



**CASE STUDY**  
**ON THE**  
**CORPORATE GOVERNANCE AND ENTERPRISE REFORM PROGRAM**  
**(Loan 1546-KGZ[SF])**  
**IN THE**  
**KYRGYZ REPUBLIC**

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REPORT PREPARED FOR  
THE ASIAN DEVELOPMENT BANK  
AUGUST 2002

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## CURRENCY EQUIVALENTS

Currency Unit – Som

	<b>At Appraisal 30 April 1997</b>	<b>At Project Completion 3 March 2000</b>	<b>At Operations Evaluation 15 June 2002</b>
Som1.00 =	\$0.057	\$0.021	\$0.021
\$1.00 =	Som17.66	Som47.30	Som47.40

## ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CDC	–	Corporate Development Center
CGERP	–	Corporate Governance and Enterprise Reform Program
FSU	–	former Soviet Union
GDP	–	gross domestic product
IAS	–	International Accounting Standards
IMF	–	International Monetary Fund
JSC	–	joint stock company
METI	–	Ministry of External Trade and Industry
MOF	–	Ministry of Finance
MOJ	–	Ministry of Justice
NBKR	–	National Bank of the Kyrgyz Republic
NSC	–	National Securities Commission
PCR	–	project completion report
SOE	–	state-owned enterprise
SPF	–	State Property Fund
TA	–	technical assistance
USAID	–	United States Agency for International Development

## NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

## CONTENTS

BASIC DATA	ii
I. FOREWORD	1
II. BACKGROUND	1
A. Rationale	1
B. Formulation	1
C. Purpose and Outputs	2
D. Cost, Financing, and Executing Arrangements	3
E. Completion and Self-Evaluation	3
F. Evaluation	3
III. METHODOLOGY	4
IV. PROGRAM DESCRIPTION	5
A. Development Context	5
B. Scope and Objectives	7
C. Coordination and Cooperation	8
D. Expected Outputs	8
E. Expected Impact	10
V. PROGRAM EVALUATION	11
A. Relevance	11
B. Efficacy	11
C. Efficiency	12
D. Sustainability	13
E. Institutional Development	13
F. Overall Assessment	13
G. Performance of ADB and the Government	14
VI. LESSONS, ISSUES, AND FOLLOW-UP ACTIONS	14

## BASIC DATA

### A. Loan Identification

1. Country Kyrgyz Republic
2. Loan Number 1546-KGZ
3. Project Title Corporate Governance and Enterprise Reform Program
4. Borrower Kyrgyz Republic
5. Executing Agency Department of Economic Sector Development,  
Prime Minister's Office
6. Amount of Loan \$40 million equivalent from the Asian Development Fund
7. PCR Number PCR:KGZ 600

### B. Loan Data

1. Appraisal
  - Date Started 14 April 1997
  - Date Completed 30 April 1997
2. Loan Negotiations
  - Date Started 29 July 1997
  - Date Completed 31 July 1997
3. Date of Board Approval 25 September 1997
4. Date of Loan Agreement 8 December 1997
5. Date of Loan Effectiveness in Loan Agreement
  - Actual 9 December 1997
  - Number of Extensions None
6. Closing Date in Loan Agreement
  - Actual 31 December 1999
  - Number of Extensions 26 November 1999
  - None
7. Terms of Loan
  - Service Charge 1% per annum
  - Maturity 40 years
  - Grace Period 10 years

### 8. Disbursements

<b>Initial Disbursement</b> 17 December 1997	<b>Final Disbursement</b> 1 July 1999	<b>Time Interval</b> 16.5 months
<b>Effective Date</b> 9 December 1997	<b>Original Closing Date</b> 31 December 1999	<b>Time Interval</b> 24.6 months

### C. Data on Missions

Name of Mission	Date	Number of Persons	Number of Person-Days	Specialization of Members
Reconnaissance <sup>1</sup>	2–10 Oct 96	4	21	Economist (2)
Fact-Finding <sup>2</sup>	6–20 Nov 96	6	63	Deputy Director, IED Senior Programs Officer Economist Project Engineer, IEEN
Appraisal <sup>3</sup>	14–30 Apr 97	8	89	Director Senior Economist Senior Counsel Economist (3)
Review 1	16–19 Feb 98	1	9	Economist
Review 2 <sup>4</sup>	27 Jul 98– 10 Aug 98	2	22	Senior Economist Financial Economist
Review 3	12–23 Apr 99	1	9	Financial Economist
Program Completion <sup>5</sup>	29 Feb– 03 Mar 2000	1	4	Financial Economist

<sup>1</sup> The Mission was supported in the field by the Programs Review Mission led by P.V. Brevern, Senior Programs Officer, PE3.

<sup>2</sup> Two staff consultants under TA 2712-KGZ (Preparation and Implementation of Guidelines on Best Practice in Corporate Governance) assisted the Mission.

<sup>3</sup> Five consultants under TA 2712-KGZ (Preparation and Implementation of Guidelines on Best Practice in Corporate Governance) assisted the Mission.

<sup>4</sup> A staff consultant on corporate governance assisted the Mission.

<sup>5</sup> The Mission consisted of R. Subramaniam, Financial Economist, IEFI.

## I. FOREWORD

1. This report was prepared by Christopher S. Bender of Professional Education Ventures, LLC for the Asian Development Bank (ADB). It is submitted in satisfaction of terms of reference to prepare a background paper on Loan 1546-KGZ(SF): *Corporate Governance and Enterprise Reform Program*, pursuant to TA 5979-REG: *Impact and Special Evaluation Studies of ADB Operations in Developing Member Countries*, under Contract Number COCS/02-463.

