

BUSINESS ISSUES BULLETIN

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GOOD CORPORATE GOVERNANCE: A prerequisite for sustainable business

Put simply, corporate governance (CG) is the internal system that organizes the direction and control of a corporation. Corporate governance specifies the rights and responsibilities of different stakeholders in a company when there is separation between ownership and control, including its shareholders, managers, Board of Management¹ and Supervisory Board.² Corporate governance also sets the rules and procedures for making and implementing decisions within a company; its ultimate aim is to ensure that the company is being managed in the interests of the shareholders. This means it will minimize abuse and reduce unforeseen risks, such as those arising from related party transactions, conflicts of interest and inadequate disclosure and transparency standards. As Vietnam's business environment continues to develop rapidly and larger corporations emerge, both the business community and policymakers are increasingly interested in CG as a tool to differentiate between

1. Good CG practices increase access to capital and enhance company performance

Recent studies by McKinsey & Company, Credit Lyonnais Securities Asia, and the World Bank have all shown that a strong correlation exists between good CG practices and: 1) higher share price valuations, and 2) improved performance ratios. This in turn means a higher rate of return for shareholders and greater benefits for other stakeholders. As a result, investors are often willing to pay a 'CG premium' (i.e., a higher price for shares of companies with good CG procedures). Banks are also more willing to lend funds and may charge a lower interest rate, because good CG practices: 1) decrease the chances of loan misuse, and 2) increase the likelihood that the loan will be repaid in full. In contrast, poor CG practices can lead to undesirable consequences, such as bankruptcy or even company collapse. Recent corporate scandals at a number of large multinational firms—including Enron, Tyco International, Daewoo, and WorldCom—are good examples of the dangers that can stem from poor CG. Closer to home, recent difficulties at enterprises such as

PetroVietnam, VNPT and Seaprodex have stemmed in part from inadequate CG practices.

2. Vietnamese firms should improve their knowledge and practice of CG

Corporate governance is still a new concept in Vietnam. In a recent IFC-MPDF study of 85 large Vietnamese companies, less than 25% believed that businesspeople in Vietnam understand the basic concepts and principles of CG. In-depth interviews with company directors revealed that there is still some confusion over the difference between corporate governance and operational management. As a result, few Vietnamese companies have good CG systems. A large majority of the directors interviewed in the study concurred that Vietnamese firms should improve their CG practices, particularly in the following areas:

1) The role and functions of the Supervisory Board: At present, in most companies these are unclear and/or ineffective.

2) Financial disclosure and corporate transparency: In Vietnam, it is difficult to obtain reliable information regarding corporate performance and practices. Since tax

policies can be applied inconsistently and arbitrarily, companies tend to obscure results. To the extent data is available, its quality is often poor. The lack of clarity and openness ultimately impedes companies' growth potential. For example, when there has been a "closed" share sale in some equitized companies, interested investors have had limited access to timely and accurate information. Consequently, such companies have often failed to attract the kind of strategic investors that can contribute significantly to their development.

3) Ambiguous roles of state shareholders in equitized companies: When state shareholders "interfere unduly", companies can experience internal conflicts and may also face political interventions that favor state management agencies. In other cases, such investors can be overly passive, and their lack of engagement may stall necessary changes or prolong inefficiencies.³

4) Related party transactions: A related party transaction occurs when two or more of the involved participants have had a special

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The "Business Issues Bulletin" provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Vietnam, and exposure to different opinions held by various stakeholders on the topic.

The statements and opinions presented here are only meant to provide additional reference material and do not reflect official opinion of the Vietnam Chamber of Commerce and Industry (VCCI) or the Mekong Private Sector Development Facility (MPDF)/IFC.

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(1) The equivalent of the Board of Directors in other countries.

(2) Also known in Vietnam as the Inspection Committee, the Supervisory Board performs the internal audit function within a company.

(3) Dau Anh Tuan, VCCI, Presentation entitled "Some Corporate Governance issues in Vietnamese equitized companies" at a workshop on "Comparing CG practices in Vietnam with

From businesses...



● In my opinion, corporate governance is very important in a market economy where businesses are facing ever-increasing challenges and competition. All types of businesses—whether state-owned or private, large or small—need to pay attention to this issue. Most joint-stock companies in Vietnam

are small. Not only do their management boards lack the knowledge and skills needed to implement CG, but they are also unaware that CG promotes healthy growth, enables companies to demonstrate accurate financial positions, and fosters shareholder confidence.

We are a private joint-stock company established in November 2001. Fortunately, our founders have a great deal of management experience and they recognize the importance of good corporate governance. From the beginning, our goals have included operating in a professional manner. Towards this end, we have applied advanced international management methods and recruited consultants to develop a long-term strategic plan. We also have clear CG regulations concerning the split of functions between Board of Management and company managers, the procurement and tendering procedures, approval limits, etc.

Company disclosure and transparency is still quite a big issue due to many constraints in Vietnam's legal framework. For example, tax policies are not always clear and their implementation is subject to the discretion of the tax officials; this actually discourages companies from being transparent. However, in our company, we report all this information in a candid manner to our shareholders. We cannot just blame the legal environment, since many foreign companies operating in the same environment in Vietnam still maintain good CG practices. I believe that transparent information disclosure can contribute to the unity and consensus of company shareholders.

