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Transparency and Disclosure

Corporate Governance in Georgia

by

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Corporate Governance in Georgia

Major Concern

- **Audit as a tool to exercise corporate control**

Reviews

- **Georgia's GDP**
- **Structure of Trade**
- **Russian crisis: Impact and partial recovery**
- **Equity Market**
- **Role of Banking Sector in Industry**

The information presented in this document is primarily based on GCG's professional experience and research conducted in various sectors of country's economy. Part of this document reflects statistical data provided by State Department of Statistics and several research agencies.

Macroeconomic Characteristics

GDP

From 1995 Georgia began to experience increasing level of GDP growth. In 1997 Georgia's economy grew by 12 percent, which was attributable to reestablishment of political and economic stability and reduced rates of inflation. Economic growth and reforms has slowed in 1998, due to the Russian financial crisis. Despite financial crisis of 1998 Georgian economy continued to grow in 1999. GDP grew by 3 percent and in current prices it amounted to GEL 5.6 billion. Agriculture, industry, transport and communications remained the main sectors contributing to economic growth.

GDP growth rate in 2000 was only 1.9 percent, the lowest since 1995. The total amount of GDP was GEL 6.186 billion. Per capita GDP amounted to GEL 1,340. Distinctive feature of 2000 is the rise of national product in almost all sectors of the economy excluding agricultural sector.

Table 1.1. Dynamics and structure of Georgia's GDP, 2000

Sector	Change from the last year (100)	% of Total
Agriculture	87.4	21.5
Industry	103	18
Construction	104	3.5
Trade	108.5	11.8
Hotels and restaurants	104.6	2.2
transport	109.3	11.5
Telecommunications	115.5	2.5
Financial Intermediaries	115.5	1.6
Operation with real estate, commercial activities	102.5	7
State management, defense	98.4	3
Education	106	3.2
Health care	103.9	4.9
Other Services	105	3.3
Net Taxes	124.5	5.9

Investment

The amount of investments in fixed capital in 2000 amounted to GEL 349 million a bit more than in 1999 GEL 312 million. The ratio of investment versus GDP 5.6 percent remained almost the same as in 1999 (5.5 percent). This is one of the lowest among CIS countries. The lack of investments can threaten a fast recovery of the national economy. A peaceful environment, the reduction of corruption and the enforcement of law are preconditions to attract higher investments into the Georgian economy; it seems necessary to grant additional incentives to investments, e.g. tax reductions for those who invests.

Foreign Direct investment (FDI) has declined in recent years. According to the state department of statistics, FDI in 2000 was USD 60 million, compared to USD 83.65 million in 1999, USD 288 million in 1998 and USD 242,5 million in 1997.

The completion of Baku-Supsa oil-pipeline construction and the lack of new large-scale investment projects might explain such a poor investment performance.

Trade

The Georgian trade has a rationale quite similar to that of most of the market economies of the world. In most of the market economies we can observe that the main trade partners are the neighboring regional powers and the EU. This is true in Georgia as well. Georgian foreign trade is mainly conducted within the CIS. Georgia's trade deficit with the CIS countries represented 55 per cent of the total trade deficit.

Traditional trade pattern is becoming more diversified as Georgia expands its trade and economic relationship with foreign countries. At present there are trade relations with more than 100 partners.

The normalization of Georgian trade relations with the rest of the world has made some further progress, in particular with the USA. The trade deficit of Georgia keeps on reducing even if a large part is out of the Georgian official registration. CIS, EU and Turkey remain the main trade partners of Georgia. As WTO member Georgia has to be ready for the new Millennium round and the accession of new members; the country should learn how to use at best the trade tools allowed by WTO.

<u>Registered trade turnover and direction of trade</u>
During 2000 the external trade turnover reached USD 1,030.1 million, from which export amounted to USD 329.9 million and import – to USD 700.2 million. Thus, Georgia's trade deficit was USD 370.3 million, that is USD 12.6 million less than in the 1999. It represents 12 per cent of GDP while in the previous year it was 13.6 per cent of GDP.

Georgia had a trade deficit with 79 trade partner countries and a trade surplus with only 35 countries. Georgia's trade deficit with the CIS countries represented 23.1 per cent of the total trade deficit.

