AMCHAM HUNGARY POSITION BRIEF No. V

GOOD CORPORATE GOVERNANCE AS A PILLAR OF HUNGARIAN NATIONAL COMPETITIVENESS: LEADING TO BETTER DECISIONS, INCREASED VALUATIONS & MORE INVESTMENT

APRIL 2005

PURPOSE OF THIS PAPER

The American Chamber of Commerce in Hungary (AmCham) believes that improved Corporate Governance would significantly enhance national competitiveness and increase the overall value of the Hungarian business sector.

Good Corporate Governance leads to better business decisions, increases investor confidence, provides corporations with more options for attracting fresh capital, increases the valuation of corporations, and leads to increased investment at both corporate and the national level.

This Position Brief is aimed equally at Government-owned corporations as well as privately-owned companies of all types, including Rts, Kfts, publicly traded companies, and their shareholders, Boards and Management. The adoption of best Corporate Governance practices is particularly important for companies with or seeking outside investors, as well as Government-owned corporations given the government's responsibility to the public.

MAJOR RECOMMENDATIONS:

FOR LEADERSHIP:

- There is nothing more important than "The Tone at the Top". Leadership within Government, non-profit organizations and publicly and privately owned organizations should embrace both best Corporate Governance practices and ethical behavior. Individuals follow the example of their leaders. While there is a role for legislation and regulation to set the "rules of the game", experience has shown that ethical behavior cannot be legislated.
- Leaders of government, companies and non-governmental organizations should devote at least one substantive meeting per year to Corporate Governance issues within their own organization.
- Director Training Programs should be made available to further develop the pool of competent and qualified directors.

FOR COMPANIES:

- Public and private companies should establish Codes of Ethics and Corporate Social Responsibility Policies.
- Boards should establish guidelines emphasizing the processes that they use in carrying out their duties of loyalty, candor and care to shareholders, including processes for handling conflicts of interest appropriately.
- Boards and Management should act consistently with the law and in the interest of all shareholders and not only in the interest of a specific group of shareholders; they should also try to avoid conflicts when possible and disclose all unavoidable conflicts to ensure appropriate arms-length handling of such conflict.
- Companies' Boards should include directors who are independent of both Management and controlling or other significant shareholders to help assure that the Board acts in the best interests of the shareholders as a collective body, and should disclose information publicly that demonstrates the independence of these directors.
- Board and Management compensation should be disclosed, particularly in publicly traded companies, consistent with IFRS (International Financial Reporting Standards) requirements from 2005, and public institutions.
- Boards and Management should establish and implement internal control systems to support responsibility to shareholders and other stakeholders.

CREDITS:

AmCham considered Corporate Governance to be such an important issue, that in 2003 it formed the Corporate Governance Committee. This document represents a collective effort of the Committee's members, utilizing inputs from several internationally recognized experts, who recently visited Hungary and spoke to the AmCham membership. The Committee's members include representatives of the Central European University Business School's Center for the Social Foundations of Business, the Hungarian Venture Capital and Private Equity Association and the Canadian Chamber of Commerce. Further credit and thanks go to two prominent international experts, Alan Patricof, Co-Founder, APAX Partners and Holly Gregory, Partner, Weil Gotshal & Manges for their review of this document.

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DOCUMENT'S APPROACH

This document presents a series of practical recommendations. It approaches Corporate Governance best practices beginning with the concept of business ethics, leading into corporate responsibility to and rights of shareholders and other stakeholders. It then moves to the issues of independence of directors, appropriate handling of conflicts of interest involving Board members, Management and shareholders, corporate disclosure and transparency, and internal controls as mechanisms supporting that responsibility. It ends with corporate social responsibility, emphasizing that good Corporate Governance is a social responsibility in itself but also encourages other socially responsible behavior.

