Corporate Governance in a Transition Economy: a Case Study of Russia

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Corporate governance has become a popular topic in recent years. Although much attention has been given to corporate governance in the United States and other Western countries as a result of recent scandals, and in Japan and other East Asian countries because of the financial crisis that occurred there a few years ago, much has also been going on in Russia and other transition economies in the area of corporate governance. This paper discusses recent developments in corporate governance in Russia and includes information gathered during interviews conducted in Russia during the summer of 2003.

Introduction

Corporate governance has become an important topic in Russia and other transition economies in recent years. Russian directors, owners and corporate managers have started to realize that there are benefits that can accrue from having a good corporate governance structure. Good corporate governance helps to increase share price and makes it easier to obtain capital. International investors are hesitant to lend money or buy shares in a corporation that does not subscribe to good corporate governance principles. Transparency, independent directors and a separate audit committee are especially important. Some international investors will not seriously consider investing in a company that does not have these things.

Several organizations have popped up in recent years to help adopt and implement good corporate governance principles. The Organisation for Economic Cooperation and Development, the World Bank, the International Finance Corporation, the U.S. Commerce and State Departments and numerous other organizations have been encouraging Russian firms to adopt and implement corporate codes of conduct and good corporate governance principles.

Review of the Literature

Hundreds of articles and dozens of books have been written about corporate governance in the last few years alone. One book that should be mentioned is *Corporate Governance*, which is edited by Monks and Minow. This book is required reading for the ACCA Diploma in Corporate Governance program. Davis Global Advisors publishes an annual *Leading Corporate Governance Indicators*, which measures corporate governance compliance using a variety of indicators.

The Cadbury Report (1992) published the findings of the Committee on Financial Aspects of Corporate Governance. The Greenbury Report (1995) discusses directors' remuneration. The Hampel Committee Report (1998) addresses some of the same issues as the Cadbury and Greenbury reports. It has separate sections on the principles of corporate governance, the role of directors, directors' remuneration, the role of shareholders, accountability and audit and issued conclusions and recommendations. The *Encyclopedia of Corporate Governance* is a good reference tool for obtaining information on corporate governance. It is available online. The OECD's *Principles of Corporate Governance* (1999) has been used as a benchmark for a number of corporate governance codes in transition economies. OECD has also published a *Survey of Corporate Governance Developments in OECD Countries* (2003). The European Corporate Governance Institute maintains many links to codes of corporate conduct for many countries on its website.

Several academic journals are devoted either exclusively or partially to corporate governance issues. The following four journals are devoted exclusively to corporate governance issues:

! Corporate Governance: An International Review;

! Corporate Governance: International Journal of Business in Society;

- Journal of Management and Governance;
- Corporate Ownership and Control.

Governance is an international monthly newsletter devoted exclusively to corporate governance issues. *Economics of Governance* also publishes articles on corporate governance, in addition to articles on governance in the nonprofit and governmental sectors.

Several websites are also devoted to corporate governance issues and contain many articles, research papers and reports on a wide variety of corporate governance issues. These include:

- British Accounting Association Corporate Governance Special Interest Group;
- Corporate Monitoring;
- European Corporate Governance Institute;
- Global Corporate Governance Forum;
- International Corporate Governance Network;
- Organisation for Economic Cooperation and Development;
- World Bank.

Within the field of corporate governance literature is a subfield of corporate governance in transition economies. The OECD has published a *White Paper on Corporate Governance in South Eastern Europe* (2003) that is used for guidance by enterprises in that part of the world. This *White Paper* contains sections on shareholder rights and equitable treatment, the role of stakeholders, transparency and disclosure, the responsibilities of the board, and implementation and enforcement. Much of what is contained in this *White Paper* is applicable to corporate governance in Russia as well, although the *White Paper* is not specifically addressed to Russian enterprises.

The OECD website section on corporate governance is subdivided by country. There is a link for Russia that contains studies, papers and announcements pertaining to Russia. One important paper is the OECD's *White Paper on Corporate Governance in Russia* (2002), which contains recommendations for improving corporate governance in Russia. The Russian Corporate Governance Roundtable website also contains documents and announcements pertaining to corporate governance in Russia. The International Finance Corporation, which is affiliated with the World Bank, has a Russia Corporate Governance Project. Its website provides up to date information about several aspects of corporate governance in Russia. The Global Corporate Governance Forum website provides links to more than 60 organizations that are involved in corporate governance issues.

