

GOVERN

companies

on sustainable way

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Abstract

In the past decade, due to several issues (e.g. Enron, Worldcom and recent stories of the financial sector), corporate governance came in the lime-light of the business world.

In the beginning of the century McKinsey undertook a survey called 'Global Investor Opinion Survey' of over 200 institutional investors. Results showed that 80% of the respondents would pay a premium for well-governed companies. Why corporate governance is so important that 80 % of involved investors would pay more for shares where, beside strong fundamentals of course, the governance of a company provides transparency and accountability in its operation and follow certain measures important for the market?

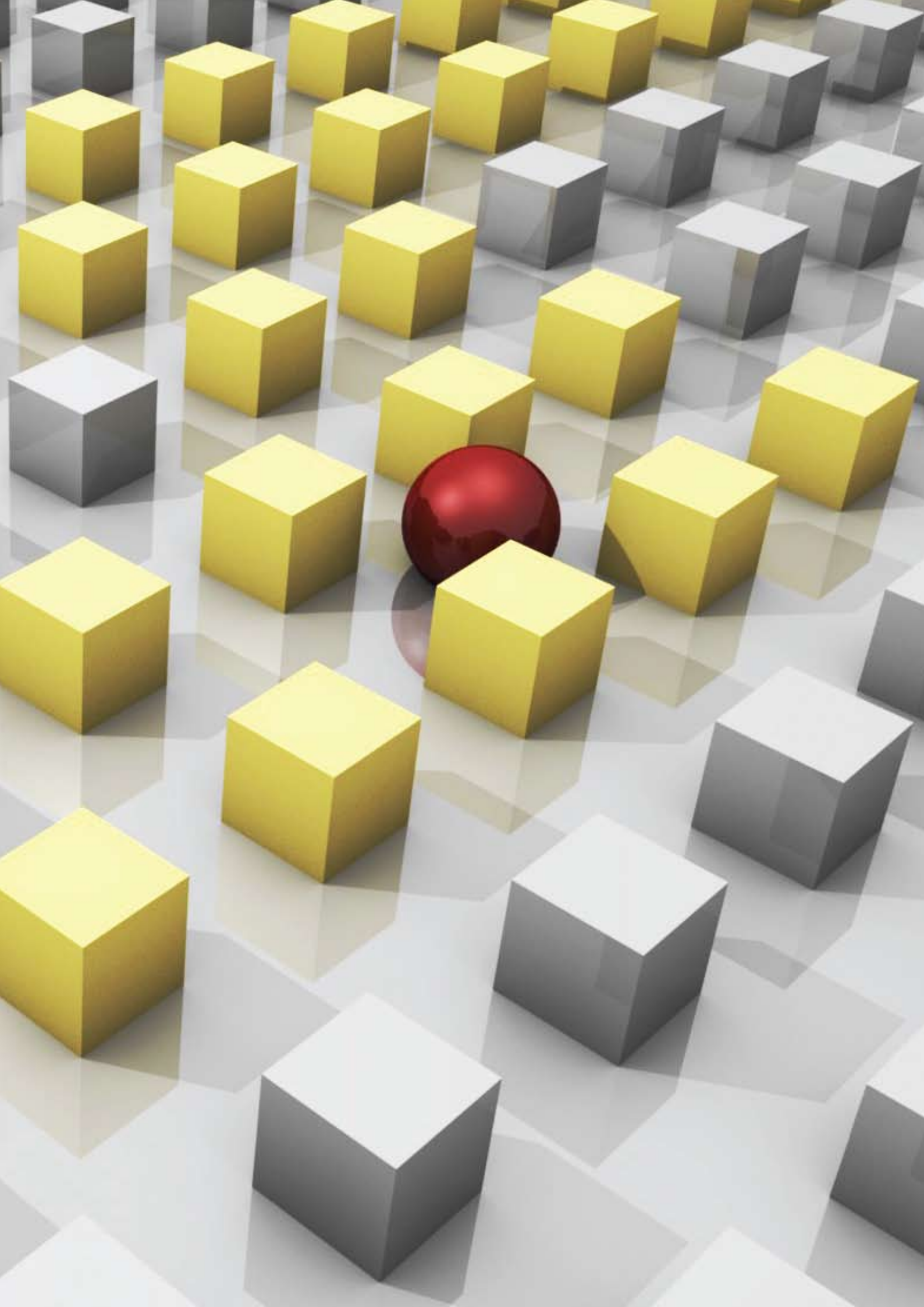
In this article we would like to examine this question and show briefly the concept of corporate governance, its importance, its approach from the sustainable development philosophy point of view and close our article with a short view on MOL's approach.

