UNITED
NATIONS

TD

United Nations Conference on Trade and Development

Distr.
GENERAL

TD/B/COM.2/ISAR/25
2 September 2004

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and Related Financial Issues
Intergovernmental Working Group of Experts on
International Standards of Accounting and Reporting
Twenty-first session
Geneva, 27 – 29 October 2004

REVIEW OF THE IMPLEMENTATION STATUS OF CORPORATE GOVERNANCE DISCLOSURES AND THE ROLE OF SUCH DISCLOSURES IN ADDING SUSTAINABLE VALUE[*]

Report by the UNCTAD Secretariat

Executive summary

The UNCTAD secretariat prepared this report in response to the request made at the twentieth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) calling for a review of the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value.

This report highlights developments in corporate governance disclosures that occurred after the twentieth session of ISAR and discusses challenges in implementing good corporate governance disclosure practices. In particular, the report provides an overview of the main international initiatives in the area of corporate governance disclosures, including increasing trends towards convergence in the area of corporate governance disclosures, and it discusses the status of implementation of good practices of corporate governance disclosures at the company level. The role of corporate governance disclosures in adding sustainable shareholder value is also addressed.

[*] The late submission of this document was caused by the secretariat's workload in the period following UNCTAD XI

GE.04-52320

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INTRODUCTION

1. Over the years, different issues relating to corporate governance disclosure practices have been on the agenda of the Intergovernmental Working Group of Experts at its various sessions. At its seventh session in March 1989, the Group of Experts deliberated on information disclosure items in annual reports of Boards of Directors. At the tenth quadrennial conference of UNCTAD, which took place in Bangkok, Thailand, in February 2000, member States requested ISAR to "promote increased transparency and financial disclosure by encouraging the use of internationally recognized accounting, reporting and auditing standards and improved corporate governance". The Group considered this request at its seventeenth session in July 2000, and at that session, it proposed reviewing existing corporate governance practices at the regional, country and company levels at its eighteenth session.

2. In concluding its eighteenth session, ISAR proposed conducting further work in the area of corporate governance. Accordingly, an ad hoc consultative group was formed and submitted its report (TD/B/COM.2/ISAR/15) to the nineteenth session of ISAR. The report offers global and comprehensive coverage of corporate governance disclosure practices, and identifies an extensive list of good corporate governance practices. At its nineteenth session, the Group proposed reviewing case studies on corporate governance disclosures at its twentieth session. In accordance with that request, case studies on transparency and disclosure on corporate governance were conducted on Brazil, France, Kenya, the Russian Federation and the United States of America (see TD/B/COM.2/ISAR/19 and addenda 1–5). The case studies focused on major implementation issues and used the guidance set out in TD/B/COM.2/ISAR/15 as a benchmark for the assessment. The findings of the case studies (TD/B/COM.2/ISAR/19) were discussed at the twentieth session of the Group of Experts in October 2003.

3. The Group of Experts proposed reviewing at its twenty-first session the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value (see TD/B/COM.2/ISAR/22). Accordingly, the secretariat prepared this paper and is submitting it for consideration by the Group at its twenty-first session. The objectives of this paper are to present an overall assessment of the common aspects of implementation of corporate governance disclosures, including the adequacy and extent of such disclosures and their role in adding sustainable value, as well as to provide an update on recent developments in the area of corporate governance in different parts of the world. Particular attention is drawn to the company level, companies being the entities responsible for implementing corporate governance practices.

4. As part of the assessment carried out in compiling this report, a checklist of disclosure items was developed on the basis of the practical guidance on corporate governance disclosures that ISAR initially deliberated on at its nineteenth session. This checklist was used in reviewing a sample of selected company annual reports and regulatory filings, where publicly available. In addition to facilitating the assessment exercise at the company level, the checklist provided valuable feedback on the practical use of the corporate governance disclosure items that ISAR has identified.

I. OVERVIEW OF MAIN RECENT DEVELOPMENTS IN THE AREA OF CORPORATE GOVERNANCE DISCLOSURE

5. During the ISAR intersession period of 2003/04, the issue of corporate governance and transparency continued to receive unmatched levels of attention.

6. A major development since the twentieth session was the revision of the OECD Principles of Corporate Governance originally released in 1999. The revision relied on a series of global round tables that addressed countries with differing corporate governance traditions. The revised OECD Principles contain a new chapter on principles for the development of the regulatory framework necessary for underpinning good corporate governance to promote transparent and efficient markets.

7. The revised Principles also strengthen disclosure requirements. In particular, they give greater prominence to disclosure information about Board members, including independence, remuneration, qualifications and the selection process. Further, the revised Principles underscore the responsibility of the external auditor to shareholders and also encourage analysts, brokers, rating agencies and others to ensure they are free from material conflicts of interest that might compromise the integrity of their analysis or advice.

8. In 2003, the European Commission (EC)[1] proposed an Action Plan covering proposals on corporate governance, capital maintenance and alteration, groups and pyramids, corporate restructuring and mobility, and other issues. Concurrently with the Action Plan, the EC established 10 priorities for improving and harmonizing the quality of statutory audit throughout the EU.[2] A new Prospectus Directive, which entered into force on 31 December 2003, offers common criteria for the acceptance of offering prospectuses throughout the EU.[3] In addition, a new Transparency Directive, which was agreed by the European Parliament on 30 March 2004, aims to upgrade transparency for securities issues and investors, and sets out a wide variety of disclosure requirements. The Committee of European Securities Regulators (CESR) is taking on an increasingly important role as an independent pan-European advisory group, and will assist the EC in preparing draft implementing measures.[4]

9. In 2003/04, significant reforms continued to be introduced in the United States. Reforms in the area of corporate governance in the United States are of considerable importance, as they can be expected to have international implications due to the many foreign listings on US exchanges, the influence of US investment funds globally and the fact that the Sarbanes Oxley Act (SOA) assigned the Securities and Exchange Commission (SEC) the authority to direct US stock exchanges to prohibit the listing of companies that do not meet their disclosure requirements.

