SmartLessons
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Making the Business Case: Direct Engagement with Companies and Banks to Improve their Governance Practices

Good corporate governance practices can keep companies out of trouble, help attract investment, ease access to cheaper capital, and outperform their competition. But companies, particularly in emerging markets, may be resistant to making needed changes. After encountering such resistance, IFC's corporate governance advisory services teams identified an approach that addresses the resistance head-on and includes public seminars, private consultations, and a pilot program, so companies can experience for themselves the tangible performance improvements that come with better governance.

Quantitative and anecdotal evidence alike indicate that well-governed companies receive higher market valuations. For companies in emerging markets, good governance is particularly important: improving corporate governance is likely to increase other capital flows and reduce the cost of capital—a key issue in emerging markets, where the perception of risk is higher. Improved governance structures and processes also help ensure quality decision making, encourage effective succession planning for senior management, and enhance the company's long-term growth prospects, while giving companies opportunities to help manage risks and add value to clients.

BACKGROUND

Many companies are unaware of the value of focusing on corporate governance practices. With so many critical priorities, why should companies spend time and resources on such seemingly minor details as how many times shareholders meet during the year? Banks also may not make the connection between reduced portfolio risk and investment in well-governed companies.

In our years of experience developing corporate governance advisory services projects, we faced this challenge over and over again: how to demonstrate to companies that there is a strong and compelling business case for improved corporate governance.

To address these issues—and to get at the necessary change of culture and mindset—we take a multi-pronged, graduated approach to our work with companies and banks that includes public seminars, private consultations and workshops, pilot programs, and corporate governance document review.

These activities have yielded some important lessons.

LESSONS LEARNED

1) Use public seminars as a gateway to future engagement, and structure them to appeal to busy top management.

Public seminars are often the first opportunity for management and board members of companies and banks to learn about corporate governance best practices. Seminars typically last a half-to-full day and include a presentation by a speaker well-versed in the topic, a broad selection of reference materials,

and—occasionally—breakout sessions for more detailed discussions or case studies. In seminars we have conducted, we address a range of topics, including:

- Definition of corporate governance
- Role of the supervisory board
- Board committee functions
- Annual shareholders' meetings
- Protection of minority shareholders' rights
- Conflicts of interest
- Internal control systems
- Internal audit functions
- Financial reporting, transparency, and information disclosure

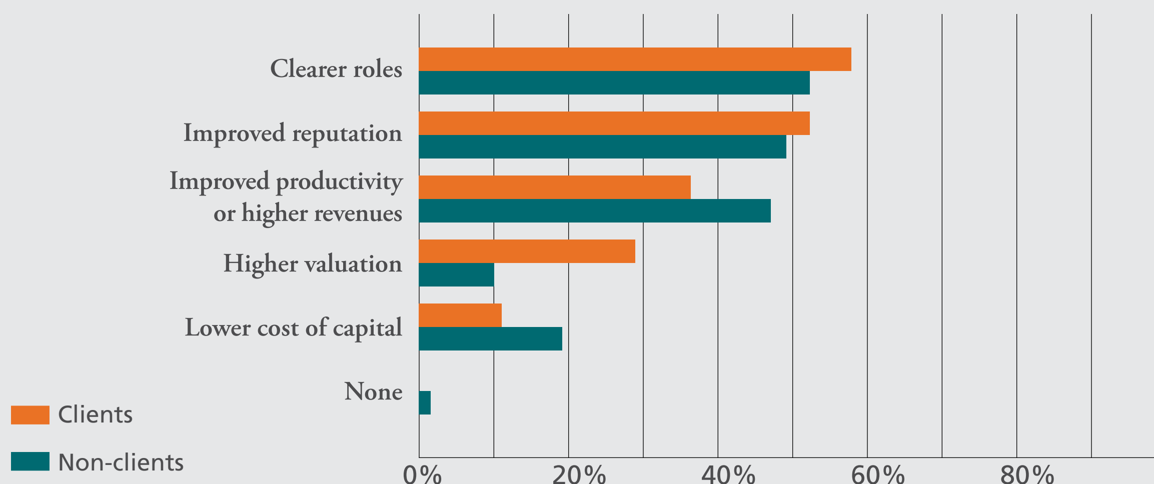
Company executives who attend the seminars may use the information to start making improvements in these areas on their own. The seminars also encourage companies to follow up by requesting private consultations/workshops or applying for the pilot program.

