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Strengthening corporate governance to combat corruption

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Strengthening Corporate Governance to Combat Corruption

'I call on member countries to work urgently with us to address major corporate governance failures. This will be a vital step to reinforcing market integrity.' - Angel Gurría, Secretary-General, Organisation for Economic Co-operation and Development (OECD).

The collapse of global financial markets in September 2008 has ignited a debate on what caused their quick undoing. As captured in the comments of the OECD Secretary-General, there is a growing sentiment that poor corporate governance is one of the forces to blame. It allowed the transparency, accountability and integrity of companies to be compromised and for abuses to go unchecked, particularly on matters of corruption.

What is Corporate Governance?

For TI, corporate governance is understood to mean the “procedures and processes for how private sector organisations are directed, managed and controlled”.⁴

This includes the relationships between, responsibilities of and legitimate expectations among different stakeholders (Board of Directors, management, shareholders, and other interested groups).

Laws and regulations provide the framework on which corporate governance systems are built. These are complemented by voluntary measures that companies adopt.

When corporate governance systems are effective, they prevent managers from abusing the power that shareholders have granted them to represent their interests and the consent stakeholders have extended to them to operate in their communities.

Stakeholders include any actor who has a ‘stake’ in a company rather than simply owning its legal ‘stock’: employees, customers, suppliers, communities, government and society at large.⁵

Transparency International (TI) considers strong corporate governance systems a vital component of company efforts to reinforce the right incentives and practices and to address the corrupt practices they confront. As empirical evidence has shown, without good corporate governance systems in place, the overall impact of anti-corruption initiatives is reduced and the growth of companies — and the countries where they operate — is undermined.¹

High profile cases of corporate mismanagement or employee misconduct, from Siemens in Germany and UBS in Switzerland to IBM in Argentina and Samsung in South Korea, demonstrate what can happen when the tenets of corporate governance — transparency, accountability and integrity — are absent, inadequate or abused.

Despite the benefits of corporate governance, insufficient work has been done to realise its potential as a bulwark against abuses and for preventing and managing a company’s corruption risks. This policy paper sets forth TI’s recommendations for an effective agenda of action and reform. It offers a timely input into the search for medium-term solutions for rebuilding the markets, economies and confidence which the current global crisis has eroded.

1. Why is corporate governance critical?

Good corporate governance serves as a framework to secure investor confidence, enhance access to capital markets, promote growth and strengthen economies. By providing for clear ‘rules of the game’ and ‘checks and balances’, corporate governance systems help to lower company costs (for capital and production) and increase economic output.² Such characteristics make corporate governance necessary, beneficial and useful for all sectors and types of companies whether they are multinationals, state-owned enterprises, domestic firms, small businesses or family-owned operations.

Although corporate governance frameworks differ from country to country based on the legal, regulatory and institutional environment, they have a common aim: to define clearly the rights, responsibilities and behaviours that are required of a company’s owners (the ‘principals’) and managers (the ‘agents’) for the business to operate successfully.³ ‘Owners’ include any group or individual holding an equity stake in the business, usually in the form of shares. ‘Managers’ comprise all persons who have been extended the right to run the business on behalf of the owners. These individuals can be company executives or members of the board of directors, who are either appointed or elected to their position.

When breaches in corporate governance happen, they may be systemic, result from negligence or reflect the actions of rogue employees. When systemic failures occur as have characterised the global crisis, they are a strong signal that the balance of interests which a good corporate governance structure should ensure — between owners (including stakeholders) and management (including the board of directors) — is out of equilibrium.

2. What is covered by corporate governance?

Corporate governance typically addresses measures to manage and reduce financial and operational risks by building the integrity, transparency and accountability of a company’s management toward different actors at varying

levels within a company: board members, managers, employees and shareholders.⁶ Key issues include:

1. shareholders' rights

- protection of owners' rights and facilitation of their participation in company meetings including voting on changes to the company's structure (i.e. 'articles of incorporation') and key governance decisions (i.e. board membership and the remuneration of its members).

2. stakeholders' rights

- recognition of the company's impact on broader interest groups such as employees, customers and communities.

