



CORPORATE GOVERNANCE IN EMERGING MARKET ECONOMIES: THE THEORY BEHIND CORPORATE GOVERNANCE AND ITS PRACTICAL APPLICATION IN THE BRICS COUNTRIES –ANALYSIS OF THE BRAZIL EXAMPLE

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Abstract:

This article examines the role of corporate governance regulations in the emerging market economies giving a critical analysis of the example of a BRICs country - Brazil. The article presents a study of the theoretical aspects of corporate governance regulations, how they work and what effect they have on the economy of a developing country. The study is motivated by the question how corporate governance can benefit foreign investment into an emerging market country. The findings of the study are illustrated by the Brazilian example of how the corporate governance regulations were introduced into company practice in the country and what effect they had on the economic situation. This analysed example shows what problems were identified in the process and various ways to overcome them to provide more confidence to the foreign capital investment into the country.

Keywords: Corporate Governance; Emerging Market; Brics; Brazil; Company Management.

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1. Introduction

In the recent years there has been noted a substantial growth in corporate governance development at the global level, and this trend is especially strong in the emerging economies. The BRICs countries, which represent developing countries with one of the highest growth rates, are showing an increasing interest in the promotion of the use of the corporate governance codes by the companies, aiming to protect the interests of the shareholders, the stakeholders and the economy in general. International organisations such as the Organization for Economic Cooperation and Development (OECD) have worked out internationally acceptable standards of corporate governance to facilitate the process of the creation of the corporate governance codes (Solomon, 2010). It can be said that the Corporate Governance has become an important part of the global organisational system that is standardized, unified and clearly defined at the international level.

In this paper, the authors will focus on the analysis of the system of corporate governance from the perspective of the theoretical framework and by providing an example of how corporate governance system is represented in an emerging economy of one the BRICs countries – Brazil.

2. Defining Corporate Governance

The understanding of how corporate governance system works comes from the understanding of the phenomenon of corporate governance in today's world. According to the work of J.Solomon (2010), there does not exist one universally accepted definition of corporate governance. Depending on the country, the definitions vary considerably. The 'narrow' approach to defining corporate governance views it simply as a relationship between a company and its shareholders. This traditional view is expressed in the Cadbury Report (1992), which defines corporate governance as 'the system by which companies are directed and controlled'¹. However, in the recent years this approach has undergone a review and a broader approach is currently used more often by the academia and the practitioners worldwide.

The broadest definition suggests that companies are accountable to the whole of society, future generations and the natural world. Thus, in the broadest terms corporate governance is defined as the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity (Solomon, 2010).

Analysing the definitions of corporate governance further, it can be noted that the purpose of corporate governance is summarized by the following aspects:

- Corporate governance is aimed at facilitating and stimulating the performance of corporations by creating and maintaining incentives that motivate corporate insiders to maximise firms' operational efficiency, return on assets and long-term productivity growth;
- Corporate governance is aimed at limiting insiders' abuse of power over corporate resources – whether such abuse takes the form of insiders' asset stripping or otherwise siphoning off corporate resources for their private use, and/or their causing significant wastage of corporate-controlled resources (the “agency problems”) – which are otherwise likely to result from insiders' self-serving behaviour;
- Corporate governance provides the means to monitor managers' behaviour to ensure corporate accountability and provide for reasonably cost-effective protection of investors' and society's interests vis-à-vis corporate insiders.

Corporate governance as the modern system of corporate control appeared as an answer to several big scandals, such as the Enron case in 2001, or the case of the 'European Enron' – Parmalat in 2003. The fall of Enron accelerated the worldwide agenda for corporate governance reforms (Healy, Krishna, 2003). The Organisation for Economic Cooperation and Development (OECD) has played a significant role in the development and the worldwide implementation of the corporate governance norms and principles.

The final report 'The financial aspects of corporate governance' (usually known as the Cadbury report) was ¹ published in December 1992 and contained a number of recommendations to raise standards in corporate governance

The OECD principles of corporate governance were first issued in 1998 and have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide (OECD, 2004). They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries.