Összefoglalás

Az elmúlt évtizedben, számos ügynek köszönhetően (pl. Enron, Worldcom és az elmúlt időszak történései a pénzügyi szektorban) középpontba került a Társaságirányítási Rendszer kérdésköre.

A McKinsey a század elején 200 intézményi befektető megkérdezésével lebonyolított egy felmérést "Globális befektetői vélemények feltárása" ('Global Investor Opinion Survey') címmel. Az eredmények azt mutatták, hogy a válaszadók 80%-a hajlandó lenne prémiumot fizetni olyan társaságok részvényeiért, amelyek Társaságirányítási Rendszere megfelelő minőségű. Miért annyira fontos a vállalatok Társaságirányítási Rendszerének kérdésköre, hogy a megkérdezett befektetők 80 %-a hajlandó lenne többet fizetni azon cégek részvényeiért, ahol – természetesen erős fundamentumok megléte mellett –, az Irányítási Rendszer átlátható, számonkérhető működést biztosít és bizonyos, a piac szempontjából fontos intézkedések bevezetésre kerültek?

Cikkünkben ezt a kérdést szeretnénk megvizsgálni, illetve röviden be szeretnénk mutatni a Társaságirányítási Rendszer kereteit, annak fontosságát, kitérünk a Fenntartható Fejlődéssel való kapcsolatára és egy rövid betekintést adunk a MOL gyakorlatába.



Why corporate governance is important?

Corporate governance involves all those processes, policies and laws which define how a corporation is directed, controlled, administered. It provides accountability, transparency in a way to minimize principal-agent problem. The principal-agent problem is the problem circle where the ownership and the management of a certain corporation is divided and the interests of the management and the owners (shareholders) (can) stand in conflict.

It includes the relationships with the different stakeholders (employees, customers, creditors, suppliers, buyers as primary stakeholders, and regulators, governmental, non governmental organizations, environment, future generations, etc as secondary stakeholders). It is also related to economic efficiency.

Many lecturers state that the advantage of a good corporate governance system for a company cannot be measured in an explicit way, however the lack of a (good) corporate governance system results visible effects, destroys value. We can quote a few value destroying incidents from the past, the Enron, Worldcom, or Andersen scandals at the beginning of the millennia and the recent bankruptcy of major financial institutions in the US that shocked the financial world.

Definition of corporate governance

As for the definition we will never find a short and stable definition, as all people, corporate citizens, or to get answer from the top, the CEOs – understand the issue, based on their knowledge, educational and company background, at least slightly, different.

Gabrielle O'Donovan defines corporate governance as *"an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace*

commitment and legislation, plus a healthy board culture which safeguards policies and processes". (O'Donovan, 2003)

To show an example of this slightly different understanding, we can mention a broader definition: "The system by which companies are directed and controlled" or a narrower definition *"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."* (Lukács, 2007)

From these three definitions we can see that, in the middle point of any corporate governance system the focus is on the interest of the shareholder and other stakeholders, and the adherence of the legal expectation towards the companies.

Parties in corporate governance

Parties involved in corporate governance include the Chief Executive Officer, the Board of Directors (BoD), Supervisory Board (SB), Audit Committee (AC), executive management and shareholders. Other stakeholders who take part include suppliers, employees, creditors, customers and the community at large.

In corporations, the shareholder delegates decision rights to the manager to act in the principal's best interests. This separation of ownership from control results a loss of effective control by shareholders over managerial decisions. Partly as a result of this separation between the two parties, a system of corporate governance controls should be implemented to assist in aligning the incentives of managers with those of shareholders.

A Board of Directors often plays a key role in corporate governance. It is their responsibility to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the organisation to its owners and authorities.

All parties to corporate governance have an interest, direct or indirect, in the effective performance of the organisation. Directors, workers and management receive salaries, benefits and reputation, while shareholders, investors receive

capital return. Customers receive goods and services; suppliers receive compensation for their goods or services. In return these individuals provide value in the form of natural, human, social and other forms of capital. (This network of connections also shows the necessity of corporate governance form sustainable development point-of-view).