10. In its continued efforts to implement the SOA, the SEC approved significant regulations, in particular with respect to Board members; in November 2003, it adopted rules to enhance the transparency of Board operations with respect to disclosure when nominating committees and how shareholders communicate with directors.[5] Also in November 2003, the SEC approved the new rules for corporate governance and disclosure proposed by the New York Stock Exchange (NYSE) and NASDAQ in 2002.[6] For companies listed at both of these exchanges, the new rules require that the Boards have a majority of independent directors. Generally, companies listed on both the NYSE and NASDAQ are requested to comply with the new rules by the earliest at their first annual meeting after 15 January 2004 or 31 October 2004.

11. Some other significant new rules for companies listed on the NYSE cover the following: disclosure by boards of specific information with respect to the presiding director, communication processes with the directors, nomination and remuneration committees, adoption and disclosure of corporate governance guidelines and committee charters, and the existence of an internal audit body.[7]

12. The new rules at NASDAQ require listed companies to disclose which directors are independent and that either a majority of independent directors or a remuneration committee

composed solely of independent directors is to determine compensation for top executives. The NASDAQ rules also require that either a majority of independent directors or a nominating committee composed solely of independent directors select or recommend director nominees to the Board.

13. As part of a review of corporate governance reform, a 2003 study commissioned by the SOA found that an increase in audit independence could be achieved more effectively in ways other than through mandatory audit firm rotation. The US Government Accounting Office (GAO), which conducted the study, released its conclusions in November 2003[8], suggesting that the costs of mandatory audit firm rotation exceed the potential benefits. The report also finds that current requirements for audit partner rotation, auditor independence and other reform, once implemented, would be sufficient to meet the intended benefits of mandatory audit firm rotation.

14. Following months of international dialogue, in June 2004, under the auspices of the SOA, the Public Company Accounting Oversight Board (PCAOB) adopted rules related to the oversight of non-US public accounting firms that prepare or furnish audit reports with respect to US public companies.[9] The rules specify a framework under which, with respect to non-US firms, the PCAOB could implement the provisions of Section 106(a) of the SOA by relying, to an appropriate degree, on a non-US system. Section 106(a) of the SOA provides that any non-US public accounting firm that prepares or furnishes an audit report with respect to any US public company is subject to the SOA and the rules of the PCAOB.

15. The latest national corporate governance codes and guidelines are being written with a recognizable hardening of norms around commonly held governance principles.[10] Virtually all countries with equity markets, even those with small or emerging stock markets, have corporate governance codes or guidelines. Many of the newer second-generation practices are more rigorous than prior codes and require greater levels of detail in disclosure, for example, Aldama in Spain, AFEP-MEDEF[11] in France and the Higgs Report in the United Kingdom, all of which appeared in 2003. A common trend in corporate governance reform is to enhance the independence of the Board and managers with regard to their controlling interests, where independence may be impaired.

16. There have also been significant developments in corporate governance reform in other parts of the word. In this respect useful information can be found in the World Bank and IMF Reports on the Observance of Standards and Codes (ROSCs)[12] on corporate governance. These reports assess country compliance with each OECD Principle for Corporate Governance, and policy recommendations may be offered if a Principle is less than fully observed. So far, there are 27 ROSCs on corporate governance (including three on countries for which ROSCs were prepared for the second time). These reports provide valuable information with respect to corporate governance in general and implementation issues in particular.

17. Since the twentieth session of ISAR, three new ROSC reports have completed, i.e. on Egypt, India and Mexico. Recommendations vary and suggest, among other things, that annual reports be more standardized and include disclosure of ownership and related party transactions, and that there is a need for a framework regarding quality and independent audit processes.

18. While some criticize the growing costs associated with corporate governance reform, views on what is good corporate governance disclosure practices are converging,[13] and the type of information to be disclosed is becoming more similar.[14] This may be due to a number of factors, including global interest in corporate governance issues, the increasing influence of the OECD Principles of Corporate Governance and of the initiatives of the International Corporate Governance Network, international efforts to promote better securities market

regulation, increasing acceptance of International Financial Reporting Standards (IFRS), and importantly, increased recognition of the added value of sound corporate governance practices. Despite very different legal origins and governance traditions, there appears to be a growing trend towards reliance on disclosure, a growing consensus on the contents of disclosure and broader agreement on the role of the Board in overseeing disclosure. For example, the audit committee is increasingly viewed as the most important tool to help the Board and companies achieve their goal of transparency, a view echoed by the EC in its Corporate Governance Action Plan in 2003.

19. The trend towards convergence was facilitated by the US SEC and the EU CESR dialogues on corporate governance issues. These centred on discussion on cooperation among regulators, and in particular on the issue of the oversight of public accounting firms. The PCAOB released a briefing paper outlining a cooperative approach with non-US accounting firms and engaged in dialogues with many of its foreign counterparts that demonstrate common objectives.[15] These include protecting investors, improving audit quality, ensuring effective and efficient oversight of audit firms, helping to restore public trust in the auditing profession and buttressing the efficient functioning of capital markets. These dialogues contributed to the development of a landmark EU proposal for an independent auditor oversight regime in Europe.[16]

20. International convergence also continued in the area of financial reporting. Since the twentieth session fo ISAR, a number of developments have taken place in the areas of International Financial Reporting Standards (IFRS/IAS) and International Standards on Auditing (ISA).[17] At the end of 2003, the International Accounting Standards Board (IASB) completed its improvements project, under which it revised and issued 13 IAS. The completion of the improvements project brought the IASB closer to its commitment to have a platform of high-quality improved standards in place by March 2004. The timing was set in such a manner as to ease the implementation of the IFRS/IAS in many countries that have announced their transition to the IFRS, including the European Union, beginning from 2005.

21. It is to be recalled that in September 2003, the European Commission adopted a regulation endorsing IFRS/IAS, including related interpretations of all IAS that existed as of July 2003, with the exception of IAS 32 and IAS 39 and related interpretations. In July 2004, the European Financial Reporting Advisory Group (EFRAG)[18] recommended to the European Commission the adoption of IAS 32. However, the recommendation of EFRAG was silent on IAS 39. Certain preparers, particularly the banking sector, had expressed significant concerns with respect to fair value accounting requirements of IAS 39 for hedge accounting and demand deposits.

