Organisation for Economic Co-operation and Development
In co-operation with the World Bank Group

SECOND SOUTH-EASTERN EUROPE CORPORATE GOVERNANCE ROUNDTABLE

"Transparency and Disclosure"

Meeting Hosted By
The OECD Centre for Private Sector Development
and
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Opening Session: Welcoming remarks

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Welcoming Remarks
2nd Meeting of South East Europe Corporate Governance Roundtable
Istanbul

Mierta Capaul, World Bank

Distinguished hosts, ladies and gentlemen, on behalf of the World Bank, it is a great pleasure - and a great honor - to join my colleagues in welcoming you for the second time to the South East Europe CG Roundtable, here in beautiful Istanbul. The second meeting of the South East Europe Corporate Governance Roundtable will focus on disclosure and transparency. Concerns about transparency were really at the root of the international interest in corporate governance. Last century's Asia crisis not only highlighted the vulnerability of emerging markets to volatility and financial shocks, it also showed how the opacity in markets could lead to badly priced risk and poor lending and investment decisions. Without disclosure, investors cannot feel reasonably assured that they will ever get their money back.

But disclosure alone is not enough. Even if we assumed that the now notorious Enron technically reported its famous special purpose vehicles and off balance sheet subsidiaries in compliance with applicable accounting rules, - it would have been with the letter of the law and rather than with the spirit – it is clear that Enron wished to hide the amount of debt that the company had accumulated.. And this was done with the complicity of its auditor. Such practices prevented shareholders from gaining a full and fair picture of the company's financial situation until it was too late. Transparency cannot be separated from the other three pillars of corporate governance, namely responsibility, accountability and fairness. The Enron case is also important because it reminds us that we cannot take good corporate governance for granted anywhere – whether in an OECD country or in the developing world.

I commend the OECD for recognizing early on that the issue behind transparency and disclosure is accountability and that better reporting could not solely be solved with better accounting standards and other "technical solutions". Rather, the OECD Principles dedicated an entire chapter to disclosure and transparency. In addition, the sections dedicated to shareholder rights, equitable treatment, role of stakeholders, and the responsibilities of the board each contain reporting and disclosures principles.

The OECD Principles provide the framework around which the regional corporate governance roundtables like this one are structured. They also provide the standard for another World Bank initiative. In my opening remarks, I would like to briefly share with you some observations on this initiative undertaken in conjunction with the IMF: The ROSC - the acronym stands for "reports on the observance of standards and codes". Again, initially, they were known as "transparency reports" which reflects the history I briefly laid out above.

The ROSC program is a series of voluntary country assessments of corporate governance practices, benchmarked against the OECD Principles. They are a powerful diagnostic tool and provide critical and objective information on the strengths and weaknesses of the economy under review, including the functioning of the private sector and securities market.

Sixteen countries have been assessed so far, amongst which are Croatia, Bulgaria, Romania and our host, Turkey. I would like to share with you some of the key findings in the area of disclosure and transparency and then talk about some key recommendations.

While none of the assessed countries comply with the OECD Principles in all respects, all countries surveyed have undertaken or are currently undertaking reforms in their legal and

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regulatory frameworks which are expected to improve corporate governance practices over time. The OECD/WB roundtables on corporate governance and the World Bank corporate governance assessments have been a catalyst to trigger interest in corporate governance and establish consensus for reform.

Incentives shape the approach to information disclosure. In countries where business has traditionally been based on relationship and trust, corporate information is thought of as secret; and it is accepted practice to keep different sets of books, e.g. one for taxes, one for outside investors, and one for the majority shareholder. In such countries, business transactions have traditionally taken place on the basis of relationships and trust and little attention has been paid to publicly available information. Corporate governance reform is a way to extend this trust to all market participants via enforcement of shareholders rights.

But what kind of disclosure do markets and investors want? The answer is simple: High quality, comprehensible and comparable. Reporting must be relevant, useful, sufficient and timely. Material information encompasses both financial and non-financial information: Financial information is the scorecard of the company, whereas non-financial information tells the story behind it. Material information encompasses that which should be known by investors to formulate a rational investment decision..

In most of the countries surveyed, accounting and auditing standards are set by professional accounting bodies. Most of the countries surveyed only partially comply with international financial reporting standards. Croatia is the only country in full compliance with IAS, while most other countries differ in material aspects, including consolidation, segment reporting and the disclosure of cash flow statements. Related party transactions and conflicts of interest are not disclosed in sufficient detail, if at all. The notes are often only available to the public in summary form, if at all.