IMPORTANT AND ACCEPTED STANDARDS FOR ETHICAL BEHAVIOR INCLUDE:

Keep promises and contracts (Be faithful)

Do not lie or cheat (Be honest)

Respect others' rights (Be fair and just)

Avoid harming others (Be conscientious)

MAJOR RECOMMENDATIONS:

FOR GOVERNMENT:

- Legislators and regulators need to ensure that the legal environment encourages best practice governance and ethical behavior, stressing the business case for good governance: better Corporate Governance increases investor confidence, and leads to higher company values and increased investment. They should also reward good governance, while penalizing poor governance.
- Legislation should emphasize that there are certain rights owed to minority shareholders.
- Legislation should require in both public and private companies proper disclosure by calling for information to be accurate and readily available, to support responsible shareholder decisions and emphasizing that Management's responsibility for financial statements extends beyond shareholders'/unit holders' meetings.
- Fundamentals of governance, ethics and social responsibility education should be made mandatory at secondary and post-secondary levels of curricula.

What is Corporate Governance?

While interest in Corporate Governance has grown as a result of various high profile scandals over the past few years, Corporate Governance has been an issue for as long as companies have been in existence. The OECD's Corporate Governance Principles (1999, revised 2004) describe Corporate Governance as "a set of relationships between a company's Management, its Board, its shareholders and other stakeholders…The presence of an effective Corporate Governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy."

What is the objective of Corporate Governance?

As Alan Patricof, a recent speaker on Corporate Governance at AmCham Hungary, noted, the objective of Corporate Governance is to "align as nearly as possible the interests of individuals, corporations and society. This assures fairness and has the maximum impact in attracting capital for growth." Good Corporate Governance supports an environment in which investors, other stakeholders, Boards and Management of firms can operate in a transparent and accountable manner and Boards and Management are responsible and accountable to shareholders and other stakeholders.

Why is good Corporate Governance beneficial?

Effective Corporate Governance improves investor confidence that the assets they have provided to a company are being used for the agreed purpose. Therefore, employing best practices in Corporate Governance should increase access to capital, both at the level of individual companies and at a national level. This association is based on good governance's ability to lower the risk (that is, the likelihood of results being different than expected) inherent in a project or company, and in parallel increase its attractiveness, or similarly, to lower the expected rate of return investors/lenders demand for investing/lending. Better governance is therefore thought to increase the value of companies. A recent joint McKinsey and World Bank (Global Corporate Governance Forum) study suggests that investors will pay up to a 30% premium for companies with good governance in Central Eastern Europe (other supporting studies also exist). Thus, the value of Hungary's individual companies and the wealth of the Hungarian nation should increase with broad adoption of improved Corporate Governance practices. Regulators and legislators should stress this "business case" for good governance in ensuring that the Hungarian legal environment rewards good governance, and penalizes poor governance.

The implementation of certain aspects of Corporate Governance best practices will not be without cost. These costs should be viewed as investments since benefits, including increased appeal of the company to investors and business partners, should far exceed expenses.

What is the down side of poor Corporate Governance practices?

Without proper Corporate Governance, Management, shareholders, and other stakeholders can more easily enter into self-dealing, insider trading, and other activities which take advantage of other shareholders and stakeholders. Investor confidence is deteriorated by such actions or even by the risk that such actions might occur. The impact of such deterioration is a reduction in the attractiveness of the company, as well as other companies in Hungary, thereby increasing risk and cost of capital, and reducing valuations. Management, shareholders and other stakeholders therefore have a real interest in introducing best Corporate Governance practices.

A recent joint McKinsey – World Bank study suggests that investors will pay up to a 30% premium for companies with good governance in Central Eastern Europe. Other studies also support premiums for good governance.

For whom is Corporate Governance important?

Corporate Governance best practices are not only applicable to publicly traded companies but also to privately held companies (e.g., closely held Rts and Kfts), whether Hungarian or foreign owned, whether privately- or Government-owned, and whether independent companies or subsidiaries of/or joint ventures with multinational corporations. Best practices are particularly important for companies that seek bank credit or investor equity, want to conduct business with other companies, or hope to make themselves more efficient.

A good number of our recommendations also apply to governmental agencies in Hungary (e.g., state, municipal) and to organizations lobbying these agencies. They also apply to non-governmental organizations ("NGOs") and non-profit organizations as there is a link between the performance of the government, non-profit sectors and that of the corporate sector.