3. financial transparency

- disclosure of the company's financial and operating results, the remuneration policy for board members and senior executives, and all related information needed to evaluate the performance of the company and management.

4. proper accounting

- duty to record accurately all business transactions (to avoid fictitious entries and off-the-book accounts), ensure sound internal controls (including the safe custody over assets) and employ proper accounting principles (when valuing company assets and liabilities). Often external assurances can help to certify the validity of the financial information being provided by having an independent party assess the results.

5. information sharing

- obligation to provide stakeholders with reliable, accurate and timely information about what the company is doing and to use these exchanges to reinforce and ensure the right types of behaviour on the part of the business.

6. oversight

- creation of board and organisational structures (e.g. committees and chairs) that ensure persons are responsible for and evaluate different dimensions of a company's accountability and operations.

7. review

- production of reports on the implementation of policies and systems (and any remedial actions that have been taken when necessary).

While there are various institutional arrangements that can be adopted for corporate governance, a company's board of directors is viewed as the framework's centrepiece. The board takes leadership on strategic and key operational issues and is considered as having the 'duty of care' for a company

Following a series of major company collapses in the United States, Europe and Asia during the early 2000s, countries ushered in a wave of reforms to make mandatory laws more stringent.

The US took the lead in these efforts and passed the Sarbanes-Oxley Act (2002) while other countries pursued similar steps to implement and standardise more rigorous corporate governance regulations.⁷

According to a 2008 survey by the Economist Intelligence Unit of more than 1,200 senior executives from around the world, forty percent of the respondents believed additional government regulation was needed to tackle social and environmental challenges.⁸

Comparing anti-bribery and corporate governance systems

Corporate governance calls for:

1. *Rights and responsibilities.* Clear definition of rights and duties for a company's owners and managers;

2. *Controls.* Use of accountability mechanisms to protect interests of owners and a range of stakeholders vis-à-vis managers; and

3. *Oversight.* Broader company accountability through:

- a clear delegation of authority within a company (as decided by the elected board);
- the assigning of responsibilities for risk management among managers and staff;
- the mandatory and regular reporting of company revenues (and major events); and
- the need to keep accurate books, maintain sound internal controls and safeguard assets.

Anti-bribery procedures require:

1. *Rights and responsibilities.* Clear allocation of responsibilities for a company's anti-bribery programme (policies and procedures);

2. *Controls.* Sound accounting and reporting systems (as noted above), including the use of mechanisms to alert management of misdoings and abuses; and

3. *Oversight.* Regular board oversight of anti-bribery policies and programmes.

by setting the 'tone at the top' and promoting a corporate governance framework that covers all levels of the organisation and types of risks.

The regulatory support that anchors this framework is drawn from mandatory corporate and business laws (e.g. legally-binding conditions), softer regulations (e.g. conditions to participate in certain spheres of the market and economy, such as listing on a national stock exchange) and voluntary measures (e.g. company-determined standards, such as employment, environment and anti-bribery codes).

3. Aligning corporate governance and anti-corruption

The processes that characterise strong corporate governance systems align in many respects with the key elements for countering bribery that have been outlined by TI in the *Business Principles for Countering Bribery*: effective risk management, integrity, transparency standards and accountability.⁹

The overlap between rights and responsibilities, controls and oversight provide some clear entry points for linking the two complementary agendas and lessening the possibility that corrupt acts will occur (see side bar). When corruption happens in the private sector, it can arise within a company, between companies and in dealings with the public sector and private citizens.

To reinforce and operationalise this alignment, the active engagement of the board is essential. Given its organisational role, the board assumes responsibility over matters related to auditing (internal and external) standards, legal compliance systems and ethical policies which can be used to help to prevent abuses. Additionally, increasing a company's commitment to corporate social responsibility and sustainability initiatives — as part of overarching efforts to promote company values and ethical standards — can build the level of business integrity needed to mitigate corruption risks (see side bar on page 5).