Table 2.1 Registered International Trade Turnover and Direction of Trade, 2000
(USD thousand, per cent)

International Trade Turnover	Thousand	Per cent	Trade Turnover

	Import	Export	Import	Export	Thousand	Per cent
Total (USD thousand)	700, 200	329, 900	100%	100%	1 030, 119	100%
Main partner countries (total)	497, 244	268, 520	71.015	81.394	765, 764	74.3
Turkey	108, 634	73, 623	15.5	22.3	182, 257	17.7
Russia	90, 236	68, 072	12.8	20.6	158, 308	15.4
Germany	55, 999	30, 859	7.9	9.3	86, 857	8.4
Azerbaijan	56, 714	21, 093	8	6.3	77, 807	7.6
USA	70, 911	6, 425	10.1	1.9	77, 336	7.5
Ukraine	37, 739	19, 473	5.3	5.9	57, 212	5.6
Switzerland	22, 305	13, 522	3.1	4	35, 827	3.5
UK	23, 322	10, 398	3.3	3.1	33, 720	3.3
Italy	21, 810	11, 578	3.1	3.5	33, 388	3.2
Armenia	9, 574	13, 479	1.3	4	23, 053	2.2
Others	202, 956	61, 380	28.9	18.6	264 355	25.7

Source: State Department for Statistics

Table 2.2 Registered imports by region and country of origin, exports by destination, 2000
(USD thousands, per cent)

	Import		Export	
	USD thousand	Per cent	USD thousand	Per cent
CIS (including Russia)	221, 576.6	31.6	136, 203.4	41.2
EU	167, 131	23.8	68, 354.5	20.7
Turkey	108, 634	15.5	73, 623	22.3
USA	70, 911	10.1	6, 425	1.9
Others	131, 947.4	19	45, 294.1	13.9

Source: State Department for Statistics

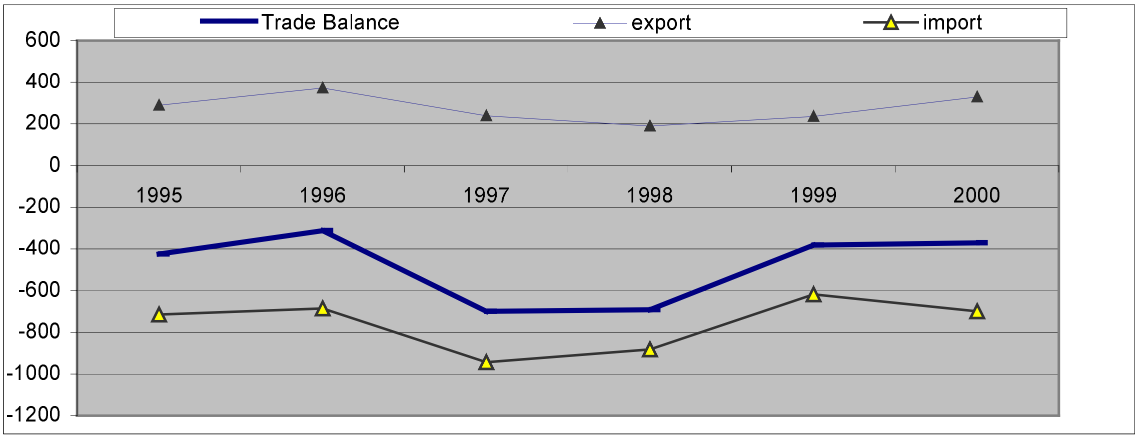
Table 2.3. Dynamics of Exports by destination

	Y1997	Y1998	Y1999	Y2000
CIS	137,325	107,234	107,096	136,203
EU	22,597	38,349	48,934	68,354
USA	4,219	11,103	9,979	6,425
OTHER	63,804	36,739	68,631	118,920

Table 2.4. Dynamics of Imports by region and country of origin

	Y1997	Y1998	Y1999	Y2000
CIS	338,719	281,223	209,547	221,576
EU	192,119	276,351	131,581	167,131
USA	70,221	76,350	71,567	70,911
OTHER	329,608	329,340	173,241	240,580

