Samuel O. Idowu
Kiymet Tunca Çaliyurt *Editors*

Corporate Governance

An International Perspective

Springer

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ISBN 978-3-642-45166-9 ISBN 978-3-642-45167-6 (eBook)
DOI 10.1007/978-3-642-45167-6
Springer Heidelberg New York Dordrecht London

Library of Congress Control Number: 2014935246

Printed on acid-free paper

Springer is part of Springer Science+Business Media (www.springer.com)

In Memory of my late father, Ali Suat Tunca and
To my mother Nimet Tunca
Kiymet Tunca Çaliyurt

Foreword

While corporate governance may not be a term that many use in their day to day life, it is in fact an idea that is more pervasive in society than ever before. People are increasingly concerned that the products and services that they use are provided in both an ethical and sustainable manner. At a time when reputation or good public image is of unparalleled value to a business, and something that they spend both large amounts of time and money honing, they cannot be seen to be irresponsible. Similarly, given the current economic situation, corporate responsibility offers businesses an opportunity to work more sustainably and efficiently.

Therefore, this book could not come at a more appropriate time. When so many are looking to engage in corporate governance, it becomes all the more important to look at what has gone before. This book provides a fascinating insight into how the broad term of corporate responsibility is actually being applied across Europe, Africa and Asia. As a result we can see not only where it has succeeded but also the challenges that it continues to face and what may need to change in order for businesses to take on their responsibilities. While there is clearly more that needs to be done in order for corporate responsibility to become the norm, many can undoubtedly see the potential benefits of a switch of focus from shareholder to stakeholder.

Anyone reading this work can be left in no doubt of the important role that corporate social responsibility has carved for itself within the corporate agenda; becoming a priority where before it was merely an afterthought. One can also not argue with the critical position it now holds within the development of any state. The process of state development has now been completely refocused from one that was purely targeted at economic prosperity not so many years ago to one that is much more far reaching. There is now a recognition that in order to achieve consistent and sustainable growth one must also look to secure the futures of the people and their environment and thus act responsibly.

I would like to congratulate the editors, Samuel O Idowu and Kiymet Çaliyurt, on drawing together such a wide range of articles from so many eminent scholars in the field. It is sure to become an exceptional addition to the work within the increasingly vital realm of corporate governance and a welcome resource for academics and professionals alike.

Westminster, London, UK Paul Burstow

Foreword

Corporate Governance can in fact easily be described as the regulation framework for corporate management. And yet, as is the case with many definitions, the difference is in the detail. Why?

On the one hand there is no international mandatory regulation which states what is good or correct Corporate Governance although the very organizations that are in need of a so-called Corporate Governance Code operate internationally or globally. Certainly there are OECD Guidelines – but how are these implemented in countries that do not have an understanding of Western ethics? Is it possible to put the guidelines into practice by countries with a completely different culture? Which values form the basis for an international common understanding of Corporate Governance? Is there such a thing as a common understanding of Corporate Governance? Not only do the philosophically ethical themes lead to many questions, legislative systems that differ globally place additional demands on Corporate Governance.

On the other hand, it is the very crises that have prevailed since 2008 – triggered by an increasingly intransparent financial market – and also the corruption scandals that have come to light in enterprises that have illustrated that the mere definition of Corporate Governance in an organization does not suffice to make this good Corporate Governance. The very lack of diversity in boards of management and directors shows us that there is more to it than documents and/or declarations of intent.

For, even the best Corporate Governance Code is of no avail if it cannot be put into practice in an organization, a task which however calls for suitable management tools. But which? Standardized as for example an ISO 9001 or voluntary guidelines such as ISO 26000 – social responsibility? Or is the willingness of management to practice good Corporate Governance not the crucial factor?

How does Corporate Governance identify itself with issues such as Corporate Social Responsibility, Corporate Reputation, Corporate Citizenship, Sustainability and many more? Is each an individual entity or should all be considered part of a business plan, namely that of a resilient organization? Is good Corporate Governance possible at all if it is not linked to sustainable management?

There is one question after another, which can probably never be conclusively answered.

This book will however guide the reader through these questions and provide the reader with answers or show him the way to his own answers. This journey through the world with a view both to and from Corporate Governance in its diversity of regions and cultural groups will illustrate the paths to good Corporate Governance and above all clearly reveal to the reader that globally implemented and good Corporate Governance is feasible but only if there is the will!

Vienna, Austria Bettina Lorentschitsch

Book Series No: 3

International Group on Governance Fraud Ethics and Corporate Social Responsibility

IGonGFESR

Preface

A series of corporate scandals and corporate collapses around the world have shaken investors' confidence to a very serious level; the still lingering global financial crisis which started in 2008 has adversely affected the economies of countries in both the developed and developing world. All these problems have exacerbated the need for all corporate entities of whatever shape or form to take the issue of a good system of governance seriously.

The Organization for Economic Co-operation and Development (OECD), the United Nations, Governments, stock exchanges, scholars, Corporate Governance Networks and stakeholders have shown increasing interest in governance in recent years. Why has this been so is perhaps a reasonable question anyone who is not too familiar with corporate governance might wish to ask. This is mainly because: if a corporate entity has unaddressed issues in this regard everyone will suffer. A company that has a system of good governance in place will enjoy investors' confidence and consequently expand and grow as investors will be too willing to invest in the company. We have seen the consequential effects of bad governance over and over in the not too distant past. When a company fails because of its weak and inefficient system of governance and sometimes as a result of fraudulent managers, the chances of the following situation becoming a reality are high. The shareholders could see their investments reduced to nothing, employees could lose their jobs and perhaps their pensions in addition to job losses, suppliers could end up getting nothing, which could put their own survival in doubt, the local, national and international communities' prosperity could be seriously affected. The end result of a single act of bad and irresponsible governance could be very devastating indeed to the global economy. This therefore means that the problem of bad corporate governance is everybody's and not just that of a set of investors or employees in one particular company. We are all too aware of this fact following the event of 2008.

It is believed that a book on corporate governance from different nation states and sectors would not only provide useful insights into how these countries and sectors are embedding good governance practices in different economic settings but would add to knowledge and hopefully be of interest to readers from around the globe, especially those who research, study and practice in the field.

The book has been very fortunate as it was able to attract interests from scholars from three continents (Africa, Asia, and Europe) and twelve countries who have provided information about corporate governance from different sectors in their countries of abode. It is hoped that the information it contains will be useful to readers from any sector of society.

London, UK
Edirne, Turkey
Summer 2013

Samuel O. Idowu
Kiymet Tunca Çaliyurt

About the Editors

Prof. Dr. Kiymet Tunca Çalıyurt graduated from the Faculty of Business Administration and Economics, Marmara University, Istanbul Turkey. Her master's and Ph.D. degrees are in the field of Accounting and Finance from the Social Graduate School, Marmara University. Her research interests are in accounting, auditing, fraud, social responsibility, corporate governance, finance, business ethics with special interest in NGOs and aviation management. She is the founder of the International Group on Governance, Fraud, Ethics and Social Responsibility (IGonGFE&SR) and the president of the National-International-Students' Conference Series on Governance, Fraud, Ethics and Social Responsibility (IConGFE&SR). She has published papers and book chapters both nationally and internationally on fraud, social responsibility, ethics in accounting/finance/aviation disciplines and NGOs. Her last book, *Emerging Fraud: Cases from Emerging Economies*, was jointly edited with Samuel O. Idowu and published by Springer in 2012.

Samuel O. Idowu is a Senior Lecturer in Accounting at the city campus of London Metropolitan Business School, London Metropolitan University, where he was course organizer for Accounting Joint degrees, Course Leader/Personal Academic Adviser (PAA) for students taking Accounting Major/Minor and Accounting Joint degrees and currently Course Leader for Accounting and Banking degree. Samuel is a Guest Professor and Research Fellow, International CSR Centre at Nanjing University of Finance and Economics, Nanjing, China. He is a fellow member of the Institute of Chartered Secretaries and Administrators, a fellow of the Royal Society of Arts, a Liveryman of the Worshipful Company of Chartered Secretaries & Administrators and a named freeman of the City of London. Samuel has published about 40 articles in both professional and academic journals and contributed chapters in edited books and is the Editor-in-Chief of two major global reference books by Springer – *Encyclopedia of Corporate Social Responsibility* (ECSR) and *Dictionary of Corporate Social Responsibility* (DCSR) and a Series Editor for Springer's *CSR, Sustainability, Ethics and Governance* books. Samuel has been in academia for 25 years winning one of the Highly Commended Awards, the Emerald Literati Network Awards for Excellence in 2008. In 2010, one of his edited books was placed in 18th position out of 40 top Sustainability books by Cambridge University Programme for Sustainability Leadership. He has examined for the following professional bodies: the Chartered Institute of Bankers (CIB) and the Chartered Institute of Marketing (CIM) and has marked examination papers for the Association of Chartered Certified Accountants (ACCA). His teaching career started in November 1987 at Merton College, Morden Surrey; he was a Lecturer/ Senior Lecturer at North East Surrey College of Technology (Nescot) for 13 years where he was the Course Leader for BA (Hons) Business Studies, ACCA and CIMA courses. He has also held visiting lectureship posts at Croydon College and Kingston University. He was a Senior Lecturer at London Guildhall University prior to its merger with the University of North London, when London Metropolitan University was created in August 2002. He has served as an external examiner to a number of UK Universities including the University of Sunderland, the University of Ulster, Belfast and Coleraine in Northern Ireland and Anglia Ruskin University, Chelmsford. He is currently an External Examiner at the University of Plymouth and Robert Gordon University, Aberdeen, Scotland. He was also the Treasurer and a Trustee of Age *Concern*, Hackney, East London from January 2008 to September 2011. Samuel is on the Editorial Advisory Board of the Management of Environmental Quality Journal and International Journal of Business Management. He has been researching in the field of CSR since 1983 and has attended and presented papers at several national and international conferences and workshops on CSR.

Being managers of other people's money rather than their own, it cannot be expected that they (managers) should watch over it with the same anxious vigilance which (they would) watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Adam Smith (Wealth of Nations, 1776)

Corporate Governance International: An introduction

The first serious attempt anywhere in the world at providing some structured direction to Corporate Governance was made in the United Kingdom through the Cadbury Committee Report of 1992 which was established by the Financial Reporting Council (FRC), the London Stock Exchange (LSE), and the UK Accountancy Profession. The Committee was established basically to restore confidence in the financial reporting of UK companies. The Committee was not constituted by the above mentioned authorities out of some voluntary action or freewill by them, but because of some unpleasant experiences emanating from corporate scandals and failures in the United Kingdom at that point in time. Financial scandals such as the BCCI, Coloroll, Polly Peck and the Mirror Group etc. are still fresh in our minds, well over two decades after they occurred. It is not being suggested here that Britain was the first nation to be affected by weak and ineffective corporate governance issues, far from it, but it is only being highlighted that the UK was the first nation which took a concerted effort to providing some guidelines which were designed to deal with these problems and prevent future occurrences of the same or similar problems. The Cadbury Report has since become a reference point globally when talking about corporate governance guidelines or in the development by countries of their corporate governance principles. The report was issued even before the OECD's attempt at providing some global guidelines on the matter in 1999.

There are many understandable reasons why the UK took a lead in this regard. The country has a well developed capital market with a diverse base of shareholders who are institutional investors, financial institutions, and private individuals (Mallin (2013)). In many of these public limited companies, directors run the affairs of the company on behalf of owners – shareholders who are often not involved in the day to day running of these companies' operational activities and where typical principal/agent problems are inevitably possible (*see Adam Smith's 1776 statements on this issue on the previous page*) which sum up problems which must prevail when managers are appointed to watch over other people's financial interests; these problems are in most cases governance related. It was necessary to ensure that the capital market continues to enjoy the confidence of all its actors since the consequences of this not being the case are indeed serious to a country's economic and social progress, in today's world; a serious problem indeed in global terms.

A series of other Corporate Governance Reports soon followed Cadbury 1992 in the UK, for example Greenbury 1995 (on Directors' Remuneration Packages), Hampel 1998 (set up to review the implementation of Cadbury and Hampel recommendations), The Combined Code which was an attempt to put together in one document the recommendations of all these Committees' Reports (the first Combined Code was published in 1998 and the latest one is the 2009), Tunrbull 1999 (on Internal Control), and several others.

Taking actions about governance issues in general terms was not only confined to the United Kingdom. The Organization for Economic Cooperation and Development (OECD) also took a step towards providing its own global guidance in what it refers to as the "OECD Principles of Corporate Governance". The six principles were first issued in 1999 as noted above but were revised in 2004. Its 2004 Guide is the applicable guidance on corporate governance as at the time of compiling this piece and it is the authoritative international benchmark on corporate governance used worldwide when countries are designing their governance codes and principles. Many countries around the world have styled their corporate governance codes around the OECD's and Cadbury's. The six OECD's principles are encompassed under the following six heads:

- Ensuring the basis for an effective corporate governance framework
- The rights of shareholders and key ownership functions
- The equitable treatment of shareholders
- The role of stakeholders in corporate governance
- Disclosure and transparency
- The responsibilities of the board

Many countries around the globe have at one time or the other been affected by some aspects of corporate governance issues or scandals. These issues have not only been confined to the advanced world but also countries which are often described as emerging or developing have experienced problems in this area. Some of the companies affected by high profile versions of governance problems have been named in the media, textbooks, research studies and even in court cases, some of them are mentioned elsewhere in this book. The consequences of these corporate scandals have led to a serious financial discomfort to shareholders, employees, suppliers and local, national and international communities, even to places far remote from where the original scandal emanated. The problem that led to the current global financial crisis is a typical example of one of them. Therefore, it was felt that a book which undertakes an exploration of how countries around the world are dealing with this important issue – corporate governance would add to knowledge and would enable readers to understand the different shapes and forms of corporate governance issues which have taken place in different nations around the globe.

The book has been fortunate it its attempt to attract interests from 12 nations in 3 continents of our world – Africa, Asia, and Europe. Its chapters have been divided into four parts: Part I Europe, Part II Africa, Part III Asia, and Part IV Editors' Summing Up. The following are summaries of all these chapters.

Abrue and David in the very first chapter on "*Accounting for Citizenship*: *Best practices of corporate governance in Portugal*" (Chap. 1) explored the organizational and legal issues of corporate governance in Portugal. These two scholars looked at the annual inquiry of Portuguese Securities Market Commission from 1999 to 2011 and found that better information, which reduces the asymmetric information, allows each citizen to understand accounting and corporate governance better than ever before. They accept that more work still needs to be carried out in this area in the country. They also concurred that to the best of their knowledge, the role of governance has not been previously emphasized in accounting for citizenship in this European country.

In Chap. 2 where Koutoupis was writing about Corporate Governance in Greece, this author espouses that the adoption of effective corporate governance codes is not a luxury in any economy but a challenge and necessity to those at the helm of governance in that economy. He notes that corporate governance and internal audit functions in Greece are legal compulsion on the part of all Greek listed companies. The chapter compares corporate governance in Greece with that of South African's King Reports I, II, and III and the UK's Combined Code. The chapter bases its discussion on a study of six Greek publicly listed companies with the main objective of testing two hypotheses the author designed.

Maria Aluchna in Chap. 3 entitled "*Corporate Governance*: *Polish lessons from the Global financial crisis*" notes that the Polish economy has successfully come out of the global financial crisis with a 1.7 % growth in its economy as at the end of 2009, but the country has experienced a series of corporate governance related problems. The chapter goes on to explore how Polish listed companies and corporate governance regulators have worked together to develop corporate governance Codes for companies operating in Poland. It also considers three CG problems which Polish listed companies experienced as a result of the financial crisis. Aluchna also argues that despite a noticeable improvement in the Polish system of corporate governance as a result of its EU membership, its corporate governance standards are still very weak when compared with other Western EU countries and the USA.

Jolevska in Chap. 4 entitled "Corporate Governance in the Banking sector of the Republic of Macedonia" provides a comprehensive analysis of corporate governance in Macedonian Banks. The chapter notes that for banks to successfully fulfill its intermediation role, a good system of governance is a key requirement. Jolevska in the chapter analyses what she describes as eight key governance principles that would facilitate good governance practices. These principles should hopefully contribute to the creation of a better, stronger, and more sustainable banking system, this author argues.

In Chap. 5, Giuseppe D'Onza writing on "Corporate Governance in Italian Listed Companies" explores the effect which insider ownership has on corporate governance variables. The chapter analyses how Italian listed companies have changed their governance model to incorporate new governance rules.

The theoretical aspect of D'Onza's study analyzes the institutional context under which Italian listed companies operate and how it has changed over the last decade whilst the empirical aspect of the study provides the findings of an exploratory study of corporate governance reports of 131 public companies listed on the Milan Stock Exchange between 2006 and 2010. D'Onza concludes that several factors observed could contribute to a high degree of reduction in the risk of insider opportunistic behavior.

In a second chapter on corporate governance in Macedonia (Chap. 6) from another sector of the economy – *Customs* – Biljan notes that good governance is not only a co-requisite of an effective and transparent management in the business sector, but it is also a necessity in the public sector. This is more so in terms of any national or local government institutions that wish to be creative and innovative in managing for local or national development. The chapter notes the absence of a generally accepted definition of good governance which has been noted by several scholars (see for example Idowu (2010)), but Biljan argues that in a governmental setting, good governance requires the judicial systems to be well reformed, existence of reform in public administration, anti-corruption, decentralization and public expenditure management. The chapter also argues that the Customs department in any nation is a core governmental institution directly responsible for running a country's international economic relations; as such, it should have a modernized management structure and an organization complying with national and international rules and regulations, Biljan suggests.

In Chap. 7 entitled "Transparency and Disclosure: Public company reporting and corporate inputs", Esendemirli and Saygili assert that national and international capital markets can only function effectively with investors' confidence intact aided by good governance systems. These two authors provide a disclosure framework which classifies public company reports into four categories of reports. The chapter notes that the board and audit sub-committee promote transparency and full disclosure practices.

Chapter 8 of the book by Sorour entitled "Corporate Governance Reform in Egypt: Achievements and challenges ahead" applauds Egypt for its commitments to reforming the system of corporate governance in order to restore investors' confidence and attract more foreign investments into Egypt. The chapter notes many achievements made by Egypt in its quest to reform corporate governance practices but also argues that many challenges still remain to be overcome. Sorour provides a series of clues which could help other willing nations which might want to take steps to reform the state of their corporate governance to meet acceptable standards and restore investors' confidence.

Samuel Fulgence writing a chapter on Corporate Governance in Tanzania (Chap. 9) argues that interest in corporate governance has been simulated worldwide as a result of corporate scandals and collapses in major corporations around the globe. This African state has equally not been unaffected by corporate scandals and collapses, Fulgence argues. The author noted a few companies which were affected by corporate scandals in Tanzania between 2000 and 2008 and raised the profile of the problem in that country. Fulgence employs the cross-sectional literature review approach to review the literature on corporate governance in both the private and public sector organizations. The author notes a series of socially irresponsible practices which have encouraged weak and ineffective corporate governance practices in Tanzania. These issues have led the country to go through the process of putting in place its own corporate governance code, which perhaps is a good result coming out of bad practices.

In the very last chapter from the continent of Africa (Chap. 10), Kasum and Etudaiye-Muthar writing on corporate governance in the financial services sector in Nigeria argue that a breakdown in the principal/agent relationship could have devastating consequences on the financial services industry of any nation. The chapter analyzes the agency problems which affected the Nigerian Banking sector in 2006. These two scholars note that a breakdown in the corporate governance code was responsible for the problems the economy of the country faced at that point in time. A series of actions have been put in place to prevent any such situation being repeated, they note.

In Chap. 11, entitled "Governance Structure and Practice in Malaysia: Board of Directors' Role and Responsibilities", Yatim and Yusoff argue that there is a strong support by the Malaysian government to ensure that the system of governance in the country is effective, transparent, and accountable. The chapter thus explores and investigates corporate governance compliance by Malaysian listed companies. The study by these two scholars looks at different areas of governance, for example Board composition, Board committees' etc. using information from the country's top 100 listed companies. The study reveals a series of salient facts about governance practices in Malaysia which readers are encouraged to read about in the chapter.

In Chap. 12, on Corporate Reputation, an important area linked to corporate governance, Karabay a young scholar from Turkey argues that corporate reputation has in recent times become a very important area for corporate survival. Karabay notes that the reputation of a company is shaped, developed or lost during its operational activities in its community and market. An entity which suffers through its careless attitude about its reputation risks losing its loyal and closest allies in its market and community since they are likely to not want to be associated with that organisation for the fear of being painted with the same paintbrush. Karabay's study presents a discussion of corporate reputation, its fundamental concepts which are found in the literature and the growing importance of reputation in today's changing environment.

In Chap. 13 on "Ethical Dilemmas and Decision making in Accounting", Calskan, Akbas and Esen argue that accountants play many key roles in providing financial information for decision purposes. But accountants appear to have been too much implicated in many, if not all the recent, financial scandals which have affected our world. It is therefore important that ethical issues which affect the profession are thoroughly understood by all accountants to ensure that, never again, would the name of the profession be dragged through the mud because of greed and irresponsible practices by its members.

Kiliç and Uyar in Chap. 14 entitled "The impact of corporate characteristics on social responsibility and environmental disclosures in Turkish listed companies" argue that modern corporate entities are well placed to derive many advantages and benefits from corporate social reporting. The chapter explores the social and environmental reporting practices of manufacturing companies listed on the Istanbul Stock Exchange in 2010. The study uses both dependent and independent variables to analyze the available information. The two authors note that their study is unique since it is the very first one to investigate this area in Turkey.

In Chap. 15 on "Corporate Governance and Earnings Management: Quarterly Evidence from Turkey", Karaibrahimoglu notes that 2003 was a turning point in the history of corporate governance in Turkey as it was the year the Capital Markets Board of Turkey issued the country's Corporate Governance Principles in order to instil confidence in the country's governance environment. The Turkish corporate governance principles were adapted from the OECD six CG Principles which Karaibrahimoglu notes are in itself a subject of debate when it comes to enhancing a firm's value. The chapter calls for corporate governance principles in Turkey to be strengthened with new regulations since the current principles are a source of misleading information on earnings.

Al Kahtani writing on "Current Board of Directors' Practices in Saudi Corporate Governance: A Case for Reform" (Chap. 16) looks at the various aspects of the Board functions in the oil rich state of Saudi Arabia. The chapter uses an analytical methodology to compare Saudi's corporate governance codes with successfully adopted codes by the OECD and those issued by various United Kingdom corporate governance committees.

The very final chapter of the book on corporate governance in China (an emerging world power) entitled "Heading towards Good Governance: A case study of Chinese Commercial Banks" by Bian (Chap. 17) argues that the developments going on in the Chinese Banking sector have been on focus in recent years. Chinese Banks have continued to expand both domestically and internationally through acquisitions. Bian notes that these expansion programmes have in fact improved the system of corporate governance in the Chinese Banking industry. The chapter notes that there is an urgent need for further enhancements in the system of governance. This is because there are still many obstacles in the way of sound and effective systems of governance in China. A few of these obstacles Bian noted in the chapter are inefficient legal framework, weak enforcement structure and inaccurate disclosure regime. These are problems everyone would agree need sorting out, especially if the country is aspiring to be in the league of world leaders.

The above taster to each of the chapters in the book has demonstrated the interesting nature of corporate governance in countries around the world. It has been affirmed that confidence, transparency and accountability are good ingredients which cannot be absent in any credible system of corporate governance. We can no longer afford anymore to be taken for granted by unscrupulous corporate managers who have no regard for decency, responsibility, sustainability and respect for their fellow human beings. Many of the actors in the field are doing their utmost to restore confidence in the system of governance globally, a number of chapters kept referring to the OECD principles and the Cadbury Report of the UK, and all countries in the world have one form of governance code or another. This can only be good for the stakeholders, the global corporate community and our world.

London, UK — Samuel O. Idowu
Edirne, Turkey — Kiymet Tuca Çaliyurt

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Acknowledgements

We are eternally grateful to all our contributors for their professionalism in ensuring the successful completion on this book. We would also like to thank members of the Network for their continuous support of this international Network of researchers and practitioners in its publications and conferences.

We also like to take the opportunity of expressing our gratitude to a number of people who have either directly or indirectly helped us in bringing the book to its final state. In particular, we want to thank our respective families for their unflinching support, even when it causes them some practical difficulties and inconveniences. Kiymet would like to thank her husband and son, Professor Dr. Okan Çaliyurt and Batu Çaliyurt, her mother and her brother and his family. Samuel would like to thank his wife and children Mrs. Olufunmilola O Idowu, Josiah O Idowu and Hannah A Idowu.

They are both grateful to their Publishing Editor at Springer Christian Rauscher and his PA Frau Barbara Bethke for their administrative support at all times.

We would like to apologize for any errors or omissions which may appear anywhere in the book, no harm or displeasure was intended to anyone.

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Halil Emre Akbas is an Assistant Professor in Accounting and Finance at Yildiz Technical University, Istanbul, Turkey. He has implemented several training courses in accounting and finance especially for hotel managers and insurance agency managers. He has also implemented a research project on the relationship between financial performance and reputation of Turkish Banks. His research interests include: Corporate Social Responsibility, Environmental Reporting, Financial Markets, Performance Management, Strategic Cost Management and Managerial Accounting. He has published in peer-reviewed journals such as the *European Journal of Economics*, *Finance and Administrative Sciences*, *International Journal of Business and Management Studies*, *International Journal of Economics and Finance Studies*, *International Research Journal of Finance and Economics* and has a forthcoming publication in the *International Journal of Critical Accounting*. Halil Emre Akbas holds a Ph.D. in Accounting and Finance from Marmara University, Istanbul, Turkey, M.Sc. in Business Administration and Bachelor of Business Administration with an Accounting major.

Faleh Al Kahtani is a graduate of Brunel University, UK (PhD, 2013); Naif Arab University, Saudi Arabia (LLM, 2006); King Saud University, Saudi Arabia (LLB, 2002). He previously worked as a supervisor of the Saudi telecom company (STC) in Riyadh from 1999 to 2008. He is a frequent speaker at national and international conferences in his area of expertise. His research areas are Legal Theory and Jurisprudence, International Commercial Law, Company Law, Corporate Law Theory, Corporate Governance, Corporate Social Responsibility, Contract Law, Human Rights, and Criminal Justice.

Maria Aluchna is an Associate Professor at the Department of Management Theory, Warsaw School of Economics, Poland. She specializes in corporate governance (ownership structure, board, executive compensation, transition economies) as well as in strategic management. Additionally, she researches in the field corporate social responsibility. She was awarded the Deutscher Akademischer Austauschdienst (DAAD, 2001/2002), a study visit research scholarship, by the Universität Passau and Polish-American Fulbright Commission scholarship to Columbia University, in the United States of America. Since 1998 she has been working at the Department of Management Theory, of the Warsaw School of Economics, where she obtained her Ph.D. degree (2004) and completing habilitation procedure (October 2011). She was also awarded the Polish Science Foundation young researcher award for two consecutive years (2004 and 2005). Recently, within a grant financed by the EU she completed a visiting scholar's stay at London Metropolitan Business School in the UK and at University of Sydney Business School in Australia. Maria Aluchna teaches "Corporate governance" (both in Polish and English), "Strategic management" (in English) and "Transition in Central and Eastern Europe" (in English). She is the author of a number of articles in both national and international journals as well as conference papers. She was serving on two editorial boards in 2008 and was the Editor-in-Chief of the Warsaw Stock Exchange portal on corporate governance best practice. Currently, she is a consultant to a law firm Głuchowski Siemiątkowski i Zwara and conducts research projects for the Capital City of Warsaw in Poland.

Jing Bian is a Senior Teaching Fellow of the Faculty of Law and Social Sciences, SOAS, University of London. She served as a research assistant in the Office of General Counsel, Hong Kong Monetary Authority; and, was formerly a civil servant in the justice department, China. Dr. Jing Bian's research interests focus on: Comparative and International Financial Regulation, Corporate Governance, Merger & Acquisition, Chinese Law, Legal and Regulatory Aspects of Financial Management. She has provided consultancy to international institutions as well as international transactions. She is currently working on the journal: *China Construction Law Review*, *Frontiers of Legal Research*.

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Part I
Corporate Governance in Europe

Portugal
Greece
Poland
Macedonia
Italy
Turkey

Chapter 1
Accounting for Citizenship: Best Practices of Corporate Governance in Portugal

Rute Abreu and Fatima David

Abstract Accounting for citizenship focuses on citizens' best interest to include both protecting their future financial well-being and ameliorating some of the harsh projections of what the world might look like for future retirees (Williams and Conley, Cornell Int Law J 38:493–551, 2005) and increasingly pressure the company strategic decisions to invest in sustainable practices (Aguilera et al., Corp Gov 14:147–158, 2006) and the better functioning of corporate governance (Aguilera and Cuervo-Cazurra, Corp Gov Int Rev 17:376–387, 2009).

The theoretical part of the research presents a comparative synopsis of the organizational and legal issues of corporate governance in Portugal. Also, different research streams have been investigated to show the role of corporate governance in the citizens' perception. The empirical part of the research is centered on the annual inquiry of the Portuguese Securities Market Commission, since 1999 till 2011, and on the disclosure of annual reports of listed companies. The results show an important impulse of the disclosure as well as exploration of convergence and divergence on recommendations.

Also, it has been noted that better information reduces the asymmetric information and allows each citizen to understand accounting and corporate governance better. But, this evidence did not establish causality and much more work needs to be done because multiple issues will update recommendations of codes of corporate governance. In this sense, this research demonstrates that monitoring the disclosure practices is an essential task to ensure the informative value of corporate governance report and, thus, the corresponding added value for investor protection.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_1,

The findings are consistent and it is urgent that the company, in general, and the citizen, in particular, must promote corporate governance report with full citizenship rights, fighting anomalies or misunderstandings, and encouraging appropriate corporate behavior. However, to the best of the understanding of these authors, the role of corporate governance has not been previously emphasized in accounting for citizenship.

1.1 Introduction

The Portuguese accounting regulation has undergone a significant change in the last few years as result of the adaptation to European Union directives, to the statements of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB). In this paper, the authors describe the relationship, in general, between accounting and an effective corporate governance system, achieved through recommendations and reports that it should lead main stakeholders to assume a higher degree of responsibility with lower level of risk management (EC 2010). This new era obliges to change the governance of companies and to stimulate the perception of the accounting for citizenship (Farh et al. 1990). Therefore, the authors will answer to research question:

What did accounting have to do with citizenship?

The answer this question appears to have particular sense on the change of behavior of the company that introduces the corporate governance to diminish malpractice, corruption and fraud. At the same time, it seeks to align citizens and management interests. From the literature, several researchers are increasingly concerned with the citizenship power (Maignan and Ferrell 2001).

First, Organ (1988, 1997) defends as extra-role behaviors that communicate and influence to the effective performance of a company but they are not explicitly required. **Second,** Amba-Rao (1993) argues that there is a growing consensus that firms and governments in partnership should accepted moral responsibility to social welfare and individuals' interest in economic transactions. **Third,** despite the lack of consensus about the dimensionality, Podsakoff et al. (2000, p. 516) defend seven dimensions, such as:

1. Helping Behavior,
2. Sportsmanship,
3. Organizational Loyalty,
4. Organizational Compliance,
5. Individual Initiative,
6. Civic Virtue, and
7. Self Development.

About these dimensions, the main reason to follow the *organizational compliance* is related with a citizenship behavior, because it is expected to obey to the company regulations, rules, and procedures at all times. Then, in this dimension, it will promote greater transparency of the decision making process of the company centered in the main principle of "comply or explain". Therefore, the Annual Report on the Corporate Governance of Listed Companies in Portugal published by CMVM (2008, p. 8) that notice:

> certain companies did not comply with the recommendations and did not explain their non-compliance in the relevant corporate governance report, meaning that they did not comply with the 'comply and explain' principle which is included in the CMVM's 2005 version of the Recommendations on Corporate Governance.

For one hand, the recognition made by the company that our recommendation will be difficult to maintain in the future, as Graham et al. (2005) defend, justify managers that may try to avoid setting disclosure precedents. Notably, the literature influences these aspects on accounting, financial reporting and voluntary disclosures, such as Green Paper of Corporate Governance in financial institutions and remuneration policies (EC 2010: 11) that argues:

> The main challenge in seeking to improve existing corporate governance practices will be to ensure real change in the behavior of the relevant actors.

Also, the divergence of behaviors of relevant actors shows evidences of the traditional dominance of the agency theory. This dominance has been identified by Martynova and Renneboog (2011, p. 1532) within three basic agency problems:

> those arising between the management and the shareholders, between majority and minority shareholders, and between creditors and shareholders.

The authors are aware that beyond agency theory, it provides the right back to the need for ensuring a broader understanding and a greater extent of social, economic, political and ethical values of relevant actors. The process by which the corporate governance change starts within the management practices and as Cadbury (1992, p. 14) emphasizes in the Committee initial definition of corporate governance:

> As a system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies.

Nowadays, there has been a growth in the literature (Healy et al. 1999; Healy and Palepu 2001) on corporate governance. For example, Solomon (2007, p. 14) defends that it is a:

> System of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.

It also seem necessary to point, other valuable dimension of Podsakoff et al. (2000, p. 516) that is the *Individual Initiative* as a voluntary act of creativity and innovation designed to improve the company's performance persisting with extra enthusiasm and effort to accomplish it, volunteering to take on extra responsibilities, and encouraging others to do the same. Furthermore, several factors can help to explain the disinterest or passivity of several companies about the lower level of effectiveness of corporate governance report. In this sense, the Annual Report on the Corporate Governance of Listed Companies in Portugal published by CMVM (2012a, p. 72) notices that:

> Another theme that deserved undivided attention in the current edition of the Annual Report on the Corporate Governance of Listed Companies was external auditing. Considering the market capitalization weighted share capital, one is able to witness the high level of concentration of this market since the most relevant two auditors (Deloitte and KPMG) represented 84.2 % of the total amount.

In this example, the corporate governance recommendation not adopted has short-term effects that are likely to be negative, because it decreases the level of assurance to the Portuguese Securities Market and the true and fair view of financial statements presented to the Portuguese Securities Market Commission. These effects can vary significantly according to the state of the economy as well as the scale of the financial crises that Portugal is dealing with. In broad terms, Dobrzynski (1988) is concerned that management is going to learn how to live with a whole class of investors who want to exercise their power on central issues facing companies.

Jointly considered, to assess the efficacy of companies' strategies, Eisenhardt (1989) argues that the investors' ability to effectively monitor a company's strategic behavior is a function of their ability. So, the emphasis on advantages provides the interpretation for potentially negative information spread on the securities market. In this sense, as Sonaecom (2011, p. 3) specifies that corporate governance means:

> Decision-making processes and the way in which our decisions are implemented, as well as, the formal structures and different bodies that are involved in preparing, challenging, approving, implementing and reporting on these decisions.

In the world of business, the actual moment must integrate citizens in the spirit of association with responsibilities of the business and as an integral part of the human society and economic system (see Miller and O'Leary 1993; Gillian 2006), assuming greater importance the particularities of each company. Many of those have individualized disclosure and report the legal issues proposed by the Portuguese Securities Market Commission (*Comissão de Mercado de Valores Mobiliários* in Portuguese). The analysis shows that it has been establishing, since 1991, several objectives, such as: efficient and regular functioning of stock markets and investor protection.

The remainder of this research is organized as follows. Section 2 (literature review) discusses the role of accounting for citizenship for an overall assessment of the corporate governance concept. Section 3 (methodology) describes the regulation of the corporate governance that explicitly provides the corporate governance report. Section 4 (Results) starts on corporate governance report of Portuguese companies to one of the best practices of the corporate governance of Portuguese companies that is the remuneration policy. Section 5 presents the discussion of corporate governance behavior promoted by Portuguese Companies. Section 6 includes the conclusion with the research limitations and the future developments related to Corporate Governance.

1.2 From Accounting for Citizenship to Corporate Governance

There has been a significant increase in the level of interest of researchers, regulators, legislators, citizens and broader groups surrounding corporate governance. Obviously, the argument for analyzing it through the accounting for citizenship will provide prosperity and adequate protection to investors, knowing that Hampel Committee (1998, p. 17) defends:

> Accountability by contrast does require appropriate rules and regulations, in which disclosure is the most important element.

Although the disclosure initially did not have a substantial impact on accounting for citizenship, the need of intervention of public agencies has been progressively higher and the authors expected that it would be reduced to strictly necessity in the next decade. Therefore, the question of research is:

> Why do we need corporate governance report?

The objective is to promote greater transparency of the decision making process of the company centered in the main principle of "comply or explain". At the same time, the accountability is extended with subsequent increase in risks and opportunities to managers and administration. But, due to limited regulatory guidance, the social contract of the company is relevant to prove the best practices with assessment process of reliability and efficiency.

The literature review provides three answers. **First,** Pigou (1938) defends that it helps markets to achieve the maximization of social welfare rather than the welfare of individual investors. **Second,** Becht et al. (2003) argue that it forces companies to commit credibly to a higher quality of governance. T**hird**, Martynova and Renneboog (2011) recognize that it is more reliable and higher quality of the transparency when the law or the securities market regulations include a comply-or-explain principle.

In this section, it is intended to be presented a synthesis of the current norms and laws about corporate governance and their relationship with questions of citizenship. It will only be identified the most important legal instruments that appear closer to consensus.

The goal of corporate governance is to better describe the company with critical aspects that are mandatory and also increases the extent of underlying uncertainties. Finally, the authors will present briefly the regulation of the European Union; the proposals of the Portuguese Institute of Corporate Governance; the norms of the Government and the last is the *Portuguese Securities Market Commission*.

1.2.1 European Union

In the Europe Union, especially, in the Company Law, approved by the European Commission on May 21, 2003, were initiated several regulatory measures related to corporate governance. Several areas of change were governance models and management of limited companies. In this line of regulation, the European Commission's Plan of Action aimed at modernising Company Law and enhancing Corporate Governance with regard to the establishment of a harmonised framework for the disclosure of financial information by companies with securities admitted to trading on a regulated market. So, several regulations have been published to promote transparency.

1.2.2 Portuguese Institute of Corporate Governance (PICG)

In 2004, the Portuguese Institute of Corporate Governance (PICG) was created as a private organization, with no profit seeking motive and centered its activity on Corporate Governance.

In 2006, the PICG published the White Book on Corporate Governance in Portugal (PICG 2006). At that time, this document was especially addressed to listed companies, giving them sufficient freedom of options to each company choose to apply. The implementation of these 96 recommendations aim:

- to detail practices and advantages following the principle of "comply or explain" and more than 96 recommendations with distribution of Corporate goals; The board of directors; Board of directors' mission; Structured and Independence of the Board of Directors; Presidency of the Board of directors and Executive Board; Non-Executive Directors; Executive Directors; Specialised Board Committees; External Auditing; Internal Auditing and Other Internal Structures for Risk Detection and Management; Supervisory Board; Remuneration Committees; General Meetings; Measures contrary to the functioning of the market for corporate control; Business with shareholders and important trade relations; Transaction on own shares; Confidential expenses; Dividend policy; Codes of ethics and conduct; Institutional investors and The State as shareholder
- to create wealth and even distribution by all the shareholders;
- to disclose their sustainable development policy and insights on social responsibility.

In 2010, after the international and national best practices analysis, which was developed by the PICG, there was a proposed Code of Good Corporate Governance 2010 with 55 Recommendations. As a result, in 2012, the Code was put out for public discussion in order to allow the public to identify areas where changes are needed in the recommendations and to focus on the option requiring voluntary and compliance stance by companies, but relying on the principle of "comply or explain". Thus, the code of IPCG is an alternative to corporate Governance Code issued by the CMVM.

1.2.3 Government

Between other norms and regulations, the Government obliged to other legal and regulatory rules companies need to comply with, such as: the Portugal Bank Information nº 10/2011 (BP 2012) that provide detailed information on the level of compliance with recommendations on Corporate Governance in the financial services companies and The Securities Code. This code that regulates the Portuguese securities market was approved by Decree-Law nº 486/99 of 13 November. It includes several amendments introduced from 2002 until the present day.

1.2.4 Portuguese Securities Market Commission (CMVM)

The companies with shares listed on the NYSE Euronext Lisbon Securities Market are subject to the Portuguese Securities Market Commission (CMVM) regulations published in the Official Gazette (Diário da República in Portuguese). Within this context, each company must adopt the CMVM recommendations on matters of corporate governance contained in CMVM's Corporate Governance Code.

In 1999, the CMVM published recommendations on Corporate Governance (CMVM 1999) which focuses on the main aspects of: Disclosure of Information, Exercise of Voting Rights and Shareholder Representation, Institutional Investors, Corporate Rules, Structure and Functioning of the Board of Directors. These recommendations induce companies to increased transparency (Alves and Mendes 2004). At the same time, the Portuguese Securities Market Commission launches the code of best practices (CMVM 1999) as non-compulsory 17 recommendations on different subjects regarding corporate governance.

Since the Cadbury Report (1992), there has been an increase in codes of practice across the globe, because it was the first code of "best practice" on corporate governance. Following this code and the Regulation of CMVM nº 1/2001, in 2007, the Portuguese Securities Market Commission published a proposal of code of corporate governance allowing it to disseminate the adoption of good practices in an existing corporate governance system (CMVM 2007). The prominence could be found in benefits of corporate governance adopted by listed companies that encourages greater exchange of the best practices and companies provide a voluntary report that shows innovation and improvement.

After February 1st, the Regulation of CMVM nº 1/2010 (CMVM 2010c) related with Corporate Governance came into force. This regulation includes several changes and in the article 1º and number 1 feature that applies to:

> The issuers of shares admitted to trading on a regulated market situated or operating in Portugal shall implement the Corporate Governance Code issued by the CMVM or similar Code.

Normally, companies would have been committed with disclosure model details of which are on the Regulation nº 1/2010 of the Portuguese Securities Market Commission that include innovative information that has not previously been covered by the CMVM's Corporate Governance Code. CIMPOR Report and Accounts' (CIMPOR 2009, p. 17) explains that:

> The company is already preparing the alterations that are to be made to remove some of the gaps and limitations of its current governance model

Zon Multimédia (2011, p. 4) made the following declaration of compliance:

> It is aware of the growing importance of corporate governance for the day to day life of any company and society in general. Zon Multimédia intends to be a benchmark in terms of governance and how it informs stakeholders about the company, constantly and actively improving this practice.

Despite the objectives of the Corporate Governance, it is not easy to fully understand all the inherent advantages in the Corporate Governance Report 2010 Teixeira Duarte (2011, p. 10) reflects that:

> TD, SA has chosen not adopt any Corporate Governance Code other than that issued by the CMVM on January 2010.

More relevant is the Sonae Capital Statement of Compliance, because Sonae Capital (2010, p. 2) argues that:

> The corporate governance structure of Sane Capital is built upon the maximization of shareholders' interests and the satisfaction of their legal and regulatory rights

This section presents a comparative synopsis of the organizational and the legal issues related with the corporate governance in Portugal. This evolution of the regulation of corporate governance contributes to the debate on whether a single system of corporate governance is likely to develop (McCahery et al. 2002; Martynova and Renneboog 2011).

The assessment of corporate governance is not intended to enforce rigid and standardized models. It is somewhat expected to contribute to the optimum development of companies and at protecting the interests of all those who are involved in these companies (MFAP 2009). Some of the mechanisms in the area of transparency and with objective to enclose the citizen is reflecting on the regulations promoted by CMVM (2012c) that are:

> on December 2001, CMVM's Recommendations on Corporate Governance ; on November 2003, CMVM's Recommendations on Corporate Governance; on November 2005, CMVM's Recommendations on Corporate Governance; on September 2007, CMVM Recommendations on Corporate Governance; on January 2010, CMVM Recommendations on Corporate Governance; and at last, January 2010, Consolidation of the Legal Framework and Corporate Governance Code.

In this research, the authors argue that the influence of citizens has increased expectations on companies to disclose corporate governance information, not only by responding to the CMVM questionnaire but also via primary corporate communications channels such as annual and sustainability reports and company websites (Sánchez et al. 2011). Equally important, because companies are beginning to feel the effect of recession, then it is necessary there are major improvements in corporate governance for Portuguese companies.

1.3 From Regulation to the Report on Corporate Governance

Corporate governance best practices reflect, in fact between others, several differences in financing options, accounting systems, corporate ownership patterns, legal origin, culture, traditions, and values. But, one similarity perspective with general consensus is that corporate governance deals among mechanisms that ensure investors in companies to get a return on their investments (Shleifer and Vishny 1997). Therefore, the question of research is:

What issues matter in Corporate Governance for citizens?

Based on Portuguese Experience, corporate governance deals with a certain irony, because it has been a forecast perspective to preparing more active citizens. At the same time, several companies ignore or only publish descriptive disclosure and it does not promote an analytical analyses allowing that recommendations and principles to be implemented for full adoption.

Emerging from literature review, the authors find three answers. **First,** Wilson (2004), details that it is to ensure that corporate power is wielded for the benefit of society and to ensure public trust, not just for a single company or its upper echelon of executives. **Second,** Palazzo and Scherer (2006) add that corporate legitimacy focuses on the appropriate role of companies in society. **Third,** Monks (2007) argues that companies are failing to provide employment and efficiently produce wealth for society.

Moreover, the sudden increase in norms and regulations about corporate governance in order to improve the quality of the annual report of listed companies in the Portuguese Securities Market Commission, as well as, in other European Union Stock Markets is often associated with the evolving hybrid role of accounting for citizenship. Inherent in such normative approach, the authors examine complexities involved accounting for citizenship through the disclosure of best practices on Corporate Governance.

The methodology, based on the content analysis (Weber 1990; Krippendorff 2004), relies on information extracted from the Annual Inquiry of Corporate Governance of the Portuguese Securities Market Commission and the Annual Report of Corporate Governance of all listed companies since 1999 till 2011 in

Table 1.1 Corporate governance framework: disclosure of the annual report

Date	Entity	Corporate governance framework
21-06-1999	CMVM	Recommendations of CMVM on Listed Corporate Governance
		Disclosure of Annual Report 2002
01-12-2001	CMVM	Recommendations of CMVM on Listed Corporate Governance
12-12-2001	CMVM	Regulation of CMVM nº 7/2001 – Listed Corporation Governance
01-11-2003	CMVM	Recommendations of CMVM on Listed Corporate Governance
02-12-2003	CMVM	Regulation of CMVM nº 11/2003 – Corporate Governance
		Disclosure of Annual Report 2004
12-12-2001	CMVM	Regulation of CMVM nº 7/2001 – Listed Corporation Governance
01-11-2003	CMVM	Recommendations of CMVM on Listed Corporate Governance
02-12-2003	CMVM	Regulation of CMVM nº 11/2003 – Corporate Governance
		Disclosure of Annual Report 2005
12-12-2001	CMVM	Regulation of CMVM nº 7/2001 – Listed Corporation Govermance
01-11-2005	CMVM	Recommendations of CMVM on Listed Corporate Governance
02-12-2003	CMVM	Regulation of CMVM nº 11/2003 – Corporate Governance
18-11-2005	CMVM	Regulation of CMVM nº 10/2005 – Corporate Governance
01-02-2006	IPCG	White Book about Corporate Governance in Portugal
20-01-2006	CMVM	Information about the disclosure of Annual Report 2005
		Disclosure of Annual Report 2006
12-12-2001	CMVM	Regulation of CMVM nº 7/2001 – Listed Corporation Governance
01-11-2005	CMVM	Recommendations of CMVM on Listed Corporate Governance
02-12-2003	CMVM	Regulation of CMVM nº 11/2003 – Corporate Governance
18-11-2005	CMVM	Regulation of CMVM nº 10/2005 – Corporate Governance
01-02-2006	IPCG	White Book about Corporate Governance in Portugal
29-03-2006	MFAPJ	Decree-Law nº 76-A/2006 – Models of Corporate Governance
30-05-2006	CMVM	Regulation of CMVM nº 3/2006 – Offers and Companies
09-02-2007	CMVM	Information about the disclosure of Annual Report 2006
		Disclosure of Annual Report 2007
12-12-2001	CMVM	Regulation of CMVM nº 7/2001 – Listed Corporation Governance
02-12-2003	CMVM	Regulation of CMVM nº 11/2003 – Corporate Governance
18-11-2005	CMVM	Regulation of CMVM nº 10/2005 – Corporate Governance
29-03-2006	MFAPJ	Decree-Law nº 76-A/2006 – Models of Corporate Governance
23-01-2008	CMVM	Information about the disclosure of Annual Report 2007
		Disclosure of Annual Report 2008
21-11-2007	CMVM	Regulation of CMVM nº 1/2007 – Listed Corporation Governance
08-03-2007	Govemment	Principles of Good Corporate Governance on Public Sector (Resolution of Minister Council nº 49/2007)
03-04-2007	CMVM	Proposal about the Code of Corporate Governance (public discussion)
01-09-2007	CMVM	Recommendations of CMVM about Code of Corporate Governance
15-01-2009	CMVM	Information about the disclosure of Annual Report 2008
		Disclosure of Annual Report 2009
15-10-2008	CMVM	Regulation of CMVM nº 5/2008 – Information duty
18-02-2010	CMVM	Information about the disclosure of Annual Report 2009
		Disclosure of Annual Report 2010
15-10-2008	CMVM	Regulation of CMVM nº 5/2008 – Information duty
15-01-2010	CMVM	Code of Corporate Governance of CMVM (Recommendations)
19-06-2009	MFAPJ	Law nº 28/2009 – Remuneration Policy

(continued)

Table 1.1 (continued)

Date	Entity	Corporate governance framework
01-02-2010	CMVM	Regulation of CMVM nº 1/2010 – Listed Corporation Governance
23-02-2011	CMVM	Information about the disclosure of Annual Report 2010
		Disclosure of Annual Report 2001
01-02-2010	CMVM	Regulation of CMVM nº 1/2010 – Listed Corporation Governance
15-01-2010	CMVM	Code of Corporate Governance of CMVM (Recommendations)
05-03-2012	CMVM	Information about the disclosure of Annual Report 2011

Portuguese Securities Market. The authors point that this review is not completely inclusive due to the higher level of information.

Between 1999 and 2011, companies were expected to disclose information about corporate governance recommendations in accordance with several recommendations published by the Portuguese Securities Market Commission (CMVM) detailed in Table 1.1.

Table 1.1 presents the corporate governance framework in Portugal within the context of all regulations and norms required for disclosure in the annual report. The purpose of the Table 1.1 is, also, to show the amount of rules which have increased dramatically during the last decade. Disclosure can be used proactively to focus on general guidelines about corporate governance recommendations adopted by the company and, also, convergence of the corporate report is likely to overlook the future. For example, EDP (2012, p. 2) published the corporate governance manual defining the objective of the manual:

> The primary objective of the Manual is to record and share the common understanding of the two governing bodies with respect to the corporate governance recommendations applicable to the EDP, as well as to the guidelines which are deemed appropriate concerning their adoption. Thus, the starting point of the Manual was the "CMVM Corporate Governance Code", published in 2010.

As Williams (2008, p. 237) argues, the report itself refers to a deliberate, timely, and formal release of voluntary or required information and the

> Discussion will focus on the topic of disclosure from a strategic choice decision-making perspective in order to more fully account for the effect of both internal and external pressures on managerial discretion

While the disclosure rules may appear straightforward, companies endorse an increase use of the visual domain, images, and text (Ball 2011) to support the "comply or explain" principle. As noted above, between 1999 and 2004, the number of pages and the level of detailed information were very undersized. For example, Sonae SGPS SA (2003) publishes the corporate governance information has an appendix with 8 pages to the report of the board of directors and exhibits that:

> This appendix gives a brief description of the Corporate Governance practices of Sonae, SGS, SA and was prepared in order to comply with regulation nº 7/2001 of December 20 of the Portuguese Stock Exchange Commission.

Thus, Inapa Annual Report has a chapter dedicated to corporate governance (Inapa 2003, p. 90) that starts to address practical implications about:

> The capital markets were badly influenced by the lack of confidence on behalf of the economic agents, by the occurrences September 11 in New York, by the economic and financial scandals in the United States of America and Europe, and, by the strong decrease in private consumption.

Also, comprehensive evidence has been included in the 2011 Annual Report on the Corporate Governance of Listed Companies in Portugal about the overall compliance of companies (CMVM 2012a, p. 12):

> As regards committees, focus is given, particularly to the existence of 17 Corporate Governance Committees or similar, and is thus one of the most common among listed companies. Said committees met on average 3.2 times and registered a global attendance of 83.3 %.

The aim of this research is to monitor the disclosure of best practices on corporate governance, between 2002 until 2011, of companies in accordance with the recommendations published by the CMVM and detailed in Table 1.2**.**

Table 1.2 shows the "gap" between action and expectation on corporate governance report. In 2002, the majority of companies (57) published the report from March 12th till December 17th (due to Football Companies that have the Fiscal Year from August to July). But, the latest year (2011) has 43 companies with reports published from January 5th till August 8th. There is a gap in 2007, because 48 companies had published the report from February 7th of 2008 till January 24th of 2011. As Table 1.1 demonstrates that this report published on Table 1.2 involve a mobilization of wide variety of actors and the power to bring citizens to assessment together in a shared experience.

In the assessment of the Corporate Governance Report published by companies, a significant increase in the average level of compliance with the CMVM's corporate governance recommendations goes from 61 % in 2004 to 80 % in 2009. As far as the Green Paper details, corporate governance could be classified with deficient application for companies that have poorly implemented it. So, as highlighting by several researchers (DiMaggio and Powell 1983; Tolbert and Zucker 1983; Strang and Macy 2001; Zatoni and Cuomo 2008), the dynamics of its use is justified on the

> Adoption of new practices within a social system may be explained referring to two main theoretical sources: efficiency (or rational) accounts and social legitimating.

However, effectiveness of corporate governance in Portugal provides only a limited insight, because the goal of the corporate governance is to reduce the adverse effects on opportunism (Sinha 2006) of some citizens and board of directors of companies.

Table 1.2 Distribution of the corporate governance report, 2002–2011

Company	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Altri, SGPS, SA	No	No	No	Yes	Yes	Yes	Yes	No	Yes	Yes
BA – Fábrica Vidros Barbosa & Almeida, SA	Yes	No	No	No	No	No	No	No	No	No
Banco Commercial dos Açores, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Banco Commercial Português, SA	Yes	No	No	No	No	No	No	No	No	No
Banco Espírito Santo, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Banco Popular Español, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Banco Totta & Açores, SA	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes
Banif – SGPS, SA	Yes	No	No	No	No	No	No	No	No	No
Brisa – Auto Estradas de Portugal, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Caixa Geral de Depósitos, SA	Yes	Yes	Yes	Yes	No	No	No	No	No	No
Celulose do Caima, SGPS, SA	Yes	Yes	No	No	No	No	No	No	No	No
Central – Banco de Investimento, SA	Yes	No	No	No	No	No	No	No	No	No
CIMPOR – Cimentos de Portugal, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
CIN – Corporação Industrial do Norte, SA	Yes	Yes	Yes	Yes	No	No	No	No	No	No
Cofaco – Commercial e Fabril de Conservas, SA	Yes	Yes	No	No	No	No	No	No	No	No
Cofina – SGPS, SA	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Comp. Industrial Resinas Sintéticas – Cires, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No
Compta – Equipamentose Serviços de Informática, SA	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Conduril – Construtora Duriense, SA	Yes	Yes	No	No	No	No	No	No	No	No
Copam – Companhia Portuguesa de Amidos, SA	Yes	Yes	Yes	No	No	No	No	No	No	No
Corticeira Amorim, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
EDP Renováveis, SA	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Efacec Capital – SGPS, SA	Yes	Yes	Yes	No	No	No	No	No	No	No
Espírito Santo Financial Group, SA	No	No	No	No	No	Yes	No	No	No	No
Estoril Sol, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
F. Ramada – Investimentos, SGPS, SA	No	No	No	No	No	No	Yes	No	Yes	Yes
Finibanco Holding – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Fisipe – Fibras Sintéticas de Portugal, SA	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No

(continued)

Table 1.2 (continued)

Company	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Futebol Clube do Porto – Futebol, SAD	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No
Galp Energia, SGPS, SA	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Gescartão – SGPS, SA	No	Yes	Yes	Yes	No	No	No	No	No	No
Grupo Media Capital SGPS, SA	No	No	Yes	Yes	Yes	Yes	No	Yes	No	Yes
Grupo Soares da Costa, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
Ibersol – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Imobiliária Construtora Grão Pará, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Impresa – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
Inapa – Investimentos, Participaçõese Gestão, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Jerónimo Martins – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Lisgráfica – Impressão e Artes Gráficas, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No
Litho Formas Portuguesa – Impres. Cont. e Mult, SA	Yes	Yes	No	No	No	No	No	No	No	No
Martifer – SGPS, SA	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes
Modelo Continente, SGPS, SA	Yes	Yes	Yes	Yes	No	No	No	No	No	No
Mota-Engil, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Novabase, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Papelaria Fernandes-Indústria de Comércio, SA	Yes	Yes	Yes	No	Yes	Yes	No	No	No	No
Papeles Y de Europa, SA (Europac)	No	No	No	No	No	Yes	Yes	No	No	No
Portugal Telecom, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Reditus – SGPS, SA	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
REN – Redes Energéticas Nacionais, SGPS, SA	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes
Sacyr Vallehermoso, SA	No	No	Yes	Yes	Yes	No	Yes	No	Yes	No
SAG Gest – Soluções Automóvel Globais, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Semapa – Sociedade Investimento e Gestão, SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Sociedade Comercial Orey Antunes, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Sociedade Têxtil Amieiros Verdes, SA	Yes	Yes	No	No	No	No	No	No	No	No
Somague, SGPS, SA	Yes	Yes	No	No	No	No	No	No	No	No
Sonae – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Sonae – Capital, SGPS, SA	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes
Sonae Com – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

(continued)

Table 1.2 (continued)

Company	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Sonae Indústria – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Tertir – Terminais de Portugal, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
VAA – Vista Alegre Atlantis – SGPS, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Banco Santander Central Hispano, SA	Yes	No	Yes	Yes	Yes	No	No	No	No	No
Banco Santander, SA	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes
EDP – Electricidade de Portugal, SA	Yes	Yes	No	No	No	No	No	No	No	No
EDP – Energias de Portugal, SA	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Glintt – Global Intelligent Technologies, SGPS, SA	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Pararede – SGPS, SA	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No
Portucel – Empresa Produtora de Pasta e Papel, SA	Yes	Yes	Yes	Yes	No	No	Yes	Yes	No	No
Portucel, SA	No	No	No	No	No	No	No	No	No	Yes
Sporting – Soc. Des. Futebol SAD	Yes	Yes	No	No	No	No	No	No	No	No
Sport Lisboa e Benfica – Futebol SAD	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Sumolis – Comp. Industiral de Frutas e Bebidas, SA	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No
SUMOL+COMPAL, SA	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Teixeira Durate – Engenhariae Construções, SA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Teixeira Durate, SA	No	No	No	No	No	No	No	No	Yes	Yes
Salvador Caetano – Indúst. Metal. Veículos Transp., SA	Yes	Yes	Yes	Yes	No	No	No	No	No	No
Toyota Caetano Portugal, SA	No	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes
PT Multimedia – Serv. Tel. Multimédia, SGPS, SA	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No
ZON Multimédia – Serviços de Telecomunicações e Multimédia – SGPS, SA	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes

1.4 From the Report on Corporate Governance to One on the Best Practice of Portuguese Companies

On corporate governance, the best practice of the Portuguese companies is related to the remuneration policy. This recommendation depends on the structure adopted by company and the performance criteria in annual accounts (Ferranini 2008).

Regarding the disclosure procedure, the corporate governance report published by companies is based on recommendations and principles of CMVM Corporate Governance Code 2010 (CMVM 2010b):

- Principle I.1.2. – General Meeting Board details that:

  The remuneration of the chair of the General Meeting Board shall be disclosed in the annual report on corporate governance.

- Principle II.1.5. – Remuneration details that:

  1. The remuneration of the members of the Board of Directors shall be structured so that the formers' interests are capable of being aligned with the long-term interests of the company. Furthermore, the remuneration shall be based on performance assessment and shall discourage taking on extreme risk.
  2. A statement on the remuneration policy of the Board of Directors and Supervisory Board referred to in Article 2 of Law nº 28/2009 of 19 June, shall contain, in addition to the content therein stated, adequate information on: i) which groups of companies the remuneration policy and practices of which were taken as a baseline for setting the remuneration; ii) the payments for the dismissal or termination by agreement of the Directors' duties.
  3. The remuneration policy statement referred to in Article 2 of Law No. 28/2009 shall also include the directors' remunerations which contain an important variable component, within the meaning of Article 248-B/3 of the Securities Code. The statement shall be detailed and the policy presented shall particularly take the long-term performance of the company, compliance with the rules applicable to its business and restraint in taking risks into account.
  7. The amount of remuneration received, as a whole and individually, in other companies of the group and the pension rights acquired during the financial year in question shall be disclosed in the Annual Report on Corporate Governance.

- Principle II.4. – General and Supervisory Board, Financial Matters Committee, Audit Committee and Supervisory Board details that

  . . . (depending on the applicable model) shall represent the company for all purposes at the external auditor, and shall propose the services supplier, the respective remuneration, ensure that adequate conditions for the supply of these services are in place within the company, as well as being the liaison officer between the company and the first recipient of the reports.

- Principle III.1.4. – General Disclosure Duties details that

  The external auditor must, within its powers, verify the implementation of remuneration policies and systems, the efficiency and functioning of internal control mechanisms and report any shortcomings to the company's Supervisory Board.

In fact, it is easy to understand that, besides each recommendation and principle, companies approve specific remuneration policy following the current legal framework (Robinson and Bennett 1995; CEACL 2011). In the Law nº 28/2009 of June 19 (AR 2009) was established the regime for approval by the shareholders' meeting of the remuneration policy of the members in organization with concerns of the investor rights. In order to pursuit the article 2º of Law nº 28/2009 of June 19 (AR 2009), there exists the need to disclosure the remuneration policy for members of the board of directors and supervisory board. Also, in the Regulation of CMVM nº 1/2010 (CMVM 2010c), the article 3º referred that:

(a) The annual remuneration amount received by members of the abovementioned Boards, as a total sum and individually;
(b) A fixed and variable remuneration, and as to the latter, the various components that sourced same, the portion that is deferred and the portion that has already been paid;
(c) The remuneration received from other companies in the group, as a total sum and individually;
(d) The pension rights acquired in the financial year at issue.

Therefore, the goals of this recommendation start with Cadbury Committee that presents the corporate governance code promoting new guidelines and regulations. Although, the Cadbury report (1992, p. 30) has the following detail:

> 4.40. The overriding principle in respect of board remuneration is that of openness. Shareholders are entitled to a full and clear statement of director's present and future benefits, and of how they have determined.

After the Cadbury Report, the Greenbury Committee (1995) produced another report by a study group established by the Confederation of Business and Industry (CBI) of the United Kingdom and it focuses on the concern about directors' remuneration packages. Subsequently, the Hampel Report (1998, p. 33) details that:

> 4.5. Disclosure of individual directors' remuneration has also lent force to the Greenbury recommendation that "remuneration committees should be sensitive to the wider scene, including pay and employment condition within the company."

Based on the evolution of the recommendation and in order to reflect critically on the perspective of human resources management, is possible to have different scopes and incentives that are revised every year by the Board of Directors. The GALP Energia (2012, p. 8) publishes the remuneration policy on 2010 in accordance with:

> ...Law nº 28/2009 of 19 June and with CMVM Regulation nº 1/2010 and with the Corporate Governance Code 2010 (Recommendations) and is aimed at strengthening values, skills and conduct compliant with the Company's long term interest, culture and strategy.

In other to ensure responsible governance oriented to value creation, the *Banco Espirito Santo*, SA published the Corporate Governance Report 2012. In this report, this best practice is highly consistent with the organizational chart and the distribution of duties among the several committees of the BES. The BES (2012, p. 64) report details, in particular, that:

> ...the Board of Directors decided to create a "Remuneration Advisory Committee" viewed compliance with Decree-Law nº 88/2011 and Bank of Portugal Notice nº 10/2011, which determined that credit institutions of a significant dimension should set up a remuneration committee consisting of non executive directors, responsible for decision shaping on remuneration issues.

Another best practice in the remuneration policy is the example of Zon Multimédia (2012, p. 3) that is aware that the remuneration policy for executive board members:

> followed in 2011, continued to be guided by general principles that have been in place since late 2007. (. . .).The metrics established by the remuneration committee generally correspond to variables such as profitability and growth that ensure the company continues to develop along with that of the national economy and all company stakeholders. The main figures under scrutiny in 2011 were: revenues, EBITDA, operating cash flow, revenue generating units and net profit.

As noted above, the remuneration policy is clearly linked with the company's overall results and it has to reflect the objectives and rules pursued by the accounting disclosure requirements, showing the essential flexibility to change company payments under the macro and microeconomic conditions. The perspective of organization citizenship behavior has been defended by Wanxian and Weiwu (2007, p. 225) knowing that employees must be concerned in-role rather than extra-role and company should promote equity on age (older), position (higher) and gender (women) as important objective of the Board of directors.

As academic literature emphasizes corporate governance examines the remuneration policy with alternative ownership structures. Based on this argument, Lambert et al. (1993) provide evidence that the CEO receive higher pay when they have appointed a greater proportion of the board. Another report of the REN, SGPS, SA (2012, p. 4) mentioned that:

> The remuneration of the members of the Executive Committee is mainly determined based on four general criteria: (. . .) (iii) performance evaluation, in accordance with the functions and level of responsibility of each person and with the assumption of adequate levels of risk and compliance with the rules governing the activities of REN; and (iv) the alignment of director's interests with the Company's interests and its sustainability and wealth creation in the long term.

The remuneration policy of the board of directors usually ignores the fact that citizens' opinion must be taken into account and probably this is the worst corporate governance practice because directors of these companies do not respect three Laws nº 12-A/2010, of June 30 (AR 2010a), Law nº 55-A/2010, of December 31 (AR 2010b) and Law nº 64-B/2011, of December 30 (AR 2011). So, as Kooiman and Jentoft (2009) explain these directors do not demonstrate respect for persons that it is more than an individual duty. Companies should have a formal and transparent procedure that ensures the equity of the remuneration policy. Again, as Kooiman and Jentoft (2009) explain the need for disclosure remuneration policy tries to define rules for fair procedures. The incentive procedure of the remuneration policy should be justified on the right of inclusion of all workers of the company. Once more as Kooiman and Jentoft (2009) explain the goal for compensation will increase the severity of crashes. In this sense, the agreement of boards and committee starts with credible political-economic vision that must be addressed to take cognizance of the challenge presented by the Government and the European Union.

