

## II. Importance of Good Financial Governance

### 1. Introduction

**G**overnance is a widely-used term covering anything from electoral arrangements to institutional structures. Financial management and governance is also a broad term which – for the purposes of this study – is narrowly defined as meaning accounting and auditing institutions and arrangements. This chapter describes the relationship of financial management and governance arrangements to development outcomes, and identifies factors that are associated with good and bad arrangements.

The increased emphasis on financial management and governance arrangements in the past couple of years is primarily due to two factors: analyses of the causes of the Asian financial crisis, and compelling economic research. The remainder of this chapter is structured as follows. Section two reviews an ADB study into the causes of the Asian financial crisis. Section three briefly discusses recent evidence about the importance of governance arrangements to development outcomes such as lower infant mortality. Section four presents a simple framework for examining the symptoms of poor financial management and governance arrangements. Section five concludes the chapter.

### 2. Causes of the Asian Financial Crisis

The collapse of the Thai baht in July 1997 marked the beginning of Asia's financial crisis. Financial turmoil spread with a ferocity that none foresaw. Millions who had successfully come out of poverty following almost three decades of sustained economic growth, were pushed back into poverty over a short period of two years.

A recent ADB study found that poor enforcement of corporate laws and regulations, underdeveloped capital markets, and high concentration of corporate ownership were the main reasons for weak corporate governance in the countries most affected by the Asian crisis.<sup>2</sup> The study identified several priority reform areas, including: strengthening banking supervision and regulation, and improving financial reporting standards and their enforcement. It made the following four recommendations: (i) corporate ownership structures

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<sup>2</sup> Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand*. Asian Development Bank: Manila.

should be rationalized (ownership concentration should be reduced); (ii) corporate internal controls and shareholder protection should be strengthened; (iii) external monitoring and discipline should be strengthened; and (iv) capital markets should be developed and the efficiency of corporate financing improved.

The study concluded that measures aimed at strengthening corporate internal control, improving standards of accounting, auditing and financial reporting systems and their enforcement should be placed at the top of the reform agenda.<sup>3</sup>

### 3. Economic Research Findings

There is strong empirical evidence that governance arrangements affect development outcomes. For instance, a 1999 study of governance arrangements in around 160 countries found strong positive relationships between good governance arrangements and per capita incomes, infant mortality rates, and literacy rates.<sup>4</sup> These researchers collected indicators which they grouped into six governance measures: voice and accountability; political instability and violence; government effectiveness; regulatory burden; rule of law; and graft. They then examined how these six measures affected per capita incomes, infant mortality, and literacy. The study results are striking – Table 1 refers<sup>5</sup>.

Table 1. Effects of a One-Standard-Deviation Improvement in each Governance Measure (Non-OECD Countries)

Governance Measure	Increase in per Capita Incomes	Decrease in Infant Mortality	Increase in Adult Literacy
Voice and accountability	98%	47%	16%
Political instability and violence	512%	84%	56%
Government effectiveness	376%	79%	44%
Regulatory burden	141%	56%	22%
Rule of law	700%	89%	55%
Graft	229%	78%	37%

<sup>3</sup> Zhuang *et al*, p. 80.

<sup>4</sup> Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobatón. 1999. *Governance Matters*, Working Paper: The World Bank.

<sup>5</sup> These percentages were calculated from the  $\beta$  value for each regression equation.

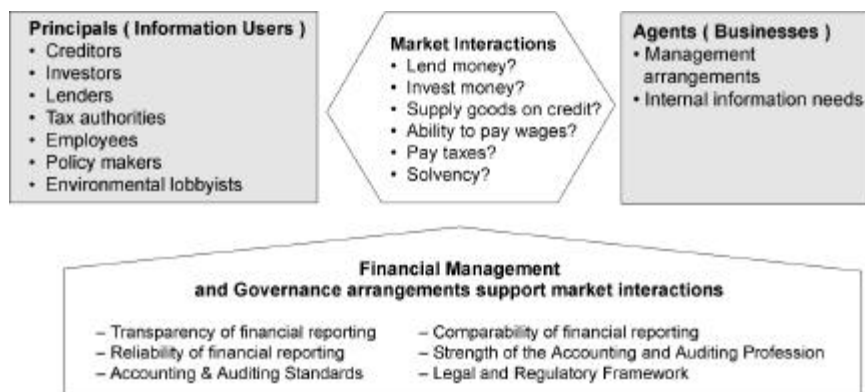
This research explains previous gaps in the literature on economic growth determinants. It also supports the contention that improving governance should be a top priority for governments and multilateral financing institutions.

These research results are not isolated. In August 2000, the World Bank published another study, which reinforced evidence that, while GDP growth is the single most powerful force in alleviating poverty, growth alone is not enough.<sup>6</sup> This study found that, among other things, countries can double their living standards by improving their legal systems and combating corruption – a particular emphasis should be placed on deepening domestic financial markets, strengthening regulation and financial supervision, and introducing effective corporate governance mechanisms.