Chart 2.5: Registered Exports, imports and trade balance, 1995 – 2000,
(USD thousand)



Source: Data from State Department for Statistics

<u>The ratio of export coverage of import improves</u>

The export coverage of import ratio can be considered as the best indicator of the country position on the world market; it also shows the trade balance of the country. Georgia needs to increase the level of this ratio significantly. Georgia's export coverage of import ratio in 2000 was 47.1 per cent. Despite the fact that this indicator is higher than it was in 1999 (39.6 per cent) Georgia needs to increase this indicator significantly. The external trade objectives should be based on the facilitation of the competitiveness of Georgia's goods and services and stimulation of export-import proportions that would be favorable to Georgia.

Exchange Rate and Inflation

The national currency regained its strength in 1999, due to tight monetary and foreign exchange policy. By the end of this year a nominal exchange rate reached GEL1.93 per USD1, while during the first three months following the adoption of free-floating exchange rate regime on December 7, 1998 it fluctuated between GEL2.10 and GEL2.50 per USD1. From March 8, 1999 Lari started to appreciate and the average exchange rate for the year was recorded at 2.019 and 2.029 for the year 2000. Inflation was particularly notable in January-February 2001 (5 percent) when currency depreciation was most sizable.

Impact of crisis

T-bills

Fiscal crisis has significantly undermined investors trust towards treasury bills of the ministry of finance. In years 1997 and 1998 T-bill trade volumes amounted to GEL15.5 million and GEL48.8 million respectively. In 1999 issue of T-bills with 30 and 90 days maturity not exceeded GEL 4.8 million out of which GEL 3.9 million (81 percent) were placed. By the year 2000 placement of T-bills with 30 and 90 days maturity reached GEL 31.75 and GEL 5.74 million. From these figures we can assume that investors sentiment towards T-bills has somehow improved.

As a result of 1998 financial crisis the activity of the domestic financial market declined significantly and was limited to ForEx and Credit markets. T-bills emission renewed in august 1999 through NBG auction. To attract investors after the crisis of 1998, NBG allowed commercial banks to hold part of the 16 per cent of required reserves in T-bills. The NBG also recognized 10 per cent of commercial bank's T-bills portfolio as liquidity instead of the 5 percent required during 1998. That measure increased the interest of commercial banks in the T-bills market.

Charts below illustrate issues and demands on Treasury Bills from 1997 to 2000.

Chart 3.1. 30-day T-bill Volumes

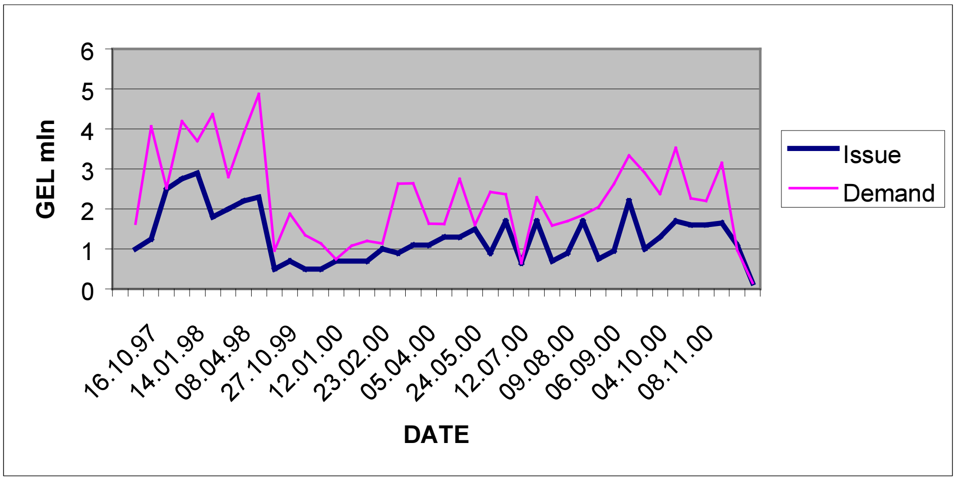
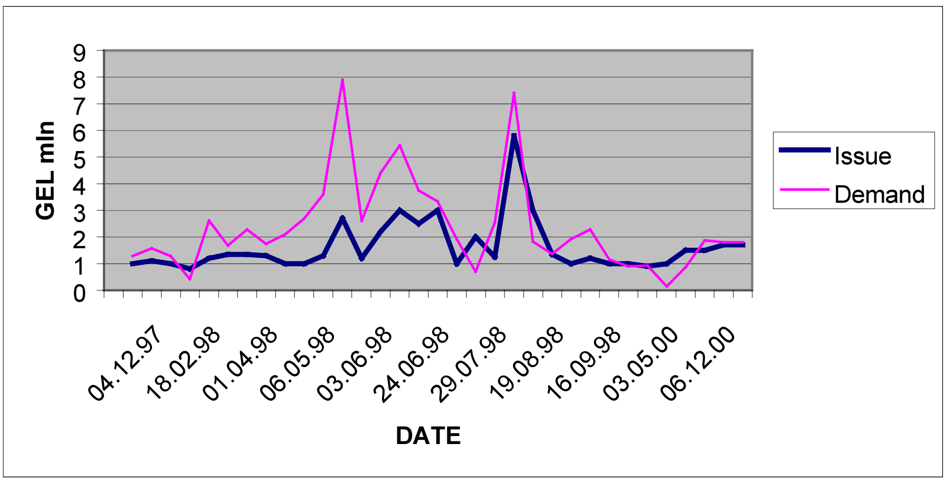


