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TRANSPARENCY & DISCLOSURE: THE STEPPING STONES TO GOOD GOVERNANCE

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Good morning, ladies and gentlemen.

It is a great pleasure to be invited to speak at this roundtable. It also feels like coming home. Since I joined PricewaterhouseCoopers I have spent 7 years living and working in Eastern Europe, including some time living here in Ukraine. Even though I am now based in London, I still spend a lot of time helping major clients in the region to improve their financial reporting. I am pleased to say that great strides have been made in that area - especially the growing trend towards reporting under IAS. But my work has also convinced me that good accounting, on its own, is not very useful if there is not also good corporate governance. The two go hand in hand. That's why it's good to see so many people here committed to improving governance standards.

[SLIDE 2]

The focus of my short presentation is Disclosure and Transparency. They are words we hear a lot about these days, but what do they mean? To get an impression, a good place to start is the Corporate Governance Principles issued by OECD. They devote a whole section to the topic, but the thrust of the recommendations are contained in this sentence. *"The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company."*

That's quite a lengthy statement, so let's break it down into what it means for companies in practice.

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In simple terms, good disclosure and transparency mean three things:

(1) Better explanations of governance structures;

(2) Better explanations of corporate performance ; and

(3) Better accounting!

Let's look at each of these in more detail.

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Potential investors are looking for information on share structure, ownership and voting rights, so they can judge whether their rights will be treated on an equitable basis with other investors. It helps them to decide whether they want to take the risk of investing. Multinationals such as Coca Cola, Cargill and Nestlé have made significant investments here in Ukraine. They would certainly have expected to see a great deal of information before making that commitment.

In particular, investors will be interested in details of significant holdings - for example, in some countries, companies are obliged to disclose the identities of owners of holdings in excess of 5% of share capital. They would also expect to see information on cross-shareholding arrangements, arrangements whereby blocks of shares are voted together, and special voting rights.

Also of critical importance are disclosures on related parties. Other parties may be able to exercise a controlling influence over a company, even without owning shares. This is quite common in Ukraine and the CIS, where the state still exercises considerable influence over the operating decisions of former state enterprises. The most important disclosures are about control, but there may be other transactions between the reporting entity and the related party which need disclosure, for example: purchases and sales of goods and services; licence agreements; loans and financing arrangements; guarantees and collaterals; and management contracts.

The other main area of structure in which investors are interested is the board of directors or senior management. After all, the success of a business is often dependent on the calibre of the individuals who are appointed to run it. At a minimum the identities of the board members should be disclosed - often in annual reports this is done by including short biographies. Ideally, these should include details of the responsibilities each person has in the business; what other directorships they may hold; their nationality and any qualifications held which are particularly relevant to their positions.

The description should differentiate between executive management (that is, those involved in day to day operations) and outside or independent directors. Outside directors are commonly found on the boards of international companies – they are appointed by the shareholders to contribute their wider experience and expertise to the board on a part-time basis. They are not there to check every decision of management, but to bring a fresh objective view to strategy and business development. Our experience is that having an independent element on the board is beneficial and can add to the quality of management decision-making.

Finally, if there are sub-committees of the board, their role and responsibilities should be explained. For example, the board may delegate to an audit committee responsibility for the financial reporting process and for overseeing the system of internal control. Such a committee, particularly if composed of knowledgeable directors, can act as a “bridge” between the external auditors and management. To help companies, my firm has published a highly successful guide *'Audit Committees - Good Practices for Meeting Market Expectations*' which outlines the practicalities of setting up and running an audit committee. It is available in both English and Russian.

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Investors are also looking for better explanations of corporate performance. We also have a guide on how to do this - it's called *'Reporting Progress'* and it follows the sections typically found in the annual reports of major international companies. (A Russian language version of this is on its way, too.)

Annual reports deal principally with historical operating and financial performance, but that performance is more easily set in context by including discussion of strategic objectives. Shareholders and analysts are better able to assess the performance of the business if the aspirations of the company (in terms of financial and other targets) are set out.

The operating and financial review is a more than a narrative version of the financial statements. It is the place where management can tell investors about the good things it has done to develop the business. It provides additional analysis and comment which could not be obtained from the accounts. A good review of business performance should include:

- the significant features of operating performance for the period. Changes in the industry or the operating environment, and their effects on results, should be explained. Ideally, this analysis should be on a segment basis;
- the main risk factors and influences that may affect future results, whether or not significant in the period of review; and
- investment in the current period which will maintain and enhance future income.

Having discussed how the operating activities of the business have performed, management should explain the financial position - how these activities were financed and how they will continue to be financed in the future.

Leading companies are also beginning to include much more voluntary comment on non-financial matters in their reports. Much of this information is of interest to groups other than investors - for example employees, consumers and regulators. The argument for including it is that long-term value can only be created for shareholders if the company treats groups such as customers fairly - alienate your customer base and your business rapidly disappears! Pick up the annual report of a major UK or US company and you will find sections on employee, environmental and corporate responsibility. The report of major oil company Shell, for example, talks about its exploration activity in parts of Central Asia and how it is dialoguing with local interest groups.

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Finally, transparency is also about better accounting. My fellow speaker, Alla Savchenko, [has already spoken] [is speaking] about progress in accounting reform in the region, so I do not want to comment too much on this. However, it is worth remembering that investors want high quality financial information which possesses certain characteristics. They want numbers which are:

- comparable (prepared according to common principles);
- comprehensive (meaning full disclosure);
- fair (that represent the economic reality of the transactions);
- relevant (the disclosures and accounting treatments are appropriate to the type of business);
- reliable (audited to a high standard); and
- timely (increasingly, they are looking for interim results, not just annual figures.)

The relevance point is important. Ukraine's capital market, for example, is dominated by energy and utility companies. So it needs accounting rules which deal with tricky issues such as revenue recognition, valuation of assets and start-up costs.

Investors also want to cut through the confusion caused by having different reporting regimes in different countries. There is a growing demand for harmonisation around international "norms". It is hardly surprising then that IAS is becoming the framework of choice for many companies - it satisfies the characteristics I have outlined and the standards are increasingly focused on the needs of modern business. There is still much work to do to bring the accounting frameworks of the

region closer to IAS. The new Accounting Regulations in Ukraine, effective from 2000, are an encouraging start.

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I will conclude by summarising the benefits for enterprises of disclosure and transparency. Relevant, high quality, comparable reporting encourages cross-border investment. Transparent reporting will lower the cost of capital. A recent study by consultants McKinsey found that investors were willing to pay a premium to acquire stakes in companies which demonstrate good governance.

Putting that into context, if more of the good practices I have described are adopted by businesses in the Ukraine and its neighbouring countries, we should see more inward investment in the region. I'm sure that is something we would all like to see.

Thank you, Mr Chairman. I would be very happy to answer any questions.