22. Another important development in the area of IFRS with implications for corporate governance was the issuing of IFRS 2, on Share-based Payments, in February 2004.[19] IFRS 2 specifies the financial accounting and reporting required by an entity when it decides to undertake a share-based payment transaction. It requires an entity to reflect in its statements of profit or loss and financial position the effects of share-based payment transactions. This includes transactions involving granting of share options to employees.

23. Early in 2004, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) issued a revised International Standard on Auditing (ISA 240), on “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”. The Standard requires the auditor to be more proactive in considering the risk of fraud in an audit of financial statements. It emphasizes the need for the auditor to maintain professional scepticism throughout the audit, notwithstanding the auditor's past experience with and professional judgment of management and those charged with governance.[20]

24. In the United States, securities regulators decided to propose amendments to Form 20-F that aim to reduce the financial reporting burden for foreign companies listed on US stock exchanges that are converting to IFRS. According to the US SEC, the proposals are addressed particularly to foreign issuers located in the EU, who, under current EU law, will generally be required to adopt IFRS for reporting on their 2005 financial year. Under the proposals, companies that convert to the international rules would have to report to US regulators only two years of financial results rather than he three required under current rules.[21]

II. STATUS OF IMPLEMENTATION OF GOOD PRACTICES ON CORPORATE GOVERNANCE DISCLOSURE AT THE COMPANY LEVEL

A. Background and methodology

25. In order to facilitate ISAR discussions of the implementation status of corporate governance disclosures, the secretariat undertook a survey of implementation of good practices of corporate governance disclosure in selected companies. The survey was carried out using as a benchmark a checklist of disclosure items developed on the basis of the paper prepared by the secretariat for the nineteenth session of ISAR, entitled “Transparency and disclosure requirements for corporate governance” (TD/B/COM.2/ISAR/15). The main outcomes of this survey are discussed below.

26. Thirty companies representing different geographical regions and industries were selected for the survey. Country selection for the survey was based on the following representation criteria: regional representation, various levels of economic development, and level of sophistication of the capital market. Company selection was based on the following criteria: publicly traded, company contribution to GNP, and diverse industry representation.

27. Since the objective of the survey is to assess the implementation status of corporate disclosure in general, the companies selected for the survey remain anonymous. Companies represent the following regions and subregions as classified by the United Nations: 4 from Africa, 7 from Asia, 4 from Latin America and the Caribbean, 7 from Eastern Europe, 4 from Northern, Southern and Western Europe, and 4 from North America.

28. Only publicly traded companies were included in the survey, as these companies are more apt to provide public access to company information. Nineteen of the selected companies were listed on a foreign securities exchange (international listing) in addition to a local exchange (local listing). Eleven companies were listed on a local securities exchange only. For the survey, the term "international listing" refers to companies that have both foreign and local listing.

29. The disclosure items checklist contained 40 items, and each was worth a point. The disclosure practices of selected companies are analysed as of 1 May 2004 (further referred to as the survey date).

30. The primary sources used for the survey include company annual reports and company filings with regulatory bodies, including proxy statements, available on company websites (further referred as the sources). Examples of regulatory filings included the US SEC 20-F and 10-K forms and Comissão de Valores Mobiliários (CVM) filings in Brazil. Ten companies posted regulatory filings with the US SEC on their company website. Of these 10, three are US companies. Five non-US companies posted a 20-F filing on the company website, and one non-US company (Asia region) posted a 10-K and an 8-K filing. One company posted, in addition to the 20-F and annual report, the filing submitted to the local

securities regulator (Latin American region). Twelve companies made available most recent company sources as of 2002, while 18 made available most recent sources as of 2003.

31. While acknowledging that the survey is based on a relatively small sample of selected companies, the results of the analysis may provide a useful snapshot of disclosure practices and a possible starting point from which a more extensive company level review could be continued.

32. However, the checklist approach also has limitations. In particular, the quantitative analysis cannot capture the range and variations in content and quality between selected companies, and the point system does not reflect degrees of importance among the disclosure items; each item included in the checklist is given equal weighting.

33. Also due to their complexity, four disclosure practices were not included in the checklist at this stage. It was felt that a more rigorous analysis beyond a checklist format would be needed to assess disclosure on these items. These included disclosure practices on related party relationships where control exists; the decision-making process for approving transactions with related parties; rules and procedures governing the acquisition of corporate control in capital markets, and extraordinary transactions.

B. Main outcomes of the survey

General overview

34. While there is increasing convergence among national and international corporate governance codes and guidelines, the disclosure practices and the content of disclosures among the selected companies varied greatly.

35. The majority of the selected companies disclosed information that is consistent with the disclosure items checklist. In general, the highest scores are associated with those disclosure items that address financial results, accounting policies and the existence of various governance structures and mechanisms. At the high end of the range, all selected companies disclosed financial and operating results, and 97% disclosed the existence of governance structures to prevent conflict of interest (table I). Lower scores concerned various aspects of the board and key executives relating to transparency, independence and attestation of confidence in auditors, as well as professional development and performance evaluation processes. The disclosure items that got the lowest scores were disclosure of decision making and impact regarding alternative accounting decisions (17%) and, with respect to the board and key executives, availability and use of an advisorship facility (23%), and performance evaluation processes (13%). Inconsistency with respect to these three items was prevalent among all selected companies, regardless of their geographic locations.