Chart 3.2. 90-Day T-bill volumes



Interbank Credit Market

After the crisis this market has become functional again from January 12, 1999. Throughout 1999, banks rarely sold credit resources at credit auctions of the National Bank or at interbank market, and in order to fill the liquidity deficit they primarily supplied foreign currency at foreign exchange markets. 7-day credits were most actively traded, and only a small group of banks was able to supply them.
Out of 50 auctions of 7-Day credits held in 1999, only 41 were successful. Total of GEL 29.4 mln was sold, GEL 23.9 mln, or 82.7 percent of which was purchased by the National Bank.

Chart 3.3. 90-Day credit auctions

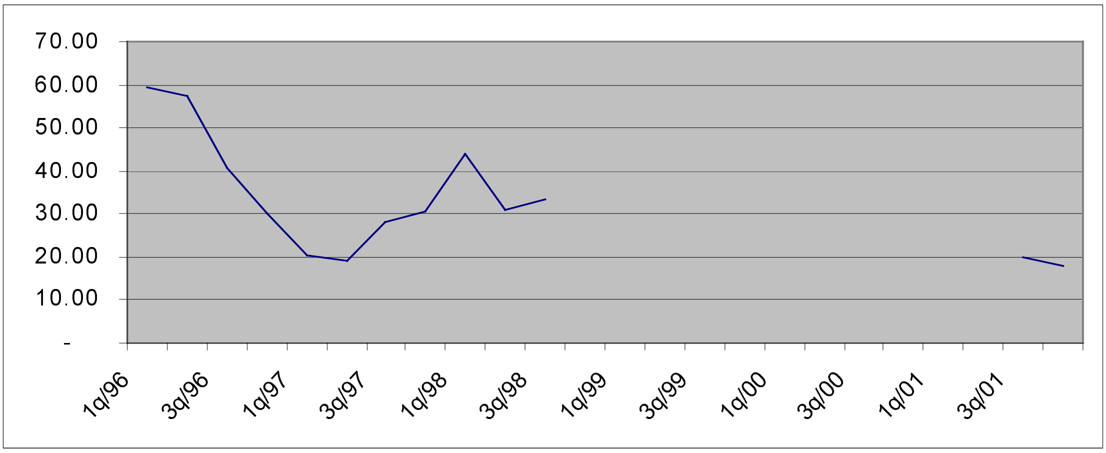


Chart 3.4. 7-Day credit auctions

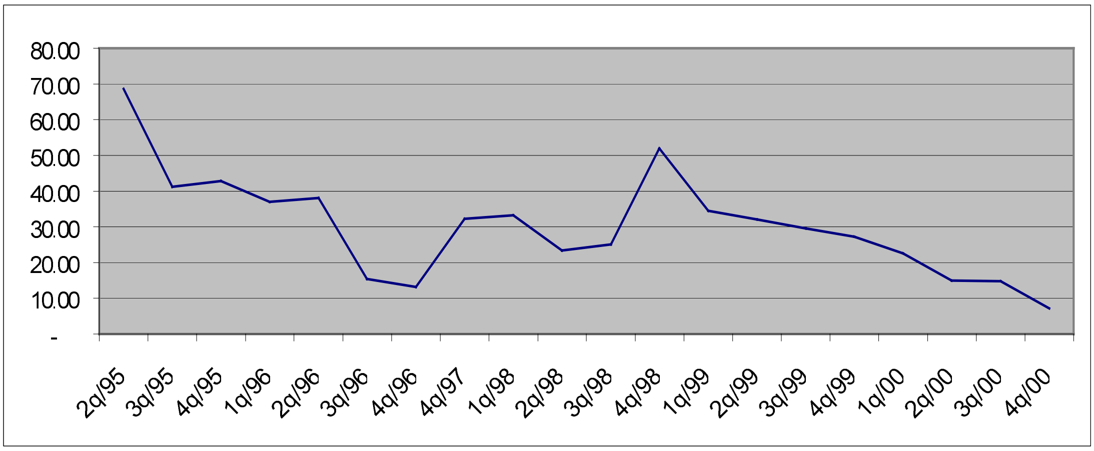
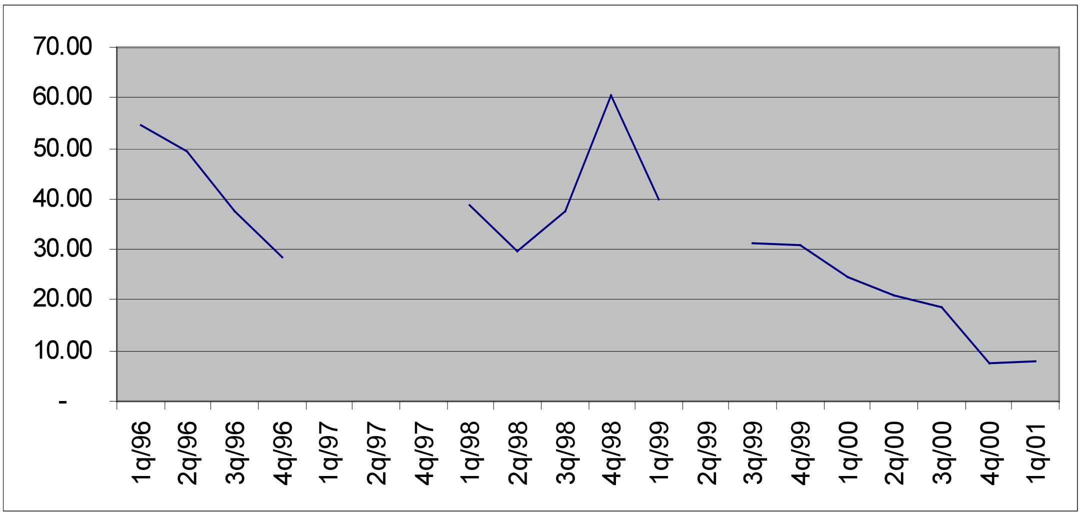


Chart 3.5. 30-Day credit auction



In 1999 no improvements have been achieved in solving the fiscal crisis. Moreover the fiscal situation worsened further resulting in serious social and economic problems. According to the law of state budget, 1999, government revenues were projected at GEL 922.5 mln. Actual receipts fell short of GEL 268.6 and amounted to GEL 653.9 mln – 70.9 percent of the budgeted revenues.

The collection of revenues fell behind the budgeted numbers primarily due to shortfalls in import revenues, the main cause of which were a substantially lower than projected volume of imports and a weak customs administration.

Corporate governance characteristics in Georgia

Corporate Governance and Ownership

The legal framework governing corporate ownership is provided by the following acts: The Civil Code; the Law on Entrepreneurs; the Law of Georgia on Securities Market; and The Law on Privatization of State Property.

