UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

SELECTED ISSUES IN CORPORATE GOVERNANCE:

REGIONAL AND COUNTRY EXPERIENCES

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Introduction

The United Nations Economic and Social Council established the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) as a standing Group of Experts in 1982. During the past two decades ISAR has examined a number of issues and has contributed towards greater transparency and disclosure in the field of accounting. ISAR’s annual sessions have provided an inclusive forum where experts from developed and developing countries as well as countries with economies in transition can discuss timely issues and exchange experiences, in this area.

The topic of corporate governance was put on ISAR's agenda after UNCTAD's tenth quadrennial conference (in Bangkok in February 2000), where member States requested UNCTAD to promote, among other things, better corporate governance practices. The Group of Experts conducted a preliminary consideration of the topic at its eighteenth session in Geneva in September 2001. At that session ISAR reviewed existing corporate governance practices and country, regional and company codes and principles. The Group agreed to continue its consideration of the subject at its nineteenth session.

Immediately after the eighteenth session, on 13–14 September 2001, the UNCTAD secretariat organized a two-day workshop on corporate governance. Over 80 participants from all regions of the world participated. Several panels examined the issue of corporate governance from various perspectives, including those of national and regional policy makers, regulators, the investing community, members of boards of directors, and others.

The forum provided participants with opportunities to exchange experiences, identify best practices, and discuss ideas for further work on the issue by the ISAR Group. This publication is a collection of articles written by the panellists based on their presentations at the workshop. The first section presents selected issues in corporate governance, including competency and training for boards of directors. The second section includes articles on regional and country experiences in corporate governance.

UNCTAD is grateful to all participants and panellists who contributed to the success of the workshop on corporate governance. Particular gratitude is owed to Shyam Khemani, resource person at the eighteenth session of ISAR and facilitator at the workshop; Geoffrey Bowes (Commonwealth Association of Corporate Governance); Nick Bradley (Standard and Poor's, London); Nelson Carvalho (Brazil); Yugui Chen (Peoples' Republic of China); Anwaruddin Chowdhury (Bangladesh); Susela Devi (Malaysia); Farouk El-Kharouf (Arab Bank Plc. Geneva); Ndung'u Gathinji (ECSAFA); Michael Gillibrand (Commonwealth Corporate Governance Network); Leo Goldschmidt (European Association of Securities Dealers); Amaro Gomes (Banco Central do Brasil); Peter Johnston (IFAC); Paul Lee (Hermes Investment Management Ltd., London); Kaspar Mueller (Swiss Association of Securities Analysts); Ralph Nash (Basel Committee on Banking Supervision); Shirley Reilly (CGA Canada and IFAC); Tony Renton (Institute of Directors, United Kingdom); John Rieger (OECD); Christian Strenger (Commission on Corporate Governance, Government of Germany); Dominique Thienpont (European

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Part I. Selected Issues in Corporate Governance

The Relationship between Corporate Governance, Transparency and Financial Disclosure

Chris Mallin*

Introduction

Corporate governance has evolved and grown significantly in the last decade. Numerous countries have issued corporate governance codes, and the recommendations of these codes, that typify "good" corporate governance, undoubtedly contribute towards increased transparency and disclosure.

There are actually many different definitions of corporate governance but they all address the following elements:

- systems of controls within the company
- relationships between the company's board/shareholders/stakeholders
- the company being managed in the interests of the shareholders (stakeholders)
- greater transparency and accountability to enable users of corporate information to determine whether the business is being managed in a way that they consider appropriate

The following definitions illustrate that, while definitions vary, the same fundamental ideas are present:

- Cadbury (1992): "the whole system of controls, both financial and otherwise, by which a company is directed and controlled."
- OECD (1998a): "A set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance are determined."
- Shleifer and Vishny (1997): "The ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."

Corporate governance can be viewed from an ***agency perspective***. As long ago as 1932, Berle and Means published *The Modern Corporation and Private Property* in the United States. This seminal work highlighted some of the problems that can occur when ownership of a corporation is separated from control of the

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corporation. For example, how do the suppliers of financing make sure that managers do not steal the capital they supply or invest it in bad projects? How do the suppliers try to ensure that the directors do not become too powerful, or use their power in ways that are not in the best interests of the corporation?

Shareholder composition varies tremendously across the world. In the United Kingdom and the United States institutional investors have become very important over the last 30 years as their share ownership has increased and they have become more active in their ownership role. Institutional investors tend to have a ***fiduciary responsibility***, the responsibility to act in the best interests of a third party (generally the beneficial, or ultimate owners of the shares). Until recently, this responsibility tended to concentrate on ensuring that the investors invest in companies that not only were profitable but would continue to be so. While this remains the case, Governments and interest groups have raised the question of how these profits are achieved. Institutional investors today are much more concerned about the internal governance of the company and also the company's relationship with other stakeholder groups.

While institutional investors are prevalent in the shareholder base of many countries, many companies across the world do not have a predominance of institutional shareholders in their structures. Some are family-owned, while others are owned by the State. Yet corporate governance is still very important for these companies. Why? Because corporate governance is fundamental to well-run companies that have controls in place to ensure that individuals or groups connected with the company do not adversely influence the company and its activities and that assets or profits are not used for the benefit of a select group to the disadvantage of the majority. Also, independent non-executive (outside) directors are key to bringing new insights to the business and helping with its development.

With the internationalization of cross-border portfolios, and the financial crises that have occurred in many parts of the world, it is perhaps not surprising that institutional investors in particular increasingly look more carefully at the corporate governance of companies. After all, corporate governance goes hand in hand with increased transparency and accountability. This increased transparency and accountability should, of itself, lead to a better flow of foreign direct investment (FDI) and more stable financial markets.

Drivers of improved corporate governance

Several key factors are behind the move to improved corporate governance:

- Collapses of prominent businesses, both in the financial and non-financial sectors, such as Polly Peck, BCCI and later Baring, have led to more emphasis on controls (e.g. to safeguard assets etc).
- Changing patterns of share ownership, particularly in the United States and United Kingdom, have led to a greater concentration of share ownership in the hands of institutional investors, such as pension funds and insurance companies. In the United Kingdom, for example, institutional investors own between 65 per cent and 75 per cent of the

United Kingdom stock market. In the United States, the figure is lower, but institutional investors are very powerful in absolute terms.

- Institutional investors are increasingly seeking to diversify their portfolios and invest overseas. They then look for reassurances that their investment will be protected.
- With technological advances in communications and markets generally, ideas can be disseminated more widely and more quickly, and institutional investors globally are talking to each other more and forming common views on key aspects of investment such as corporate governance.
- With businesses as diverse as family-owned firms and state-owned enterprises increasingly seeking external funds, whether from domestic or international sources, corporate governance assumes a greater role in helping to provide confidence in those companies and hence to obtain external funding at the lowest possible cost.
- Finally, within a country (as opposed to a company or private business), good corporate governance helps to engender confidence in the stock market and hence in the economic environment as a whole, creating a more attractive environment for investment.

Some landmarks in corporate governance

The Cadbury Report

The report of the United Kingdom Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, former chairman of Cadbury Schweppes and a director of the Bank of England, was published in 1992 (Cadbury 2002). The recommendations of the Cadbury Report influenced the development of corporate governance not just in the United Kingdom, but in many other countries, including Russia and India.

- Companies should establish key board committees covering *audit* (composed of non-executive directors, responsible to the board); *remuneration* (responsible to the board for recommending remuneration of directors; *nomination* (a formal and transparent procedure for the appointment of new directors to the board);
- There should be at least three independent non-executive directors.
- The board should include a balance of executives and non-executive directors, so that no individual can dominate the board's decision making.
- There should be separation between the roles of chair (responsible for running the board) and the chief executive officer responsible for running the business).

The OECD Principles

The Organization for Economic Cooperation and Development (OECD), in publishing its elements of corporate governance, took into account the views of many different countries on the subject of what constitutes good corporate governance.

The OECD states "The primary role for regulation is to shape a corporate governance environment compatible with societal values that allows competition and market forces to work so that corporations can succeed in generating long-term economic gain. Specific governance structures or practices will not necessarily fit all companies at all times" (OECD 1998a).

The OECD identifies the following key elements of good corporate governance:

- The rights and obligations of shareholders
- Equitable treatment of shareholders
- The role of stakeholders and corporate governance
- Transparency, disclosure of information and audit
- The board of directors
- Non-executive members of the board
- Executive management, compensation and performance

Each of these is discussed in more detail below.

The rights and obligations of shareholders

- A corporate governance framework should protect shareholder rights. It should ensure that there is one vote for one share. It should ensure that management provides sufficient and relevant information. It should encourage shareholders to participate in annual general meetings and vote. Shareholders should be able to share in residual profit (dividends). Minority shareholders should be protected. It should ensure fairness and transparency in the operations of the company.
- Obligations: use voting rights.

Equitable treatment of shareholders

- A corporate governance framework should ensure equitable treatment of all shareholders, including minority and foreign shareholders;
- Same voting rights (within same class of shares etc);
- All shareholders of same class should be treated equally.

The role of stakeholders in corporate governance

- A corporate governance framework should ensure that the rights of stakeholders are protected by law and that these rights are respected.
- It should provide effective redress for violation of rights.
- It should encourage stakeholders to assume a role in the corporation that enhances the performance of the corporation and the market;
- It should provide for disclosure of information relevant to the interests of stakeholders.

Transparency, disclosure of information and audit

- A corporate governance framework should ensure the full, timely and detailed disclosure of information on all material matters, including the company's financial situation, performance, ownership structure and governance.
- It should include the establishment of an (internal) audit committee.
- Transparency/disclosure includes disclosure of information on:

    - financial/operating results
    - ownership structure
    - members of the board of directors and management
    - quantitative and qualitative matters concerning employees and other stakeholders in the corporation
    - governance structures and policies
    - corporate targets and prospects
    - execution of unusual and complex transactions, transactions including derivative products and their level of risk

The board of directors

- A corporate governance framework should ensure the strategic leadership of the corporation, the efficient monitoring of management by the board of directors.
- Accountability of board to its corporation and shareholders.
- Meetings, for example one a month; process; Chair/CEO (separation of duties and responsibilities) etc.

Non-executive members of the board

- These members should form independent judgements, especially with respect to the corporation's strategy, performance, asset management and management appointments;
- Non-executive members should be independent from executive members of board (e.g. family members should not be admitted) and should not have a business relationship with the corporation or any other commercial involvement that may affect their independent judgment
- Interlocking directorships should be avoided.

Executive management, compensation and performance

- Management compensation should be tied to the corporation's general level of profitability and overall performance.
- Total compensation should be disclosed in financial statements.
- Procedures for determining compensation should be disclosed.
- A remuneration committee (or review committee) should be established.

The OECD, in "*Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*" (1998b), highlights the importance of transparency and disclosure: "The disclosure of the corporation's contractual and governance structures may reduce uncertainties for investors and help lower capital costs by decreasing related risk premia. Such transparency may also encourage a common understanding of the 'rules of the game', and provide employees with information that may help reduce labour friction."

The value of good corporate governance

Many institutional investors perceive corporate governance as a tool for extracting value for shareholders from under-performing, undervalued companies. This approach has been very successful for Lens Inc., California Public Employees' Retirement System (CalPERS), Hermes and Active Value Advisors, to name but a few. Targeting companies that are under performing according to one of the main market indices, and analysing those companies' corporate governance practices, can lead to improvements that unlock a company's hidden value. These improvements often include replacing poorly performing directors and ensuring that the companies comply with perceived best practice in corporate governance.

Corporate governance can also be used to help restore investor confidence in markets that have experienced financial crises. This has happened in the last few years in Japan, Malaysia and the Russian Federation, for example. In these countries, as in a number of other countries that have similarly been affected by a lack of investor confidence, particularly overseas investor confidence, new or improved corporate governance practices have been introduced. Key features of these changes include improving transparency and accountability.

While many studies have examined the possible link between corporate governance and corporate performance, the evidence appears to be fairly mixed.

In an early, much-quoted study, Nesbitt (1994) reported positive long-term stock price returns for firms targeted by CalPERS. Nesbitt's later studies show similar findings. More recently, Millstein and MacAvoy (1998) studied 154 largely publicly traded United States corporations over a five-year period and found that corporations with active and independent boards appeared to perform much better in the 1990s than those with passive, non-independent boards. However the work of Dalton, Daily, Ellstrand and Johnson (1998) showed that board composition had virtually no effect on firm performance, and that there was no relationship between leadership structure and firm performance. Patterson (2000) of The Conference Board produced a comprehensive review of the literature relating to the link between corporate governance and performance, and states that the survey does not present conclusive evidence of such a link.

Given that there is no conclusive evidence of a link between corporate governance and corporate performance, why does there seem to be a widely held perception that corporate governance can make a difference to the bottom line?

This question is partly answered by the findings of the McKinsey (2000) Investor Opinion Survey. This survey of institutional investors found that the

majority of investors were prepared to pay a premium to invest in a company with good corporate governance. The survey states that "good" governance in relation to board practices includes a majority of outside directors who are truly independent; significant director stock ownership and stock-based compensation; formal director evaluations; and responsiveness to shareholder requests for governance information.

The survey states that policy makers wishing to attract more foreign investors should also play their part, as companies cannot alone produce the magnitude of change that is necessary, particularly in emerging markets. Improving disclosure of information and strengthening shareholder rights are mentioned as appropriate target areas for policymakers. The findings indicate that investors would pay 18 per cent more for the shares of a well governed United Kingdom or United States company than for the shares of a company with similar financial performance but poor governance practices. This premium rises to 22 per cent for a well-governed Italian company and 27 per cent for a well-governed Colombian company. Investors perceive corporate governance as important, and this perception leads to the willingness to pay a premium for good corporate governance.