## II. BACKGROUND

### A. Rationale

2. In late 1996, despite several years of progressive reforms intended to facilitate the country's transition to a market economy, most enterprises within the Kyrgyz Republic were operating no more efficiently than they had under the system of central planning inherited from the Soviet era. Despite having gone through a process of corporatization, whereby state-owned enterprises (SOEs) were legally transformed into joint stock companies (JSCs), and despite the privatization of small and some medium-sized enterprises, few enterprises had become profitable. Some 316 public sector enterprises and 439 private sector enterprises—a sizeable percentage of the total—were operating at a loss, many of which were idle. In many cases, corporatization and privatization had effectively reduced transparency and had weakened enterprise oversight. Corporate control had become vested largely in management, thereby reducing incentives for managers to position their companies to become competitive in a rapidly opening environment. At the core of the problem was the intransigent refusal of enterprise managers to (i) internalize profit as their primary objective, (ii) act in accordance with a sense of fiduciary duty to the owners of the enterprises they manage, and (iii) act impartially with regard to their treatment of all shareholders. Put another way, despite the changes in the structure of *enterprise ownership*, the principles and practices of *enterprise governance* remained largely unchanged or, in some cases, had worsened. The recognition that the task of improving governance within the enterprise sector would require more than just the drafting of laws and regulations—to the contrary, it would demand a fundamental transformation of incentives and attitudes, among both managers and stakeholders, as well as a basic change in the relationship between the state and enterprises—was the underlying rationale for the Corporate Governance and Enterprise Reform Program (CGERP).

### B. Formulation

3. The design of the CGERP was established on the basis of a (i) reconnaissance mission (2–10 October 1996), tasked with assessing the interest and commitment of the Government of the Kyrgyz Republic (the Government) to reforms in the enterprise sector; and (ii) fact-finding mission (6–20 November 1996), tasked with identifying the objective and scope of a proposed program to support these reforms. The fact-finding mission determined that, “one of the most serious shortcomings in the enterprise sector is the failure of the corporatization and privatization process to firmly establish corporate governance structures through which the rights and responsibilities of owners, stakeholders (workers, creditors, suppliers, and customers), and management are clearly defined. In particular, success had yet to be achieved in clearly defining the rights and responsibilities of management so as to ensure that those who control corporate resources bear responsibility for decisions over the use of resources. This alignment of risk-bearing and control over the use of resources is a prerequisite to the internal efficiency of enterprises, as well as to their long-term strategic competitiveness in a dynamic market environment. The lack of success in implementing effective corporate governance

structures has constrained the adoption of advanced management practices and technology and is, in large part, responsible for the slow emergence within enterprises of incentives to attain efficiency.”<sup>1</sup>

4. To address the absence of a basic governance framework for JSCs, the fact-finding mission recommended the development of a set of guidelines on best practices in corporate governance under a small-scale technical assistance (TA) grant. It was envisaged that these guidelines would cover, inter alia, the (i) composition, duties, and powers of a company’s shareholder’s council and board of directors; (ii) rights and responsibilities of executive and non-executive members of the shareholder’s council and of the board of directors; (iii) system of reporting and control over enterprise operations; and (iv) systems of independent auditing and reporting. Given the urgency of the small-scale TA to the scheduled implementation of reforms envisaged under the then proposed program, the mission recommended waiving the requirements for listing the small-scale TA in ADB Business Opportunities. On the basis of these recommendations, TA 2712-KGZ: *Preparation and Implementation of Guidelines on Best Practice in Corporate Governance*, for \$100,000, was approved on 13 December 1996.

5. An appraisal mission (14–30 April 1997) further defined the scope of the proposed program. The report and recommendation of the President to the Board of Directors was completed in August 1997 and submitted for consideration by the Board in September 1997. The CGERP was approved on 25 September 1997. The Loan Agreement was dated 8 December 1997 and became effective on 9 December 1997, upon fulfillment of all loan effectiveness conditions. The first disbursement took place on 17 December 1997.

6. In addition to TA 2712-KGZ, the formulation of the CGERP was informed by TA 2297-KGZ: *Industry and Trade Sector Study*, for \$600,000, approved on 3 February 1995, which helped the Government analyze issues relating to the competitiveness of domestic manufacturing activities, and, to a lesser extent, by the formulation of TA 2876-KGZ: *Strengthening the Economic Policy Making and Monitoring Capabilities of the Prime Minister’s Office*, for \$800,000, approved on 25 September 1997, which provided 23 person-months of advisory services by two international consultants to enhance policy formulation and monitoring capacity within the Office of the Prime Minister.

### **C. Purpose and Outputs**

7. The goal of the CGERP was to promote economic growth by improving the performance and efficiency of the enterprise sector so that it could become viable in a competitive, market-based economy. As will be discussed in greater detail below, the six components of the CGERP included (i) promoting enterprise efficiency through improved corporate governance, (ii) imposing financial discipline on enterprises, (iii) promoting competition and strengthening the environment for foreign direct investment, (iv) strengthening the legal framework for insolvency, (v) promoting transparency in financial accounting and reporting, and (vi) mitigating transition costs. Program outputs were specified for each of these components and, where possible, were defined in measurable and time-bound terms.

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<sup>1</sup> Dickie, Paul, Acting Director, IED; and Officer-in-Charge, PED. 12 December 1996. KGZ: Proposed SSTA for Preparation and Implementation of Guidelines on Best Practice in Corporate Governance, Interoffice Memorandum. ADB, Manila.

## **D. Cost, Financing, and Executing Arrangements**

8. ADB supported the CGERP with (i) a program loan in the amount of \$40 million, and (ii) Loan 1547-KGZ(SF): *Capacity Building in Corporate Governance and Insolvency Procedures Project*, for \$4 million, approved on 25 September 1997, to support, inter alia, the establishment of the Corporate Development Center (CDC). Both loans were funded from ADB's Special Funds, have a repayment period of 40 years, including a grace period of 10 years, and an interest rate of 1% per annum. The first disbursement on the program loan, in the amount of \$19.65 million, was released in December 1997. The second and final disbursement, in the amount of \$19.35 million, was originally envisaged for release in May 1999, but was actually released in July 1999 upon fulfillment of all tranche release conditions.