Globally, nations have worked together to advance such good practices and policies and to provide an international standard for helping to align corporate governance and anti-corruption. These include the guidelines for multinational enterprises and principles for corporate governance that the OECD has set out as well as the passage of international anti-corruption accords such as the OECD Anti-Bribery Convention and the UN Convention against Corruption (UNCAC).¹⁰

4. Recent reform efforts

Recent corporate governance reforms have focused on the sources of system failures and their inability to effectively mitigate the full spectrum of company risks: financial, operational and corruption.

In response, companies and governments have increasingly pursued mechanisms to regulate and respond to the breakdowns that can lead to corruption by strengthening shareholder voting rights, providing clearer accounting standards to prevent fraud and making more transparent executive remuneration practices. As the current global crisis unfolds, new areas are likely to emerge that focus increasingly on board accountability, risk management and company disclosure policies (such as exposure to financial products).

Voting rights: Strengthening shareholder democracy is a trend most evident in Europe which is helping to create an accountability mechanism to combat corrupt practices on the part of a company's board. Rather than simply having 'the right of recommendation', shareholders vote to approve the board's performance from the past financial period and appoint its members. The primacy of shareholder rights — such as for share buy-backs, dividend payments and running shareholder meetings — is a shift supported by companies and new national legislation, for example in France, Germany and Italy.¹¹

Accounting fraud: The manipulation of a company's financial information may be designed to hide losses and bribes, bolster profits, inflate sales or disguise the level of indebtedness. The sudden collapses of the Italian conglomerate Parmalat (2003) and the US energy firm Enron (2002) are reminders of what can happen when accounting practices are used to misrepresent a company's true financial affairs. Despite the fallout for American banks from the Enron scandal, the current financial crisis has revealed that US financial institutions opted to use similar off-balance-sheet vehicles, which have proved to be their undoing and one of the impetuses of the turmoil.

Executive remuneration: It is difficult to determine when executive salaries and severance packages overstep the board's boundaries of trust and cross into the realm of corruption. However, most reformers agree that the lack of disclosure on why and how much remuneration company directors are given makes it hard for shareholders to hold boards accountable. This may result in feelings of 'management capture', particularly when former company officers or friends sit on the board. In response, countries such as the US and Germany have called for independent company 'remuneration committees' as well as clear criteria for setting salary levels.¹² This issue has again risen to the top of the policy agenda in response to the crisis as countries from Switzerland to the US have made salary caps a condition for private banks to access financial lifelines funded by governments.

5. Moving the agenda forward

The global crisis has revealed how excessive risk taking within companies has been fuelled by the lack of transparency, accountability and integrity which allowed abuses and corruption to go unchecked. In many instances, corporate governance systems fell short in responding to these problems as a result of not having fully aligned their corporate governance systems with anti-corruption mechanisms.

TI believes the risk management that corporate governance systems strive to achieve must equally and accurately assess corruption hazards if the framework is to function. For example, more appropriate and effective whistle blowing procedures by companies (an anti-corruption tool) could have ensured that insiders who recognised the risks and abuses could have had a channel to voice them.

Companies need to do much more to support good corporate governance and its role in contributing to the fight against corruption.

Bringing CSR into the Corporate Governance Framework

Corporate governance increasingly includes standards that address a company's responsibility and accountability for environmental and social performance.

Commonly called corporate social responsibility (CSR), these initiatives look not only at what companies do with their profits but how they make them.

It goes beyond philanthropy and compliance and addresses how companies manage their economic, social and environmental impacts, as well as their relationships in key spheres of influence — the workplace, marketplace, supply chain, community and public policy realm.

CSR asserts that companies in all markets must earn 'their licence to operate' through social consent.¹³

TI's Work on Corporate Governance

Through its chapters, TI has drawn on its private sector work and the guidance provided through the *Business Principles for Countering Bribery* to partner with countries and companies in reform efforts to reduce corruption risks.

TI has worked in Argentina and Colombia to sign integrity agreements with companies in specific sectors (natural resources, water and sanitation).

In various Asian Pacific countries, TI has undertaken initiatives to encourage business ethics in state-owned and private enterprises. Work has included promoting public awareness around the importance of curbing corruption in key sectors, such as construction, as well as building cross-sector coalitions to fight private sector abuses, as has been done by the TI chapter in South Korea.