Amongst the companies with listed shares, the perception of the board of directors about the remuneration policy was widely dispersed. From the empirical analysis developed on this research, it has chosen *Caixa Geral de Depósitos* (CGD) based only on three different measures: Remuneration Amount, Management Bonus and Mobile Expenses. Table 1.3 presents, over the period 2006–2010, the distribution of the three different measures of each member of the Board of Directors and the Audit Committee.

Apart from evidences on focus in Table 1.1 the main reason to adopt this restriction of three different measures is due to the fact that total compensation is uncertain and the reports published have dispersed information, which suggests that the exact assessment procedure used for long-term does not have consistency. However, the results also recommended the existence of quite a lot of expected payouts from various awards at the time they are granted.

First evidence, in the period of analysis, the size of the board change from one Chairman, one Deputy-Chairman and seven members to one Chairman, one Deputy-Chairman and five members. So, as Kooiman and Jentoft (2009) explain the decrease in the number of members on the Board of Directors and the increase level of efficiency, knowing that it is a principle for the choice. As complementary information, the CMVM Annual Report (2008, p. 24) generally seeks to align with:

> The Latin Model is most adopted with 78.6 %, the Anglo-Saxon Model has been chosen by 19.0 % and the Dualist Model has only 2, 4 %.

Second evidence, the Corporate Governance Code contains a new recommendation on auditing. In order to increase the independence and enhances more accountability (Kooiman and Jentoft 2009), shareholders to monitor managers could do it through the audit committee and this means that some changes are expected in the near future, then CMVM (2010a) referred:

> companies should promote rotation of the external auditor at the end of two or three mandates in accordance with, respectively, three or four years and that its continuance beyond this period must be reasoned in a specific opinion to the Board of Directors.

Third evidence, the total remuneration amount has been reducing only 6.3 % or €143.956, because the entire remuneration basis and supplementary has been increased between 2006 and 2010. One important inference due to the financial crises and the deficit of State Budget, the reduction in the remuneration amount of 15 % was approved as a result of the article 12º of Law nº 12-A/2010 of June 30 (AR 2010a) and article 19º of the Law nº 55-A/2010 of December 31 (AR 2010b). As Kooiman and Jentoft (2009) noted the transparency is a principle for governance image. Alternatively, the board of directs asks for especial authorization of the Portuguese Government to not reduce the remuneration. In these companies, the board demonstrates that it does not concern itself with national loyalty with financial crises, neither are the international economic-finance crises a determinant of the bank activity and the increase risk level. Another report of the REN, SGPS, SA (2012, p. 4) mentioned that:

> Given the current economic and financial situation, and without prejudice of temporary reductions on the remunerations provided for in Laws (. . .), the Remuneration Committee resolved that the fixed remunerations level of the current directors will be maintained under the terms fixed for the prior financial year.

Table 1.3 The distribution of the remuneration amount, management bonus and mobile expenses of members of board of directors and audit committee of CGD, 2006–2010

December 31st (Thousands of €)	Remuneration amount (basis + supplementary)					Management bonus		Mobile expenses				
Year	2006	2007	2008	2009	2010	2008	2009	2006	2007	2008	2009	2010
Board of directors												
Chairman	349,158	349,158	33,648			202,013		5,186	8,089	1,620		
Chairman (new)			362,630	371,000	371,000		155,184			3,029	1,652	3,800
Deputy-Chairman	296,735	296,785	28,601			157,402		2,286	2,812	771		
Deputy-Chairman (new)			313,874	315,350	315,350	117,841	135,150			2,904	6,133	6,600
Member 1	244,411	244,411						802	1,059			
Member 2	174,122							15,003				
Member 3	244,411	244,411	22,695			117,841		1,049	1,863	29		
Member 4	244,411	244,411	23,553			117,841				67		
Member 5	244,411	244,411	23,553			117,841		2,195	2,352	510		
Member 6	244,411	244,411	23,737			117,841		2,277	4,277	962		
Member 7	244,411	244,411	259,409	259,700	259,700	117,841	111,300	948	933	996	1,131	1,338
Member 8			254,936	259,700	259,700		108,629			12,152	8,623	13,387
Member 9			253,841	259,700	259,700		108,629			2,287	1,340	2,655
Member 10			254,936	259,700	259,700		108,629			1,712	1,977	3,671
Member 11			254,936	259,700	259,700		108,629			1,983	1,027	2,256
Audit committee												
Chairman		45,591	74,117	74,200	74,200							
Member 1		34,193	55,588	55,650	27,825							
Member 2		34,193	55,588	55,650	55,650							
Member 3					0							
Total	**2,286,481**	**2,226,386**	**2,295,642**	**2,170,350**	**2,142,525**	**1,066,461**	**836,150**	**29,746**	**21,385**	**29,022**	**21,883**	**33,707**

Source: Adaptation of CGD (2007, 2008, 2009, 2010, 2011, 2012)

Fourth evidence, the mobile expenses is one of the most stable information during the period, which allows comparing information, practices and attitudes of each member of the board. It matters to disclose this information, if the board has an explanation and rules that prevent situations of one member benefiting, misuse or abuse of mobile expenses. For example, the segregation of duties could justify that one member of board of directors could spend more on mobile, then questions addressed to their effective functioning and operating style. As a result of synthesis of Table 1.3**,** the board of directors spends nearly €33.707 on mobile expenses during of the year of 2010 in relation to € 29.746 in year 2006, an increase of 13.3 % or €3.961.

These analyses allow us to conclude that through the biggest Portuguese Banks, they have not fulfilled the information proposed in the Green Paper of Corporate Governance in relation to the board of directors, because the question of directors' pay is not consistent neither is it complete, while citizens know that a general trend of the cut in remuneration policy is a national obligation. So, the authors propose that the CGD should concentrate the disclosure of corporate governance information in the examination of the preferences for widespread recognition such as: availability and time of commitment of directors also be under scrutiny as well as questions on risk management and composition of the Board such as: gender diversity, variety of professional backgrounds and skills, location of home in different areas of Portugal.

The evidence of this specific recommendation allows us to conclude that companies in the Portuguese Securities Market concentrate the remuneration policy in packages with a basic salary component, a management bonus related to short run performance that is related to annual accounting net result (profits), a stock participation plan and diverse benefits, such as: pension rights, credit card, mobile expenses and "golden parachutes". The OECD (2011, p. 53) governance model of the Board of Directors is still evolving, as well as, board members responsibilities in the remuneration setting process.

The remuneration policy is a particular case with concentrated opinions promoted by companies, but it improves with citizen engagement and remuneration disclosure. Regardless of the existence of different remunerations, CMVM (2012b, p. 25) intended to show that:

> The remuneration of the executive directors on average decreased to EUR 449 300 (EUR 513 000 were in 2009) but remained well above the global average remuneration of EUR 264 000. Twenty-one executive received more than EUR 1 million, has been the maximum value of EUR 1.42 million, and a minimum of zero (in two cases).

The above mentioned criteria are mechanisms which are intended to promote a proper alignment with long-term citizen interests and sustainability of the company. It should be noted that the limitation of the remuneration does not seem justifiable, but if the results show a significant deterioration in the company's performance over the last financial year or when such deterioration is predicted during the relevant financial year, then the applicability will be affected by the legal framework.

Interestingly, neither is the remuneration policy sufficiently widespread nor the concerns with management bonus provides the field of study evidence. This question has, also, been suggested by Merchant and Manzoni (1989) and, of course, this was problematic. It is urgent that the modernization, austere rules and legislative basis that appear to draw, at least implicitly, as a guide for remuneration policy be implementation by companies.

1.5 Discussion

The authors recognize the importance of corporate governance recommendations, despite a wide variety of them, which promotes different degrees of convergence as a result of consensus of application and, also, divergences as influence of less consistency of domination positions on the structure of the company.

The first result of this research is based on the fairness principle of best practice of corporate governance. The findings are useful to shareholders about the performance of the companies; to regulatory authorities about the assessment of the corporate governance code; to investors about the power which attracts them to want to make more investments; to managers about the stability and the forecast information; to employees about recognition of rights, duties and dignity of the work; to associations of companies about the comparability and forum for dialogue; to universities about the research and development strategies; to public authorities about effective information for inspections mechanism (i.e. incomes to pay taxes); to political entities about the production and assessment of laws.

The second result of this research is based on the responsibility principle of best practice of corporate governance. In this sense, decision is a crucial part and needs to be made between conflicting alternatives. The citizen bases his or her decision concerning corporate governance initially on calculations alone and, then, it takes into account emotions, beliefs, formal education and other information attached to the company and thereby arrives at his formal opinion and decision.

The third result of this research is based on the accountability principle of best practice of corporate governance. The citizen has a different position that is related with difficulties to perceive value of the corporate governance decision as a whole, especially because this decision is complex (Jordan et al. 2008) and it reaches his or her formal opinion (Joppke 2007). The decision takes into account emotions, beliefs, formal education and other information attached to each corporation. The coherence must remain recognized by the adoption of the recommendations after the corporate influences through its actions on the external environment and it must produce effects in the economic decisions. In the shorter-run, corporate governance failures may be eliminated to facilitate the bridging of the gap between the micro and macro domains.

The fourth result of this research is based on the transparency principle of best practice of corporate governance, because it provides indications to citizen about public information to legitimate right to raise questions. In this context, many companies reflect growing concerns about the economic system, then developments and challenges that they want, or desire, to play in the global society. So, economic, social and market pressures are gradually leading to a change in values and in horizon of business activity and transparency is the legitimization that advocates for accounting for citizenship.

Best practices of corporate governance ensure the choices of the company that are highly influenced by four principles of corporate governance: Fairness, Responsibility, Accountability and Transparency (Aras and Crowther 2008) with the concern to require better protection for basic rights, such as: secure the ownership and gain prominence of the financial markets.

1.6 Conclusion

The research focuses on formulation, solution and dynamic of corporate governance. The same type of reasoning is very important when it will be applied to accounting for citizenship. In this research, involvedness arises from the distance between the citizen seeking for the relevant information to his or her economic decision and the source that contains this information that is corporate governance committees. So, citizens can adopt an economic decision, if they identify and understand the problem, then they likely to discover solutions to it.

Despite the results, this research is not without its limitations. Primarily, the research examines the causes and effects of adoption of Corporate Governance Regulations of CMVM based on information published and publicly available. However, the authors in future research may get further information to explain all the recommendations based on private information that is only available to shareholders and the authors hope to research this area too. Secondly, this research provides an indication as to whether an endogenous change in corporate governance occurred, which has not yet been examined the additional forces derived by exogenous change.

However, to these authors' best understanding, the role of the corporate governance has not previously been emphasized in accounting for citizenship. In addition, the findings are consistent that it is urgent that companies, in general, and the citizen and investor, in particular, must promote corporate governance with full citizenship rights, fighting anomalies in corporate governance, and appropriate corporate behavior, giving more credibility to the financial future of companies.

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Chapter 2
Corporate Governance in Greece

Andreas G. Koutoupis

Abstract The era of huge profits has gone for most businesses therefore companies nowadays should not waste resources. Within this context, the adoption of effective corporate governance codes is not a luxury, but a challenge and necessity. Corporate governance and internal audit functions within Greek enterprises are imposed by the Greek laws for publicly listed enterprises. In this paper, we examine the current status of the implied corporate governance code in Greece compared with those of South Africa (King Report) and United Kingdom (Combined Code). Both codes are considered as advanced to issues related to corporate governance and internal controls.

The first edition of King Code was published in 1994. The novelty of the corporate governance of South Africa was the issues of sustainable development. In contrast with other editions of King Report, King III Report is obligatory for all the companies of South Africa. The United Kingdom is a country with a free market economic system, which does not wish intervention by the state. The Combined Code is a predominant corporate governance code in the UK as has adopted many provisions from the previous UK corporate codes. The Financial Reporting Council (FRC) is now responsible to update the Combined Corporate Code.

After analyzing the relevant literature review, as well as the details of the codes we are analyzing whether any provisions of the above corporate codes could be implemented in the Greek publicly listed enterprises. The importance of the provisions of the international governance codes is then evaluated by members of the boards of directors and the relevant audit committees, as well as Internal and External Auditors on a small sample basis.

Specifically, our research is based on a case study analysis of six publicly listed enterprises. Three of them are traded in the high capitalization index of the Athens Stock Exchange, while the remaining three are traded in the medium – low

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_2, © Springer-Verlag Berlin Heidelberg 2014

capitalization index. Our main research objective is to examine the extent of international corporate governance codes impact in the local laws and regulations, as well as adopted best practices. Also, our secondary research objective is to evaluate the extent of the impact of corporate governance best practices among large and medium-low size publicly listed enterprises. Each selected enterprise represents a different industry.

2.1 Introduction: The Evolution of Corporate Governance

The concept of corporate governance has been evolving for more than 20 years. The Organization for Economic Cooperation and Development (OECD), as well as the Cadbury Committee define corporate governance as a system by which companies are monitored and controlled. Corporate governance codes include considerable references to the internal audit function, which along with other responsibilities may be considered as a useful tool to enhance transparency and protection of shareholders and stakeholders. The protection of shareholders is an enduring requirement, which usually appears after a disclosure of financial scandal (Owson 2009). Relevant examples involve the South Sea Company in United Kingdom in 1720, the crash of the New York Stock Exchange in 1929 and the quite recently bankruptcies of giants like Enron and WorldCom. The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd. (1992). The corporate governance codes are easier to apply in countries where there are more safeguards towards the protection of shareholders (Dowdney 2005).

A major Corporate Governance initiative was the UK Cadbury Code (1992) as it was the first document that raised the notion of internal control effectiveness considering the company objectives. Its importance lies in the fact that places the internal audit function as an important concept aiming to transform it in the modern environment.

According to Aguilera and Cuervo-Cazurra (2004) the profitability of a business in combination with regulatory pressure leads to the adoption of a relevant corporate governance code. Some institutional settlers who occasionally issue corporate governance codes are the Stock Exchanges, the government, the association of company directors, investors and professional organizations of accountants or even lawyers (Sneller and Langendijk 2007). It is also concluded that when the state or the stock market impose a corporate governance code, then it is usually considered as a mandatory requirement (Rouse et al. 2005). In contrast, when professional associations or federations propose a corporate governance code, it is usually considered as a voluntary approach.

The importance of corporate governance is becoming increasingly significant over financial crisis. The recent major financial scandals were the result of a mistaken policy on corporate governance, which significantly harmed leading companies in financial and banking sector, such as AIG, Citigroup and Merrill Lynch. From the above it becomes clear that the effective implementation of appropriate corporate governance and internal controls practices are vital for companies (Donald et al. 2003). Lack of effective implementation of corporate governance codes usually lead to business failure (Tackett et al. 2004).

2.2 Research Methodology

There are many sources addressing the application of Corporate Governance codes. Literature review includes Corporate Governance concepts, practices and the relevant application in several relevant books (for specific information see Bibliography). Literature review was based on the OECD, UK and South Africa national corporate governance codes, as well as Greek national code for corporate governance. Many other organizations such as Basel Committee on banking supervision have issued relevant guidance, while the most important relevant document in Greece is the latest issue of the Association of Enterprises and Industries (SEV) which recommends the voluntary compliance with the provisions of the code.

2.2.1 Research Setting

This study focuses on the evaluation of the introduction of International Corporate Governance codes such as Combined Code (UK) and King Report III (SA) in the Greek publicly listed enterprises. The latest should be in compliance with relevant local laws and regulations, as well as, in certain cases, with adopted corporate governance best practices. Our research is based on a case study analysis of six publicly listed enterprises. Three of them are traded in the high capitalization index of the Athens Stock Exchange, while the remaining three are traded in the medium – low capitalization index. Our main research objective is to examine the extent of international corporate governance codes impact in the local laws and regulations, as well as adopted best practices. Also, our secondary research objective is to evaluate the extent of the impact of corporate governance best practices among large and medium-low size publicly listed enterprises. Each selected enterprise represents a different industry.

2.2.2 Sources of Information

Qualitative research was carried out to address the research topic, using primary and secondary data. The focus is both on the primary and secondary sources of information. The primary sources of this study are the professional experience of authors in the field of Corporate Governance and Internal Auditing within publicly listed enterprises, whereas secondary sources are the international corporate governance codes, Greek corporate governance laws, regulations and best practices, books, working papers and published articles.

The sources of information that have been used as a basis for the theoretical and analytical part of the study are described below.

2.2.3 Primary Sources of Information

Professional experience of the author in the field of Corporate Governance as experienced consultant in all enterprises that constitute the Case Study sample, as well as the adequate knowledge with respect to adopted corporate governance best practices. Professional experience is demonstrated through participation in a number of relevant projects. Also, relevant questionnaires, checklists, manuals, reports, Board of Directors and Audit Committee Minutes of Meetings, as well as internally adopted corporate governance codes for a number of clients have been used as a primary source of information.

2.2.4 Secondary Sources of Information

1. Academic and professional journals and publications: International Journal of Auditing, Internal Auditor, Internal Auditing, Managerial Auditing Journal, Accounting & Business Research, Harvard Business review, McKinsey Quarterly, Journal of Finance, Management Accounting;
2. Participant listed enterprises' annual reports and other related published data;
3. Web site information;
4. "International Corporate Governance Codes such as Combined Code (UK) and King Report III (SA), Codes of Best Practices (mainly COSO ERM suggested framework, as well as OECD and Basel Committee suggested best practices";
5. Mazars Clients Databases (External Audit).

All selected enterprises are publicly listed in the Athens Stock Exchange (ASM), large to medium in terms of capitalization and revenue, and attract attention from domestic and foreign investors, both institutional and individual. The researchers used self-selection as the process to gather credible and adequate sample, as well as to enhance the potential to utilize their professional knowledge.

The sources above have produced a number of references that are included in the bibliography. As far as possible the included references have been read, the abstracts inspected and any relevant book reviews noted.

2.3 Case Studies Development

As stated before, six Case Studies were selected. In all cases we examined the following factors:

1. Board of Directors (BoD) – The application of International Governance codes in the composition and size of the BoD, as well as the effective discharge of

responsibilities. Also, our review raised questions associated with the ongoing monitoring of Internal Controls, Risk Management and Internal Auditing.
2. Audit Committee & Other BoD Sub-committees – The compliance with European Union and local laws and regulations, as well as the relevant best practices.
3. Remuneration Policy – The remuneration levels among different companies associated with entity and executive level performance objectives and the relevant disclosures.
4. Investor Relations – Compliance with local laws and regulations, as well as with best practices stated in the International Governance Codes.
5. Business Risk Management – The adoption of Enterprise Risk Management obligations according to International Corporate Governance codes and relevant best practices (global and local) and also the application of ERM COSO Model or any other known or not well known risk management model.
6. Internal Controls – The adoption of Internal Controls obligations according to International Governance codes and relevant best practices (global and local) and also the application of COSO Internal Controls – Integrated Framework, as well as ERM COSO Model, or any other known or not well known Internal Controls model.
7. Internal Auditing – The implications of the application of the International Governance codes and the local laws and regulations in the internal audit departments. Specifically, how those rules or voluntary practices affected the staffing, scope, human resources, methodology (working practices), reporting and other communication issues of the internal Audit department. Also, whether (if yes how) international governance codes relate with the internationally adopted Standards for Professional Practice in internal auditing.

In the following lines we are going to discuss the Corporate Governance Codes of South Africa (King Report) and United Kingdom (Combined Code) as we consider them the most representative regarding the corporate governance best practices. We will then assess Corporate Governance best practices adoption by the Greek publicly listed enterprises based on the selected cases.

2.4 The Corporate Governance Code of South Africa (King Report)

The first version of the corporate governance code of South Africa was published in 1994 and it was named as King Report. "South Africa is a well known country for its modern regulatory framework regarding the effective operation of the internal audit function (mainly after the adoption of the third review of the corporate governance code (King Report III)". The context of King Report III was influenced by two factors:

– The prevailing international trends in corporate governance and the efforts of South Africa to acquire a modern corporate governance code, which would take into account the new trends and needs.
– The Law 71/2008 regarding business operations.

The third edition of the corporate governance code of South Africa is internationally recognized proposed specific best practices for internal controls and corporate governance. The Securities and Exchange Commission of South Africa requires from the listed companies to describe how they implemented the King II Code providing them with explanations in case of non compliance. It is estimated that for the development of this corporate governance code 106 people worked.

The main innovation of the Corporate Governance Code of South Africa is that for the first time issues regarding the sustainable development are considered as an important piece of business information. Unlike the previous corporate governance codes, namely the King I and King II, King III requires the compulsory statement of Comply or Explain deviations from corporate governance best practices. Therefore, many companies should implement the code ranging from private businesses and nonprofit organizations. Each principle is equally important in order to depict a holistic approach in relation with governance. Therefore, the partial implementation of the Code does not constitute compliance (Institute Of Directors South Africa 2009, p. 16).

The objectives of the code are twofold regarding the effective operation of the internal audit function. The first relates to the operation of audit committees, while the second relates to the internal audit. Each part consists of basic principles and each principle provides a number of appropriate practices. Firstly, the code encompasses principles and appropriate practices relating to audit committees. The first principle refers to the responsibility of the board of the company to confirm that the audit committee is independent and carry out its tasks in an effective manner. The listed private companies and companies under state control should have audit committees and they should issue a relevant charter to explain the composition and duties of the audit committee. Also, the audit committee should be met at least twice a year with the external auditor. Furthermore, the audit committee should be staffed with people trained, independent and without executive and/or administrative duties. The committee's members should be at least three – the president should also be independent and non-executive. The board should elect the chairman of the audit committee, and it should be involved in forming the audit committee, as well as participating in the annual general assembly. The audit committee should oversee the consolidated financial statements of the company. The president of audit committee should agree with the risk management process of the company, perform an overview on the financial statements, including the presentation of sustainability and to monitor the financial and non-financial results at a regular basis. Another principle is that the audit committee should ensure that the company has a model of assurance (assurance model) in order to reach all the company's activities and thus to assess the risks it may face. The audit committee should have adequate resources to perform its important mission.

The Code of Corporate Governance King III as it mentioned above refers to both audit committees and matters relating to internal controls. The first principle refers to the responsibility of the board to ensure the effective operation of risk management. The board should investigate whether corporate governance and internal controls of a company are in accordance with the standards of the Institute of Internal Auditors. According to the code, the internal audit manual is a useful tool for the effective operation of internal audit function and it should be approved by the board. The next principle concerns the audit plan via the company assesses its major risks, threatening its integrity. The risk assessment of the internal audit department should be made in a written form and it should be approved by the board and audit committee.

The next principle relates to the responsibility of the audit committee to oversee the operation of internal audit. Last principle is the strategic placement of internal audit in achieving business's goals. Also, the director of internal audit should attend meetings of the board of the company and it is a proof that King III put emphasis on the quality of internal controls and corporate governance so as company to achieve the relevant strategic and operational objectives (Institute of Internal Auditors 2010).

2.5 The Corporate Governance Code of the United Kingdom (Combined Code)

United Kingdom was one of the very few countries that adopted a Corporate Governance code since the last 20 years although no legislation was implied. Specifically, the concept of Audit Committees appeared in the UK in the late 70s, when certain companies adopted relevant guidelines of the Securities and Exchange Commission of London. The United Kingdom realized relatively early compared with other countries the importance of internal controls (Financial Reporting Council 2010).

A famous code of corporate governance of the United Kingdom is known as Cadbury and it took its name from Adrian Cadbury chairman of the committee who drew up the code of corporate governance in 1992. The establishment of the code has affected many countries around the world in adopting measures to strengthen system of internal controls. The committee began its works in May 1991 in collaboration with the Financial Reporting Council, The London Stock Exchange and professional accountants. The adoption of the code was designed to recover the reduced investors' confidence, which had been shaken because of financial scandals that occurred in the United Kingdom in the early 80s. The establishment of the audit committee is a concept of this code – according to the code it should be consisted exclusively of non-executive members of the BoD. The Greenbury Committee (1995) set up a framework for directors' remuneration. Another committee that followed the Greenbury was Hampel (2008). The Hampel Committee began its works in 1996 and was designed to provide corporate governance guidelines which could be implemented by companies of all sizes. The objective of the above committee was the establishment of generic principles regarding corporate governance. The great innovation of the code was related to the internal audit function. The Combined Code (1998) was issued after the issuance of the above corporate governance codes. The Combined Code essentially assimilated influences from all the previous governance codes such as Cadbury, Greenbury and Hampel. The same code was renewed in 2003 and it was influenced by Higgs's Corporate Governance Code and Turnbull's guidance in relation with internal controls issues. The Financial Reporting Council (FRC) is responsible for updating the Combined Code.

The code of corporate governance adopted in the United Kingdom in 2010 is essentially a reissue of the Code of Corporate Governance Committee Cadbury maintaining its voluntary character. The board of directors has been assigned the responsibility to develop the company's audit committee consisting of at least three independent non-executive members. The audit committee in small firms may be consisted of only two members provided however that these members are independent and non-executive. The audit committee has the responsibility to review the consolidated financial statements of the listed firms. Moreover, the audit committee is responsible for reviewing the system of internal controls and risk management, appoint and evaluate the external auditor of the company and approve the relevant remuneration and conditions of their business. The audit committee also reviews the non-audit work that the external auditor may undertake, as well as reviews the system of internal controls within the organization. UK companies normally issue a regarding the work of the audit committee in their annual financial statements. The audit committee should investigate confidential complaints about failures within the enterprise and also evaluate the effectiveness of the internal audit function. In case the BoD refuses to accept the proposal for the appointment of external auditors it must explain the reasons in company's annual financial statements. Finally, if the external auditor provides non-audit services, then company's financial statements should note how the independence of the external auditor achieved.

2.6 The Corporate Governance Framework in Greece

Corporate Governance in Greece was an unknown practice until 2000, the year where the Greek Capital Markets Commission issued the Decision 5/204/14-11-2000 applicable to all listed to Athens Stock Market (ASM) companies. The main purpose of this was the enforcement of specific behavioral rules of the associated companies and related individuals such as members of the Board of Directors, executive management, internal auditors and external auditors (Dedoulis 2006).

The year 2002 was the most important for Corporate Governance and Internal Auditing in Greece, as the Greek state issued the Act 3016/17-5-2002 which set compulsory organizational and behavioral rules for all listed to ASM companies in a number of areas such as the composition of the Board of Directors with both executive and non-executive and independent members, remuneration practices, organization issues through the development of an Internal Regulation of

Operations (internal organization and policies manual), as well as the compulsory development for a number of departments such as Internal Auditing, Shareholder Relations and Corporate Announcements. The majority of the public listed companies assigned the shareholder relations to specific departments or staff.

Furthermore, a corporate governance and internal auditing enhancement was the enforcement of the Law 3429/27.12.05 for the better organization of non publicly listed public organizations, as well as the compulsory establishment of an Internal Audit function. Also, Bank of Greece imposed the constitution of audit committees and risk committees within banks (2006). Specifically, the Bank of Greece Governor's Act No. 2577/9.3/2006 imposed all banks to establish Audit and Risk Committees and the minimum number of members of it was three. All companies listed on the Athens Stock Exchange should have an audit committee in accordance with the law 3693/2008. The audit committee should be consisted of at least two non-executive directors and an independent non-executive member.

In addition to the above mentioned laws, an effort became recently to enhance corporate governance best practices in Greece through the application of two new laws (L.3873/2010 and 3884/2010). The L. 3873/2010 requires by the listed companies in the Athens Stock Exchange to disclose the composition and the operation of BoD and the others committees of the BoD. Moreover, each company is obliged to disclose a corporate governance statement, as well as disclose its own or the corporate governance code that adopts, or explain the reasons in case of non compliance. The L. 3884/2010 addresses the publicly listed firms' relationships with shareholders and arranges issues related to the shareholder's voting. More specifically, the law is referred to the right of shareholders to appoint a representative to the general assembly if they are not able participate. Moreover, the law provides some guidelines in relation with the voting system in the general assembly. The shareholder has the right not only to vote with physical presence, but from a distance as well.

Also, Hellenic Federation of Greek Enterprises (SEV) issued a corporate governance code in an effort to the continuous improvement of the Greek institutional framework, general business environment and to improve the competitiveness of enterprises and the Greek economy as a whole (Hellenic Federation of enterprises 2010, p. 2). The corporate code encompasses best practices elated to the board, internal controls, internal auditing, remuneration and relationships with the shareholders.

The corporate governance code of SEV is based on comply or explain approach. It recognizes that each company has different needs. The Code of Corporate Governance SEV comes at a time when an effort to strengthen corporate governance is made by law 3973/2010. The Code of Corporate Governance of SEV takes into account the smaller companies. It recognizes that it is difficult to implement some provisions and has some exceptions for smaller companies. The code of corporate governance of SEV is regularly updated to suit modern needs of Greek businesses.

2.7 International Governance Codes Similarities and Differences with Greece Based on the Case Studies Analysis

Corporate governance codes in South Africa and United Kingdom have significant similarities. In the above mentioned countries, the BoD has the primary responsibility for ensuring the effective operation of internal controls. The Combined Code and King code refer to the need of an audit committee establishment and the need for its adequate staffing of persons who combine theoretical knowledge along with professional experience. The composition of the audit committee should consist of at least three members who should be independent and non-executive. The audit committee is responsible for assessing the quality of internal controls (European Commission 2002).

The King III presents some innovations, which makes it unique. In particular, King III sets the internal audit function to a greater focus and makes the operation more important than the other codes of corporate governance. King III adds the issue of sustainability. Moreover, it proposes the implementation of internal controls written policies and procedures (manuals), as well as 2.8

2.7.1 Internal Audit Manual as per the IIA Requirements. Finally, This Code Has More Contexts Relating to the Risk Assessment

According to our case studies analysis the composition of the BoD, Greece has been affected by both Combined Code and King III Report. Hellenic Federation of Greek Enterprises (SEV) adopted the contexts related to non executive members of the board. SEV proposes the majority of members of board to be non executives. There is a similarity with the size of the board. The next important part of the board is its duties. There is a fundamental difference between corporate governance framework in Greece, Combined Code and King III report. Greece and United Kingdom has a traditional view about the role of the BoD that should ensure the firm's value. According to King III report board should not limit to firm's value, but it should ensure the interests of stakeholders as well. Greece has adopted some of the provisions related to corporate governance that follow countries such as United Kingdom and South Africa. The Corporate Governance of SEV proposes the chairman of the BoD to be periodically evaluated not the rest of the members of the BoD. In contrast, other corporate governance codes recommend the evaluation of the entire board.

Regarding Internal Auditing, Greece has adopted an approach in relation with internal auditing which is close to Combined Code (Dedoulis and Caramanis 2007). King III put emphasis on internal auditing as it is characterized as a part of strategic design. All the codes are referred to audit committees the members of whom should be at least three. The responsibility of the audit committee is to oversee the internal auditing therefore it refers to the obligation of the chief of internal audit to participate at management meetings (Douglas 2010).

Regarding the issue of remuneration, Combined Code and King III Report proposes the level of the remuneration of BoD members and the management to be decided by a remuneration committee. In contrast, board decides for the remuneration of the board in Greece according to the law 3016/2002. Nevertheless, it can be concluded that Greece has been influenced by King III Report and Combined Code. The new corporate governance code of SEV in Greece proposes the level of the remuneration of the committee to be decided by a remuneration committee.

Regarding investor relations, Combined Code and King III report have some contexts referred to communication with shareholders, general assembly, and minority shareholders. Combined Code proposes the chairman of the board to discuss with major shareholders about the governance and strategy. It proposes the board to state the steps taken so as to ensure non executive members possess better knowledge of the company. King III Report proposes the communication with shareholders to be performed with a clear language and the company should comply with law of Promotion of Access to Information. Greece has been affected by those guidelines as the recent Law 3873/2010 requires the companies to disclose certain issues in relation with the composition of the board and other committees. Moreover, the latest law 3884/2010 proposes the shareholder to have the right for voting without physical presence. The corporate governance code of SEV proposes companies to send the notice of the general assembly and related papers 20 working days before the general assembly. However, the only corporate governance code that mentions minority shareholders is the King III Report.

Both Combined Code and King III are based on comply or explain approach, so if a company decides not to follow the specific or parts of the above mentioned corporate governance codes, it has to explain why. The Law 3884/2010 states that the companies should develop or comply with any relevant corporate governance code such as the SEV one. In case they should not follow specific parts they have to state why. Consequently, it is concluded that Greece has been highly influenced by the international practices (see Appendix for a detailed analysis).

2.8 Research Results: Conclusions

Our Case Study analysis came up to the result that an important omission of the Law 3016/2002 for corporate governance, as well as the corporate governance code of SEV is that they do not refer to the risk management practices although those strategies are of the best interest of shareholders and the rest of stakeholders.

A positive point is that corporate governance code of SEV defines the concept of internal controls adopted the provisions of COSO, which are internationally recognized practices.

2.8.1 Other Weaknesses Include

Corporate Governance

– Members of the Board should be independent and non-executive. There are not contexts related to the procedures for the selection of members, so as a transparent procedure regarding the selection process.
– There is no requirement to separate the role of the Chairman of the BoD and the CEO.
– No requirement included regarding limitations on the duration of the independent and non executive directors of the BoD membership.

Internal and External Auditing

- Internal audit function: It is crucial to strengthen the functioning of the internal audit department through improvements over the scope, staffing, working practices, reporting and communication. The complaisance of staff people dedicated and full-time job imposed by law 3016/2002. The code of corporate governance of SEV proposes to adopt international standards of internal auditing. This fact is very important for the operation of internal audit function.
- It is necessary to upgrade the role of external auditors mainly regarding the focus on the internal controls review. It is a good practice the mandatory certification of the system of internal controls by the external auditor. We consider also as a good practice to periodically review of the adequacy of internal controls of listed companies by a different external audit firm periodically (i.e. every 3 years).
- The Capital Markets Commission should strengthen its supervisory role. In particular, it should strengthen its monitoring role over companies especially regarding compliance with relevant laws and regulations 3016/2002 and 3873/2010, as well as the content of companies' corporate governance statements.

Appendix

	Greece	South Africa	United Kingdom	Conclusions (Differences-Similarities)
1.Board of directors and members				
Composition and size	1. The board of directors should be composed by non executive directors at least of 1/3 of its members. (Two members	1. The board should comprise a balance of power, with a majority of non-executive directors. The majority of non-executive	1. The board should be consisted of executive and non-executive directors. Except for smaller companies, at least	1. The non executive directors are the 1/3 of the board members. Nevertheless, SEV considers that the majority

(continued)

	Greece	South Africa	United Kingdom	Conclusions (Differences-Similarities)
	should be independent). The existence of independent members isn't necessary if they participate as members-representatives of minority shareholders. (L. 3016/2002)	directors should be independent	half the board, excluding chairman, should comprise non-executive directors determined by the board to be independent	of the board should be independent members
		2. Directors should be appointed by a formal process	2. The board should identify in each annual report each non-executive director	2. Same size
	2. The board of directors should be composed predominantly of non-Executive members. At least two directors of them should be independent. Excluding small businesses. (SEV 2010) 3. The 1/3 of the board of directors should consist of independent non-executive members. (SEV 2010) 3. Sufficient size. (L. 3016/2002) 4. 7–15 members (SEV 2010)	3. Sufficient size	3. Sufficient size	
Duties	Should target to improve the long-term value of enterprise	1.Be responsible for the strategic direction of the company and for	1. Set the company's strategic aims	Stakeholder-inclusive approach of governance hasn't been

(continued)

	Greece	South Africa	United Kingdom	Conclusions (Differences-Similarities)
		control of the company 2.Set the values of company (code of conduct) 3.Ensure that the company's management operates under the principles 4. Stakeholder-inclusive approach of governance	2. Ensure company's obligations are met 3. Monitor internal controls	adopted by Greece until now
2. Audit committee & internal auditing				
Responsibility of internal auditing	1.Supervise the internal rules of the company 2. Indicates cases of conflict of interests 3. Inform the Board once a quarter on internal control issues 4. Provide relevant information when the board asks it. (L. 3016/2002)	1. Should ensure the effectiveness of internal controls	1. The board is responsible for ensuring an effective risk based internal audit 2. Internal audit should follow a risk based approach 3. A written assessment of controls and risk management should be submitted to board 4. Internal audit is a part of strategic design	South Africa has shown increased interest in internal auditing. Greece has adopted the traditional approach
Members of audit committee	At least three members. Two of which should be independent and non executive. (L.3693/2008)	At least three members. All the members should be independent and non executive	At least three members or in smaller companies, at least two, but independent, non executive	Many similarities between Greece, South Africa and the United Kingdom
Responsibility of audit committee	Is responsible for overseeing internal audit	Is responsible for overseeing internal audit	Is responsible for overseeing internal audit	Same authorities
	No mention	No mention	The internal auditing	Greece has not contexts

(continued)

	Greece	South Africa	United Kingdom	Conclusions (Differences-Similarities)
Issues of sustainable development			function should review issues related to the issues of sustainable development	relating to issues of sustainable development
Presence of chief of internal auditing function at management's meetings	No mention	Reference	No mention	No mention in Greece
3. Remunerations				
Level of remunerations	1. The remuneration policy is decided by the board. (L. 3016/2002) 2. The remuneration policy should be decided by a relevant remuneration committee (SEV 2010)	1. Combination rewards between individual and corporate performance 2. The remuneration committee should set the remuneration policy 3. The remuneration policy should address base pay and bonuses, employee contracts, severance and retirement's benefits and share-based and other long-term incentives 4. Non-executive fees comprise a base fee as well as an attendance fee per meeting	1. Combination Rewards between individual and corporate performance 2. The remuneration committee. Should set the remuneration policy 3. Long-term benefits, e.g. shares, call options	Issues of remuneration policy are decided by remuneration committee in the United Kingdom and South Africa. In contrast, the board decides in Greece

(continued)

	Greece	South Africa	United Kingdom	Conclusions (Differences-Similarities)
4. Investor relations				
Communication with shareholders	The financial statements should disclose the composition and the operation of board and the others committees of the company. (L. 3873/2010)	1. Clear and understandable language 2. Companies should explain if refuse to accept proposals which are in accordance with law about Promotion and Access to information	1. The chairman of the board should discuss with the major shareholders about governance and strategy 2. The board should state in the annual report the steps taken so as to ensure non-executive members of the board have knowledge of the company	Greece is making efforts on enhancing information for shareholders, according to international standards
General assembly of shareholders	1. The shareholder has the right not only to vote without physical presence, but from a distance as well. (L. 3884/2010) 2. The company should arrange for the notice of the AGM and related papers at least 20 working days before the meetings. (SEV 2010)	The board should encourage stakeholders to attend AGM'S	1. The company should propose a separate resolution on each substantially separate issue 2. The company should arrange for the notice of the AGM and related papers at least 20 working days before the meetings	Greece adopts provisions so as to enhance participation of shareholders in general assembly
Minority shareholders	No mention	The code states the board should ensure the minority interests	No mention	No mention in Greece

(continued)

	Greece	South Africa	United Kingdom	Conclusions (Differences-Similarities)
5. Other issues				
Obligation of firms for the adoption of corporate governance codes	1. The previous laws were not referred to corporate governance codes 2. Companies should select a corporate governance code and to explain why if they have not implemented some contexts. (L. 3884/2010)	Comply or explain	Comply or explain	Greece adopted the international practices by L. 3884/2010

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Greek Laws and Regulations

Capital's Markets Commission Decision 5/204/14-11-2000
Greek Laws and Regulations
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Chapter 3
Corporate Governance: Polish Lessons from the Global Financial Crisis

Maria Aluchna

Abstract The current economic crisis, resulting from the credit crunch has had a major impact on the global economy and companies. Both national governments and companies were forced to react in order to avoid significant financial problems. So far the Polish economy has proved to have successfully overcome the crisis experiencing an economic slowdown with a GDP growth of 1.7 % at the end of 2009; however several problems in reagard to corporate governance have surfaced. This chapter discusses the characteristics of the Polish corporate governance system and its shortcomings. The central question refers to the activities undertaken by listed companies and regulators, in particular the direction of corporate governance development. The chapter analyses three corporate governance problems of Polish listed companies which were identified as being due to the global financial crisis. These problems include risk management, majority shareholders practices and liquidity problems. The analysis reveals the dynamics of corporate governance development from the perspective of an economy in transition. The Polish governance system has experienced significant improvement over the last 10 years supported by the EU law harmonisation process and market pressure to comply with the best practice code. However, the control standards remain lower as compared to Western Europe and the US, which proved to be significantly visible during the period of the world financial crisis.

3.1 Introduction

The economic crisis resulting from the credit crunch has had a major impact on the global economy and companies. So far the Polish economy has proved to have successfully overcome the crisis experiencing an economic slowdown with a GDP

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_3,

growth of 1.7 % at the end of 2009, 3.8 % in 2010 and 4.2 % in 2011. However, the decrease in demand, mostly in the Western European countries, which remain the major export direction for Poland, as well as the decline in all equity markets have also a significant impact on the Polish economic reality. The interdependence of economies (Kotyński 2009; Ministry of Economy 2007), lower investors' confidence towards emerging markets and the Polish dependence on export to Western Europe had an impact on the economic situation of Polish companies. The predominant results included lower demand for Polish products and currency fluctuations; although the overall impact of the crisis on the Polish financial system was limited. The crisis identified however, several severe corporate governance failures referring to the functioning of the supervisory boards, the practice of majority shareholders and the policy of top management teams (TMT), signaling the need for further reforms.

The paper focuses on major crisis lessons from Poland referring to the characteristics of the corporate governance system and its shortcomings. Twenty years of systemic transformation in Poland and the accession to the European Union allowed for significant economic, institutional and social development. However, as an emerging market the Polish economy still depicts certain corporate governance shortcomings. The Polish corporate governance system relies more on hierarchies such as ownership structure or board, whereas external market mechanisms, such as the stock market, remain weaker. The system is characterized by the significant ownership concentration (Dzierżanowski and Tamowicz 2002), small proportion of independent directors, small popularity of committees on board (Campbell et al. 2006) and insufficient corporate disclosure (Grzybkowski and Wójcik 2006). Despite the strong law on paper, enforcement is relatively poorer and the judicial system remains highly ineffective. Therefore, the central question asked in this chapter refers to the strategies and activities undertaken by Polish listed companies in the period of the global financial crisis. In particular, the three main lessons presented in the paper illustrating three board failures heavily rooted in the structural characteristics of the Polish system answered the question on the direction of corporate governance development, which may call for either further progress or regression.

The paper is organized as follows. The first section presents an overview of the Polish corporate governance system. The analysis refers to the most important elements of corporate governance structure discussing the ownership structure; board functioning, stock market development and legal regime quality. The discussion of the main corporate governance shortcomings based on both the empirical studies and practical evidence is presented in the second section. The analysis reveals the dynamics of corporate governance in the period of the global financial crisis. The Polish governance system has experienced significant improvements over the period of the last 10 years supported by the EU law harmonization process and the market pressure to comply with the best practice code. However, the control standards of Polish companies remain lower when compared to Western Europe and the US, which proved to be significantly visible during the period of the world financial crisis. The third section presents the three main Polish lessons from the crisis pointing out the severe failures of the control structure and regression of the development process. The analysis adopts a case study approach as these three failures rooted in various corporate areas of operation, which relate mostly to board failures. These three main problems identified in Polish listed companies include:

- Risk management failure (currency options) – the constant increase of the Polish zloty to the euro noted after the accession to the EU encouraged many companies to use the currency options not only as a tool to lower risk but also to gain additional profits. Particularly, the speculation on currency fluctuation and the use of a so called ‘costless’ currency option undertaken by TMT led to severe financial problems. Several public listed companies noted substantial losses (millions of dollars) due to their involvement in derivatives. None of the supervisory boards blocked the risky transactions showing the failure of risk management;
- Majority shareholders practice abusing minority shareholder rights – majority shareholders such as strategic investors and private founders who control either large listed companies (TVN) or business groups (Getin Bank, Cersanit) undertook actions to realize private benefits abusing minority shareholders. These actions included investment and dividend policies, related party transaction within the business groups conducted at the cost of the minority shareholders;
- Problems with financial policy – the economic slowdown impaired the financial position of many listed companies due to the liquidity problems of their subcontractors. These challenges show the failure on financial policy which currently leads to bankruptcies and to the rise in importance of factoring activities at the same time.

The three identified control failures delivered significant problems both for the companies as well as for the stability of the economy. Moreover, these examples illustrate the severe shortcomings of an emerging market to cope with crisis and to address relatively sub-routine problems of risk management, majority shareholder policies and liquidity problems.

3.2 The Polish Corporate Governance: An Overview

3.2.1 The Development of Polish Corporate Governance After 1989

The development of the Polish corporate governance system after 1989 is heavily rooted in the three main processes taking place in the economy, which include the transition from centrally planned to market economy, development of the emerging market and the EU accession followed by the harmonization process. The current characteristics of the Polish governance system reveal an example of path dependency referring to existing laws and institutional order. These three processes are crucial for understanding the contemporary control structure, business reality and indicated shortcomings.

The transition reforms undertaken in Poland in 1990 aimed at the unprecedented change of the political and economic regimes evolving from socialism to democracy and from central planning to market economy (Mihalyi 1997; Kołodko and Nuti 1997). From the perspective of corporate governance the ultimate goal of the reform was to create a sound system of control mechanisms and institutions of private property, a set of institutions ensuring the enforceable allocation of responsibility (commercial codes, collateral, bankruptcy), institutions that control and monitor the behavior of those who hold the property of others (banking regulators, stock markets, security regulators) that would replace the state intervention and the central planning (Murrell 1999; Frydman and Rapaczynski 1995; Frydman and Rapaczynski 1996). The privatization schemes adopted under the condition of the lack of capital, experience and know how were dominated by the case-by-case approach leaving very few companies to the highly criticized mass privatization programs (Kozarzewski 2003, 2006). The evolutionary ownership shift contrasted significantly with the macroeconomic shock therapy that imposed hard budget constraints of the state owned companies (Svejnar 2001; Balcerowicz 1995). The adopted, or de facto resulting from ongoing political and social debates, privatization programs helped avoid dispersion of ownership and assets stripping (Coffee 1999; Nellis 2000; Frydman 1998) and resulted in significant ownership concentration in the hands of strategic investors dedicated to costly restructuring programs (Bornstein 2000; Kozarzewski 2006).

The development of the emerging market was aimed at the reemergence of market mechanisms, rebuilding of entrepreneurial spirit and increasing the contribution of the private sector to GDP. These elements were to bring back the healthy competition on the market, which was traditionally very weak in centrally planned economy, perceived as the mechanism of natural price regulation and quality enhancement. This should also have impact on the economy to provide a more balanced and dispersed market structure eliminating the concentration of production noted in the socialistic economy where leading firms' output accounted for 30 % in 60 % of the markets at a three-digit level and over 60 % in 25 % of the markets (Commander et al. 1999; Estrin 2000).

Poland's accession to the EU undoubtedly contributed to the development of control structure and strengthening of the investor protection and market mechanisms. The obligation of member states to harmonize laws and to adopt a set of regulations reforming corporate governance leads to higher disclosure requirements, greater (if any) presence of independent directors on the board, stronger investor protection and better enforcement of shareholder rights (Olsson and Alasheyeva 2000). These three processes indisputably influenced the development of Polish corporate governance and impacted its characteristics which are presented below.

3.2.2 Ownership Structure

The analysis of the ownership structure of Polish listed companies reveals stable characteristics over the whole period they were conducted. Since the first research, the shareholder structure of Polish companies shows a significant concentration of ownership characterized by the average majority shareholder stake estimated at 41 % shares (Kozarzewski 2003; Dzierżanowski and Tamowicz 2002; Aluchna 2007; Urbanek 2009). The ownership structure analysis depicts a slight evolution of the identity of the dominant shareholder which results from the three above mentioned processes. Not surprisingly, the strategic foreign investor appeared to be the most frequent identity of the dominant shareholder in the 90s as a result of the case-by-case privatization (Konings 2001). Strategic foreign investors such as the dominant shareholders were surpassed by domestic private and domestic strategic investors in line with the economic development and entrepreneurship surge as well as the creation of corporate groups, respectively. This phenomenon of the large importance and substantial involvement of the private domestic investors in Polish listed companies is presented in Table 3.1

As presented in Table 3.1 domestic individual investors prove to be the most frequent majority shareholders of Polish listed companies. The individual investors often combine the role of majority shareholders (playing key roles via their representatives in supervisory board) and the role of executives at the management board. Therefore they combine decision making and supervision power exerting full control over the company. The importance of strategic investors as well as of individual investors acting via other companies (holding companies, financial vehicles) in the ownership structure of Polish listed companies led to creation of corporate groups and the pyramidal structures which show to be a popular phenomenon noted recently (Aluchna 2010).

3.2.3 The Supervisory Board

Polish corporate governance is based on the dual model including the management board and the supervisory board composed solely of non-executive directors. Weak external governance mechanisms during the transition period attested for the expectations of the essential role of the supervisory board and professional directors. Within a two-tier system, a separate supervisory board has the competence for control and advice to the management. The law itself does not give provision for a strong position of the supervisory board allowing a lot of discretion for a company's bylaws. The law provides little guidance on the duties of care and loyalty of the directors and does not sufficiently resolve the conflict of interest issue (World Bank 2005a). The analysis of the Polish listed companies reveals positive results of the board composition (well-educated, experienced experts); the shortcomings however are detected in the board structure. In many cases the supervisory board is a

Table 3.1 Shareholder identity according to the size of controlled stakes (no. of sample companies, % of sample companies)

	1st largest	2nd largest	3rd largest	4th largest
Top management team members	88 (25.1 %)	49 (17.3 %)	31 (15.3 %)	18 (14.5 %)
Supervisory board directors	39 (11.4 %)	40 (14.1 %)	28 (13.8 %)	12 (9.7 %)
Other individual	24 (7.1 %)	24 (8.5 %)	25 (12.3 %)	13 (10.5 %)
Strategic foreign investor	60 (17.1 %)	18 (6.4 %)	8 (3.9 %)	5 (4.0 %)
Financial foreign investor	6 (1.7 %)	14 (4.9 %)	9 (4.4 %)	5 (4.0 %)
Strategic domestic investor	71 (20.3 %)	26 (9.2 %)	16 (7.9 %)	6 (4.8 %)
Financial domestic investor	28 (8.0 %)	66 (23.3 %)	47 (23.2 %)	42 (33.9 %)
NIF	4 (1.1 %)	2 (0.7 %)	–	–
Pension fund	7 (2.0 %)	36 (12.7 %)	35 (17.2 %)	20 (16.1 %)
State	14 (4.0 %)	4 (1.4 %)	1 (0.5 %)	1 (0.8 %)
Cross shareholding (to be liquidated)	4 (1.1 %)	4 (1.4 %)	3 (1.5 %)	2 (1.6 %)
Dispersed ownership	7 (2.0 %)	–	–	–
Total	350 (100 %)	283 (100 %)	203 (100 %)	124 (100 %)

Source: Compilation based on Urbanek (2009), pp. 392–393

forum for the efficient work of the shareholders' representatives and (a few) independent directors. In other cases however members are connected with the owner-managers/founders of the company and supervisory boards are treated strictly instrumentally and its main activity is limited to fulfilling formal, statutory obligations (Rudolf et al. 2002; Aluchna 2007). Additionally, there are still some pathological examples – in privatized or partly privatized companies – where the supervisory boards' composition is subject to political influence of the ruling party. The instrumental role and ineffective work of the board is heavily rooted in the characteristics of the shareholder structure of Polish companies. Ownership concentration results in the majority shareholders controlling not only the shareholder meetings but also having dominant influence over the supervisory board followed by the composition of the top management team (Rudolf et al. 2002; Domańska 2008).

3.3 Stock Market Development

The Warsaw Stock Exchange (WSE) which developed successfully due to a relatively strict legal framework and institutional order is the market for over 380 companies exceeding €105 bn in capitalization that accounts for ca. 45 % of GDP. The development of the WSE is presented in Table 3.2.

The Polish stock market experienced significant growth after the country's accession to the EU – the IPO number (as presented in Table 3.2) places the WSE at the top of European markets (2005–2010). Additionally, the New Connect Market ('novo mercado') developed successfully listing 139 listed companies. However, the relatively low capitalization of the market (as well as of IPOs

Table 3.2 The Warsaw Stock exchange spanning the years 1991–2010

Year	Domestic company equity (PLN million)	Number of companies	Stock turnover (PLN million)	Securities turnover (PLN million)	Contract turnover volume	WIG rate of return (%)
2010	450,180	383	224,594	1,185	7,812,604	−1.48
2009	421,178	379	351,885	2,951	13,424,593	46.85
2008	267,359	374	331,316	4,999	12,233,935	−51.07
2007	509,887	351	479,480	3,495	9,477,868	10.39
2006	437,719	284	334,539	5,536	6,386,046	41.60
2005	308,418	255	191,096	5,507	5,378,517	33.66
2004	214,313	230	118,518	8,353	3,609,125	27.94
2003	140,002	203	79,774	12,674	4,231,949	44.92
2002	110,565	216	63,662	4,131	3,175,890	3.19
2001	103,370	230	80,443	5,133	3,754,854	−21.99
2000	130,085	225	169,096	4,590	1,516,042	−1.30
1999	123,411	221	88,974	4,766	207,372	41.30
1998	72,442	198	62,338	8,581	24,320	−12.80
1997	43,766	143	52,342	13,488	–	2.30
1996	24,000	83	29,895	16,219	–	89.10
1995	11,271	65	13,671	19,276	–	1.50
1994	7,450	44	23,420	3,300	–	−39.90
1993	5,845	22	7,873	557	–	1,095.30
1992	351	16	228	21	–	13.20
1991	161	9	30	–	–	−8.09

Source: Compilation based on http://www.gpw.pl/gpw.asp?cel=informacje_gieldowe&k=1&i=/statystyki/opis_statystyka&sky=1

estimated for 2010 at ca. 3 % of the total European ones) and substantial ownership concentration reduces the number of shares in public circulation and results in its limited control function small. Table 3.3 presents the dynamics of IPOs at the Warsaw Stock Exchange between 2005 and 2010.

Poland implemented strict regulatory mechanisms for investor protection from management or large blockholders and also put considerable effort into enforcement mechanisms (Pistor et al. 2000). The market is transparent, information requirements are comparable to Western European standards although according to some experts the regime is believed to be too strict and to have "suffocated the capital market development" (Pistor and Xu 2002). The most significant weaknesses refer to the low liquidity of the stock market and inadequate transparency mostly in terms of insufficient information on corporate strategy and outdated websites (Sroka 2006; Grzybkowski and Wójcik 2006). Thus, the monitoring role of the stock exchange is significantly weaker as compared to the developed countries (Pajuste 2004), however it plays a leading role in setting high standards for disclosure and supervision, investor activism and implementing new regulations.

Table 3.3 Number and value of IPOs on the Warsaw Stock Exchange (2005–2010)

Year	Number of IPOs	Value of IPOs (PLN bn)
2005	35	6,980
2006	38	4,158
2007	81	18,256
2008	33	9,326
2009	13	6,988
2010 (as of 30 July)	11	12,901

Source: Compilation based on Warsaw Stock Exchange data, http://www.gpw.pl/gpw.asp?cel=informacje_gieldowe&k=2&i=/zrodla/spolkigieldowe/debiuty/debiuty2010.html&sky=1

3.4 The Shortcomings of Polish Corporate Governance

Emerging markets and economies in transition reveal a specific characteristic that impacts the effectiveness of corporate governance. As noted by Berglöf and Claessens (2006) the crucial control role is played by large shareholders, whereas the monitoring function of external mechanisms (stock market, market for corporate control, reputation) is significantly weaker. The potential of monitoring from the board remains unexplored and hindered. The board is unlikely to be influential when the controlling owner can hire and fire board members. Additionally, the quality of law enforcement depends critically on the quality of the general enforcement environment. These identified shortcomings depicted in emerging markets are discussed below with reference to Polish corporate governance system.

3.4.1 Majority Shareholder Policy and Corporate Groups

Polish companies revealing the significant ownership concentration experience both advantages and disadvantages of such shareholder structure. As noted in the literature the concentrated ownership proves to be an important monitoring mechanism being the second best solution when market/external mechanisms are not working well (Morck and Steier 2005) as it may be the solution to agency problems and free rider problems that result from dispersed ownership and lead to higher profitability (Neun and Santerre 1986; Holderness and Sheehan 1988). However the significant ownership concentration may result in some corporate governance inefficiencies related to the abuse of minority shareholder rights. Dominant shareholders tend to board favoring (Fama and Jensen 1983), may expropriate minority shareholders through a tunneling or compensation policy (Stulz 1988), blocking dividend payout or limited access to information. Additionally, the ownership concentration is usually to the mentioned above phenomenon of building pyramids which consist of several layers of ownership relationships characterized by complicated structure and listed companies placed at the apex of the pyramid. The form of a pyramid allows for control over decision making process, value transfer within the group and M&A transactions questioned by minority investors.

The analysis on the ownership structure of Polish listed companies reveals some controversies on the majority shareholder practices (Aluchna 2007). The analysis shows strategic investors blocking minority shareholder from the access of their representative to be appointed to the supervisory board, value decreasing mergers and acquisitions or blocking dividend payout. Additionally, Polish listed companies reveal the separation of ownership and control. They tend to create corporate groups built in the form of a pyramid with the listed company at the apex controlled by the strategic investor. As the dominant position of large shareholders and the pyramidal groups' environment provide the potential sphere for abusing minority shareholders, the ROSC Report by the World Bank (2005a) recommended improvement of related party transaction monitoring.

3.4.2 Poor Board Supervision

As noted by Berglöf and Claessens (2006) the board role in emerging markets is significantly limited due to the strong decision making power by large shareholders. The analysis of the board of Polish listed companies identified the significant dependence of directors on the large shareholder, the foreign or domestic strategic investor, the family or the state. This feature may be perceived as positive phenomena of reducing agency costs and avoiding de facto the costs of the two-tier system in the family controlled companies. However, the lack of independent and professional directors reveals significant limitations for efficient governing mechanisms leaving management with huge discretion. Traditionally, the analysis of corporate governance practice indicate that majority of listed companies did not comply with three fundamental rules – the proportion of independent directors (76 % of listed companies), audit committees formed within the supervisory board (69 % of listed companies) and selection and rotation of the auditor (46 % of listed companies) (Campbell et al. 2006; Nogalski and Dadej 2006).

The third version code of best corporate governance practice known as "Best Practices of WSE Listed Companies" adopted in 2008 and amended in 2010 was perceived as the solution to the structural problems of Polish boards recommending the presence of at least two independent directors (in line with the EU Directive), creation of specialized committees, particularly audit committees, increasing corporate disclosure and strengthening the activity of shareholders. However, the research results on the code implementation remain far from optimistic and refer to the classical shortcomings of Polish corporate governance (Warsaw Stock Exchange Report 2009; Kuchenbeker 2008; Krukowska 2007):

- Seventy percent of current reports on non-compliance show that companies do not follow the transparency recommendations and do not publish information on corporate websites. Companies claim that information is either provided in the annual report, or may be used by competitors, will not be delivered (e.g. incentive schemes, shareholders' questions) or is impossible to obtain (e.g. independence status);

- Twenty-four percent of current reports on non-compliance reveal that the management board does not consult a "contract of significant importance" with the supervisory board due to the lack of precise definition on such contracts;
- in 18 % of current reports on non-compliance companies do not intend to provide at all (now and in future) additional comments to the GSM resolutions;
- Forty-five percent of current reports on non-compliance state that the supervisory board provides neither its evaluation nor internal control report for the GSM;
- Fifty-three percent of current reports on non-compliance refer to the lack of two independent directors on the board, whereas in 30 % of companies they are not able to provide information on the independence status of the directors. What is worse, companies do not understand the need for independent directors claiming that "shareholders have the right to control the board"
- according to 80 % of the current reports on non-compliance, companies do not intend to form an audit committee;
- companies do not understand the idea of internal control and risk management as well as the supervisory board reporting;
- companies tend to copy the content and layout of current reports from other companies.

Moreover, the content of the new code was highly debated as the recommendations stressed the importance of transparency and development of investor relations leaving the problems of ineffective boards to large shareholders. Interestingly, despite the optimistic view expressed by the Warsaw Stock Exchange (Sobolewski 2007) researchers emphasize the significant shortcomings of the new code considering it as lowering corporate governance standards in Poland and perceiving it as a "move backwards" compared to what has been achieved so far. It is important to emphasize that in the four main aspects of proportion of independent directors, recommended committees formed within the supervisory board, auditor rotation and disclosure of directors (executives and supervisory board members) compensation "Best Practices of WSE Listed Companies" lowered the standards as compared to the 2005 code. For instance replacing the 2005 version (Warsaw Stock Exchange 2005) recommendation of "At least half of the members of the supervisory board should be independent" the new code suggested "at least two members of the supervisory board should be independent". The recommendation lowered the standards of the suggested committees – from audit and remuneration to an audit committee only. The auditor rotation recommendation was eased from "once every five years" (2005) to "at least once every seven years". The 2008 code did not suggest any requirement for the disclosure of directors' remuneration although the earlier version required companies to disclose the total amount of all directors' (management and supervisory boards) remuneration, the remuneration of individual directors and breakdown of its various elements, information on the procedures and rules applied to determine the remuneration. Moreover, out of 48 guidelines the new code formed only 24 principles subject to the ‘comply or explain’ rule. The new code does not provide for a clear independence definition which will not enhance Polish companies compliance with this principle (Campbell and Jerzemowska 2008). It was previously signaled that the potential of the best practice code referring to the creation of an effective business environment and good corporate governance might not be realized since the content of the new code does not correspond with the suggested directions for policy intervention.

3.4.3 *Insufficient Investor Protection*

Poland, experiencing transition economy heritage and emerging market characteristics, faces insufficient investor protection. As researchers stress, reformers in Poland as in other transition economies appeared not to have any particular corporate governance model in mind while reforming the law on the books. Regulations were to strengthen in all directions and international comparative analysis of corporate governance structure shows that according to the law on the books, transition economies have, worldwide, the highest creditor indices and the second highest shareholder rights indices, ranked after common law countries (Pistor et al. 2000). Therefore, despite successful and complex reforms the transition efforts lacked coordination and a coherent approach to governance structure development that may now result in some dysfunctions (Dzierżanowski and Tamowicz 2002). Although the law on the books offers standards of investor protection comparable with Western European countries, the legal enforcement is lagging behind (World Bank 2005a, b; Grzybkowski and Wójcik 2006; Anderson et al. 2005). The inefficient court system limits the investor/shareholder rights to submit a case to the court. As noted in the World Bank report (2005b) the systems in CEEC should improve their efficiency by: (1) introducing disciplinary procedures for judges, (2) increasing transparency via the publication of decisions (3) providing a random assignment of cases and (4) introducing citizen feedback.

3.5 The Polish Model

Using the comparative analysis of national corporate governance systems the Polish control structure shows some systemic similarities to the so called Latin model. Table 3.4 presents the Polish corporate governance system with the reference of comparative analysis.

As shown in Table 3.4 the control structure characteristics for Polish companies relies on a two tier system dominated by a shareholder representatives supervisory board and the top management team, significant ownership concentration and the emergence of the stock market and enhanced disclosure of corporate information.

Table 3.4 Corporate governance systems

		Relation-based system	Poland	
Control mechanism	Market based system (US)	Universal banks (Germany)	Main banks (Japan)	
Internal control/board of directors	Primary outside members with strong CEO influence	Two tier board: management and supervision	Primary insiders	Two tier board: management and supervision Primary insiders
Equity ownership	Widely held	Concentrated in family, corporations and banks; separation of cash flow and control rights	More diffuse, incorporate and bank ownership	Concentrated by corporations and by individuals, to a lesser extent by financial institutions
Share voting	Share concentration through investment funds and strong proxy system	Banks vote as custodians as well as owners on their own	Voting and ownership shares	Concentrated by owners
Equity market	Liquid and efficient	Illiquid	Minor influence	Illiquid, minor influence but growing
Debt vs. equity	High levels of equity	High levels of debt	High levels of trade debt	
Financial system	Arm's length system	Control oriented system	Control oriented system	
Corporate control	Vigorous, External group pursue takeovers	Little activity, Dominating shareholders and bank arrangements	Little activity, dominating shareholders arrangements	
Role of financial institutions	Strong rules constrain financial institution involvement	Active participation by financial institutions	Participation by financial institutions limited because costly	
Dominant agency conflict	Shareholder vs. management	Controlling vs. minority shareholder	Controlling vs. minority shareholder	
Investor orientation	Portfolio oriented	Control oriented	Control oriented	

Source: Compilation based on Halpern (2000, p. 8), Berglöf (2000, p. 249), Hoskisson et al. (2000, p. 133) and Lis and Sterniczuk (2003, p. 31)

These characteristics are inherited from the case-by-case privatization method and the surge of newly founded companies that expanded and underwent IPO. Referring to the corporate governance system typology the Polish model is based on hierarchies (not on markets), is control (not competition) oriented (according to the characteristics presented in Berglöf 2000) and is the insider system in terms of ownership concentration and the tendency to create pyramidal groups. Weaker institutional order and weaker market mechanisms (Tamowicz and Dzierzanowski 2003; Aluchna 2007) limit the disciplinary role of the stock market, the market for corporate control and the market for executives as well as lowering the incentive role of the executive compensation (low pay to performance relation) (according to the characteristics presented in Allen and Gale 2000). Reforming the banking system could not fill the gap of the source of external financing – thus the Polish model remains very different from the traditionally bank based systems of Germany and Japan (according to the characteristics presented in Halpern 2000). As noted by Hall and Soskice (2001) any control structure shall provide capacity for efficient monitoring, efficient information flow and efficient sanctioning which may be realized by markets and hierarchies. In the Polish, the control functions are fulfilled predominantly by the majority shareholders and their representatives on the board yet leading to the dominant agency problem of large vs. minority shareholders conflicts.

3.6 Lessons from the Crisis

The structural shortcomings of the Polish corporate governance system although identified as discussed above, appeared not to constitute major criteria for investment decision. The 2005–2007 period of economic development, increase of IPOs and stock market capitalization growth did not encourage regulators to set up higher standards of board supervision or higher liquidity ratio of listed companies. Investors satisfied with the share price increase and good ROI did not pressure for changes either. However, the mentioned shortcomings proved to cause essential structural problems during the economic slowdown resulting from the global financial crisis.

