Why Does Corporate Governance Matter

Workshop on Corporate Governance Reporting

Indonesia
June 2014
Discussion Points for Our Session

• What is Corporate Governance?
• Its Relevance to the Indonesia?
• Why Should Journalists Care?
• The Media Guide
• Case Study

“Corporate governance is at the heart of what goes right and wrong in business.”

John Plender
Member of PSAG and senior editorial writer and columnist for the Financial Times
Why Does Corporate Governance matter?

“No transparency, no trust; no trust, no credit; no credit, no investment; no investment, no growth. There is a simple logic: corporate governance and financial reporting are an essential building block for financial intermediation, foreign investment, and sustainable economic development.”

Martin Gruell, CFO and member of management board, Raiffeisen Bank International AG
Key Factor in Economic Development

Improvements in corporate governance quality lead to higher GDP growth, productivity growth, and the increased ratio of investment to GDP.

When a country’s overall corporate governance and property rights systems are weak, voluntary and market corporate governance mechanisms have limited effectiveness. Proper regulatory framework and enforcement mechanisms are crucial to promote good CG practices.

“Good governance is an essential part of a fair and transparent business environment.”

Arthur Levitt
Senior Advisor, Carlyle Group; former Chairman of US SEC
Successive financial crises heightened political interest to intervene and mandate responses to public concerns

- Notably the East Asian, Brazil and Russian financial crises closely followed by the OECD CG Principles in 1999

- Then, Enron and various corporate calamities in the US followed by Sarbanes-Oxley in 2003

- If that was not enough, the global financial crisis of 2007/8 and numerous regulatory interventions globally

“Our system of oversight fails to account for how sensible individual choices can add up to collective disaster.”

John Cassidy
Capitalism and Financial Crashes
The New Yorker October 5, 2009
Leading to a Proliferation of Codes & Guidelines

...OECD core although markets saddled by perplexing multitude of competing principles and escalating complexity of issues

Dodd-Frank Act (2010): 2,319 pages and growing
Gramm-Leach-Bliley Act (1999): 145 pages
Interstate Banking Efficiency Act (1994): 61 pages
The Glass-Steagall Act (1933): 37 pages
Federal Reserve Act (1913): 31 pages

UK Corporate Governance Code
CG Codes and Rules are important but implementation is key...

Corporate governance frameworks may be sound, yet:
- Their application is often distorted
- They guarantee compliance, not behavioral change

Many difficulties and challenges arise:
- Political interference, resistance from vested interests
- Lack of resources and capacity to implement good CG
- Lack of awareness, understanding among market participants as to benefits of good CG
- Underdeveloped or outdated legal and regulatory framework

Successful implementation requires a change in mindset and behavior

.....in the end, corporate governance is about what people in privileged or responsible positions actually do (or don’t do) with other people’s (e.g. shareholders’ and taxpayers’) money
Why is Corporate Governance Important?

Numerous studies have confirmed the importance of good Corporate Governance on firm performance and access to finance. This is important for our own IFC investments - but also to help catalyze investment across the markets we are striving to develop in emerging markets.

- **Improved Operational Performance**
  Emerging market companies with good governance rated 8 percentage pts higher vs. peers in EVA (Credit Lyonnais, 2001)

- **Improved Risk Management**
  Companies with superior governance had much lower risk profiles (Brown, 2004)

- **Higher Firm Valuation & Share Performance**
  Investors willing to pay premium up to 40% for well-governed companies (McKinsey, 2001)

- **Better Access to Capital**
  Strong correlation between good governance and lower capital costs (Dyck & Zingales, 2004)

- **Improved Sustainability**
  Helps address family governance issues for Family-Owned Enterprises and ease succession to future generations.

Investors willing to pay a premium for strong corporate governance?

- Latin America: Yes, 76%
- North America: Yes, 76%
- Asia: Yes, 78%
- Western Europe: Yes, 78%
- Middle East: Yes, 77%

How much of a premium are Investors willing to pay?

An avg. premium of 20%


Empirical evidence has shown that companies scoring poorly have an increased likelihood of experiencing financial distress and often must pay nearly 20 basis points more on bank loans than firms scoring well.
Its Relevance to Indonesia?