Table 1
Disclosure item rankings among the selected companies

Disclosure item	All selected companies	Local listing only	International listing	2003 sources	2002 sources
1. Financial and operating results	100%	100%	100%	100%	100%
2. Governance structures, such as committees and other mechanisms to prevent conflict of interest	97%	100%	95%	94%	100%
3. Critical accounting policies	93%	82%	100%	94%	92%
4. Nature, type and elements of related-party transactions	93%	82%	100%	94%	92%
5. "Checks and balances" mechanisms	93%	82%	100%	100%	83%
6. Ownership structure	87%	73%	95%	89%	83%
7. Composition of board of directors (executives and non-executives)	87%	64%	100%	94%	75%
8. Process for holding annual general meetings	87%	73%	95%	94%	75%
9. Changes in shareholdings	80%	55%	95%	83%	75%
10. Control structure	80%	73%	84%	78%	83%
11. Control and corresponding equity stake	80%	64%	89%	83%	75%
12. Mechanisms protecting the rights of stakeholders in business	80%	55%	95%	83%	75%
13. Composition and function of governance committee structures	77%	55%	89%	83%	67%
14. Company objectives	73%	64%	79%	72%	75%
15. Role and functions of the board of directors	73%	45%	89%	89%	50%
16. Policy and performance in connection with environmental and social responsibility	73%	55%	84%	78%	67%
17. Risk management objectives, system and activities	73%	45%	89%	89%	50%
18. Process for interaction with internal auditors	73%	27%	100%	89%	50%
19. Material interests of members of the board and management	70%	45%	84%	78%	58%
20. Qualifications and biographical information on board members	70%	45%	84%	78%	58%
21. Availability and accessibility of meeting agenda	70%	36%	89%	83%	50%
22. Duties of the directors	67%	18%	95%	83%	42%
23. Plan of succession	67%	27%	89%	83%	42%
24. Duration of directors` contracts	67%	27%	89%	83%	42%
25. Compensation payable clauses in directors` contracts	63%	27%	84%	83%	33%
26. Internal control systems and their effectiveness	63%	27%	84%	78%	42%
27. Determination and composition of directors` remuneration	60%	18%	84%	83%	25%
28. Impact of environmental and social responsibility policies on the firm's sustainability	60%	36%	74%	61%	58%
29. Process for interaction with external auditors	60%	36%	74%	72%	42%
30. Process for appointment of external auditors	60%	45%	68%	72%	42%
31. Maintenance of independence of the board of directors	57%	18%	79%	78%	25%
32. Number of directorships held by the directors	57%	18%	79%	72%	33%
33. Process for appointment of internal auditors	57%	18%	79%	72%	33%
24. Control rights	53%	53%	53%	53%	53%
35. Existence of procedure(s) for addressing conflicts of interest among board members	43%	18%	58%	61%	17%
36. Board confidence in independence and integrity of auditors	40%	9%	58%	61%	8%
37. Professional development and training activities	27%	9%	37%	44%	0%
38. Availability and use of advisorship facility during reporting period	23%	9%	32%	39%	0%
39. Impact of alternative accounting decisions	17%	9%	21%	28%	0%
40. Performance evaluation process	13%	0%	21%	22%	0%

Note: Caution should be exercised in making comparisons between types of companies, as there is not an even dispersion among the categories of companies.

36. In general, and recognizing that selected companies are not evenly dispersed among different countries and types of companies, international listing companies and companies that made available sources as of 2003 tended to score higher marks than local listing only companies and 2002 source companies, and selected companies from North America and Northern, Southern and Western Europe tended to score higher marks than the other regions. The reasons for this tendency may include more rigorous disclosure requirements for international listing regulation compared to local regulation, changes in disclosure regulations in the United States and Europe in 2002, and moves by more companies to voluntarily enhance their disclosure practices to meet the demands of stakeholders.

37. In particular, all international listing companies disclosed, in addition to financial and operating results, information on critical accounting policies, the nature, type and elements of related-party transactions (though these disclosures do not necessarily reflect decision-making processes concerning the transactions), “checks and balance mechanisms”, the composition of the board of directors, and the process for interaction with internal auditors. At the low end, only 32% of the international listing companies disclosed the availability and use of an advisorship facility, 21% disclosed the existence of a performance evaluation process and 21% disclosed the decision-making process and impact with respect to alternative accounting decisions.

38. None of the local listing only companies or the 2002 source companies disclosed information regarding the existence of a performance evaluation process. Further, none of the 2002 source companies disclosed information on professional development and training activities, the availability and use of an advisorship facility, or the decision-making process and impact of alternative accounting decisions.

39. As seen in table 2, there is a significant range in the disclosure item scores among the selected companies. With a maximum of 40 disclosure items and the average score of 27, or 67%, two companies received the highest score of 38, or 95% (a US, international listing, 2003 sources company and an Asian, local listing, 2003 sources company). At the low end, a company received a score of 7, or 18% (Eastern Europe, local listing only, 2002 sources).

40. In addition to the widespread accessibility of corporate disclosures via the Internet, some of the encouraging findings of the survey are a high rate of disclosure on issues such as "checks and balances" mechanisms on key individuals in the enterprise; the nature of related-party transactions; ownership structure; internal control systems and their effectiveness; and composition of boards. However, the survey also highlighted important corporate governance issues on which disclosure is not yet a widespread practice. It is particularly a matter of concern to note that the performance evaluation process of boards is not being widely disclosed. Given the growing complexity of business operations and of issues that boards have to deal with, the investing public would be interested to know whether members of the board of the enterprises in which they have invested or plan to invest in have advisorship facility to seek external expertise, or have been undertaking professional development and training activities. The survey results also indicate that, in general, companies in developing countries seem to score relatively lower.

41. With respect to certain disclosure items, a number of more detailed findings were drawn from the survey, as discussed below.

Table 2
Selected company rankings based on the 40 disclosure items

Region	Company name	Most recent company reports[a]	Listing[b]	Summary results	
				Score	*Percent*
AFRICA					
Southern Africa	A1	2003	International	32	80%
Southern Africa	A2	2003	International	26	65%
North Africa	A4	2003	International	26	65%
East Africa	A3	2002	Local	13	33%
ASIA					
South-East Asia	AS6	2003	Local	38	95%
South-East Asia	AS4	2003	International	35	88%
South-Central Asia	AS3	2003	International	33	83%
East Asia	AS1	2003	International	32	80%
East Asia	AS5	2003	International	32	80%
West Asia	AS7	2002	Local	16	40%
South-Central Asia	AS2	2003	Local	10	25%
LATIN AMERICA					
South America	LA1	2002	International	32	80%
South America	LA3	2002	International	32	80%
Central America	LA4	2002	International	31	78%
South America	LA2	2002	Local	22	55%
EASTERN EUROPE[c]					
Eastern Europe	EE3	2003	International	31	78%
Eastern Europe	EE2	2002	Local	20	50%
Eastern Europe	EE6	2002	International	19	48%
Eastern Europe	EE1	2002	Local	15	38%
Eastern Europe	EE4	2002	Local	11	28%
Eastern Europe	EE7	2003	Local	9	23%
Eastern Europe	EE5	2002	Local	7	18%
NORTH, SOUTH & WESTERN EUROPE					
Northern Europe	N,S,W E1	2003	International	36	90%
Western Europe	N,S,W E2	2003	International	36	90%
Western Europe	N,S,W E3	2003	International	34	85%
Southern Europe	N,S,W E 4	2002	International	30	75%
NORTH AMERICA					
North America	NA3	2003	International	38	95%
North America	NA1	2003	International	37	93%
North America	NA2	2003	International	36	90%
North America	NA4	2003	Local	30	75%
			Mean	27	67%
			Median	31	78%
			Max	38	95%
			Min	7	18%

