



2nd Meeting of the Eurasian Corporate Governance Roundtable

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Transparency and Disclosure

SYNTHESIS NOTES

hosted by

**The National Securities Commission of Georgia
The Georgian Stock Exchange
International Regional Federation of Accountants and Auditors Eurasia**

with the support of



**The Government of Japan
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Priorities for improving disclosure: a summary of debates

Introductory remarks

Inadequate corporate governance practices have created a severe barrier to investment in many of the now independent countries that comprised the former Soviet Union. In response, policy-makers in the region are beginning to take steps to tackle such shortcomings.

To assist in this process, the OECD and the World Bank Group launched the Eurasian Corporate Governance Roundtable in Kiev last October with the support of the International Finance Corporation, the US Agency for International Development, the Japanese Government, and the Global Corporate Governance Forum.

On 7-8 June, over one hundred high-level representatives of governments and from the private sector, as well as academics, members of international financial institutions and experts from OECD member countries met in Tbilisi, Georgia, to monitor and evaluate corporate governance developments in the region and examine in depth the importance of transparency and disclosure on all matters regarding the corporation.

Hosted by the National Securities Commission of Georgia, the Georgian Stock Exchange and the International Regional Federation of Accountants and Auditors of Eurasia, this Second Meeting of the Eurasian Roundtable:

- Explored the role of disclosure and its contribution to improving both the domestic and foreign investment climate;
- Considered impediments to the implementation of better disclosure practices in the Eurasian context and contributed to improve the understanding of disclosure practices;
- Served as a central vehicle in the process of identifying key areas for improvement in the regulatory domain and in private practice.

Participating Eurasian countries included Georgia, Armenia, Azerbaijan, Ukraine, Moldova, Kazakhstan, Uzbekistan, the Kyrgyz Republic, and Mongolia. While these countries are at different stages of economic development, they are currently undertaking steps to reform their corporate governance regimes and their legal and institutional frameworks in order to achieve long-term economic growth. In the field of transparency and disclosure, their efforts have particularly focused on introducing international accounting and audit standards although implementation and enforcement of these standards remain critical issues.

The following summary has been prepared under the responsibility of the OECD Secretariat.

1. General findings

1.1 The importance of disclosure

Full, accurate, and timely disclosure is indispensable for good corporate governance. Corporate governance is a mechanism of interactions between corporate insiders and outsiders, and when the latter does not possess sufficient information on the affairs of the company in order to be able to make informed decisions, the corporate governance mechanism cannot function properly.

The roundtable stressed the importance of disclosure for attracting investors, especially to help foreign investors make informed investment decisions. Although good disclosure is not a sufficient condition to attract investment, the lack of disclosure is perceived as an increased risk by outside investors. It can lead to higher capital costs for a company and/or reduced investment in it. In contrast, the enforcement of effective disclosure will make corporate insiders more exposed and responsive to external pressure and thereby enhance investor confidence.

The interests of minority shareholders and stakeholders and the role of good disclosure as a way to protect these parties from being exploited or expropriated was particularly emphasised in discussions.

Fair disclosure is important to enhance the company's effectiveness. It provides management with the opportunity to review the company's achievements and work out its future business strategy in an objective manner. It could also prevent fraud or other business misconduct. Transparency and disclosure can therefore help change the way a business is managed, bringing with it accountability as a powerful force to drive improvements in efficiency and growth.

Good disclosure is consequently an effective tool for influencing companies, protecting shareholders, and attracting domestic and foreign investment. In that regard participants also mentioned that a reliable disclosure system is crucial to enable governments to conduct sustainable and stable economic policies. Corporate transparency goes hand in hand with public transparency. Especially in the Eurasian region the lack of public transparency hinders the development of good corporate disclosure practices.

1.2 The Eurasian context

Roundtable participants described the weakness of company disclosure throughout the Eurasian region. One of the main impediments was attributed to the low levels of awareness regarding the importance of transparency and disclosure. Attributed to a large extent to the legacy of the Soviet systems, the lack of awareness can be found at all levels, especially among managers, local shareholders, and among public officials.

In particular, the importance of non-financial information is not yet fully appreciated. Although, non-financial information is valuable to assess a company's governance and is particularly relevant in the Eurasian context to understand changing ownership and control arrangements, there is a marked reluctance to disclose information considered as private by insiders. This has perpetuated some problems with the implementation of standards at the company level and jeopardised the confidence of investors.

Besides the lack of a transparency and disclosure culture, the costs and efforts to switch to a new reporting system, the burden of taxes and the pride in contravening state rules were also considered major deterrents to fair disclosure and the enforcement of international disclosure standards. Examples were provided showing that management, often in alliance with controlling

shareholders, has superior access to information and can manipulate the decision making process of the company to the disadvantage of minority shareholders. Minority shareholders are the first victims of the lack of disclosure as management often finds ways to keep secret details of transactions and other operations from minority shareholders that have not teamed up with them.

