a consequence of the efforts to streamline the regulatory structure, there are now five principal authorities involved in regulating the capital market. They are the SC, BNM, Registrar of Companies (ROC), Foreign Investment Committee (FIC) and Ministry of Trade and Industry (MITI) (Khoo, 2003).

Under the reformed setup, SC is the regulatory authority on all matters in relation to the securities and futures market. Its functions include ensuring enforcements of securities and futures laws; licensing, regulating and supervising the conduct of market institutions and licensed intermediaries, and encouraging and promoting the development of the capital market. On the other hand, BNM takes care of the regulation and supervision of the financial institutions which are exempt dealers under the SIA, as well as approval of issues of securities by financial institutions licensed under BAFIA and control of the shareholding in licensed financial institutions. ROC handles substantial shareholding reporting requirements, and the enforcement of offenses under the CA which relate to the securities industry. The FIC provides recommendations to the SC on national policy aspects of an acquisition for the purpose of exemptions from the provisions of the Malaysian Code on Takeovers and Mergers. Relatedly, it administers the FIC guidelines mainly pertaining to the regulation of merger and acquisition activities. MITI is in charge of regulatory approval for the issuance of securities by companies regulated by MITI such as manufacturing companies (Khoo, 2003).

The most recent example of measures to improve corporate governance is the strengthening of the Code on Take-overs and Mergers brought into effect on 1st January 1999. The Code now requires higher standards of disclosure and corporate behavior from those involved in mergers and acquisitions. The principles that under girds the Code is the creation of a level playing field and ensuring that there is, at least normatively a framework for level playing field for improvement of governance process by facilitating battle market control (Koh and Soon, 2004).

The master plan also reinforces the SC's enforcement capacity on a continuous basis. Enforcers will be constantly equipped with up-to-date knowledge and information on financial transgressions which increasingly are becoming more complex and dynamic. To complement the enforcement role, the SC will develop front line regulators (FLR) like the KLSE and self-regulatory organizations (SRO) such as professional bodies. They are expected to play an increasing role in policing their respective segments of the market. This will pave the way for better surveillance. Applying effective and efficient enforcement in a timely and consistent manner will assure market participants of the fairness, efficiency and integrity of the capital market (Khoo, 2003).

So far, the SC's work has been well-supported by a team of professional staff. Its leadership in shaping various corporate governance initiatives leading to enhanced disclosures, and enhanced penalties for defaults against securities legislation, has been recognized both regionally and internationally.

There has been perception about the lack of autonomy of the SC. This widely-held belief stems from the lack of prosecution of offenses and the SC's apparent failure to enforce the requirement for general offers as per its takeover code. The criticism is not totally fair as some confusion has been caused by the overlap in jurisdiction between different regulators. An example is the UEM Renong debacle. In the eyes of the public the decision to waive the requirement for a general offer ought not to have been granted. The grant of waiver to extend a mandatory general offer was made by the Foreign Investment Committee (FIC) and not the SC and yet the SC took the brunt of the criticisms. In the wake of this the Minister of Finance invoked the Securities Commission (Amendment) Act 1995 which makes the SC the sole authority to grant exemptions from provisions of the new Code.

Some amendments to securities laws have introduced duplication in regulation. For example, the Securities Industry Act 1983, introduced in early 1998, imposes duties on chief executives and directors of publicly listed companies to disclose their interests in the company or any associated company to the SC. The SC now has the power to apply to court for disqualification of chief executives and directors of listed companies who have been convicted of offenses under securities laws or have had a civil action taken against them for breach of Listing Requirements or of the insider trading or market manipulation provisions. But while these amendments have introduced some overlap in company regulation, the amendments may be justified on grounds that they facilitate the SC's enforcement of securities laws.

In the past the requirements for disclosures in prospectuses are found in the Companies Act 1965 despite the fact that every company issuing securities would have to seek approval of the SC under section 32 of the Securities Commission Act 1993. This fragmentation in regulation has now been rationalized. The amendments deleted from the Companies Act provisions relating to raising of funds and vested in the SC exclusive jurisdiction over prospectuses.

### **Greater separation of ownership and management**

The duality of roles of the Chairman of the Board and Chief Executive Officer (CEO) being held by the same person is generally not so predominant in practice, as gleaned from recent surveys (Khoo, 2003). Some 86 percent of companies have a clear division between the CEO and chairman roles. (IR on the Net.com, 2003). Studies indicate that boards are active and confine to the following tasks: formulating long term strategies; selecting, monitoring and replacing CEOs; reviewing key executive and director remuneration; effectively overseeing potential conflicts of interest; ensuring the integrity of the firm's financial reporting and disclosure and actively communicating with shareholders and stakeholders; and ensuring the effectiveness of various governance practices. The boards are likewise held to be effective forums for serious discussion of all significant matters of the firm (Khoo, 2003).

### **More independent directors**

Every board should have a good proportion of executive directors and independent directors. At least one third of the board should be independent directors, if the Code were to be observed strictly. The KLSE listing rules, on the other hand, stipulates that at least two directors or one third of the board (whichever is higher) must be independent directors. Generally and from the survey results, this requirement has been diligently followed (Khoo, 2003). Recent the research shows that 96 percent of companies have one-third independent board members and almost half have appointed a senior independent director

to whom minority shareholders can direct concerns (IR on the Net.com, 2003). The Bursa Malaysia Securities Berhad/Price Waterhouse corporate governance survey indicates a reasonably proportionate mix of independent non-executive directors, non-executive directors and executive directors. Almost all (90 percent) of companies have at least in name, two independent directors of which half (49 percent) have two independent directors and nearly a quarter (23 percent) have three independent non-executive directors.

The term independence in the Listing Requirements refers to two crucial aspects: first, independence from management and second, independence from a significant shareholder. Bursa Malaysia Securities Berhad has introduced an expanded definition of independence to exclude substantial shareholders.<sup>4</sup>

According to the Code, the board of every company should appoint a committee—exclusively of non-executive directors of which the majority must be independent—charged with the responsibility of proposing new nominees for the board and for assessing the performance of the directors on an on-going basis. The final decision is still the responsibility of the full board after considering the recommendations of the committee. Again from the respondents of the survey received, it appears that such committee has been set up and the suggested composition has been followed. While broadly speaking the companies have abided by the Code, it will be very hard to ascertain whether the spirit of the Code is being observed. In principle, the committee should be free of any influence from the controlling shareholders or the executive directors. In practice, there is evidence that they are.

The survey results also indicate that the independent directors do actively participate in the discussions at board meetings but rarely or if not never add, alter or disapprove board meeting agendas. Some 36 percent of the respondents state that Independent directors sometimes convene formally or informally without management to discuss corporate matters (Khoo, 2003).

On access to information, most respondents including independent directors indicate that they have full access to the firms' business records. Do they have access to independent professional advice if required and to the services of the company secretary? All the survey respondents except one indicate that there is a contact person designated to support the independent directors. Yet, while access is given, independent directors only rarely have discussions with managers of the company who are not board members. Plausibly, this can be due to a number of reasons, such as:

- Independent directors have their own full-time job or commitment;
- Remuneration given to independent directors are inadequate to justify offering of more time than is necessary;
- Access to the managers may merely be just a lip service; and
- Managers do not provide full disclosure to the independent directors for fear of being reprimanded by the executive directors.

Any of the above, if is true for a large proportion of the cases, would seriously impair the effectiveness of independent directors in discharging their duties (Khoo, 2003).

Both the CEO and independent directors by and large agree that the following tasks enhance the effectiveness of the board (Khoo, 2003):

- Selecting more of better qualified, truly independent directors;
- Separating the CEO from the board chairman;

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<sup>4</sup> Substantial shareholding is a defined term in Malaysia and recent revisions to the Companies Act 1965 (Companies (Amendment No.2) Act 1998 now specify a "substantial shareholder" as a persons who has interests in at least two percent of the voting shares in a company.



- Promoting boardroom culture that encourages constructive criticism;
- Timely provision of relevant information to the directors;
- Providing education program and adopting codes of conduct for directors;
- Formal annual evaluation of the board and directors;
- Formal CEO evaluation by the board;
- Giving (independent) directors better compensation and making it more linked to firm performance; and
- Better disclosure of board activity.

The same opinion was given that the following statements contribute towards better performance of the independent directors (Khoo, 2003).

- Greater attendance in board meetings;
- Better preparation for, and more active participate at, board meetings;
- Better knowledge of the business of the firm;
- Greater awareness of their fiduciary duties to all shareholders; and
- Willingness to speak for minority shareholders.

#### **Authorities encouraging boards to serve shareholder interests**

Shareholder level protections are generally more effective than board-level protections but more costly. But the more effective the board is in serving shareholder interests, the fewer the decisions that should require shareholder action. Towards this extent there are provisions in Malaysia that attempt to strengthen the effectiveness of the board's oversight function through basic prescriptions on board structure and composition including prescriptions mandating the presence of independent elements on the board, provisions relating to the appointment and removal of directors and the imposition of strict and onerous duties of directors.

By way of background, Malaysian boards are essentially unitary in nature. The Code of Corporate Governance stresses this point when it sets out as the first principle of corporate governance: *"Every listed company should be headed by an effective board which should lead and control the company."* This stresses the dual nature of the board. Boards are generally made up of a combination of executive and non-executive directors' the latter are meant to exercise independent judgment on the board.

The Malaysian Code on Corporate Governance fleshes out the board to form an audit committee of at least three directors, a majority of whom is independent and chaired by an independent non-executive director within the Listing Requirements. The Bursa Malaysia Securities Berhad /Price Waterhouse Survey provides some insight into the profile of audit committee members set out in Table 3.

The Malaysian Code on Corporate Governance sets out an additional function of the audit committee, i.e., to consider and where it deems necessary to investigate any matter referred to it or that it has come across in respect of a transaction, procedure or course of conduct that raises questions of management integrity, possible conflict of interest or abuse by a significant or controlling shareholder. The report further recommends that, where upon reporting its findings to the board, the board fails to take any action, the directors of the committee should be required under the Listing Requirements to report the matter directly to Bursa Malaysia Securities Berhad. Some listed companies in Malaysia have an internal audit function though law does not mandate this. The Price Waterhouse/ Bursa Malaysia survey suggests that about 68 percent of companies that responded to the survey have internal audit functions and 33 percent out of those have outsourced this function.

The Code on Corporate Governance attempts to strengthen the selection process somewhat by recommending that non-executive directors should be selected through a formal and transparent process. The centerpiece of the suggested formal process is a nomination committee, with the responsibility for proposing to boards any new appointments, whether of executive or non-executive directors. The proposed nomination committee should have a majority of independent non-executive directors and should be chaired by such a director. The Executive summary of the Bursa Malaysia Securities Berhad /Price Waterhouse corporate governance survey indicates that only about 20 percent of companies that responded to the survey had a structured process for selecting independent non-executive directors, and amongst them, the majority (81 percent) involved the Board as a whole.

Table 3. Profile of audit committee members

<b>Representation</b>	<b>Majority</b>	<b>About half</b>	<b>Minority</b>	<b>None</b>	<b>No answer</b>
Financial professionals	20%	17%	37%	21%	5%
Legal professionals	6%	8%	23%	52%	11%
Retired industry leaders	7%	6%	17%	61%	9%
Retired senior government officials	9%	6%	32%	45%	8%

Source: Price Waterhouse

### **Effective legal system protects private assets**

*Danaharta* has been established in 1998 to acquire non-performing loans from banks and assets from distressed companies to minimize the problem of a credit crunch as well as to facilitate an orderly payment/write-down of debts. It will have the same claims as the original creditors and will rely on a number of asset disposal methods (including private placements, public auctions and public tender offers) to recover its claims.

The legal process to be followed by *Danaharta* aims to compensate for the absence of a well-defined scheme of judicial management of corporate restructuring under the Companies Act.<sup>5</sup> The goal is to expedite and shorten the legal procedures and to bring to

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<sup>5</sup> *Danaharta* can appoint Special Administrators (SA) that would have a legal mandate to manage and oversee all operations of the distressed enterprise. On the appointment of the SA, a moratorium for a period of 12 months (which can be extended if necessary) will take effect over winding-up petitions, enforcement of judgments, proceedings against guarantors, repossession of assets, and applications under Section 176 of the Companies Act.

bear professional expertise in design and implementation of reorganization plans. The operations of *Danaharta* are covered under a special act that confers on it broad ranging powers to acquire and manage assets.

### **Public ethics: promotion of Islamic financial services**

Malaysia has set a great example by developing and advancing Islamic financial services, which carries through social and ethical needs. Islamic finance and investment is for Muslims who want to earn money while standing by the requirements of religion. Their capital is invested in other than conventional banking and the gambling, tobacco and liquor industries. In fact, many subscribers use Islamic funds as a proxy for ethical funds, since the latter too avoid “sinful” products and services (ACCA, 2004).

### **Unique system for training directors**

Malaysia ushered in another regional first by requiring all the directors of publicly listed companies to go to mandatory training known as the Mandatory Accreditation Program (MAP). The directors receive training on corporate governance, duties, responsibilities and liabilities of directors, risk management and the legal framework amongst others. They will have to complete the program within four months of assuming the appointment. Beginning July 2003, those who have gone through the MAP are subject to a Continuing Education Program (CEP), under which directors are required to accumulate at least 48 CEP points a year by attending relevant seminars or courses to keep themselves abreast with the latest knowledge. Some 88 percent of all directors have completed the mandatory accreditation program. Malaysia is apparently the only country in the world where director training is mandatory (IR on the Net.com, 2003).

The government hopes that constant retooling will enhance professionalism in directors. The OECD Principles of Corporate Governance suggests that board members should act on a fully informed basis, which would mean acquiring a certain level of experience, competency and training. An effective director needs to be well-versed in among others, financial literacy, strategic planning, human resource development and the vagaries of the business environment. From the survey results, most of the respondents indicated that training is given to directors only on occasional basis. Khoo (2003) suggests that tax incentives could be given by the government.

Overall, with the introduction of the Code, the revised KLSE listing rules and other reforms, the corporate governance mechanisms and structure are in place to enhance the effectiveness of the boards in discharging their fiduciary duties. They should pave the way for a better implementation of the process, in form and in substance, and a buy-in and a positive shift in mindset of the controlling owners (Khoo, 2003).

### **More objective auditing**

If an auditor, in the course of the performance of his duties as auditor of a company, is satisfied that: (a) there has been a breach or non-observance of any of the provisions of the Companies Act 1965; and (b) the circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by the directors of the company, he is required forthwith to report the matter in writing to the Registrar. The penalty for a breach of this provision is imprisonment for two years or thirty thousand ringgit or both.

The obligation to report is triggered when the auditor is satisfied that a breach of the Companies Act 1965 has occurred and where he has no confidence that the directors will deal adequately with the matter. This introduces a subjective element to the duty to report. Reform initiatives are moving in the direction of enabling auditors to report matters that in

“their professional opinion” constitute a breach of the Companies Act 1965 thus providing the auditors an objective standard on which to base their decision to or not to report.

### **Corporate social responsibility**

There is mounting evidence that Malaysian corporate leaders are treating CSR as a business mainstream that is relevant and paramount to support responsibility and governance structures. The recent ACCA survey found more companies communicating and embracing CSR. The quality of CSR practices varies, but the better ones take the exercise seriously to communicate corporate transparency, reputation and sustainability issues. Malaysian corporate leaders increasingly address issues such as diversity and equality, environment stewardship, community work, talent management and building trust. Some of the best examples are as follows (ACCA, 2004).

#### *Diversity and equality*

Southern Bank differentiates itself from others with its gender-friendly policies. The bank was the first to offer a credit card tailored for women. It set up bank facilities and offered financial services at The Women’s Institute of Management. The goal is to make sure SBB WIM Master cardholders are part of “an organization that looks forward to women's involvement in the community, a novel way of fulfilling the agenda for woman's social and business advancement in society.”

#### *Environment stewardship*

Open disclosure practices on sustainable development are already in place among the leading resource-based companies. Petronas crafted a corporate sustainability framework that is committed to seven broad areas: sustaining shareholder value and energy resources; committing to health; safety and preserving the environment; product stewardship; respecting human rights; limiting greenhouse effects; and sustaining biodiversity. It is hoped that Petronas will extend this commitment and bench strength to its supply chain, stakeholders and competitors.

#### *Connecting to community.*

Both Microsoft Malaysia and Maxis Communications have carried out programs to narrow the digital divide in the rural communities. Maxis’ Bridging Communities targets rural children who learn to use computers and surf the Internet at cyber camps. The project involves 500 Maxis employees in volunteer brigades. Similarly, Microsoft Malaysia has a community technology support network to help rural folk to keep up the technology advancement. DiGi has an ongoing Yellow Mobile program, which makes stopovers in various states where its staff volunteers teach young, disadvantaged orphans to appreciate the country’s history of music and culture.

## **A GOOD TRACK RECORD IN PROTECTING SHAREHOLDER RIGHTS**

Malaysian shareholders have been accorded a number of rights to protect their interests by the CA and the KLSE listing rules. These rights have expanded in the aftermath of the Asian financial crisis.

### **Voting and appointing proxies**

Acknowledging that “best practice” requires shareholder rights to participate in corporate strategic decision, the Malaysian government has exerted effort to improve the

quality of AGMs, not unlike those developed by the Institute of Chartered Secretaries in the United Kingdom which basically establishes and defines best practices for the conduct of AGMs and the rights of shareholders in relation to them. Nevertheless there may be scope for statutory intervention in critical areas, such as members' resolutions, and the right to ask questions at AGMs.

The Malaysian Code on Best Practices proposed that companies should use the AGM to communicate with private investors and encourage their participation. Private investors are able to make little contribution to corporate governance. The main way of achieving greater participation is through improved use of the AGM, e.g., the Chairman should provide reasonable time for discussion at the meeting and encourage shareholders to ask questions.

Malaysia has and complies with many best practice standards, e.g., all shareholders are entitled to attend AGM and vote or appoint proxies. Generally there are no stringent constraints on the eligibility of proxies as evidenced by the replies from the survey where most ticked "yes" to the question if anybody can serve as a proxy. A shareholder is entitled to attend and vote at the general meetings of the company if his name has been entered into the register of members not less than three market days before the general meeting, based on the KLSE listing rules (Khoo, 2003).

The principal right of shareholders in respect of their right to vote is their right to vote on the election of directors, on amendments to the constitutional documents of the company, and on key corporate transactions which include transactions where an insider has an interest in the transaction, sale of all or a substantial part of a company's assets, mergers and liquidations. This limits the discretion of the insiders on these key matters.

In this respect the one-share-one vote rule with dividend rights linked directly to voting rights is taken as a basic right in corporate governance. The one-share-one-vote rule is entrenched and observed strictly in Malaysia. Section 55 of the Companies Act 1965 provides in the case of public companies and their subsidiaries that each equity share (and this includes preference shares with voting rights) may carry only one vote thereby prohibiting the existence of both multiple voting and non-voting of ordinary shares and does not allow firms to set a maximum number of votes per shareholder in relation to the number of shares he owns. The idea behind this basic right is that, when votes are tied to dividends, insiders cannot appropriate cash flows to themselves by owning a small share of the company's share capital but by maintaining a high share of voting control.

The CA ensures the shareholders' right to participate in the decision making process involving some of the key corporate governance issues (Khoo, 2003) such as:

- Appointment and removal of directors. Board appointees retiring at the forthcoming Annual General Meeting (AGM) are eligible for reappointment by the shareholders. Directors can be removed from office by the shareholders under Section 128 of the CA, requiring a resolution with only a simple majority but with 28 days notice. Shareholders can nominate candidates for appointment as director. From the survey replies, 82 percent indicated that minority shareholders could nominate candidates for directorships. In practice, effectively directors are nominated and appointed by the controlling shareholders. This is evident from the replies to the survey question where most respondents indicated that it is rarely or unthinkable that director candidates proposed by management failed to be elected.
- Approval of directors' fees. Under the CA, directors' remuneration is subject to shareholders approval. However, the Act is silent on what constitutes remuneration. In practice, most companies only table directors' fees at the AGM for the shareholders' approval as required by the KLSE listing rules.

- Appointment and removal of company auditors under Section 172 of the CA.
- Declaration of dividends. However, interim dividends can be declared by the directors provided they are franked out of profits of the company.
- Approval of the acquisition of an undertaking or property of substantial value or the disposal of a substantial portion of the company's assets.
- Approval of the issue of new shares of the company and amendments to the company's Articles.
- Approval of substantial property transactions involving the directors. The reform is in the direction of ex-ante approval of the transaction to replace the current practice of ex-post ratification.
- Approval of related party transactions. This requirement has been further enhanced by the new KLSE listing rules. For related party transactions exceeding 5 percent of the given percentage ratios in the guidelines, the company must issue a circular to the shareholders providing full details of the transaction and appoint an independent advisor to advise the shareholders on the transaction. If the transaction exceeds 25 percent of the given percentage ratio, the company must appoint a main advisor to ensure that the transaction is carried out in fair and reasonable terms, and not detrimental to the minority shareholders. Such approvals must be obtained prior to the transactions taking place. Interested parties to the transaction and persons connected to them must abstain from voting on the resolution to approve the transaction.

Voting may be by show of hands or by poll. In general practice, voting by poll is very rare unless there are disputes between substantial shareholders. Each member is entitled to one vote on a show of hands unless the articles of a company provide otherwise. But on a poll, a member will have as many rights as his shareholding entitles him. The right to demand a poll is therefore an integral right as a member has then the opportunity to realize his full voting power. The chairman is also not permitted to refuse a demand for a poll nor can he exercise his power in a manner that protects the control of management power by the incumbent directors.

The Companies Act 1965 provides for a statutory right for the appointment of proxies. The statutory provisions are aimed at curbing undue restrictions that may be inserted in articles of associations against voting by proxy. Voting by mail currently has not been legislated yet. Voting by mail certainly makes it easier for shareholders to cast their votes. It overcomes several practical difficulties associated with having to attend general meetings. The objective of broadening shareholder participation suggests the law should consider favorably the enlarged use of technology in voting, including electronic voting. Cumulative voting is also currently not in the law yet. The SC is presently studying the matter (Khoo, 2003).

### **Shareholders' right to requisition a meeting**

Shareholders have the right to requisition for a general meeting under the Companies Act 1965 if they hold 10 percent or more of the paid up capital of the company. If the directors do not convene a meeting within 21 days after the receipt of the requisition, the requisitionists may convene the meeting themselves; in this case the meeting must be held within three months of the date of deposit of the requisition. Crucially any reasonable expenses incurred by the requisitionists in calling the meeting are to be paid by the company, which may reimburse itself out of any sums due to the defaulting directors by way of fees or other remuneration. Members also have an independent power to convene

an extraordinary general meeting under section 145(1) of the Companies Act 1945 which essentially provides that two or more members holding not less than 1/10th of the company's issued share capital may call a meeting of the company.

Shareholders can propose resolutions to be put forth in the general meeting for consideration if they own 5 percent of the voting rights or the requisition is made by at least 100 shareholders each owning not less than RM500 fully paid up shares in the company. From the survey replies 82 percent indicated that minority shareholders could request the company to disseminate relevant information prior to the shareholders meeting (Khoo, 2003).

In addition, all shareholders have a right to obtain a copy of the audited annual reports (under Section 170 of the CA) and circulars issued by the company. The annual reports include the audited financial statements of the company and statutory disclosures as required by the CA under section 169 and the Ninth Schedule and the KLSE listing rules. The statutory disclosures include both financial and non-financial information as well as directors' declaration and statements. Other rights to information include the following:

- Under the new KLSE listing rules issued in 2001, the directors must give supplemental statements on the state of the internal controls in the company and the extent of compliance of the Malaysian Code of Corporate Governance.
- Beginning 1999, publicly listed companies must make quarterly announcements on their financial results and financial position. These announcements are made available to the investing public and must be made by the end of the second month after the quarter end.
- Under the amendments to SICDA in 1998, shareholders can identify the amount of equity ownership of the major shareholders. Companies are required to list the top 20 shareholders of the company together with their shareholdings in the annual report. In the survey results, most respondents "strongly agreed" to the statement that it is not difficult to know how much equity ownership the major shareholders control.
- The CA accords the shareholders the rights to inspect certain statutory records and registers of the company such as the register of members, register of directors, register of substantial shareholders, register of charges and others. The shareholders have also the right to inspect the minutes of AGMs (Khoo, 2003).

### **Shareholders' right to freely transfer shares**

The nature of shares as personal property is recognized in Malaysia. Shares may be freely transferred as provided by the Articles of Association and are also capable of being inherited or transmitted by operation of law. Section 98 of the Companies Act 1965 provides that shares are subject to the general law relating to ownership and dealing in property. The principle of free transferability of shares is fundamental to listed shares. The Listing Requirements are clear that the Articles contain no restriction on the transfer of fully paid securities, which are quoted on it.<sup>6</sup> In addition, re-registration of shares into beneficial owners' names is not required. Shares being voted cannot be blocked for trading.

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<sup>6</sup> The law permits free transferability of shares with some exceptions. If the sale and transfer of shares involved that of a corporation that requires the approval of a Minister then there could well be inhibitions as to free transferability or even sale by private treaty. In private companies the problem arises as to the directors being vested with a right to refuse to register a share. Also it would appear that if directors refused to register a transfer on grounds that such refusal is done primarily to endorse the government's policy of encouragement of active.

### **Relief for abuse of minority by reverse takeovers and back door listings**

At the height of the boom years in the 90s a number of corporate players utilized the mode of reverse takeovers as a means of gaining a back door listing. In so doing a huge premium was paid for mere listing status whilst the existing business was hived back to the previous controllers. Under existing Malaysian law which follows the English position, the controllers owed no direct fiduciary duty to the minority. In so far as they act as vendors of their controlling block and are not also involved intentionally in abetting any offense under the take over legal regime, the minority shareholders are left in the cold in event the new controllers are not able to inject fresh assets or businesses into the company that can justify the premium paid. In such a circumstance the price of the share will suffer a severe fall to the detriment of the remaining shareholders.

There is no rule or principle that prohibits the controllers as common law does not impose a fiduciary duty on the controlling shareholder qua shareholder. The Securities Commission in response to the abuse of back door listings now requires, under Chapter 18 of Policies and Guidelines on Issue/Offer of Securities, prior permission before a back door listing can be effected. The idea is to minimize abuse of the minority. The law also makes clear that there is a case for recognizing the fiduciary duty of the controllers to the minority in situations where there is a change of control.

### **Enforcement of shareholder rights<sup>7</sup>**

The CA provides statutory remedies for shareholders who are unhappy with the act of or inequitably treated by the company or discriminated. The shareholders may apply to the court for appropriate actions under Section 181 of the CA or apply to the court to wind up the company if it is just and equitable to do so under Section 218 of the CA. Generally, the oppressed shareholders apply to the court under Section 181 as it has a wider range of remedies. The minority shareholders can apply for remedies under the following grounds:

- *Oppression:* (a) the affairs of the company are being conducted in a manner oppressive to one or more of the members including the petitioner, and (b) the powers of the directors are being exercised in a manner oppressive to one or more of the members including the petitioner.
- *Disregard of interest:* (a) the affairs of the company are being exercised in disregard of the petitioner's interests as a member of the company, and (b) the powers of the directors are being exercised in disregard of the petitioner's interests as a member of the company.
- *Unfair discrimination:* (a) some act of the company has been done or is threatened which unfairly discriminates against one or more of the members including the petitioner, or (b) some resolution of the members or any class of them has been passed or is proposed which unfairly discriminates against one or more of the members including the petitioner.
- *Prejudicial act:* (a) some act of the company has been done or is threatened which is otherwise prejudicial to one or more of the members including the petitioner, and (b) some resolution of the members or any class of them has been passed or is proposed which is otherwise prejudicial to one or more of the members including the petitioner.

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<sup>7</sup> The references for the court rulings and cases cited in this section and in the next can be supplied upon request from the author.



The court has wide powers to award the appropriate relief under section 181(2). The section provides that the court “with a view to bringing to an end or remedying the matters complained of” may make such order as it thinks fit:

- Direct or prohibit any act or cancel or vary any transaction or resolution;
- Regulate the conduct of the affairs of the company in future;
- Provide for the purchase of the shares or debentures of the company by other members or holders of debentures of the company or by the company itself;
- In the case of a purchase of shares by the company, order a reduction accordingly of the company’s capital; or
- Order that the company be wound up.

In exercising its discretion to award the appropriate remedy, the court will consider the matter at the time of the hearing and not, for example, at the date of the presentation of the petition. The reliefs rank equally and it is not correct to say that the primary remedy under this section is winding up. The court hearing a section 181 petition is empowered to grant a winding up order even if it is not prayed for. The Court in exercising its discretion to wind up a company under section 181(2)(e) will have in mind the drastic character of this remedy, if sought to be applied to a company which is a going concern; it will take into account (a statement which is not exhaustive) the gravity of the case made out under section 181(1); the possibility of remedying the complaints proved in other ways than by winding the company up; the interest of the petitioner in the company; the interests of other members of the company not involved in the proceedings.

The courts have a wide and an unfettered discretion as to the reliefs they may grant which are in no way limited to those listed in section 181(2)(a) to (e). In *Automobiles Peugeot SA v Asia Automobile Industries Sdn Bhd* the High Court allowed an application to amend the petition by adding another prayer that sought to make the second respondent personally liable to pay damages to the first respondent (the company) for alleged breaches of his fiduciary duties as a director of the company. One of the contentions of the second respondent was that the petitioner had no *locus standi* as the proper party in an action of any alleged wrong done by the second respondent to the company should be the company itself. The High Court expressed the view that:

“The injured party in this action is (the company) and s 181(1) and (2) of the Companies Act 1965, under which this petition is presented and relief sought, is specially enacted to overcome the problem posed by *Foss v Harbottle*, and to strengthen the position of the minority shareholders in limited companies. Since there is statutory sanction for a shareholder with a minority interest in a company to institute proceedings against directors from conducting the affairs of the company in a manner prejudicial to the company, there is no longer any need for a derivative action to be filed by the petitioner in the manner suggested by the second respondent for that would amount to a duplicity of actions relating to the same subject matter.”

As regards abuses by controlling shareholders in connection with related party transactions, revisions in the KLSE Listing Requirements made in 2001 now require a company, if a threshold is reached in respect to value, to appoint an independent corporate adviser to advise minority shareholders as to whether the transaction is fair and reasonable and whether or not that transaction is detrimental to minority shareholders (Koh and Soon, 2004).

Malaysia has a number of other provisions designed to curb abusive behavior by interested, related or connected parties, which range from provisions requiring shareholder approval upon disclosure to absolute prohibitions in some cases:

- Loans to directors or director-related parties are prohibited unless they are subsidiaries.
- The approval for disposal by directors of a company's undertaking or property.
- The approval for issue of shares by directors
- Substantial property transaction involving directors and persons connected to directors. Ratification is sometimes the only option for the shareholders due to costs associated with turning back or unwinding a substantial transaction.
- Prohibition of certain transactions involving shareholders and directors.
- Disclosure of shareholding and changes in substantial shareholding to both the company and Bursa Malaysia Securities Berhad.