There should be more opportunities for



● 10/10 Textile Company is an equitized SOE and has had relatively good growth trends. However, corporate governance in our company—as in all other equitized SOEs—is still an issue.

First, in equitized companies, shareholders are normally not aware of their rights and responsibilities as owners. The

responsibilities of running and developing the company fall mainly on the shoulders of the Management; while limited responsibilities are shared by the Board of Management, the Supervisory Board and employees. Reasons for this include inadequate knowledge and capacity and low awareness of the rights and responsibilities associated with their shareholding among those not responsible for daily management. Some Board of Management members pay little attention to the company's development strategy, while the Supervisory Board fails to perform its roles of monitoring and protecting shareholders' rights and ensuring financial transparency. Employee shareholders only care about the dividend rate. Due to these reasons, many equitized companies lack a clear development strategy and it is possible for the company's managers to abuse their position to advance their own interests.

Second, in equitized companies where the State remains a shareholder, officials from different state agencies are nominated to act as representatives of State shares and participate in the companies' Board of Management or Supervisory Board. These representatives cannot make quick decisions when necessary; instead they have to go back and consult their agencies, which can take quite a long time. In my opinion, there should be a single state agency in charge of managing the State's shares in equitized SOEs—this would be more efficient.

Corporate governance awareness among the general

From local experts...



● In general, corporate governance is critical to a company's business efficiency and performance. First, good CG practices help improve a company's results by creating incentives for both management and employees to improve productivity, maximize operational efficiency, and generate returns.

Second, CG systems help prevent problems arising from principal-agent relations and discourage managers from

abusing their authority and/or wasting company resources. Good CG is one of many factors that enable companies to mobilize funds and other resources for company growth and expansion at a lower cost.

More specifically, there are three types of businesses in Vietnam—foreign-invested, state-owned, and private; each type has unique characteristics that influence its adoption and practice of CG.

Foreign-invested enterprises normally apply the CG standards of their international headquarters. Generally, those systems are well developed and mainly serve the

interests of the foreign company's investors rather than those of minority shareholders, who in the case of joint ventures are mostly Vietnamese companies. Foreign investment-related laws and regulations also fail to protect minority shareholders. Moreover, the minority shareholders in Vietnamese joint-venture businesses are often SOEs; the individuals representing them do not have enough of a personal interest in the business to advocate on behalf of the SOEs.

Corporate governance issues relating to state-owned enterprises are different. The representatives of the State's share in such companies are not aware of CG's importance; consequently, most SOEs and their managers do not apply internationally accepted standards and rules. The lack of an appropriate legal framework gives managers an incentive to act dishonestly or even recklessly, which can in turn lead to abuses such as related party transactions. Ultimately, the overall corporate governance problem in SOEs stems from the fact that there are no real economic owners. Since SOEs are actually owned by the public and nobody has a personal stake in them, managers do not have to answer to a specific group of owners. In addition, there are no mechanisms in place to effectively monitor whether or not managers are properly fulfilling their obligations.

Private businesses in Vietnam are often small and



● The corporate sector in Vietnam consists mainly of solely-owned or family-controlled businesses; as a result, there is no separation of ownership from management. For small businesses, family-style management can be appropriate. However, when a business grows larger and the owner has to hire a manager, he must face the challenge of controlling the risks

that a manager can abuse or risk his investment. The manager is in an advantageous position, since he has access to more information and also makes daily decisions. He can use these conditions to benefit himself at the owner's expense—for example, by entering into related party contracts.

In Vietnam, many CG conflicts have occurred in equitized companies. Most of these disputes have stemmed from the fact that employees sold off the shares they were given/sold at preferential prices through the equitization program. Consequently, different investor groups with conflicting interests were formed; some sought a controlling stake at any cost. The companies' charters, which were originally created as a matter of form rather than substance, proved inadequate as CG tools and ended up doing little to resolve these conflicts. The courts could not effectively resolve the disputes, as it proved difficult to balance the disparate interests and issues, and as a result, settlements have rarely been enforced. A specific example is the (equitized) Huu Nghi

Joint Stock Company, which, due to internal conflicts, has not been operational for the past four years.

The existing Enterprise Law does provide CG stipulations, specifically on protecting minority shareholders' interests. However, there are a number of regulations that do not balance the interests between minority and majority shareholders and have consequently led to conflicts of interest in a number of companies. Take the example of the right to call for a general shareholders' meeting (GSM). Under the existing Enterprise Law, shareholders owning over 10% of shares and those owning over 51% of shares have to follow the same procedures to call for a GSM. In my opinion, the new Enterprise Law should have another stipulation that allows majority shareholders, e.g. any group of shareholders owning over 51% of shares, to be able to vote on the replacement/appointment of Board of Management members without convening a general shareholder meeting, because regardless of whether or not a general shareholder meeting is held, a resolution can be passed with over 51% of votes.