Comparing the Eurasian landscape with other regions, notably with Asian countries, has shown that social welfare can not be improved in an anti-transparent environment. More generally, participants noted that once confidence was lost, it is extremely difficult to regain it in the short to medium term. Even though there is no “one size fit all” model, participant stressed the need to enforce fair, clearly identified and well-understood disclosure mechanisms.

1.3 Improving disclosure

Roundtable debates chiefly focused on ways to improve disclosure in the Eurasian context through proper incentives and stricter enforcement mechanisms. Access to cheaper capital was generally quoted as the main incentive for companies to comply with disclosure rules.

Yet, access to capital in the region depends on the development of well functioning local capital markets, which in turn depends on adequate disclosure, or more broadly good corporate governance. The improvement of corporate governance should therefore be pursued hand in hand with the establishment of capital market institutions.

Legal frameworks for corporate activities and disclosure practices are being established throughout the region. Regulatory and professional bodies as well as stock exchanges increasingly require high standards of disclosure. These institutions can play an important role in raising awareness and in monitoring compliance with disclosure standards and improving channels for disclosure. In many countries, stock exchanges are actively seeking ways to create incentives for companies to improve disclosure through their listing requirements. However, stock exchanges in the region may feel reluctant to de-list corporate offenders as they are afraid that de-listing could have a detrimental impact on the development of newly created stock markets. Regional experts stressed that the particular difficulty within the Eurasian region laid precisely in the fact that most companies were forced to go public through the privatisation process without any strategic development perspectives. Nevertheless, Eurasian regulators, after a period of time where they permitted companies to familiarise themselves with listing requirements and disclosure rules, are beginning to focus on stricter enforcement of rules, including imposition of sanctions .

Regulators and state officials themselves should be accountable and transparent to have sufficient credibility to promote transparency in the corporate sector. If people or companies distrust their governments or regulators, the regulatory regime can not function properly.

The improvement and the effective implementation of disclosure practices depends on the existence of a reliable court system composed of accountable and well trained judges in matters of commercial law, company law and securities law. Effective insolvency procedures have to be in place to ensure that non-viable companies exit the market in a timely manner.

A more activist attitude of shareholders toward company management could be a powerful incentive for better disclosure. As a result of mass-privatisation, shareholdership is dispersed and shareholders are often passive. The education of shareholders could therefore be key in this context.

2. Specific issues

2.1 The relevance of international standards

Roundtable presentations briefly recalled that proper accounting and auditing practices are at the heart of a disclosure regime. Accounting is the basic language of business and financial reporting. It is the primary means by which information on company performance is communicated to market participants. For many investors, the quality of financial disclosure has the most important impact on their investment decision.

Although the pace of reform is different among countries of the region, efforts are being made throughout the Eurasian region to bring accounting and audit standards in line with international standards. There is general agreement that disclosure standards need to be of sufficiently high quality to fully inform the investment community regarding their investment decisions. Investors, in particular, tend to agree that the use of international standards that allow for meaningful comparisons between companies of different countries is desirable in order to make informed decisions about the acquisition, ownership and sale of shares. It was acknowledged that the use of internationally recognised standards also helps to improve public understanding of the structure, activities and policies of enterprises. The debates between representatives of the region more specifically focused on whether it is better to directly introduce International Accounting Standards or rather national standards based on International Accounting Standards. International experts stressed that the important factor was to adopt high quality standards recognised by the international business community.

In practice, some companies previously prepared IAS -consistent accounts but in many cases the conversion of joint stock companies and limited liability companies to new standards did not begin before 2000. Traditionally, companies exclusively reported to the State (i.e. the Tax Department). In many Eurasian countries the Ministry of Finance still requests companies to report in the traditional format which obliges companies to maintain a de facto costly double standard accounting system. As this issue affects private companies as much as public companies, participants questioned whether smaller private companies needed to comply fully with international standards.

One of the major issues pointed out during discussions was the need to secure qualified accountants and auditors in substantial numbers in order to successfully implement new reporting rules. The proper application of disclosure standards requires sufficient training and expertise of accountants, and the existence of institutional structures that can improve and maintain the quality of the profession. Currently there is a critical lack of human resources throughout the region. Many countries in the region urged for effective accounting training programs. Professionals also underscored that accounting is much more than just a bookkeeping formality. Thus, introducing new international standards can not be reduced to a change of format. The training of accountants should focus on the conceptual understanding of the international standards.