The high level Finance Committee has advocated new statutory provisions to assist the shareholders to obtain access to company records for the purposes of gathering sufficient evidence for a court action. The court must be satisfied, however, that the shareholder is acting in good faith and the inspection is made for appropriate purposes. In cases of unjust compulsory takeover by the controlling shareholder, the minority shareholder can seek court relief under Section 180. Presently the CA does not sanction any derivative actions or class actions that could be taken by the aggrieved minority shareholders. However the high level Finance Committee has recommended inclusion of both the derivative actions and class actions in the statutes. Under the amended SCA, the SC can bring about a derivative action on behalf of the aggrieved party under Section 155. The SC is currently studying the practicality of implementing an investor compensation program. The scheme aims to indemnify the investors up to a certain amount in the event of firm failure (Khoo, 2003).

### Examples of judicial relief

#### *Where oppression is alleged*

*Coliseum Stand Car Service Ltd; Abdul Khalik v Mohamed Jee.* The company had 15,000 shares, out of which 1,364 were held by the petitioner and 10,909 were held by the 1<sup>st</sup> respondent and the balance held by an administrator of a shareholder. Though the company had credit balance, no dividends were declared for a number of years.

*Held:* The acts alleged constituted oppression and that the 1<sup>st</sup> respondent had conducted the affairs of the company without proper regard to the interest of the petitioner. Loans from the funds of the company were given to the majority shareholder and his son without the approval of the company or its directors. The majority shareholders contended that the loans had been repaid.

*Held:* There was nothing to show that the loans were made for the benefit of the company. It was quite improper for the company, controlled entirely by the 1<sup>st</sup> respondent, to authorize the use of the company's funds for a purpose unconnected with the company's affairs.

*Owen Sim Liang Khui v Pasau Jaya Sdn Bhd.* The petitioner, a minority shareholder, held 15 percent of the shares in a company. The company wrote to the petitioner alleging that he owed it a sum of RM111,734.60. The petitioner denied owing the sum. The company's board resolved that the petitioner's shares should be sold to satisfy the debt, and the petitioner's shares were subsequently sold. The petitioner contended that the acts of the company were oppressive or unfairly discriminatory or otherwise prejudicial to him. On an application made by the company, the petition was struck out by the High Court. On appeal to the Court of Appeal, the decision of the High Court was set aside.

*Held:* The matters alleged in the petition, if true, may in law amount to oppression or unfairness. Mismanagement is not an essential element in the concept of oppression. Therefore, an allegation of mismanagement does not have to be pleaded in every case of alleged oppression to make the petition an acceptable pleading.

*Where substratum of company is gone*

If it were shown to the satisfaction of the court that the whole substratum or the whole business which a company was incorporated to carry on has become impossible, it may be just and equitable to wind up the company.

*German Date Coffee Co.* The company was formed for the purpose of purchasing and working Henley's German patent Frankfort for the manufacture of coffee substitute from date fruit. It was discovered that the German patent could not be obtained as the German Empire would not grant patent.

*Held:* The company would be wound up as the substratum of the company had failed.

*Where business is carried on in a fraudulent manner*

Where the business of a company is being carried on in a fraudulent manner, a petition may be presented to wind up the company.

*Thomas Edward Brinsmead & Sons Ltd.* A firm, "JBS," was a noted piano maker. Some employees of the firm set up another company, T Ltd, to manufacture pianos which the court found were to be passed off as the products of the JBS. JBS obtained an injunction against T Ltd. from using the name.

*Held:* The company was formed for the purpose defrauding JBS. The shareholders, who had been misled into believing that the company had the right to use the name and goodwill of JBS could to refuse to continue in a business which was a fraud. In view of the fraud that had been committed, and to protect the interest of the innocent shareholders, the company was wound up.

*Where members can no longer continue to work in association*

The ground can be applied in circumstances where the relationship between members of a company has reached a "deadlock". The question whether such a deadlock exists as makes it just and equitable to wind up is a question predominantly of fact in each case. In assessing whether it would be just and equitable to wind up on this ground, the court will consider who has caused the deadlock. Otherwise, a wrongdoer may deliberately cause the deadlock and then ask the court to wind up the company. There may not be a stalemate as long as the day-to-day management of the company is still possible. If there is a possibility that the impasse could be resolved in some other manner, the court may not grant an order for winding up.

*Re Yenidje Tobacco Co Ltd.* A company was set up by 2 persons, R and W, to carry on the business of tobacco manufacturer. They were the only shareholders, holding equal voting rights and the only directors. Subsequently they fell out, and could not get along with each other. Eventually, they ceased to communicate with one another except through the secretary. R had sued W in a separate action alleging fraud.

*Held:* It could not be expected that the two shareholders would work together. No substantial business was being transacted. Even though the company was still making large profits, it was ordered to be wound up.

*Exclusion from management*

Where a petitioner has been deliberately excluded from the management of a company in contravention of an understanding that he will be allowed to participate in managing the company, it may be just and equitable to wind up the company.

*Ebrahimi v Westbourne Galleries Ltd.* A company was incorporated to take over the business of a partnership. The partnership business had been carried on by E and N as partners, equally sharing the management and the profits. Both of them became the shareholders holding equal shares and they were made the first directors of the company. Soon after the formation, N's son, G, was made a director and each of the original shareholders transferred to G 10 percent of the shares. Therefore, N and his son G had a majority control of votes in general meeting. The company did not distribute dividends but the directors were paid remuneration. Subsequently, a resolution was passed removing E as director.

*Held:* Winding up order to be granted. E, after a long association in the partnership, during which he had an equal share in the management, joined in the formation of the company. The inference must be indisputable that he and N did so on the basis that the character of the association would, as a matter of personal relation and good faith, remain the same.

#### *Derivative action*

A derivative action is taken where a minority shareholder is desirous of enforcement of the company's rights against the majority. A Court's judgment or ruling would be given in favor of the company. The Company is made a party to the proceedings. It should be noted in this respect that the director's fiduciary and statutory duties as well as their common law duties of care, skill and diligence are owed to the company and not the individual shareholders. Also, the power to institute action in the company's name generally rests with the board. It is practically very difficult to cause the company to commence action against the defaulting director especially where he controls the board. So it is not uncommon to find that a company commences action after there has been a change in management or where the defaulting director has left the company. The avenue for minority shareholders to institute action in the company's name is through a derivative action. But to do so the minority shareholder would have to fall within one of the exceptions to the rule in *Foss v Harbottle*. Malaysia recognizes the exceptions—if there are *ultra vires* acts or illegality, fraud on the minority, and there has been a denial of individual rights of membership.<sup>8</sup>

There has been some debate whether a statutory derivative action should be provided. The Singapore Companies Act<sup>9</sup> has introduced provisions to that effect in 1993 but has excluded the operation of such a statutory remedy from listed public companies. It is evident that shareholder litigation is costly and involves a fair amount of monies. If the action is derivative in nature the benefit resides with the company. The incentive to engage in such litigation is minimal whilst the disincentives are prohibitive.<sup>10</sup> The Corporate Law

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<sup>8</sup> There has been suggestion of another exception, that is, "in the interests of justice". It is unclear that such an exception is an independent one and whether Malaysian Courts recognize it.

<sup>9</sup> See sections 216A and 16B of the Act.

<sup>10</sup> There is a judicial attempt in Malaysia to forge a solution to the costs issue in respect of a derivative action. It is clear that a grant of indemnity is seldom available. For example, if the suit is representative in nature or to seek remedies against an abuse of fiduciary powers then it would not be proper to apply such an indemnity.

Economic Reform Program in Australia (CLERP) argues for the introduction of a statutory derivative action.<sup>11</sup>

Section 155 of the Securities Commission Act 1993 now provides that the Commission may recover loss or damage by reason of the conduct of another person who has contravened any provisions or regulations made under this Act, whether or not that other person has been charged with an offence in respect of the contravention or whether or not a contravention has been proved in a prosecution. This new provision enables SC to take on derivative action against malfeasant officers and third parties which has caused loss and damages for the company.<sup>12</sup>

### **Entrenchment of rights**

The Companies Commission of Malaysia Act 2001 (“CCMA 2001”) came into force on April 16, 2002. The Act establishes the Companies Commission of Malaysia (CCM), provides for its function and powers and for matters connected therewith. The CCM is a merger of the Registry of Companies and Registry of Business. In contrast to the memorandum, the articles of association may, subject to the Companies Act 1965, be freely altered or added to. This power of alteration by special resolution can affect the pattern of rights and duties to the prejudice of a member’s rights. In practice, there have been a variety of devices which have been employed to entrench member’s rights and duties. Shareholder agreements and voting arrangements can be entered into providing various procedural and substantive arrangements that delineate the lines of power and entitlements.

In certain companies the use of special voting rights entrenches certain rights under its constitution. For example the Projek Lebuhraya Utara-Selatan Berhad (PLUS), the corporate vehicle that is part of UEM which implemented the North–South highway concessionaire has a Special Share that may be held only by or transferred only to UEM or any wholly owned subsidiary of UEM. Basically the Special Share entitles the holder of the share to exercise a negative veto over any resolution tabled.

In certain Government Linked Companies (GLCs), the Government also holds a Special Share. For example, the national electric corporation, Tenaga Nasional Berhad (TNB) has a Special Shareholder i.e., the Minister of Finance Inc. (MOF Inc.). MOF Inc. as Special Shareholder has the right to appoint “any person to be director...so that there shall not be more than six (6) Government Appointed Directors at any time”. The Special Shareholder has clear veto rights over a number of matters. This type of Special shareholder rights is a device used for privatized government corporations, e.g., the national airlines (MAS) and the national telecommunications company (Telekom). This golden share holding may be utilized as a disciplinary measure for recalcitrant controllers, which the government is displeased with. It also alters and impacts the governance process. There are nevertheless some restrictions to the power to alter articles. First, when voting to alter the articles, a member must act “*bona fides for the benefit of the company as a whole*”.

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<sup>11</sup> Its introduction is viewed, not as imposing a new form of liability on directors, but rather as removing uncertainty and therefore providing for a more effective means by which the director’s duties to a company may be enforced. This would increase private enforcement in the long run and reduce the need for public or regulatory interference. In this respect, CLERP does look at the statutory derivative action as a valuable tool to enhance corporate governance and maintain investor confidence.

<sup>12</sup> See *Australian equivalent: ASC v Deloitte Touche Tohmatsu* (1996) 138 ALR 655;21 ACSR 332.

## **SOME PROBLEMS PERSIST AND NEED TO BE PAID SERIOUS ATTENTION**

### **Shareholder participation is low**

The level of participation by minority shareholders in corporate governance remains relatively low: Essentially the minority shareholders groups in Malaysia are made up of the following categories of investors:

- Institutional investors, both foreign and local,
- Fund managers with smaller portfolios,
- Retail or individual investors, and
- Market speculators.

Shareholder activism is generally weak in Malaysia. Minority shareholders generally do not maximize their role in ensuring good corporate governance practices by their boards.

This could be due to the following constraints/factors (Khoo, 2003):

- Prevalence of large controlling shareholders in the companies they invest in.
- Eastern social culture of no open confrontation particularly if the controlling shareholder is a high profile personality.
- Minority shareholders free-riding on the controlling shareholder if the company is consistently generating good returns
- Private and individual investors do not hesitate to choose divestment as the easy way out, rather than slugging it out with management.
- It is costly and time consuming to institute legal action and to obtain compensation from the companies.
- Collective action problem of minority shareholders with regard to their need to seek legal recourse and to procure sufficient vote for additional strength.
- Information asymmetry—private and individual investors may lack the required knowledge to fully comprehend the disclosures and the impacts of any abusive transactions.
- Low awareness of shareholders' legal rights.
- Low culture of investment over the long term. Investment motives may be driven by rumors and hearsay and rather than sound fundamentals.

Shareholders attending AGMs are generally private or retail investors. On the other hand, Institutional investors generally prefer private briefings with the company's management for information on the company. As evidenced from the survey results, few shareholders attend AGMs. This is to be expected because of the superiority in voting of controlling shareholders. Minority shareholders are aware that resolutions will still be carried through even if they object because of the majority control by the controlling shareholders. Poor attendance can also be ascribed to the practice of private briefings for the institutional investors. It effectively deprives the shareholders of the opportunity to understand concerns raised by the institutional investors and the answers given by the company. The practice may lead to the private shareholders feeling disenfranchised (Khoo, 2003).

There is no formal provision in the CA for shareholder questions during the AGM. The handling of shareholder questions is left to the discretion of the board of directors. The shareholders have to confine their queries to matters in the resolution under common law. However, in practice, an open forum for the shareholders allows them to ask a wide range of questions under the agenda item adopting the reports and accounts. Normally shareholder questions are few in number and there is not much communication of the

company's business plans or strategies by the board to the shareholders during the AGM (Khoo, 2003).

A number of developed economies have focused efforts on increasing the quality of shareholder communications, namely through the AGM, for it gives all shareholders, whatever the size of their shareholding direct and public access to boards. The idea should be to increase its effectiveness so institutional shareholders see value in attending the meetings.

### **Meeting and proxy information not conveyed in timely manner**

Another crucial area in increasing the effectiveness of the shareholder's right to vote is in terms of improving the quality and timeliness of information that gets out to shareholders before shareholders meetings. Companies start the visible process of preparing for Annual General Meeting ("AGM") by sending shareholders the notice of AGM. Section 145(2) Companies Act 1965 requires at least 14 days notice of meetings other than for a meeting to pass a special resolution (21 days) or for one requiring special notice (28 days). This means that there must be 14 clear days between the issue of the notice and the date of the meeting. This applies to both AGMs as well as EGMs. Notice of meetings must be given to every member. The company's auditor is also entitled to notice of meetings.

However under common law, the notice calling a meeting must contain sufficient information to enable a prudent member to decide whether or not he will attend a meeting. Otherwise a member may be able to invalidate any resolutions passed. In the context of election or re-election of directors, in practice too few boards currently make any real effort to persuade shareholders of the merits of directors nominated for election or re-election. There is certainly scope for improvement in the information that accompanies notice of meetings.

### **Historical domination by majority investors**

In Asia the more serious problem arises not from large shareholdings but from the more widespread practice of pyramiding and cross-holdings. This causes a major divergence between the control and cash flow rights of insiders. Therefore, the incentive is for insiders to maximize their private benefits of control and not necessarily that of shareholder value. There is thus a higher probability that minority shareholders run the risk of being expropriated or squandered. The managers or controlling shareholders in a company are in a position to expropriate minority shareholders:

- By selling to a connected party the output or an asset of the company at below market price,
- By buying from a connected party an input or an asset at above market price, and
- By acquiring an interest in a company connected with a related party at above market price.

A sample of the more reputable or larger of the listed companies (comprising 13 percent of the total in number and over 50 percent in market capitalization) showed that the incidence of concentrated shareholding (even as measured by the shareholding of the largest shareholder) is very pronounced in the Malaysian market. The incidence of dispersed shareholding is uncommon. The incidence of interlocking ownership and cross-guarantees between firms in the same conglomerate is low compared to the situation in Japan or Korea. However, concentrated shareholding through a pyramid structure is more widespread. The number of layers between the controlling shareholder and the most

distant subsidiary is three, nonetheless it still makes for a significant divergence between control and cash flow rights of the controlling shareholder.

A large investor may be rich enough that he prefers to maximize his private benefits of control (including investments in unrelated activities, whether for diversification or for the purpose of empire building), rather than maximize his wealth. Unless he owns the entire firm, the large investor will not internalize the cost of these control benefits to the other investors. This will then be reflected in the failures of large investors to force their managers or companies to maximize profits and pay out the profits in the form of dividends.

An examination of the foreign controlled companies, especially those which have a clear majority shareholder, shows that these companies have been paying out a high proportion of their profits in the form of dividends (and not reinvesting the profits in diversified or empire-building activities). Such high dividend payout ratios may have been facilitated by the more healthy relationship between the control rights of the majority shareholder with its cash flow rights.

In the case of locally-controlled companies, the control rights were usually well in excess of the cash flow rights of the controlling shareholder, usually because of the pyramid structure of companies in the same group. This could explain their much lower dividend payout ratios and their greater propensity to reinvest their profits even in unrelated activities, at least in part to maximize the insider's private benefits of control.

The Malaysian corporate sector has shown high ownership concentration. The largest five shareholders accounted for more than half the voting shares or stocks in an average company. The largest shareholder held, on average, about 30.3 percent of the shares of an average company. That suggests that minority shareholders are all but powerless to prevent large shareholders from dominating company decision-making (Samad, 2002).

With this structure being widespread, the agency problem between the controlling shareholders and the minority shareholders is potentially serious and the threat of expropriation of minority shareholders' rights becomes very real. Expropriation can be avoided only if management is separated from ownership or the appropriate corporate governance mechanisms are in place to check any abuse of power. Current corporate governance reforms do not come up to this issue. However, the current reform initiatives do attempt to put proper corporate governance mechanisms in the management of such organizations (Khoo, 2003).

The exclusion of substantial shareholders from independent participation on boards, (especially if a substantial shareholder is defined as one with a shareholding of 5 percent or more), can have the effect of disenfranchising a significant group of persons with a strong incentive (as a result of their large shareholding) to ensure that their rights are not aggrieved by the conduct of the controlling shareholder. Collective action problems preclude effective monitoring by small shareholders. But large shareholders, in defending their own self-interests will often defend the interests of small shareholders as well. Therefore to exclude these persons or their nominees from the definition of independence and thereby from the various board committees that mandate the presence of an independent majority seriously erodes the ability of large outside shareholders to make it harder for the insiders of a company to ignore or deceive a minority shareholder.

Given ownership concentration in Malaysia, the basic rights and improvements suggested above will not sufficiently address minority shareholder protection concerns and their fair treatment. Investor confidence that the capital they provide will be protected from misuse or misappropriation by controlling shareholders, managers and directors is an important factor in capital markets.



### **Corporate attitudes undervalue performance assessment**

In Malaysia there are many instances where the controlling shareholders are also the directors, making the task of assessing performance very delicate and sensitive in the absence of an agreed and formalized mechanism or evaluation instrument and set criteria. Bosses do the evaluation and are not evaluated. 360 degrees performance evaluation is not widely practiced. It is an uphill task for the remuneration committee to play its role meaningfully. From the survey, all respondents signaled that formal mechanisms to evaluate the performance of directors exist but they are ineffective (Khoo, 2003).

### **External auditors: too much discretion**

External auditors are meant to provide an external and objective check on the way financial statements have been prepared and presented. However, the framework under which auditors operate is not well designed. For instance, accounting standards and practice allow boards too much scope for presenting facts and figures in a variety of ways. Whilst shareholders formally appoint auditors and the audit is carried out in their interests, shareholders have no effective say in audit negotiations and no direct link with auditors. Auditors instead work closely with management. Breaking out of the closeness of the relationship is difficult, as auditors have no easy line of communication with the shareholders to which they report. Audit firms also compete for audit work. There is, therefore, a significant amount of pressure for an auditor to reduce the scope of the audit to the minimum necessary. The situation is made worse by the apparent use by some auditors of “lowballing” or “predatory pricing” practices using audit as a loss leader for other more lucrative non-audit services.

### **Lack of division between politics and the corporate sector**

In Malaysia, corporate governance institutions have acquired respectability for regulating the financial market. But because of the hegemony of the executive over the state, the relevance and effectiveness of these institutions depends primarily on the will of key government leaders to enforce corporate governance. Simply put, regulatory institutions can—and often—behave independently but may also be used as tools by powerful politicians for vested interests. These politicians can exert influence so that these regulatory institutions do not press sanctions against favored businessmen (Gomez, 2003). There are generally two forms of political favoritism said to exist in Malaysia. The first is the official status awarded to companies that are run by the Bumiputras and the second consists of much more informal ties that exist between leading politicians and companies (Liew, 2006).

## **ACTIVATING THE DRIVING FORCES OF CHANGE**

The Malaysian corporate governance code of best practice was introduced in recognition of the crucial role that enhanced standards of corporate governance can play in boosting international investor confidence. Significantly, empirical evidence indicates that foreign investors are certainly one of the main forces driving corporate governance reforms in Malaysia. (Liew, 2006). It is only right for foreign investors to exert pressures for good corporate governance.

Institutional investors are also realizing they can wield substantial influence. They are taking the lead in improving shareholder activism in Malaysia. They can exercise their clout either through their representatives in the boards or the effective use of their votes in AGMs. The SC has made substantial efforts to encourage institutional investor

involvement, including promoting the independence of the board of directors of financial institutions that provide investment services, expanding the fiduciary obligations of the directors of these institutions, reducing these institutions' conflicts of interest and related party transactions, and increasing their disclosure of information about their investments. In turn, the SC will evaluate the appropriate shareholder value maximization disclosures that institutional investors are required to provide with regard to their investment decisions (Khoo, 2003).

Non-governmental organizations like the Malaysian Institute of Corporate Governance are contributing to training and education. The MICG has conducted 30 corporate governance training programs for 7,000 participants (9th Malaysia Plan 2006–2010).

A minority shareholder watchdog group—Badan Pengawas—is working to unite minority shareholders and raise governance standards, as well as to monitor and combat abuses by insiders against the minority. The major activities of this MSWG include the following (Khoo, 2003):

- Corporate governance monitoring services where quarterly and special reports are issued to the public.
- Proxy voting services – minority shareholders can appoint MSWG to attend general meetings on their behalf.
- Governance scanning of 200 securities listed in KLSE.
- Providing training, education and awareness programs to promote shareholder activism and the benefits of good corporate governance practices.
- Investigating complaints from minority shareholders.
- Collaborating with the SC on corporate governance issues.

The MSWG conducted the Corporate Governance Rating Survey and developed the Corporate Governance Screencard as well as the Corporate Governance Monitoring Control Sheet (9<sup>th</sup> Malaysia Plan, 2006–2010).

Stakeholder activism can complement robust shareholder action. Stakeholders include employees, customers, suppliers and creditor banks. The rights of stakeholders are guaranteed by various statutes in the country such as labor law, contracts law and insolvency law. From the survey results, both the executive and independent directors affirmed the goal (besides making profits for the shareholders) of attaining the well being of various stakeholders. It is in the long-term interest of corporations to foster wealth-creating cooperation among the stakeholders. Traditionally stakeholders are viewed as passive business partners (customers, suppliers and creditor banks) external to the organization. Employees are viewed merely as a labor resource. In more recent times, in line with the OECD Principles of Corporate Governance provision that “the corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation”, proposals have been made to permit more active monitoring by creditor banks of their corporate clients' accounts and by employees of the performance of the firm (Khoo, 2003).

Malaysian banks, however, are currently in the phase of consolidation and restructuring their own operations to face the challenges of greater competition and market liberalization. Giving them the policing role at this point in time may be overloading the management of the banks. They also need to put their own house in order first: during the financial crisis banks extended loans based on personal relationships rather than on sound system of lending practices, resulting in a high rate of non-performing loans. As regards the labor union movement in Malaysia, it has generally been weak. Currently labor unions

mostly comprise of blue-collar workers, non-executives and specific industry workers. Although traditionally labor unions were seen as adversaries of management, today they do accept being organized into problem solving groups or quality circles because of the Total Quality Management movement that swept the country in the last decade or so. It is expected that education and exposure to modern management thinking would generate feelings of partnership and goodwill. Management who are exposed to the modern management thinking and concepts tend to have a more positive view of labor unions and joint labor management committees. Examples of governance mechanisms for labor participation include employee representation on boards, employee share option schemes or other profit sharing mechanism and governance processes that consider employees' viewpoints in certain key decisions. This is evident from the survey results received where a good percentage of the respondents indicated they have stock option plans, problem solving groups and job rotation and cross training for the non-managerial/supervisory employees. Participation gives employees more stakes in their firms' performance, encouraging them to monitor management's behavior. The only setback is employees who may come to have knowledge of abuse or wrongdoing may not so willingly come forward and be the whistle blowers to expose the abuse/wrongdoing. There are many possible reasons: fear of losing one's job, fear of being victimized by the management, fear of being ostracized by fellow employees. Likewise, in the Asian context submitting to authority and avoiding adversarial relations with management are the social behavioral norms (Khoo, 2003). But these can be surmounted.

## **WHAT GOVERNMENT CAN DO FURTHER**

### **Strengthen the enforcement capability of statutory regulators**

A critical area for improvement in lies in strengthening the effectiveness of enforcement action by the regulators. There has been considerable criticism of the speed and effectiveness of enforcement efforts by the various regulators. Critical areas for improvement include (World Bank, 2005):

- Strengthening the autonomy of powers granted to regulators to enforce laws – Consistency in enforcement of laws and regulations ensures a level playing field for all participants.
- Rationalization of the regulatory framework – Fragmentation obstructs enforcement in two critical ways. First it confuses jurisdiction over laws that often lead to regulators struggling to react to situations and often in uncoordinated enforcement activity. A fragmented framework relies heavily on arrangements between regulators. Second, it causes confusion with the public, which then leads to unwarranted but inevitable blame being laid on a regulator, not responsible for regulating that activity, thus further entrenching the perception that regulators are not enforcing the law.
- Modernizing the range on enforcement powers of regulators which would include the introduction of a general power that allows the regulator to institute civil action on behalf of an investor to recover damages suffered by the investor as a result of transgressions. This right should be extended to investors to enhance their private enforcement capabilities.<sup>13</sup>

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<sup>13</sup> Sections 90 and 90A of the Securities Industry Act 1983 now provide for the recovery of losses caused by insider trading, by way of civil actions instituted either by the Securities Commission or the investor. Contrast the general power given to the Australian Securities Commission under the Australian Securities

- Developing the right experience and skills in enforcement – Priorities should be altered from market development to supervision and enforcement.
- Enhancing the accountability and transparency of regulators – Disclosure of details of enforcement activity and action taken allows the public to evaluate the extent to which the regulators are enforcing laws and the effectiveness of action taken which creates the right incentives for regulators to be pro-active in its enforcement efforts.

In addition to these, according to Khoo (2003), the various regulatory bodies can start paying more attention to other areas of improvement such as:

- Statutory provisions for derivative and class actions,
- Investor compensation programs,
- Activities to improve institutional investor and shareholder activism,
- Activities to create better awareness for good governance practices, and
- Studying to amend/add certain statutory provisions to improve corporate governance such as mail voting, cumulative votes and codification of the fiduciary duties of directors.

### **Improve the audit system**

Steps have been taken to improve the audit system. The Financial Reporting Foundation and its Associated body, the Malaysian Accounting Standards Board have been set up to improve and tighten accounting standards, to give these standards the force of law and to facilitate enforcement of these standards through companies. This is a very important step for accounting standards provide important reference points against which auditors exercise their professional judgment.

The audit framework could be strengthened further. For instance, there should be full disclosure of fees paid to audit firms for non-audit work. The problem with non-audit work is that where auditors undertake non-audit services, it will increase the value of the firm to the auditorship and thus make the auditors more reluctant to do anything which will render it likely that the board of directors will seek to get rid of them as auditors. Full disclosure of fees will enable the relative significance of the company's audit and non-audit fees to be assessed. As such subparagraph 1(q) of the 9th Schedule of the Companies Act 1965, the requirements in respect of disclosures in profit and loss accounts, should be extended to include disclosure of fees paid in respect of non- audit work. A key reform item is strengthening the relationship of the external auditors with the audit committees, including duties of Audit Committees consistent with international best practices (World Bank, 2005).

### **Encourage industry buy-in of good corporate governance**

Malaysia recognizes industry buy-in to the efforts by the regulators in promoting corporate governance. Listed companies in particular must embrace corporate governance in total. However, rules and regulations by themselves may not be effective if not accompanied by acceptance and desire to comply by the industry. This is where surveillance, monitoring and enforcement continue to be part of Bursa Malaysia's duty to the industry and without fear or favor. In tandem with the rising expectations of directors' performance and accountability to the company and its shareholders, Bursa Malaysia is

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Commission Act 1989, which allows the Commission to take action in a person's name for recovery of property of the person.

empowered under the new Listing Requirements, to take action against the directors personally, where they commit a breach of the Listing Requirements. This will serve as a wake-up call that they have been put in positions of trust and that they must honor this trust and act in the best interests of the company. To assist the directors in discharging their duties, Bursa Malaysia has also mandated them to attend training programs on a continuous basis. This mandatory attendance at CPD has attracted both commendations and criticisms.

### **Protect whistle-blowers**

The SC has also introduced whistle blowing protection legislation. This is a laudable measure to engender and foster a milieu which will permit disclosure of corporate wrongdoings without concomitant penalties of victimization and dismissal visited upon the witness. There has been some work done in areas of statutory derivative action and improvement of proxy voting mechanisms in SC. This has yet to be completed or promulgated.

### **Strengthen the private enforcement capacity of investors**

There is a major deficiency in the ability of investors to institute action against directors for breach of their fiduciary duties. The existing common law provisions on derivative actions have several practical and substantive difficulties that have proven to be almost insurmountable to minority shareholders. There is also considerable uncertainty whether ratification by some shareholders of a director's breach of duty would result in denying other shareholders, the right to bring a derivative action to protect a company. The introduction of a statutory derivative action provides for a more effective means by which a director's duties to a company may be enforced. Additionally, there is no provision related to class-action lawsuits. Steps should be taken to make it possible for shareholders and investors to file class-action suits against directors and managers for breaches of duty and violations of the law. These would increase private enforcement in the long run and reduce the need for public or regulatory interference (World Bank, 2005).

### **Strengthen the effectiveness of independent director representation on boards**

There has been a discernible trend in Malaysia to increase the range of matters where decision-making authority is reserved to the general meeting of shareholders. But while shareholder level protections may be more effective, they are also more costly than board level protections. But the more effective the board is in serving shareholder interests, the fewer the decisions that should require shareholder decision. In Malaysia there appears to be increasing reliance on independent directors to strengthen the necessary checks and balances when broad powers of management are conferred on directors. There are broadly three areas of improvement that one may suggest

- As argued above, that any attempt to exclude large shareholders (albeit minority shareholders) from participating as independent board members can have the effect of disenfranchising a significant group of persons with a strong incentive (as a result of their large shareholding) to ensure that their rights are not aggrieved by the conduct of the controlling shareholder.
- One way of harnessing the ability of these large minority shareholders to put their representatives on the board is for the law to provide for cumulative voting for directors. Bearing in mind the heavy reliance on independent directors to take the lead in management oversight and control self dealing by controlling shareholders, a strong case may be made for strengthening the process by which independent

directors are given a presence on boards.

- Once on boards, the law should ensure that the independent directors are empowered sufficiently to ensure that they are able to participate effectively. There is scope therefore for section 131 of the Companies Act 1965 to be strengthened to require an interested director to abstain from voting in respect of transactions that the director has an interest in (World Bank, 2005).

### **Facilitate the shareholder's ability to exercise his right to vote**

A second area for reform is to strengthen the ease with which a shareholder is allowed to vote by providing for voting by mail whether by member or by proxy. Voting by mail overcomes several practical difficulties associated with having to attend general meetings,<sup>14</sup> not to mention that it is a cheaper and more efficient manner of enabling shareholders to exercise their right to vote. This should be supplemented with provisions mandating longer notice periods and sufficient disclosure of information to give shareholders the opportunity of deciding how they should vote.

### **Revise the Companies Act 1965 provisions on related party transactions**

To prevent the abuse of minority shareholders by the controlling shareholders and other insiders, there are legal and regulatory provisions requiring the approval of shareholders on substantial and connected party transactions. However, there are still weaknesses which must be addressed as expeditiously as possible to reduce ownership concentration and increase the reliance of companies on external finance. Therefore the first critical area for reform would be to strengthen the related party provisions in the Companies Act 1965.

