Chapter I

Overview

a) Definition of corporate governance:

"Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of return" [www.encycogov.com, Mathiesen 2002].

"Corporate governance deals with the ways in which suppliers of Finance to corporations assure themselves of getting a return on their Investment", The Journal of Finance, Shleifer and Vishny [1997, page 737].

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other Stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance", OECD April 1999. OECD's definition is consistent with the one presented by Cadbury [1992, page 15].

"Corporate governance - which can be defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society -….", from an article in Financial Times [1997].

"Corporate governance is about promoting corporate fairness, transparency and accountability"[J. Wolfensohn, president of the Word bank, as quoted by an article in Financial Times, June 21, 1999.]

“Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges…corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy” Maw *et al*. [1994, page 1].

-"Governance is typically thought to be the purview of Boards of Directors. However, in the broader context, it is a responsibility delegated by shareholders and the public, defined by legislators and regulators and shared by boards, in some measure, with managers. The logical point at which to begin any discourse on governance is with a working definition . The following definition is offered to provide context for the current discussion:

“Governance is the exercise of authority, direction and control of an organization in order to ensure its purpose is achieved. It refers to who is in charge of what; who sets the direction and the parameters within which the direction is to be pursued; who makes decisions about what; who sets performance indicators, monitors progress and evaluates results; and, who is accountable to whom for what. Governance includes the structures, responsibilities and processes/practices that the board of an organization uses to direct and manage its general operations. These structures, processes and organizational traditions determine how authority is exercised, how decisions are taken, how stakeholders have their say and how decision-makers are held to account.

Governance is:

The structures, traditions and processes of Leadership and Stewardship that:

- Assign Power
- Define Roles, Responsibilities and Relationships
- Govern Communications with Stakeholders, and
- Ensure Accountability (from which legitimacy is derived)

That is:

- Who has influence?

- Who decides?

- How decision-makers are held to account"

[Mel Gill, President, Synergy Associates Inc. Presentation to Insight Conference on Corporate Governance, Calgary, Dec. 2002]

b) Importance of corporate governance:

1-Corporate governance and firm performance

In its 'Global Investor Opinion Survey' of over 200 institutional investors first undertaken in 2000 and updated in 2002, 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 outside 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).

Other studies have linked broad perceptions of the quality of companies to superior share price performance. In a study of five year cumulative returns of Fortune Magazine's survey of 'most admired firms', Antunovich et al found that those "most admired" had an average return of 125%, whilst the 'least admired' firms returned 80%. In a separate study Business Week enlisted institutional investors and 'experts' to assist in differentiating between boards with good and bad governance and found that companies with the highest rankings had the highest financial returns.

On the other hand, research into the relationship between specific corporate governance controls and firm performance has been mixed and often weak.

2-Board composition

"Some researchers have found support for the relationship between frequency of meetings and profitability. Others have found a negative relationship between the proportion of external directors and firm performance, while others found no relationship between external board membership and performance. In a recent paper Bagahat and Black found that companies with more independent boards do not perform better than other companies. It is unlikely that board composition has a direct impact on firm performance".[www.wikipedia.com]

3-Remuneration/Compensation

"The results of previous research on the relationship between firm performance and executive compensation have failed to find consistent and significant relationships between executives' remuneration and firm performance. Low average levels of pay-performance alignment do not necessarily imply that this form of governance control is inefficient. Not all firms experience the same levels of agency conflict, and external and internal monitoring devices may be more effective for some than for others.

Some researchers have found that the largest CEO performance incentives came from ownership of the firm's shares, while other researchers found that the relationship between share ownership and firm performance was dependent on the level of ownership. The results suggest that increases in ownership above 20% cause management to become more entrenched, and less interested in the welfare of their shareholders.

Some argue that firm performance is positively associated with share option plans and that these plans direct managers' energies and extend their decision horizons toward the long-term, rather than the short-term, performance of the company. However, that point of view came under substantial criticism circa in the wake of various security scandals including mutual fund timing episodes and, in particular, the backdating of option grants as documented by University of Iowa academic Erik Lie and reported by James Blander and Charles Forelle of the Wall Street Journal. Even before the negative influence on public opinion caused by the 2006 backdating scandal, use of options faced various criticisms. A particularly forceful and long running argument concerned the interaction of executive options with corporate stock repurchase programs. Numerous authorities (including U.S. Federal Reserve Board economist Weisbenner) determined options may be employed in concert with stock buybacks in a manner contrary to shareholder interests. These authors argued that, in part, corporate stock buybacks for U.S. Standard & Poors 500 companies surged to a $500 billion annual rate in late 2006 because of the impact of options. A compendium of academic works on the option/buyback issue is included in the study Scandal by author M. Gumport issued in 2006.

A combination of accounting changes and governance issues led options to become a less popular means of remuneration as 2006 progressed, and various alternative implementations of buybacks surfaced to challenge the dominance of "open market" cash buybacks as the preferred means of implementing a share repurchase plan". [www.wikipedia.com]

c) Corporate governance and stakeholders:

"Parties involved in corporate governance include the regulatory body (e.g. the Chief Executive Officer, the board of directors, 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 implies 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 is implemented to assist in aligning the incentives of managers with those of shareholders. With the significant increase in equity holdings of investors, there has been an opportunity for a reversal of the separation of ownership and control problems because ownership is not so diffuse.

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

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

A key factor in an individual's decision to participate in an organization e.g. through providing financial capital and trust that they will receive a fair share of the organizational returns. If some parties are receiving more than their fair return then participants may choose to not continue participating leading to organizational collapse".[www.wikipedia.com]

Shareholders

1. Shareholder Rights

" Shareholders shall receive all necessary information prior to exercising their rights, and shall be able to exercise their rights through proper procedure.

1.1 Shareholders, as owners of the corporation, possess basic rights including the following:

- **A right to participate in profit sharing;**
- **A right both to attend and to vote at general shareholder meetings;**
- **A right to obtain relevant corporate information in a timely and regular manner.**

As owners of the corporation, the basic rights of shareholders cannot be taken away or restricted even through the articles of incorporation, the general shareholder meetings, or the decision of the Board of Directors. Shareholders may participate in the corporation’s profit sharing and hold residual claims, and also hold the right to attend the general shareholder meetings and exercise their voting rights. Also, shareholders hold the right to obtain relevant information on the corporation to exercise their rights; and the corporation must faithfully provide, barring any justifiable reason, any information requested by shareholders.

1.2 To protect utmost the rights of shareholders, the following matters which cause fundamental corporate changes and shareholder rights shall be decided at the general shareholder meetings.

- **Amendments to the articles of incorporation;**
- **M&A and business transfer;**
- **Corporate disbanding and dissolution;**
- **Capital reduction and others.**

It is highly desirable that shareholders be allowed to make decisions directly on issues which carry weighty influence on the corporation's very existence and the rights of shareholders. These are aside from those matters already specified for resolution at the general shareholder meetings under the current related statutes.

- **Shareholder rights shall be protected, and shareholders shall be able to exercise their rights through proper procedures.**
- **Shareholders shall be treated equitably under the principle of shareholder equality.**
- **Controlling shareholders have the corresponding responsibilities when they exercise any influence toward the corporate management other than the exercise of voting rights.**

1.3 Resolutions from the general shareholder meeting shall be made through transparent and fair proceedings. Also, shareholders shall receive sufficient prior notice including the time, location and agenda of the meeting; such time and location shall be set so as to allow maximum number of shareholder participation.

Information shall be provided to shareholders so that sufficient review of the agenda may be made prior to the general shareholder meeting. Previously, the amount and distribution method of information provided to shareholders was limited due to the burden placed on the corporation. It is, however, now possible for corporations to provide large amounts of information at minimal cost through the internet and other electronic communication means; therefore sufficient information on the meeting's agenda shall be provided to the shareholders.

Also, the time and location of the meeting shall be set such that shareholder attendance can be facilitated. Most notably, the number of minority shareholders holding shares of several different corporations has recently been on the rise; therefore, holding general shareholder meetings at different times would be judicious to maximize minority shareholder attendance.

1.4 **Shareholders may submit items for the meeting agenda to the Board of Directors; they may question and demand explanation on the agendas at the meetings. The corporation shall ensure that shareholders' opinions are sufficiently reflected at the general shareholder meetings**.

Aside from any intention to disrupt the order of the general shareholder meetings or from asking repetitious or unjustified questions, the shareholder shall be given the full capacity to sufficiently question and gain explanations prior to resolution of the agenda.

1.5 Shareholders shall be able to exercise their voting rights, either directly or indirectly, in the simplest manner possible.

The exercise of voting rights, either through direct or indirect means, has the following two implications: The first regards the exercise of one's voting right; the shareholder may exercise his voting right by participating, in person, in the general shareholder meeting, or he may exercise his voting right indirectly through a proxy. The second regards the means of exercising the voting right; the shareholder may participate in the general shareholder meeting and exercise his voting rights or may exercise his voting right through a ballot that is of written or electronic means.

In light of the considerable development in electronic communication means and the growing trend of foreign and minority shareholders, highly desired is that corporations vary the voting methods to facilitate the exercise of voting rights by shareholders."

[Corporate governance best practices, post Enron Era Convention]

2. Equitable Treatment of Shareholders

"Shareholders shall hold fair voting rights according to the type and number of shares possessed, and all shareholders shall equally be in possession of corporate information.

2.1 Shareholders shall hold the right to one vote per share, and there shall be no infringement on basic shareholder rights. However, voting rights for certain shareholders may be somewhat restricted as indicated by law.

The current *Commercial Code* recognizes one vote for each share for all shareholders, and the voting right is one that is inherent to the shareholder which, in principle, may not be restricted by any person.

The *Commercial Code* and certain statutes, however, allow restriction on voting exercise by certain shareholders. Justified and necessary is such to prevent adverse effects, should controlling shareholders be given unlimited exercise of voting rights.

With large corporations expanding into the financial industry, including that of investment trust business, and with the scale of investment by financial institutions in stocks and corporate bonds on the rise, the large corporation's grip on power on other corporations is similarly on the increase. To prevent any adverse effect from this development, therefore, a new form of voting right restriction shall be introduced, if considered justified.

2.2 Shareholders shall be provided all necessary information---both sufficiently and impartially---from the corporation in a timely manner, and the corporation shall not show partiality to certain shareholders by providing undisclosed information.
Shareholders need to be informed periodically of information---aside from those matters disclosed regularly---on the corporation which may have influence on its stock value. The corporation, therefore, shall make every effort to provide as much information to all shareholders impartially. In particular, the corporation shall disclose such information at its presentations to those absent shareholders and other retail investors.

2.3 Shareholders shall be protected from unfair conducts of insider trading and self dealing.
The management or shareholders must not engage in insider trading or self-dealing with the intent of personal gains. Particularly, self-dealing must be dealt within reasonable bounds away from any breach of moral obligation by the management. For such, the corporation shall be equipped with an internal control mechanism to handle insider trading and self-dealing, and the details of such transactions shall be disclosed through a fair means."
[Corporate governance best practices, post Enron Era Convention]

3. Shareholder Responsibilities

"Shareholders shall make every effort to exercise their voting rights. Controlling shareholders, aside from exercising their voting rights accorded to the shares possessed, shall take corresponding responsibility whereby they exercise influence over the corporate management.

3.1 Shareholders, understanding that the exercise of their voting rights has bearing on the corporate management, shall make every effort to exercise their voting rights for the corporation's best interests.
The shareholders' exercise of voting rights is a freedom of choice. For the sound and transparent management of the corporation, however, a general shareholder must make every effort to exercise his given rights, such as taking serious interest in the corporation's management and exercising his voting rights.

3.2 Controlling shareholders wielding influence on the corporate management shall act in the best interests of the corporation and all its shareholders. For any action running counter to such, the controlling shareholders shall bear all corresponding responsibility.

The controlling shareholder is one, regardless of his proportion of shareholding, who exercises *de facto* influence over major matters involving corporate management, such as appointment and dismissal of management.

The responsibility of running the corporation lies with its directors and management. In truth, however, it is difficult for such directors to completely reject the unequal power yielded by the controlling shareholder so long as he possesses influence over the selection of directors. Therefore, controlling shareholders---aside from exercising their voting rights on shares possessed or from directly participating in the corporate management as directors---shall accept responsibilities for their power yielded, corresponding to the influence exercised on the corporate management using their vantage position.

Any unjustified intervention in management by the controlling shareholder, contrary to the interests of the corporation, may be controlled through strengthening managerial accountability of directors and revitalizing the outside director system. However, for the controlling shareholders' influence on the corporate management---aside from exercising their voting rights or from directly participating in the corporate management as directors, it is of utmost importance that the following be understood: responsibilities they possess is proportional to their exercise of influence."

[Corporate governance best practices, post Enron Era Convention]

Board of Directors

1. Functions of the Board

" The Board shall make the key management policy decisions in the best interests of the corporation and its shareholders, and shall perform effective supervision of the directors and management.

1.1 The Board, holding comprehensive power over the corporate management, shall perform the following functions of decision-making and management supervision:

- **Setting business goals and strategies;**
- **Approving business plans and budgets;**
- **Supervising management and evaluating management performance;**

- **Replacing the management and also reviewing the remuneration;**
- **Monitoring major capital expenditures and corporate takeover;**
- **Mediating the conflicting interests among directors, management and shareholders;**
- **Ensuring integrity of the accounting and financial reporting systems;**
- **Supervising risk management and financial control;**
- **Supervising the compliance of statutes and ethics-related regulations;**
- **Monitoring the effectiveness of governance practices;**
- **Overseeing the process of information disclosure.**

At present, the Board is designed to be the heart of corporate operations. The Board, therefore, must perform all its duties not only to protect minority shareholders and other parties of interest monitoring and restraining the self-validating management or controlling shareholders but to prevent corporate insolvency. For this, the Board's major functions and duties regarding corporate decision-making and management supervision shall be clearly stated so that its role played in corporate governance is understood.

1.2 **The Board may mandate its authority to its internal committee or to the representative director. Excluded, however, are key matters as stated in the articles of**

- The Board of Directors (hereafter the "Board") shall make the corporation's key management policy decisions and shall supervise the activities of directors and management.
- The directors and the Board shall perform their duties faithfully in the best interests of the corporation and its shareholders; they shall also perform their social responsibilities and consider the interests of various stakeholders.
- The Board shall observe the related statutes and the articles of incorporation when performing its duties, and shall ensure that all members of the corporation also observe them.

incorporation and the Board Operating Regulation.

Many corporations, especially those large, have become so specialized in their management and also so functional-oriented that they have become unsuitable for all Board members to assemble any time when an occasion arises for execution of all corporate operations. Moreover, with the sharp rise in the number of outside directors, holding Board meetings frequently has become difficult.

Therefore, to vitalize the Board's functions and to have all such functions executed, it shall be able to mandate---as long as no violation is made on the statutes and laws or the articles of incorporation---a portion of its authority to its respective internal committees or the representative director. That is, it is highly advised that the Board concentrate on key management decision-makings and mandate relatively lesser or trivial matters to the representative director or the management; or that the Board establish internal committees within itself to which a portion of the authority can be delegated.

The internal committees, composed of directors with expertise and interest in the area concerned, shall enhance the effectiveness and expertness of the duties performed by the Board through division of labor, thereby creating effective control over the management." [Corporate governance best practices, post Enron Era Convention]

2. Composition of the Board

" **The Board shall be composed so as to allow effective decision-making and supervision of the management.**

2.1 The number of directors shall be such that it allows the Board to have fruitful discussions and to make appropriate, swift and prudent decisions. For large public corporations, it is highly advised that the number of directors on the Board be appropriate for effectively managing internal committees.

There is no perfect number of directors appropriate for all the different circumstances of corporations. The reason lies with the many different factors that may influence the Board's size, e.g., the corporation's size, the business environment, and special characteristics. Nevertheless, the Board's size shall be such that it allows the discussions to be fruitful and the decisions made to be appropriate, swift and prudent. A large-scale public corporation is one having a total asset value of more than one trillion won.

2.2 The Board shall include outside directors capable of performing their duties independently from the management, controlling shareholders and the corporation. The number of outside directors shall be such that the Board is able to maintain practical independence. Particularly, it is recommended that financial institutions and large-scale public corporations gradually increase the ratio of outside directors to over half of the total number of directors (minimum three outside directors).

To raise transparency of corporate management and to improve corporate governance, stock listed corporations shall appoint outside directors to fill a minimum one-quarter of the total; banks and public sector corporations, a minimum one-half.

The most important role of outside directors is to enable the Board to perform its management supervisory functions effectively. Such directors hold an independent position from the corporation, management and controlling shareholders when compared to standing directors, thereby making possible effective management supervision and objective management counseling.

For outside directors to perform their functions properly, it is important that the number of outside directors appointed is adequate for them to exercise actual influence in the Board's decision-making process. Therefore, the proportion of outside directors shall be decided at the level where the Board would be able to maintain actual independence from the management and the controlling shareholders while exercising influential authority over management decisions.

For financial institutions and large-scale public corporations, particularly, the Board's management supervisory function holds much importance; it is highly advised that the ratio of outside directors be gradually increased to a minimum one-half of the total number" [Corporate governance best practices, post Enron Era Convention]

3. Appointment of Directors

" **Directors shall be appointed through a transparent procedure that reflects broadly the diverse opinions of shareholders.**

3.1 It is advised that a committee be established and managed for fair nomination of directors. The committee shall be organized such that the fairness and independence of the nomination process are ensured.

Directors appointed by the controlling shareholders or management is much influenced by the in performing their duties, thereby raising concerns their obligation of fairly executing duties as the managing agent of all the shareholders may be impaired. To maintain independence of directors, therefore, there shall be a procedure for appointing directors that broadly reflects the diverse opinions of shareholders.

For this purpose, there is a need to thoroughly examine the adoption of a committee system that allows recommendations of director nominees to be fairly made. For one, consideration needs to be given to the director nomination committee---formed at least one-half with outsider directors---that recommends the nominees for outside directors, and also a plan to gradually make recommendations for standing directors. Not only that, there needs to be a review of the method of establishing a shareholder committee---composed of shareholders based on their shareholding rank---who will represent the interests of shareholders overall.

3.2 The opinions of shareholders other than the controlling shareholder shall also be reflected when appointing directors. For this purpose, it is recommended that a cumulative voting system be adopted, and that it be disclosed regardless of its adoption.

In the process of nominating and appointing directors, the opinions of general shareholders shall also be reflected. If such a process is not improved, it would be difficult to expect directors not just standing but also outside directors---to retain actual independence regardless of how much the requirements and qualification for outside directors are strengthened.

It would, therefore, be best to adopt the cumulative voting system, not just to ensure the independence of directors or to reflect the shareholders' diverse opinions when appointing directors, but also to consider the significant influence controlling shareholders yield on the management. To encourage adoption of this system, disclosure of whether such has been adopted by the corporation shall be made mandatory.

3.3 The Board shall make actual contribution to the corporate management by appointing
competent professional directors, and shall respect the appointed directors' term of office.

For the Board to perform its functions dutifully and to make actual contribution to the corporate management, directors shall be competent and professional. Such directors refer to those possessing the following qualities: a vision for and a strategic perception of the corporate management; a level-headed and sound managerial judgment; an ability for managing and supervising the organization; a knowledge of law and finance; and some experience suitable for the corporation concerned.

On the other hand, the term of office for the director---appointed through due process at a general shareholder meeting---shall be respected so that his functions as managing agent for all shareholders may be performed dutifully. The exceptions are the following: the director is found liable for any illegal act; gross violation is made of the statutes or the Article of Incorporation; or the director is deemed quite inept for office.

3.4 The corporation shall, by disclosing the nominated directors prior to the general shareholder meeting, ensure that the shareholders exercise their voting rights with information on the nominees.

If the nominated directors, following the Board's decision, are not disclosed prior to the general shareholder meeting, shareholders will not have sufficient prior information on the nominees, rendering the meeting a mere formality. Therefore, any such information (e.g., personal profile) shall be disclosed beforehand, as it may aid the exercise of shareholders' voting rights and contribute to selecting competent directors.