The McKinsey Emerging Market Investor Opinion Survey (2001) showed that respondents (in this case private equity investors invested in a range of emerging market countries in Asia, Eastern Europe and Latin America, and managing approximately US$4.1 billion in these regions) considered greater transparency the most important corporate reform in emerging markets.

In short, without good corporate governance, both corporate performance and the investor’s money may be at risk. While the evidence, both academic and practitioner-based, on balance suggests that good corporate governance helps realize value and create competitive advantage, this is more of an intuition, as the studies are trying to single out corporate governance variables that may affect performance, which is very difficult to do. However, shareholder activism is the key to ensuring good corporate governance and without this there is less accountability and transparency, and hence more opportunity for management to engage in activities that may negatively affect the bottom line

Corporate governance rating systems

With increasing emphasis on corporate governance across the globe, it is perhaps not surprising that a number of corporate governance rating systems have been developed. Two firms that have developed such systems are Deminor and Standard & Poor’s. The rating systems cover several markets: for example, Deminor has tended to concentrate on European companies, while Standard & Poor’s has used its corporate governance rating system in quite different markets, such as the Russian Federation. These corporate governance rating systems should benefit both investors (both potential and current ones) as well as the companies themselves.

Deminor's corporate governance ratings are based on four main categories in which each company receives a rating from 5 to 1, with 5 representing best practice and 1 the most questionable standard. The categories are:

- rights and duties of shareholders
- absence of takeover defences
- disclosure
- board structure.

The *disclosure* category looks at the transparency of a corporation as measured by the quantity and quality of the publicly available information on the governance structure. Deminor state that "information to shareholders is one of the most important aspects of corporate governance, as it reflects the degree of transparency and accountability of the corporation towards its shareholders".

The Standard and Poor's system awards scores from 10 (highest) to 1 (lowest) in four categories that together form the overall corporate governance score (for further details see the article by Nick Bradley in this chapter). The individual components are:

- ownership structure and influence
- financial stakeholder relations
- financial transparency and information disclosure
- board management structure and process.

In relation to *financial transparency and information disclosure*, the criteria examined are the type of public disclosure standards adopted; the timing of, and access to, public disclosure; and the independence and standing of the auditor.

Other corporate governance ratings systems such as Governance Metrics (of which Steve Davis is co-founder) and the Corporate Library's Board Analyst service, are currently being developed and finalized for launch. The latter service will assign boards grades of A through F. Interestingly, accounting issues will be overweighted in the analysis, so that companies with a history of special charges or poor audit practices will receive a low grade.

An appropriate approach for a corporate governance rating system could be as follows: First, produce a rating of the corporate governance in a given country. For example, how transparent are accounting and reporting practices in the country? Are there corporate governance practices in place? Is there a code of best practice? To what extent is that code complied with, and what sanctions are imposed on companies that do not comply? Once the country rating is completed individual companies can be rated. The ratings would generally be based on the companies' approach to the rights of shareholders; the presence of independent non-executive (outside) directors; the effectiveness of the board; and the accountability and transparency of the company. Corporate governance rankings of companies in, for example, the banking sector can be assessed both within a country and also across countries, providing a valuable additional benchmark for investors.

The ratings will also help Governments identify the perceived quality of corporate governance in their country compared to other countries in their region, or in other regions, whose companies may be competing for limited foreign investment. In emerging-market countries in particular, companies with a corporate governance infrastructure will, other things being equal, be less subject to cronyism and its effects on corporate wealth. These companies tend to be more transparent and accountable,

and hence more attractive to foreign investors. A desire for improved transparency and accountability to help ensure that companies are perceived as attractive investments has led to significant corporate governance reform in countries as diverse as Greece, Hong Kong (China), Japan, Malaysia and Poland.

Overall, corporate governance rating systems should provide a useful indication of the corporate governance environment in specific countries, and in individual companies within those countries. Such systems provide a useful benchmark for the majority of investors and stakeholders who identify good corporate governance with a well-run and well-managed company.

Conclusion

While "no single universal model of corporate governance exists nor is there a static, final structure in corporate governance that every country or enterprise should emulate" (Commonwealth Association for Corporate Governance, 2000), transparency and disclosure are key attributes of any model of good corporate governance.

Surveys of investor opinion highlight the importance of transparency and disclosure in a good corporate governance system. Additionally, the corporate governance ratings systems discussed in this paper all include disclosure and transparency as core attributes of good corporate governance and rightly so. Without transparency and disclosure, shareholders and stakeholders would not be able to assess how the company was being managed, and hence no meaningful accountability would exist.

It is appropriate to conclude this paper with a quote from Arthur Levitt who sums up the importance of the relationship between good corporate governance, transparency and disclosure, and the impact on FDI and economic growth if these attributes are lacking (from his remarks at a conference sponsored by the Federal Reserve Bank of New York, December 2000);

"If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be suffer the consequences."

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The Need for and Value of Good Governance: An Institutional Investor's View

Paul Lee*

Introduction

Research is increasingly showing that good corporate governance can lead to improved share price performance. What's more, the evidence is that the potential for out performance is greatest in developing economies. Studies also show that investors are keener to invest in well-governed companies. Therefore, developing economies can receive a substantial boost from the additional investment and economic performance that good corporate governance can bring. Thus corporate governance can be a powerful development tool.

This article explores what Hermes means by good corporate governance and in what areas we believe that UNCTAD's ISAR can best help countries to unlock this value. Hermes tends to be quicker to speak publicly than most institutions, but we are in touch with a large number of major investors in the United Kingdom and across the world, and we believe that our views are largely representative.

It may be worthwhile to start with a brief introduction to Hermes Investment Management so that readers can understand the background to our stance. Hermes is owned by, and is the principal fund manager for, the British Telecom (BT) Pension Scheme, the United Kingdom's largest. Hermes also manages portfolios for the Post Office Pension Plan and a number of other major corporate and public pension schemes. In total, Hermes manages over €75 billion, representing equity investments in over 3000 companies worldwide.

Though Hermes does run a number of actively managed portfolios, the bulk of the funds that Hermes manages are passive, index-tracking mandates. This means that it invests equally across the range of companies in a broadly based index the FTSE Euro top 350, for example – and does not trade unless there are changes in the constituents of the index or it faces cash flows into or out of its funds. Though we tend to be passive investors, we are active in our relationships with the companies in which we invest. Indeed, we regard this as a natural consequence of being passive investors: because we cannot sell our holdings, if we believe there are problems at an investee company, we must engage directly with the company to clear up those issues.

This shareholder involvement is only logical: our clients, as shareholders, are part owners of the companies. They, as owners, employ the management to run the business as their agents (economic theory calls this area the "agency problem"). Inevitably, conflicts of interest will arise for the management in this situation. For example, it may be tempted to enter into a major acquisition that may add little value

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for shareholders but might be in management's interests by raising its prestige or protecting it from the threat of a hostile takeover. The clearest area where the conflict of interest arises is in executive remuneration, where shareholders' money is passed directly to the management. To regulate these conflicts of interest, there need to be checks and balances to ensure that shareholders' interests are protected. These checks and balances are the foundations of corporate governance.

The bedrock of our thinking is that shareholders are long-term owners of businesses. The major institutions hold money on behalf of pensioners and other individuals investing for the long term. Given their scale and the prevalence of index tracking, institutions will continue to be invested in most companies over that same long time period. Consequently, they need to act as stewards of those companies, ensuring their long-term success rather than having the very short-term perspective that is normally associated with investment.

Building on its heritage of active engagement with United Kingdom companies, Hermes has in recent years begun to export its skills and experience to the global jurisdictions where its clients are invested. Our experience has helped us to identify factors, that indicate whether a company is well run and will tend to promote (and protect) value for all shareholders. They are outlined in our latest United Kingdom Statement on Corporate Governance and Voting Policy, which is supplemented by our statement on International Corporate Governance Principles supplements this. Both are available at *www.hermes.co.uk/corporate-governance/site/statements.htm.*

These documents build on the governance principles of the OECD. They are not intended as an imposition of our views, but rather to help companies understand what we and other institutional investors regard as best practice. We welcome robust debate on the issues covered and will always listen to whatever reasons companies may have for not attaining the standards; our policies are always applied pragmatically, responding to the particular circumstances of the company in question. There are general standards, but we are always keen to understand companies better to see which standards are or are not relevant to them. Furthermore, the standards are ideals to be worked towards, not something we expect to see achieved overnight.

In short, the key aspects of the Hermes corporate governance approach are:

- Communications and disclosure
- Voting rights and minority shareholder protection
- Non-executive/outside directors
- Remuneration
- Strategic and operational focus
- Companies and their stakeholders

The rest of this article explores each of these areas in more detail, with an emphasis on disclosure and other areas that fall squarely within the remit of UNCTAD-ISAR.

Communication and disclosure

A company that is honest and direct with its shareowners inspires their confidence. By building such trust, companies can be assured of the continued support of their investors. In contrast, their shareholders will not trust companies that engage in non-transparent or related-party transactions or do not disclose market-sensitive information promptly. Such companies will therefore not be valued as highly as their more transparent rivals, and they will find it harder to raise additional funds and may open themselves to hostile takeovers.

To take an example: The Russian gas utility, Gasport, has had commercial dealings with what the *Economist* called "its mysterious Florida-based partner company", Itera, which some investors have complained were not on full commercial terms. To Hermes, it is no wonder that Gazprom trades at a tiny fraction to the value of its reserves and at a huge discount to other energy companies. We have welcomed the steps that the company has recently taken to introduce more independent board members and clarify its opaque activities. These changes have been inspired and encouraged by shareowner action in Russia, which, despite the absence of real shareholder influence over the company, has succeeded by embarrassing the Government into intervening. We look forward to future developments that will serve to further change investors' perceptions of the company and lead to a revaluation of its shares.

A key feature of disclosure is a genuinely independent audit of a company's accounts. Repeated experience in developed economies shows loss of investor confidence in the company when the accounts are unexpectedly restated. For example in the case of Enron, auditors decided to change the way they had classified certain related-party transactions. As a result of these changes, investors lost confidence in the company to such a degree that Enron collapsed into bankruptcy.

Usually the results are not so dramatic, but even so, doubt regarding transactions or the independence of the audit can have a corrosive effect on shareowner confidence and so share valuations. Being able to rely on the accounts produced by a company is a fundamental requirement of minority shareholders. The published accounts are their main insight into a company's financial position and provide basic data on the health of existing investments. They also provide a valuable guide to management's ability to generate an adequate return on the funds available to them, and therefore to the decision whether to make and maintain an investment. Minority shareholders need to be able to rely on the accuracy and independence of published accounts and that is why public companies are required to have their accounts audited by an independent professional firm.

Some have argued that these failures demonstrate that audit firms should not provide any other services for their audit clients. There are, after all, many cases where commentators have suggested that the auditors' views may have been clouded by the substantial additional fees the non-audit work generates frequently 10 times the audit fee, or even more. However, Hermes does not subscribe to this argument. For one thing, if auditors could not provide other services, the auditing profession might become a very dull one. For another, there are certain areas of work which it is only sensible (and a good deal cheaper) for the auditors to perform, such as providing tax

advice or doing preparatory work for the mergers and acquisitions. Furthermore, a blanket ban on non-audit work should not be necessary: the independence of the audit can and should be ensured by the company's audit committee.

The audit committee should, in our view, be a formally constituted board subcommittee. Its members should all be non-executive, and the majority shall be fully independent of the executive team, as will be discussed later on in this article. Executives may be invited to attend the committee, but this should not be a regular occurrence, and they certainly should not be members of the committee. Only in this way can the audit committee genuinely act independently of the executive team and so provide shareholders with the assurance that the audit is genuinely as thorough and independent as it needs to be. We believe that to properly fit into and play its full part in the audit process, the audit committee should meet at least three times a year.

The role of this genuinely independent and active audit committee should be to provide shareholders with the formal assurance that the auditors are fully independent. A full report from the committee should be included in the company's annual report to shareholders. It should provide full disclosure of the audit and non-audit fees paid to the auditors, with those audit fees broken down by the various areas of work. This will allow the shareholders to see if there is any danger of a financial interest hampering the independence of the audit. The company should also disclose its policy on awarding non-audit work to the auditors and the financial threshold above which the award of any such work must formally be justified to the audit committee. The committee should finish its report to shareholders with the assurance to shareholders that, having considered all the relevant factors and discussed the issue with the audit partner and his or her colleagues, it considers the auditing firm to be fully independent of company management, and therefore the audit itself to be an independent one.

There is other information that a company should disclose in its annual report. In addition, to create a liquid and informed market in the company's shares, any changes in such information should promptly be publicly and fully disclosed. Such information includes the names and holdings of major shareholders. "Major" is sometimes difficult to define; in the United Kingdom it means 3 per cent or more; in much of continental Europe it is 5 per cent this level would probably be reasonable in most jurisdictions), and any changes in those levels; the shareholdings of the directors, and any trading that they do; and the names of the company's principal advisers bankers, auditors, lawyers, brokers, etc. and any changes in these. This information will allow investors to understand the company better and recognize danger signals as soon as they appear.

Voting rights

Voting rights are largely controlled by national law, but there are things that companies can do to maximize the rights of their shareholders, and to disclose to them useful information. Of course, we believe that companies should not lobby against changes to the law which would protect and ensure the voting rights of shareholders.