It should be stated at the outset that the Listing Requirements on related party transactions are much tighter and better defined, especially the new rule which came into force in July 1998. Reliance on just the Listing Requirements, however, is not satisfactory for the following reasons.

- The range of penalties open to the Listing Requirements to take, while impressive, cannot compare with that of the statutory regulator. Section 11 of the Securities Industries Act 1983 provides that in addition to any other action a stock exchange may take under its rules, Bursa Malaysia Securities Berhad can take the following actions – directing the person in default to comply with the rules, impose a penalty, the quantum of which shall commensurate with the gravity of the breach, provided that it does not exceed one million ringgit and finally reprimand the person in default. Bursa Malaysia Securities Berhad may under its Listing Requirements also suspend or de-list a company and where the companies are punished through suspension or delisting, one may end up compounding the losses of the injured parties, namely the minority shareholders.
- There have also been doubts expressed as to the extent to which the Listing Requirements may restrict a shareholder from voting his shares in respect of a transaction that he is directly interested in. Bursa Malaysia Securities Berhad rules it is felt cannot deny a shareholder that fundamental property right.
- Bursa Malaysia Securities Berhad does not have the enforcement infrastructure available to a statutory regulator, which would include for example the statutory

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<sup>14</sup> Shareholders may be dispersed all over the country, not to mention foreign institutional investors, who may not be based in the country, so that attendance at general meetings would be difficult and costly.

right to require information, rights of search and seizure that would make its enforcement exercise more effective.

The provisions on related party transactions in the Companies Act only requires the transactions to be disclosed and approved by shareholders but the interested parties are not required to abstain from voting. The Listing Requirements do not suffer from the same deficiency. Therefore, the Companies Act should be amended to require the interested parties to abstain from voting on a connected party transaction.

With the recent amendments to the Securities Industry Act, penalties for insider trading have been increased to three times the insider's gain. The new civil penalties also allow investors to seek full compensation for loss from the offenders. As substantial and connected party transactions have the potential to inflict more harm on minority shareholders than even insider trading, as amply demonstrated by recent events, the penalties for the breach of legal provisions with respect to such transactions should be reviewed and substantially increased. There is also a pressing need for improving the quality of legal enforcement against the breaches of such provisions.

### **Restrict large creditors' role to bankruptcies**

The banks in the country do play a major governance role in times of corporate insolvencies. They appoint receivers or liquidators. But for companies which are not insolvent but illiquid and which require to be restructured or rehabilitated, the procedures for turning control over to the banks (including the rules for them to change managers and directors) are not well established. Nonetheless, the legal environment, until recently, was more favorable to the creditors. And in the absence of well-established rules for the rehabilitation of companies, this may have caused firms suffering from illiquidity to be driven into insolvency. Banks do not play a role in governance save in bankruptcies. But there are some who are in favor of promoting in Malaysia governance based on banks or even state enterprises as large shareholders as an alternative to current arrangements.

This recommendation is doubtful. Banks in Malaysia as well as in Asia are hardly able to take care of themselves. Therefore, it will not be advisable to entrust them with a key role in the governance of listed companies. The loss of focus is likely to make matters even worse. Furthermore, the incentive of a bank in governance is likely to be severely distorted, as its primary interest is in lending. Where it is a significant minority shareholder and exercises control over a company by voting these shares and the shares of others for which it acts as a proxy, its main interest is in enhancing its own income from its lending and other related activities and not in enhancing shareholder value.

### **Improve the quality of annual meetings**

Another area of reform is to improve the quality and effectiveness of the annual general meeting (AGM), which would help motivate institutional shareholders to attend and participate. As evidence suggests, attendance at AGMs in Malaysia is not high, and is dominated by retail investors. While the Malaysia Code on Best Practices represents a positive effort to attain the excellence of AGMs, similar to that of the Institute of Chartered Secretaries in the United Kingdom, through focusing on the conduct of AGMs and the rights of shareholders in relation to them, there may be scope for statutory intervention in this area (World Bank, 2005). It may be worthwhile, as Khoo (2003) suggests, to require directors, by way of statute provision, to brief the shareholders on the performance of the reporting financial year and the business plans/strategies for the coming year without giving away any confidential secrets which may imperil the competitive position of the company. This will give the private investors the chance to

hear out the directors and to judge for themselves the future profit prospects of the company. It will also give them an added reason to attend the AGM, not so much as to vote, but to hear the directors' briefing. They won't feel it is an absolute waste of their time to attend when their votes will not materially affect the passing of resolutions.

### **Reform GLCs**

The government is currently implementing a series of reform to enhance the performance of government-linked corporations (GLCs). In this context, the government should review the organization of ownership function of the state in order to ensure that the policy/regulatory functions are clearly separate from the ownership function, in line with international good practice (World Bank, 2005). As Qian (1996) points out, unlike private owners, the government does have political and social objectives other than the asset value of the firm, which could be very costly to economic efficiency. Maintaining the government's control over firms entails high political costs because of political interference, and expanding managerial autonomy also induces high agency costs when government managers tend to experience a lack of accountability. Government control of SOEs also brings about credible commitment problems, especially in carrying out its announced policy and imposing hard budget constraints. Government control may likewise well overload the government. The government has many other things to do, such as regulate and provide public goods, and therefore, control of firms is likely to overburden it. The "core competence" of the government is regulation and provision of public goods, not corporate governance.

### **Keep the Code up-to-date**

The revised Listing Requirements, which took effect in June 2001, aim to elevate the standard of conduct of directors and company officers of publicly listed companies, and to promote the development of effective internal governance and compliance. The LRs gave rise to the MCCG, which resolved those issues that required the most immediate attention. The corporate governance environment is evolving, however, and the Code and supplemental materials need to be kept up-to-date with evolving best practices (World Bank, 2005).

### **Educate the investing public**

It is good to have timely and adequate disclosures by the publicly listed companies so that the investing public can make informed investment decisions. However a big proportion of the minority investors (not in terms of investment amount but in terms of numbers) are private individuals who may not have the necessary training and legal knowledge on their rights to get the picture fully of what the disclosures are all about. They may not even be cognizant of what the listed companies are duty-bound to abide by in order to push for their rights. As such a systematic education or awareness program should be considered to enhance awareness amongst the investing public before any shareholder activism can really be effective (Khoo, 2003).

### **Introduce a scorecard**

The Malaysian government can consider and expedite the introduction of a corporate governance rating for all publicly listed companies. Private investors looking for performance indicators can at least rely on the ratings to know the degree of corporate governance practice in the company and to make their own conclusions from there.

Investors recognize the improvements made by government, regulators and



corporations but challenges remain: Convergence in regulations, attitudes and pressure from institutional investors and shareholder groups must continue. Strong supervision and enforcement of new standards are essential for success. The Malaysian “state of mind” must firmly recognize and put into practice the precepts of accountability, transparency and integrity. The laws and listing rules have been changed to promote corporate governance. That was the easy part. A paradigm shift is also necessary to adopt the true spirit of corporate governance. Ethical conduct cannot be prescribed by black letter law. As Khoo (2003) succinctly puts it, it is time to “walk the talk”.

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# **BREAKTHROUGHS IN CORPORATE SOCIAL RESPONSIBILITY IN THE PHILIPPINES**

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## **INTRODUCTION**

The old idea is that the duty of firms is to produce profits for their shareholders. Their job is to focus on the core business. The quest for improved competitiveness, higher productivity, and good corporate governance is important only to the extent that it makes a positive contribution to the firms' business objectives. Accordingly, research has focused on the links between corporate rules and practices, on the one hand, and profitable outcomes, on the other.

It is no surprise that despite great differences among Asian countries, the Asian Productivity Organization (APO) study of Asian corporate governance in 2004 found a "common ground" among Asian firms: a consensus to adopt principles of corporate governance that hew more closely to generally accepted global benchmarks in order to improve returns on assets or investment. Whether widely-held or closely-held, Asian firms are heading toward a "convergence" of corporate practices that are going to make them better equipped to make their way in the global capital market (Gonzalez, 2004).

In the Philippines, the APO study suggests, the government has instituted reforms to improve board governance, enhance disclosure and transparency of corporate activities, ensure diligence and independence of audits, and increase protection of minority shareholders—all in the name of greater firm performance.

This article of faith among Asian corporations is still holding ground firmly. But of late, Asian firms have allowed themselves to be "infected" by a new thought: the idea that it is not enough for firms to make money for their owners. Today, there is a widely-held view that a globalizing company needs—as *The Economist* puts it—to take account of social problems in its new markets, or that social responsibility will be its own reward, in happier employees, lower legal costs and improved productivity (*The Economist*, 25 June 2004). In the past, this emerging view is what would be expected of environmentalists, social activists and civil society organizations. Now many corporate owners and CEOs have embraced it. Interestingly, even the APO study indicates that a majority of Asian firms share the conviction that the interests of the community are as important as those of shareholders and stakeholders.

Indeed, many corporations have gone further: corporate social responsibility, or simply, CSR, does support the business goals of the company. As Baker (2001) points out, if the process of managing social responsibility leads a corporate CEO to take her eye off the core business, her problem is not that she is doing it at all, but that she is doing it badly. Well-managed CSR holds up the profit objectives of the company, builds relationships with key stakeholders whose opinion will be most valuable when times are hard, and should reduce business costs and maximize its effectiveness.

It is in this context that the Philippine corporate sector is examined in this paper. Interestingly, even under a business policy environment that has its large share of mishaps, the Philippines has managed to dominate the Asian corporate social responsibility

sweepstakes—perhaps because in general, Philippine firms are socially-oriented. Philippines-based firms have stood out in the Asian CSR Awards, which are given annually by the Asian Forum on CSR<sup>1</sup>. The awards recognize Asian companies for demonstrating the leadership, sincerity and on-going commitment in incorporating ethical values, compliance with legal requirements, and respect for individuals, communities and the environment into the way they do business. It has several categories: environmental excellence, support and improvement of education, poverty alleviation, best workplace practices, concern for health, and special awards (e.g., small company CSR) (AIM, 2006).

In 2003, for instance, Nestle Philippines garnered an “environmental excellence” CSR award for its “greening the supply chain” program. The program, set out from board level, encouraged Nestle’s business partners to adopt environmental management. The company has now recruited 55 more of its 300 or so suppliers to join the scheme. The benefits include not just sound environmental practices, but economic returns for the company. Its carton supplier, Unibox Packaging Corp., involved its workforce in devising an environmental management system that allowed the company to reduce waste by 8 percent, water consumption by 15 percent and energy consumption by 8 percent. Unibox has sought both ISO 9001 and ISO 14001 certification. The winner of the “best CSR policies” category was Union Cement Philippines. The company’s CSR policy focused on education (providing scholarships, school facilities and equipment), livelihood (improving family income and enhancing the quality of life in host communities) and infrastructure (supporting shelter programs in various partner communities) (Baker, 2003).

The arresting feature of the Asian CSR Awards was the extent to which Filipino businesses were proving to be as good as, if not better than, multinational corporations in

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<sup>1</sup>The Asian CSR winners in the last two years include the following Philippines-based firms:

**2006**

Category: Support and improvement of education

Winner: Text2Teach, Globe Telecom in cooperation with Ayala Foundation, Chikka Asia, Department of Education, International Youth Foundation, Nokia, Pearson Foundation, PMSI Dream Cable, SEAMEO Innotech and UNDP Philippines

Merit Awardee: Little Red Schoolhouse Project, Coca Cola Foundation

Category: Environmental excellence

Merit Awardee: Project Eliminate, Unilever Philippines

Category: Poverty Alleviation

Winner: Pier One Seaman's Dormitory

Category: Best workplace practices

Winner: Developing the Modern Water System Manager, Manila Water

Merit Awardees: Embracing Diversity @ IBM, IBM Philippines, Inc.; Go for Gold Program, Chowking Foods Corporation

Category: Concern for health

Merit Awardee: Training & Employment of Deaf and Hearing - Impaired Persons in Jollibee, Jollibee Foods Corporation

**2005**

Category: Support and improvement of education

Winner: Knowledge Channel, SKYCable

Runner-up: Sitio Agusuhin Development Program, Shell Philippines Exploration B.V.

Category: Environmental excellence

Runner-up: Bantay Kalikasan Program, ABS-CBN Foundation, Inc.

Category: Best workplace practices

Winner: Department of Surgery, Ospital ng Maynila Medical Center

Source: [www.asianforumcsr.com](http://www.asianforumcsr.com)

carrying out their social responsibility (see footnote 1). Only a few home-grown firms of the supply chain get into the act as a result of the pressure of multinational firms. Of course, it is hard to gauge whether this is truly representative of the situation on the ground, since few small and medium companies are hardly represented in the Asian Forum.

Business response to societal obligations, either out of volition or by force of circumstances, is a long-standing practice in the Philippines. Interestingly, Filipino corporations tend to project their social obligations onto auxiliary associations. Filipino companies, for example, have long funneled their CSR resources into the Philippine Business for Social Progress, a long-running non-profit group that absorbs the burden of social responsibility of member companies. Membership in this body, where top executives get personally involved in corporate citizenship projects, is a measure of a firm's responsiveness to the country's social problems. PBSP itself has won a special achievement Asian CSR in 2003 (Baker, 2003). PBSP also was cited as "one of the world leaders in corporate citizenship" by the London-based Prince of Wales International Business Leaders Forum (IBLF) in 1996 (Nuguid-Anden, 2003).

The widely held belief of Philippine firms is that corporate social responsibility is about "business giving back to society". Thus, social investment, otherwise known as corporate giving (which has a long history in the Philippines), is seen as a common demonstration of good corporate citizenship. It can be said that Filipino firms have closed the profit-cum-responsibility circle: managing workplace concerns, community relations, environmental protection, and other cross-cutting social issues as a business strategy to enhance corporate reputation, in turn, profitability and, in the long run, continuity.

## EVOLUTION OF CORPORATE SOCIAL RESPONSIBILITY

The literature records an impressive history of the concept of corporate social responsibility. Management experts trace the beginnings of CSR in the post-war period of the 1950s which stressed the interdependence of business and society in reconstructing war-ravaged economies. From this "Marshall Plan" perspective, CSR concerns expanded during the 1960s, and gained a wider audience during the 1970s. In the 1980s, alternative themes such as corporate social performance, stakeholder theory, and business ethics theory caught the imagination of business. All suggest that while the primary role of business is to produce goods and services that society wants and needs, business and society both need a stable environment. Since the 1990s, firms have recognized that they are closely linked organically to many stakeholders, who either influence or affect, or are influenced or affected by, their operations. Without their continuing participation and involvement, the corporation cannot survive (Clarkson, 1995).<sup>2</sup>

Traditionally in the United States, philanthropy rather than CSR has been the norm. Companies generate profits without hindrance, and their only "public duty" is to pay taxes. Philanthropy kicks in when they donate a certain share of the profits to charitable causes. To receive any benefit from the giving—such as making more profits out of this corporate virtue—is seen as tainting the act for the company (Baker, 2006). A more polished argument along these lines, one that supports the shareholder model of corporate governance, is that as a rule managers do not own the firms they work for. They are entrusted with the care of assets belonging to others, the firm's shareholders. *The*

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<sup>2</sup>Clarkson, M.B.E. (1995), "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance", *Academy of Management Review*, Vol. 20, pp. 92-117, cited in Moir (2001).

*Economist* (22 January 2004) argues that supporting good causes out of the managers' own generous salaries, bonuses, deferred compensation, options packages and incentive schemes would be praiseworthy; doing it out of income that would otherwise be paid to shareholders is effectively, theft. Indeed, some laissez-faire advocates, according to Baker (2001), have suggested that CSR deprives shareholders of their property rights. It should be the shareholders who can decide social-policy priorities. CSR is philanthropy at other people's expense.

In defense of CSR, Baker (2001) contends that its detractors miss the point. If CSR is seen as a process by which the business manages its relationships with a variety of influential stakeholders who can have a real influence on its license to operate, the business case becomes obvious straight away. CSR involves building relationships with customers, attracting and retaining talented staff, managing risk, and protecting reputation. Baker cites as an example the case of Coca-Cola, 96 percent of which is made up of "intangible shares" which rests mainly on the reputation of the company. No one would conceivably tinker with a company's reputation when it is so large a part of what the shares represent. In any case, with rights comes responsibility. If shareholders are to be accorded full property rights one would expect them to be balanced by the actions taken by the enterprises they own. Since most shareholders are hardly conscious of any such responsibility, it can only fall to the management, as the skippers of the company, to take that responsibility on.

Moir (2001) recalls that the current thinking on CSR evolved from the notion of corporations' obligations to work for social betterment to corporate social responsiveness or the capacity of a corporation to respond to social pressures. Implicitly, business is expected to respond to societal issues, e.g., to enhance social cohesion, not simply out of charity but because it has a social contract that obligates it to do so. Society grants power to business but as part of the social contract, and it expects business to use this power responsibly. Those who will not use the power in a manner which society considers responsible will tend to lose it. The United Nations Conference on Trade and Development (UNCTAD) also espouses the view that enterprises are responsible for job creation and to do so, society grants them the "license to operate". This license, which spells out rights and duties in laws and regulations, sets the entrepreneurial terms in starting new firms, extracting natural resources, introducing new products and technologies, and taking the risks that are necessary in seeking out business opportunities.

Certainly, every country wants the firms that operate within its borders to flourish and grow so that they can create wealth and improve standards of living. But in pursuit of these objectives, a firm necessarily commands tremendous financial resources and exploits natural resources. As it is, a firm has the power either to do good or to do evil. Of course, firms are able to generate employment opportunities and are able to pay fees and taxes out of their incomes but at the same time, firms can negatively affect the community where they operate. Jurisprudence would show that even firms with vast operations are not exempted from circumventing laws such as labor laws, product standards, environmental laws, and the like, for the sake of profit.

Compliance with the law is the minimum expectation from firms. But a firm's social responsibility also includes obligations to protect and enhance the society in which it functions. The scope of corporate social responsibility encompasses the direct impacts of a firm's activities as well as the spillover effects it may have on society. The UNCTAD stresses that even in countries where legal obligations of firms are not spelt out in detail, it is important that business still make an effort to meet societal expectations. As Gray, et al. (1996) suggests, it is not always that business might act in a responsible manner because it

is in its commercial interest, but because it is part of the social contract or how society implicitly expects business to operate. According to him, the macrosocial contract in the context of communities would be an expectation that business provide some support to its local community. The specific form of involvement would be the microsocial contract. Corporate social responsiveness also translates to management decision-making that is accountable and based on ethical foundation. Moir (2001) describes the scope of corporate social responsibility to cover economic responsibility, public responsibility, and social responsibility. This means corporate accountability for: (1) actions performed that go beyond the corporation's domain of authority or permissibility; (2) non-performance of acts within the corporation's domain of responsibility; and (3) inferior performance of acts within the latter domain. He specifies the obligations of firms:

- To treat employees fairly and equitably;
- To operate ethically and with integrity;
- To respect basic human rights;
- To sustain the environment for future generations; and
- To be a caring neighbor in their communities.

Given these considerations, it is no accident that the World Business Council for Sustainable Development has defined CSR as “the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large” (Baker, 2006).

Companies are answerable to both the internal aspect (the quality of management, in terms of both people and processes) and the external aspect (nature of their impact on society) (Figure 1). Of the various stakeholders, it is financial analysts who are predominantly focused on quality of management as an indicator of likely future performance. The rest look mainly to the outer circle—what the company has actually done, good or bad, in terms of its products and services, its impact on the environment and on local communities, or in how it treats and develops its workforce (Baker, 2006).

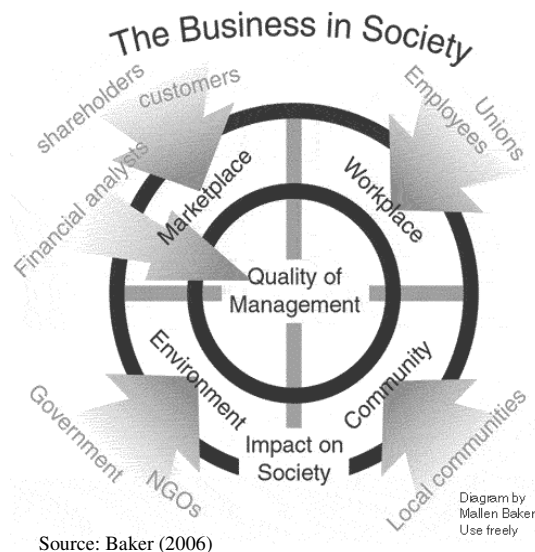


Figure 1. The burden of social responsibility

If the US is hooked on philanthropy, the European model pays more attention to operating the core business in a socially responsible way, complemented by investment in communities for solid business case reasons. Baker (2006) argues that this model is more sustainable because (1) social responsibility becomes an integral part of the wealth creation process, which if managed properly should enhance the competitiveness of business and maximize the value of wealth creation to society; and (2) when times get hard, there is the incentive to practice CSR more and better (if it were a philanthropic exercise which is peripheral to the main business, it will always be the first thing to go when push comes to shove). Baker cautions that no “one size fits all and that priorities and values that shape how business will act differ across countries.

To Moir (2001), whether or not business should take on CSR, and the forms that responsibility should assume, depend upon the economic perspective of the firm. He typified the response into three broad strands: the neo-classical approach, a moral approach linked to social expectations, and enlightened self-interest. Those who adopt the neo-classical view of the firm believe that the only social responsibilities to be adopted by business are the provision of employment and payment of taxes. This view, he said, is oftentimes taken to the extreme, i.e., maximizing shareholder value. It is consistent with the CSR as philanthropy perspective discussed above. Again, following to Moir (2001), the second view is associated with some form of moral or ethical imperative (a quasi-moral obligation) that because business has resources, it is part of its role to assist in solving social problems. (This implies that there is social expectation that a legitimate business would act in a particular manner—which is in effect some form of social contract as mentioned earlier.) The third view which Moir critically agrees with is that it is in the enlightened self-interest of business to get socially involved, as the business benefit that might accrue would include enhanced reputation and greater employee loyalty and retention. Here, corporate involvement is viewed by business as a way to maintain trust, support and legitimacy with the community, government and employees. This view leaves open the issue of whether the advocates of enlightened self-interest are also motivated by profit and regard greater corporate social responsibility as the manner in which to achieve maximization of shareholder wealth or ensure sustainable growth for business in a responsible manner

Table 1. How much do you feel that CSR initiatives contribute to your company’s corporate reputation?

	<b>Significant amount</b>	<b>Moderate amount</b>	<b>A little</b>	<b>Not at all</b>	<b>NA</b>
Total	30%	50%	17%	3%	1%
North American	26%	50%	19%	3%	1%
European	44%	50%	6%	0%	0%
Asian	30%	49%	19%	3%	0%

Source: Corporate Reputation Watch Study, 2003

This approach of business is confirmed by the 2003 Corporate Reputation Watch Study, which highlights the role of CSR in firm reputation management. CEOs who responded to that survey believe that corporate reputation is more important today than in the past (ORC, 2005). The fact that most CEOs place the responsibility for managing corporate reputation on themselves is the proof of its importance. In the survey, Asian corporations claim that their corporate reputation helps them promote transactions and strategic partnerships, enhance stock price and increase sales (see Table 1). In a new book, *Building Reputational Capital*, the author, Kevin Jackson, a professor of legal and ethical studies at Fordham University in New York, argues that corporations need to be socially responsible to build their “reputational capital,” which is identical with, but larger than, any brands they might market. A company with huge reputational capital will be able to attract better employees, charge higher prices, negotiate better deals, attract more investors and “cut more slack when a crisis hits” (*The Economist*, 25 June 2004).

But what is the relationship between corporate reputation and CSR? The same study shows that CEOs believe that CSR initiatives contribute at least moderately to corporate reputation. Globally, CEOs report that CSR initiatives have less effect than corporate reputation on bottom line issues of increased sales and enhanced stock price. But among Asian firms, corporate social responsibility initiatives is seen to contribute most to (1) favorable media coverage (57 percent), which is crucial because media is considered as the most critical stakeholder in promoting good corporate reputation; (2) recruiting and retaining employees (53 percent); (3) promoting transactions and strategic partnerships (47 percent); (4) enhancing stock price (38 percent); (5) increasing sales (37 percent); (6) building support for public policy initiatives (32 percent); and (7) helping withstand the impact of crisis (27 percent).

Table 2. What are the three most important business objectives that corporate social responsibility helps fulfill?

	Recruiting/retaining employees	Favorable media coverage	Promoting transactions/partnerships	Help withstand impact of	Increasing sales	Support for public policy initiatives	Enhancing stock price	Other
Total	71%	51%	40%	38%	35%	27%	21%	4%
North American	78%	45%	43%	43%	36%	26%	11%	6%
European	61%	64%	25%	28%	32%	24%	25%	3%
Asian	53%	57%	43%	27%	37%	32%	38%	1%

Source: Corporate Reputation Watch Study, 2003

But while it is apparent that business is taking voluntary actions to address its competitive interests, the interests of the wider society should not be relegated to the sideline. The other notion of corporate social responsibility is closely linked to the concept of “sustainable development”. Many people think of industrial firms as the primary villain in environmental damage. The 1987 Brundtland Report found that the current model of economic development could not be sustained in the long term, as it depletes natural



resources and harms society. It defines sustainable development as a “development that meets the needs of the present without compromising the ability of future generations to meet their own needs”.

One of the methods proposed for the control of firm activities that damage the environment is the adoption of voluntary programs, such as mandatory investment in pollution control equipment by firms or voluntary recycling of wastes by consumers. But volunteerism has proved to be unreliable. Understandably, no business, whatever its virtues, can long afford to spend so much on good works that rivals can easily underprice. As a result, voluntary business programs sometimes have been more helpful to the public relations objectives of companies than to environmental protection (Baumol and Blinder, 1998). Thus, at the 1992 United Nations Conference on Environment and Development in Rio de Janeiro, the leaders of over 100 countries adopted Agenda 21, a blueprint for achieving sustainable development in the 21<sup>st</sup> century. Governments that agreed to implement this plan in their countries are monitored by the United Nations Economic and Social Council’s Commission on Sustainable Development (UNCTAD, 2003). Essentially, as it is considered in progressive economies like the United Kingdom, CSR should be taken to mean how business takes account of its economic, social and environmental impacts in the way it operates, that is, maximizing the benefits and minimizing the downside. Philippine business has not been remiss in this area. Shortly after the Rio conference, Philippine firms committed themselves to the country’s own environmental platform, Philippine Agenda 21.

Liberalization and globalization have also extended the business reach of firms, thus putting them in a position to have an even greater impact on society. The UNCTAD reported that despite the existence at the international level of treaties, agreements and conventions, there is no set of international rules to regulate business activities and their impact on society. This means that the increased power of corporations must be balanced by a sense of ethical business practices. Governments, nongovernmental organizations and local communities are demanding increased transparency and accountability, not only in the firms’ daily business operations but also with regard to how those operations affect society. With the recent accounting scandals and disasters arising from explorations and production operations of companies, these concerns have become more acute. But even UNCTAD laments that in a world where transnational corporations’ economic power compares with that of countries, governments sometimes find it difficult to balance the need to protect their citizens with the need to attract foreign direct investment.

Of late, in response to this, the United Nations launched the Global Compact to engage corporations in the promotion of equitable labor standards, respect for human rights, protection of the environment, and anti-corruption. The Global Compact is a voluntary international corporate citizenship network initiated to support the participation of both the private sector and other social actors to advance responsible corporate citizenship and universal social and environmental principles to meet the challenges of globalization. The Compact espouses human rights, labor rights, and environment and anti-corruption principles (Table 3).

The Global Compact recognizes that given market-based incentives, the most significant contribution of the private sector to development is to invest and to be successful, and to do so in a socially and environmentally responsible manner, thereby creating enormous social benefits, including employment and income. Sustainable development can be achieved and the benefits of globalization can be shared more widely if firms observe the ten principles. A reporting system, called communication of progress, tracks the stakeholders’ progress in implementing the Global Compact’s principles. The

Compact today includes nearly 2,200 companies from more than 80 countries. Of these, 301 are Asian firms.

Table 3. UN Global Compact principles

<b><u>Human Rights</u></b>
<b>Principle 1:</b> The support and respect of the protection of international human rights;
<b>Principle 2:</b> The refusal to participate or condone human rights abuses.
<b><u>Labor</u></b>
<b>Principle 3:</b> The support of freedom of association and the recognition of the right to collective bargaining;
<b>Principle 4:</b> The abolition of compulsory labor;
<b>Principle 5:</b> The abolition of child labor;
<b>Principle 6:</b> The elimination of discrimination in employment and occupation.
<b><u>Environment</u></b>
<b>Principle 7:</b> The implementation of a precautionary and effective program to environmental issues;
<b>Principle 8:</b> Initiatives that demonstrate environmental responsibility;
<b>Principle 9:</b> The promotion of the diffusion of environmentally friendly technologies.
<b><u>Anti-Corruption</u></b>
<b>Principle 10:</b> The promotion and adoption of initiatives to counter all forms of corruption, including extortion and bribery.

Source: Global Compact Office, 2005

Within Asia, the Philippines leads other countries in terms of the number of corporate subscriptions to the Global Compact. When the Compact was launched in the Philippines in 2001, more than 115 corporations immediately signed up. Since then, conformance to the stated principles of the Compact has become the benchmark for measuring global corporate citizenship for many Filipino companies.<sup>3</sup>

### CSR IN THE PHILIPPINES

Filipino corporations are generally perceived across all areas, localities, social classes, and gender and age groups to have “obligations” to their employees, the environment, and communities in need.

This is gleaned from the survey conducted by the Social Weather Stations in 2003. What is remarkable is that when asked about four prelisted things that private corporations could do, majority of Filipinos expect private corporations to voluntarily: (1) increase the wages of employees in proportion to the increase of prices of basic commodities (68 percent); (2) spend for cleaning or for restoring any damages in the environment (58 percent); (3) send volunteers from the corporation to a community to help in tree planting and construction of houses or teach selected courses to out-of-school youth (57 percent) and; (4) give substantial donations to the poor or communities in need (56 percent). Ironically, the same survey revealed that only one out of 10 (12 percent) Filipinos is aware

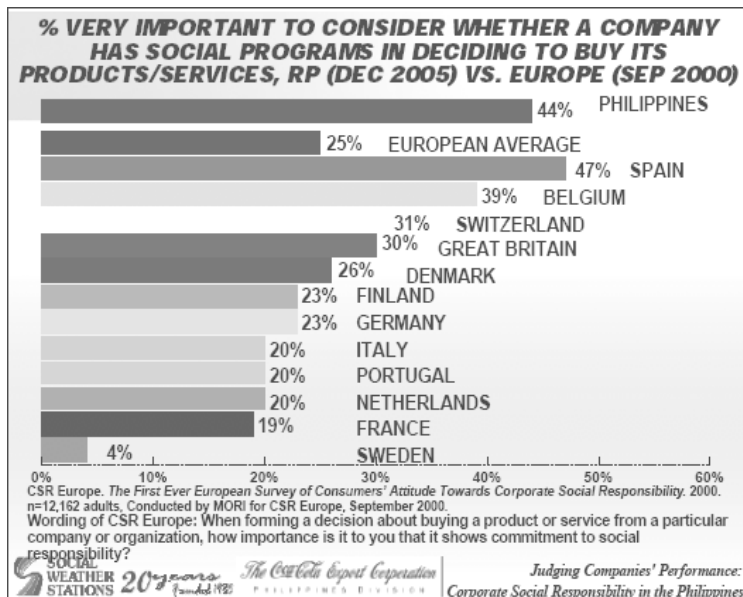
<sup>3</sup> After the initial enthusiasm and show of support, a number of subscribers failed to submit their Communication of Progress (COP). Efforts are now being exerted to guide companies in the preparation of COP and sustain efforts to align corporate programs, policies, and practices with the Global Compact principles (Global Compact Office, 2005).

of the term corporate social responsibility or CSR. Knowledge of CSR is higher in the National Capital Region (Metro Manila) and among the upper social classes, but remains low across gender and age groups.