“If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere.”

Arthur Levitt, former Chairperson of the US Securities and Exchange Commission
Why CG Matters in Indonesia

Indonesia has enjoyed record growth and significant FDI and capital inflows over the past five or so years [ACGA CG Watch 2012] but...

- Lags the region in fundamental CG rules and practices
- Absence of “CG culture” among listed companies
- Regulatory enforcement regarded as weak and disclosure considered poor
- Government support for CG considered to be absent while Central Bank strong other agencies/institutions weak and under resourced
- High audit and accounting standards but weak audit quality is a prevailing view

...however, lot of interest in establishment of OJK and director associations working hard to advance good corporate governance practices
“The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including its financial situation, performance, ownership, and governance of the system.”
### Indonesia’s Low Ranking......Perception or Reality?

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<tbody>
<tr>
<td>Singapore</td>
<td>65</td>
<td>67</td>
<td>69</td>
<td>(+2)</td>
<td>Improving, but culture needs to open more</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>67</td>
<td>65</td>
<td>66</td>
<td>(+1)</td>
<td>Static, but reinvigorated regulator positive</td>
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<tr>
<td>Thailand</td>
<td>47</td>
<td>55</td>
<td>58</td>
<td>(+3)</td>
<td>Improving, but corruption a major issue</td>
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<tr>
<td>Japan</td>
<td>52</td>
<td>57</td>
<td>55</td>
<td>(-2)</td>
<td>Government stalling, companies opening</td>
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<tr>
<td>Malaysia</td>
<td>49</td>
<td>52</td>
<td>55</td>
<td>(+3)</td>
<td>Culture at last showing signs of openness</td>
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<tr>
<td>Taiwan</td>
<td>54</td>
<td>55</td>
<td>53</td>
<td>(-2)</td>
<td>Rules improving, but still behind the curve</td>
</tr>
<tr>
<td>India</td>
<td>56</td>
<td>48</td>
<td>51</td>
<td>(+3)</td>
<td>Enforcement up, Delhi an obstacle</td>
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<tr>
<td>Korea</td>
<td>49</td>
<td>45</td>
<td>49</td>
<td>(+4)</td>
<td>Government more open, companies less so</td>
</tr>
<tr>
<td>China</td>
<td>45</td>
<td>49</td>
<td>45</td>
<td>(-4)</td>
<td>Rules improve, but culture still weak</td>
</tr>
<tr>
<td>Philippines</td>
<td>41</td>
<td>37</td>
<td>41</td>
<td>(+4)</td>
<td>Improving, but will it be sustained?</td>
</tr>
<tr>
<td><strong>Indonesia</strong></td>
<td><strong>37</strong></td>
<td><strong>40</strong></td>
<td><strong>37</strong></td>
<td><strong>(-3)</strong></td>
<td><strong>Regressing, but new regulator (OJK) may help</strong></td>
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Source: “CG Watch” surveys, Asian Corporate Governance Association & CLSA Asia-Pacific Markets
ASEAN CG Scorecard...Game Changer?

Average

CG Scorecard: Results for Indonesia
So.....why should Journalists care?

“Most governance problems can be traced to a lack of ethical values at some level of the organization. Boards can change corporate culture through example and action.”

Paul O’Neill
Special Advisor, Blackstone
former Secretary of the US SEC
What Informs the CG System?

**PARTIES**
- Stakeholders
  - Employee
  - Unions
  - Customers
  - Suppliers
  - NGOs

**INFLUENCERS**
- Laws and regulations
  - Companies Act
  - Securities law
  - Listing requirements
  - Insolvency law,
  - Markets’ listing rules

**Reputational Agents**
- Accountants
- Lawyers
- Credit-rating agencies
- Investment bankers
- Financial media
- Investment advisors
- Governance analysts