Several Russian organizations also have websites and publication on corporate governance. The Russian Institute of Directors website contains news items and well as publications. Some of its publications and links include a *Code of Corporate Governance* (2002), several Foreign Best Practices Codes and several corporate codes of conduct. They also publish surveys and provide training for corporate directors in Russia. The Independent Directors Association also has a website that provides current information and various documents on corporate governance, mostly pertaining to directors. It also publishes a newsletter, which is available on its website. The Institute of Corporate Law and Corporate Governance also has a website that contains publications about corporate governance in Russia. One of its studies is *Managing Corporate Governance Risks in Russia* (2002). It also provides corporate governance ratings of Russian firms.

Methodology

Research for this paper began with a review of the literature. When the review was completed, a list of tentative questions was formulated. Experts on corporate governance in Russia were then contacted and interviews were scheduled. Interviews with the following organizations were conducted in July and August 2003:

- Deloitte & Touche, Moscow office [www.deloitte.ru]
- KPMG, Moscow office [www.kpmg.ru]
- KPMG, St. Petersburg office [www.kpmg.ru]
- PricewaterhouseCoopers, Moscow office [www.pwcglobal.com/ru]
- Ajour, a Russian auditing and consulting firm, Moscow [www.ajour.ru]
- PKF (MKD), a Russian audit and consulting firm, St. Petersburg office [www.mcd-pkf.com]
- Independent Directors Association, Moscow [www.independentdirector.ru]

This paper incorporates the information gathered during those interviews. The information gathered from these interviews was combined with information that was already published and available. While much of the information gathered during the course of the interviews confirmed what the existing literature already said, much new information was gathered that filled in the gaps in the existing literature and extended and updated prior studies in several important ways.

Corporate Governance Activity in Russia

Corporate governance is in its formative stages in Russia. Like other economies transitioning from a centrally planned economy to a market economy, Russia is going through rapid changes. Transparency in financial reporting is a relatively new concept. The Russian culture and mentality feel more comfortable with secrecy and prefer not to disclose anything they do not have to disclose.

A survey conducted by PricewaterhouseCoopers of transparency in 35 countries ranked Russia number 34, just ahead of China [Haigh 2001]. With such a lack of transparency it is little wonder why Russian firms find it so difficult to raise foreign capital. Russia is attempting to overcome this problem by instituting good corporate governance principles such as the appointment of independent directors, establishing audit committees and insisting on more financial disclosure.

Change in the Russian attitude toward transparency and full disclosure is taking place mostly because of the need for foreign capital. Foreign investors hesitate to invest in a company that does not disclose all important financial information. Russian companies found they had to compete for capital in international financial markets and that was the impetus for change.

Some major changes have already taken place, although there is still much work to do. A few private sector organizations have been formed to assist Russian companies upgrade their corporate governance structure to meet international standards. The Russian Institute of Directors and the Independent Directors Association are both engaged in educating Russian directors and monitoring Russian corporations. The International Finance Corporation (IFC), a World Bank funded organization, is devoting substantial resources into its Russia Corporate Governance Project. The Organisation for Economic Cooperation and Development is sponsoring conferences, publishing White Papers and conducting research to help Russian companies upgrade their corporate structures as well. The United States Agency for International Development (USAID) and other organizations have also supported corporate governance initiatives. The International Trade Administration and the IFC developed a charter of basic principles.

Each of the Big-4 accounting firms – Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers – are also actively engaged in educating corporate directors and top management about the need for good corporate governance. The education process is part of their regular client service. All four firms have newsletters or other kind of educational documents that they distribute to their clients to educate them and keep them up to date on various accounting and corporate governance issues.

The Independent Directors Association (IDA) was formed in 1998, shortly after Russia's financial default. Its stated mission is to establish a community of independent directors. Foreign and Russian investors who used intermediaries to buy shares found their property was disappearing. Brokers and dealers had to do something but they didn't know what to do. One option was to sue, using the class action approach but this option did not exist in Russia. Also, lawsuits are not an efficient way of recovering property in Russia. The Independent Directors Association was developed as a vehicle to protect investors. It is a coordination center.