3.6.1 Currency Option

The dependence of Polish companies on export revenues and the fluctuation of the PLN/euro currency rate have had a huge impact on their financial results. Facing the adoption of the euro by Poland in the long term perspective, Polish companies used a derivative called currency options being a contract between two players to buy/sell a certain amount of currency as a tool to manage risk related to the currency rate fluctuations. As the Polish zloty (PLN) experienced significant appreciation after the EU accession, the appreciation proved to be problematic for exporters as it lowered their revenues and made Polish exports less competitive, companies could, however import raw materials at a relatively lower cost. As the currency options were adopted by the majority of Polish listed exporters, some management boards searched for additional income gained on currency speculation. Therefore instead of buying a regular put option, managers engaged in “the costless contract” in order to eliminate the option fee. Thus the currency option deal offered by a bank and accepted by a listed company allowed (similar to the second case presented in the footnote) to secure its revenue (e.g. of € 1 m) and a lower risk for currency appreciation. To eliminate the option fee (e.g. of 10.000 PLN) the bank sold the option to buy e.g. 1 m PLN at the PLN/€ = 3.5 rate, whereas the company sold the option to buy e.g. 3 m at the PLN/€ = 3.5 rate. Such a currency option version meant that the risk was greater for companies than for banks! Such a derivative became de facto a speculation – listed companies were speculating on Polish zloty appreciation, using additional funds (e.g. future profits) to secure the transaction and selling the option to buy three times more than the bank offered. As long as the PLN/€ rate was below 3.5, companies were able to gain additional profits on derivatives. However, the PLN/€ rate rose to 4.64 in 2008 leaving listed companies with huge obligations towards the banks.

The companies (and boards) involvement in risky operations and de facto currency speculation appeared to be a major problem not only from the perspective of the financial results of these companies but also for the entire banking system in Poland. The obligations derived from the currency option became toxic assets for banks and a huge burden for companies. The total costs for companies were estimated at 15 bn PLN (at the rate PLN/€ = 4.64) and led to the financial problems (e.g. Jastrzębska Spółka Węglowa, PKM Duda, Police, Puławy Erbud, PPWK, Odlewnie Polskie, Mostostal Chojnice) and bankruptcy of several listed companies. To name only a few Krośnieńskie Huty Szła, one of the first five companies listed on WSE, was declared bankrupt as its share price dropped by 60 %, Zakłady Magnezytowe Ropczyce estimated its obligations towards the banks at 19.5 m PLN due in 3 days, Lewo (Ropczyce subsidiary) calculated its currency operational loss at 150 mPLN, Lotos (the second largest petroleum company) estimated its losses at 95.3 m PLN and the total cost for 277 m PLN, Ciech (chemical conglomerate) restituted its loss on currency options for 100 m PLN lowering profit, Duda (meat processing company) calculated the loss at 27 m PLN.

According to companies, the boards engaged in currency option referring to the government forecast currency rate that predicted the PLN/€ rate to be 3.35, whereas experts forecasted 3.10. The PLN/€ rate reached 4.65 in 2008. The accusation towards banks which offered such contracts on purpose began a political battle on bank speculation on the Polish zloty and requirements for government intervention. The majority of companies made the settlements with their banks (Karnaszewski 2009) – for instance according to the settlement between the above mentioned Zakłady Magnezytowe Ropczyce and the bank the company has to pay back 12 m zloty in 5 years.

The problem of the currency option, the extraordinary companies' exposure to risk and severe financial losses incurred with the speculation on the PLN/€ rate could be however seen as an example of board failure. The board, lacking audit committees, professional and independent directors as well as effective risk management procedures proved to be dysfunctional and did not react to the risk and the speculation on derivates by executives. The lack of derivative experts on the board deprived them of the professional assessment of risk and the ability to identify the source of potential financial losses. None of the supervisory boards blocked the risky transactions showing the failure of risk management.

3.6.2 Majority Shareholders Practices

The economic slowdown and the downward trend on the stock market observed in 2007 and 2008 as the results of the global financial crisis lowered the value and the creditworthiness of many listed companies. The lower market cap and the hindrance of access to capital encouraged large shareholders to use their dominant position in the ownership structure to secure funds for further expansion and strategic plans. The case study analysis (Aluchna 2010) shows how the majority shareholders acting within corporate groups took advantage of their dominant positions abusing the minority shareholders rights. The majority shareholders used to conduct wealth transfer transactions within the business groups that allowed for optimal capital management and the realization of private benefits. These transactions covered mostly merger, acquisitions or takeovers and were conducted by the listed company at the apex of the pyramid and at the cost of minority shareholders.

A good illustration of these practice is provided by the case of the business group controlled by Michał Sołowow, one of the richest Poles, including four well known public listed companies of the market cap estimated at ca. 3.5 bn PLN:

- Barlinek SA operating in housing equipment materials and producing predominantly wooden floors – in this company Mr. Sołowow controls with his subsidiary Barcocapital Investment Ltd. the stake of 68.8 % of shares,
- Cersanit SA operating in ceramic sector – in this company Mr. Sołowow as an individual shareholder and via Synthos SA controls the stake of 48.6 % of shares,
- Echo Investment SA a construction company specializing both in residential and commercial housing – in this company Mr. Sołowow controls with his subsidiary Beva-Hold Sp. z o.o. the stake of 40.45 % of shares,
- Synthos SA operating in the rubber sector – in this company Mr. Sołowow controls with subsidiaries such as Magellan Pro-Equity Fund I SA the stake of 56.91 % of shares.

Facing the need for leverage required for further development Mr. Sołowow decided to buy shares of Cersanit (7.8 % of shares) and Echo (4.3 % of shares) via Synthos for a total of 220 m PLN to increase the creditworthiness of the two companies. The transaction used Synthos net profits of 490 mln PLN generated in 2007 and 2008 as well as additional corporate funds, still leaving 555 m PLN in cash, to increase stock capital of Echo and Cersanit (400 m PLN in debt with EBITDA of 90 m PLN) with the idea to increase funds for growth and as a collateral. This transaction allows rolling the Cersanit debt up to 824 mln PLN by

2015, paying back 1.6 mPLN in 2009 and obtaining additional leverage from EBRD for projects in Romania and the Ukraine.

Other examples come from one the largest media companies, TVN SA, and one of the largest financial conglomerates, Getin Noble Bank. Both companies are controlled by the founders and are located in the business group.

3.6.3 Liquidity Problems

The economic slowdown impaired the financial position of many listed companies due to problems and sale drops of their subcontractors which affected the collection of dues and as a result hampered their financial stability. The rapid increase of risk rates restricted the access to finance offered by banks which affected the liquidity significantly. According to the report of Euler Hermes (2009) from 2008 to 2009 the 'pay back morality" rate dropped by 14 percentage points to reach the level of 50 points (out of 100) while the pay back delay increased from an average 18 to 30 days. The rate of uncollected debt rose from 2.2 % at the end of 2007 to 9 % in March 2008. As noted in the report of Coface Poland (2010) the number of bankruptcies increased by 50 % in 2009 reaching the level of 691 companies and according to the forecast is estimated to reach 1,000 companies in 2010 (Sofuł 2010). The subcontractors' problems and the restricted access to capital deteriorated the liquidity of several listed companies. These challenges show the failure on financial policy which currently leads to the rising importance of factoring activities.

3.7 Discussion

The presented case studies analyzed three selected phenomena identified as the corporate governance failure of Polish listed companies in times of the economic slowdown resulting from the global financial crisis. Although these failures refer to three different areas of corporate functioning, they all appear to have a common ground of insufficient board performance and are rooted in the discussed structural shortcomings above of the Polish model. The most crucial problems of the Polish control structure identified both in academic discourse (Tamowicz and Dzierzanowski 2003; Campbell et al. 2006; Aluchna 2007) as well as international analyses (World Bank 2005a, b) refer to the lack of independent and professional board members, the insufficient investor protection and the full control exerted by large shareholders. As discussed, problems are not caused by one, sole determinant, rather the interdependence of these shortcomings resulted in the risk management failure of the currency option, controversial related party transactions undertaken by majority shareholders and liquidity problems. Although these failures are heavily rooted in the structural characteristics of concentrated ownership and

Table 3.5 Potential solutions to identified corporate governance failures

Failure	Potential solution
Risk management and currency option	Systemic solution
Weak, instrumental board	Independent directors on board, derivative experts
Lack of professional/independent directors	Audit committee
	Risk management procedures
Majority shareholders within business groups	Systemic solution
Dominance of majority shareholders in decision making process	Related party transaction committee
	Stronger legal enforcement
	Improvement of judicial system
Financial policy and liquidity problems	Systemic solution
	Increase board responsibility
	Risk management procedures

weak legal enforcement, it is the board that bears the responsibility for the inability to identify and to react to these problems.

The analysis of the failures confronted with the shortcomings of the system deliver the potential solutions recommending some systemic changes as presented in Table 3.5.

The case of financial losses incurred by the currency option misusage, point out the need for reforming the board. The most crucial element is the increase in quality of board members by introducing independent and professional directors and to adopt risk management procedures. The recent report by Grand Thornton Frąckowiak (2009) on risk management procedures in listed companies revealed significant differences in adopted standards. Whereas in 30 % of 286 sample companies the TMT is responsible for the risk management policy, the supervisory board fulfils the function only in 17 % of analyzed companies. In the majority sample companies the risk management refers to financial statements lacking a broader and more holistic approach. However, only 6 % of the sample does not have any risk management system whatsoever. The requirement (not a recommendation) for each board to form an audit committee appears to be crucial for strengthening the monitoring functions. Although such amendments of the Accounting Law (2009) stipulate the obligatory formation of the audit committee for listed companies the enforcement of this requirement remains an open question.

The insufficient minority shareholder protection and the controversial related party transactions conducted by majority shareholder appear to be a very problematic issue of Polish corporate governance. Despite a program on increasing companies' free float and stock market liquidity adopted by the Warsaw Stock Exchange, no major changes should be expected due to the large shareholder strategy of maintaining control over companies. One possible solution is to form a related party transaction committee responsible for monitoring transactions within the corporate group. However, the experience showing that listed companies which engaged in the controversial transaction did have such committees within the board raises the question of legal enforcement. The lack of reforms of the judicial system may issues which question the efficiency of the suggested solutions.

3.8 Conclusion

The analysis presents the three identified failures of Polish listed companies as a result of the global financial crisis. The relative underdevelopment for the Polish stock market and absence of the advanced financial instruments (CDOs, CDSs) lowered the scope of the financial crisis affecting the economy by slowdown, yet not a severe recession.

The case study analysis sheds light on the structural shortcomings of the corporate governance system which corresponds to the ‘classic’ transition and emerging market characteristics. The control structure of Polish listed companies heavily depends on their origin – companies privatized during the transition reforms within the framework of case by case methods reveal significant ownership concentration and the control exerted by mostly foreign or domestic strategic investors. Listed companies founded after 1990 which experienced rapid economic growth are usually controlled by the individual investor, predominantly founder or founder family. The path dependency effect identified in the significant ownership concentration confronted with the weak investor protection impacts the structure of corporate control and provides potential for the abuse of minority shareholders. The majority owners having full influence over the composition of the supervisory board control the decision making process, dividend policy, structure executing compensation and pursue related party transactions to realize private benefits. The supervisory board constituted of gray, affiliated members with a low presence of independent and professional directors proves to be inefficient in its work of protecting shareholders rights, providing objective assessment of the management team and relating pay to performance. Although the stock market reveals rapid growth and the largest listed companies show improvement in governance standards, the overall quality of the corporate control requires improvement as noted in the World Bank and ERBD reports as well as in the empirical research and academic discussions. Some development of corporate governance and improvement of standards is observed in line with the EU harmonization law process and adoption of the EU Directives, the structural problems linked to the concentration of ownership, an inefficient board, lack of specialized committees within the board (audit, remuneration) and weak investor protection are not in place however. Non adopted recommendations suggested by international organizations and academics proved to not constitute a major problems during the rapid economic growth observed recently (2005–2007) and the boom on the stock exchange due to the increase of pension funds assets (pension funds are allowed by law to invest in the Polish market only). The structural shortcomings rebounded however during the times of economic slowdown (2007–2009) resulting from the global financial crisis.

The three discussed failures of the financial losses increased by listed companies from speculation on the currency option, controversial related party transaction conducted within corporate groups controlled by large shareholders and liquidity problems clearly show the identified problems of weak board supervision, problematic concentration of ownership under the condition of inefficient judicial system and weak investor protection. Despite the earlier stage of corporate governance development on the Polish corporate governance, the recommendation of further reforms corresponds with those formulated for developed economies. The challenges refer to the need for strengthening the board that should include professional, independent members and directors having knowledge in derivates (Kirkpatrick 2009). Specifically for Polish boards the requirement to form audit and related party transaction committees remains the key element of the recommendations. Boards should adopt procedures addressing the company management system, mostly referring to operational activity as well as financing policy and improve internal auditing and risk management systems (Isaksson 2009). The crucial element of the agenda of forthcoming reforms should also list the improvement of legal enforcement and quality improvement of the judicial system.

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Chapter 4
Corporate Governance in the Banking Sector of the Republic of Macedonia

Evica Delova-Jolevska

Abstract The aim of this chapter is to provide a comprehensive analysis of the corporate governance in the banks in Macedonia and some recommendation for strengthening corporate practices of banks.

The banks in Macedonia have crucial importance in financial intermediation in the economy. Given the prevailing role of banking institutions as a source of finance in Macedonia, the good corporate governance of banks is of the utmost importance. By the implementation of good corporate practices the banks become more efficient, transparent, safe and attractive to investors.

Macedonian banking law defines the framework for corporate governance in banks. However, the largest significance for the establishment of good corporate practices is the adoption of special by-laws for the basic principles of the corporate governance in a bank. There are eight principles, which will be analyzed in this chapter. The principles more clearly define standards for good corporate governance and seek to strengthen the control role of the management, adequate risk management and effective internal control systems and enhance role of internal audit. Improvement of corporate governance will contribute to the creation of a better, stronger and more sustainable banking system in the country. Strengthened corporate governance in banks remains an important objective for the development of the financial sector and the real economy.

4.1 Introduction

The banks have essential importance for each national economy as extremely important generators of economic growth. Only reliable and stable banking institutions that enjoy the confidence of economic agents can be efficient intermediaries

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_4, © Springer-Verlag Berlin Heidelberg 2014

of the resources of the national economy towards intensification of economic growth. The essential issue of achieving and maintaining confidence in banking institutions is the functioning and implementation of sound corporate governance practices in the banking sector.

The large number of stakeholders whose economic well-being depends on the safety and efficiency of the banking system are interested in implementation of appropriate regulatory standards and good corporate governance guidelines. Van Greuning and Branjovic Bratanovic (2003) noted that there are several groups of stakeholders: (a) systemic stakeholders: legal and regulatory authorities, bank supervisors; (b) institutional stakeholders: shareholders, board of directors, executive management, audit committee/internal audit, external auditors; and (c) consumer stakeholders: outside stakeholders/public.

Corporate governance in banks differs from the corporate governance of other companies. Cigna (2009) noted that this is due to the nature of the banking business, the need for protection of the depositors and the systemic risks that a bank failure might cause. The banks represent the life blood of financial assets in any economy. As a result, the banks are subject to stricter regulation in comparison with other entities, since they are responsible for protecting the rights of the depositors, ensuring the stability of the payment system and reducing systemic risk (Turlea et al. 2010).

Corporate governance is a historically grown set of lessons learned from experience (Winzeler 2010). As Palmer and Hoong (2010) observed weak and ineffective corporate governance in systemically important financial institutions has been an important contributing factor to the global financial crisis that began in 2007. Good governance is essential for long term survival and success (Charkham 2003). Many banks have successfully solved the challenge and improved their governance, mostly on their own or with guidance by their regulator.

Gopinath (2005) found that although globalization of financial markets necessitates some basic international standards of corporate governance for financial institutions, it is also recognized that such uniform international standards may result in different levels of systemic risk for different jurisdictions because of differences in business customs and practices and institutional and legal structures of national markets. Each country will therefore need domestic regulations that prescribe specific rules and procedures for the governance of financial institutions that address national differences in the political, economic and legal systems while adopting international standards and principles (Gopinath 2005). It is normal, since every country has its own history, culture, tradition, legal framework with high influence to the corporate governance practice. This chapter reviews the corporate governance framework and practise in the banks in Macedonia. The objective of the chapter is twofold, to analyse the content of the corporate governance principles and to provide a overview of their implementation in the Macedonian banks, identifying areas for further research and reforms.

4.2 The Characteristics of the Banking System in the Republic of Macedonia

The banking system in the Republic of Macedonia is the dominant segment in the financial system, covering about 90 % of its total assets. Thus, the banking system is distinguished as the most significant segment for the stability of the entire financial system. On 31.12.2011 it was comprised of 17 banks and 8 saving houses. The total sector assets is around EUR five billion.

In the 90s of last century started the process of privatization and transformation from centrally planned economy towards a market driven economy. In the first phase, the privatization was carried out with model received by employees who became owners of the banks. This model resulted in highly dispersed ownership structure of the banks with reflection of inadequate bank governance. In the post-privatization phase began the process of concentration of ownership. Significant transformation resulted from the privatization and acquisition of Macedonian banks by international banks, mainly by EU countries, which have entered as strategic investors and created a favorable environment for the development of corporate governance in the banking sector. In a relatively short period of time, a considerable progress in creating a legal framework to allow banks to reorganize, consolidate and increase their competitiveness in domestic and foreign markets has been achieved.

On 31.12.2011, 97.7 % of the banking assets are owned by the private sector.

Financial institutions with a share of 63.3 % in the total equity are the dominant owners of banks. The share of foreign capital in total banks' capital is equal to 73 %. Fourteen of the total numbers of banks have foreign shareholders as dominant owners and they have above 85 % share in all balance sheet positions of the Macedonian banking system. Thus, the market share of foreign banks' subsidiaries in the total assets of the banking system has been continuously maintained at around 60 %. This composition of the banking sector has been stable since 2008. The analysis of the structure of the banking system points out that the dominant shareholders with 70.8 % are the European Union Member States.

The concentration measured with the Herfindahl index indicates that the banking system is highly concentrated in all the banking activities. The three largest banks hold 2/3 of total assets, loans and deposits of the banking system. 11 out of 17 banks have asset share of up to 3 % each (or in total 15.6 %) and only in three banks the individual share in the total assets of the banking system is greater than 19 %.

The banking sector has crucial role in the financial system through channeling the financial resources to the deficient economic agents. Despite the positive movements, the financial intermediation in the Republic of Macedonia is still on the lowest level (Assets/GDP = 72 %; Loans/GDP = 44 %) relative to some countries from the European Union and the Eurozone average.

The structure of the banks' assets and liabilities indicates that the Macedonian banks business model is a traditional one. The dominant banking activities are collecting deposits and granting loans. On the liabilities side, the deposits of non-financial entities with 70 % are dominant source of financing. The assets side is dominated by loans on non-financial entities whose share in the total assets is 55 %. The banks are not involved in complex financial activities and their dependence on foreign sources of finance is minor. All Macedonian banks are universal type of banks.

The National bank of the Republic of Macedonia is a sole regulator of the banking system, responsible for safe and sound banking system. It has proactive role for development of sound principles of corporate governance for banks.

The present characteristics of the activities of the banks in Macedonia, the structure of the banking system, changes in corporate ownership as well as the prudent regulation demand fair and sound rules for bank activities.

4.3 The Legal and Institutional Framework of the Corporate Governance

The corporate governance system in Macedonia corresponds to the principles that the OECD recommends to participants and regulators of financial markets and the enhanced corporate governance rules for banks presented by Basel Committee on Bank Supervision. Macedonia's legislation, regulation and practice are benchmarked to these principles.

The banking law adopted in 2007 defines the basic tenets of the model of corporate governance of banks in the Republic of Macedonia. It indicates a step towards a modern corporate governance infrastructure in the banks. The banking law clearly determines that banks are governed under a two-tier system of governance, reinforces the need to establish a system of risk management by each bank in clearly divided responsibilities of bodies that are responsible for identifying, assessing, measuring and controlling the risk profile of the banks, increases the significance of the overall internal control systems of the bank, including internal and external audit and establishes a new function that the bank is responsible for compliance with the bank regulations.

According to the regulation, the corporate governance in a bank denotes a sum of mutual relations between the Board of Directors, other persons with special rights and responsibilities performing management function in the bank, Supervisory Board, the bank's shareholders and other stakeholders. So, the corporate governance in a bank denotes: Clear organizational structure of the bank with the rights and responsibilities of the members of the supervisory and management bodies and other bank employees being precisely defined; Efficient procedures for identification, measurement, monitoring and control of the risk the bank is exposed to; Efficient internal control mechanisms, which, inter alia, include detailed administrative and accounting procedures of the bank; Transparency in the bank operations relative to all stakeholders; Surveillance and control systems established at least at the following levels: (a) surveillance by the Supervisory Board and control and monitoring of operations by the Board of Directors; (b) internal control systems; (c) integrated risk management system; (d) establishing function for control of the compliance with the regulations, and (e) independent internal audit (National Bank of the Republic of Macedonia 2007b).

The corporate governance has multiple dimensions and aspects: Functional dimension that is expressed in mutual relations established between the authorities of control (management), shareholders, depositors, investors and other stakeholders; Legal and organizational dimension that is expressed in a clear organizational structure with clearly defined rights and responsibilities of the bank bodies, clear procedures for risk management, establishing systems of internal control and transparency in the bank. These two dimensions are directed to the third economic-target dimension that is expressed in the definition of successful financial goals and development strategies whose implementation will ensure successful operation which will satisfy managers, shareholders, depositors, creditors, employees and public authorities.

4.4 Principles of Corporate Governance in Banks in Macedonia

National bank of the Republic of Macedonia, as a regulator, has issued a set of eight principles for enhancing corporate governance practices of banks. The banks should follow the principles as a roadmap to promote practices of good corporate governance in banks. The purpose of applying the principles of corporate governance is to develop a culture of professional values and ethical behavior of all stakeholders. The principles are focused on the responsibility and accountability of the boards, transparency and internal control and audit.

4.4.1 The First Principle

The first principle defines that the members of the Supervisory Board have to be appropriately qualified, understanding their role in the corporate governance of the bank and capable of actual assessment of the bank operations.

The shareholders exercise their rights in the General Assembly of the bank, where they appoint the members of the Supervisory Board. The Supervisory Board has one of the most important roles in the corporate governance of a bank. The principal responsibilities of the Supervisory Board are to appoint and dismiss Board of Directors. It approves the bank's business policy and development plan, financial plan, risk management policy and internal system of control including the internal audit. Though the Board has many duties, the essential precept of corporate governance is that the board carries overall and ultimate responsibility for the bank's stability and performance. Thus, the clear and better understanding of the role and responsibilities of the Supervisory Board is probably one of the most serious challenges to improve bank governance.

The quality of Supervisory Board members is an important issue of bank supervisors. According the Banking law, the National bank issues approval for appointment of the members of the Supervisory Board. The Governor may conduct an interview with the proposed bank Supervisory board member, where the candidate's knowledge of the regulations in the area of banking and/or finance, the management and organizational skills and the appropriate experience is assessed. The Supervisory board members are considered to have an appropriate reputation if they are honest, competent, diligent and assures that their work will not endanger the bank's safety and soundness and that they will not disrupt the bank's reputation and trust.

The Supervisory Board consists of at least five and maximum of nine members. At least one fourth of members have to be independent members (National Bank of the Republic of Macedonia 2007a).

Independent member is defined as a person who is not employed or a person without special rights and responsibilities in the bank, is not a shareholder with qualified holding in the bank or does not represent a shareholder with qualified holding in the bank (Banking Law 2007a). The intention is to improve the capacity of the Board in direction to make objective and unbiased economic decisions. The independent persons, with their professionalism, background and critical view have to contribute to a constructive and effective dialogue. Also, that provision intends to protect the bank and stakeholders against the possible negative effects of conflict of interests. Their presence is expected to have an important reputational effect to the bank. But, in practice the value and effectiveness of independence is widely discussed. Generally, a qualified independent board member with financial experience and banking knowledge is very difficult and almost impossible to find.

The chairperson of the Supervisory Board has responsibilities is to set the board agenda and ensure that important decisions are subject to constructive discussion and fruitful examination. Yet, the Macedonian regulation doesn't need additional requirements for a chairperson and doesn't make difference among board members.

Self-assessment of how well the board works and the contribution from the aspect of the individual members and all of them together is delicate and difficult, but it needs to be done at least once a year. It's one of the characteristic of good corporate practice. The evaluation should address the weaknesses in the board performance and it shouldn't be done for the sake of doing it.

4.4.2 The Second Principle

The second principle defines that the bank's management and surveillance bodies have to determine and monitor the fulfillment of the strategic objectives and corporate values of the bank, informing all their employees thereof.

The Supervisory Board has to approve the bank's code of ethics, which represents a sum of professional standards and corporate values applied equally to the members of the Supervisory Board and all other bank employees. These professional standards and corporate values refer to avoiding cases of corruption and other non-ethical behavior and activities, avoiding conflict of interests, transactions with affiliated entities with the bank and keeping bank secret. The Supervisory Board has to establish policy and procedure enabling smooth communication and creating possibility for any bank employee to report on corruption cases and other illegal and non-ethical behavior and activities. In fact, Supervisory Board must play a leadership role in promoting ethical business culture, integrity standards and a system of moral values.

The Supervisory Board to better fulfill its obligation establishes Board Committees. The Board Committees help the board to successfully manage the complex and sensitive issues. The number and nature of committees depend on various factors, such as the bank's risk profile, its size and complexity of operations. The Auditing Committee is mandatory to be established by the Supervisory Board. It consists of at least five and maximum of nine members. The majority members have to be elected from among the members of the Supervisory Board and the other members have to be independent members. To ensure both, professionalism and independence, at least one of the members needs to be an auditor. All Audit Committee members need to have knowledge of accounting and auditing, the risk management policies of the bank and internal control systems. They discuss the financial statements of the bank, review and make assessment of the internal control systems. The Auditing Committee has to provide the shareholders annually with an assurance of the ongoing integrity of the bank's financial reporting, systems of internal control and risk management.

According the Corporate Governance Code of the Macedonian Stock Exchange, the listed companies and banks have to establish Nomination Committee and Remuneration Committee at the Supervisory Board level. Board committees have to be composed exclusively of board members, but the decision making is responsibility of the whole board. The creation and composition of Board committees should be carefully considered, because they don't have to be a substitute for proper oversight by the Board (EBRD 2011).

The legal obligation for establishing Risk Management Committee is considered as positive sign for the effective risk management process. In the hierarchical structure of the bank this committee is positioned directly below the bank's Supervisory Board and acts as his "extended hand". One of the members of the Board of Directors has to be a member of the Risk Management Committee. The significance of this committee and risk management process can be recognized with the provisions that the Risk Management Committee must meet at least once a week. This Committee permanently monitors and assesses the risk level of the bank and the bank's risk management systems, determines short and long term strategies for managing certain types of risk the bank is exposed to and informs at least once a month the Supervisory Board on the changes in the bank's risk position, as well as the undertaken measures and instruments for hedging risks and the effects.

Implementing the effective and reliable risk management is one of the most important challenges for effective corporate governance. Boards have to define the strategy and risk appetite of the bank and to respond in a timely manner, accurate, requiring efficient reporting systems.

An important risk management tool is stress testing. But, the technical side of risk management and stress testing is not corporate governance question. The corporate governance dimension is how such information is used in the bank including transmission to the board and how it is useful to make strategic decisions and to put control mechanisms in place to oversee the bank's risk appetite. The Supervisory Board has to pay more attention to the results of forward-looking stress scenarios towards reviewing the business strategy. The recommendation is to strengthen Supervisory Board oversight of risk issue and business strategy from a forward looking perspective, not just review current risk profile and financial results. The Boards need to be more educated to understand and properly determine the risk appetite, the bank's performance against it and indentifying emerging areas of risk.

4.4.3 The Third Principle

The third principle states that the supervisory and management bodies establish appropriately defined responsibilities and reporting lines among all bank employees.

The banks are governed under a two-tier system. It means that board structure is consisted of the Supervisory Board and Board of Directors. The Board of Directors consists of at least two and maximum of seven members. It manages the bank and is responsible for risk management and providing working conditions for the bank in compliance with the regulation. The members of the Board of Directors should be sufficiently qualified to be able to effectively and successfully fulfill their obligations. The dual structure imposes significant governance demands on the functional relationship between two tiers. The relationship among members is critical to the function of the bank and it must be professionally based on trust and respect. Having strong policies and procedures in place which precisely define their rights and responsibilities can improve cooperation between the two bodies. It is especially important to establish and build relations not just the hierarchical, but relations of continued and permanent cooperation between these authorities with reference to business policy and development goals and strategies of the bank.

The supervisory and management bodies are obliged, in conformity with the volume and the type of its activities to enable understandable, transparent and documented decision-making procedure and clear and consistent segregation of rights and responsibilities. The Boards have to define the bank's business objectives, strategies for undertaking and management of risks, the bank's risk profile and the policies for fulfillment of the business objectives. For further strengthening the role of Boards is required knowledge of the latest managerial techniques, risk management procedures, technological developments in banks and financial markets as a whole.

4.4.4 The Fourth Principle

The fourth principle indicates that the bank's Supervisory Board should be sure that the Board of Directors and other persons with special rights and responsibilities perform appropriate surveillance and monitoring of the bank's operating.

The line of responsibility is accomplished in the following mechanism: General Assembly of Shareholders – Supervisory Board – Board of Directors – middle management – direct executors, or top-down approach. Despite the line of responsibility, the line of control starting from down-up approach: executors -middle management – Board of Directors – Supervisory Board – and finally shareholders. Through this concept is expressed the control function of the Supervisory Board for the most critical issues of the bank's operations and function of the Board of Directors for the efficient and legal operation of the bank. The control and management function are intertwined among each other and complement the intention for successful implementation of the bank's strategic goals and values. Also, effective corporate governance includes an on-going two-way dialogue between management and employees, culture of shared responsibility and mutual respect.

4.4.5 The Principle Number Five

The principle number five defines that the Supervisory Board, the Board of Directors and other persons with special rights and responsibilities performing management functions in the bank, should efficiently use the work of the Internal Audit Department in the bank, as well as the operating of the audit company.

The Supervisory Board establishes the internal audit function on a permanent basis, through creating special organizational unit, as a pillar of the modern corporate governance structure. Hierarchically, it is located above the operational organizational parts, being immediately below the Supervisory Board and the Audit Committee. The Internal Audit provides objective and independent estimation of the adequacy and the efficiency of the internal control system, the accuracy of the accounting record and the financial statements, the compliance with the bank's internal policies and procedures, and the effective laws and regulations, as well as of the general efficiency in the bank's operating. The Internal Audit and risk management are related, but in the same time they are also very different.

Internal audit is crucial for an effective corporate governance process. The internal auditor reports to the management administratively and to the Supervisory Board functionally. The auditors have substantive independence from the management and have direct access to the Supervisory Board. The control function has to be properly positioned with sufficient authority, stature, staff, independent and effective.

The law explicitly provides an obligation for the external audit, with which the banks must comply. There is a strict provision that an external auditor cannot audit the bank's financial reports for more than three consecutive years. The internal and the external auditors have mutual interests, with regard to the existence of an efficient internal control system as a basis for an adequate financial reporting and establishment of an adequate accounting system, reducing the operating risks with the banks in order to provide quality and efficient bank management. The realization of these mutual interests directly depends on the quality and the efficiency of their mutual cooperation.

4.4.6 The Principle Number Six

The principle number six defines that The Supervisory Board and the Board of Directors should be certain that the remuneration policy and the appropriate procedures are in line with the corporate culture, the long-term objectives and the strategy, as well as with the control environment of the bank. The bank's Supervisory Board adopts a policy for remunerating the members of the Board of Directors and other bank employees. The policy contains rules and criteria for determining the variable amount of the compensation, the annual bonuses and the other non-monetary income. The following criteria should be taken into consideration: the volume of the competencies, the successfulness in performing the function, the implementation of the strategy and annual plan of activities, the economic conditions the bank acts under. In that way, the management is expected to be motivated to work in achieving the interests of shareholders. Remuneration of Boards and senior management remains a highly questionable issue in many developed countries. But, the reward of bonus payment for Macedonian banks is not a significant issue. Probably, it is because the banks are of small size and are not involved in complex banking products and derivatives operations.

4.4.7 The Seventh Principle

The seventh principle is about providing transparency of the corporate governance in the bank. It is in connection with the third Basle pillar – market discipline. The transparency is fundamental to the effective governance of any bank and is a key feature of best practice. The corporate guidelines require that banks should be adequately transparent to their shareholders, depositors, regulators and other relevant stakeholders and market participant. The law establishes detailed rules for disclosure of the important corporate governance data, such as financial results, organizational structure of the bank, the composition and the functioning of the Supervisory Board, the Board of Directors and other bank bodies, the bank's shareholders structure information, related party transactions, corporate governance code, etc. The disclosure has to be one of the priorities of the banks' boards. Banks have obligation to disclose data and information on their websites and to prepare a corporate governance report as an integral part of the annual report on the bank operations. The respect of the market discipline indirectly will address any weaknesses in corporate governance and will contribute for its improvement. Therefore, the principle of transparency has to be realized in its full sense and it needs more attention. The principle of transparency is necessary for accountability, relevant information and addressed directly to added value of the bank.

4.4.8 The Eighth Principle

The eighth principle considers that the bank's Supervisory Board and the Board of Directors shall know their operational structure, including also the cases when the bank operates in other countries, or through other structures reducing the transparency (i.e. "know your structure" principle). In that case, the Supervisory Board and the Board of Directors of the bank have to establish policies and procedures about managing activities and all possible risks, including also the legal and reputation risk arising from such activities.

The banks with implemented basic principles of corporate governance in practice have internal and external benefits. The internal benefits are: Improving the competitiveness of the bank; Better positioning in the domestic and foreign market; Creation of an ethical and motivated working environment; Provision of better, appropriate and efficient approach and allocation of human potentials and financial resources in the bank. The external benefits are: Increased value of the bank; Increased reputation; Easier access to do financial resources on the market; Attracting the domestic and foreign investors and increased public confidence to the bank. The real and objective application of the principles of good corporate governance by banks is a possibility to create conditions for successful operation and development.

4.5 Conclusion

The comprehensive review of the existing framework as well as of current practices shows that corporate governance of banks in the Republic of Macedonia is conceived and postulated under international standards, prudent domestic legislation and internal acts of corporate governance of banks. Although reflecting the specifics of the national banking system, the Macedonian banks could be considered to be aligned with the modern format of corporate governance, with contemporary trends and practice.

Implementation of the legislation is an important issue. The positive effects and results from the adopted principles and guidelines of corporate governance depend on the level of their implementation in practice by the holders of the separate functions of the bank. Generally, the banks comply with the legal requirements and respect the regulation and principles of good corporate governance with the final aim of making banks safer and more attractive to investors and depositor.

The development of the practices of corporate governance is a dynamic process. Continuing changes in financial markets inevitably lead to a revision of the existing principles and practices. Banks and regulatory institutions must constantly look to enhance the regulation and practices and to try to find better ways and means to address and fulfill their mission of maintaining stability and strengthening the public confidence in the banking system.

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Chapter 5
Corporate Governance in Italian Listed Companies

Giuseppe D'Onza, Giulio Greco, and Silvia Ferramosca

Abstract In the past few decades a growing number of research studies have investigated the effect that insider ownership has on other corporate governance variables like the risk of expropriation for the minor shareholders, the demand for outside directors, etc. An increasing number of studies have analyzed the relationship between insider ownership and corporate performance in Anglo-Saxon countries, Continental Europe and emerging economies.

Regarding Italy, previous studies on corporate governance have highlighted that a listed company featured by concentrated ownership is likely to have a high incidence of insider shareholders representation on the board. This context might enhance an agency conflicts between large controlling shareholders and other stakeholders like minority shareholders and other outside investors. In this case the presence of an adequate number of non executive and independent directors as well as a functioning board's committees appear to be fundamental to counterbalancing the power exercised by owner-managers (or by managers-owner) and reduce the risks of private benefits exploitation. The recent changes in Italian normative requirements goes in this direction and recommend the introduction of mechanisms like the presence of independent directors, the CEO duality, the audit and remuneration committee that are not in line with the traditional corporate governance systems of Italian company but might reinforce the level of protection for outside stakeholders.

Basing on the aforementioned considerations, the researchers intend to analyze if and how Italian listed companies have changed their governance model to incorporate the new corporate governance rules. A specific focus regards the interaction of insider owners and outsider directors that seem to be a critical factor for the effectiveness of the corporate governance system in Italian context where lots of listed companies are controlled by a family/individual.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_5, © Springer-Verlag Berlin Heidelberg 2014

The theoretical part of the research analyzes the institutional context in which Italian listed companies operate and how it has changed in the last decade and the main research streams that have investigated the interaction between the inside ownership and the outsider directors.

The empirical part of the research is based on the analysis of the data collected through an empirical survey of companies listed to Milan Stock Exchange. A total of 145 corporate governance reports (corresponding to about 60 % of the total non-financial listed companies) issued in the period 2006–2010 has been investigated.

Some features observed like ownership structure, insider ownership remained the same over the period analyzed while other variables like the percentage of outside shareholders (like hedge funds), the proportion of independent directors, the number of the audit committee meetings changed noticeable.

Overall, the results show that the increasing of monitoring mechanism (like a high proportion of independent directors) during the period observed could contribute to reduce the risk of insider opportunistic behaviour.

5.1 Introduction

In recent years, the academic community has been debating about the effectiveness of the monitoring role played by independent directors, especially in settings with concentrated ownership, where the agency conflict is between large controlling shareholders and minority shareholders (Gutierrez Urtiaga and Saez 2012). In this setting, featuring the majority of the countries in the world (Shleifer and Vishny 1997), there's a growing debate regarding whether the independent directors are the right pill to cure the problem of the minority expropriation. In such a context, large controlling shareholders can control the nomination process of directors, selecting independent directors under their influence in order to contain the intensity of board monitoring (Jensen 1993; Vafeas 1999; Shivdasani and Yermack 1999).

Dominant shareholders expressing board leadership (CEOs or executives) can also set the board's and the committees' agenda, influencing the decision control activity (Carcello et al. 2002; Laksmana 2008).

The situation depicted above is likely to make the monitoring action exercised by the independent directors trivial and inconsistent and to reduce the protection of the minority shareholders interests.

This paper focuses on Italian listed companies. Italy is featured by large controlling shareholders, often sitting in the board as CEOs or executives. Other hallmarks of the Italian context are the widespread perception of a lack of independence by outside directors and the weak legal protection for small investors (Di Pietra et al. 2008; Allegrini and Greco 2011). This type of context is subject to significant risks of wealth expropriation by dominant shareholders and that of scant minority investors' protection (Zingales 1994; Shleifer and Vishny 1997).

The Italian legislation allows minority shareholders to nominate a number of directors at the general shareholders meeting. If the minority shareholders propose a list of candidates, at least one, is to be mandatorily included in the board.

"Minority directors" are usually non-executives and have the requisites to be classified as independent.

In our research, we distinguish between independent directors nominated by the controlling shareholders and minority directors. We then investigate whether institutional investors' shareholding affects the presence of such types of directors. The research extends to whether the presence of minority directors affects the audit, remuneration and nomination committees presence and activity.

This article proceeds as follows: Sect. 5.2 provides a brief overview of the changes regarding Italian rules on corporate governance over the past 20 years. The analysis is focused on the requirements introduced to strengthen the protection of the minority shareholders and particularly on the percentage of the minority in the board. Section 5.3 discusses the literature and describes the hypotheses. Section 5.5 presents the empirical results. The conclusions are included in Sect. 5.6

5.2 The Institutional Background

This paragraph intends to provide a brief overview of Italian legal and institutional frameworks regarding the corporate governance system and how it has evolved over the past two decades. This analysis is mainly focused on the regulations introduced for reinforcing the protection of the minority shareholders and particularly on a new actor sitting on the board, "the minority director".

During the 1990s, many authors (Barca 1994; Bianchi and Enriques 2001) pointed out that Italian rule-makers needed to put the legal protection of the outside investors at the top of the reform's agenda. Zingales' analysis (1994), regarding the value of different types of stocks (voting vs. non-voting), showed that in Italian listed companies the market price of voting shares were approximately 90 % more than non-voting shares (*azioni di risparmio*), whilst in other countries this difference counted on average less than 20 %.

Zingales' conclusion was that this difference is mainly due to the weak legal protection for minor shareholders, who generally own non-voting shares against the risk of exploitation of the company's resources made by managers and controlling shareholders.

In a macro perspective, this lack of protection might reduce the ability of the listed company to raise outside funds and disincentive the investment of institutional investors. La Porta et al. (2000) believed that the low protection of outsider investors explains why the Italian stock market was so underdeveloped compared to other industrialized economies.

Other features affected the protection of outside investors in the Italian context. Traditionally the majority of Italian listed companies featured as a concentrated ownership structure[1] controlled by a family, a coalition and in some cases by the State. The pyramidal groups are widespread and the hostile takeovers quite rare. These factors together with cross-ownership and interlocking directorates determined a limited contestability of the company's control and consequently reduced the effectiveness of the threats that the minor shareholders may exercise on block-holders.

In the family company, the largest shareholder often sits in the board as Chairman and/or CEO increasing the risk that the controlling shareholder may extract private benefits from the company by using a variety of methods (Anderson and Reeb 2004; Atanason et al. 2011).

Taking into account all of these circumstances, in this setting the principal-agent problem is not between the shareholders and the managers (Fama and Jensen 1983), but between the minority shareholders and the block-holders (Melis 2000).

Since the mid 1990s, a set of rules has been introduced in Italy to protect outsider investors and support the growth of the national stock market.[2] Before analyzing how the legal protection of the minority has changed, it is worthwhile to point out some peculiarities regarding the governance system of Italian companies in order to help readers to understand which mechanisms might reduce the minority expropriation problem in the Italian setting.

Since January 2004, listed companies could choose to adopt one of the following systems[3]: dualistic horizontal, an Italian-specific system, dualistic vertical, inspired by the Rhenish system[4]; monistic, inspired by the Anglo-Saxon system.[5]

A research carried out on Italian listed companies pinpoints that the dualistic horizontal system is much more widespread than the other two models (Assonime 2011), see Table 5.1. This Italian specific system is dualistic, given the existence of the board of directors acting as the managing body and the board of statutory auditors (called Collegio Sindacale) which is charged with a control responsibility, and is defined as "horizontal" because both of these bodies are appointed at the shareholders' meeting.

Focusing on the minority shareholders protection, one can distinguish the mechanisms of safeguarding in two groups: direct and indirect.

The *direct mechanisms* are those that can be executed directly by the shareholders such as the convocation of the shareholders' meetings or the exercise of voting rights. To strengthen the rights of the minority in listed companies, the

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[1] A research carried out by Consob (1999) shows that largest shareholders own on average 60 % of the company shares. See for details Bianchi and Enriques (2001).

[2] The main legislative acts we refer to are the Draghi reform (1998), the reform of company law (2003), the so-called "Law of Saving" (2005) and the Legislative Decree n. 12/2010 for the enactment of the European Shareholder Rights Directive.

[3] Before the 1st January 2004, joint stock companies could only adopted the dualistic horizontal models so that today this model is called "traditional" model.

[4] The dualistic vertical model features by a supervisory board elected by the shareholders and a management board elected by the supervisory board.

[5] The monistic model is frequently named one-tier system due to the presence of a single body: the board of directors.

Table 5.1 Governance models used in Italian listed companies

	Frequency (%)
Dualistic horizontal model	96.1
Dualistic vertical model	2.6
Monistic model	1.3

Source: Assonime 2011 (The empirical investigation of Assonime considers only Italian companies which are listed exclusively to the MSE for a total of 252 firms. Foreign companies listed to MSE (45) have been excluded from the analysis)

national legislators have defined a specific regulation for these firms. In respect to the non listed company, the Draghi reform has reduced the thresholds: (1) to ask for the convocation of the shareholders' meeting, from 20 % to 10 % of the equity issued[6]; (2) to bring a liability action against the directors for serious irregularities, from 10 % to 5 %; (3) to exercise other rights such as requiring an investigation into the board of statutory auditors.

Moreover, the direct mechanisms also include measures introduced by the European Shareholder Rights Directive (2007/36/EC) adopted in Italy in 2010. A detailed analysis of the contents of the Directive doesn't fall into the scope of this work. Suffice to say that this Directive intends to reinforce the minority shareholders activism through the possibility to use electronic means for exercising voting rights, and a greater transparency of the voting procedures at the shareholders' meetings (including proxy voting), etc.

The *indirect mechanisms* involve the representation of the minority shareholders on the board of directors and on the board of statutory auditors (called "Collegio Sindacale"). Regarding this issue, comparative studies of corporate governance regulations in different countries, notes that Italy shows some interesting peculiarities (Hopt 2001). Particularly, for Italian listed companies the representation of the minority shareholders on the above-mentioned bodies is mandatory. The law imposes that at least one member of the board of directors and also of the board of statutory auditors is elected by the monitory of shareholders.[7]

The election of these members is based on a list of candidates proposed only by the minority shareholders and the election procedure is regulated by each company by-law according to the criteria defined by the Consob.

The law does not require that the minority directors should be non-executive or independent even though it's likely that these board's members are not involved in managing the organization.

It is worth highlighting that all these requirements define only the minimum thresholds to which firms must comply. To strengthen the protection of the minority shareholders, in their company, by-law each firm can voluntarily state to have a

[6] The law recognizes the possibility to listed companied to define a threshold lower than 5 % of common share could be introduced by the company-by-law.

[7] Furthermore regarding the board of statutory auditors the law imposes that the Chairman must be chosen among the members elected by the minority shareholders.

higher number of minority directors and/or require the participation of such a director to be a member of the board's committees (Bianchi et al. 2011).

The independent directors could also be seen as an indirect mechanism to protect the minority in the presence of a block-holder. Bebchuk and Hamdani (2009) assert that independent directors can protect the minority shareholders if they oriented their monitoring activities to the controlling shareholders rather than the CEO. However Gutierrez Urtiaga and Saez (2012) are quite skeptical about the possibility that independent directors elected by the controlling shareholders can reduce the risk of a minority expropriation because the possibility that they conform to the interests of whoever elected them is quite high.

Based on these circumstances, it is interesting to empirically analyze the composition of the board of the companies listed on the MSE (Milan Stock Exchange) in order to evaluate:

- To which extent independent directors appointed by controlling shareholders and minority directors sit on the company's board;
- Whether the ownership composition is associated with the presence and the number of the independent and minority directors;
- Whether the distinction between independent and minority directors influences the activism of the board's committees.

5.3 Literature Review and Research Hypotheses

In the agency theory perspective, the independent directors are often seen as an internal control mechanism, aimed at reducing the potential conflicts of interest between the management and shareholders. This view is reflected in many corporate governance codes and listing rules, which consider the independent directors as an important line of defense of shareholders against the power of managers, Academic literature, studying especially the Anglo-Saxon countries, extensively studied the contribution of the independent directors in the mitigation of agency conflicts. Empirical research found mixed evidence about possible benefits to shareholders related to a higher proportion of independent directors in the board, such as increased voluntary disclosure (Eng and Mak 2003; Cheng and Courtenay 2006; Lim et al. 2007), constrained earnings manipulation (Bradbury et al. 2006; Park and Shin 2004; Peasnell et al. 2005; Cornett et al. 2008), and reduced frequency of financial frauds (Carcello et al. 2002) The differences may depend on the context studied and on the effective role played by independent directors.

The effectiveness of the monitoring function exercised by independent directors depends upon many factors, for instance the "real degree" of independency, as well as the knowledge of the company's operations, the professional background, etc.

A relevant issue for independency regards the nomination process of directors and who appoints the independent directors. Where independent directors are appointed by the same (controlling) shareholders who appointed the CEO and other executive directors, the independency might be hindered and the protection of the minority shareholders reduced. A stream of corporate governance literature has empirically analyzed the relationship between ownership structures and the presence of independent directors in the board. Several empirical studies found that ownership concentration is negatively associated with the presence of independent directors (Li 1994). Also, institutional investors' ownership was found to be positively associated with board composition. A higher institutional investors' shareholding was found to be positively related to board composition in U.S., U.K. and French firms (Bathala and Rao 1995; Gillan and Starks 2000; O'Sullivan 2000; Chouchene 2010). These studies also found that the institutional investors are more active than the individual investors and that they participate more frequently in the directors' nomination process.

It is therefore interesting to analyze if similar results may be found in Italian listed firms. For this purpose, we split the directors labeled as independent into two categories: independent directors appointed by the controlling shareholders and those appointed by the minority shareholders. We test if the presence of institutional investors may favor a higher percentage in both cases. Consistently with prior research, we hypothesize that the participation of institutional investors has a positive impact on the presence of independent and minority directors. We formulate the following hypotheses.

H1: *Institutional ownership is positively associated with the proportion of independent directors nominated by controlling shareholders in the board*
and

H2: *Institutional ownership is positively associated with the proportion of minority directors in the board*

The representation of shareholders in the board can affect the composition and the functioning of the board's committees, as well as the functioning of the board itself. Since 1999, the Italian corporate governance code has recommended to listed companies the creation of three committees: the audit, the remuneration and the nomination committee, each with a majority of independent directors. These committees are traditionally seen as important mechanisms for reducing the various conflicts between managers and shareholders and to foster the independency-in-fact, giving to the independent directors the possibility of acting both jointly and autonomously together with a high level autonomy from the CEO (Gordon 2003).

The effectiveness of these committees in fulfilling their responsibilities depends on different features. If we consider the studies regarding the audit committee (DeZoort and Salterio 2001; Abbott et al. 2004), authors use as indicators for measuring the quality of the monitoring action on the financial reporting process, the financial expertise and auditing knowledge of the committee members. Undoubtedly, the expertise of independent directors represents a critical issue for the effectiveness of the monitoring function but no less important is the nominating process of independent directors.

In companies which dispersed ownership, authors (Lorsh and MacIver 1989) highlight the risk stating that when the CEO controls the selection process of the board's members the independent directors may assume passive and ineffectual behavior.

If we consider the companies with a concentrated ownership structure, this problem is more likely to appear when independent directors are elected by the same owner that elects the CEO rather than from the minority of shareholders. In this case, independent directors could tend to conform to the interests of the shareholders who appointed them, serving as "stewards" and/or providing a mild monitoring activity.

Considering the distinction of the independent directors between those elected by the controlling shareholders and those elected the minority, it is interesting to analyze whether the percentage of minority directors is associated with the presence of the board's committees and on the level of activity of these committees, measured by the number of meetings held. Thus we posit the following hypotheses:

H3: *The proportion of minority directors in the board is positively associated with the presence of the audit, remuneration and nomination committees;*

H4: *The proportion of minority directors in the board is positively associated with of the audit, remuneration and nomination committees meeting frequency.*

5.4 Research Methodology

5.4.1 Sample Selection

Our initial sample includes all non-financial companies listed on the Italian Stock Exchange.[8] We discarded the companies: (1) with a dualistic vertical governance structure; (2) included among the Micro-Cap segment of MSE (that is very small listed companies); (3) not listed continuously from the year 2006 to 2010.

Our final sample is composed of 145 companies (corresponding to about the 60 % of the population of non-financial listed companies). For each company we gathered the corporate governance data needed from reports downloaded from the Italian Stock Exchange website. We collected the 2010 governance data.[9]

5.4.2 Variable Definitions

To test the hypotheses, the dependent variables used in this study are defined as follows. The percentage of minority directors in the board is measured by their number on the total amount of directors (MINORIND). We also used the proportion of independent directors nominated by controlling shareholders over the total

[8] We did not consider financial, banking and insurance companies, because of different governance requirements and specific monitoring activity delivered by Authorities (i.e. Bankitalia, ISVAP).

[9] As mentioned below, we also collected the 2009 data to perform a robustness check.

number of directors (MAJORIND).[10] We used three dummy variables for the presence of the board's committee: audit (AC), remuneration (REM) and nomination (NOM). Consistently with prior research (Menon and Williams 1994; Sharma et al. 2009; Greco 2011), we proxied the directors' activity with the number of meetings held in the year 2010 for the audit committee (ACMEET), the remuneration committee (REM) and the nomination committee (NOM).

The independent variables used in this study are defined as follows Ownership concentration (OWN) which is measured by the proportion of ordinary shares held by the first owner (Parbonetti and Cerbioni 2007; Allegrini and Greco 2011). Institutional ownership (INST), which is measured using the proportion of ordinary shares held by institutional investors compared with those held by others (Koh 2003; Greco 2011).

We also included in our model three other control variables. The presence of CEO duality (CEOCH) is measured by a dummy variable coded 1 if the CEO is also the Chairman of the board, 0 otherwise. The executive directors' weight in the board is measured by their number on the total number of directors in the board (EXE). We also controlled in our models for the total number of directors in the board (BSIZE) (Table 5.2).

5.5 Empirical Analysis

5.5.1 Descriptive Statistics

Tables 5.3 and 5.4 report the descriptive statistics. We found 81 minority directors in the sample companies representing 5 % of the total directors (1463).

Forty six companies out of 145 had at least one minority director about the 31 % of the sample. This result shows the absence of a minority director for a majority of the companies analyzed, which means that the minority shareholders have not presented a list of candidates. Based on this evidence, it will be interesting to analyze in detail whether the presence of institutional investors as minority directors is associated with the presentation of the list of directors.

All the minority directors found were independent, with just one exception of non-executive not independent.

Independent directors nominated by controlling shareholders are present in all the sample companies (with just one exception), and they are on average 35 % of the total directors in the board.

Ownership concentration is high, being on average 45 % of the total ordinary shares (Table 5.3). This is consistent with the feature of the Italian capital market, with most companies controlled by families or a single shareholder owning often more than 50 % of the ordinary shares.

[10] These directors were nominated in the so-called "majority list", the list of presented by the controlling shareholders.

Table 5.2 Definition and measurement of variables

Variable	Definition	Measurement	Data source
MINORIND	Directors nominated by minority shareholders	Proportion of directors nominated by minority shareholders over the total number of directors	Corporate governance report
MAJORIND	Independent directors nominated by controlling shareholders	Proportion of independent directors nominated by controlling shareholders over the total number of directors	Corporate governance report
AC	Presence of an audit committee	Dummy variable, 1 if the committee is present, 0 otherwise	Corporate governance report
REM	Presence of a remuneration committee	Dummy variable, 1 if the committee is present, 0 otherwise	Corporate governance report
NOM	Presence of a nomination committee	Dummy variable, 1 if the committee is present, 0 otherwise	Corporate governance report
ACMEET	Audit committee meeting frequency	Number of meetings held in the fiscal year 2010	Corporate governance report
RMEET	Remuneration committee meeting frequency	Number of meetings held in the fiscal year 2010	Corporate governance report
NMEET	Nomination committee meeting frequency	Number of meetings held in the fiscal year 2010	Corporate governance report
OWN	Ownership concentration	Proportion of ordinary shares held by the first owner	Consob
INST	Institutional investors ownership	Proportion of ordinary shares held by institutional investors	Consob/Corporate governance report
CEOCH	CEO duality	Dummy variable (1 if the CEO is also the Chairman of the board, 0 otherwise)	Corporate governance report
EXE	Executives	Percentage of executives directors in the board	Corporate governance report
BSIZE	Board size	Total number of directors in the board	Corporate governance report

Institutional investors are present in 54 % of the sample companies. In all these cases the institutional investors are minority shareholders. Their average weight is 4 % of the ordinary shares (median 2 %, see Table 5.3). CEO duality is widespread with about one third of the company[11] having the CEO serving also as Chairman of the board.

[11] Allegrini and Greco (2011) provide an international comparison among the board of directors featured in Italy, Spain, UK, Australia and US.

Table 5.3 Descriptive statistics for board features and ownership structure ($n = 145$)

Continuous and count variables	Mean	Standard deviation	1st quartile	Median	3rd quartile
MINORIND	0.05	0.94	0.00	0.00	0.10
MAJORIND	0.35	0.16	0.25	0.33	0.43
EXE	0.29	0.15	0.15	0.28	0.40
BSIZE	10.09	3.32	7.00	9.00	12.00
OWN	0.45	0.19	0.30	0.50	0.59
INST	0.04	0.05	0.00	0.02	0.07
Dichotomous variables (1,0)	Yes% (1)	No% (0)			
CEOCH	32.6 %	67.4 %			

Variables definition: *MINORIND* proportion of minority directors on the total number of directors, *MAJORIND* proportion of independent directors nominated by controlling shareholders on the total number of directors, *OWN* ownership concentration, percentage of ordinary shares of the first owner, *INST* institutional investors shareholding, percentage of ordinary shares owned by institutional investors, *CEOCH* dummy variable, 1 if the CEO is also the Chairman of the Board, 0 otherwise, *EXE* percentage of executives directors in the board, *BSIZE* board size, total number of directors in the board

Table 5.4 Descriptive statistics for the audit, remuneration and nomination committee ($n = 145$)

Continuous and count variables	Mean	Standard deviation	1st quartile	Median	3rd quartile
ACMEET	5.84	3.61	4.00	5.00	7.00
RMEET	2.66	2.01	1.00	2.00	3.00
NMEET	2.87	2.01	1.00	2.50	5.00
Dichotomous variables (1,0)	Yes% (1)	No% (0)			
AC	93.1 %	6.9 %			
REM	88.9 %	11.1 %			
NOM	11 %	89 %			

Variables definition: *AC* dummy, 1 if there is an audit committee, 0 otherwise, *REM* dummy, 1 if there is an remuneration committee, 0 otherwise, *NOM* dummy, 1 if there is a nomination committee, 0 otherwise, *ACMEET* audit committee meeting frequency, number of meetings of the audit committee in the year 2010, *RMEET* remuneration committee meeting frequency, number of meetings of the remuneration committee in the year 2010, *NMEET* nomination committee meeting frequency, number of meetings of the remuneration committee in the year 2010

Regarding the board's committee, the audit and remuneration committees are much more widespread than the nomination committee which exists in one company out of ten (Table 5.4). Several companies explain in the Governance Report that they do not create a nomination committee, being granted to the minority shareholders the possibility to appoint at least one director, by presenting a list at the general shareholder meeting.

5.5.2 Correlation Analysis

Table 5.5 reports the results of the Pearson correlation analysis. The proportion of minority directors in the board (MINORIND) is positively related to institutional investors ownership (INV), with p-value <0.05. The minority directors percentage on the board is not significantly associated with the presence of committees, but is positively and significantly associated with the activity of the audit committee (ACMEET, correlation significant at the 1 % level), the remuneration committee (RMEET, correlation significant at the 5 % level) and the nomination committee (NMEET, correlation significant at the 1 % level).

Also, the proportion of minority directors is negatively related to ownership concentration (OWN), with *p-value* <0.01, and is lower in companies with CEO Duality (CEO, negative correlation significant at the 1 % level) and higher proportion of executives in the board (EXE, negative correlation at the 5 % level).

The proportion of independent directors nominated by the controlling shareholders in the board (MAJORIND) is not significantly associated with the institutional investors shareholding and is positively associated with ownership concentration (*p-value* <0.05). Interestingly, the independent directors' proportion in the board is associated neither to the presence nor to the activity of the committees.

Overall, the results suggest that in firms with highly concentrated ownership, strong board leadership and a higher presence of executives, it is less likely to find minority directors. Active and organized shareholders (the type of shareholders usually nominating minority directors) probably prefer companies with more dispersed ownership along with a more open governance structure. The results may also suggest that minority directors are more active in the committees than the independent directors nominated by the controlling shareholders. Although formally belonging to the same category (they are all classified as independent), the shareholders nominating them appear to be influencing their behaviour. According to our results, the independent directors do not appear to be a homogeneous group with the same behaviour.

5.5.3 Multivariate Analysis

To test our hypotheses, we estimated the following Models. Models 1, 2 and 4 were estimated with OLS regressions. Model 3 with a Probit regression estimated for each committee: audit, remuneration, nomination. Model 4 was estimated only for the firms having an audit committee (134) and for those having a remuneration committee (126). The limited number of firms with a nomination committee (16) made the multivariate analysis inapplicable.

Table 5.5 Pearson correlation analysis

	MINORIND	MAJORIND	AC	REM	NOM	ACMEET	RMEET	NMEET	OWN	INST	CEOCH	EXE	BSIZE
MINORIND	1	−0.154*	0.074	0.027	0.011	0.286***	0.206**	0.490***	−0.236***	0.204**	−0.207***	−0.179**	0.015
MAJORIND		1	0.094	0.079	0.031	0.148*	0.094	−0.013	0.176**	0.114	−0.056	−0.105	0.654***
AC			1	0.730***	0.091	0.000	0.000	0.000	0.104	0.200**	−0.007	−0.000	0.283***
REM				1	0.124	−0.140	0.000	0.000	0.073	0.224***	0.008	−0.048	0.301***
NOM					1	0.131	0.229***	0.000	−0.101	0.151**	−0.055	−0.014	0.003
ACMEET						1	0.504***	0.595***	−0.023	0.066	−0.262***	−0.131	0.151*
RMEET							1	0.829***	−0.086	0.126	−0.311***	−0.192**	0.158*
NMEET								1	−0.218	0.320	0.578**	−0.092	0.326
OWN									1	−0.153*	−0.036	0.113	0.036
INST										1	−0.162*	0.031	0.244***
CEOCH											1	0.169**	−0.321***
EXE												1	−0.306***
BSIZE													1

All p-values are two-tailed

***Coefficient is significant at the 0.01 level (two-tailed)

**Coefficient is significant at the 0.05 level (two-tailed)

*Coefficient is significant at the 0.10 level (two-tailed)

Variables definition: *MINORIND* proportion of minority directors on the total number of directors, *MAJORIND* proportion of independent directors nominated by controlling shareholders on the total number of directors, *AC* dummy, 1 if there is an audit committee, 0 otherwise, *REM* dummy, 1 if there is an remuneration committee, 0 otherwise, *NOM* dummy, 1 if there is a nomination committee, 0 otherwise, *ACMEET* audit committee meeting frequency, number of meetings of the audit committee in the year 2010, *RMEET* remuneration committee meeting frequency, number of meetings of the remuneration committee in the year 2010, *NMEET* nomination committee meeting frequency, number of meetings of the remuneration committee in the year 2010, *OWN* ownership concentration, percentage of ordinary shares of the first owner, *INST* institutional investors shareholding, percentage of ordinary shares owned by institutional investors, *CEOCH* dummy variable, 1 if the CEO is also the Chairman of the Board, 0 otherwise, *EXE* percentage of executives directors in the board, *BSIZE* board size, total number of directors in the board

Model 1

$$\text{MINORIND}^i = \beta_0 + \beta_1\text{OWN}_i + \beta_2\text{INST}_i + \beta_3\text{CEOCH}_i + \beta_4\text{EXE}_i + \beta_5\text{BSIZE}_i + \varepsilon_i$$

Model 2

$$\text{MAJORIND}^i = \beta_0 + \beta_1\text{OWN}_i + \beta_2\text{INST}_i + \beta_3\text{CEOCH}_i + \beta_4\text{EXE}_i + \beta_5\text{BSIZE}_i + \varepsilon_i$$

Model 3

$$\text{Presence of the committee}_i = \beta_0 + \beta_1\text{OWN}_i + \beta_2\text{INST}_i + \beta_3\text{CEOCH}_i + \beta_4\text{EXE}_i + \beta_5\text{BSIZE}_i + \beta_6\text{MINORIND}_i + \varepsilon_i$$

Model 4

$$\text{Committes meeting frequency}_i = \beta_0 + \beta_1\text{OWN}_i + \beta_2\text{INST}_i + \beta_3\text{CEOCH}_i + \beta_4\text{EXE}_i + \beta_5\text{BSIZE}_i + \beta_6\text{MINORIND}_i + \varepsilon_i$$

Variables definition: MINORIND = proportion of minority directors on the total number of directors; MAJORIND = proportion of independent directors nominated by controlling shareholders on the total number of directors; OWN = ownership concentration, percentage of ordinary shares of the first owner; INST = institutional investors shareholding, percentage of ordinary shares owned by institutional investors; CEOCH = dummy variable, 1 if the CEO is also the Chairman of the Board, 0 otherwise; EXE = percentage of executives directors in the board; BSIZE = board size, total number of directors in the board.

For Model 1 we detected heteroskedasticity with the White's (1980) test. We re-ran the regression with the White's (1980) heteroskedasticity-consistent standard errors and covariance and obtained the same results. This procedure shows that heteroskedasticity does not significantly affect our results (Wallace and Silver 1988; Greene 2003). We did not detect heteroskedasticity in the other models.

The variance inflation factor (VIF) score was calculated for each independent variable, in order to evaluate whether multicollinearity may be a cause of concern. VIF scores higher than 10 are likely to cause a multicollinearity problem (Gujarati 2004, p. 366). The highest VIF obtained across the models is slightly above 1.

Table 5.6 displays the results of the regression of Model 1 and Model 2. The proportion of minority directors (MINORIND) has a significant positive association with the institutional investors ownership (*p-value* <0.05). This result provides support for HP1. Institutional investors are qualified and professional shareholders actively participate in the directors' nomination process. The higher the investors stake is the more significant the presence of minority directors is on the board. This

Table 5.6 Multivariate analysis Model 1 and 2

	OLS Dependent variable: Independent directors nominated by minority shareholders (MINORIND) $n = 145$		OLS Dependent variable: Independent directors nominated by controlling shareholders (MAJORIND) $n = 145$	
	Coeff.	*t*-statistic	Coeff.	*t*-statistic
Const	0.166***	4.43	0.329***	4.88
OWN	−0.093**	−2.59	0.119	1.56
INST	**0.317****	**2.03**	−0.074	−0.23
CEOCH	−0.038**	−2.43	−0.005	−0.18
EXE	−0.107**	−1.99	−0.155*	−1.83
BSIZE	−0.003	−1.53	0.002	0.49
	Adj R^2	0.12	0.01	
	F-statistics	4.84	1.62	
	p-value for F test	<0.00	>0.10	
	Max VIF	1.28	1.28	

All *p*-values are two-tailed
***Coefficient is significant at the 0.01 level (two-tailed)
**Coefficient is significant at the 0.05 level (two-tailed)
*Coefficient is significant at the 0.10 level (two-tailed)
Variables definition: *MINORIND* proportion of minority directors on the total number of directors, *OWN* ownership concentration, percentage of ordinary shares of the first owner, *INST* institutional investors shareholding, percentage of ordinary shares owned by institutional investors, *CEOCH* dummy variable, 1 if the CEO is also the Chairman of the Board, 0 otherwise, *EXE* percentage of executives directors in the board, *BSIZE* board size, total number of directors in the board

is consistent with the need for minority investors to monitor the firm's management and mitigate the agency conflicts along with the information asymmetry.

The minority directors' percentage is negatively associated with ownership concentration (OWN), strong board leadership (CEO Duality, CEOCH) and executives' percentage in the board (EXE), in all the cases with the coefficients are significant at the 5 % level. This could suggest that companies with more dispersed ownership and with more open governance structure are selected by active and organized shareholders to propose candidates to directorship.