Notes: a Date of most recent company reports available, as of the survey date.
b Listing refers to the location of the securities exchange(s) where company is listed.
c Eastern Europe includes countries in Central Europe and the Russian Federation.

Financial disclosure

42. *Financial and operating results and critical accounting policies*: All selected companies provided easy access to financial and operating results via the company website on the Internet, but only 27 of the 30 disclosed complete annual reports or regulatory filings on the Internet.

43. *Impact of alternative accounting decisions:* Only 17% of selected companies made transparent the rationale that management used in deriving certain accounting figures and the financial impact. For example, only one selected company disclosed alternative fair value

assessments and their impact. Companies did not receive a point if they only acknowledged that management makes assumptions when preparing financial statements.

44. *Material interests:* 70% of selected companies disclosed the material interests of the board and managers in related parties or other areas affecting the company, for example stock or debt holdings. For the purpose of the survey, managers were interpreted to include high-level managers and key executives.

45. *Related party transactions*: Disclosure of related party transactions varied among selected companies. For the purpose of the survey, the analysis focused exclusively on disclosure of a description of the transactions and the parties involved. The survey did not assess disclosure of the corporate rationale behind the decision to enter into these transactions, nor the decision-making process between the related parties. Selected companies received one point for disclosing the nature, type and elements of related party transactions. Ninety-three per cent of selected companies disclosed this information. Two companies that did not disclose this information had local listing only; one made available company reports from 2003, the other, from 2002.

Non-financial disclosures

46. *Company objectives*: More selected companies disclosed information on what the company does than information on company objectives, strategies and goals. While all the selected companies disclosed a description of the company and 73% provided business enterprise objectives, only 3 companies stated increasing shareholder value and only 2 stated increasing shareholder and stakeholder value as a company objective.

47. *Ownership and shareholder rights*: Ownership and shareholder rights results reveal a possible disparity between disclosure of ownership structure and disclosure of rights. From the set of selected companies, and based on the sources used, shareholders may be less aware of their rights than they are of the ownership structure. This implies that, while shareholders may be aware of the ownership structure, they are less aware of their rights with respect to the ownership structure. With respect to company ownership, 80% of selected companies disclosed information on changes in shareholdings, the control structure, and control and corresponding equity stake, but only 53% disclosed information on ownership control rights. It should be noted, however, that selected companies might disclose information on shareholder rights in other material not reviewed in this survey.

48. *Rules and procedures governing acquisition of corporate control and corporate assets:* While disclosure of rules and procedures governing the acquisition of corporate control in capital markets and extraordinary transactions were not included in the checklist analysis, it should be noted that, in line with companies' generally accepted accounting principles, selected companies disclosed the accounting policies and methods used for the transactions.

49. *Governance structures and policies*: The results of the survey indicate a disparity among selected companies between the disclosure of the existence of governance mechanisms and the disclosure of information on the transparency and effectiveness of these mechanisms. While 97% of the selected companies disclosed the existence of governance structures and 93% disclosed the existence of a system of checks and balances or accountability mechanisms between the board and key executives, 87% disclosed the composition of the board (including executives and non-executives), 77% disclosed the composition and function of the governance structure, 73% disclosed the role and functions of the board, and only 57% disclosed efforts toward maintenance of the independence of the Board, e.g. quota

requirements for independent member representation and mandatory disclosure of conflicts of interest.

50. *Members of the board and key executives:* Results reveal different levels of transparency among selected companies with respect to the board and confirm a strong tendency on the part of international listing companies to score higher than local listing only companies. Seventy per cent of selected companies disclosed the qualifications and biographical information of each Board member, while 67% of selected companies disclosed the duties of the directors and 57% disclosed the number of directorships and other positions held by directors. Of the 21 companies that disclosed the qualifications and biographical information, 16 had international listing. Of the selected companies that disclosed the duties and number of directorships, only 2 had local listing only.

51. Eighteen (60%) selected companies disclosed information on the determination and composition of directors' remuneration at the individual or aggregate level, and of those companies that disclosed this information, 16 had international listing. Sixty-seven per cent of selected companies disclosed the duration of directors` contracts and the plan of succession for board members and key executives. A point was given for disclosing the existence or general description of a plan, not necessarily the details of the plan. Sixty-three per cent of selected companies disclosed the existence of compensation payable clauses related to remuneration (such as a stock option plan).

52. Only 43% of selected companies disclosed information on the existence of procedures for addressing conflicts of interest among members of the board, and 85% of the companies in question had international listing. Examples of such procedures include mandatory disclosure of conflicts of interest and non-participation in activities where conflict exists.

53. Overwhelmingly, and as shown in table 1, the selected companies, in particular local listing companies, received the lowest scores with respect to disclosure of professional development and training, an advisorship facility and performance evaluation for the Board.

54. *Material issues regarding employees and other stakeholders*: Eighty per cent of selected companies disclosed the existence of mechanisms that protect the rights of stakeholders in the business. This disclosure item was interpreted to include stakeholders in addition to equity shareholders, for example employees, customers, debt holders and suppliers. Examples of such mechanisms include union representation on the board, agreements with suppliers, debt covenants and employee stock ownership plans.