I. SETTING THE STANDARD – THE TONE AT THE TOP AND CORPORATE GOVERNANCE IN HUNGARY

While great advances have been made in the area of Corporate Governance (e.g. the Budapest Stock Exchange recently issued Corporate Governance recommendations for publicly traded companies), Hungarian general practices do not yet conform to best Corporate Governance standards.

Hungary's leaders need to ensure that legal and organizational structures encourage ethical behavior. Further effective regulations may need to be established and enforced to both punish poor governance and reward good governance. These can also stress the positive business case for good governance.

Heads of corporations and other community leaders can set standards and provide subordinates and the community with role models of good behavior by setting the "Tone at the Top". This tone "will set the example for what is right," says Alan Patricof. Individuals in an organization will follow the example of its leaders. Companies (also governments and NGOs) can encourage the development and promotion of ethical corporate cultures with the support of Codes of Ethics and CSR Policies.

"… the Tone at the Top will set the example for what is right – in a company, non-profit or even in government…" Alan Patricof, APAX (recent speaker at AmCham Hungary).

Leaders of companies, government and NGOs can demonstrate the importance of Corporate Governance by including in their annual organizational goals a commitment to devote at least one substantive meeting per year to Corporate Governance issues within their own organization.

Legal reform, by itself however, is not enough. "No matter where you are," noted Stewart Greenbaum, Dean of the Olin School of Business at Washington University, St. Louis, Missouri, USA (another of AmCham's recent speakers), "…all the laws in the world do not protect you from unethical behavior." As a result, much more is required than legal reforms; in specific situations common sense, ethical behavior and responsible business practices would constitute good Corporate Governance.

"Ethical behavior" refers to actions consistent with accepted standards of good conduct. While AmCham recognizes that some standards differ globally and that the degree of tolerance for behaviors inconsistent with accepted standards certainly differs globally, accepted standards for ethical business behavior include:

Keep promises and contracts (Be faithful)
Do not lie or cheat (Be honest)
Respect others' rights (Be fair and just)
Avoid harming others (Be conscientious)

"… all the laws in the world do not protect you from unethical behavior," Stewart Greenbaum, Dean, Olin School of Business, Washington University, St. Louis, Missouri, USA (a recent speaker in Hungary on Corporate Governance).

Hungary should encourage an even greater sense of ethics among its population through informal and formal education, beginning at an early stage.

The bar for Corporate Governance best practice is rising. Investors expect companies to comply with best practice in Corporate Governance, and this usually requires going well beyond statutory requirements in attempting to comply with ethical expectations.

SETTING THE STANDARD: RECOMMENDATIONS

- *Good Corporate Governance depends on ethical behavior, which cannot truly be legislated. Thus we must rely upon market participants – leaders in publicly traded and private corporations, Government-owned companies, NGOs and Government itself – to act ethically and responsibly. Hence the "Tone at the Top" must embrace both best practice governance and ethical behavior, and concurrently reject poor governance and unethical practices.*
- *Leaders of companies, government and NGOs should devote at least one substantive meeting per year to Corporate Governance issues within their own organization.*
- *Hungary's regulators and legislators need to ensure that the legal environment encourages ethical behavior and good governance.*
- *Hungary should encourage an even greater sense of ethics among its population through informal and formal education, including mandatory ethics courses at all high school and above levels of educational curricula.*

2. CORPORATE RESPONSIBILITY TO AND RIGHTS OF SHAREHOLDERS AND OTHER STAKEHOLDERS

While there may be a debate about the responsibilities of the corporation to stakeholders other than shareholders (e.g. employees, suppliers, customers, the community), it is generally accepted that, a company is organized for the profit of all shareholders. It is thus best Corporate Governance practice to promote the fair treatment of all shareholders; whether they are minority or majority, Management shareholders, financial investors, or strategic investors.

"It is best Corporate Governance practice to promote the fair treatment of all shareholders."

Hungarian corporate legal structures are a combination of Anglo-Saxon and Continental models and include two basic forms.