The proportion of independent directors nominated by controlling shareholders is not significantly associated with institutional investors' ownership (Table 5.5). There is therefore no support for HP1. This result marks a significant difference with studies on the US and the UK settings (Bathala and Rao 1995; Gillan and Starks 2000; O'Sullivan 2000). Controlling shareholders may appoint independent directors for stewardship purposes and/or to ensure mild decision control activity. For this reason, minority investors clearly prefer their own monitors in the board.

The Probit regressions of Model 3 with the presence of the committees as dependent variables fail to provide support for HP3 (not reported). The proportion of minority directors in the board has no impact on the decision to set up the audit, the remuneration and the nomination committee. The regression analysis results are in line with the results of the correlation analysis (see above).

Table 5.7 Multivariate analysis Model 4

	Panel A		Panel B	
	Dependent variable: Audit committee meeting frequency (ACMEET) $n = 134$		Dependent variable: remuneration committee meeting frequency (RMEET) $n = 126$	
	Coeff.	*t*-statistic	Coeff.	*t*-statistic
Const	4.286**	2.50	3.2455***	3.25
OWN	0.857	0.51	−0.465	−0.49
INST	−1.593	−0.27	2.164	0.63
CEOCH	−1.341*	−1.89	−1.075***	−2.67
EXE	−0.515	−0.23	−1.486	−1.18
BSIZE	0.113	1.08	0.0170	0.28
MINORIND	**10.069*** **	2.97	2.370	1.24
Adj R^2	0.14		0.10	
F-statistics	3.40		3.19	
p-value for F test	<0.00		<0.00	
Max VIF	1.16		1.16	

All *p*-values are two-tailed
***Coefficient is significant at the 0.01 level (two-tailed)
**Coefficient is significant at the 0.05 level (two-tailed)
*Coefficient is significant at the 0.10 level (two-tailed)
Variables definition: *MINORIND* proportion of minority directors on the total number of directors, *ACMEET* audit committee meeting frequency, number of meetings of the audit committee in the year 2010, *RMEET* remuneration committee meeting frequency, number of meetings of the remuneration committee in the year 2010, *OWN* ownership concentration, percentage of ordinary shares of the first owner, *INST* institutional investors shareholding, percentage of ordinary shares owned by institutional investors, *CEOCH* dummy variable, 1 if the CEO is also the Chairman of the Board, 0 otherwise, *EXE* percentage of executives directors in the board, *BSIZE* board size, total number of directors in the board

Table 5.7 shows the regression of Model 4 with the audit committee and the remuneration committees meeting frequencies. The minority directors' percentage in the board is positively associated to the audit committee meeting frequency, with a high level of significance (Panel A, coefficient significant at the 1 % level) and has no significant association with the remuneration committee meeting frequency (Panel B). The lack of significant association with the remuneration committee activity might depend on the poor variability of the number of remuneration committees meeting frequency across companies (see descriptive statistics in Table 5.4). This committee usually meets twice a year. Thus, in this case the proxy could not capture the differences in the activity of the directors.

Overall, the results support HP4 in regard to the audit committee. The minority directors are engaged to play an active monitoring role, especially in relation to financial external reporting and the transactions with related parties. Minority shareholders have significant incentives to foster the audit committee activity, since an intensive monitoring environment can limit the information asymmetry and the risk of private benefits extraction by controlling shareholders (Leftwich et al. 1981; Shleifer and Vishny 1997; Dyck and Zingales 2004).

5.5.4 Further Investigations

We repeated the regressions of Model 3 and 4 using the proportion of independent directors in the board instead of that of the minority investors. The results show that the independent directors' percentage has no significant association with either the audit committee or the remuneration committee meeting frequencies. We added this variable to our models obtaining consistent results.

We also re-ran our model to include other control variables, such as the size of the firm and the profitability, obtaining consistent results. Finally, we re-ran our models using the 2009 governance data, also obtaining consistent results.

5.6 Conclusions

In this paper, we investigated whether the presence of minority directors and that of independent directors nominated by the controlling shareholders is influenced by institutional investor ownership. We also investigated the impact of the minority directors percentage on the board based on the presence and activity of the audit, remuneration and nomination committees.

Our results show that increased institutional investors shareholding is associated with a higher proportion of minority directors in the board however it is not associated with the proportion of independent directors.

The findings show that an active and organized minority shareholder is fundamental for ensuring the presence of the minority directors who become a key element in reducing the risk of minority expropriation.

When the minority shareholders are inactive, and do not present a list of candidates, they tend to rely on the monitoring action exercised by the independent directors. The results show that the percentage of independent directors increases in the presence of a higher concentrated ownership.

Combining these evidences, it seems that there might exist, a sort of tacit agreement between the inactive minority shareholders and the controlling owners, in addition the controlling shareholders appoint a higher number of independent directors in order to provide a high level of assurance to the minority, who relinquish presenting a list of their candidates.

However in this setting the presence of a high proportion of independents may provide only the appearance of a more effective monitoring action.

This study shows that the minority directors percentage in the board is associated to an increased activity of the audit committee, whilst in the case of the independent directors appointed by the majority of shareholders the association is weaker. An implication of this finding could be that controlling shareholders appoint independent directors as stewards and/or to ensure mild decision control activity.

Generally speaking, in a setting featured by large controlling shareholders, an active audit committee may serve as an effective device in reducing the information asymmetry and risks of wealth expropriation by dominant owners.

The study acknowledges some limitations. Firstly, the meeting frequency is an imperfect proxy for the monitoring activity delivered, since we have no idea of how the meeting time is spent. The presence of minority directors could improve the monitoring "quality" (i.e., the time spent in effective decision control), by providing more attentive and dutiful work. However, in regard to this limitation, it should be acknowledged that useful decision control is unlikely to occur if the committees meetings take place only once per year or no meetings are held at all (Fernandez Mendez and Arrondo Garcia 2007). Secondly, we studied the 2010 data and the 2009 data in order to check the robustness of the results. However, since governance structures do not usually change in the short term, future research could investigate how the impact of the presence of minority directors changes over time. Future research could also focus on international comparisons.

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Chapter 6
Good Governance in Customs: The Case of the Republic of Macedonia

Jovanka A. Biljan

> *Good Governance gives societies sound structures for economic and social development*
>
> Kofi Anan, inauguration speech as UN Secretary-General, July 1997.

Abstract The complexity of the economic and social global and regional impacts considerably influences not only the business sector, but the national governmental authorities, as well. As public service providers, governments should discover new methods and paths to manage their activities in national social developments. There are several concepts that elaborate public management. One of the most prominent concepts is the good governance, which was established in the early 1990's. There is no generally accepted definition of good governance and usually it is defined mainly by emphasizing its core principles. Most governments present good governance as an important objective for reform of judicial systems, public administration reform, anti-corruption, decentralization, and public expenditure management. The Customs administrations are core governmental institutions directly involved in international economic relations. As a governmental institution mainly tasked to control and to facilitate trade, Customs administrations had to modernize their management structure and organization, complying with national and international trade and customs regulations. This paper is dedicated to the specifics of good governance in Customs, with a special emphasis on the Macedonian Customs

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_6,

Administration's experience. Generally, the implementation of customs risk management and its usage in customs simplifications in the Macedonian Customs Administration (MCA) will be analyzed.

6.1 Introduction

Customs administrations as governmental institutions mainly involved in international supply chains, should keep pace with the contemporary trends in public management improvements generally through modernization of their management structure and organization, complying with national and international trade and customs regulations, as well as with ICT developments. Through the implementation of the process of customs modernization, which is defined as a comprehensive streamlining of processes, formalities, procedures and documents handled by Customs (De Wulf and Sokol 2005), the customs administrations are able to keep up with contemporary economic, legal and technological advantages. This process consists of several interdependent activities related with establishment and implementation of improved law regulations; implementation of CRM and simplified customs procedures; usage of ICT, creating paperless environment and e-customs; improved human resource management and strengthening of cooperation among customs administrations and between customs and business sector (Customs-to-Customs and Customs-to-Business cooperation). However, the core element in customs modernization process is CRM implementation in overall customs operations, especially in simplified customs procedures which enables greater inclusion of trade operators in customs issues, such as the concept of "authorized economic operator" (AEO).

Customs administrations as institutions generally responsible for customs policy implementation are required to manage the new trends and tasks especially rising value and volume of internationally traded goods during the previous 20 years, as well as the decreased safety and security of international supply chains particularly after the 09/11/2001 terrorist attacks in New York, USA. Mainly, due to those two trends, the spectrum of customs policy objectives, along with controlling of international trade flows, collecting revenues and collecting statistical data, was supplemented with the necessity for trade facilitation and the need of ensuring social safety and security. Achievement of these objectives is only possible by application of risk management concept in Customs, which is interconnected with good governance principles focused on improvements of legal, economic and social environment in which markets, private enterprises and civil society function.

The Republic of Macedonia proclaimed its independence in 1991, and since then it operates as a unique customs territory. According to the achieved customs sovereignty, national authorities started to build up national legal, institutional and managerial structures that would be responsible for customs matters.

6.2 Literature Review

The national government as a public service provider, should face all challenges and manage all activities by discovering new methods and paths to increase overall economic and social developments in the country. There are several definitions of the term governance presented by the most influential international institutions, which generally emphasize the way of which the authorities exercise the power for social and economic development in the country (Abdellatif 2003). According to the World Bank definition, governance includes: (a) the process by which those in authority are selected, monitored and replaced; (b) the capacity of the government to effectively manage its resources and implement sound policies, and (c) the respect of citizens and the state for the institutions that govern economic and social interactions among them.

There are several concepts that elaborate the questions about governance and public management, especially the differences between management process in business and public sector, as well as the applicability of certain concepts in different groups of countries due to achieved economic development (developed or developing countries). One of them is the New Public Management (NPM) paradigm that as a reform agenda of several OECD countries emerged in the 1970's (Monteiro 2002). It was mainly applied in the developed Anglo-Saxon administrations, although some elements of it have spread more widely. However, there are several theoretical attempts for elaboration of the question whether the NPM is a good method for developing countries or not (Polidano 1999). As a response to those attempts, in the early 1990's a new concept that was referring to developing countries, known as a good governance concept was developed. As a public governance concept, good governance aims to create legal, economic and social conditions for improvement of the environment in which markets, private enterprises and civil society function (Abdellatif 2003). Every government should define the good governance goals and principles that would be applied as management objectives. Most governments presented good governance as an important objective for reform in their countries. Central among these were the reform of judicial systems, public administration reform, anti-corruption, decentralization, and public expenditure management. Governments create the conditions in which governmental institutions, markets, private enterprises and civil society organizations function. The Organization of United Nations concludes that good governance is an 'ideal state'. It is currently reached by only several countries in the world and therefore, more often instead of reaching good governance one works towards "Good enough governance" (Grindle and Merilee 2002).

There is no general accepted definition of good governance, although the important international institutions such as the UNDP (the United Nations Development Programme), USAID (the United States Agency for International Development), the World Bank and the European Union define good governance mainly by emphasizing its core principles, such as: rule of law, transparency, effectiveness and efficiency, responsiveness and accountability (Abdellatif 2003).

Concerning good governance, there are four principles which are very important for Customs: accountability, transparency, predictability and participation (Schiavo-Campo Salvatore 1999). Accountability in Customs is considered as the capacity to call customs officials to account for their actions. Effective accountability has two components: answerability, as the requirement to respond periodically to questions concerning one's official actions, and consequences, which should be predictable and meaningful. Transparency entails low-cost access to relevant trade and procedural information, which should be relevant and understandable. Predictability results primarily from customs regulations that are clear, known in advance and uniformly and effectively enforced. Participation is needed both to obtain reliable information and to serve as a reality check for government action.

Customs modernization process is considered as a good governance practice that should help customs administrations in their reforming process aimed to face new challenges in increasingly globalised environment, on one, and to improve the quality of the services they provide to the business sector and other stakeholders, on the other hand.

Biljan and Trajkov (2012) emphasize that the main dilemma in Customs management, especially during the last two decades, is balancing the needs for trade facilitation as a process of simplification, standardization and unification of documents and procedures in international supply chain, on the one, and the level of controls and interventions, on the other hand. Dealing with this dilemma, Customs significantly changed its role and position in the international supply chain. Mainly, Customs replaced its gatekeeper's role, with the new modernized, complex and very sophisticated CRM approach. The main characteristic of CRM approach is determining which persons, goods, and means of transport should be examined and to what extent. High-risk persons, goods and means of transport are subject of high-level controls and interventions; despite of low-risk ones that receive high-level trade facilitation (UNCTAD 2008).

Widdowson (2005) concludes that effective CRM is central to modern customs operations, which provides the means to achieve an appropriate balance between trade facilitation and regulatory control. Additionally, he concludes that the principles of CRM can be applied manually or automatically by all administrations, but one of the most important elements is gaining a clear understanding of the nature of risks.

One of the most significant research on essential components and the state-of-play regarding CRM on global scale today, on the differentiates among administrations located in high GDP per capita versus low GDP per capita regions/countries, and on the possibilities of CRM improvements on both strategic and operational levels, was performed by Hintsa et al. (2011). Regarding the answers from the conducted survey on CRM in 24 customs administrations, they have drawn two conclusions: *firstly*, all 24 administrations in the survey had at least some of the CRM elements understood and implemented, but, no administration appears to have CRM as a masterpiece of their management systems, neither on strategic nor on operational level, and *secondly*, Customs operating in less developed economies perceive the benefit potential as lower and obstacles as higher than their counterparts in the wealthier nations. Limited efforts to manage human resources, and lack of CRM tools and data feeding into CRM processes are key examples where the administrations in poorer countries are falling behind today.

6.3 Methodology

This paper aims: *firstly*, to analyze the basic steps in the process of CRM implementation performed by the MCA, and *secondly*, to reveal whether the implemented CRM system has positive impact on customs performance in order to improve the services' quality especially those provided to the business sector. Therefore, the main accent in this analyze will be put on the effects of certain activities in the customs modernization process such as improvements in CRM and implementation of simplified procedures on performance effectiveness in the MCA.

The official data published by the MCA regarding CRM will be the basic source in this research, while the World Bank data on customs efficiency will be used as a basis for customs efficiency perception analyses. Therefore, according to the data, the research will be conducted through qualitative and quantitative analyses. The first part of the research will be conducted mostly through qualitative analyze of the MCA's experience in CRM implementation, and the second one will be a quantitative analyze of the effects of CRM on the MCA's performance and on business environment improvements.

Along with the introduction, literature review, methodology and conclusion sections, this paper is consisted of three parts. The first part is related to the MCA's experience in CRM implementation process, while the second part is dedicated to the types and practices in simplified customs procedures. The effects of performed activities in customs modernization, especially CRM, on the MCA's performance and achieved efficiency, as well as on the quality of services provided to business sector, are presented in the third part.

6.4 Implementation of Customs Risk Management in the Macedonian Customs Administration

The CRM process, as the systematic identification and implementation of all measures necessary to limit exposure to risk treated on strategic, operational and tactical level, consists of several procedures that Customs administrations should put through: risks identification; risk assessment that is consisted of risk analyses and risk evaluation; risk treatment; monitoring and reviewing, and communication and consultation within national Customs administrations, C2C (Customs to Customs) and C2B (Customs to Business) (WCO 2003) (Fig. 6.1).

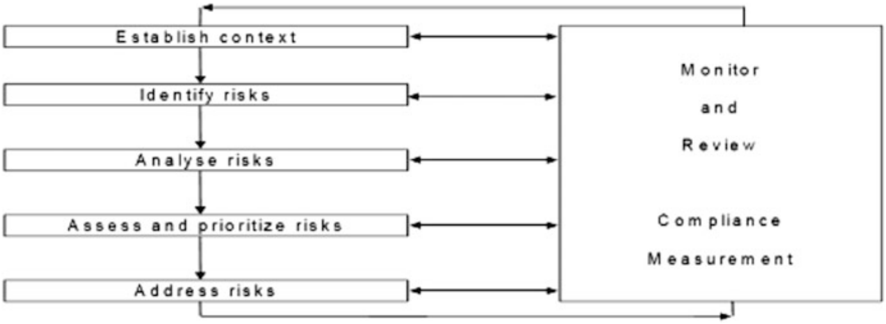

Fig. 6.1 Risk management process (Source: WCO 2003)

The CRM process is very complex and dynamic, and its activities are highly interdependent and mixed, as well. Also, it is a process under continually monitoring and controls which as a feedback, reveals necessities for permanent improvement and development.

The first step in implementation of CRM in the MCA was done in 2002 when the application of the selectivity method, as pilot programme in some Customs offices, started (MCA 2006). After that it was accepted as general policy of the Customs Administration in all Customs offices and it was automated in 2004.

The organizational scheme of the MCA was developed, as well. The new organizational unit, called the Risk Analysis Department (RAD), was established within the framework of the Sector of Controls and Investigation in the MCA (Biljanoska 2011). The tasks of this unit are: to analyze, evaluate, identify and define customs risks, risk indicators and risk profiles; to purpose them for adoption; to monitor the CRM activities and to coordinate the activities on different levels; to control the fulfillment of measures and procedures in the field of CRM; to revise and update the defined customs risks, risk indicators and risk profiles.

The legal developments regarding the CRM implementation were imposed in the national Customs legislation. Along with that the appropriate strategic and operational documents by the MCA were adopted. In this context, the MCA has adopted several documents, among which the CRM strategies are the main documents. The first strategy on CRM applied to 2006–2010 period, and the new one applies to 2011–2014 period (MCA 2011a).

The Risk Management Strategy 2011–2014, which is based on the provisions of the EU Risk Management Standards Framework and the Macedonian Strategic Plan of Customs Administration 2009–2011, was adopted by the MCA in January 2011 (MCA 2011b), and set out the main strategic goals and commitments in relation to managing risks facing Customs and points out the key activities for efficiency improvements. The long term goal of Customs Administration is to develop appropriate techniques for (1) systematic risk determination; (2) implementation of all measures necessary to limit exposure to risk; (3) implementation of international and national strategies, in accordance with relevant legislation; (4) collection of data and information; (5) analysis and assessment of risks; (6) adoption of activities and (7) monitoring of the results, in order to facilitate, improve and direct the control procedures. This long-term goal shall be achieved through the following strategic goals: (1) providing legal framework for implementation of CRM; (2) Development of a harmonized model of CRM covering all aspects of operations; (3) Determination of activities to establish the high-risk areas; (4) Application of appropriate process of managing risks; (5) Implementation of measures to enhance cooperation with other institutions; (6) Implementation of measures to improve internal communication; (7) Implementation of measures to improve relations with companies and public, and (8) Purchasing of equipment and technology to support the process of managing risks.

The planned activities according to the Strategy should be fulfilled until the end of 2014 through annual action plans. One of the main objectives in capacity building activity is establishment of the Risk Management Committee, as a coordination body whose members will be appointed from all internal organizational units included in the CRM system.

Customs frauds and threats on social safety and security are the two main risk areas defined in strategies and programs adopted by the MCA.

Customs frauds, as evading payment of tariffs and other duties, are treated through: declaring and accepting improper customs value; declaring and accepting misclassification; declaring and accepting improper origin of goods; discharging of import for processing; discharging of outward processing; illicit removal of goods from customs supervision; and undeclared import goods for customs clearance, are one of the most important and highly recognized risks in customs management strategies worldwide.

Threats on social safety and security in terms of public health, environment and consumers, including proper implementation of measures related to import and export of goods to and from Macedonia, as a risk area is regarded to: smuggling of weapons; smuggling of drugs and precursors; money laundering and terrorist financing; smuggling endangered animal and plant species; smuggling of nuclear and radioactive material; smuggling of high technology and weapons; illicit trade in dual-use goods; smuggling of cultural heritage; trafficking in counterfeit/pirated goods; ecological crime, and human traffics.

Determined risk areas, along with the information from different sources (IT system for processing declaration; internal detailed records from different related units within Customs Administration; information from external governmental institutions; international customs cooperation), are the main basis for *identification of risks*. In the *risk analyses* phase each identified risk is being analyzed in terms of probability of risk occurrence and consequences of the risk occurrence. The level of risk is determined as high, medium or low. Determination whether identified and analyzed risk is acceptable (*risk evaluation*), is a condition for determination of different risk profiles and risk indicators (*risk treatment*), as kind of goods; traders; tariff lines; prices; currencies; values, country of origin; country of destination, etc.

Risk profiles in documentary or electronic form contain the following data: risk area; risk indicators; risk assessment and sources of information; parameters of selectivity; treatment – information that requires action to be taken to deal with the identified risks, as well as feedback information from the organizational units that treat certain risk to the RAD, which include: the date when action is taken, results of the action taken and assessment of the action taken.

The risk profile information is used as the basis for selection criteria. Consequently, declarations and supported documents processed by Customs are compared against the risk profile information. The decision on control channels' routing is made according to the matched information. In the MCA, the comparison and routing of consignments, vehicles, goods and persons on different control channel are automatically performed by the ASYCUDA (Automated System for Customs Data) system, which should be replaced by new Customs declaration processing software – CDPS, which will be compatible for interconnection with the EU customs systems. This software package will introduce: electronic processing of declarations for import, export and transit, additional sub-systems and revenue collection functionalities, guarantees, risk-analysis, authorizations, customs tariff, as well as sub-systems for management of laboratory, excise, intellectual property, knowledge base and e-learning. Also, rerouting of the control channel could be done by the Customs officers. There are four types of Customs control channels: green (no control – immediate release without examination); yellow (documentary control); red (documentary and physical control) and blue channel (control at a later stage – post-clearance audit). The structure of the import declaration processed on different control channels in 2010 compared to 2005, s indicates that Macedonian Customs has permanently improved its CRM system as a facilitation tool for legal trade, on one hand, and as a control mechanism towards law compliance, on the other hand (Biljan and Trajkov 2012).

Risk management is not a static process, but it is a dynamic one and it is a subject of updating and improvements. Once a year, the RAD is obliged to revise, amend and purpose changes in defined risk indicators and risk profiles, as well as to analyze the achieved results from *monitoring and reviewing* and if it is necessary, to initiate changes of risk levels.

The MCA in continuation builds up effective systems for *communication and consultation* among involved internal units, C2C and C2B relations. The effectiveness of this system depends on developing and implementation of clean channels within management information systems as the determinant for accurate, relevant and quick information flows (Iordace and Voiculet 2007). The MCA, itself and along with other institutions, has developed and implemented several IT solutions as a CRM support tools: National Customs Valuation Data Base; South-East European Messaging System – SEMS; Systematic Electronic Exchange of Data – SEES; Transit of Foreign Currency, securities and Precious Metals; Dual Use Goods Reporting – TRACKER. The main activity in CRM undertook by Western Balkans and the EU is developing and implementation of IT network called Risk Assessment for Customs in Western Balkans – RACWeB. RACWeB is designed to enhance the identification of risk profiles through the utilization of data mining techniques and to develop an advanced web-based risk assessment service in customs declarations. Its implementation will improve customs efficiency, as well as transparency in everyday activities.

According to established performance measurement of CRM, the MCA has established a long list of indicators, such as monthly imports (value and volume) per customs branches for selected goods; collected customs duties; collected VAT and like. Also, the MCA has imposed an obligation for submission of annual and quarterly plans, as well as monthly, quarterly and annual reports on realization for each customs post targeted on customs clearance (undeclared goods, undervaluation, origin, classification, IRP, physical inspection) and border crossing (seized goods, customs offences, foreign exchange offences).

6.5 Simplified Customs Procedures

Simplified customs procedures are one of the most important trade facilitation measures in the customs modernization process that were implemented by the Revised Kyoto Convention (WCO 1999). In general, there are simplified customs procedures related to customs declaration, specific simplified transit procedures and the highest level of simplification, known as the concept of AEO. These kinds of Customs simplifications are implemented in the EU Modernized Customs Code, as well as in the Macedonian Customs Code.

Simplified procedures related to customs declaration are implemented by the Standard 3.12–3.15 of the Revised Kyoto Convention (WCO 1999). According to these standards, an economic operator could lodge a customs declaration, although all necessary data or documents are not available at the moment to complete declaration for its submission to Customs. These customs simplifications include several exemptions of the regular lodgment of a Customs declaration (Atanasovski and Biljanoska 2010):

- Lodgment of incomplete customs declaration. The customs legal regulation limit the requested information and documents that should be presented in the declaration, except the data related to customs debt determination the compilation of statistics and the application of the Customs law;
- Lodgment of a commercial or administrative document, instead of customs declaration, and
- Local clearance: Placing the goods in customs procedure only with their registration in the bookkeeping records of the authorized economic operator. Goods may go directly to or from the premises of economic operators, provided that they are entered into the records of the company.

The lodgment and acceptance of incomplete or provisional customs declaration, as well as commercial or administrative document either bookkeeping records, must contain at least the data indispensable for customs goods' identification, that is data necessary to customs debt determination and application of customs regulations. This facilitation measure could be granted to an economic operator, who shall submit a written request to the Customs. Along with the data on the type of the requested procedure, a written request shall prove that all legal provisions related to requested customs simplified procedure are fulfilled. Only low risk trade operators who meet all legal requirements will be authorized by Customs.

Despite the kind of the simplified customs procedure applied, the authorized trade operator is obliged to submit a supplementary declaration that may be of a general, periodic or summary nature.

The simplified customs transit procedures as authorized consignor and authorized consignee are special facilitation measures that are implemented in Macedonian customs legislation. An authorized consignor is a regular, large-scale consignor of goods who may be authorized by customs authorities to issue and authenticate transit documents without having to present them to Customs at the time of export/dispatch. An authorized consignee is a trader who may be authorized by state authorities to move goods which arrive under the transit procedure to his own premises without presenting them to Customs at the destination.

Macedonian economic operators, as well as transport firms are very interested in utilization of simplified customs procedures, and therefore the number of licenses issued for different types of simplifications is increasing permanently.

In 2007, the MCA issued 11 authorizations for local clearance in export and 26 authorizations for local clearance in transit, which increased more than threefold in 2011 when 46 authorizations for local clearance in export and 76 authorizations for local clearance in transit were issued (Fig. 6.2). Similarly, in 2007, the MCA issued 13 licenses for authorized consignee in transit and only 1 license for authorized consignor. During the analyzed period, the number of issued licenses increased considerable and in 2011 the MCA issued 55 licenses for authorized consignee in transit and 23 licenses for authorized consignor.

As a conclusion, at the beginning of the analyzed period, the number of issued authorizations was lower, especially because of the insufficient information on benefits and advantages from such facilitation measures available for traders and transporters. Therefore, the participation of processed import declarations in simplified procedures increased almost twice, from 19 % in 2007 to 36 % in 2011. Although, the participation of the processed export declarations in simplified procedures in total export declaration is quite lower than the participation of processed import declarations in simplified procedures in total export declarations, in the analyzed period, it increased rapidly from 6 % in 2007 to 22 % in 2011 (MCA 2012, own calculations).

The next type of customs simplification instrument developed by the WCO, i.e. the SAFE Framework is known as AEO which is "a party involved in the international movement of goods in whatever function that has been approved by or on behalf of a national Customs administration as complying with WCO or equivalent supply chain security standards. AEOs include manufacturers, importers, exporters, brokers, carriers, consolidators, intermediaries, ports, airports, terminal operators, integrated operators, warehouses and distributors" (Polner 2011).

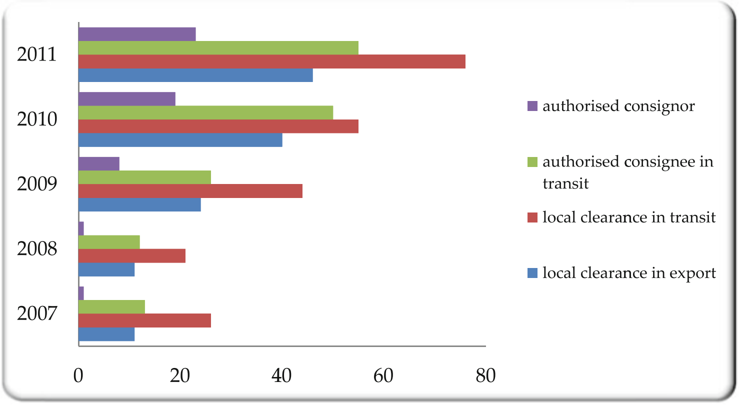

Fig. 6.2 Issued authorizations for simplified procedures by MCA (Source: MCA 2012)

Out of 164 countries that have signed the SAFE Framework Letter of Intent, 15 AEO programmes have been established in 41 (14 + 27) countries (due to the EU-27 uniform programme) and 9 countries plan establishment in the near future (Polner 2011). Macedonia has imposed legal provisions for implementation of AEO in export and import according to the three-level horizontal system: AEO Customs simplification, AEO Security and safety and AEO customs simplifications/security and safety. Until today, the MCA has not issued any authorization for AEO that means that still no one trade operator can benefit from this kind of simplification.

6.6 Did Customs Risk Management Improve the Quality of Provided Services to the Business Sector?

The CRM, as a part of customs modernization process, is mainly a concept which helps customs administrations in compliance management dealing with the main dilemma: facilitation versus control. Therefore, it enables customs administrations to face new challenges in increasingly globalised environment, especially in improvement of the services' quality provided to the business sector. Actually, that is the interconnection between customs modernization, especially CRM and good governance principles. The quantitative analyses of customs performance referring to the implementation of good governance principles consist of determination of several indicators, such as those related to workload, efficiency, customs time to export and import, etc.

The main indicators of customs performance related to customs workload show that in the last 10 years, the MCA has improved its performance. After the implementation of traditional CRM approach and selectivity control in 2002, which was supplemented with the strategic concept in 2004, the number of

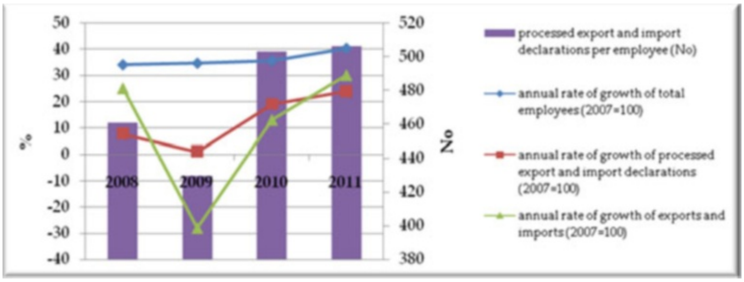

Fig. 6.3 Basic performance indicators for the MCA (Source: MCA 2012, own calculations)

processed import and export declarations significantly grew (Biljan and Trajkov 2012).

In the 2007–2011 period, the number of import and export customs declarations processed by the MCA continuously increased and in 2011 it reached the number of 599 thousand declarations, which is 24 % more than in 2007 (Fig. 6.3). In the same period, the value of imports and exports in Macedonia also continuously grew, while in 2011 it grew by 30 % compared to 2007. The MCA successfully has managed the foreign trade growth, while it achieved an increase in the number of processed declarations per employee from 461 in 2008 to 506 declarations in 2011. Generally, worse results were achieved in 2009, when due to the negative influences from the world economic crises the value of foreign trade declined for 28 % related to 2007.

As mentioned before, revenue collection is one of the oldest tasks of customs policy, and therefore customs frauds are one of the two determined risk areas in the MCA's policy.

The number of customs frauds as criminal actions that are committed by different offenders and detected by the MCA increased from 52 in 2007 to 60 in 2010, which resulted in a significant increase of their participation in the total number of customs criminal actions detected by the MCA from 31 % in 2007 to 59 % in 2010 (Fig. 6.4). In 2011, the number of detected customs frauds decreased to 31, which led to a decrease of their participation in the total number of customs criminal actions to 51 %. Additionally, in 2007, on every one hundred thousand processed import declarations, 19 were subject of customs frauds, and in the following years, the number decreased on nearly 10 in 2011. This might be a result from incurrence of different conditions, but the most significant one is the successful risk managing of the customs procedures. The MCA has strongly reinforced its capacities in order to fight against fraudulent activities in means of not letting them remain concealed and unpunished. Having in mind that more than 90 % of customs frauds are related to "double invoicing", the MCA deployed its resources towards development of stronger customs valuation and control system and especially by creating a national data base on customs value (Biljanoska 2011). The decreased numbers of detected criminal actions, especially customs frauds in 2011 could be a good sign that the undertook activities in the framework of the CRM system have

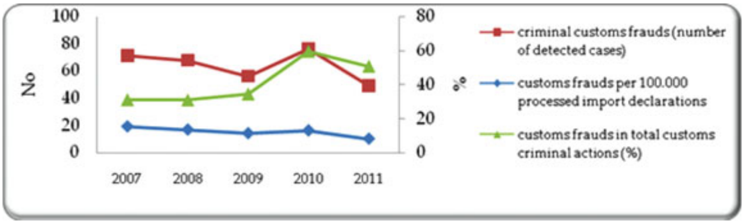

Fig. 6.4 Detected customs frauds in the MCA (2007–2011) (Source: MCA 2012, own calculations)

produced positive changes related to prevention of customs frauds, which is one of the most important objectives of CRM policy.

The modernization processes according to the contemporary trends in international customs environment that have been implemented in the MCA, had a strong positive impact on the efficiency of customs clearance process during the 2005–2009 period (Table 6.1). The score of efficiency of customs clearance process for Macedonia has risen from 2.00 in 2005 to 2.55 in 2009 that implied almost a double rank jump, from 126 to 61. But, in 2011, the score of the efficiency of customs clearance for Macedonia fell to 2.24, which resulted in almost a double rank fall from 61 to 120. Regarding this trend, the achieved score of the efficiency of customs clearance in the MCA changed from 50.1 % of the best performer in 2005 (Netherlands with a score of 3.99), to 63.1 % in 2009 (Luxemburg – 4.04) and 54.6 % in 2011 (Singapore – 4.10).

The strong efforts that the Macedonian government has put on trade facilitation and customs modernization, especially CRM and selectivity approach have lowered the time of export and import in the Macedonian economy, as well as the customs time in import and export. Customs time in import declined from 3 days in 2006 and 2007 to 2 days in 2008, and additionally decreased to 1 day in 2009. The same tendency occurred in customs time in export (World Bank 2012b). The positive impact of such time delay reductions on business sector is argued by Djankov et al. (2008), who concluded that a 10 % reduction in delays increases exports by about 4 %, all else equal.

The reduction of the delays in Customs time in import and export could be calculated as tariff equivalents that would express the impact of the delay reduction in terms of tariff liberalization (Hummels 2007). The estimated per-day tariff equivalent on the import side for the Republic of Macedonia is 0.9 % (1 day reduction of import delay is equivalent of 0.9 % ad-valorem tariff). Multiplying the per-day tariff equivalent by the total number of days for customs time in import in 2006, we reach a tariff equivalent of 2.7 % (0.9 % * 3 days). If we suppose that everything else despite customs time to import is equal, the tariff equivalent for Macedonia in 2011 is 0.9 % (0.9 % * 1 day). That means that the reduction of customs import time from 3 to 1 day implied tariff equivalent reduction from 2.7 % to 0.9 %. The estimated per-day tariff equivalent on the export side for the Republic of Macedonia is 0.7 % (1 day reduction of export delay is equivalent of 0.7 %

Table 6.1 Efficiency of customs clearance process in the Republic of Macedonia

	2005	2009	2011
Rank	126	61	120
Score	2.00	2.55	2.24
% of the best performer	50.1	63.1	54.6

Source: World Bank (2007, 2010, 2012b), own calculations
Notes:
The reports published in 2007, 2010 and 2012 show results of the surveys conducted in 2005, 2009 and 2011, respectively
Efficiency of customs clearance process rated from "very low" (1) to "very high" (5)

ad-valorem tariff). That means that the reduction of customs export time from 3 to 1 day implied tariff equivalent reduction from 2.1 % to 0.7 %. In terms of export that means that the customs time reduction in export has the same effects as reduction of tariffs that Macedonian exporters face at the international markets. That is another argument for the positive effects of customs modernization and CRM on business in the Macedonian economic environment.

6.7 Conclusion

Good governance principles applied in customs modernization process especially in CRM and simplified procedures helped the MCA in improvement of the environment in which markets, private enterprises and civil society function. There are positive trends toward greater facilitation of legal trade, as well as a stronger basis for prevention and detection of customs fraud activities. Overall activities implied to greater customs efficiency, reduction of customs time delays on import and export which positively influenced the business environment. Certain negative trends occurred in 2011, which are primarily a result of the non-implementation of the new software for customs declaration processing and the implications that occurred due to this delay.

The next steps in customs modernization process should be done in the sphere of practical implementation of the AEO concept, which will considerably and positively influence the business climate in the Macedonian economy.

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Chapter 7
Transparency and Disclosure: Public Company Reporting and Corporate Inputs

Ebru Esendemirli and Arikan Tarik Saygili

Abstract International capital markets seek to achieve investor confidence through corporate governance mechanisms. Transparency and disclosure is one of the most important aspects of corporate governance which becomes more important every single day as global business applications spread all over the world and information needs of owners, investors, creditors and other interest groups to businesses increase. In the first part of the study a framework for disclosures is provided by classifying public company reports into four main categories which are financial reports, annual reports, securities exchange commission filings and corporate social responsibility reports. Each report category is discussed in light of the attributes of disclosed information, recent regulations, reporting trends and practices. In the second part, the concepts of transparency and full disclosure are studied and analyzed through perspectives of board of directors, members of internal control (audit) committee and external auditing function. Through literature review, we note that having independent members on board and the audit committee seem to be the most important aspect promoting transparency and full disclosure practices. In addition, number of meetings held and financial literacy of the board and audit committee members are questioned and they seem to have some impact on transparency and full disclosure as well. However, having independent outsiders on corporate boards and audit committees seems to be the most important feature of sound corporate governance applications.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_7, © Springer-Verlag Berlin Heidelberg 2014

7.1 Introduction

Globalization trends in processing and use of financial information provided by different industries, financial systems, stock markets influence consumers and investors' behavior. Consequently, the international flow of funds increased along with significant developments in communication and information technologies. For instance, McKinsey Global Institute (2011) reported that cross border capital flow amounted to 4.4 trillion dollars and global foreign investment assets reach a historical peak of 96 trillion dollars in 2010. Developed and developing countries seek ways to attract global investors, to achieve continuous economic growth through capital markets.

Corporate disclosure and transparency, one of the four pillars of corporate governance, have a bridging role between public companies and society. Hence, a strong disclosure regime contributes to the effectiveness of corporate governance (OECD 2004) while strengthening investor confidence. The aim of this study is to provide a framework for public company disclosures in accordance with recent trends, laws and regulations while discussing the corporate inputs effecting transparency. In the first part of the study company disclosures are analyzed referring to the attributes scheme for disclosed information after being classified into four main groups. In the second part of the study the relation between internal company forces and transparency is reviewed in light of the research results conducted by scholars.

7.2 Public Company Reporting

Today we are living in the information age and due to the increased disclosure requirements, public companies continuously disseminate information to users and the most commonly used channel is company websites. A large number of the disclosures are in a report format and it is possible to classify the most common used ones into four groups as shown in Fig. 7.1

The essential mandatory disclosure instruments are; audited financial reports summarizing the financial results and annual reports representing the operating results. Additionally, regulators of capital markets (Securities Exchange Commissions) require filings other than financial and annual reports. For instance, examples of Securities Exchange Commission (SEC) filings include statements for insider transactions, quarterly reports and proxy statements.

Furthermore, companies give information about environmental issues, social responsibility projects, supplier relations, safety, health, workplace and strategies for sustainability in social reports. These issues are presented under similar headings such as corporate social responsibility report, sustainability report, global responsibility report, corporate citizenship report etc. Moreover, disclosures about internal corporate governance mechanisms like board of directors, board

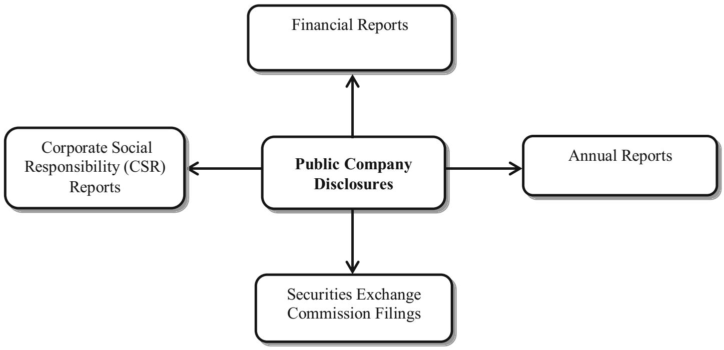

Fig. 7.1 Classification of public company disclosures

committees, code of ethics and stockholder involvement can be found in annual reports and/or CSR reports.

The quality of disclosures increases if the presented information fit to the attributes given in Fig. 7.2. The basic idea behind full disclosure requires disclosed information to be relevant, sufficient, reliable, understandable, regular & timely, material, accurate and comparable. The recent laws enacted by governments and codes issued by regulatory institutions intend to achieve investor confidence through disclosures that possess all the features mentioned.

The attributes are necessary for providing the users of financial reports with proper information needed to make rational decisions. However, it should be noted that attributes of financial information listed above are integrated and most of the time should be considered together rather than separately. In other words, a piece of information may be relevant to a specific fact; however does not serve to a purpose, unless it is timely and material as well. For example information about re-evaluation method, ratios or depreciation methods and ratios employed for fix assets might be considered relevant information during mergers and acquisitions but does not serve to intended purpose unless it is disclosed on a timely, understandable, comparable manner and related to a materially important group of assets. By the same idea accuracy may not mean much to a decision maker unless it is material, timely and understandable or materiality of information is not a significant factor in decision making unless it is complemented by sufficiency, reliability, relevancy, timeliness, understandability and comparability attributes as well.

The scope and practices of public company disclosures and reporting are determined by a wide range of factors. For instance, public company disclosures and reporting practices are closely related with the different corporate governance models and government regulations in countries. The distinctive factor in the two governance models; shareholder (outsider) model and stakeholder (insider) model, is the participation of related parties in public companies. To illustrate, in US and UK the main purpose of public company reports is to meet information needs of the shareholders. The high rate of small shareholder involvement in capital gave rise to acceptance of shareholder model also known as Anglo-American corporate

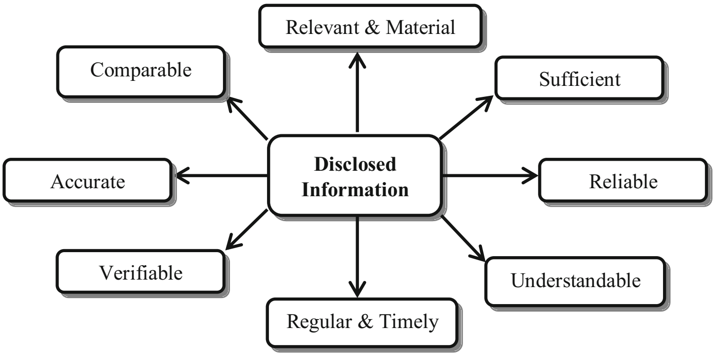

Fig. 7.2 The attributes scheme for disclosed information

governance model in these countries.[1] Meanwhile, in Continental Europe and Japan, stakeholder participation and dominance of institutional investors resulted in adaption of stakeholder model. Consequently the influence of powerful shareholders reduces transparency (Ooghe and Langhe 2002) and narrows the scope of reports. Some of the other factors determining the disclosure and reporting practices are; economic conditions, rules and regulations, the legal type of the company, the industry in which the company is operating.

Aguilera and Jackson (2003) explain variations of corporate governance models across the advanced capitalist economies with factors like ownership concentration, the structure of the financial system, inter-firm networks, labor, firm-level representation skills, union organization, skill formation, management and career patterns.

7.2.1 Financial Reports

Consideration of corporate governance principles and practices through perspective of Generally Accepted Accounting Principles (GAAP) provides a deeper insight to interest groups. Actually, corporate governance should not be thought separately from GAAP's. Especially social responsibility, substance over form and periodization principles along with the remaining ones are in full compliance with are thought to be drawing the conceptual framework of whole corporate governance philosophy. Among those principles, transparency and disclosure quality can be related to corporate governance system rather easily.

Actually, financial accounting information should be thought as a product of corporate accounting and external reporting systems that are both responsible from

[1] Besides US and UK; Canada, Australia and New Zealand accepted Anglo-American corporate governance model.

measuring and disclosing both financial and non-financial data which decision makers use and rely on for understanding financial position and performance of publicly held companies and making crucial decisions regarding their capitals. The simplest way of understanding the importance of accounting principles and financial accounting applications and systems is considering the fact that issues including investments, productivity and value-added by processes and operations are being monitored and recorded through accounting systems and therefore determine stock prices contain the information directly provided by financial accounting systems. (Bushman and Smith 2001)

The information disclosed in financial reports should have all the attributes presented in Fig. 7.2 to serve the needs of the users. Shareholders, potential investors, creditors and tax institutions use financial and operating results of public companies in their decisions. Thus, investors in financial markets lost substantial amount of funds due to the financial reporting deficiencies of corporations[2] in terms of accuracy, reliability, materiality, sufficiency and timeliness. Consequently, financial and annual reports may not be effective in reflecting significant aspects of public companies (Mallin 2005). Reports are outcomes; therefore the corporate system preparing the reports should be carefully designed.

The collapses bring forward the importance of accounting and auditing mechanisms for effective corporate government practices. In July 2002 U.S. congress enacted Sarbanes-Oxley Act[3] (SOX) with the main objective of protecting investors through public company accounting and auditing reform (Welsh 2002). The law is also known as Public Company Accounting Reform and Investor Protection Act, the short title of the bill as it was introduced in 2002. The official title of the bill summarizes the scope of the law (H.R. 5070 2002):

> To improve quality and transparency in financial reporting and independent audits and accounting services for public companies, to create a Public Company Accounting Oversight Board, to enhance the standard setting process for accounting practices, to strengthen the independence of firms that audit public companies, to increase corporate responsibility and the usefulness of corporate financial disclosure, to protect the objectivity and independence of securities analysts, to improve Securities and Exchange Commission resources and oversight, and for other purposes.

The mandates of SOX reveal the fact that accounting and auditing practices have a vital role in ensuring effective corporate governance and investor protection. There are no exceptions for foreign companies so SOX has a world-wide impact on securities exchange markets (UNCTAD 2003). The rules that stand out with SOX (2002) are:

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[2] Some of the known examples for company collapses (Mallin 2005) are: Enron (US/2001); WorldCom (US/2002), Royal Ahold (Dutch/2003), Parmalat (Italy/2006), HIH (Australia/2001), China Aviation Oil (China/2004).

[3] The full title is "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."

(i) PCAOB is established to monitor public company audits and to improve audit quality (S. 101).
(ii) Accounting firms are prohibited from providing a list of non-audit services (such as certain MAS-Management advisory services) to their audit clients to promote auditor independency (S. 201).
(iii) The signing officers, chief executive officer (CEO) and chief financial officer (CFO), are responsible from the fair presentation of the financial condition and the results in financial reports in terms of all material respects. Moreover the signing officers are responsible for internal controls and the deficiencies in internal control activities (S. 302).
(iv) The list of "Enhanced Financial Disclosures" under Title IV of the act are as follows:

- Disclosures about off balance sheet transactions and special purpose entities (S. 401).
- Enhanced conflict of interest provisions prohibiting personal loans to executives (S. 402).
- Disclosures of transactions involving management and principal stockholders (S. 403).
- Management assessment of internal controls (S. 404).
- Disclosing code of ethics for senior financial officers (S. 406).
- Disclosure of audit committee financial expert (S. 407).
- Enhanced review of periodic disclosures by issuers (S. 408).
- Real time issuer disclosures should be understandable and include material financial and operating aspects of the companies (S. 409).

The requirements of Sarbanes-Oxley Section 404 aim to improve the internal control systems of the companies which will result in high quality financial reports. Accordingly, poor internal control systems result in lower quality financial reports (Moehrle and Reynolds-Moehrle 2005). Nagy (2010) provides evidence that compliance with S404 reduces the possibility of issuing materially misstated financial reports.

According to Cohen et al. (2010), after SOX the corporate governance environment is more effective in terms of improved internal controls, active audit committees and internal auditors contributing to the quality of financial reporting. On the other hand, management is still dominant in the auditor selection and dismissal process. Evidence suggests that well supported corporate governance practices have a positive impact on the quality of financial reporting (Cohen et al. 2010) in terms of reductions in restatements (Abbott et al. 2004), lower levels of fraud (Beasley et al. 2000) and earnings management.

Another attempt to ensure financial reporting quality is to provide compliance with International Financial Reporting Standards (IFRS). IFRS contribute to resolving agency problem by setting the rules for disclosing capital allocation and performance monitoring (Brown 2011). IFRS foundation established in 2001 issued the first standard IFRS 1, through its standard setting body International Accounting Standards Board (IASB) in 2003. Since then almost in 120 countries the use of IFRS is permitted and promoted (IFRS 2013). The expected benefits of using IFRS in accounting disclosures are; improvements in transparency, comparability and quality of information with reduced preparation costs. Therefore countries are adapting IFRS to achieve lower cost of capital through increasing investor confidence in capital markets (Tarca 2012).

Corporate governance and IFRS adaption is interrelated. The adoption of IFRS has distinct economic effects (Daske et al. 2008) giving rise to varying results in the financial reporting quality in terms of disclosure and compliance (Verriest et al. 2013). Companies with strong governance mechanisms have better performance in accomplishing the disclosure and compliance requirements of IFRS (Verriest et al. 2013).

According to the research results released in UNCTAD Review (2011), 35 % of the companies used IFRS in financial reports, 38 % used national accounting standards whereas the application rate of US GAAP is 27 % among 83 countries. In 2001 the usage rate of IFRS was 1 %, national accounting standards was 65 % and US GAAP was 34 %.

While the application rate of IFRS grew considerably in the last decade, the arguments about the complexity of the standards also grew. Complexity is defined by FRC (2009) as "*anything that makes regulations or the reports themselves unnecessarily difficult to understand, implement or analyze*." According to FRC (2009) an increase in the amount of details may affect the relevance of disclosed information. As the details increase they may cover the main theme of the financial reports. Tsalavoutas, Evans and Smith (2010) found in their study 481 mandatory disclosure items required by 31 standards. The length of IFRS Disclosure Checklist issued by KPMG (2012) is 135 pages. As the standards get more complex users have difficulties in understanding the financial reports. One of the views emerged in the discussions held by IFAC (2011) to improve corporate governance is "*Users should carefully consider their requests for more disclosures, standard setters should limit their disclosure requirements and organizations should restrict the number and level of detailed disclosures in their mainstream financial reporting to the essentials and provide links to further disclosures elsewhere*". The key recommendations to enhance financial reporting quality include the following points (IFAC 2011):

- Direct cash flow statement essential to the analysis of the financial performance of an organization should be encouraged.
- Financial reporting standards should be simplified by standard setters.
- Financial reporting burden on smaller and non-listed entities should be limited.
- The use of fair value in financial reporting should be supported.
- Application of financial reporting standards should be more principles based.
- Global capital markets would be best served by one set of principles-based, high-quality financial reporting standards.
- Professional behavior and a minimum level of qualification should be required for preparers of financial information.

7.2.2 Annual Reports

Annual reports are used to disclose information about non-financial and distinctive features of the companies that will affect the decision making process of the users. Today's corporations develop strategies and allocate resources to be competitive in the complex business environments. Consequently the value of the competitive assets and strengths like human resources capital, market position, customer loyalty created by companies is increasing every day. Annual reports fulfill the need of presenting corporate information. Recently information regarding corporate structure, financial and operational results, issues about corporate governance, stakeholders, environment and sustainability, human resource policies, business overviews, management's discussion, competitive advantages, forward looking statements including risks, uncertainties, and assumptions, are revealed in annual reports. The annual report may also include the CSR and governance report then it is referred as integrated report (EC 2010)

The aim of annual reports is to communicate corporate issues to stakeholder groups and they are one of the most widely used reports by users.[4] Therefore, companies should determine the reporting content by engaging stakeholders and analyzing cost-benefit impacts while selecting the appropriate frameworks and standards for effective business reporting process (IFAC 2013). These reports should comprise all the characteristics featured in Fig. 7.1 for high quality disclosures. The content of annual reports may have some differences according to the type of the sector and country[5] in which companies operate.

In United States a significant number of companies use the official filing document Form 10-K for annual report purposes.[6] Some of the public Companies prefer to publish annual reports with images describing the business activities where they publish a summary of the Form 10K (Walmart 2012; Exxon Mobil 2012). In fact nearly all the annual reports have at least a few images about the companies. Additionally companies prepare separate documents for sustainability and corporate social responsibility issues (Walmart 2012[7]).

Due to the recent regulations and the expectations of the information users, the disclosure burden of the companies is increasing every day. As a result annual reports are getting longer in many companies. Annual reports of the US companies are shorter because they publish a summary of the SEC Filing Form 10-K. Some examples for the extent of annual reports in terms of total pages of are as follows:

[4] Fifty percent of the respondents in the study of ACCA (2012) stated that they rely on annual reports to asses company Performance.

[5] For instance in France the name of the document used for annual reporting is *Registration Document*.

[6] Some examples for annual reports issued in 2012 include Cabot Microelectronics, Petsmart, Magellan Petroleum Corp. and McCormick & Co. Inc. (http://www.annualreports.com, 2012).

[7] For instance Walmart prepares Global Responsibility Report and Exxon Mobil prepares Corporate Citizenship Report.

ENI (Italy) 2012 annual report	264 pages
Total (France) 2012 registration document	374 pages
Volkswagen (Germany) 2012 annual report	368 pages
Walmart (US) 2012 annual report	64 pages
Exxon Mobil (US) 2012 annual report	52 pages

The survey conducted by ACCA (2012) suggests that key risks and their management including mitigation, future plans and prospects, key performance indicators and financial results were the parts of annual reports which drew more attention after the post financial crises. Some of the criticisms were about the length and the publication frequency of the annual reports. Because financial reports provide historical information, it is suggested that if annual reports are issued on a quarterly basis they will serve the needs for forward looking information.

7.2.3 Securities Exchange Commission Filings

Public companies are subject to securities exchange commissions' rules regulating capital markets in their country. In Anglo-American corporate governance model companies should meet the information needs of shareholders. Therefore Securities Exchange Commission in countries like UK and US require quite a few mandatory company filings (forms). In this part mandatory filings required by Securities Exchange Commission (SEC) in US will be reviewed.

SEC requires both foreign and domestic companies to file quite a number of documents electronically through EDGAR System. EDGAR provides free access to more than 20 million filings. Web-based technology is used for submitting files. The system accepts ASCII, HTML or XML as primary documents while PDF and XBRL formats can be used as unofficial documents. XBRL is an interactive data format which is used for electronic exchange of business and financial information by investors and other users to analyze and compare data (SEC 2013).

The forms required by SEC can be grouped under categories like; 1933 Act Forms, 1934 Act-Forms, Small Business Forms, International Business Forms, Forms for Insiders, Investment Company Registration and Reporting etc. Among a number of mandatory forms; 3, 4, 5, 10-K, 10-Q, 8-K, DEF 14-A, are widely used by investors. The short explanations of the mentioned forms are as follows (http://www.sec.gov/):

Forms	Explanations
3	Initial statement of beneficial ownership of securities
4	Statement of changes in beneficial ownership of securities
5	Annual statement of changes in beneficial ownership of securities
8-K	Current report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934
10-K	Annual report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934
10-Q	General form of quarterly reports under Section 13 or (15) of the Securities Exchange Act of 1934
DEF	14-A Proxy Statement

The aim of forms 3, 4 and 5 are to give information about insider transactions. Domestic issuers submit annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. Companies provide material corporate events in Form 8-K to disclose significant information timely rather than waiting until the quarter report (10-Q) or annual report (Form 10-K) (SEC 2012). Material impairments, changes in control of registrant, unregistered sales of equity securities, bankruptcy or receivership are some examples of material events provided by Form 8-K.

Form 10-K, which is presented in Table 7.1, is the official version of annual report. Annual reports sometimes include colorful presentations to attract investors while form 10-K gives detailed information about the financial company's operational and financial results, the risks it faces and management's discussion. Additionally Section 404 of mandates management assessment of internal controls over financial reporting to be disclosed as a part of annual reports which shall:

(i) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
(ii) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

In Form 10-Q unaudited financial statements, legal proceedings, management discussion, analysis of financial condition and results of operations are reported on a quarterly basis. A public company issues Form 10-Q three times a year.

Proxy statements presented in Table 7.2 (DEF 14-A) provide information to the shareholders about proxy voting process. Issues like voting, corporate governance principles and board matters, director compensation and stock ownership guidelines and proposals to be voted on are revealed in proxy statements.

The new proxy disclosure enhancements released by SEC in US require new or revised disclosures for public company proxy and information statements, annual reports and registration statements (SEC 2009):

> Compensation policies and practices that present material risks to the company; stock and option awards of executives and directors; director and nominee qualifications and legal proceedings; board leadership structure; the board's role in risk oversight; and potential conflicts of interest of compensation consultants that advise companies and their boards of directors.

SEC filings and disclosure requirements have a wide international impact because world's largest capital markets operate in U.S. where a number of foreign companies are listed as well as domestic companies (UNCTAD 2003).

7.2.4 Corporate Social Responsibility (CSR) Reports

Companies disclose information about the environmental, social and economic aspects of their operations in CSR reports. Recently the European Commission

Table 7.1 Major parts of Form 10-K

Part I	**Part III**
1. Business	10. Directors, executive officers and corporate governance
1A. Risk factors	11. Executive compensation
1B. Unresolved staff comments	12. Security ownership of certain beneficial owners and management and related stockholder matters
2. Properties	13. Certain relationships and related transactions and director independence
3. Legal proceedings	14. Principal accounting fees and services
4. Mine safety disclosures	
Part II	**Part IV**
5. Market for registrant's common equity, related stockholder matters and issuer purchases of equity securities	15. Exhibits, financial statement schedules
6. Selected financial data	
7. Management's discussion and analysis of financial condition and results of operations	
7A. Quantitative and qualitative disclosures about market risk	
8. Financial statements and supplementary data	
9. Changes in and disagreements with accountants on accounting and financial disclosure	
9A. Controls and procedures	
9B. Other information	

Source: http://www.sec.gov/about/forms/form10-k.pdf

Table 7.2 Proxy statement

1. Date, time and place of information	13. Financial and other information
2. Revocability of proxy	14. Mergers, consolidations, acquisitions and similar matters
3. Dissenters right of appraisal	15. Acquisition or disposition of property
4. Persons making the solicitation	16. Restatement of accounts
5. Interest of certain persons in matters to be acted upon	17. Action with respect to reports
6. Voting securities and principal holders thereof	18. Matters not required to be submitted
7. Directors and executive officers	19. Amendment of charter, bylaws or other documents
8. Compensation of directors and executive officers	20. Other proposed action
9. Independent public accountants	21. Voting procedures
10. Compensation plans	22. Information required in investment company proxy statement
11. Authorization or issuance of securities otherwise than for exchange	23. Delivery of documents to security holders sharing an address
12. Modification or exchange of securities	24. Shareholder approval of executive compensation

Source: http://www.sec.gov/about/sched14a.pdf

(EC) defined CSR as (EC 2011) "*the responsibility of enterprises for their impacts on society*". The renewed EU strategy 2011–2014 for Corporate Social Responsibility summarizes the multidimensional nature of CSR in the light of the above principles and guidelines as follows (EC 2011): "*CSR at least covers human rights, labor and employment practices (such as training, diversity, gender equality and employee health and well-being), environmental issues (such as biodiversity, climate change, resource efficiency, life-cycle assessment and pollution prevention), and combating bribery and corruption. Community involvement and development, the integration of disabled persons, and consumer interests, including privacy, are also part of CSR agenda. The promotion of social and environmental responsibility through the supply chain, and the disclosure of non-financial information are recognized as important cross-cutting issues.*" In this respect companies should integrate their business operations with social, environmental, ethical, human rights and consumer concerns to maximize community wide value creation and minimize the possible adverse effects. Therefore, companies are expected to collaborate with stakeholders while determining their strategies.

Even though the content of the CSR reports may vary in different sectors some common disclosure issues expected by information users can be summarized as follows (EC 2010; KPMG 2008):

- Corporate governance (independent board members, remuneration policy, employee stock ownership, gender equality);
- Environment (carbon footprint, waste management);
- Work place safety (number of accidents);
- Supply chain.

The term CSR report is used interchangeably with sustainability report, corporate responsibility report, corporate citizenship report and environmental reports etc. The information in the CSR reports may be disclosed as a part of annual reports while a number of companies prefer to issue separate CSR reports. Globally, corporate reporting systems have a heterogeneous structure changing according to the countries, geographical continents and economic unions. Even companies in the same country have different corporate reporting systems. Some examples from public companies are given below to summarize the differences in corporate reporting systems.

Exxon Mobil (USA)	Company prepares a summary of Form 10K as an annual report. Corporate citizenship report is issued for sustainability matters
Walmart (USA)	Company prepares a summary of Form 10K as an annual report. Global responsibility report is issued for sustainability matters
ENI (Italy)	Integrated reporting system is used. Company issues a detailed annual report and consolidated sustainability statements while users can prepare their own reports according to their needs
Total (France)	

(continued)

	Company prepares a detailed annual report. Corporate social responsibility report prepared according to Global Reporting Initiative (GRI) standards is issued for sustainability matters
Volkswagen (Germany)	Company prepares a detailed annual report. A comprehensive group sustainability report is issued and certified in accordance with AA1000AS standard and also rated by GRI

The reliability of CSR reports increase if the company follows internationally accepted principles and guidelines. Particularly the following documents issued by international organizations provide a framework for companies (EC 2011):

- The OECD Guidelines for Multinational Enterprises,
- The ten principles of the United Nations Global Compact,
- The ISO 26000 Guidance Standard on Social Responsibility,
- The ILO Tri-partite Declaration of Principles Concerning Multinational Enterprises and Social Policy,
- The United Nations Guiding Principles on Business and Human Rights.

An increasing number of companies are releasing CSR reports, while the leading factors motivating companies for CSR vary in different years. The results of the study conducted by KPMG in 2008 revealed that 80 % of the world's largest 250 companies (Global Fortune 250/G250) issued CSR reports, jumping from 50 % in 2005. In 2011, it is found out by KPMG that 95 % of G250 released CSR reports.

What are the leading factors motivating companies to prepare voluntary CSR reports? To answer this question the comparative results, in relation with studies among G250 conducted by KPMG in 2008 and 2011, are given in Fig. 7.3. Interestingly in a 6 year time interval, dramatic changes can be observed in the main reasons of companies for issuing CSR reports. In 2005, the leading motivating factor was economic considerations (74 %) followed by ethical considerations (53 %) and innovation & learning (53 %). In 2011, the leading factor is reputation or brand (67 %), which had a rate of 27 % in 2005, followed by ethical considerations (58 %). Interestingly the rate of economic considerations has dropped to 32 %. There is a fruitful research area for scholars to find out the reasons behind the varying results in such a short time interval. The consistency in the rate of the ethical considerations, once again indicate the importance of ethics in business operations and corporate reporting.

CSR reports issued by public companies are heterogeneous in terms of their title, length, and content, thus a growing number of CSR reporting standards, principles and guidelines are developed by different organizations. The schemes related with sustainability reporting and assurances, given in Table 7.3, are classified into four major groups. The first group consists of schemes and guidelines from different areas of sustainability reporting followed by the second group comprising the assurance schemes for sustainability reporting. Schemes for financial reporting are clustered in the third group and finally schemes for environmental and social management and performance are presented in the fourth group. Recently

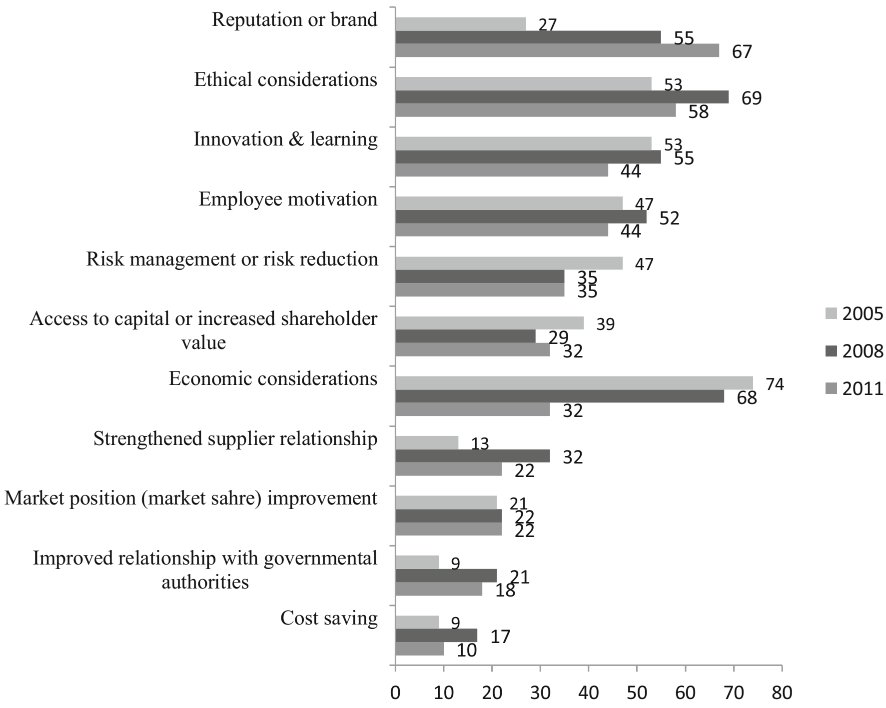

Fig. 7.3 Drivers to corporate responsible reporting (G250) (Sources: KPMG (2008, 2011))

assurance of CSR reports is getting more important for companies to increase credibility and accountability (EC 2010).