9. The Department of Economic Sector Development, under the Office of the Prime Minister, acted as the Executing Agency for the CGERP. The Ministry of Finance (MOF) administered the proceeds of the program loan, while CDC administered the proceeds of the TA loan. CDC, operating within the Department of Economic Sector Development, coordinated the activities of the CGERP, in cooperation with MOF, Ministry of Justice (MOJ), State Property Fund (SPF), National Securities Commission (NSC), National Bank of the Kyrgyz Republic (NBKR), and Supreme Arbitrazh Court. A steering committee, chaired by the Prime Minister and staffed with representatives of each of these ministries and agencies, was established to monitor progress on a quarterly basis.

## **E. Completion and Self-Evaluation**

10. Three program review missions were fielded (in February 1998, July 1998, and April 1999) during the scheduled 3-year period of the CGERP. The program loan officially closed in November 1999. A program completion mission was fielded in February 2000. A program completion report (PCR) was released in December 2000 (PCR: KGZ 29149). The PCR reviewed the CGERP favorably on the basis of a detailed analysis of compliance with the program's second tranche release conditions and a comparison of the logical framework and policy matrix with the realized accomplishments of the program, supported by data, where available. The primary concerns raised by the PCR—concerns which related less to shortcomings of the CGERP than to the perceived need for continued support by ADB for governance development—included (i) persistent weaknesses in the enforcement of governance standards, particularly with regard to the banking sector; (ii) the need to strengthen financial sector governance, which the PCR noted was being pursued through the then ongoing Loan 1723-KGZ(SF): *Financial Intermediation and Resource Mobilization Program*; (iii) the timeliness and objectivity of the judiciary in adjudicating bankruptcy and restructuring cases; and (iv) the need for direct support for enterprise restructuring. The PCR was well formulated and appears to be objective. It did not address TA Loan 1547-KGZ(SF): *Capacity Building in Corporate Governance and Insolvency Procedures*, which was then still ongoing. No PCR has since been prepared on the TA loan, given that it was extended beyond its original closing date of June 2001.

## **F. Evaluation**

11. This evaluation—submitted as a background paper—is intended to support a larger report assessing the use of concessional funds for ADB's developing member countries. The larger report will be the primary output of a special evaluation study of Asian Development Fund (ADF) VI and ADF VII being undertaken by the Operations Evaluation Department of ADB,

under TA 5979-REG: *Impact and Special Evaluation Studies of ADB Operations in Developing Member Countries*.

### III. METHODOLOGY

12. This background paper was prepared on the basis of a mission to the Kyrgyz Republic conducted during the period 5–26 June 2002. Interviews were conducted with representatives from a broad range of governmental ministries, agencies, regulatory bodies, and committees, the CDC, and all major bilateral and multilateral donors. In addition, the following four loan documents were reviewed as part of the evaluation: (i) proposed small-scale TA for Preparation and Implementation of Guidelines on Best Practice in Corporate Governance (12 December 1996); (ii) report and recommendation of the President to the Board of Directors on proposed loans and a technical assistance grant to the Kyrgyz Republic for the CGERP (August 1997); (iii) Loan 1546-KGZ: *Corporate Governance and Enterprise Reform Program*, TA Loan 1547-KGZ: *Capacity Building in Corporate Governance and Insolvency Procedures*—back-to-office report of review mission (13 May 1999); and (iv) program completion report on the CGERP (December 2000). A list of meetings held and documents reviewed during the mission has been submitted under separate cover.

13. This background paper follows the evaluation methodology established in ADB's *Guidelines for the Preparation of Project Performance Audit Reports* (September 2000), including the application of ADB's five-fold assessment criteria—relevance, efficacy, efficiency, sustainability, and institutional development—to the CGERP. The effectiveness of this methodology when applied to the CGERP, however, is to some degree constrained by the following factors:

- (i) The 3-year period of the CGERP ended only approximately 18 months ago, roughly half the elapsed time recommended by the auditing guidelines. Moreover, the CGERP's associated TA loan, which was used to fund, inter alia, the operation of the CDC, has yet to be completed.
- (ii) The exogenous shock of the Russian ruble crisis of 1998 severely impacted the Kyrgyz economy, forcing a depreciation of about 50% in the value of the currency, an increase in interest rates, and a sharp contraction in export markets for domestic manufacturers.
- (iii) The transition from central planning to a market economy—which has been ongoing with varying degrees of success across much of the former Soviet Union (FSU) and Yugoslavia—has proven to be more complex than was generally understood a decade ago and, even with sustained political commitment, is now understood to require more time to generate meaningful economic returns in the form of increased output and job creation.

14. Despite the above factors—which together weaken the measurable connection between the CGERP and current indicators of economic performance—an evaluation of the CGERP's effectiveness (or lack thereof) can be performed and conclusions can be reasonably drawn on the degree to which the program met its performance objectives. The program's ultimate economic impact, however, cannot be assessed with any meaningful degree of certainty until more time has passed to provide the basis for its estimation.

## IV. PROGRAM DESCRIPTION

### A. Development Context

#### 1. The Economy

15. Prior to independence in August 1991, the Kyrgyz Republic's economy ranked among the poorest in the FSU. Product specification, production volumes, channels of distribution, sources of supply, resource allocation, and investment were all determined by a process of central planning managed in Moscow. The economy was narrowly based—primarily on textiles, clothing, and leather goods (27% of industrial output), industrial engineering (25%), food processing (24%), and mining (4%)—and highly dependent upon on trade with the rest of the FSU for supplies of inputs and markets for outputs. A sizeable net negative resource balance equal to roughly 11–12% of the gross domestic product (GDP) was met through fiscal and material transfers from elsewhere in the FSU. Enterprises were highly inefficient by the standards of non-socialist economies and were protected from competition by interlocking patterns of inter-republican trade. These initial conditions meant that at the time of independence, the Kyrgyz economy was (i) dependent upon subsidies for governmental fiscal operations, (ii) dependent upon transfers to balance the external account, (iii) lacking in institutions for monetary and fiscal control, (iv) based on the production capacities of enterprises that were intrinsically inefficient, and (v) highly vulnerable to exogenous shocks.