IDA pushed for the election of independent directors to represent minority shareholders. It advocated unanimous voting on corporate boards so that even one dissenting vote could prevent a measure from passing. The large Russian corporations balked at this provision, since they thought such a provision would result in having their corporation run by minority shareholders. Gasprom, a state owned monopoly, was especially vigorous in its opposition to this provision.

The IDA has also been pushing for Russian corporate boards to have subcommittees to perform various functions. Having subcommittees like a compensation committee or an audit committee is a new concept for many Russian companies but one they are not opposed to. The IDA has been pushing to have the audit committee composed exclusively of independent directors. There is some external pressure for Russian companies to have independent directors, especially on the audit committee. The New York Stock Exchange has given nonresident companies two years to comply with NYSE rules as a condition of having their stock listed on its exchange. One of its requirements is to have independent directors on the audit committee. One important factor investors look at when determining whether to invest in a Russian company is whether the company has independent directors. If it does not, the company is much less attractive as a potential investment.

As a coordination vehicle, the IDA acts as a facilitator. It brings interested parties together and disseminates information. At the time of the interview, it had 30 investment banks and hedge funds as members. As of September 2003 it opened up membership to corporations as well. It also has contacts with each of the Big-4 accounting firms as well as smaller accounting firms and representatives of the various Russian stock exchanges. It has also formed a relationship with the National Association of Corporate Directors in the United States. The IDA also gives awards each year for the company with the best financial statements. The award looks at disclosure and transparency, not the bottom line or financial ratios.

The New York Stock Exchange and the London exchange are the two main targets for Russian companies in need of foreign capital. The IDA has established a relationship with both of these exchanges as well as Standard & Poors. Whether Russian companies issue financial statements using U.S. Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS) depends on which of the two exchanges they are targeting. Companies that want to raise capital in the United States tend to prepare GAAP statements, whereas those that want to raise capital in London tend to issue IAS statements.

In the last few years there has been a shift away from GAAP statements toward IAS statements. The reason given in the interviews was that in a post-Enron world, U.S. accounting standards are seen as being of lower quality or less reliability than International Accounting Standards. Since the Russian Finance Ministry has ordered Russian companies to adopt IAS effective January 1, 2004 (one year before the EU), this trend away from GAAP statements is likely to continue. However, GAAP statements may not disappear altogether from Russian company financial reports. Russian companies that are affiliates of a U.S. company is still likely to prepare financial statements based on U.S. GAAP, since it is more likely to try to raise capital at one of the New York stock exchanges than the London exchange.

Standard & Poor's initiated a pilot project out of its London office to measure the extent to which Russian companies complied with certain corporate governance attributes. It chose five Russian companies and scored them based on a variety of factors. The four key components the S&P study scored were:

! Ownership structure;

! Relations with shareholders and shareholder rights provisions;

! Financial transparency and information disclosure; and

! The structure of the board of directors. [Feinberg 2000]

It used the following 16 corporate governance criteria to arrive at the scores for each company:

1. Ownership structure and influence;

2. Transparency of ownership;

3. Concentration and influence of ownership;

4. Financial stakeholder relations;

5. Regularity of, ease of, access to, and information on shareholder meetings;

6. Voting and shareholder meeting procedures;

7. Ownership rights (registration and transferability, equality of ownership rights);

8. Financial transparency and information disclosure;

9. Type of public disclosure standards adopted;

10. Timing of, and access to, public disclosure;

11. Independence and standing of auditor;

12. Board and management structure and process;

13. Board structure and composition;

14. Role and effectiveness of board;

15. Role and independence of outside directors; and

16. Board and executive compensation, evaluation and succession policies. [Anon. 2000/2001]

The Standard and Poor's study came about partly because of the McKinsey & Co. Investor Opinion Study of June 2000, which concluded that:

> *"Three quarters of investors say board practices are at least as important to them as financial performance when they are evaluating companies for investment, especially in emerging markets… Over 80% of investors say they*

> *would be prepared to pay more for the shares of well-governed companies than those of poorly governed companies." [Anon. 2000/2001]*

The methodology it used could also be applied to companies in other countries, making it possible to compare a Russian company to a company in a developed market economy. The pilot project proved to be so successful that S&P plans to expand it to rate companies worldwide based on their adherence to corporate governance principles.