7.3 Corporate Inputs of Transparency and Disclosure

There are various factors within organizational control affecting transparency and disclosure practices. The most important determinant of transparency and disclosure within an organization is management's philosophy along with certain characteristics and practices of board of directors such as number of independent directors in the board, competencies of board members, remuneration of board members, number of board meetings and etc. Firms subject to Accounting and Auditing Enforcement Releases (AAERs) are usually the ones with weaker governance structure (Dechow et al. 1996). These types of companies mostly have more insiders in their boards. Therefore, insiders possess more stock and voting power compared to independent outsiders and CEO is selected mostly by the votes of insiders which lead to foundation of a less independent and therefore a weaker audit committee and other components of corporate governance systems

Another important factor affecting transparency and disclosure activities is composition and practices of audit committee. As the number of outsiders that

Table 7.3 Schemes and guidance for sustainability reporting and assurance

I. Schemes and guidance for sustainability reporting	II. Assurance schemes for sustainability reports	III. Schemes for financial reporting	IV. Schemes for environmental and social management and performance
1. A. Carbon Disclosure Project B. Water Disclosure Project	10. The AA1000 Assurance Standard (AA1000AS)	12. European Federation of Financial Analysts Societies Guidelines	15. AA10000 Standards
2. Connected Reporting Framework	11. International Standard for Assurance Engagement	13. International Financial Reporting Standards	16. Environmental Management and Audit Scheme
3. Energy Industry Sustainability Reporting Guidelines		14. World Intellectual Capital Initiative	17. GoodCorporation Standard
4. Forest Footprint Disclosure Project			18. GS Sustain
5. Global Reporting Initiative's (GRI) Sustainability Reporting Guidelines			19. International Chamber of Commerce Business Charter
6. Greenhouse Gas Protocol			20. ISO 14000
7. International Integrated Reporting Committee's (IIRC) Integrated Reporting Framework (Under development)			21. IFC's Policy and Performance Standards on Social and Environmental Responsibility
8. International Standards of Accounting and Reporting			22. ISO 26000
9. UN Global Compact Communication on Progress			23. London Benchmarking Group Model
			24. OECD Guidelines for Multinational Enterprises
			25. Principles for Responsible Investment
			26. SA8000 Standard
			27. UNEP Finance Initiative

Source: EC (2010)
Related websites are listed in Appendix

are independent members increase in audit committees so do their independence and therefore the reliability of work done and reports produced by them as well (Klein 2002). Owners' and shareholders' approach to internal audit function within the organizational hierarchy is crucially important in defining the duties, responsibilities and authorities of this committee which in return, determines the level of transparency and disclosure of financial information for both internal and external users. In addition to owners' and shareholders' approach, certain factors such as number of independent directors in audit committee, financial literacy and experience of audit committee members and number of meetings held by these committees are in direct relation with the quality of work performed by these committees including design and applications of internal control system and risk management systems and practices all of which directly and/or indirectly affects transparency and disclosure practices. Audit committee members should have knowledge in accounting, auditing, internal control and legal framework (DeZoort 1997, 1998).

Additionally, factors like skills, experience of CEO, CFO and other executives as well as remuneration policies and incentive contracts regarding them have an effect on transparency and disclosure practices along with corporate governance code and code of ethics. A negative association between independence and activity level of the audit committee and occurrence of restatement can be found in almost every case. Also, a negative association between financial expertise of audit committee members and restatements can be easily seen in most cases as well (Abott et al. 2004). Moreover, the interactions between all these group of factors mentioned above determine the level transparency and disclosure quality.

7.4 Board of Directors

In Cheng and Courtenay's study (2006) examining the association between board monitoring and the level of voluntary disclosure the relationship between having independent members in board and level of transparency and disclosure is very clear. The results of the study indicate that the level of voluntary disclosure is higher in firms where the board is composed of mostly independent members. Also, factors such as board size and CEO duality are investigated in order to see whether there is any relation to transparency and disclosure quality and it is found out that neither of these factors have any significant impact on the matter as much as having independent members in the board does. Beasley's study conducted in 1996 had also similar findings. In terms of analyzing a more proper form of corporate governance practice from the perspective of transparency and disclosure principles the study conducted by Beasley in 1996 displays supporting results in favor of having independent members in boards. His study presents findings suggesting that the proportion of outside members on the board of director is lower for firms experiencing financial statement fraud compared to no-fraud firms. Independent members put more emphasis on transparency and full disclosure practices in order to prevent fraudulent activities since concealment of any kind of activity will diminish as transparency and disclosure principles are exercised more.

The researches and studies investigated slightly different aspects of independency of board's impact on various issues such as earnings management, asset expropriation, protecting interest of shareholders and etc. all of which is a matter of transparency and full disclosure of both financial and non-financial data about an organization. It is possible to interpret the bottom line in all these studies as the increase in proportion of independent external members in boards tend to increase the degree of transparency and disclosure while decreasing negative practices and outcomes experienced in companies where boards are dominated with executives of the same company. However, it is worthy to mention that only having independent board members is not sufficient to increase the degree and quality of disclosures. Board members need to be experienced in related fields in order to perform their duties properly and disclose the required data in the proper form on a timely manner. The board members experienced and knowledgeable in the fields of financial and managerial accounting principles and applications, familiar with tools and techniques of financial statement analysis as well as quantitative analysis along with EDP and ERP systems and other managerial skills and experiences are crucially important in today's highly demanding financial and economic systems. Finally, supporting duties, activities and responsibilities of board members by an independent and competent audit committee is a must for proper application of corporate governance.

7.4.1 Audit Committee

The role of the audit committee in promoting the level of transparency along with quality of disclosure while mitigating the likelihood of fraud is investigated by various researchers. In these researches the findings might differ. However, when they are analyzed, it can be clearly seen that the real reason for mitigating fraud or fraudulent activity is not the presence of an audit committee solely. The matter is rather related to the composition and activity level of the audit committee. Audit committee meetings play a key role in configuring meanings of effectiveness (Gendron and Bedard 2006) and there is no doubt that audit committees are crucially important in providing a useful oversight mechanism for financial reporting process and accurate financial data (Wild 1996).

The audit committees composed of mostly independent directors and having regular meetings more frequently seem to have a positive impact on decreasing the level of fraudulent activities and thought to be promoting the degree of transparency and quality of disclosures. Higher quality audit committees in terms of independence and knowledge are associated with stronger boards (Beasley and Salterio 2001). It should also be noted that audit committee activity is reduced in firms where chairman position is held by CEO's and insiders are more involved in these committees (Collier and Gregory 2000). Abbott extended prior researches in this area and added an extra measure to his research for investigating audit committee independence and activity level. It is found that firms with audit committees which are composed of independent directors and which meet more regularly are experiencing lesser fraudulent activities and misleading reporting (Abbott et al. 2000).

As it was mentioned before, one of the most important GAAP is full disclosure within a social responsibility concept. Setting up an internal control system and information flow structure as well as monitoring and ensuring proper applications of these systems are among the major responsibilities of audit committees. These are the systems that produce reliable, sufficient, timely, accurate and relevant information for both internal and external users. The real intention of the committee is protecting the rights of owners and shareholders while safeguarding companies' assets through optimum practices of corporate governance philosophy. While this ideal is strived for, the musts of proper corporate governance for diminishing information asymmetry and cases of misrepresentations, that are, transparency and full disclosure principles need to be greatly emphasized.

The philosophy of corporate governance in broader sense aims to benefit the society in every possible way one of which is to enable everyone having access to accurate, reliable, sufficient information for their decisions on a timely manner. The compositions of audit committees that are one of the most important components of corporate governance systems are crucially important in proper applications that will benefit both the companies and environments surrounding them. Therefore, the features of these committees need to be carefully considered in order to enable them serve the purpose expected from them.

The most important factor ensuring proper performance of audit committee is the importance devoted to them by owners and shareholders. The board of directors representing owners and shareholders must totally understand the necessity of internal audit function and audit committee and believe in benefits derived from properly functioning internal audit process in corporate governance. The role of audit committee in organizational hierarchy is extremely important. Its role in organizational chart is also an indicator of the emphasis given by board of directors. The audit committee should be placed in a way that it should report to board only. The audit committee needs to be free from any pressure from management and managerial functions in order to function at optimum level in analyzing, inspecting controlling the work and performance of the management and produce reliable, accurate, sufficient information on a timely manner. In an organization where internal audit function and audit committee is not separated from managerial groups and activities it will be almost impossible to expect proper compliance with transparency and disclosure principles.

In most of the studies and researches conducted to understand the dynamics of audit committees, certain attributes such as number of independent members and experience and skills of the members in the audit committee seem to be the most important factors for these committees serve their purposes. The audit committees composed of mostly independent members favor the "substance over form" approach as they should be. Therefore, in recent years there are more supporters of the idea that audit committees need to be composed of independent auditors only. Moreover, audit experience and financial literacy are crucially important for audit committee members to perform their duties optimally. The results of the study provides solid basis for justification of the opinion that varying knowledge levels cause systematic differences among audit committee member judgments and lowers the amount and quality of the information disclosed (Dezoort and Salterio 2001). Transparency and disclosure concepts are highly crucial and sensitive as well. The type and content of information presented as well as sequence of data and format of reports presenting this information should be decided and designed properly. These types of functions need to be performed by experts very knowledgeable in the related field of internal audit, risk management, financial reporting, internal control structure and systems as well as GAAP's in order to protect the company from legal suits and provide information for both internal and external users while safeguarding assets of organization and protecting rights of owners and shareholders.

7.4.2 Board, Audit Committee and External Auditing

At this point it is worthy to note that there is a very interesting relation between the characteristics of board of directors and audit committee composition. In the study conducted by Beasley and Salterio in 2001, it is found that the boards composed of mainly independent members tend to include more independent members for audit committee as well. This type of staffing decision affect the ability of the audit committee to monitor management's financial reporting process on behalf of the board. The same study conducted among Canadian firms show that firms that have more independent members in their boards tend to voluntarily include more outside directors on their audit committees than the mandated minimum level and these independent board members prefer to segregate the board chairperson position from the CEO/president positions. Also, boards of directors that are composed of more independent outside members and that are chaired by independent members instead of CEO's or presidents of the companies have tendency of forming audit committees composed of independent members with financial reporting and audit committee knowledge and experience (Beasley and Salterio 2001).

The benefits to be derived from a properly formed audit committee are also very clear in the area of external auditing which is an indispensable component of corporate governance in broader sense. The audit committees are responsible from selection of external auditors. Also, audit committee members are required to be in very close contacts with financial auditors. Therefore, audit committee members fully understanding the framework and disclosure requirements of external financial auditing are able to prepare the reports and data that are more suitable to this process and its requirements.

7.5 Conclusion

This study provides an analytic framework for public company disclosures by classifying company reports and discussing current reporting issues in relation with the attributes scheme for disclosed information. To summarize, there are some differences in public company reporting practices in different countries due to the corporate governance models and government regulations. In contrast with reporting differences, similar problems are experienced in general. One of the key matters is the length, variety and complexity of company reports causing understandability problems for users. As a result the regulators and practitioners should be "*Aiming for better rather than more disclosure, and disclosure that is adapted to the circumstances of the company*" (Report Leadership 2011). Another concern is the standardization of the reports and the reporting processes. For instance, financial reporting covered a distance with the widespread acceptance of IFRS whereas there are various reporting standards and guidelines for CSR reporting. In US, SEC filings set a model for a common report format. To illustrate, most of the public companies use form 10-K for their annual report presentations. Finally assurance of the company reports remains significant for sustainable governance practices.

Globalization of business practices, recent economic crisis caused by information asymmetry as well as audit scandals increased demand for accurate, timely, related, reliable and comparable financial and non-financial information about especially publicly traded companies. As a must of providing information for decision makers, transparency and full disclosure principles strongly emphasized by both GAAP and IFRS have gained greater attention and importance. Three most important determinants for enforcing proper applications of transparency and full disclosure are thought to be board committee, audit committee and external auditing functions and the most important factor ensuring proper functioning of these three determinants is independence. In other words, boards composed of more independent members meet more regularly and consider dynamics of the businesses more objectively. Also, independent boards tend to form audit committees by employing more independent members as well.

The placement of audit committees and the reporting system seem to be more proper in the organizational hierarchy as more independent board members get involved in selection and formation of these committees. Other factors, such as experience and knowledge level of board members and audit committee members are extremely important for these units to perform their duties properly. However, having experienced and knowledgeable board members and/or audit committee members are questionable unless they are independent as well.

External audit function is also an important element in producing and publishing financial reports prepared according to full disclosure principles, since the audit standards, especially the reporting ones, strongly emphasize the importance of full disclosure of every material fact, even the ones that occur after balance sheet date. As Arens and Loebecke (1999) states, in an environment where remoteness of information, voluminous data, complexity of transactions and biases and motives of providers of information are considered, the importance of an independent assurance service, that is, external audit performed by fully competent and independent experts can be understood more clearly.

Appendix: Related Websites for Table 7.3[8]

1. A. Carbon Disclosure Project: https://www.cdproject.net/en-US/Pages/HomePage.aspx
   B. Water Disclosure Project: https://www.cdproject.net/water-disclosure
2. Connected Reporting Framework: http://www.sustainabilityatwork.org.uk/strategy/report/0
3. Energy Industry Sustainability Reporting Guidelines: http://www.ipieca.org/topic/climatechange/measuring-and-reporting
4. Forest Footprint Disclosure Project: http://www.forestdisclosure.com/
5. Global Reporting Initiative's Sustainability Reporting Guidelines: http://www.globalreporting.org
6. Greenhouse Gas Protocol: http://www.ghgprotocol.org/and http://www.ghgprotocol.org/sixtycorporations-begin-measuring-emissions-from-products-and- supply-chains
7. International Integrated Reporting Committee's (IIRC) Integrated Reporting Framework (Under development): www.integratedreporting.org
8. International Standards of Accounting and Reporting: http://www.unctad.org/Templates/StartPage.asp?intItemID=2531&lang=1
9. UN Global Compact Communication on Progress: http://www.unglobalcompact.org/cop/index.html
10. The AA1000 Assurance Standard (AA1000AS): http://www.accountability.org/aa1000series
11. International Standard for Assurance Engagement: http://www.accountability.org/uploadedFiles/Issues/ISAE_3000.pdf
12. European Federation of Financial Analysts Societies Guidelines: http://effas.net/
13. International Financial Reporting Standards: http://www.unctad.org/Templates/Startpage.asp?intItemID = 2531
14. World Intellectual Capital Initiative: http://www.worldici.com/index.php
15. AA1000 Standards: http://www.accountability.org/aa1000series
16. Environmental Management and Audit Scheme: http://ec.europa.eu/environment/emas/about/summary_en.htm
17. GoodCorporation Standard: http://www.goodcorporation.com/

[8] Source: EC (2010) http://ec.europa.eu/social/main.jsp?langId=en&catId=89&newsId=1013&furtherNews=yes

18. GS SUSTAIN: http://www2.goldmansachs.com/ideas/environment-and-energy/goldmansachs/gs-sustain/index.html
19. International Chamber of Commerce Business Charter: http://www.iccadr.com/
20. IFC's Policy and Performance Standards on Social and Environmental Sustainability: http://www.ifc.org/ifcext/enviro.nsf/Content/PerformanceStandards
21. ISO 14000: http://www.iso.org/iso/iso_catalogue/management_standards/iso_9000_iso_14000/iso_14000_essentials.htm
22. ISO 26000: http://www.iso.org/iso/catalogue_detail?csnumber = 42546
23. London Benchmarking Group Model: http://www.csisolutions.co.za/lbg-model.php
24. OECD Guidelines for Multinational Enterprises: www.oecd.org/daf/investment/guidelines
25. Principles for Responsible Investment: http://www.unpri.org/
26. SA8000 Standard: http://www.sa-intl.org
27. UNEP Finance Initiative: http://www.unepfi.org/

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Part II
Corporate Governance in Africa

Egypt
Tanzania
Nigeria

Chapter 8
Corporate Governance Reform in Egypt: Achievements and Challenges Ahead

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Abstract In the recent years, Egypt has committed itself to reform corporate governance, this was urged to increase investors' confidence in the Egyptian business environment and accordingly attract more foreign investment. So far many developments have taken place regarding corporate governance reform but still many challenges do exist. This paper offers an analytical account of evolution of corporate governance in Egypt, and identifies the main deriving forces of this reform and the challenges ahead. Overall, this paper contributes to literature on international corporate governance, and offers policy makers the understanding that can better guide corporate governance reform in the future.

8.1 Introduction

Reform refers to "attempts at generating agreement between the way things ought to be and the way they are -between ideals and practice" (Brunsson 2009, p. 1). From this perspective corporate governance reform can refer to the attempts undertaken by possibly a state or a private corporation to change corporate governance practices towards ideals. In fact the world has witnessed a wave of corporate governance reforms during the last two decades, obviously these reforms were responses to big corporations' scandals related to weak corporate governance such as Maxwell corporations, Barings bank, Enron and WorldCom (2003). As such corporate governance reforms were initiated to avoid the recurrence of such detrimental scandals. For instance the USA passed the Sarbanas-Oxly (SOX) act in 2002 after Enron Scandal. While, the UK as a pioneer country in corporate governance reform has started earlier in 1992 by issuing the Cadbury report after the Maxwell case had become an issue of public concern (Solomon 2007).

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_8,

More recently, the global financial crisis 2007 introduced a new – maybe-stronger wave of corporate governance reforms worldwide as a response to weak corporate governance practices within financial institutions including inappropriate risk management, reckless boards and abnormal management compensation. Indeed, this necessitated putting corporate governance of financial institutions under scrutiny to avoid the recurrence of such scandals in the future (Frederick and Scheherazade 2011; Kirkpatrick 2009; De Larosière et al. 2009). Notably, as abovementioned it is the fear of business failures that drives corporate governance reform. But having good corporate governance can also be sought as a main objective of corporate governance reforms at the country level. Being an essential factor to attract foreign direct investment, as it is widely considered as the best safeguard against the sort of business failures cited above (Vinten 1998). So if a country lacks the reputation for strong corporate governance practices, investors will be reluctant to invest in this country (Levitte 1999; Judge 2007).

Obviously, the abovementioned business failures and subsequent reforms represent the experience of developed countries such as UK and USA. However, developing countries may have additional reasons to reform their corporate governance systems. According to Reed (2002) reasons for corporate governance reform in developing countries include: (1) provide legitimacy for governments towards the public when undertaking liberalizing policies and privatization to "developing more effective corporate structure that will generate the conditions for growth and development" (p. 229). (2) As developing countries may have poor economic performance and consequently have debt negotiation problems with international donating organizations such as the International Monterey fund (IMF) and the World bank, they become obliged to undertake structural adjustment programs to liberalize their economies, with corporate governance issues a main element of such programs (ibid.). Overall, it thus can be argued that globalization forces put forth an escalating pressure on developing countries to reform their corporate governance systems (Rabelo and Vasconcelos 2002). Thus it was unsurprising that a global investors' survey shown that investors are willing to pay a premium for companies that exhibit high corporate governance standards, this premium reached 39 % in the case of Egypt (Mckinsey and Company 2002). In conclusion, corporate governance reform in developing countries can help to achieve government's legitimacy towards the public and international donating organizations (Reed 2002) and above all avoid the type of corporate scandals abovementioned. In addition to a range of benefits such as "High and sustainable rates of growth, increases confidence in the national economy, and deeper capital market and increases its ability to mobilize savings . . . encourages growth of private sector by supporting its competitive capabilities, helping to secure financing for projects" (Dahawy 2009, p. 2).

Egypt is no exception, where corporate governance reform has been sought as a priority for policy makers within a wider structural reform agenda for "gaining trust of international community and FDI" (Dahawy 2009, p. 3). Meantime, avoidance of corporate scandals such as Al-Rayan group (CIPE n.d.) as well as bank failures during the late 1990s and early 2000s related to weak corporate governance (Sorour et al. 2012) emphasized the need to corporate governance reform.

Over the last decade many developments have taken place regarding corporate governance reform in Egypt, but still many challenges do exist. This paper offers an analytical account of evolution of corporate governance in Egypt, and identifies the main deriving forces of this reform and the challenges ahead. Overall, this paper contributes to literature on international corporate governance with reference to Egypt, and offers policy makers the understanding that can better guide corporate governance reforms in the future. This is undertaken through reviewing the relevant literature and conducting three semi- structured interviews with Egyptian corporate governance experts (interview questions are shown in Appendix). These interviews have given the study more precision in addition to offering useful insights in relation to understanding the reform process and the challenges facing corporate governance in Egypt.

8.2 Evolution of Corporate Governance Reform in Egypt

The lack of awareness regarding the corporate governance concept has been a major obstacle in front of reforms in the Middle East where there was no equivalent term in local languages (ibid). In fact it was only recently when the term "Hawkamat Al-Sharikat" came to existence. Indeed, this is the Arabic translation of corporate governance. This translation has appeared during the early 2000, although there was a dispute around the proper Arabic translation of corporate governance, the term Hawkamat Al-Sharikat was widely accepted "following its endorsement by Al-Azhar university in Cairo, a renowned authority on the Arabic language" (World Bank 2010) [online].

Consequently, reform efforts had been directed towards increasing the corporate governance awareness amongst the business community as a first step towards reforming corporate governance. This paper identifies four mechanisms through which corporate governance reform have taken place: assessment and policy recommendations by international organizations, establishment of the Egyptian institute of directors (EIOD), arising corporate governance requirements through new legal and regulatory reforms and the emerging emphasis of the Egyptian banking sector on corporate governance. In the following sections the role of each of these mechanisms is discussed in the light of semi-structured interviews. Then the paper concludes with the challenges ahead of corporate governance reform in Egypt and how these challenges can be faced.

8.2.1 *The Role of International Organizations in Corporate Governance Reform*

International organizations namely the World Bank and the International Monetary Fund (IMF) have contributed effectively in corporate governance reform in Egypt. This has taken place through their co-operation with the Egyptian government in what is known as report on the observance of standards and codes (ROSC). Egypt's corporate governance has gone through the ROSC process three times in 2001, 2004 and 2009.

ROSC (2001) has assessed corporate governance practices amongst listed companies in Egypt against the organization for Economic Co-operation and Development (OECD) principles of corporate governance and addressed a number of policy recommendations to minimize the gap between the corporate governance practices of Egyptian listed companies and the OECD principles. It focused on enhancing disclosure of ownership and control structures, disclosure of financial and non-financial information, improving corporate governance training and capacity building for regulators and private sector, enhancing the effectiveness of shareholders, improving boards of directors' role in corporate governance and introduction of a formal system to scrutinize auditors' work (ROSC 2001). In fact, Egypt had moved forward to achieve such improvements and the subsequent ROSC (2004) has documented that tangible improvements have taken place in relation to corporate governance. Notably, the new listing rules that came into effect in 2002 have paid more attention to disclosure and corporate governance requirements for listed companies; this has led to a wave of de-listings to take place, squeezing out of the stock market 99 companies due to their non-compliance with the stock market listing rules (ibid).

During the same period (2001–2004) reforms were introduced to the company law and the accounting and auditing standards (ibid). Meantime the ROSC (2004) has documented an increase in corporate governance awareness not only because of reform efforts but also due to the number of bank failures at the time, especially that behind these failures were weak corporate governance practices (discussed in more details in the role of banking sector governance section). Indeed, this agrees with corporate governance reforms in other countries, which were initiated post business failures. Finally, ROSC (2004) set out a number of further reforms focusing on three initiatives: the legislative reform initiative which emphasized on upgrading the accounting and auditing laws; the enforcement initiative related to continuing the enforcement of disclosure rules by the Capital Market Authority (CMA) and Cairo and Alexandria Stock Exchange (CASE) as the regulators of the stock market at that time. This necessitated enhancing the corporate governance awareness among the staff of CMA and CASE. Finally is the private sector initiative which documented that regulative reforms of corporate governance are moving much faster than the business culture, as such special attention should be given to the establishing a centre for directors that can produce a voluntary code of corporate governance as well as quickly "create a director training capability" (ibid., p. 15).

The recommendation was to issue a corporate governance code on a "comply or explain" basis then with time certain key provisions can be moved into law. Obviously, immediate action have taken place to establish the EIOD in 2003 (Dahawy 2009) during drafting the ROSC (2004). The EIOD was a milestone towards reforming corporate governance in Egypt, as it was the first institute focusing on corporate governance in the region (EIOD 2012) [Online]. Indeed, EIOD[1] collaborates with many leading international organizations providing reform assistance in the field of corporate governance such as the OECD, the World Bank Institute and IFC (ibid) [Online].

Another key initiative in the reform process was the ROSC (2009). This was the third corporate governance practices assessment exercise amongst listed companies. It has acknowledged the progress of corporate governance reform process in terms of establishing the EIOD, issuance of corporate governance codes and a number of corporate governance measures taken by the CMA namely enacting tighter insider trading rules, strengthening disclosure rules, requiring listed companies to form an audit committee (ROSC 2009).

Additionally, ROSC (2009) determined additional reform initiatives including: modernization of accounting and auditing standards according to the international benchmarks, obviously, as this requirement was raised earlier by ROSC (2004), it seems that more effort was still necessary. Additionally, the CMA created a specialized corporate governance department in the stock exchange to enforce the listing rules (ibid.). Notably this bundle of measures had led to a second wave of de-listings that decreased the number of listed companies from 1148 in 2002 to 333 in 2009, a decrease of 71 % (ibid.). However, a crucial aspect documented by (ROSC) 2009 is that listed companies are mostly complying by appearance, in other words listed companies especially those outside the largest 30 companies so called EGX-30 disguise their non-compliance to achieve legitimacy and avoid penalties by the CMA. Corporate governance experts have also confirmed this during the interviews stating *"A main issue and a challenge at the same time is that companies are adopting corporate governance requirements to achieve legitimacy in the eyes of authorities" (corporate governance expert).*

This report raised the need for further reforms to implement the corporate governance code on "a comply – or – explain" basis, review corporate governance code of 2005; reform the company law; support the EIOD to achieve its role in directors capacity building (ibid.).

[1] The EIOD was established as an affiliate of the ministry of foreign trade, in 2003 its affiliation has changed to the ministry of investment and finally in 2011 it has changed once again to work under direct supervision of the Egyptian Financial supervision authority chairman.

8.2.2 The Role of the EIOD in Corporate Governance Reform

The EIOD focuses on raising corporate governance awareness, offering corporate governance training, undertake corporate governance consultancy and publishing corporate governance related reports (ibid.). Establishing the EIOD was an important step in corporate governance reform in Egypt especially that it had been assigned the drawing up of corporate governance codes (BCDS 2010). The EIOD has issued the first voluntary Egyptian code of corporate governance in 2005.[2] Adoption of the code provisions by corporations was not a legal requirement (ECOCG 2005).

This code has targeted companies listed on the stock exchange, joint stock companies and financial institutions even if not listed on the stock exchange (ibid.). However, the code has encouraged other forms of companies to consider its adoption especially if these companies plan going public in the future (ibid.). The focus of the code was on listed companies as they are considered a driving force for improving corporate governance in Egypt (BCDS 2010). Similarly, financial institutions were addressed by the code for the same reason as they have a wide base of clients who can be asked to adopt corporate governance requirements while doing business with financial institutions (ECOCG 2005). This can be justified as listed companies only represent no more than 2.5 % of Egyptian joint stock companies (ibid.). In addition to the fact that banks provide about 90 % of financing needs of business community (El-Said 2009). However, financial institutions cannot ask others for adoption of the code provisions unless they are good models themselves.

To summarize, this code meant to promote "responsible and transparent behavior in managing corporations according to international best practices and means that strike equilibrium between various party interests" (Dahawy 2009, p. 7). Another achievement of the EIOD is issuing the code of corporate governance for state owned companies in 2006.

This code was also issued on voluntary basis and acts as a guideline for good practices of corporate governance in state owned corporations (SOCs) (ECOCGSO 2006). The code was issued as good corporate governance was seen an essential factor that help SOCs to achieve their social and economic objectives (ibid.). Though the code had a voluntary nature SOCs were encouraged to adopt its principles. However, as the concept was totally new to the business environment and requires raising awareness SOCs were tempted to show compliance to even some of the code provisions in order to achieve legitimacy given that the ministry of

[2] This code was written by the chairman of the general authority for investment and free zones (GAFI) in cooperation with the chairman of Cairo and Alexandria stock exchanges. However, it was decided to submit the code to the EIOD for adoption and promotion amongst the business community (ECOCG 2005).

investment which manage the SOC took also the leadership to promote the corporate governance concept (Chairman of SOC).

With the ROSC (2009) recommendations the EIOD has reviewed the corporate governance code issued earlier in 2005; the new updated code was issued in March 2011. The new code was issued as a guideline on corporate governance practices, however, the code expects that companies should either comply with the code or explain their non-compliance. It also required that companies should disclose their compliance on their respective websites and annual reports (ECOCG 2011). However, still companies including those listed are not enforced to comply or explain rather encouraged to comply or explain (Corporate Governance Expert).

8.2.3 The Role of Legal and Regulatory Reforms

Corporate governance reforms "requires a legal, regulatory and institutional foundation that all market participants can rely upon" (BCDS 2010, p. 13). Indeed, the last decade has witnessed many improvements in this respect. Regarding the legal framework of corporate governance in Egypt it is underpinned by two legislations: the capital market law of 1992 and its executive regulations in addition to companies' law 159 and its executive regulations (ROSC 2009; BCDS 2010). From a corporate governance perspective these laws have been amended in many occasions to provide better legal institution underpinning corporate governance (ibid.). Legal reform introduced included updating the capital market listing rules requiring the existence of a board level audit committee, added disclosure requirements, enhanced the capital market law to fight insider dealing, and changed the company law 159 to stop the requirement that directors have to hold guarantee shares (ROSC 2009). However, still the legal framework of corporate governance requires further reforms to provide a proper framework that promotes good corporate governance (ibid.). Obviously the Egyptian government although committed to corporate governance reform, stringent corporate governance was avoided (ibid.) rather gradual introduction of related rules was the preferred course of action. Possibly the justification can be the fear of the negative consequences of sudden radical changes, as the introduction of new listing rules brought about two waves of delisting that reduced the number of listed companies by about 71 % in 2009 compared to 2002. Meantime, according to participants one major issue regarding the legal foundation of corporate governance in Egypt is that corporate governance regulations are scattered amongst various laws governing companies in Egypt *"In fact the corporate governance regulations are scattered, as each type of companies are governed according to a particular law, i mean that not all companies are regulated by one universal law" (corporate governance expert).* Here the participant was raising an important issue in relation to the possible conflict or at least the lack of harmonization between laws governing different types of companies. Indeed, this is another challenge facing corporate governance reform in Egypt.

However, the ROSC (2009) has already identified this challenge and the government *"committed itself to pursue a uniform company law, a new draft of which has already been prepared, with a view towards consolidating the many company law provisions that are scattered across a wide variety of laws, regulations, and decrees, into one principle document" (ibid., p. 24),* still this objectives are pending.

On the regulatory reform, prior to mid 2009 the CMA and the Egyptian Stock Exchange in particular were responsible for "developing, regulating, and enforcing the capital markets" (ROSC 2009, p. 7). However, in 2009 a major reform to coordinate the supervisory responsibilities on listed companies has taken place, when the Egyptian Financial supervisory authority (EFSA) has been created by Law 10/2009 (BCDS 2010). It superseded the "Egyptian Stock Exchange, the capital markets authority, MISR for Central Clearing, Depositary and Registry" (ibid., p. 15). Today EFSA is the single non-banking regulator who took the leadership for promoting corporate governance reform agenda, essentially, independence and objectivity will be key measures for the success of EFSA in corporate governance reform.

It must be noted that accounting and auditing professions have been subject to reform during the last decade; indeed, accounting and auditing are a pre-requisite for transparency and disclosure. In 2006 the CMA has created an auditors' registry by which only registered auditors are allowed to audit listed firms (Dahawy 2009). Moreover, in 2007 a code of ethics for auditors was issued to address important issues including: "independence, objectivity, competence, secrecy, and professional conduct" (ibid., p. 6). Meantime in 2006 a new set of Egyptian accounting standards was issued and although these standards are in harmony with the International Accounting Standards (IAS), few discrepancies exist (BCDS 2010). However, authorities are trying to bring them in line with (IAS) (ibid.). Obviously, more effort should be devoted to this issue as despite these reforms that took place, still ROSC (2009) urged the authorities to modernize accounting and auditing standards. Moreover although the reform initiatives addressing the issue of disclosure, recent research shows that disclosure and especially corporate governance related remains a challenge (BCDS 2010). Especially that many non-financial disclosure requirements are lacking such as corporate governance structures and policies, executive remuneration and the management discussion and analysis section in annual reports (ibid.). Table 8.1 summarizes the key developments in corporate governance reform that took place during the last decade in a chronological order.

8.2.4 The Role of the Banking Sector

The Egyptian codes of corporate governance (2005, 2011) has assigned the Egyptian banking sector a major role in promotion of corporate governance amongst the business sector. Indeed, this cannot be achieved but only if corporate governance practices of the banking sector itself is in-line with good corporate governance practices as outlined by for instance in the Basel committee guidelines on enhancing good corporate governance in banking organizations (BCBS 2005, 2010). As

Table 8.1 Key developments in Egyptian corporate governance reform during (2000–2011).

Year	
2000	Appearance & acceptance of an Arabic equivalent term of corporate governance "Hawkamt Al-Sharikat"
2001	ROSC (2001) assessed the corporate governance practices of companies listed in the Egyptian stock exchange compared with the OECD corporate governance principles. This report set priorities for corporate governance reform including (disclosure, training and capacity building of regulators and private sector, board of directors' practices, external auditors' role)
2002	Introduction of the new listing rules to the stock market, which paid more attention to disclosure and corporate governance related requirements for listed companies
	A wave of de-listing has taken place as a response to new rules, this wave squeezed out 99 companies
2003	Establishing the Egyptian Institute of Directors (EIOD) it must be noted that this development took place while the ROSC (2004) was being drafted
2004	ROSC (2004) documented corporate governance awareness increase as a result of bank failures. It came-up with many policy recommendations such as building a centre of directors (this was already implemented), developing a code of corporate governance, enforcement of new listing rules and carrying-out a legislative reform to bring the policy framework into compliance with the OECD
2005	Issuance of the first code of corporate governance
	Compliance with the code provisions was voluntary
	It addressed listed companies, financial institutions and other joint stock companies that may decide to go public in the future
2006	Issue new set of Egyptian Accounting Standards in Harmony with IAS
	EIOD Issuance of second voluntary code of corporate governance for state owned companies
2007	Issuance of the code of ethics for auditors
2009	ROSC (2009) documented a number of changes to legal and regulatory framework most importantly: tighten insider trading related provisions, strengthen disclosure rules, require companies board-level auditing committee, modernize the accounting and auditing framework
	Capital Market Authority created special corporate governance department
	Establishing a single non-banking supervision authority the Egyptian Financial Supervisory authority (EFSA) by law 10/2009 that supersedes the Egyptian stock exchange, capital market authority, MISR for central clearing, depository and registry
2010	Issuance of MENA- OECD business climate development strategy report addressing corporate governance in Egypt
2011	EIOD Issuance of the second version of the corporate governance code but on a voluntary comply-or-explain basis

Source: Prepared by the researcher

such, improving bank governance in Egypt would have far reaching advantages beyond the banking sector (Sorour et al. 2012). Essentially, this provides a practical approach to the improvement of corporate governance in the Egyptian business environment, especially that most of the companies in Egypt are family owned and not listed on the stock exchange. Consequently, because banks are the principal source of funds for most of these corporations banks can insist on good corporate governance from their side and such can only be realizable if banks themselves are good models of good corporate governance. A recent study by Sorour (2011) has indicated that bank governance reform in Egypt is a continuously evolving process, where banks adopt corporate governance principles to achieve legitimacy from the Central Bank of Egypt (CBE) and shareholders. However, the study has indicated that some banks really comply with corporate governance requirements, still other banks disguise their non-compliance to maintain their legitimacy. This is very similar to the argument made earlier in this paper regarding listed companies that follow the same approach. This is unsurprising as almost 17 banks out of 30 were listed on the Egyptian stock exchange when this study has been carried-out in 2009.

Sorour et al. (2012) have indicated that although the CBE has achieved progress in reforming its banking sector governance still the future reforms should deal with a number of challenges namely: improving the corporate governance competence of banks' board members through training and capacity building; re-designing of the remuneration and payments schemes of bank executives and board members to discourage the emphasis on achieving short-term objectives of the bank in order to maximize their bonus and pay (Short- termism), enhancing disclosure and transparency; emphasizing the independence of the CBE, as previous studies such as by Farrag and Kamaly (2007), concluded that "the CBE enjoys a moderately low degree of independence" (p. 21). However, improving the independence of any central bank would require having supportive public governance (Sorour et al. 2012). In this respect public governance indicators such as the Corruption Perceptions Index (CPI) prepared by an international organization dealing with transparency (Mimicopoulos 2007) indicates that Egypt's CPI world ranking was deteriorated in the last 3 years (111th in 2009, 98th in 2010 and 112th in 2011) (Transparency International 2009, 2010, 2011a) [online]. Indeed, this requires fighting of corruption as a major obstacle in front of good public governance in Egypt and indeed, a major obstacle to build corporate governance culture. Fortunately, the 25th of January 2011 revolution and the free elections of the new president have opened doors to the reform of public governance in Egypt (Transparency International 2011b) [Online]. One favorable developments post the revolution included the CBE announced some regulatory reforms that would bring about better governance of the CBE itself (Zekry and AlAyotty 2011).

The implementation of these reforms by the CBE will be a main pillar of bank governance landscape in Egypt. Another, favorable development in banking sector corporate governance was the issuance of a corporate governance code for the EBS in August 2011. Through this code, the CBE requires all banks in Egypt to comply with the code provisions or explain to the CBE the reasons for non-compliance. Banks should be in compliance with this code by no later than March 2012 (CBE 2011). Accordingly, issuing such code should enhance corporate governance practices in the banking sector and help deal with previous failures that occurred by providing all banks with a clear benchmark of good corporate governance based on the international best practices in relation to those issues specific to Egypt.

The abovementioned developments in banks' corporate governance would mean that if this process continues evolving we will essentially see developments in terms of insistence of banks on good corporate governance from their clients. Indeed, this together with the hopes that the new president and government expected efforts to fight corruption and improve public governance will be a major pillar in enhancing the corporate governance scene in Egypt.

8.3 Conclusion

Egypt has committed itself to corporate governance reform a decade ago, during which many developments have taken place obviously; the main drivers of reform were gaining trust and legitimacy of international community (Investors and International organizations) and avoidance of corporate scandals related to weak corporate governance such as Egyptian bank failures and Al-Rayan group scandal. This reform was substantiated by means of the assessment and policy recommendations by international organizations (World Bank), the establishment of the EIOD and subsequent awareness raising and codes producing, arising corporate governance requirements through new legal and regulatory reforms and the emerging emphasis of the Egyptian banking sector on corporate governance.

Although, this reform process has many achievements as outlined in the paper, still it has to deal with a number of challenges. Firstly, is the moderate level of awareness regarding corporate governance, which requires the EIOD and the Egyptian Banking institute to continue their efforts in raising awareness of companies directors and executives about corporate governance as well as investors whom activism will put pressure on companies to have good corporate governance in place. Secondly, the lack of harmony in the legal framework governing companies, which requires on one hand finalizing the companies uniform law and on the other hand effective enforcement from the regulators (EFSA and CBE). Moreover, increasing the independence of regulators (especially the CBE) will be a decisive factor for success of reform efforts. Thirdly, although the new corporate governance code (2011) is based on a comply-or-explain approach, adoption of the code is still voluntary, indeed, having better corporate governance would require that compliance with the code be compulsory. As participants had indicated that this is the only way to progress with corporate governance reform, while having rigors enforcement and supervision from the regulators (EFSA and CBE) would make compliance based on reality rather than appearance (ceremonial basis). Fourthly, having good corporate governance within the Egyptian banking sector is a decisive factor for putting pressure on companies to comply with corporate governance codes, whether they are financial or non-financial institutions, and especially in the case of companies non-listed on the stock exchange. Although, many favorable developments have taken place in relation to corporate governance within the banking sector, more emphasis is still required to enhance awareness, disclosure, competence of directors and executives within the banking sector. Finally, the lack of supportive public governance is a major challenge that requires huge amount of effort to be exerted by the new regime to fight corruption and promote transparency in Egypt. As working on facing these challenges will eventually lead to promoting a corporate governance culture amongst the Egyptian business environment.

Appendix: Interview Questions and Details of Interviewees

1. What is the current status of corporate governance in Egypt?
2. Do you think Egypt has achieved progress in corporate governance reform? Why?
3. What are the derivers of corporate governance reform?
4. Who are the main players of corporate governance reform?
5. Is corporate governance derived by the objective of achieving legitimacy?
6. Is the reform going in the right direction? Why?
7. What are the obstacles of corporate governance reform?
8. What is the impact of recent changes on the corporate governance reform?

Participants

Two Corporate governance experts who have been involved in the reform process through the government in addition to a SOC chairman who has been engaged in corporate governance improvement.

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Chapter 9
Corporate Governance in Tanzania

Samuel E. Fulgence

Abstract Interests in corporate governance have been stimulated by a number of factors, among which include the collapse of major corporations such as the Bank of Credit and Commerce International (BCCI), the Maxwell Empire, Ferranti, Coloroll, British & Commonwealth Holdings in the UK; Enron, WorldCom and other major corporations in the US in 2002 as well as the Asian economic crisis. In Tanzania, corporate governance practices have been debated in the context of state ownership as well as corporate scandals such as EPA, MEREMETA, DOWANS and RICHMOND from 2000 to 2008. These have raised the profile of corporate governance both nationally and internationally. The chapter aims at exploring corporate governance in Tanzania. The study employs cross-sectional literature review to explore corporate governance current status both in the public and the private sector. The findings reveal that in Tanzania there is corruption (embezzlement, nepotism) managerial incompetence, political interference and government subsidisation of failing enterprises. Despite the fact that, the government has gone through several reforms to establish an effective system of corporate governance. The development of Tanzanian's own national code of corporate governance, CSMA, and bank corporate governance guidelines marked an important milestone in the commitment towards sorting out and rescuing the situation. By accumulating knowledge of, and recommending continuous improvements in corporate governance, this study hopefully will be of interest in the attempt to create awareness amongst Practitioners, Researchers, Academics, Politcians, Investors and the nation at large which in turn will help to improve the country's competitiveness in attracting foreign investments, as well as encouraging local entrepreneurs to invest.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_9,

9.1 Introduction

Corporate governance refers to the structures and mechanisms by which organisations are directed and controlled in the best interests of the owners and all other stakeholders (Lovell 2005; Mnali 2012; Tukuta 2012). Corporate governance has been in a crisis worldwide and the activities of the corporate boards have been under increasing scrutiny since the onset of the global wave of liberalization and privatization in the early 1990's (Rwegasira 2003). Corporate governance emerged as an issue of international concern and debate in the early 1980s, through 1990s and this has continued into the twenty-first century. Corporate governance is not new; it has existed since the incorporation of business began (Vinten 2003). The recognition of the centrality of major enterprises in allocating resources in the economy underlies contemporary debates about corporate governance.

Recent interest in corporate governance has been stimulated by a number of factors. The collapse of major corporations such as the Bank of Credit and Commerce International (BCCI), the Maxwell Empire, Ferranti, Coloroll as well as Commonwealth in the UK. This drew the world's attention to this phenomenon. The collapse of Enron and WorldCom as well as other major corporations in the US in 2002 reinforced interest in corporate governance (Fulgence 2013). The Asian economic crisis also contributed to raising the profile of corporate governance as the crisis has been linked to poor corporate governance practices (Hoa 2000; Karugor 2011; Wolfensohn 1999). The notion of shareholder value, promoted by the conservative governments in the UK and US in the early 1980s, also had a significant impact on corporate governance developments. Fulgence argues that in Tanzania, corporate governance practices have, until recently, been debated in the context of state ownership of corporations where corruption (embezzlement, nepotism) managerial incompetence, political interference and government subsidisation of failing enterprises have been the defining features. There have recently been attempts to address the challenge of corporate governance in Tanzania. The privatisation policy, the enactment of the Banking and Financial Institutions Act in 1991, and its Regulations in 1997, are important developments in this regard. In 2002, the Capital Markets and Securities Authority (CMSA) and the Steering Committee on Corporate Governance in Tanzania introduced separate but related sets of principles for effective corporate governance which companies are being encouraged to adopt and implement (Melyoki 2005; Bank of Tanzania 2008; Fort and Schipani 2002).

Furthermore, the corporate scandals of EPA, MEREMETA, DOWANS and RICHMOND which occurred in Tanzania between 2000 and 2008, caused a lot of torments to the majority of shareholders, stakeholders, practitioners, politicians and academicians (Fulgence 2013). The scandals thought to originate from the lack of accurate, transparency and in negligence of procedures which led to high negative impacts on the government funds. This alarmed the Government to strengthen its financial system, improve corporate governance and timely provision of financial information. It forced the government to establish PPRA which make compulsory separation of the duties (accounting staff officers and procurement officers) which also imposed updated procedures on tendering and consignment contracts (Fulgence 2013).

9.2 The Nature of Corporate Governance

Corporate governance, briefly defined, is the system by which companies are controlled and directed. It specifically focuses on public companies and how powers are exercised by the directors and the accountability of the directors to the company's owners, and equity shareholders. The directors of companies, being managers of other people's financial resources rather than their own, it cannot be expected that they should watch over it with the same anxious vigilance with which the partners in the private co-partner watch over their own Smith (as cited in Melyoki 2005). Smith did not use the term corporate governance; the term only emerged in the 1980s (Tricker 2000). However, this comment indicates that he had a sound understanding of the issue of corporate governance.

The nature of the debate on corporate governance is influenced by the way in which corporations are viewed. However, an essential characteristic of a corporation is its ability to have a separate existence apart from those who own it. When a corporation has acquired its own separate existence, the issue of control arises. The Modern Corporation and Private Property (Berle and Means, as cited in Melyoki 2005), they observe that, in the modern corporation, these two attributes of ownership (control and economic rights) no longer attach to the same individual or group. The stockholder has surrendered control over his wealth. He has become a supplier of capital, and a risk taker pure and simple, while ultimate responsibility and authority of ownership is attached to the stock ownership, the other attribute is attached to corporate control. Must we not, therefore recognise that we are no longer dealing with property in the old sense? Does the traditional logic of property still apply? Because an owner who also exercises control over his wealth is protected in the full receipt of the advantages derived from it, must it necessarily follow that an owner who has surrendered control of his wealth should likewise be protected to the full?

Berle and Means suggest that the notion of ownership of property when applied to corporations especially large ones, is not straightforward. It is in this context that Minztberg (1984) poses the question: who should control the corporation, and for the pursuit of what goals? Minztberg contends that as ownership of corporations became dispersed, owner-control weakened and corporations came under the implicit control of their managers. Stiles and Taylor (2002) point out that although corporate governance as a subject has attracted widespread interest internationally, the nature of the debate about it is still largely shaped by the Berle and Means analysis.

9.3 Corporate Governance Systems

Corporate governance affects the efficiency with which resources are allocated within the economy (Melyoki 2005). Decisions about investments made by corporations are determined within the framework of their governance structures. This implies that, to the extent that corporations allocate resources in the economy, their efficient allocation depends on the effectiveness of their corporate governance systems.

One of the most striking differences between countries' corporate governance systems is the difference in the ownership and control of firms that exist across countries. Systems of corporate governance can be distinguished according to the degree of ownership and control and the identity of controlling shareholders. While some systems are characterised by wide dispersed ownership (outsider systems), others tend to be characterised by concentrated ownership or control (insider systems). In outsider systems of corporate governance (notably the US and UK) the basic conflict of interest is between strong managers and widely-dispersed weak shareholders. In insider systems (notably Germany and Japan), on the other hand, the basic conflict is between controlling shareholders (or block-holders) and weak minority shareholders.

One would ask whether Tanzania Corporate Governance system is outsider or insider; this might be simple to answer. Since Tanzania is also a member of the British Commonwealth, obviously it should be expected to implement outsider system. However; Tanzanian companies tend to have a unitary board structure comprising of a balance of executive and non-executive directors. This is explained in Company Act, Cap 212 and The Capital markets and Security Act Guideline on Corporate Governance which provide the regulatory framework for corporate governance in corporations, both private and public companies.

9.3.1 Corporate Governance Theoretical Framework

There are three theoretical frameworks to justify the needs of corporate governance structures and systems, the agency theory, the transaction cost theory and the stakeholder theory.

9.3.2 Agency Theory

The agency theory is based on the separation between the ownership of the company and the control of the company's actions. It is essentially a contract between the owners and managements who have varying interests. Therefore the central notion of the agency theory is that owners need to have some form of monitoring or incentivizing programmes for the managers.

9.3.3 The Transaction Cost Theory

The transaction cost theory on the other hand is based on the view that managers have bounded rationality and opportunism and their actions need to be monitored and controlled.

9.3.4 The Stakeholders' Theory

The stakeholder's theory takes the view that the company's management should have regard to the interests of all major stakeholders as well. This is discussed hereunder.

9.4 Approaches to Corporate Governance

Based on these theories, three main approaches to effective corporate governance have developed: the shareholder value approach, the enlighten approach and the stakeholder (or pluralist) approach (Majoni 2011). These approaches are also applied in Tanzania

9.4.1 Shareholders' Approach

The shareholder value approach is based on the agency and transaction theory and states that directors should run the company and maximize the wealth of the shareholders. Although this is the best established approach, it does not take other interests into account. The Board of Directors and managers are appointed to represent the interests of shareholders. Their mandate is to fulfil three main objectives whilst carrying out their duties;

- Maximising profits available for distribution to shareholders
- Safeguarding the wealth of investors through increased value of shares since shareholders expect that a dollar invested today is not a dollar tomorrow.
- Increased earnings per share; as a result of high dividends

The Board of Directors is required to act in utmost good faith whilst conducting business agendas; they must be transparent in concluding business transactions.

However, experience in Tanzania shows that, organisations engaged with this approach have a tendency of exploiting customers and employees by expecting abnormal profits at the least possible costs.

This has been witnessed in Tanzania where in most firms employees are paid very low salaries after long hours of working. It further shows that corporate governance and business ethics are closely interrelated since an entity associated with high cases of unethical practises clearly indicates that there are some loopholes on prioritising a culture of effective corporate governance in an organisation.

9.4.2 The Enlightened Approach

The enlightened approach tries to include stakeholders' interests but this is difficult as it is based on directors running the company with the interest of shareholders looking at the long term, but again it would need the backing of the law. The point is that directors are accountable to the shareholders and responsible to stakeholders.

9.4.3 Stakeholders' Approach

The term stakeholder is referred to as individuals and artificial persons that are affected by the operations of the business. For the purpose of this work, a stakeholder does not necessarily mean a shareholder but a shareholder can be a stakeholder. Organisations using this approach are customer oriented, also value their employees and suppliers at the same time respecting the community in which they operate in. The main objective under this approach to good corporate governance is to provide goods and services that meet customers' expectations and demand within the targeted market. This is achieved through enhanced standards in providing goods and services at the same time trying to maintain costs at reasonable levels.

The government and the community at large are the major influencers in decision making process. Organisations attached to this approach include public-owned corporations (Parastatals), GBEs, Government Agencies, Institutions and Ministries. However, though the main objective is far from profit maximisation, organisations using this approach are ineffective since very few resources are allocated to Research and Development (R&D) toward enhancing the competitiveness of the industry. Leaders and managers who run these corporations are politically imposed. This alone has led to a situation where individuals have been diversifying company resources to pursue other motives that are parallel to the firm's objectives Majoni and Menezes (as cited in Fulgence 2013). Previous studies have indicated that politically imposed business leaders and managers are still lagging behind in adopting effective corporate governance principles. This being due to limited theoretical background to effective corporate governance which led to high corruption level in most of developing countries particularly in Tanzania (Menezes 2011; Melyoki 2005).

9.5 Corporate Governance Perspectives

Corporate governance can be addressed from two broad perspectives: the liberalist and the communitarian perspectives (Melyoki 2005). The liberalist perspective views corporations as only accountable to shareholders. In this perspective, a corporation's legitimate goal is to serve the interests of those who own it i.e. the shareholders. The legitimate claims of other stakeholders are satisfied by meeting the contractual terms between them and the corporation.

Within the communitarian perspective, corporations are required to be accountable to other stakeholders than the shareholders alone. In this respect, shareholders become one stakeholder group among a number of stakeholder groups. The results of these differing views are different goals for corporations, for which managers are held accountable (Bradley et al., as cited in Melyoki 2005).

The two perspectives are of great importance in the discussions on corporate governance. Corporate governance practices are expressions of these perspectives, and are embedded in the problem of social conflict (Roe 2003). Corporate governance evolves to address incentive problems brought about by the separation of ownership from management (Tricker 1994). The two perspectives shape the manner in which corporate governance develops. The Anglo-Saxon perspective suggests a conflict perspective, and thus corporate governance evolves to protect the interests of shareholders (Albert, as cited in Melyoki 2005). In other countries, for example Japan and Germany, corporate governance is viewed as enhancing performance for the long-term survival of the corporations and for the benefit of multiple stakeholders (Sebora and Rubach; Weimer; Maassen; Letza et al., as cited in Melyoki 2005 and Fulgence 2013). The distinct perspectives indicate that understanding the prevailing perspective in a particular context is of paramount importance in understanding corporate governance in that context.

9.6 Corporate Governance in the Context of Tanzania

This work addresses corporate governance in the Tanzanian context. The issues discussed in the previous sections have to be applied to the context of this country. The central planning system for economic coordination in Tanzania, and the ownership of corporations by the state, implies that the significant experiences of corporate governance will be related to state-owned corporations. Between 1967 and 1995, state-owned corporations were the most common type of large corporations found in Tanzania. In these corporations, corruption, (embezzlement and nepotism) managerial incompetence, political interference and government subsidisation of failing corporations were the predominant characteristics of corporate governance. Corporations were shielded from the discipline of the market (Bagachwa; Kihiyo, as cited in Melyoki 2005). Control and accountability became the prime casualty within these corporations. Melyoki point out that the lack of accountability and effective control of these corporations left the managers with unfettered powers. They attribute these problems to the ambiguous property rights in the state-owned corporations.

The problems reported by Fulgence (2013); apply to a large extent to other countries in sub-Saharan Africa. Melyoki (2005) reports the paucity of corporate governance in sub-Saharan Africa arising from the ambiguous relationship between the state, as the owner of the corporations, the boards of directors and senior management. The paucity of corporate governance in state-owned corporations in Tanzania has resulted in dismal performance and the failure of these corporations (Melyoki 2005; Fulgence 2013). One result of the poor performance of these corporations has been their inability to provide the necessary "push" for the attainment of social and economic development as envisaged by the post-independence government (United Republic of Tanzania [URT] 1999).

Developments in the African region and worldwide have also created the need to develop an understanding of corporate governance practices in Tanzania. As a member of the African Union (AU), Tanzania is required to join the comity of other African countries in improving corporate governance practices. The Africa Union has developed a development vision in which member countries are individually required to implement initiatives to improve corporate governance practices within them. This vision, called New Partnership and Development [NEPAD], recognises corporate governance as one of the key issues that need to be addressed to achieve social and economic development on the African continent. Corporate governance plays a key role in poverty alleviation since it improves efficiency in the allocation of resources (Gathinji, as cited in Melyoki 2005).

Interest in Corporate Governance issues within the Commonwealth countries whose membership includes Kenya, Botswana, Tanzania, Gambia, Ghana, Mauritius, Trinidad, Tobago, U.K, Malaysia and South Africa etc. had its origin in performance improvement efforts and state enterprises privatisation. (Beyond the African region, Tanzania being a member country of the British Commonwealth which has agreed to undertake measures to improve corporate governance practices [CACG] 1999, 2009). CACG points out that corporate governance is important in improving the competitiveness of member states in attracting capital and in enhancing the performance of corporations. This adds to the need to understand current practices and make such understanding the basis for further improvement initiatives in the Tanzanian context.

9.7 Rationale for Corporate Governance in Tanzania

Aforementioned, the importance of corporate governance in Tanzania arises from its influence on government and corporation's ability to allocate resources efficiently, attract capital at low cost, and attain long-term sustainability development. Tanzania is required to develop corporate governance as an important measure for addressing issues of corruption and poverty alleviation (Norad 2011). Corporate governance is sought to contribute to the development of the private sector, which is currently viewed as the "engine of economic growth". Development of the public and private sector depends, among other things, on the steady supply of long-term capital for which the effectiveness of corporate governance is a critical factor (OECD 1999; World Bank 1999; Melyoki 2005; Fulgence 2013). Developing countries, such as Tanzania, face the challenge of attracting the foreign capital flow needed to stimulate the economy. Improving corporate governance contributes by improving a country's competitiveness in attracting foreign capital flow (Sebora and Rubach 1998). Figure 9.1 shows that foreign direct investment (FDI) flows to Tanzania have been increasing over the last 10 years, but that there have also been large fluctuations. The high levels of FDI in 2008 and 2011 reflect large investments inflows in the mining sector (URT 2004, 2012). To sustain and encourage further investment inflows into the economy, corporate governance issues have to be addressed.

9.8 Legislations in Tanzania Dealing with Corporate Governance

The main regulatory framework for corporate governance in Tanzania is provided under the 1992 Public Corporations Act, the 1994 Capital Markets and Securities Act, and the 2002 Companies Act which came into force on March 1 2006. The Capital Markets and Securities Act are modelled on international standards, particularly those in the UK and are also based on the 'comply or explain' principle. This UK Corporate Governance Code was published May 28, 2010 and came into effect June 29, 2010. Although merely a guideline, it requires that company either comply or explain why they have not followed the Code.

The Capital Markets and Securities Act states that the guidelines on corporate governance practices by public listed companies in Tanzania contains a list of recommended best practices in corporate governance. These guidelines were developed, taking into account several other jurisdictions including the United Kingdom, Malaysia, South Africa, the Commonwealth Association for Corporate Governance and OECD Principles of Corporate Governance. These guidelines were developed to promote the standards of self-regulation to bring the level of governance in line with international standards (Menezes 2012). However, in the 2009 Doing Business Report, the World Bank reported that Tanzania was below the OECD average.

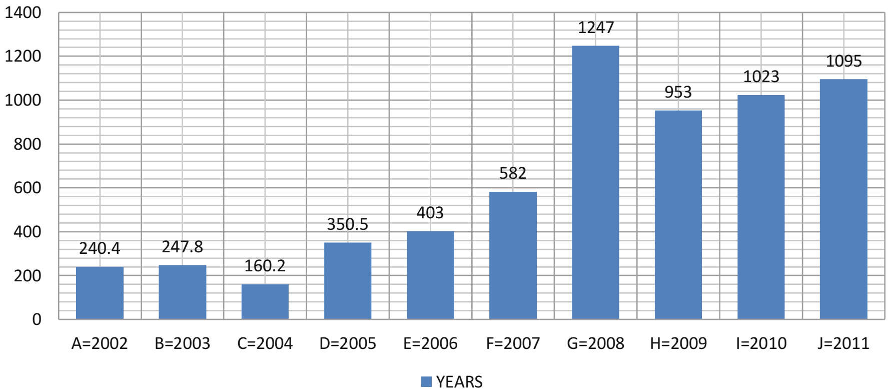

Fig. 9.1 FDI inflows to Tanzania from 2002 to 2011 (Source: UNCTAD World Investment Report 2012)

Since the very recent advent of the East African Common Market, the Securities Market is yet to be denationalized. The capital account is yet to be fully liberalized in Tanzania to enable citizens to participate in cross listing.

The guidelines require that the responsibilities of the board of directors should be defined, and that the appointment and qualifications for an effective board and the remuneration of the directors should also be outlined. Every listed company is required to ensure equitable treatment of shareholders, including the minority shareholders. All shareholders should receive relevant information on the company's performance through distribution of regular annual reports and accounts. Every shareholder should have a right to receive information on voting rules and procedures, to participate and vote at the general shareholders meeting. Also shareholders should be entitled to ask questions or seek clarification on the company's performance (Menezes 2012; Melyoki 2005; Fulgence 2013).

9.8.1 Board of Directors' Composition

Tanzanian companies tend to have a unitary board structure comprising of a balance of executive, independent and non-executive directors (including at least one third independent non-executive directors) of diverse skills or expertise in order to ensure that no individual or small group of individuals can dominate boards decision-making processes. The guideline recommends three committees to be formulated. These include; Remuneration Committee, Audit Committee and Nomination Committee. Apart from these three committees; in practice, some of the organisations have formulated forth committee – Disclosure committee. This committee amongst other things is responsible to promote disclosure and compliance issues subject to the existing guidelines including national and international standards.

9.8.2 Appointment of Directors

Directors are appointed by shareholders at the annual general meeting and must upon appointment, sign and deliver for registration at the Companies Registry consent in writing to act as directors. Subject to Company Act Cap.212 (CA) and limitations by shareholders' resolutions, the articles of the company specify the scope of the directors' powers and duties, which involve managing the company's affairs.

The guideline restricts a person to hold more than three directorships in any public listed company at any one time; however this does not apply to the Treasury Registrar who may hold more than three directorships by virtue of his office being the custodian of government shares in public companies. All directors are legible for re-election at regular intervals or at least every 3 years. Executive directors should have a fixed service contract not exceeding 5 years with a provision to renew subject to regular performance appraisal and shareholders' approval.

9.8.3 Director's Duties and Responsibility

The directors' duties and responsibilities are laid down in the company's articles and their appointment letters. However, their statutory duties include a duty to disclose any remuneration they receive and any interests they might have in contracts entered into by the company. Although a director's liability depends on the company's memorandum, the CA restricts any clauses that exempt any director from any liability that, by virtue of any rule of law, would attach to them in respect of any negligence, default, breach of duty or breach of trust.

As for the shareholding structure of the company, the CA provides that a private company must have a minimum of two members to be able to carry on its business. The general powers of shareholders are stipulated in the company's articles. These include voting powers at any general meeting, and power to approve decisions made at director level. Minority shareholders are protected under the CA. They are entitled to apply for court intervention if they believe that they are oppressed or the company is being mismanaged.

Corporate governance principles in relation to internal control of business risks are also provided under the CA, which stipulates that every company keeps proper accounts for all sums of money received and expended, its sales and purchases, and its assets and liabilities. Furthermore all companies must appoint auditors at the annual general meeting, who will incur civil liability for professional negligence if the audited accounts are inaccurate and will be criminally liable if they intentionally circulate false accounts.

9.8.4 Role of Chairman and Chief Executive

The guideline clearly states that "there should be a clear separation of the role and responsibilities of the chairman and chief executive". This will ensure a balance of power of authority and provide for checks and balances such that no one individual has unaffected powers of decision-making. Where such roles are combined a rationale for the same should be disclosed and approved by the shareholders. And that no person shall hold more than two chairmanships in any public listed company at any one time.

9.8.5 Corporate Governance in Banking and Financial Institutions

The proper conduct of a bank or financial institution requires that the board of directors function appropriately and at high standards. The responsibility for the oversight and direction of banking institutions rests with the Board of directors. In discharging his responsibilities effectively, a director, must command a high level of integrity, honesty, competence and ability to adhere to effective corporate governance principles. From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management, and in particular, how banking institutions:

- Set corporate objectives;
- Operate the bank's business on a day-to-day basis;
- Meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders;
- Align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- Protect the interests of depositors.

The Bank of Tanzania has legitimate interest in ensuring that banking institutions operate in a safe and sound manner. This goal can be largely attained if boards of directors effectively discharge their oversight roles. To assist board of directors of banking institutions, the Bank of Tanzania has decided to issue these Guidelines which spell out minimum standards required to be observed by directors of banking institutions. The objectives of these Guidelines are to:

- Promote and maintain public confidence in banking institutions;
- Establish standards for corporate governance processes and structures;
- Provide guidance to directors for proper discharge of their fiduciary responsibilities.

9.8.6 Composition and Conduct of the Board of Directors

A board of directors of a banking institution should be composed of membership of not less than five, majority of whom must be non-executive and have banking or related experience.

(i) The chairperson of the board must be an independent non-executive director;
(ii) Each banking institution should appoint at least two Tanzanians to its board; and a board member should not simultaneously serve as a board member or in any executive capacity in other banking institution in Tanzania.
(iii) To avoid conflict of interest, no individual who is a member of National Assembly or House of Representatives or local government authority should be appointed as director of a banking institution.
(iv) The board of directors should meet at least quarterly, to discuss the business affairs through reports as submitted by management in writing in a form prescribed by the board of directors.

9.8.7 Practicing Professionals

(a) In order to tap expertise of practicing professionals, a banking institution may appoint such professionals as board directors provided that they are not employed by or partners in a firm which is engaged to conduct audit of or consultancy work for the banking institution;
(b) Practicing professionals who are appointed as directors of banking institutions should exercise the highest degree of integrity and professionalism. They must always avoid being involved or appearing to be involved in any self-serving practices and conflict of interest situations while serving as directors of a banking institution.

9.8.8 Criteria for Fit and Proper Persons

Every banking institution should ensure that only fit and proper persons are appointed to their boards. In assessing fitness and propriety of a person to be appointed to the board of directors, every banking institution must consider his honesty, integrity, diligence, fairness, competence, capability and financial soundness. The following criteria should be used to determine a fit and proper person-

(i) Possession of formal qualifications and management or business or professional experience of at least 5 years, preferably, possession of a track record in banking industry or related activities;
(ii) Non- conviction in any criminal
(iii) Non-involvement as a member of the management of board of directors, with a banking institution whose registration or license has been revoked or cancelled or which has gone into liquidation.
(iv) Absence of default record of any credit accommodation taken by him or his related parties from any banking institution.
(v) Absence of bankruptcy record or suspension of payments or composition with his creditors.

9.8.9 Disqualification from Serving

(a) A person should not serve as a director if his business or permanent occupation creates a permanent conflict of interests between him and the institution, or if it is reasonable to assume that such conflict may exist permanently.
(b) A person shall not be appointed a director if he was a director of another banking institution and less than a year has passed since he ceased to serve as a director of that institution unless the permission of the Bank is obtained.

9.8.10 The Duties and Responsibilities of Board of Directors

The board of directors of a banking institution has the following major duties:

(i) Appointment of Executive Officers to manage the affairs of the banking institution while ensuring that the banking institution has an appropriate plan for executive succession.
(ii) Effective Oversight of the Banking Institution's Affairs. In connection with effective oversight, directors are also responsible for establishing and ensuring effective functioning of various board committees and management in key areas.
(iii) Regulatory Compliance. The business banking is governed by rules and regulations. Directors' responsibility in this respect is to establish policies and monitor operations to ensure their banking institutions comply with laws and regulations.
(iv) Setting and Reviewing Policies and Objectives. The board of directors must establish policies and objectives that will direct the activities of a banking institution in all areas of operations. The policies must clearly quantify

the acceptable risk and specify the capital required for safe operation of the banking institution. The board of directors should ensure that senior management adheres to objectives set by the organization.

(v) To Develop a Strategic Plan. The board of directors in collaboration with management is obliged to prepare a strategic plan and adopt policies to achieve it. The strategic plans are roadmap and should be reviewed whenever business and economic conditions call for change and communicated to all employees.

(vi) To Ensure Arm's Length Transactions with Insiders. The board of directors should monitor compliance with policies and procedures relating to insider transactions on a regular basis.

(vii) Setting and Enforcing Clear Lines of Responsibility and Accountability. Boards of directors should clearly define the authorities and key responsibilities for themselves as well as senior management.

