

Corporate Governance Globally and in the Caribbean:

An Institutional Investor and Rating Agency Perspective

Caribbean Corporate Governance Forum, September 3, 2003, St Kitts

My emphasis is related to the Caribbean

- Day-to-day realities are not adequately covered in the literature from which we are seeking to extract rules and best practices
- Immediate action is needed to facilitate improvements by adopting a sustainable, enforceable set of minimum standards
- Institutional investors need to consider Corporate Governance explicitly because all market players are influenced by perceptions regarding governance - perceptions can be inaccurate – this can create distortions in the market – especially in small countries where the market is too small to support a *business* press that would be widely regarded as independent. Smart PR should not earn a market premium. For that reason, the ultimate test of good practice will be the transparency of rules and judgments.

There are three major strategic factors that affect and influence Corporate Governance.

1. Auditing environment
2. Composition and functioning of Boards
3. Leadership

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In my view, these are all *weak in the Caribbean, lacking in depth and consistency of application* and they are not suitably supported by *corporate or investor culture, institutional practices or law*. Is this a developmental issue or a deeper societal issue? I do not know. But if we did get all of this right, it would be easier to practice *enterprise-wide risk management* – which itself is an essential component of good corporate governance.

[1] Auditing environment

- **acceptance of the value of audits**
 - ❖ there is a wide *expectation gap* between what the public (and many business people) think independent auditors are responsible for and what auditors believe their responsibility is in auditing financial statements
 - ❖ medium size to larger companies have annual audits but most small businesses may have an *audit just to satisfy the requirements of a bank loan* – thus allowing the bank to satisfy the bank inspectors.

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- **auditing standards**

- ❖ In virtually every Latin American country, the bank regulator adopts or establishes accounting regulations and procedures (based on IFRS in most cases). Recently, the ECCB took an initiative to facilitate an accounting authority, stopping short of the active role played by its LA counter-parts. All that is required is for a *Central Bank to formally adopt or establish accounting regulations and procedures* as a basis for prudential credit risk management in banks. Everyone else would soon conform. It is mainly a question of putting a financial value to good corporate governance.

- **economics of auditing**

- ❖ fee pressure placed on auditors in the Caribbean, especially in the OECS, adversely affects the quality of their services. It is un-likely that an SME audit which costs less than US\$ 4,000 would have been carried out in full conformance with today's auditing standards and procedures. A bank ought to be aware of the inadequacy of such an audit and should carry out additional review procedures especially regarding internal controls. *Un-economic audit fees* in a listed company, just like inappropriately high fees, should be regarded as an auditor independence issue that warrants explanation.

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- ❖ Since credit rating agencies would be helpless without reliable financial statements and disclosures, their ratings will not be reliable unless there are proper audits carried out by regulated professionals. There is no case for subsidizing credit rating agencies. If subsidies are on the table to be granted, there is a better case for subsidising SME audits or even small audit firms.
- **structure and scope of audit firms**
 - ❖ It is difficult to structure an appropriate business model for an auditing firm in the Caribbean given the distribution of firms by size. It has become clear that the best and biggest local firms are better off focusing only on multinationals and large firms – but then they may as well become simply a branch office of Miami or Atlanta. Regional firms have begun to take shape in the last few years. This should be *strongly* encouraged in terms of work permits, withholding taxes etc. It would also be a good idea to have protective legislation (as is now being proposed in the UK)

Proposition

1. For SME in the Caribbean, *periodic* audit processes and internal control reviews by *multi-service, regional or international professional firms* will better ensure the effectiveness of accounting functions, management control and compliance with standards.

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- Banks should be required to have such reports on their files within one year of initiating a loan with up-dates provided every three years
 - Smaller audit firms can then be relied on to *certify the fairness of annual balance sheets and income statements*. In that context, periodic, un-audited financial reports provided by management will be more reliable and useful.
2. Companies listed on a stock exchange or which have loans in excess of US\$ 10 Million from a bank, should be *required to comply with IFRS, without exception*. There are issues and there are costs. IAS 19 (employee benefits) and IAS 39 (valuation of financial instruments) do present problems – but they certainly focus management on financial issues that sometimes pass by un-noticed.

All other companies should be required to comply with IFRS but if this is not practical, all departures and differences from the Standards must be clearly *listed by the auditors in terms of significance* with or without justification and without requiring explanation.

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[2] Composition and functioning of Boards

1. Companies do not do not usually carry out effective Board recruitment processes
2. They do not usually determine selection criteria by *viewing the Board as a whole* – they look at the players, not the team

The small number of ideal, willing candidates country makes it difficult to create eligibility lists from a rational set of pre-determined selection criteria.

We have to be practical yet we must have *at least three minimum standards*.

1. Directors who are otherwise employed or engaged should not serve on more than six (6) Boards or be Chairman or Deputy Chairman of more than three (3) Boards regardless of their capacity or standing
2. At least 80% of Directors of a Board should be non-executive
3. On every Board, at least 25% of the *non-executive* Directors should be independent of the company, other Directors and management. The Chairman of the Board, together with directors who have served for more than ten years or who are official or de facto representatives of the State or who currently serve on more than six (6) Boards should

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not be considered “independent” on a particular Board regardless of any mitigating factor or circumstances.

Application of those standards will improve the functioning of Boards and will also reduce the issue of lack of independence arising from “interlocking directorships”.

These minimum standards will also encourage Boards to widen the pool of eligible candidates.

There are other standards which must be applied but which require caveats and transitional arrangements.

4. Chief Executives should always be appointed to the Board whether as a Managing Director or a General Manager but terms of service and tenure must be governed by an employment contract
5. The CEO should not be the Chairman of the Board unless he/she owns or controls directly a major block of shares or is appointed CEO directly by shareholders who own or control 50% or more of the shares
6. Governments must apply these minimum standards to State Enterprises and Public Utilities

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[3] Leadership

With regard to Corporate Governance, the prime role of leadership is to actively promote integrity through openness – the most important characteristic for the manager of the future. Leadership that practices *negative organisational politics is the antithesis of corporate governance and leadership without integrity is its nemesis.*

How can we practice and recognize good leadership?

Six key areas of competence for the corporate leader of the future: ¹

1. specialist knowledge coupled with drive and stamina
2. inner strength and independence of mind
3. strategic and visionary thought
4. emotional intelligence
5. communication skills
6. an international perspective.

But we must not forget what is in fact the most important characteristic of all for the manager of the future – openness – *this is the key to dealing with the challenges of the future.* According to Peter B. Baltensperger “*openness as*

¹ **The corporate leader of the future – key attributes of the modern manager**

Peter B. Baltensperger, Egon Zehnder International Zurich

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an attitude and attribute has gained a central importance in our global, increasingly networked and fast-moving age”

My interpretation of this is that the convenience of “politic correctness” has been un-masked as a practice that falls closer to deceit than to truth.

- We must understand reality to be able to question values, practices and conditions
- We must be clear in our minds about fundamental values and truths if we want to embrace change.

All of that takes openness, that is, reflection, dialogue, trust – *leadership is a quest for integrity*. In the corporate context, good leadership creates good governance and effective governance creates effective leadership.

We need to focus on those processes in the Caribbean.