Background of corporate governance systems

Theoretical background of the corporate governance is derived from Ronald Coase's (1937) "*Transaction costs theory*", from the "*Agency theory*" (Fama, Jensen, 1983), and the "*Stakeholder theory*" (Freeman, 1984).

We can make distinction between the one-tier system (Anglo-Saxon model), where the control, evaluation of the Board of Directors, Managing Directors performance is the task of the Board of Directors (who were elected by the owners), and the two-tier system where the control of the Board of Directors is in the hand of a different body, the Supervisory Board (German model). There are debates on the effectiveness of the two types, but as analyses of the two systems shows neither can be superior to the other in this aspect (Jungman, 2006)

In the last sixty years as corporate structures became more and more complicated, the number of multi/transnational companies grew at a never before seen pace. This led to the various issues, debates which made corporate governance one of the important issues in the eyes of investors as the demand for having transparent, accountable operations has grown amongst them to protect their interests, investments too.

Problems in the business world, from time to time, further shape corporate governance practices. As previously written, the lack of corporate governance is value destroying. The 1997 East Asian Financial Crisis reflected on the institutional discrepancy of the institutions in the most affected Asian countries (Thailand, Indonesia, South Korea, Malaysia and the Philippines). At the beginning of the decade the bankruptcy of Enron and Worldcom put the corporate governance issues in limelight again (to be discussed later).

The current financial crisis also shows the importance of good corporate governance. It highlighted the lack of good corporate governance where proper Risk Management systems and remuneration guidelines at affected financial institutions were not properly matched and addressed. The instant lesson learned from this crisis for the OECD countries is to review again (after 2004) their corporate governance guidelines, policies. The standards of accounting and external regulations were also insufficient in these areas, and the risk taking, remuneration policies of certain companies, institutions were not in line with the long term interests. (Kirkpatrick, 2009)

The ultimate outcome of a good corporate governance system in general means a transparent and efficient institution/corporation which helps the development of the society and common good.

Also the lack of a well established corporate governance system can be felt on share prices of companies, as investors are willing to pay a premium for shares of a well governed company, the market is pricing any disfunctionalities which can be traced back to a bad corporate governance system. (Dallas, 2003) In its 'Global Investor Opinion Survey' of over 200 institutional investors undertaken in 2000 and a few years later again, McKinsey found that 80% of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly out-side (non-executive) directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests for information on governance issues. The size of the premium varied by market, from 11% for Canadian companies to around 40% for companies where the regulatory backdrop was least certain (those in Morocco, Egypt and Russia).

Although, it has to be mentioned that it cannot be said explicitly by which percentage are investors taking the corporate governance system of any company into account when pricing the fundamentals of the company, investing into it. It must be mentioned also that the corporate governance system is only one pillar in the building of corporate success, a competitive advantage, core competence, extreme expertise in the business of the company is also requisite for success. (Leuscher, 2006)

Main principles, controls of corporate governance

A good corporate governance system is honest, open, transparent, accountable and towards the owners of the company gives them an oversight. All these have to be manifested in the corporate governance documents of the companies. As these are very general comments on the major principles, these can be put explicit in the following (not complete) capitulation:

- Rights and equitable treatment of shareholders
- Interests of other stakeholders to be taken into account
- Role and responsibilities of the board must be set clearly, the mixture of executive/non-executive directors must be healthy to ensure real control
- Integrity and ethical behavior
- Disclosure and transparency

Also clear policies must be developed for the following corporate governance related issues:

- selection procedure of independent auditor,
- risk management,
- oversight of the preparation of the entity's financial statements,
- dividend policy,
- procedure for nominations of Board of Directors, Supervisory Board, Audit Committee
- remuneration of the executive officers.

There are certain internal and/or external control methods for corporate governance systems. The before mentioned one-tier and two-tier system can be a good control process, monitoring system over the executive management; also healthy Board structure (proportion of executive, non-executive directors) as internal control mechanism. External controls, as seen from different managerial theories, include competition, debt covenants, government regulation, media pressure, takeover attempts or even the managerial labour market.

Sustainable development and corporate governance

The connection of corporate governance issues and Sustainable development are multiple. The corporate governance system is one of the most important economical pillars of a company or institution operating in a given business-social environment.

Sustainable Development is connected corporate governance as a good corporate governance system is essential for the control of any institution/corporation, and in this way it can ensure its long term successful performance, it eliminates the possibilities of fraud, corruption, blackmail, unethical behavior, etc. serving the good of stakeholders.