For corporate information, it shall be made available using timely disclosure media to allow easy access by shareholders. There is a need to ease the corporation's burden of having to determine the nominees when the call to convene the general shareholder meeting is made. The information on the nominees shall be disclosed at least three business days before the general shareholder meeting is convened, affording shareholders a minimum amount of time to evaluate it. When minority shareholders are looking to nominate directors, such intention shall be announced at the time the general shareholder meeting is notified; then the nominees shall be recommended and disclosed before the general shareholder meeting"

[Corporate governance best practices, post Enron Era Convention]

4. Outside Directors

_"Outside directors shall be able to independently participate in important corporate management decision-making, and to supervise and support the management as Board members.

**4.1 Outside directors shall hold no interests that may hinder their independence from the
corporation, management or controlling shareholder. The outside director shall submit a letter of confirmation, which the corporation shall disclose, stating that he holds no interests affiliated with the corporation, management or controlling shareholder at the time of his consent to the appointment.**
The outside director system was adopted to strengthen the supervisory and supporting functions on the management. Therefore, outside directors shall be independent from the management or controlling shareholders, and shall hold no interests that might impair performing duties impartially from the corporation, management or controlling shareholder. To ensure independence of outside directors, disclosures concerning any interest of the outside director at the appointment stage shall be strengthened. For this purpose, the outside director, at the time consent is given to appointment, shall submit a letter of confirmation, which the corporation shall disclose, stating that he holds no interests that might impair performing duties impartially from the corporation, management, and the controlling shareholder.
Though no concern exists of the impartial performance of the outside director's duties being impaired, he shall state in a letter of confirmation if there exist other interests and disclose such information. Also, should there be any change in the information stated in the letter following inauguration into office, the outside director shall immediately submit a corrected letter of which the corporation shall disclose.

4.2 The corporation shall provide, at the appropriate time, outside directors with information necessary to perform duties to allow accurate assessment of the corporation's managerial situation. Particularly, when a Board meeting is to be convened, information shall be provided beforehand so that the director may sufficiently review the agenda. Also, the outside director may request information necessary for performing duties to be swiftly provided. For important confidential information of the corporation, however, it shall be provided only at the request of the majority of outside directors, to which the management, barring any justifiable

reason, shall comply.

For the outside director to perform his role effectively, he must receive sufficient information concerning business plans or the corporation's managerial situation. Therefore, management, including its head, must provide to outside directors any necessary information, sufficiently and timely, so that they may accurately assess the corporation's managerial situation. Particularly,

when a Board meeting is to be convened, the related information on the pending agenda shall be provided to the outside directors to allow prior review.

An outside director shall be given easy access to information necessary for reviewing opinions on the management's objectives or the corporation's strategic decisions. For this purpose, the outside director shall be able to request information from anyone in the corporation. But to prevent leakage and abuse of confidential information, such shall be provided at the request of the majority of outside directors, of which the management or its head shall comply, barring any justifiable reason. Also, the corporation shall designate a division to oversee such matters within the corporation to facilitate any request for information by outside directors.

4.3 Outside directors shall allot sufficient time towards performing their duties, and shall

review all related information before attending a Board meeting. Outside directors shall listen to the opinions of shareholders and shall make every effort to acquire information from various sources within and outside the corporation.

Outside directors shall, in performing their duties, collect and review sufficient information on the agenda up for decision-making and shall make every effort to make the best decision in the interests of the corporation. For this, the outside director shall allot sufficient time towards performing his duties, attending all Board meetings, and reviewing the material provided carefully. If the material proves insufficient, the outside director shall collect the necessary material himself and review them, e.g., reading the account books or related documents. Also, outside directors shall endeavor to gather diverse opinions concerning the corporate management, and shall make every effort to obtain necessary information from diverse sources within and outside the corporation, including shareholders, to minimize the risk of management failure.

4.4 The outside director may receive support from executives, employees or outside professionals through due process when necessary, for which the corporation shall cover any reasonable expense.

The outside director shall, if necessary, be able to seek through due process the support or advice of executives, employees or outside professionals like external auditors, legal advisors and others. Any such expense incurred within reasonable limits shall be borne by the corporation.

4.5 To raise the outside director's management supervision and supporting functions, a Regular meeting participated by outside directors only is recommended. Outside Directors and the management shall put every effort to make opportunities for regular Discussions on managerial issues.

The outside director system, adopted to raise transparency in corporate management, shall be Approached more realistically and concretely if it is to take root and achieve its intended Objective.

For this, a system of cooperation must first be established among outside directors. Meetings for outside directors-only shall be held regularly; a representative shall be appointed among the outside directors to supervise such a meeting and to handle important issues delegated to them.

Outside directors and the management shall make every effort to raise opportunities for regular discussions on matters concerning management. Through regular contact with the management, outside directors will be better able to manage the Board by clearly grasping the managerial situation; the management, on the other hand, will be able to gain the understanding and cooperation of outside directors concerning corporate management.

[Corporate governance best practices, post Enron Era Convention]

5. Steering of the Board

"**The Board shall be operated efficiently and rationally to allow the best course for management to be decided in the interests of the corporation and shareholders.**

5.1 The Board meetings shall, in principle, be held regularly, at least once every quarter.

To convene a Board meeting, prior notification of its date and time shall be made to each director. The meeting, however, can be held at any time without effecting such a procedure, given the unanimous consent of the directors and auditors. Their unanimous consent is not required each time a meeting is held: The date and time of the Board meetings can be stated in the *Board Operating Regulations*, or can be decided with the consent of the full Board, thereby allowing meetings to be held without notification.

If the majority of directors are outside directors having other principal occupation, then the Board meeting could be run more efficiently if the management provided reports on important matters to the outside directors. The directors decide beforehand the venue for the meeting where they would be able to present their opinions.

There are significant differences in the issues and the actual role that the Board meeting plays in each corporation; therefore, it is difficult to decide on a uniform standard for the frequency of such meetings. But since the Board itself must vote on important matters concerning corporate management, Board meetings shall be held regularly, a minimum once every quarter, and special meetings held whenever necessary.

5.2 To efficiently operate Board meetings, the Board Operating Regulation shall be drafted that specifically states the Board's rights and responsibilities, along with the steering procedures.

Because the Board is composed of various standing and outside directors, a clearly defined standard for operating the Board meetings shall be required, without which disputes could arise in the actual steering process. To prepare for efficient running of board meetings, each corporation shall draft a *Board Operating Regulation* that comprehensively regulates matters related to the steering of Board meetings. The Regulations shall state the rights and authority, composition and operational procedures for Board meetings, all of which shall be observed.

5.3 The Board shall draft minutes or audio record proceedings of the meeting each time. The minutes shall state important discussion topics and resolutions as detailed and clearly as possible. The minutes and audio recordings of the Board meeting shall be maintained and stored.

To put reasonable pressure for accountability on the Board, it is important that detailed and exact records of the Board's discussions and resolutions, along with individual proposals and arguments, be kept.

Therefore, the corporation shall draft detailed minutes of the proceedings or shall make audio recordings of the entire meeting. The minutes or audio recordings shall be made for every Board meeting, along with important discussions and resolutions made by each speaker recorded clearly and in detail. Also, these records shall be maintained and stored, serving later as important pieces of evidence when problems concerning directors' accountability arise.

[Corporate governance best practices, post Enron Era Convention]

6. Committees of the Board

"To have the Board run efficiently, committees composed of some of the directors may be established within the Board.

6.1 The Board may, if necessary, establish internal committees that perform specific functions and roles, such as the Audit, Operation and Remuneration Committees.

It is unreasonable for the full Board to convene on all occasions for handling corporate matters.

Particularly with the sharp increase in the number of outside directors, it has become more difficult to convene a Board meeting frequently. Also, considering the size of the Board or the

short length of meetings, it is not easy to achieve sufficient discussion or to arrive at a satisfactory resolution during meetings.
Therefore, an internal committee for each related field shall be established, and directors having such expertise or those interested shall be placed on the committee; the committee shall then focus on studying the important issues that occur periodically or that need closer review.
Through operating these types of internal committees, the Board shall be able to raise professionalism and efficiency in their performance of duties.

6.2 The committee's resolution on a matter mandated by the Board shall hold the same effect as the Board's resolution, and the committee shall report such resolution to the Board.
For the Board with internal committees, the Board usually only performs duties which demand its direct attention under the law; other matters are delegated to the internal committees. When the Board mandates matters within its jurisdiction to the internal committee, the committee's resolutions shall hold the same effect as the Board's resolutions, allowing their actual functions to be performed. Also, the committee's resolutions shall be reported to the Board so that all its members are aware of the committee's activities"
[Corporate governance best practices, post Enron Era Convention]

7. Duties of Directors

" **Directors shall perform their duties fairly, with prudence and faithfulness, in the best interests of the corporation and its shareholders.**

7.1 Directors shall, in performing their duties, do their utmost to observe the duties of prudence and faithfulness expected of a proper manager. Directors, as heads of corporate management, shall at all times seek results that would be in the best interests of the corporation and its shareholders.
Directors, according to the main purpose of entrustment as stewards, shall perform their duties with prudence of a proper manager. Directors shall review various materials with care and shall attend all Board meetings, and if needed, receive the advice of specialists before attending.
A director may pose necessary questions and present opinions to the management on corporate operations. Also, if required, he may request advice from external auditors and outside specialists. In performing the duties, the director shall always be careful to ensure that no laws are violated by the corporation or himself.

7.2 Directors shall faithfully perform their duty of loyalty toward the corporation and shareholders. Directors shall not exercise their authority for their own benefit or that of a third party, and shall place the interests of the corporation and shareholders before themselves.

The duty of loyalty particularly applies when a conflict of interest arises between the corporation and the director, or when a certain opportunity may be used by both of them. When the director as a party of the corporation, directly or indirectly---has any economic or personal gain in a contract or other transaction, or when he plans to engage in a transaction which is in competition with the corporation, then such director is considered as having an interest.

In such cases, the director shall act with the interests of the corporation before himself. When a conflict arises for the director having interests in a transaction or contract, he shall clearly disclose such interests and related important information to the Board, and also shall receive the approval of directors having no such interests.

7.3 Directors, in accordance to performing their duties, shall not divulge or use, for their own or third parties' benefit, any corporate secret obtained.

A director must keep secret any confidential matter of the corporation that he has acquired in the process of performing his duties. He shall not openly discuss the confidential matters, and he shall ensure that a third party does not reveal such information. Also, the director shall not use corporate secrets for his own gain or that of a third party. The use of corporate secrets by a director, even it bears no financial harm to the corporation, may erode confidence in the corporation or may incur losses on the part of shareholders and creditors; therefore, it shall be prohibited" [Corporate governance best practices, post Enron Era Convention]

8. Responsibilities of Directors

"When a director has violated the law or the articles of incorporation, or has neglected his duties, he may be liable for damages to the corporation or a third party. But managerial decisions by the director that are based on due process and also faithful and rational decision-making, shall be respected.

8.1 When a director has violated the law or the articles of incorporation, or has neglected

his duties, he may be liable for damages to the corporation. If there was malicious

intent or gross negligence on the part of the director, he may also be liable for damages to a third party.

A director shall observe the law and the articles of incorporation in performing his duties, and shall not be negligent in his duties. If a director does not perform his duties properly, he may not be reappointed or may even be dismissed. These measures alone, however, do not ensure effectively the proper performance of duties by the director, and also do not make up for losses already incurred to the corporation and third party. An effective means of securing proper performance of duties by the director is to hold him materially accountable, that is, in proportional terms.

8.2 If the director, in the process of making a managerial decision, has collected and sufficiently reviewed with care a significant amount of reliable material and information, and has then performed his duties---according to his faithful and reasonable judgment---using means deemed to be in the best interests of the corporation, then such decision shall be respected.

Managing a corporation is very complicated, requiring technical knowledge. Therefore, it is almost impossible, and inappropriate, to hold one accountable for damages by determining any existence of negligence based on examination of *ex post* results. Directors may perform their duty with conviction only if actions made within their capacity, based on reasonable judgment, are respected.

The United States recognizes the business judgment rule in relation to limiting responsibilities.

There are two major reasons why such principle was applied to directors. First, if the director has committed an act, although considered wrong, with all due faithfulness and prudence, he shall be exempted from any responsibility, thereby enabling him to maintain his adventurous yet entrepreneurial spirit. Second, it is not appropriate for the court of law, as a non-professional in the field of management, to directly intervene in business judgments of directors.

Generally, the business judgment rule is only applied with respect to the following cases: The director shall make active business judgments concerning operations of the corporation, and he shall not have any interests on matters needing business judgment. He shall, in the process of making a business judgment, make decisions only after collecting and reviewing sufficiently and carefully a significant amount of reasonably reliable data and information. Also, the director shall rationally believe that such business judgment is of benefit to the corporation.

Considering that an environment would be created whereby directors could act with conviction and that competent managers be protected, the business judgment rule shall be

adopted. It is difficult to predict results of corporation's managerial activities due to changing circumstances.
Therefore, the court of law shall uphold caution when ruling on the question of negligence in the directors' business judgment.

8.3 The corporation, to ensure effectiveness of holding directors accountable and to attract competent persons as directors, may purchase, at its own expense, coverage for the directors with liability insurance.
As the size of corporations grows, the amount involved in liability claims on directors is expanding. Therefore, the effectiveness of filing a suit for accountability would decrease if the director lacks sufficient funds. To ensure such effectiveness, liability insurance shall be purchased with a portion of the directors' remuneration so that compensation can be adequately made for damages to the corporation or third party. Also, to actively recruit those competent but shy due to possibility of lawsuits on outside directors, it is recommended that corporations seriously consider purchasing liability insurance for directors.
However, controversy could arise concerning the question of legitimacy in purchasing liability insurance at the corporation's expense to pay for director's liabilities towards the corporation or third party. Therefore, it would be best if the corporation pay for insurance premiums for liability insurance to supplement for any losses by directors to the extent that no irresponsible business judgment is encouraged"
[Corporate governance best practices, post Enron Era Convention]

9. Evaluation and Compensation

" To promote active performance of duties by the management, outside directors and the Board, their activities shall undergo fair evaluation; based on such results, the matters of remuneration and reappointment shall be decided.

9.1 Business activities of the management shall be evaluated fairly, and the evaluation results shall be reflected appropriately in the remuneration. Remuneration for the management shall be decided by the Board, that is, within the limit approved by the general shareholder meeting. If a committee centered on outside directors is established within the Board, then that committee may make the decision.
The ultimate goal of evaluating the management's activities lies in enhancing the corporation's business results by increasing their rate of contribution to the corporation. Therefore, the management's activities shall be evaluated under objective standards, including business results, achievement of business strategy goals, and others. The evaluation

results shall be used as the basis for determining remuneration and reappointment for management.
Remuneration for the management shall be decided by the Board, that is, within the limit approved by the general shareholder meeting. If an internal committee exists within the Board, it would be best for that committee to propose the remuneration for the management and to gain the Board's approval. Such remuneration shall be rational---proportional to the position as it is compensation for performance of duties. Also, the amount decided shall be befitting of the corporation's financial state.
Calculation criteria for stock options shall always be disclosed in detail prior to any decision regarding it; such criteria shall in general be justified to accurately reflect results achieved through the management's efforts. Also, it would be best to place a ceiling on the criteria, so that the shareholder's interests are not unduly infringed with inordinate endowment of stock options, despite the criteria being reasonable.

9.2 The activities of an outside director should be evaluated fairly, with the remuneration being commensurate to the evaluation results. Activities and evaluation results of outside directors shall be disclosed.
Evaluations on outside directors shall be based on their contributions, and such results shall be used as grounds for deciding the remuneration and reappointment of outside directors. Remuneration for outside directors shall be decided at an amount deemed appropriate; this is considering the responsibility and risk involved with their duties, and also their time allotted to performing such duties. The activities and evaluation results of outside directors, through disclosure, shall aid in the shareholders' decision-making and shall be reflected in the human resources market for business managers.

9.3 Activities of the Board shall be evaluated fairly, the results of which shall be disclosed.
Regarding the activities of the Board, an internal committee may evaluate the Board and its results tendered to the Board for examination. Other possibilities are the evaluation of Board's activities by the general shareholder meeting or by the business manager human resources market; recently, the latter has been regarded as making more effective evaluations. Therefore, activities and the evaluation results of the Board shall, through disclosure, assist in the decision-making by shareholders and shall be reflected in the business manager human resources market. Such disclosures presented in the annual report are also advisable."
[Corporate governance best practices, post Enron Era Convention]

d)Corporate governance principles:

"Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization.

Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness. In particular, senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports Commonly accepted principles of corporate governance include :Rights and equitable treatment of shareholders: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.

Interests of other stakeholders: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

Role and responsibilities of the board: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors. The key roles of chairperson and CEO should not be held by the same person.

Integrity and ethical behavior: Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that systemic reliance on integrity and ethics is bound to eventual failure.

Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

Disclosure and transparency: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters

concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information".

Issues involving corporate governance principles include:

-Oversight of the preparation of the entity's financial statements

-Internal controls and the independence of the entity's auditors review of the compensation arrangements for the chief executive officer and other senior executives.

-The way in which individuals are nominated for positions on the board .the resources made available to directors in carrying out their duties oversight and management of risk .

-Dividend policy"[www.stryker.com]**.**

e) Corporate governance facing the big test:

"Election periods are very anxious times for investors and people in business in any country.
To a majority of businesses it is actually a make or break time, hence the energies and excitement it exudes. It is a time when new contacts and contracts are secured, old businesses and businessmen/women are reunited and sometimes enmities and fallouts are hammered.
Traditionally, organizations give campaign contributions to gain access to decision makers with the hope of gaining favors after one has won.
Election periods in Kenya have not been an exception, in the past arm twisting and muscle flexing among companies to be the among the biggest contributors has been witnessed.

It is not always a pursuit for new business that makes organizations and businesses to contribute to campaign kitties.

It has been found that organizations would lobby lawmakers and regulators to eliminate flaming oversight, safety, environmental and other policies, and pass favorable regulations, subsidies and tax breaks.

This is mainly made with the understanding that they scratch the politicians back at time of need and the flurry of benefits will follow later.

From a distant such practices may be flowered and called corporate responsibility.

Scott Klinger, the co-director of Responsible Wealth, a project of United for a Fair Economy, warns that these practices have violated corporate ethics.

There has not been a clear cut line between social responsibility contribution verses buying partisanship that is profiting from political influence.

During the reign of Enron, USA, it acquired its political capital with campaign gifts, and reinforced it with jobs.

No asset was more valuable at Enron than the company's political capital. Companies should focus on their vision and strive to achieve what they intend to do with their missions.

The reporting of a company's contributions and resources spent on campaign and lobbying for tax rebates, policies and other issues needs to be transparent.

History has shown that companies with little independent board of directors are more likely to fall into the pitfalls of corporate ethics cheating. It is common knowledge that directors like members of parliament decide how much they wish to compensate themselves.

How would you like a job where you decide how much you earn? Sweet isn't it.

Board members not only do that they also select each other. Suppose such a board is filled with insiders and friends or people related to one another?

Chances are pretty high they would support lavish compensation and ask not very hard questions on business. This becomes a prime spot for harboring unscrupulous business transactions undercover.

Sound corporate governance policy holds that corporate boards should be made up of a majority of independent individuals, without direct or indirect ties to the company.

Mind you it is also proven that declaring conflict of interest only is not enough".

[www.styker.com]

f)Cases:

1-Enron.

After a series of revelations involving irregular accounting procedures bordering on fraud, perpetrated throughout the 1990s, involving Enron and its accounting firm Arthur Andersen, Enron stood at the verge of undergoing the largest bankruptcy in history by mid-November 2001. Daniel Scotto an All American top team analyst, number one ranked utility analyst for an unprecedented nine consecutive years published and stated in August 2001 that **Enron** was likely to implode. Scotto was the first analyst to recommend the sale of all **Enron** securities, including its common stock. He was also the first to divulge publicly the magnitude of Enron's financial leverage and lack of corporate ethics, and to question the reliability of Enron's reported earnings results, despite those results being audited by Arthur Andersen. A white knight rescue attempt by a similar, smaller energy company, Dynegy, was not viable. Enron filed for Bankruptcy on December 2, 2001.