- The Rt – Company Limited by Shares – Typically characterized by: (i) a chief executive officer entrusted with the company's operations; and (ii) a combination of an Anglo-Saxon style Board of Directors, potentially including both executive and non-executive directors, and (iii) a Continental-style Supervisory Board, including non-executive members, and in certain cases employee representatives. As a general rule shareholders appoint and dismiss members of the Board of Directors or Supervisory Board. The Board of Directors can also dismiss the CEO or other Management.
- The Kft – Company with Limited Liability – This form is similar to a German GmbH, and is typically led by one or several managing directors who manage the company's operations and are appointed and dismissed by the owners. There is no Anglo-Saxon style Board of Directors, although a Continental-style Supervisory Board may be created, and is compulsory for larger Kft-s.

Best practice principles of Corporate Governance apply in particular to those in positions of decision making or supervisory authority, be they members of Boards of Directors or Supervisory Boards (collectively "Boards"), or Management. Companies should establish a written Code of Ethics and also guidelines dealing with the role and responsibilities of members of Boards and Management and those guidelines should embody the concepts of the:

- Duty of Loyalty – Acting in good faith for the benefit of the organization and all its shareholders and other stakeholders, including avoiding self-dealing;
- Duty of Candor – Disclosing conflicts of interest and assuring that information sent to shareholders and other stakeholders about the company and its performance is accurate and complete; and
- Duty of Care – Paying close attention to the issues facing the company and applying reasonable diligence and prudence in all decision-making on behalf of the company.

Management and the Board should act in the interest of all shareholders (in both publicly traded, public and privately held companies). One mechanism to help assure that Management does so is to ensure that the Board has a sufficient number of directors who lack close relationships to Management or to controlling or other significant shareholders and are therefore deemed to be "independent". Such independence, positions directors to make objective judgments and make decisions in the best interests of the company's shareholders as a collective body.

We note that the Act on Business Associations (the "Act") technically and conceptually considers all directors, even independent directors, to be "members of executive Management" upon their election to the Board of Directors, which may confuse their true independence. This is not true for members of the Supervisory Board. The Act should be changed to clarify that independent directors are not members of the company's executive Management. Additionally, companies should disclose information publicly that demonstrates the independence of independent directors.

Boards should reinforce independence through the use of committees composed predominantly of independent directors. These committees should include the audit, nominations, and compensation committees. As with all directors, members should be nominated and elected on the basis of competence and qualification (in particular in the specific committee's area of expertise).

Independent directors are useful even in privately held companies. In privately held companies, where the senior Management or a Manager is the controlling owner, or an outside financial or strategic investor is the controlling owner, an independent director(s) can still help to ensure that all shareholder interests are considered.

To further develop the pool of competent and qualified directors, Director Training Programs should be made more readily available.

"For directors, the definition of "independent" requires that directors are not dependent on Management for their continued relationship with the company, but are instead dependent on shareholder support, and thus are not, other than their Board role, associated with the company, its senior Management or its controlling or significant shareholders."

INDEPENDENCE: RECOMMENDATIONS

- *Boards and Management should develop written guidelines in the form of Codes of Ethics and Bylaws addressing responsibilities to shareholders and stakeholders. These guidelines should include the concepts of Duty of Loyalty, Candor and Care.*
- *Legislation should also ensure that controlling shareholders owe certain fiduciary duties to minority shareholders. Boards and Management should act in the interest of all shareholders and not only in the interest of a specific shareholder group.*
- *Boards should include a significant number of independent directors who represent the interests of all shareholders. Companies should disclose information publicly that demonstrates the independence of these directors.*
- *The Act should be changed to clarify that independent members of the Board of Directors are not members of the company's executive Management.*
- *Each Board should establish an audit committee, nominations and compensation committees composed predominantly of independent directors.*
- *All Board members should be nominated and elected on the basis of competence and qualification, particularly in their committees' specific areas of expertise.*
- *To further develop the pool of competent and qualified directors, Director Training Programs should be made available.*

"This independence from Management and dependence on shareholders enables and encourages independent directors to act in the interest of shareholders."