Strengthening corporate governance to combat corruption

The 2008 Investor Relations Global Rankings survey of 160 companies in 31 countries across all continents showed that detailed disclosure of executive compensation was one of the lagging areas evaluated for corporate governance.

Only six percent of Latin American companies followed such disclosure practices. While the results were not as stark for other regions, only half of all firms in Africa, Asia and the Pacific disclosed how much executives were being paid. (www.irglobalrankings.com)

To promote this change, TI advocates for action to strengthen the transparency, accountability and integrity of corporate governance.

Transparency:

- 🌐 Board and senior executive remuneration and benefits packages should be made public, tied to sustainable performance and determined by independent, non-executive directors. TI supports governments and institutional investors in their call for shareholder approval of individual board and senior executive remuneration packages (including long-term incentives, stock options and pensions).
- 🌐 Companies should publicly report on corporate governance structures and anti-corruption systems, including their overall operations and performance. While many companies dedicate a section in their annual report to describe their corporate governance system, this should be complemented by information on what a business is doing to combat corruption. Coverage of these issues may be alternatively included in corporate citizenship or sustainability reports that companies publish.

Accountability:

- 🌐 External assurance processes should be used to independently verify financial and non-financial data. These are now almost universally mandated by law for company financial reporting. Consideration should be given to requiring assurance work in other areas such as employment, environmental and integrity standards, including anti-bribery programmes.
- 🌐 Shareholder and stakeholder rights should include holding boards, owners and senior management accountable for their actions and respecting the rights of owners. The rights of minority shareholders must also be safeguarded to ensure their voice. Strengthened rights help to counter decisions that could provide a veil for boards to hide their corrupt actions or mask abuses.
- 🌐 Consideration should be given to formalising stakeholder dialogues as a way of improving stakeholder rights. This measure is particularly essential to provide for management's accountability on important business decisions which directly impact stakeholders and corruption risks.

Integrity:

- 🌐 The same good corporate governance standards should be applied across all units of a company and in all countries where it operates. Good corporate governance standards, rules and ethical principles should not be limited to the parent company. Poor practices should not be allowed to be passed off to operating units or exported to other countries. Equally, companies should be committed to improving corporate governance standards in entities where they have influence (e.g. agents, joint ventures and consortia and suppliers).

- Specific board responsibilities should be designated to oversee corporate governance as well as ethical and integrity issues. Functions for policy formulation and oversight in the areas of corporate governance and company ethics should be clearly assigned to certain board member(s) and committees. TI strongly supports the creation of independent audit and remuneration committees.
- Employees alerting the management of abuses should be protected from victimisation and retaliation. Case after case of corporate whistle blowing has shown that the majority of employees who report claims of corruption and misconduct are victimised and often forced to leave the company. To create a safe haven, TI calls for confidential hot lines, a supportive corporate culture and tailored trainings.

In supporting these components of good corporate governance, companies will be able to establish some of the mechanisms needed to mitigate corruption risks and demonstrate their zero tolerance for abuses. The effective creation, implementation and review of such a framework will insure that corruption is no longer considered an acceptable cost of doing business. •

This TI Policy Position was written by Jermyn Brooks in collaboration with the Private Sector team and the Policy and Research Department at the TI Secretariat in Berlin.

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To learn more about TI's work on the private sector, please visit:
http://www.transparency.org/global/priorities/private_sector.

For more information about this policy position and others in the series, please contact Craig Fagan at the TI-Secretariat: [pfres\[at\]transparency.org](mailto:pfres[at]transparency.org).