As the scandal was revealed, Enron shares dropped from over US$90.00 to just pennies. As Enron had been considered a blue chip stock, this was an unprecedented and disastrous event in the financial world. Enron's plunge occurred after it was revealed that much of its profits and revenue were the result of deals with special purpose entities (limited partnerships which it controlled). The result was that many of Enron's debts and the losses that it suffered were not reported in its financial statements.

In addition, the scandal caused the dissolution of Arthur Andersen, which at the time was one of the world's top accounting firms.

2- **Worldcom.**

Executives at telecommunications giant WorldCom perpetrated accounting fraud that led to the largest bankruptcy in history. The fraud was revealed to the public in June 2002 and WorldCom filed for bankruptcy in July 2002. Evidence shows that the accounting fraud was discovered as early as June 2001, when several former employees gave statements alleging instances of hiding bad debt, understating costs, and backdating contracts. However, WorldCom's board of directors did not investigate these claims. In June 2001, a shareholder lawsuit was filed against WorldCom, but it was thrown out of court due to lack of evidence.

When the Securities and Exchange Commission (SEC) launched its own investigation in March 2002, it was discovered that the prior claims were valid. As a result, the SEC filed a civil fraud lawsuit against WorldCom and federal charges were filed against several executives.

WorldCom Investigation: The SEC’s investigation into the accounting fraud at WorldCom turned up several key players. The following is a list of high-ranking WorldCom executives and other employees who are implicated in the accounting fraud:

- Bernard Ebbers – former CEO of WorldCom. Ebber is suspected in the accounting fraud but no charges have been filed against him.
- Scott Sullivan – former CFO of WorldCom. Sullivan was indicted on charges of securities fraud, conspiracy, and false statements to the SEC.
- David Myers – former controller of WorldCom. Myers is charged with securities fraud, conspiracy, and false statements to the SEC.
- *Buford Yates Jr.* – former director of general accounting. Yates pled guilty to charges of securities fraud and conspiracy.
- *Betty Vinson* – former director of management reporting. Vinson pled guilty to charges of conspiracy to commit securities fraud.
- *Troy Normand* – director of legal entity accounting. Normand pled guilty to securities fraud and conspiracy charges.

WorldCom is currently settling the civil fraud lawsuit with the SEC.

Chapter II

Corporate governance and accountability

a) What is Accountability?

"Accountability" stems from late Latin *accomptare* (to account), a prefixed form of *compuatre* (to calculate), which in turn derived from *putare* (to reckon).[2] The word is an extension of the terminology used in the money lending systems that first developed in Ancient Greece and later, Rome. One would borrow money from a money lender, be that a local Temple or Merchant, and would then be held responsible to their account with that party. Responsibility is also a close synonym. Perhaps the first written statement of accountability is in the Code of Hammurabi, Hammurabi describes certain undesirable actions and their consequences. One example:

If a man uses violence on another man's wife to sleep with her, the man shall be killed, but the wife shall be blameless." [Corporate governance and accountability by Dan A.Bavly, page 23]

“The notion of accountability is an amorphous concept that is difficult to define in precise terms. However, broadly speaking, *accountability* exists when there is a relationship where an individual or body, and the performance of tasks or functions by that individual or body, are subject to another’s oversight, direction or request that they provide information or justification for their actions.
Therefore, the concept of accountability involves two distinct stages: *answerability* and *enforcement*. Answerability refers to the obligation of the government, its agencies and public officials to provide information about their decisions and actions and to justify them to the public and those institutions of accountability tasked with providing oversight. Enforcement suggests that the public or the institution responsible for accountability can sanction the offending party or remedy the contravening behavior. As such, different institutions of accountability might be

responsible for either or both of these stages”[www.oecd.org].

.b)Importance of Accountability

“Accountability ensures actions and decisions taken by public officials are subject to oversight so as to guarantee that government initiatives meet their stated objectives and respond to the needs of the community they are meant to be benefiting, thereby contributing to better governance and poverty reduction”.[www.oecd.org]

“Accountability is one of the cornerstones of good governance; however, it can be difficult for scholars and practitioners alike to navigate the myriad of different types of accountability. Recently, there has been a growing discussion within both the academic and development communities about the different accountability typologies. This Note outlines the present debate focusing on the definition and substance of different forms of accountability and considers the key role that legislatures play in ensuring accountability.”[www.oecd.org]

"The job of the CEO and the board is tough. It is an intense juggling act that they must perform in the face of many conflicting demands. Little wonder that so many businesses fail. But, as the fates of Ken Lay, John Roth and many of their peers attest, very few captains ‘go down with the ship’.
Accountability is crucial to effective governance. The lines of accountability and responsibility are badly blurred when senior managers comprise a substantial proportion of board membership.
Boards cannot govern ‘independently and objectively and ensure proper accountability’ when ‘effective control’ over corporate direction and board membership is vested in the CEO and other ‘related directors’".[Corporate governance and Accountability by Dan A.Bavly, page 32]

“Evaluating the ongoing effectiveness of public officials or public bodies ensures that they are performing to their full potential, providing value for money in the provision of public services, instilling confidence in the government and being responsive to the community they are meant to be serving”[www.oecd.org]

"Some Essential Steps to Accountability and Credibility

1. Strictly limit use of stock options as a method of executive compensation to 10% of base salaries; make them available to all employees; award them only on the basis of sustained performance rather than short-term share values; offer them only at the then current market value of the stocks; prohibit downward adjustments to the option price; expense them in the year they’re provided.
2. Restore some reasonable balance between executive and employee compensation. Eliminate obscene executive compensation levels where CEOs are compensated at rates hundreds of times higher than the average employee.
3. Eliminate the practice of having ‘inside directors’ on boards. The CEO and senior managers can influence corporate direction sufficiently with ‘voice without vote’ in board decision-making.
4. Establish a Canadian Securities Commission with real teeth to issue sanctions for breach of shareholder and public trust. Vigorously enforce existing civil and criminal sanctions and examine what new legislative or regulatory safeguards and sanctions may be needed.
5. Establish a mechanism under such a newly created CSC to ‘accredit’ the governance practices of corporations against established ‘best practices’ as a condition of obtaining and maintaining public trading rights on Canadian stock market exchanges.
6. Encourage (or require) corporate boards to establish ‘Risk Management’ Committees that audit corporate risks that derive from operations beyond those which may be discovered through the financial statements which are the focus of ‘Audit’ Committees".[Corporate governance and Accountability, by Dan A.Bavly, page 65]

c)Types of accountability

"There are 8 types of accountability, namely: moral, administrative, political, managerial, market, legal/judicial, constituency relation, and professional.

“The concept of accountability can be classified according to the type of accountability exercised and/ or the person, group or institution the public official answers to. The present debate as to the content of different forms of accountability is best conceptualized by reference to opposing forms of accountability. As such the main forms of accountability are described below in reference to their opposing, or alternate, concept”[www.oecd.org].

Horizontal vs. Vertical Accountability

“The prevailing view is that institutions of accountability, such as parliament and the judiciary, provide what is commonly termed horizontal accountability, or the capacity of a network of relatively autonomous powers (i.e., other institutions) that can call into question, and eventually punish, improper ways of discharging the responsibilities of a given official. In other words, horizontal accountability is the capacity of state institutions to check abuses by other public agencies and branches of government, or the requirement for agencies to report sideways.

Alternatively, vertical accountability is the means through which citizens, mass media and civil society seek to enforce standards of good performance on officials.

While parliament is typically considered as a key institution in constructs of horizontal accountability, it is also important in vertical accountability. Citizens and civil society groups can seek the support of elected representatives to redress grievances and intervene in the case of inappropriate or inadequate action by government. In addition, through the use of public hearings, committee investigations and public petitioning, parliament can provide a vehicle for public voice and a means through which citizens and civic groups can question government and seek parliamentary sanctioning where appropriate”.[www.oecd.org]

Another School of Thought: Horizontal versus Vertical Accountability

“A minority of commentators diverge in their opinion as to what constitutes horizontal and vertical accountability. An alternate conception of horizontal and vertical accountability relies on the relationship between parties to determine whether one party exercises horizontal or vertical accountability over the other. In instances where there is a classic top-down, principal agent relationship, whereby the principal delegates to the agent, the agent is accountable to their direct superiors in the chain-of-command and this constitutes a form of vertical accountability. For instance the public official answers to the department/ agency minister, the department answers to the minister, the minister answers to parliament (in particular in parliamentary systems), and parliament answers to citizens.

Parliament is again a key actor. In terms of holding government officials to account, parliament is the principal and the official the agent. Parliament, as principal, requires the government and its officials, as agents, to implement the laws, policies and programs it has approved – and holds the government and officials to account for their performance in this regard. Parliament is also an agent, in that the electorate (the principal) elects legislators to enact laws and oversee government actions on their behalf. The electorate then hold legislators to account at election time and, in a few jurisdictions, through recall, where dissatisfied voters can recall their elected representative and vote for an alternative.

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The absence of the direct principal-agent relationship relegates the accountability relationship to one of horizontal accountability or social accountability. In order for there to be social or horizontal accountability a hierarchical relationship is generally lacking between actor and forum, as are any formal obligations to render account”.[www.oec.org]

-Political Accountability

The case in which the Congress, or the legislature, holds other civil servant accountable is part of political accountability. Mechanisms of political accountability are vested in constitution, either written or unwritten, or statute and implemented in three dimensions: election, legislature and ministerial.

Election is the most direct way for accountability, and is a way for enforcement. An election gives a chance for the proposed cabinet and proposed legislators to run for campaigns and attend forums so as to explain and inform their purposes and goals if they are elected. On the other hand, it is also a sanction for those who misbehaved or failed to act as a representative for one’s field in the past tenure – by giving the vote to someone else.

Constitution or equivalents also empowers legislature to hold civil servants accountable. Firstly, legislature may invite public servants for inquiry sessions to explain explicitly planning or policies made, or to unfold any misappropriates. Further, legislature can organize an investigation committee for particular issue by inviting outsiders as committees. Abovementioned are mechanisms aiming to compel civil servants in to dialogue and hence, gives answerability. It can introduce motions for impeachment and no-confidence in case for misbehavior or misconduct.

Ministers, as conceived as the top of the hierarchy of the ministry, are supposed to hold accountable for every affairs in the ministry; as all civil servant within are merely cogs and wigs and operate in the light of the ministers' vision. However, ministerial accountability is vague in parliamentary system. The parliamentary have to constitute the cabinet to executive the government, yet, holding the executives accountable as abovementioned.

-Administrative Accountability

Internal rules and norms as well as some independent commission are mechanisms to hold civil servant within the administration of government accountable. Within department or ministry, firstly, behavior is bounded by rules and regulations; secondly, civil servants are subordinates in a hierarchy and accountable to superiors. Nonetheless, there are independent "watchdog" units to scrutinize and hold departments accountable; legitimacy of these commissions is built upon their independence, as it avoids any conflicts of interest. Apart from internal checks, some "watchdog" units accept complaints from citizens, bridging government and society to hold civil servants accountable to citizens, but not merely governmental departments.

-Judicial/legal accountability

Court action and judicial review are two mechanisms by which the public may address violations of law and constitution. Moreover, court actions also fill the gap between accountability between executive and legislature; if the executive fail or reluctant to exercise legitimate decision made by legislature, or vice versa, one can appeal through the court and the tribunal base on constitution or equivalents.

-Professional accountability

Professional public servants, namely lawyers, doctors, engineers, and accountants, are also bound by professional codes and norms established in the light of public interest. Professionals are obliged to join correspondent professional societies and take oaths to be licensed.

-Market Accountability

Under voices for decentralization and privatization of the government, services provided are nowadays more “customer-driven” and should aim to provide convenience and various choices to citizens; with this perspective, there are comparisons and competition between public and private services and this, ideally, improves quality of service. As mentioned by Bruce Stone, the standard of assessment for accountability is therefore “responsiveness of service providers to a body of ‘sovereign’ customers and produce quality service. Outsourcing service is one means to adopt market accountability. Government can choose among a shortlist of companies for outsourced service; within the contracting period, government can hold the company by rewriting contracts or by choosing another company.

-Constituency Relations

With this perspective, whether a particular agency or the government is being accountable depends on whether voices from agencies, groups or institutions, which is outside the public sector and representing citizens’ interests in a particular constituency or field, are heard. Moreover, the government is obliged to empower members of agencies with political rights to run for elections and be elected; or, appoint them into the public sector as a way to hold the government representative and ensure voices from all constituencies are included in policy-making process."[www.wiley.com]

Diagonal Accountability

"The concept of diagonal accountability is far from settled with two groups of commentators adopting different definitions.
The literature does not support a convergence of their ideas. Although, there is conjecture as to what constitutes diagonal accountability, the prevailing view is that diagonal accountability entails vertical accountability actors. Generally speaking diagonal accountability seeks to engage citizens directly in the workings of horizontal accountability institutions. This is an effort to augment the limited effectiveness of civil society's watch dog function by breaking the state's monopoly over responsibility for official executive oversight.
The main principles of diagonal accountability are:

- ***Participate in Horizontal Accountability***

Mechanisms – Community advocates participate in institutions of horizontal accountability, rather than creating distinct and separate institutions of diagonal accountability. In this way, agents of vertical accountability seek to insert themselves more directly into the horizontal axis.

- ***Information flow* – Community**

advocates are given an opportunity to access information about government agencies that would normally be limited to the horizontal axis, for instance internal performance reviews etc.
Furthermore, they have access to the deliberations and reasons why horizontal accountability institutions make the decisions they do. Meanwhile, community advocates bring first hand experience about the performance of the government agency to the accountability process.

- ***Compel Officials to Answer* –**

Community advocates co-opt the horizontal accountability institution's authority to compel a government agency to answer questions (as in the example given above of an MP questioning a Minister about issues of concern to his/her constituents); and

- ***Capacity to Sanction* – Community** advocates acquire the authority of the horizontal accountability institution to enforce the findings or influence elected officials.

Some argue that civil society can strengthen the effectiveness of horizontal accountability institutions by pressuring existing agencies to do their jobs more effectively. This type of participation in accountability is not direct action against wrongdoing, as with vertical accountability, but rather society driven horizontal accountability, such as citizen advisory boards that fulfill public functions, like auditing government expenditures or supervising procurement.

More generally, active citizens and civil society groups can work with elected representatives to enhance parliaments' representation role.

A minority of commentators diverge in their opinion as to what constitutes diagonal accountability. Some commentators suggest administrative accountability, exercised primarily through quasi-legal forums, such as ombudsmen, auditors, and independent inspectors reporting directly or indirectly to parliament or the responsible minister, is a form of independent and external administrative and financial oversight and control. This form of accountability is different to the classic top-down/ principal agent relationship because the administrative accountability institution is not in a hierarchical relationship to the public officials and often do not have formal powers to coerce public officials into compliance. It is argued that these administrative agents are auxiliary forums of accountability that were instituted to help the political principals control the great variety of administrative agents and that their accountability relations are, therefore, a form of diagonal accountability".[www.oecd.org].

Social Accountability versus Diagonal Accountability

"Recently the World Bank argued that social accountability is broad enough to encompass mechanisms of diagonal accountability. It was argued that diagonal accountability mechanisms can also be considered a form of social accountability. Considering social accountability is not meant to refer to a specific type of accountability, but rather to a particular approach for exacting accountability, it might be a broader concept than diagonal accountability. This lends weight to the idea that diagonal accountability mechanisms could be a component of the broader approach of social accountability.

However, this is contrast to some commentators who draw a sharp distinction between social accountability and diagonal accountability. They argue that the state is often resistant to citizens poaching its exclusive oversight domain, instead encouraging new forms of social accountability, which they dismiss as being merely a form of outreach that provides an opportunity for civil society to inform government about public perception of government behavior."[www.oecd.org]

Conclusion

"Parliaments are key actors in what has been termed the 'chain of accountability'. They are, along with the judiciary, the key institution of horizontal accountability, not only in their own right but also as the institution to which many autonomous accountability institutions report. They are the vehicle through which political accountability is exercised. Along with civil society organizations and the mass media, they are also important institutions in vertical accountability.
Newer concepts of accountability have emerged: social accountability and diagonal accountability. The former, defined as 'society driven horizontal accountability' seeks to provide direct answerability from government to citizens; parliaments and elected representatives are important vehicles through which citizens and civic groups can also extract enforcement. And – no matter how defined – parliaments are one of the institutions through which diagonal accountability can be exercised

d) Social Implications

"In politics, and particularly in representative democracies, accountability is an important factor in securing legitimacy of public power. Accountability differs from transparency in that it only enables negative feedback *after* a decision or action, while transparency also enables negative feedback *before* or *during* a decision or action. Accountability constrains the extent to which elected representatives and other office-holders can willfully deviate from their theoretical responsibilities, thus reducing corruption. The relationship of the concept of accountability to related concepts like the rule of law or democracy, however, still awaits further elucidation".
[www.wiley.com]

e) Contemporary Evolution

"Accountability involves either the expectation or assumption of account-giving behavior. The study of account giving as a sociological act was recently articulated in a 1968 article on "Accounts" by Marvin Scott and Stanford Lyman and Stephen Soroka although it can be traced as well to J.L. Austin's 1956 essay "A Plea for Excuses," in which he used excuse-making as an example of speech acts.

Communications scholars have extended this work through the examination of strategic uses of excuses, justifications, rationalizations, apologies and other forms of account giving behavior by individuals and corporations, and Philip Tetlock and his colleagues have applied experimental design techniques to explore how individuals behave under various scenarios and situations that demand accountability.

In Britain, accountability has been formally identified by Government since 1995 as one of the *Seven Principles of Public Life*: "Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office." The goal of accountability is at times in tension with the goal of leadership. A constituency may have short-term desires which are at odds with long-term interests. It has also been argued that accountability provides in certain situations an escape route for ministers to avoid the consequences of ministerial responsibility, which would require resignation.

Recently, accountability has become an important topos in the discussion about the legitimacy of international institutions. Because there is no global democracy to which organizations must account, global administrative bodies are often criticized as having large accountability gaps. One paradigmatic problem arising in the global context is that of institutions such as the World Bank and the IMF who are founded and supported by wealthy nations and provide aid, in the form of grants and loans, to developing nations. Should those institutions be accountable to their founders and investors or to the persons and nations they help? In the debate over global justice and its distributional consequences, Cosmopolitans tend to advocate greater accountability to the disregarded interests of traditionally marginalized populations and developing nations. On the other hand, those in the Nationalism and Society of States traditions deny the tenets of moral universalism and argue that beneficiaries of global development initiatives have no substantive entitlement to call international institutions to account.

Accountability is becoming an increasingly important issue for the non-profit world. Several NGOs signed the "accountability charter" in 2005. In the Humanitarian field, initiatives such as the HAPI (Humanitarian Accountability Partnership International) appeared. Individual NGOs have set their own accountability systems (for example, the ALPS, Accountability, Learning and Planning System of Action Aid)" [www.wiley.com]

f) Board Responsibilities:

"1-Financial Reporting

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

- The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.

- The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

2-Internal Control

The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

The Turnbull guidance suggests means of applying this part of the Code.

3- Audit Committee and Auditors

The board should establish an audit committee of at least three, or in the case of smaller companies 18 two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

_ to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company’s financial performance, reviewing significant financial reporting judgments contained in them;

_ to review the company’s internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company’s internal control and risk management systems;

_ to monitor and review the effectiveness of the company’s internal audit function;

_ to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

_ to review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;

_ to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the

provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.
The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.
The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

The audit committee should have primary responsibility for making are commendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

The annual report should explain to shareholders how, if the auditor provides non audit services, auditor objectivity and independence is safeguarded."
[www.oecdobserver.org]

Chapter III

Corporate governance Transparency and Disclosures

a) What is Disclosure?

"1-In Computer security, full disclosure means disclosing full information about vulnerabilities.

2-Journalism, full disclosure refers to disclosing the interests of the writer which may bear on the subject being written about, for example, if the writer has worked with an interview subject in the past.

3-In law:

The law of England and Wales, disclosure refers to a process that may form part of legal proceedings, whereby parties inform ("disclose") to other parties the existence of any relevant documents that are, or have been, in their control. This compares with the process known as discovery in the course of legal proceedings in the United States.

In U.S. civil procedure (litigation rules for civil cases), disclosure is a stage prior to trial. In civil cases, each party must disclose to the opposing party the following: names of witnesses which it may use to support its side, copies of documents (or mere description of these documents) in its control which it may use to support its side, computation of damages claimed, and certain insurance information. Disclosure is related to, but technically prior to, the discovery stage.

