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CORPORATE STRATEGY

GOOD GUYS FINISH FIRST

For companies that have adopted strong controls since 1997, the bottom line is looking better.

By Steven Crane

The company directors at family-run Hong Kong-based Pioneer Industries International have a nasty habit of thumbing their noses at shareholders. Despite a six-fold increase in the company's net loss for the year ending March 31, 1999, directors awarded themselves a performance-related pay increase which in some cases totalled 300 percent. And in November, those same directors at Pioneer sold HK\$552 million worth of assets to a second company owned by another branch of their family. Had the sale taken place three years ago, as minority shareholders urged, the proceeds could have been in the billions of Hong Kong dollars. One analyst says: "Management's principal rationale [has been] to run the company like a private fiefdom for the benefit of the family and not for the benefit of external shareholders."

Unfortunately, Pioneer Industries is not an isolated case. Poor enforcement of corporate laws and regulations and a high concentration of corporate ownership - in short, corporate governance issues - were among the main reasons behind the Asian financial crisis, according to a recent study by the Asian Development Bank (ADB). "The corporate structure of Asian companies has given family-based owners and their affiliated companies excessive power to pursue their own interests to the detriment of minority shareholders, creditors and other stakeholders," states the ADB study of the five countries most affected by the crisis: Indonesia, South Korea, Malaysia, the Philippines and Thailand.

To address this, the ADB produced a list of recommended reforms last November, including broadening corporate ownership, strengthening corporate internal controls and shareholder protection. In addition, the ADB suggests improving external monitoring and bankruptcy procedures, developing Asian capital markets, and widening the sources of corporate financing from a heavy reliance on banks. "While the recession has largely bottomed out," says Manila-based ADB regional vice-president Myoung-Ho Shin, "we cannot afford complacency and must not allow inappropriate practices to remain unchanged."

Indeed, the results of poor corporate governance are only too apparent. From Thailand to Indonesia, says Hong Kong-based Patrick Ong, CFC at Ogden Aviation, there's growing recognition that the practice of ignoring shareholders and being less than truthful with accounts has already inflicted heavy damage. Because markets have the tendency not to reward bad habits, private lending for the five Asian crisis countries has all but disappeared. According to a report by the US-based Council on Foreign Relations, lending has changed from a net inflow of US\$65 billion in 1996 to a net outflow of US\$43 billion in 1998. One of the results of this US\$1 00 billion reversal, is that more than a quarter of all listed firms in South Korea, Malaysia and Thailand and nearly two-thirds in Indonesia are unable to service their debts. "Bad companies are feeling the heat," notes Ong, "and many have already disappeared." But a new generation of professionally trained finance people, Ong believes, should help assure that there's no return to the old days of cronyism and shareholder abuse.

Along with this new crop of finance executives comes a new definition of the scope of internal controls. Most competent CFOs already have a comprehensive internal control system in place that accounts for assets,

payables and receivables, etc. But what's developing now is a system that encompasses all controls - financial, operational and compliance.. with the stress on risk management. UK-based Chartered Institute of Management Accountants (CIMA) president David Meivill argues that because risks traditionally beyond the financial area, such as changes in consumer behavior, product obsolescence, and supply-chain management, for example, all represent threats to financial success, they should be subject to internal control systems. For CFOs, that means including these issues as part of the reporting loop.

Bottom's up

The result of all this good work, Melvill emphasizes, will be improved stakeholder confidence, risk reduction, better leadership, and performance stimulus. In other words, a better bottom line. According to a survey by US-based consulting firm McKinsey & Company, companies that performed well prior to strengthening corporate governance practices did even better afterwards. Those with poor performance to begin with, however, continued to decline following the implementation of only the minimum requirements. Still, putting an exact dollar value on corporate governance isn't easy. "There is unlikely to be any statistical link with corporate governance compliance," admits CIMA's London-based director technical services, Tony Dart.

That said, investors appear willing to pay a premium for companies that practice good corporate governance. According to the McKinsey study, 50 percent of respondents stated they would be willing to pay more for stock if one of the companies were well governed, given the choice between two well-performing companies. That's because companies with good board governance practices have a shareholder-value focus, says one respondent. Survey results show that the average premium among those willing to pay more was 16 percent, while based on the entire survey group, including those who said they wouldn't pay more, the average premium was 1.1 percent. Good corporate governance, then, not only serves to attract investors but can affect the price they're willing to pay.

While there's growing recognition among CFOs that good corporate governance pays off, the term itself was rare before 1980. Melvill describes the recent history of corporate governance as something like an Icelandic saga - a series of reports and guides of heroic proportion culminating in the 1999 publication of *Internal Control: Guidance for Directors on the Combined Code [on Corporate Governance]* (www.icaew.co.uk/internalcontrol). The report offers practical advice so that corporate board members are aware of their business risks and the procedures necessary to manage them. "We may have reached a situation," says Melvill, "where specific practical reports will show whether companies take internal controls seriously."

The Urge to De-list

Of course, rather than complying with the voluntary code, companies can simply de-list. Indeed, in the UK, 27 companies

Corporate Governance Checklist

Honesty is the best policy

- Obtain management buy-in at all levels of the organization
- Prepare a plan
- Identify clear company objectives
- Prioritize the risks to the achievement of the objectives
- Establish a clear risk management policy & control strategies
- Consult throughout the business
- Improve the business culture where appropriate
- Keep it simple and straightforward
- Monitor continuously

bought up
their shares
and went

- **Avoid audit committee overload**
- **Aim to obtain business improvement when implementing the guidance**

private in 1998 compared with seven in 1997 and four in 1996. Most of the companies, though, were relatively small with a market value each of less than US\$80 million. In Asia, too, there appears to be a growing move towards withdrawal from the market. Last July, Hong Kong-based department store Lane Crawford went private and in November, insurance company AXA National Mutual de-listed AXA China Region. Not having to deal with the cost and complexity of maintaining a listed status, says AXA's chairman Tony Killen, will allow more emphasis on business growth.

While the number of companies exiting the market hardly makes for a stampede, it does suggest that the burden of public accountability may be too much for some. Trend or not, Melvill expects more companies will strengthen corporate governance, rather than less.

The strongest pressure for change, of course, remains with investors. And investors in the region are smarter and more cautious these days about where they put their money. "Unless people are given the information they need," says former president of CIMA's Hong Kong division, Peter Wong, "they'll assume the worst." That means those companies that restrict the flow of information will have to offer a much higher premium to attract the same amount of capital. With increased competition, companies with the highest standards of disclosure will win out. "In Asia," says Wong, "the question of having too much corporate governance is something you don't have to worry about."

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