Corporate ownership framework has been shaped during the privatization process started eight years ago. In 1992, the privatization of Georgian state assets was initiated with the law on privatization of state enterprises. In the result of voucher privatization the population has received its portion from the state property. Later the employees of enterprises have received their shares in the result of the Employee Share Ownership Plan (ESOP). The largest portion of state owned enterprises went to former directors, with little regard to free market economy. Their lack of knowledge and experience in a new environment and widespread corruption hamper passage of new conceptions of corporate ownership. In addition, questions have arisen over the methods of privatization used in some larger enterprises. The Georgian government and parliament have launched investigations of past privatizations involving allegations of wrongdoing by government officials.

What are the major reasons for poor corporate governance in Georgia? The central problem is rooted in widespread corruption in all levels of government bodies. There also exist more general problems, which hinder the process of corporate governance reform: an imperfect legal and tax environment, for example, an obsolete system of litigation and prosecution.

The law must administer shareholder protection more efficiently. The law should ensure access by small shareholders to any information, concerning the current operations of a business. The role of a general meeting, internal auditor should be revised in order to secure greater accountability of managers to shareholders and their representatives on the board, and also greater independence from the management of the internal auditor.

Generally information disclosure is very poor. A primary area, which must be addressed, is the upgrading of information disclosure standards. It is also rare that a company can effectively communicate its business development to investors.

Although the above problems relate to the business sector, The way to change investor's sentiment towards the market in general is to originate the reform of the corporate governance. Practices can not be improved without changes in legislation.

Other factors, that are influencing good corporate practices, - transparency and predictability at the corporate level, are also very poor. Investors want to see the management with a modern work ethic, which is well positioned to facilitate good returns on investment over a short and long term and which possesses trained and motivated staff. In this light equity financing is not and can not be a wide practice for Georgia, though equity market is not new to this country. Under this condition the reforming of corporate governance is not an end in itself but the way to make enterprises more attractive for investors both local and foreign.

Role of Banking Sector in Industry.

Based on AA/GCG experience with audits of banking Georgian clients we are not aware if any bank has substantial (or even minority) equity investments in industrial sector. Vise versa some banks are owned by the companies (or people) who control industrial enterprises and companies. We cannot claim at all that in Georgian industrial and financial capital merge together, and therefore, based on our experience, we are not aware of any corporate groups with participation of the banks.

The most significant source of financial resources for the Georgian banks (as well as for industrial enterprises – especially in the energy sector of economy) is the long-term credit facilities of International Financial Institutions (World Bank, EBRD, IFC etc.). The banks actively participate in lending of industrial sector, so lending operations are the most significant active operations of the Georgian banks. As a rule such loans are short term and not longer than 1-2 years.

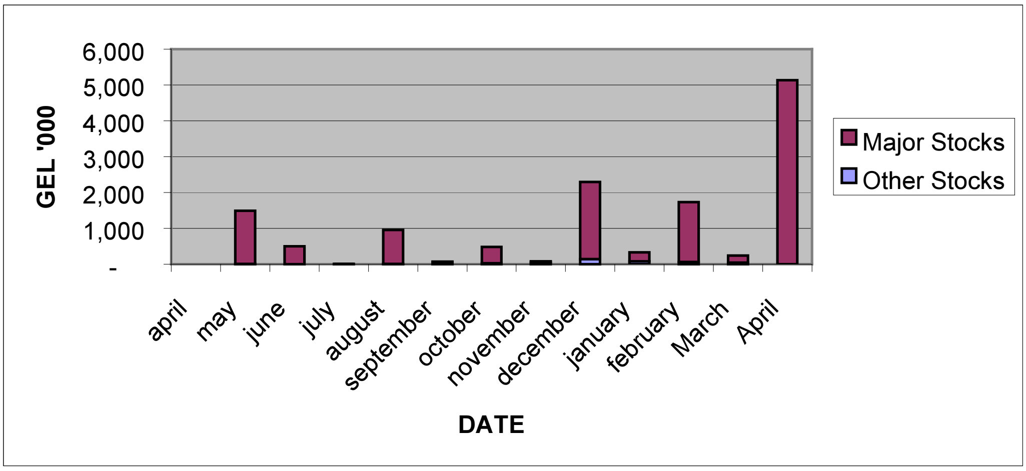
As explained above, the corporate debts of Georgian enterprises consist of short-term or middle term financing from the local banks and long-term resources of International Financial Institutions. Operations with securities have very immaterial volume and enterprises do not use such instruments as bonds, etc.