**SHAREOWNERS DIRECTORS MANAGERS**
CASES OF COMPANY SCANDALS

PT. Anugerah Nusantara
PT Anak Negeri
Political Connection

Deutsche Bank, US
Tax fraud shelter

OLYMPUS
Your Vision, Our Future
Lack of transparency and disclosure

Enron
Accounting Fraud

MCI
Accounting Fraud

Tunneling

PT. Hardaya Inti Plantations
Kickbacks

Peregrine Investment
Holding, HK
Non transparency

Accounting Fraud

Insider Trading

Trading Huddles

Ponzi Schemes
Some Thoughts on why it should matter

- People want to look good
- They want credit when things go well.
- They don’t want all the blame when it goes wrong
- So.............what does this mean?
- They have motivation to speak to you
- Motivation = potential sources

- There are many sources
  - Competing companies
  - Other news sources e.g. social media, LinkedIn, blogs, etc.
  - Regulatory offices and public-source information e.g. stock exchange
  - International news sources

- **Show you are Pro**, gain confidence in market as reliable, discrete and reporter of interesting stories and news positions
It Doesn’t have to always be Sensational or a Scandal......

- Model stories on reputable business leaders
  → Local and internationally relevant to the region, e.g. Jack Welsh, <ark Mobius

- What was their greatest success, what was their biggest mistake and why............successful people like to talk about themselves

- What is the political angle.........always interesting in emerging markets like Indonesia

- What events are taking place overseas, how is this relevant to Indonesia.......can it happen here e.g. Lehman Bros collapse

- New CG Code for Indonesia, is it covering all the issues and concerns you observe in the market

- .........................and, so on!
Pillars of Corporate Governance

Accountability
- Ensure that management is accountable to the board
- Ensure that the board is accountable to shareowners

Fairness
- Protect the shareowners’ rights
- Treat all shareowners, including minorities equitably
- Provide effective redress of violations

Transparency
- Ensure timely, accurate disclosure on all material matters, including:
  - the fiscal situation
  - performance
  - ownership
  - corporate governance

Responsibility
- Recognize shareholders’ rights
- Encourage cooperation between the company and shareholders in creating wealth, jobs, and economic sustainability

Essential Elements for a Well Functioning Board

Good Board Practices
Effective Control Processes
Transparent Disclosure
Well-defined Shareowner Rights
“The case for training journalists in corporate governance is...that good governance is fundamental to public trust in wealth creation and to the legitimacy of whatever form of capitalism a country pursues. From an economic point of view, good governance is a key to ensuring stable capital inflows into emerging markets.”

John Plender, Lead Writer for the Financial Times and member of the Private Sector Advisory Group
Overview of the CG Media Training Program

This program constitutes an important part of IFC’s efforts to raise awareness of the issues and advance good corporate governance practices in emerging markets and developing countries.

Program Objectives

- To draw on journalists’ unique ability to disseminate information on corporate governance to the business community and to the wider reading public, and to make readers aware of company activities that can have significant impact on society
- To increase the awareness level of media business owners and their board members on the importance and benefits of corporate governance.

Progress to date

- 10 language translations of the Media Guide (French, Arabic, Bahasa Indonesia, Bulgarian, Farsi, Mongolian, Portuguese, Russian, Spanish, Vietnamese)
- Over 25 regional/country media workshops/seminars delivered globally in partnership with IFC CG Regional Programs and external partners
- Close to 350 journalists trained across all regions with trainers from Thomson Reuters Foundation, Agence France Presse Foundation, Financial Times, ICFJ
Corporate governance needs journalists:
• Act as a monitor against abusive practices by management, directors or controlling shareholders
• Highlight good practices and expose poor or questionable conduct

Business journalists need to know corporate governance:
• Many journalists already report on corporate governance without realizing it
• If you cover companies, you need to know how they are governed and controlled ...... ......and, for whose benefit
• CG stories can serve an extremely varied audience which includes consumers, investors, taxpayers, business leaders, directors, regulators, policymakers, etc.
• CG stories are ultimately about people, money and power = interesting to readers
Role of the Media

- To serve your readers/listeners/viewers
- To challenge business leaders, politicians, regulators, and others that influence the governance of private and State companies
- To report on issues that get little publicity, balance, compare and contrast views, opinions and inform/educate
- To not just report results but inform and investigate what goes on in companies that might be of public interest/concern
- To create a climate of discussion and influence policy makers
- To contribute to an environment of good governance and sound economic management through monitoring and reporting
Thank You!

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