In Company law (known as "corporate law" in the United States), disclosure refers to giving out information about public or limited companies or their officers, which might be kept secret if the company was a private company or a partnership.

In real property transactions, disclosure refers to providing to a buyer information known to the seller or broker/agent concerning the condition or other aspects of real property that would affect the property's value or desirability. These rules regarding what information must be disclosed, and whether the information must be disclosed even if a buyer does not ask, vary from one jurisdiction to the next.

To individuals with disabilities, disclosure refers to informing others as to one's disability. This is typically done in a school or work environment and is needed to request accommodations." [www.europa.eu.int]

b)Transparency and its importance:

"A natural next step is the development of a more comprehensive framework for conceptualizing and measuring the key aspects of the domestic information environment.

A fundamental feature of the information environment is corporate transparency, defined as the widespread availability of relevant, reliable information about the periodic performance, financial position, investment opportunities, governance, value, and risk of publicly traded firms (Bushman, Piotroski, and Smith 2001). As a measure of corporate transparency, the CIFAR index used in prior studies has at least three major shortcomings. First, it captures only one dimension of the quality of corporate reporting-disclosure intensity. Second, the CIFAR index does not capture cross country differences in the extent, speed, or accuracy with which information reported by firms is disseminated throughout the economy. Third, the CIFAR index does not incorporate cross country differences in private information acquisition and communication activities.

BPS develop a framework for conceptualizing and measuring corporate transparency at the country level. In their framework, corporate transparency has three main elements:

1) corporate reporting (voluntary and mandatory),

2) information dissemination via the media and Internet channels, and

3) private information acquisition and communication by financial analysts, institutional investors, and corporate insiders.

We describe the framework here to stimulate further thought on the measurement of corporate transparency and of domestic information environments more generally. We also use their framework to illustrate some directions for future research into the economics of information.

The first element in the BPS framework is the quality of corporate reporting. They consider not only corporate disclosure intensity as measured by the CIFAR index, but also the prevalence of specific types of accounting and governance disclosures, the timeliness of disclosures, and the credibility of disclosures as measured by the share of Big-6 accounting firms in total value audited. All measures of corporate reporting used in BPS are collected from Center for International Financial Analysis and Research (1995), and appear in the table

Variables Used to Measure Corporate

Transparency and Data Sources a

Corporate reporting b

-Financial accounting disclosures

-Long-term investments: Research and development,

-capital expenditures

-Segment disclosures: Product segments, geographic segments

-Subsidiary disclosures

-Footnote disclosures

-Governance disclosures

-Identity of major shareholders

-Range of shareholdings

-Identity of managers

-Identity of board members and affiliations

-Remuneration of officers and directors

-Shares owned by directors and employees

-Timeliness of disclosures

-Frequency of reporting

-Number of specific accounting items disclosed in interim reports

-Consolidation in interim reporting

-Reporting of subsequent events

-Accounting policies

-Consolidation of subsidiaries

-Use of general reserves

-Credibility of disclosures

-Share of Big-6 accounting firms in total value audited

Other

-Financial statements available in English

-Degree of disclosure of important accounting policies

-Information dissemination

-Penetration of media c

-Number of newspapers per 1,000 people

-Number of televisions per 1,000 people

-Media ownership d

-Percentage state-owned newspapers of top five daily newspapers in 1999Market share of state-owned newspapers of aggregate market share of top five daily newspapers in 1999

-Private information acquisition and communication

-Direct reporting of detailed private information

-Number of analysts following firms e

-Indirect communication of aggregate value-relevant information via trades

-Prevalence of institutional investors f

-Total assets of pooled investment schemes to GDP

-Insider trading laws and enforcement g

The second element is private information acquisition and communication by financial analysts, institutional investors, and corporate insiders. BPS measure private information acquisition of financial analysts by the average number of financial analysts following large companies, as reported in Chang, Khanna, and Palepu (2000). They measure private information acquisition by institutional investors by the assets of pooled investment schemes relative to GDP. Finally, they measure insider trading by the degree of enforcement of restrictions on insider trading, as reported in Bhattacharya and Daouk (2001).

The third element in the BPS framework is the quality of information dissemination throughout the economy. They consider two aspects of the information dissemination infrastructure in a given economy that are expected to affect the speed, accuracy, and reach of the dissemination of information reported by firms. The first aspect is the penetration of media, as measured by the number of newspapers and televisions per capita obtained from World Development Indicators (2000). The second aspect is the prevalence of state versus private ownership of newspapers, as reported in Djankov, McLiesh, Nenova, and Shleifer (2001).

This extended representation of corporate transparency allows a variety of research questions to be addressed. We discuss three sets of questions for future research:

1) the relation among measures of the quality of corporate reporting, information dissemination, and private information acquisition and communication in an economy;

2) the economic consequences of the quality of corporate reporting, information dissemination, and private information acquisition, including interactions among these three elements of corporate transparency and interactions with legal and other domestic institutions; and

3) political, economic, or other reasons for cross-country or intertemporal differences incorporate transparency."

[aSource: Bushman, Piotroski, and Smith (2001).

bSource: Center for International Financial Analysis and Research (1995).

cSource: World Development Indicators (2000).

dSource: Djankov, McLiesh, Nenova, and Shleifer (2001).

eSource: Chang, Khanna, and Palepu (2000).

fSource: Beck, Demirguc-Kunt, and Levine (1999).

gSource: Bhattacharya and Daouk (2001).]

"The relation among measures of the quality of corporate reporting, information dissemination, and private information acquisition and communication.

An intriguing direction for future research is the relation of measures within and across the three elements of corporate transparency: the quality of corporate reporting, information dissemination, and private information acquisition and communication. For example, is higher quality corporate reporting associated with higher quality channels for dissemination of the information reported by firms? Do lax restrictions on insider trading encourage or stifle corporate reporting? Is higher audit rigor associated with greater disclosure intensity? Do lax restrictions on insider trading suppress private information acquisition and communication by financial analysts or institutional investors?

Economic consequences of the quality of corporate reporting, information dissemination, and private information acquisition and communication.

A second interesting direction for future research is the economic consequences of the quality of corporate reporting, information dissemination, and private information acquisition and communication. A variety of economic effects are of interest, such as the cost of debt and equity capital, the stability of the financial sector, the size of the capital markets, the liquidity, informational efficiency, and functional efficiency of the stock market,17 the intensity of investments in high-risk technologies, the growth in the number of firms, the speed and intensity with which financial and human capital are invested in value-creating opportunities and withdrawn from value-destroying ones, and GDP growth.18In the investigation of the economic effects of corporate reporting, future research can go beyond disclosure intensity to consider the economic effects of specific types of accounting or governance disclosures, as well as the timeliness, measurement, credibility, or language of corporate disclosures. Research can also consider whether these dimensions of the quality of corporate reporting have complementary economic effects, such as complementarities between disclosure intensity on the one hand, and timeliness, credibility, or measurement of disclosures on the other hand.

In the investigation of the economic effects of information dissemination, future research can explore the effects of the per-capita penetration of the media, the state versus private ownership of the media, and interactions between the penetration and ownership of the media. We also think it is interesting to explore whether corporate reporting and information dissemination have complementary economic effects, whereby the economic effects of quality corporate reporting are enhanced by a quality information dissemination infrastructure, and vice versa.

In the investigation of the economic effects of private information acquisition and dissemination, future research can consider the independent effects of the private information activities of financial analysts, institutional investors, and corporate insiders. We also think there are potentially interesting interactions to explore between private information acquisition on the one hand, and corporate reporting and information dissemination on the other hand. For example, evidence in Bhattacharya and Daouk (2001) suggests that relatively weak enforcement of restrictions on insider trading is associated with a relatively high cost of equity capital. Is this effect mitigated by high-quality corporate reporting and information dissemination, as expected if high-quality corporate reporting and information dissemination reduce information asymmetries between corporate insiders and other investors?

Although the suggestions above concern the interactions among the components of corporate transparency, we also think it is promising to consider potential interactions between measures of corporate transparency and other domestic institutions. For example, since LaPorta, Lopez-De-Silanes, Shleifer, and Vishny (1997), researchers have documented a variety of economic effects of the domestic legal regime, such as laws protecting investors' rights and enforcement of laws.

A recent example of studies in this vein is Lombardo (2000), who documents evidence that the cost of equity capital is negatively associated with the enforceability of contracts and the impartiality and observance of the law, while it is positively associated with corruption and risk of expropriation.

Another natural direction for future research is to understand *how*—that is, through which specific channels—corporate transparency achieves its first-order economic effects. For example, to what extent do high-quality corporate reporting and information dissemination lead to better corporate governance, producing gains through the governance channel depicted in the exhibit? Bushman and Smith (2001) discuss empirical designs that can be used to isolate the economic effects of financial accounting information operating through the governance channel.

Similar designs can be used to isolate the economic effects of additional elements of corporate transparency through the governance channel.

Political, economic, or other reasons for cross-country and
Inter temporal differences in corporate transparency.

The research proposed above is motivated at a fundamental level by an interest in the question of what combination or combinations of domestic institutions are most conducive to economic growth and efficiency. We think that the more comprehensive measurement of corporate transparency illustrated by the BPS framework will generate new insights into how and why the availability of relevant, reliable information about firms from a variety of sources affects economies, and how these economic effects vary with other factors.

We think that another important direction for future research is to explore why elements of corporate transparency vary across countries and over time. We expect that evidence concerning the efficiency effects of corporate transparency and how they vary with the financial architecture, industrial development, corporate governance structures, globalization, or other factors will guide the development of hypotheses concerning inter country and inter temporal differences in the demand for corporate transparency. We also think that recent theories predicting the political conditions under which financial development will be suppressed to promote agendas other than economic efficiency and new databases measuring these political forces will provide valuable input into this line of inquiry. Of particular interest is the role of regulation in promoting corporate transparency. Although there has been much debate on disclosure regulation, there is no universal agreement on what disclosure regulation should be or whether regulation is even necessary, thus leaving many open questions. A large literature on corporate governance assumes that financial market regulation is unnecessary. This conclusion relies on the idea that sophisticated parties can write enforceable contracts tied to their specific circumstances and that entrepreneurs have adequate incentives to minimize agency costs through bonding, commitment to audited disclosure, and other limits on discretion.20 Implied in this position is the existence of effective judicial enforcement of complex contractual arrangements and an absence of externalities.

However, advocates of market regulation point to a variety of potential failures, such as the ability of insiders to expropriate both potential and existing investors through misrepresentation or asset diversion, or a lack of incentives by courts to enforce laws and contracts effectively. Some scholars argue for the enforcement of securities laws by regulators as opposed to judges. For example, Glaeser, Johnson, and Shleifer (2000) argue that regulators may be required to provide adequate resources and high-powered incentives for optimal enforcement of laws, and support this argument by comparing the regulation of securities markets (including disclosure Requirements) through corporate and securities laws in Poland and the Czech Republic. Romano (2001) argues for the introduction of regulatory competition in which firms choose the regulatory regime to which they will be subject from available jurisdictions around the world. Admati and Pfleiderer (2000) develop a model that demonstrates that even in the presence of externalities to public disclosure (disclosure by one firm provides information about other firms), mandatory disclosure requirements often are unable to achieve welfare maximizing outcomes.

A variety of interesting empirical issues emerge concerning the effects of accounting and disclosure regulation. For example, to what extent does governmental adoption of superior accounting *rules* actually lead to superior corporate accounting *practices*, and what other institutional factors must be present for such an effect?21 To what extent do disclosure requirements lead to higher quality voluntary disclosures, as discussed in Ball (2001)?

The BPS measurement scheme is of limited use for empirical investigations into the regulation of corporate reporting because it reflects corporate reporting practices resulting from both voluntary and mandatory reporting behavior. Hence, an important step for future research is to develop a multinational database of domestic corporate reporting regulatory environments to facilitate future research into the causes and effects of accounting and disclosure rule sand regulations.

Other aspects of the information environment.

Our focus above, corporate transparency, is but one aspect of the domestic information environment. Although we believe that corporate transparency is a fundamental feature of the information environment in an economy, we think that it is useful to extend the research proposed above to consider other types of transparency. Vishwanath and Kaufmann (1999) describe a more comprehensive framework for transparency that includes transparency in both the public and private sectors.22 We think that such research has much potential for contributing to a more complete understanding of the economics of information."[www.ecgi.org]

c)Continuous Disclosure Policy:

"Scope

1.The purpose of this policy is:

a) To ensure there are procedures in place so that share markets in which the company's shares are traded are properly informed of matters which may have a material impact on the price at which the shares are traded.

b) To ensure compliance with the Australian Stock Exchange listing rules and specifically Rule 3.1.

Performance Criteria

2. The Chief Executive Officer and the Chief Financial Officer/Company Secretary shall have the joint responsibility of determining:

2.1 whether a matter would have a material effect on the price of Agenix shares and, therefore, should be considered disclosable

2.2 in the case of a matter being assessed as likely to have a material effect whether the matter qualified for exemption from disclosure by addressing:

2.2.1 whether the information falls within a category listed in paragraph (iii) of Listing Rule 3A(1)
2.2.2 whether the information is confidential, and then
2.2.3 whether a reasonable person would not expect it to be disclosed.

3. If the matter is not likely to have a material effect on the price of Agenix shares, the CEO or CFO/Company Secretary (in consultation with the Chairman of the board and the company's public relations consultants) will assess whether a disclosure will, in any case, be made to keep the share market further informed.

4. If it is agreed that disclosure is required, the CEO or CFO/Company Secretary shall draft an announcement to market and circulate the draft to the Chairman of the board, public relations consultants, and all senior employees and/or consultants necessary to achieve accuracy of the information being released. Once the draft is approved, the CFO/Company secretary or his nominee in his absence shall make the disclosure to the stock exchanges as appropriate.

5. To ensure the share market is properly informed, it is required that senior managers in the company and directors keep the Chief Executive Officer and the Chief Financial Officer/Company Secretary informed of matters of a nature which they consider material and which they consider may require disclosure. The attached ASX

rules, and specifically the examples included therein, give assistance as to the nature of such matters.

6. The CFO/Company Secretary shall keep a record of all announcements to the market and of all matters which in his experience require consideration of notification to the market. Where there is uncertainty, the CFO/Company Secretary shall keep a record of the issue on the Continuous Disclosure Assessment Form attached and where he/she deems it necessary, discuss the matter with the relevant stock exchange for clarification.

Notes

7. The company is obliged to make disclosure of information of which it becomes aware.

8. The company is deemed to have become aware of information where a director or executive officer has, or ought reasonably to have, come into possession of the information in the course of performance of duties as a director or executive.

9. Corporations Law section 674 imposes penalties on listed companies for 'intentionally' failing to notify the securities exchange of information that is not generally available and that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of the shares. This means that the information would or would be likely to influence persons who commonly invest in securities in deciding whether or not to invest the securities." [www.dti.gov.uk]

APPENDIX

ASX LISTING RULE 3.1

- Immediate notice of material information

General Rule

3.1 Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect (see note below) o the price or value of the entity's securities, the entity must immediately tell ASX that information. This rule does not apply to particular information which each of the following applies.

3.1.1 A reasonable person would not expect the information to be disclosed.

3.1.2 The information is confidential.

3.1.3 One or more of the following applies:

a) It would be a breach of law to disclose the information.
b) The information concerns an incomplete proposal or negotiation.
c) The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
d) The information is generated for the internal management purposes of the entity.

e) The information is a trade secret.

Examples

The following information would require disclosure if material under this rule:

- a change in the entity's financial forecast or expectation
- the appointment of a receiver, manager liquidator or administrator in respect of any loan, trade credit, trade debt, borrowing or securities held by it or any of is child entities
- a transaction for which the consideration payable or receivable is a significant proportion of the written down value of the entity's consolidated asserts. Normally, an amount of 5% or more would be significant, but a smaller amount may be significant in a particular case
- a change in the control of the responsible entity of a trust
- a proposed change I the general character or nature of a trust
- a recommendation or declaration of a dividend or distribution
- a recommendation or decision that a dividend or distribution will not be declared
- under subscriptions or over subscriptions to an issue

- a copy of a document containing market sensitive information that the entity lodges with an overseas stock exchange or other regulator which is available to the public. The copy given to ASX must be in English
- information about the beneficial ownership of securities obtained under Part 6C.2 of the Corporations Act
- giving or receiving a notice of intention to make a takeover
- an agreement between the entity (or a related party or subsidiary) and a director (or a related party of the director).

d)Types of Disclosure:

I. FINANCIAL DISCLOSURES

***Enterprises should disclose their financial and operating results*.**

"One of the major responsibilities of the board of directors is to ensure that shareholders and other stakeholders are provided with high-quality disclosures on the financial and operating results of the entity that the board of directors have been entrusted with governing. Almost all corporate governance codes around the world, including the OECD and the ICGN Principles, the CACG Guidelines, the Cadbury Report, and the King II, specifically require the board of directors to provide shareholders and other stakeholders with information on the financial and operating results of a company to enable them to properly understand the nature of its business, its current state of affairs and how it is being developed for the future.

The quality of financial disclosure depends significantly on the robustness of the financial reporting standards on the basis of which the financial information is prepared and reported. In most circumstances, the financial reporting standards required for corporate reporting are contained in the generally accepted accounting principles recognized in the country where the entity is domiciled. Over the last few decades, there has been increasing convergence towards a set of non-jurisdiction specific, widely recognized financial reporting-standards. The International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board provide a widely recognized benchmark in this respect.

Furthermore, the board of directors could enrich the usefulness of the disclosures on the financial and operating results of a company by providing further explanation, for example in the Management's Discussion and Analysis section of the annual report, on critical accounting estimates1 of the company in addition to the disclosure required by the applicable financial reporting standards.
The board could clearly identify inherent risks and estimates used in the preparation and reporting of the financial and operational results of the company in order to give investors a better understanding of the risks they are taking in relying on the judgment of management. For example, in some cases, financial reporting measurement requirements call for the valuation of certain assets on a fair value basis.
However, while for certain assets deep markets might exist and fair value could be obtained with reasonable objectivity, that might not be the case for others. Situations of the latter kind may invite management to exercise great latitude and influence the direction of earnings in its favor by resorting to less objective estimates based on modeling hypothetical markets.
In addition to the disclosure required by the applicable financial reporting standards, the board of directors may provide further comfort to shareholders and other stakeholders by disclosing that the board or its audit committee has reviewed fair value computations, if any, and that the computations were conducted in an objective manner.

The board's responsibilities regarding financial communications should be disclosed.

A description of the board's duties in overseeing the process of producing the financial statements should be provided. This is useful for supporting the notion that the board is responsible for creating an overall context of transparency. It is generally accepted that the board has responsibility for reporting on the financial and operating results of the corporation. Almost all corporate governance codes describe the basic responsibility of the board for reviewing financial statements, approving them, and then submitting them to shareholders. When the duties of the board in this area are clearly disclosed, shareholders and other stakeholders could find it useful in providing an additional level of comfort

regarding the fact that the financial statements accurately represent the situation of the company. The quality of financial disclosure could be undermined when consolidation requirements on financial reporting are not followed appropriately. In this respect, the board of directors could provide additional comfort to users of its financial reports.
For example, the board of directors could state that it had ascertained that all subsidiaries and affiliated entities, including special-purpose ones, which are subject to consolidation as per the financial reporting standards applicable to the entity, have been properly consolidated and presented.

Enterprises should fully disclose significant transactions with related parties.

Many shareholders and stakeholders would be interested in information that would help them determine that management is running the enterprise with the best interest of all shareholders and stakeholders in mind and not to unduly benefit any related parties (see also section II.E.6 below on conflict of interest). Most national financial reporting standards, and IFRS, require extensive disclosure on this matter.
However, in circumstances where the financial reporting requirements are less stringent, as a minimum, the board of directors should provide the following disclosures that are generally considered best-practice: significant related-party transactions and any related-party relationships where control exists; disclosure of the nature, type and elements of the related-party transactions; and related-party relationships where control exists (irrespective of whether there have been transactions with parties under common control). The decision making process for approving related-party transactions should also be disclosed. Members of the board and managers should disclose any material interests in transactions or other matters affecting the company.