Equity Market

Equity market is regulated by the Law of Georgian on Securities Market.
Georgian Stock Exchange was created in April 2000 with the assistance of Barents Group and USAID's Capital Markets Development Project. This is a two-tier market with Trading and Listing tiers. There are 270 companies on trading tier and none on Listing tier, provided requirements for listing are yet unattainable for Georgian companies. The fact of low volumes on the Exchange is attributed to undeveloped environment and poor dealer/brokers. There are 37 brokerage companies.

There are two trades a week on an Exchange (total of 120 trades from the date of foundation). Daily trade volumes greatly differ from each other. Total volume of trades amounted to GEL 10 million (appr. USD 5 million). There is not a single precedent of stock valuation, which makes stock prices unreal. In fact, out of 270 stocks admitted on the exchange there are three to five stocks which are in an active trade. These stocks are United Georgian Bank (UGB=0.456), Bank of Georgia (GEB= 1.959) and Tbilisi Central Superstore (UTB=1.000). Here is a dynamics of trades on an Exchange.

Chart 4.1. Volumes of Trade



From the date of creation of the Exchange the 70 percent and 17 percent of total volume is attributed to UBG and GEB respectively.

In the table below, we present monthly contributions of these stocks to Exchange's total volume of trades.

Table 4.1. Volumes of Trade

In Gel '000									
Months	**Major Stocks**					**Total Major**	**Other Stocks**	**Total Trades**	**% of Major in Total**
	UGB	**GEB**	**UTB**	**TEPU**	**HAJR**				

Apr, 00	1					1		1	100
May, 00	1,485					1,485	9	1,494	99
June, 00	499					499	4	504	99
July, 00							10	10	2
Aug, 00	22	924				946	10	956	99
Sep, 00				30		30	42	72	42
Oct, 00	345	78		30		453	30	482	94
Nov, 00		39				39	42	81	48
Dec, 00	2,151					2,151	140	2,292	94
Jan, 01			248			248	79	327	76
Feb, 01	12	1,673				1,685	60	1.733	97
Mar, 01	5	32	4		147	187	48	237	80
Apr, 01			5,132			5,132	47	5,179	99
Total	**4,521**	**2,746**	**5,384**	**60**	**147**	**12,857**	**521**	**13,370**	**96**

Audit as a mean to exercise corporate governance

At large, the corporate governance in Georgia as well as in other Former Soviet block countries is a new concept. A trusting relationship between management and minority shareholders is critical. In most of the Georgian corporations key managers have the majority ownership in equity and therefore they are principal decision-makers in such enterprises. One of the sound principles of corporate governance is an open communication with shareholders through provision of audited accounts, and information about the progress and operations of the company. Contrary to this principle, major shareholders acting at the same time as key managers do not need an unbiased monitoring of company performance and do not very often use outside auditing services as a mean for minority shareholders to control management's performance. At the same time, a non-existence of high quality control and supervision of auditing activity is another drawback of current corporate governance. As a result JSC with managing shareholders only seek to obtain any kind (even of very poor quality) audit reports to satisfy requirements of statutory audit.

Auditing activity and licensing is regulated by the Audit Council of the Parliament of Georgia. This body is regulated and supervised by Budgeting and Finance Committee of the Parliament of Georgia. It holds absolute authority to carry out licensing activity for auditors. This body also provides training courses for auditors and issues certificates as a compulsory step for further licensing examination. The alternative professional body for monitoring of accounting and auditing activity is Georgian Professional Federation of Accountants & Auditors (GPFAA). It is generally acknowledged that GPFAA provides training courses and that graduates of GPFAA have better knowledge and ground for further practice. Nevertheless, graduates of this program are not authorized to take licensing examination. Instead, they need to take Audit Council's courses in order to be admitted to the licensing examination. In this light it is doubtless, that rising recognition of GPFAA and high quality of its training courses require updating of licensing procedure in favor of GPFAA.