Corporate governance failures in developed countries, and their impact on not only the shareholders but also other stakeholders have attracted widespread attention. Employees, banks, consumers, governments, regulatory agencies and multilateral organizations are all paying increasing attention to the accountability mechanisms that are in place for the private sector. The state of corporate governance can have an important impact on the availability and cost of capital for firms and financial stability, a critical ingredient to sustainable development.

Corporate governance constitutes a set of relationships among a company’s management, its board, its shareholders, and other stakeholders. Those relationships define, among other things, the property rights of shareholders, the mechanisms of exercising and protecting those rights, and the path of ensuring a fair return. Corporate governance also sets the structure through which a firm sets its objectives, as well as determining the means of attaining those objectives and monitoring performance. Good corporate governance provides proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders.

**Rationale for Good Corporate Governance?**

A good corporate governance regime is central to the efficient use of capital. First, it promotes market confidence; helps to attract additional long-term capital, both domestic and foreign; and fosters market discipline through appropriate disclosure and transparency. Second, good corporate governance helps to ensure that corporations take into account the interests of a wide range of constituencies, particularly when the board recognizes that corporate social responsibility can mutually benefit the company and its operating environment. Those actions, in turn, help to ensure that corporations operate for the benefit of society as a whole, and induce stable business development and growth, lower risk, and sustainability.

The experiences of economic transition and all too frequent financial crises in developing and emerging market economies have confirmed that a weak institutional framework...
for corporate governance is incompatible with sustainable financial markets and private sector development. As a result, good governance structures are valued increasingly highly by investors, particularly those seeking to diversify their portfolios to include stakes in developing countries. They also mitigate the risks posed by weak institutions. Furthermore it is expected that poor corporate governance is going to become a critical foreign policy issue as cross-border investors and the importance of securing their rights gain more importance.

OECD Principles of Corporate Governance

In response to a call by its council, the OECD issued the *OECD Principles of Corporate Governance* in 1999 after extensive consultations. These were later revised in 2004 following a comprehensive survey of corporate governance practices in and outside the OECD area. Since their launch, the principles have formed the basis for corporate governance initiatives in both OECD and non-OECD countries alike. They represent the minimum standard that countries with different traditions have agreed on, being applicable to countries with a civil and common-law tradition without being unduly prescriptive.

The principles have been devised with four fundamental concepts in mind: responsibility, accountability, fairness, and transparency, and enabling diversity of rules and regulations. They outline the following: (a) the basis for an effective corporate governance framework, (b) the rights of shareholders, (c) equitable treatment of shareholders, (d) the role of stakeholders in corporate governance, (e) disclosure and transparency, and (f) the responsibilities of the board.

OECD Principles of Corporate Governance: Overview of the Main Areas of the OECD Principles

1. The Basis of an Effective Corporate Governance Framework
   - The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.

2. Rights of Shareholders and Key Ownership Functions
   - The corporate governance framework should protect and facilitate the exercise of shareholders’ rights. Seven core principles in this category spell out the various rights of shareholders and call for effective shareholder participation in key corporate governance decisions.

3. Equitable Treatment of Shareholders
   - The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

4. Role of Stakeholders in Corporate Governance
   - The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and should encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and sustainability of financially sound enterprises.

5. Disclosure and Transparency
   - The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters with respect to the corporation, including the financial situation, performance, ownership, and governance of the company.

6. Responsibilities of the Board
   - The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.

Note: Information in this box is based on the *OECD Principles of Corporate Governance*, 2004.
disclosure and transparency (for example, on related party transactions), thus making auditors more accountable to shareholders and promoting auditors’ independence.\(^3\)

Most recently, in April 2005, the OECD adopted new guidelines on corporate governance of state-owned enterprises which provide suggestions on finding a balance between the state’s responsibility for actively exercising its ownership functions while at the same time refraining from imposing undue political interference in the management of the company. The guidelines are also designed to foster a level playing field in markets where private sector companies can compete with state-owned enterprises. Furthermore, experience demonstrates that good corporate governance benefits SOEs in the same way it does private companies. Moreover, as in the case of private companies which may aspire to go public, SOEs which may be under consideration for privatization can gain significant value by early adoption of a good corporate governance regime.\(^4\)

The OECD principles have been endorsed by the Bank and the Fund executive boards, and they form the basis of the corporate governance component of the World Bank–IMF Reports on the Observance of Standards and Codes (ROSCs).