The OECD main criteria that the countries are advised to include in their corporate governance codes are the following:

- Ensuring the Basis for an Effective Corporate Governance Framework
- The Rights of Shareholders and Key Ownership Functions
- The Equitable Treatment of Shareholders
- The Role of Stakeholders in Corporate Governance
- Disclosure and Transparency
- The Responsibilities of the Board

These criteria unite all of the main principles of corporate governance and identify the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibility of the board of directors (World Bank report, 2005). Including the mentioned principles in the corporate governance code of a developing country ensures the correct understanding of the functioning of the corporate governance system. For emerging market countries, improving corporate governance is crucial, and it serves a number of objectives. Good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the costs of capital, and leads to capital market development. At the same time, weak corporate governance reduces investor confidence and can discourage outside investment. Pension funds are now continuing to invest more in equity markets, and good corporate governance is crucial to preserve retirement savings (World Bank report, 2005).

3. Theoretical Framework of Corporate Governance

There are several theories that have evolved to help explain and analyse the system of corporate governance. The theoretical approaches analysed below each view corporate governance in a different way depending on the perspective from which the corporate governance is explained. Thus, from the field of finance arises the agency theory paradigm, and from the field of economics – transaction cost theory (Solomon, 2010). Also, according to Solomon (2010), such framework as the stakeholder theory arises from a more social oriented perspective of corporate governance.

The agency problem was first recognized in the 1970's by Jensen and Meckling (1976) when the introduction of limited liability and of corporate ownership to the general public through share ownership (Solomon, 2010) changed the way the companies were controlled. The agency relationship was defined as a contract under which one party (principal) engages another party (the agent) to perform some service on their behalf. The principal delegates some decision-making authority to the agent (McColgan, 2001).

The agency problem arises due to the impossibility to have a full control over the actions and decisions of the agent by the principal. Thus, the agency theory presents a view to the problem of how to induce an agent to work in the best interest of the principal. One of the main assumptions in the theory is that the goals of the agent and principal conflict. It is noted by Solomon (2010) that managers sometimes have a tendency towards 'egotism', concentrating on their own interests and not the interests of the shareholders. This can lead to the managers' focus on projects and company investments that provide high short-run profits rather than the maximisation of long-term shareholder wealth by investing in projects that are long-term in nature.

Solomon (2010) suggests that to overcome this agency problem monitoring techniques can be introduced by the shareholder, as well as remuneration contracts for management and debt contracts which seek to align the interests of management to those of the shareholders.

The transaction cost theory, which was introduced by Williamson in 1996, is, in his words, 'an interdisciplinary alliance of law, economics, and organisation' (Solomon, 2010, p.13). Transaction cost theory bases on the fact that firms have become so large that they can substitute for the market in determining the allocation of resources.

The organisations have a choice between two methods of obtaining control over resources:

- the ownership of assets – hierarchy solution – where decisions over production, supply, and the purchases of inputs are made by managers and imposed through hierarchies;
- buying in the use of assets – market solution – when individuals and firms make independent decisions that are guided and coordinated by market prices.

A good example of the ownership of assets idea is the case of oil companies that control and make decisions over the process of production, from oil exploration to refining, and eventual redistribution by sales. An example of the second method is any small retail shop whose decisions are guided and coordinated by the market prices.

Another important theory of the analysis of corporate governance is the stakeholder theory that has developed beginning from the 1970's. This theory appeared because the role of companies in society started to receive greater amount of attention over time, with the impact on employees, the environment, local communities (the stakeholders), as well as the shareholders (Solomon, 2010). A basis for the stakeholder theory is that companies are so large, and their impact on society is so great, that they should discharge an accountability to many more sectors of society than just their shareholders. In the broader understanding of the stakeholder theory, the general public may also be viewed as stakeholders because they are taxpayers that provide companies with a national infrastructure in which they work (Pige, 2002). Closely linked to the stakeholder theory is the idea of corporate social responsibility of the company, which is becoming a major issue for companies in the current economic and political environment.

Thus, the theoretical framework analyses corporate governance from different perspectives by showing the impact that it has on the shareholders of the company, on the managers and employees acting on behalf of the shareholders and to the environment and society in which a

company operates. This analysis has a huge importance in understanding the nature of corporate governance.

