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# Sound business standards and corporate practices

A set of guidelines



**European Bank**  
for Reconstruction and Development

# Foreword

A draft of this document was prepared by the European Bank for Reconstruction and Development (EBRD) with the assistance of Coopers & Lybrand for a seminar on Sound Business Standards and Corporate Practices held in London on Sunday 13 April 1997 during the Annual Meeting of the EBRD. A number of leading business people, lawyers and other practitioners active in central and eastern Europe participated in various panels, presentations and discussions.

Panellists and other participants at the seminar agreed that it was important to promote sound business standards and corporate practices for companies in the EBRD's countries of operations. The enclosed guidelines were broadly endorsed by the seminar participants and reflect their comments.

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## Why guidelines?

The success of a company in the long term depends not only on having a sound strategy, competent management, valuable assets and a promising market. Success also hinges on the company maintaining a sound relationship with the various constituencies on which it depends: customers, shareholders, lenders, employees, suppliers, the community in which it operates, government and local authorities. Lenders and investors who take a long-term view, before entrusting their money to a company, will want to satisfy themselves that it has a sound and stable relationship with these constituencies. This will feature as an integral part of their due diligence exercise before they make their commitments.

Sound and stable relationships depend on sound practices, behaviour and standards. Thus the long-term success of a company and its ability to attract capital depends on establishing and meeting these standards. The purpose of this set of guidelines, which has been developed by the EBRD with the assistance of Coopers & Lybrand, is to articulate these standards and thus help companies understand some of the broader concerns that reputable lenders and investors have when considering a potential loan or investment opportunity. For the EBRD, it is essential that clients address these concerns and be committed to sound business standards and corporate practices.

While these guidelines apply across the board, they need, of course, to be elaborated on a country-by-country and case-by-case basis to take into account

applicable laws, regulations and other specific circumstances (such as the size of the company). These guidelines are not intended to be a full statement of investment criteria.

In economies where legal and fiscal systems are in a state of flux and where a consensus has yet to develop on the business standards that are immediately achievable, it will be difficult for all companies to apply, at once, each and every one of the following guidelines. It is important, however, for companies to understand clearly the kind of standards to aim for and to be committed to achieving them.

## Relationship with customers

A loyal customer base is essential for the success of any company. It is thus up to the company to gain the loyalty of its customers through commitment to quality and value for money. Lenders and investors thus expect from companies in which they invest a genuine commitment to:

- provide products or services of a consistent quality at competitive prices;
- deal with customers in a transparent way and furnish them with reliable information on the goods and services provided;
- focus on all dimensions of the service to customers, including overall reliability of service, meeting of deadlines, prompt handling of complaints and proactive processes to gather and act upon customer feedback. Many companies around the world have successfully put

in place Total Quality Management Programmes, which serve as good models of best practice in this field; and

- develop relationships with customers with a long-term perspective and refrain from abusing a favourable bargaining position for the maximisation of short-term gains.

### **Relationship with shareholders – corporate governance**

The shareholders are the owners of the company. The relationship between management bodies and shareholders is thus critical. It is essential for investors, and also for lenders, to understand clearly and to be satisfied with the manner in which shareholders can oversee the performance of the management and participate in key decisions. This is the core aspect of “corporate governance”, which refers to the way a company is “governed”.

Sound principles of corporate governance include the following:

- setting out in legal form in the company charter the roles and responsibilities of management bodies and shareholders;
- the existence of a transparent shareholding structure with disclosure of the voting rules and of the beneficial ownership of major blocks of shares. Inadequate information about the identity of large shareholders would lead to fears about possible connections with criminal elements, which would clearly disqualify companies from obtaining

investment or loans from reputable sources. It would also make it more difficult for shareholders to monitor situations where certain shareholders might have specific objectives that are at odds with those of other shareholders;

- respect for the right of minority shareholders to be protected against share dilution (e.g. through capital increases from which some shareholders are excluded) or other loss of value (e.g. through transfer pricing with connected companies);
- procedures for the protection of the integrity of the shareholders’ registry;
- systematic and open communication with shareholders through the provision of properly audited accounts, information about the progress of the company and explanations of the major decisions taken by management in the form of an Annual Operational and Financial Review included in the Annual Report;
- providing shareholders with adequate information on matters to be decided by them which, in the case of public companies, includes observance of the precise rules (proxy and other) that govern the holding of, and decision making at shareholders’ meetings;
- clearly established and well-understood division of authority between the various governing bodies of the company, i.e. Executive Management, Board of Directors<sup>1</sup> and Shareholders’ Assembly.