Weaknesses in Corporate Governance

Russia has a well earned reputation for poor corporate governance. As of 2001, the largest Russian companies still hid their assets and cash flow from minority shareholders. Gazprom, Russia's largest company, ignores the legal requirement of an independent audit. Lukoil, Russia's largest oil company, routinely issues its financial statements months beyond promised deadlines, and when it finally did issue some financial statements, they were unaudited statements covering just a six-month period rather than the full year statements that investors were expecting. [Anon. 2001a].

Various private groups have issued codes of corporate governance that set out principles to be followed by boards and corporate officers. These codes provide guidance and attempt to raise the ethical quality of Russian executives to that of Western company executives. The Russian Duma has passed laws tightening up corporate governance requirements. But laws and voluntary (or even mandatory) codes of corporate conduct are not enough. Merely making rules and laws will not necessarily result in good actions by board members. Rules are useless without ethics. One of the positive aspects of the Code of Corporate Conduct that was prepared under the direction of the Federal Commission for the Securities Market (FCSM) is that ethics are stressed. The Code is imbued with ethics [Metzger et al. 2002].

Merely passing laws is not enough, either. A study by Pistor, Raiser and Gelfer [2000] concluded that the effectiveness of legal institutions is much more important than having good laws on the books. Transplanting Western laws into transition economies and having extensive legal reforms are not sufficient to strengthen corporate governance, although such things are necessary.

Protecting Shareholders

Shareholders in every country are in need of protection, but especially so in Russia and other transition economies that have not yet established a strong rule of law and corporate legal principles that protect shareholders, especially minority shareholders. Until a few years ago, minority shareholders were not only totally ignored but actually abused by the Russian companies they owned shares in. It was a common practice for Russian companies to manipulate shareholder registries or even erase their names from the corporate registry [Metzger et al. 2002] and funnel money into an intricate web of shell companies, thus depriving minority shareholders of cash flow. Management would sell off assets to entities they controlled indirectly, depriving minority shareholders of value [Iskyan 2002]. Such practices became less severe after the Russian Duma enacted legislation to protect minority shareholders, but it would be premature to say that such practices have stopped altogether. The rule of law is still weak in Russia. It is difficult to protect property rights in a country where property rights did not exist for three generations.

The Independent Director Code

As was previously mentioned, a number of corporate governance codes have been developed in the last few years, both by international organizations and by Russian organizations. The Independent Director Code is one of them. This code was developed by the Independent Directors Association jointly with the Russian Institute of Directors in partnership with Moscow Interbank Currency Exchange, the International Finance Corporation and the Good Governance Program of the International Trade Administration of the U.S. Department of Commerce.

Russian Code of Corporate Conduct

The Russian Institute of Directors [RID] issued the final version of its Corporate Governance Code in April 2002. Although Russian law deals with many aspects of corporate governance, the laws that are on the books were considered to be inadequate to deal with certain issues that are not of a legal nature. Furthermore, it was recognized that the law should not try to address all issues relating to corporate governance, since some things legitimately lie outside of the law, such as private contract and management issues. Also, the legal system is not designed to respond to rapidly changing conditions. Thus, the need was felt for a corporate governance code to provide the needed guidance.

The Code contains a list of recommendations for best practices and incorporates many of the recommendations included in various OECD publications. Chapter 1 states that corporate governance should be based on respect for the rights and lawful interests of all participants and mentions trust as a primary ingredient of good corporate management. In the past, shareholders at some Russian companies have found it difficult or impossible to exercise their rights. The Code states that shareholders should be provided with the means of registering their shares and they should also be given the opportunity to quickly dispose of them. Shareholders should be notified of shareholder meetings and should be able to attend. They should be able to easily vote their shares. Sec. 1.4 states that shareholders should have the right to receive regular and timely information about the company. This can be accomplished by:

! providing shareholders with comprehensive information on each item of the agenda in preparation for a general shareholders meeting;

! providing information that is sufficient for evaluating the results of operations, such as an annual report; and

! establishing the position of corporate secretary, whose job it will be to ensure that shareholders have access to information about the company.

Such provisions may seem bland and obvious to readers from developed market economies, but the reason why such provisions were included in the very first chapter of the Code was because of the widespread abuse of shareholders in regard to exercising shareholder rights and having access to corporate information.