Corporate governance and Sustainable Development cannot be viewed only as an internal policy or regulation package of a company. Based on the ideas of the stakeholder theory, the effects of a corporate governance system are felt not just among the primary stakeholders of the company, but as well as through the whole stakeholder map (with secondary stakeholders). Different metrics evolved in recent years for the measurement of SD performance, although we have to highlight these aren't followed in a unified manner by all companies and have different meanings all over the world. Also they have currently a short history regarding reliability on performance of the companies. These performance measuring methods focus on the Natural Capital (energy usage, pollution, recyclability), Human Capital (Development, diversity and equal opportunity, workplace safety and relation), Social Capital (community engagement, corporate philosophy, costs/benefits to local economy) (Leuscher, 2006) and also on the economic dimensions of the company (risk Management, corporate governance, etc). The so-called ESG performance measuring is one of such. ESG reflects on the environmental, social and corporate governance performance of the companies.

The benchmarking, measuring of corporate governance as part of Sustainable Development is yet short lived, but more companies are taking part each year in such surveys on a voluntary



basis. As mentioned before these are just one part of every industries global participant, but the participants number is growing each year in the industries.

ANOTHER CONNECTION OF CORPORATE GOVERNANCE AND SUSTAINABLE DEVELOPMENT

The beforehand mentioned approach to corporate governance is based on the assumption that a good corporate governance system of a company or institution is good for its performance, “development” in classic terms, thus helping to develop a sustainable operation of the company which is also in favor of other stakeholders.

If we approach corporate governance principles from the Sustainable Development side we can see, that it has now a majority part in the way a 21st century publicly traded company is governed, managed. The impact of various events, international agreements in the past (environmental movements, effects of environmental catastrophes, Kyoto Protocol, demonstrations, etc) can be felt in the policy

making of the companies, corporate governance systems (e.g.: the establishment of MOL Groups Sustainable Development Committee of the Board of Directors can be seen as the manifestation of Sustainable Development infiltrate into Mol Groups culture). Also the establishment of Investment Funds by companies dedicated to Sustainable Development, and the previously mentioned SD performance measurement/ scoring systems can be seen as the SD being more and more part of corporate cultures.

The adoption of the following principles by the International Council on Mining & Minerals shows clearly the spreading of this view on global level (www.icmm.com):

1. Implement and maintain ethical business practices and sound systems of corporate governance.
2. Integrate sustainable development considerations within the corporate decision-making process.
3. Uphold fundamental human rights and respect cultures, customs and values in dealings with employees and others who are affected by our activities.
4. Implement risk management strategies

- based on valid data and sound science.
5. Seek continual improvement of our health and safety performance
 6. Seek continual improvement of our environmental performance
 7. Contribute to conservation of biodiversity and integrated approaches to land use planning
 8. Facilitate and encourage responsible product design, use, re-use, recycling and disposal of our products
 9. Contribute to the social, economic and institutional development of the communities in which we operate
 10. Implement effective and transparent engagement, communication and independently verified reporting arrangements with our stakeholders

The 1st, 2nd and 4th principle are clearly issues which affect all the stakeholders, and must be set in the corporate governance System of the mining companies.

THE ENRON SCANDAL AND ITS CONSEQUENCES

In the following paragraphs we would like to show a short case study about the importance of corporate governance systems, and the need for an effective legislation about related issues in any country's legal environment.

The Enron scandal was a financial scandal involving Enron Corporation and its accounting firm Arthur Andersen, that was revealed in late 2001. Lack of proper control, mainly as a result of insufficient regulatory background backing the free-market system led to investors losing their money on Enron.

Enron was one of the most successful companies of all time. Success followed success at the energy trader company, which was highly backed by favorable regulatory framework also (as a result of strong lobbying power). Enron's share price was soaring, the company looked unstoppable. Fortune magazine awarded Enron for five consecutive years with the "America's most innovative company" title (www.lycos.com).

However, below the surface, due to improper corporate governance systems Enron was able, hidden from shareholders and other stakeholders, build a house of cards (backed by their accounting firm, Arthur Andersen also as a financial consultant to the company) that main features were:

- real results became secondary to share price increase
- losses hidden through offshore companies what Enron took off of the balance sheets
- showing investors a picture of a continuously profitable business
- top executives with insider information traded with Enron's shares for their own purposes
- implementation of an accounting practice (called mark to market) where projected future profits were calculated as if real today – as a result Enron could record profits (even if some of them later turned out to be a failure)
- hiding important pieces of information from investors.