While this division of authority will vary in each case, the Board of Directors

<sup>1</sup> By Board of Directors we refer to the Main Board and/or to the Supervisory Board (if applicable). We do not include Executive Management Boards which consist only of full-time employees of the company.

should typically be responsible for:

- the selection of the Chief Executive and the monitoring of his or her performance;
- directing the strategy and assessing the general conduct of the business;
- approving major transactions;
- endorsing the financial statements prior to submission to the Shareholders' Assembly;
- providing recommendations to shareholders on issues on which they have to vote; and
- monitoring the financial resources of the company to ensure that the company does not continue to trade if it is becoming insolvent.

The typical role of the Shareholders' Assembly is to:

- elect Directors to sit on the company's Board;
  - approve the company's accounts;
  - appoint the auditors;
  - approve changes to the charter and major decisions involving a reorganisation in the company or a change in its activities; and
  - approve the payment of dividends (although interim payments can often be approved by the Board only).
- a well-functioning Board with Directors who have the skills, the time and the access to information needed to discharge their responsibilities

effectively. In the case of larger companies, independent committees of the Board with clear responsibility for matters such as overseeing the preparation of financial statements and deciding on management compensation and contract terms will often be appropriate;

- a Board of Directors that is acting in a fiduciary capacity on behalf of the entire shareholding and that, in the case of public companies, includes a sufficient number of Directors who are truly independent from the Executive Management. Companies need to address concerns that may arise when government officials or representatives are appointed as Directors. Directors should be elected for a strict term of office (which can be renewed); and
- a policy of disclosure of personal financial interest of Board members in company-related transactions and other conflict-of-interest situations as well as a policy of non-involvement of Directors with a personal interest in matters to be decided.

### **Relationship with employees**

Companies have an important responsibility towards their employees. While there are profound cultural and social differences from country to country with respect to this issue, there are a number of basic principles that typically guide the attitudes of successful companies towards their employees:

- due regard to labour laws;
- commitment to adequate standards of worker health and safety;
- a policy of non-discrimination in the recruitment, compensation and promotion of employees;
- respect for the right of workers to participate in union activity;
- effective systems for consultation with employees on employment conditions and other issues that will affect them directly in the workplace;
- clearly stated and transparent policies relating to compensation, benefits, promotions and other employment conditions; and
- concern for employees' long-term welfare, evidenced by diligent payment of necessary or voluntarily committed company contributions to employee pension plans and by the strict protection of the integrity of any company-sponsored plans through the separation of assets owned by the pension plan from those on the company balance sheet and through the use of independent trustees for the management of pension plan assets.

These guidelines should not be construed as limiting the right of enterprises and their management to enforce discipline among the labour force and to terminate the employment of redundant workers in accordance with local laws (e.g. on consultation, notification periods and severance pay). It is necessary for the survival of companies that the management is able to exercise this prerogative.

## **Relationship with suppliers**

Many companies depend crucially on their suppliers and on their suppliers' ability and willingness to provide reliable support. Thus, fairness and transparency in dealing with suppliers is an essential element of sound corporate practice as it creates the conditions that enhance the loyalty and efficiency of suppliers. Therefore, companies must:

- have clear and transparent purchasing policies;
- severely sanction those employees found to be receiving bribes;
- avoid doing business with suppliers, be they local or foreign, who attempt to divert the purchasing process to their own benefit;
- maintain arm's-length relationships with suppliers, in particular those connected through ownership links. In such cases, they should refrain from transfer pricing arrangements where prices do not reflect the real value of the goods and services provided but are set to benefit certain parties (such as those connected through ownership links) to the detriment of other shareholders, lenders or other interested parties;
- be committed to paying suppliers promptly; and
- refrain from purchasing materials whose trade is banned by international environmental and other conventions.

## Relationship with the community

As any company is an integral part of the local community in which it resides, a sound relationship with the community is essential. Companies must:

- be sensitive to the concerns of the local population;
- communicate and, when necessary, consult with the local population and with relevant public interest groups; and
- be sensitive to the impact of their activities on the environment and abide by all applicable environmental laws and regulations.

While caring for the environment is presented here as a responsibility of the company towards the immediate community, this responsibility can extend far beyond, to include all other communities and areas whose environment can be affected by the activities of the company. Damage to the environment can also give rise to substantial liabilities for companies. Environmental care is now a broad concern for all responsible investors and lenders.