(viii) Maintenance of Adequate Capital. Directors are responsible for ensuring that the banking institution is adequately capitalized at all times and plan for capital needs commensurate with banking institution's risk profile and projected future activities.

(ix) Effective Utilization of Internal and External Auditors' work. The board of directors should recognize and acknowledge that independent, competent and qualified auditors, as well as internal control functions (including compliance and legal functions), are vital to the corporate governance process in order to achieve corporate objectives.

(x) Evaluation of the Board of Directors. Board of directors should regularly review its mix of skills and experience and other qualities in order to assess the effectiveness of the board and its committees annually.

9.8.11 The General Function of the Board of Directors

Company law in Tanzania, as in many other countries, states that directors will manage corporations. However, it does not specify what activities constitute "managing a corporation". The guidelines recommended by the Steering Committee on Corporate Governance provide, in broad terms, a definition of the function of the board of directors: determination of the purpose and values of the corporation and defining the strategy through which the purpose of the corporation will be achieved. In executing this function, directors are called upon to exercise leadership, enterprise and integrity in directing the affairs of a corporation; and should demonstrate transparency, accountability and responsibility (Melyoki 2005).

9.9 Integrity and Corporate Governance

Tanzania like many other Sub-Saharan Africa countries achieved its independence with a severely underdeveloped economy and extremely limited infrastructure. However, Tanzania has made concerted efforts to improve its economy, raise living standard of its people and create a conducive environment for private sector development & investment. However, Tanzania suffers from a high corruption, with reportedly an estimate of 20 % of the government budget lost to corruption.[1]

Since early 1980s, governments of developing countries have been supporting and implementing strategies of encouraging competitive free markets, privatisation of state owned enterprises (parastatals), move from closed (no trade) to open (trading) economies and opening up the domestic economy through free trade and attracting foreign direct investment. This was done as a way of recognising the lead role that private sector can play in economic development.

The private sector expressed concern that the system of corporate governance in the region is still tinged with corrupt practices. According to the Transparency International's annual Corruption Perception Index (CPI)[2] for 2003, out of the 133 countries that were surveyed, the East African countries of Kenya, Uganda and Tanzania ranked relatively high in levels of corruption. The rankings were 122 for Kenya (with a CPI score of 1.9 out of 10 indicating no corruption), 113 for Uganda (with a CPI score of 2.2) and 92 for Tanzania (with a CPI score of 2.5). But by 2009 Tanzania's score was back to 2003 levels. It has consistently scored and ranked below the average for the Africa region over the period (Cooksey 2007).

Tanzania currently ranks as the second least corrupt country in East Africa on Transparency International's CPI and Transparency International-Kenya's East Africa Bribery Index. However, Tanzania's score on the Index (corruption prevalence) has risen from 17 % in 2009 to 28.6 % in 2010. Perceptions data from the same survey also paint a gloomy picture with a total of 85 % of the respondents feeling that Tanzania is either corrupt or extremely corrupt, with a larger percentage (45.6 %) feeling that it is extremely corrupt. In addition, two of its institutions, the police and the judiciary, appear in the top ten most corrupt institutions in East Africa (Cooksey 2007; Norad 2011).

Although in all the three countries, efforts are being taken to curb corruption as systems are made to become more transparent with better placed to apply the rule of law in government operations; a recent PWC report has suggested that the war on corruption in East Africa is being lost because of lack of political will in the high

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[1] Norad (2011), Chene (2009). Overview of Corruption in Tanzania. Estimate from Tanzania's Auditor General); Global Integrity Report 2006 http://back.globalintegrity.org/reports/2006/tanzania/index.cfm; US State Department. 2006. Country Report on Human Rights Practices. www.state.gov/g/drl/rls/hrrpt/2006/78761.htm; The Citizen. 10 July 2009. Tanzania: Over 30 % of Budget Eaten by Corrupt Officials, Says President. Reporting a speech made by President Kikwete on the opening of PCCB's new offices. http://alafrica.com/stories/200907100946.html

[2] CPI and WBI scores are derived from surveys or assessments from a number of data sources including for example, the Africa Development Bank and Economist Intelligence Unit.

echelons (top management support); inadequate funding and equipment for anti-corruption institutions, an inappropriate legal framework and lukewarm enforcement as most bureaucrats who are charged with the responsibility of fighting corruption are themselves corrupt (Sitta 2005). The relevance of this argument is evidenced in the following corporate scandals which tormented most of the shareholders in Tanzania as discussed hereunder (Fulgence 2013)

9.10 Corporate Governance and the Fight Against Corruption

In most African countries including Tanzania corruption was at a relatively low level during' colonial rule; However, after independence and the move to single party systems, which concentrated power into small cliques, corruption began to rear its ugly head. As time passed, the integrity environment became dramatically eroded (Sitta 2005; Toby and Meg 2008). In order to foster integrity environment and create a better environment for investment and private sector development, the Tanzania government has taken several steps. First, in 1991, the government set up the Prevention of Corruption Bureau (PCB) – now PCCB. In 1995, the government formed the Public Leadership Code of Ethics to curb impropriety at higher levels of public service and later it established the Commission for Human Rights and Good Governance in 2001. In reality the government was preparing the legal framework to curb corruption and bring about integrity in public service. Later, the government established the Permanent Commission of Inquiry (Ombudsman) in 1996 to check abuse of power by government officials and its agencies (Sitta 2005; Melyoki 2005).

When, President Benjamin William Mkapa came into power in 1995, he declared war on corruption so as to enhance the integrity environment. As a first step he established the Presidential Commission Against Corruption in January 1996. Ten months later, the Commission produced one of the most respected and commended analyses of corruption by any Africa state (commonly referred to as the Warioba Report). The report identified areas/environments where corruption occurs and also revealed regulations and procedures that facilitate corruption. It also cited examples of dubious decisions/contracts in several departments that were perceived corrupt.

The Warioba report concluded that there was much evidence of Corruption. The report classified corruption into two categories. The first type relates to those who receive bribes to cater for their daily living needs (Petty Corruption) while the other group involves high level leaders and public officials, who are motivated by excessive greed for wealth accumulation and money (Grand Corruption). The Warioba Report had the further benefit of opening up public discussion on corporate governance. Accordingly, the government took several measures to address the problem. Such measures included:-

- Appointment of a good governance Minister, who is responsible for among other things in monitoring overall strategy & implementation of anti-corruption measures,
- Adoption of Natural Anti-Corruption Strategy for Tanzania. The strategy focused on the need for transparency and accountability in government,
- Appointment of the Prevention of Corruption Bureau (PCB now PCCB). This is a unit that investigates and prosecutes corruption with approval from the Director of Public Prosecutions (DPP),
- Establishment of the Commission for Ethics to deal with administering and enquiring into senior public appointee's declaration of assets and making recommendations to the president.

The Public Sector Reform Programme of Tanzania, which was officially launched by His Excellency, the President of the URT in June 2000 aims to transform the public service into a result-oriented public service. Among other things, it aimed at creating a public service of the high calibre and integrity that is both responsive to and supportive of national efforts. Furthermore it aimed at delivering service, to ensure effective corporate governance and to facilitate poverty reduction. Despite these reforms, still extra efforts need to be tabled since a there are a lot of corporate scandals in Tanzania history as memorised hereunder.

9.11 Recent High Profile Grand Corruption Scandals in Tanzania

Recently Tanzania has faced a number of high profile Grand corruption scandals which includes (i) The External Payment Arrears (EPA) Account, (ii) BAE Security Radar Scandals, (iii) Richmond and Dowans Electricity Power Scandals as detailed hereunder.

9.11.1 The External Payment Arrears (EPA) Account

The External Payment Arrears (EPA) account facility at the Bank of Tanzania allowed companies to borrow money from the bank when they were making foreign currency transactions. The corruption scandal involved fraudulent payment of around Tshs 133 billion (US$96 million) from the account to 22 companies in 2005–2006.[3] The scandal came to light as a result of a regular annual audit in 2006, and was later confirmed by a special independent audit, which the NAO completed in November 2007. The audit concluded that "Tshs 134 billion was spent under the account out of which Tshs 90 billion was fraudulently paid, while Tshs 44 billion

[3] http://www.jamiiforums.com/jukwaa-la-siasa/197601-corruption-scandals-in-tanzania-history-just-to-memorize.html. Accessed on 21 **Feb** 2013.

needed further analysis to determine whether the amount was properly spent, and or unaccounted for." The President sacked the then governor of the Bank of Tanzania in January 2008. In his speech to the Parliament the President was reported as saying that those who returned stolen money 'would not be taken to court', a statement interpreted by some commentators as a form of pardon.[4]

9.11.2 BAE Security Radar Scandal

Tanzania government agreed to buy over-priced radar, which at the moment it cannot maintain. It came to be known later; more than a third (over a US$40 million radar deal) of the total purchasing price was paid to a middleman of British citizenship to secure the contract. Also based on Interpol report, one government minister had siphoned more than £1 m to his bank account in Jersey, UK. In 2008, a government minister resigned over allegations of taking a US$1 million bribe from the British company (Norad 2011). BAE negotiated a plea bargain and the criminal prosecution was dropped, however BAE was ordered by British court to pay £30 m to Tanzanian government (Norad 2011, p. 13).

9.11.3 Richmond, Dowans Electricity Power Scandals

The Richmond scandal was concerned with fraud and corruption in connection with a contract the involved an American firm Richmond Development Company. In 2006 Tanzania faced a serious crisis in electricity supply and, as an emergency measure Richmond was awarded a contract to supply generators to provide 100 MW at a cost of TShs 172 billion (Norad 2011). The generators failed to arrive on time and when they did they did not work as required. Under part of the contract however the government agreed to pay some $137,000 a day regardless of the amount of electricity provided (Norad 2011, p. 13).

Concerns raised by the Trade and Investment Parliamentary Committee, prompted the Speaker of Parliament, Samuel Sitta, to appoint a Silent Committee to carry out further investigation. The report of the Silent Committee was tabled and debated in Parliament in February 2008, leading to the resignation of the then Prime Minister and two cabinet members, and subsequently to the dissolution of the entire cabinet, described by donors as a significant democratic breakthrough. However, the Tanzanian government had to keep the contract and keep paying a non-existing company US$137,000 a day without any power being generated (Norad 2011, p. 14)

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[4] Transparency International-Kenya. 2010 cited from Norad (2011), Joint Evaluation of Support to Ant-Corruption Efforts Tanzania Country Report, June 2011 Study Report.

9.12 Discussion, Conclusion and Recommendations

The effectiveness of corporate governance is laid on its ability to manage risk which affects not only corporation's performance but also its long-term ability to survive goodwill and prosper. The question that the cumulative collapse of big companies around the world solicits is whether the failure is one of Corporate Governance or not. Following the examples of Enron, WorldCom and others in the United States, the Sarbanes-Oxley Act introduced some major changes to US Corporate Governance; "leading commentators argued that this should not be seen as a failure of Corporate Governance since the failure was principally due to a misguided strategy, rather than a collective board failure *Anderson R. 2002 pg.5*." Following this logic, one might well argue that the Financial Crisis was not so much a failure of Corporate Governance but rather a "Perfect Storm" within the global banking industry, which boards could neither be expected to foresee or to react to swiftly enough to make a substantial difference. The board of directors cannot and should not be involved in actual day-to-day risk management. However, they should instead, through their risk oversight role, satisfy themselves that the risk management process designed and implemented by the executives and risk managers are adapted to the boards' corporate strategy. This should be functioning as directed, and that necessary steps are taken to foster a culture of risk adjusted decision-making throughout the entity (Rosen 2008; Toby and Meg 2008).

Corporate governance has been in a crisis worldwide and the activities of the corporate boards have been under increasing scrutiny since the onset of the global wave of liberalization and privatization in the early 1990s. Why were there failures in corporate governance in the case of the corporate collapse of Barings bank in UK in 1995 or of Enron in 2001 and WorldCom in 2002 in USA? Why was there a corporate governance lapse in the financial scandal of Royal Ahold, a Dutch transnational retail group, in 2003? Why did we also at the same time have good examples of corporate governance practices and disclosure in Telecom Italia in Italy or Deutsche Bank in Germany? What about Kookmin Bank in South Korea and Tokyo Electron in Japan as shinning beacons in the Far East? What was the basis of accolades to the boards of VimpelCom, a Russian telecommunications company or Petrobras, a Brazilian petrochemical giant and SABMiller, the world's leading brewer in emerging markets in South Africa? Why there were trick contracts in URT such as that signed between government and RICHMOND as well as DOWANS. The answer to the above questions may be in the effectiveness of the boards. Without promoting effective corporate governance, Tanzania may as well forget being able to attract any foreign investment financial resources into the national financial and capital markets. This will leave it alone being unable to build a vibrant and internationally competitive but socially responsible private business sector. Which investor would want to put money abroad in a foreign company about which he is not convinced how well it is directed and controlled? What factors and attributes distinguish effective from non-effective boards?

9.12.1 Determinants of Effective Board of Directors

The effectiveness of a board lies in its ability to carry out its primary functions. Namely, concern for corporate performance (– policy and strategy) and corporate conformance (– monitoring and supervising management as well as accountability and reporting to stakeholders). The board invariably works with and through the chief executive officer, CEO, it appoints.

Pundits and researchers of corporate governance may not agree on every detail. However in this case, in as much as there is no one single best board model for all corporations and for all the time, there are some attributes which have been more often associated with effective boards and the way they go about their business. The effectiveness of board of directors is determined by five key factors which are reflected in the guidelines of corporate governance recommended by CMSA. These include a board constitution, board leadership structure, appointment and independence of directors, board meetings and the board audit committee.

9.12.2 Challenges in Implementing Effective Corporate Governance in Tanzania

Despite the war established and discussed above (Sect. 9.10), high profile grand scandals were experienced in Tanzania's history. These recall corporate governance rules, regulations and codes established in US, UK and other developed countries as discussed above in this paper, yet they experienced incredible economic fall-apart after the collapse of a lot of giant corporation's despites its emphasis. "This implies that, the compliance of the rules and regulations are just one side of the coin, but one should be able to consider the other side as well (Fulgence 2013, pg.86)". *Merson* in his book "*Rules Are Not Enough*" argued that, "*you may stick to the rules yet be wrong*". If this is the case, what else is required apart from the rules? To address the second side of the coin, Zinkin (2010) challenged corporate governance arguing that, the failures in corporate governance related to performance rather than conformance or compliance. In his book *Zinkin* argued that,

> companies were destroyed by a combination of three elements that are essential to good performance which were found to be wanting. These are:-
>
> i. A lack of proper understanding by the board of its business and strategy,
> ii. A total lack of appreciation of both the strategic risk and more important the systematic risk created by the products-markets into which the financial institution entered because others were doing it too, and
> iii. A total failure of board to ensure that the rewards and remuneration system for top executive and CEOs reflected the long-terms of the business rather than encouraging irresponsible behavior that placed the company's future at risk and as it turned out, the entire global financial system in jeopardy (Fulgence 2013, pg.86)

Zinkin arguments were also in line with *Merson, 2012* who argued that, the board of directors should consider the long-term plans, business risk and overview of the business performance rather than only compliance of PCGCBP and SOX. Toffler (as cited in Fulgence 2013), stressed that, the compliance of the PCGCBP, bank guidance, CSMA Guidelines etc., Company Acts and SOX could mean nothing if the business performance is poor. To keep the debate hot, Fulgence 2013, emphasized that, "the PCGCBP and SOX are meaningless if the hearts of the top management and NEDs are not in the business plans (Fulgence 2013, pg.87)"

9.12.3 Other Challenges and or Obstacles to Effective Corporate Governance

As per the Warioba Report and other surveys on corruption (as discussed above) and improving integrity such as the study "Striving for Good Governance in Africa" done by UN – Economic Commission for Africa (ECA). It has been revealed that although constitutional government is getting stronger and more democratic, countries perform badly in efforts to control corruption and building an integrity environment.

The report identifies ten areas in need of urgent action including strengthening parliaments, protecting the autonomy of the judiciary, improving the performance of the public sector, supporting the development of professional media encouraging private investment and decentralizing the delivery of services. On the other hand, the UNCTAD Study on Good Governance in Investment Promotion and Facilitation (2002), major obstacles to Good Governance in Investment Promotion are:

- Limited infrastructure, and institutional capacity
- Capital resources/financial constraints,
- Skills and education,
- Transportation,
- Legal system and crime,
- Bureaucracy and corruption,
- Institutionalised negative mindset.

9.12.4 The OECD Principles on Corporate Governance

The OECD Principles on corporate governance (2004) constitutes a balanced benchmark for corporate governance. The Principles are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing effective corporate governance. They also provide the basis for an extensive programme of cooperation between OECD and non-OECD countries and underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes (ROSC). However, as the world is becoming smaller and with increased globalisation, corporations worldwide cannot escape from the global movement that shapes standard principles of corporate governance. Tanzania has so far developed her own national code of corporate governance.

9.12.5 Cost of Lack of Effective Corporate Governance

The aforementioned, Lack of corporate governance, fuels a crisis of confidence for Tanzanian investors. Thus, lack of effective corporate governance has allowed manipulative practices such as misleading financial reporting which has a very big negative impact to investors especially during the decision making process; and in general it undermines the confidence of the investors to participate in any type of collective investment scheme, which indeed is another setback as far as collective investments scheme industry is concerned.

While most Tanzanian's still put their money in a mattress instead of putting it in the bank, stories associated with theft which are caused by lack of effective corporate governance do not help them at all. The recent high profile grand corruption scandals discussed above have led to loss of billion of money which could be used to reduce the poverty level. In addition to this, donors have slashed aid to Tanzania; over US$300 million for the past 5 years. "Tanzanian trust has been sold out too cheap (Fulgence 2013; Sitta 2005)". This means, this convinces the Tanzanians who are not in the market place that the safest place to put their money is under their mattress. The truth is; more savings and investments are needed, this is only obtained by building confidence in the people who can and should invest their financial resources in the formal sector instead of putting their money under the mattress.

9.12.6 Effective Corporate Governance in Private Sector

As the private sector is increasingly becoming a key partner in development in many African countries, the importance of creating better environments for private sector development is critical. Similarly, in order to build integrity and attract both local and foreign investors, the private sector has to accept, and implement Corporate Governance. Establishing effective boards is also an important element which will enable private sector to strengthen their corporate governance level. The empirical review has evidenced that there is nothing which impacts the effectiveness of the board like the board composition, board size, directors' competences, directors' diversity, and the proportion of outside independent directors on the board. The more the independents the better the board and better performance.

In many African countries nowadays, corporate governance has become a critical element of business management and economic growth. Elsewhere, massive economic crises and corporate failures have been closely associated with the lack of effective corporate governance. This has fuelled corruption and cronyism while suppressing sound and sustainable economic decisions. Results from some surveys carried out, demonstrated that there is a positive correlation between effective corporate governance and increasing capital flows. It has been suggested that effective corporate governance reduces cost of capital as it provides a positive global premium that tends to attract investment.

9.12.7 Pillars of Effective Corporate Governance

The pillars of effective corporate governance should be enhanced in every industry including both the private and the public sectors. Pillars of corporate governance include transparency, accountability, probity and respect for the rights of all stakeholders. If these pillars are not implemented, the effective governance should remain in mouth leaving a significant gap in practice arena.

9.12.8 Concluding Remarks

Though in many African countries, leadership has done much to advance their national economies over the past decade nevertheless much remains to be done, as overall economies are small and underdeveloped. There is not conducive environment for investment promotion and economic growth. Good governance and enhanced Integrity environment as pillars for better economic and investment climate are yet to be achieved. Many countries are perceived to be corrupt as the **political will** to counter corruption is perceived as lacking. It is true in many countries that there is "much talk" but little real action against corruption.

In the absence of high-level will within the Government, the corporate governance cannot be so effective but rather in-crippled. There is nowhere in the world it has been evidenced a successfully system without a clear champion support and will from the top management (Fulgence 2012). Thus it is generally agreed that the effectiveness of corporate governance lies in the top management support, the spirit which should be inherited by the subordinates. This effectiveness is further steered by good planning, the control structure and the control process as well as the composition of the board itself. Last but not least, it should be agreed that "Without Genuine Commitment, transparent, honest and genuine mind set with the spirit of citizenship– All Is Lost!!! (Sitta 2005)".

In Tanzania, like a number of jurisdictions, there are guidelines for effective corporate governance; however this has not been legalized. This leaves another remarkable gap. The author has got feelings that the principles of effective corporate governance has not yet born in Tanzania. If it has, then it should be at kindergarten level if not a breasting child. This is evidenced by corporate scandals discussed in Sect. 9.11 above. However, in the midst of economic and environmental hazards, corporate governance should no longer be optional. The voluntary and self-regulatory nature of corporate governance model should be revised and harmonized across the region. Melyoki, in his research about the effective corporate governance in Tanzania came out with findings which showed that, the compliance level to the principles of effective corporate governance in Tanzania is high. However to this level it can be argued that, these findings were rather fallacy since he used only four companies which under no any circumstance these can be generalized to Tanzania as a whole, but rather specific to such case studies. Yet since then (2005), a lot of corporate scandals have occurred which is the practical evidence on the unreliability of this findings particular when they are generalized. I am encouraging the regulators; the Dar Es Salaam Stock Exchange (DSE) the Capital Markets and Securities Authority (CMSA), the Tanzania Chamber of Directors, the National Board of Accountants and Auditors (NBAA) and the Business Registrations and Licensing Agency, to be at the top of their game in promoting corporate governance.

9.12.9 Recommendations

Leaders Should Institute and Promote Effective Corporate Governance

Top Management particularly politicians and professionals have to institute and promote good governance and integrity environment as a foundation for creating a favourable investment climate. Government operating an integrity environment creates willingness in people and the business community to trust and cooperate. Courage is of utmost importance in maintaining integrity. Without strong, clear leadership and support throughout the top government leaders, its various departments and the law enforcers, it is very difficult for any real advance in the fight against the evils of corruption to succeed (Sitta 2005; Fulgence 2012). Government and corporate leaders must:-

- Live and openly be seem to be role-model in integrity in all their dealings,
- Make morally and ethically correct decisions regardless of cost or difficulty,
- Hold on to the vision of clean government and business,
- Be courageous in sharing their sentiments and recommendations,
- Have clear values to guide them so as to take bold decisions,
- Have the courage of owning their mistakes and learning from them.

Rectification of Good Governance Codes and Related Offices

All African Countries and Tanzania in particular must rectify the African Union Convention on Prevention and Combating Corruption and Related Offences to remove avoidance clauses. They must also agree to take part in peer reviews of their corporate governance performance. Measures like strengthening the legal and judiciary system, enhancing public financial accountability and strengthening oversight and watchdog institutions are critical in promoting integrity environment.

Creation of Public Awareness on Standards and Codes of Conduct

Another important factor in promoting good governance is public awareness on procedures, standards of services, codes of conduct and their rights in general. Information regarding services provided by Ministries, Departments and Agencies should be spelt out clearly in the client charters and disseminated freely (Sitta 2005; Melyoki 2005). Success in creating an integrity environment for investment promotion and economic growth depends on commitment and political will to implement necessary reforms as recommended (Fulgence 2012).

Promoting Corporate Governance at the Top Agenda of Firms Policy

Moreover, an important factor for the success of our private sector development is dependent on the quality of its management. Therefore corporate governance should be at the top of the agenda as a pro business policy and should be embraced by all stakeholders in the society (Sitta 2005; Rwegasira 2003; Fulgence 2012). At the end of the day we need more disclosure and transparency, in all listed companies and we should not let our companies and Banks become a gateway for diverting our nations' wealth into the pockets of few politicians and business men. For example, our banks have been one of the most reckless in corporate governance in the past few years; they have been the gateway of EPA, RICHMOND and many others. All of these frauds have gone unnoticed without their anti fraud and money landing department noticing anything. More recently, there has been a lot of frauds reported in our banks, and all of these bad news represents concerns of many Tanzanian's who are looking for someone to trust and it seems no one is there to fill in this trust vacuum.

Prevention of Resources Exploitation

Tanzanian entrepreneurs should not act like a small number of Europeans who set out to establish colonial rule. These Europeans needed the help of African soldiers to help them control their new subjects and labour to create the required infrastructure and exploit resources (Menezes 2012). In a modern Tanzania today, we are observing local Tanzanians' acting in a similar fashion to the former colonial rulers; by attracting investments from their fellow Tanzanians and using the same power and money to reap off their fellow citizens' investments through fraud or other forms of misuses of money (Sitta 2005; Melyoki 2005; Fulgence 2013). Moreover, the bottom line is that, it does not enhance sustainable development and it will not build a strong private sector if we keep embracing this type of corporate corruption.

Corporate Governance Research Gap

Research in corporate governance in Tanzania is hardly undertaken. Examples of these are traceable to the previous studies conducted by Abayo and his colleagues in 1993 which involved a case study of 51 companies; and Melyoki in 2005 which involved a case study of only four companies listed on the Dar Es Salaam Stock Exchange Market. Since then there has been a lot of changes as it has been discussed above. The most recent research on corporate governance was carried out by Fulgence in 2013, but this concentrated on determinants of corporate governance specifically on internet reporting. Most of the other reports concentrated only on one pillar of effective corporate governance or special survey/ investigation such as Warioba report, Samuel Sitta and others. Other studies if any are still to be published thus difficult to access. Thus generally it can be evidenced that there is a significant gap in studies on corporate governance in Tanzania.

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Chapter 10
Corporate Governance Breach: An Overview of the Owner-Manager Agency Problem in the Nigerian Banking Industry

Abubakar Sadiq Kasum and Oyebola Fatima Etudaiye-Muthar

Abstract The effects of a breakdown in the principal/agent relationship in the Nigerian financial services industry, especially in the banking sector, cannot be overemphasized. The required alert is due to the fact that this type of industry requires that there must be trust between the principal and the agent who is making decisions on behalf of the principal's financial investment in the business environment. This paper analyses the agency problem that surfaced in the Nigerian banking sector, following the recapitalization exercise that took place in the industry in 2006. The study found that, to a large extent, the breakdown in the corporate governance code was a major cause of the crisis. The paper also examines the various ways the regulatory agencies responded to the problem and the measures that are being instituted to forestall a reoccurrence.

10.1 Introduction

Agreements in which one party has agreed to act as in the interest of another and has difficulty in monitoring the activities are the main issues in agency theory. An agency relationship is one in which one person called the agent agrees to act for the benefit of another called the principal.

The main problem comes up when the principal cannot monitor the agent's performance. The shareholders of a corporation who hires the manager to work for them have a big challenge in getting the manager to act in their interests because of the likelihood of the manager acting in his own interest. This is caused in part by the principal's inability to observe the agents actions and the existence of information asymmetries. Information asymmetries occurs when there is difference in the information processed by the two parties i.e. the principal and the agent. The

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_10,

agency theory assumes that every person will give up as little as possible in any exchange. Agents according to Boatright (2008) can then be expected to engage in opportunism by seizing any chance to enrich themselves at the expense of the principal. The principal/agency relationship suggests that hired managers will have different objectives from that of the owners as they will use the firm's resource to satisfy their own demand (Oyejide and Soyibo 2001).

The cost inherent in the agency problem can be reduced by investments in monitoring and the structuring of relationships such that agents are induced to act in the interest of the principals without a need for further monitoring such as offering bonuses and inducing them to monitor each other. Another way is the payment of stock options as this aligns more closely with the interest of the agents (Jensen and Meckling 1976).

It is difficult to avoid conflicts in the financial services sector because in acting as an intermediary for other peoples' financial transaction and custodian of their financial assets, the agents are often forced to choose among the competing interest of others and weigh them against their own. This conflict primarily arises as a result of trying to provide as many possible services as they can to different parties at the same time.

In the banking industry, the agency problem is mainly between the management and the shareholders and solutions are likely to be found in the procedural rules and incentive contracts or it could come in the form of external support through banking regulations. According to Arun and Turner (2003), however, the nature of the contractual form of banking in developing economies calls for corporate governance mechanisms in the banks to include both the depositors and the shareholders.

In the financial industry, the retention of public confidence through the enthronement of good corporate governance remains of utmost importance given the role of the industry in the mobilization of funds, the allocation of credit to the needy sectors of the economy, the payment and settlement system and the implementation of monetary policy (Wilson 2006).

According to Andres and Vallelado (2008), the relevance of banks in the economic system and the nature of the banking business make the problems involved in their corporate governance highly specific, as are the mechanisms available to deal with such problems. The complexity of the banking business increases the asymmetry of information and diminishes stakeholders' capacity to monitor bank managers' decision.

In the Nigerian banking industry, poor corporate governance has been identified to be responsible for the distress in the sector in previous years. With the recapitalization exercise of 2006 where the banks were required to raise their minimum share capital from \$13.4m to \$167.5m, the banks were faced with a lot challenges. Key amongst these challenges were the availability of the required skills and competencies needed by the board of directors and management of the banks to improve the shareholders value and balance of same against other stakeholders interests in a competitive environment (Central Bank of Nigeria 2006).

This paper attempts to investigate the agency problem that surfaced in the Nigerian banking sector following the recapitalization exercise that took place in the industry, the breakdown in the corporate governance code, the various ways the regulatory authorities came out to curb the problem and also the measures that are being put in place to forestall a reoccurrence.

The rest of the paper is organized as follows: Sect. 10.2 reviewed relevant literature and gave an overview of the Nigerian Banking Industry; Sect. 10.3 discusses corporate governance issues in the Nigerian Banking Industry while Sect. 10.4 concludes the study.

10.2 Agency and Corporate Governance

The relationship between the owners and managers of a firm is an agency type. Jensen and Meckling (1976) define the agency relationship as a contract under which one party (the principal) engages another party (the agent) to perform some services on their behalf. "An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some services and then delegate decision-making authority to the agents. The primary agency relationships in business are those between stockholders and managers and between debt holders and stockholders".

The concept of agency dates back to the time of first separation of ownership from management. "Among the influences -of agency discuss- are organization economics, contract law, and political philosophy, including the works of Locke and Hobbes". Other scholars involved in agency theory's formative period in the 1970s included Armen Alchian, Harold Demsetz, Michael Jensen, and William Meckling. "Specifically, agency theory is directed at the ubiquitous relationship, in which one party (the principal) delegates work to another (the agent), who performs that work". Agency theory attempts to describe this relationship using the metaphor of a contract (Eisenhardt 1989, p. 58). Agency theory suggests that the firm can be viewed as a nexus of contracts between resource holders, the owners of material/ financial resources and of intellectual and managerial resources.

Agency topic is usually in focus because of interest asymmetry. Issue of self and divergent interest cannot be overemphasized. Agency problems arise from conflicts of interest between two parties to a contract, and as such, are almost limitless in nature (McColgan 2001). Agency theory argues that in modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximize shareholder returns (Pratt and Zeckhauser 1985, p. 108). Agency theory, according to Jensen and Meckling (1976), holds that managers will not act to maximize the returns to shareholders in the large corporation, unless appropriate governance structures are implemented to safeguard the interests of shareholders. Agency loss, therefore, arises. Agency loss is the extent to which returns to the residual claimants, the owners, fall below what they would be if the principals, the owners, exercised direct control over the corporation (Jensen and Meckling 1976).

Agency theory raises a fundamental problem of self-interested behavior, on the one hand, in an organization. "A corporation's managers may have personal goals that compete with the owner's goal of maximization of shareholder wealth". Agency theory suggests that, in an imperfect labor and capital markets, managers will seek to maximize their own utility at the expense of corporate shareholders. Agents have the ability to operate in their own self-interest rather than interest of the shareholders. Evidence of self-interested managerial behavior includes the consumption of some corporate resources in the form of perquisites and the avoidance of optimal risk positions, whereby risk-averse managers avoid profitable opportunities in which the firm's shareholders would prefer to invest.

> In the majority of large publicly traded corporations, agency conflicts are potentially quite significant, because the firm's managers generally own only a small percentage of the common stock. Therefore, shareholder wealth maximization could be subordinated to an assortment of other managerial goals. For instance, managers may have a fundamental objective of maximizing the size of the firm. By creating a large, rapidly growing firm, executives increases their own status, create more opportunities for lower and middle-level managers, improve salaries and enhance their job security, because an unfriendly takeover is less likely (Jensen and Meckling 1976).

Checking the perceived excesses of the managers is usually not without its costs. Like any other cost, agency problems will be captured by the financial market and be reflected in a company's share price. These costs can be seen as the value loss to shareholders, arising from divergences of interests between shareholders and corporate managers (McColgan 2001). Authors have defined agency cost as those costs borne by shareholders to encourage managers to maximize shareholders' wealth rather than behave in their own interests. Jensen and Meckling (1976) defined agency costs as the sum of monitoring costs, bonding costs, and residual loss. According to encyclopedia of business, the costs include expenditures to monitor managerial activities, such as audit costs; expenditures to structure the organization in a way that will limit undesirable managerial behavior, such as appointing outside members to the board of directors or restructuring the company's business units and management hierarchy; and opportunity costs, which business incurs when shareholders imposed restrictions. On the need to monitor the managers, scholars are of divergent opinion. Denis et al. (1997) posited that effective monitoring could be restricted to certain groups or individuals. Cadbury (1992) provide a contradictory view on monitoring, arguing that too much restriction will constrain managerial initiative and will act as deterrent to managerial entrepreneurship. Himmelberg et al. (1999) recommended optimal levels of monitoring of managerial policies that are specific to the individual firm's contracting environment.

The core issue of governance of a corporation is how to ensure that managers will use the company's reserves in the interest of the shareholders. Because of the transparency required particularly in the banking sector, the information asymmetries between the outsiders and insiders are more pronounced especially as it relates to the risks characteristics and the quality of the assets. Stliglitz (1992) stated that the problems occur in the presence of information asymmetries. This can either be in the form of an action or information (Muhammad and and Muhamad

2007). Harri and Raviv (1990) while examining the relationship between asymmetric information and agency model found out there is a relationship between the two under conditions of default probability and that the presence of asymmetric information is likely to influence the return on investment. In Oyejide and Soyibo (2001), the main issue in the agency theory was identified to be asymmetric information due to the fact that owners do not have access to full information on corporate performance. For this reason, the separation of ownership and control bring to the fore, the agency problem i.e. managers being expected to represent the interest of the external owners. Going further, they asserted that:

> The discretionary control rights of managers are further increased by the existence of asymmetric information between themselves and external investors. This advantage allows the managers the freedom to conceal some pieces of information from external investors. Such action serves to increase the cost of monitoring and therefore enables managers to pursue their own rather than those of the equity investors, by entrenching their position or engaging in behavior that could be sub-optimal for the equity investors. The possibility of higher monitoring costs is particularly strong if there are large numbers of dispersed external investors, because a free-rider problem emerges if there are large costs to monitoring while the benefits accruing to each individual are relatively small.

Two ways by which a principal can reduce the risk of an inappropriate conduct by an agent according to Jensen and Meckling (1976) are by monitoring of the agent and bonding of the manager or the agent to certain positive outcomes.

From the above, we can deduce that the principal agent problem is reflected in management pursuing activities that are detrimental to the interest of the shareholders of the firm. The agency problem can usually be reduced through the protections derived from good corporate governance (Okeahalam and Akinboade 2003).

Shleifer and Vishny 1997 (as cited in Kajola 2008) opines that effective corporate governance reduces "control rights" shareholders and creditors confer on managers increasing the probability that managers invest in positive net present value projects. This Al-Faki (2006) says should make the relationship between the boards and management to be characterized by transparency to shareholders and fairness to other stake holders which will in turn have the effect of mitigating the agency costs as pointed out by Jensen and Meckling (1976).

Corporate governance as defined by Obi (2009), "is a term that refers broadly to the rules, processes, or laws by which businesses are operated, regulated and controlled". It goes further to explain that the terms can refer to internal factors as defined by the stakeholders of the company. An effective and efficient corporate governance that is put in place will assist the organization in achieving its' corporate objectives easing operations and impacting positively on the market value of the company.

On a broader perspective, corporate governance as defined by Gillan and Starks (2000), is a system of laws, rules and factors that control operations of a corporation i.e. it refers to the distribution of rights and responsibilities among different participants in the corporation such as the board of directors, managers, shareholders and other stakeholders. It equally spells out the rules and procedures for making decisions on corporate affairs.

Due to the distress experienced in the 1990's in Nigeria's banking industry which was principally driven by agency conflicts and information asymmetries, there have been measures put in place to ensure that the industry adopts good corporate governance practice which will cover the full disclosure of information, the avoidance of insider dealings and transparency in operations. One of such measures is the Code of Corporate Governance for Banks in the Post Consolidation period that was issued in 2006 after the recapitalization exercise in the banking industry.

10.3 An Overview of the Nigerian Banking Industry

Banking started in Nigeria in 1892 with the establishment of the African Banking Corporation. The first legislation on banking did not come until when 1952 when the first ordinance in the industry was made. Then only five banks that were in existence where made up of three foreign banks and two indigenous banks. The Central Bank of Nigeria (CBN) which is the apex regulatory authority in the financial industry was set up in 1959.

Up to the mid 80's the sector was highly regulated but by the late 80's financial liberalization had taken place to encourage growth and development in the sector. With the liberalization came a competitive market but alongside came a laxity in the regulatory functions, bad credits, policy somersaults and finally, bank distress. To curtail the distress, the CBN came out with policy measures such as the introduction of the prudential guidelines, moratorium on new bank licenses, and the privatization of banks to allow for better management. A decree was also put in place to prosecute cases of mismanagement in the sector as the government of the day was a military regime. With the coming in of a democratic government in 1999, there was the urgent need to open up the economy so as to be able to compete in the global economy. Programs that were geared towards economic liberalization and deregulation were put in place (Ahunwan 2002). Such programs directly affected governance and the liberalization of the capital market. The consolidation exercise in the banking industry of 2006 was part of the reforms put in place to open up the economy and as a result most of the privately owned banks were made to go public as they had to source for fund in the capital market to meet up with the capital requirements.

10.3.1 Corporate Governance Issues in the Nigerian Banking Industry

The importance of corporate governance in a developing and emerging economy like Nigeria cannot be overemphasized. The institutionalization of a good corporate governance policy helps to facilitate and stimulate the performance of corporations by creating and maintaining incentives which motivates insiders to maximize the firms operating efficiency (Sanda et al. 2005). This process at the same time has the effect of limiting insiders' abuse of power over corporate, resources as well as providing the means of monitoring managers' behavior in order to ensure corporate accountability (Ogbechie and Koufopoulos 2007).

As a result of the recapitalization exercise in 2006, the industry witnessed a tremendous growth but neither the sector nor the regulatory authorities were in the position to maintain and monitor growth in the sector. These culminated in the most recent crisis that affected the banking sector which witnessed the removal of chief executive officers and directors of nine major banks in the country. As a result, eight factors were identified as the main agents of the crisis that happened after the consolidation exercise (Sanusi 2010). Amongst them is the failure in corporate governance and the inadequate disclosure and transparency about the financial position of the banks.

The failure of corporate governance and by extension, the agency problem, was identified to be the major cause of the crisis. The banks, according to the CBN governor were engaged in "unethical and potentially fraudulent business practices". This led to the enrichment of senior top management executives to the detriment of the shareholders and depositors. Even though the banks grew in size, the boards of the banks did not carry out their responsibilities of monitoring and checking of management of the banks as entrusted upon them by the shareholders. The managing director had overbearing influence on the board which also hindered them in carrying out their functions. This was coupled with the lack of expertise and skill they needed to work. Unethical practice of setting up SPV's (special purpose vehicles) to siphon the depositors' funds was uncovered. Other practices included the acquisition of private jets, properties in choice places both within and outside the country, engagement in acts of nepotism, falsification of banks books to make the regulatory authorities believe the accounts were okay. These practice shows that the agency problem was an issue, as the management were no longer acting in the interest of the agents (i.e. the depositors and the shareholders).

Relating to the asymmetric information, the accounts provided by the management of the banks to the public and the regulatory authorities were inaccurate, incomplete, and often times are rendered late. This is clearly against the principle that for an investor to make an informed decision about his investment, information has to be timely and accurate. Other unethical practices involved in, according to the CBN governor includes the manipulation of share prices in order to make the share price of the bank rise and thus causing bubbles in the stock market. These bubbles had earlier burst in the stock market crisis of March 2008. Others practices included the "conversion of non-performing loans to commercial papers and bankers acceptances and the setting up of off balance sheet special purpose vehicles to hide losses".

As a result of the above practices by the management of the banks, the regulatory authority sacked the management of nine banks out of the 25 banks in the industry in August 2009. The sacked managing directors had combined assets worth over $2.7b in real cash and choice properties. In addition to sacking them, they are being prosecuted in the law courts for financial crimes and have had their assets both within and outside the country confiscated (This dayonline 2010). The banks are Oceanic Bank Plc, Intercontinental Bank Plc, Union Bank Plc, Fin Bank plc, Afri Bank Plc, Bank PHB, Spring Bank Plc and Equitorial Bank. The managing director and chief executive officer of Oceanic Bank plc was eventually found guilty. She was convicted and had her assets taken over by the Federal Government.

The above situations clearly showed that there was a serious problem with the principal/agent relationship in the industry as the agents had clearly abused the trust placed upon them. It was equally noticed that most of the managing directors had spent too long a time holding the position which made them to abuse the privileges of the office.

10.4 Conclusion

As can be seen in the preceding section, the major causes of the agency problem highlighted are:

1. The lack of an effective and efficient corporate governance in the sector and
2. The presence of information asymmetries.

If the above are removed then the problem will be greatly reduced. In furtherance to these recommendations, the Central Bank of Nigeria has equally come out with policy measures and reforms to prevent a reoccurrence. These measures includes

1. The enforcement of the corporate governance code to strengthen the industry. These will cover areas of establishment of mandatory board committees with a clear cut definition of the responsibilities expected of them,
2. The introduction of tenure limits for banks managing directors to prevent sit tight managing directors who can easily manipulate their ways around. The tenure was limited to a maximum of two 5 year terms such that some bank managing directors were forced to resign their posts for the policy to become effective.
3. Adoption of a system whereby information and data are rendered on time and the quality is not in doubt. This will enable investors and other stake holders make informed decisions.

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Part III
Corporate Governance in Asia

Malaysia
Turkey
Saudi Arabia
China

Chapter 11
Governance Structure and Practice in Malaysia: Board of Directors' Role and Responsibilities

Normahiran Yatim and Haslinda Yusoff

> *Corporate governance must become a need and not remain a want in order to be effective. . .they [companies] must feel the need to comply and not just want to do it. . . You must have the passion, you must have the belief; this is the way to move forward.*
>
> Tan Sri Megat Najmuddin Megat Khas
> President of Malaysian Institute of Corporate Governance
> The Star Online, October 29th, 2010

Abstract The Malaysian government has established a strong regulatory framework that underpins the national corporate governance (CG) ecosystem through local rules, regulation and best practices. Following that, this paper seeks to explore the CG compliance – governance structure and practices – of public listed companies in Malaysia. Particularly, this paper investigates the Board-related structure and practice which comprise of board size, board composition, board committee, CEO duality, multiple directorships, board meeting and the age limit for director. Content analysis was used to collect the CG related information of the top 100 companies via their annual reports. The information disclosed was then analyzed against the four key Malaysian CG-related requirements, namely; Companies Act 1965, BM CGG, MCCG and the CG Blueprint 2011. It was found that the board size of the Malaysian companies is appropriate and manageable, with majority of the companies complying with the requirements pertaining to the appointments of INED. Additionally, many companies favor for the separation between CEO and Chairman of the Board in governing their businesses. The companies also regard

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*, DOI 10.1007/978-3-642-45167-6_11, © Springer-Verlag Berlin Heidelberg 2014

multiple directorships as a 'healthy' practice; and that their practices in conducting board meeting also in comply with the referred requirements. This study also found that all companies had appointed some of their BODs with the age ranging between 50 and 69. Overall, these findings put forward an insight that majority of the Malaysian companies studied complied beyond the minimal requirement of CG.

11.1 Introduction

The public demands and pressures for corporate governance (CG) have increased over the years. Industry players, academia, even the public have given attention to the importance for CG practice. One of the key benefits of effective CG pertains to providing the path for corporate success and growth. In Malaysia, CG has been given a greater concern and recognition especially in a period after the economic crisis i.e. 1997. Initiatives have been taken in developing measures and guidelines locally towards improving the aspects of fairness, transparency, accountability and responsibility in an organization. The High Level Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (1999) has defined CG as:

> the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders.

CG also refers to the set of business structure in ensuring an appropriate balance between the rights of shareholders and the need for Board of Directors (BOD) and Management, for them to be able to direct and manage the business's affairs towards providing the expected returns to shareholders over time. The Cadbury Report (1992) UK has described CG as "the system by which companies are directed and controlled". Accordingly, BODs are responsible for the governance of their respective companies. Dalton et al. (1999) highlights that the three essential roles of BOD relate to (i) monitoring or controlling role, (ii) service or expertise role, and (iii) resource dependence role. BODs play a role in overseeing the retention of Chief Executive Officers (CEO) as well as resolving conflicts among managers, in any case if any. BODs also are expected to continuously advise the CEO and top management on administrative and other managerial issues. Apart from that, BODs has the responsibility to facilitate the acquisition of business resources.

Prevailing literature has shown that to certain extent best practices concerning the structure and functioning of BOD are related to better operating performance (see Jensen 1993; Bauwhede 2009). Following this stance, the research seeks to explore the governance structure and practices of public listed companies in Malaysia. In particular, the research contributes to the literature on the insights about CG from a developing nation i.e. Malaysian perspective. It primarily focuses on BOD structure and functioning, and not on other dimensions of corporate governance (such as, rights and duties of shareholders and range of takeover defences), on the belief that the structure and functioning of the Board have significant effect on the efficiency and effectiveness of company's operation and performance.

In the next section, this chapter will discuss the CG related regulatory settings and best practices of CG in Malaysia. Then, the chapter will explain the methodology of the study covering the sample of study and the data collection, followed by the discussions on the study findings. The last section of this chapter will provide the conclusions for the study as well as the recommendation for future research.

11.2 CG Regulatory Requirements and Best Practices on Board of Directors in Malaysia

11.2.1 Evolution of CG

Generally, Malaysia has benefited from a good governance regime which involves a number of laws and regulations that facilitates the corporate governance reforms and exercises in the country. The evolution of CG in Malaysia has been in place since the Asian financial crisis in 1997/1998; a crisis that to a certain extent acts as the catalyst for the beginning of progressive efforts by regulators who worked closely with industry to promote good CG in Malaysia (see Mohamad Mokhtar et al. 2009; Khoo 2003).

Over the years, from 2000 to 2010, the Malaysian government has established the building blocks for a strong regulatory framework that now underpins the Malaysian CG ecosystem (see Corporate Governance Blueprint 2011). As illustrated in Fig. 11.1, the foundation of CG in Malaysia was laid through the first Capital Market Masterplan following with the development of various regulatory frameworks and code of best practices on CG structure and practice. Recent launch of Capital Market Masterplan 2 (2011–2020) and the Corporate Governance (CG) Blueprint 2011 indicate the maturity of the CG structure and process in Malaysia. These are evidences with a transformational shift from a mere regulatory discipline to a balanced approach involving market and self discipline in line with an attempt to cultivate the spirit of CG in the culture of business corporations Table 11.1.

The development and evolution of CG structure and practices in Malaysia has actually undergone three significant phases, as shown in Fig. 11.1.

It is also interesting to note that the development of CG in Malaysia is also complemented with the establishment of the Malaysian Institute of Corporate Governance (MICG) and the Minority Shareholders Watchdog Group (MSWG) that function as institutional bodies in facilitating the implementation and improvement of corporate governance in Malaysia (Mohamad Mokhtar et al. 2009).

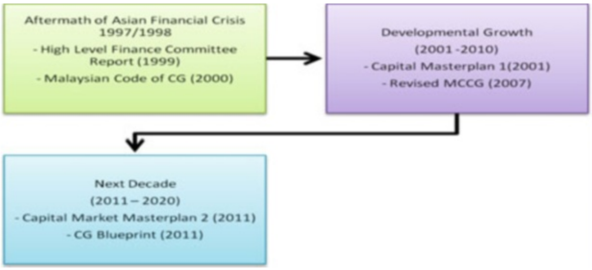

Fig. 11.1 Evolution of CG in Malaysia (Source: Securities Commission Malaysia 2011)

Table 11.1 The milestones of corporate governance in Malaysia

Year	Milestones
1999	High Level on Finance Committee Report on Corporate Governance
2000	Malaysian Code on Corporate Governance (CG Code)
	Minority Shareholder Watchdog Group (MSWG)
2001	Capital Market Masterplan (CMP)
	First Corporate Governance Report on the Observance of Standards and Codes (CG ROSC) by World Bank
	Corporate governance requirements incorporated into the Kuala Lumpur Stock Exchange Listing Requirements
2004	Whistle blowing provisions in securities laws
2005	Second CG ROSC commenced
2007	Qualification criteria for directors introduced, audit committee strengthened and internal audit function mandated
	Enforcement powers for civil and administrative actions expanded to allow recovery of up to three times the amount of losses for a wider range of market misconduct offences
	MSWG Guide of Best Practices for Institutional Shareholders
2009	The SC's enforcement powers broadened by the introduction of sections 317A and 320A of the Capital Markets and Services Act 2007 (CMSA)
2010	Audit Oversight Board (AOB)
2011	Securities Industry Dispute Resolution Center (SIDREC)
	Capital Market Masterplan 2 (CMP2)

Source: Corporate Governance Blueprint (2011, p. 2)

Malaysian has also received multiple international recognitions for progressive efforts taken to strengthen its corporate governance framework. This, which include:

1. Malaysia has consistently been ranked 4th for investor protection in the World Bank Doing Business Report during 2006–2010.
2. The World Bank Corporate Governance Report on the Observance of Standards and Codes (CG ROSC), in 2006, awarded full marks for Malaysia's compliance with IFRS.
3. The Institute of International Finance (IIF) in 2007 ranked Malaysia in the top quartile of emerging market countries surveyed for compliance with the IIF Corporate Governance Guidelines.

11.2.2 Board of Directors' (BODs) Role in Governance

This study emphasizes on BOD because it is one (if not the only) of the most important mechanism of CG. As one of the key element of CG, BOD provides additional provisions to shareholders as well as other investors of the firms because it serves as an effective monitoring mechanism to reduce the agency conflict. The success of the Board in fulfilling its oversight responsibility depends on its size, composition, and leadership qualities.

Boards that observe good governance are a critical safeguard against unethical conduct, mismanagement and fraudulent activities. Apart from playing the role of stewards and guardians of the company, the Board is a key factor for first-class corporate governance standards. The ideal Board builds on the legal framework to raise standards beyond compliance to a level where the spirit of best practices and their intent are fully embraced. Additionally, the Board is also responsible in ensuring an internal culture that promotes good corporate governance. Good corporate governance culture adds value to the company; hence, the Board should no longer be reactive, dependent and accommodating. With the importance of the Boards' role and its significance, our overall objective is for Boards to shift away from their role as mere advisers and begin to become active and responsible fiduciaries.

With the expanding roles and responsibilities of BODs, they are expected to adopt a formal charter that places their strategic plans, functions and responsibilities; those which are in line with the key values, principles and aims of the company. The Securities Commission Malaysia recommends a Board Charter that is useful and capable to facilitate the discharge of duties by BODs (refer to Fig. 11.2 below).

11.2.3 Regulatory Requirements

Section 131B (1) of the Companies Act 1965 states that the business and affairs of a company must be managed and directed by the BODs. The Boards are obligated to play an active role in directing management. While this does not mean they should be involved in operational matters, it certainly implies that Boards can longer be passively endorsing decisions of the management. The Act also declares "the board of directors has all the powers necessary for managing and directing and supervising the management of the business and affairs of the company" [see Section 131B (2) of Companies Act 1965]. Section 132 of the Act further describes the two primary aspects of BODs' duties; namely: (1) loyalty and good faith, and (2) care, diligence and skill (refer to Fig. 11.3).

Fig. 11.2 Board Charter (Source: Securities Commission Malaysia 2011)

11.2.4 Best Practices of CG

The production of Bursa Malaysia Corporate Governance Guide (BM CGG hereafter) is intended for BODs of public listed companies to gain a clear and constructive direction on CG best practices. This guide offers information on clear roles and requirements needed by the companies to enhance CG practices among their Boards and committees, thus, contributes the achievement of their business strategic goals and values. The guide also provides the integral ways BODs and their core committees in exercising their authorities and discharging their oversight duties effectively. In general, the BM CGG is designed to help directors understand their role and duties to the company and its importance to the business-stakeholders

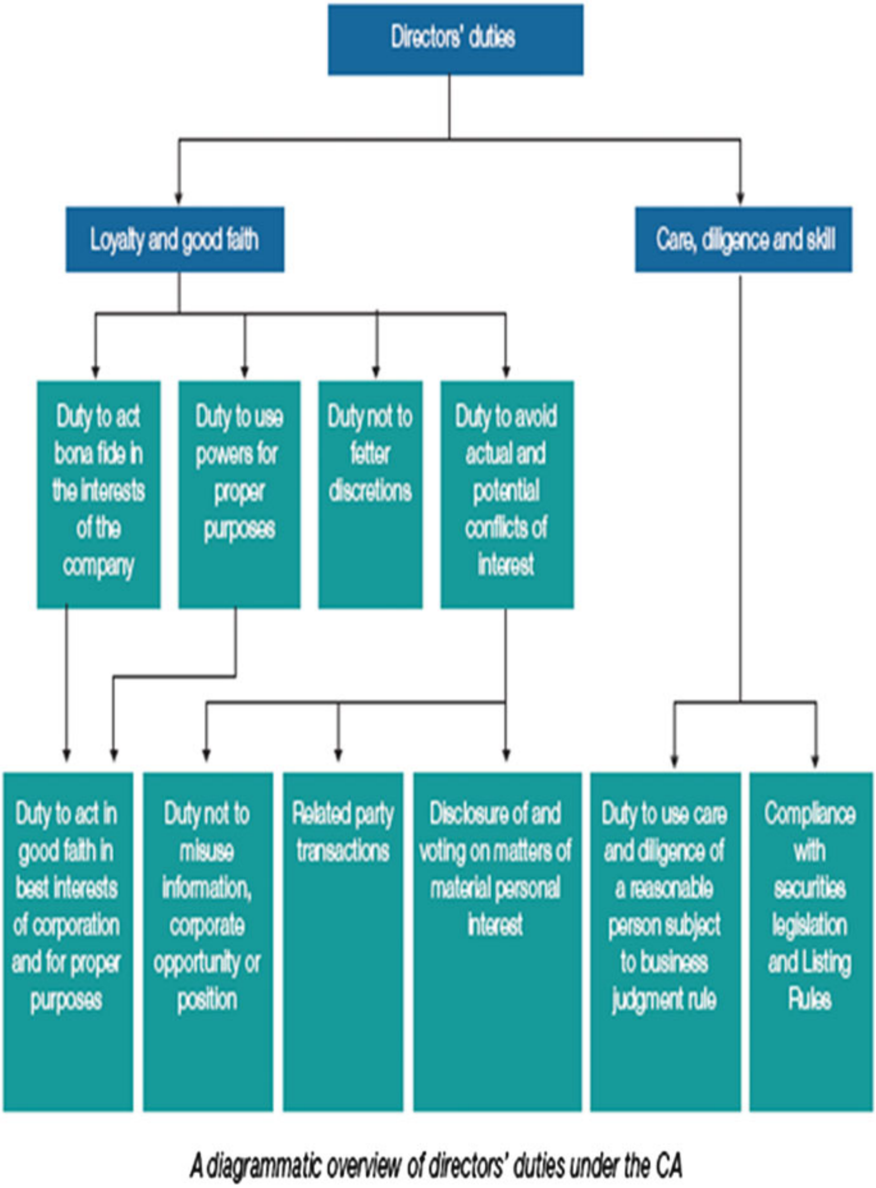

Fig. 11.3 Directors' Duties (Source: BM CG Guide 2009, Bursa Malaysia 2009)

relationships. With the primary objective is to enhance professionalism in both the Boards and their committees, the guide provides the followings:

- suggestions on how to fulfill the governance obligations of companies listed on Bursa Malaysia Securities Berhad; and

- practical examples of how the principles and best practices of CG can be implemented.

The BM CGG aims to raise the level of CG through the structuring and implementation of sound practices and processes which engender an effective Board. It aims to provide practical insights into best practices, including how such practices can be adhered to in substance rather than in form, in addition, it is also to help Boards achieve their strategic objectives and build sustainable value in their businesses. Principle A1 of Malaysian Corporate Governance Code (MCCG hereafter) 2007 prescribes that every listed company should be headed by an effective Board; one that should lead and control the company. Accordingly, the company's governance framework should be designed to:

- enable the board to provide strategic guidance and effective oversight of management;
- clarify the roles and responsibilities of board members and management to facilitate board's and management's accountability to the company and shareholders; and
- ensure a balance of authority so that no single individual has unfettered powers.

Laid by the Best Practice AAI of the MCCG 2000 (then, the Revised MCCG 2007), explicitly, the Board has these six key responsibilities:

1. Reviewing and adopting a strategic plan for the company;
2. Overseeing the conduct of the company's business to evaluate whether the business is being properly managed;
3. Identifying principal risks and ensure the implementation of appropriate systems to manage these risks;
4. Succession planning, including appointing, training, fixing the compensation of and where appropriate, replacing senior management;
5. Developing and implementing an investor relations programme or shareholder communications policy for the company; and
6. Reviewing the adequacy and the integrity of the company's internal control systems and management information systems, including systems for compliance with applicable laws, regulations, rules, directives and guidelines.

Pursuing on strengthening the responsibilities of BODs, the BM CGG 2009 highlights the need for a vigilant Board that are also supportive of the management. Accordingly, the essential responsibilities laid out in guide include:

1. Proactively participate in strategic decisions;
2. Challenge management with questions based on informed knowledge;
3. Oversee management's plans, decisions, and actions;
4. Monitor management's ethical conduct, financial reporting and regulatory compliance; and
5. Be capable of effectively achieving good governance and protecting stakeholders' interests.
6. Elements of BOD Structures and Practice.

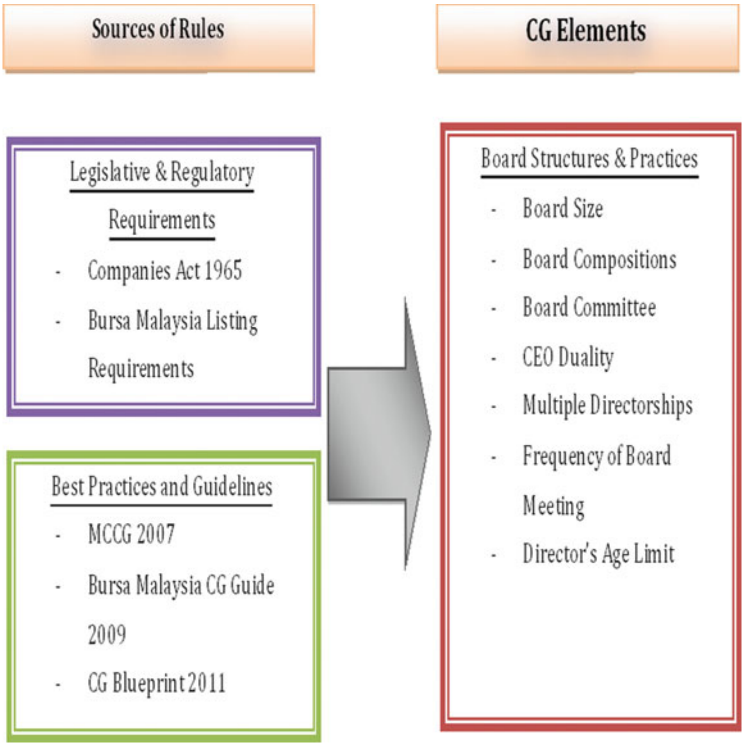

Fig. 11.4 Key CG rules and guidelines for BOD's structure and practices

BOD structure and practices are essential elements in ensuring company's CG. As illustrated in Fig. 11.4, it can be seen that there are a number of local sources of rules, regulation and best practices established as guidance for Malaysian companies to practice good CG. Chan (2011) affirms that balancing board size, board composition, board governance and continuous board evaluation is crucial in achieving the long term success of a company.

11.3 Board Size

The MCCG 2007 highlights the need for a Board to determine the appropriate size required for the effective discharge of its roles and responsibilities for the benefit of the company and its business. According to the Best Practice AAXII of the MCCG 2007, every Board should examine its size, with a view to determining the impact of the number upon its effectiveness. There is no prescriptive rule for a Board's optimum size (see BM CGG 2009); however, the Companies Act 1965 specifies only the minimum number of directors. The Act does not set a maximum number of directors although companies normally specify the maximum number in their Articles of Association. Nevertheless, the following factors should be considered in determining the number of seats in a Board:

- The evolving circumstances and needs of the company in terms of its size, scope or geography;
- The need to achieve an appropriate balance of executive and non-executive directors and the independent elements of non-executive directors. A Board with a balanced composition will ensure that no individual or small group of individuals will dominate decision-making;
- The establishment of board committees becomes impracticable with very small Boards; and
- Quorum requirements for board meetings.

11.3.1 Board Composition

Every Board should have a good proportion of executive directors and independent directors. A listed company must ensure at least two directors or one-third of its Board (whichever is the higher) are independent. Paragraph 15.02(3) of the Bursa Malaysia Listing Requirements (BM Listing Requirement hereafter) provides that if a vacancy in the Board results in a non-compliance with the required composition, the vacancy must be filled within 3 months. Additionally, the MCCG 2007 requires the Board to disclose on an annual basis whether one third of the Board is independent.

Persons appointed as independent directors must satisfy the definition of independent director set out in Paragraph 1.01 and Practice Note 13 of BM Listing Requirement. Paragraph 1.01 of the Listing Requirements describes independent director as one who is independent of management and free from any business or other relationship that could interfere with the exercise of independent judgment or the ability to act in the best interests of a listed company. Although defined by regulatory standards, independence in thought and action should always be evaluated qualitatively and on a case-by-case basis by the collective Board. The BM Listing Requirement states that Boards are expected to give effect to the overall company's spirit and intention. Independent directors may bring in the quality of detached impartiality to the company; this is important for the protection of the interests of minority shareholders. Such a factor may also support the potential significant contributions to a company's decision making. An independent director is especially important in areas where the interests of management, the company and the shareholders diverge, such as executive performance and remuneration, related party transactions and audit.

Principle AII of the MCCG 2007 states that the Board should include a balance of executive directors and non-executive directors (including independent non-executives), in which, it is unaccepted for an individual or a small group of individuals to dominate the Board's decision making. The Best Practices AAIII of the MCCG 2007 explains that non-executive directors should be persons of calibre, credibility with the necessary skill and experience; such criteria are essential for the directors to be able to result in an independent judgment for matters that pertain to company's strategy, performance and resources. The appointment information should also be made available to the public, in which the Best Practices AAIV of the MCCG 2007 laid out that disclosures pertaining to the Board appointments and composition are to be made an annual basis, especially in circumstances where the company has significant shareholders. Such a disclosure will satisfy the requirement to fairly reflect, through Board representation, the investment of the minority shareholders in the company. The appointment of non-executive directors is essential as a Board is strengthened significantly by this group who has no connection with the company. The non-executive directors may actually bring dispassionate objectivity that a director with a relationship with the company may not provide.

The composition of the Board is also laid out in the CG Blueprint 2011; in which the recommendations include the followings:

1. Mandate the limit on the tenure of independent directors
A cumulative term limit of up to 9 years will be imposed on independent directors. Directors may continue to serve thereafter, but will be re-designated as non-independent directors.

2. Mandate assessment on independence and its disclosure
Boards must undertake an assessment on independence annually, upon re-admission and when any new interests or relationships surface; based on a set of criteria established by the Boards. They must disclose in the company's proxy form and annual report that such an assessment has been carried out.

11.3.2 Board Committee

According to the Best Practice AAXXIII of MCCG 2007, where the Board appoints a committee, it should detail out the authority of the committee and, in particular, whether the committee has the authority to act on behalf of the Board or just on certain authority to examine a particular issue and report back to the Board with a recommendation. The establishment of board committees facilitates the BODs in the discharging of their duties and responsibilities. Such an establishment may:

- allow directors to make better use of their limited time;
- allow more focus to be given to complex issues and recommending courses of action; and
- reinforce the role of independent directors in monitoring company activities.

The setting up of the Audit Committee is mandated by the BM Listing Requirement (see Paragraph 15.10). Additionally, the MCCG 2007 recommends the establishment of the Nominating and Remuneration committees. Table 11.2 below

Table 11.2 The types, functions, and related requirements and best practice of board committees

Types of committee	General functions	Legislative requirements	Best practices
Audit Committee	Provides the Board with assurance of the quality and reliability of financial information used by the Board and of the financial information issued publicly by the company	BM listing requirements paragraph 15.10	Best practice BBI of MCCG 2007 BM CGG 2009 Chap. 2
Nomination Committee	Annually review the Board's required mix of skills and experience and other qualities, including core competencies, which non-executive directors (NEDs) should bring to the Board	None	Best practice AAIX and AAX of the MCCG 2007
	Annually assess the effectiveness of the Board as a whole, the committees of the Board and the contribution of each individual director		BM CGG 2009, Chap. 7 CG Blueprint 2011, Recommendation 3.4
Remuneration Committee	Develop a policy on the remuneration of executive directors and propose balanced packages to these directors. Also to attract, retain and motivate executive directors of the quality required	None	Best practice AAXXIV of MCCG 2007 BM CGG 2009, Chap. 8

provides the types, function and the related requirements and best practice of Board committees.

11.3.3 CEO Duality

> One of the desirable practices of an effective board structure is for the roles of the Chairman and CEO to be held by separate individuals, for a better check and balance.
>
> Rita Benoy Bushon,
> Chief Executive Officer, Minority Shareholder Watchdog Group (MSWG)
> at the Presentation of Survey Findings of the Malaysian Corporate Governance Index,
> 07 December 2011

CEO duality is a situation where there exists a combined role whereby the CEO is also the Chairman of the BOD. It has been argued that such a CEO duality situation may increase agency problem because the Chairman is suppose to monitor the performance of the CEO (see Mohamad Mokhtar et al. 2009). On one hand, according to BM CGG 2009, a Chairman should undertake, amongst others, the following responsibilities:

- Monitor the workings of the Board, especially the conduct of board meetings;

- Ensure that all relevant issues for the effective running of the company's business are on the agenda;
- Ensure that quality information to facilitate decision-making is delivered to Board members on a timely basis;
- Encourage all directors to play an active role in Board activities;
- Chair general meetings of shareholders; and
- Liaise with the CEO and the company secretary on the agenda for board meetings.