#### 4. Symptoms of Good and Bad Arrangements

The previous sections demonstrated the importance of financial management and governance arrangements, but provided no basis for assessing these arrangements. In this respect, Figure 1 presents a simple framework for examining private sector financial management and governance practices – it illustrates the idea that governance arrangements support market interactions.

Figure 1. A Simple Framework of Private Sector Financial Governance



<sup>6</sup> Thomas, Vinod, Ashok Dhareshwar, Ramon E. Lopez, Yan Wang, Nalin Kishor, Mansoor Dailimi, and Daniel Kaufmann. August 2000. *The Quality of Growth* World Bank and Oxford University Press.

Table 2 presents information on user objectives, the importance of sound interactions, and indications of good and poor arrangements – from the perspective of financial information users.

Table 2. Indicators of Good and Poor Arrangements

Users and Interests	Importance	Good and Poor Arrangements
LENDERS want to recover their principal and earn interest at levels commensurate with risks.	The ability of businesses to access debt finance at reasonable rates affects economic growth. When businesses pay high risk premiums to compensate for unreliable financial information, fewer business opportunities will be viable.	<b>Good:</b> Banks rely on financial statements when making lending decisions. <b>Poor:</b> Banks do not rely on financial statements.
SUPPLIERS of goods and services want to be paid on time.	The ability to obtain goods and services on credit is a sign of a healthy market economy. It reduces transaction costs and indicates trust in the rule of law. Reliable financial reports provide decision-making information to suppliers.	<b>Good:</b> Goods and services are provided on credit. <b>Poor:</b> Cash payments are required in advance.
TAXATION AUTHORITIES are presumably interested that the tax system is both fair and efficient.	Tax systems impose: (i) economic costs that result from behavioral changes caused by taxes; (ii) compliance costs incurred by taxpayers; and (iii) administration costs. Studies show that the latter two costs make up around 50 percent of taxes collected. <sup>7</sup> The availability of reliable financial statements provides a good basis for tax assessments and reduces the need for tax authorities to engage in on-site inspections and reconstructions.	<b>Good:</b> Tax authorities rely on financial statements. <b>Poor:</b> Tax authorities ignore financial statements in favor of on-site inspections and reconstructions.

<sup>7</sup> See, for instance: Pope, J., R. Fayle and D Chen. 1990. *The Compliance Costs of Public Companies' Income Taxation in Australia 1986-87*: Australian Tax Research Foundation, Sydney.

## IMPORTANCE OF GOOD FINANCIAL GOVERNANCE

Users and Interests	Importance	Good and Poor Arrangements
INVESTORS want future economic returns.	Investment is a key driver of economic growth. Businesses need access to foreign and domestic capital. Reliable historical financial information provides a basis for assessing future earnings and solvency. <sup>8</sup>	<b>Good:</b> Investors rely on forecasts that include historical financial information. <b>Poor:</b> Investors do not rely on historical financial information.
EMPLOYEES are interested in the ability of a business to sustain or increase employment levels and remuneration.	Reliable, transparent and timely financial reports provide employees with a basis on which to assess a businesses' ability to pay employees.	<b>Good:</b> Employees have access to reliable financial reports. <b>Poor:</b> Employees do not have access to reliable financial reports.
OTHER groups, such as environmental lobby groups and government policy makers are interested in a wide range of issues.	Reliable and comprehensive financial reports provide information for these groups.	<b>Good:</b> Reliable financial information is easily accessible. <b>Poor:</b> Reliable financial information is not easily accessible.

### 5. Conclusion

This chapter showed that poor financial management and governance arrangements were a key cause of the 1997 Asian Financial Crisis. It also reviewed compelling research that links governance arrangements (including financial management and governance) to development outcomes such as lower infant mortality rates.

Furthermore, the state of accounting systems, financial information, and audit methodologies, play a critical role in the success of

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<sup>8</sup> Contrary to popular belief, historical financial information does provide a basis for future decision-making. See, for instance: Lev, Baruch. 1989. On the Usefulness of Earnings: Lessons and Directions from Two Decades of Empirical Research. *Journal of Accounting Research*. 1989 Supplement.

privatizations. However, the accounting structures and processes of many government enterprises are inadequate. There is evidence to suggest that effective privatization will be more difficult if financial management issues are not addressed beforehand.<sup>9</sup> There is also evidence that this can have a negative impact on the level of privatization proceeds – through valuation difficulties.

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<sup>9</sup> See, for instance, Enthoven, Adolf. 1998. Privatization and the Role and Impact of Accounting and Auditing. University of Texas at Dallas: Paper presented at 21<sup>st</sup> EAA Congress: Accounting in Times of Transition. Antwerp, April 1998.