To the greatest extent possible within their nation's law, companies should ensure that each share carries equal voting rights. We believe that all votes should be on a poll according to the number of shares held rather than on a show of hands at the actual meeting. Companies should also use the full extent of the law to enable voting by shareholders who would find it prohibitively expensive to attend the meeting in person. We and other major institutional investors are currently in effect prevented from voting at companies in one country because they require us to physically carry our share certificates to the meeting. The cost of the armoured car that would be necessary to carry all the relevant paperwork to the meeting (not to mention the travel costs for individual employees) makes this prohibitive. Where possible, companies should avoid disenfranchising their shareholders with such requirements.

In the same way, companies should avoid disenfranchising shareowners who hold their shares through more complex ownership structures such as depositary receipts. In a survey of the rules related to American Depositary Receipts (ADRs), I found that these depositary agreements act in many subtle ways to limit the voting and other rights of investors. Companies and their depositaries between them write the depositary agreements, so it is within the power of companies to ensure that shareowners are enabled to participate fully in the activities of the companies of which they are financially the owners.

One important area of disclosure in relation to voting that affects the participation of all shareholders is that voting levels (though not how particular shareholders voted) should be disclosed, perhaps in the next annual report. This enables investors to assess the views and concerns of their fellow shareholders. It should also ensure that companies do not become dismissive of shareholder discontent which may be substantial without having yet reached the level at which it amounts to a vote against management.

Protection of minority shareholders

The protection of minority shareholders, too, is again an area affected more by national legislation than by the actions of individual companies. Areas where we believe national law should protect minorities include, a first of all, pre-emption rights (ensuring that existing shareholders have the first right to invest in any new issue of shares, so that their ownership is not diluted without their own consent). Also, no shares should be issued at undervalue; minorities should be treated equally in takeovers; and, where the audit has failed to ensure full information to shareholders, the auditor should be potentially liable for damages to those who have suffered loss as a result.

While much of this is determined by national legislators, one area namely, that of related-party transactions can bee controlled by companies themselves. In many countries, deals above a *de minimis* level with organizations linked to the company, its major shareholders or its directors, may not go ahead until approval has been received from independent shareholders. Even where the law does not require this, companies can inspire a great deal of shareholder confidence by presenting any such transactions to shareholders for approval, or pledging to do so. This avoids the kind of loss of confidence that South Korea's Samsung suffered last year when it bought a number of

apparently failing Internet businesses from the heir to the company's dominant family without consulting other investors.

Non-executive/outside directors

It is fundamentally important, in our view, for each director to be seen as fully accountable to all shareholders. While this situation is usually enshrined in law, there is a very simple way of demonstrating it in practice that companies should adopt, whether or not the law and their rules require it. Namely, every director should regularly have to face re-election and so seek shareholder approval for his or her continued role at the company. We find it hard to understand how provisions insulating board members from re-election by shareowners can ever be justified.

To enable shareholders to cast fully informed votes, and to enable them to be properly informed about their board, there should be full disclosure concerning each board member. This should include, at a minimum, members' background, the skills they bring to the board, their current activities, and any factors that might affect their independence (from the executive team) or how their independence may be perceived. Such disclosure has two important results. First, shareholders have full information readily available. Second, companies that address potential questions about conflicts of interest head-on are more likely to be viewed favourably than companies that attempt to bury such issues. Companies that are honest and straightforward with their shareowners will be rewarded with greater confidence and a higher valuation.

It should be clear from the information provided to investors what value each of the board members brings to the company, and that the board represents a proper balance of skills and experience to ensure that the company will continue to be stewarded effectively. There should also be a proper balance of independent directors, to ensure that the agency problem does not intrude and see shareholder value is not dissipated. Very few investors insist that all non-executives be independent non-independent individuals can bring tremendous value to a board but most now insist that there be a sufficient number to maintain a proper external perspective. Companies should be prepared for their investors to disagree with their view as to the independence of non-executives; appearances play an important part here.

Factors that may affect investor perceptions of independence include being or having been an employee of the company; having served as a director for a prolonged period of time; being so old as to be unlikely to be offered roles in other companies (meaning a candidate might not be sufficiently outspoken, for fear of losing his or her current roles); being on the board to represent significant shareholders or other single-interest groups (such as suppliers or customers); receiving money from the company's other than non-executive directors' fees; participating in the company equity-linked incentives or performance-related pay; having conflicting or cross-directorships; and having any other significant financial or personal tie to the company or its management that might interfere with the director's duty to shareholders.

Non-executive directors play two key roles. The first role which is played by all non-executives, whether they are perceived as independent or not, is to provide the board with a long-term perspective, and so help formulate long-term strategic plans. Furthermore, they need to assess the executives' progress on achieving the short- and

long-term goals that have been set, to ensure that the company remains on target to achieve them.

The second role, which is only for the independent non-executives, is a highly important but should always be seen as secondary to the primary role discussed above. This secondary role is that of independent watchdog, and to a large extent it is carried out by the non-executives in the board subcommittees and in the audit, remuneration and nomination committees. Ideally, only the nomination committee should include executives or even non-independent non-executives, and even then these should be in the minority. Each of these committees should be formally established with full terms of reference. Their role is to report to the full board, which will take collegial responsibility for their decisions.

Remuneration

One key way to minimize the agency problem is to have managers themselves acting as owners. The easiest way to achieve this is for them actually to be owners. Investors therefore favour equity-linked remuneration which ensures that executives build up substantial stakes in the business. This should ensure that they act in the interests of all shareholders.

Many investors are, however, concerned about the use of share options as an incentive. The danger with options is that the managers do not in fact feel like long-term owners, but rather are inspired to exaggerate the success of the company to the point when the options vest, exercise them and at once sell the resulting shares, without ever becoming true shareholders. At Enron, senior executives made huge profits on generous option schemes even while doubts were beginning to surface about the company's accounting policies.

If companies do employ option schemes, they should also have share retention policies so that executives who exercise their options have to retain, say, half of the shares (or as many as is sustainable given their tax circumstances). Most investors favour incentive schemes that pay executives in actual shares, again with a retention requirement. Most also now believe that broadly based employee share ownership adds value to companies (though there is a point at which shareholders begin to lose out where their interests are diluted excessively to provide pay to employees).

All executive remuneration, including equity-linked incentives, should involve a substantial proportion that is at risk. In particular, most of it should be performance-related so that executives have an incentive to perform well for shareholders, meeting the targets set by the board and translated by the independent remuneration committee into specific individual pay thresholds for members of the senior executive team. This helps ensure that the strategic targets of the business are achieved and the company produces shareholder value.

All of these targets should be clearly expressed and publicly disclosed to shareholders. The shareowners foot the bill for the pay so they have a right to see that their money is being used wisely to increase the value of the company. Therefore, pay to the senior executive team should be disclosed. The basis for any bonuses or equity-linked incentive payments should also be freely disclosed by the company. Directors

should not be shy to justify payments they have made: after all, given their duty to shareholders, they will only have them paid because they believe such payments will add value to the company. Investors do not mind seeing executives paid generously, provided they see that they are getting value for that money.

Strategic and operational focus

To add value, companies need to focus on their core competencies. They need a clear strategy, so that the executives know what they are trying to achieve on behalf of shareholders. That strategy should be explicitly and clearly disclosed to shareholders, allowing them to assess their investment.

It is the duty of the board as a whole to ensure that the company is operationally successful in carrying out its business. It is also the board's duty to ensure that the company follows the strategy as explained to shareholders.

Any change in the articulated strategy should be clearly disclosed to shareholders. Furthermore, any major strategic shifts by the company should be presented to shareholders for their approval.

Corporate citizenship

Following some corporate failures and losses, investors have in recent years begun to pay more attention to the area of non-financial risks. As the costs of environmental problems and employment disputes have become more clear in recent years not least because of the increasing impact of consumer power and activism by nongovernmental organizations companies and their investors can no longer ignore this area.

Hermes strongly recommends adherence to the guidelines laid out by the Turnbull committee established by the Institute of Chartered Accountants in England and Wales. We believe that the report, which can be found at *www.icaew.co.uk*, sets up a structure that UNCTAD-ISAR could build in its work. All the disclosures in the so-called Turnbull Report offer shareholders valuable insights into their company. The report makes clear the obligation for directors of companies to ensure that there are sufficient internal controls to limit the potential impact on the business of these types of risk. The board is obliged to disclose that it has assessed these issues and has managed its activities so that their impact is minimized to the greatest extent practicable in the context of its business.

Investors accept that companies must take risks. Without risk, there will be no financial return. But companies need to have mechanisms and procedures in place to ensure that they know what risks they are running, and to be certain that those risks are appropriate. If the company is exposing its shareholders to unknown or unquantifiable risks that are not immediately apparent, the directors cannot carry out their duty to protect shareholder interests.

In many ways, investors are using the risk management work that directors are doing, and their attitude towards these shareholder concerns, as an insight into the overall quality of management and its control of the business. If the board fails on

these measures, shareholders will not be convinced that it is competent to manage other issues effectively.

It goes without saying that companies should comply with all applicable laws, so that they do not expose shareholders to the risks of fines and reputational damage. But we believe that a company's place in its community requires something more. Unless a company effectively manages its relationships with all stakeholders, including staff members, customers and the wider community, it will not have a long-term future. It is in the interests of long-term investors, therefore, that the company conducts itself so that those groups and any others that might be similarly affected are not exploited. Otherwise the company will find itself squeezed out of its markets or facing an intolerable burden of fines. To give shareholders the assurance that this will not happen, we believe that companies should make full disclosure on such issues as employee relations and environmental matters. These disclosures should make clear that the board is managing these issues with the long term in mind.

The value of getting it right

Studies are increasingly showing that getting corporate governance right can drive share price outperformance. See table next page for details of two such studies. The measures of governance quality used in the studies are exactly those discussed in this article.

If companies in a country become more attractive to investors, they will increase in value and the country as a whole will receive increased inward investment. Furthermore, the wider economy will be boosted as companies with greater value have lower capital costs and thus invest more, creating jobs and economic growth.

Companies and countries should recognize the vested interest they have in improving corporate governance. UNCTAD-ISAR can provide valuable guidance in this process.

Table 1

Evidence of out performance:

3-year return of corporate governance leaders	267%
3-year return of average companies	127%

Source: CLSA Emerging Markets Survey "Saints and Sinners: Who's Got Religion?"

Measures of governance quality:
Discipline, Transparency, Independence, Accountability, Responsibility, Fairness, Social Awareness

Investors' willingness to pay a premium for a well-governed company
(developed economies are excluded from the following list)

Country	*Would be willing to pay a premium (%)*	*Average premium (%)*
Republic of Korea	91	24.2
Mexico	90	21.5
Thailand	89	25.7
Brazil	89	22.9
Taiwan, Province of China	89	20.2
Indonesia	88	27.1
Malaysia	88	24.9
Argentina	82	21.2
Chile	82	20.8
Venezuela	78	27.6
Colombia	78	27.2

Source: McKinsey & Co Investor Opinion Survey June 2000.$

Measures of governance quality:

Number of outside directors
Outside directors truly independent
Large proportion of director pay is share-related
Formal director evaluation in place
Very responsive to investor requests for information

Corporate Governance and Globalization: The Role and Responsibilities of Investors

Kaspar Müller[*]

Introduction

Enhancement of a company's value for shareholders and all other stakeholders

Corporate governance includes the debate on the appropriate management and control structures of a company and the rules relating to the power relations between owners, the board of directors, management, auditors and last but not least stakeholders such as employees, suppliers, customers and the public at large. The aim of good corporate governance is to enhance the long-term value of the company for its shareholders and all other partners. The enormous significance of corporate governance is clearly evident in this definition, which encompasses all stakeholders. Corporate governance integrates all the participants in a process that is both economic and social. This definition is deliberately broader than the frequently heard narrower interpretation that only takes account of the corporate governance postulates aimed at shareholder interests. This paper explains why this broader interpretation is crucial for the long-term success of a company.

Corporate governance is a concept, rather than an individual instrument. It addresses topics such as publication of important information; protection of shareholders´ rights; promotion of the balance of interests between managers, shareholders and other stakeholders, the independence of the board of directors; internal controls (committees of the board of directors); and the function of audits. The motives for the serious integration of corporate governance postulates into their dealings vary among participants. The subjects on which they focus vary accordingly.

A prerequisite for the inclusion of other stakeholders is a balance between economic and social objectives and the reconciliation of the interests of the individual, the company and society. Many examples have shown the negative effects of inadequate corporate governance not only for shareholders and bondholders, but also for employees, suppliers and customers, as well as for society at large. Without the inclusion of other stakeholders such as employees, suppliers, customers and the public, the ability of corporate governance to promote productive economic development will be limited.

Only with the inclusion of other stakeholders does the difference between the corporate governance concept and the shareholder value concept becomes clear. The long-term enhancement of the value of a company for shareholders is not a new objective, neither is the realization that control structures are required to make

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managers toe the line with shareholders. These two aspects form the core postulates of the shareholder value philosophy. This leads to the question: Is the term *corporate governance* simply synonymous with pouring old wine into new bottles? In the "Reflections" section of the *Neue Züricher Zeitung* of 27 December 2001, the theory was aired that "Matters that place the focus of attention on company bosses are easier to sell than matters that are intended to increase the wealth of shareholders."