On the other hand, BM CGG also indicates that CEOs play an important role in ensuring the performance hence the sustainability growth of a company. A CEO is expected to provide strong leadership, clear strategic vision, good and right judgment and wisdom and strong capabilities in leading the company to meet immediate performance targets without neglecting longer-term growth opportunities of the company.

The MCCG 2007 highlights the need to have clear accepted responsibilities of the "head of company", as it will ensure a balance of power and authority, and that no individuals will be mistreated. Nevertheless, CEO duality is an acceptable practice; and in the event the roles are combined, the Code recommends that "there should be a strong independent element on the board" to strive for independent decision-making. A decision to combine the roles of Chairman and CEO however should be publicly explained in the annual report (as per Best Practice AAII of MCCG 2007).

11.3.4 Multiple Directorships

Membership on Boards represents a significant time commitment and it is expected that directors allocate sufficient time to the company to perform their duties effectively. The BM Listing Requirement provides a guideline on the appointment of multiple directorships for company's BODs. Paragraph 15.06 "Restriction on Directorships" of the BM Listing Requirement indicates that a director of an applicant or a listed issuer must not hold more than 25 directorships in companies, of which:

- the number of directorships in listed issuers must not be more than 10; and
- the number of directorships in companies other than listed issuers must not be more than 15.

The CG Blueprint 2011 also provides recommendations for multiple directorships. Paragraph 3.5 states the limit number of directorships held by individual directors:

- Directors are permitted to serve up to only five listed companies in Malaysia;
- Directors must advise the Chairman or senior independent director in advance of accepting any invitation to serve on another company Board;

- Assessment through the Nominating Committee and approval of the existing Board is required prior to accepting any new appointments on Boards of other listed companies; and
- The Board must disclose in the company's proxy form and annual report, which such an assessment has been carried out by its Nominating Committee.

11.3.5 Board Meeting

Best Practice AAXIV of the MCCG 2007 describes that Board meeting should be carried out regularly. The Board is required to record the detail deliberations from the meeting; in terms of the issues discussed, and the conclusions in discharging its duties and responsibilities. The Board should disclose the number of board meetings held in a year and the details of attendance of each individual director in respect of meetings held in the company's annual report. Disclosure of the total number of Board meetings held and attendance of directors during the financial year is mandated under the BM Listing Requirement [See Chap. 9, Appendix 9C Part A (paragraphs 3 and 12)]. The Companies Act 1965 further emphasizes that Board meeting must be organized at least once in every 12 months, and not more than 15 months.

The frequency of meetings must be dictated by the requirements of the company. A listed company would typically have a minimum of 6–8 board meetings (i.e. meetings to approve the quarterly financial statements for announcement to the Exchange and to approve the annual financial statements of the company, etc.) annually. In certain circumstances (e.g. major transactions or take-over bids) and for regulated industries, e.g. banking, insurance, etc., the Board has to meet more frequently.

11.3.6 Directors Age

The Companies Act 1965 provides that the maximum age limit of directors appointed in Malaysian companies is 70; as prescribed in Section 129 (1) of the Act. Nevertheless, it is possible for a person over 70 to continue in office as director, with the condition that his re-appointment is secured by a resolution passed by not less than three-fourths members of the company who are entitled to vote, whether in person or by proxy, at an annual general meeting. Other key regulatory guidance including the BM Listing Requirement, MCCG 2007 and CG Blueprint 2011 have no provision on the age limit for company's director.

11.3.7 Summary

The above discussions provide a general idea about the regulatory and best practice setting for corporate governance structure and practice in Malaysia. In particular, the discussions have focused on the aspect pertaining to the Board-related structure and practice which comprise of board size, board composition, board committee, CEO duality, multiple directorships, board meeting and the age limit for director. These inputs are used as the study framework to explore and investigate the actual Board structure and practice in the Malaysian business industry. In particular, the framework acts as guidance on the scope of CG compliance of companies in Malaysia.

11.4 Sample and Data

This study applied content analysis technique in exploring companies' CG structure and practice. Krippendorff (1980, p. 21) states that "content analysis is a research technique for making replicable and valid inferences from data according to their context". The utilization of content analysis in this study was relevant as it is an approach that had gained acceptance from researchers due to that the data collected are objective, systematic and reliable (e.g. Krippendorff 1980; Gray et al. 1995; Krippendorf 2004; Guthrie and Abeyeskera 2006).

The main source of reference for this study was the corporate annual report of the top publicly listed companies of Bursa Malaysia (for the financial year ending 2010), which had been downloaded directly from the stock exchange's website. The use of corporate annual reports as the main data source for CG-related information explored was elicited by the following justifications:

- a communication medium to external audiences, and corporate management has complete editorial control;
- the most significant source of information due to its statutory compliance, regular production, high degree of credibility; and
- the most accessible source of information for listed companies, both in hard copies and electronically (e.g. Mariri and Chipunza 2011).

Initially, top 100 companies were chosen based on size of companies – a size ranking of market capitalization. The selection of using study using market capitalization as a proxy for size has also been used by previous researchers such as Guthrie and Parker (1990), Hackston and Milne (1996), and Kamal and Deegan (2011). Nevertheless, this study finalized the sample to 80 companies based on its national/local establishment; in which the other 20 companies were multi-national corporations. Such a selection for the study sample was made consistent with the aim of study, i.e. to investigate the CG structure and practice based on the Malaysian-related guideline and codes. The list of selected companies can be referred to in Appendix 1. A checklist was developed in assisting the content analysis performed. The CG structure and practice investigated comprised of the followings:

1. Board size
2. Board composition
3. Board committee
4. CEO duality
5. Multi directorship
6. Number of Board meeting
7. Age limit of directors

The information pertaining to CG structure and practice were collected from the content analysis made in the Corporate Governance section of the Annual Report of each top 80 companies. The CG disclosures were analyzed against the four key Malaysian CG-related requirements, which encompassed Companies Act 1965, BM CGG, MCCG and the CG Blueprint 2011 (refer to Table 11.3 below).

11.5 Findings and Discussion

11.5.1 Demographic Information

Figure 11.5 below illustrates the industry sectors that the publicly listed companies studied belong to. Among the top 80 of local Malaysian companies listed under Bursa Malaysia, approximately 41 % of the companies (33) are categorized under the Trading and Services sector, followed by 10 companies from the Finance sector, whilst the least number of companies were from the Technology sector (i.e. two companies).

11.5.2 Board Size

The study also explored the board size of the top 80 local publicly listed companies in Malaysia. Board size is determined by the number of board of directors who sit on the board (see Chen et al. 2006), and that it may affect the monitoring ability of the board. Only two companies are found to have the lowest number of BOD (i.e. with five members), while the highest number of directors on board is 15. On average, among the top 80 local public listed companies, Malaysian companies have a mean score for their board size of 9.29.

Figure 11.6 demonstrates that 36 out of 80 companies (45 %) had BOD members ranged from 8 to 10, while 20 companies had 11–13 BODs and only two companies

Table 11.3 Summary of recommended CG structure and practice based on Malaysian Regulations

Requirement	Companies Act 1965	BM CGG 2009	MCCG 2007	CG Blueprint 2011
Board size	At least two directors, who each has his principal or only place of residence within Malaysia	No prescriptive rule for a board's optimum size	Focus on the impact of the number upon its effectiveness	None
Board Composition (INED/DED)	None	(i) At least two directors or one-third of its Board (whichever is the higher) are independent directors	(i) One-third of the Board should comprise independent non-executive directors	(i) Ensure Boards have no interest or ties in the company that could adversely affect independent and objective judgment and place the interest of the company
		(ii) A meaningful proportion of non-executive directors should have the key attribute of independence, and be known to act independently		(ii) Boards must ensure the right mix of members with the appropriate skills, and experience to cope with the 3Cs – Complexities, Competition and Changes
Board Committee	None	(i) Clear description on the authority of the committee. Whether the committee has the authority to act on behalf of the Board or just the authority to examine a particular issue and report back to the board with a recommendation	(i) Clear description on the authority of the committee. Whether the committee has the authority to act on behalf of the board or just the authority to examine a particular issue and report back to the Board with a recommendation	None
		(ii) Should at least appoint: **Audit committee** **Nominating committee** **Remuneration committee**	(ii) Should at least appoint: **Audit committee** **Nominating committee** **Remuneration committee**	

(continued)

Table 11.3 (continued)

Requirement	Companies Act 1965	BM CGG 2009	MCCG 2007	CG Blueprint 2011
CEO duality	None	(i) In the event the roles are combined, "there should be a strong independent element on the board" to strive for independent decision-making (ii) A decision to combine the roles of chairman and CEO should be publicly explained in the annual report	(i) Where the roles are combined there should be a strong independent element on the board (ii) A decision to combine the roles of chairman and chief executive officer should be publicly explained	No regulatory requirement for the roles of chairman and CEO to be separated
Multiple directorships	None	Not more than 10 directorships in public listed companies	None	Ensure the capacity and commitment by directors Should be limited to a maximum of five (in public listed companies), prior to the approval of the board
Board Meeting	At least once in every calendar year and not more than 15 months after the holding of the last preceding annual general meeting	(i) A minimum of 68 board meetings annually (ii) The frequency depends on the nature of the company's operations	(i) The board should meet regularly, with due notice of issues to be discussed (ii) Disclosure should be made on the number of board meetings held a year and the details of attendance of each individual director in respect of meetings held	None
Director age limit	No person of or over the age of seventy years shall be appointed or act as a director of a public company or of a subsidiary of a public company (automatic exercise)	None	None	None

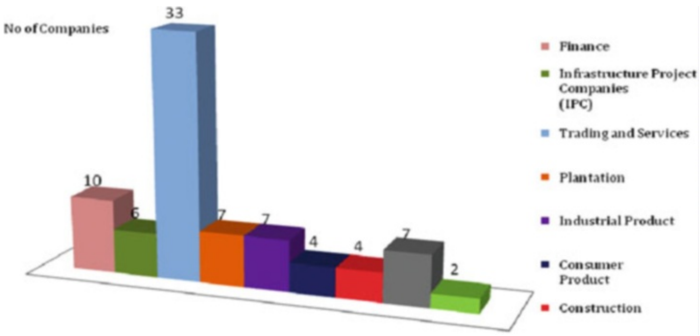

Fig. 11.5 Study samples based on industry sector

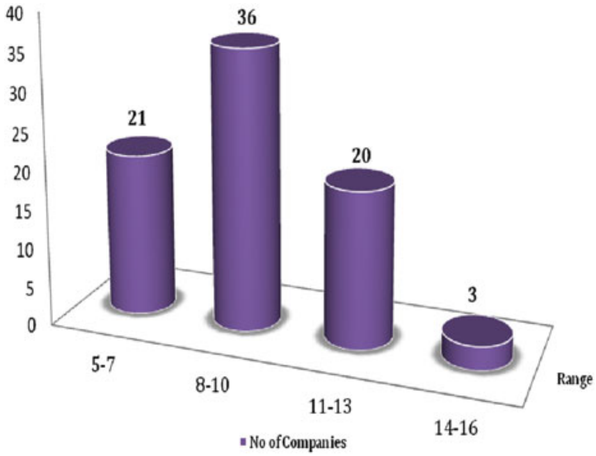

Fig. 11.6 Board sizes of top 80 local Malaysian public listed companies

had board size of 14–16 directors. Interestingly, 21 companies (approximately 26 %) had a board size that ranged from 5 to 7 directors.

First, this finding indicates that the Malaysian companies comply with the Companies' Act 1965 minimum requirement i.e. a company should have at least two members in its Board. Second, the finding also implies that the board size of the Malaysian companies is appropriate and manageable (also see Abdullah 2010); this, which is in line with MCCG's assertion that the board size is essential towards ensuring BOD's effectiveness (FCCG 2000). The ranges of number of directors found signify that many of the Malaysian companies studied consider having an appropriate number of BODs as useful and that it facilitates the governing of the company with their different education backgrounds, knowledge and expertise. In general, the study finding provides a preliminary idea that majority of the Malaysian companies took an average approach on appointments of BOD. This is in line with the assertions made by the literature about larger boards may lead to ineffective board (e.g. Abdul Rahman and Mohamed Ali 2006; Fiegener and Brown 2000).

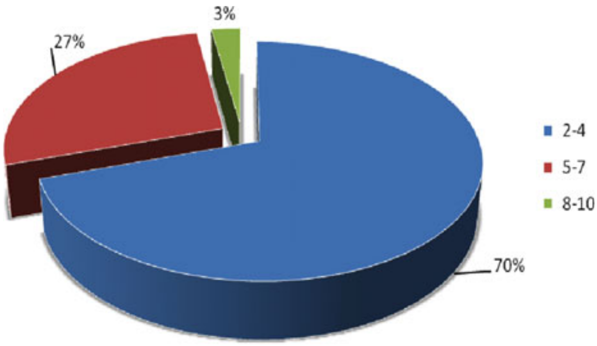

Fig. 11.7 Board composition: appointment of independent non-executive director (INED)

11.5.3 Board Composition

> Every public-listed company should be headed by an effective board which can both lead and control the business. . .a board made up of a combination of executive directors, with their intimate knowledge of the business, and outside [independent] non-executive directors, who can bring a broader view to the company's activities. . .
>
> MCCG (2000, para 4.18)

As highlighted by Fama and Jensen (1983), the number of independent directors in a Board (board composition) is essential for greater monitoring and controlling over management. This is also consistent with the agency theory's perspective that highlights about board domination and the potential for less attentive monitoring of the management. BM Listing Requirements (see Bursa Malaysia (2010)) defines *independent directors* as "directors who are not officers of company and are free of any relationship that could interfere with exercise of independent judgment"; which focus on the independent character and judgment of the directors.

This study found that 70 % (56/80) of the top local companies in Malaysia had appointed only 2–4 I.E. in their companies (refer Fig. 11.7). Figure 11.7 also demonstrates that 27 % of them (22) had appointed between 5 and 7 INED, and only 3 % had between 8 and 10 INED. in their companies.

Prevailing literature has found mix results pertaining to the influence of INED on business performance. On one hand, Abdullah (2004) discovered no relationship between board composition and its effect on performance among companies in Malaysia. On the other hand, Dehaene et al. (2001) who studied on Belgian companies found a significant positive relationship between percentage of outside director (INED) and ROA, a proxy used for company's performance. Despite the mix results, agency theory supports the idea about the potentials of having high number of independent directors in BOD. Principally, compliance (through minimum requirement) on board composition is not sufficient (see Abdullah 2010) for deep understanding on the influence of governance structure and the success of a company. The crucial governance-related aspect relates to the discharge of duties and responsibilities towards effective BODs in leading the sustainability of a company's growth. Consistent with the CG Blueprint 2011, Boards must ensure

Table 11.4 Information on board composition

	Board composition	
	INED (%)	DED (%)
Mean	45	55
Max	78	77
Min	23	22

the right mix of members with the appropriate skills, and experience to cope with the 3Cs – Complexities, Competition and Changes.

Table 11.4 lists the mean scores, as well as the maximum and minimum percentages of INED and DED over the board size of the top local Malaysian companies studied. INED is measured using the number of INED who sit on board. On average, 45 % of the BODs in Malaysian local companies are INED, whilst 55 % comprised of dependent executive directors (DED). It has also been found that the highest percentage of INED was 78 %, and the lowest composition was 23 %. Such a finding indicates that majority of the Malaysian companies studied followed the existing regulations (e.g. BM Listing Requirement and MCCG); in which, they had appointed INED more that 1/3 of their BODs (approximately 33 %). Specifically, 86 % of the companies were found to have met the MCCG 2007 and BM Listing Requirement on the appointments of INED.

11.5.4 Board Committee

Both the BM Listing Requirement and MCCG 2007 have stated that in general, companies in Malaysia should at least established three board committees; which comprise of Audit Committee, Nomination Committee and Remuneration Committee.

Figure 11.8 describes that 54 out of 80 (67.5 %) top local public listed companies in Malaysia have established between 3 and 4 types of board committees. While, 8 companies (10 %) have 1 to 2 board committees and 18 companies (22.5 %) established a minimum of 5 board committees. Overall, the companies have complied with the existing CG-related Malaysian regulations, in which a total of 90 % have established more than the 3 stated board committees. In particular, the average number of board committees is approximately 4 (3.75), with maximum of 7 and minimum of 1 committee (refer to Table 11.5).

On average, the companies studied have approximately 4 board committees; this which indicates the compliance of CG structure with the key CG regulations and best practices in Malaysia. Interestingly, it has been found that 1 company disclosed that only Audit Committee has been set up; as the company discloses:

> ... does not elect to establish other board committees as the Board believes that all members must be equally responsible for the overall core responsibilities of the Board which must be carried out with due care to ensure that high ethical standards are upheld, and that the interests of stakeholders are always taken into consideration...

Fig. 11.8 Number of board committees

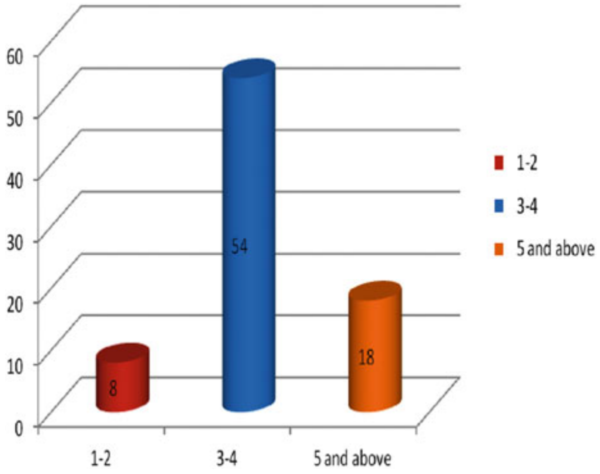

Table 11.5 Information on board committee

	No. of co.
Mean	3.75
Max	7
Min	1

11.5.5 CEO Duality

Prevailing studies had found mixed results on the link between duality status of BODs and company's performance (e.g. Chen et al. 2005; Abdullah 2004; Dehaene et al. 2001; Dalton et al. 1998). Nevertheless, some previous research argues the strength of separating the CEO and the Chairman of BODs; which include (1) ensures directors' independence (Chaganti et al. 1985), and (2) supports Board effectiveness in monitoring the management (Agrawal and Chandha 2003). In this case, an extended research on the effect of Board's role duality on company's performance may be useful in gathering further understanding on Malaysian practices.

It has been found that only 7 out of the 80 companies studied (i.e. approximately 8.7 %) had their CEO also holding the position as the Chairman of their BODs (refer Fig. 11.9). Such a finding put forward an idea that many of companies in Malaysia favor for the separation between CEO and Chairman of the Board in the governing and strategizing of their business. This finding is also consistent with the findings from the Malaysian Corporate Governance Index 2011, in which it has been found that between 2009 and 2011, the percentage of the separation of Chairman and CEO has increased from 60 % to 82 %. Despite that CEO duality is allowed under MCCG 2007, according to the CG Blueprint 2011, there is no regulatory requirement for the roles of Chairman and CEO to be separated. The low percentage of CEO duality also signifies that Malaysian companies support the

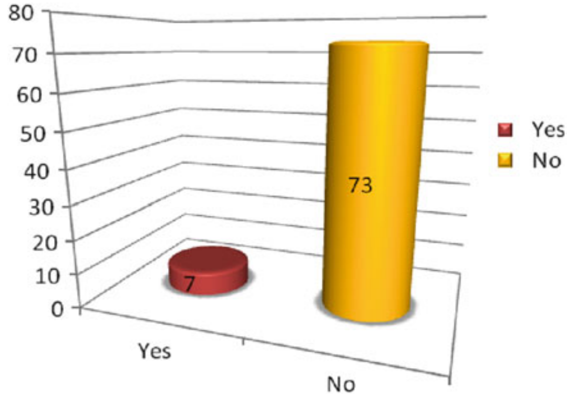

Fig. 11.9 The practice of CEO duality

"check and balance" practice (see Haniffa and Cooke 2002) and move towards Board effectiveness (e.g. Agrawal and Chandha 2003).

11.5.6 Multiple Directorships

Sometimes known as 'interlocks' or cross-directorships, multiple directorship relates to a situation in which directors sit on more than 1 Board. The CG Blueprint 2011 recommends that the number of directorships held in listed companies should be limited to a maximum of 5. Some literature highlights the drawback of multiple directorships; for instance, Haniffa and Hudaib (2006) found low multiple directorships will lead to better market performance. In addition to that many directorships may lead to ineffective Board (e.g. Abdul Rahman and Haniffa 2005) as well as may result in distractions in performing the role of a director (Pass 2004). Nevertheless, a study by Che Haat (2006) found significant link between cross-directorship and firm market performance. According to the study, such a practice may facilitate directors to develop and implement good business strategies among the companies they hold directorship.

As presented in Fig. 11.10, this study found that directors in 58 out of 80 (72.5 %) companies studied held multiple directorships while the rest only have a single directorship. Such a finding put forward a preliminary insight about that Malaysian companies regard multiple directorship as a 'healthy' practice; i.e. obtaining various experience from different companies hence contributing to greater knowledge, skills and innovativeness in leading and strategizing towards the sustainable development of the respective businesses.

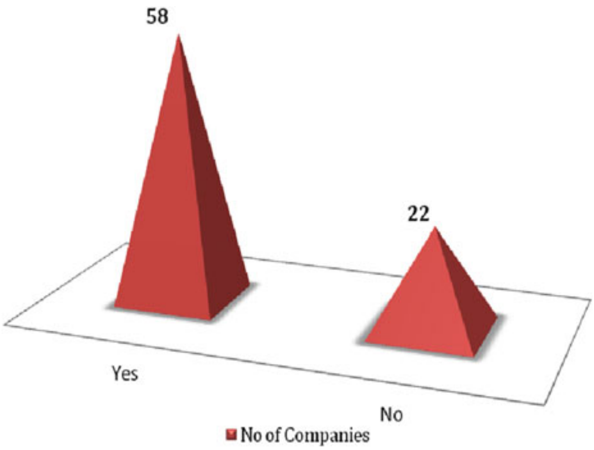

Fig. 11.10 Number of multiple directorships (interlocking directors)

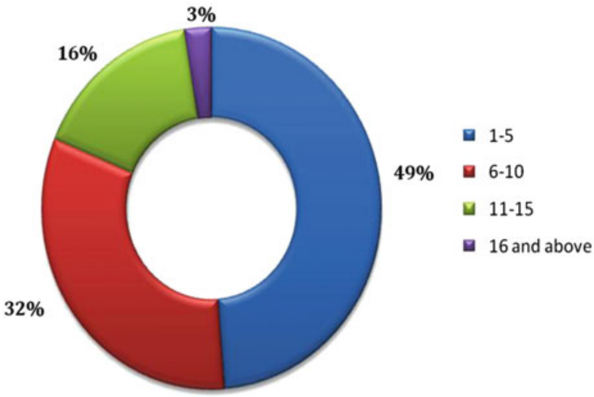

Fig. 11.11 Number of board meeting

11.5.7 Board Meeting

Board meeting is measured using the frequency of board meetings within the year. The highest number of meeting among the companies studied is 33 meetings, while the lowest number of meeting is 3 in a year. On average, the top local Malaysian companies conducted around 7 meetings in a year. This study also discovered that majority of the top 80 local Malaysian companies (i.e. 49 %) reported that they have conducted minimal number of board meeting, i.e. between 1 and 5 times annually; as illustrated in Fig. 11.11.

Thirty-two percentage of the companies conducted between 6 and 10 board meetings while 16 % of them had conducted between 11 and 15 board meetings in that year. Interestingly, only 3 % of the companies studied had their BODs met 16 times or more in that particular year. These practices indicate the compliance of the Malaysian companies concerning board meeting with the guidelines stated in the Companies Act 1965, BM Listing Requirement and MCCG 2007.

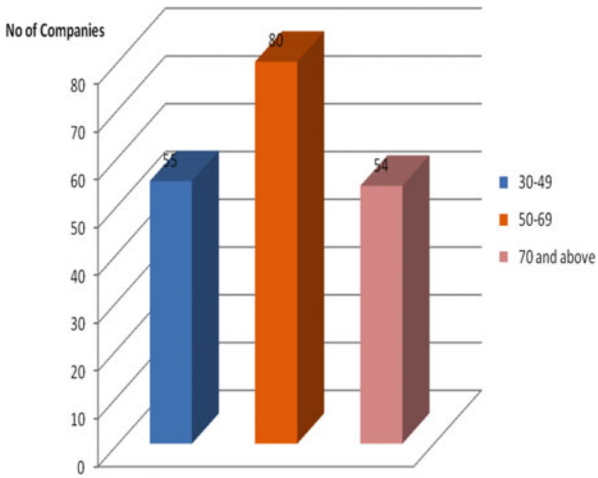

Fig. 11.12 Age of Malaysian directors

All companies had also made some form of disclosures in their annual reports about the number of board meetings held a year and the details of attendance of each individual director in respect of meetings held; this, which is consistent with the MCCG 2007. Above all, most importantly, the Board should frequently meet and discuss on the related business issues, often which depends on the nature of the company's operations.

11.5.8 Age of Malaysian Directors

The range of age for directors' appointment is essential, as to certain extent, age relates to the level of skills, experience and wisdom. Hence, having BODs with a range of different age is pertinent for a balance of expertise who act as stewards and guardians of the company's affairs.

When studied the age of BODs, it had been discovered that the youngest director from the top 80 companies is 30 years old while the oldest is 83 years old. This study also found that all top 80 local Malaysian companies had appointed some of their BODs with the age ranging between 50 and 69. Out of the 80, 55 companies (68.8 %) also appointed board members from the age of 30 until 49. Refer to Fig. 11.12.

Under the Companies Act 1965, a person of or above 70 years old should not be appointed as BOD, however with agreement in annual general meeting the person can be appointed as board members. From the data collected, 54 companies (67.5 %) have directors from this range of age (i.e. 70 and above). Despite that many companies still appoint directors of age above the limit laid out by the Companies Act 1965, disclosures have been made pertaining to it. This finding indicates that in relation to the age of directors, majority of the local companies had complied with the existing CG guidelines and best practices.

11.6 Conclusions

The BODs are a group of people appointed as the key individuals with responsibilities to govern and direct the strategic movements of a company, in the best interest of stakeholders. With the responsibilities to oversee the management capabilities of the 'agents', it is no doubt that board structure and practice is a crucial factor in ensuring the sustainability growth of the company. The exploration carried out in this study had focused on the governance structure and practice among public listed companies in Malaysia, based on the prevailing national CG regulatory and best practices' references. In particular, this study seeks knowledge about the structure and practices of BODs in local Malaysian companies.

The study has resulted that on average, the board size is nine directors. With regards to board composition, on average, the BOD comprised of 45 % INED, with majority of them had appointed between 5 and 7 INED. The average number of board committees was approximately four; with a total of 90 % have established more than 3 board committees. Nevertheless, there a few companies with board committees of only one. It has been found that role duality is very low in Malaysia; in which approximately only 8.7 % had their CEO also holding the position as the Chairman of their BODs. In relation to multiple directorships, directors in majority of the companies (i.e. 72.5 %) also held position as BOD in other companies. Majority of the top local Malaysian companies had conducted their board meeting with an average of between 1 and 5 times annually. In general, the companies studied in Malaysia have their directors with the age ranging from 50 to 69.

Overall, this study provides insights about the current board structure and governance practices in which the Malaysian local companies comply beyond the minimal requirement of CG. The Board size, Board composition, CEO duality, multiple directorships, and number of board meetings have been found to conform to the CG-related requirements and guidance as laid down in the Companies' Act 1965, BM Listing Requirement, BM CGG 2009, MCCG 2007 and CG Blueprint 2011. Only the finding pertaining to the age of director has showed differently; this study discovered that majority of the companies have appointed their BODs that aged above 70 years old.

Above all, it is most important that the companies ensure good corporate governance is in place, with their existing appointments of BODs. Effective and efficient BODs will in fact lessen the agency problem in business corporations. Apart from the importance of compliance with CG guidelines and regulations, other values including culture, ethics and honesty, which based on trust, transparency, accountability and fairness, are crucial for good CG (see Teng et al. 2011). In other words, the setting of board structure and practice sets the foundation for good CG, in addition to that, individual and organizational good values complement towards achieving the effectiveness of CG in the business world.

The results of this study have to be interpreted with caution because this study only involved the top 80 local Malaysian companies. Further research exploring more companies, with different establishment (local and multinational) may offer greater insights on the board structure and practice of business market in this country. Additionally, investigation on the effect of the board structure and practice on company's performance and management practice will further enhance understanding on the usefulness good CG.

Appendix 1: Top 80 local public listed companies in Malaysia

No	Companies
1	Maybank Banking Berhad
2	CIMB Group Holdings Berhad
3	Maxis Berhad
4	MISC Berhad
5	Tenaga National Berhad
6	IOI Corporation Berhad
7	Axiata Group Berhad
8	Genting Berhad
9	Petronas Gas Berhad
10	PPB Group Berhad
11	Digi.Com Berhad
12	Kuala Lumpur Kepong Berhad
13	Plus Expressway Berhad
14	YTL Power International Berhad
15	Genting Malaysia Berhad
16	Am Bank Holdings Berhad
17	YTL Corporation Berhad
18	RHB Capital Berhad
19	Telekom Malaysia Berhad
20	Petronas Dagang Berhad
21	Hong Leong Financial Group Berhad
22	MMC Corporation Berhad
23	Malaysia Airlines System Berhad
24	IJM Corporation Berhad
25	Berjaya Corporation Berhad
26	Berjaya Sport Toto Berhad
27	Gamuda Berhad
28	Malaysia Airport Holdings Berhad
29	Parkson Holdings Berhad
30	Berjaya Land Berhad
31	UEM Land Berhad
32	Genting Plantation Berhad
33	EON Capital Berhad
34	Batu Kawan Berhad
35	Affin Holdings Berhad
36	Alliance Financial Group Berhad
37	SP Setia Berhad Group
38	Top Glove Corporation Berhad
39	Bursa Malaysia Berhad

(continued)

No	Companies
40	Boustead Holdings Berhad
41	AirAsia Berhad
42	JCY International Berhad
43	Oriental Holding Berhad
44	Malaysia Bulk Carrier Berhad
45	KLCC Property Holdings Berhad
46	Tan Chong Motor Holdings Berhad
47	Proton Holdings Berhad
48	Sapuracrest Petroleum Berhad
49	Bintulu Port Holdings Berhad
50	IGB Corporation Berhad
51	The Star Publication (Malaysia) Berhad
52	IJM Land Berhad
53	Kencana Petroleum Berhad
54	Multi-Purpose Holdings Berhad
55	Titan Chemicals Corporation Berhad
56	LPI Capital Berhad
57	Dialog Group Berhad
58	Mudajaya Group Berhad
59	Media Prima Berhad
60	KNM Group Berhad
61	Malaysian Resources Corporation Berhad
62	DRB Hicom Berhad
63	WCT Berhad
64	IJM Plantation Berhad
65	YTL Cement Berhad
66	Hartalega Holdings Berhad
67	Supermax Corporation Berhad
68	Hap Seng Plantations Holdings Berhad
69	Hap Seng Consolidated Berhad
70	Sunway City Berhad
71	Wah Seong Corporation Berhad
72	KPJ Healthcare Berhad
73	Lingkaran Trans Kota Holdings Berhad
74	Masterskill Education Group Berhad
75	NCB Holdings Berhad
76	QL Resources Berhad
77	Pos Malaysia Berhad
78	Mah Sing Group Berhad
79	Malaysian Pacific Industries Berhad
80	TA Global Berhad

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Chapter 12
Corporate Reputation: A Definitional Landscape

Melisa Erdilek Karabay

Abstract Corporate reputation in recent times has continued to become very important in business and it, today, plays more decisive role in sustaining the growing presence of organizations in their many markets in terms of their future survival. The reputation of a company is shaped, developed or lost during its operations in its community and market. The reputation of a corporate entity, affects that entity's activities and many other organizations it interacts with. Therefore, to gain a sustainable reputation over time and avoid the loss of reputation, maintaining good reputation should be considered as an important factor which will contribute to the organisation's value creation ability. In contrast to the popular belief, any of loss of reputation by an entity will not be easy to gain back or compensate for. This study presents a discussion of corporate reputation, fundamental concepts that are found in the literature and the rising importance of reputation in today's corporate changing environment.

12.1 Introduction

Increasing competition in a globalized economy promotes the identification of drivers of sustainable competitive advantages. The extensive search for these drivers is no longer restricted to tangibles, but has also spread to the field of intangible assets as firms' reputation is considered as an essential asset (Louisot 2004, p. 35; Tadelis 1998, p. 1; Schwaiger 2004, p. 46). There has been a resurgence of interest in the reputation construct among researchers and practitioners (Weigelt and Camerer 1988; Schwaiger 2004; Helm 2005; Dowling 2001). Within the past few years, the importance of intangible assets in general and the significance of corporate reputation in particular have grown rapidly (Schwaiger 2004, pp. 46–47).

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_12,

Companies act as an opportunity platform when they generate intangible assets, such as reputational capital, commitment, loyalty, and legitimacy, which provide opportunities for their sustainability (Gardberg and Fombrun 2006, p. 331). Furthermore, to create market entry barriers, to foster customer retention and to strengthen competitive advantages, intangible assets are vitally important.

Since the importance attached by managers of not only for-profit but also non-profit organizations to be realized as a "good" and "beneficial" organization for the society it requires to have a positive corporate image and increasing reputation as the academic studies reveal (Eroğlu and Solmaz 2012, p. 1). Indeed the concern for reputation that is a professional service supporting organizations increased in 1990s (Deephouse 2002, p. 9). Therefore reputation has become one of the most common concepts used by organization leaders and managers (Gümüş and Öksüz 2009b, p. 3).

Addressing reputation that is hard to earn but easy to lose in business world is an inevitable competition tool where consumer awareness and pressure increased and competition became more intense (Saylı et al 2009, p. 172). Corporate reputation applications become a necessity for organizations and gradually gain importance as a differentiation criterion. In parallel with this, organizations have started to organize their management activities considering their reputation (Esen 2011, p. 290). Hence, it's seen as many companies' chairmen of the board often mention in their messages that corporate reputation is their most important value (Gümüş and Öksüz 2009b, p. 3).

Besides the growing importance there is a lack of consensus on the dimensions of reputation, so this study aims to fulfill the gap within the conceptualization of reputation as it is need to be investigated in more detail. The remainder of the work is structured as follows: In the first section, a brief theoretical background about corporate reputation is given. Other sections involve the identification of role of corporate reputation in sustaining the corporate social responsibility of corporations and the implications regarding its benefits and as well as the perspectives on measuring the corporate reputation. Finally, the future recommendations are discussed.

12.2 The Conceptual Framework of Corporate Reputation

From an empirical point of view, corporate reputation has remained a rather controversial issue, has not yet reached a clear and precise definition and measurement so far (Esen 2012, p. 47; Saylı et al 2009, p. 172).

Gotsi and Wilson (2001) *state that "Corporate reputation is a stakeholder's overall evaluation of a company over time"* (Gotsi and Wilson 2001, p. 29).

As Wartick mentions; "Corporate reputation is the aggregation of a single stakeholders' perceptions of how well organizational responses are meeting the demands and expectations of many organizational stakeholders" [i] (Wartick 2002, p. 372).

Corporate reputation is a long-term product of what the shareholders and organization is, how the organization fulfill its responsibilities, how the expectations of shareholders are met and of all assessments concerning organization's performance for adaptation to sociopolitical environment. (Logsdon and Wood 2002, p. 366)

In general terms, the concept corporate reputation can be defined as the combination of all views, decisions and ideas of people about an organization, the belief in the organization and reliability of the organization. (Eroğlu and Solmaz 2012, p. 1)

Addition to the statements above, the growing body of literature has led to an abundance of different definitions of corporate reputation (Şakar 2011, p. 5; Helm 2005, p. 99). The term *corporate reputation* is also expressed with such concepts as "organizational prestige," "identity," "image," and "brand" in the literature. However, any of these concepts cannot explain corporate reputation individually (Esen 2011, pp. 291–292).

Regarding the scope of this section it will be worthwhile to deal with the similar concepts that play role in the reputation's determination, construction and the development. In this context the emerging concepts received priority consideration in the various studies concerning corporate identity (Abratt and Kleyn 2012; Hatch and Schultz 2000; Şakar 2011), corporate image (Gray and Balmer 1998; Pruzan 2001). It's seen that corporate reputation is used as synonymous with similar concepts by many authors (Wartick 2002; Clark 2000; Smaiziene and Jucevicius 2009). According to Wartick; image should be related mostly to customers and to other external stakeholders; identity should be more of a construct focused on internal stakeholders, that is, employees, managers, and so forth; and reputation then becomes the aggregation of identity and image (Wartick 2002, p. 376).

Corporate reputation is also significantly related with corporate strategy and corporate culture (Gümüş and Öksüz 2009b). To the effect that; corporate culture, reflects the essential tips about how the tasks are carried out in an organization, how the organization communicates with the employees, the priorities and the basics concerns of the organization (Gümüş and Öksüz 2009b, p. 24).

A crucial subject that should be dealt concerning the corporate reputation is "*corporate social responsibility*." Social responsibility appears as an important dimension relevant to reputation in terms of company expectations, environmental consciousness, and humanitarianism (Aqueveque 2005, p. 71; Gümüş and Öksüz 2009a, p. 2141; Hillenbrand and Money 2007, p. 265).

Corporate social responsibility (CSR) highlights the assessment of business performance not only in economic terms but also with its social and environmental aspect. Thus, what an organization did in terms of corporate social responsibility is the things undertaken by this organization voluntarily for the sake of the society without pressure (Şakar 2011, p. 78).

The most obvious link of corporate social responsibility with business performance is reputation. It's put forth by empirical studies that businesses which participate in works for social benefit much more have a better reputation (Gümüş and Öksüz 2009a, p. 2141). Today, it has become an important indicator of "performance" in whole business life to show what have done for corporate social responsibility no matter it produces energy or offers automobiles or financial services. If an organization maintains certain business standards for its employees, contributes to the environment in which it operates or protects natural environment, then its reputation increases. Increased reputation protects current business relations of an organization as well as provides to gain new customers and establish new partnerships, thus maintaining competitive advantage (Şakar 2011, p. 78). Within this line of reasoning, intangible assets—such as good reputations—are critical because of their potential for value creation, but also because their intangible character makes replication by competing firms considerably more difficult (Roberts and Dowling 2002, p. 1077).

The importance of corporate social responsibility in business success is highlighted with these words: "Today, not only traditional factors such as quality, service, price, and benefit have an impact on business success; but also other variables such as business applications, employee behavior, social responsibility, and environment have gained an effect" (Gümüş and Öksüz 2009a, p. 2130). Participating in social responsibility activities differentiates views of employees, suppliers, customers, public and investors about the organization. As illustrated in Table 12.1, various cases from world have been found attractive.

A significant case of CSR belongs to Turkcell in Turkey. Turkcell has provided grant to more than 10,000 students since 2000 by means of its "Snowdrops, Modern Girls of Modern Turkey" project. And Milliyet Newspaper has been carrying out its similar and well-known CRS project titles "Dad, send me to school" (Şakar 2011, pp. 80–81).

According to researches, consumer products, industrial products, food and beverage manufacturing, computer and general retail companies scored highest. At the other end of the spectrum, telecommunications, energy and diversified financial companies earned the weakest scores. Texas Instruments recently ranked 18th on America's Most Reputable Companies list, a ranking generated by Reputation Institute, a firm that investigates what drives reputation across stakeholder groups and reports its findings in Forbes magazine. The scores were statistically derived from four emotional indicators: admiration, esteem, good feeling and trust.

The Reputation Institute uses a measure called RepTrak, which has been developed through factor analysis with respondents among the general public in about 25 countries. The instrument has found seven drivers of reputation (products and services, innovation, workplace, citizenship, governance, leadership, and financial performance). There also are 23 attributes of reputation within these drivers. In addition to the overall RepTrak, the Reputation Institute uses a more frequent "Pulse" that examines emotion, feelings and trust toward companies. The Reputation Institute survey is published yearly in Forbes.com (Schreiber, http://www2.lebow.drexel.edu/PDF/Docs/CCRM/EssentialKnowledge.pdf, p. 12).

The most famous measure of reputation is the Fortune magazine "Most Admired American Companies" survey that is conducted yearly. The survey is conducted on the ten companies with the largest revenues within each industry group. Questionnaires are sent to executives, directors and financial analysts within the industry

Table 12.1 Global reputation rankings

2012 rank	Company	Industry	2012 pulse score
1	General mills	Food – Manufacturing	83.0
2	Kraft Foods Inc.	Food – Manufacturing	80.0
3	Johnson & Johnson	Consumer products	79.9
4	Kellogg's	Food – Manufacturing	79.0
5	Amazon.com	Retail – General	78.6
6	UPS	Transport and logistics	78.4
7	The Coca-Cola Company	Beverage	78.1
8	Apple	Computer	77.7
9	PepsiCo	Beverage	77.6
10	Procter & Gamble	Consumer products	77.3
11	Sara Lee	Food – Manufacturing	76.7
12	Lowe's Home Improvement	Retail – General	76.3
13	Google	Information and media	76.2
14	Colgate-Palmolive	Consumer products	76.1
15	Deere & Co.	Industrial products	76.0
16	Berkshire Hathaway	Financial – Diversified	75.8
17	The Walt Disney Company	Information and media	75.7
18	Texas Instruments	Computer	75.5
19	IBM	Computer	74.6
20	HJ Heinz	Food – Manufacturing	74.6

http://www.forbes.com/sites/jacquelynsmith/2012/04/04/americas-most-reputable-companies/3/

segment so that there is a level of familiarity with the companies in question. Eight dimensions are analyzed: financial soundness, wise use of corporate assets, value as a long term investment, social and environmental responsibility, people management, quality of management, product and service quality, and innovation (http://www2.lebow.drexel.edu/PDF/Docs/CCRM/EssentialKnowledge.pdf, p. 11). Corporate reputation has a very substantial impact on organizations so that this impact is called as "reputation capital" or "intangible assets" in literature. And its economic benefits are accepted as Return on Reputation (ROR). So we can assume that a company's reputation is a highly fragile phenomenon; one which can also be seen very differently depending on the stakeholder's perspective (Klewes 2009, p. 287).

There are many studies showing that a good reputation increases the sales and attracts the investors (Aula and Mantere 2008, p. 45). Research in this area has shown that reputation provides several intangible benefits (Schnietz and Epstein 2005, p. 329; Uzunoğlu and Öksüz 2008, p. 112).

In the various researches (Barney 1991; Eberl and Schwaiger 2005) the benefits that a good reputation of company are summarized in three dimensions[ii];

In market dimension good reputation:

- Provides an increase in market share,
- May facilitate complex, long-term stakeholder management which, in turn, ought to enhance a firm's ability to outperform against its competitors,
- Provides a competitive tool against the competitors,

- Makes it easier to improve customer's loyalty and trust on firms.

In organizational dimension;

- A good reputation may create economic value by improving a firm's ability to recruit and retain its primary investors, employees, customers and suppliers,
- Provides an increase in employee commitment and productivity,
- Reputation serves as a signal of a firm's past interactions with stakeholders and thus may be difficult for other firms to imitate,
- Promotes the skilled staff,
- Provide second chance in case of a crisis.

In customer dimension;

- Helps customers to make their choices among the homogenous products (television) and services (education, legal services),
- Allowance of stakeholders suffering from imperfect information about a firm's product quality or commitment to social responsibility to nonetheless assess a firm's ability to deliver valued outcomes.

Scholars (Fombrun 1996; Gregory 1998; Schnietz and Epstein 2005) have previously suggested that firms with good reputations may withstand crises with lesser economic losses than firms without good reputations.

12.3 The Factors Affecting Corporate Reputation

A good corporate reputation is gained over a period of time by achieving continuous successes in the eyes of an entity's stakeholders. If the reputation that has been gained in many years is lost due to simple failures and negligence, it takes many years of success again to reach the same reputable position (Savram and Karakoç 2012, p. 328).

The crises regarding the reputation are frequently resulted from unethical behaviors of management or employees. Therefore employees are not only the centre of corporate reputation; but also the primary factors for preventing reputation lost or decrease. If employees are aware of their key roles, they can play a role in management of corporate reputation. In other words, employees become more responsive to how corporate reputation lost damages the organization (Cravens and Oliver 2006, p. 295). Corporate reputation is also affected by affiliated organizations' reputation. For instance, when Hudson Foods, meat supplier of Burger King, fell into disrepute due to bacteria microbe problem, it caused the reliance of Burger King consumers to be affected negatively (Miles and Covin 2000, p. 300).

It's seen that studies concerning corporate reputation management are generally carried out to assess the corporate reputation of commercial organizations (Eroğlu and Solmaz 2012, p. 1). However, it has been recently understood that having reputation is important not only for for-profit organizations but also for non-profit organizations. And this situation has increased the number of studies concerning reputation carried out in state universities both inside and outside Turkey (Oktar and Çarıkçı 2012, pp. 128–129).

12.4 Approaches in Corporate Reputation

According to Wartick (2002), there are several distinctions that have to be considered such as (a) while prestige or esteem are positive, reputation is neutral (according to sociology); (b) image is applied in marketing to brands but not to companies;(c) one way to define reputation is "as a publicly recognized name"; and (d) in accounting, goodwill has a mystical quality to it, and thus, it becomes "the most intangible of the intangibles." Given all of this, one conclusion might be that the measurement of corporate reputation does not really matter not because we cannot define it but rather because we cannot define it in a manner that separates it from this vast array of other constructs (Wartick 2002, p. 374). The approaches regarding corporate reputation can be collected under two main complementary titles called pragmatic and reflexive (Esen 2011, pp. 291–292; Helm 2005, p. 95; Pruzan 2001, p. 50). These approaches are important as they put forth the treatment of organizations towards corporate reputation concept (Şakar 2011, p. 7).

- Pragmatic approach highlights the idea that primary aim of an organization is to increase income and that performance of managers will be executed in terms of profitability level. For this approach, reputation is just a means that leads organizations and managers to the fundamental aim. This approach based on economic rationalism deals with traditional idea production of corporate success (Pruzan 2001, p. 59). The primary investigation area of this approach is the value attached to an organization by its shareholders. And its aim is to protect and develop the corporate image (Pruzan 2001, p. 50; Şakar 2011, p. 7).
- For Reflexive Approach, on the other hand, an organization assumes certain responsibility for the groups that are in an interaction with and rather than aiming at increasing the income, reputation must be a reflection of efforts to fulfill these responsibilities (Esen 2011, pp. 291–292).

It's seen that reflexive approach mainly focuses on corporate identity and provides more comprehensive precautions for corporate success compared to the pragmatic approach. It has a reflective feature (that reflects corporate identity) rather than communicative. It deals with internal "characteristic" of organization rather than its external appearance. Besides, increased concern for the concepts of corporate social responsibility, corporate citizenship and value-based leadership makes reflexive approach to be adopted much more (Pruzan 2001, p. 50; Şakar 2011, p. 8).

It has been mentioned that following only the pragmatic approach for corporate image causes the needs of shareholders and individuals who are vital for the survival of corporate success and organization itself to be ignored. By using both approaches, it would be possible not only to reflect corporate identity but also to realize more realistic methods such as measuring, assessing and reporting the organization's components and its general impact on society (Pruzan 2001, p. 61).

Shareholders, on the other hand, are defined as individuals or groups (customers, employees, suppliers, managers, creditors, media and public) that continue the existence of organization, that are affected by organization or that affect the organization. Due to the mentioned importance, total value attributed to organization by shareholders and their perception styles of the organization create the reputation of that organization (Esen 2011, pp. 291–292).

Corporate reputation is as valuable source as other physical and financial sources. Thus, it depends not only on whole perception of shareholders but also on activities and behaviors of the organization that supports the perceptions of shareholders (Acquaah 2003, p. 390).

As Carmeli and Tishler (2005) state, "Stakeholders' perception of the institution is based on the positive reputation that the organization has can be more attractive than others" (Carmeli and Tishler 2005, p. 13).

12.5 Measuring Corporate Reputation

Corporate identity management is described as the most difficult management type by many professionals. Reputation is not a concrete, numeral concept that can be easily-measured like accounting, sales management (Savram and Karakoç 2012; Clardy 2012, p. 285). Thus, it's required to know the level of corporate reputation of an organization, in other words to measure the corporate reputation, for creating true corporate reputation strategies (Şakar 2011, p. 15).

An organization that realizes the importance of corporate reputation must firstly know its own reputation level to follow a strategy in this regard. In literature, it's mentioned that reputation can be measured, followed and directed. However, many organizations do not know the exact level of their reputation and even do not have a measurement system (Şakar 2011, p. 16).

The growing interest in reputation has led to the development of a variety of different construct measures (Helm 2005, p. 96). The proliferation of different methods measuring corporate reputation has raised the question of whether or not a standard can be established. However, it seems there is no consensus at the moment (Schwaiger 2004, p. 51). As stated in its definition, on the other hand, it's very hard to measure this abstract concept (Esen 2011, p. 293).

Thus, organizations should set forth how shareholders they are in interaction with in this dynamic structure perceive them and should determine the current situation by means of measuring the abstract concept reputation. If there's anything negative, necessary precautions should be taken in reputation management process without delay. This assessment process is highly beneficial for the organizations that have a very negative reputation. What's important for organizations in this point is to select and apply the proper measurement method (Şakar 2011, p. 16).

As is known, a non-measured corporate reputation cannot be developed that reputation must be measured regularly to be directed. To form a good reputation management system, target population and sample that would represent this population should be determined, reputation measurement method should be selected, measurements should be performed and the goals to be reached within a certain period of time should be defined according to the measurement results (Argüden 2003, p. 12).

There are three prominent corporate reputation measurement methods in literature. These methods based on the following concepts, respectively (Berens and Van Riel 2004, p. 161)[iii]:

– *Corporate social expectation,*
– *Corporate personality,*
– *Trust,*

To give information about how to measure reputation, one of the most important and popular measurement methods is Reputation Quotient (RQ) by Reputation Institute (Walsh and Wiedmann 2004, p. 304). This scale is used to show how corporate reputation is perceived by shareholders, employees, society, customers, rivals, financial sources and suppliers by means of twenty statements and six elements. These elements are as follows: emotional attraction, products and services, financial performance, vision and leadership, job environment and social responsibility (Esen 2011, p. 294).

12.5.1 Measurement Based on Corporate Personality

The underlying idea of this approach is that "behaviors of an organization can be assessed by its corporate personality in the same way as behaviors of an individual are explained by his/her characteristic" (Şakar 2011, 21).

12.5.2 Measurement Based on Trust

The basic idea of this approach developed by Newell and Goldsmith (2001) is that it's a trust-based measurement. This approach deals with the thought that behaviors of organizations are predictable. For this approach, reputation of organizations can be measured by the criteria of reliability, honesty and kindness.

It's stated in the literature that the best practicable of the above-mentioned three approaches used for measuring corporate reputation is social expectation approach (Berens and Van Riel 2004, p. 172).

It has been enabled to determine perceptions of shareholders concerning the organization by means of index work titled 'Reputation Quotient/Harris-Fombrun Reputation Quotient' by C. J. Fombrun and Harris Interactive company. Within this index, it's possible to determine how shareholders perceive the reputation of organization in terms of defined features and to transform the results into information which can be used for increasing the reputation of organization (Çillioğlu 2010, p. 41; Oktar and Çarıkçı, 2012, p. 130).

12.6 Conclusion

The extensive search for sustainable competitive advantages is no longer restricted to tangible assets, but has also reached the field of intangible assets. The study illustrates that both the scientific community and the majority of practitioner consider corporate reputation as an intangible asset that is scarce, valuable, sustainable, and difficult for a competitor to imitate. Reputation, in this context, can be defined as an appropriate tool to achieve strategic competitive advantages. Due to the similarity to attitude concepts, building up a strong reputation takes its time, and that the payoff from reputation may require longer periods to become visible.

Scholars have previously suggested that firms with good reputations may withstand crises. As a result, corporate reputation provides great facilities to organizations accomplishing their goals. Finally, it can be stated that it is vital to have a positive reputation, but to acquire and maintain the reputation obtained play significant role for corporations.

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Chapter 13
Ethical Dilemmas and Decision Making in Accounting

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Abstract Accountants have a crucial role to play in today's global business life as they are key providers of financial information to investors, lenders and other stakeholders of companies. They are expected to maintain records of reliable and trustworthy information and also to behave in responsibly while carrying out their professional duties. On another hand, the recent financial reporting scandals indicate that like other professions, accountants also can face ethical dilemmas and behave unethically (which has resulted in the loss of reputation for some accountants and almost damaged the profession to a serious extent). Another issue is decision making in accounting which has some ethical dilemmas, a situation requiring more than just technical competence. For this reason, an understanding of the ethical decision making environment in which accountants function is important. In this study, the importance of ethics in the area of accounting, the ethical dilemmas and ethical decision making process which accountants confront are discussed extensively in order to enable our readers to understand the issues and suggest responsible solutions for dealing with them.

13.1 Introduction

Accounting plays a crucial role in the business environment as an information system that provides useful information about firms' activities to their stakeholders. With this role accounting also has significant impacts on the social and economic development of the countries, since investors, lenders, government entities and other economic actors of the countries rely on the fairness of the accounting

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_13,

information in the financial reports of the firms. From this point of view it won't be wrong to say that the accounting profession plays a significant role as key providers of financial information (Keller et al. 2007, p. 300; Leitsch 2006, p. 135). Therefore, accounting professions have an obligation to their clients, their organizations, their profession and generally the public to maintain the highest standards of ethical behavior by being competent, preserving their credibility, integrity and objectivity while performing their services (Fatt 1995, p. 997). It can be said that traditionally it had been believed that accountants were honest and trustable persons who provided an efficient and valuable service for their clients and the public (Leitsch 2006, p. 135). On the other hand, the recent accounting scandals resulting bankruptcies such as Enron, WorldCom, Global Crossing, HIH Insurance, Parmalat had unexpected and negative impacts on the financial markets and public and led to a loss of public confidence in the integrity of financial reporting. Especially with the bankruptcy of Enron, the collapse of Arthur Andersen, which was one of the "Big 5 Accounting Firms", raised serious doubts about the integrity of accountants and caused the loss of public confidence in the profession. As a result of these events, the area of business ethics in accounting and ethicality of accounting professions' behaviors have received a great deal of attention from the professional accounting bodies and academicians in recent years (Pierce and Sweeney 2010, p. 80; Leitsch 2006, pp. 135–136; Jackling et al. 2007, pp. 928–929; Jakubowski et al. 2002, p. 111; Flanagan and Clarke 2007, p. 493; Sweeney and Costello 2009, p. 75; Yang and Wu 2009, p. 333; Roxas and Stoneback 1997, p. 503).

Ethics can be defined as a "body of moral principles or set of beliefs and values about what is right or wrong, true or false, fair or unfair, proper or improper" (Paliwal 2007, p. 3). Although the "study of ethics" is an ancient tradition and has roots in religions, cultures and philosophical beliefs, it is possible to say that "the study of business ethics" is a relatively recent phenomenon especially in the area of accounting (Lewis 1985, p. 377; Buchan 2005, p. 165) and there hasn't been developed a universal definition of business ethics yet. Lewis (1985), one of the pioneers of this area, after reviewing selected 208 textbooks and articles in the management area and 185 survey definitions which were made by blue-collar workers and white-collar workers, synthesized the following definition: "Business ethics is rules, standards, codes, or principles which provide guidelines for morally right behavior and truthfulness in specific situations" (Lewis 1985, p. 381). Besides the definitional issues the interest in business ethics and accounting ethics increased explosively during 1980s and 1990s and most of the research in this area has attempted to develop models which can help to better understand individuals' ethical decision-making process (Sweeney and Costello 2009, p. 75; Cernusca 2007, p. 239).

Ethical decision making can be described as a way of resolving conflicts in situations where ethical dilemmas are present (Lin and Ho 2008, p. 1214). As ethics is one of the major elements of accounting profession (Keller et al. 2007, p. 300), it is possible to say that the application of ethical decision making to the accounting practices has become a topic that the accountants encounter on almost daily basis.

It is a topic no longer limited to academic journals, on the contrary in the light of recent scandals mentioned above, it has become a broader social issue that threatens the credibility and reputation of the accounting profession worldwide (Flanagan and Clarke 2007, p. 488). Therefore we mainly focus on ethical dilemmas and ethical decision making in the area of accounting in this study. In this context, the next section highlights ethical dilemmas in accounting. Afterward, ethical decision making in accounting is discussed. This section is followed by conclusion.

13.2 Ethical Dilemmas in Accounting

Accounting is language of business and its main purpose is to provide trustable information for those who benefit from its service. As a member of business environment/life and community, it is expected from accountants to behave properly in providing professional services to their client since their act influences both use and distributions of resources in economy (Özsözgün Calışkan et al. 2011, p. 198; Cooper and Robson 2006, p. 415; Kardes Selimoglu 2006, p. 201). To product reliable information, it is inevitable to pay attention to ethical rules and regulation and the worldwide accounting's representative bodies has determined ethical rules to protect its members' reputation, status, recognition (Parker 1987, p. 134; Dellaportas and Davenport 2008, p. 1092). And the other intention of the rules are to guide and establish high professional standards (Finn et al. 1988, p. 607) and develop effective strategies that constrain its members to comply and also adapt essential ethical principles into their decision making process (Flanagan and Clarke 2007, p. 493; Likierman 1989, p. 617). In addition to those, code of ethics is used as to create expectations of professional ethical behavior in public (Dellaportas and Davenport 2008, p. 1087). Although these normative guidelines/frameworks were supposed to guide the behavior of accounting professions, the recent accounting scandals at prominent companies such as Enron, HealthSouth, Tyco, WorldCom, Microsoft, Rite Aid, Parmalat, HIH Insurance and Xerox among many others indicate that it does not guarantee to prevent ethical conflicts and dilemmas (Jackling et al. 2007, pp. 928–929; Leung and Cooper 2005, p. 80; Armstrong et al. 2003, p. 1). Now all this scandals have been questioning by teachers, academics and institution to find what went wrong and how and why accounting professions acted in (generation of) the ethical dilemmas (Jennings 2004, p. 7; Low et al. 2008, p. 236).

According to Parker (1987) ethical dilemmas in accounting relate to more than one category in professional code so it is not easy to found a single magic wand that give answers and resolve all problem regarding to what is behind the ethical dilemmas and what would be done to not to experience them. Like other professions, accountants perform their tasks in a challenging business environment which is shaped by globalization, technological revolution and strong competition (Jackling et al. 2007, p. 929; Onyebuchi 2011, p. 275). In such difficult conditions, these professions encounter *to the situation where it is very difficult to choose what is right and what is wrong* (Banik 2010, p. 117). In case of ethical dilemmas, the professions of accounting have to decide, under the stress of two or more unpleasant and equally judicable alternatives in which values compete (Banik 2010, p. 117; Sun 2011, p. 23; Leung et al. 2006, p. 56). Since all the choices perceived undesirable in that situations, it is so hard for the accountants to decide what to do. As (accounting) professionals are faced with different and complex ethical dilemmas that both includes exercise of professional values and possible trade-offs between costs and benefits, it is impossible to relate the dilemmas to specific reasons (Sun 2011, p. 24; Leung and Cooper 2005, p. 80). However, according to IFA (Low et al.2008, p. 225), *misleading auditors, auditors looking the other way, disguising transactions, withholding information, providing unbalanced advice, abuse of trust, and misusing insider information, following self interest without concern for the interest of the stakeholders* are some of the reasons behind the latest reporting failures. Furthermore, self interest, failure to maintain objectivity and independence and withstand advocacy threats, lack of competence and ethical sensitivity, inappropriate professional judgments, lack of professional body support and organizational and peer support, improper leadership and ill-culture are the factors contributing to the ethical failure according to IFAC (Leung et al. 2006, p. 56). As accountants work in different departments at different jobs, ethical problems faced by accountants also can be so various (Leung and Cooper 1995, p. 29). According to Leung and Cooper (1995), *conflict of interest, client proposal to manipulate financial statements, client proposals for tax evasion and presenting financial information in the most proper manner so as not to deceive* users are the most encountered ethical issues in the majority of accountants in respectively.

Whatever the form of unethical issues and the factors behind the dilemmas, the area of ethics has attracted increased attention and has led many to question the ethical reasoning of accountants, in response to accounting scandals that have rocked the accounting profession worldwide. Much of the research in the area has focused on developing numerous models to better understand individuals' ethical decision-making process as 'understanding why and how individuals and groups make ethical decisions in a business context should improve the ethical decisions made in the organizational context' (Sweeney and Costello 2009, p. 75; Keller et al. 2007, p. 300).

Most accountants do not realize the extent to which their practice has an ethical dimension until it is perhaps too late to respond effectively. Their failure to recognize this multidimensional nature of accounting arises often because they lack the knowledge and skills to analyze issues effectively. Poor investigative technique means that when they are confronted with ethical problems they are often unable to resolve issues in a manner consistent with their own professional values and their community's expectations. They simply do not know enough to make good decisions (Flanagan and Clarke 2007, p. 489).

13.3 Ethical Decision Making in Accounting

The ethical decision making that occurs in organizations involves individuals' evaluations of different questionable business practices (Valentine and Rittenburg 2007, p. 125; Cohen et al. 2001, p. 321). An ethical decision is defined as "a decision that is both legal and morally acceptable to the larger community" whereas an unethical decision may be regarded as "either illegal or morally unacceptable to the larger community" (Selart and Johansen 2011, p. 129).

Jones (1991) offered another definition: An ethical decision is a decision that is both legally and morally acceptable to the larger community. Conversely, an unethical decision is a decision that is either illegal or morally unacceptable to the larger community (Tenbrunsel and Smith-Crowe 2008, p. 549). Ethical decision making deals with moral issues: A moral issue is present where ever individual actions, when freely performed, may harm or benefit others. Thus, the action or decision must have consequences for other people and involve choice on the part of the decision maker. A moral agent is the person who makes a moral decision. The status as a moral agent is defined by choices and their consequences for other people, but does not suppose that a moral agent recognizes that moral issues are at stake. This is important to the model as the extent to which moral agents recognize moral issues constitute an outcome that the model seeks to explain.

Jones (1991) significantly contributed to the literature by noting that the ethical decision making process, within an organization, was dependent upon many organizational factors as well as the issue itself. He suggested that moral issues could vary from situation to situation in terms of intensity. Issues of high intensity capture the individual's attention more often than issues of low intensity. Alternatively, issues of low intensity may not be viewed as unethical by the decision-maker. Jones (1991, p. 373) extended Rest's (1986) four stage model by identifying specific issue-related components that are also important in moral decision-making. This model is presented in a logical sequence of steps and it represents a framework for considering what must happen in order for moral behavior to occur. These four stages were moral sensitivity, moral judgment, moral intentions, and moral behavior. Rest (1986) noted that his model's four stages have distinct functions, which interact with each other (Leitsch 2006, p. 136). Research in accounting ethics also has been significantly influenced by the work of Rest. The first stage, identification of an ethical dilemma, involves awareness that a dilemma may affect the welfare of others. Once a dilemma is identified, an individual comes to an ethical judgment (second stage) based on evaluating the outcomes that ought to occur in a given situation. Once an ethical judgment is made, the individual formulates an intention to act ethically (third stage) based on an assessment of the right choice versus other alternatives. The final stage is the actual carrying out of the ethical action and little research has been carried out on this stage due to difficulties in measuring and observing behavior (Sweeney and Costello 2009, p. 77; Thorne 2000, p. 142).

Some authors have attempted to develop such a theory or ethical decision-making model that attempts to take into account the major moral theories and approaches. For instance, Carroll and Buchholtz (2000) suggest the use of an ethics screen that combines a conventional approach (personal, organizational, societal, international standards and norms), a principles approach (ethical principles of justice, rights, utilitarianism, and the golden rule), and an ethical tests approach in order to determine whether a particular course of action is morally acceptable. Post et al. (2002) use an analytical framework that compares the result of three questions based on utility (do benefits exceed cost?), rights (are human rights respected?), and justice (are benefits and costs fairly distributed?). The decision making rule suggested is: (1) if the answer to all three questions is “yes”, then the action is morally ethical, (2) if the answer to all three questions is “no”, then the action is probably unethical, and (3) if the answers are “mixed”, then priorities should be assigned to one of utility, rights, or justice. Velasquez (2002) also advocates the integration of utility, rights, justice, and caring in making moral judgments (Arjoon 2007, p. 396).

Several theoretical models have been suggested to explain ethical behaviors Keller et al. (2007), by adding a hermeneutical perspective, have improved the ethics model of Epstein and Spalding (1993), which comprised pragmatism (egoism), utilitarian, deontological (Modarres and Rafiee 2011, p. 137) and also we should argue the justice, relativism.

13.3.1 Egoism

It means that although a decision is contrary to others’ interests, it is ethical if it serves the decision maker’s good. The general principle is to behave in one’s own interest. In other words, this theory promotes selfishness, and many people think it is unethical. This theory is the foundation of neoclassical economic theories (Modarres and Rafiee 2011, p. 137). Egoism, like utilitarianism, belongs in the camp of teleological ethical theories, with the main difference between the two philosophies on the subject of the decision. While utilitarianism focuses on society’s long-term interests, egoism focuses on the individual’s long-term interests (Hansen 1992, p. 525; Cohen et al. 1996, p. 101; Cruz et al. 2000, p. 227). Ethical egoism is also another form of consequential thinking. If we consider solely the consequences of an action, ultimately we may ask how to maximize our own benefits. Ethical egoism states that one ought to first and foremost, benefit oneself (Kujala and Pietilainen 2004, p. 155).

13.3.2 Utilitarian

Mill described that “Actions are right proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness”. Mill continues that “the happiness” he is talking about is “not the agent’s own greatest happiness, but the greatest amount of happiness all together" (Modarres and Rafiee 2011, p. 137). Utilitarianism that is one of two teleological theories of ethics is concerned with the consequences of actions and is rooted in the thesis that an action is right if it leads to the greatest good for the greatest number or to the least possible balance of bad consequences (Hansen 1992, p. 525; Cohen et al. 1996, p. 101; Cruz et al. 2000, p. 227).

13.3.3 Deontology

Dating back to Socrates and work of (Hudson and Miller 2005, p. 385; Hunt and Vitell 1986, p. 6). Based on this model, an action is moral if it is done to fulfill an obligation and to do one's duty. Therefore, deontological ethics focuses not on the results of an action, but rather on the action itself. The problem with deontology is that it provides "no basis for the continued evaluation of what is best". Since the duty of accountants is to provide useful information for decision-making, based on the model they should evaluate their actions for the purpose of satisfying this duty (Modarres and Rafiee 2011, p. 138). Deontology maintains that the concept of duty is independent of the concept of good, and that actions are not justified by the consequences of the actions, but insists on the importance of the motives and character of the agent rather than the consequences actually produced by the agent (Hansen 1992, p. 525).