55. *Environmental and social stewardship:* Seventy-three per cent of selected companies disclosed the company policy and performance in connection with environmental and social responsibility, although in most cases relationships between a company's policy and performance and their impact could not be discerned. The content of disclosure varied among selected companies. A few companies disclosed specific natural environmental targets, while others disclosed more employee training and health programmes and/or contributions made to the natural environment and community. Sixty per cent of selected companies also stated that policies that promote corporate social and environmental responsibility impact firm sustainability. Examples of impact include cleaner natural environments, more efficient use of company resources, improved employee and supplier relationships, and community goodwill.

56. *Material foreseeable risk factors*: Seventy-three per cent of selected companies disclosed risk management objectives, systems and activities, e.g. corporate entities and financial instruments established to address market risks. Companies received a point if they

disclosed the existence of specific corporate structures whose function is to manage risk, not for only disclosing various risk factors.

57. *Internal control mechanisms*: Sixty-three per cent of selected companies disclosed information on their internal control systems and their effectiveness. The 19 companies concerned disclosed that the effectiveness of the company's internal controls and procedures had been evaluated. Ten of these 19 companies disclosed this information in their US SEC filing posted on their company website. Eight of the 11 companies that did not disclose this information had local listing only.

58. *Independence of auditors*: Although only 12 selected companies (40%) disclosed in a statement that the board of directors had confidence that the auditors were independent and their integrity had not been compromised in any way, all selected companies, except one, disclosed the complete letter of the "Independent Audit Report" in their annual report or other source. Of the 12 companies that disclosed such a statement, 11 had international listing and 1 was a US local listing only company.

59. More selected companies disclosed a process for interaction with internal auditors (73%) than with external auditors (60%) and more selected companies disclosed the process for appointment of external auditors (60%) than of internal auditors (57%). Typically the company disclosed the processes under the roles and responsibilities of certain governance structures, the most common being the audit committee, and under the rights of shareholders. The process for the appointment of internal auditors concerned the approval process, often involving an audit committee, for the appointment. Interaction processes concern monitoring and evaluation activities in the form of meetings and reviews.

60. *Annual general meetings:* Among the selected companies, disclosure of the availability and accessibility of the shareholder meeting agenda was not always made. Seventy per cent of selected companies disclosed information on how to obtain the meeting agenda.

III. THE ROLE OF CORPORATE GOVERNANCE DISCLOSURES IN ADDING SUSTAINABLE SHAREHOLDER VALUE

61. The implementation of good corporate governance practices and the disclosure of such practices would usually imply additional costs. Management and shareholders would be more willing to incur such additional costs if they were convinced that good corporate governance and disclosure practices increase shareholder value in a sustainable manner. It would be intuitive to assume that such a positive relationship exists. Demonstrating the existence of such a relationship on an empirical basis remains challenging, as it is difficult to determine which particular aspects of corporate governance and disclosure practices contribute more towards adding long-term value to the enterprise. Nevertheless, over the years, a number of studies have been conducted with that objective, and many provide evidence of a positive relationship.

A. Overview of findings of selected empirical studies

62. A 1998 study by Millstein and MacAvoy, on boards of directors of large publicly traded companies in the United States in the early 1990s, indicated that the performance gap between well and poorly governed firms exceeded 25% in terms of the return for investors. The difference in corporate value added performance between those firms where a

professional board was present and those where such a board was absent, measured in terms of percentage annual return for a five-year period, amounted to 4.94%.[22]

63. The issue of opacity,[*] on which corporate governance and disclosure practices have a significant bearing, has important implications that extend beyond the micro level. In a study published in 2001, PricewaterhouseCoopers developed an opacity index that took into consideration several factors such as corruption, the legal system, economic policy and environment, accounting and reporting, and regulation.[23] The study indicated that opacity deterred a very considerable amount of foreign direct investment (FDI) from flowing to developing countries. The study estimated the cost of the adverse effect of opacity in the form of a hidden surtax equivalent on FDI. For example, a 20-point increase in the opacity factor was equivalent to about a 16% increase in corporate income taxes. The deterrence of FDI is likely to increase the cost of capital to enterprises in such economies and decrease the value added to shareholders, as well as the economy in general.

64. A study conducted by Credit Lyonnais Securities Asia (CLSA) on the corporate governance of 495 enterprises in 25 emerging markets and 18 sectors showed that, while the total average return (in US dollars) for the 100 largest enterprises across emerging markets was 127%, the return for those in the top corporate governance quartile ranking was more than double, 267%.[24] This study further showed that stocks of companies with better corporate governance ratings performed better and that such companies had superior financial ratios and premium valuations.

65. A survey conducted by McKinsey and Company in 2002 reported that a significant majority of investors were willing to pay a premium for a well governed company.[25] As many as 73% of the respondents indicated that they were willing to pay a premium of as much as 27% for a well governed company.

66. A study by Bhattachary et al (2003)[26] analysed disclosure practices in a cross-section of 34 countries from developed as well as emerging markets and demonstrated that lack of disclosure or opacity was related to an increase in the cost of equity capital and a decrease in trading volume in stock markets. It indicated that an increase in the overall measure of earnings opacity from the 25th percentile rank to the 75th percentile rank was associated with a 2.8% increase in the cost of equity when measured using dividend yields or 3.2% when an international asset pricing factor model was used. A similar move in percentile rank was also associated with an 8.8% decrease in annual trading volume in the stock market. The authors stated that these effects were economically as well as statistically significant.

67. A recent survey prepared by the OECD on corporate governance in its member countries discussed several studies on corporate governance practices and the economic performance of firms.[27] One study by Gompers, Ishii and Metrick cited in the survey analysed approximately 1,500 firms during the 1990s and provided evidence linking corporate governance and stock performance. According to the study, an investment strategy that bought firms with the strongest shareholder rights and sold firms with the weakest rights would have earned additional (abnormal) returns of 8½ %.