Chapter 2 addresses the rules and procedures that should exist regarding the general shareholders meeting. Procedures for holding a shareholders meeting must be put in place and shareholders must be treated fairly and given the opportunity to participate in such meetings. At least 30 days notice should be given before every meeting, even though the law requires that only 20 days notice be given. The notice should contain sufficient information to allow shareholders to make informed decisions regarding the issues and to decide whether, and to what extent they shall participate. Agenda items should be stated clearly so that there is no misinterpretation as to their meaning. Meetings should be held at times and places that are convenient for shareholders. There are rules about quorums and what to do if a company has a large number of small shareholders.

Chapter 3 addresses issues relating to the duties of the board of directors. The Board is supposed to provide efficient supervision of the company's financial and business operations, safeguard and protect the rights of shareholders and help resolve corporate conflicts. There are three categories of director – executive, non-executive and independent. An independent director is one who:

! has not been an officer or employee of the corporation for at least three years;

! is not an officer of another company in which any company officer is a member of the appointments and remuneration committee of the board;

! is not affiliated with the company's managing organization;

! is not bound by certain contractual obligations with the company;

! is not a major business partner of the company; and

! is not a representative of the government.

There are also provisions prohibiting the gainful use of insider information, provisions discussing the duties of the audit committee and the ethics committee and the liability of board members.

Chapter 4 discusses executive bodies of the company, which are charged with managing the company's current affairs, making them responsible for attaining the company's objectives and goals and implementing the company's strategies and policies. Chapter 5 outlines the duties and responsibilities of the corporate secretary. The secretary is responsible for preparing and holding the shareholders' meeting as well as for a wide range of other activities involving shareholders.

Chapter 6 is about major corporate actions that result in fundamental corporate changes, such as a change in the rights of shareholders, reorganizations, acquisitions and liquidation. Chapter 7 addresses issues relating to disclosure about the company. The enterprise's policy should guarantee low cost and unhampered access to information. A great deal is said about the forms that disclosure should take. There are discussions about the information that should be included in the annual and quarterly reports and about the necessity to disclose all relevant information to shareholders in a timely manner. The annual report should include:

! the company's position in the industry;

! attainment of the firm's strategic objectives;

! annual results, both actual and planned;

! prospects for the company's development, which includes discussions of sales, productivity, market share, income generation, profitability and the debt/equity ratio;

! major risk factors;

! relations with competitors; and

! review of the company's most significant transactions during the prior year.

Chapter 8 discusses supervision of company's financial and business operations. There are sections on the organization of activity of the audit committee, the actual audit and the need for an independent, certified audit. Chapter 9 discusses dividends and dividend policy and suggests that the company implement a transparent and easily understood mechanism for determining the amount of dividends to be paid and the payment strategy. Chapter 10 discusses the resolution of corporate conflicts.

The interviews revealed that corporate codes of conduct are becoming increasingly popular. One might think that adopting a corporate code of conduct would be a major positive step, which it well may be. However, the interviews also revealed that many corporations either do not have a corporate code of conduct or, if they do have one, tend to ignore it. Adopting such codes is sometimes seen as a public relations gimmick, something to be brought out and displayed to the financial community, but not something that can be referred to and used to manage or guide the corporation. If this is true, it means that much must be done before substantive change can be achieved.

Concluding Comments

Russian financial statements still suffer from a lack of transparency. It is difficult to overcome generations of Russian culture and the Russian mentality, which prefers secrecy to disclosure. But the trend is toward more transparency, more independent directors and financial statements that have a degree of international credibility.

Poor corporate governance policies cause the shares of Russian firms to sell for $54 billion less than they would if their companies had good corporate governance policies, according to James Fenkner of Troika Dialog, Russia's largest brokerage firm [Anon. 2001a]. Bernard Black, using data from Troika, conducted a study to determine whether corporate governance matters, in terms of share price. He found that it made a huge difference [Black 2001]. Likewise, Russian companies that improved their corporate governance practices by adopting and implementing the Corporate Governance Code saw their share prices increase [Miller 2002].

However, much still needs to be done. It is difficult to superimpose a corporate code of conduct on the Russian culture, especially if the code is drawn up by foreigners. Codes of conduct and the corporate governance policies they espouse will only take a firm hold in Russia when a significant number of Russian directors and managers actually believe that having and utilizing such codes is the right thing to do.

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