## Relationship with government and local authorities

Well-managed companies abide by the laws of the countries in which they operate and pay taxes. This is the best and only lasting way of maintaining a sound relationship with government authorities. It is thus a fundamental principle of sound lending and investing to require from companies that they:

- pay all fairly computed taxes;
- abide by all mandatory regulations;
- obtain all permits and other government licences and approvals required for their business; and
- deal with local and central government authorities in an arm's-length way without resorting to bribery or improper ways of influencing administrative decisions.

In countries where the laws, fiscal regimes and judicial systems are in a state of flux, these guidelines might sometimes be viewed as overly onerous or just not feasible. In such cases, it is better to engage in open and transparent dialogue with the authorities on the inappropriateness of certain provisions of the local laws than to take action that could create future liabilities and other problems.

In many countries, governments bear a significant responsibility for the lack of compliance with local laws by companies in their country, particularly in the area of taxes, because of unrealistic legislation or tacit acceptance of bad practices. The burden is thus also on governments to improve the investment environment and continue to liberalise the economy, which would significantly contribute to an improvement in the standards of legal, regulatory and fiscal compliance by companies in their country. Examples of liberalisation include the abolition of quotas, arbitrary controls and licensing which place special discretionary powers in the hands of authorities. Such quotas, controls and licensing reduce investment,

inhibit entrepreneurial energies, stimulate the seeking of privileged positions and lead to corruption. In this way, and more generally in managing their affairs in an open and even-handed manner, governments can lead by example. Thus they must be seen to take an active stance in fighting corruption and in eliminating special deals and privileges.

### **Proper checks and balances**

A proper system of checks and balances is necessary to ensure the ongoing integrity of the company and of its relationship with the relevant constituencies. Such a system of checks and balances is part of corporate governance, for which basic guidelines have already been articulated. It is based on the general principles of disclosure, management accountability, separation of responsibility and sound internal controls.

The cornerstone of a disclosure policy is the publication of a comprehensive Annual Report, including Annual Accounts with a report from independent external auditors. However, the disclosure policy should also encompass:

- statements of the company's strategic aim and policies, with a commentary on how well these have been achieved during the past year and the plans for the forthcoming period;
- prompt reports to the company's various constituencies on any events which could have a material impact on the company; and
- proper disclosure to the relevant bodies (be it senior management, Board or

shareholders) of all important relationships between the company or its officials and other parties.

The core element of a system of checks, balances and management accountability requires that the shareholders are able to monitor the performance of management and to sanction poor performance, if needed by removing the managers (which can be all the more contentious when management has itself a significant shareholding). The power of the shareholders to direct and remove management has, however, to be balanced with the need to provide the management team of a company with a certain amount of stability in their employment, without which they will not be able or sufficiently motivated to manage the company successfully with a long-term perspective.

Finally, at a more detailed level, internal controls should include:

- a management structure that fosters information-sharing and some collegiate element in decision-making, to avoid an excessive concentration of power, which could increase the risk of mismanagement or fraud;
- procedures to identify and report to the Board and, where appropriate, to shareholders situations of conflict of interest affecting Directors, managers or other senior employees of the company;
- processes to enable management to secure effective control of the business and, in particular, to control movements of cash;

- competent internal audit and compliance officers reporting to the Board of the company, with responsibility for auditing the compliance with internal procedures as well as for monitoring all aspects of legal compliance, professional good conduct and good business practice; and
- independent external auditors taking responsibility for auditing the accounts of the company, for examining and commenting on the integrity of the company's financial systems and procedures, and for monitoring compliance with applicable regulations. Ideally, external auditors should also be engaged to report on the company's achievements with respect to their stated corporate governance and business standards policies.

### **Creation of a culture that fosters sound business standards and corporate practices**

Ultimately, efforts made by companies to adopt sound business standards and corporate practices will fail if, within the company as well as within the environment in which it operates, a culture that fosters such standards does not develop. While, at the company level, this effort needs to be led from the top, i.e. by the Executive Management and key shareholders, conscious steps need to be taken to promote this attitude throughout the company. This could include:

- the preparation and dissemination within the company of a code of conduct for employees;

- the training of employees; and
- sanctions against misconduct.

While the above steps are important, they will not in themselves be sufficient if the investment climate in which the company operates rewards those companies and individuals that do not follow such standards. It is thus incumbent upon the authorities concerned, the company, its suppliers and customers, and its lenders and investors, be they local or foreign, to cooperate with each other and with others in the private sector, to help create a business environment where companies realise that it is clearly in their long-term interests to operate according to sound business principles and corporate practices.

Ultimately, this is the kind of investment climate that will attract reputable investors and lenders.