16. This last point—the vulnerability of the Kyrgyz economy to exogenous shocks—is critical, as the dissolution of the FSU was an exogenous shock of catastrophic proportions for the Kyrgyz economy. Virtually overnight, external demand collapsed, FSU inter-republican trade and payment systems were disrupted, large transfers from Moscow ceased (and domestic production subsidies proved unsustainable), and the terms of trade deteriorated by roughly 40% as the relative price structure moved into line with international levels. With the financial and technical support of ADB, the World Bank, and the International Monetary Fund (IMF), as well as the technical support of the United States Agency for International Development (USAID) and other bilateral donors, the Kyrgyz Republic undertook a program of macroeconomic stabilization and systemic reforms covering a broad range of activities, including the elimination of controls regarding pricing, trade, and distribution, the elimination of consumer subsidies, a reduction in the size of the civil service, the development of the legal system, and the strengthening of the financial sector. While these reforms were generally successful in restoring macroeconomic stability and curbing hyperinflation, GDP still fell by more than half in real terms between 1990 and 1995, creating extreme hardship for the majority of the population.

#### 2. Privatization

17. Integral to the Government's early economic reform program was a three-phase privatization program, intended to transfer control over enterprise assets and resources to the private sector as a means of encouraging entrepreneurship and stimulating economic growth. The first phase of the Government's privatization program (1991–1993) focused on small state-owned enterprises involved in retail trade and the provision of services. Roughly 4,700 enterprises were fully privatized through noncompetitive cash and privatization voucher auctions to managers and workers. The second phase of the privatization program (1994–1995) focused first on the corporatization (the legal transformation of SOEs into JSCs) of roughly 1,300 medium and large enterprises and then on the privatization of some of those enterprises. The stated intention for privatization included the free distribution of 5% of shares to workers and managers, the distribution of no less than 25% of shares through voucher auctions, and the

distribution of the remaining shares through competitive private bids or by selling them directly to strategic investors. In actual practice, however, the number of shares divested and the proportions by which they were distributed varied widely, according to the perceived strategic importance of the enterprise being privatized and in response to pressure from buyers (often managers and workers). The third phase of privatization involved some of the larger state monopolies in more strategic sectors. By the end of 1996, about 1,000 of the targeted 1,300 SOEs had been through the voucher auction process. Of these enterprises, the Government had fully divested its shares in about 660 of them. By the time of the CGERP fact-finding, public sector enterprises—defined herein as enterprises in which the Government retains 50% or more of shares outstanding—had fallen to about 44% of industrial output and about 21% of GDP. Such enterprises, however, continued to represent an essential core of the economy, claiming 53% of total credits and loans and receiving more than Som108 million in budgetary transfers from the Government in the first three quarters of 1996.

### **3. Enterprise Performance**

18. Despite the success of the privatization program in divesting the Government's holdings in all small and most medium-sized SOEs, operating performance by both public and private sector enterprises had not improved significantly by the time of the CGERP fact-finding. According to data available in late 1996, 316 public sector enterprises and 439 private sector enterprises were classified as being loss-making. Under international accounting practices, which better recognize depreciation and other non-cash charges to the income statement and which impose stricter standards for expensing receivables that are unlikely to be collected, the number of loss-making enterprises was probably far higher. While poor enterprise performance could, in part, have been attributed to the lingering recession, the Government's initial objective of establishing a competitive market-based economy capable of generating sustainable and stable growth had clearly not been achieved. Contributing to the problem were the following:

- (i) The voucher approach to privatization had resulted in shares being distributed in small numbers to a large number of outside shareholders thereby limiting the ability of shareholders to monitor enterprise performance and influence governance.
- (ii) The practice of awarding sizeable minority blocks of shares (in the range of 30–35% of shares outstanding) to existing managers and workers had given effective control over many enterprises to insiders who refused to disclose adequate information to outside investors, who often acted in their own self-interest without regard to interests of other shareholders, and who lacked the management skills necessary to compete in a market environment.
- (iii) The continued flow of governmental subsidies to public-owned or controlled JSCs was undermining financial discipline, impairing competition, and reducing incentives to improving efficiency.
- (iv) The existence of unresolved weakness in the legal framework (particularly with regard to the adjudication of bankruptcy cases) and in disclosure requirements (which depended upon the establishment of national accounting standards and the development of regulations governing reporting and auditing) was limiting the disciplinary efficacy of these external mechanisms of governance enforcement.

- (v) The lack of awareness on the part of public officials, shareholders, and the general public of the principles and practice of corporate governance was limiting the willingness and ability of stakeholders to demand greater fiduciary responsibility on the part of enterprise managers.

19. At the core of the problem of enterprise performance was the issue of enterprise governance. As stated earlier, while the Government's privatization program had resulted in changes in the structure of enterprise ownership, the principles and practices of enterprise governance had remained largely unchanged or, in some cases, had worsened. Improvements in enterprise efficiency depended critically on creating incentives for enterprise managers to embrace profit as their primary objective and to manage enterprises in the interests of all their shareholders.

## **B. Scope and Objectives**

20. The fact-finding mission should be credited with recognizing that the task of improving governance within the enterprise sector in the Kyrgyz Republic would require far more than the drafting of laws and regulations. To the contrary, the mission recognized that improving governance would require nothing less than a fundamental transformation of incentives and attitudes, among both managers and stakeholders, as well as a basic change in the relationship between the state and enterprises. To this end, the CGERP was structured as umbrella program with six components, each designed to address a distinct set of governance issues. These components included:

- (i) Promoting enterprise efficiency through improved corporate governance: reforms aimed at the development and institutionalization of governance principles and practices, the development of institutional capacity in corporate governance and enterprise restructuring, and the elevation of public and stakeholder awareness and understanding of the issue of governance and its role in a market economy.
- (ii) Imposing financial discipline on enterprises: reforms intended to eliminate budgetary support for state-owned or controlled enterprises.
- (iii) Promoting competition and strengthening the environment for foreign direct investment: reforms intended to prevent the creation of trade barriers and other impediments to competition.
- (iv) Strengthening the legal framework for insolvency: reforms intended to improve the adjudication of creditor claims and thereby enforce greater accountability on the part of enterprise managers and to expedite the liquidation of insolvent enterprises in order to promote a more rapid redeployment of viable assets.
- (v) Promoting transparency in financial accounting and reporting: reforms intended to introduce internationally recognized accounting standards (IAS) in enterprises.
- (vi) Mitigating transition costs: reforms intended to assure adequate resources to the Employment Fund to cover the costs of unemployment benefits for retrenched workers and to fund retraining programs.