Indeed, if corporate governance were understood as merely being the rules of play for the distribution of power between owners and the management, the relationship between shareholder value and corporate governance would be an extremely close. This, however, is not the case if corporate governance is wider in scope and includes the interfaces between the company and other stakeholders such as employees, suppliers, customers and even the public, thereby institutionalizing the balance between economic, social and individual objectives**.**

Corporate governance is not a buzzword

It became apparent as far back as the 1930s, with the decline and fall of various family business dynasties, that increasing division between ownership (possession of the company) and control (management of the company) produced problems (Berle and Means, 1932). At the end of the 1980s, corporate governance principles were introduced in the United States under the influence of institutional investors such as the California Public Employees' Retirement System (CalPERS) pension fund and the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA/CREF). This was originally a reaction to measures against take-over bids decided unilaterally by company management often against the interests of the shareholders. At the same time, the field of corporate governance was developing in Great Britain as a consequence of several spectacular bankruptcy cases that aroused mistrust among investors. The City of London instructed the Cadbury Committee to re-establish confidence in the market and to improve the functioning of boards of directors and the transparency of the company accounts. The report published in 1992 had a significant effect both in Great Britain and abroad. On the basis of this report, new guidelines were drawn up in numerous industrial countries on the initiatives of stock market supervisory authorities, shareholder associations and investment managers as well as institutions faced with the problem of responsible investment. In 1998 the Organisation for Economic Co-operation and Development (OECD) published its corporate governance principles. The objective was to help member states evaluate and improve their national frameworks governing the organization of power relations in companies. In this way the OECD offered the stock market supervisory authorities, investors and companies a basic concept for best practice guidelines.[1]

The subject is by no means new. What is new, however, is the forcefulness with which it was suddenly foregrounded in some countries. There are a variety of different reasons for this. In Switzerland, for example, institutionalized saving (via pension funds) has led to further anonymity in the ownership of shares and therefore to a widespread separation between ownership and control. This imbalance between

[1] This paragraph is taken from an Ethos foundation publication; *Codes of Best Practice for Corporate Governance*; Ethos, Swiss Investment Foundation for Sustainable Developments; March 2001; download in French or German at *www.ethosfund.ch*.

power and control (checks and balances and incentives) has increased. In a few cases, managers have not missed the opportunity to accumulate power, which in the long term has proved to be damaging to the company and to society as a whole.

The problem has been recognized, and the most effective strategy for rectifying the situation is the introduction of codes of best practice. This enables the use of voluntary recommendations as an alternative to the drafting, implementing and enforcement of new, frequently inflexible legislation. A number of different codes have already been drafted, owing to the fact that, on the one hand, the corporate governance debate involves many different stakeholders and, on the other hand, each group of stakeholders champions the code that addresses its particular concerns. The codes deal with the entire spectrum of subjects relevant within the framework of the corporate governance debate (see the first paragraph of this paper).

The Codes can be divided into supranational, national or institutional codes, depending on author.

- Examples of supranational codes include those of the OECD, the International Corporate Governance Network (ICGN), and the Commonwealth Association for Corporate Governance (AGN).
- Examples of national codes include the Viénot Report from France, as well as the Cadbury, Greenbury and Hampel Reports and the Combined Code from the United Kingdom.
- Examples of institutional codes are those of: Calpers, Hermes Investment Management, and Amnesty International.

A list of the main codes and a description of their contents appear, for example, in *Codes of Best Practice for Corporate Governance.*[2]

Corporate Governance in Practice

Two major players: Investors and Company Directors

Corporate governance is the talk of the town. It is easy to disseminate definitions and theories on the subject, but that does not really get us anywhere. The decisive factor is the conduct of two players, the companies and the shareholders. Visible and measurable progress can be achieved only if the main participants actually apply corporate governance postulates. They can do this only in their area of responsibility. Even the best company cannot take over responsibility from sleepy shareholders, just as the efforts of shareholders remain largely useless as long as company directors fail to pull along.

What are the fields of activity for concrete and seriously intended action? The legislation and regulations (e.g. of the stock exchange) include various binding directions for action. However, effective corporate governance structures require additional measures (in practice, voluntary codes with voluntary recommendations), which often extend far beyond the minimum statutory framework.

[2] Full publication information appears in footnote 1.

Effective proposals for corporate action

Companies can build a modern corporate governance structure on the basis of existing codes. The voluntary codes are intended to lead companies step by step in the desired direction, for example, improved publication of important information in connection with corporate governance postulates (e.g. the level and structure of directors' remuneration); protecting shareholders' rights by facilitating rather than hindering shareholders in the exercise of their rights; taking all stakeholders seriously; the establishment of professional internal controls (committees of the board of directors), also to guarantee the independence of the board of directors; and, finally, the creation of a structure that allows independent and effective audits. If in the long-term, a company wishes to remain attractive to investors, it will find there is no way around up-to-date and forward-looking corporate governance structures.

Investors: opportunities and trends

For shareholders, effective corporate governance structures have become an important criterion for selecting the companies in which they wish to invest.

Basically there are two approaches. The first focuses on the analysis of corporate governance structures. As investors interested in the long term, pension funds examine the extent to which a company has implemented the recommendations contained in the most important codes. This analysis is the starting point for a comparison of various companies with respect to good corporate governance. The results influence investment decisions. Companies with poor structures are avoided.

The second, far more effective approach consists of acting as shareholders who exercise their proprietary and other rights. Shareholders have the right to demand information from the company at any time about important questions in connection with management. However, they also have the right to participate in the shareholders´ general meeting, to propose resolutions for the agenda, and to speak, last but not least, they have the obligation to take positions and vote accordingly.

Against this background, the Confederate Council of Switzerland (the national government) has introduced a regulation to the Swiss ordinance regulating vocational provisions (BVV2) obliging Swiss pension funds to define whether and how they wish to exercise their shareholders´ rights as from 1 January 2002. This decision will encourage many pension institutions to exercise their shareholders´ rights, in particular their voting rights, in a systematic and responsible manner. Pension funds own about 10 per cent of the market capitalization of Switzerland, amounting today to approximately 1 trillion Swiss francs. The trend is still upward.

The influence of investors and particularly pension funds on companies will therefore continue to grow not only as a consequence of the increasing proportion of shares in the portfolios of pension institutions, but also because of their increasingly active exercise of their rights. However, this also requires that private as well as institutional shareholders prepare themselves adequately for their increased responsibility. The systematic exercising of voting rights demands, for example, clear and transparent guidelines on voting rights. It may be assumed that institutional investors (e.g. pension funds) will increasingly join forces to form groupings. Such

grouping not only enable tasks to be executed efficiently, they also enable additional influence to be executed on the company. These groupings will not remain purely national, but, as the example of the ICGN illustrates, will increasingly operate worldwide.

A practical example: The Ethos Foundation

Forming groupings has many potential advantages, as the following example from Ethos, the Swiss Investment Foundation for Sustainable Development, shows. Founded in 1997, Ethos currently has 93 pension funds throughout Switzerland. Acting on the instructions of its members, Ethos manages six investment segments in shares and bonds amounting to about 750 million Swiss francs in accordance with the financial, ecological and social criteria of sustainable development. The main objectives are promoting companies that contribute to sustainable development as well as giving companies clear signals from their investors relating to desired long-term development. Constructive dialogue with the companies plays a key role in achieving these objectives. Another objective of Ethos is to enable its members to exercise their voting rights in a responsible manner.

In-depth analyses of the agendas of general meetings are carried out in accordance with the detailed voting guidelines in order to enable shareholder-voting rights to be exercised in a systematic and socially responsible manner at shareholders´ general meetings of companies in which the foundation holds shares. Voting recommendations are made to the members on this basis. It is particularly important that voting rights are exercised based on detailed voting guidelines that are transparent and public. The Ethos proxy voting guidelines[3] refer in particular to the Ethos Charta (which is based on the concept of sustainable development) and to the main national and supranational codes of best practice in corporate governance. These voting recommendations are driven by the determination to sustainably increase the company's value in the interests of its owners (shareholders) and all the company's stakeholders, including employees, customers, suppliers, public bodies and society as a whole. Over the last years Ethos has exercised its voting rights at approximately 150 general meetings of Swiss and foreign corporations. Ethos has supported a variety of resolutions.

Two examples illustrate this process. The first describes a resolution concerning environmental and social policy: The second concerns support for improvements required in connection with corporate governance structures, in particular the independence of the board of directors.

Example 1: Resolution on environmental and social policy

Since the year 2000, resolutions relating to oil drilling in the Arctic have been introduced at each shareholders´ general meeting of BP Amoco. In 2000, a group of shareholders presented the shareholders´ general meeting of BP Amoco with a resolution demanding that all oil drilling in the Arctic be stopped. Ethos supported this proposal, which received a total of 13 per cent of votes (corresponding to capital

[3] See: "Proxy Voting Guidelines"; Ethos, Swiss Foundation for Sustainable Development, March 2001; download in English, French or German at *www.ethosfund.ch*

amounting to 8 billion £ stg. As a consequence of this impressive result, the administrative board will in the future also have to take more seriously the concerns of those shareholders who, in the case of the Arctic, place greater emphasis on the protection of the environment. Activities in environmentally and culturally sensitive regions incur not only environmental risks but also great risks to the financial value of BP Amoco. At the forthcoming shareholders´ general meeting in spring 2002, various shareholders will therefore introduce a resolution demanding that BP Amoco periodically inform shareholders how these risks are assessed and what precautions are being taken to avoid damage to the environment and to shareholders. This proposal was drawn up under the leadership of the World Wildlife Fund. Over 115 private investors in the United Kingdom as well as institutional investors, such as the Ethos Foundation, the RSPB, the Joseph Rowntree Charitable Trust, the US Public Interest Research Group, Trillium Asset Management, Walden Asset Management of Boston, the Green Century Balanced Fund, Ethical Funds Inc. of Canada, the Enterprise Foundation of the Rockefeller Family Fund, Clean Yield of Vermont Catholic Healthcare West and members of the Interfaith Center on Corporate Responsibility.

Such proposals intensify the dialogue with corporations and also give corporations clear signals from groups of shareholders that environmental and social issues are to be taken just as seriously as financial issues. The past years have shown that constructively driven resolutions in the environmental and social area gain a high proportion of votes (10% and above) at shareholders´ general meetings. This also reinforces the management position in the case of disputes with shareholders who are concerned only with short-term financial gain.[4]

Example 2: Measures to guarantee board independence

At the shareholders´ general meeting of the Credit Suisse Group in 2001 the proposal by the Ethos foundation that "the board of directors implement suitable measures to guarantee its independence" was rejected by the majority of shareholders. However, the proposal initiated a discussion in Switzerland about the independence of the board of directors and also influenced the attitude of the Credit Suisse Group management regarding the rules of conduct relating to corporate governance. The President of the board of directors resigned from the nomination and compensation committee of the board, and a member of the board of directors was appointed to the post of senior board member. In particular, a senior board member has the authority to convene the board of directors without its president.

The opportunities for active intervention are determined by the corporate governance structure with regard to shareholders´ rights. They can develop full effectiveness only if a fair structure for capital and voting rights exists for all investors. Voting shares can significantly affect the sphere of action of committed investors. The same applies if shareholders are not able to vote with all their votes but only with a part-share in the vote as a result of percentage limitations.

[4] See also: the main social and environmental shareholder resolutions, Annual General Meetings 2000, Ethos, Swiss Foundation for Sustainable Development, March 2001; download in French or German at *www.ethosfund.ch*

Good corporate governance as an opportunity for companies and investors

The long-term success of a company depends on sensible measure of good corporate governance. However, good corporate governance also requires that all stakeholders, and especially shareholders, exercise their participatory rights. In particular, shareholders should be aware that they elect the board of directors who decide on company strategy and monitor the implementation of that strategy. Being annoyed with the board because of a large financial loss is of little use if, when electing the board, one did not constructively address the question of whether the board of directors standing for election had the necessary qualifications, independence and time to do its job properly.

Boards of directors and managers should advocate structures that meet today’s needs. Good corporate governance is not a trap, but an opportunity to understand and enhance the value of a company in the long-term view.

Such conduct is imperative for institutional investors (i.e. pension funds) to remain a solid base for shareholders looking to the long-term.

Corporate governance and the quality of globalization

Corporate governance and financial markets

The question of which countries are interesting to investors is, in addition to the economic efficiency of a country, closely linked with the issue of whether foreign investors in a country can depend on a stable political system and a legal system that protects property rights. Shareholders are owners of companies and, as owners, have property rights and other rights in all countries.

If, in the eyes of the investors, these conditions do not prevail in the financial markets of a country, they will avoid investing in that country. This leads to high national interest levels, which in turn cripple the economic development of the country.

A stable legal system and supportive current legislation (which includes not only the constitution and laws, but also the accounting systems or regulations governing the official listing of securities on the stock exchange) are vital factors in the attractiveness of a country. However, these alone are often insufficient to attract investors. Further generally accepted forms of conduct are needed that often extend far beyond the minimal legal framework. Such forms of conduct are laid down in voluntary corporate governance codes of best practice, among others. The corporate governance structures of a country are therefore a further important indicator of the credibility of the economy as a whole and of the financial market in particular.

A discussion of the criteria that determine the competitiveness of a country's financial markets often ends at this point. It is said that the objective of developing countries and emerging countries should be to alter their social and political structures in such a way that the countries become more attractive for international investors. This is the key to economic and social development.

However, the crucial debate only begins once a country has set up the main general framework for foreign investors and once foreign investors are investing in the country. This debate has to address the issue of the roles and responsibilities of the investors. The quality and future of globalization will depend on the conduct of investors in developing and emerging nations.