2.2 Materiality and timeliness

Roundtable participants further discussed the components of a strong disclosure regime. In order for shareholders, creditors and other stakeholders to effectively monitor a company and its management and allow potential investors to gauge a company's prospects and compare different investment possibilities, all material information regarding the company should be fully and accurately disclosed on a timely basis. More specifically, experts discussed why the core concepts of materiality and timeliness are key to a good disclosure regime.

It was recalled that material information is information whose omission or misstatement could influence the economic decisions made by the users of information. Participants noted that, the question regarding what to disclose is important both for companies, who may be concerned about the costs of complying with disclosure requirements, and regulators, who want to ensure that the information they demand is genuinely useful for meeting their regulatory objectives. Applying the concept of materiality in developing disclosure requirements helps companies and regulators to decide what information is truly relevant. The concept of materiality is utilised to determine the minimum amount of information that must be disclosed by a company. As materiality may vary according to the local context, the roles of securities commissions and stock exchanges are critical in setting the rules, monitoring disclosure and ensuring that all relevant information is furnished.

As out-dated information can frustrate the investment decision making process and limit the benefit of good disclosure, companies are also required to disclose routine company information on a periodic basis and price-sensitive information immediately. Here again the monitoring roles of commissions and exchanges should be underscored. Securing equal access to information through timely, but also cost-efficient channels was acknowledged as a key challenge for the countries of the region. Disclosure through the press can be an effective tool of communication. To support equal access to information, securities commissions have engaged in “open house policies” that invite interested parties to consult available company reports.

Participants concluded that there is an inevitable trade-off between the level of materiality and timeliness required on one hand and the cost for them on the other hand. The optimal balance would depend on each country’s situation. At this stage major investors systematically insist on having a seat on company boards in order to gain proper access to information.

2.3 Overseeing disclosure

In addressing the issue of overseeing disclosure the roundtable focused on the respective roles of boards of directors and independent auditors.

2.3.1 The board

After demonstrating that companies themselves should ensure that the information they provide to market participants gives a true and fair view of the enterprise, presentations described the different setting for internal oversight structures. In general, two types of legal setting for internal oversight structure co-exist in OECD countries. The one-tier system is common among Anglo-Saxon countries, whereas the two-tier system has been adopted in many continental European countries. Whatever system is adopted, the board should include independent, well-informed and experienced members to ensure that monitoring systems are in place and that appropriate accounting, audit and disclosure standards are applied.

Experts noted that in the future, changes in board structures and procedures might be required in order for boards to better fulfil their obligations. Audit committees may, for example, be established to be responsible for selecting the external auditor, receiving and approving the report of the auditor and communicating the results to shareholders. They may also be responsible for alerting the executive of irregularities in systems of control. Priority should be attached to the education of independent board members. Experienced foreign institutions and institutional investors could be invited to designate board members in order to foster good board practices.

2.3.2 External independent auditing

As stated in the OECD Principles, roundtable presentations recalled that an independent auditor should conduct an annual audit in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented. Discussions emphasised the importance of the independence of auditors. Whatever the nature of the information, its value can only be enhanced by an independent audit. Independent audit provides greater assurances regarding the truthfulness of the statements that are made to users of information. The conduct of an independent audit is, in turn, subject to the observance of standards designed to protect its quality. Governments may wish to establish rules for ensuring the auditor's independence. The profession itself is generally understood to have a responsibility towards the public interest in the conduct of the audit.

Taking advantage of the lack of competent professionals, external auditors merely see a good business opportunity to also serve as consultants, which in some cases seriously limits independence. Here too, participants stressed the importance of enforcing sanctions in case of gross negligence or wrongdoing. Yet, it was admitted that enforcement of these sanctions might remain limited as long as there will be an important lack of trained professionals on the market.

3. Future steps

Over the next 24-30 months, the Eurasian Corporate Governance Roundtable will further assist selected countries in developing public policy responses, using the OECD Corporate Governance Principles as a conceptual framework.

Participants agreed to hold the next roundtable meeting in Kiev, Ukraine in spring 2002. This meeting will review shareholder rights within the region and identify priorities for improvement.

Furthermore participants discussed the drafting of a regional comparative corporate governance progress review which will constitute the Eurasian roundtable process' major output. Based on country specific input and using the OECD Corporate Governance Principles as a benchmark, this review will especially compare legal frameworks, implementation policies, institutions and corporate practice in the region and could include overall regional recommendations. This review will benefit from the roundtable discussions as well as from international and local expertise. The OECD Secretariat will establish a list of core roundtable participants who will actively be participating in the drafting and monitoring of this review.

Roundtable participants also welcomed the initiative of setting up a dedicated web-site where substantive background documentation could be made public and disseminated. On-going debates could be reflected in this web-site, which could constitute the corporate governance hub for the region.