An Introduction to Corporate Governance: A Global Concept for Vietnamese Enterprises

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Traditionally, Vietnamese state-owned enterprises have had little incentive to deal with Corporate Governance issues and legislation in this area has been lacking. Beginning in 1986, however, the country has embarked on a process of renovation (đổi mới) and open door (mở cửa) policy and quickly moved towards a market economy. Progress in this process has been marked by Vietnam normalizing relations with the USA (1994), membership in ASEAN (July 28, 1995), and the signing of the Bilateral Trade Agreement (BTA) with the USA (2001). Further, discussion about Vietnam applying for membership in the World Trade Organization (WTO) is ongoing. With integration into the world economy, there is a growing need to increase the awareness and knowledge about good corporate governance among management, board members, and other stakeholders of equitised or soon to be equitised enterprises as well as other business leaders, government officials, and entrepreneurs.

A recent survey by Danida (2002), undertaken during a series of workshops on Corporate Governance for Vietnamese enterprise managers, confirms that there is a strong need for raising awareness and providing training on corporate governance. The small survey of 88 enterprise managers shows that more than half (56%) believed that Corporate Governance is the same as "business administration". Another interesting finding from this survey is that one quarter (24%) of respondents expressed that their enterprises currently are lacking a good Corporate Governance mechanism. This acknowledgement of the need for improvement in this area is positive and should be welcomed.

As Vietnam adapts to the global environment, Vietnamese enterprises will face intense competition at home and abroad for market share as well as investment capital. To meet this competition successfully, the management of each enterprise must modernize and optimise its operations in order to ensure the successful performance of the enterprise and hence satisfy the expectations of customers, shareholders and others who finance the enterprise. Corporate Governance deals with the relationship between the management bodies, the shareholders and other financiers.

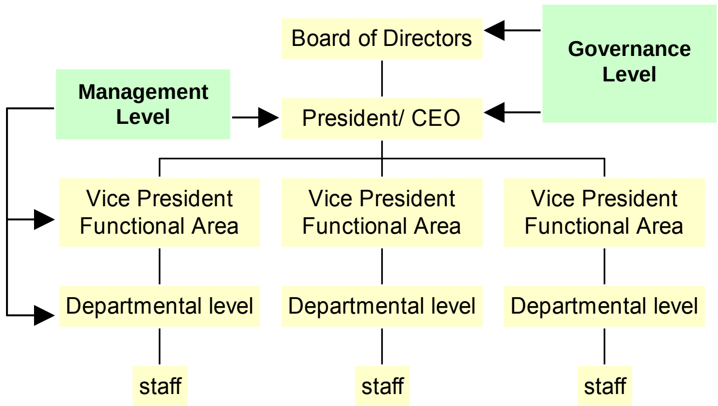
The Concept of Corporate Governance

There are many definitions of Corporate Governance. For example, Shleifer and Vishny state that, "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest in bad projects? How do suppliers of finance control managers?" (Schleifer and Vishny, 1996, p. 2).

More broadly, however, J. Wolfensohn, president of World Bank has suggested that, "Corporate governance is about promoting corporate fairness, transparency and accountability" *Financial Times*, June 21, 1999. In application and demonstrated on figure 1 below, corporate governance often refers to the relationships among the board of directors, top management, and shareholders of a business enterprise. The board of directors oversees the top management, with the concurrence of the shareholders (the business owners.) (Monks and Minow, 1995, p.1).

Figure 1

Generic Organizational Chart for Firms in a Market Economy



Good organizational governance is especially relevant to any arrangement where owners themselves do not undertake the management function directly. Under this arrangement, the owners (typically called shareholders) select representatives to oversee their investment who fulfil this function as members of the board of directors. As illustrated in Figure 1 above, the board of directors provides oversight to management. The Board also hires and evaluates the firm's Chief Executive Officer (CEO), normally also called the President. The CEO serves as a connecting link between the Board, or Governance Level, and management team. In effect, the CEO's dual role is one of a number of challenging aspects of this governance model.

Corporate Governance in Vietnam

Vietnam's system of state-owned enterprises (SOEs) provides another example where owners do not actually manage the firm. SOEs constitute a major segment of business and industry in Vietnam. As the SOEs are ultimately owned by everyone (the Vietnamese people), yet they are owned by no one in particular, they represent the classic case of the "principal-agent problem." This means that the principal (owners, i.e. the Vietnamese people) bears the risk and the agent (the management) is in control without any clear recourse in case the SOE is under-performing. (For a general discussion of the application of Agency Theory to Corporate Governance see Wheelen and Hunger, 2000).

The core organization of the Corporate Governance system in Vietnam involves three constituent decision-making bodies:

- Shareholders' annual general meeting
- Board of directors (management)
- Control committee (supervisory board) when having more than 11 shareholders

It is important to note that this architecture does not constitute the Corporate Governance system but merely the framework for exercising Corporate Governance. The effectiveness depends on how the framework is operationalized.