The role and responsibilities of investors

Responsible investors are aware that their actions can have an enormous effect on many different stakeholders. A decisive factor in this is not only the distribution of the financial value created, but also how the financial value is created. Therefore, responsible investors carefully analyse the relationship of the effects of their planned investment within the framework of the investment process: Is the desired and possible increase in the market value of a company linked to a severe violation of human rights? Are the rules governing occupational safety infringed? Is an ecologically unacceptable risk created (e.g. by nuclear waste)? Will a health risk be created through contaminated water? Or are unfair trade relations the basis of success? and so on. In other word, investors who apply their responsibility in the globalization process, recognize and acknowledge the concerns of other stakeholders as long-term value drivers. These include employees, suppliers, and in particular the population of a country. Long-term safeguarding of the value of a company for the owners is not feasible if (transient) success is gained at the cost of other stakeholders.

Responsible investors not only analyse such interrelations but actively demand improvements where these are needed. Good corporate governance by investors with the inclusion of various stakeholders is an important precondition for permanently integrating an economy in a global setting based on fair rules. Corporate governance permeates the economic transactions of companies and investors everywhere, extending far beyond the narrow business framework to which certain circles would like to see it confined.

The corporate governance debate also addresses the distribution of power, a central issue for any government or economy, as well as for any company. The inclusion of other stakeholders presupposes a balance between economic and social objectives and the reconciliation of the interests of individuals, the company and society. Various examples from many countries show that failure at the management level can have an enormous impact on the economy as a whole, causing significant damage not only to shareholders and bondholders, but also to employees, suppliers, customers and society in general.

The lack of consideration for stakeholders common today and the small group of people seriously involved in are expressions of a deficit. Whether this situation can be remedied depends on the one hand on a realization of the "powers that be" that this circle must be expanded. On the other hand, it depends greatly on the ability of stakeholders, poorly represented so far, to make use of a existing channels. Only a few investors at present face up to their responsibility as co-owners. Those who do so are often investors who place short-term financial objectives above all else. As a result, the quality of worldwide development is increasingly delegated to a minority of active participants in the financial markets. Hence, in a world in which countries, markets

and corporations are growing closer together and trading with each other, the active participation of all investors is a major precondition for balanced, fair development that takes into account as many interests as possible. In the medium and long term, those people enjoying short-term advantages gained at the cost of others will also be made painfully aware of the consequences of the economic, ecological and, last but not least, social damage caused.

If investors are interested only in short-term success and there are many such investors then the opening up of the financial markets of a country (whether it is a developing, emerging, or even industrial country) will result in the plundering of that country by investors with short-term objectives. As a consequence, the country will be saddled with high debts, reduced creditworthiness and accentuated social problems. Investors with short-term aims are often unaware of their responsibilities. The effects of their actions on a nation's economy and society do not count among their criteria. Forensic skills are not required to predict the foundering of globalization should this scenario prevail.

Facing up to responsibility means participating actively

The terms stakeholders and *distribution of power* incorporated into the definition of corporate governance contain central messages that are closely linked with the essence of socially responsible investment. Investors play a central role in the further integration of the nations of the world. Without the strong quantitative and qualitative growth of socially responsible investment, globalization will flounder. In other words, there is no such thing as a "neutral" investor. Investors are always owners too, and as such share the responsibility. There is no escaping the active exercising of voting rights or the proposing of socially and environmentally relevant resolutions.

Corporate Governance:

A Risk Worth Measuring?

Nick Bradley*

Introduction

Corporate governance, defined by Standard & Poor’s as “the way in which a company organizes and manages itself to ensure that all financial stakeholders receive their fair share of a company’s earnings and assets”, is increasingly a major factor in the investment decision-making process. Poor corporate governance is often cited as one of the main reasons why investors are reluctant, or unwilling, to invest in companies in certain markets. It can also explain why, in some economies, the shares of many companies trade at a significant discount to their true value. Even better-governed companies are "tarred with the same brush" almost a case of guilt by association.

For many investors, corporate governance is an additional risk that requires assessment when they are evaluating potential investment opportunities. If investors are unable to evaluate this risk, they are likely to be reluctant to invest or will require a significant premium to mitigate the unknown. In many cases where investors are unable to evaluate the risks associated with governance practices, equities may be incorrectly priced. This works to companies' disadvantage and raises the cost of capital.

Where poor governance practices are suspected, a company’s share price will often trade well below what should be the real economic value of the enterprise. For example, the market capitalization of one major natural resources company in a country whose economy is in transition to market economy that is suspected of shareholder abuses is 90 per cent less than that of its Western equivalent, although its reserves are six times greater.

Standard & Poor’s has recently introduced a service to evaluate a company’s corporate governance practices (see the description later in this paper). The confidential service diagnoses a company's governance practices, compares these to international best practices and identifies areas for improvement. Companies can also use the service publicly to demonstrate greater transparency to investors and to further differentiate themselves from their peers.

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Corporate governance and the economy

Effective corporate governance is at the core of an efficient market economy. Shareholders and other financial stakeholders must have access to information and the ability to influence and control management, through both internal governance procedures and external legal and regulatory mechanisms, in order to ensure that a company's assets are being utilized in the interests of all financial stakeholders. This is important in both developed and developing economies.

In developed markets, large institutional investors pay considerable attention to corporate governance practices. Some US pension funds, such as the California Public Employees' Retirement System (CalPERS) and the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA/CREFF), actively pursue corporate reform through their positions as major shareholders. Every year, for example, CalPERS publishes a list of the best and worst US corporate boards in an attempt to promote change. As institutional investors own more than 50 per cent of the equity of US companies, companies are becoming much more sensitive to the desires of these shareholders.

The market rewards those companies that do change. Some studies have shown that efforts by a company to improve the quality of its board have a significant and positive effect on share price. Similarly, companies that continue to engage in activities that place the interests of management over those of shareholders tend to trade at a discount relative to other companies in their sector.

In emerging economies, the quality of corporate governance can vary enormously. Indeed, poor governance or corrupt governance ("crony capitalism") negatively affects the returns on investment in many countries and also contributes to larger, systemic problems at national and regional levels. The scarcity and poor quality of publicly available information, along with limited legal and regulatory recourse, frequently complicates efforts by financial stakeholders to ensure that management is acting in their interests.

The sometimes legal expropriation of outside investors is a major problem of corporate governance. Although expropriation is not exclusive to emerging economies, it is certainly much more prevalent there. Examples of expropriation include cash flow diversion (transfer pricing), dilution of minority shareholders, asset stripping and delay (or non-payment) of dividends.

One of the aims of good governance should be to introduce checks and balances to create the conditions necessary to facilitate external finance. This view is apparently supported by a number of studies, including a recent one by Credit Lyonnais Securities (CLSA) Emerging Markets, which found that the shares prices of companies with high corporate governance standards have been more resilient during market downturns.

The study comments that *"those [*companies in the survey] *with weaker governance see their shares collapse when market turmoil results in a higher discount for mismanagement. Transparency, accountability, independence, fair treatment of minorities, management discipline and responsibility; key features of good*

governance are crucial in assessing and reducing investment risks in emerging markets". The study also showed that the share prices of companies with good governance have significantly outperformed. Taking this a stage further, higher share prices should lead to a reduction in the overall cost of capital.

On a macroeconomic level, other studies have shown that in countries where higher investor protection measures existed, and where corporate governance standards were higher, the impact of economic crises was relatively milder. Studies in the United States have examined the depreciation of currencies and the decline of the stock markets in a number of emerging economies during the Asian crisis of 1997-98. The studies revealed that countries with higher standards of investor protection were better insulated against market turmoil than those countries where investor protection laws were weak.

A June 2000 survey of 200 global institutional investors by the management consulting firm McKinsey found that these institutional investors said that they would be willing to pay a significant premium for the shares of companies that they knew to be well governed. In fact, some investors stated that good governance practice was a key determinant of whether they would invest in a particular company or not. Not surprisingly, the average premium differs from country to country. Companies domiciled in countries with high governance standards could expect to pay significantly smaller premium than companies in countries where the reverse is true.

McKinsey's findings are consistent with good risk management practices, where logic suggests that investors will pay a premium to reduce risk (in this case, risks associated with poor governance practices). Conversely, these investors will expect to receive a discount for assuming greater risk.

A 2001 study, *Corporate Governance and Equity Prices*, of US companies by Paul Gompers and Joy Ishii of the Harvard Business School and Andrew Metrick of the Wharton School found " a strong relationship between corporate governance and stock returns". A strategy of buying stocks with good governance and selling those with poor governance would have produced increased returns of 8.5 per cent per annum through the 1990s.

At a more fundamental level, investors often cite poor corporate governance practices as a reason for not investing at all, or for reducing the level of investment in a particular stock.

For all the above reasons, the need to introduce standards of corporate governance and build greater transparency in emerging markets is increasingly recognized. The Organisation for Economic Co-operation and Development (OECD) and multilateral development banks, for example, are seeking to improve awareness and conceptual understanding of corporate governance, and to encourage both governments and companies to take practical steps to improve corporate governance practices.

At the government level, emphasis is placed on encouraging the building of a strong legal and regulatory environment, including reinforcing the effectiveness and

the enforceability of existing laws as well as implementing the level of transparency and disclosure required by the market.

At the company level, this means adopting governance practices consistent with increasingly accepted principles of corporate governance in global markets. However, there is no one model of corporate governance that works in all countries and in all companies. Indeed, there exist many different codes of "best practices" that take into account differing legislation, board structures and business practices in individual countries. However, there are standards that can apply across a broad range of legal, political and economic environments. For example, the Business Sector Advisory Group on Corporate Governance to the OECD has articulated a set of core principles of corporate governance practices that are relevant across a range of jurisdictions. These are (i) fairness, (ii) transparency, (iii) accountability and (iv) responsibility.

Measuring corporate governance practices

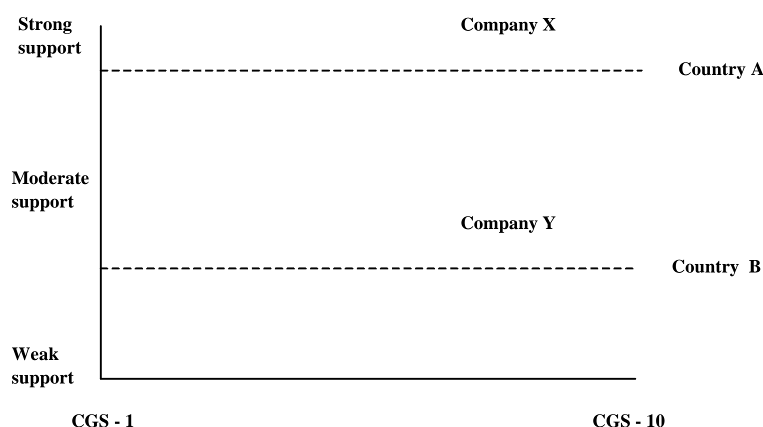
Standard & Poor's recently launched a new service, Corporate Governance Scores, to evaluate the corporate governance practices of companies.

The analysis evaluates corporate governance practices at individual companies. Using a synthesis of the OECD's and other international codes and guidelines relating to corporate governance practices as cornerstones of the scoring methodology, Standard & Poor's assigns scores to a company's overall practices and four individual components (ownership structure, financial stakeholder rights and relations, financial transparency and information disclosure, and board structure and process). In all, approximately 130 factors of a company's corporate governance practices are evaluated using both public and non-public information.

The extent to which, in the opinion of Standard & Poor's, a company adopts and conforms to international codes and guidelines of good corporate governance practices, is reflected in the award of a Corporate Governance Score ('CGS') on a scale from CGS-1 (lowest) to CGS-10 (highest). In addition, the four components described above all contribute to the CGS and receive individual scores from 1 (lowest) to 10 (highest).

Although Standard & Poor's does not currently score individual countries, consideration of a country's legal, regulatory and market environment is an important element in the overall analysis of the risks associated with the governance practices of an individual company. For example, two companies with the same company scores, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate, in other words, in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better-enforced laws and regulations. However, a Standard & Poor's considers that companies with high corporate governance scores have less governance-related risk than companies with low scores, irrespective of the country of domicile.

Figure 1: Company Scores and country support on corporate governance matters



Investors and other interested parties are able to use the country and company scores as part of the overall risk assessment process. Whilst companies with the same *company* scores are considered to have similar standards of corporate governance, irrespective of the country of domicile, the *country classification* is also necessary to assess the overall governance risk profile. The *country* score is of particular relevance should a previously highly scored company's standards subsequently deteriorate.

In the example in figure 1, both Company X and Company Y are considered to have similar standards of corporate governance. However, Company X is domiciled in a country where the legal, regulatory and market environment provides greater support to governance practices at the company level. Consequently, should either of these two companies' corporate governance standards subsequently deteriorate, investors in Company Y are at great risk than investors in Company X.

Although the Standard & Poor's corporate governance analysis focuses primarily on shareholders, and less directly on creditors and other financial stakeholders, a review of interactions with creditors (but not other stakeholder) is also undertaken because both shareholders and creditors are providers of finance. In this sense, shareholders and creditors have a common interest in the overall operating and financial performance of a company and the degree to which the company's corporate governance processes may influence this performance.

Different models of corporate governance around the world reflect the nature of local legal and regulatory systems, as well as differing approaches to economic management. The Anglo-Saxon system focuses primarily on the shareholder, while other systems, such as the German ones, attempt to achieve a greater balance of interests between shareholders and other external stakeholders (including creditors, employees, the community, the environment, etc.) By addressing the interests of both creditors and shareholders, the scoring model recognizes the importance of stakeholders' rights beyond solely the rights of the shareholder. Hence, this system can be applied generally in many countries around the world, operating with differing general approaches to corporate governance. However, it should be strongly noted that the Standard & Poor's evaluations are designed specifically for financial stakeholders, primarily shareholders.