Table 4. Global Compact subscribers in Asia

Country	Number of subscribers	COP submitted	Percent
Indonesia	1	1	100%
Japan	9	8	89%
Nepal	5	3	60%
Pakistan	2	1	50%
India	84	35	42%
Philippines	115	15	13%
China	16	2	13%
Thailand	11	1	9%
Turkey	35	1	3%
Armenia	1	0	0%
Georgia	1	0	0%
Total	301	70	23%

Source: Global Compact Office, 2005



Source: Social Weather Stations (2003)

Figure 2: To buy or not to buy the firm's products

Similar concerns on corporate social obligations were cited in the most recent Social Weather Station Survey, where 44 percent of Filipino adults consider a company's social programs as very important in deciding to buy its products<sup>4</sup> (Figure 2). This figure is higher compared to Europe, where an average of only 25 percent of the respondents in 12 major EU countries considers that a company's social program is an important factor in making buying decisions (SWS, 2005). To the public, among the corporate social concerns that a firm is obliged to address are health and safety of its employees, job security, control of harmful products, respect for human rights, and equal treatment of employees (Figure 3). Filipinos consider as less important the corporate obligations to help solve social problems, invest in education and training, support charities and community projects, ensure nonparticipation in bribery, listen/respond to the public, and make socially responsible investment.

No matter how it is perceived, making social investment is the most common form expression of CSR in the Philippines. The widely held view is that the long-term interests of business are best served when its profitability and growth are accomplished alongside the development, and the improvement of people's quality of life (PBSP, 2002). Filipino firms generally adhere to the philosophy that to the extent that business activities "generate imbalance in society and create social tensions", business must undertake development programs to restore the balance. As one prominent Filipino executive puts it, the business of business is business, as long as in doing it, it grows in its ability to help society solve its problems of unemployment, income inequity, and maintaining its competitiveness in the markets of the world (Tolentino and Luz, 1994).

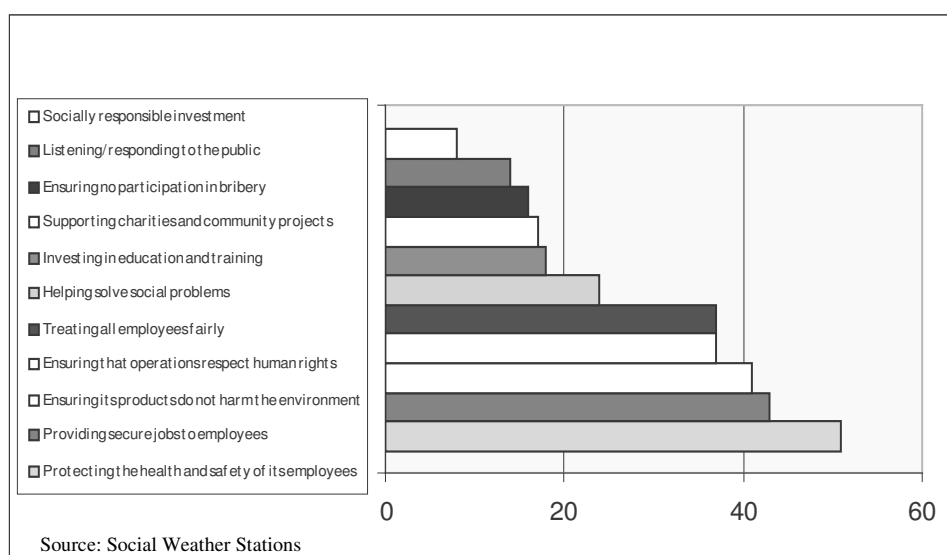


Figure 3. What should companies address?

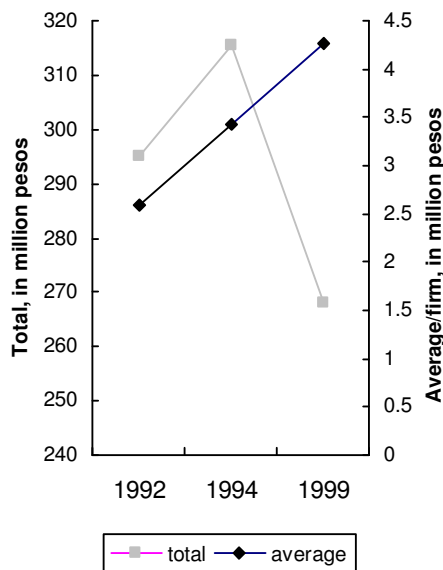
What is remarkable is that Philippine firms tend to externalize these CSR functions through auxiliary associations such as corporate foundations, the Philippine Business for

<sup>4</sup>This result is part of a pioneering module on CSR, sponsored by the Coca-Cola Export Corporation, included in the 4th Quarter 2005 Social Weather Survey of 1,200 Filipino adults nationwide.

Social Progress and the League of Corporate Foundations. CSR is not necessarily an internal corporate function. Corporate social response is also channeled through business associations and coalitions dealing with specific issues that are clearly outside business. The following sections attempts to present some of these CSR best practices in the Philippines.

### **FILIPINO CORPORATE GIVING AS PRECURSOR OF CSR**

One cannot but recall the beginnings of corporate philanthropy when discussing CSR in the Philippines. Hasan (2005) traces back philanthropy in the Philippines to the Spanish period in the 17th to 19th century as Catholic religious organizations created and maintained orphanages, schools, asylums and hospitals, supported by contributions from the political and economic elite. Hasan recalls that philanthropic work in the country has been traditionally practiced within the family and kinship groups, and not through organizations. As time went by, corporations got themselves involved in philanthropic work. Such practice eventually evolved into a coordinated effort to what is known as corporate giving today. Corporate giving involves the voluntary transfer of resources from corporate budgets to non-business organizations, sectors and/or beneficiaries (Tolentino and Luz, 1994). Corporate contributions either in cash or in kind often find their way to charitable organizations.



Source: Social Weather Stations

Figure 4. The amount of gift-giving in the Philippines

One impetus for people's involvement in philanthropic activities is the Philippine Corporation Law of 1906, which recognized religious entities, colleges and other educational institutions as non-profit organizations. The Public Welfare Board established by the government in 1915 to coordinate philanthropic activities in social services, and the

public rehabilitation organizations that were formed following World War 2 bolstered support for private organizations undertaking philanthropic work. In the 1950s and 1960s, private philanthropy gained more prominence as wealthy individuals and corporations began spearheading fund-raising activities and campaigns to complement the work of the church and the government. It was during this period when the Philippine Congress enacted the Science Act of 1958 that recognized the important contribution of private foundations in the scientific and social services arena. The renewed emphasis given by the Catholic Church on social responsibility in the mid-1960s also gave further impulse to the creation of philanthropic institutions. By the early 1970s, efforts to coordinate their work resulted in the creation of organizations that today promote collective response to social concerns Hasan (2005).

Corporate philanthropy is interpreted today as contributing to the public good in a more strategic and focused manner. Corporate giving is manifested in different ways: through corporate donation programs implemented by a company unit, a corporate foundation, or other innovative mechanisms. There is no accurate accounting of the amount of corporate giving in the Philippines. Nevertheless, local surveys of corporate giving conducted in 1992, 1994 and 1999 give indications on its extent (Figure 4). Table 5, taken from the 1999 survey, suggests how corporate giving is distributed among Philippine-based firms.

Table 5. Total corporate giving by size of program

<b>Range of contribution (in pesos)</b>	<b>Total amount contributed (in pesos)</b>	<b>% to Total</b>	<b>Number of company-respondents</b>
1,000 – 100,000	639,317	2.0%	11
100,000 – 1.0 million	9,785,063	3.7%	32
1.01 million – 10 million	39,157,385	14.6%	13
> 10 million	218,446,286	81.5%	7
Total	268,028,051	100.0%	63

Source: RVR-AIM, 2001

In the 1992 survey, education, disaster response and community development were the priority areas which were given assistance. Civic and community affairs, science and technology, culture and arts, and youth and sports activities received less attention. There were some indications of a shift from reactive to proactive forms of giving, and possibly more developmental approaches over welfare-influenced dole-outs. Corporations considered their involvement in disaster preparedness as a program of assistance more than disaster relief. The use of non-cash assistance in the form of products, technical expertise and services, and facilities was considerable. In specific instances such as disaster response, technical expertise or donated services had as great value as capital funds. The involvement of internal constituents (employees) of corporations in corporate giving would be an important factor for corporations in the coming years. The size of the

corporate giving staff did not dramatically increase despite an increase in the size of the assistance. Most assistance was channeled to existing organizations to minimize company overhead expenses (Tan and Bolante, 1997).

In 2001, the Asian Institute of Management Report on Corporate Giving<sup>5</sup> indicated that monetary donations comprised 73 percent of the total corporate giving for 1999. In-kind donations represented about 21 percent. The rest of contributions were in terms of technical expertise and use of facilities. The financing, insurance and real estate sector had the highest percentage share of cash donations, comprising nearly half of the total corporate giving for the year. This was followed by the agriculture, fisheries and forestry sectors. Manufacturing firms came third. As in previous surveys, commitment to education continued to be the highest priority for the company respondents with 23 percent of the giving directed to this sector (Table 6).

Table 6. Corporate giving by areas of assistance

Area	% to Total
Education	23.04
Social services	13.36
Original support	11.24
Health	10.14
Culture and arts	8.44
Support for government program	8.28
Livelihood/community credit	5.81
Environment	5.08
Civic & communication arts	2.54
Disaster relief and rehabilitation	2.02
Youth & sports	1.15
Campaign program	0.76
Science & technology	0.33
Others	7.81
Total	100.00

Source: RVR-AIM, 2001

Schools and educational institutions remained the major channel of assistance utilized by 18 percent of the company-respondents. These were followed by foundations and non-government organizations (16 percent); trade, civic and professional organizations (14 percent); and community associations (11 percent).

The RVR-AIM results showed that companies tended to give closer to home (where their operations were located). They were also strongly motivated to pursue gifting as a reaction to the highly unstable political and economic situation in the Philippines at the time the survey was conducted. At any rate, almost all of the respondents (97 percent) believed in the significance of being viewed as a good corporate citizen when giving.

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<sup>5</sup>The RVR-AIM 2001 Report on Corporate Giving is primarily intended to establish baseline data on corporate giving practices of Filipino and Philippine-based firms covering fiscal year 1999. The surveys on corporate giving in 1993 and 1994 were conducted by the Center for Corporate Citizenship of PBSP. RVR-AIM conducted the 1999 survey using the PBSP instrument.

The study also revealed that corporate foundations in the Philippines have mushroomed as a way to sustain CSR programs (including corporate giving) in the past few years. While some corporations give through channels distinct and independent of the company, a growing number of firms have chosen to direct their charitable contributions through their own corporate foundations. The survey results showed that 33 percent of the company respondents considered funding their own corporate foundations as part of their corporate giving for the year.

These surveys confirm the increasing practice of corporate giving as a vehicle for providing the corporate donor a number of long-term benefits, including the production of goodwill, enhancement of the company's reputation (which in turn generates customer loyalty), and corporate name awareness and product recognition. It likewise provides a means for developing a continuing relationship with community officials and leaders. CSR also improves employee commitment and productivity (PBSP, 2002). In addition, there is an immediate benefit to corporate giving. The Tax Reform Act of 1997 provides for five percent limited deduction from the taxpayer's taxable income, computed after expenses arising from trade, business, or profession, but before any deductions arising from donations made. The 1999 survey noted that almost half (49 percent) of the company-respondents claimed tax exemption.

#### **PBSP AS A VEHICLE FOR CORPORATE SOCIAL RESPONSE<sup>6</sup>**

The Philippine Business for Social Progress (PBSP) is a business-initiated social development foundation organized to serve as vehicle for a collective social response. Modeled after the *Venezuelan Dividendo Voluntario para la Comunidad*,<sup>7</sup> the PBSP is recognized as the first nonprofit consortium of corporations in Southeast Asia spearheading the advocacy and practice of corporate social responsibility.

The PBSP was established in 1970 by prominent business leaders in the Philippines who were looking for a response to the worsening political and social situation in the country. At the time, the business community was regarded as one of the causes of the lopsided distribution of wealth. It is interesting to note that today's firm's *raison d'être* for corporate social responsibility slightly differs from the impetus of this collective social response of corporations in the 1970s. At that time, business was motivated by fear that the country was on the verge of revolution. Self-preservation meant engaging in efforts to alleviate poverty and build self-reliance among disadvantaged communities throughout the country. While many business corporations were already involved in charity and social welfare activities, those were seen to have little impact on the overall poverty situation and perceived to be inadequate to counter the social unrest (Tan and Bolante, 1997). Box 1 gives a detailed account of the origin of PBSP.

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<sup>6</sup>The account on PSBP is largely based on Tan and Bolante (1997).

<sup>7</sup>The *Dividendo Voluntario Para la Comunidad* is a development foundation organized by Venezuelan industries in 1963. Corporate members of *Dividendo* contribute 1 percent of pre-tax income for the foundation's operations (Tan and Bolante, 1997).



Box 1

**Origins of PBSP**

*“PBSP was conceived at a politically turbulent time when the country was in an economic crisis: about half of the Filipino population were poor with very limited resources or opportunities to rise above their poverty, while the less than five percent of the population held most of the country’s wealth and the same were in control of the political establishment.*

*In the communist analysis, big business was essentially a part of the problem because it continued to profit from the inequitable system. Therefore, society could not expect corporations to support change or to provide the means to effect change. This situation is rapidly building up the pressure on the political and economic institutions ... and in the countryside, the Communist Party of the Philippines is gaining ground since people have no alternative.*

*In the corporate sector, there was apprehension on the unraveling events but business people were highly divided on the matter of addressing the social ills of the country. To some, business could and should only be accountable if it failed to perform its primary function, which was to generate wealth. But one of the PBSP founders attributed this tendency to laissez faire capitalism, which he believed to be inherently wrong. According to him, “An economic system which operates solely on the basis of maximizing economic profits cannot continue to prosper indefinitely. A system which achieves the rapid growth of one sector while leaving the rest of the community far behind will sooner or later encounter two grave problems; economic contradiction and social contradiction... And this anomaly or contradiction was looking for a correction.*

*Even though business people were divided on the extent of their responsibility to society, it was clear to all that the violence and the virulence of the protest action was infringing on the conditions of doing business. In an atmosphere of discontent, business would not thrive. So it was the interest of business to ensure that its environment continued to be peaceful and harmonious and that its economic growth within society would not destroy its fabric. While the business is not responsible for the entire society, it is responsible for its own unique social function.*

*Within the corporate sector, there were efforts to respond to the social concerns of the day. Many businesses were driven into social action, principally, by fear – a fear that the country was on the verge of revolution.*

*For several months during 1970, top businessmen gathered to discuss a new agenda for business, given the worsening situation. While the common motivation was fear, there emerged an agreement for business to undertake viable and self-sustaining social development programs. Fifty business leaders agreed with this imperative and were moved to organize the Philippine Business for Social Progress. The task is to steer the corporate sector’s response to the prevailing social unrest: to provide a capitalist alternative to communist rhetoric.”*

Source: PBSP, 1995

Like its Venezuelan counterpart, the members of PBSP are business corporations and partnerships that are willing to give one percent of their pre-tax income to social development.<sup>8</sup> Not surprisingly, its 50 initial members include major business blocs in the country. By 2004, PBSP membership, which ranges from single proprietorships to multinational corporations, stood at 183 companies. In the past, most firms used to rely on PBSP to perform their corporate obligations. Presently, on top of their PBSP commitments, most members also have their own corporate social development activities. Nevertheless, at any given time, at least 50 chief executives and representatives of these members are directly and actively involved in the PBSP’s community activities and programs.

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<sup>8</sup> In the early years, PBSP administered 60 percent of this contribution, and the remaining was left for use at the company’s discretion. In 1989, the PBSP board reduced the amount it administered due to the difficulty of collecting during the recession in the 1980s. Today, PBSP administers only 20 percent of this amount.

## Box 2

**PBSP's statement of commitment**

*We believe:*

*First: Private enterprise, by creatively and efficiently utilizing capital, land and labor, generates employment opportunities, expands the economic capabilities of our society and improves the quality of our national life;*

*Second: The most valuable resource in any country is man. The higher purpose of private enterprise is to build social and economic conditions which shall promote the development of man and the well being of the community;*

*Third: The growth and vigorous development of private enterprise must be anchored on sound economic and social conditions;*

*Fourth: Private enterprise must discharge its social responsibility towards society in a way which befits its unique competence. It should involve itself more in social development for the total well-being of the nation;*

*Fifth: Private enterprise is financially and technologically equipped to participate actively in social development. In terms of scientific technology and managerial competence, private enterprise can help provide the total approach for social development in our depressed communities;*

*Sixth: Private enterprise, together with other sectors of society, shares obligations and responsibilities which it must discharge to the national community. The ultimate objective of private enterprise is to help create and maintain in the Philippines a home worthy of the dignity of man.*

*Therefore:*

*We hereby pledge to set aside out of our company's operating funds an amount for social development equivalent to 1% of the preceding year's net profit before income taxes, of which 60% shall be delivered to, and for management and allocation by, a common social development foundation, to be known as Philippine Business for Social Progress.*

Today, PBSP is the largest grant making organization in the Philippines. Over the same period, a total of USD17.5 million was contributed by its members. That in turn has been leveraged to raise an additional USD32.5 million from private and bilateral donor agencies (i.e., for every dollar raised from member companies, an additional dollar and fifty cents was mobilized from other sources). The total grants assistance of USD50 million has supported 3,440 projects through 1,000 NGO partners benefiting some 1.78 million Filipinos (Velasco, undated).

PBSP's CSR delivery strategy has evolved over time. Its records show that early PBSP efforts were relatively simple and short-term. Projects centered on improving living conditions such as community organizing, livelihood, social credit, basic social services and environmental protection that intended to benefit landless rural workers, sustenance fisherfolk, marginal upland farmers, urban poor and indigenous cultural communities. Perhaps its unique contribution to development work is the application of business management skills and hardheaded business sense in approaching social issues. In 1991, PBSP established the Center for Corporate Citizenship to assist its member companies to take part in activities that contribute to society's well-being, from corporate giving to community relations, policy-formulation and networking. Two driving forces shaped the establishment of the CCC: (1) corporations concerned with being profitable in the long-term must be challenged to make equally long-term social investments in communities if (local) economies are to grow and the quality of life to improve; (2) in a world of limited resources, sustainable development is a challenge for corporations to be more critical of business practices that are harmful to the environment and the community where they carry out their business (Velasco, undated). The center promotes the practice of corporate

citizenship by way of strategic contributions in social investment, corporate-community partnership, managing workplace concerns, and environmental stewardship. Table 7 summarizes the scope of these focus areas.

Table 7. The four thematic areas and the corporate citizenship framework

<b>Social Investment</b>	Companies make strategic contributions to support programs directly addressing social issues such as education, health and housing. Through this, the business sector gets to expand its traditional role by helping government in community development
<b>Corporate-Community Partnerships</b>	Companies re-define their relationship with communities from donor-donee to partners in local development and business. Engaging communities and other stakeholders in mainstream business operations is a concrete manifestation of the company's commitment to create value to the society.
<b>Managing Workplace Concerns</b>	Management provides an enabling working environment characterized by programs on health and safety, compensation, rewards and working hours, family welfare, disciplinary practices, equal opportunity and others. The logic is clear: employees who are more secure and fairly compensated tend to be more productive and supportive of the company.
<b>Environmental Stewardship</b>	Companies take responsibility and assume accountability for any adverse impact their operations have on the environment. These efforts have been driven by the demand of communities for better living environment, and by the awareness that a sustainable environment allows more cost-efficient business operations.

Source: (Nuguid-Anden, 2003)

Nuguid-Anden (2003) has compiled the Center's leading edge corporate citizenship programs, the most important of which are as follows:

- *Benchmarking Corporate Citizenship Program*: This is a four-year program which developed the following: (a) a program management systems framework that guides and enables companies to design effective CC programs; (b) a set of indicators that helps CC practitioners measure the impact of CC initiatives to the company, the communities and other stakeholders of companies; (c) benchmarking tools to help companies improve their operations based on the standards set by CC practitioners. The program has produced the Benchmarking CC Practice Report (July 2003) which, along with the benchmarking self-assessment tools, enabled participating companies to track their competitiveness or leadership positioning in CSR as well as established performance indicators and goals in pursuing strategic corporate citizenship programs.
- *Business and Peace Program*: The program works toward enhancing the capacity of local companies to adopt and implement internal management policies that promote peace, cultural diversity, and unity in the workplace. Furthermore, the program aims to strengthen the competitiveness of business management practices of Muslim SMEs through technology transfer by way of mentoring and internship initiatives. At least two of the program components demonstrate the overarching theme of the program: "Creating Peace Dividends through Corporate Citizenship".
- *Young Muslim Professionals for Business and Peace or "YuPPeace"*: This internship engagement program provides an opportunity for young Muslim professionals, currently employed in local business enterprises, to gain work experience in Mindanao-based and Manila-based companies.

- *Business Links Initiative*: This component aims to facilitate community enterprise development by way of encouraging companies to invest in business partnerships with local communities in such business functions as procurement of raw materials, hiring, sub-contracting and outsourcing of services, and marketing and distribution of products and services.
- *Greening the Supply Chain Project*: The project enables companies to institutionalize policies and mechanisms to address environmental concerns through supply chain environmental management. It has the following components: capability building, mentoring, learning exchange, and tools development.
- *HIV/AIDS in the Workplace Program*: The program assists the business community to design, implement, and sustain HIV/AIDS workplace programs.
- *Business and Society Learning Program*: Some of the learning courses being offered are: employee volunteering, HIV/AIDS peer education and counseling, and greening the supply chain.
- *Corporate Citizenship Learning Resource Center*: CCC also manages a Resource Center for PBSP's internal and external publics. Beyond its role as CC knowledge management repository, the Resource Center identifies relevant issues confronting business and society and develops strategies and tools that are helpful in catalyzing CSR discourse.

PBSP's task of helping people to help themselves, though, did not come easy. In the beginning PBSP's financing—three-fifths of one percent of members' pre-tax income—was rather measly. At some point, the amount passed on by companies to PBSP was reduced to one-fifth of one percent. Realizing it could not survive on corporate "crumbs," PBSP then used the members' contributions to leverage funds from varied sources such as international donors, government, private foundations, and other funding institutions to support its various programs.<sup>9</sup>

Promotion and capacity building on corporate social responsibility and good citizenship for its member companies continues to be key program of PBSP. A noteworthy feature of the PBSP is the personal involvement of company executives in social development programs. CEOs serve in the board and various committees of the foundation. CEOs and company representatives also participate in the implementation of selected projects in the field. The CCC itself is the locale where CEOs could discuss long-term issues such as the environment, education, local governance and countryside development, and identify strategic social investments that business can undertake. Here, CEOs learn how to make "investments" as a way of thinking about more permanent interventions rather than *ad hoc* giving (Velasco, undated). As one former chairman of PBSP claimed, the business sector's most vital and lasting contribution to social development through PBSP is not its money but its unique competencies. These include the ability to pool resources, to plan and carry out practical objectives, to prepare for both the short and the long term, and to foster the spirit of enterprise (PBSP, 1995).

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<sup>9</sup> By 2004, member companies had contributed PhP38.15 million for poverty alleviation projects nationwide. About PhP171 million was received from donor agencies and corporate benefactors. From 2002 to 2004, some 20 companies funded over PhP2.6 billion worth of social investment. More than PhP800 million represented the combined commitments of PBSP members (PBSP Annual Report 2004).

## **FORGING SYNERGY AMONG CORPORATE FOUNDATIONS<sup>10</sup>**

Besides PBSP, corporate foundations perform philanthropic and other social obligations on behalf of their corporate sponsors. In fact, corporate foundations predated the PBSP. Most of them are members of the Association of Foundations, a nationwide network of nongovernment organizations and people's organizations. Even as they serve as conduits of funds, some corporate foundations directly carry out social development projects and become active partners of communities where they operate. In the past, while doing so, corporate foundations faced numerous challenges and a variety of issues which needed to be resolved if they were to become an effective voice for corporate philanthropy (Erni, undated). One of those key issues confronting the foundations was the perception that they provided mainly "window dressing" to the business operations of their mother corporations and acted as tax shelters. To offset this negative image, corporate foundations struggled to obtain the support of their principals to make CSR a part of the strategic plan and corporate culture of their corporate sponsors. Along this line, 13 corporate foundations got together in the 1990s to establish a new CSR coalition, the League of Corporate Foundations, Inc. Through the LCF, the foundations adopted a common agenda to respond to their companies' social obligations.

LCF agreed to implement its programs largely through committees. Its seven committees represent the major areas of involvement of the league: arts and culture, education, entrepreneurship development, environment, health, communications, and research and training. The programs jointly undertaken by members are usually those that are common to individual members, thereby providing a venue to share best practices and maximize resources and impacts. The league also adopted as a practice working with government agencies and other social development organizations in order to promote multi-sectoral partnership and cooperation. To maintain the association, LCF assesses member foundations with membership and specific fees to defray expenses for common activities and fund projects implemented by the league. Over the years, aside from providing service to its members in enhancing institutional capabilities in social development, LCF has involved itself in external advocacy work for business. For instance, it successfully overturned attempts to remove the tax deductibility of corporate donations, which eventually would have discouraged corporate philanthropy (Erni, undated).

The first decade of LCF's existence proved successful. By 2002, the total assets of the 53 member foundations reached PhP4 billion (roughly USD79.2 million), with a consolidated annual operating budget of PhP1 billion (roughly USD19.8 million), on top of its numerous socially-relevant projects. The league has also promoted sharing of best practices on corporate giving.

The value of networking as a means of pooling resources is also exemplified by the Corporate Network for Disaster Response. CNDR was formed in the wake of the 1990 earthquake and the haphazard relief operations that transpired after what proved to be the first of a series of major disasters. Reflecting on the sad state of relief operations in the Philippines, many companies realized that the scale of relief required a more coordinated and efficient response. Government corruption and lapses in disaster mitigation likewise were noted. In response, these firms decided to band together and form a structure parallel to the government's disaster response council, utilizing the vast network of NGOs

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<sup>10</sup> The notes on LCF are based mainly on the paper prepared by Marilou G. Erni entitled "The League of Corporate Foundations: A Case Study of an Association of Corporate Foundations".

operating in the affected areas as channels of delivery. CNDR and its partner NGOs (which previously organized themselves into the Inter-Agency Network for Disaster Response) consciously developed a system separate from, but in conjunction with government relief agencies (Velasco, undated).

The idea, according to Velasco, was to establish a quick-response central command center which could ascertain basic needs at the community level once a disaster strikes and set up an efficient system for relief operations. The scheme includes informing corporate donors who would either send goods directly to the contact points or channel them through the network, monitoring the timely delivery of goods and reporting back to the donors on how the resources were utilized. To lessen the burden of sorting and the waste of transportation resources, donors are encouraged to send only those things that are actually needed, in the form that would be most efficient, e.g., cash in lieu of bulky relief goods is the preferred form of assistance in far-flung areas where transportation could be a major problem. Companies with branches near the disaster area are asked to mobilize their employees for relief distribution. Banks are requested to open accounts for receiving donations from the public.

Two years after the network was created, the country suffered a string of disasters—floods, volcanic eruptions and lahar flooding. In 1993, CNDR decided to focus its thrust on mitigation and preparedness. Seeing the cost efficiency of the effort (studies showed that every dollar invested in preparedness is equivalent to USD20 in relief operations), the network began to work closely with the regional command centers it had organized to formulate a plan for disaster mitigation. After setting it up, CNDR "devolved" the planning process to local government units, since under the law, it is local jurisdictions which formulate and regularly update a disaster management program. Localizing management efforts make the communities better able to prepare for disasters, meet their immediate needs and begin the task of rehabilitation as early as possible.

CNDR also tried to adopt disaster mitigation within companies. After finding out that very few companies have a fully updated and operational safety plan, much less a disaster management plan, CNDR embarked on consciousness raising programs by tapping local and international resource agencies it had worked with in the past. These programs also became a means of raising additional income to support the network's operations (Velasco, undated).

The major challenge now, for both PBSP and the corporate foundations, is how to sustain the commitment of the corporate community to CSR and convince companies to continuously invest in social development. This, all the more, emphasizes the need for some measurements and benchmarks to gauge the level and impact of CSR activities.

## **DEVELOPING A CORPORATE SOCIAL RESPONSIBILITY INDEX**

With mounting stakeholder expectations for business to take a larger role in development and greater CEO involvement in pursuing the social mission of Filipino companies, questions arise on whether companies are doing the right thing and whether companies are getting returns from social investment (CCC, 2003). Cognizant of this need, the PBSP, through its Center for Corporate Citizenship, again pioneered the development of an instrument that would enable a company to measure its corporate citizenship activities against certain specific standards, as well as in relation to the CSR performance of other companies. Out of its efforts, two self-assessment tools came out. The first instrument, called the Corporate Citizenship Benchmarking System and Process Assessment Tool, would enable managers to determine the quality of their companies'

corporate citizenship practice. That is, it would help managers to gauge the effectiveness, and strengths and weaknesses, of their firms' internal systems and processes. The second one, called the Corporate Citizenship Impact Measurement and Assessment Tool, would help in measuring the impact of the CSR programs on the company's so-called triple bottom line: financial, social and environmental outcomes.

The benchmarking tool assesses the quality of the companies' corporate citizenship practice in the context of the following: (1) leadership (i.e., the manner by which CEO and senior leaders champion corporate citizenship through their actions and behavior); (2) the alignment of the company's policies with the company's social and environmental agenda; (3) the program's strategic importance and responsiveness to the company's social, environmental, and governance agenda as well as to the needs of the community; (4) the effectiveness of internal systems and procedures to carry out the corporate citizenship agenda; and (5) the company's ability to measure its programs' results and impacts, and to report these to its internal and external stakeholders (CCC, 2003).

The impact assessment tool, on the other hand, measures the level of impact and the strength of evidence of a company's corporate citizenship initiatives on its triple bottom line. It is based on the following premises. Firstly, corporate citizenship activities are driven by financial factors. A proactive effort to address social and environmental concerns could avoid incurring costs that would have arisen if these concerns had worsened. A company could leverage its corporate citizenship programs in enhancing the company's image, which in turn could result in attracting and retaining customer (and employee) loyalty. Secondly, corporate citizenship programs foster the social objectives of the corporation. A positive public perception of the company could maintain supportive relationship with the community and encourage business-friendly policies and incentives through legislation and local ordinances. Thirdly, corporate citizenship activities could help address environmental concerns. A company that adopts environmentally sound processes can reduce overhead costs as well as minimize whatever negative impact its business operations may have. And by working through networks, companies can share risks and expand reach of their resources (CCC, 2003).