### C. Coordination and Cooperation

21. Given the multi-disciplinary nature of the tasks involved in the CGERP, the Government entrusted the task of program coordination to the Office of the Prime Minister because it could function in a neutral capacity vis-à-vis all the relevant ministries and agencies responsible for policy formulation, the enforcement of corporate governance standards, and the restructuring of public sector enterprises. CDC was entrusted primarily with information dissemination and training to promote broad awareness and understanding of corporate governance issues. As will be discussed further below, CDC appears to have performed well in this role. The other ministries and agencies—MOF, MOJ, NBKR, NSC, SPF, Supreme Arbitrazh Court, and Ministry of External Trade and Industry—undertook the role of policy formulation and enforcement, loosely coordinated by a steering committee chaired by the Prime Minister and staffed with representatives of most of these ministries and agencies.

22. In addition, given the scope of the CGERP, coordination and cooperation with the programs of the bilateral and other multilateral donors was essential—both during formulation and during implementation of the program—to preventing overlap and to promoting consistency across the broader developmental assistance strategy. Efforts were clearly made—and were seemingly successful—during the formulation of the CGERP to assure harmony with the support being provided by, inter alia:

- (i) USAID: devising and implementing the mass privatization program; drafting laws to help strengthen the legal framework for a market economy, including insolvency procedures; providing training to the judiciary; supporting the conversion by individual companies to IAS; and facilitating the listing of eligible companies on the Kyrgyz Stock Exchange.
- (ii) World Bank: supporting privatization and restructuring through a *Privatization and Enterprise Sector Adjustment Credit* and a *Agricultural Privatization and Enterprise Adjustment Credit*; supporting a comprehensive restructuring of the banking system through a *Financial Sector Adjustment Credit*; and reforming the budgeting process through a *Public Sector Resource Management Adjustment Credit*.
- (iii) IMF: supporting monetary and macroeconomic stabilization through its *Enhanced Structural Adjustment Facility*.
- (iv) European Union: supporting, among other reforms, the partial privatization of the major utilities.

### D. Expected Outputs

23. Although the overarching goal of the CGERP was the promotion of economic growth—indeed the first output listed in the logical framework of the report and recommendation of the President to the Board of Directors (RRP: KGZ 29149) is the, “sustained growth of the economy and of the enterprise sector as indicated by an increase in the rate of growth of GDP, as well as in gross value added and enterprise profitability,”—the components of the CGERP actually focused on the more basic objective of creating the *building blocks* for improving governance. Such a focus was appropriate, given that at the time the CGERP was formulated none of these building blocks existed in the Kyrgyz Republic. Even the term, *corporate governance*, lacked a Russian-language equivalent. One of the primary objectives of the CGERP—and, as will be

discussed below, one of the primary achievements of the program—was to develop broader awareness of a concept that, at the time the program was formulated, was virtually unknown outside of a small circle of policy makers and academics. The most important of these building blocks, organized by program component, included:

## **1. Promoting Efficiency Through Improved Corporate Governance**

24. Institutionalizing corporate governance practices by (i) requiring open JSCs (companies with more than 50 shareholders) to adopt a model corporate charter developed under TA 2712-KGZ: *Preparation and Implementation of Guidelines on Best Practice in Corporate Governance*, and (ii) amending the Civil Code and Law on Economic Partnerships and Societies to require the holding of annual general meetings in order to amend company charters, elect members to boards of directors, make appointments to audit committees, form and dissolve executive bodies, approve annual reports and company accounts, and decide upon issues related to reorganization or liquidation. Performance targets included the adoption of the model corporate charter by 100% of public sector JSCs under supervision of the SPF and by 60% of all JSCs.

25. Enforcing the adoption of good corporate governance practices by four strategic public sector enterprises, with the intention of providing a “demonstration” effect. The target enterprises included Kyrgyz Energo (electrical power), Kyrgyz Telecom (telecommunications), the National Aviation Company (Kyrgyz Airlines), and Kyrgyz Gasmunaizat (natural gas distribution). Performance targets included (i) the corporatization of these enterprises and their partial privatization through the coupon privatization program, and (ii) the self-certification by these companies of their compliance with the model corporate charter or their submission of time-bound plans for attaining compliance with the model charter.

26. Institutionalizing corporate governance as a public policy priority by establishing the CDC underneath the Office of the Prime Minister to (i) develop public awareness of the principles and objectives of corporate governance and of shareholder rights and responsibilities, (ii) conduct training for enterprise managers and other stakeholders, and (iii) facilitate coordination among governmental ministries on the legislative and regulatory reforms required by the program. Performance targets included the requirement that (i) a minimum of 125 enterprise managers be trained on management, marketing, product development, and governance issues; (ii) a minimum of 60 governmental officials be trained to evaluate compliance by enterprise managers with corporate governance requirements; (iii) a minimum of 800 enterprises be provided with informational materials on corporate governance; (iv) a minimum of 50 enterprise meetings, 11 public meetings, and 12 media events be conducted; (v) corporate governance be introduced into the educational programs of at least 30 institutions; and (vi) a minimum of 15 press releases, 8 special television or radio programs, 24 question and answer columns, 200 press kits, and 50,000 copies of informational leaflets and other materials produced and disseminated.

## **2. Imposing Financial Discipline on Enterprises**

27. Reducing direct budgetary support for state-owned or state-controlled JSCs to encourage financial discipline within these enterprises. Performance targets included (i) a reduction in governmental budgetary support by 50% of the prior year’s level for each year of the program, and (ii) the issuance by NBKR of a directive that it will not guarantee loans extended to enterprises by commercial banks and that commercial lending with public enterprises must be conducted on commercial terms.