These micro- and macroeconomic components are both important to the practice of corporate governance. Specific evaluation factors can be identified to analyze governance practices and facilitate objective and comparative analysis of corporate governance practices at individual companies. Inclusion of the country score enables individual companies to be placed in a more international context, facilitating a comparison of country governance environments.

Competency and Training

Shirley Reilly[*]

For all boards, effective board governance depends on both the competencies that individual governors bring with them and the training that the board provides to help governors master board issues and develop the skills needed to participate effectively.

Effective governance also depends on an effective selection process for new governors, which in turn rests on a clear definition of what the duties of a governor are. Duties vary depending on the type of organization involved: for profit, not for profit, government agency, and so on. However, all boards have five basic responsibilities:

1. Directing and supervising *strategic* management and the integrated planning and implementation of the major changes needed to improve corporate performance.
2. Appointing and overseeing the chief executive officer (CEO) and other officers. This includes appointing, setting terms of employment, supervising, evaluating, compensating, and if necessary, removing all corporate officers, starting with the CEO. It also includes approving major organizational changes and ensuring that adequate succession plans are in place.
3. Representing and reporting to the shareholders, or, in not-for-profit and governments agencies, the stakeholders.
4. Protecting and enhancing the company's assets.
5. Fulfilling fiduciary and legal requirements.

Competence is the possession of characteristics that enable a person to perform specified duties and responsibilities, and it is a critical success factor for directors and boards. Unfortunately, selection of governors does not always hinge on competence. Some boards are elected, some are appointed and some have a clearly defined selection process. Still others select members who are known to them, or for their public prestige, or to fulfil some personal or political agenda. In some of the latter instances, competence rates very low in the selection process.

Following are some of the competencies that, in the author's opinion, are essential for board members:

- Knowledge of the primary vision and the goals and objectives of the organization. Without a road map, it is difficult to plot a course.
- Interpersonal communications' skills to work effectively within the collegial environment often present in governing bodies, and the ability to communicate effectively in oral and written form (a highly underrated skill).

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- Knowledge of and experience with the primary management aspects of corporate governance, such as business plans, financial statements, performance goals, budgets, strategic planning, and so on.
- The ability to work as part of a team of professionals dedicated to common objectives.
- A solid foundation of experience and understanding of the needs and objectives of the constituency group being represented at the governing council or board. Governors "at large" require knowledge of the expectations of society or of the community served by the organization. This is especially true in the non-profit and government sectors.
- Knowledge of the rules of procedure used by the governing body. Considerable time can be wasted if members do not understand Robert's Rules of Order or the particular system being used by the board. The Certified General Accountants Association of Canada (CGA) periodically provides training in this area, especially if there has been a large turnover.
- A willingness and ability to support and promote the decisions of the governing body and communicate these decisions to the constituency group, along with the ability to prioritise multiple and complex issues.
- Common sense which unfortunately is sometimes very uncommon.

No one director will possess all these attributes, but it is important that the board as a whole possesses these skills. In CGA, while the Provincial Boards are elected, the nominating committees try to ensure a slate of proposed directors that represents all sectors of the profession and that includes all constituency groups (e.g. women, members of minority groups).

In 1994 the Toronto Stock Exchange (TSE) issued a report on corporate governance called *Where Were the Directors*?, usually called the Dey Report after the author. This was in response to some high-profile corporate disasters, particularly in the financial sector. In 1999 the TSE issued a follow-up report entitled "*Five Years to the Dey*". This report found that most boards still had no formal orientation program for new directors, preferring recruits to learn as they went along. Only in about half of the cases did directors visit company operations to gain a better understanding of the business. Little support was demonstrated for external education programs. Either the need is not recognized or such programs have failed to date to prove their value. The TSE guidelines provide that nominees to a board be proposed through a committee composed exclusively of non-management directors, the majority of whom are unrelated. Only a minority of boards has adopted this recommendation. In 40 per cent of cases the chair chooses the nominee and seeks board approval. Only one third of boards have separate nominating committees. The study found that, in connection with the recruitment of directors, the majority of responses dealt with the scarcity of acceptable candidates or the fact that desirable candidates held too many directorships. However, the University of Western Ontario, in attempting to set up a database of qualified women for corporate boards, was astonished at the number and quality of the women who responded to their request for resumes.

Three years after the Dey report, the Conference Board of Canada found that those corporations that have implemented the best governance practices had attained the best results on key performance criteria.

The Institute on Governance did a study titled *Governance Do's and Don'ts – Lessons from Case Studies on Twenty Canadian Non-Profits.* In Canada, governments at all levels have historically used non-profit organizations for the delivery of services and as instruments of government policy. There are some 175,000 voluntary or non-profit organizations and registered charities in Canada, employing 1.3 million Canadians and paying over can$40 billion in salaries and benefits. Fifty-six per cent of these jobs are in teaching institutions and hospitals.

They also found that the Policy Governance Model made famous by John Carver was too complex for most volunteer organizations to understand and implement. However, two of the Certified General Accountants Provincial Associations are operating using this model, although one modified it substantially to meet local requirements. The study found that the process used to select board members could greatly affect ownership and accountability. Individuals who are elected rather than appointed do not begin their terms of office on an equal footing. This creates an immediate climate of suspicion and distrust.

A review of the governance of the Province of Saskatchewan Health Districts suggested that appointed members were perceived as having more influence with and being more subject to the influence of the government that had appointed them. Elected members were perceived as having greater latitude to criticize the government, but as having less influence with it. The report states that valuable lessons on board orientation, succession planning, membership recruitment and volunteer management can be drawn from the exemplary practices of the Lions and Kiwanis International Service Clubs.

Governance practices also differ again in corporations having one majority shareholder. These types of corporations typically use boards in an advisory capacity, and the director's responsibility is largely what the shareholder says it is. In companies that have minority shareholders, both the law and increasingly accepted practice require directors to represent the interests of the minority as well as the controlling shareholders. However, even in these types of corporations, directors retain legal and fiduciary responsibilities. The company of which the author was chief financial officer was a third generation family firm. It had a board of advisors. Each of the three directors represented skills that the company perceived itself as being weak in. One was the CEO of an insurance corporation with wide marketing experience. The second had been the CEO of a business in a different section of the relevant industry and was a professional accountant. The third was the CEO of a manufacturing corporation with skills in production and inventory control. These skills complemented and enhanced those on the management team. One of the main reasons that family firms do not survive the generational transfer is that owners often believe they have all the answers. A board of advisors is very effective in dispelling the results of tunnel vision.

In summary, effective boards must consist of a diverse collection of skills and competencies. Selection of directors is a key factor in the success of the board. Directors must be chosen with a view to the current and future needs of the board. No one director will possess all the required competencies; however, a corporation would do well to consider training its directors, just as it provides training for senior staff.

Training of Directors

Tony Renton[*]

Introduction

The board is the "mind and will" of the company. The constitutions of most companies contain a provision stating that "the business of the company will be managed by the directors, who may exercise all such powers of the company", or words to this effect. Executive powers are therefore vested in the board as a whole. In practice, the board delegates executive responsibility to the executive directors, especially the managing director, who heads the management of the business, but this does not negate the board's ultimate responsibility for the company's affairs. In addition, the board often reserves certain powers to itself as a way of limiting the powers of executives. This paper is about training for directors in their board membership role rather than in their managerial role. Many of the issues mentioned here are more fully discussed in Institute of Directors (2001).

"Training" usually means activities that are designed to help individuals or groups learn. "Development" is sometimes taken to mean an increase in ability through stimulation of changes in behaviour, beliefs, knowledge and understanding. In this note, however, "training" is used to denote a whole variety of activities, many of which would normally be classed as developmental activities.

In 1998 an Institute of Directors survey, *Sign of the Times* (Institute of Directors, 1998), showed that a significant number of directors in the United Kingdom were not engaging in training and development activities. Approximately 35 per cent of all directors had had no preparation at all for directorship, only 6 per cent had had proper board induction, and 73 per cent had never been on an external training course. The reasons given for the lack of training included its cost, the lack of role models, and the failure of the chair to champion the idea, but the major hindrance seemed to be the need to commit a sizable bloc of time.

However, now there is probably increased recognition that training at the board level is desirable. First, there is a growing desire among many companies to be more professional, especially in response to ever more demanding shareholder and stakeholder expectations. Second, there is now some acceptance of the idea that value in a company is shifting to some extent from capital to knowledge, which is often the scarce factor of production, so that development of human capital may be crucial to a company's competitiveness – especially on the board, where leverage is very high. It is thus increasingly considered essential that directors not allow their skills and knowledge to become obsolete which can happen all too easily in times of rapid and substantial changes in technology, legislation, knowledge, competitive pressures and social priorities. Finally, the national standard of living depends largely on the international competitiveness of a nation's firms, and in turn the performance of any

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company depends crucially upon the performance of its board. Consequently, the professional education of board members is a vital element of national long-term economic performance.

For these reasons, the Combined Code on Corporate Governance (London Stock Exchange, 1998), which applies to all companies listed on the London Stock Exchange, recommends that *Every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary* (Code Provision A.1.6).

Finally, underpinning any training and development should be a business need. So, in designing a training programme for directors, it is important to understand the context in which they will work, that is, the board. First, one needs to understand the purpose and tasks of a board, since these largely determine what training is appropriate for a director. Second, the board needs to be an effective group; it is not a club or a committee. There should, therefore, be a regular review of the board's composition to ensure that the required mix of knowledge and attributes is available to address the future issues that the company and the board are likely to face. Training is one of the means of moving towards an optimal board blend.

The work of a board

The purpose of a board

The Institute of Directors, based on a study of good practice involving several hundred UK directors and many boards, defined the board's purpose as follows:

The key purpose of the board is to ensure the company's prosperity by collectively directing the company's affairs, whilst being accountable to its shareholders and meeting the appropriate interests of relevant stakeholders (Institute of Directors, 1999b).

This is a summary view.

The tasks of a board

To ensure that the company prospers, the board must address some key tasks and ensure that they are carried out effectively.

The four key tasks of the board identified in Institute of Directors (1999b) are to:

A. Establish and maintain vision, mission and values

In order to carry out this task, the board must

- A.1 Determine the company's vision and mission to guide and set the pace for its current operations and future development.
- A.2 Determine the values to be promoted throughout the company.
- A.3 Determine and review company goals.
- A.4 Determine company policies.

B. Set strategy and structure

This involves:

B.1 Reviewing and evaluating present and future opportunities, threats and risks in the external environment; and current and future strengths, weaknesses and risks relating to the company.
B.2 Determining strategic options, selecting those to be pursued, and deciding the means to support them.
B.3 Determining the business strategies and plans that underpin the corporate strategy.
B.4 Ensuring that the company's organizational structure and capability are appropriate for implementing the chosen strategies.

C. Delegate to, and monitor, management

In order properly to address this task, the board should:

C.1 Delegate authority to management, and monitor and evaluate the implementation of policies, strategies and business plans.
C.2 Determine monitoring criteria.
C.3 Ensure that internal controls are effective.
C.4 Communicate with senior management.

D. Exercise accountability to shareholders and be responsible to relevant stakeholders

That is, the board should:

D.1 Ensure that communications both to and from shareholders and relevant stakeholders are effective.
D.2 Understand and take into account the interests of shareholders and relevant stakeholders.
D.3 Monitor relations with shareholders and relevant stakeholders by the gathering and evaluation of appropriate information.
D.4 Promote the goodwill and support of shareholders and relevant stakeholders, “manage” shareholder/stakeholder relations.

In considering training for directors, it is essential to keep these goals in mind.

Direction is not management. It is widely acknowledged that the tasks of a board are different from the tasks of management. The relationship between the board and managers is complex, dynamic and company-specific, but there are a number of areas that illustrate the differences between the responsibilities of directors and those of managers:

- **Prosperity**. Responsibility for the long-term prosperity of the company rests with the board of directors, not the management.
- **Decision-making.** Directors have to make the important decisions that determine the future of the company and how it relates to its "stakeholders" and the

legal/regulatory framework. Management is concerned with implementing those decisions and the policies that follow from them.

- **Duties and responsibilities.** Directors are required by law to apply skill and care in exercising their duty to the company. If they are in breach of their duties or act improperly, directors may be made personally liable.
- **Accountability to shareholders.** The directors are responsible to the shareholders and may be dismissed by the shareholders.
- **Leadership.** Day-to-day leadership of the company is in the hands of the managing director or chief executive, but he or she acts on behalf of the directors. It is the board of directors that must provide the intrinsic leadership and direction at the top of the company, including the determination of its values and ethical position. The management must enact that leadership ethos, taking its direction from the board.
- **Company administration.** Directors are responsible for the company's due administration. The related duties can be delegated to management, but this does not relieve the directors of ultimate responsibility for company administration. In the United Kingdom one of the easiest ways of getting disqualified as a director is by persistently filing annual returns late, or not at all, or making false returns.
- **Statutory provisions.** In most countries there are numerous statutory provisions in most countries that can create offences of strict liability under which directors may face penalties if the company fails to comply. Employee relations, health and safety, taxation, consumer and environmental protection are examples of areas where directors may be liable under statute.

Approaches to training

There are many ways of training and developing directors and boards. The most common are:

- **Coaching.** This one-to-one advice is usually specific and task-oriented, addressing a short-term development need, with a focus on the individual's performance. The agenda is normally set by the coach, probably helped by the chairman of the board.
- **Mentoring.** This typically addresses long-term development needs. Ideally, the mentor should be a respected role model who can act as a critical friend. Such people are not easy to find.
- **External courses.** These are in principle an efficient way of imparting straightforward knowledge (e.g. details of relevant company law). However it is very important that the pedagogy be appropriate.