II. NON-FINANCIAL DISCLOSURES

A. Company Objectives

***The objectives of the enterprise should be disclosed*.**

“There are two general categories of company objectives: the first is commercial objectives, such as increasing productivity or identifying a sector focus; the second is much more fundamental and relates to governance objectives: it seeks to answer the basic question, "why does the company exist?" This section refers to these governance objectives. The objectives of enterprises may vary according to the values of society. In many countries, but by no means all, the primary corporate objective is to maximize the long-term return to shareholders (shareholder value). This objective appears in many codes throughout the world. However, despite an increasing awareness throughout the world that shareholder requirements must be met in order to attract and retain long-term, low-cost capital, the emphasis on shareholder value maximization has not precluded a growing emphasis on other corporate objectives. Many codes now include social, environmental and economic objectives as part of the fundamental objectives of an enterprise. In particular, the codes emphasize the need for enterprises to address the interests of a range of stakeholders in order to promote the long-term sustainability of the enterprise. If an enterprise knowingly damages the interests of its stakeholders, it can risk negatively affecting its own ability to produce long term shareholder value. This suggests that rather than viewing shareholder value and stakeholder value as mutually exclusive objectives, there are indications that the opposite is true, and that the two objectives are probably interdependent in the long run. This emphasis on a broader set of objectives can be found in the Revised OECD Guidelines on Multinational Enterprises, the 2004 edition of the OECD Principles of Corporate Governance, proposed revisions of the UK Companies Act, and the King II Report”[www.oecd.org]

B. Ownership and Shareholder Rights

"The beneficiary ownership structure should be fully disclosed to all interested parties. Changes in the shareholdings of substantial investors should be disclosed to the market as soon as a company becomes aware of them.

The beneficiary ownership structure of an enterprise is of great importance in an investment decision, especially with regard to the equitable treatment of shareholders. In order to make an informed decision about the company, investors need access to information regarding its ownership structure.

It is recommended that this disclosure includes the concentration of shareholdings, for example the holdings of the top twenty largest shareholders. This information is of particular interest to minority shareholders. In some countries (e.g. Germany) disclosure is required when certain thresholds of ownership are passed.

Disclosure should be made of the control structure and of how shareholders or other members of the organization can exercise their control rights through voting or other means. Any arrangement under which some shareholders may have a degree of control disproportionate to their equity ownership, whether through differential voting rights, appointment of directors or other mechanisms, should be disclosed. Any specific structures or procedures which are in place to protect the interests of minority shareholders should be disclosed.

In certain cases, control is exercised indirectly via the ownership of one or several entities that in turn (collectively) control a corporation (i.e. a pyramid structure). In such cases, the disclosure of ultimate control is considered best practice.

As noted in the OECD Principles, information about record ownership may need to be complemented with information about beneficial ownership, in order to identify potential conflicts of interest, related-party transactions and insider trading. In disclosing beneficial (or ultimate) ownership, information should also be provided about shareholder agreements, voting caps and cross-shareholdings, as well as the rights of different classes of shares that the company may have issued.

A company might have a single shareholder or group of shareholders with majority control of the company, either through holding the majority of the company's outstanding equity or through holding shares with superior voting rights. In this situation, without safeguards for minority shareholders, the latter group may be adversely affected. This issue is emphasized by a number of codes, including the OECD Principles.

A number of international statements advocate a “one share one vote” approach. Although the OECD Principles do not advocate any particular view on the "one share one vote" approach, the Principles include examples of other international statements that do advocate a "one share one vote" approach. The International Corporate Governance Network, among others, is a strong supporter of this approach. Advocates of the "one share one vote" approach view any deviation from this approach as an undesirable distortion of the connection between investment risk and the decision-making process. However, actual practice might be different. For example, in the European Union, many member States do allow shares with multiple or no voting rights. While this practice remains controversial, it may be tolerated by investors as long as differentials in voting rights are disclosed. The European Association of Securities Dealers does not support such differentials but allows flexibility, noting that if they cannot be avoided they should at least be indicated by a different share class (EASD Principles, Recommendation II.2).

C. Changes in Control and Transactions Involving Significant Assets

Rules and procedures governing the acquisition of corporate control in the capital markets and extraordinary transactions such as mergers and sales of substantial portions of corporate assets should be disclosed.

Best practice suggests a substantial amount of pre control transaction disclosure, including the disclosure of the intention to acquire control, and to take the company private, and of associated squeeze-out/sell-out rights relevant for minority shareholders. Other typical disclosures include the identity of the bidder, past contacts, transactions and agreements between the merging entities (or acquirer and target, as the case may be), and a discussion of the consequences of the control transaction for the shareholders of the companies involved, as well as disclosure of the financial situation of the bidder and its source of funds for the control transaction.

This disclosure should include any anti-takeover measures established by the enterprise. It should also cover the compensation policy for senior executives leaving the firm as a result of a merger or acquisition.
Best practice disclosure for sales of substantial portions of corporate assets include a notice to all shareholders (usually at the annual general meeting), accompanied by an independent evaluation report. In the Republic of Korea, for example, the Corporations Code requires a special resolution for a transaction that may result in the sale of a substantial part of the enterprise. For such transactions involving listed companies, additional disclosure and substantive requirements are imposed. In South Africa, the Companies Act requires approval of the shareholder meeting for sales of the whole or the greater part of the company's assets, and for listed companies such approval is required for any transaction over 30% of assets. In most governance systems, it is generally considered good practice to submit questions of extraordinary transactions (including mergers, acquisitions and takeovers) to a general meeting for shareholder approval.

In the interest of protecting minority shareholders, the principle of "equality of disclosure" should be practised, such that all shareholders receive information equally.
Any information disclosed to one shareholder should also be equally available to all shareholders (FEE, 2003a). This reflects the view that all shareholders should have a right to be equally informed, and complements the issue of simultaneous disclosure of information discussed in section IV below. Major shareholders such as institutional investors should not have privileged access to information that is unavailable to minority shareholders.

D. Governance Structures and Policies

The structure, role and functions of the board

The term "board" has different meanings in unitary and two-tier systems. A unitary board is composed of executive and non-executive directors. In a two-tier system the term “board” is distinguished between the management board, whose members have executive responsibilities, and the supervisory board, responsible for the monitoring and supervision of the company’s management. Variations exist among the two-tier systems, and the responsibilities of the supervisory board could in some countries include responsibilities for the strategic direction of the company. While the two-tier system is not as widely utilized as the one-tier system, it is nevertheless prevalent in several large economies such as Austria, Germany and the Netherlands. In this document, the term "board" is used to refer to the highest governing and monitoring body or bodies of an enterprise on which executive and non-executive or supervisory board members sit. The recommendations contained herein typically apply to both one-tier and two-tier systems.

The composition of the board should be disclosed, in particular the balance of executives and non-executive directors, and whether any of the non-executives have any affiliations (direct or indirect) with the company. Where there might be issues that stakeholders might perceive as challenging the independence of non-executive directors, companies should disclose why those issues do not impinge on the governance role of the non-executive directors as a group.

One of the main issues in relation to the board structure and its disclosure is that, regardless of which structure exists in the company, independent leadership within the board is ensured. Some countries would give more emphasis to the need for a clear division of responsibilities between the chairman and the chief executive officer (CEO) (Cadbury Report, para. 4.9) Increasingly, codes mention that while a combined CEO/Chair is tolerable (in a one-tier system), the separation of the two is desirable and considered best practice, as it helps to promote a balance of power within the leadership structure. There is also increasing debate on the need for an independent Chair of the board. Even within economies where a combined role is still common, the accepted view is that measures are called for to balance the power at the head of the corporation such that no single individual has unfettered control of the company.

If the roles of chairman and CEO are combined, the proportion of independent directors within the board structure assumes greater importance. For example, the Cadbury Report recommended that where the roles were combined, there should be a strong independent element on the board and that there should be a lead non-executive director to whom issues regarding the executive management could be addressed. This idea is followed by the Indian code and was also addressed in the 2002 Report of the Kumar Mangalam Birla Committee on Corporate Governance. The idea is also expressed in the Malaysian Code on Corporate Governance (2000). However, the definition of an independent director varies in different countries. Therefore, a reference to a particular approach used in defining director independence might be useful in disclosing and discussing the board structure. FEE (2003a), for example, recommends that a principles-based approach used for assessing the independence of external auditors (see section H below) can also be usefully applied to the assessment of independence among non-executive (supervisory) directors. A crucial general principle in this respect is the principle of self interest threat; a self-interest threat occurs when a director could benefit from a financial or other interest in the enterprise, as a result of unethical behavior or lack of independence (FEE, 2003b). FEE further recommends that the board should disclose its reasons for considering a non-executive (or supervisory) director to be independent. It is recognized that not all non-executive directors can be considered independent directors. The Narayan Murty Committee Report in India, for instance, makes a clear distinction between non-executive and independent directors.

For example, non-executive directors who are employees of banks and other financial institutions with which the enterprise has a business relationship cannot be considered independent.

Similarly, for the boards of subsidiary companies, it is not uncommon for non-executive directors to be employees of the parent firm or some other subsidiary related to the parent firm.

Any relationship of directors to the parent firm or its subsidiaries should therefore be disclosed. Such a relationship could be considered in assessing the ability of the non executive director to fulfill his or her duties.

The board's role and functions must be fully disclosed.

Most guidelines and codes of best practice emphasize the stewardship and supervision functions of the board and distinguish its responsibilities from those of management. It is important that directors disclose what their functions and retained powers are, otherwise they may be considered accountable for all matters connected with the enterprise. In many Commonwealth countries, for example, the Companies

Act makes the directors accountable for the "management" of the company, but also allows them to delegate; hence the importance of recording and disclosing the retained powers of the directors, along with a clear statement about which powers are delegated to the CEO. However, there are differences in the specificity with which the board's role is explained. For example, the Dey Report (Canada), the Vienot Report (France), the Korean Stock Exchange Code, Malaysia's Report on Corporate Governance, Mexico's Code of Corporate Governance and the King II Report (South Africa) specify board functions as strategic planning, risk identification and management selection, oversight and compensation of senior management, succession planning, communications with shareholders, integrity of financial controls and general legal compliance. In India, for example, a director's responsibility statement outlining the board's responsibilities on compliance with standards, internal controls, risk management, fraud detection and other matters, is a disclosure requirement under both the law and stock exchange rules. The degree of differences between codes may reflect the degree to which company law or listing standards specify board responsibilities.

Board committees

It has become a common practice for boards to establish board committees to facilitate fulfillment of certain of the board's functions and address some potential conflicts of interest. The use of board committees is, among other things, intended to enhance independent judgment on matters in which there is potential for conflict of interest, and to bring special expertise in areas such as audit, risk management, election of board members and executive remuneration. While it may be advisable for the preparatory work of certain key board functions to be assigned to separate committees, there is an international consensus that the full board holds collective and final responsibility (FEE, 2003a).

Governance structures should be disclosed. In particular, the board should disclose structures put in place to prevent conflicts between the interests of the directors and management on the one side, and those of shareholders and other stakeholders on the other.

These structures may include committees or groups to which the board has assigned duties regarding the oversight of executive remuneration, audit matters, appointments to the board, and the evaluation of management performance.

The composition and functions of any such groups or committees should be fully disclosed. Committee charters, terms of reference or other company documents outlining the duties and powers of the committee or its members should also be disclosed, including whether or not the committee is empowered to make decisions which bind the board, or whether the committee can only make recommendations to the board. Where any director has taken on a specific role for the board or within one of these structures, this should be disclosed.

Internationally, there has been consensus that although a board has collective and final responsibility, the use of committees for the preparatory work of certain key board functions is advisable. This is especially true where executives may find themselves facing conflicts of interest, for example in the areas of audits, remuneration and director nomination. A number of codes address this issue, also outlining the need for clear terms of reference for such committees (e.g. Australia, India, Malaysia, South Africa).

As a general rule, codes have recommended, and in some cases stock exchange regulations require, that some board committees be substantially or exclusively staffed by non-executive or outside directors, particularly independent directors, and especially with regard to the committee chairpersons. Disclosures that are becoming increasingly common include the disclosure of committee charters or terms of reference, committee chairs, reports on activities (in particular those of the audit committee), composition, nominations committee disclosure on whether use is made of external advisers/advertising to find new directors (as opposed to potentially conflicting informal connections), and the effectiveness of executive remuneration in providing incentives for executives.

Ethics policy and support structure

The existence of an enterprise code of ethics and any governance structure put in place to support that code of ethics should be disclosed. Any waivers to the code of ethics or the rules governing ethics procedures should also be disclosed.

Ethics management is important for the promotion of good business practices, transparency and risk reduction. As ethics management becomes more common in enterprises, the existence of its key structural features is an important area of disclosure. It is noted that, with the exception of some countries such as the United States, no general or international best practice has yet been established in this area. Nevertheless, some possible features subject to disclosure might include: the existence of a senior ethics officer and that person's responsibilities; the existence of an ethics committee and its relationship to the board; policies for breaches of the ethics code, including reporting mechanisms and "whistleblower" protection mechanisms; and policies on the dissemination and promotion of the ethics code.

E. Members of the Board and Key Executives

1. Duties and qualifications

The number, type and duties of board positions held by an individual director should be disclosed. An enterprise should also disclose the actual board positions held, and whether or not the enterprise has a policy limiting the number of board positions any one director can hold.

Shareholders need to be aware of the number, type and duties of outside board and management positions that any individual director holds. Information on outside board and management positions should be disclosed for key executives as well. The purpose of this information is to make a judgment on the ability of directors and key executives to meet all of their commitments; thus the number as well as the type and duties of the position (which gives some indication of the commitment involved) should be disclosed.

Many codes and institutional investors have specified disclosure requirements (and/or actual limitations) on the number and type of positions held by directors. Among others, such disclosure requirements can be found in the positions of the FEE and the Winter Group Report, the Dey Report, the Indian Code, the Malaysian Code, the King II Report and the National Association of Pension Funds in the UK. Some guidance, such as the report of the FEE, also recommends disclosure of positions held in public or not-for-profit organizations.

There should be sufficient disclosure of the qualifications and biographical information of all board members to assure shareholders and other stakeholders that the members can effectively fulfill their responsibilities. There should also be disclosure of the mechanisms which are in place to act as "checks and balances" on key individuals in the enterprise.

Most governance guidelines and codes of best practice address topics related to directors' qualifications and board membership criteria. These may include experience, personal characteristics, core competencies, availability, diversity, age, specific skills (e.g. the understanding of particular technologies), international background, and so on. The CACG, for example, indicates that the director has to have integrity, common sense, business acumen and leadership.

Some codes specifically require financial literacy (e.g. the National Association of Corporate Directors in the United States) or knowledge of business and financial technology (e.g. the Brazilian Institute of Corporate Governance).

There should be disclosure of the types of development and training that directors undergo at induction as well as the actual training directors received during the reporting period.

Recently, some countries have started to require specific training for directors. For example, in India, the Companies (Amendment) Bill 2003 makes director training mandatory. The Naresh Chandra Committee on Corporate Audit and Governance, also of India, recommends training for independent directors and disclosure thereof.

The board should disclose facilities which may exist to provide members with professional advice. The board should also disclose whether that facility has been used during the reporting period.

On certain legal and financial matters, directors might discharge their duties more effectively if allowed access to independent external advisers, for example legal and financial experts. If used correctly, access to external expertise can enhance the ability of directors to fulfill their duties properly. In New Zealand, for example, it is considered vital for directors to have access to independent advice, and therefore this principle is stated in that country's Companies Act. The Merged Code in Belgium also points out the need for an agreed procedure for using external expertise, a point also mentioned in the Dey Report (Canada), and the Vienot (France), Mertanzis (Greece) and Olivencia (Spain) reports. Best practice suggests that whatever approach is used, the approach should be disclosed.

2. Evaluation mechanism

The board should disclose whether it has a performance evaluation process in place, either for the board as a whole or for individual members. Disclosure should be made of how the board has evaluated its performance and how the results of the appraisal are being used.

Along with the duties and responsibilities of directors, shareholders will need to know how directors were evaluated, what criteria were used and how they were applied in practice, particularly with reference to remuneration. CACG Guidelines stress that evaluations should be based on objective criteria. The IAIM Guidelines (Ireland) and Preda Code (Italy) leave to the remuneration committee the selection of appropriate criteria and the establishment of whether these criteria have been met.

An important aspect of performance is the attendance of directors at board and committee meetings. Specific requirements regarding disclosure of the frequency and procedures of board meetings can be found, for example, in the Indian Code, the King II Report and the Combined Code of the United Kingdom.

3. Directors' remuneration

Directors should disclose the mechanism for setting directors' remuneration and its structure. A clear distinction should be made between remuneration mechanisms for executive directors and non-executive directors. Disclosure should be comprehensive to demonstrate to shareholders and other stakeholders whether remuneration is tied to the company's long-term performance as measured by recognized criteria.

Information regarding compensation packages should include salary, bonuses, pensions, share payments and all other benefits, financial or otherwise, as well as reimbursed expenses. Where share options for directors are used as incentives but are not disclosed as disaggregated expenses in the accounts, their cost should be fully disclosed using a widely accepted pricing model.

The current level of disclosure relating to directors' remuneration varies widely. However, the trend appears to be towards greater levels of disclosure in this area, especially in Europe: France, Germany, Luxembourg, the Netherlands, Switzerland and the United Kingdom have all introduced laws to enforce the disclosure of directors' individual remuneration. In the United Kingdom, for example, the report of the company's remuneration committee must identify each director and specify his or her total compensation package, including share options. Recently added regulations also require companies to put their remuneration report to a shareholder vote at each annual general meeting. Elsewhere in the world there are other examples of this practice. The Indian Code, for instance, requires disclosure about remuneration in a section of the annual report on corporate governance, in addition to suitable disclosure on directors' remuneration in the profit and loss statement.

The length of directors' contracts and the termination of service notice requirements, as well as the nature of compensation payable to any director for cancellation of service contract, should be disclosed. A specific reference should be made to any special arrangement relating to severance payments to directors in the event of a takeover.

4. Succession planning

The board should disclose whether it has established a succession plan for key executives and other board members to ensure that there is a strategy for continuity of operations.

OECD Principle IV.D.2 stresses that overseeing succession planning is a key function of the board, while the Dey Report (Canada) considers it an important stewardship duty of the company, and the Vienot Report I (France) recommends that the selection committee be prepared to propose successors at short notice. While specific details regarding potential successors might be the subject of confidentiality, the existence of a procedure and a preparedness to appoint successors as necessary is not confidential, and should be the subject of disclosure.

5. Conflict of interest

Conflicts of interest affecting members of the board should, if they are not avoidable, at least be disclosed. The board of directors should disclose whether it has a formal procedure for addressing such situations, as well as the hierarchy of obligations to which directors are subject.

Conflicts of interest are required to be disclosed by law in many countries. The critical issue is that all conflicts of interest should be disclosed, along with what the board decided to do regarding the specific situation and the relevant director involved.

F. Material Issues Regarding Stakeholders, and Environmental and Social Stewardship

***The board should disclose whether there is a mechanism protecting the rights of other stakeholders in a business*.**

OECD Principle IV concerns itself with ensuring that the rights of stakeholders protected by law are respected. Even where no legislation exists, it is considered good practice to make additional commitments, as corporate reputation and performance may require recognition of broader interests. For example, the CACG Guidelines require that a board identify the corporation’s internal and external stakeholders and agree on a policy for how the corporation should relate to them.

***The role of employees in corporate governance should be disclosed*.**

Among member States of the European Union, for example, various practices exist where employees elect some of the supervisory directors, can be given a right to nominate one or more directors or can have an advisory voice on certain issues discussed by the board. This practice is considered by some to dilute the influence of shareholders, and to be a distortion of the connection between investment risk and the decision-making process. Others consider the strong interest of employees in the enterprise to warrant their special status in the governance process, and view employee involvement as having a beneficial effect on the overall sustainability of the firm. Regardless of one's views, any mechanisms for employee involvement in the governance of the enterprise should be clearly disclosed

.

The board should disclose its policy and performance in connection with environmental and social responsibility and the impact of this policy and performance on the firm's sustainability.