In 2003, the PBSP-CCC asked 49 companies<sup>11</sup> to make a self-assessment of their corporate citizenship programs using this framework. The results show that companies managing stewardship and managing workplace concerns programs has the highest mean rating at 4.30. Companies managing corporate community partnerships, on the other hand, have the lowest mean score for almost all elements at 4.13. The mean score of system and process index for the 49 companies is 4.17, which suggests that corporate practice in the Philippines needs to be improved significantly.<sup>12</sup>

When company respondents were asked to name the specific area of corporate citizenship expression in which the company had achieved considerable success and maturity, 80 percent identified social investment as their main expression of social responsibility; 61 percent were implementing programs in environmental sustainability; 76 percent were carrying out CSR programs in partnership with a community of their choice; and 53 percent were managing employee-related services and processes in the workplace.

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<sup>11</sup> Of the 49 respondents, 80 percent are large industries, 15 percent are small and medium enterprises, and five percent nonbusiness (CCC, 2003).

<sup>12</sup> Each of the elements is assessed on a five-point scale. A rating of 5 means the indicator or standard item is in place and effective. A rating of 4 means the item is in place but needs improvement. A rating of 3 means that the item still is being developed. A rating of 2 means that the item is of interest and a rating of 1 means that the item is not applicable (CCC, 2003).

The survey also helped in finding out which among the impact indicators were of real value to the business.<sup>13</sup>

The survey likewise showed that corporate citizenship activities, to a certain extent, made positive contribution to the company's financial bottom line due to employee retention and customer loyalty. With 44 percent net rating, the majority of respondents claimed strong evidence for their view that their employees were proud to be part of the company because of its good corporate citizenship practice, and that their employees felt that the social agenda of the company helped fulfill their personal social responsibility. The majority of respondents claimed strong evidence that corporate citizenship helped develop loyalty and commitment among the company staff. A large number of respondents asserted that corporate citizenship practice begot customer loyalty to the brand, and thereby placed their products in a better market position than the products of companies without social involvement. But on whether the company's security expenses had gone down as a result of improved community relations, more respondents said they had no evidence to show for it.

As to the social impact of corporate citizenship activities, more companies claimed that good corporate reputation and social acceptability had a strong impact on their social bottom line. (A net 23 percent rating indicates strong evidence for the claim that the responsiveness of company leadership to development issues has a strong impact on its social bottom line.) Likewise, respondents claimed to have strong evidence that community participation in decision-making process empowered the communities where their companies operated. Thus, the community's dependence on the company was lessened. However, a significant number of respondents cited only weak evidence that companies communicated accurate and appropriate information to all their stakeholders.

On environmental concerns, company respondents claimed strong evidence for the strong impact corporate citizenship technologies had on their environmental bottom line, by improving their operational efficiency. It must be noted however that almost the same number of companies stated that eco-efficient practices had either weak or no impact, although they admitted weak or no evidence for this claim. Nevertheless, more respondents said good corporate citizenship practices reduced negative media publicity. Moreover, pickets and strikes were less frequent and in some instances had been completely prevented. On risk management, however, there was weak evidence that environmental programs of the company decreased the incidence of crime and insurgency. The overall results of the study are shown in Table 8.

In interpreting the results, however, caution is needed. Like many other CSR studies, the problem is in part the endogeneity of the relationships. As Claessens (2003) points out, does good performance beget better social corporate responsibility, as the firm can afford it? Or does better social corporate responsibility lead to better performance? He notes that firms that adopt ISO standards, for example, might well be the better performing firms

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<sup>13</sup> Impact ratings are based on the following indicative points: strong and moderate positive impact – indicates the program contributes significantly to business success; weak or no impact – indicates corporate citizenship appears to have positive business benefits, but these are likely marginal and insufficient for building a business case or, do not constitute direct financial or social returns. As to strength of evidence, strong evidence means that the company uses a formal tool or mechanism to show that the corporate citizenship program has impact on the company's operations or its financial and/or social bottomlines; weak evidence means that the company has inadequate measures or studies to show that the corporate citizenship program has impact on the company's operations. These measures are based mainly on the observations or perceptions of key people in the company (CCC, 2003).



even if they had not adopted such standards. At the country level, a higher level of development may well allow and create pressures for better social responsibility, while at the same time enhancing corporate governance. The key lesson here is to be rigorous in ascertaining cause and effect between firm performance and CSR.

Table 8. PBSP Corporate Citizenship Impact Index

		Impact indicators	Level of impact	Strength of evidence
Financial Driver	Human Capital	Employees regard company as employer of choice	Strong	Strong
		Encourages employee loyalty	Strong	Strong
		Corporate citizenship fulfills the social agenda of the company	Strong	Strong
	Competitive advantage	Marketing advantage	Strong	Strong
Social Driver	Reputation Capital	Public perception that company is caring and socially responsible	Strong	Strong
		Stakeholders share and support social vision	Strong	Strong
	Social Acceptability	Company reports accurate and appropriate information to all stakeholders	Strong	Weak
		Clients support the corporate citizenship agenda of the company	Strong	Strong
		Community trusts the company	Strong	Strong
		Communities empowered to manage local resources	Strong	Strong
		Community participates in decision making process	Moderate	Strong
	Favorable Environment	Others adopt the company's program	Strong	Strong
		Communities access equal opportunity to gainful employment	Strong	Strong
Environmental driver	Operational efficiency	Resource efficient operation and practice	Strong	Weak
		Supply chain development and management	Strong	Weak
	Risk Management	Health and safe workplace environment	Strong	Strong
		Decrease or eliminate incidence of crime and insurgency	Moderate	Weak
		Decrease or eliminate incidence of payment to pressure group	Strong	Weak
		Business community shares responsibility in solving social environmental problems	Strong	Strong

Source: Center for Corporate Citizenship, 2003

All things considered, the CSR index introduced by the PBSP can be considered a breakthrough. It allows subscribers to assess if their corporate citizenship programs are meeting the financial, social or environmental objectives of their firms. Good results would mean that the companies simply have to continue what they are doing. Bad results would, however, give the companies the appropriate signals on whether it is time to reinvent their CSR programs. Companies can also compare their scores with those of other companies, and benchmark themselves against firms with the highest ratings.

### A FINAL WORD: CAVEATS AGAINST DEFAULTING ON CSR

It is easier to ignore, rather than practice, CSR. Apart from the specious view that CSR is equivalent to stolen property rights, there are a number of excuses that companies, especially those found in developing countries in Asia, can advance in order to brush aside CSR. In closing, this paper summarizes the points made by Baker (2001) against companies who keep finding excuses to defer CSR.

- *Argument:* The company is too busy surviving hard times to do CSR. It cannot afford to take its eye off the core business. Very big companies have an arsenal of resources at their disposal. Those fighting for survival cannot keep on spending money on unnecessary actions, especially when they are laying people off and morale is rock bottom. Employee volunteering will not make any difference when they feel cynical and negative about how the company operates.
- *Response:* Managing social responsibility is like any other aspect of managing business. If the process of managing CSR leads a company to stop paying attention to core business, the problem is not that it is doing it at all—it is that it is doing it badly. Well-managed CSR backs up the business objectives of the company, establishes relationships with key stakeholders whose opinion will be most valuable when times are hard, and should reduce business costs. Even when times are hard, it is in the interest of any company to pollute more and run an increased risk of prosecution and fines, not to mention attracting the attention of environmental pressure groups. It is not in the interest of any company to lose some of its most talented people—serving or potential—by erecting barriers on the basis of race, gender, age or sexual orientation. It is not in the interest of the company to ignore changing values in its customer base towards socially responsible goods and services by producing goods just the way it always has. Finally, it is not in the interest of the company to ignore the fact that local communities around its plant are poor living environments, making the company an island of prosperity in a sea of deprivation.
- *Argument:* It is the responsibility of the government (and the politicians) to deal CSR. Business has traditionally been beyond social policy. The company will do what it is permitted to do. It expects the government to provide the legal framework that establishes what both business and society have to put up with.
- *Response:* Consider that of all the institutions which are currently getting more powerful in the world, they are essentially the global players—multinational corporations. The institutions whose power and influence are declining are those linked to the jurisdiction of the nation-state—governments first and foremost. It is politically correct therefore to look towards the multinationals to take a lead in creating solutions for global problems where the governments seem incapable of achieving co-operative solutions. In truth, many companies actually spend considerable energy and money seeking to influence the formation of public

policy in their area of interest. And since that area of interest can range far and wide—from international treaties on climate change, to domestic policy on health (such as prohibiting smoking)—the fact is the lobbying activities of companies show that they have a role, whether they like it or not. If that lobbying has involved blocking legislation that serves a social end purely in order to continue to profit in the short term, then the company is on very shaky ground. If CSR is simply about obeying the law and paying taxes, then perhaps the above statement is fair comment. But if it is about managing the demands and expectations of opinion formers, customers, shareholders, local communities, governments and environmental NGOs, if it is about managing risk and reputation, and investing in community resources on which the firm later depends, then the argument is has no intelligible meaning.

- *Argument:* CSR lowers the profit line.
- *Response:* The difficulty of buying into environmental protection has to be acknowledged. For instance, “selling” waste minimization to managers who really need to save money can run into serious obstacles, including the perception that it will cut into the company’s fragile bottom line. Yet study after study after study of just about any business one can think of, has shown that if waste minimization is carried out for the first time, the company can shift one percent of its overall turnover straight onto its bottom line. That is not an insignificant figure. And yet, getting out and selling more products somehow remains more attractive for business managers than making more profit through wasting less. It will take a long time and a change in fundamental attitudes towards doing business before a sea change can happen. But in the mean time, companies should keep looking at the evidence of successes in CSR investments.

Philippine companies are reaping the benefits of their social investments but the remaining challenge is how to widen corporate enthusiasm to make sustained social investments and to raise the standards in observing their obligations to their various stakeholders, not only because it is the profitable to do, but because it is the natural thing to do. Filipino and Asian firms should recognize CSR as a business framework which makes possible wealth creation as if people and the environment mattered.

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# THE EVOLUTION OF THE DISCLOSURE REGIME IN SINGAPORE

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## PRELUDE

Singapore is a regional financial center in Southeast Asia. Its system of corporate governance has been ranked the best in Asia by the Asian Corporate Governance Association in its annual rankings of Asian countries from 2000 to 2004 (Asian Corporate Governance Association, 2005). The creditability of Singapore's corporate boards has also received global recognition. In the World Competitiveness Report, the country has consistently found itself placed in the top 10 position for the effectiveness of its corporate boards in supervising the management of company in the same five-year period (IMD, 2000-2004). In 2005, Singapore is ranked 11th (IMD, 2005). The rankings are an indication of the level of corporate governance in place in Singapore. They indicate that Singapore has made considerable progress in introducing best practice and a corporate governance framework with systems in place to encourage good governance.

Part of the reason is Singapore's migration to a disclosure-based regime. Singapore has fairly high standards of corporate disclosure compared to its neighbors in the Asian region as well as the US and European countries, according to Gautam Banerjee, executive chairman of PricewaterhouseCoopers (Anandarajah, 2005).

It wasn't an easy shift. Past efforts to improve disclosure, according to Farr (undated) were hindered by the shareholder structure of many large Asian firms, which are typically dominated by a single controlling party or family concerns. It was apparently a waste of time and money disclosing information for the benefit of minority investors. But as Farr notes, the companies were not entirely to blame for the poor level of disclosure in the region. Market regulators were part of the problem as they only belatedly had shown an interest in corporate transparency. So were the investors. Farr quotes Elaine Giam, senior consultant with financial PR consultancy Baldwin Boyle Shand in Singapore, who said that there was not much pressure on companies from investors because until recently all companies had been in a growth phase—anything money is poured into, whether in fish food or manufacturing widgets, was going to make a profit.

The situation analysis made by the Organization of Economic Cooperation and Development was clear-cut: The disclosure regime in most Asian economies was defective. Fundamental accounting standards seemed to be in place but implementation was at best patchy. Corporate audits were far from precise in giving investors a true picture of the liabilities in individual companies. Crucially, the standards for consolidated financial accounting were not operative. Obscure cross-ownership patterns often shifted control in corporations in ways that were not known to shareholders. A web of off-balance sheet liabilities such as cross guarantees of debt increased the risk exposure of individual companies (OECD, 2001).

Luckily, corporate governance in Singapore had and still has much in common with that in English law as the Companies Act drew upon English precedents. The Companies Act also drew on precedents from other jurisdictions such as Australia. Thus, the structure

and responsibilities of the board of directors are similar to those in England and in most respects similar to those in most Commonwealth countries. It could be said that this foundation of corporate law and regulations enabled Singapore to improve its corporate governance with time, as there is much that is commendable in the English system of corporate governance.

The need for better disclosure practices has become all the more urgent because of recent reports of non-disclosure of various aspects of financials and shareholdings as well as the issuance of profit warnings by several companies listed on SGX. Many of the companies falling short of the disclosure requirements have been the smaller cap companies, raising questions about whether independent directors are truly performing their roles of oversight, and whether perhaps the regulators themselves need to be more alert to the companies seeking listing on SGX and perhaps do more, including introducing more stringent laws. Yet inadequate corporate governance and internal controls are prevalent in companies of all sizes. Ironically, the apparent heightened lack of governance controls in some companies could be a direct result of the good disclosure structure that has come out in Singapore over the years. It has effectively prevented inadequate disclosures and poor compliance practices from being concealed by companies (Anandarajah, 2005).

In this paper, we explore the corporate governance framework in Singapore highlighting what underlies the best practices in disclosure in Singapore. It is sound public policy to adapt the best in disclosure practice for Singapore that partly accounts for Singapore's high ranking internationally. The underlying objective on the part of the policy makers is to establish Singapore as an international financial center and a global hub for commerce. To achieve this, Singapore must adopt standards and practices international corporations are accustomed to and expect. This paramount objective shapes the future of corporate governance best practice, especially in disclosure and transparency.

This paper begins by expounding on the need for good disclosure effort. It examines the disclosure rules that occur as a compromise. Then we set the stage outlining a background to the Singapore's shift to a disclosure regime. Then it provides a brief account of the current disclosure practices, the reforms and changes to the framework, recent incidents involving Singapore corporations, before examining possible future improvements.

## **WHY THE NEED FOR GOOD DISCLOSURE PRACTICES IN CORPORATE GOVERNANCE**

A strong disclosure regime is a critically important characteristic of market-based monitoring of companies and is central to shareholders' power to exercise their voting rights. Likewise, it is the right tool for changing (for the better) the behavior of firms and for shielding investors, as the experience of developed countries (those with large and active equity markets) has proven. For shareholders and investors alike, access to regular, reliable and comparable information in sufficient detail helps them appraise the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Asymmetric or insufficient information hinders the ability of markets to function, increases the cost of capital and results in a poor allocation of resources. Needless to say, a solidly-founded disclosure regime can help maintain confidence in the capital markets. For stakeholders and the public-at-large, good disclosure practices improve public understanding of the structure and activities of enterprises, corporate policies and performance with respect to environmental and ethical standards, and

companies' relationships with the communities in which they operate (OECD, 1999).

Corporate governance has four pillars: (1) board processes, (2) disclosure and transparency, (3) auditing and compliance, and (4) accountability to shareholders. It is disclosure and transparency that relates to the effective and total communication between the company, its shareholders and stakeholders within its sphere. In today's competitive global business landscape, many businesses are actively contending for their shareholders' attention so that they can continue to rely on them for their financing needs. An effective communication program is therefore critical to ensure that key company strategies, directives and messages are relayed in a timely manner. Evidence suggests that investors will pay a premium for better governance, which includes a powerful disclosure regime. In an Investor Opinion Survey conducted by McKinsey, the World Bank and the Institutional Investor magazine in 2002, 89 percent of respondents in Asia said that they would ante up more for the shares of a well-governed company than for those of a poorly governed company with similar financial performance (Donc, 2003).

Of the four pillars, corporate disclosure, doubtless, will have the most substantial and direct effect on a company's valuation. Business analysts may use various yardsticks to value a company, but what is common to all the different valuation methods is the use of an equity premium. The equity premium translates into an information premium if there is a solid level of disclosure. Good disclosure practice will raise the company's value, as it lowers risk and uncertainty, and lowers the premium. Lower premium in turn leads to higher value. A good corporate disclosure practice means prompt and voluntary disclosure of information about the company's financial performance and of transactions involving the interests of directors, managers and controllers. PricewaterhouseCoopers recommends the following acts as exemplary disclosure practice: disclosing material information in a timely manner; avoiding selective disclosure during meetings with investors; providing broad market information to all retail and institutional investors, both local and foreign; and offering information above and beyond statutory requirements (Donc, 2003).

Empirical studies compiled by Donc (2003) clearly indicate the power of a good disclosure regime. A study made by Catherine Schrand and Robert Verrechia of the Wharton School of the University of Pennsylvania indicates that greater disclosure frequency in the pre-IPO period is associated with better and more reflective IPO pricing. Furthermore, the evidence suggests that lower levels of disclosure resulted in higher cost of capital, as found in the form of wider bid-ask spread and analyst forecast dispersion. The study was conducted using US samples. In the case of Asian markets, Kevin Chen, Zhihong Chen and John Wei (HKUST) find that disclosure practices have a significantly negative effect on the cost of equity. Their findings also show that risks of expropriation and unfair minority shareholders treatment are lowered if an unequivocal disclosure policy is adopted. Finally, Janice How (Curtin University) and Julian Yeo (University of Melbourne) provide a more specific research on the impact of forecast disclosure and accuracy on IPO pricing. In their paper, they find that those companies which consistently failed to forecast rightly experienced a higher level of price volatility.

## **THE TRADEOFFS**

Too many cooks will spoil the broth. In a similar vein, too many rules and regulations will stifle the entrepreneurial spirit. Yet at the same time, too few rules would leave the investing public unprotected against unscrupulous business practices (Ling, 2004). Tradeoffs are necessary to resolve this dilemma.

To be sure, there has to be a set of fundamental *mandatory* standards. On top of that,

companies are encouraged, in a *voluntary* way, to adopt a set of best practices as spelt out in the Code of Corporate Governance (Ling, 2004). Mandatory measures are often legislated or made part of the rules. Other standards are left to the market to enforce. In certain instances, according to PricewaterhouseCoopers' Banerjee, careful legislation could bring out results at a pace quicker than market-driven solutions. Market-driven practices may not always oblige voluntary compliance by companies. He cites as a good example the non-mandatory Guide for the Operating and Financial Review (OFR) issued by the CCDG, saying it remains to be seen how many companies would disclose the information relating to the financial and non-financial drivers of a company's performance as envisaged by the OFR (Anandarajah, 2005).

On the other hand, as Tan and Tan (undated) argue, a flurry of management frauds might tempt the regulators or advisory bodies responsible for good corporate governance to overreact as they peer into the areas where abuse occurs. The regulators' new guidelines might require the corporate disclosure of board activities. Yet the link between the activities, their intended results and the actual results might be tenuous or distant, leading any overzealous auditors to rein in value creation activities.

Then there is the matter of the high start-up cost of transparency. The principal-agent problem suggests that shareholders have less knowledge of the company and its operations than the managers do. As a consequence, they often tag an information discount to a company's value. Various empirical studies have proven the existence of this discount. To reduce the discount, companies have begun to put in place a governance framework that will align shareholders' and managers' interests better. At the same time, company managers also have started imparting sensitive information to their shareholders which were once exclusively given to a select group of managers and analysts. However, these practices come at a high price. In order to enjoy any incremental benefits, the increase in value needs to be greater than the cost of putting the governing structure and disclosure practices in place (Donc, 2003).

As a keen observer of Singapore's corporate governance points out, the decision of the regulators to introduce Sarbanes-Oxley types of interventions in the financial reporting processes and controls, executive certification of financial statements and the processes that generate them, while welcome, is not to be taken lightly as compliance may drive up the cost of doing business. Too much intervention may also dilute the attractiveness of Singapore to foreign investors, and its cost may far exceed the benefits of reining in only a few rogues (Virtual Roundtable, *Business Times*, 18 December 2004).

Yet the OECD is optimistic that disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. Nor are companies being asked to give away information that may endanger their competitive position. The minimum requirement, however is that the investor is fully informed of the investment decision to avoid misleading him or her. The key concept that should be applied in disclosures is *materiality*. Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by its users (OECD, 1999).

Finally, as a top corporate insider calls attention to, the big question is whether Singapore has the infrastructure to support the relatively pure disclosure-based regime that is being instituted. Good infrastructure translates into sophisticated shareholder activism, effective self-regulating organizations, capacity to enforce laws and regulations and the like. Apparently, there is an expectations gap between regulators and investors—regulators would like to see more market enforcement of rules and regulations, while investors believe that regulators should do more. But it is difficult for investors to enforce



their rights. Shareholders face a costly collective action problem (Virtual Roundtable, *Business Times*, 18 December 2004).

## **A PREFERRED APPROACH FOR A DISCLOSURE-BASED REGIME**

A disclosure regime refers to the information-breaking practice required by the capital markets. There are two basic types: merit based regime and disclosure-based regime. In a merit based regime, regulators prescribe and provide specific guidelines and direction in corporate disclosure. In a disclosure-based regime, companies are encouraged to ascertain their level of disclosure independently, although presumably the market will decide if the level is sufficient through the information premium that has been described earlier. Both types can be influenced through regulation. However, it is likely that disclosure practices will fall within a spectrum that ranges from fully merit-based to fully disclosure-based. For instance, some basic requirements for public offering and listing are of a merit nature since the listing company will have to abide by them before it qualifies for membership in the exchange. The disclosure nature becomes apparent when investors have more information to exercise their own judgment—they have to bear the consequences of their own investment decision—and the regulator relinquishes its role in judging the suitability of securities being made available to investors. Regardless of type, a successful regime will still need guidelines and criteria, and more crucially, effective enforcement (Donc, 2003).

So far the trend has been toward the establishment of a disclosure-based regime, with its associated philosophy of allowing market participants greater choice and freedom to take calculated risks. Its superiority over the merit-based system is ensconced in major benefits to be reaped, including a reduction in the cost of capital (lower equity premium), fewer moral hazard problems and the advancement of innovation (Donc, 2003). In Singapore, the switch from merit-based regulation to a disclosure-based system came in several steps.

### **Engineering the shift**

A Corporate Finance Committee, responsible for improving the efficiency of the corporate fund-raising process and corporate disclosure, was formed in December 1997, prior to the Asian crisis. The committee recommended reducing the role of regulators and introducing fundamental changes to the legal and regulatory framework, accounting and auditing standards, codes of best practices and the role of third-party watch-dogs (Mak and Chng, 2000). The recommendations were far-reaching and sought to open the financial markets in Singapore to the world. Among the notable proposals were:

- predominantly disclosure-based regulation with a high standard of prospectus and continuous disclosure,
- more timely release of annual reports and interim results,
- encouraging listed issuers to report their results on a quarterly basis,
- consolidating securities legislation into a unified code, and
- moving to a single securities regulator responsible for enforcing all aspects of securities law and regulation (including disclosure obligations) and prescribing accounting rules.

A comprehensive review of corporate legislation and governance followed the release of the Corporate Finance Committee's report in October 1998. In December 1999, the Ministry of Finance set up three private sector led committees to carry out a comprehensive review of issues relating to disclosure and governance. These issues included: company legislation and regulatory framework; disclosure and accounting

standards; and corporate governance. The Committee for Disclosure and Accounting Standards (DASC) reviewed the process by which accounting standards were set, maintained and regulated. It examined the approach, development and promotion of best practices in disclosure requirements among Singapore's publicly listed companies. The DASC recommendations sought to improve the process of formulating and preserving accounting standards in Singapore. They aimed to align Singapore's standards in the areas of accounting and auditor independence with international standards (e.g., those laid down by the International Accounting Standards and the US Generally Accepted Accounting Principles), as well as promote good disclosure practices in Singapore (Donc, 2003).

The recommendations of the three committees led to the strengthening of the corporate disclosure framework, the adoption of the Financial Reporting Standards (modeled after the International Accounting Standards Boards), and changes to the corporate law and regulations. Their idea was to implement a corporate governance regime avoiding two extremes: a prescriptive approach under which companies must comply and a non-prescriptive self-regulatory approach where every company is free to adopt its own practices. Instead they adopted the balanced approach, which is similar to the system existing in Canada and the United Kingdom (Donc, 2003).

To improve the standard of disclosure, the Companies (Amendment) Act 2000 brought in a "reasonable investor" test, which requires any issuer making a public offer to include in the prospectus all material information that an investor would reasonably require in order to make an informed decision on the securities being offered. Further, to enhance accountability for prospectus disclosure, the new law holds an underwriter (in addition to the issuer and its directors) liable for misleading or inadequate prospectus information and requires an issuer to publish a supplementary or replacement prospectus if a registered prospectus was found to contain false or misleading information or to have omitted material details (Economic Research and Resource, 2001). The Companies Amendment Act (2000) came into effect on 22 January 01.

A Corporate Governance Committee was subsequently set up to come up with a Code of Corporate Governance, which was accepted by the Singapore Government in April 2001. The Singapore Code of Corporate Governance was introduced in 2001 and implemented from January 2003. It was also included in The Singapore Exchange's listing rules. The Code sets out principles and best practices in four main areas, namely board matters, remuneration, accountability and audit, and communications with shareholders. The Code aims to encourage Singapore-listed companies to enhance shareholder value through good corporate governance. All listed companies are required to include a complete description of their corporate governance practices with reference to Code provisions in their annual report and to provide adequate explanations when deviations occur (Tan and Tan, undated; Sim, 2001). The Code is consistent with Singapore's disclosure-based regime for the capital markets. The intent is not just to mandate requirements, but also to strengthen disclosure and promote fair dealing. In general, listed companies have stood by the principles set out in the Code (Yam, 2003).

Besides the board and remuneration matters, the Code of Corporate Governance also provides guidelines to improve the quality of corporate financial reporting. It spells out the mechanism to safeguard the company's assets and resources (accountability and audit; internal controls) as well as accountability to shareholders through effective and comprehensive communications. The accounting, audit, internal audit and accountability to shareholders principles work towards strengthening companies' corporate governance practice. Through board monitoring, these changes will limit the discretion management has on the nature and extent of information disclosed in annual reports.

These corporate disclosure practices are similar in principles to guidelines asserted by other international reports such as the Cadbury Committee's *Report on Financial Aspects of Corporate Governance* (1992) in the UK; the Toronto Stock Exchange Committee on Corporate Governance (1994) in Canada; the Bosch Committee (1995), in Australia; the Organization for Economic Cooperation and Development (OECD) *Principles of Corporate Governance* (1999) and the *Commonwealth Association for Corporate Governance Guidelines* (1998). The common theme in all these reports is that the board plays a crucial role in ensuring the quality of financial reporting, including corporate disclosure practices. The Singapore Code has thus placed the role in the hands of the boards.

A private sector-led mechanism was set up to assist government in promoting business culture, and in continuously monitoring and improving the disclosure process. The Council on Corporate Disclosure and Governance, founded in 2002, advises the Ministry of Finance on matters of corporate governance and disclosure, and prescribes accounting standards to be applied in Singapore. The Council represents diverse interests across professions and business organizations (Yam, 2003).

### **Keeping the reform going**

Efforts to develop a disclosure-based regulatory regime continued apace in 2002. The Monetary Authority of Singapore implemented the Securities and Futures Act ("SFA") and Financial Advisers Act ("FAA") in October of that year to maintain fair and efficient markets. Though the SGX is entrusted with the day-to-day running of the market, the Monetary Authority of Singapore (MAS) has the job of overseeing the development of the financial markets, and that includes its disclosure regulations (Farr, undated). MAS fine-tuned Singapore's capital-raising regulatory framework in order to enhance market accountability and raise the standard of prospectus disclosure. Among other changes, issuers are now required to lodge their prospectuses with MAS for a two-week period during which they will be published for public comment before they are registered. MAS may refuse to register a prospectus if it does not comply with this requirement. The SFA also empowers MAS to stop an offer if a registered prospectus is later on found to be misleading or substandard (MAS, 2003).

Besides raising disclosure standards in the primary market, the SFA has attempted to improve disclosure in the secondary market. The SFA made the continuous disclosure of material information by listed companies a statutory requirement (previously a listing requirement of the securities exchange). In the past, substantial shareholders in a listed company were required under the Companies Act to notify the company of their shareholdings and changes thereto within two days of their trades. In turn, SGX requires the company to disclose such notifications to SGX. The SFA abbreviates this two-stage reporting process and makes disclosure to SGX a legal responsibility by requiring fairly large shareholders of listed companies to notify SGX of their trades directly (Economic Research and Resource, 2001).

A disclosure-based regime demands an effective market enforcement regime. The SFA has introduced provisions to improve market enforcement. New laws on insider trading now can capture a wider pool of persons who seek to take advantage of inside information. The civil penalty regime, which allows MAS to bring an action in Court against a defendant, now embraces all forms of abusive market behavior. Such civil penalty action must be complemented, however, by enhanced investigative powers for MAS' enforcement officers (Economic Research and Resource, 2001). MAS stresses that the burden is not so much on it to keep an eye on companies; rather it is on the companies

to bring out the benefit of better disclosure. So far, the island state's government reports that reaction from companies to MAS initiatives aimed at improving disclosure has been positive, while investors have also been supportive (Farr, undated).

To supervise the areas of accounting standards and corporate governance review, the Council on Corporate Disclosure and Governance ("CCDG") was established on 16 August 2002. Its role is to:

- Prescribe accounting standards in Singapore,
- Strengthen the existing framework of disclosure practices and reporting standards taking into account trends in corporate regulatory reform and international best practices,
- Review and enhance the existing framework on corporate governance and promote good corporate governance in Singapore whilst taking into account international best practices, and
- Revise the Code periodically in compliance with international best practices (Tan and Tan, undated).

One best practice that ought to be highlighted lies in the establishment of the Audit Committee at the board level as the arena for oversight over management in terms of financial and non-financial disclosures (MCGA, 2002). Singapore has imbedded the provision in its Companies Act and in the listing requirements of the Singapore Exchange.

The *Cadbury Report* (1992) recommends that "(t)he board should establish an audit committee of at least 3 non-executive directors with written terms of reference which deal clearly with its authority and duties" (1992a, Article 4.3). Although the *Cadbury Report* may not be applicable in Singapore, it must be noted that the requirement for audit committees for publicly listed companies was introduced in 1989 even before the *Cadbury Report* was published. This requirement is provided for in Section 201B of the Companies Act. The Singapore Exchange Listing Manual reinforces this requirement for the audit committee through its Best Practices Guide addressing corporate governance.

The audit committee is to be appointed by the directors. The committee is to comprise no less than three members of the board of directors. Most of the listed companies maintain audit committees meet this minimum requirement. The committee must be chaired by a non-executive director who is not in the employment of the company or its related companies. A majority of the committee must also be independent non-executive directors. Thus if a company decides to adhere to the minimum requirement of three, two of the members have to be independent non-executive directors and the third could be a non-executive director or an executive director.