Instructors should be highly competent in their field, with an established peer group reputation, and they should possess good teaching skills. In addition, ideally they should have directorial experience themselves, so that they are familiar with the rough-and-tumble of a director's life and carry credibility in the classroom. Instructors with all these attributes are relatively rare.

It is important that the courses not be merely "off-the-shelf", but rather attempt to address the specific needs of directors rather than managers . The emphasis on

directors means that instructors should constantly point out the difference between management and direction, should attempt to discuss topics in the context of the speed and inevitability of change in business, should encourage a "hands-off" perspective, and should be more prepared to tackle conceptual issues than would be appropriate for executive management courses.

Team-building, lateral communication and transparency are important features of direction. This suggests that, for as many activities as possible, delegates should work in small groups. The workload and the organization of tasks should be such that participants learn to rely on their colleagues and to learn from each other.

Also, learning by doing is often more effective than mere "chalk and talk". It is important that the courses include plenty of group work, exercises, cases, and so on, so as to provide practice in both decision-making and communication skills. This approach also gives participants more exposure to their peers, and an increased chance of learning from others with different backgrounds.

Contact time with instructors may often be optimised by providing the participants, where possible, with computer discs or handouts covering basic techniques and factual elements *before* the course starts. Sessions can then build on the previously distributed material. The courses should impart knowledge, but it is equally important to develop the participants' ability to organize and assimilate information, to identify problems and their causes, and to analyse business problems.

The teaching style should in each course be a mix of lecture and discussions (in which the trainer will introduce concepts and models), case studies (where the participants will have to make decisions and justify them in open discussion), and exercises (where the participants will be asked to observe and criticize actual business practices).

In addition to knowledge per se, effective directors need to possess a number of skills. For example, they must be able to make good judgements, be change-oriented, see the "big picture" amid the hurly-burly of the immediate situation, assimilate and organize information, foster teamwork and motivate managers, and offer clear leadership. It is difficult to impart these skills directly, but the way in which courses are structured and taught can encourage participants to acquire desirable habits and skills and to practise them.

The content of training

Directors' knowledge

Each company and each board is unique; it is therefore impossible to produce a comprehensive and definitive list of all the elements of knowledge and understanding that a director should possess. Nevertheless, some key areas of directors' knowledge and understanding are known. The following recommendations are mainly the result of research. Many focus groups of experienced directors and academics contributed to defining a minimum set of the knowledge and techniques required by company directors. A fuller description is given in Institute of Directors (1999b).

Three areas seem to be particularly important:

Governance:

A director should be aware of his or her role and should appreciate the crucial differences between management and direction. Directors should have an understanding of the legal framework within which they operate. A director should have a good understanding of a board's operations and how to ensure its effectiveness.

Strategic business direction:

Being charged with determining the company's strategic direction, a director should know and understand the issues and processes involved in formulating, implementing and controlling the company's corporate and business strategies.

Finance:

A director should have a sound background knowledge of company accounting, financial language and concepts, and relevant financial tools and techniques. At the least he or she should be able to read a balance sheet, to understand the differences between management and financial accounts, and to ask searching questions of the finance director.

Personal attributes

Research (see Dulewicz, 1994) and Dulewicz et al.,1995) has identified a number of desirable personal attributes of directors. No single individual will have all these attributes, but each of those deemed necessary for a particular board should be possessed by at least one director. A proper balance of personal attributes among by the directors will help to ensure that the board can work as an effective group.

The attributes in question can be classified into six groups relating to specific aspects of company direction. They are relevant to a director's role, whether as chairman, managing director, executive or non-executive director.

The groups are:

- Strategic perception
- Decision-making
- Analysis and the use of information
- Communication
- Interaction with others
- Achievement of results

Other characteristics are also found to be useful attributes for directors to have:

- Courage/strength of character
- Common sense
- Tenacity

- Diplomacy/tact
- Wisdom
- Intellect

Many of these attributes are components of *leadership*, by which is meant the ability to conduct the company's affairs, govern, guide and motivate others. The board of directors leads the company and whether it does this well or badly depends in part on the personal attributes of its members.

The work of the Institute of Directors

The Institute of Directors intends both to emphasize and to broaden its role as the definitive voice about what constitutes good performance in company direction. The aim is to increase the perception of company directors as professionals with recognized standards of competence, with the Institute of Directors as the relevant professional body setting the standards.

The Institute of Directors strongly holds the view that planned professional development for every company director throughout his or her career is of great importance. There is wide acceptance of this point of view across most professions. Hence the Institute of Directors, like most professional Institutes, insists as a condition of continued registration that "chartered" members satisfy a continuing professional development requirement.

Consequently, it is a declared aim of the Institute of Directors to help company directors improve both their knowledge and their skills so as to increase their effectiveness in directing their companies. The main vehicle for achieving this aim is an extensive range of short courses for directors and aspiring directors. These are delivered at the Institute of Directors, at a number of business schools in the United Kingdom, and in collaboration with the Japan Management Association in Japan. General courses appropriate to all board members are supplemented by specialist courses and by courses aimed at particular types of director. For example, chairmen, CEOs and non-executive directors have roles sufficiently different to justify specialist courses for them. The Institute of Directors also works with companies to devise and deliver in-company training programmes, where all the participants are directors of the same company or group of companies. Each year thousands of directors participate in courses run by the Institute of Directors.

The Institute of Directors also runs a Company Direction Programme, which aims to cover all the areas of knowledge and comprehension necessary for successfully directing a modern British company. This programme consists of seven short courses, each of between one and three days' duration. Total training time is 15 days. Candidates who attend the entire programme and then pass an examination testing their knowledge and understanding of the programme content are awarded the Institute of Directors Diploma in Company Direction.

The Institute of Directors has also created the world's first professional qualification for directors – the Chartered Director. No one can become a Chartered Director without, as part of the process, satisfying the Institute of Directors that he or she has what is regarded as the minimum basic knowledge for competency as a

director. Training and development is therefore a very important element in the Institute of Directors' attempt to create and define this new professional standard for directors. Also, all Chartered Directors must undertake continuing professional development throughout their working life. The Institute's Code of Professional Conduct (Institute of Directors, 1999a), to the provisions of which all Chartered Directors subscribe, includes the words (Article 10): *It is the responsibility of a director continually and systematically to add to his/her knowledge and expertise; it is not enough to match present good practice and thereafter regard oneself as adequately equipped for the future. A Chartered Director should ensure that he/she keeps himself/herself abreast of both practical and theoretical developments in direction to ensure that his/her expertise is constantly relevant.*

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Part II. Regional and Country Experiences

Corporate Governance in the European Union

Dominique Thienpont*

Introduction

The European Commission is a much solicited participant in the debate about corporate governance, although Community law remains almost silent on the subject. The reason for this is the difficulty of arriving at a common approach on specific corporate governance issues, even on a non-binding basis, as is illustrated by the lengthy discussions on the European Company Statute and the draft fifth Directive, which led member States to invoke more clearly the subsidiary principle.

The corporate governance debate: different approaches

Member States have different systems of corporate governance that reflect their different views about the roles of corporations and the way in which their industry should be financed. In countries with more developed equity markets (known as "outsider systems"), listed companies are more widely held. In countries with less developed equity markets (known as "insider systems"), listed companies are more often controlled by one or a group of controlling interests.

The corporate governance debate first started in the "outsider systems" (in particular in the United States and the United Kingdom), because institutional shareholders became more active in seeking to ensure that management managed in a way that maximizes their interests. As capital markets have become more important in the traditionally insider systems, the debate has now spread to the rest of Europe, where it is more about the protection of minority shareholders.

At the member State level, those whose economic interests are protected by current arrangements, whether it is management or controlling shareholders, are usually powerful advocates for their own system and against any change at the national or EU level. However, corporate governance is a subject of intense debate in many member States, where it has often been triggered and encouraged by spectacular corporate failures. In this context, a series of corporate governance codes have been adopted over the last decade, at the national or international level, with the aim of better protecting the interests of shareholders and/or stakeholders. They have different origins, do not necessarily cover the same issues, and are not enforced the same way. To date, there has been no analysis of these differences or of their practical consequences for a single European capital market.

* European Commission

Why should the European Union be concerned about these issues?

The structure of ownership of companies has shifted :

- Privatisation, both of companies themselves and of pension funding, has resulted in a more dispersed ownership of company equity, with an increased involvement of institutional shareholders.

- The introduction of the euro has added more impetus to the process of integration and competition between EU capital markets, and technological developments support this.

- EU capital market investors are now moving quickly to a sectoral basis of asset allocation and away from domestic markets.

In view of these developments, which have led to a rapidly growing number of cross-border issuances and cross-border investments, the time is now right to introduce an EU dimension to the debate.

In the Financial Services Action Plan published by the European Commission in May 1999 and endorsed by the European Council in Lisbon in March 2000, one of the identified prerequisites for achieving deep and liquid European capital markets was an improved corporate governance framework in the European Union.

Differences in corporate governance arrangements may indeed create uncertainty for both issuers (e.g. a company deciding to collect capital in different European countries might have to apply different codes) and investors (e.g. investors active in different markets in the European Union might not benefit from the same rights everywhere).

A comparative study of the corporate governance codes in force within the European Union

Based on these observations, the Financial Services Action Plan announced that the Commission would launch a review of existing codes of corporate governance. The purpose of this review is to provide the Commission with a study that :

1) Identifies the various corporate governance codes that may affect now companies are directed and controlled in the European Union,
2) Performs a detailed comparison of all the rules contained in these codes (and in the national framework of laws and regulations to the extent necessary) and presents a synthesis of the main lines of convergence and divergence of these rules;
3) Makes a comparative analysis of the extent to which enforcement of these provisions has been organized; and
4) Presents information about the expected developments in the area of corporate governance codes within the European Union. Where are we now? The interim report, which covers section 1 (identification of the codes relevant to the European Union), was received in May 2001. The final report, which will cover all four sections, is expected for December 2001.

Determining the need for an EU-level initiative

The analysis of the results of this comparative study will allow the Commission to determine to what extent any legal or administrative barriers stemming from the existence of different corporate governance arrangements may require an intervention at EU level, and, if so, what steps should be taken.

The Commission is fully aware of the sensitivities in this area. Preference should therefore be given to self-regulatory solutions. But self-regulation does not necessarily mean no regulation. We should concentrate on the real obstacles to the development of an integrated market, and it could be that targeted legislation might be the most efficient way to address specific topics raised in the corporate governance debate (such as the protection of minority shareholders).

Disclosure is a key element in ensuring good corporate governance. Compulsory disclosure of corporate governance practices can be a strong force to bring about convergence, as demonstrated by the "comply or justify" approach applied in certain member States.

The results of the comparative study will be submitted to the High Level Group of Company Law Experts that has been set up by the Commission and is due to make recommendations on a number of company law issues (including corporate governance) in July 2002. The High Level Group recommendations will then be discussed with member States and the European Parliament, with a view to identifying the actions, if any, that may be necessary at the EU level.

Corporate Governance in the Eastern, Central, and Southern African Region

Ndung'u Gathinji*

The countries in the Eastern Central and Southern African regions have a colourful history of British, German and Portuguese colonial rule. Progress to majority rule took several forms, and this was reflected in the extent to which domestic legislation was allowed to flourish. While the white-ruled countries of South Africa and Zimbabwe (Rhodesia) enjoyed a legal system that kept pace with the aspirations of the ruling class, the legal systems of the remaining countries concentrated more on ensuring control and subjugation of the native peoples. As far as commercial law developments were concerned, domestic law tended to be based on statutes enacted elsewhere (mainly India and England) and modified to suit the preferred local motives.

Consequently, the operative company ordinances in most of the British territories were based on the 1929/48 British Companies' Acts, which had been enacted at a time when corporate governance had not been invented. Several factors militated against the development of the process:

- The colonial economy was founded on the basis of exploitation of the countries' resources and people in a manner that could not hold up to close scrutiny.
- There was no organized representation or voice that could press for better disclosure and accountability.
- The population was, and largely still is ignorant of its rights.

Political independence brought new rulers, but the economic equation remained largely unchanged. The protection of foreign companies previously guaranteed by the colonial government could still be obtained through corrupt practices.

Critical analysis, previously welcomed as anti-colonial, was now suppressed as unpatriotic. The new leaders were more interested in promulgating laws that ensured their stay in power than laws that promoted accountability and transparency. Moreover, the new leaders took interests and positions in various businesses and consequently preferred to ensure secrecy of these operations rather than have them disclosed.

The development of corporate governance became inevitable after the Prime Minister of Great Britain, Edward Heath, described some of Tiny Rowland's activities in Lonrho as the "unacceptable face of capitalism". The Cadbury report in the United Kingdom and the King report in South Africa, the guidelines of the Organisation for Economic Co-operation and Development, and various national codes on corporate governance attest to the importance now attached to corporate governance. One

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reason for this is the realization that good corporate governance is necessary for economic growth and that one reason why there is so much poverty in developing countries despite their natural resources is poor governance in both the public and corporate sectors. If public-sector governance is bad, it follows that corporate governance in the private sector will also be inadequate to promote growth.

The majority of countries in the ECSAFA region belong to the British Commonwealth and it is therefore not surprising that the Commonwealth Association on Corporate Governance (CACG) has spearheaded moves in the region to promote awareness of corporate governance.