3. DISCLOSURE AND TRANSPARENCY

Disclosure of material financial and corporate information leads to transparency and the ability of shareholders and other stakeholders to evaluate individual and company characteristics. Disclosure of potential conflicts of interest is one mechanism that allows shareholders to evaluate whether directors (even independent directors) are acting in the company's best interests rather than in their own self interest, and whether the directors can truly represent the interests of the shareholders as a collective body. Similarly, Management has a duty to disclose information both about their relationships that might affect their behavior, including conflicts as well as to disclose information about the company itself.

While disclosure associated with Boards generally concerns ensuring independence from Management and the company, Management disclosures focus on ensuring alignment with shareholders' interests – and conversely, the lack of any conflict of interests with those of shareholders. Management's duty is to act honestly and in good faith in the best interest of the company as a whole.

Management is expected to fulfill their duties with care, diligence, and skill and to avoid conflicts of interest. Management should also disclose information regarding transactions or relationships that might create a conflict of interest, and allow an independent committee to review such disclosures. All conflict of interest disclosures, at both the Board and Management levels, should precede the execution of any potentially conflicting contract. Mechanisms should be devised to help isolate the conflicted manager or director from decision making about issues in which they have a conflict of interest.

"Mechanisms should be devised to help isolate the conflicted Manager or director from decision making about issues in which they have a conflict of interest."

Corporate Governance best practice also requires disclosure of quality financial and non-financial information about the company's activities and performance, including about the company's ownership structure and about its Corporate Governance practices (regardless of what those practices are, and in particular, Board and Management remuneration) to allow shareholders, potential investors, and other stakeholders to evaluate and respond to those practices. In fact International Financial Reporting Standards (IFRS) will require disclosure from 2005 onwards of compensation paid and various other benefits provided in total to key Management personnel.

Disclosures must be relevant, reliable, timely, understandable, and comparable, both over time and with those disclosure formats of other similar entities. Investors in privately held companies are entitled to the same level of disclosure on matters that may have a significant impact on the company's business or prospects as investors in publicly traded companies.

A significant part of disclosure expectations revolve around shareholder meetings. Corporations should give proper notice of meetings and publish in advance a complete, timely, and accurate set of information useful in assessing and predicting financing, investing, and operating activities as well as predicting future cash flows and changes in equity. Meeting agendas should be planned so that all items are considered, sufficient time is allotted to each item, and certain agenda items (i.e. remuneration, audit, Management disclosure) should be standing items.

Minutes should be made available within a reasonable time frame. Legislators should stress that Management's responsibilities for financial statements must extend beyond shareholders'/unit holders' meetings.

"Disclosures must be relevant, reliable, timely, understandable, and comparable – both over time and with those disclosure formats of other similar entities."

Hungary's evolution to international financial reporting standards will also help remove uncertainty in any disclosures. Convergence in tax reporting to EU and other international standards would also assist the government in achieving its objectives in assuring proper tax accounting. Both of these areas should be accelerated.

DISCLOSURE AND TRANSPARENCY: RECOMMENDATIONS

- *Legislation should require in both public and private companies proper disclosure by calling for information to be accurate and readily available, to support responsible shareholder decisions and emphasizing that Management's responsibility for financial statements extends beyond share-holders'/unit holders' meetings.*
- *Board members and Management must avoid conflicts of interest, but disclose in writing any that exist.*
- *Disclosure of conflicts of interest should precede the execution of any potentially conflicting contract and mechanisms should be developed to isolate the conflicted-party from participating in the particular decision at issue.*
- *Board member and Management remuneration should also be disclosed, particularly in publicly traded companies and public institutions – consistent with IFRS requirements from 2005.*
- *Companies should provide timely notice of all meetings, and relevant, accurate information reasonably in advance. Agendas should be complete and predictable, and minutes should also be circulated within a reasonable time frame.*
- *Accelerate convergence to international tax and accounting standards.*

4. INTERNAL CONTROL

Internal controls help to assure that the company assets are being used appropriately are not subject to employee theft, and financial records are being accurately kept. Therefore internal controls are a key aspect of disclosure and transparency. Additionally, internal control supports the responsibility of the corporation and the accountability of Management (making individuals identifiable within the corporation for decision-making responsibility) to the company and its shareholders and other stakeholders.