The oversight role presumes the adoption of a system of accountability and audit, the principles of which were laid out in the *Cadbury Report* (1992) and strengthened in the *Hampel Report* (1998).

- *Financial Reporting*. The board should present a balanced and intelligible appraisal of the company's position and prospects.
- *Internal Control*. The board should maintain a sound system of internal control to protect shareholders' investment and the company's assets.
- *Relationship with the Auditor*. The board should establish formal and transparent arrangements for considering how to apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors (MCGA, 2002).

The Audit Committee thus serves as a part of the infrastructure for governance that helps put order into the review of transactions of the firm, both within and with outside parties, as a way of minimizing potential conflict which could threaten to undo or upset

opportunities to realize mutual gains on the part of shareholders. It is important to note, however that the oversight role of such a committee involves monitoring of management. It should not perform its functions directly at the board level (MCGA, 2002).

In general, the functions of the audit committee are to review a number of key areas-- financial and other reporting, internal control, and internal and external audit (MCGA, 2002). It reviews the auditor's work and supervises the company's internal audit and accounting procedures. Audit committees were introduced as a measure to guard against corporate fraud following the Pan Electric debacle in 1985.

In a broader context, the audit committee looks at related functions that may arise in the context of the standard reviews. The most critical of these would be the examination of related-party transactions and unusual items including one-off transactions. Singapore firms not only see the committee responsible for ensuring an effective system of internal controls; it also has some views that the committee be responsible for the detection of fraud (MCGA, 2002).

The key to committee effectiveness remains in the quality of the committee membership. The Committee will only be as good as the people who compose it. Singapore has adopted the Hong Kong criteria for audit committee membership, which recommend that members possess the following (MCGA, 2002):

- The authority and necessary skills and experience to tackle complex financial and operating issues.
- Soundness of judgment, independence of mind and a healthy degree of skepticism.
- Sufficient understanding of accounting or law.
- A clear understanding of the company's business, its corporate and management structure and management control and reporting systems.

The benefits of an effective functioning of Audit Committee have been identified by best practice companies (MCGA, 2002):

- Marked improvement in the quality of financial reporting.
- A climate of discipline and control, which greatly reduces the opportunity for fraud.
- Independent director judgment being brought to bear on assessing internal matters that are of material interest to shareholders.
- Clear channels of communication established with external auditors.
- Clear framework of analysis established with external auditors where independence of judgment can be exercised.
- Internal audit function strengthened with greater independence from management exercised.

The Accounting and Corporate Regulatory Authority (ACRA) came into existence on 1st April 2004, a result of a merger between the then Registry of Companies and Businesses (RCB) and the Public Accountants Board (PAB). This agency has been tasked with the mission to provide a responsive and forward looking regulatory environment for companies, businesses and public accountants, conducive to enterprise and growth in Singapore. ACRA is established as a statutory board as part of a change in approach in setting accounting standings. Previously standards were set by the industry through self-regulation. This change was felt necessary in the wake of big accounting scandals such as Enron's in the United States. ACRA's role would be to achieve synergies between monitoring of corporate compliance with disclosure requirements and the regulation of public accountants performing statutory audit.

In March 2002, MAS announced that it is compulsory for banks to rotate their external audit firms every five years. Also mandatory for banks are audit committees comprising of non-executive members of which majority have to be independent. All these changes have to be implemented by 2006.

To look after the interest of shareholders, the Securities Investors Association (Singapore), a non-profit organization, was established in June 1999<sup>1</sup>. The SIAS continues to periodically assess all listed companies on their disclosure performance. It has received feedback that pinpointed some companies in the construction industry as being reluctant to reveal information, and hoped this could be corrected. Its members were concerned with issues like remuneration, benefits accorded to their directors, and details on their investments.

The shift towards a disclosure-based regime has also been matched by the Singapore Exchange's exercise of its powers to halt trading of a company's shares, suspend trading or de-list a company's shares. Under Article 14 of the Singapore Code, firms have an obligation to provide accounting information and disclosure. Paragraph 1303 (3) (c) permits for the SGX to suspend trading when there is an audit qualification or emphasis of a matter in respect of the issuer (or significant subsidiary) that raises a going concern issue. Paragraph 1303 (4) encompasses an even wider basis for suspension—when the listed company is unable or unwilling to comply with, or contravenes a listing rule. The Exchange occasionally has suspended trading as seen in the cases outlined in the subsequent section.

In the end, it is proper disclosure and transparency which increases public confidence in the credibility and objectivity of financial statements and of boards. This was a basic failing that helped aggravate the Asian financial crisis. If done well and consistently, good disclosure practices should help forestall another such crisis (MCGA, 2002).

## COMPLEMENTARY DEVELOPMENTS

There have been other developments outside of the legal and regulatory framework that promote a disclosure culture in Singapore.

### Annual Report Award

One of these dates back to 1974: the Annual Report Award (ARA) Competition. The ARA Competition began 31 years ago with the objective of encouraging companies to make full voluntary disclosures in their annual reports. In 2005, the ARA Competition came under the umbrella of the Singapore Corporate Award which is in turn jointly organized by the Business Times with various partners such as the Singapore Exchange, the Institute of Certified Public Accountants of Singapore and the Investment Management Association of Singapore (*Straits Times*, 20 September 2005).

The Annual Report Award has the following objectives:

- To encourage effective, full and prompt disclosure to shareholders, employees, creditors and the public of relevant financial and other information regarding a business enterprise or organization.
- To create an awareness of the mandatory and voluntary accounting guidance issued by the Council on Corporate Disclosure and Governance and the Institute of Certified Public Accountants of Singapore.

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<sup>1</sup> The website address of the Securities Investors Association (Singapore) is [www.sias.org.sg](http://www.sias.org.sg)

The aim of the competition—encouraging excellent annual report presentation and a wider scope of disclosures beyond the minimum statutory requirements—remains as relevant as it was at its inauguration. At that time, there were slightly more than 80 eligible companies participating in the competition. As of 2005, there are 638 companies. Companies that are listed on the Singapore Exchange—including foreign companies with primary listings—are eligible for the competition. The most recent annual reports available as of 30 September each year are considered for the awards. The annual reports of statutory boards were added as a separate category to the competition in 1989. The annual reports of companies listed on the second board, SESDAQ, were assessed as a separate category with effect from 1996.

### **The *Business Times* Corporate Transparency Index**

The *Business Times*, a business daily newspaper, launched its Corporate Transparency Index (CTI) in July 2000, a few weeks after the SIAS launched the award to recognize the “most transparent” company in Singapore. The index benchmarks the listed companies on their disclosure to shareholders in particular,

Published twice a year, the CTI has generated considerable interest in corporate governance, functioning as a corporate monitor located in the market place. The CTI measures the quality of the listed companies’ financial statements (“content”) and how effectively they communicate this information to shareholders and investors (“context”). 60 points are awarded for “content” and 40 points goes to “context”—the weightage of the latter component is a decrease from 50 points when the CTI was launched in 2000 (*Business Times*, 4 January 2005). The “passing mark” is 50 points.

There have been benefits from the publication of the index as it has produced scathing remarks from the press on the state of transparency in the interim earnings announcements.

In 2000, the *Business Times*, for instance, noted that the great majority of Singapore's listed companies “failed to make the grade” for transparency, even though some among them have impressive performances that are among the world's best (Thompson, 2000). That involved 246 of the 291 local companies (85 per cent) that posted interim results on the CTI. In 2005, six years after its launch, the passing rate has improved to 37.1 per cent, with 234 companies out of the 630 that made up the index population scoring more than 50 points (*Business Times* 11 July 2005). Whilst the overall pass rate has improved, there are disparities within the “content” section. Participating companies were noted to have been forthcoming in providing basic qualitative information but were short on content and disclosure when it came to information on issues such as risk, future plans, review of past performance and borrowings (*Business Times* 11 July 2005). Where financial statements were concerned, the companies were criticized for their lack of voluntary disclosure above and beyond what is expected from the minimum legal requirements (*Business Times*, 4 January 2005). The *Business Times* also added that although the pass-mark of 50 points is used as a benchmark, companies that aspire to world class standards should aim to score at least 40 points in the content section and 20 in the context section (*Business Times*, 4 January 2005).

## **HIGHS AND LOWS OF THE DISCLOSURE REGIME**

Keeping abreast of the times, many companies in the Asian region have taken it upon themselves to increase the flow of information to the market. IRAsia.com is one firm hoping to take advantage of the flourishing company information market. It has lately opened new offices in Singapore and Sydney, reflecting the growing corporate interest in

disclosure. As Alison Chow of IRAsia.com explains, Singaporean companies do file a lot of statutory information to the regulatory bodies, but they need to do more than just communicate information required by the regulators. What IRAsia.com is trying to accomplish is to help these companies reach a greater number of investors—It assists investors understand companies better (Farr, undated).

Another firm that is making a breakthrough in Asia's financial communications is Singapore Technologies (STE). The outcome of the merger of four separate defense companies in 1997, STE is now recognized as a company with one of the most advanced disclosure strategies in the Asia region. Shirley Tan, STE vice president of corporate communications, has seen the company's disclosure strategy develop rapidly as the government tried to encourage companies to become more transparent. In the old days, the standard of communications was so low in Singapore that even companies merely holding press briefings were regarded as good corporate communicators. Following the 1997 merger, as part of her learning process, Tan attended several aerospace analyst conferences, watching how rival companies such as Boeing and British Aerospace presented themselves to investors, marveling at the amount of information they provided and the closeness of the relationships between analysts and the companies. STE decided to adopt an open regime, which was recognized by the *Business Times* when Singapore Technologies occupied the top rung in its Corporate Transparency Index (Farr, undated).

#### Case Vignette 1. Citiraya

Citiraya is a fully integrated electronic waste recycling and processing company, listed on the Singapore Exchange since July 2002. It was a favorite amongst investors and was named as Singapore's "Best Newly Listed Company" in 2002 based on an annual poll conducted by *Asiamoney*, a leading financial magazine in Asia (Edge, 2005).

In January 2005, the company came under public attention when the local press reported market rumors of disagreement between the company and its auditor, Deloitte & Touche and the possibility of a profit warning (*Business Times*, 2005a). Subsequently, the company announced that it was asked to assist the Corrupt Practice Investigations Bureau ("CPIB") with certain investigations. The company appointed an independent investigator and financial advisor to carry out a thorough and comprehensive probe into the transactions in question (*Straits Times*, 2005a). The investigations has since revealed that the firm's key employees were involved in the trading of electronic waste that was designed for recycling (i.e., to be destroyed) as trading electronic waste was far more profitable than recycling (*Straits Times*, 2005c).

Shares of Citiraya have been suspended since 24 January, 2005, pending investigations over alleged fraud. They were then traded at S\$1.08 cents (*Straits Times*, 2005a). Late-breaking news (as of time of writing) indicates that Citiraya is in deep trouble. The Corrupt Practices Investigation Bureau (CPIB) has had a number of people charged with corruption and misappropriation of company funds. Citiraya has its own probe going presided by an independent investigator and financial adviser. A key rescue effort by Venture One, pulled out in May this year, saying the due diligence exercise had not worked out well. Citiraya then obtained a court order to hold back any winding-up moves by creditors (Sabnani, ChannelNewsAsia, posted 23 September 2005).

Besides the police probe, Citiraya faces legal suits from creditors, a dwindling cash reserve and the loss of its customers to its competitors. Adding to Citiraya's woes was a failed rescue plan by white knights and the disappearance of former CEO, Mr. Ng Teck Lee (*Business Times*, 2005d; *Straits Times*, 2005b). Mr Ng Teck Lee and Mr Raymond Ng, the siblings who founded the company, have a combined shareholding (direct and deemed interest) of 46.41 percent in the company. The CPIB had stopped the sale of Teck Lee's bungalow, and Teck Lee is believed to have left the country (*Straits Times*, 2005b).

The pressure for improved disclosure was also evident in the regulators' willingness to act when breaches occurred. Brief accounts of two such cases, Citiraya and China



Aviation Oil, are provided as case vignettes below. It is evident from the corporate incidents that the Singapore Exchange is prepared to act in relation to corporate governance failures particularly in the area of disclosure. The Code by itself would not be effective if the interests of the investing public were not assured through the willingness and quick response on the part of the Exchange to suspend the trading of shares of companies where there is reason to do so. This preparedness to act lends credibility to the disclosure-based regime.

As the Code is adopted on a voluntary basis, the presence of sanctions to address the lack of transparency and disclosure is an integral part of the overall framework. The Singapore Exchange's ability to act on the share trading of a defaulting company's shares has proven to be an important prong to the corporate governance framework.

#### Case Vignette 2. China Aviation Oil

Listed on Singapore Exchange in December 2001 with a registered capital of 3.6 billion Yuan (US\$435 million), China Aviation Oil's core business is the procurement of jet fuel from overseas markets for distribution to China's civil aviation industry through its parent company, China Aviation Oil Holding Company (CAOHC). CAO was hailed as a leader in corporate governance when it won the "Most Transparent Corporation" award endorsed by Securities Investors Association (Singapore) in 2002 (CAO 2002). Its board had five non-executives directors, one executive director and three independent directors. The Chairman was a non-executive director and was not the CEO (CAO 2003). An Audit Committee was tasked to assist the board in the identification and monitoring of significant business and financial risk.

In spite of a three-layered formal system of internal control<sup>2</sup>, CAO stunned investors and markets regulators when it announced US\$550 million losses from derivatives trading in the energy markets. It was also seeking court protection from creditors. Trading of its shares has been suspended on 29 November 2004 after the shares dropped to below \$0.60 per share.

The company is facing criminal investigation by the Commercial Affairs Department (CAD) for alleged insider trading. Chen Jiulin, the suspended CEO, is currently assisting CAD in investigations of these offenses under the Singapore Securities and Futures Act. In a statement to the Singapore Supreme Court on 30 November 2004, Jiulin outlined the company's ill-fated venture into options trading. The first few transactions were profitable. However, the worldwide increase in oil prices in 2004 caught CAO's trading team unprepared. It made bets on the direction of oil prices and ran up losses as New York oil futures surged to a record US\$55.67 a barrel on 25 October 2004. Instead of leaving the market and accepting losses of several million dollars, the company raised its bets until it faced losses that it could not meet. The company was only authorized to trade crude oil futures up to a value of US\$5 million, or 2 million barrels. Instead, it transacted trades involving 53 million barrels, resulting in losses of about US\$550 million.

The CAO case, in which the company failed to disclose huge losses on oil derivatives trading, has triggered a debate in Singapore, normally a show-off as one of the best-regulated financial markets in Asia. Attracting more foreign listings was seen as essential for the SGX's growth because of Singapore's small corporate base. The SGX has focused on wooing mid-sized Chinese companies, such as CAO, that might be ignored in bigger bourses.

The issues being raised include whether the Singapore Exchange should tighten listing requirements and whether independent directors are effective at all in supervising

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<sup>2</sup> Comprising of the respective heads of each divisions (who are responsible for supervising the daily work of their division staff and held accountable for the proper compliance to stipulated work procedures and limits daily), an independent Risk Management Committee and an Internal Audit Division.

companies. Critics blamed SGX's decision several years ago to relax entry rules by switching from a merit system to a disclosure-based regime as the culprit in the financial scandals among listed companies, including local ones. But the adoption of the principle that listed companies should bear the onus of responsibility for disclosure—part of a liberalization plan to make Singapore competitive against other regional centers such as Hong Kong and Tokyo—remains sound, according to SGX executives. But the Monetary Authority of Singapore, the main financial regulator, said it would review corporate governance rules once investigations were completed. There have been calls for authorities to impose tougher penalties for those who violate disclosure rules (WCFCG, 2006).

## THE WAY FORWARD

As the pendulum swings towards a disclosure-based regime in Singapore, the need for continued progress along a wide front of concerns has become more urgent. The following are some of the next steps that need to be made, if a middle ground is desired.

### **Benchmarking for better disclosure**

There are models elsewhere to be explored, especially those that will allow companies to see more tangible rewards from better disclosure. One best practice will allow market discipline to exert greater sway on the conduct of companies, according to Ling (2004). In Brazil, the Bovespa stock market is stratified along corporate governance lines. Because of the high number of non-voting shares, dominant shareholders in Brazil can legally exercise control over listed companies with as little as a 17 percent equity stake. But companies can voluntarily elect to list on Bovespa's "Level 1" by agreeing to additional disclosures or to list on "Level 2" by granting limited voting rights to non-voting shareholders. Essentially, the companies have two choices: attract investors and raise capital more cheaply by giving up some control or adhere to standards that are more stringent than is required by law. Ling suggests considering this approach for Singapore. Instead of dividing all listed companies into the mainboard and the second board based on size, they can be segregated based on their level of corporate governance and disclosure standards. Those that choose to be listed on Level 1 or Tier 1 will have to meet all the best practices of good corporate governance—transparency and timeliness of accounts, compliance with the spirit of applicable codes, and so on. With such a high level of corporate governance, it is anticipated that the risk premium would go down. In other words, their share price would command higher valuations and they could obtain loans at a cheaper rate.

Happily, Singapore does not have to start from zero, as there is already an "informal" stratification of stocks on the SGX, made obvious by the disparity of their performance. The *Straits Times* Index component stocks have continued to scale new multi-year highs, while the second-tier market is languishing.<sup>3</sup> But the STI is made up of companies with sizeable market capitalization. Meanwhile those with a smaller stature but with similarly good corporate governance have no way to distinguish themselves. A scandal like that triggered by CAO sparked off an indiscriminate selling of all China stocks. Ling suggests

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<sup>3</sup> There are two bourses in Singapore. The Singapore Exchange Main Board and the secondary board, SESDAQ (Stock Exchange of Singapore Dealing and Automated Quotation System), and as of 2005, there are 638 companies listed on the two boards.

that companies be segregated along corporate governance lines, in the hope that the resultant difference in the cost of capital for the various groups of companies would establish the link more directly. He argues that the rewards for companies which make it to the top of the lists (e.g., the *Business Times*' Corporate Transparency Index, the corporate governance ranking by Standard & Poor's and the Corporate Governance & Financial Reporting Centre at the National University of Singapore) are still not that tangible (Ling, 2004).

### **Greater assistance for newly listed firms**

Anandarajah (2005) makes the point that corporations in Singapore are not on a level-playing field, which makes it difficult to sustain a regime of self-enforcement and disclosure. She underscores the need for greater enforcement and oversight, with special emphasis on smaller cap companies, which stand to gain from more intense examination of their corporate governance practices and internal control measures. Saying that introducing more rules and regulations will not necessarily improve Singapore's disclosure regime, PricewaterhouseCoopers' Banerjee recommends a holistic approach in assisting newly listed smaller firms by focusing enforcement on the following aspects:

- Corporate/organizational codes of conduct,
- Compliance and ethics awareness and training,
- Properly documented policies and procedures which are adhered to, and
- Demonstrating expected behavior particularly by directors and senior management.

This will instill a culture and mindset that will encourage a longer-term view on company growth as opposed to a focus on short-term profitability (Anandarajah, 2005).

### **Enforcing Sarbanes-Oxley**

Some elements of Sarbanes-Oxley are worthy of adoption, according to Banerjee. These include the following:

- A clear definition of the responsibility of management and auditors in the area of internal control system and financial reporting. That means requiring auditors to provide an independent report to the shareholders and board of directors on management's assertion on the effectiveness of the company's internal control over financial reporting;
- The inclusion of an internal control report by management in the company's annual report;
- Requiring management to document and test controls. This should provide management with assurance on the financial numbers they are producing.
- Requiring sign-offs by CEOs and CFOs (Under section 302 of the Sarbanes Oxley Act, CEOs and CFOs are required to attest to the accuracy of the quarterly financial reports).
- Putting in whistle-blowing provisions provided by Sarbanes Oxley Act to protect reporters of corporate wrong-doings.

Any progress along the disclosure front must emphasize that the overall responsibility for the establishment and maintenance of an effective internal control and financial reporting system rests squarely with management and the Board. The responsibility cannot be delegated (Anandarajah, 2005).

### **Effective training**

Training is essential to improve disclosure practices. Awareness created through training will ensure more effective vigilance. Mandating training may not be the optimal approach, but efforts must be taken to ensure that corporations conduct effective training for their directors and key officers, and not just pay lip service to it. For new corporations being listed, requiring training for directors before (rather than after) the IPO process just might work (Anandarajah, 2005).

### **Stronger surveillance**

The disclosure-based regulation does require surveillance and strong enforcement to deter and penalize those who would bend or break the rules, according to Susan de Silva, partner and head of corporate/commercial group, Alban Tay Mahtani & de Silva. She suggests maximum penalties under the Securities and Futures Act (SFA) for those who run afoul of the continuing disclosure requirements (The maximum fine is \$250,000 and/or up to seven years' imprisonment, and a civil penalty—payable to the MAS—at up to three times the gain made or loss avoided.) (Virtual Roundtable, *Business Times*, 18 December 2004). On this score, MAS has to continue to build up its enforcement capabilities to undertake investigation and civil penalty action. To support its enforcement activities, MAS has acquired a market surveillance system to enhance its capability in detecting irregular trading activities. (Economic Research and Resource, 2001).

### **Non-discrimination in listing**

On the question of listed overseas companies, ideally, the same rules should apply to all companies, without discrimination. Unfortunately, the SGX may want to be more stringent with overseas companies seeking listing to ensure some quality control and not risk putting Singapore's reputation at stake, according to Angela Tan, senior correspondent of *The Business Times*. A fair amount of scrutiny may give local investors more assurance and protection. But there is a tradeoff: more cumbersome rules may deter foreign companies from choosing to list in Singapore, argues Ong Lien Wan, president of the Association of Certified Fraud Examiners. But Mak Yuen Teen, co-director of the Corporate Governance and Financial Reporting Centre at the NUS Business School, counters that with Singapore relaxing rules for foreign companies, it may end up attracting companies with lower corporate governance standards—attracting too many poor quality companies may lead to a situation where the bad drives out the good. The key, according to De Silva, is simply not to discriminate and apply the same rules to all (Virtual Roundtable, *Business Times*, 18 December 2004).

### **Protecting whistle-blowers**

Whistle-blowers are not paid informants, and the least that could be done is to protect them from reprisals, points out Teen. According to Wan, a 2004 survey done by the Association for Certified Fraud Examiners in the US has shown that almost 40 percent of frauds are discovered from a tip-off; and that recent KPMG studies on fraud in Singapore also supported the fact that almost 53 percent of fraud cases are uncovered due to notification by external parties, informants or anonymous letters. That makes a whistle-blowing program a most powerful tool in detecting management fraud. But there is little incentive for top management to install a whistle-blowing program, since it is a cost item. Wan argues that it is necessary for the government to pass a bill requiring listed companies to have a whistle-blowing program, as the US has done in the Sarbanes-Oxley Act. The Act must be coupled by very strong commitment from management to support whistle blowing and trust in the people who implement the system, suggests Teen (Virtual

Roundtable, *Business Times*, 18 December 2004).

### **Signing up small enterprises**

Corporate governance is largely tied in with larger companies, which are confounded by the agency problem. The agency problem comes about when members of an organization have conflicts of interests, which in turn arises within a firm when there is no separation between ownership and management. At first glance, corporate governance would not apply to SMEs since the agency issues are less likely to subsist. SMEs are not accountable to the public since they have not accessed the investing public for funding. On this ground, the applicability of disclosure and transparency may be questionable (Tan and Tan, undated).

To Jamie Allen, secretary general of the Asian Corporate Governance Association Ltd, in order to “incentivize” SMEs to take disclosure more seriously, the most effective short-term measure is likely to be some vigorous enforcement action by the regulator against small companies found breaching disclosure rules. The long-term strategy is to change mindsets, which could either be forced on these companies from without (i.e., by the market), or come from within (i.e., enlightened management). Small company owners and managers will need to be convinced that they could gain competitively from better disclosure, stronger accountability structures and fairer treatment of shareholders/stakeholders (Anandarajah, 2005), that the presence of proper accounting and bookkeeping practices will increase confidence in the firm and makes them less risky to invest or finance, and that better information disclosure will lead to healthier growth rates (Tan and Tan, undated).

### **Final note**

The Singapore government, based on the evidence presented, has undoubtedly taken the right step in promulgating good disclosure practice through the introduction of a new regime and regulatory reform. Will a higher proportion of investor funds seek safe investment havens and more companies, even foreign ones, seek listing on the exchanges, as Donc (2003) confidently predicts? Whether Singapore and the listing companies will find the gains outweighing the costs, only time will tell. Yet as Anandarajah (2005) remarks, good corporate governance is an evolving process and perfection will never be attained. The journey, which will invariably be bombarded with constant criticisms of insufficient steps being undertaken by regulators, will find corporations improving themselves over time. Singapore has, on balance, done well for itself.

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# THE EQUITIZATION PROCESS IN VIETNAM: MAKING A HEADSTART IN A LONG JOURNEY

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## SOME THEORETICAL PERSPECTIVES

In the corporate governance literature, there is an extensive body of work on the problem of public ownership, addressing the frequently observed fact that state owned enterprises (SOEs) are generally less profitable and less efficient than privately owned ones.

From a political perspective, government pursues *multiple objectives* (social, political, economic) and as owner of business, it behaves quite differently from private ones, who primarily concern with the profit maximization. Government is arguably more concerned with political and macroeconomic stabilization objectives: output prices might be set lower than market prices to control inflation or to subsidize the consumption of certain products (especially food and energy); more staff are deliberately employed than economically desirable to generate employment at the cost of production efficiency (arising from both higher labor cost and overcrowding), or companies under government control may make heavy investments in areas where there is high risk but with potentially fast return and they may be exposed to a wide range of market failures (e.g., free rider problem). Anytime the government tilts heavily toward highly politicized decisions, the outcomes will most likely have negative impacts on the profitability of the companies and the allocation of resources.

From a managerial perspective, the separation of ownership (the state) and management (civil servants, public sector managers) gives rise to the principal-agent problem, which suggests that even when the government systematically requires firms under its ownership to maximize profits, inherent problems of corporate governance will emerge. The manager's interests diverge from that of the owners and he/she will be concerned to use some proportion of firm-specific rents to satisfy management's own demands—job security, high pay, fringe benefits, managerial power and so on.

In the private sector, the monitoring of management is carried out under heavy constraints imposed on the firm by product and capital markets. Stock price fluctuations, the threat of bankruptcy, and management takeovers help to discipline managers and workers. However in the case of SOEs, where multiple objectives are pursued, it is not clear what criteria management's performance should be measured against. When profit maximization is no longer the primary goal, and in the presence of a soft budget constraint, managers have little incentive to improve their performance. Moreover, they are not easily monitored.

Furthermore, SOEs are solely owned by the state. Although managers and staff are stakeholders, they do not hold the company's share, a situation which effectively keeps their eyes off the companies' fortunes or fate. The lack of clear ownership identification subverts corporate governance as it leaves open the issue of who exactly should be



monitoring the managers. From 1995 onwards, the capital and assets of SOEs have been put under control of the Ministry of Finance, but the operation of SOEs is still overseen by their respective line ministries or local governments. That is why the directors of SOEs are still encumbered by regulations from many organizations (Tho, 2001). Neither is it clear who represents the state as owner of SOEs and how their interests are aligned with those of the companies.<sup>1</sup> Arguably, the responsible bodies which are in charge of the SOEs have little incentive to keep an eye on the managers for efficient operation.

SOEs also do not participate in the stock market, which plays an important monitoring role through the movement of stock prices. Lacking this significant source of information, the government as business owner has more difficulties in monitoring its managers than private or publicly listed companies. Information on each SOE is almost undisclosed. Nobody, including the government itself, is well informed about the financial situation of SOEs (Tho, 2001). The diagram below indicates this agency problem.

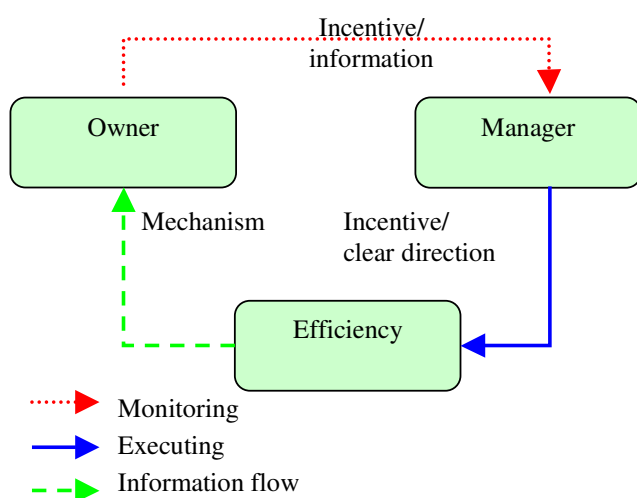


Figure 1. The agency problem

In summary, the corporate governance issues in SOEs resulted from three shortcomings:

- The owner lacks the incentive and the information to monitor managers.

<sup>1</sup> According to the 2003 Law on State Enterprises, the following individuals and organizations assume the role of representatives of state ownership in SOEs:

- The Prime Minister directly represents or mandates relevant ministries to represent state owned-assets and to exercise the owners' rights and obligations in special SOEs.
- Ministries and Provincial People Committees act as owners of SOEs which do not have a Board of Management.
- The State Financial Investment Corporation (SFIC) acts as representative of enterprises whose charter capitals are wholly invested by SFIC (Dzung, 2004).

- The managers have no clear directions from the owner on what the primary enterprise target is (each SOE has many agenda while a private company has only profit maximization as goal). They will have no motivation to drive the company's performance levels.
- There is no clear indicator on how the company is performing. Even in cases where there are initiatives for profit maximization, the information available to SOEs owners/managers is limited as the enterprises which they oversee do not participate in the capital market and has soft budget constraint. It should be noted that budget constraints turned from "soft" to "hard", but recently tended to return to "soft" again, particularly in large SOEs. It is easy to see why. Beginning the latter half of 1997, helped along by the adverse effects of the Asian crisis, many SOEs experienced financial difficulties and the government has to bail out the large SOEs, on account of their leading role in a socialist economy (Tho, 2001).

Due to these problems, many observers associated the collapse of the socialist economies in the late 20<sup>th</sup> Century to the dysfunction of the centrally planned economic system and its centerpiece, the SOEs. As the result, some transition economies have been pushing hard for privatization in an effort to re-establish a market economy and improve economic efficiency. Vietnam is one of those in the transition process toward a market economy. The Doi Moi (Renovation) program started in 1986, initiated far-reaching reforms aimed at introducing market mechanism into the economy, encouraging the development of private sector and restructuring the SOEs (including the diversification of ownership of factors of production outside of the government domain).

It should be emphasized at this point that SOEs in the capitalist system in the West and SOEs in the socialist countries in the East (Vietnam in particular) operate under very different economic structures. The SOEs in socialist countries function in a non-market system and are under no obligation to achieve financial objectives. They exist merely as units of production, and as tools to carry out centrally planned targets. Therefore privatization in the transition economies not only represents the re-establishment of private property rights, which underlie a market economy, but also provides incentives for firms to rationalize their organization, change product lines and find market niches to meet the new opportunities opened up by liberalization (of pricing, among others). Arguably, the poor performance of the SOEs in Vietnam is an outcome of not only poor managerial incentive (a corporate governance issue) but of constraints imposed by the economic system. The reform of SOEs must be preceded by the reform of the economic system through the introduction of market forces and price signals.