The legal and institutional framework for Corporate Governance in Vietnam

Institutional set-up:

The government of Vietnam only recently has begun to seriously address some of the legal issues that relate to Corporate Governance development. Therefore, although there are many encouraging developments in the area, the institutional framework remains incomplete.

The Enterprise Law:

The Enterprise Law, which came into effect January 1st 2000, provides the main legislative framework for Corporate Governance systems in Vietnam. However, there is a range of other laws influencing the Corporate Governance framework including accounting laws and labour laws.

Shareholders, large or small, have a number of rights by law. In Vietnam, these rights are stipulated in the Enterprise Law.

Shareholders' knowledge of these basic rights is an important first step towards a healthy corporate governance system.

Box 1: Rights of shareholders

Protection of shareholders' rights and the capability of shareholders to influence the behaviour of the corporation are pillars of good governance.

An ordinary shareholder (holding minimum one ordinary share) has certain rights according to the Enterprise Law. Among other things he or she shall be entitled to:

- Participate to vote for all issues within authority of the shareholders' meeting including change of corporate charter, hire and fire board of management
- Authorization of major strategic decisions
- Receive dividend
- Priorities in buying newly issued shares
- Receive assets in case of bankruptcy

Company charter:

Corporate Governance arrangements are typically codified in the company charter containing core provisions stipulated by the legal and regulatory framework. However, these provisions are often formulated in very general terms (vague language) and subsequently less effective in practice. Contrary, if very detailed safeguards and provisions are written into the charter, there is a risk that the freedom of management in exercising initiative is circumscribed. The ability to formulate and understand company charters is therefore of great importance for executive SOE managers and other stakeholders involved in the equitisation process.

Box 2: The role of the Board of Director

The board is the main mechanism for monitoring management and developing strategy. In order to ensure the monitoring function it is crucial that the board is independent from the management. It is therefore advisable to have non-executive participation on the board hindering executive control.

Specific tasks of the board are:

- Auditing
- Deciding on remuneration for executive management
- Nomination to the management
- Ensure that the enterprise acts fairly with respect to various groups of shareholders
- Deal fairly with stakeholders, assure compliance with law
- Review the business strategy and planning
- Manage potential conflicts of interest
- Assure integrity of accounting
- Reporting and communications

Responsibilities of Board of Director:

The main function of the board is to monitor the management in a variety of ways and to provide strategic guidance concerning the future business development of the company.

Some key issues of Corporate Governance in Vietnam

Ownership structure and exercise of control rights:

It is argued that when ownership is dispersed among many shareholders and no controlling stakeholder exists, there is little option or incentive for individual shareholders to seek influence on the management's dispositions. Contrary, when ownership is concentrated and some stronger shareholders exist, there will be a greater ability to discipline poorly performing management – and the shareholder will have more incentive to intervene and seek to influence the management of the company. However, whilst this influence may be positive, it should be kept in mind that there is a risk of possible exploitation of influence by larger shareholders at the expense of minority shareholders.

In Vietnam the State in some cases maintains a controlling equity stake in equitised enterprises. Since SOEs tend to be characterized by weak internal safeguards this might continue to be so if the controlling shareholder remains the same as before (the State). In such cases – as in all cases with controlling shareholders – there is a need to be aware of the risk that the rights of minority shareholders are not honoured.

In other cases, the management and employees acquire the enterprises. Employees will often only hold a few shares each while management tends to hold larger stakes. Such a buy-out by employees and management may be considered advantageous as it ensures that the original stakeholders remain. However, it also creates some risks. One risk is that the employees continue to consider themselves subordinates of the management and therefore fail to exercise their control rights (*see box 1 above*). This may happen either because the employees only possess limited knowledge about their rights as shareholders and/or because of continued loyalty to the management meaning that they do not seek to influence the management's decisions. This type of insider controlled ownership structure is likely to give the management excessive power in decision-making leaving little incentive to install an independent board of directors with external members involved.

External investors rarely obtain a controlling stake during equitisation in Vietnam. Furthermore, external investors are often not considered to be serious investors "working" in the interests of the enterprise. However, over the longer term, as the State starts to sell off its interest in equitised enterprises and inside minority shareholders (management and employees) start to trade their shares, it is likely that external investors will play a more visible role in enforcing control on management and its decisions. This is likely to meet some initial resistance among employees and management who may fear that outside investors will be highly profit driven and therefore will seek to cut costs, including wage and employment costs. However, whilst external investors may be profit driven they are also usually often growth driven and seek to expand the business, both by employing more people and by retaining good employees through higher wages. In addition to this, external investors can possibly help (force) the enterprise to strengthen its Corporate Governance system.