The environmental dimension of this issue was addressed by ISAR in its agreed conclusions on Accounting and Financial Reporting for Environmental Costs and Liabilities. ISAR noted that an enterprise's environmental performance could affect its financial health and hence its sustainability. At its twentieth session, ISAR concluded that the pressure for better reporting on social issues was increasing and that enterprises were producing more information on this topic. Among others, the King II Report (South Africa), the Association of British Insurers (UK) in its Disclosure Guidelines on Socially Responsible Investment, and the guidelines of the Global Reporting Initiative encourage disclosure of governance mechanisms in place to support improvement of social and environmental performance. Such governance disclosure is also relevant for creators of "socially responsible investing" indexes, such as the Domini 400 Social Index produced by KLD Research & Analystics in the United States, the FTSE4GOOD produced by FTSE in the United Kingdom, or the Dow Jones Sustainability Worlds Indexes (DJSI) produced by the SAM Group of Switzerland in conjunction with Dow Jones Ltd and STOXXX Ltd.

G. Material Foreseeable Risk Factors

The board should give appropriate disclosures and assurance regarding its risk management objectives, systems and activities. The board should disclose existing provisions for identifying and managing the effects of riskbearing activities. The board should report on internal control systems designed to mitigate risks. Such reporting should include risk identification mechanisms.

In recent years, much attention has been paid to the role of the board in risk assessment or management and internal controls designed to mitigate risk. This issue is emphasized in most codes and principles, including the OECD Principles, the CACG Guidelines, King II and the United Kingdom's Combined Code.

Users of financial information and participants in the marketplace need information on foreseeable material risks, including risks specific to industries or geographical areas, dependence on certain commodities, financial market risk and derivative risks. The corporate governance structures in place to assess, manage and report on these types of risks should be the subject of corporate governance disclosure.

H. Independence of External Auditors

The board should disclose that it has confidence that the external auditors are independent and their competency and integrity have not been compromised in any way. The process for the appointment of and interaction with external auditors should be disclosed.

Independent external audits should provide an objective assurance that the financial statements present a true and fair view (or are presented fairly in all material respects) of the financial condition and performance of the audited entity.

Therefore, most governance codes and guidelines define procedures for enhancing the independence, objectivity and professionalism of the external audit. A number of approaches regarding the external audit, such as the need for audit partner rotation and the avoidance of possible conflicts of interest involved in providing non-audit services, can be considered to ensure that external audits serve shareholder and other stakeholder interests in the intended manner.

Auditor independence is a prerequisite for the reliability and credibility of the audit of financial statements. Adopting a principles-based approach to auditor independence (as set out in the EC's 2002 recommendation on auditor independence and in the IFAC Code of Ethics) is valued for its adaptability to new practices. The principles-based approach sets out the fundamental principles which must always be observed by the auditor and considers the threats and safeguards (including restrictions and prohibitions) to be in place to ensure the auditors' independence and objectivity. However, it could be useful for enterprises to disclose a substantial definition of those activities that would be regarded as non-audit-related, especially in those cases where audit and non-audit-related fees are not subject to mandatory disclosure.

Disclosures should cover the selection and approval process for the external auditor, any prescriptive requirements of audit partner rotation, the duration of the current auditor (e.g. whether the same auditor has been engaged for more than five years and whether there is a rotation of audit partners), who governs the relationship with the auditor, whether auditors do any non-audit work and what percentage of the total fees paid to the auditor involves non-audit work.

The audit committee should play a role in establishing a policy on purchasing non-audit services from the external auditor; this policy should be disclosed along with an explanation or assessment of how this policy sufficiently ensures the independence of the external auditor (FEE,2003a).

I. Internal Audit Function

Enterprises should disclose the scope of work and responsibilities of the internal audit function and the highest level within the leadership of the enterprise to which the internal audit function reports. Enterprises with no internal audit function should disclose the reasons for its absence.

An effective internal audit function plays a significant role within the corporate governance framework of a company.

The scope of work and responsibilities of an internal audit function are often determined by the board (or management board in a two-tier system), typically in conjunction with the audit committee, and can vary significantly depending on the size, structure and complexity of the company and the resources allocated. Given the potential variation in the internal audit function among enterprises, it is recommended that details of this function be disclosed.

III. GENERAL MEETINGS

Disclosure should be made of the process for holding and voting at annual general meetings and extraordinary general meetings, as well as all other information necessary for shareholders to participate effectively in such meetings. Notification of the agenda and proposed resolutions should be made in a timely fashion, and be made available in the national language (or one of the official languages) of the enterprise as well as, if appropriate, an internationally used business language. The results of a general meeting should be communicated to all shareholders as soon as possible.

The OECD Principles outline a general consensus as to the nature of shareholder meetings and the requirement to make shareholder participation as simple and effective as possible and ensure the equitable treatment of all shareholders. The Principles state that shareholders should be informed of the rules and be furnished with information regarding the date, location and agenda of the meeting as well as the issues to be decided. Sufficient information should be provided so that shareholders can make fully informed decisions. Enterprises should do everything possible to facilitate the effective participation of all (including foreign) shareholders in general meetings.

In most governance systems, it is either required or considered good practice to put certain issues to shareholder approval at a general meeting. Best practice in this area entails that issues subject to shareholder approval be presented individually and unbundled, allowing shareholders to accurately exercise their voting rights. These rules can vary across different countries, and therefore disclosing information on the subject would be useful, especially for foreign investors. In some countries, for some enterprises, new types of voting technology are being employed, for example Internet voting. The enterprise should, when issuing notice of the meeting, disclose the relevant details of voting technologies employed.

The enterprise should disclose all relevant information on the process by which shareholders can submit agenda items, and should disclose which shareholder proposals (if any) were excluded from the agenda and why.

It is considered good practice in most governance systems to allow shareholders to include items on the agenda of a general meeting.

TIMING AND MEANS OF DISCLOSURE

All material issues relating to corporate governance of the enterprise should be disclosed in a timely fashion. The disclosure should be clear, concise, precise and governed by the "substance over form" principle.

Some issues may require continuous disclosure. Relevant information should be available for users in a cost effective way, preferably through the websites of the relevant government authority, the stock exchange on which the enterprise is listed (if applicable) and the enterprise itself.

The location of corporate governance disclosures within the annual report is not generally defined and can vary substantially in practice. Some degree of harmonization of the location of corporate governance disclosures would be desirable to make the relevant data more accessible. Two possible approaches include putting all corporate governance disclosures in a separate section of the annual report, or in a stand-alone corporate governance report. Examples of the former approach are found in the recommendations of the Hong Kong Society of Accountants and the listing requirements in India and Switzerland, which provide for corporate governance disclosures to appear in a separate section of the annual report and in a prescribed format. Where corporate governance disclosures are not consolidated, there should be sufficient cross-referencing to different disclosures to improve access to the information.

Some information related to corporate governance may require immediate disclosure, and some codes and listing requirements address this issue. For example, in Malaysia listing requirements call for immediate disclosure of a change in the management, external auditor or board structure.

Traditional channels of communication with stakeholders, such as annual reports, should be supported by other channels of communication, taking into account the complexity and globalization of financial markets and the impact of technology.

The OECD Principles state that the Internet and other information technologies provide the opportunity for improving information dissemination. In some countries (e.g. the United States), Internet disclosure is now accepted as legal disclosure and annual reports must indicate where company information can be found on the Internet. The King II Report also emphasizes the need for critical financial information to be made available to shareholders simultaneously and supports the idea that traditional channels of communication be complemented by new means, such as the Internet.

Whatever disclosures are made and whatever channels used, a clear distinction should be made between audited and Un-audited financial information, and means of validation of other non-financial information should be provided.

GOOD PRACTICES FOR COMPLIANCE

Where there is a local code on corporate governance, enterprises should follow a "comply or explain" rule whereby they disclose the extent to which they followed the local code's recommendations and explain any deviations. Where there is no local code on corporate governance, companies should follow recognized international good practices.

The use of "comply or explain" mechanisms in many countries allows investors and other stakeholders greater access to information about the corporation and is to be encouraged. In relation to this "comply or explain" rule, some countries now require companies with foreign listings to disclose the extent to which the local governance practices differ from the foreign listing standards.

The enterprise should disclose awards or accolades for its good corporate governance practices.

It is recognized that there is an increase in the number of corporate governance accolades, awards, ratings, rankings and even corporate governance stock market indexes where constituents are selected on the basis of exhibiting good practices in corporate governance. Especially where such awards or recognitions come from major rating agencies, stock exchanges or other significant financial institutions, disclosure would prove useful since it provides independent evidence of the state of a company's corporate governance.

e) What is to be disclosed:

"The Listing Rules require a statement to be included in the annual report relating to compliance with the Code, as described in the preamble. For ease of reference, the specific requirements in the Code for disclosure are set out below:

The annual report should record:

_ A statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management (A.1.1);

_ The names of the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees (A.1.2);

_ The number of meetings of the board and those committees and individual attendance by directors (A.1.2);

_ The names of the non-executive directors whom the board determines to be independent, with reasons where necessary

_ The other significant commitments of the chairman and any changes to them during the year .

_ How performance evaluation of the board, its committees and its directors has been conducted
_ The steps the board has taken to ensure that members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company .The report should also include:

_ A separate section describing the work of the nomination committee, including the process it has used in relation to board appointments and an explanation if neither external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director

_ A description of the work of the remuneration committee as required under the Directors' Remuneration Reporting Regulations2002, and including, where an executive director serves as a no executive director elsewhere, whether or not the director will retain such earnings and, if so, what the remuneration is :

_ An explanation from the directors of their responsibility for preparing the accounts and a statement by the auditors about their reporting responsibilities

_ A statement from the directors that the business is a going concern, with supporting assumptions or qualifications as necessary.

_ A report that the board has conducted a review of the effectiveness of the group's system of internal controls.

_ A separate section describing the work of the audit committee in discharging its responsibilities.

_ Where there is no internal audit function, the reasons for the absence of such a function.

_ Where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement from the audit committee explaining the recommendation and the reasons why the board has taken a different position ; and

_ An explanation of how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded .

_ The terms of reference of the nomination, remuneration and audit committees, explaining their role and the authority delegated to them by the board.

_ The terms and conditions of appointment of non-executive directors and

_ Where remuneration consultants are appointed, a statement of whether they have any other connection with the company."[www.kpmg.ca]

The board should set out to shareholders in the papers accompanying a resolution to elect or re-elect:

"_ Sufficient biographical details to enable shareholders to take an informed decision on their election or re-election.

_ Why they believe an individual should be elected to a non executive role .

_ On re-election of a non-executive director, confirmation from the chairman that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role, including commitment of time for board and committee meetings and any other duties .

The board should set out to shareholders in the papers recommending appointment or reappointment of an external auditor:

"_ If the board does not accept the audit committee's recommendation, a statement from the audit committee explaining the recommendation and from the board setting out reasons why they have taken a different position."

[The Combined code, July 2003]

Chapter IV

Corporate governance-Relation with internal controls and risk management

Risk Management Tools

"An excellent source for risk management tools is the Basel Committee on Banking Supervision; this organization provides direction and guidance to bank regulators and banks around the world. The risk management group of that committee is responsible for some of the most useful risk management solutions, and has issued leading edge policy and discussion papers related to internal control, risk management and assurance.

Risk management tools must follow global best practices, as they relate to Basel operational risk, very closely. A risk management tool must assist financial service organizations to meet the new Basel operational risk expectations as they apply to audit risk management.

Risk management solutions should allow for the full integration and utilization of the efforts of all assurance providers and risk managers. Risk management tools should also include senior management, all work units, internal and external audit, as well as safety, environment, risk and insurance, and others. Paisley offers several effective risk management tools."[www.wiley.com]

a) Internal control requirements of the Combined Code

1.When the Combined Code of the Committee on Corporate Governance (the Code) was published, the Institute of Chartered Accountants in England & Wales agreed with the London Stock Exchange that it would provide guidance to assist listed companies to implement the requirements in the Code relating to internal control.

"2. Principle D.2 of the Code states that 'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'.

3. Provision D.2.1 states that 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management'.

4. Provision D.2.2 states that 'Companies which do not have an internal audit function should from time to time review the need for one'"[code of ICA].

"5. Paragraph 12.43A of the London Stock Exchange Listing Rules states that 'in the case of a company incorporated in the United Kingdom, the following additional items must be included in its annual report and accounts:

(a) A narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied;

(b) A statement as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the ase of provisions whose requirements are of a continuing nature)

complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance'.

6. The Preamble to the Code, which is appended to the Listing Rules, makes it clear that there is no prescribed form or content for the statement setting out how the various principles in the Code have been applied. The intention is that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances which have led to them adopting a particular approach."[London stock exchange rules]

7. The guidance in this document should be followed by boards of listed companies in:

_ assessing how the company has applied Code principle D.2;
_ implementing the requirements of Code provisions D.2.1 and D.2.2;
and
_ reporting on these matters to shareholders in the annual report and accounts.

b) Objectives of the guidance

"This guidance is intended to:

_ reflect sound business practice whereby internal control is embedded in the business processes by which a company pursues its objectives;
_ remain relevant over time in the continually evolving business environment; and

_ enable each company to apply it in a manner which takes account of its particular circumstances.
The guidance requires directors to exercise judgment in reviewing how the company has implemented the requirements of the Code relating to internal control and reporting to shareholders thereon.

The guidance is based on the adoption by a company's board of a risk based approach to establishing a sound system of internal control and reviewing its effectiveness. This should be incorporated by the company within its normal management and governance processes. It should not be treated as a separate exercise undertaken to meet regulatory requirements".[Code of ICA]

c) Risk management

1-"Scientific" Theoretical Perspective on Risk Management

Modern financial theory contains some very important ideas that have informed scholarly and practitioner thinking about risk management. One important idea is that investors require higher expected returns to assume higher levels of risk. A second important idea is that investors can eliminate a great deal of the risk associated with owning a single stock (company) by holding, instead, a well-diversified portfolio of stocks – the notion of diversification. What follows from the second idea is that investors require a risk premium only for that risk which they cannot eliminate through diversification – what is called systematic or market risk. The third idea is that managers can increase the value of a company only if they can do something individual investors cannot do on their own. With respect to risk management, this something means altering the risk/return profile or increasing the present value of cash flows in ways unavailable to individual investors.

For example, consider a U.S. based chemical company selling in global markets. The cash flows of this company are exposed to commodity price and foreign currency risk. If the company has debt in its capital structure, the cash flows are also exposed to interest rate risk. However, do (or should) these risks matter to a well-diversified investor concerned only about risk and expected return? In the perfect market world of early financial theory the answer is no because the risks could be eliminated through diversification or through risk management strategies implemented by the individual investor.

Why? Well, what may be “bad draws” on commodity prices for the chemical company are “good draws” for the companies supplying the chemical feedstock. For the investor holding the common stock of both companies, these “draws” will offset each other. The same holds true for exchange rate risk if the investor holds an internationally diversified portfolio. Alternatively, if the investor wanted to hedge his expected cash flows from the chemical company, he could obtain the commodity and foreign currency risk management products on his own. Therefore, in either case, the manager of the chemical company cannot lower the company’s cost of capital (which is the investor’s required rate of return) by simply smoothing the cash flows through managing the company’s exposure to these risks.

The cornerstones of modern financial theory are, arguably, the capital structure irrelevance propositions of Modigliani and Miller (1959); portfolio theory (Markowitz, 1959); the capital asset pricing model (Sharpe, 1964; Lintner, 1965) and efficient markets theory (Samuelson, 1965; Mandelbrot, 1966; Fama, 1970). Taken together, these theories, models and propositions led to certain but not always explicitly recognized assumptions about how managers should manage the corporation and what managers should and shouldn’t do, especially with regard to risk management.

Markowitz formalized the old adage of “don’t put all your eggs in one basket.” He did so by showing that investors could reduce risks by forming portfolios of securities whose expected returns were less than perfectly positively correlated with one another, with the emphasis being on maximizing portfolio returns for a given level of risk. This formalization led to the capital asset pricing model that stated that investors, in perfect capital markets, demanded a risk premium only for market risk. The model’s normative managerial implications were that managers should not worry about whether the firm survives or fails in and of itself. Instead, managers should worry only about whether the expected return from a proposed investment would satisfy a well-diversified investor concerned with whether the expected return was adequate for the effect the investment would have on the systematic risk of his portfolio.

The contribution efficient market theory brought to the table was evidence that investors did behave rationally in the sense of focusing on expected return and risk when pricing securities and incorporating information as quickly as possible into asset prices. Arbitrage opportunities were few and far between; and, when they appeared, they were quickly eliminated".[www.wiley.com]

2-From Theory to Practice: Why Firms Should Manage Risk

"Not until the re-emergence of corporate governance concerns about the separation of owners and managers articulated by Berle and Means in the 1930s reappeared in the “modern” finance literature did risk management enter the “scientific” world of financial economics. This re-emergence in the scholarly literature can be traced to Ross (1973) and Jensen and Meckling (1976) who introduced the term agency theory into finance. At the core of financial agency theory was the notion that in a world of informational asymmetries and self-seeking behavior, individuals would use informational and other advantages to transfer wealth to themselves from others. Although such behavior was ascribed to all stakeholders, early attention focused on conflicts on interest between shareholders and managers (a concern of Berle and Means) and shareholders and bondholders. Later, other stakeholders were brought into the scheme. Ways of solving or mitigating these conflicts are the concerns of corporate governance.
Basically, early and late financial agency theory took the seminal works of early financial theory that were developed around the notion of perfect capital markets and introduced imperfections into the analysis. The introduction or recognition of these imperfections led to many reasons for having managers manage risk (Smith and Stulz, 1985; Froot, Scharfstein and Stein, 1993), reasons that have found their way into contemporary financial management textbooks (e.g., Grinblatt and Titman, 2001). We review these reasons in order to set the stage for connecting them to more fundamental social welfare concerns about corporate governance and risk management. The usual reasons are:

1. Risk management can be used to lower the firm's expected tax payments.
2. Risk management can reduce the costs of financial distress and bankruptcy.
3. Risk management can be used to encourage and protect firm specific investments.
4. Risk management can be used to align the interests of management with those of the owners of the company.
5. Risk management can be used to design management compensation plans that hold management accountable only for the factors under their control.
6. Risk management can be used to assist firms in developing financial plans and funding programs.
7. Risk management can be used to stabilize cash dividends".[www.wiley.com]

3- Using Risk Management to Lower Taxes

"Although not associated with informational asymmetries, taxes qualify as a market imperfection. To the extent that taxes levied on corporate income differ from those on personal income or treat some forms of income differently from others, risk management strategies can be used to arbitrage or negate tax code asymmetries.

One tax code asymmetry is the differential treatment of interest expense and cash dividends. Interest payments are tax deductible and paid from before tax dollars, cash dividend payments are paid from after tax dollars. Consequently, debt financing may reduce the overall after tax cost of capital to the company by creating an interest expense tax shield with the benefits accruing to the shareholders. To the extent that risk management enables a firm to use more debt (increase its financial leverage) risk management becomes a way of reducing taxes by letting a firm borrow more money and obtain interest expense tax shields.

Another common tax code asymmetry is the differential treatment of gains and losses. Exchange rate or commodity price gains may be taxable; however, losses may not be fully or immediately deductible. If the gains average out over a business or price cycle, the average tax paid will be lower if the firm hedges its exposures to these price changes and pays taxes on the average gain over the entire cycle. In contrast, if the firm did not hedge the exposures, the losses could not be used to offset the gains. Any such tax-coded asymmetry is exacerbated under a progressive tax code, especially if the progressivism is steep. More interesting from a corporate governance perspective, however, are reasons for risk management emanating from how the company is financed – itself a governance structure issue – and how the suppliers of capital monitor and control managers". [www.wiley.com]

4-Reducing Financial Distress and Bankruptcy Costs

"While fully diversified equity investors may not pay much attention to the unique risks associated with price, currency and interest rate volatility, other stakeholders take a different view of the situation. These other stakeholders include creditors, customers and suppliers and they could suffer substantial costs should a company find itself in financial difficulty.

Consider Toolco, a machine tool manufacturer that produces and sells highly specialized equipment to customers who rely on the company to honor warranties, provide on-going service and technical assistance and supply spare parts. Southeast Asia and Europe are both major markets for Toolco with German and South Korean manufacturing firms being major customers. Toolco prepares bids, quotes prices and bills customers in local currency – Euros and South Korean won. Toolco uses both debt and equity to finance itself.