In different parts of the world the concept of corporate governance varies greatly. Major variations have been made because of circumstances, which are different from country to country. The two major models of corporate governance are:

- 1) Civil law countries. These countries like France, Italy and Germany came up with the focus on the stakeholders in their corporate governance framework and therefore the role of corporate governance was interested to have a balance between their stakeholder groups such as managers, suppliers, employees etc. (Solomon & Solomon, 2004). Also known as an insider model of corporate control, this approach has the biggest control in a company by employees who are very close to the firm's actual workings (Department of Treasury, 1997).
- 2) Common law countries. Countries such as the UK, the USA, Australia and Canada had traditional structures and therefore developed corporate governance framework with the focus on shareholders and their returns and interests. These structures should guarantee corporations' achievements and set objectives by their owners. This approach, also known as the outsider model identifies the distance between the owners and the management of a firm (Department of Treasury, 1997).

The two approaches were very different but also had similarities. In both models, shareholders elected the management board of a firm and gave them the authority to manage the firm under policies set from the firm's shareholders (Himler, 1998). Corporate governance systems in the countries were adaptations from both major models of corporate governance (Solomon & Solomon, 2004).

4. Example of A Corporate Governance Model in An Emerging Economy: Brazil

Brazil, as one of the BRICs countries and an emerging market country, is a very good place to study the development and the changes, as well as the problems and the recent state of corporate governance regulation (Black et al., 2014). The reasons for an emerging market like Brazil to have corporate governance are the growth of Brazilian's stock exchange listings in 2000, which attracted a lot of investors, the issuance of the OECD principles of CG as well as to rise investment capital and to avoid corporate governance scandals. Since the beginning of the 2000s Brazil has become a more feasible and a more attractive place for companies to raise equity capital, including specific actions to change corporate governance. Economic change includes strong economic growth, achievement of macroeconomic stability, investment grade status for the government and many individual firms. The growth of the pension funds, which became the major investors in public company shares, has also played an important role in the development of Brazil's corporate governance system (Black et al., 2014).

The corporate governance reform in Brazil started in the end of the 90s. Brazilian's corporate governance code was issued in 1999 and has been revised in 2001, 2003, 2004 with the latest version being released in 2010. This code incorporates the best practice of corporate governance and was issued by the Brazilian Institute of Corporate Governance (IBGC). Due to the code, Brazil now is at an advanced stage of corporate governance development (World Bank report,

2005). The demand for voting shares, transparency, tag along rights and other corporate governance rights has significantly increased. The private sector took the initiative to provide incentives that would bridge the gap between the existing legal framework and best practice for issuers who want to distinguish themselves in the competition for capital at home and abroad. Thus, the requirement for stricter corporate governance regulation was introduced that has given investors a benchmark against which to measure corporate governance.

The objectives of the code are to provide principles and bases of corporate governance to publicly or privately held companies as well as to the limited liability and service provider companies and non-governmental organizations with the purpose of increasing the company's value, facilitate access to capital at a lower cost, enhance corporate performance and insure the sustainability and survival of a company for a long term².

The basic principles of Brazil's corporate governance are divided into four major categories:

Fairness: All minority groups should be treated fair and equal, whether by the owners or the stakeholders. (Stakeholders are a vast group that includes suppliers, employees, customers etc.). Discrimination according to policies is completely unacceptable.

Accountability: For the accountability of Brazil, corporate governance agents should report all their actions throughout the time they were employed.

Corporate responsibility: Directors of a company must insure a long-life existence, sustainability and a long-term vision of their organizations and must include therefore environmental as well as social interest in the business and its operations. A company's social role should involve for their associates job opportunities, training and work force diversity, as well as improved living standards by including environmental, cultural, social and educational initiatives into the creation of wealth of a company.

Transparency: Management board of companies should inform their owners to build up a base of trust internal of an organization as well as external to communicate with their local environment. Communication in terms of economic and financial accomplishment shouldn't be limited to the intangible values such strategies and market activities.

The compliance with these principles allows the companies to solve their managerial problems and to show their reliability where the interests of shareholders and stakeholders are concerned.