It is important that top managers commit to attending the seminar, because they are the decision makers and can set the process in motion to start effecting change. But sometimes, these senior managers may not want to commit to a full day or half day away from the office. The key is to make these managers want to come. We found that this can be achieved in different ways: by featuring well-known speakers, by providing an opportunity to network, and by arranging a convenient time frame, among others.

In Russia, we altered our original format to create condensed versions of seminars, delivered as a highly successful series of breakfasts for CEOs. Breakfasts featured high-profile speakers, good food, an opportunity to network, and a brief time frame. This helped to attract time-stressed businesspeople.

Still, management buy-in at seminars is not always sufficient to get to the next stage. Sometimes, we found that certain company officers were assigned to attend seminars. They acted as "scouts" for the firm's executive team and board, testing the content to determine its value. The real successes come when board members and company owners, along with the

BENEFITS FROM IMPROVED CORPORATE GOVERNANCE (89% OF CLIENTS AND 76% OF NON-CLIENTS RESPONDING)



Source: *Joint IFC SECO External Evaluation of IFC Corporate Governance Projects in Russia*, February 2010

senior management team, commit to attending.

The value of the public seminars, consultations, and workshops extends beyond the information that can be shared with participants: they also provide the CG team with additional insight about potential participants in pilot programs.

2) *Be selective and choose pilot companies with care.*

Given the amount of project resources that go into working with pilot companies, careful selection of appropriate companies is critical. Consider the extent of the effort involved:

- **Assessment of the client's corporate governance practices**: Work includes reviewing corporate documents; minutes of shareholder and board meetings; and financial statements; and interviewing board members, managers, and shareholders.
- **Preparation and presentation of corporate governance assessment report:** Work includes analysis of current practices and detailed recommendations for improvement prioritized by urgency and ease of implementation.
- **Consultation with directors and managers:** Work includes prioritizing areas of focus and developing an improvement plan.
- **Assistance with implementation of priority improvements:** Work includes consultations, workshops and orientation sessions for boards of directors, help in revising corporate documents, help in organizing shareholder meetings, advising on effective corporate structures and meetings, developing the role of corporate secretary, providing assistance in improving financial reporting and information disclosure, and improving internal control systems and internal audit functions.

The goal of such in-depth direct assistance is to demonstrate short-term and longer-term benefits, such as the ability to attract investment, streamline decision making, reduce corporate conflicts, and increase efficiency.

Use a competitive process to choose participants in a comprehensive pilot program, basing selection on criteria such as:

- Level of company commitment to change
- Transparency
- Willingness to disclose information
- Business reputation
- Financial condition and growth potential
- Lack of resources to hire international consultants

The inclusion of one or two high-profile, wealthier companies in a pilot can set a strong example for other firms.

We also note here that while enthusiasm from individual company executives is nice, full buy-in from the entire management team is critical for pilot companies. It is easy to get drawn in by managers who show enthusiasm to participate as part of a pilot—or as the scout sent by the management team to a public seminar. But given the intensive work required for a pilot firm, it is important to gain commitment from the board of directors and shareholders, not just from management. This will help ensure that the recommended changes will occur at all levels, and that new procedures, often outlined in company bylaws, will be adopted by these key groups. If you cannot get this full commitment, it might be a good idea to pass on this company's participation in the pilot.

3) *Take a practical, business-oriented approach to improvements, because compliance-driven approaches may not work.*

Since many developing countries lack extensive corporate governance regulations, companies operating in these markets may not be compelled to make changes because of compliance-related issues—there's not much with which to comply. So, suggesting solutions that are strictly compliance-driven or that focus on adoption of international best practices may not be met with much enthusiasm. In

fact, taking this approach could lead companies to become less invested in the process—companies often view such approaches as overly cumbersome and expensive, with little value.