When the company's success was measured against commonly used financial statements Enron's balance sheets were not sufficient enough to prove the reported successes. Investors began to worry and questioned Enron's transparency. Many observers made similar statements like: "It's really hard for analysts to determine where Enron are making money in a given quarter and where they are losing money," (Oppel, 2001), or: "Enron stock is trading under a cloud." (Berenson, 2001).

Investors' mistrust connected to the lack of transparent corporate governance and bad results made public, as well as downgrades from credit agencies and an investigation against Enron's auditor, Arthur Andersen LLP led to dramatic fall of share prices in the fall of 2001. The house of cards began to collapse. To survive, Enron began to seek investors (even buyout was on the agenda) but it was too late.

Its stock price fell from around \$90 to \$0.61 between September and December 2001 (ca. encarta.msn.com). One month later Enron was filed for bankruptcy.

As a summary it can be concluded, that the regulatory background and lack of a good corporate governance system made it possible that

- shareholders, stakeholders power to look into the company's operation was limited
- the auditor company of Enron (or of any company) could provide significant financial consultant services for the same company, thus losing their independency (which is a basic for an auditor)
- regulation on financial statements was improper
- lack of proper control from owners in form

of delegating non-executive directors to Board of Directors

- there was less emphasis on financial frauds and sanctioning connected consequences

THE AFTERMATH OF THE ENRON CASE

Securities law historian Joel S. Seligman was quoted in The Washington Post saying, "*[t]his was the most important corporate scandal of our lifetimes. It was one of the immediate causes of the Sarbanes-Oxley Act, the governance reforms of the New York Stock Exchange..., and the most consequential reorientation of corporate behavior in living memory.*" (www.money.cnn.com)

The Sarbanes-Oxley Act (SOX) and OECD steps to improve corporate governance principles

Enron's collapse contributed to the creation of the U.S. "*The Public Company Accounting Reform and Investor Protection Act of 2002*" or better known as the Sarbanes-Oxley Act or SOX (named after sponsors Senator Paul Sarbanes and Representative Michael G. Oxley). signed into law on July 30, 2002 and was taken over partly by other OECD's countries (Organisation for Economic Co-operation and Development) into the Principles of Corporate Governance in 2004.

It was named by President George W. Bush when he signed it into law, "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt" (The New York Times, 2002).

SOX contains 11 titles, or sections, ranging from additional Corporate Board of Directors responsibilities to criminal penalties. The most important of these eleven titles are: Auditor independence, Corporate responsibility, Enhanced Financial, Analyst Conflicts of Interest, Corporate and Criminal Fraud, White Collar Crime Penalty Enhancement

THE MAIN AREAS OF THE REVISED OECD CORPORATE GOVERNANCE PRINCIPLES (WWW.OECD.ORG):

„I. Ensuring the basis for an effective corporate governance framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

II. The rights of shareholders and key ownership functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

III. The equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

IV. The role of stakeholders in corporate governance

The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

V. Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

VI. The responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."

Corporate governance in MOL Group

MOL Plc. (together with all MOL Group member companies) as an international operating company was and is committed and strive for being amongst the best achievers also regarding corporate governance practices. Without a well designed corporate governance system MOL could not have reached its current performance level.

MOL's corporate governance system is continuously being developed to respond to the challenges resulted from becoming a more and more complex and international operating company; as well as to respond to the demands coming from stakeholders. MOL as a listed company on Budapest and Warsaw Stock Exchanges (BSE and WSE), regularly reports about its compliance with corporate governance Recommendations, which is regularly updated based on international expectations. The BSE report is published after its approval by the Annual General Meeting.

The company's corporate governance policies are stated in the documents of corporate governance, which consist of fundamental documents, corporate governance declarations and other documents (see Table 1.).

As described in the Picture 1. the General Meeting is the supreme body of the Company consisting

of the totality of shareholders. The Board of Directors is the executive management body of the Company. The Supervisory Board acts as the first control point between the shareholders and the Board of Directors. The Executive Board responsible to implement MOL Group's strategy and manage MOL Group operations in line with the frames set by the Board of Directors.