This paper concentrates on the impacts of the diversification of ownership (equitization) in previously state-owned enterprises in Vietnam. It outlines the history of SOEs in post-colonial Vietnam and the country's subsequent economic reforms as the backdrop for the SOEs restructuring programs, particularly the equitization process. Finally it examines the impact of the diversification of ownership and the withdrawal of the government's role in the management of the enterprises.

## **A BRIEF HISTORY OF STATE-OWNED ENTERPRISES IN VIETNAM**

After the war against the French ended in 1954, the new socialist government pursued a Soviet style economic model, which was believed as the best framework for development and the right path to socialism. Immediately, the SOE sector was established, largely by nationalizing the existing privately owned enterprises. By the end of 1960, 100 percent of industrial establishments, 99.4 percent of commercial establishments, and 99

percent of transportation facilities, which once belonged to foreign and Vietnamese capitalists, were nationalized and transformed into state enterprises. The newly found SOEs had very limited autonomy—they were seen as production units and had no decision power on what, how, how much to produce and for whom. They were under the direct control and management of the of line ministries of the central government or different departments of the local government. Their only task was to receive and carry out formulated plans, which specified detailed production targets, sources of inputs and output disposal. Operating profits were also pre-determined in the plan (but was rarely achieved) and needed to be transferred to the government budget. Losses were made up from government budget expenditure (Ngu, 2002).

After the unification of North and South Vietnam in 1975, the number of SOEs expanded quickly when business establishments of the former administration in the South were transformed into Northern style SOEs. By early 1978, 1500 large and small-scale capitalist enterprises, which employed 130,000 workers or 70 percent of the workforce in private capitalist enterprises, were nationalized and converted into 650 SOEs (Ngu, 2002). Before putting through the *doi moi* (renovation) policy in 1986, only two components of the economy existed: the state sector and the collective sector. That's why the Vietnamese economy entered the last decade of 20th century with more than 12,000 state-owned enterprises (Huong, undated).

The weakness of the central planning economic system became apparent in the years after the war. The second 5 year-plan (1976–1980), which focused on developing the industrial SOE sector, was a complete failure, despite large amounts of investment. SOE performance was ineffective and sometimes induced negative industrial growth. The growth rate of national income was only 1.7 percent instead of the targeted 13 percent to 14 percent per year in this period. The average annual growth rate of industrial production was 1.5 percent in the industrial SOE sector and 0.6 percent for the whole economy. The threat of economic collapse forced the government to reconsider the merits of its economic strategy. Some limited reforms were made but remained within the context of the existing centrally planned economic system. Table 1 illustrates this unsuccessful experience.

Table 1. Targets and actual performance for selected economic indicators of the 2nd Five Year Plan (1976–1980)

Indicators	Unit	Plan targets	Actual performance	Actual targets (%)
Coal	Million tons	10	5.3	53.00
Electricity	Billion kilowatt hour	5	3.68	73.60
Cement	Thousand tons	2000	641	32.05
Steel	Thousand tons	300	62.3	20.77
Fabrics	Million meters	450	175.3	38.95
Chemical fertilizers	Thousand tons	1300	313	24.08
Paper	Thousand tons	130	46.8	36.00

Source : Vo Nhan Tri (1990)

In December 1986, the Sixth National Congress of the Communist Party of Vietnam decided to embark on a far reaching renovation program 'the *doi moi*' abandoning centrally planning in favor of a market-based, multi-sector economy with a socialist orientation (Leung & Riedel, 2002). Under the banner of *doi moi*, the SOEs were to be restructured to be more efficient, enabling them to continue being the backbone of the economy. The introduction of the market mechanism into the economic system triggered

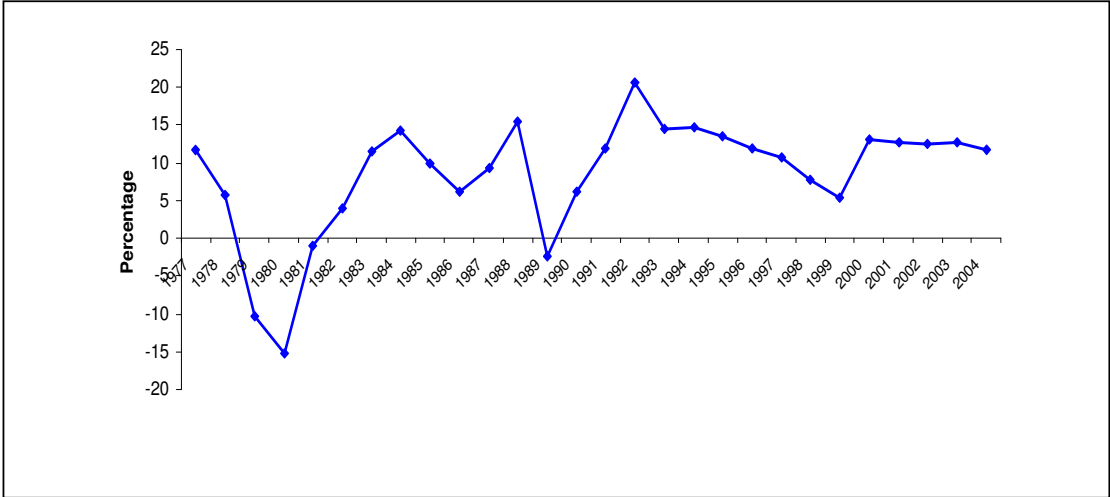
the first wave of SOE reform, which started to operate as business enterprises, where financial targets began to matter. SOEs were given the autonomy to formulate and implement their own operating plans based on socio-economic development guidelines set by the government under a decision reached in November 1987. Price control was relaxed, and companies purchased inputs via the market and could sell their outputs directly to customers. SOEs' profits were calculated based on real cost, and except for compulsory transfers to the State Budget, profits were retained by the enterprises and used at their own discretion. Along with the progress in *doi moi* policy, particularly since 1989, managerial autonomy has been further accorded to SOEs, with freedom to set output target and prices, disburse bonuses, and use retained profits to fund intra-firm social services (Tho, 2001).

In the initial stages of the reform program, many SOEs were not able to adapt to the changes. At constant 1989 prices, the industrial output of the SOE sector in 1989 fell 2.5 percent compared with that of 1988 and it was estimated that by 1990 some 38 percent of SOEs were generating losses. To tackle the problem, in 1991 the government required all SOEs to re-register, and those judged to be inefficient or lacking capital or technology or did not have sufficient market demand for their outputs were dissolved or merged. As a result, the total number of SOEs dropped from 12,297 to 6,264 by April 1994. Most of the changes came from small locally managed SOEs with less than 100 employees and capital of less than VND500 million (USD45,000). Total assets of the liquidated enterprises accounted for less than 4 percent of the total state enterprises assets and about 5 percent of SOE turnover. The SOE sector was further reorganized into General Corporations with the issuance of Decision 90 and 91 in 1994.

The State-Owned Enterprise Law, enacted in 1995, formalized the roles and functions of SOEs and provided the first legal basis for their operation. This law (and other subsequent policies), gave all SOEs legal status. They were now legally equal to each other. They had the right to decide what, how and for whom to produce and where to source inputs and market their outputs. They were allowed to do business freely with each other and with non-SOEs (including foreign partners) in the form of a joint venture or a business contract. They were also allowed to hire and fire employees and set wages, within prescribed policy guidelines. All after-tax profits belonged to SOEs. They had almost total freedom to use their capital. They could 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. The SOEs in Vietnam became somewhat similar to those in the West—business enterprises (rather than a policy tool) with financial targets and more or less financial independence.

The reform of the economic system and the restructuring of SOEs brought positive impacts on the economy as the whole and on the industrial SOE sector in particular. The yearly growth rate of SOE industrial output value became more stable at high levels compared to the erratic pattern of the pre-1990 era (Figure 2).

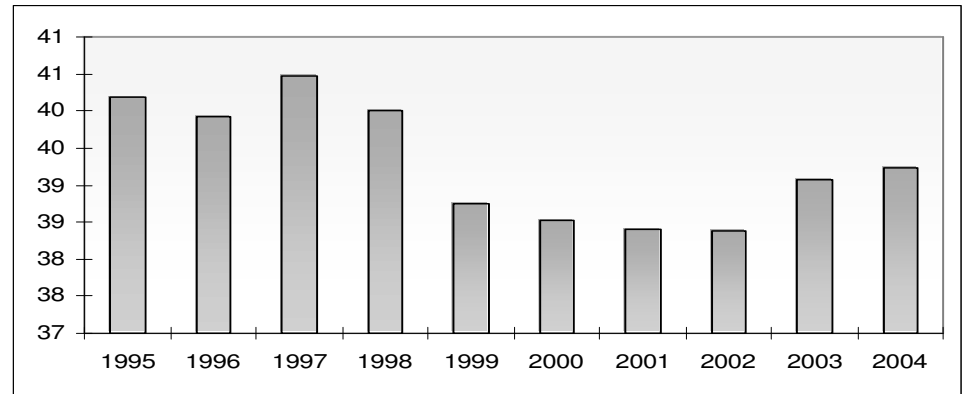
The spectacular turnaround of the Vietnamese economy in the first half of the 1990s is now well known. Between 1991 and 1997, real GDP rose to between 7 percent and 9 percent per annum; inflation stayed mostly in the single digits; exports grew at an average rate of around 30 percent annually, and foreign direct investments arrives in great numbers at a rapid rate. Almost all (about 98 percent) of FDI inflows went into the state sector, chiefly in the form of joint ventures with the SOEs. This course was so striking that the state sector was actually getting ahead of the non-state sector during this period (Leung and Riedel, 2002).



Source: (Ngu, 2002).

Figure 2. Year on year growth rate of industrial SOE output

State-owned enterprises in Vietnam rule the industrial sector. In the economy as a whole, SOEs and their foreign joint-venture partners account for about 50 percent of GDP, and in the manufacturing sector their share of value-added is about 75 percent. Their claim on the nation's savings is even larger than their relative contribution to GDP, with about 80 percent of all investment outlays accounted for by the SOEs and their joint-venture partners. As providers of employment, however, their contribution is small, absorbing only 10 percent of the labor force. Thus, the private sector, which consists mostly of household farms and businesses, absorbs 90 percent of the labor force, but is allocated only 20 percent of the nation's capital resources (Leung & Riedel, 2002).



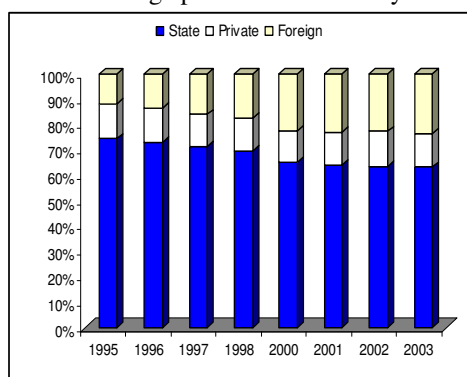
Source: GSO and CIEM

Figure 3. Share of SOEs in GDP

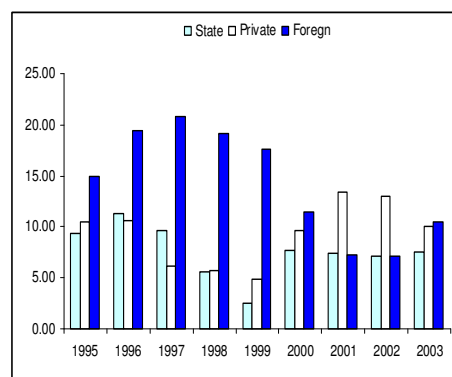
After the initial “shake up” (liquidation and mergers to eliminate the non-viable enterprises; reorganization into general corporations), the SOEs continued to be the linchpin of the economy, as Figures 3, 4 and 5 show. In 1992 the national assembly reaffirmed the roles assigned to SOEs:

- SOEs are the instruments through which the government steer the national economy in the direction of achieving socialist targets. SOEs are prominent in important industries such as cement, electricity, steel, and petroleum, in the process providing infrastructure, energy, inputs, and social services to the economy in general.
- SOEs are the main engines of industrialization and modernization, which require big investment, high risk and slow rate of return. SOEs also generate important employment opportunities that help maintain social stability.

Entering the 1990s with a more viable structure, the SOEs however met new challenges, as they had to compete with private and foreign investors. On average the growth rate of SOEs compared to other sectors was always lowest and many SOEs are still enduring losses. Statistics from Ministry of Finance shows that three-fifths of SOEs were unprofitable as of the end of 1997. In 1999, only 40 percent of SOEs earned profits (*Lao Dong* newspaper, 2000). According to the *Vietnam Economic Times* (1999), the ratio of profits to total capital for the SOE sector decreased continuously from 1995 to 1997. GDP share of SOEs in the 1990s was in a downward trend, reflecting its weakness in the new era and the need for further reform. The government acknowledged that the weakness of the SOEs sector could be resolved by shifting ownership to those outside of the government domain, and by releasing important internal potential within the enterprises. These two objectives found haven in equitization, which was therefore introduced in 1991. The equitization program started cautiously and slowly in the early half of the 1990s and started to accelerate thereafter as the government became more committed to withdraw its influence in large parts of the economy.



Source: GSO



Source: GSO

Figure 4. Share in total GDP by ownership

Figure 5. Growth rates by ownership

## **EQUITIZATION: ORIGINS AND SIGNIFICANCE**

In the past, under the command economic structure, SOEs were in trouble not because of poor corporate governance issue but because the system as a whole was dysfunctional. SOEs were but policy means to socialist ends and passive production units. After the introduction of market forces and the re-registration of SOEs as business enterprises operating within a market structure, the corporate governance issues became prominent in the 1990s. Equitization emerged as the primary governance instrument, subjecting the management of SOEs to better monitoring and disciplining measures. A cautionary note is provided by Fforde (2004), however, when he suggested that interests associated with SOEs are expecting an extension of private economic power and thus blending the use of state power to ensure favorable resourcing with an underlying maintenance of particularist control.

In summary, the SOE restructuring program therefore can be categorized as follows:

- 1986–1990: Introduction of market forces and price signals, breaking up of the centrally planned system, transformation of SOEs from passive production units into active and autonomous business entities with financial targets.
- 1991–2001: consolidation of the new market economy with socialist direction, SOE reform initiatives in the context of competition, and a new focus on the problems of corporate governance in publicly owned firms. The government started to experiment with *co phan hoa* or equitization.

Equitization is Vietnamese-style privatization, and is defined as the conversion of SOEs into joint-stock companies. A large part of the shares in the company is sold to private investors, mostly the firm's workers and managers. That is, the preferential rights of purchase are given to employees (Ngoan, 2003). Equitization differs from western-style privatization in that it does not necessarily mean that the government loses its grip over the firm. The government still holds decisive voting rights in many cases. The proportion of shares transferred to insiders is quite substantial, however. The equitization process in Vietnam took place in two stages—a pilot stage, from 1992 to 1996, and an expansion stage, from 1996 onwards (Loc, Lanjouw and Lensink, 2004).

In 1991, a Party resolution decreed the “conversion of a number of eligible State enterprises into joint stock which should be undertaken on a pilot basis and under close guidance, and experiences should be drawn with utter care before divestiture is conducted on an appropriate scale”. The move was cautious and was on voluntary basis: the first few enterprises were actually equitized late in 1993 and all of 17 converted by end of 1997 were small local SOEs. Equitization involved small SOEs from the transportation, shoes, machine and food-processing industries. In most of those enterprises, the employees hold the dominant portion of shares, while the government still owns nearly 30 percent of the shares (Loc, Lanjouw and Lensink, 2004).

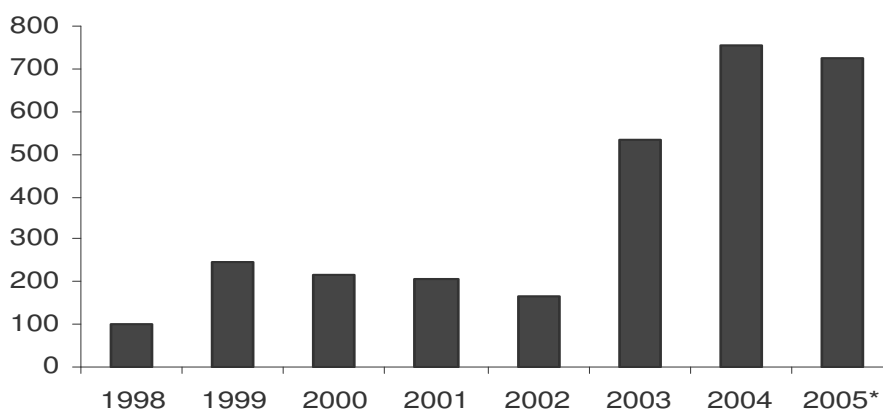
The equitization process accelerated between 1996–2001, as the government issued decree 28 in 1996 abolishing voluntarism and strengthening the institutional framework by identifying more clearly which types of SOEs were to be subjected to the process, asset valuation measures, and new policies regarding employees after equitization. In 1998, Decree 44 provided a new and comprehensive framework under which most of the equitization was executed. It specified the sectors (including SOEs) where government would retain full ownership, hold fewer but controlling stock, or relinquish all shares. The new policy helped to increase the number of equitized SOEs to 25 in the years 1996–1998. Since 2000, the speed of equitization has quickened because of pressure from international

donors and the strong determination of the government in accelerating the pace of reform. As a result, the number of equitized SOEs climbed up to 745 in the period 1998-2001.

The years 2002–2005 further confirmed that equitization was the primary means to liberate productive forces and improve economic efficiency. The government overcame its doubts over the political implications of the program and issued a series of decrees urging Party members, government offices, and responsible bodies to push forward the process in a transparent and effective way. The scope of equitization also expanded to include big and profitable companies, in almost all sector of the economy (including SOEs previously under the defense, health, and education ministries, as well as credit institutions, notably the Vietnam Commercial Bank). The General Corporations, the most technologically advanced business enterprises also underwent far-reaching restructuring, including equitization of their subsidiaries. Figure 6 shows the big number of firms equitized between 1998 and 2005. By early 2006, Vietnam had equitized 3,107 state-owned enterprises (SOEs). Around 30 percent, however, retain state capital of more than 50 percent, which holds back development promised by the equitization process (VietNamNet, 7 April 2006).

Equitization put particular emphasis on wide public ownership of shares, with insiders (staff and managers) being the main beneficiaries. It tried to avoid ownership capture by a small number of investors as in the case of other transition economies. Given the problems SOEs were facing, the equitization process was supposed to:

- Improve incentives resulting from secure property ownership,
- Separate management and administrative/policy aspects, freeing the enterprises to concentrate on doing business,
- Mobilized capital from the public, and
- Increase the role of the public as owner of means of production with the power to monitor and evaluate the performance of management.



Source: *VN Economic Times* (23 March 2005)

Figure 6. Number of equitized SOEs over the years

Despite the rapid pace of equitization, the majority of the companies which have been equitized are small and in non-strategic sectors. The total amount of state capital involved in the process was only 8 percent of the total capital in all SOEs (Figure 7). The total amount of government capital in SOEs (VND214,000 billion or USD13.5 billion) is found



mainly in the General Corporations (80 percent). Of these, three sectors (petroleum, electricity, telecommunication) have the lion's share of VND113,000 billion (USD7.15 billion), accounting for 53 percent of the total. For the equitization process to have substantial impact on the economy, it is important to push forward the equitization process to involve corporations, a direction which the government is taking in recent years.

Surveys and studies conducted by different bodies on different groups of companies show a very positive picture, with most of the equitized companies enjoying significant

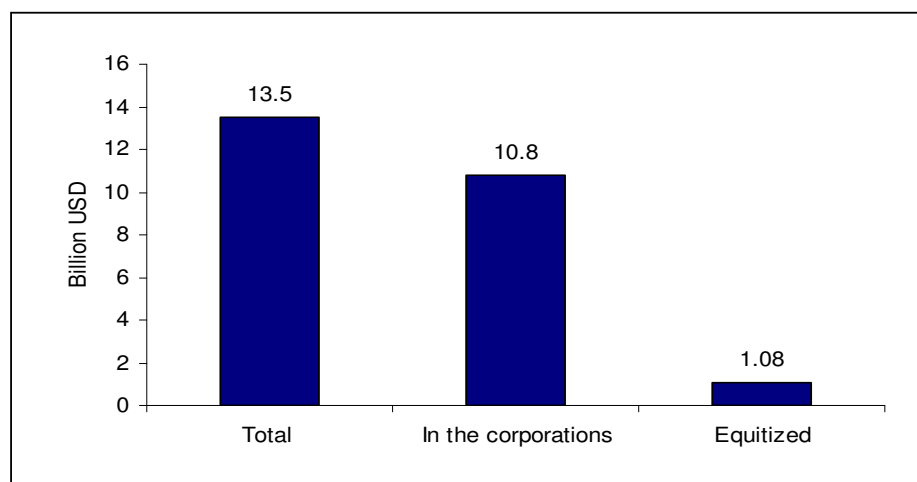


Figure 7. State capital in general corporations and in equitized firms

improvements in their performance and profitability.

An early study on the process of reforming industrial SOEs in Vietnam, showed positive effects on enhancing SOEs' economic performance. The growth rate of total factor productivity averaged 3.05 percent over the whole period studied (1976–98 period). The TFP growth rate, shown in Table 2, was derived using aggregate data on gross output, fixed capital, labor and intermediate inputs. For the entire period, TFP accounted, on average, for 40.9 percent of the change in industrial SOE output. Adding to this impressive result was a remarkable annual growth rate of industrial output of 13.7 per cent in the industrial sector, in which SOEs recorded a rate of 12.3 percent, and accounted for nearly half of the industrial output during the period (Ngu, 2002).

Table 2. Growth rate of total factor productivity in industrial SOEs

Average TFP growth rate of industrial SOEs for the 1976-98 period			
Periods	Reform development	TFP growth rate	Percentage
1976-1981	Pre-reform	-0.0197	-1.97
1982-1986	Partial reform	0.0608	6.08
1987-1989	Failure of price, wage and money reform	0.0111	1.11
1982-1989	Whole partial reform period	0.0422	4.22
1990-1998	Full reform	0.0537	5.37
1976-1998	Whole study period	0.0305	3.05

Source: Ngu (2002).

In an international corporate governance roundtable sponsored by the OECD and World Bank in Vietnam in 2004, the view was that restructured SOEs have so far mobilized an additional amount of VND3.300 billions for their business activities. Moreover, objectivity and transparency were seen to have been gradually enhanced through public share auctioning regime which allowed investors to have access to companies' shares and contributed to thrust up the capital market. Equitized enterprises reportedly not only succeeded in preserving state invested capital but also maintained a dividend pay-out rate of 10-15 percent per year (Dzung, 2004).

Surveys of 850 enterprises that were equitized showed that their average chartered capital increased 44 percent, revenue was up 23 percent, profits were up 139.6 percent, contributions to the State Budget were up 24.9 percent, workers' average income was 12 percent higher, dividends averaged 17 percent annually, over 90 percent of enterprises earned a profit following equitization, and 6.6 percent more workers were employed (Quynh, 2005).

Similarly, a survey conducted by the Overseas Economic Cooperation Fund (OECF) of Japan in late 1994 on 208 manufacturing firms (148 SOEs and 60 private firms) in Hanoi and Ho Chi Minh City, showed that during the 1991–1994 period, many SOEs improved their operation in terms of their capacity utilization rate, changes in nominal profitability and the ratio of redundant labor to total labor, and their competitiveness to domestic products and imports. The study also suggested that the ownership pattern has not shaped the performance of the firms surveyed. Rather the factors specific to each enterprise such as managerial independence, and size and degree of competition were more strongly associated with performance (Tho, 2001).

Another study measured the impact of equitization on firm performance in Vietnam by comparing the pre- and post-equitization financial and operating performance of 121 former state-owned enterprises (SOEs). The study found substantial increases in profitability, sales revenue, efficiency and employee income. Other important findings include stepped-up employment and a decline in leverage of newly-privatized firms, although the changes are statistically insignificant. Regression analyses revealed that firm size, residual state ownership, corporate governance and stock-market listing are key determinants of performance improvements. In the main, the empirical results suggested that equitization works in the sense of improving firm performance in terms of most performance measures (Loc, Lanjouw and Lensink, 2004).

In this paper, the results of the most comprehensive survey done by the Central Institute for Economic Management (CIEM) in 2002, are presented. Although the results are somewhat dated and much has happened in the equitization process in the last four years, it remains the most authoritative survey conducted so far. All the same, the insights the survey reveals are still useful for the discussion of equitization in Vietnam.

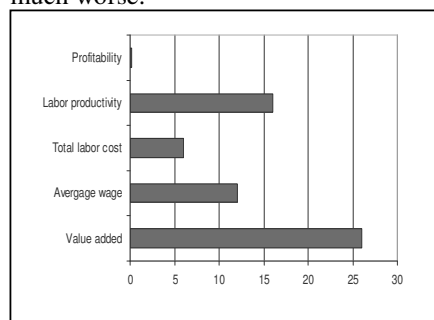
## **HOW EQUITIZATION HELPS IMPROVE PERFORMANCE**

### **Survey results**

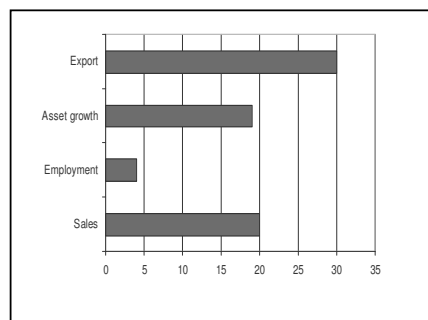
In 2002, Center Institute for Economic Management (CIEM) conducted a survey of 425 companies which were equitized before 2000. It covered all companies with at least one full year of post equitization results. The outcome of the survey confirmed what theory suggests, and what empirical studies show, that the companies generally enjoy improvement in their performance following equitization. When applicable, the CIEM

survey results are compared with another survey involving 121 equitized firms conducted from March 15 to April 30 2004 by Loc, Lanjouw and Lensink (2004).

More specifically, the results indicated that 90 percent of the respondents claim that financial performance was better or much better and only 3 percent say it was worse or much worse.



Source: CIEM, 2002



Source: CIEM, 2002

Figure 8. Annual rate growth, various indicators

In Figure 8, the chart on the right suggests that the equitized companies are expanding with more investment on assets, generating more job opportunities, and increasing sales both domestically and internationally. In the Loc study, to measure efficiency the inflation-adjusted sales per employee and income before tax per employee were the indicators used. Sales efficiency rose from an average (median) 1.02 in the pre-equitization period to 1.26 in the post-equitization period. Similarly, income efficiency rose from an average (median) 1.10 during the pre-equitization period to 3.21 after equitization. These results suggest that the equitized firms use their resources with much greater efficiency after equitization (Loc, Lanjouw and Lensink, 2004)

As an SOE transforms into a joint stock company, it loses the privileges it previously enjoyed—subsidies, government procurement, cheap and easily accessed credit—which would cause post-equitization difficulties to the business. It is impressive however, that despite dropping off these advantages, sales of the equitized companies grew at almost 20 percent per year, reflecting strong competitiveness and better management. The expansion of sales did not consume more resources as value-added grew considerably faster (26 percent). The firms actually enjoyed higher efficiency level as intermediate input consumption rose less rapidly than output.

The expansion also reflected the increase in dynamism of the firms as more firms went into export. Total exports in the year before equitization was approximately USD20 million involving 19 enterprises. By 2001 this had grown to USD61 million involving 31 firms. The growth in numbers of exporters may be more important as an indicator of entrepreneurial fervor than the growth in value itself.

Profitability is the most important indicator to measure the performance of firms. The chart on the left shows that overall profitability (profit over assets) increased slightly. This might seem like a letdown at first but considering the large increase in assets, the figure actually shows that profit increased at a rate higher than 19 percent annually, a very impressive performance indeed. Total profits of the SOEs before equitization were about VND80 billion (USD5 million), but had grown to VND425 billion by 2001. The survey

also shows profitability appears to increase immediately after equitization, neither accelerating nor decelerating with time. In a similar vein, as expected, the results of the Loc et al. study showed that all profitability ratios, namely income before tax on assets (IBTA), income before tax on sales (IBTS), and income before tax on equity (IBTE), became bigger significantly after equitization (Loc, Lanjouw and Lensink, 2004).

Perhaps the most interesting fact is that employment in the surveyed companies actually grew four percent annually, contrary to conventional expectation that SOEs are overstaffed and equitization would imply cost-cutting and efficiency improvement through extensive laying off of workers. Employment has not decreased significantly over the post-privatisation period. In fact, mean employment increased by 30 employees after equitization (Loc, Lanjouw and Lensink, 2004). SOEs have to provide social security (medical care, pension, etc.) for the employees, which are often excessive. Under a socialist regime, workers regard SOEs as sources of lifetime employment. As long as social safety nets, social welfare systems, as well as employment opportunities elsewhere are not widely developed, resistance to reform programs, which may result in the lay-off of workers, is strong (Tho, 2001).

This suggests that the equitized companies must have enjoyed incredible improvement in efficiency, reducing waste and cutting costs *other than labor*. Labor productivity actually improved by 16 percent, enabling them to expand output. The benefits from higher profit/efficiency gains (in the form of value added) mainly went to workers including managers as average wages grew about 12 percent per year. As a result, total labor cost rose 16 percent. The results of the Loc study reveal similar features. The mean inflation-adjusted annual income per employee moved up from VND12.2 million in the pre-equitization period to VND 17.3 million in the post-equitization period, and 88.4 percent of the sample firms reported paying higher salaries to their employees. The remarkable thing about this is that it did not preclude improvements in profitability and efficiency. A plausible reason is the incentive effect: as income rises, it stimulates the employees to work more efficiently (Loc, Lanjouw and Lensink, 2004).

Equitization therefore can be said to have the desired results: improving productivity and profitability while generating more employment and distributing a large share of profit gained to workers, who are the majority shareholders in Vietnam's enterprises.

To uncover what factors exactly influenced these changes, it is necessary to take a close look at signs of changes in incentive structure, corporate government structure, management structure and entrepreneurship spirit of the companies before and after equitization.

### **Changes in incentives**

There are clear sign of changes in incentives among the staff (workers and managers) as performance-related bonuses and wages both changed significantly. Note that wages rose 12 percent annually, suggesting that "spillover" changes were present in other indicators. Where the share of workers is higher, the growth rate of wages is likewise higher (Figure 9). Turning employees into stakeholders increases their incentive to perform better and aligns their interest with that of the organization.

Another important indicator of incentive improvement for managers is the fact that equitization gives the companies more/much more autonomy to pursue profit and efficiency. The survey reveals that the manager's autonomy to pursue profits and efficiency has increased but the time spent dealing with state agencies only decreased slightly, suggesting that the firms were still prey to the same level of bureaucracy, which increases transaction costs and hinders the firms' efficiency (Figure 10).

It is easy to conclude that equitization has succeeded in increasing the focus on financial objectives and raising the incentives of the firms. The big question however is whether these gains are short-lived or are the foundation for better corporate governance.