### **3. Promoting Competition and Strengthening the Environment for Investment**

28. Liberalizing factor and output prices, removing barriers to entry within the enterprise sector, and limiting restrictions and tariffs on imports in order to promote competition and improve the environment for foreign investment. Performance targets included (i) a complete prohibition of increases to import tariffs (unless such tariffs comply with the World Trade Organization's provisions on anti-dumping), (ii) a complete prohibition of other quantitative restrictions on international trade, and (iii) the enactment of amendments to the Law on Foreign Investments.

### **4. Strengthening the Legal Framework for Insolvency**

29. Improving the adjudication of creditor claims and thereby enforce greater accountability on the part of enterprise managers by (i) strengthening the legal framework governing insolvent enterprises, and (ii) providing training to bankruptcy judges. Performance targets included the (i) passage of a new Law on Bankruptcy, (ii) adoption of changes to the Civil Code, (iii) provision of training to a minimum of 20 judges specialized in bankruptcy proceedings and 20 insolvency practitioners, and (iv) filling of all existing vacancies within the Arbitrazh Court.

### **5. Promoting Transparency in Financial Accounting and Reporting**

30. Adopting national accounting standards and implementing a program to assist enterprises to comply with these standards. Performance targets included the adoption of national standards that substantively comply with IAS by at least 80 enterprises.

### **6. Mitigating Transition Costs**

31. Easing the burden of the economic transition on displaced workers by assuring adequate resources to the Employment Fund to cover the costs of unemployment benefits and to fund retraining programs. Performance targets included the (i) introduction of IAS-compliant accounting and reporting systems by the Social Fund, and (ii) allocation of Som20 million for training and Som30 million for unemployment benefits in the 1998/1999 budget.

## **E. Expected Impact**

32. The essential focus of the CGERP was to establish the building blocks for improving corporate governance. As stated in the report and recommendation of the President to the Board of Directors (RRP: KGZ 29149), "the program will strengthen the Kyrgyz Republic's continued efforts to establish a market-based economy. Experience has shown that liberalization measures alone may not promote market-oriented behavior in an economy with the serious institutional rigidities typical of a command system. The program, while deepening the Government's ongoing reform measures, is designed to bring about changes in the governance of enterprises that currently dominate the economy. The program will support the reform and the strengthening of the legal and policy environment for operations in the enterprise sector and will promote the development of institutions that will set in place a market-oriented structure of incentives at the enterprise level. To this end, the program is designed to help improve the efficiency and prudence of decision making in enterprises and to instill greater financial discipline on enterprise operations. The improved incentive structure at the enterprise level will lead to better performance by the sector and will result in a more efficient mobilization and allocation of scarce resources—financial, managerial, and material—within the overall economy. This will facilitate structural adjustment and contribute to efficient economic growth."

## V. PROGRAM EVALUATION

33. The CGERP was ADB's first program to focus explicitly on reforms intended to improve enterprise governance. It was ambitious in the scope of its local framework, bringing together a portfolio of reforms under one programmatic umbrella with the objective of effecting very basic changes in the incentives and attitudes of enterprise managers and stakeholders. Given its historical context—as a cornerstone program for a reformist government in a country still relatively early in the transition from central planning to a market economy—the CGERP was well timed to play a pivotal role in the country's economic development.

34. What follows is an evaluation of the success of the program, as measured against the stated objectives of the report and recommendation of the President to the Board of Directors (RRP: KGZ 29149), as well as a discussion of the program's contributions to its broader goal of improving growth through improved enterprise efficiency. Assessments are scored in strict accordance with the definitions provided in *Guidelines for the Preparation of Project Performance Audit Reports* (September 2000).

### A. Relevance

35. In any market economy, the principles and practices of modern corporate governance establish the basic incentives for enterprise managers to (i) internalize profit as their primary objective, (ii) act in accordance with a sense of fiduciary duty to the owners of the enterprises they manage, and (iii) act impartially with regard to their treatment of all shareholders. The complete absence at the time of the CGERP's formulation of modern corporate governance principles and practices—as well as mechanisms for their enforcement—in the Kyrgyz Republic represented a binding constraint to improving the performance of the enterprise sector. Their continued absence would have severely impeded the progress of other reforms intended to facilitate structural adjustment and promote economic growth. The CGERP was an essential component to the Government's overall developmental strategy at the time of its approval and—given the enduring importance of enterprise governance to growth—its relevance, almost 5 years later, has not diminished. **Assessment: Highly Relevant.**

### B. Efficacy

36. The CGERP was broadly successful in meeting the performance targets of its logical framework. The PCR (PCR: KGZ 29149) provides more detailed information on what was accomplished under the program and the Government's compliance with second tranche release conditions. The key accomplishments of the CGERP include (i) adoption of the model corporate charter, and widespread compliance with the core governance requirements established by the charter, by virtually all open JSCs;<sup>2</sup> verified compliance by three of the four “demonstration” enterprises with the core corporate governance requirements established in the model corporate charter;<sup>3</sup> establishment of CDC, which appears to have done an exceptional job of promoting public awareness and understanding of corporate governance and of

<sup>2</sup> Governance infractions continue to occur, of course, particularly with regard to (i) inadequate disclosure of financial data in public media, (ii) violations of procedures governing annual general meetings, (iii) inadequate disclosure of information to shareholders, (iv) the existence of related party transactions, (v) violations of the right of existing shareholders to participate in new share issuances, and (vi) asset stripping to the benefit of controlling shareholders. Such infractions do not, however, appear to be very common.