"Internal controls help to assure that the company assets are being used appropriately…"

Internal control is commonly defined as a process designed to provide reasonable assurance regarding the achievement of the following objectives:

- operational effectiveness and efficiency;
- reliability of financial reporting; and
- compliance with applicable laws.

In Hungary, legislation does not explicitly prescribe Boards' or Management's responsibilities with respect to the development and implementation of best practice internal controls. While The Budapest Stock Exchange Corporate Governance Recommendations identify Board of Directors' responsibilities for internal control, we recommend that the Act also require an organization's Board and Management to establish, implement and monitor a system of internal controls.

Internal controls should include five interrelated components: (i) The Control Environment includes the "Tone at the Top" and the tone of the entire organization, and includes the establishment of a Code of Ethics. (ii) Risk Assessment is the identification and analysis of relevant risks, providing the information necessary for appropriate disclosure and Management of those risks. (iii) Control Activities ensure that Management directives are carried out. (iv) Information and Communication policies, including financial reporting, ensure that pertinent information is identified, captured and communicated in a useful form and timeframe. (v) Monitoring processes evaluate the quality of the internal control system's performance over time and should include an independent internal audit function that reports to the Boards or Audit Committee. Evaluations made should be disclosed to stakeholders and other shareholders (in Hungary, through the Business Report).

INTERNAL CONTROL: RECOMMENDATIONS

- *Boards and Management should establish, implement, monitor and report regularly on a system of internal controls.*
- *Boards and Management should adopt an internal control system independent of Management evaluation to report directly to shareholder representatives such as the Board.*
- *Companies should establish a code of ethics for all employees, which all individuals should confirm their compliance in writing and Management should communicate its contents on an annual basis.*

"Monitoring processes … should include an independent internal audit function that reports to the Boards or Audit Committee."

5. CORPORATE SOCIAL RESPONSIBILITY: CSR

Corporate Governance encourages and is an aspect of broader corporate social responsibility (CSR). A broad definition suggests that CSR is a reliance on basic ethics in corporate decision-making and activity. Such reliance is thought to encourage companies to manage business processes in a way that produces an overall positive impact on society. The fundamental tenets of CSR thus include companies' need to comply with the law (keep promises and contracts), to compete in a fair and transparent manner (not lie or cheat), and to both account for and be accountable for their impact on the environment and society (respect others' rights, and avoid harming others).

Good Corporate Governance also encourages the recognition of all shareholders' and other stakeholders' rights. It encourages corporate social responsibility more generally by emphasizing an institutional structure made up of internal control and Board and Management structures that support ethical corporate behavior, including the establishment

"Companies should have an explicit and public CSR policy … That CSR policy should be embedded within the organization's culture …"

of a Code of Ethics. Corporate Governance ensures the institutional structure for implementing responsible corporate behaviour.

There is no doubt that the reality of business management throughout the world is fundamentally altering in favor of CSR. Companies who behave irresponsibly are increasingly financially penalized, whereas companies that address their broader social responsibilities benefit through improved performance.

Companies should have an explicit and public CSR policy, identifying their CSR goals and how those goals are met at least in the areas of environmental responsibility, human rights, labor relations, and Corporate Governance. That CSR policy should be embedded within the organization's culture, requiring it to be reasonable, including to all shareholders, and understandable to ensure awareness and support. Effective systems must be established for its implementation, including regular monitoring of its success through internal audits and independent, expert evaluations.

"… Government may require, and educators should support, both formal and informal social responsibility education."

Governments and universities should encourage research on the effectiveness of CSR, and awareness by providing access to international CSR information sources, and through multi-stakeholder discussion forums. At all levels, Government may require, and educators should support, both formal and informal social responsibility education.

CORPORATE SOCIAL RESPONSIBILITY: RECOMMENDATIONS

- *Companies should establish an explicit CSR policy, including a Code of Ethics, established as part of an internal control system, and ensure that the policy is embedded in the organization and disclosed to all shareholders and other stakeholders.*
- *Government and universities should promote awareness of CSR's effectiveness.*
- *Social responsibility education should be mandatory in curricula at all levels.*