Disclosure of non-financial information is a new concept in most developing countries and transition economies. In Turkey, layoffs of more than 20 percent of the workforce, as well as collective bargaining agreements, must be disclosed. Malaysia and India require the disclosure of governance structures and policies under the listing rules as part of their code of best practice. The remuneration of board members and key executives is generally set by the AGM in the aggregate and maybe disclosed as a total number in the annual report – but never at the individual level.

Auditors are expected to provide an independent assessments of financial statements prepared by company management. This is why they play a key role in assuring markets that they are perceiving reliable information. On occasion, we find that auditors have given unqualified opinions and certified that the accounts audited provide a fair and true picture, despite the fact that many defects were noted. The penalties for such behavior are low and enforcement generally lax. In many countries, the press does not play the role of a whistle blower and the market does not penalize such behavior. None of the countries surveyed opted to set auditor liability at a high enough percentage of share capital to act as an effective deterrent.

One of the reasons for unsatisfactory professional standards is the lack of professional oversight – or the lack of corporate governance of the audit profession. The accounting and auditing organizations generally in charge of monitoring their members and their professional conduct often lack legal backing. They do not have real sanctioning powers beyond excluding a member from their organizations. And this often does not mean that the auditor can no longer practice. Further, the monitoring is carried out by the same market practitioners that are being

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supervised. Peer review is a concept that is being questioned worldwide and increasingly replaced by independent practice review.

Compliance by issuers is generally monitored by the securities regulator or, as in South Africa, by the stock exchange. Often these institutions do not have the necessary expertise nor sufficient staff to fulfill this obligation fully.

In some countries the legal and regulatory framework represents a structural hindrance to good corporate governance and must be reformed. However, in most countries surveyed, the legal and regulatory framework –while far from perfect – could be acceptable if only its stipulations were adhered to.

The OECD Principles assume not only that countries have an efficient legal and regulatory framework in place, but that regulators and the courts have the means and capacity to enforce the rules and regulations of their capital markets. However, experience from the countries surveyed demonstrates that this is often not the case. Typically courts are under-financed, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt. Moreover, securities regulators have little direct power to enforce penalties. This leads to poor enforcement of the rules and regulations underlying corporate governance.

This is why the ROSC policy recommendations focus mainly on the supervision and enforcement of existing regulations -including such issues as independence, proper staffing, training, budgets, sanctioning powers, the collection of fines and the power to prioritize investigations to set precedents. Where the judicial system is ill equipped to deal with commercial cases, we may recommend arbitration as a practical means of action against directors and controlling shareholders for violation of law or by-laws. These policy recommendations should serve as a means for setting priorities and implementing reform at the national or country level.

Last, but not least, we strongly support voluntary and private sector initiatives. A code of best practice, for example, can be a guide for companies to judge where they stand with regards to corporate governance practices. We usually recommend that it be voluntary in nature, but that the stock exchange or securities regulator instruct companies to disclose in the annual report whether they comply or explain why, if they do not ("comply or explain"). A code helps raise awareness of corporate governance among public companies and investors in a give country. It fosters a culture of greater non-financial disclosures, such as e.g. governance structures and stakeholder relations.

The other private sector initiative we recommend is the creation of a listing segment following higher corporate governance standards. This was adopted in Romania for example, where it is known as the *Transparency Plus* market segment. Such a market segment can represent international best practice, such as adherence to IAS, one share one vote or better treatment for minority shareholders. It offers a choice for issuers who wish to distinguish themselves in the competition for equity capital at home and abroad and gives investors a benchmark against which to measure corporate governance in a given country.

I am looking forward to the following two days' discussions, and learning more about the current debates on the hot topic of disclosure and transparency with our particular focus on South East Europe. What cannot be in doubt, is that corporate governance has become a central issue of concern for the World Bank, and to that end, we welcome this opportunity to participate in the policy dialogue upon which effective reform can be built.

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I would like to thank the OECD for taking the lead in the regional corporate governance roundtables and our local hosts and sponsors, who, as in Bucharest, have been essential to the success of the roundtable process. And to the rest of this meeting's participants, my best wishes for a successful and productive meeting. Thank you.

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