<sup>3</sup> The fourth enterprise, Kyrgyz Gasmunaizat, was restructured by the Government in September 1998 (following revelations of serious financial irregularities on the part of the company's General Director) without first holding a shareholders meeting on the grounds that interruptions in gas supplies had the potential to lead to social unrest.

conducting training for enterprise managers and other stakeholders; (ii) elimination of direct budgetary support and termination of the practice of providing loan guarantees for state-owned or state-controlled JSCs; (iii) ascension by the Kyrgyz Republic to membership in the World Trade Organization; (iv) passage of the Law on Bankruptcy in September 1997, with subsequent amendments approved in December 1998;<sup>4</sup> adoption of required changes to the Civil Code; filling of all Arbitrazh Court vacancies; (v) conversion to the newly established Kyrgyz Accounting Standards (based on IAS) by more than 1,000 JSCs;<sup>5</sup> (vi) sufficient resources to the Employment Fund to fund unemployment benefits and retraining programs. **Assessment: Highly Efficacious.**

### C. Efficiency

37. No economic rate of return can reasonably be calculated for the CGERP, given that most of the proceeds of the loan were used for general budgetary support. Moreover, as was discussed previously, any attempt to measure the impact of the CGERP on current indicators of economic performance will be distorted by (i) the impossibility of disaggregating the role of enterprise *governance* from that of enterprise *management* (effective management depends upon a number of factors not addressed by the CGERP—including access to human and financial capital which remains limited at this time in the Kyrgyz Republic), (ii) the fact that the 3-year period of the program only ended approximately 18 months ago so the full impact of the program has yet to be felt, (iii) the impact of the Russian ruble crisis, which severely depressed economic output during the implementation of the program, and (iv) the fact that the broader transition to a market economy is now understood to require more time to generate meaningful economic returns than was expected when the program was formulated.

38. That said, the timing and formulation of the CGERP benefited from an *efficiency of process* that merits recognition. The CGERP (i) effectively leveraged work being done in other sectors by ADB (including, for example, the *Financial Intermediation and Resource Mobilization Program*) and by other donors, as discussed above in the section entitled, “Coordination and Cooperation;” (ii) was formulated and implemented at a time when a basic framework of corporate governance was crucially needed (subsequent to the corporatization phase of the Government’s privatization program but prior to the enactment of more complex and time-consuming reforms to the legal framework); (iii) was structured as an umbrella project, which brought together a portfolio of reforms under one programmatic umbrella, seemingly with greater impact than would have been achieved had the individual components of the program been pursued in isolation; (iv) established a new institution (the CDC) tasked with overall responsibility for promoting public awareness and understanding of corporate governance, seemingly with greater success than would have been achieved by assigning this responsibility to a branch or division of an existing ministry or agency; (v) placed the CDC under the Office of the Prime Minister, which heightened its political visibility and enabled it to operate with greater neutrality; and (vi) leveraged existing political requirements to enforce compliance with performance targets.<sup>6</sup> **Assessment: Highly Efficient.**

<sup>4</sup> The amendments (i) enable bankruptcy procedures to be initiated if a debtor fails to abide by debt repayment obligations, regardless of the financial condition of the debtor’s balance sheet; (ii) impose personal liability on enterprise managers if they fail to make appropriate recommendations to shareholders on issues related to the repayment of the enterprise’s debts; (iii) provide greater independence to special administrators; and (iv) provide extraordinary powers to courts to eliminate political interference. The legislation is comparable to that found in a number of more developed countries.

<sup>5</sup> The process of conversion to these standards by individual enterprises was supported by USAID.

<sup>6</sup> This last point refers to provisions in the policy matrix of the CGERP whereby (i) JSCs registering with the NSC were obligated to adopt the model corporate charter, and (ii) JSCs wishing to qualify for procurement contracts with the Government were also obligated to adopt the model corporate charter.

## D. Sustainability

39. Many of the building blocks for improving corporate governance developed under the CGERP have become institutionalized and are likely to endure even in the absence of further governance reforms. The governance framework provided by the model corporate charter, for example, has been effectively subsumed by the new JSC Law currently before Parliament for its second reading. The adoption of IAS compliant accounting standards has established meaningful standards for financial accounting and reporting. The Law on Bankruptcy provides an effective procedure for adjudication of creditor claims and has the potential to expedite the liquidation of insolvent enterprises and to serve as an incentive to improve accountability on the part of enterprise managers. The usefulness of these building blocks, however, in terms of improving governance practices and, ultimately, to improving profitability and economic growth will be driven primarily by the Government's sustained commitment to corporate governance as a policy priority. Given this, assessing the sustainability of the reforms initiated the CGERP is problematic. While the prognosis for the sustainability of the program appears reasonably positive, (i) systemic weaknesses in the legal system, (ii) chronic tax evasion on the part of enterprises (which creates incentives toward *reduced*, rather than *increased*, transparency in financial reporting),<sup>7</sup> and (iii) ingrained rent seeking activities by some governmental officials are cause for serious concern. **Assessment: Likely.**

## E. Institutional Development

40. The CGERP made substantial progress in terms of (i) legislative and regulatory reform (including, especially, the passage of the Law on Bankruptcy, amendments to the Civil Code and the Law on Economic Partnerships and Societies, and resolutions governing the adoption of the model corporate charter and other corporate governance requirements); (ii) norms and practices (by institutionalizing basic governance principles and practices); (iii) organizational capacity development (including, especially, the establishment of the CDC to conduct training for enterprise managers and other stakeholders and to develop public awareness of the principles and objectives of corporate governance and of shareholder rights and responsibilities); and (iv) participatory attitudes of society (as indicated by a small but emerging shareholder class). **Assessment: Substantial.**

## F. Overall Assessment

41. In conformance with the methodology established in ADB's *Guidelines for the Preparation of Project Performance Audit Reports* (September 2000), the overall rating of Loan 1546-KGZ(SF): *Corporate Governance and Enterprise Reform Program* is **highly successful**.

Criterion	Assessment	Rating (0-3)	Weight (%)	Weighted Rating
Relevance	Highly Relevant	3	20	0.60
Efficacy	High Efficacious	3	25	0.75
Efficiency	Highly Efficient	3	20	0.60
Sustainability	Likely	2	20	0.40
Institutional Development	Substantial	3	15	0.45
<b>Overall Rating</b>	<b>Highly Successful</b>		<b>100</b>	<b>2.80</b>

<sup>7</sup> Evidence for this comes from the fact that half – perhaps far more – of enterprises that were certified by USAID as having converted to IAS are now believed to be no longer compliant.