**World Bank ROSC Corporate Governance Assessments**

As part of the ROSC initiative, the World Bank has established a program to assist its member countries in strengthening their corporate governance frameworks. The objectives of this program are to accomplish the following:\(^5\)

- Benchmark the country’s corporate governance framework and company practices against the OECD Principles for Corporate Governance.
- Assist the country in developing and implementing a country action plan for improving institutional capacity with a view to strengthening the country’s corporate governance framework.
- Raise awareness of good corporate governance practices among the country’s public and private sector stakeholders.

Participation in corporate governance ROSC assessment is voluntary and is conducted at the invitation of country authorities. Although the assessments are relevant to all countries, they are particularly pertinent in middle-income countries seeking to build strong capital markets. They are a useful instrument for transitional economies, where mass privatization has created a large pool of listed companies with thousands of shareholders, and for low-income countries seeking to attract international portfolio investors. The assessments also serve as a tool for communication between policy makers and domestic and international investors to reach a common understanding in an environment where countries are grappling with the establishment of new capital markets and are competing to attract capital investments.

The assessments are complementary to private sector rating activities in this field. The World Bank assessments focus on country analysis, whereas some rating agencies have started to focus on corporate governance of companies.

**Key Findings from Country Assessments**

The work of Fremont and Capaul (2002)\(^6\) reviews the lessons of corporate governance assessments and its findings are discussed in this section. In most countries surveyed, there is a growing interest toward improving corporate governance practices. A large number of countries, including Brazil, Croatia, the Philippines, and Romania have developed their own corporate governance codes of best practice.

Some of the key policy issues that have arisen in corporate governance assessments can be accessed at [http://www.worldbank.org/wbi/businessanddevelopment/](http://www.worldbank.org/wbi/businessanddevelopment/).

Studies have demonstrated that, at the firm level, (1) investors will pay a higher premium for good corporate governance, (2) good corporate governance reduces the cost of debt, and (3) good corporate governance improves the stability, op-
The importance of corporate governance relative to financial issues (percent)

<table>
<thead>
<tr>
<th>Region</th>
<th>Less important</th>
<th>Equally important</th>
<th>More important</th>
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<tbody>
<tr>
<td>Eastern Europe/Africa</td>
<td>15</td>
<td>45</td>
<td>40</td>
</tr>
<tr>
<td>Latin America</td>
<td>16</td>
<td>66</td>
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<td>Asia</td>
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<td>North America</td>
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<tr>
<td>Western Europe</td>
<td>44</td>
<td>41</td>
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The importance of corporate governance relative to financial issues has been recognized in various studies. In a 2002 McKinsey survey, institutional investors said they would pay premiums to own well-governed companies. Premiums averaged 30% in Eastern Europe and Africa, and 22% in Asia and Latin America. An ABN AMRO study showed that Brazilian firms with above-average corporate governance had ROEs—returns on equity—that were 45% higher and net margins that were 76% higher than those with below-average governance practices. A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA) in 2001 showed that companies with the best corporate governance in each of a large number of emerging market countries had eight percentage points higher measures of economic value added than firms in their country average. There are many other studies that similarly highlight benefits that firms can derive from better corporate governance.

Some countries, such as Brazil, have segmented their stock markets based on the companies’ compliance with strict corporate governance requirements. Longitudinal studies from such initiatives demonstrate that those companies with strict standards perform better and have access to cheaper capital.

At the country level, improving corporate governance contributes to the development of the public and private capital markets. Poor standards of governance, particularly in the area of transparency and disclosure have been a major factor behind instability in the financial markets across the globe. Building improved capacity for corporate governance, and fostering the implementation and exercise of these measures requires a multisectoral approach. Large companies can link with their suppliers and partner with smaller local businesses to help them gain access to markets, financing opportunities, technology and know-how. At the same time they can create and capitalize on new business opportunities in lower-income markets. Large firms can lead by example, by setting high standards of corporate governance and accountability that benefit not just their long term viability but the economy as a whole. Good corporate governance is not only relevant for poor countries. Investors everywhere worry about expropriation by controlling owners and managers. Whether in rich or poor countries, corporate governance creates more value for everyone.

Notes