"Transparency and balanced interests" are the major sentiments underlying corporate governance. In my opinion, transparency of information is crucial to a company's growth. The Enterprise Law should provide clear guidance as to what kind of information should be made public and what should remain confidential for business operations. At present, information disclosure by joint stock companies, including the listed ones, has



● The stock exchange encourages listed companies to implement good corporate governance practices, thereby promoting a transparent and fair market and protecting the legitimate interests of shareholders, especially minority ones. Furthermore, the disclosure and auditing requirements are resulting in significant improvement in corporate governance practices, which are very new to Vietnamese companies.

Although Vietnam's stock exchange is in its primary stage of development, the companies listed in the stock exchange can be considered market leaders in good corporate governance. By adopting the model charter for listed companies,* they have, in principle, demonstrated the basic CG concepts recommended by OECD in two major regards. First, they are ensuring equitable treatment of shareholders and affirming the rights of all shareholders, especially minority ones, to access information, nominate and vote, etc. This can only strengthen shareholder monitoring of companies' business activities. Second, by fulfilling requirements on auditing and information disclosure (either regularly or by request on an ad-hoc basis) to the State Securities Commission and shareholders, companies allow for greater transparency.

However, the implementation of good CG practices in Vietnamese companies faces certain obstacles, including:

1) Vietnam's economy, which is still transitioning to

(*) This is a result from a project to support corporatization and corporate governance in Vietnam, which is a cooperative effort between the Government of Vietnam and the Asian Development Bank.

► market principles and thus still demonstrates many non-market aspects;

2) the existence of a certain level of state subsidies in terms of capital, material inputs, and prices;

3) the legal environment, which as of yet has not created a level playing field for both the state and private

sectors;

4) the economic environment, which lacks transparency and consistency. For example, listed companies face compulsory disclosure and auditing requirements, but unlisted companies do not; and

5) the very limited understanding of CG among

From investors...



● When investing in private companies, we consider that the most significant corporate governance problem is the low level of corporate transparency. Specifically, most private companies lack well developed accounting systems and internal control systems, which makes it difficult for shareholders to understand the company's true

financial condition. This increases the risk facing investors because the financial reports may be incorrect; also, if there is fraud within the company, it will be more difficult for shareholders to be aware of it. This is one reason why we work closely with companies to improve their accounting systems and management reporting systems after we invest. Another common problem with some private companies is related-party transactions between multiple companies that are owned by the same shareholders. When these related party transactions happen, it is easy for the controlling shareholder to transfer profit between the companies that he/she controls, and this can disadvantage minority shareholders.

When investing in equitized companies, the CG risks are somewhat different. In equitized companies there often aren't controls in place to prevent key managers from receiving commissions on the company's purchases; as a result, the risk of this happening is quite high in some cases. If suppliers pay commissions to a company's key managers, the company confronts higher raw materials and equipment costs, so in effect it is like transferring profit from the company to the management team. However, shareholders can also add value after they invest by helping companies improve both internal controls and the official bonus system for management.

I don't believe that the government can or should force all companies to have good CG, although some CG standards may be imposed on companies that list on the stock exchange or have a public offering of shares. It is

really the responsibility of the shareholders or the Board of a company to take steps to ensure that a company has high CG standards. However, improving tax enforcement would probably have a positive impact on



● It is recognized worldwide that investors regard corporate governance to be just as important as the operational efficiency of a company when considering investment decisions. Specifically, the investors care about the shareholders' structure of a company, the relations between managers and the Board of Management, the competency of the Boards' members, and transparency. Advanced models should be introduced to Vietnam to promote the society's and business community's awareness and thereby encourage better CG in Vietnamese companies.

Vietnamese companies have not yet done very well in defining their development strategy and often fail to present this strategy in the business plans they make public to investors. There are two reasons for this. First, defining the long term development strategy should be the Board of Management's responsibility, but because functions and responsibilities of the two boards are not clearly specified, the Board of Management rarely actively participates in this important work. Second, the managers are overloaded with daily operations and have limited capacity, so they also do not spend adequate time on longer term development strategies. Moreover, compensation packages for managers, especially in equitized companies with State shares, are not market-competitive. Not only does this discourage them from contributing fully to business development, but it also creates the incentive to promote their own interests.

Companies do not develop or maintain professional relationships with investors. For example, many Management teams do not consider periodic meetings with investors to be important. In my opinion, this can

(Continued from page 1) enforcement against related party transactions is still very limited.

relationship prior to the transaction taking place. Related party transactions are quite common in many Vietnamese state-owned enterprises (SOEs), especially for big procurement contracts like machinery and equipment. Such transactions can reduce a company's performance, thereby preventing shareholders from receiving their share of the firm's real income. In Vietnam, government

3. Vietnam needs a uniform CG framework

At present three laws govern enterprises in Vietnam, depending primarily on their ownership profile and legal status: 1) the Enterprise Law of 1999 for domestic private enterprises, 2) the revised State-owned Enterprises Law for SOEs, and 3) the Foreign Investment Law for foreign-invested enterprises (FIEs). Because each law addresses