68. The studies discussed above presented different approaches towards gauging the impact of good corporate governance practices and disclosure of such practices on the performance of enterprises and on increasing shareholder value in the long term. Some considered micro level factors while others took into account macro level issues. To a varying

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[*] Opacity is the lack of clear, accurate, formal, easily discernible, and widely accepted practices in the world's capital markets and national economies. The opacity index is an estimate of the lack of transparency on five dimensions, including opacity in accounting standards and information released by corporations, banks and Governments.

extent the studies highlight the complexity of the issue and the limitations of their respective findings. However, the issue has important policy implications with a bearing on implementation. Given its importance, it may be worth further analysis and consideration.

B. Selected companies' feedback

69. As part of the company level survey, the selected companies were requested to complete an anonymous questionnaire that addressed added value and sustainability issues surrounding company disclosure practices. The questionnaire asked selected companies to report, *inter alia*, on changes to company disclosure practices, motivations for such changes, public access to disclosure information, the aspects of company disclosure that changed, and changes in operations or corporate financing since the implementation of changes in disclosure practices. Among the 30% of the selected companies that responded, the findings indicate positive company associations with increased company disclosure practices.

70. Seven of the selected companies that responded to the questionnaire listed external demand from stakeholders or regulators as reasons for increasing company disclosure practices. On an individual company basis, the questionnaire responses may throw light on the potential impact of increased corporate transparency and disclosure practices. All respondents reported that increased disclosure resulted in a net benefit to the company. The respondents provided examples of positive changes that the companies experienced subsequent to increasing disclosure practices. Examples of such changes include improved investor confidence, improved managerial capabilities, increased investment activity, better employee, supplier and customer relations, and improved and cheaper access to financing.

71. In general, the responses to the questionnaire indicate encouraging feedback with respect to the positive impact of good corporate governance disclosure practices on the performance of enterprises and increased shareholder value. To allow for more comprehensive conclusions, efforts may be made to build on the work of the questionnaire to include a much larger sample of companies.

IV. CHALLENGES ON FURTHER IMPROVEMENT OF CORPORATE GOVERNANCE DISCLOSURES

72. Despite recent positive developments in the area of corporate governance disclosure reform, certain challenges remain with respect to implementation of reform.[28]

73. On the one hand, challenges and implementation timetables in corporate governance reform are different for each region and country. Among the countries with the most developed securities markets, there is a sense that both companies and regulators and other institutions need time to digest the significant changes that have occurred.[29] At the same time, in many developing countries, although considerable efforts have been made, some basic institutional capacities, for example in respect of law enforcement, still require attention.

74. On the other hand, given the mobility of global capital, developing markets can face the same types of challenges as those faced by the more advanced markets, which could have the effect of intensifying corporate governance reform processes in these developing market countries and facilitating international convergence in this area. In an increasingly integrating global economy, corporate governance developments in one part of the world are prompting similar changes in other parts of the world.

75. While there is a growing consensus on the benefits of good corporate governance practices, the challenge remains as to how countries and companies are to implement new

corporate governance practices. In many developing countries, while laws and regulations contain the necessary fundamental elements, the gap between formal provisions and practice is often large, which suggests that these countries need to pay particular attention to enforcement bodies. For example, for publicly traded companies, IFRS are increasingly recognized as the norm. There are, however, substantial differences between what is required by the regulations – even if they are deemed IFRS-compliant – and actual practice. Closing this gap will need better oversight and self-regulation by the accounting and auditing professions, increased training for accountants, auditors and regulators, and better enforcement of stock exchange listing requirements.[30]

76. Implementation might be expected to be more of a challenge in countries and companies where corporate governance structures historically have had a high degree of concentrated ownership and where the securities markets are less developed. In these countries, there are greater concerns regarding shareholder rights and abuses resulting from a concentration of ownership combined with weak shareholder protection and insufficient disclosure.[31]

77. Companies' absorption capacity regarding an increasing number of regulatory changes is not unlimited. In 2003/04 regulators began to focus attention on two other key committees of the board, namely the nomination and compensation committees. This comes at a time when many companies are still adjusting to the new regulations concerning audit committees, director independence and transparency requirements.

78. Good corporate governance has costs, and these costs appear to be rising. Studies are beginning to quantify not only the benefits but also the costs of good governance. According to surveys conducted by Foley & Lardner LLP of Chicago, the average cost of being public, for public companies with annual revenue under $1 billion surveyed, more than doubled to almost US$ 3 million per annum after the passage of the SOA.[32] These surveys also found that as many as one in five companies surveyed are considering going private as a result of new corporate governance and disclosure reforms. Though no noticeable de-listings have occurred since the SOA, John Thain, Head of the NYSE, does partially attribute the drought in foreign listings, the red tape and the class action lawsuits to the SOA.[33] A small number of governance codes now recognize the important resource limitations that smaller companies, in particular, suffer from, and they modify their recommendations accordingly.[34]

79. Increased expectations concerning the board of directors make the job more challenging, and the consequences of personal failure more serious. It can be expected that proxy advisory firms and regulatory bodies will be tougher on boards, especially in the areas of independence and equity-based compensation.[35] As a result, individual board members are questioning their capacity to meet new expectations. Limiting board membership may become a practical necessity in the future and may also presage a scarcity of willing and able directors.

80. There is increasing recognition of the need for mechanisms to protect company employee "whistle blowers", who risk their livelihood when reporting corporate wrongdoing. According to a study[36] cited in the "Findings and Recommendations" with respect to accounting and auditing issued in the United States by the Conference Board's Commission on Public Trust and Private Enterprise on 9 January 2003, 69% of whistle blowers lose their jobs or are forced to retire. Whistle blowers have an important role to play in ensuring the proper functioning of the corporate governance system. A growing number of countries now require companies to establish procedures to receive and respond to concerns of whistle blowers and to protect them form retaliation. Typical requirements range from requiring audit committees to have procedures for investigating corporate wrongdoing, to telephone lines and email addresses for employees to contact regulators.

81. Although new disclosure information is required, more attention must be paid to the clarity and presentation of information on corporate governance. Although present regulations have resulted in an increased amount of reporting, corporations and regulators have not given sufficient attention to clarity and the ability of users to process the information effectively. In the future, regulators and investors may require that business information be provided in plain and understandable language. Related to this is the challenge of making the additional information accessible and meaningful to those who use it. Increases in the amount of information disclosed may not translate into increased transparency if the users are not able to process and use the information effectively.[37]

82. In addition, demands for accelerated disclosure and filings and real-time investor information pose challenges for companies, boards and regulators. While most markets require listed companies to disclose material information as soon as it becomes available, there is considerable divergence in practice.