Should the U.S. dollar appreciate substantially relative to the euro and won, the dollar value of Toolco's outstanding bids and accounts receivables will plummet. Furthermore, should the dollar remain strong for an extended period, Toolco's overall competitive position will weaken relative to its foreign competitors. This strengthening of the dollar will cause a substantial reduction in Toolco's profits and cash flows, a reduction that will affect its ability to provide service and spare parts and, ultimately, produce and deliver high quality machine tools as contracted.

Toolco can use risk management strategies to mitigate the potential financial problems associated with currency risks. It can hedge its exchange rate exposures and adopt other exchange rate exposure strategies – such as currency swaps for financing its foreign operations – that reduce the likelihood of Toolco experiencing severe financial problems from unexpected exchange rate movements. Managing currency risk may also lead to an increased willingness of customers to buy from Toolco because of its ability to withstand financial difficulties. In turn, the improvement in Toolco's financial position may improve the terms on which suppliers sell to Toolco. The end result for Toolco will be an increase in the market value of its common stock, an outcome desired by its shareholders.

Contemporary textbook treatments of risk management also develop the story that locking in a certain level of operating cash flows may also permit Toolco to use more debt to finance itself. The explanation offered is a reduction in financial distress costs along with the deductibility of interest expense story".[www.wiley.com]

5-Using Risk Management to encourage and Protect Firm Specific Investment

"Stakeholders of the firm include its employees, managers, suppliers and customers. These stakeholders find it very difficult to diversify away the risks they are exposed to in their relationships with the firm, especially if the stakeholders make firm specific investments (Williamson, 1985). So, to the extent that risk management is able to reduce the risks of financial distress and failure, the firm will enjoy an improved competitive position in its product and labor markets.

For example, employees have a considerable interest in the success of a company because they would incur substantial adjustment costs were the firm to fail. These costs go beyond the costs of looking elsewhere for employment, especially for highly skilled technical and managerial employees. These individuals typically make major commitments of time and effort to develop company specific skills and look to the continued growth and success of the company for the returns on these investments. The returns are not entirely pecuniary, but come in the form of promotions, status and job security. So, as pointed out in most textbook treatments of the subject, firms that can offer security and the prospects of financial success to their employees and managers are likely to garner greater employee loyalty and recruit and retain the "better" workers and managers.

But, a more fundamental relationship exists between having employees and other stakeholders make firm specific investments and the need for firm survival. We would argue that it is the firm specific skills amassed by the firm's employees that make it possible for the firm to earn more than its cost of capital. Expressed in the terminology of financial management, these firm specific skills enable the firm to find and undertake positive net present value projects.

This notion of the importance of firm survival and the need to manage total risk so as to support the development of firm specific skills to make positive NPV projects fits nicely into David Durand's critique of Modigliani and Miller's irrelevance of capital structure given perfect capital markets. Durand (1989) notes that Modigliani and Miller did not restrict the firm's investment opportunities to only perfectly competitive zero net present value projects but, instead, let firms earn excess returns due to special circumstances such as patents and other factors. Durand then argues that this "rationale implies that their [MM] perfect market is not perfect enough to accord everyone, whether firm or individual investor, equal access to the better opportunities …. Perhaps what MM have in mind is a two-tier market, with one tier for securities and the other for physical assets." Durand concludes that investors in security markets can earn only a zero NPV return because the investor does not have access to the monopolistic opportunities available to the firm.

We want to suggest another way of phrasing Durand's critique. Instead of ascribing the excess returns to monopolistic practices, let's ascribe them to firm-specific skills and accumulated knowledge. These firm-specific skills generate the positive NPV projects, including the patents that Modigliani and Miller invoke for explaining the existence of economic rents. And, to ensure these unique, firm-specific skills are developed, the firm needs to survive as a going concern; hence, the need for managing total risks. And, also, an outcome that investors cannot duplicate on their own regardless of whether financial markets are perfect.

As we mentioned earlier in connection with financial distress costs, suppliers and customers also have a direct interest in the financial health and survival of the firm. Suppliers are unlikely to make firm specific investments in plant, equipment and production technology to service weak customers who may not be around next year to buy the components. Therefore, risk management actions that reduce the likelihood of a firm failing will increase the willingness of suppliers to enter into long-term contracts and make investments in equipment and product development that benefit the buying firm. These complimentary firm specific investments between suppliers and users support and produce inter-firm efforts that, in turn, generate relational rents (Dyer and Singh, 1998).

Many small and medium-sized firms are privately owned and owner managed. Usually, the owners have most of their wealth tied up in the company and cannot obtain the benefits of portfolio diversification that would eliminate the unique financial risks of the company. To exacerbate matters, the owners have their human capital tied up in the company as well. So, risk management becomes a very important way for owner-managers of closely held firms to protect themselves from commodity price and exchange rate risk.

The above reasons for risk management arise not so much out of conflicts of interest among stakeholders as out of the benefits associated with the survival of the firm. Think of it this way: The firm can be characterized as a voluntary association to create new wealth with new wealth thought of as positive NPV projects. This new wealth requires firm specific skills and investments such that, once the firm's stakeholders become vested in the company with their firm specific investments, they have an interest in sustaining the firm and their association with the company. Hence, the need to manage total risk at the firm level rather than only the systematic risk at the investor level".[www.wiley.com]

6-Using Risk Management to Monitor and Control Managers

"From a public shareholder's perspective (a perspective generally assumed by financial theory), the objective of management should be to maximize the price of the company's common stock. However, managers are likely to be interested in their own well being as much as the well-being of the owners of the company. Therefore, in a world of self-seeking behavior and informational asymmetries (where managers have more information than owners), conflicts of interest between managers and owners of publicly held companies are likely to arise. Managers may seek to extract perks from the company and grow the company at the expense of the shareholders by making unprofitable investments so as to keep control of corporate resources, preserve their jobs and increase their salaries. These actions create costs called agency costs and they reduce the market value of the company.

Students of financial economics and organizational behavior use financial agency theory to analyze and understand these costs and recommend ways to reduce them. One important application of agency theory is the design of management evaluation and compensation systems that reduce conflicts of interest between managers and owners by aligning managers' interests with the shareholders.

Risk management enters into this process the following way: Unlike shareholders, managers cannot diversify away the unique risks associated with the company; managers are exposed to the total risk of the company, not just the systematic risk. Regardless of why the firm fails, the managers are out of a job. Consequently, managers are likely to make decisions based on the total risk of a venture whereas shareholders would prefer managers to consider only the systematic risk.

Now, recall that we said financial theory predicted that hedging would not improve firm values if all it did was to reduce the variance of the firm's cash flows because investors could do this on their own through diversification. However, reducing the total variance of firm cash flows may be very important for managers who, unlike investors, cannot diversify away the risks associated with certain business ventures. By letting managers eliminate these risks through hedging, the shareholders need not worry about managers rejecting projects that are very profitable based on their systematic risk exposures but unlikely to be undertaken unless managers can hedge the unique risks to protect their jobs and the company in the event of a "bad draw." Such hedging costs the public shareholders nothing in terms of expected returns on the hedged project and also doesn't affect the systematic risk. However, by reducing the consequences of project failure for management, a project which would have been discarded without the knowledge of public shareholders is now undertaken. Hedging has effectively reduced agency costs and increased the market value of the company even though the project's systematic risks and expected rate of return are unaffected.

Risk management strategies are used in conjunction with managerial performance evaluation and compensation systems to separate financial outcomes under management control form those not under their control. For example, suppose you are a large institutional investor who owns stock in Wadco Enterprises. Wadco manufactures circuit boards in Thailand and sells them to U.S. companies. Wadco costs are in Thai baht and its revenues in dollars. Wadco has an executive compensation program with bonuses tied to operating cash flows measured in U.S. dollars. Now, suppose the Thai baht substantially depreciates against the dollar. With costs denominated in Thai baht and revenues in dollars, Wadco's Thai division will report very high profits as a result of the Thai devaluation. However, should the mangers of Wadco be paid a bonus for this performance? What control did they have over the devaluation of the baht? Suppose the baht had appreciated instead of depreciated? Should the managers of Wadco be penalized for this outcome?

A widely held opinion is that Wadco management bonuses should not be affected by unexpected exchange rate movements because managers had no control over these events. Bonuses and performance evaluations should be based only on outcomes over which managers have control. So, by having Wadco managers hedge the exchange rate exposures, stockholders, like the large institutional investors, can focus management attention on things management can control, such as production, marketing and sales. Furthermore, by requiring managers to hedge the exposures, shareholders make it more difficult for management to claim that poor performance was caused by events outside of their control".[www.wiley.com]

7-Using Risk Management to Improve Decision Making and Capital Budgeting

"Substantial volatility from quarter-to-quarter and year-to-year in operating cash flows and net income makes it difficult to evaluate the fundamental performance of a company and divisions or other units within the company. The noise introduced into these measures by volatile commodity prices, exchange rates and interest rates can be removed through risk management strategies that minimize cash flow and income variability. Removing the noise improves decision making by providing higher quality information on fundamental performance, especially across divisions, product lines and geographic locations. This higher quality information makes it easier to decide how to allocate funds within the firm and may increase the “trust” of competing managers in the capital allocation process.

Risk management can also be used to protect against disruptions in implementing a capital budget by ensuring that substantial shortfalls in internally generated funds do not occur as a result of unexpected price movements. Normally, firms would have a capital budget in place along with a plan to finance the expenditures. By hedging commodity price, exchange rate and interest rate exposures, firms can better plan both the capital expenditures and the funding arrangements".[www.wiley.com]

8-Risk Management and Dividends

"Do dividends (like capital structure) matter? Miller and Modigliani (1961) said no; but, of course, this claim is true only for perfect capital markets. Since then, an extensive body of literature has shown that dividends do matter – especially if dividends are cut. So, by stabilizing cash flows, risk management makes it possible to maintain cash dividends and smooth out the dividend cash flow stream. To the extent that dividend policy and investment policies (capital budgeting) are not independent of each other, risk management designed to stabilize dividend payments is really stabilizing the total cash flow stream available for investment and dividend payments.

Note that while stabilizing the cash flows available for investment and distribution to owners as cash dividends is important for all firms, it is especially important for firms with public shareholders. This stabilization of dividend payments is needed to communicate information about future investment returns, dividend payments and the financial health of the company to all the firm’s stakeholders.

For example, the customers of companies that develop software programs for proprietary use want to be sure the developer will be around to supply second and third generation products and to service the existing systems. Consequently, these customers monitor the cash flows, stock prices and dividends of the suppliers to assess the supplier’s financial health and ability to develop new products. Dividends, therefore are important for maintaining a company's competitive position in its product markets as well as for providing shareholders with an adequate return on their investment".[www.wiley.com]

9-Back to Berle and Means

"Many of the reasons listed in financial management textbooks for undertaking risk management are informed by potential conflicts of interest among the stakeholders of a company and, in particular, among shareholders, managers and creditors; conflicts that were noted by Berle and Means in the 1930s. The Berle and Means critique of the modern corporation was subsequently adopted by Jensen and Meckling in 1976 and turned into financial agency theory. Later, Jensen (1986) appended his free cash flow theory to agency theory.

As usually formulated, financial agency theory continues to assert, as did early financial theory, that the objective of management should be to maximize the value of the firm for the fully diversified investor. Now, however, certain actions needed to be taken to control managerial self-interest because managers will behave opportunistically in a world of informational asymmetries and seek advantages at the expense of public shareholders. Basically, ways needed to be found that would discourage managers of firms facing limited investment opportunities to grow the firm at the expense of the shareholders by making negative net present value investments rather than returning cash to the shareholders.

Two of the usual prescriptions for reducing agency costs by preventing the misuse of free cash flow are substituting debt for equity and paying cash dividends. Both prescriptions call for increasing the debt ratio of the company, leading to increases in financial risk and the likelihood the firm will face financial difficulty. So, with risk management seen as a means for enabling a firm to increase its use of debt financing and debt financing seen as a way of controlling managers and focusing their attention on shareholder concerns, risk management becomes a way of solving agency problems associated with free cash flow. It does so by enabling the firm to substitute the governance structure of debt for the governance structure of equity.

But, we think the rationale and motivation for risk management can be extended beyond the boundaries of modern financial theory where imperfections are needed to explain why firms use risk management. We do so by moving beyond the assumption that shareholder wealth maximization is an end in itself rather than a means to an end.

When Berle and Means wrote about the separation of management and ownership in the modern corporation, they were concerned about how to make the corporation compatible with democracy in a world where the managerially controlled corporation had replaced the simple market economy of the nineteenth century. The allure of the pre-modern corporation past was that it allowed workers to become owner-managers of small firms. This ownership arrangement supported the moral development of the individual and encouraged his active participation in the market and politics because he had a vested interest in protecting his property from the opportunistic behavior of others. It also motivated the owner-manager to act in a socially responsible manner towards his neighbors so as to preserve his property. Consequently, the concerns of Berle and Means and others focused on the societal role of the corporation. They were concerned with reconciling the emergence of the modern corporation with American notions of the moral development of its citizens, democratic pluralism and economic opportunities – what is loosely described as corporate social responsibility (Kaen, Kaufman and Zacharias, 1988). They were also concerned with how economic efficiency fit into this equation and were seeking ways to reconcile economic efficiency objectives with political economy objectives.

Conflicts of interest, as they were eventually developed in modern financial agency theory and related to shareholder wealth maximization objectives, were important to writers in the Berle and Means era in the context of how to make managers serve the best interests of the community at large, not themselves. The writers were seeking ways to advance the development of character and democracy in America – ways that included enhancing economic efficiency by preventing managers from squandering "society's" economic resources (Kaufman, Zacharias and Karson; 1995). Who was to say that the only or most desirable way to get economic efficiency was to have managers ultimately serve the interests of shareholders? Shareholder wealth maximization was a means to an end rather than the end itself.

Corporations were to serve more fundamental societal interests than making people rich. They existed to provide jobs, develop the citizen's personality and if not preserve, at least not hinder, the operation of democratic institutions. For the modern corporation to serve these societal objectives implied that there were benefits to having a company survive as a social organization – benefits that would be lost whether the firm disappeared for systematic or unsystematic reasons.

So, where does risk management fit into this theme? Well, risk management is a means of protecting the survival of the firm from failure due to unsystematic events. So, risk management and risk management products can be seen as developments that enable managers to serve the broader societal objectives of the modern corporation. The products and strategies do not need to be justified within the narrower and some would say "scientific" world of financial economists. In other words, managers should use risk management for more than maximizing shareholder wealth; they should use it to ensure the survival of economically viable firms so as to carry out their societal role and social responsibilities.

An interesting implication of this perspective is that governments and regulatory agencies should support the development and functioning of risk management products and markets that assist managers in carrying out these responsibilities. Such support would be consistent with viewing the corporations as an institution promoting economic efficiency within a broader set of political economy objectives".[www.stryker.com]

d) The importance of internal control and risk management

." A company's system of internal control has a key role in the management of risks that are significant to the fulfillment of its business objectives. A sound system of internal control contributes to safeguarding the shareholders' investment and the company's assets."

. Internal control facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.

. Effective financial controls, including the maintenance of proper accounting records, are an important element of internal control. They help ensure that the company is not unnecessarily exposed to avoidable financial risks and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.

. A company's objectives, its internal organization and the environment in which it operates are continually evolving and, as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed. Since profits are, in part, the reward for successful risk- taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

Groups of companies

Throughout this guidance, where reference is made to 'company' it should be taken, where applicable, as referring to the group of which the reporting company is the parent company. For groups of companies, the review of effectiveness of internal control and the report to the shareholders should be from the perspective of the group as a whole."[The Turnbull Guidance ,September 1999]

e)Maintaining a sound system of internal control

"Responsibilities

. The board of directors is responsible for the company's system of internal control. It should set appropriate policies on internal control and seek regular assurance that will enable it to satisfy itself that the system is functioning effectively. The board must further ensure that the system of internal control is effective in managing risks in the manner which it has approved.

. In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:

_ The nature and extent of the risks facing the company;

_ The extent and categories of risk which it regards as acceptable for the company to bear;

_ the likelihood of the risks concerned materializing;

_ The company's ability to reduce the incidence and impact on the business of risks that do materialize; and

_ The costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

. It is the role of management to implement board policies on risk and control. In fulfilling its responsibilities, management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board.

. All employees have some responsibility for internal control as part of their accountability for achieving objectives. They, collectively, should have the necessary knowledge, skills, information and authority to establish, operate and monitor the system of internal control. This will require an understanding of the company, its objectives, the industries and markets in which it operates, and the risks it faces.

Elements of a sound system of internal control

. An internal control system encompasses the policies, processes, tasks, behaviors and other aspects of a company that, taken together:

_ facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives.

This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed;
_ Help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organization;
_ Help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.

. A company’s system of internal control will reflect its control environment which encompasses its organizational structure. The system will include:

_ Control activities;
_ Information and communications processes;
and
_ processes for monitoring the continuing effectiveness of the system of internal control.

. The system of internal controls should:
_ be embedded in the operations of the company and form part of its
culture;
_ be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment; and
_ include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified together with details of corrective action being undertaken.

. A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgment in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances.

. "A sound system of internal control therefore provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives, or

in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen. A system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations."
[The Turnbull Guidance September 1999]

f) Reviewing the effectiveness of internal control

1-Responsibilities

." Reviewing the effectiveness of internal control is an essential part of the board's responsibilities. The board will need to form its own view on effectiveness after due and careful enquiry based on the information and assurances provided to it. Management is accountable to the board for monitoring the system of internal control and for providing assurance to the board that it has done so.

. The role of board committees in the review process, including that of the audit committee, is for the board to decide and will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the significant risks that the company faces. To the extent that designated board committees carry out, on behalf of the board, tasks that are attributed in this guidance document to the board, the results of the elevant committees' work should be reported to, and considered by, the board.
The board takes responsibility for the disclosures on internal control in
the annual report and accounts.

2-The process for reviewing effectiveness

. Effective monitoring on a continuous basis is an essential component f a sound system of internal control. The board cannot, however, rely solely on the embedded monitoring processes within the company to discharge its responsibilities. It should regularly receive and review reports on internal control. In addition, the board should undertake an annual assessment for the purposes of making its public statement on internal control to ensure that it has considered all significant aspects of Internal control for the company for the year under review and up to the date of approval of the annual report and accounts.

. The reference to ‘all controls’ in Code Provision D.2.1 should not be taken to mean that the effectiveness of every internal control (including controls designed to manage immaterial risks) should be subject to review by the board. Rather it means that, for the purposes of this guidance, internal controls considered by the board should include all types of controls including those of an operational and compliance nature, as well as internal financial controls.

. The board should define the process to be adopted for its review of The effectiveness of internal control. This should encompass both the scope and frequency of the reports it receives and reviews during the year, and also the process for its annual assessment, such that it will be provided with sound, appropriately documented, support for its statement on internal control in the company’s annual report and accounts.

. The reports from management to the board should, in relation to the Areas covered by them, provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact that they have had, could have had, or may have, on the company and the actions being taken to rectify them. It is essential that there be openness of communication by management with the board on matters relating to risk and control.

. When reviewing reports during the year, the board should:

_ consider what the significant risks are and assess how they have been identified, evaluated and managed;

_ assess the effectiveness of the related system of internal control in managing the significant risks, having regarded, in particular, to any significant failings or weaknesses in internal control that have been reported;

_ consider whether necessary actions are being taken promptly to remedy
any significant failings or weaknesses;
and
_ consider whether the findings indicate a need for more extensive monitoring of the system of internal control
. Additionally, the board should undertake an annual assessment for the purpose of making its public statement on internal control. The assessment should consider issues dealt with in reports reviewed by it during the year together with any additional information necessary to ensure that the board has taken account of all significant aspects of internal control for the company for the year under review and up to the date of approval of the annual report and accounts.
. The board's annual assessment should, in particular, consider:
_ the changes since the last annual assessment in the nature and extent of significant risks, and the company's ability to respond to changes in its business and the external environment;
_ the scope and quality of management's ongoing monitoring of risks and of the system of internal control, and, where applicable, the work of its internal audit function and other providers of assurance;
_ the extent and frequency of the communication of the results of the monitoring to the board (or board committee(s)) which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed;
_ the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material Impact on the company's financial performance or condition; and
_ the effectiveness of the company's public reporting processes.