Box 3: Strategic members of the board

Having strategic members on the board can prove to be a source of critical inputs for the individual enterprise. External participation at the board level can strengthen its competences significantly. Just as important is the opportunity to benefit from the extensive network that strategic board members' may have. Examples of potential strategic members include:

- Bankers (rep. the enterprise's main banks)
- Lawyers
- Business people with industry knowledge
- Raw material suppliers
- Institutional investors
- Investment fund managers

Management and incentives:

In most equitised enterprises, the management is subject to little or no change at least in the initial period following equitisation. Consequently, the mindset of the SOE era is being carried over to the new entity and this often creates difficulties when the company has to compete commercially on market terms. Bringing external people into the executive management is a way to change the mindset of the existing management just as it allows the enterprise to strengthen its capacities in certain areas. However, there seems to be some reluctance towards including executive managers from the outside.

Another issue is the lack of correlation between the remuneration of executive managers and firm profitability and size. It is generally argued that in order to ensure that the management works in the interest of its owners and other stakeholders, it is important that there is correlation between remuneration and enterprise profitability and size in order to provide managers incentive to perform. An additional benefit of introducing managerial incentives is that it is likely to reduce the risk of opportunism and rent seeking.

Separation of powers:

An important aspect of the governance system is the monitoring mechanism, which lies with the board of management. In many of the equitised enterprises this mechanism is not functioning properly. One reason being that often the role of the board is not well defined in the company charter. This especially holds true in companies where management also dominates the board. Having the executive management dominate the board obviously interferes with the independence of the board and hinders an objective monitoring system.

For shareholding companies with a control committee (supervisory board), separation from the board of management (directors) is equally important. The control committee, with its obligation to supervise the activities of the board, should be entirely independent.

Executive control at the board tends to foster a closed Corporate Governance system controlled by a small number of insiders. The immediate consequences appear to be a lack of transparency and disclosure, which prevent minority shareholders and other stakeholders from having sufficient information and insight into the performance of the company.

External participation on the board can help overcome some of these risks, in as far as it aids to separation of the board and executive managers. As well as providing the board with a degree of independence, outsiders (non-executives) on the board may also provide other benefits.

The potential benefits of strategic board members for example may very well outweigh the additional cost of having external members on the board (costs incurred as they are likely to request higher remuneration than board members from the existing management and others already on the payroll).

However, some enterprises are also restrained by the lack of qualified candidates in the external environment to hold seats at the board. The market for managerial labour (including board representatives) in Vietnam is still small and the supply of qualified candidates insufficient.

Mobilisation of capital and transparency:

As part of the restructuring process enterprises often need to mobilise new capital in order to undertake crucial investments. During the era of central planning (and to some extent still), SOEs relied almost entirely on debt financing via state banks. Upon restructuring to become Joint-Stock Companies, access to favourable financing from the State banks is likely to become gradually more difficult, especially for those companies with limited or no State participation. This is in part a consequence of the ongoing banking reforms, which seek to commercialise the banking sector. Most equitised companies will find that the cost of loans will be substantially higher than it used to be. Some companies may be in a position where they cannot obtain loans from neither state controlled banks or private banks.

As financing through the debt market becomes more expensive, it is foreseen that the equity market gradually will play a more and more important role in capital mobilization as the legislative framework in this area improves.

The issue of financing is relevant to Corporate Governance as enterprise performance is critical to the market price of capital. Also, the financing structure affects the shareholder structure and is therefore of interest to current shareholders. The financial market will play an important role in financing future investments and the issue of transparency and disclosure will have to be considered seriously by the companies.

Transparency is critical to obtaining finance both in the debt- and equity markets. However, given the legacy of central planning with its low transparency and disclosure requirements, it is not surprising that restructured enterprises often remain reluctant to disclose information. However, with rapidly changing ownership structures and reform of the domestic financial market much more attention will have to be given to the issue of transparency and disclosure in the years to come. In the future, investors and financiers alike will be looking for companies that are able to openly document a strong enterprise performance (by way of audited accounts, registered contingencies, timely and precise forecasts, etc).

Profitable enterprises will have to consider whether to pay dividends to its shareholders instead of reinvesting profits. By reinvesting profits the enterprise might increase shareholder value just as it reduces the need to raise capital in the debt market. Vietnamese enterprises are in general paying rather high dividends with the purpose of attracting investors and satisfying existing shareholders. However, this policy might be short-sighted as a high dividend ratio can disadvantage to the enterprise in the long run. There is a profound risk that a high dividend ratio will be at the expense of critical investments, which in the long run can have severe consequences for the enterprise (and its shareholders).

The Changing Landscape of Vietnamese Boardrooms

While the eventual outcomes of Vietnam's renovation process are uncertain, one fact is becoming clear: Vietnam's private sector is developing rapidly, and the governance of the more successful private firms is following a pattern similar to the Board of Directors Governance Model discussed above. A recent Private Enterprise study sponsored by the International Finance Corporation (IFC) and the World Bank surveyed over 600 private and 100 SOE firms regarding their governance structure (among other issues.) The unpublished working papers from this study indicate a correlation between power sharing with the boards of directors and higher performance of the firms. While this is not the final statement from either this or future research studies, it bodes well for the future as Vietnamese enterprises learn how to organize and govern themselves to compete in the global economy. Whether or not Vietnam's State Owned Enterprises will successfully follow the example of their private sector counterparts, however, remains uncertain.

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