VI. CONCLUSIONS

83. The pace and extent of implementation of corporate governance disclosures are being affected by various ongoing developments. Corporate governance in general and its transparency and disclosure aspects in particular are undergoing continuous review and enhancement in most member States. At this moment, the implementation of corporate governance disclosures seems to be “work in progress”.

84. The Group of Experts may therefore wish to continue reviewing the implementation status of corporate governance disclosures. In addition to the observations noted in this report, a broader survey of implementation of good disclosure practices on corporate governance, which were outlined by the Group at its nineteenth session, could provide a useful input for assessing the progress made in this area, as well as for revising the list of existing good practices. Also as discussed in this report, empirical feedback on the contribution of good corporate governance disclosure practices to the economic performance of the enterprise and to value added for shareholders in the long term may have a positive impact on the extent of implementation. The Group of Experts may wish to consider this issue further at its future sessions.

NOTES

[1] Communication from the Commission to the Council and the European Parliament, “Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward”, COM (2003) 284 final.
[2] European Commission IP/03/715.
[3] Directive 2003/71/EC.
[4] In June 2001, the Committee of European Securities Regulators (CESR) was established by the European Commission as one of two key committees central to the implementation of the Financial Services Action Plan. CESR’s objectives are to: (1) improve coordination among securities regulators; (2) act as an advisory group to assist the EU Commission in preparing draft implementing measures in the securities field; (3) work to ensure more consistent and timely implementation of EU legislation in the Member States. CESR is mentioned in the EU regulation on International Financial Reporting Standards (IFRS) as the body through which the EU Commission may liaise with the Member States on enforcement issues.
[5] Additional information on the activities and pronouncements of the US SEC can be found on its website at: http://www.sec.gov/.
[6] For an up-to-date collection of all US SEC rules, see the US SEC website at: http://www.sec.gov/. Rules can be found under Regulatory Actions: Final Rule Releases.
[7] For the new rules, see the NYSE website at: www.nyse.com/pdfs/finalcorpgovrules.pdf
[8] http://www.gao.gov/new.items/d04216.pdf
[9] See http://www.pcaobus.org/rules_of_theboard.asp
[10] *International Comparison of Selected Corporate Governance Guidelines and Codes of Best Practice: The Americas, Europe, Asia, Africa, Australia*, Weil, Gotshall and Manages, LLF, 2003.
[11] Association Française des Entreprises Privées (AFEP)-Mouvement des Entreprises de France (MEDEF). This code builds upon its predecessors Vienot I and II and the Bouton code.
[12] http://www.worldbank.org/ifa/rosc.html
[13] *International Comparison of Selected Corporate Governance Guidelines and Codes of Best Practice: The Americas, Europe, Asia, Africa, Australia*, Weil, Gotshall and Manages, LLF, 2003.
[14] *The Role Of The Board In Disclosure: An Examination Of What Codification Efforts Say*, Richard Frederick, OECD South-Eastern Europe Corporate Governance Roundtable on Transparency and Disclosure: Implementation and Enforcement, June 2004.
[15] PCAOB Briefing Paper, “Oversight of Non-US Public Accounting Firms”, 28 October 2003, PCAOB release No. 2003-020.
[16] 24 June 2004 Testimony of William McDonough before US House of Representatives Panel, per US Mission to the EU website at: http://www.useu.be.
[17] International Accounting Standards Board (IASB) (2004), *International Financial Reporting Standards*, London.
[18] http://www.efrag.org
[19] International Accounting Standards Board (IASB) (2004), *International Financial Reporting Standards*, London.
[20] ISA 240 can be downloaded from the IFAC web site at http://www.ifac.org
[21] US Mission to the EU website at http://www.useu.be
[22] “The Active Board of Directors and Performance of the Large Publicly Traded Corporations”, Millstein I and Paul W. MacAvoy, *Columbia Law Review*, Vol. 98:1238, pages 1283-1321, New York, United States of America, 1998.
[23] “PwC's Opacity Index: A Powerful New Tool for Global Investors”, Lipsey, R , *The Journal of Corporate Accounting & Finance*, pages 35-44, Sept/Oct 2001, 2001.
[24] *Saints & Sinners: Who Has Got Religion?,* Credit Lyonnais Securities Asia, 2001
[25] *Global Investors Opinion Survey*, McKinsey and Company, July 2002.
[26] “The World Price of Earnings Opacity”, Bhattacharya, U., H. Daouk, and M. Welker, *Accounting Review*, Vol. 78, No. 3, pages 641-678, 2003.
[27] *Corporate Governance: A survey of OECD countries*, OECD, Paris, 2004.
[28] For analysis of implementations issues on corporate governance disclosure, see also “Major issues on implementation of corporate governance disclosure requirements”, Report of the UNCTAD secretariat, twentieth session of ISAR, October 2003.
[29] *Global Proxy Report*, Davis Global Advisors.
[30] ibid.
[31] ibid.

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[32] *The Impact of Sarbanes-Oxley on Private Companies, and the Cost of Being Public in the Era of Sarbanes-Oxley*, Foley & Lardner, Chicago, 2004.
[33] *Wall Street Journal*, May 27, 2004
[34] "The Role of the Board in Disclosure: An Examination of What Codification Efforts Say", Richard Frederick, OECD South-Eastern Europe Corporate Governance Roundtable on Transparency and Disclosure: Implementation and Enforcement, June 2004.
[35] "Leading Proxy Advisory Firm to Scrutinize Executive Compensation and Board Responsibility" Press Release, Institutional Shareholder Services, 8 January, 2004. Rockville, Maryland.
[36] Rothschild J. and T. D. Miethe, "Whistle-Blower Disclosures and Management Retaliation," Work and Occupations, Vol. 26, no. 1, (February 1999), p. 120.
[37] Thomson Financial, CCBN, *Improving Corporate Transparency: More Data is Not the Answer*, J. Paul Carey & Jeffery P. Parker, 2002.