5. Problems of the Brazilian Corporate Governance Model

The Brazilian corporate governance problems arise from such factors as the concentration of the decision-making in the hands of few shareholders, poor functioning of the board and disregard of minority shareholders' rights. These are the problems that the corporate governance model that exists in Brazil is aimed at solving. One might say that these are the universal problems that any country faces, but for Brazil it is essential to overcome these difficulties in the corporate management of companies to be able to attract more foreign investors.

The major aims of the Brazilian corporate governance model are the reformatting of the ownership structure, setting up a more strict and transparent control of the board of directors and

Code of Best Practice of Corporate Governance. IBGC – Instituto Brasileiro de GovernancaCorporativa. 2010. See ² section: Objectives and basic principles

creating and granting to all the stakeholders the access to the public information of the companies.

In the ownership structure companies are often family-controlled and even listed corporations are controlled fully by its owners. There is a high concentration of voting shares held by its shareholders as well as a high level of issuance of preferred (non-voting) shares.

The problem of the board of directors is the lack of defined roles between the managers, boards and the controlling shareholders in a family-owned corporation. Directors with an informal work method in terms of lack of internal regulations and misuse of guidelines and the amount of external, not independent, directors are problems which corporations must face. Furthermore, there is a lack of formal accomplishment by board members and CEOs. The only reason board structures are still retained is to meet legal requirements.

Finally, the problem that the Brazilian corporate governance model has encountered is the access to and the content of public information available about the company online or in other open resources (Eddis et al, 2013). The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including the financial situation, performance, ownership and governance of the company (World Bank report, 2005).

To improve how the theory of corporate governance is applied to practice and to show the problems of the Brazilian corporate governance model, it is useful to analyse a current example of a Brazilian company which has problems dealing with the corporate governance: the Petrobras scandal.

More than two dozen executives from six large construction companies were arrested for inflating bids for Petrobras contracts and paying bribes to members of parliament and the company embezzled money of approximately US\$752.6 million over 7 years. Due to this scandal on February 4, 2015, Fitch downgraded the company's debt ratings to BBB- from BBB, with a negative outlook. The president to Brazil at the time, D. Rousseff, was the chairman of Petrobras in the years of 2003 to 2010 while the embezzlement was going on. She stated that the problems of Petrobras arose from the lack of corporate governance regulations in the company which led to the possibility of high quantity money embezzlement.

Due to the fact that the Federal Government of Brazil controls approximately 60.5% of the Petrobras' voting rights, it has a direct influence on the company's choice of management and operations. Thus, the lack of corporate government regulations in the company was known to the Government as well as the managing bodies of the company. Prosecutors also claimed that the executives conspired to inflate the price of refineries, ships, advertising and other goods and services.

Owing to this reproach and the scandal of embezzled money, the company lost foreign investors, which removed a key source of impetus for improving governance, even though Brazilian funds are increasingly stepping into the breach.

As a result of this, Brazilian nation called for the impeachment of the President, as anger intensified over the increasing economic hardship and the multibillion-dollar corruption scandal at the state oil company of Petrobras.

This example of failure to comply with the corporate governance regulations and of high level corruption in a particular company with extensive government connections shows the need for the corporate governance code to be introduced into company practice. Moreover, the provisions of the code need to be complied with to provide the best environment for the company management to act within the corporate governance requirements as well as for the investors to feel safe about their investment.

6. Conclusion

Analysing the state of corporate governance regulation at most emerging market countries, it is safe to say that it is characterized by corporate structures with various levels of ownership and inside shareholders such as minority shareholders (Gerlach 1992; Heugens et al 2009). The consequences of this problem depend on the way institutions work within the country and the strict observance of a country's corporate governance policy. Minority shareholders can't be protected against self-dealing by dominant shareholders if there is no regulation and control in a country. Furthermore, corporate governance can't work out properly if a country's institutions admit dominant shareholders to benefit from its owned and controlled firms.

As it can be seen from the example, Brazil needs to work on its corporate governance rules and regulations to avoid the creation of ownership structures inside the companies, corruption and embezzlement like the example of Petrobras shows above. Due to these reasons of failure of corporate governance foreign investors have doubts and worries when planning to invest into emerging markets so the economies of countries such as Brazil can develop continually.

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