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- ¹ A study by Wu (2005) showed that there was a positive and significant correlation between corporate governance and reduced levels of corruption in a country. See: X. Wu, 'Corporate Governance and Corruption: A Cross-Country Analysis', *International Journal of Policy, Administration and Institutions*, 18(2), pp. 151-170.
- ² See: OECD, *The OECD Principles of Corporate Governance* (Paris, France: OECD, 2004). www.oecd.org/dataoecd/32/18/31557724.pdf.
- ³ Corporate governance addresses the classic principal/agent relationship. Managers ('the agent') are asked to act on behalf of shareholders ('the principals') to oversee the company's operations and meet the agreed upon rights and obligations. Tension results when the agent's interests are in conflict with his/her duties to the principals.
- ⁴ See: *Online Glossary of Statistical Terms*. OECD. <http://stats.oecd.org/glossary/detail.asp?ID=6778>. Definition also based on OECD principles on corporate governance. See: http://www.oecd.org/faq/0,3433,en_2649_34813_31717413_1_1_1_1,00.html.
- ⁵ TI adopts a broader definition of 'stakeholders' than applied under the legal frameworks supporting corporate governance standards. The group of actors included reflects corporate social responsibility's assertion that companies must earn their right to exist – often called their 'licence to operate' – through responsible actions.
- ⁶ See: OECD, *OECD Principles of Corporate Governance* (Paris, France: OECD, 2004). www.oecd.org/dataoecd/32/18/31557724.pdf. Also see: UK Government Financial Services Authority, *The Combined Code. Principles of Good Governance and Code of Best Practice. Committee on Corporate Governance* (London, United Kingdom: UK Government, May 2000). www.fsa.gov.uk/pubs/ukla/lr_comcode.pdf; Teresa Barger, *Corporate Governance – Working Definition*, Paper presented at the International Corporate Governance Meeting: *Why Corporate Governance Matters for Vietnam* (Hanoi, Vietnam: 6 December 2004). www.oecd.org/dataoecd/18/47/34080477.pdf.
- ⁷ For more information on the Sarbanes-Oxley Act, see: www.law.uc.edu/CCL/SOact/toc.html. Other countries that have made moves to strengthen corporate governance laws include the United Kingdom (the Turnbull Report) and South Africa (the King Report). For a list of all countries, see: www.ecgi.org/codes/all_codes.php.
- ⁸ The survey covered 1,254 executives from around the world and was conducted in 2007. See: Economist Intelligence Unit, *Doing Good: Business and the sustainability challenge*, Sponsored by A.T. Kearney, Bank of America, Orange, Jones Lang LaSalle, Pricewaterhouse Coopers, SAP, ExxonMobil and SunGuard (London, United Kingdom: EIU, 2008).
- ⁹ The *Business Principles for Countering Bribery* provide a framework for companies to develop comprehensive anti-bribery programmes. While large companies have no-bribes policies, all too few implement these initiatives effectively. Introduced in December 2002, TI's *Business Principles* are the product of a collaborative effort involving companies, academia, trade unions and non-governmental bodies. See: Transparency International and Social Accountability International, *Business Principles for Countering Bribery: An essential tool for business* (Berlin, Germany: Transparency International and Social Accountability International, 2009). www.transparency.org/content/download/561/3429/file/BPCBfinal.pdf.
- ¹⁰ The United Nations Convention against Corruption (UNCAC) includes measures in chapters one (e.g. article 12), two (e.g. articles 21-23, 30 and 39) and five (e.g. article 52) that outline actions that involve the private sector. The OECD Anti-Bribery Convention also highlights areas to be addressed to combat corruption, although the focus is on foreign public officials. See: www.unodc.org/pdf/crime/convention_corruption/signing/Convention-e.pdf and www.oecd.org/document/21/0,3343,en_2649_34859_2017813_1_1_1_1,00.html.
- ¹¹ See: Luca Enriques and Paolo Volpin, 'Corporate Governance Reforms in Continental Europe', *Journal of Economic Perspectives*, Vol 21(1), Winter 2007, pp. 117-140. http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID970796_code135680.pdf?abstractid=970796&mirid=1
- ¹² The German government created a commission to prepare a national corporate governance code. A final version was approved in February 2002 with revisions in June 2007. For more information on independent remuneration committees, see section 4.2.2: www.corporate-governance-code.de/index-e.html.
- ¹³ See: European Foundation for Quality Management (EFQM), *The EFQM Framework for CSR* (Brussels, Belgium: EFQM, April 2004).

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Transparency International (TI) is the civil society organisation leading the global fight against corruption. Through more than 90 chapters worldwide and an international secretariat in Berlin, Germany, TI raises awareness of the damaging effects of corruption, and works with partners in government, business and civil society to develop and implement effective measures to tackle it. For more information go to: www.transparency.org