On the other hand, evidence from studies of our Ukraine and Russia corporate governance projects shows that pointing to best-practice examples of companies that have improved their governance practices—and the positive bottom line impacts that resulted—are a powerful motivating factor for other companies. For instance, of the 69 client companies participating in the Ukraine Corporate Development Project that responded to our survey, 77 percent cited the experiences of other companies as a prime motivating factor for their own corporate governance improvement efforts.

4) Create a "pull" in addition to the "push" by encouraging banks and investors to consider corporate governance in evaluating risks of potential investments.

Urging or pushing companies or banks to improve governance for its own sake is one thing; creating an incentive for better governance can pull more companies into the process. Better-governed companies are less risky, meaning that investment in such firms reduces the bank's or investment fund's portfolio risk—and enhances these firms' ability to attract new investment. In fact, there's a growing body of evidence to suggest that companies can lower their cost of capital by demonstrating corporate governance improvements.

Encouraging financial institutions to consider corporate governance when evaluating the creditworthiness of companies seeking financing is a way to create an incentive to pull companies forward into making improvements.

The good news in this regard is that IFC itself, as a financial institution, is taking the lead here: we are now requiring that new investments be analyzed for corporate governance risks before making an investment decision.

PRIVATE CONSULTATIONS AND WORKSHOPS: BUILDING ON THE GENERALITIES OF A PUBLIC SEMINAR

Enterprises that either attend seminars or hear about IFC's CG advisory services work may be interested in more specific information relating to issues that affect their particular company. Detailed consultations might include:

- **Document reviews by project specialists** of charter and bylaws to assess compliance with local laws and recommend improvements to align with international best practices and go beyond what is required in the local legislation. In many cases, this work involves recommending additional by-laws for the company to cover issues not addressed by the current corporate documents. Reviews also might include work on a company-level corporate governance code. It is usually possible to charge a fee for drafting such documents.
- **In-house workshops** for boards of directors or management boards, lasting from a few hours to a full day. Topics are often similar to the issues covered in seminars, but include analysis of and reference to specific issues, policies, and procedures of the company in question.
- **One-on-one discussions** on specific problems and topics of corporate governance.

These consulting services are typically provided free of charge in new markets. However, in more developed markets it is often possible to charge for more in-depth written consultations, document reviews, and workshops. A reasonable number of verbal consultations are usually free of charge, due to the administrative burden involved in charging fees for small amounts.

MOST INFLUENTIAL FACTORS FOR CORPORATE GOVERNANCE IMPROVEMENTS IN RUSSIA, 2010

1. Example set by other companies and banks
2. Activity of IFC Corporate Governance Project
3. Government regulations
4. Strategic investor actions
5. Activity of consulting firms
6. Activity of other donor-sponsored projects

Source: *Joint IFC-SECO External Evaluation of IFC Corporate Governance Projects in Russia,* February 2010.

The new policy comes on the heels of a directive issued by the IFC Management Team last spring integrating corporate governance into all aspects of IFC's business. As of September 30, 2010, all larger and potentially riskier new IFC investments must be analyzed for corporate governance risks and opportunities as part of the due-diligence process. The requirement will apply to all investments starting July 2011.

We know from our own experience that it can take bank officers a considerable amount of time to evaluate the corporate governance practices of their clients. If the process is too long and burdensome, banks may skip the process altogether. Because of this, we developed easy-to-use assessment tools for bank credit officers and investment officers so they can evaluate the corporate governance performance of companies in which they are considering investments. The tools can be customized for the specific needs of the bank or investment fund, and depending on the type of investment—equity or debt. They are the same tools that are being rolled out within IFC for use by investment teams as they assess the corporate governance risks of new investments.

CONCLUSION

As IFC mainstreams corporate governance considerations into its own investment operations, we will have a first-hand way to understand the associated successes and challenges. Our own experience with our own client companies, coupled with our experience working with other client companies and banks, will help us to refine our approach even more.

ABOUT THE AUTHOR

Roman Zyla, Corporate Governance Officer and Global Product Specialist for corporate governance, joined IFC in 2002 as manager for the Ukraine Corporate Development Project, based in Kyiv, Ukraine.

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APPROVING MANAGER

Darrin Hartzler, Manager, Business Advisory Services

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