For the effective operation MOL Board of Directors established its,

- Finance and Risk Management Committee (FRC) that supports oversight of the company's financial statements, its internal audit function and its risk management. (FRMC consists solely of non-executive and financially or legally knowledgeable members.)
- Corporate Governance & Remuneration Committee (CGRC), whose primary task is to assist in the appropriate implementation of corporate governance standards and is responsible for the development, oversight and evaluation of compensation plans and long-term incentive schemes. (The majority of CGRC members are independent and non-executive.)
- Sustainable Development Committee (SDC), is the highest Governance body related to sustainable development headed by MOL Group CEO, with two non-executive members, thus ensuring the highest commitment to and representation of sustainability issues in both internal and external Group relations.

Fundamental documents

Articles of Association
Charter of the Board of Directors
Charter of the Supervisory Board
Charter of the Committees operated by the Board of Directors
Corporate governance Code
Code of Ethics

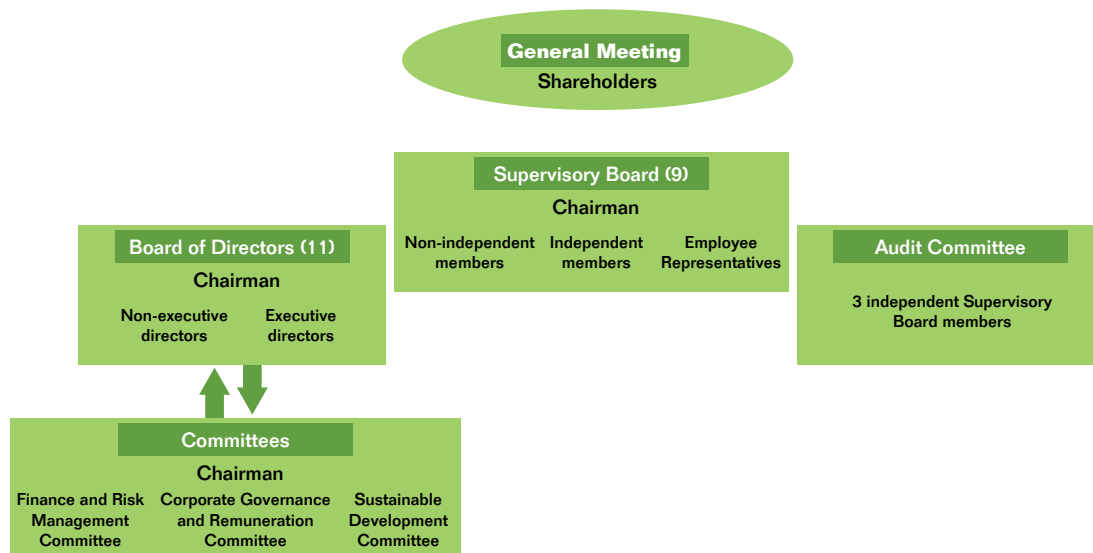
Corporate governance declarations

Declaration in connection with corporate governance Recommendations published by the Budapest Stock Exchange, regarding corporate governance practices
Statement on the application of Warsaw Stock Exchange corporate governance standards

Other documents

Deminor corporate governance Rating & Investor Report
Composition of Board committees
Independence criteria for Members of MOL Group Board of Directors
Principles on inside trading in MOL Plc. according to the corporate governance Recommendation of BSE

Table 1. Documents of Corporate Governance



Picture 1. MOL Plc. corporate governance system, based on Lukács, 2007

The Supervisory Board (SB) monitors the Board of Directors' activities on behalf of the shareholders and ensures that it carries out its duties with the outmost loyalty and due care. The majority of members are independent and not employed by MOL with the exception of employee representatives.

The Audit Committee (AC) complying of independent members of the Supervisory Board is mainly responsible for overseeing financial statements and selection of external auditor. It has to be noted that although the Audit committee complies of the independent members of the SB it is not subordinated to that.

MOL's (MOL Group's) corporate governance system is continuously being shaped to combine the requests of being transparent with the need of accountability on all levels and to serve the customers as well as with following a strong

financial and value oriented approach thus generating profit to the shareholders as well as to the Group to finance its strategic goals.

MOL Plc. Corporate governance performance is assessed yearly within the framework of the SAM sustainable development assessment. This assessment grades MOL since it is taking part in it with good rating compared to other oil industry participants who were assessed within the same framework.

The Board of Directors performance evaluation is also carried out regularly, as it can be seen in the Documents of corporate governance.

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