. Should the board become aware at any time of a significant failing or weakness in internal control, it should determine how the failing or weakness arose and re-assess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.[The Turnbull Guidance, September 1999]

g) The board's statement on internal control:

"In its narrative statement of how the company has applied Code Principle D.2, the board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the company, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board and accords with the guidance in this document.

. The board may wish to provide additional information in the annual report and accounts to assist understanding of the company's risk management processes and system of internal control.

. The disclosures relating to the application of principle D.2 should include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness.
It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

. In relation to Code provision D.2.1, the board should summarize the process it (where applicable, through its committees) has applied in reviewing the effectiveness of the system of internal control. It should also disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts.

. Where a board cannot make one or more of the disclosures in the above first and last Paragraphs, it should state this fact and provide an explanation.
The Listing Rules require the board to disclose if it has failed to conduct a review of the effectiveness of the company's system of internal control.

. The board should ensure that its disclosures provide meaningful, high-level information and do not give a misleading impression.

. Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying this guidance, this should be disclosed".[The Turnbull Guidance ,September 1999]

Risk Management Solutions

“There must be several different types of Risk Management Solutions available to meet the many types of risks in an organization. Risk management solutions should allow for fully integrated and utilized efforts of all assurance providers, work units, internal and external audit, and managers, including senior management, specialty groups such as environment, safety, risk and insurance, and many others.

A specific set of risk management tools may be focused on the Sarbanes Oxley Act, for example. You can use this for the collection, storage and analysis of risk, control and performance data, organizations can achieve full realization of the business benefits of integrated assurance and audit risk management.

There is yet another type of risk management solutions classification; a database to manage risk and control governance throughout your organization. Risk management solutions that have been designed to specifically assist an organization to meet new emerging requirements related to operational risk management defined by the Basel Committee, stock exchanges and public sector oversight groups.”[www.wiley.com]

Audit Risk Management

“Audit risk management solutions are a must with the rising scrutiny for both the auditee and the auditing firm. It simply makes more sense then ever to have a solid, replicable audit process. All organizations need to continue managing costs and shortening timelines. There is a premium on conducting audits with great efficiency. If your organization faces these challenges then an audit risk management solution is the answer.

An excellent audit risk management solution is Issue Track for Lotus Notes®. This software can be used as a stand-alone tool or as a companion with AutoAudit®. This specific audit risk management tool is the only tool that automates the communication flow between auditors, audit managers and issue coordinators, making it much easier to track, post and monitor problems that occur during audits.

Powerful Paisley Solutions

Issue Track is a system that is web-enabled allowing auditors to post issues to the Issue Track website. These posted issues can be a result of an internal or external audit, or any other type of external review such as compliance or regulatory reviews. Audit Risk Management tools are essential to any organization as they allow for timely and organized methods of communications between departments in the organization. Issue coordinators for the auditee can be assigned to each issue. These coordinators have the ability to access the website and update their progress on the specific issue. Once the issue is resolved, the issue coordinators pass the issue to the responsible auditor for review and closure. Audit risk management tools are definitely essential to any organization.

AutoAudit software takes the paperwork out of work papers. It’s a comprehensive, fully integrated audit automation system that lets audit departments complete all of their work in a single database. With modules for audit risk management, planning, scheduling, work papers, reporting, issue tracking, time and expenses, quality assurance and personnel records, AutoAudit is the most complete way to update an audit department and is a must for chief risk officers or others involved in developing risk management solutions.”[www.wiley.com]

Chapter V

Corporate governance and auditing

Corporate Governance Defined

§ International Standard on Auditing (ISA) 260:
“Communications of Audit Matters with Those Charged with Governance”
§ Governance is the term used to describe the role of persons entrusted with the supervision, control, and direction of an entity.
§ Depending on the jurisdiction, different bodies may have responsibility for corporate governance:
§ Board of Directors
§ Audit Committee
§ Other supervisory committees
§ ISA 260 requires the auditor to determine those persons that are charged with governance
Benefits of Good Corporate Governance

§ Most direct benefit is to non management shareholders.
§ Ultimate benefit is the more efficient allocation of capital to its most productive uses.

Reasons for Corporate Governance Failures
§ No governance system, no matter how well designed, will fully prevent greedy, dishonest people from putting their personal interests ahead of the interests of the companies they manage.
§ But many steps can be taken to improve corporate governance and thereby reduce opportunities for accounting fraud.
§ The auditing profession has an important role to play.

Where does the auditor fit in?
§ The auditor does not have direct corporate governance responsibility but rather provides a check on the information aspects of the governance system.

Auditor’s Role in Corporate Governance
§ Corporate governance involves decision making, accountability, and monitoring.
§ Decisions require relevant and reliable information.
§ Accountability involves measuring, reporting, and transparency.
§ Monitoring involves systems and feedback.
§ Auditor’s primary role is to check whether the financial information given to investors is reliable.

Objective of an Audit
§ To express an expert opinion on the fairness with which financial statements present, in all material respects, a company’s financial position, results of operations, and cash flows in conformity with GAAP.
§ To be able to express such an opinion, the auditor must examine the financial statements and supporting records using sound auditing techniques.

Reliance on Financial Statements

§ People rely on financial statements to make economic decisions.

§ Especially people outside the enterprise.

§ Audit provides confidence.

§ Audit reduces uncertainty and risk.

§ Audit adds value.

“Present Fairly in Conformity with GAAP”

§ Why might financial statements NOT present fairly? Two main reasons:

§ ERROR.

§ FRAUD.

§ Auditor’s role is to look for misstatements caused by either reason.

Focus on Internal Controls

§ One reaction to corporate governance failures has been to focus on public companies’ internal controls:

§ Sarbanes-Oxley Act (SOX) requires separate report on effectiveness of internal controls

§ Recent changes to ISAs place a much higher focus on the auditor understanding internal controls as part of the audit

§ Both ISAs and EU 8th Directive require reporting of material internal control weaknesses to Audit Committee.

Reforms to ISAs

§ Another reaction to the audit and corporate governance failures is the expected changes to ISAs dealing with:

§ Group audits – requiring the group auditor to have a more intimate understanding of the entire group and its audit

§ Related parties – placing more responsibilities on the auditor to identify related party relationships and transactions

Auditing is a Public Responsibility

§ Public accounting firms offer many services to clients.

§ Auditing is different.

§ It involves a public responsibility that is more important than the employment

Relationship between the Board and the Auditors

§ To meet its obligations to shareholders, the board must ensure that it receives relevant and reliable information.

§ Auditor assists the board in achieving that goal.

§ There must be open and frank dialogue between the auditors and the board.

§ Auditor must be open (candid) in communicating with the board and its audit committee.

§ May have to say things the client does not want to hear.

§ May have to stand up to the client relationship with the client .it in?

Audit Matters of Governance Interest

§ SOX, EU 8th Directive and ISAs all require the auditor to communicate to the audit committee and the board about:

§ Approach, scope, limitations of the audit.

§ Going concern uncertainties.

§ Selection of and changes in accounting policies and practices.

§ Significant risks and exposures, such as litigation, requiring disclosure.

§ Disagreements with management that could affect the financial statements or audit report.

§ More communication items:

§ Audit adjustments that could significantly affect the financial statements.

§ Weaknesses in accounting and internal control systems.

§ Expected modifications to the auditor’s report.

§ Irregularities, fraud, non-compliance with law and regulations.

§ Other matters agreed in the terms of the audit engagement.

Relationship between the Board and the Auditors

§ Auditors must express, to the board, their view on the appropriateness – not just the acceptability – of the accounting principles used or proposed to be used, and on the transparency and completeness of the disclosures.

Relationship between the Audit Committee and the Auditors

§ An effective audit committee is a vital component of an effective corporate governance system:

§ The Audit Committee and the Auditors need to maintain an ongoing dialogue independent of management and the rest of the board.

Audit Committees

§ Audit committees should:

§ Include mainly non-executive directors.

§ Approve the appointment of the auditors.

§ Establish the audit fees.

§ Approve all non-audit services provided by the auditors (SOX).

§ Meet with the auditor independently of the rest of the board.

§ Review earnings releases and management's presentations to analysts.

Audit Committees

§ Audit committee members must have "financial competence":

§ Minimum – a financial background.

§ Even better – qualified accountants.

§ Better audit committee training is needed.

§ 1993 study by the Institute of Internal Auditors said this is the single most important key to audit committee effectiveness.

Regulation of Auditors

§ Regulators are increasingly taking an interest in the activities of auditors evidenced by:

§ Regulation of the relationship between the auditors and the company (independence and freedom from conflicts)

§ Public inspections of audit firms (quality control systems within the firm and

appropriateness of audit work)
§ It is imperative that the auditor is perceived to be independent of the client
§ SOX adopts a rules-driven approach setting out prohibited services and requiring pre-approval by audit committee of non-audit services
§ International Federation of Accountants (and EU 8th Directive) apply a “threats and safeguards” approach
§ Rotation of audit partners every 5 years (SOX) or 7 years (IFAC)
§ Inspection of audit firms is important to enhance public confidence in audits
§ PCAOB expected to begin inspections in Asia next year
§ Most jurisdictions currently enhancing systems of oversight and inspection.

In Conclusion
§ The cost of accounting and audit failures is immense:
§ Immense in terms of skepticism about the auditors and the companies.
§ Immense in terms of litigation against the auditors and the companies.
§ Immense in terms of the survival of the auditors and the companies.
§ Immense in terms of misallocation of capital to companies that don’t deserve it or that should be paying more for it.
§ And immense in terms of the investors and society.

a) Corporate Governance -Audit Committee Charter:

"This Charter governs the operations of the Audit Committee of the Board of Directors of Stryker Corporation (the "Committee"). The Committee shall review and reassess the adequacy of this Charter at least annually and recommend any proposed changes to the Board of Directors for approval. This Charter may be amended only by the affirmative vote of the Board of Directors.

1-Organization

The Committee shall be appointed annually by the Board of Directors upon the recommendation of the Governance and Nominating Committee and shall comprise at least three directors, each of whom has been affirmatively determined by the Board to be independent of the Company. A director shall not be considered independent if he or she (i) accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the Company or any of its subsidiaries other than in his or her capacity as a member of the Committee, the Board of Directors or any other committee of the Board, (ii) is an affiliate of the Company or any of its subsidiaries, (iii) has a material relationship with the Company or any of its subsidiaries (either directly or as a partner, shareholder or officer of an organization that has a relationship with the Company or a subsidiary and determined not merely from the standpoint of the director but also from that of any person or organization with which

the director is affiliated) that may interfere with the exercise of his or her independence from management and the Company or (iv) does not meet any other independence requirement under applicable laws, rules or stock exchange listing standards, each as in effect from time to time all Committee members shall be financially literate, as determined by the Board in its business judgment, and at least one member shall qualify as an "audit committee financial expert" as defined in rules promulgated by the Securities and Exchange Commission ("SEC").

The Board of Directors must determine, when applicable, that simultaneous service by a Board member on more than three public company audit committees does not impair the ability of such person to serve on the Audit Committee. Such determination will be disclosed in the Company's annual proxy statement.

2-Meetings

The Committee shall meet as often as it deems necessary to fulfill its responsibilities, but not less frequently than quarterly. Periodically during the year, the Committee shall meet separately with management, the internal auditors and the independent auditors to discuss issues and concerns warranting Committee attention. The Committee shall report regularly to the Board of Directors.

3-Statement of Policy

The Committee shall provide assistance to the Board of Directors in fulfilling its oversight responsibility to the shareholders, potential shareholders, the investment community and others relating to the integrity of the Company's financial statements and its financial reporting process, the Company's compliance with legal and regulatory requirements, the independent auditors' qualifications, independence and performance and the performance of the Company's internal audit function. In so doing, it is the responsibility of the Committee to maintain free and open communication among the Committee, the Board of Directors, the independent auditors, the Company's internal auditors and management of the Company.

In discharging its oversight role, the Committee is empowered to investigate any matter brought to its attention, with full access to all books, records, facilities and personnel of the Company and the independent auditor and the power to retain, at the Company's expense, independent legal, accounting and other advisers to provide advice and assistance as the Committee deems necessary or appropriate to carry out its duties.

4-Responsibilities and Processes

The primary responsibility of the Committee is to oversee the accounting and financial reporting processes of the Company and the audits and reviews of the financial statements of the Company and to report to the Board with respect thereto. While the Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Committee to plan or conduct audits or to determine that the Company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. Management is responsible for preparing the Company's financial statements and the independent auditors are responsible for auditing the Company's annual financial statements and for reviewing the Company's interim unaudited financial statements. The Committee shall take appropriate action to set the overall corporate "tone" for quality financial reporting, sound business risk practices and ethical behavior.

The Committee in carrying out its responsibilities believes its policies and procedures should remain flexible, in order to best react to changing conditions and circumstances. The following shall be the principal duties and responsibilities of the Committee and are set forth as a guide, with the understanding that the Committee may supplement them as appropriate"[www.stryker.com]

b) Relationship with the Company's Independent Auditors

"• The Committee shall be directly responsible for the appointment, retention and oversight of the work of the firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services, which firm or firms shall report directly to the Committee, and for the determination of the compensation to be paid by the Company for such services.

• The Committee shall evaluate the qualifications, performance and independence of the independent auditors (after receipt of the written disclosures and letter required by Independence Standards Board Standard No. 1 from the independent auditors confirming the professional judgment of the independent auditors that the firm is independent of the Company).

• The Committee shall pre-approve all audit and non-audit services to be provided by the independent auditors (other than non-audit services that satisfy an exception provided by applicable law) and, in the case of non-audit services, provide for the disclosure of such approval as required by SEC regulations. The independent auditors shall not be engaged to perform any non-audit service proscribed by law or regulation. The independent auditors shall not be engaged to provide any permitted non-audit service unless it is affirmatively determined that performing such service is compatible with maintaining the independent auditors' independence. The Committee may delegate pre-approval authority to a member of the Committee. The decisions of any Committee member to whom pre-approval authority is delegated must be presented to the full Committee at its next scheduled meeting.

• At least annually, the Committee shall obtain and review a report by the independent auditors that describes:
• The independent auditors' internal quality control procedures;
• Any material issues raised by the most recent internal quality control review, or peer

review, of the independent auditor, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to one or more audits carried out by the independent auditor and the steps taken to deal with any such issues; and

• All relationships between the independent auditors and the Company (in order to assess independence).

• The Committee shall evaluate the partner of the independent auditors who has primary responsibility for the audit, taking into account the opinions of the Company's management and its internal auditors, and shall ensure that such lead partner and the reviewing partner are rotated at least every five years.

• The Committee shall set clear hiring policies for employees or former employees of the independent auditors that meet applicable SEC regulations and stock exchange listing standards. "[www.stryker.com]

***c*) Oversight Responsibilities**

"• The Committee shall discuss with the independent auditors the overall scope and plans for the audit, including the adequacy of staffing, and the estimated fees.

• The Committee shall discuss with the Vice President, Internal Audit the responsibilities, budget and staffing of the internal audit function and the planned scope of internal audits and any significant changes therein and review summaries of the reports issued by the internal audit function, together with management's responses and follow-up to such reports.

• The Committee shall discuss with management, the Vice President, Internal Audit and the independent auditors the adequacy and effectiveness of the accounting and financial controls, and special audit steps adopted in light of any material control deficiencies that could significantly affect the Company's financial statements.

• The Committee shall review with the independent auditors any audit problem or difficulty encountered in the course of the audit work, including any restriction on the scope of activities or access to required information, and any significant disagreement with management.

• The Committee shall resolve disagreements between management and the independent auditor regarding.

Financial reporting

• The Committee shall receive regular reports from the independent auditors regarding the critical accounting policies and practices used by the Company and the alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, the ramifications of the use of such alternative treatments and the treatment preferred by the independent auditors.

• The Committee shall review any management or internal control letter or schedule of unadjusted differences and other material written communications between the independent auditors and management.

• The Committee shall review and discuss with management the Company's policies and practices with respect to risk assessment and risk management, including the guidelines and policies that govern the assessment and management of the Company's exposure to risk, including with regard to foreign exchange, interest rates, investments and derivatives, and discuss with management the Company's major risk exposures and the steps management has taken to assess, monitor and control such exposures.

• The Committee shall review matters that have come to the attention of the Committee, through reports of management, legal counsel and others, that relate to the status of compliance and anticipated future compliance with laws and regulations, internal policies and controls and that could be material to the Company's financial statements.

• The Committee shall review with management and the independent auditors the potential effect of regulatory and accounting initiatives on the Company's financial statements."[www.stryker.com]

d) Review of Periodic Statements and Disclosures

"• The Committee shall review management's certifications of disclosure controls and procedures and internal control over financial reporting as of the end of each fiscal quarter and at year end and, in the case of the report of management as of year end, the required report of management and attestation of the independent auditors regarding management's evaluation of the internal control over financial reporting.

• The Committee shall review analyses prepared by management and the independent auditors of significant accounting and financial reporting issues and judgments made in connection with the preparation of the Company's financial statements and its financial reporting generally, including an analysis of any significant changes in the Company's selection or application of accounting principles, the critical accounting policies and practices used, off-balance sheet financial structures and the use of non-GAAP financial measures.

• The Committee shall review and discuss with management the policies with respect to earnings press releases, as well as the financial information and earnings guidance to be provided to analysts and rating agencies. Such review may be done generally (consisting of reviewing the types of information to be disclosed and the types of presentations to be made) and need not be in connection with each earnings release or each instance in which the Company provides earnings guidance.

• The Committee shall discuss the results of the annual audit and any other matters required to be communicated to the Committee by the independent auditors under generally accepted auditing standards, including the matters required to be discussed by Statement on Auditing Standards No. 61, as amended by Statement on Auditing Standards Nos. 89 and 90, relating to the conduct of the audit.

• The Committee shall review and discuss with management and the independent auditors the audited financial statements and the disclosures under Management's

Discussion and Analysis of Financial Condition and Results of Operations, and recommend to the Board of Directors that such financial statements and disclosures be included in the Company's Annual Report on Form 10-K (or the annual report to shareholders if distributed prior to the filing of Form 10-K).

• The Committee shall prepare its report to be included in the Company's annual proxy statement, as required by SEC regulations.

• The Committee shall discuss the results of the quarterly review and any other matters required to be communicated to the Committee by the independent auditors under generally accepted auditing standards.

• The Committee shall review and discuss the interim financial statements and the disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations with management and the independent auditors prior to the filing of the 10K." [www.stryker.com]

e) Other Activities:
Company's Quarterly Report on Form 10K

"• The Committee shall review reports from management, including the General Counsel and the Company's Vice President, Internal Audit, regarding compliance with the Company's policies and procedures to assess and monitor its legal and ethical compliance programs. The Committee shall advise the Board with respect to the Company's policies and procedures regarding compliance with applicable laws and regulations and with the Company's Code of Conduct and Code of Ethics.

• The Committee shall establish procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters that provide protection to an employee who reports such information.

• The Committee shall perform an evaluation of its performance at least annually to determine whether it is functioning effectively."[www.stryker.cm]

Conclusion

In this thesis we have shown that corporate governance is a set of elements and processes that contribute in improving the companies performance, such as, accountability, transparency and disclosures , risk management and auditing.

So the Companies that have strong governance processes in place are more capable of attracting investors, winning public confidence, and building organizations that will enhance shareholder value. By identifying and prioritizing compliance-related risks that require management and control — and then establishing governance processes that integrate their GRC (governance, risk, and compliance) activities, companies are more efficient, compliant, and legally sound.

Perhaps the most important initiative for ensuring strong governance and compliance processes is a company's success in establishing an ethical "tone at the top" that permeates the entire organization. When executive leadership and Boards of Directors manifest ethical behavior, live according to scrupulous principles, and demand nothing less from employees, they effectively establish ethics and integrity as a vital part of the corporate culture and employees at all levels are more likely to embrace those values.

And, ultimately, the values that lie at the heart of a company's decision-making processes determine how it operates in good times, but, more importantly, in times of difficulty or uncertainty.