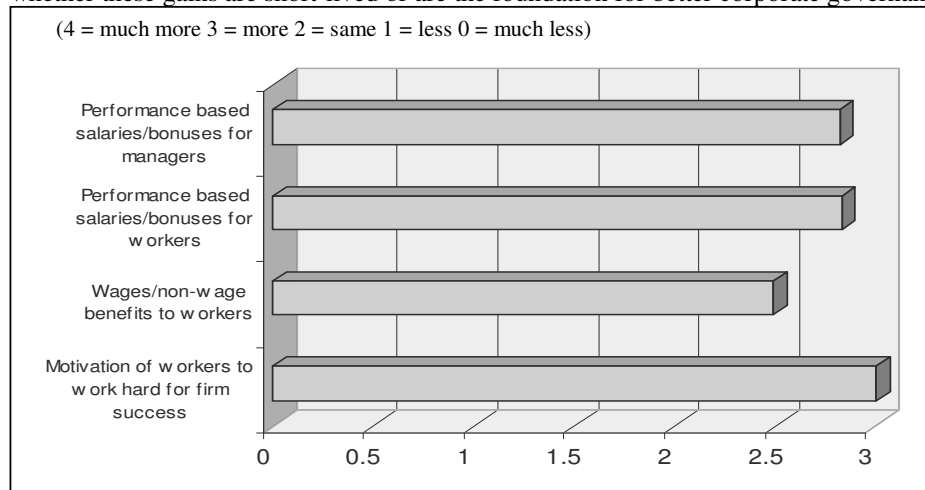


Figure 9. Changes in benefits

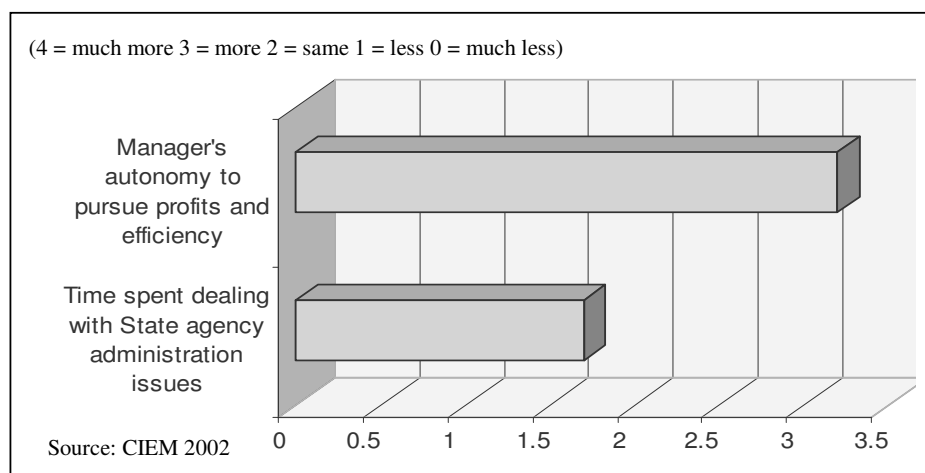


Figure 10. Changes in the firm's autonomy

### **Corporate governance: who makes the decisions?**

Good corporate governance implies that the decision making power lies in the hands of the owners. Since the equitization process transfers power from government to individuals, it can only have its desired effects only if decision-making actually shifts according to the shareholding structure. The survey shows that after equitization has taken place, the power of the Board and the Director increases, the power of workers changes little, and the power of the other stakeholders (local government, central government,

party cell) declines (Figure 11).

In the Loc study, firms that have a chairperson of the board of directors representing private investors made improvements in almost all performance measures, as opposed to firms that have a chairperson of the board of directors representing the state. This is in line with expectations that advances are greater for the former as compared to the latter. Firms with investor-led boards tended to yield greater changes in profitability and real sales following equitization, had higher improvement in both operational and sales efficiency (Loc, Lanjouw and Lensink, 2004).

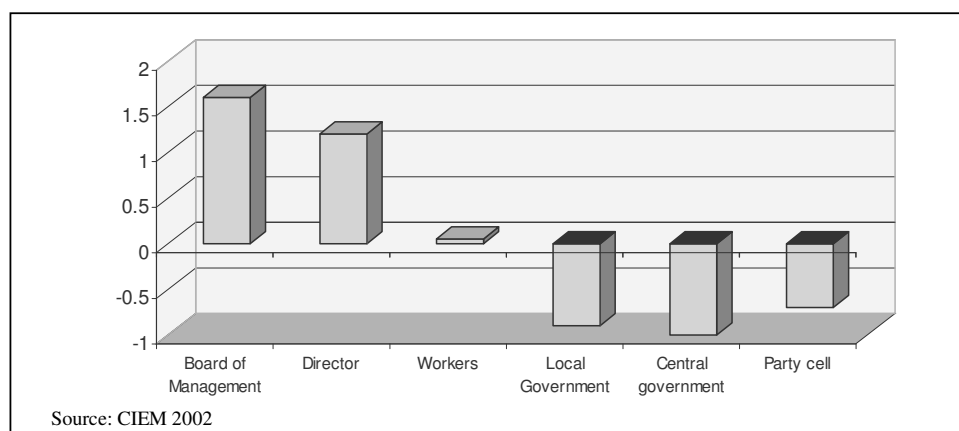


Figure 11. Changes in the influence of stakeholders

Apart from the insignificant increase in the power of the workers after equitization, all other changes are as expected and would theoretically have positive impact on corporate governance. The small increase in the role of the workers should not be viewed as an abnormality since workers in a socialist economy already have a significant voice. What is most important here is the significant shift in the power structure away from government bodies (which have primarily political agenda) to the board and directors (which are primarily preoccupied with business agenda).

More specifically, in the appointment of a director, it is the board which has the most power. The workers (the biggest shareholding group) are not far behind. Government and the parent body are the two least influential in the decision making process. This is consistent with good corporate governance, suggesting that equitization has the desired impact by enhancing the power of the share holders, majority of whom are workers. The government's role becomes larger as government shareholding increases; the workers' power likewise steps up as worker shareholding increases. These are all in line with good corporate governance.

As expected, the Board has the biggest influence in major investment decisions and the least influence in marketing and distribution (Figure 12). Still in accordance with good management, the Director has the most influence in all cases. Participative management is apparent, as workers and the Party have considerable say in firm decisions.

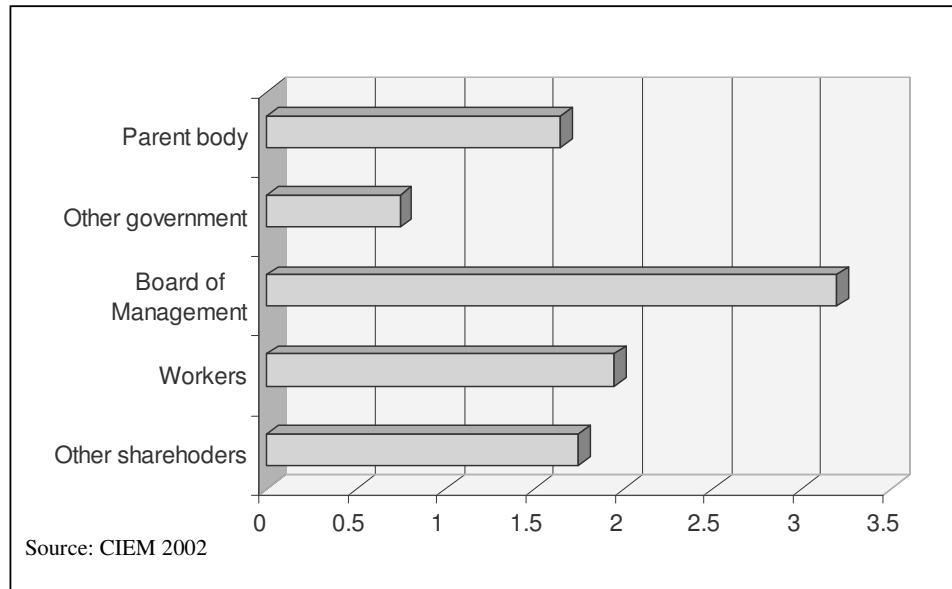


Figure 12. Who has the most influence on the selection of the director?

### **Entrepreneurship**

Apart from increase in incentives, progress must also have been due to newfound the dynamism of the firms which have maximized profit, while at the same time facing a hard budget constraint. In this situation, entrepreneurship is expected to increase, reflected in some changes in the product/market mix, production technique and technology and quality of the product (Figure 13).

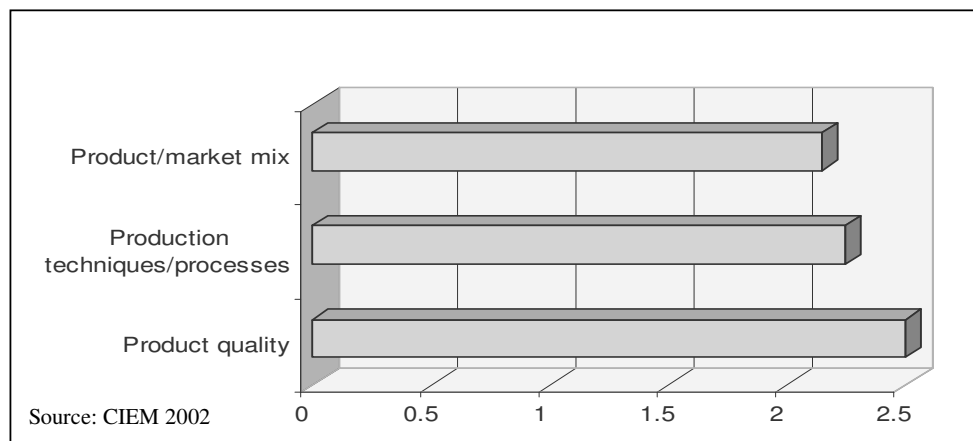


Figure 13. Indicators of increased entrepreneurship

### Other interesting findings

It is interesting to note that top level management in the equitized company rarely changes (Table 3). During equitization, nearly 90 percent of directors and deputy directors held the same position and around 80 percent of them retained their seats in the year that followed. What it means is that all the improvements in the management of the equitized firms were purely from the incentives and dynamism released during the equitization process (and not from the change of management). While the achievements of the directors in equitized companies are acknowledged, the rigidity in management structure was the result of a bad practice—managers acquiring more shares than they can have officially during equitization, through buy-back from workers. This gave them voting power which kept them in their seats.

Table 3. Changes in management, before and after equitization

Senior Management Position	During equitization				After equitization			
	No change	Retirement	Voluntary departure	Involuntary change	No change	Retirement	Voluntary departure	Involuntary change
1. Chairperson					85.2	4.2	4.6	6.1
2. Director	88.6	5.7	2.0	3.7	81.5	6.0	7.0	5.6
3. Deputy Director	91.1	4.3	2.1	2.5	77.9	6.2	7.0	9.0
4. Chief Accountant	90.9	3.9	3.2	2.1	78.2	5.1	9.9	6.8

Source: CIEM 2002

The awareness of the workers on ownership is low, and many do not recognize or appreciate their roles as shareholders. In many instances, workers do not have the financial means to acquire shares. Even if they do, they seldom exercise their right (as shareholders) to choose and monitor the management team. Note that the concept of a hired managing director is foreign to a socialist setup.

Variations in performance between different companies, the survey suggests, depends only on size and the amount of share the state holds. The number of workers, geographical location, date of equitization, and the parent organizations are considered irrelevant factors. In the Loc survey, smaller firms reported greater rises in income efficiency and employee income. Bigger firms showed greater improvements in real sales and sales efficiency. Theory indicates that smaller firms are more flexible in adjusting to the new environment, and this is validated by the survey (Loc, Lanjouw and Lensink, 2004).

Bigger firms seem to grow faster but those with government majority shares do better. Size matters since economies of scale allow bigger companies more advantages to exploit new possibilities and their own potential after equitization. It is not surprising to see companies with assets valued higher than VND5 billion enjoying sales and growth rates 3 times higher than those with less than VND5 billion in assets value (Table 4).



Table 4. How does growth vary with capital and state share?

If	Mean annual growth rates were		
	Sales	Value-added	Profits
Assets<VND 5 billion	0.08	0.23	0.10
Assets>VND 5 billion	0.24	0.53	0.31
State share <=50%	0.17	0.24	0.10
State share >50%	0.39	0.44	0.36

Source: CIEM 2002

The whole point of equitization is to reduce the power of government in these enterprises in the hope of improving their performance. The table shows that firms with government majority significantly do better. Their annual growth rate of profit is 3.6 times higher than firms where government holds less than 50 percent equity. Why might this be so? The usual explanation is that the playing field is not level, so that firms that are closer to the government get along better. However, if this were true, SOEs should have done better in the first place. A more plausible reason is selection bias. The government is more inclined to hold on to its shareholdings in profitable companies. To the extent that current performance is related to performance before equitization, it is not difficult to understand why the government is keeping more shares in fast growing equitized companies. These firms that earned profits before equitization are likely to continue making profits because they have less difficulties to overcome, and since the management teams in all companies virtually remain unchanged. However, closer scrutiny reveals where the comparative advantage of these companies lie. In the Loc study, firms with residual state ownership (less than 30 percent) showed greater improvements in profitability, income efficiency, employment and employee income than firms where residual state ownership was greater than or equal to 30 percent. However, the latter showed larger improvements in real sales, sales efficiency and leverage (Loc, Lanjouw and Lensink, 2004).

### **SOME FAILINGS OF THE EQUITIZATION PROCESS IN VIETNAM**

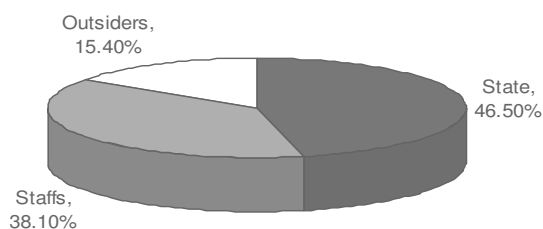
All things considered, the equitization process (which has largely been partial privatization of previously state owned enterprises) gave birth to many joint stock companies with government still holding substantial amount of shares. However the majority shareholders are staff and managers whose incentive to perform has improved as their goals are aligned to the firms' objectives. In short, the equitization has resolved the agency problem in these companies. The reduction in the power of the state to some extent has helped the managers to focus more on financial targets, thus boosting the firms' sales, productivity and returns to the owners (including increased wages and bonuses for managers and staff).

Although equitization so far has delivered some desirable results, they are far from optimal. As regards the goal of improving corporate governance and reducing government involvement in the operation of businesses, the equitization process is only at the beginning stage.

The government on average still holds controlling stakes in all the equitized companies, which explains why many equitized companies are observed to behave as though they are still SOEs. In 2004, it is reported that 46 percent of the total chartered capital in all the equitized companies is still held by the government while staff held 38.1 percent and independent investors only held 15.4 percent (Figure 14). According to the *Vietnam Economics Time* (March 2005), the proportion of companies where government is holding majority shares is 82 percent, 29.5 percent of which has the government holding more than 50 percent of the equity. Equitization reduced a significant amount of debts from the public sector.

This increased the *absolute size* of the state sector. However, the transformation of the SOEs has been simultaneous with the rapid growth of the private sector, which explains the steady decline in the *relative size* of the state sector (Ngoan, 2003).

The attractiveness of equitized firms may be compromised by the state holding up huge shares. A clear instance is in the power sector. The Vietnam Association of Financial Investors has asked the government to reduce the percentage it owns in Electricity of Vietnam (EVN)'s Vinh Son – Song Hinh and Tach Ba hydropower plants, as well as the Pha Lai Thermo



Source: Dau tu chung khoan

Figure 14. Ownership structure in equitized companies, 2004

Power Company (EVN holds 60 percent, 75 percent and 75 percent of shares of those companies, respectively). Because of government's substantial share holdings, investors have no power despite their considerable investment. Investors are interested not just in business results or development potentials of equitized SOEs, but in possible changes in management modes. To that end, they are not interested in equitized companies in which the State still holds high percentages of capital. With the 51 percent government stake, investors will be lukewarm to bring modern technology and management skills, particularly risk management to the equitized firms (VietnamNet, 7 April 2006).

Although the CIEM's survey results suggest companies with majority government shareholdings tend to perform better, the causality is likely to be in the other direction: that the government is unwilling to let go of its control of profitable enterprises. It is therefore necessary and urgent that the equitization process must address this issue, and the government must take the initiative to sell more shares to the public.

While foreign investors are able to bring fresh changes with more energy and entrepreneurial spirit, statutory restrictions on equity share holding serve to limit the ownership share of outside investors to no more than 30 percent of equity in domestic enterprises. This is a matter of serious concern because evidence from China and elsewhere shows that little is gained in terms of improved efficiency and profitability when the majority-owners of equitized enterprises are insiders (Leung and Riedel, 2002). However, current reform initiatives include relaxing these restraints. With greater participation of outside investors, it is likely that equitized firms will have to submit themselves to more scrutiny and tighter control.

It would, of course, be far more interesting to examine the impact of equitization on the performance of big corporations. Recently the government has announced its commitment to expand the scope of equitization to include the big and profitable companies including the state-owned commercial bank (Vietcombank) and some 91 other corporations. A monitoring system is being planned to keep an eye on bank borrowing and budgetary support for the larger, highly-indebted SOEs, which are to be made subject to credit ceilings to ensure that they implement restructuring. Yet any program of SOE reform would be incomplete if it did not address the problems of the State's General Corporation, especially in the traded-goods sectors, which are going to come under increasing pressure from both domestic and foreign competitors as Vietnam carries through its obligations under the AFTA and the proposed Vietnam-US bilateral trade agreement. In the non-traded goods sectors, the large corporations have significant market power in strategic sectors of the economy such as energy, aviation, telecommunication and transport. Without a good competition policy, the costs flowing to the traded goods sector are high, thereby compounding the problems of the SOEs as they face international competition. The focus of current reform measures must shift away from short-term concerns about equitized companies and toward the much broader and potentially more serious impact of government owned monopolies on the economy (Leung and Riedel, 2002).

## **CHALLENGES TO EQUITIZATION**

Although the impact of equitization has been positive, curiously, the process has been very slow and many SOEs seek ways to avoid it. So far no SOE has volunteered to equitize; all claim that they are equitizing because of "order from higher authority".

The most important reason for such slowness lies in the unwillingness of the SOEs' managers to push forward the process. Numerous equitized enterprises, especially those in which the State holds ruling shares, have not made changes in management and have maintained old, and questionable, business methods (Quynh, 2005). Many rent seeking managers are abusing their positions to extract personal benefits at the expense of the companies. Public choice theory suggests that it is in their interest to entrench themselves and the privileges they enjoy.

Many employees, on the other hand, worry about being laid off. In the sample just examined, there was a general increase in employment but a detailed picture might show that some firms might be shedding jobs while others were creating jobs through expansion. A reality check would show that after restructuring, the number of redundant jobs or positions has hovered above 20 percent (with some firms maintaining unneeded positions at 30-40 percent). These redundant workers are not multi-skilled and find it difficult to find other employment opportunities. For those who remain, many are not familiar with their new role as stakeholders, and are likely to resist any changes introduced by the restructuring programs.

The equitization process also faces obstacles due to the limited institutional capacity in implementing the policy. Many government officials have not yet understood clearly the market economy and what equitization means. Local government authorities only see the conversion of SOEs into joint stock companies as a change of name and continue to expect to have control over their business activities. Enforcement is a serious problem because of poor capacity and the lack of experience in dealing with recalcitrant companies. Studies on the process and its implications are few, with policy-makers finding little help in lesson-drawing.

The administrative process is time consuming and complicated, although the average time taken to equitize a company has gone down from 512 days in 2001 to 437 days in 2004. The time required to set up an enterprise reform committee and finish its valuation takes about 270 days, almost 62 percent of the total time needed for equitization. There is enormous confusion over the valuation procedures and over problems related to land ownership, liability transfer, policies regarding social welfare services and the classification of different types of SOEs. The classification scheme is a bit self-serving as the idea is to determine which one the government needs to hold onto its controlling stakes and which one would be allowed to sell 100 percent of the shares to the public.

Following equitization, some enterprises have seen production and sales come down due to a number of business troubles, obsolete equipment, lack of competitiveness, and high costs in operation. Surveys indicate that 28 percent of enterprises experienced a fall in revenue after equitization, with 10 percent of them actually incurring losses. A full 42 percent of them have been paying-in less to the State budget. This should probably be interpreted to mean that unless the managers of equitized enterprises are actually dynamic and creative, and are willing and able to attract shareholders to invest in and improve the enterprises, equitizing will not be the way to success and profits (Quynh, 2005).

More than half of the assets of the state-owned banks were in the form of loans to SOEs (admittedly down from 90 percent in 1990 to 55 percent by 1997). In a related vein, the Law on Credit Institutions enacted in 1997 provided for preferential bank credit for SOEs, cooperatives, and remote areas. Together, these generous provisions undermined the commercial viability of Vietnamese banks and other financial institutions. The financial sector was thus made vulnerable to the fluctuating fortunes of the SOEs (Leung and Riedel, 2002).

Apart from firm-level problems, equitization in socialist context has large political implications. Central government officials worry about institutional impairments to carry out Party and government policies. Party cells believe that equitization will disturb the Party organization and structure in equitized companies. Particularly bothersome to the Party is the considerable power that will be vested on foreign investors.

All the above help to slow down the pace of equitization and present a serious challenge to the government, which, fortunately has shown a credible commitment to surmount current impediments. The experiences gained from the last decade will help government refine the policies step by step to quicken the pace of the equitization program. The Vietnamese authorities are well aware that equitization is, in their own assessment, the most important solution to rationalize SOEs, renew management structure and improve business efficiency, contribute to economic growth, and contribute positively to the process of administrative reform and fighting corruption. Decision 04/2005/CT-TTg requires periodic close assessments of the SOE restructuring in ministries, local authorities and General Corporations. In the case of the General Corporation, equitization must be carried out in the majority of the subsidiaries. Even the annual assessment of Party members includes contents related to the restructuring and equitization of the SOEs where they are active.

Reforms are underway to simplify the equitization process. The most time-consuming phase is firm valuation. Valuation procedures must be openly and transparently carried out by independent auditors, and the sales of the equitized companies' shares must be auctioned publicly. It takes between 423 and 536 days<sup>2</sup>, or more than a year, to complete

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<sup>2</sup> More precisely, 423 days for cities under central government administration, 437 days for ministries, and 536 days for the General Corporation.

the process. The current plan is to complete everything in just 200 days. To do this, valuation should take up no more than 100 days. That means drastically reducing the time needed to complete the three phases of valuation: forming the committee of enterprise renewal, valuation proper, and valuation-approach approval.

At the same time, proposed policies will further diminish state ownership of the enterprises. The new unified enterprise and investment laws, which took effect 1 July 2006, clearly identify the sectors where government ownership is absolutely necessary, while encouraging wider public ownership and foreign investor participation in all other areas of the economy. To rationalize government representation and ownership in the equitized companies (until recently, ministries and local governments represented state interests in these firms), the State Capital Investment Corporation (SCIP) was established recently. This is a measure to separate management from administration (akin to separating the board and the CEO in typical western corporations) and make government presence in these companies more business oriented. In a very confusing way, government's capital in privatized SOEs was managed by provincial authorities and ministries. This resulted in overlapping ownership, which in turn reduced the level of accountability and management efficiency in equitized enterprises.

## **CAPITAL MARKET DEVELOPMENT AS HANDMAID TO EQUITIZATION**

Monitoring management is a key issue in corporate governance. As equitization is the diversification (decentralization) of ownership, it must be complemented by the development of the capital market, which places management behavior under close scrutiny. Under a well functioning capital market, companies are screened, monitored and disciplined through the pricing process and takeover mechanism.

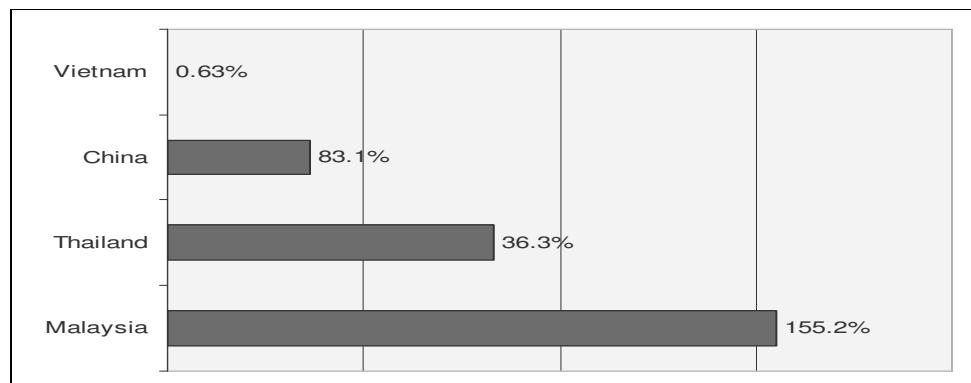
Share prices reflect the market's judgment on the performance of the company (and hence, the management team). The market is sensitive, and can provide signals on the quality of the company (and its management). If the managerial team is thought to be incompetent or inefficient, the share price will fall, bringing pressure to bear on managers to improve their performance. A persistent poor share price performance will encourage an alternative managerial team to mount a takeover bid, confident they can make better use of the company's assets and earn more for the owners. In this case the capital market acts as an impartial monitor and disciplining force.

In the case of Vietnam, when the equitization process is best described as equivalent to partial privatization. The government is still holding a significant number of shares and hence still has significant influence on the objective and operation of the firm. Yet, even if an equitized firm remains under government control and continues to be prone to political interference, if its shares are traded on public stock markets, the information on the firms' performance as judged by market can be used by the owner (still the state) to better monitor the managers and by managers themselves in the executive job market as a public verdict on their performance.

Vietnam's stock market, despite being only 5 years old, is doing quite well. It had a slow start. From a market capitalization of USD144 million involving only 22 listed companies when it began operations, by 2005 its capitalization was still only 0.63 percent of GDP. By contrast, total market capitalization of the stock market in Malaysia is 155.2 percent of GDP; in China, it is 83 percent of GDP (Figure 15). As of April 2006, however, Vietnam's stock market was booming, and was the second best performing exchange in the world. Market capitalization has increased tenfold, to USD1.5 billion for 35 companies (Prasso, 2006). This must have been the response to Decision 528, issued in 2005 by the

Prime Minister's office, asking 538 companies in which the government is still holding controlling stakes, to enlist in the stock market immediately.

In July 2005, the Vietnam stock index measured around 250 points, increasing by only 150 points in five years. Out of more than 24,000 trading accounts, only 1,000 accounts, or about 5 percent, actively traded in the last two years. With no new account registered, the stock market seemed to be standing still, with average daily total transaction amounting to only USD190,000). Yet by April 2006, the Vietnam Stock Index was up 60 percent (Prasso, 2006).



Source: Dau tu chung khoan

Figure 15. 2005 market valuation (% GDP)

In March 2004, the Hanoi over the counter market—officially, the Hanoi Securities Trading Center—opened to facilitate transactions involving small companies' stocks, but as of 2005, only 6 companies had registered. The low base of the HSTC had at least doubled, with a foreign firm, Taiwan's Tung Kuang Industrial Company being the 12<sup>th</sup> enterprise (*Vietnam Investment Review*, 11 November 2006). The Asian Commercial Bank, Vietnam's fifth largest bank, is likewise set to join the HSTC (*Vietnam Financials*, 15 November 2006).

In spite of the steady progress of the two exchanges, the fact that equitization has created more than 2500 joint stock companies, yet only 35 companies are listed in the Ho Chi Minh exchange and 12 are registered in Hanoi, suggests that the capital market has not developed in tandem with the equitization process. Ironically, in the Loc study, listed companies greatly benefited from the stock exchange operations. The study recorded higher increases in real sales, sales efficiency, and employment for listed firms as compared to non-listed firms. Furthermore, there was greater decrease in leverage for the listed firms than for non-listed firms. However, non-listed firms had higher profitability improvements than listed firms. Yet even this finding is not a drawback: it meant that by exploiting the benefits from listing, listed firms substantially expanded their business (Loc, Lanjouw and Lensink, 2004).

The government has been eager to accelerate the development of the stock market but the main obstacle is the disinterest of the joint stock companies, for many of which the capital market is unfamiliar terrain. Many managers find it easier to operate in traditional ways. As mentioned above, most of the equitized firms are behaving as though they are still SOEs. Their organizational structure remains unchanged and they continue to enforce

SOE regulations especially on social security, wages and promotions. Of course, the stock market is not something that requires little effort. Understanding the transparency requirements for listed companies, for instance, takes time and energy. Most Vietnamese managers are not familiar with publishing financial information about their companies' operation.

Acknowledging the importance of the stock market as means of mobilizing capital and disciplining firms (thus improving corporate governance), the government has actively taken steps to promote the Ho Chi Minh stock exchange and the Hanoi OTC, encouraging big and profitable equitized companies as well as small enterprises to seek listing. But the task has not been easy. The OTC market has been delayed several times since few companies showed interest in listing. A recent survey by the Center for Stock Market Training shows that among 447 enterprises interviewed, only 217 (48.6 percent) had the intention to register for trading in the Hanoi market, with only 12 businesses indicating that they would register within 2005. The majority, indicated they would sign up later—34 within 2006, and 97 within 2007. However, current restrictions on foreign investors' active participation in the market may also have something to do with the lukewarm support for the stock exchanges. Such constraints have significantly reduced the liquidity of the market.

In addition, the new Investment and Enterprise Laws will attempt to unify the investment landscape for both foreign and domestic investors. Many business areas now will be open freely to foreign investors. The new laws are still silent on the restriction on foreign investors' holding of domestic companies' equity. The current 30 percent cap is expected to be scrapped, however, when implementing regulations are formulated. Some areas of the economy will remain restricted, but the new ceiling is expected to be increased to 49 percent. This new regulation, if it materializes, will allow foreign investors to be more active in the stock market. The unified laws are part of Vietnam's effort to meet the criteria for accession to the World Trade Organization. However, no truly common legal framework has been achieved in all areas of the economy (Freshfields Bruckhaus Deringer, 2006).

The commitment to make big profitable equitized companies to be listed on the stock market will help increase the depth and spread of the stock market, improve its liquidity and its ability to perform more efficiently its monitoring, pricing and disciplining functions.

## **FINAL NOTE**

The SOE restructuring program in Vietnam that started in the late 1980s has traveled a long way and has achieved significant results. The reform initiatives, bannered by equitization, have improved the efficiency of the firms without fully privatizing the ownership. Measures to harden budget constraints and grant autonomy to management have yielded benefits for the Vietnamese economy. However, there remains the urgent need to reform the equitized enterprises further and to push for the socialization of ownership as well as better corporate governance. Deeper reforms will help

- improve the performance of the government sector and increase its contribution to GDP,
- increase the competitiveness of the equitized firms in the face of strong international challenges and the growing visibility of the private sector,
- improve the utilization of capital resources more efficiently (which requires in part the reduction of subsidies to SOEs), and

- create favorable conditions for the development of the private sector (enhancing the market aspects of the economy).

More positive impacts would be achieved if the ownership structure of the equitized companies were allowed to be more diverse to include independent investors. The government must have the political will to carry out more divestment. The most important policy in term of raising the quality of corporate governance and getting the most of the equitization process is the development of an active and effective stock market. The road ahead is long and winding but Vietnam has taken a few good steps forward.

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