The CACG hopes to establish affiliates in each country and so far has helped establish the Private Sector Corporate Governance Trust (PSCGT) in Kenya in 1999, Uganda and elsewhere. French-speaking Africa is not as advanced in this respect. In July 2001, a Pan-African Corporate Governance Forum was convened in Midrand, South Africa, to promote the governance message continent-wide. Various initiatives, including the formation of institutes of directors in various countries, were mooted. The PSCGT operates as the interim secretariat for the Pan- African initiative and also conducts various courses on corporate governance, the top event being a five-day residential training course for company directors which also serves as a training and examination course for future corporate governance trainers. Planned future activities include the awarding of diplomas and degrees in corporate governance by accredited institutions.

Owing to how the economy is structured and the level of development of institutions generally, it is often necessary to seek to develop different sets of codes for different purposes (e.g. state-owned enterprises, public companies including cooperatives, quoted companies, etc).

The ideal would be for all managers and directors of enterprises to undergo the training. Thereafter one could address the question of what aspects of the codes should be incorporated into statutes.

There are real or perceived concerns regarding some disclosure issues (e.g. directors' and senior managers' pay). Most countries in the region have unemployment of 50 per cent or more and minimum wages are very low; of ten less than a dollar a day. At the other end of the scale, however, executive pay, pushed by expatriates' remuneration expectations, is quite high and compares favourably with levels in developed countries. As such levels of pay are irrespective of performance, it is not surprising that executives do not want their pay levels disclosed.

Another problem is transfer pricing by subsidiaries of multinational corporations. This was, in fact, the original raison d'être for the establishment of ISAR's predecessor bodies, and it is not surprising that the practice persists and that such subsidiaries, although raising capital locally, do not want to account for their profits locally. Individual countries may find it difficult to promote good corporate governance practices in the face of determined opposition from such vested interests. That may, in the end, be the real problem to be tackled

Corporate Governance as an Evolutionary Process: A Malaysian perspective

S. Susela Devi[*]

Introduction

In Malaysia, efforts to enhance standards of corporate governance have been ongoing. Various initiatives have been undertaken by the relevant authorities and professional bodies in developing best practices on corporate governance. It is recognized in these deliberations and initiatives that no matter how good the standards of corporate governance are, top priority should be given to inculcation of the ethics of good governance amongst the players involved (Azimon and Azizah, 2001).

It is accepted that systems of corporate governance are a result of different historical developments, different cultures and different economies (Clarke, 2001). The Report of the *Business Sector Advisory Group on Corporate Governance* (OECD, 1998) acknowledges that essentially the role of regulation is not to impose a rigid framework, but "to shape a corporate governance environment compatible with societal values, that allows competition and market forces to work so that corporations can succeed in generating long-term economic gain". Essentially this paper views corporate governance as an evolutionary process. The discussion of the development of corporate governance in Malaysia provides insights on the Triple A Strategy (Awareness, Advocacy and Action), critical for the successful implementation of corporate governance standards in the country.

Corporate governance initiatives in Malaysia

The impetus towards providing corporate governance initiatives began long before the 1997 financial crisis. Table 1 provides a chronological list of corporate governance initiatives in Malaysia. The discussion in this section views the developments in three phases: Awareness, Advocacy and Action.

Awareness

A corporation cannot have good governance if the institutional milieu in which it exists does not embrace good governance principles (Koh, 2001). Awareness of corporate governance issues is the first step towards good corporate governance. The establishment of the Federation of Public Listed Companies Bhd (FPLC) in April 1987 could be viewed as the deepening of awareness for corporate governance initiatives. In 1989 the FPLC introduced a Code of Ethics for publicly listed companies (PLCs). It is acknowledged that a paradigm shift was necessary to instil good corporate governance. Mindset is not the easiest thing to change. It is claimed that culture of good governance may even take a generation or more to instil.

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The early 1990s exposed several cases such as those of the Maxwell Group and Polly Peck and the BCCI scandal that called into question the strength of accounting standards and quality of auditing. The accounting profession felt there was some unfairness in the criticisms: Accountants and auditors were getting blamed for something that was really the responsibility of directors. In Malaysia, accounting standards were perceived to be set by the accounting profession with little consultation with the other constituents (Susela, 1999).

The awareness that good corporate governance demands high-quality, transparent financial reporting so that the real financial position can be seen and confidence established was created. To have confidence, investors must believe that a company will apply recognized accounting standards consistently (Rutteman, 2001) That, in turn, requires an enforcement mechanism.

This led to the establishment of the Financial Reporting Act 1997, which established an independent accounting standards body, the Malaysian Accounting Standards Board (MASB). The Board included representatives from all constituencies, preparers, auditors, regulators, analysts, corporations, and the accounting profession, as well as academics and others. Approved accounting standards became enforceable by law when the Companies Act 1965 was amended in 1998 to mandate compliance with approved accounting standards. The responsibility for enforcement was placed with the Registrar of Companies, the Central Bank and the Securities Commission. Additionally, amendments to the Act paved the way for placing responsibility for compliance with approved accounting standards on the directors of companies. A statutory declaration is required by two directors of the company stating that the accounts have been drawn up in compliance with approved accounting standards.

Advocacy

The Asian Financial crisis of 1997 intensified initiatives in corporate governance. The High-Level Finance Committee was set up in 1998 and issued the Code of Corporate Governance in 1999. This code was further amended in 2000. The Malaysian Institute of Corporate Governance (MICG) was set up in 1998. The MICG[1] has since organized public awareness campaigns to promote good corporate governance with emphasis on the Malaysian Code of Corporate Governance. Its activities include:

- Conducting regular seminars and talks on corporate governance issues jointly with various professional bodies and industry groups
- Conducting educational public seminars, especially for investors under the MICG Investor Education Programme
- Providing assistance to various regulatory agencies in developing the Mandatory Accreditation Training and Continuing Education Programmes for Directors of PLCs

[1] For more on the MICG, see *www.micg.net*.

- Networking with international organizations such as The Organisation for Economic Co-operation and Development (OECD), the Commonwealth Association for Corporate Governance (CACG), the World Bank, the Asian Development Bank, the Transparency International Institute on Governance (IOG) and others on corporate governance principles, initiatives and issues.
- Developing a multi-disciplinary institute for service, research and education in corporate governance

(Source: http://www.micg.net)

Action

As can be seen from Table 1, various proactive steps have been undertaken since the issue of the Malaysian Code of Corporate Governance. The focus has been on the control environment. The control environment is the whole culture and ethical values of the company (Rutteman, 2001). As Rutteman (2001) states, controls will only work effectively if it is known throughout the company that they are not there to be circumvented. Above all, the tone has to be set from the top… (p. 36)

The action plans are the result of a cohesive and consultative process of deliberations and discussions among the various professional and regulatory authorities, and the Government[22].

The following are some of the more important actions taken to facilitate the implementation of the requirements of the *Malaysian Code of Corporate Governance.*

Statement on Internal Control: Guidance for Directors of PLCs

An effective internal control system is an essential part of the efficient management of a company. The Malaysian Code of Corporate Governance as amended in March 2000 includes as a principle of Corporate Governance that the board of a listed company should "maintain a sound system of internal control to safeguard shareholders' investment and the company's assets." Subsequently, the Kuala Lumpur Stock Exchange (KLSE) established an industry Task Force to formulate guidance to assist listed companies in making disclosures in their annual reports on the state of internal control in compliance with the Listing Requirements of the KLSE.

The guidance entitled, *Statement on Internal Control: Guidance for Directors of Public Listed Companies* was issued in December 2000. (Available at: http://www.klse.com.my/websit/listing/).

[2] The National Economic Action Council (NEAC) established on 7 January 1998 is the consultative body to Malaysia's cabinet to deal with the economic crisis. Initiatives to improve corporate governance, transparency of decisions, diversification of resources of financing and better regulation on the part of the Government are all part of an overall effort to improve the performance of the corporate sector.

Revamped Listing Requirements of KLSE

This was issued in January 2001 and embodies the requirements of *Malaysian Code of Corporate Governance.* (This is available at: http://www.klse.com.my/website/).

Mandatory Training of Directors of PLCs

The Revamped Listing Requirement of KLSE prescribes that Directors attend the following training programmes:

- The Mandatory Accreditation Programme (MAP); and
- The Continuing Education Programme (CEP) on an annual basis.

The MAP is organised by the Research Institute of Investment Analysts Malaysia (RIIAN), an affiliate company of the Exchange. Other approved bodies have also begun conducting such courses. The KLSE has issued Practice Note 5/2001 which provides guidance on this mandatory training of directors.

Exposure draft on guidelines on internal audit function for directors of PLCs

One of the most effective means of monitoring the continued effectiveness of the internal control system is through a high quality internal audit function. Towards this end, it was envisaged that some guidance should be provided to assist the Board of Directors of PLCs in the effective discharge their responsibilities in relation to the establishment of an Internal Audit Function.

The Securities Commission took the lead this time to establish a task force comprising internal audit practitioners, representatives from professional bodies and industry groups to provide a balanced view on the state of the Internal Audit Function in Malaysia.

The draft guidelines have been released for comments since December 2001. Essentially the guidelines have been developed in the context of providing a reasonable standard and are intended to be updated regularly with the latest best practices in tandem with the evolving challenges of the internal audit profession. (Available from: http://www.iiam.com.my/IAFG.htm)

Audit committees

The Revamped Listing Requirement (RLR) of the KLSE mandates the establishment of an Audit Committee by PLCs. The rules are spelled out in paragraph 15.10- 15.21. However, concerns have been raised that since the Audit Committee comprises non-executive directors it is unrealistic to believe that it will have the same knowledge of the business that executive directors will have. It is alleged that in some ways non-executive directors may assume greater responsibilities than they realise or than is reasonable. In this context the presence of an Internal Audit function with clearly defined roles and relationship with the Audit Committee may be worth exploring.

Overall audit committee has been positive and seen as one of the best contributions to improved internal control and corporate governance (Rutteman, 2001). However, in the context of Malaysia, the relationship between the audit committees and internal audit function has not been investigated thoroughly. There is a void in terms of empirical studies in this area. Grounded studies in this area could provide feedback as to the problems and issues that may arise from the implementation of the RLR.

Corporate governance : the way forward

As outlined above, the corporate governance initiatives in Malaysia have been spearheaded by both internal and external developments. Regulatory reforms have been introduced after much consultation and deliberations with all interest groups with the blessings of the government. The reform and rigour of company board of directors were the focus of much of corporate governance policy making thus far. The concern has been the integrity of internal control and the basic institutions and relationships of governance at the corporate level.

In moving forward a review of the implementation issues and problems at the ground level may be necessary. Enforcement and surveillance mechanisms by the regulatory bodies are critical. There is little doubt that the reality of corporate governance is that those in control of corporations will always have one eye on the laws governing his/her actions and more particularly the penalties that go with any breach thereof and another eye on wealth-making for the corporation (Chan, 2001).

The focus has now shifted to the enforcement by regulators:

> … with all the welter of laws and regulations that we already have, it is surprising that there has not been the number of prosecutions which ought to have taken place let alone successful ones. The answer at the bottom of it all is the vigorous enforcement of existing laws and regulation as opposed to the promulgation of new ones … (Chan, 2001, p.22)

Therefore moving forward in this evolutionary process, decisive and timely actions by the respective regulatory bodies need to be publicised in order to drive the message that the authorities are serious about Corporate Governance and it is not just some rhetoric.

The focus on educating directors and the public is commendable. The Ministry of Education has also mandated all Public Universities to offer compulsory courses in moral and professional ethics in all disciplines of study. This is a long-term strategy to create the awareness and instil good governance and ethics.

Conclusion

This paper has offered some insights into the evolutionary process of Corporate Governance in Malaysia. The Triple A strategy has been a contributing force to the successful implementation of these initiatives. However, it remains to be seen whether the momentum provided by the 1997 crisis will continue to push Corporate Governance efforts in the future.

Table 1: Chronological Account of Corporate Governance Initiatives in Malaysia

Date/ Year	Initiatives
April 1987	Establishment of the Federation of Public Listed Companies Bhd. (FPLC). Recognised as the official spokesperson for PLCs in Malaysia.
1987	Amendments to Companies Act 1965, Section 132 E, Section 132F and Section 132G pertaining to substantial transactions involving directors…
1989	FPLC introduced a Code of Ethics for PLCs
1993	Establishment of the Securities Commission.
1994	Audit Committees mandated by KLSE Listing Requirements.
1997	Establishment of the Financial Reporting Act 1997. Established the Malaysian Accounting Standards Board (MASB).
January 1998	Establishment of the National Economic Action Council (NEAC)
March 1998	Establishment of High Level Finance Committee on Corporate Governance. Establishment of Malaysian Institute of Corporate Governance
Sept. 1998	Amendments to Companies Act 1965 to mandate compliance with Approved Accounting Standards. Section 166A. Directors required to make a statutory declaration regarding compliance with approved accounting standards. Section 169(15).
1999	Issue of the Malaysian Code on Corporate Governance
March 2000	Malaysian Code on Corporate Governance amended.
May 2000	Setting up of Task Force by KLSE to formulate guidelines for Statement of Internal Control by Directors of PLCs.
December 2000	Issue of Guidelines for Statement of Internal Control by Directors of PLCs.
January 2001	Revamped Listing Requirements by KLSE issued. Chapter 15 addresses issues of Corporate Governance. Practice Note 5/2001 mandates Training for Directors.
May 2001	Securities Commission establishes industry taskforce to formulate guidelines on Internal Audit Function.
December 2001	Exposure Draft: Guidelines on Internal Audit Function, issued by the Institute of Internal Auditors.

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