## G. Performance of ADB and the Government

42. Interviews with government officials revealed no substantive concerns with regard to the performance of ADB or ADB staff involved with the CGERP. The program appears to have been monitored closely, both from ADB headquarters and from the field during the program's three review missions. Formulation and implementation of the CGERP appear to have been conducted in unusually close cooperation and coordination with bilateral and other multilateral donors, as discussed above. A review of program documents revealed no substantive concerns on the part of ADB staff involved with the CGERP with regard to the performance of the Government.

## VI. LESSONS, ISSUES, AND FOLLOW-UP ACTIONS

43. The CGERP represents the first structured approach taken by any of the Central Asian republics to address the problems of enterprise governance. When measured against its logical framework, the CGERP was highly successful. Although some work remains before the governance foundation developed by the CGERP will be finished—particularly with regard to harmonization of the legal framework—the program can be credited with a number of accomplishments, including especially (i) providing a governance framework at a time when such a framework was crucially needed; (ii) substantially elevating the awareness of public officials, enterprise managers, shareholders, and the general public of the importance of corporate governance and the right of stakeholders to demand fiduciary responsibility on the part of enterprise managers; and (iii) creating an institution (in the form of CDC) to continue the work of promoting improved governance beyond the existence of the program and empowering the organization by placing it under the supervision of the Prime Minister's Office. These were essential and valuable contributions.

44. Not surprisingly, the lessons to be learned from the CGERP's achievements are similar to those than can be learned from other successful projects, including the recognition that in order for development projects to produce useful outputs they must be (i) designed to meet meaningful and attainable objectives, such as removing a known and binding constraint to growth (which was the essential objective of the CGERP); (ii) supported by adequate TA, with a strong emphasis on building local capacity; and (iii) actively embraced as a developmental priority by the borrower. Local ownership over the project is essential. The CGERP also demonstrates the (i) merits of an umbrella approach to reforming complex public policy issues (particularly those that involve large public education components and require the active cooperation and support of a number of governmental agencies and ministries); and (ii) importance of identifying the proper executing agency to ensure the project receives both sufficient political support, as well as sufficient political attention. Finally, the CGERP illuminates the importance of promoting policies that relax government-imposed distortions to market efficiency. This is particularly important in transition economies where the role of the state often remains inexorably intertwined with the activities of the ostensibly private economy.

45. The most important question yet to be asked of the CGERP, however, is whether the governance *framework* it provided will actually lead to improved governance *practices* on the part of enterprise managers and, ultimately, to improved profitability and economic growth. As stated earlier, the framework of modern corporate governance in any market economy establishes the incentives for enterprise managers to act as fiduciaries for the benefit of all of the owners of the enterprises they manage. For these incentives to be meaningful, however, they must be reinforced by *mechanisms of enforcement*, such as the (i) active and informed participation of shareholders in the governance process, (ii) presence of competition and the

absence of undue political interference in the activities of private enterprises, (iii) disciplinary effectiveness of banks and the capital markets in allocating investment capital to profitable enterprises in preference to enterprises incapable of generating meaningful economic returns, and (iv) existence of an efficient and impartial legal system to adjudicate claims and enforce accountability on the part of enterprise directors and managers. Moreover, effective enforcement, in turn, depends upon the (i) existence of acceptable standards for financial and operational reporting; and (ii) transparency and impartiality of public officials, particularly those involved in tax collection, business licensing, and the judiciary.

46. The fundamental transformation of incentives and attitudes—as well as the basic change in the relationship between the state and enterprises—envisaged by the CGERP has yet to take place in the Kyrgyz Republic. In large measure, this is because the mechanisms of governance *enforcement* remain underdeveloped. This will effectively impede improvement of governance *practices* in the absence of further reforms. While some constraints to improved governance are structural and can be resolved in time with TA and targeted investment, the most important constraints can only be eliminated by the application of concerted political will. The Government must be committed to enforcing the governance requirements contained in the model corporate charter (and, now, in the proposed JSC Law) even when the enforcement of these requirements may not be in its own financial or political interests. In addition, the Government must recognize that

- (i) The financial performance of JSCs in which the Government remains the dominant shareholder will fall short of expectations as long as the Government's objective function includes conflicting objectives, such as job creation, and the Government tolerates poor financial performance by existing managers because their appointment reflects political patronage. While steps can be taken to improve the governance of such enterprises, the Government should eventually privatize them.
- (ii) The effectiveness of the financial sector in encouraging improved governance will remain limited as long as enterprises do not view banks or the capital market as viable sources of investment capital. This problem is, to a large degree, self-reinforcing, as investors will remain reluctant to provide capital as long as enterprises fail to disclose accurate (and reliable) financial data and managers fail to establish track records for acting in the interest of shareholders. The Government should continue to support development of the financial sector.
- (iii) The objective of improving governance practices on the part of enterprise managers and efficiently and equitably restructuring (or liquidating) insolvent enterprises will be handicapped as long as governance standards cannot be enforced in the court system, either because of political interference or corruption. The Government should continue to support the reform of the judiciary.
- (iv) The imposition of governance requirements—such as the production of timely and reliable financial statements—will not result in anticipated outcomes as long as enterprise managers have no practical reasons for complying with them. This is particularly evident when applied to the disclosure of financial data by enterprises that are successfully evading taxes. The State Tax Inspectorate should require the submission of IAS compliant financial statements with tax

filings. The Government should take steps to curb tax evasion and limit rent-seeking by revenue collectors.

47. In addition to supporting those measures described above—privatization, financial sector reform, and judiciary reform—the donor community can help by supporting programs to (i) strengthen public governance (including, especially the curtailing of rent-seeking behavior by public officials involved in tax collection, business licensing and regulation, and the judiciary); (ii) strengthen financial sector governance (particularly with regard to limiting insider lending, improving auditing, and imposing meaningful civil penalties in the case of malfeasance); and (iii) facilitate enterprise restructuring (particularly with regard to improving the human capital of enterprise managers).

48. No follow-up issues are specified here, given that all such issues appear to be adequately addressed by the currently ongoing *Second Phase of the Corporate Governance and Enterprise Program*, approved by ADB Board of Directors in late 2001.