13.3.4 Justice

Organizational justice concept based on Aristotelian notion and includes rules and social norms which define how to distribute the end results, procedures of distribution and regulations of interaction among employees (McMahon and Harvey 2007, p. 27; Cohen et al. 1996, p. 100). It has been examined by three components: Distributive justice, procedural justice and interactional justice (Ozdevecioglu 2003, pp. 77–96). Distributive justice refers to fairness in the allocation of a set of outcomes to a defined circle of recipients, and the primary concern in most distributive justice research is reactions to pay injustices. Procedural justice, on the other hand, refers to fairness in the means by which decisions or outcome distributions are made (Warner et al. 2005, p. 393). Interactional justice is viewed as a distinct construct of justice and emphasizes the quality of the interpersonal treatment people receive in the implementation of procedures (Moorman 1991, p. 847).

13.3.5 Relativism

Is based on the idea that no universal ethical rules exist (McMahon and Harvey 2007, p. 27) since there is variety of cultures in the world and each community has its own rules of conduct to structure its life (Cohen et al. 1996, p. 101). Relativism maintains that decisions concerning what is ethical are a function of a culture or individual, and therefore, no universal rules exist that apply to everyone (Hansen 1992, p. 525; Cruz et al. 2000, p. 227). Ethical relativism somewhat challenges consequential and non-consequential ethics as it argues that morality is relative to a particular environment and that for example cultures, societies or religions affect moral views and opinions (Kujala and Pietilainen 2004, p. 155; Cohen et al. 1996, p. 101; Cruz et al. 2000, p. 227).

Flory et al. (1992) and Cohen et al. (1993, p. 13, 1996, p. 99) are the pioneer as they improve and constitute MES (Multidimensional Ethics Scale) in accounting case. Above mentioned egoism, justice, deontology, relativism, utilitarianism and egoism are the ethical theories that are included in MES to measure ethical awareness, ethical orientation and intention of accountants (Flory et al. 1992, p. 289; Cohen et al. 1996, p. 99, 2001, p. 320).

The dimension of ethical awareness refer to the extent to which an individual perceive that a particular action is unethical regarding to above mentioned ethical theories. The dimension of ethical orientation refers to the extent to which each of the ethical theories is able to explain the overall evaluation of respondents' and the last dimension of our study, intention of accountants', refers to the probability that the accountant and his/her peers and colleagues would do the action in which the scale include (Cohen et al 2001, p. 319).

MES is a comprehensive instrument to understand the philosophies or rationales that highlight ethical issues. The earlier instruments did not allow researchers to analyze more than two theories. Thus, Reidenbach and Robin (1988, 1990) developed a multidimensional ethics scale in which justice, relativism, egoism, utilitarianism, and deontology are the ethical theories that are identified as major dimensions to eliminate the deficiency of current measurement practices. According to Reidenbach and Robin (1990, p. 639), there are several reasons that should be taken into the consideration while making ethical decisions and their importance is affected by the function of the problem. Because MES is the most extensive scale that developed to examine ethics in decision making (Reidenbach and Robin 1995, p. 160), its different forms have been conducted in several empirical research on business ethics and Flory et al. (1992) and Cohen et al. (1993, 1996) are the pioneers as they improve and constitute MES in accounting case (Cruz et al. 2000; Kujala 2001; Cohen et al. 1993, 1996, 2001; Hansen 1992; Henthorne et al. 1992; Hudson et al. 2007; Hudson and Miller 2005; Jackson et al 2000; Nguyen et al. 2008; McMahon and Harvey 2007; Nguyen and Biderman 2008; Rittenburg and Valentine 2002; Tsalikis and Nwachukwu 1988; Tsalikis and Ortiz-Buonafina 1990; Flory et al. 1992; Ozsozgun Caliskan et al. 2011, p. 198).

13.4 Conclusion

In today's business life which is shaped by globally increasing competition, accelerating foreign investments, internalization of financial markets, and etc., the accounting profession plays a crucial role in both development and emerging economies as the key providers of financial information to investors, lenders and other stakeholders of companies. In such an environment, the economic development of countries heavily depends on the fairness and integrity of the financial information providing by accounting profession. In the light of this fact, accountants should maintain the highest ethical standards as well as the highest technical competence. On the other hand, accountants frequently face with ethical dilemmas as they have responsibility of providing confidential information not only for their clients but also for whole stakeholders. For the purpose of helping accountants to deal with ethical dilemmas international and local professional associations have issued codes of ethics which can serve as guidance to the profession. It should be stated that these codes of ethics cannot be sufficient to help accountants resolving the ethical dilemmas and preventing unethical behaviors. Therefore, the factors affecting the ethical/unethical behavior should be determined by examining the ethical decision making process of accountants.

This study considers the ethical dilemmas and ethical decision making of accountants from the perspectives of ethical or unethical behaviors in organizations. Based on the literature about these ethical issues in accounting, empirical researches show that there are differences among accountants in ethical decision making process according to individual and organizational differences. Accountants are faced with different ethical dilemmas while they are performing their jobs. We suggested that moral decisions could vary from accounting issues to issues based on ethical perspectives, intentions or consequences of accountants' behaviors. This study so contributes the literature about all factors encouraging ethical dilemmas and ethical decision making.

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Chapter 14
The Impact of Corporate Characteristics on Social Responsibility and Environmental Disclosures in Turkish Listed Companies

Merve Kılıç and Ali Uyar

Abstract Corporate social reporting proposes several advantages to corporate entities of our time, for instance; it enhances an entity's image and position, and it strengthens community relations, and legitimizes the entities of activities. This study seeks to explore the nature and extent of the corporate social and environmental reporting (CSER) practices of manufacturing companies listed on the Istanbul Stock Exchange. The study also examines the impact of the corporate characteristics on the CSER disclosures of these listed companies. The sample of the study consists of manufacturing companies listed on the Istanbul Stock Exchange (ISE) in 2010. The related data was collected by adopting content analysis of annual reports of the constituent companies. The relationship between the CSER disclosures with corporate characteristics was investigated with multiple regression analysis. The model includes a dependent variable (i.e. corporate social and environmental reporting index) and eight independent variables (i.e. firm size, profitability, leverage, auditor size, ownership structure, proportion of independent directors on board, listing age, and industry). The contribution of this paper to the literature is of great importance, because there is no prior study in Turkey that has dealt with the relationship between the firm characteristics and corporate social responsibility and environmental reporting disclosure level to this extent.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_14, © Springer-Verlag Berlin Heidelberg 2014

14.1 Introduction

Corporate social responsibility and environmental disclosures have been one of the rapidly growing body of accounting literature due to their importance for all stakeholders. 'Pollution, resource depletion, waste, product quality and safety, the rights and status of the workers, and the power of large corporations are issues which have become the focus of increasing attention and concern' (Gray et al. 1987, p. 1). Companies try to make their activities more visible by making voluntary disclosure about their social activities. Some of those voluntary disclosures are directed at investors, whereas others are for the benefit of customers, employees, media, general public, or other stakeholder groups (Simnett et al. 2009). Stakeholders can get additional information about the companies' social responsibility and environmental activities and practices through analyzing their annual reports, web sites, or other sources of information. So, corporate social reporting is a key tool for entities in managing the relationship with their stakeholders (McMurtrie 2005).

Environmental disclosures are one of the most costly disclosures that are made voluntarily (Verecchia 1983). Corporate social reporting and environmental disclosures are costly, but they offer many advantages to the companies. For instance, entity's image and position can be enhanced and advocated by those disclosures which may also strengthen customer and community relations (Williams and Pei 1999). Stakeholders gain an overall understanding of a company's social and environmental performance through this type of reporting (Bouten et al. 2011). Corporate social and environmental disclosures of the companies can be understood much better within legitimacy theory which is discussed in the literature by various researchers (Dowling and Pfeffer 1975; Newson and Deegan 2002; O'Donovan 2002; Staden and Hooks 2007). Especially, poor environmental performers choose to disclose more than the other firms to legitimize their activities (Hughes et al. 2001; Freedman and Patten 2004). Organizations are reluctant to disclose any negative implications of their activities in their reports because of the pressure groups and so tend to disclose positive environmental information more than their counterparts to counter the negative news (Deegan and Rankin 1996). Besides, Dawkins and Fraas (2011) indicate that high environmental performers also tend to disclose voluntary information to distinguish themselves from their competitors.

Corporate social responsibility and environmental disclosures can be presented as a part of annual report, or as a discrete report. Discrete report can be an environmental report itself, or a sustainability report that covers all environmental disclosures and sourcing activities of the entity. There are many studies that focus on the relationship between several company characteristics and social corporate responsibility and environmental disclosures (Williams 1999; Cormier and Gordon 2001; Gao et al. 2005; Hasseldine et al. 2005; Staden and Hooks 2007; Branco and Rodrigues 2008; De Villiers and Van Staden 2011). However, there is no study in Turkey as a developing country that deal with the relationship between the firm characteristics and corporate social responsibility and environmental reporting disclosure level. This paper will fill this gap by providing an empirical study that analyzes the association between firm characteristics and the corporate social responsibility and environmental reporting.

The rest of this article is organized as follows. In the next two sections, literature review and theoretical framework are provided, respectively. Section 14.4 develops nine hypotheses. Section 14.5 includes the sample, data, and determination of the corporate social and environmental disclosure index. Finally, the conclusion part discusses the results, implications, and limitations of the study.

14.2 Literature Review

In recent years, firms have been evaluated on the basis of not only their financial performance, but also on their social responsibility and environmental performance. Many organizations realized that financial reporting alone no longer satisfies the needs of the shareholders, customers, communities, and other stakeholders for information about the overall organizational performance (Siregar and Bachtiar 2010). So, the companies tend to make disclosures about their corporate social and environmental activities in addition to the financial information. Reporting based on three items (corporate social, environmental, and financial information) is referred to as triple bottom-line reporting by several researchers (Deegan 2004; Abd Rahman et al. 2011; Cormier et al. 2011). Carroll (1979, p. 500) defines corporate social reporting as encompassing 'the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point of time'. Companies try to meet those expectations of the society by making such social responsibility and environmental activities and by disclosing them in several channels. Deegan and Rankin (1996, p. 56) give the definition of environmental disclosures as 'any disclosures pertaining to the organizations' interaction with the environment (i.e. the installation of environmentally friendly machinery, undertaking site rehabilitation, recycling activities, admission of pollution emissions, incurrence of fines relating to environmental misdemeanours, and the like)'. Karim et al. (2006, p. 81) defined corporate social and environmental disclosure as 'the set of information items that relate to a firm's past, present, and future environmental management activities and resulting financial implications'. Social corporate and environmental disclosure communicates the social and environmental effects of an organization's economic actions to particular interest groups within society and to society at large (Gray et al. 1987). Hence, the determinants of corporate financial reporting are different from corporate social reporting in that, while the corporate social reporting appeals to all society, corporate financial reporting's focus is on information needs of investors and creditors (Van Der Laan Smith et al. 2005). Corporate social and environmental disclosures differ from country to country (Williams and Pei 1999; Hooghiemstra 2000; Newson and Deegan 2002; Hope 2003; Freedman and Jaggi 2005; Van Der Laan Smith et al. 2005; Golob and Bartlett 2007), and from industry to industry (Hackston and Milne 1996; Gray et al. 2001; Newson and Deegan 2002; Freedman and Jaggi 2005; Hasseldine et al. 2005; Clarkson et al. 2008; Sobhani et al. 2009; Bouten et al. 2011; Dawkins and Fraas 2011). Thus, the number of corporate social and environmental disclosure items is higher in the environmentally sensitive industries (Campbell 2003; Bouten et al. 2011). This indication also supports the legitimacy theory, because environmental disclosures are being used to close legitimacy gaps which will be structurally higher in aggregates, chemicals, and petrochemicals than in retailing and brewing (Campbell 2003). Another point about corporate social disclosures is that those disclosures have increased, especially, in developed countries because of increases in legislation, risk, and activities of pressure groups, ethical investors, specific events, awards, economic activities, media interest, societal awareness, and politics (Haniffa and Cooke 2005).

'Corporate social disclosure covers a broad and diverse range of disclosures including product information, environmental impact of corporate operations, labor practices and relations, and supplier and customer relations' (Van Der Laan Smith et al. 2005, p. 124). Several studies categorize corporate social and environmental disclosure into different sub groups. Haniffa and Cooke (2005) categorize it as environmental disclosure, employee disclosure, community disclosure, product disclosure, and value-added disclosure. Sobhani et al. (2009) categorize it as human resource disclosure, consumer and product disclosure, community disclosure, environmental disclosure, and general disclosure.

14.3 Theoretical Framework

While many researchers work out the corporate social reporting and environmental disclosure behavior, there is no consensus on the theoretical framework of this concept. However, there are several theories used to explain the corporate social reporting and environmental disclosure behavior of the entities, such as legitimacy theory, political economy theory, and stakeholder theory (Gray et al. 1995; Cormier and Gordon 2001; Newson and Deegan 2002; O'Donovan 2002; Campbell 2003; Freedman and Jaggi 2005; Naser et al. 2006). Although there is not a consensus in the accounting profession and theoretical accounting literature about why companies disclose information of their social and environmental activities, the number of companies which disclose those information voluntarily has increased (Hackston and Milne 1996).

Legitimacy theory emphasizes the relationship between organizations and the society. Organization is a social institution and its activities and role must be accepted by the society for its survival and growth (Sethi 1978). There are some contracts between organizations and societies through which they can legitimize their activities and sustain their survival and growth (Cormier and Gordon 2001). Therefore, the "social contract" concept which represents the expectations of the society from the organizations is central to organizational legitimacy (Newson and Deegan 2002). Legitimacy theory indicates that as the likelihood of unfavorable social perceptions of how an organization is acting increases, the level of attempts of organizations to manage these perceptions also increases (O'Donovan 2002). Companies can manage legitimacy effectively (O'Donovan 2002) by determining publics' social and environmental values and perceptions of the corporation and by evaluating the tactics and disclosure options that are available and suitable to meet those expectations. If the companies cannot manage the legitimacy effectively, there will be a gap between the business performance and societal expectations. If this gap continuously widens, the company will lose its legitimacy and its survival will be threatened (Sethi 1978). Therefore, society may act to remove the organization's rights to continued operations (Deegan and Rankin 1996). Lindblom (1994) describes four strategies that firms should adopt to legitimize their business. These strategies are:

- The relevant public may be informed and educated by the organization about actual changes in its performance and activities,
- The organization may seek to change the perceptions of the relevant publics without having to change its actual behavior,
- Perception of the public may be manipulated by the organization by deflecting attention from the issue of concern to other related issues,
- The organization may seek to change external expectations of its performance.

With those strategies, the companies will prevent the "legitimacy gap" and obtain the support of the society. Of course, no organization can completely satisfy all audiences and no manager can completely ignore the expectations of the public, but the management can make their activities as desirable, proper, and appropriate as possible (Suchman 1995).

Stakeholders contain all of the groups that have a direct or indirect relationship with the company (i.e. managers, customers, stockholders, employees, customers, suppliers, and the general public). To survive and to succeed in the long-term entities should gain the support of all of the stakeholders by communicating them via several channels (Van Der Laan Smith et al. 2005). This communication is sustained and the public pressure by stakeholders is responded to by the management by disclosing demanded information voluntarily they demand (Tilt 1994; Freedman and Jaggi 2005). Therefore, management's concern is the continued survival and success of the company and this requires the approval of their activities by the stakeholders (Gray et al. 1995). Corporate social and environmental disclosures sustain communication with a varied set of recipients by giving social, political, and economic messages to avoid possible regulation regarding its disclosure (Naser et al. 2006).

14.4 Hypotheses Development

14.4.1 Firm Size

There is a consensus in the literature that larger firms prefer to disclose more information about their corporate social and environmental activities, and thus make them more visible to the society. This attitude of the firms can be more understandable via the legitimacy theory. Larger firms which are scrutinized by various larger groups would disclose their social activities to legitimize their business (Cowen et al. 1987). Although some studies could not find any significant relationship between size and corporate social reporting and environmental disclosure level (Staden and Hooks 2007; Elsayed and Hoque 2010), there are many others that found a positive relationship between size and corporate social and environmental disclosure level (Belkaoui and Karpik 1988; Hackston and Milne 1996; Choi 1999; Williams 1999; Cormier and Gordon 2001; Gray et al. 2001; Chau and Gray 2002; Freedman and Jaggi 2005; Gao et al. 2005; Haniffa and Cooke 2005; Hasseldine et al. 2005; Naser et al. 2006; Branco and Rodrigues 2008; Clarkson et al. 2008; Monteiro and Aibar-Guzmán 2010; Siregar and Bachtiar 2010; Abd Rahman et al. 2011; Cormier et al. 2011; Uwuigbe 2011; Andrikopoulos and Kriklani 2012). Thus, the proposition is constructed as:

H1. There is a positive association between the firm size (as measured by sales revenues) and corporate social and environmental disclosure level.

14.4.2 Performance

High performing entities tend to disclose more information than low performers because they can afford to spend more on environmental activities (Freedman and Jaggi 2005). To legitimize their existence by demonstrating their contribution to the society's well being, profitable companies disclose more social information (Haniffa and Cooke 2005). In the literature, there are many studies that could not find any significant relationship between corporate social and environmental disclosure level and corporate performance (Belkaoui and Karpik 1988; Hackston and Milne 1996; Chau and Gray 2002; Freedman and Jaggi 2005; Clarkson et al. 2008; Monteiro and Aibar-Guzmán 2010; Siregar and Bachtiar 2010; Abd Rahman et al. 2011). However, there are also many studies that have denoted positive association between corporate social and environmental disclosure level and corporate performance (Cormier and Gordon 2001; Gray et al. 2001; Haniffa and Cooke 2005; Branco and Rodrigues 2008; Uwuigbe 2011). Hence, the hypothesis is proposed as follows:

H2. There is a positive association between the performance (as measured by return on equity (ROE)) and corporate social and environmental disclosure level.

14.4.3 Leverage

There is not a common view in the literature about the association between the corporate social and environmental disclosure level and leverage. According to some researchers, the companies with high debt ratio tend to disclose more detailed information to assure investors and lenders than those who have low levels of risk (Naser et al. 2006), to reduce uncertainty (Iatridis 2011), and to avoid agency costs (Jensen and Meckling 1976). According to another view, as the debt of the companies' increases, they prefer not to disclose much information because debt holders do not require information as shareholders (Rahman 2002). Negative association between leverage and social disclosure indicates that managers of companies with debt to equity ratios tend to choose an accounting procedure that reduces reported earnings (Belkaoui and Karpik 1988). Therefore, management of highly leveraged firms is likely to be adverse to make environmental disclosure in their company's reports (Karim et al. 2006). There are contradictory results in prior studies which analyze the relationship between leverage and environmental disclosure level. Some have found a negative relationship (Belkaoui and Karpik 1988; Cormier et al. 2011; Andrikopoulos and Kriklani 2012), some a positive one (Choi 1999; Cormier and Gordon 2001; Naser et al. 2006; Clarkson et al. 2008), and others a non-significant relationship (Chau and Gray 2002; Freedman and Jaggi 2005; Haniffa and Cooke 2005; Karim et al. 2006; Siregar and Bachtiar 2010; Abd Rahman et al. 2011; Cormier et al. 2011). By taking the literature into consideration, proposition is developed as follows:

H3. There is negative association between the leverage (as measured by debt to total assets) and corporate social and environmental disclosure level.

14.4.4 Ownership Structure

Agency theory indicates that the separation between ownership and management causes agency costs because of the conflicts of interest between contracting parties (Jensen and Meckling 1976). There are some studies that could not find any significant relationship between ownership structure and corporate social and environmental disclosure (Choi 1999; Naser et al. 2006). Many studies also propose that the wider the ownership diffusion, the higher the level of corporate social and environmental disclosure level (Chau and Gray 2002; Cormier et al. 2011). Thus, the fourth hypothesis is constructed as:

H4. There is a positive association between ownership diffusion and corporate social and environmental disclosure level.

14.4.5 Auditor

The auditors' guidance affects the companies' corporate social and environmental disclosure behavior. As the auditing firm size increase, they are less subject to the influence of their clients and the level and quality of the corporate social reporting and environmental disclosure will also increase (Choi 1999). The level of disclosures of the companies which are audited by big auditing firms will be high because they tend to follow internal procedures and controls that are required by their affiliated international auditing firms (Uwuigbe 2011). Contrary to expectations, however, Chau and Gray (2002) found no significant relationship between the auditing firm size and the corporate social disclosure level. Yet, there are some studies that indicate positive association between auditing firm size and corporate social and environmental disclosure level as expected (Choi 1999; Uwuigbe 2011). Hence, the hypothesis is developed as:

H5. There is a positive association between the size of auditor and corporate social and environmental disclosure level.

14.4.6 Independent Directors

Presence of independent directors on the board as a representative of other stakeholders put pressure on the management to behave on their behalf (Haniffa and Cooke 2005). Moreover, the existence of independent directors plays a crucial role in corporate governance by forcing the entity to release more information about its activities (Akhtaruddin et al. 2009). There are contradictory results in the literature about the affect of the presence of independent directors on the disclosure level of the corporations. Some studies found negative relationship between the ratio of independent directors and corporate social and environmental disclosure level (Haniffa and Cooke 2005), some found no significant association (Naser et al. 2006), and still others found a positive association (Barako and Brown 2008; Kathyayini et al. 2012). The proposition is thus constructed as:

H6. There is a positive association between the number of independent directors on the board and corporate social and environmental disclosure level.

14.4.7 Institutional Ownership

Jensen and Meckling (1976) propose that institutional investors play an important role in the monitoring process of the companies. Karim et al. (2006) suggests that large institutional shareholders' influence the management due to their possible effect on the price of stocks. For example, the sale of stock by a large institutional investor can cause a large drop in a company's stock price. The existence of the institutional owners forces the management to make more disclosure about their corporate social and environmental activities (Naser et al. 2006). The proposition is constructed as:

H7. There is a positive association between the institutional ownership and corporate social and environmental disclosure level.

14.4.8 Board Size

Larger board size will make the monitoring process more effective and this will force management to disclose more corporate social and environmental information (Cormier et al. 2011). Said et al. (2009), Siregar and Bachtiar (2010), Cormier et al. (2011), and Kathyayini et al. (2012) have found significant positive relationship between board size and corporate social and environmental disclosure level. The proposition is constructed as:

H8. There is a positive association between the board size and corporate social and environmental disclosure level.

14.4.9 Industry

Industry is a factor that has potential to affect the corporate social and environmental reporting disclosure level of the entities (Hackston and Milne 1996). Industry will affect the corporate social and environmental reporting disclosure level of the entities because pollution propensity and outside monitoring vary from industry to industry (Dawkins and Fraas 2011). The sectors may be divided as "more environmentally sensitive or high profile" and "less environmentally sensitive or low profile" according to their activities' possible effect on the environmental pollution and exploitation and their exposure to the political and social environment (Newson and Deegan 2002; Campbell 2004). Those corporations which operate in the environmentally sensitive sectors such as electricity and utility or high profile industries such as raw material extraction, chemical, wood and paper are more likely to disclose more about environmental issues (e.g. waste recycling, energy conservation and pollution control) and corporate social activities in order to create a positive social image (Newson and Deegan 2002; Gao et al. 2005). Companies in high environmentally sensitive sectors try to legitimize their activities (Campbell 2003; Prado-Lorenzo et al. 2009) and engage in reputation building activities (Hasseldine et al. 2005) by disclosing more information about their operations. Karim et al. (2006) have found that petroleum industry has the highest average score of corporate social and environmental reporting because it is one of the most pollution prone industries. According to Haniffa and Cooke (2005) chemical industries are likely to disclose more environmental information to show their sensitivity to environmental problems and similarly consumer oriented industries can be expected to disclose their social activities to enhance their corporate image. Brown and Deegan (1998) proved that entities in industries such as chemicals, forestry and forest products, gold etc. make more environmental disclosure to confirm legitimization motive by corporate managers. Hence, the hypothesis is developed as follows:

H9. Corporate social and environmental reporting disclosure level is affected by the type of industry.

14.5 Research Methodology

14.5.1 Data

The sample of the study consists of manufacturing companies listed on the Istanbul Stock Exchange (ISE) in 2010. There are 138 manufacturing companies from various industries such as food, beverage; wood, paper, printing; chemical, petroleum, plastic; basic metal; metal products, machinery; nonmetal mineral products; textile, leather. Previous studies obtain the related data by examining mostly annual reports (see for example, Hackston and Milne 1996; Williams 1999; Williams and Pei 1999; Cormier and Gordon 2001; Hughes et al. 2001; Chau and Gray 2002; Newson and Deegan 2002; Campbell 2003; Gao et al. 2005; Haniffa and Cooke 2005; Hasseldine et al. 2005; Hossain and Reaz 2007; Brüggen et al. 2009; Sobhani et al. 2009; Elsayed and Hoque 2010; Bouten et al. 2011; De Villiers and Van Staden 2011), web sites (Williams and Pei 1999; Clarkson et al. 2008; Orens et al. 2009) or other sources such as environmental reports (Clarkson et al. 2008) and sustainability reports of the companies separately. Some of the studies get the data by analyzing all of those reports together (Freedman and Jaggi 2005; Van Der Laan Smith et al. 2005; Staden and Hooks 2007; Branco and Rodrigues 2008). Most of the prior studies have used annual reports because they are printed regularly and are widely read (Gray et al. 1995), have a widespread distribution (Unerman 2000), are the most commonly preferred measure of corporate social and environmental disclosure (Tilt 1994), and are more accessible to researchers compared to other corporate reports (Woodward 1998). Taking into consideration such related literature, we have also used the annual reports of the firms. The annual reports of companies were downloaded for the year 2010 from their corporate web sites. However, annual reports of some companies were unavailable on their web sites. So, we requested the annual reports of those firms via email. Most of them responded and sent their annual reports again by email or cargo. As a consequence, the final sample of our study comprised 131 corporations.

The sample consisting of 131 manufacturing firms is broken down into seven sectors based on the ISE industry classification as shown in Table 14.1.

Table 14.1 Industrial breakdown of sample firms

Industries	Frequency	Percent
Food, beverage	18	13.7
Wood, paper, printing	16	12.2
Chemical, petroleum, plastic	21	16.0
Basic metal	14	10.7
Metal products, machinery	22	16.8
Nonmetal mineral products	26	19.8
Textile, leather	14	10.7
Total	131	100.0

14.5.2 Corporate Social and Environmental Reporting Disclosure Index

In the literature, generally, content analysis is performed to determine the disclosure level of the companies. Content analysis is defined by Krippendorff (1980, p. 21) as "a research technique for making replicable and valid inferences from data according to their context". In prior studies, various techniques of content analysis have been used. Some are based on counting words (Campbell 2004; Haniffa and Cooke 2005; Gao et al. 2005); others on counting lines or sentences (Williams and Pei 1999; Hughes et al. 2001; Newson and Deegan 2002; Hasseldine et al. 2005; Sobhani et al. 2009; De Villiers and Van Staden 2011), and still others pages (Unerman 2000) that refer to social corporate and environmental activities of the entity. Pros and cons may be cited for each of those techniques. Counting words, sentences or lines may be a useful way of determining disclosure level, but they omit the graphs, charts, and photographs which are mostly used to disclose the corporate social and environmental information (Preston et al. 1996; Unerman 2000) and thus may cause enumeration errors (Unerman 2000). There are also many studies that check presence or absence of the disclosure item to determine the disclosure level (Choi 1999; Williams 1999; Chau and Gray 2002; Haniffa and Cooke 2005; Freedman and Jaggi 2005; Staden and Hooks 2007; Branco and Rodrigues 2008; Elsayed and Hoque 2010; Bouten et al. 2011). Following these studies, we have performed a content analysis by analyzing the annual reports of the companies about social corporate responsibility and environmental disclosures. There are 11 items, 5 of them under social responsibility, and other 6 under environmental disclosure. Each of these items is evaluated according to its presence or absence. An item is scored "1" if it was disclosed and "0" otherwise. Thereby, the corporate social and environmental disclosures score (CSESCOR) is formulated as follows (Hossain and Reaz 2007):

$$\mathbf{CSESCOR} = \sum_{j=1} \frac{d_j}{n}$$

Where;

$d_j = 1$ if the item is disclosed; 0 otherwise
n = number of items

Table 14.2 Corporate social and environmental disclosure index

Social responsibility disclosure index		**Min.**	**Max.**	**Mean**	**Std. Dev.**
1.	Sponsoring public health	0.00	1.00	0.305	0.46
2.	Sponsoring sport activities	0.00	1.00	0.305	0.46
3.	Sponsoring cultural recreations	0.00	1.00	0.335	0.47
4.	Sponsoring education	0.00	1.00	0.549	0.49
5.	Charitable donations	0.00	1.00	0.473	0.50
Environmental reporting disclosure index		**Min.**	**Max.**	**Mean**	**Std. Dev.**
6.	Environmental policy	0.00	1.00	0.656	0.47
7.	Environment friendly products	0.00	1.00	0.351	0.47
8.	Environmental indicators	0.00	1.00	0.358	0.48
9.	Environmental awards and certificates	0.00	1.00	0.564	0.49
10.	Environmental costs	0.00	1.00	0.007	0.08
11.	Environmental education for employees and others	0.00	1.00	0.297	0.45
	Average social responsibility disclosure index	0.00	0.91	0.382	0.27

Corporate social and environmental reporting disclosure items are presented in Table 14.2. The average of the corporate social and environmental reporting disclosure index score is 38.2 %. There are some companies that disclose none of the corporate social and environmental reporting items, there are also some companies that disclose 91 % of them. The most highly disclosed items are environmental policy (mean = 65.6 %), environmental awards and certificates (mean = 56.4 %), sponsoring education (mean = 54.9 %), and charitable donations (mean = 47.3 %). The least disclosed item is environmental costs (mean = 0.7). Majority of the items are disclosed between 30 % and 50 % level; so, there is not a huge difference between the means of disclosure items among Turkish companies.

14.5.3 Model Development

Ordinary Least Square (OLS) regression is employed to explore the association between the explanatory variables and corporate social and environmental disclosure level. We have initially examined this relationship with three different research models by changing the dependent variable. In the first model, the dependent variable is the total corporate social and environmental reporting index. In the second and third models, we have divided the total corporate social and environmental reporting index into corporate social reporting index and environmental reporting index and analyzed them separately. There are seven independent variables in Model 1, Model 2, Model 3 as sales, return on equity (ROE), leverage, auditing firm size, ownership diffusion, proportion of independent directors on the board, and listing age. We further developed another three models by adding industry as an independent variable. There are 14 independent variables in those research models. Seven of the fourteen variables are industry-specific which are included into model to explore the effect of the industry on the corporate social and environmental disclosure level of the corporations. Model 1, Model 2, Model 3, Model 4, Model 5, and Model 6 are presented below:

Model 1.

$$\begin{aligned} \text{CSESCOR} = {} & \beta_0 + \beta_1\,\text{SALES} + \beta_2\,\text{ROE} + \beta_3\,\text{LEVER} + \beta_4\,\text{AUDIT} + \beta_5\,\text{OWDIF} \\ & + \beta_6\,\text{INDIR} + \beta_7\,\text{LAGE} + \varepsilon \end{aligned}$$

Model 2.

$$\begin{aligned} \text{CSSCOR} = {} & \beta_0 + \beta_1\,\text{SALES} + \beta_2\,\text{ROE} + \beta_3\,\text{LEVER} + \beta_4\,\text{AUDIT} + \beta_5\,\text{OWDIF} \\ & + \beta_6\,\text{INDIR} + \beta_7\,\text{LAGE} + \varepsilon \end{aligned}$$

Model 3.

$$\begin{aligned} \text{ESCOR} = {} & \beta_0 + \beta_1\,\text{SALES} + \beta_2\,\text{ROE} + \beta_3\,\text{LEVER} + \beta_4\,\text{AUDIT} + \beta_5\,\text{OWDIF} \\ & + \beta_6\,\text{INDIR} + \beta_7\,\text{LAGE} + \varepsilon \end{aligned}$$

Model 4.

$$\begin{aligned} \text{CSESCOR} = {} & \beta_0 + \beta_1\,\text{SALES} + \beta_2\,\text{ROE} + \beta_3\,\text{LEVER} + \beta_4\,\text{AUDIT} + \beta_5\,\text{OWDIF} \\ & + \beta_6\,\text{INDIR} + \beta_7\text{LAGE} + \beta_8\,\text{XFOOD} + \beta_9\,\text{XPAPER} + \beta_{10}\,\text{XCHEM} \\ & + \beta_{11}\,\text{XMET} + \beta_{12}\,\text{XMACH} + \beta_{13}\text{XMINR} + \beta_{14}\text{XTEXT} + \varepsilon \end{aligned}$$

Model 5.

$$\begin{aligned} \text{CSSCOR} = {} & \beta_0 + \beta_1\,\text{SALES} + \beta_2\,\text{ROE} + \beta_3\,\text{LEVER} + \beta_4\,\text{AUDIT} + \beta_5\,\text{OWDIF} \\ & + \beta_6\,\text{INDIR} + \beta_7\,\text{LAGE} + \beta_8\,\text{XFOOD} + \beta_9\,\text{XPAPER} + \beta_{10}\,\text{XCHEM} \\ & + \beta_{11}\,\text{XMET} + \beta_{12}\,\text{XMACH} + \beta_{13}\,\text{XMINR} + \beta_{14}\,\text{XTEXT} + \varepsilon \end{aligned}$$

Model 6.

$$\begin{aligned} \text{ESCOR} = {} & \beta_0 + \beta_1\,\text{SALES} + \beta_2\,\text{ROE} + \beta_3\,\text{LEVER} + \beta_4\,\text{AUDIT} + \beta_5\,\text{OWDIF} \\ & + \beta_6\,\text{INDIR} + \beta_7\,\text{LAGE} + \beta_8\,\text{XFOOD} + \beta_9\,\text{XPAPER} + \beta_{10}\,\text{XCHEM} \\ & + \beta_{11}\,\text{XMET} + \beta_{12}\,\text{XMACH} + \beta_{13}\,\text{XMINR} + \beta_{14}\,\text{XTEXT} + \varepsilon \end{aligned}$$

where:

CSESCOR	Total Corporate Social and Environmental Reporting items disclosed/maximum score for firm
CSSCOR	Total Corporate Social Reporting items disclosed/maximum score for firm
ESCOR	Total Environmental Reporting items disclosed/maximum score for firm
SALES	Total sales revenues

ROE	Return on equity
LEVER	Leverage as measured by total liabilities divided by total assets
AUDIT	Dummy variable for audit firm size, coded as 1 for Big-4 and 0 otherwise
OWDIF	Ownership diffusion (i.e. percentage of shares held by unknown shareholders)
INDIR	Proportion of independent directors on the board
LAGE	Listing age
XFOOD	Food, beverage (Dummy variable; 1 for XFOOD, 0 for else)
XPAPER	Wood, paper, printing (Dummy variable; 1 for XPAPER, 0 for else)
XCHEM	Chemical, petroleum, plastic (Dummy variable; 1 for XCHEM, 0 for else)
XMET	Basic metal (Dummy variable; 1 for XMET, 0 for else)
XMACH	Metal products, machinery (Dummy variable; 1 for XMACH, 0 for else)
XMINR	Nonmetal mineral products (Dummy variable; 1 for XMINR, 0 for else)
XTEXT	Textile, leather (Dummy variable; 1 for XTEXT, 0 for else)

14.6 Analysis and Results

14.6.1 Descriptive Statistics

Table 14.3 shows the descriptive statistics for the independent variables of the research model. The average return on equity (ROE) ratio is 3 %. The average sales revenue is 1,015,119,239.79 TL (Turkish Liras). Firms are moderately leveraged (44 %). Sixty-one percent of the corporations are clients of the Big-4 auditing firms. The average mean of shares held by unknown shareholders is 35.02 %. On average, 5 % of board members are independent directors. This ratio is quite below the average ratio provided in two other studies; namely, Haniffa and Cooke (2005) and Akhtaruddin et al. (2009), respectively, 49.87 % and 38.3 %. The average listing age of the firms is 17.67 years. Since the ISE was established in 1985, the average listing age of the firms is not very high.

14.6.2 Correlation Analysis

The multicollinearity among the explanatory independent variables and the dependent variable is tested by the Pearson correlation analysis. The results of the

Table 14.3 Descriptive statistics for the independent variables (N = 131, year 2010)

	Minimum	Maximum	Mean	Std. Deviation
Corporate social and environmental reporting disclosure index	0.00	0.91	0.38	0.27
Sales (TL[a])	4,090,310.00	26,165,954,000.00	1,015,119,239.79	2,937,426,045.47
Return on equity	−0.76	0.56	0.03	0.23
Leverage	0.02	1.04	0.44	0.22
Auditing firm size	0.00	1.00	0.61	0.49
% of shares held by unknown shareholders	0.49	95.07	35.02	20.41
Independent directors	0.00	0.60	0.05	0.11
Listing age	1.00	27.00	17.67	6.09

[a]Turkish Liras

analysis are presented in Table 14.4. Findings of the correlation analysis shows that corporate social and environmental reporting disclosure index, corporate social disclosure index, and environmental reporting disclosure index have significant positive correlation with sales and auditing firm size. Corporate social and environmental reporting disclosure index has significant negative correlation with textile industry. However, multicollinearity is not a problem in this analysis because all of the significant correlation coefficients are below the threshold values of 0.8 (Bryman and Cramer 2001) or 0.90 (Hair et al. 2009).

14.6.3 Multivariate Analysis

Results of the OLS regression are presented in Table 14.5. This analysis shows that all of the models are statistically significant. Adjusted R^2 values of models 1, 2, and 3 are 0.256, 0.214 and 0.157, respectively, implying that the research model explains 25.6 % of the variance in corporate social and environmental reporting disclosure index, 21.4 % of the variance in corporate social reporting disclosure index, and 15.7 % of the variance in environmental reporting disclosure. After the industry is introduced into the research model as an explanatory variable, the adjusted R^2 values of the models do not change much. The adjusted R^2 of values of models 4, 5, and 6 are 0.253, 0.212, and 0.142, respectively, implying that the research model explains 25.3 % of the variance in corporate social and environmental reporting disclosure index, 21.2 % of the variance in corporate social reporting disclosure index, and 14.2 % of the variance in environmental reporting disclosure. Thus, inclusion of industry did not improve the expected power of independent variables. Adjusted R^2 values of previous studies using OLS regression vary from 9.50 % to 46.70 % [(e.g. Hackston and Milne (1996), 46.70%; Williams (1999), 21.60 %; Freedman and Patten (2004), 9.50 %; Siregar and Bachtiar (2010),

Table 14.4 Pearson correlation analysis

	CSESCOR	CSSCOR	ESCOR	SALES	ROE	LEVER	AUDITOR	OWDIF	INDIR	LAGE	XFOOD	XPAPER	XCHEM	XMET	XMACH	XMINR	XTEXT
CSESCOR	1																
CSSCOR	0.865**	1															
ESCOR	0.863**	0.492**	1														
SALES	0.389**	0.313**	0.359**	1													
ROE	0.157	0.169	0.102	0.143	1												
LEVER	−0.073	−0.110	−0.016	0.167	−0.470**	1											
AUDITOR	0.370**	0.393**	0.246**	0.187*	0.078	−0.044	1										
OWDIF	−0.168	−0.161	−0.129	−0.076	−0.131	−0.059	−0.287**	1									
INDIR	0.148	0.100	0.157	0.028	0.037	−0.009	−0.071	0.079	1								
LAGE	0.116	0.117	0.084	0.024	0.079	−0.024	0.171	−0.178*	−0.251**	1							
XFOOD	0.054	0.033	0.061	−0.046	−0.194*	0.164	0.046	−0.047	0.039	−0.187*	1						
XPAPER	−0.073	−0.034	−0.092	−0.103	−0.034	−0.112	−0.132	−0.064	0.036	−0.183*	−0.149	1					
XCHEM	0.144	0.140	0.109	0.264**	0.174	−0.088	0.221*	−0.173*	−0.104	0.209*	−0.174*	−0.163	1				
XMET	0.076	0.078	0.053	−0.017	−0.018	0.002	−0.231**	0.120	0.149	0.076	−0.138	−0.129	−0.151	1			
XMACH	−0.011	−0.087	0.069	0.086	0.022	0.252**	−0.060	−0.020	0.121	−0.033	−0.179*	−0.168	−0.196*	−0.155	1		
XMINR	−0.022	0.020	−0.057	−0.114	0.125	−0.321**	0.162	0.073	−0.143	0.099	−0.199*	−0.186*	−0.217*	−0.172*	−0.224*	1	
XTEXT	−0.190*	−0.165	−0.162	−0.093	−0.125	0.148	−0.079	0.136	−0.069	−0.010	−0.138	−0.129	−0.151	−0.120	−0.155	−0.172*	1

CSESCOR total Corporate Social and Environmental Reporting items disclosed/maximum score for firm, *CSSCOR* total Corporate Social Reporting items disclosed/maximum score for firm, *ESCOR* total Environmental Reporting items disclosed/maximum score for firm, *SALES* total sales revenues, *ROE* return on equity, *LEVER* leverage as measured by total liabilities divided by total assets, *AUDIT* dummy variable for audit firm size, coded as 1 for Big-4 and 0 otherwise, *OWDIF* ownership diffusion (i.e. percentage of shares held by unknown shareholders), *INDIR* proportion of independent directors on the board, *LAGE* listing age, *XFOOD* food, beverage (Dummy variable; 1 for XFOOD, 0 for else), *XPAPER* wood, paper, printing (Dummy variable; 1 for XPAPER, 0 for else), *XCHEM* chemical, petroleum, plastic (Dummy variable; 1 for XCHEM, 0 for else), *XMET* basic metal (Dummy variable; 1 for XMET, 0 for else), *XMACH* metal products, machinery (Dummy variable; 1 for XMACH, 0 for else), *XMINR* nonmetal mineral products (Dummy variable; 1 for XMINR, 0 for else), *XTEXT* textile, leather (Dummy variable; 1 for XTEXT, 0 for else)

*Significant at the 0.05 level (2-tailed); **Significant at the 0.01 level (2-tailed)

Table 14.5 OLS regression results

Independent variables															
Models		(Constant)	SALES	ROE	LEVER	AUDITOR	OWDIF	INDIR	LAGE	XFOOD	XPAPER	XCHEM	XMET	XMACH	XTEXT
Model 1 (Independent variable = CSESCOR)	Coef.	0.252	3.17E-011	0.013	−0.138	0.155	−0.001	0.448	0.004						
	t	2.435	4.228**	0.116	−1.256	3.438**	−0.803	2.363**	1.150						
	VIF		1.142	1.422	1.419	1.154	1.150	1.075	1.117						
Adjusted $R^2 = 0.256$															
F-ratio = 7.374 $p = 0.000$															
Model 2 (Independent variable = CSSCOR)	Coef.	0.241	3.09E-011	0.047	−0.194	0.226	−0.001	0.418	0.004						
	t	1.781	3.142**	0.329	−1.354	3.819**	−0.598	1.681*	0.924						
	VIF		1.142	1.422	1.419	1.154	1.150	1.075	1.117						
Adjusted $R^2 = 0.214$															
F-ratio = 6.063 $p = 0.000$															
Model 3 (Independent variable = ESCOR)	Coef.	0.260	3.23E-011	−0.016	−0.090	0.096	−0.001	0.473	0.004						
	t	2.236	3.835**	−0.131	−0.730	1.890*	−0.727	2.215**	0.976						
	VIF		1.142	1.422	1.419	1.154	1.150	1.075	1.117						
Adjusted $R^2 = 0.157$															
F-ratio = 4.465 $p = 0.000$															
Model 4 (Independent variable = CSESCOR)	Coef.	0.208	3.24E-011	0.032	−0.147	0.173	−0.001	0.365	0.004	0.093	0.032	0.006	0.134	0.028	−0.041
	t	1.772	4.041**	0.285	−1.219	3.608**	−0.635	1.861*	1.127	1.186	0.400	0.081	1.591	0.363	−0.498
	VIF		1.225	1.486	1.711	1.289	1.225	1.146	1.248	1.738	1.600	1.688	1.614	1.936	1.558
Adjusted $R^2 = 0.253$															
F-ratio = 4.380 $p = 0.000$															
Model 5 (Independent variable = CSSCOR)	Coef.	0.181	3.08E-011	0.088	−0.160	0.251	−0.001	0.336	0.004	0.082	0.061	−0.004	0.173	−0.031	−0.051
	t	1.172	3.024**	0.599	−1.013	4.001**	−0.453	1.306	0.885	0.794	0.585	−0.040	1.564	−0.314	−0.473
	VIF		1.225	1.486	1.711	1.289	1.225	1.146	1.248	1.738	1.600	1.688	1.614	1.936	1.558

(continued)

Table 14.5 (continued)

Independent variables															
Models		(Constant)	SALES	ROE	LEVER	AUDITOR	OWDIF	INDIR	LAGE	XFOOD	XPAPER	XCHEM	XMET	XMACH	XTEXT
Adjusted $R^2 = 0.212$															
F-ratio = 3.686 p =0.000															
Model 6 (Independent variable = ESCOR)	Coef.	0.231	3.19E-011	−0.015	−0.136	0.107	−0.001	0.389	0.004	0.103	0.007	0.014	0.102	0.077	−0.033
	t	1.736	3.619**	−0.117	−0.995	1.977**	−0.590	1.750*	0.970	1.153	0.082	0.169	1.065	0.890	−0.349
	VIF		1.225	1.486	1.711	1.289	1.225	1.146	1.248	1.738	1.600	1.688	1.614	1.936	1.558
Adjusted $R^2 = 0.142$															
F-ratio = 2.652 p = 0.003															

CSESCOR total Corporate Social and Environmental Reporting items disclosed/maximum score for firm, *CSSCOR* total Corporate Social Reporting items disclosed/maximum score for firm, *ESCOR* total Environmental Reporting items disclosed/maximum score for firm, *SALES* total sales revenues, *ROE* return on equity, *LEVER* leverage as measured by total liabilities divided by total assets, *AUDIT* dummy variable for audit firm size, coded as 1 for Big-4 and 0 otherwise, *OWDIF* ownership diffusion (i.e. percentage of shares held by unknown shareholders), *INDIR* proportion of independent directors on the board, *LAGE* listing age, *XFOOD* food, beverage (Dummy variable; 1 for XFOOD, 0 for else), *XPAPER* wood, paper, printing (Dummy variable; 1 for XPAPER, 0 for else), *XCHEM* chemical, petroleum, plastic (Dummy variable; 1 for XCHEM, 0 for else), *XMET* basic metal (Dummy variable; 1 for XMET, 0 for else), *XMACH* metal products, machinery (Dummy variable; 1 for XMACH, 0 for else), *XTEXT* textile, leather (Dummy variable; 1 for XTEXT, 0 for else)

*Significant at 0.10 level; **Significant at 0.05 level

10.80 %; Abd Rahman et al. (2011), 30.80 %; Cormier et al. (2011), 42.46 %)] indicating that adjusted R^2 values of the models of this study are at acceptable levels.

VIF values in all models are less than the threshold value of 10 implying that there is no multicollinearity problem (Chau and Gray 2002; Naser et al. 2006; Elsayed and Hoque 2010; Andrikopoulos and Kriklani 2012). The XMINR (non-metal mineral products industry) is automatically excluded from the regression analysis of Model 3, Model 4, and Model 5 because of collinearity issues.

The results of the regression analysis indicate that firm size, measured by sales revenues, has a positive significant relationship with CSESCOR, CSSCOR, and ESCOR at 0.01 level in all models. This shows that, as the firm size increases, the disclosure level of the corporate social and environmental activities also increases. Hence, Hypothesis 1 is accepted. Many earlier studies (i.e. Belkaoui and Karpik 1988; Hackston and Milne 1996; Williams 1999; Cormier and Gordon 2001; Gray et al. 2001; Haniffa and Cooke 2005; Hasseldine et al. 2005; Naser et al. 2006; Monteiro and Aibar-Guzmán 2010; Cormier et al. 2011; Andrikopoulos and Kriklani 2012) have also found a similar significant positive association between size and corporate social and environmental reporting disclosure level.

Auditing firm size also has a positive significant relationship between CSESCOR, CSSCOR, and ESCOR in Model 1, Model 2, Model 4, and Model 5 at 0.01 level and Model 3 and Model 6 at 0.05 level. Auditor firms were categorized as Big-4 and Non Big-4. This finding implies that, if an entity's auditor firm is in the Big 4 category, this entity will disclose more information about its corporate social and environmental activities. Therefore, Hypothesis 5 is accepted. This finding is parallel to the findings of earlier studies (Choi 1999; Uwuigbe 2011).

The existence of independent directors in the board of directors has a significant positive relationship with CSESCOR, CSSCOR, and ESCOR in all models, except Model 5. Hence, the presence of independent directors affects the corporate social disclosure. If there are independent directors in the board, the corporate social disclosure level of the entities increases. Hence, Hypothesis 6 is accepted.

As seen from the regression results, surprisingly, there is no significant relationship between the corporate social and environmental disclosure index and industry. The correlation analysis is also comparable with regression results. Corporate social and environmental reporting disclosure index has correlated negatively only with XTEXT according to Pearson Correlation analysis. Thus Hypothesis 9 is rejected.

Other variables such as performance (ROE), leverage, ownership structure, institutional ownership, and board size have no significant association with CSESCOR, CSSCOR, and ESCOR of the firms. Hence, Hypothesis 2, Hypothesis 3, Hypothesis 4, Hypothesis 7, and Hypothesis 8 are rejected.

14.7 Conclusions and Limitations

The purpose of this study was to measure the relationship between several firm characteristics and the corporate social and environmental reporting disclosure level. To examine this relationship, the annual reports of manufacturing companies listed on the ISE for the year 2010 were examined through content analysis. For deeper analysis, the corporate social and environmental reporting disclosure was divided into corporate social disclosure and environmental reporting disclosure. By adding industry as an explanatory variable, six different research models were developed. This study extends the previous research on the relationship between corporate characteristics and corporate social and environmental reporting disclosure index in several ways. First, the determinants of the corporate social and environmental reporting disclosure were investigated comprehensively for nine different hypotheses. Another aspect which makes this study different from prior studies was that it analyzed the corporate social and environmental reporting disclosure practices of Turkish companies. There are not many studies in Turkey examining the relationship between corporate social and environmental reporting disclosure level and corporate characteristics. Because Turkey is a developing country, and most of similar studies were conducted in developed countries, this study makes significant contribution to existing literature.

According to the findings of this study, firm size, presence of independent directors, and auditor firm size have positive and significant relationship with the corporate social and environmental reporting disclosure level. As the firm size increases, the corporate and social environmental reporting disclosure level of the companies increases. The firms which are audited by Big-4 make more corporate social and environmental reporting disclosure compared to the companies that are audited by non Big-4. The presence of independent directors also affects the corporate social and environmental disclosure level of the companies positively. This study also concludes that there is no any significant association between performance, leverage, ownership structure, institutional ownership, board size, industry and corporate social and environmental reporting disclosure level.

Those findings present several implications for corporations, auditing firms, investors, and regulators. Corporate social and environmental disclosures offer several advantages to corporations and investors. Managers should carefully evaluate the costs and benefits of those disclosures for their companies. Investors are the users of the corporate social and environmental reporting disclosures of the corporations. If they demand the necessary disclosures from the companies, the companies will consider the importance of those disclosures and will choose this channel for communication. In this way, the corporate social and environmental disclosure will serve a bridge between investors and companies. Auditing firms and regulators also have an important role in the corporate social and environmental disclosure level of the companies. Auditors and regulators offer guide the entities several guidelines and lead them into making better corporate social and environmental disclosures.

This study has some limitations. Firstly, the sample of the study consists only of manufacturing companies. This research may be expanded by adding other industries such as service and merchandising into analysis in future studies. Secondly, this analysis was conducted by analyzing only the annual reports of the entities. Future studies can examine other resources of corporate social and environmental reporting such as press releases, web sites, and prospectuses for deeper analyses. Finally, this research analyzed the annual reports of the firms for the year of 2010. This study may be extended by examining other years' annual reports.

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Chapter 15
Corporate Governance and Earnings Management: Quarterly Evidence from Turkey

Yasemin Zengin Karaibrahimoğlu

Abstract In 2003, following other developed and developing economies, the Capital Markets Board of Turkey (CMB) issued Corporate Governance Principles, in order to improve the board structure, increase shareholders rights, and enhance financial reporting quality through public disclosure and transparency in order to raise public confidence in, and restructure the Turkish capital market. One of the central issues in corporate governance is that there is no unique definition of good corporate governance practices that fit with the needs of all jurisdictions or firms. Considering Turkey's legal environment, the effectiveness of corporate governance principles in the country is of utmost importance. The CG principles developed in the country were adapted from Corporate Governance Principles of the OECD, which is a subject of debate in terms of enhancing the firm value. Therefore, this chapter aims to present the role of corporate governance on the quality of reported earnings of the ISE listed firms. Overall, the results indicate that the role of the board on quarterly earnings management in Turkey is highly contradictory and it is related to the direction of earnings management and external audit conducted by the Big-4 accountancy firms. Therefore, as a further policy implication, the corporate governance structure of Turkish firms should be strengthened by new regulations taking into account the needs of Turkish firms and the nature of the business culture in the country.

This chapter is derived and developed from the unpublished PhD thesis "The Role of Corporate Governance on Earnings Management: Quarterly Evidence from Turkey", submitted to the Graduate School of Social Sciences of Izmir University of Economics in December, 2010.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_15, © Springer-Verlag Berlin Heidelberg 2014

15.1 Introduction

Within the past decade, the issue of corporate governance has gained increasing attention from all capital market regulators. A number of regulations have been set by the capital markets board in both developed and developing countries and reports have been issued both in developed countries (e.g. US in 1998; UK in 1992; Germany in 2000; the Netherlands in 1997 and in developing countries (e.g. China in 2001; India in 1998; Brazil in 2001). Similarly, in Turkey, one of the largest transition economies, with an increasingly developing capital market, corporate governance has received priority consideration, especially since 2003. In that year, the Capital Markets Board of Turkey (CMB) issued Corporate Governance Principles, which aim to improve the board structure, increase shareholders rights, and enhance financial reporting quality through public disclosure and transparency in order to raise public confidence in, and restructure the Turkish capital market and attract capital inflow into Turkey.

One of the central issues in corporate governance is that there is no unique definition of good corporate governance practices that fit with the needs of all jurisdictions or firms. The definition of corporate governance depends on different country-level and firm-level factors; such as legal rights in the country, the ownership structure, the composition of management and board, capital markets regulations and the economic environment. Moreover, the role of corporate governance shapes its definition. Therefore, a definition which reflects the economic conditions, regulations and institutional settings in one country may not absolutely meet the expectations of another. Theoretically, good governance practices are associated with higher financial reporting quality. However, due to the multi-dimensional nature of corporate governance and institutional differences between countries' legal infrastructure and business environment, the optimal corporate governance structure shows variations among countries. For this reason, the direction and magnitude of the impact of the corporate governance mechanism is likely to vary across different economies due to the changing country-level corporate governance mechanisms and firm specific characteristics.

Earnings management is an important dimension of financial reporting quality and a central issue for all corporate stakeholders and defined as "*earnings manipulations within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings*" (Dechow et al. 1996). It is purposeful and done in response to certain motivations and incentives (Mulford and Comiskey 2002, p. 59). Whatever the motivation (capital market, contracting or political incentives), accounting standards require judgments in accounting practices, and flexibility in both applying accounting standards and in reporting financial performance. As a result, this flexibility provides management with the opportunity to manage earnings (Christie and Zimmerman 1994). Earnings numbers are more likely to be reliable and relevant when earnings management opportunities are controlled (Wild 1996).

Corporate governance and external audit are two important aspects that can potentially influence the financial reporting and disclosure quality by providing effective monitoring over management in order to mitigate the information asymmetry, agency problems, and consequently control management's opportunistic behavior in regard to earnings. Empirical studies concerning the importance of corporate governance provide supporting findings on the relation between poor governance and poor financial reporting quality associated with earnings management, restatements and fraudulent reporting (e.g. Beasley 1996; Dechow et al. 1996; Peasnell et al. 2000; Klein 2002; Davidson et al. 2005). However, most of these studies are conducted in developed countries, and therefore their findings are not sufficient to explain corporate governance mechanisms and their expected role in emerging economies.

Most of the fraudulent financial reporting cases start with quarterly misstatements (Yang and Krishnan 2005). As quarterly interim financial reports are generally not subject to audit and require relatively less detailed disclosures, they provide management with greater opportunity to manipulate earnings (Jeter and Shivakumar 1999). Since an effective board of directors with internal audit and control committees, and ownership structure substitutes the role of the external audit in monitoring financial reporting process, the importance of a strong corporate governance structure gains more importance in interim periods.

Therefore, considering the significance of an effective and strong corporate governance structure and external audit in financial reporting quality and the importance of quarterly interim financial reporting in enabling investors to make timely decisions, this chapter aims to examine the impact of corporate governance on quarterly earnings management taking into account the role of external audit and the direction of earnings management (income-increasing versus income-decreasing) in Turkey.

In recent years, Continental European countries are improving the protection of shareholders in order to avoid or minimize agency conflicts. Turkey was the last OECD country to have a corporate governance code (Ugur and Ararat 2006). According to the Global Competitiveness report, Turkey is showing an improving trend in the efficacy of corporate board (WEF 2010). In accordance with the efforts made by the Capital Markets Board, the quality of both internal and external corporate governance mechanism seems to be improving in Turkey. However, the effectiveness of corporate governance mechanism in terms of enhancing the firm value is a subject of debate.

In the light of these developments, in order to assess whether the issuance of corporate governance principles and improvement in the enforcement mechanisms do matter in enhancing the capital markets, Turkey provides a unique setting to study the impact of the effectiveness of corporate governance mechanisms on financial reporting quality in an emerging economy. Overall findings suggest that the role of corporate governance mechanisms on quarterly earnings management in Turkey is highly contradictory, and is related with the direction of earnings management and external audit conducted by Big-4, which calls into question the effectiveness of corporate governance mechanisms. This chapter addresses the gap in the literature by examining whether firm-level governance mechanisms play a significant role by substituting external audit to restrict quarterly earnings management in an emerging economy.

The rest of the chapter is organized as follows: Sect. 15.2 provides information about quarterly earnings management, corporate governance and legal environment in Turkey. Section 15.3 describes data and methodology. Section 15.4 documents the empirical findings and Sect. 15.5 concludes.

15.2 Background

15.2.1 Quarterly Earnings Management in Turkey

In Turkey, between the years 2006 and 2009, mean value of quarterly earnings management measured by discretionary accruals was −0.012, approximately 1.2 % of total quarterly beginning assets (see Table 15.1). Mean of annual discretionary accruals calculated based on a total of four quarters was −0.04, or approximately 4 % of total beginning assets. These results imply that mean discretionary accruals of Istanbul Stock Exchange (ISE) firms were lower for the period 2006–2009, compared to earlier periods: 1992–2003, when the mean discretionary accruals were 0.28 during initial public offerings (Yükseltürk 2006), 1998–2002, when mean discretionary accruals were −0.12 (Ayarlıoğlu 2007). On average, although the level of discretionary accruals has decreased dramatically since 2005, it is still comparatively higher than in developed countries.

Figure 15.1 presents the average quarterly discretionary accruals in Turkey. Overall, while mean discretionary accruals are income-decreasing both in interim and fourth quarters, consistent with previous studies conducted in Turkey (e.g. Ayarlıoğlu 2007; Karacaer and Özek 2010) discretionary accruals are higher in the fourth quarter compared to interim quarters.

Due to the changing economic conditions, inflation and high debt levels, Turkish companies have been operating in a high-risk economical environment (Atik 2009). This environment has had significant influences on the operations and profitability of firms and has caused fluctuations in the reported income in financial statements. Therefore, it is possible that one of the main reasons for concentrated income decreasing discretionary accruals in Turkey is the motivation for firms to manipulate their financial statements to create smoother income level (Atik 2009). Moreover, political costs seem to be another factor playing an important role in the use of negative discretionary accruals for Turkish firms operating in ISE. Also, it is expected that the use of income-decreasing discretionary accruals might be due to the high level of conservatism in Turkey.

Turkey is a developing capital market in which firms tend to avoid public attention in order to avoid costly public oversight and political pressures. Minority shareholders always prefer dividends over retained earnings, because they fear that

Table 15.1 Summary statistics for all firm-quarters

Variables	Mean	Median	Standard deviation	Minimum	Maximum
QDA_{it}	−0.012	−0.010	0.072	−1.62	1.658
$\lvert QDA\rvert_{it}$	0.037	0.026	0.063	0.000051	1.658
$BIG-4_{it}$	0.498	0	0.500	0	1
$BOARD\_IND_{it}$,	0.038	0	0.103	0	0.6
$\mathrm{BOARD\_SIZE}_{it}$	6.210	6	1.89	3	14
$\mathrm{CEO\_D}_{it}$,	0.160	0	0.366	0	1
$\mathrm{ACC\_SIZE}_{it}$	1.95	2	0.662	0	5
$\mathrm{INST\_OWN}_{it}$,	0.843	1	0.363	0	1
OWN_CNCT_{it}	50.77	50.93	21.85	0.78	99.36
$BLOCK_{it}$,	0.923	1	0.265	0	1
FIN_DEBT_{it}	0.254	0.173	0.413	0	5.72
$SIZE_{it}$,	19.08	19.07	1.50	15.67	23.20

n = 2,135 firm-quarter observations between the years 2006 and 2009. $\lvert QDA\rvert_{it}$ is absolute quarterly discretionary accruals and QDA_{it} is quarterly discretionary accruals measured by using the Adapted Larcker and Richardson Model, $BOARD\_IND_{it}$, independence of Board of Directors; $\mathrm{BOARD\_SIZE}_{it}$, size of Board of Directors; $\mathrm{CEO\_D}_{it}$, CEO Duality; $\mathrm{ACC\_SIZE}_{it}$, size of the Audit Committee; $\mathrm{INST\_OWN}_{it}$, Institutional Ownership; OWN_CNCT_{it}, Ownership Concentration; $BLOCK_{it}$, Blockholdership, $BIG-4_{it}$ is the dummy variable which takes the value of 1 when the firm is audited by BIG-4 audit firms, 0 otherwise, FIN_DEBT_{it}, Financial Debt to Total Assets; $SIZE_{it}$, size of the firm

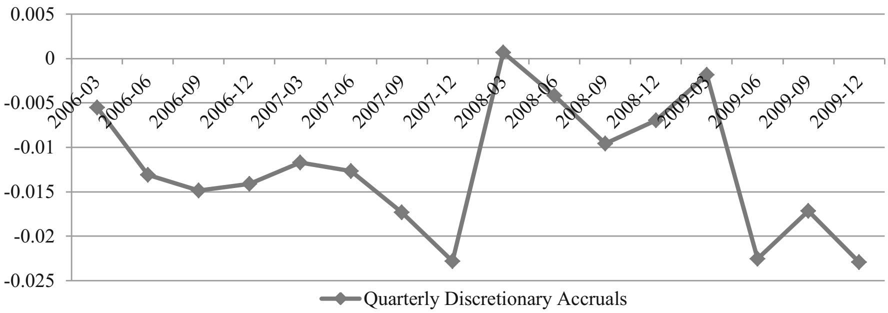

Fig. 15.1 Quarterly discretionary accruals in Turkey (2006–2009)

retained earnings might be used by majority shareholders for their own benefit against the interest of minorities (Shah et al. 2010). Due to the low investor' and minority shareholders' protection, majority shareholders, who mostly controls firm management, may use negative discretionary accruals in order to decrease the potential dividend payouts.

15.2.2 Legal Environment and Corporate Governance in Turkey

Since 1980s, the Turkish economy has experienced significant changes in the capital and market structure, in terms of a movement from a public-controlled market economy to a more liberal market economy that aims to encourage both domestic and foreign investments, and increase the capital transfers in the economy. Following these developments, the foundation of a capital market in Turkey was initially proposed in the early of 1980s and the CMB was established in 1981.

As of December 2009, there are 315 listed companies in ISE, with a market capitalization of TL 351 billion (US$ 236 billion) and trade volume of TL 475 billion (US$ 306 billion), respectively representing 50 % and 45 % of gross domestic product in 2009 (CMB 2010). According to World Federation of Exchanges' (WFE) report in 2009, among 54 stock exchanges around the world including America, Asia Pacific, Europe, Africa and Middle East, ISE ranks 27th in terms of market capitalization and 32nd in terms of number of listed companies. In addition, it is among Top 10 performing broad market indexes in 2009, in local currency terms.

Both ISE and CMB continue their efforts, supported by the introduction of new financial instruments and markets, constitutions of new regulations in accounting and auditing standards, and recommendation on the compliance with corporate governance principles in order to increase market efficiency, strengthen the position of ISE in the international capital markets and increase equity financing.

Despite the efforts of the ISE, CMB and in spited of WFE' indications that the Turkish capital market is one of the most promising markets in terms of internationalization, it remains a typical emerging market characterized by a limited number of listed firms, relatively small amount of market capitalization and trading volume.

Turkish companies use debt rather than equity as a source of finance and the capital market is not as liquid and developed as those in Anglo-Saxon countries (Hacımahmutoğlu 2007). The reasons for such an undeveloped capital market can be explained by Turkey's political, economic and historical developments, inadequate regulatory framework for the investor protection, the concentrated ownership, mostly with family-oriented and complex-pyramidal structure, and lack of enforcement mechanisms (IIF 2005).

Turkey has a Commercial Code derived from the French Commercial Code and influenced by both the German and Italian Commercial Codes (Balsarı et al. 2009). Therefore, in the accounting system of Turkey, the Continental Europe model is strongly perceptible. As a consequence, taxation law has a significant influence on the Turkish accounting system (Balsarı et al. 2009; Elitaş and Üç 2009).

Since 2001, the Turkish accounting system has seen significant changes in terms of the Anglo-Saxon influence on accounting and financial reporting, particularly for listed firms and financial institutions in the ISE. The CMB issued two important communiqués in order to improve financial reporting quality, and increase the understandability and comparability of financial reports. The Communiqué on Accounting Standards in Capital Markets (Serial: XI, No: 25) issued in 2003 (CMB 2003b), effective from 1 January 2005, requires all listed firms in ISE to comply with the accounting and financial reporting standards issued by the CMB, which are in line with IFRSs, but listed firms are also encouraged for early adaptation of IFRSs in the years 2003 and 2004. The Communiqué on Financial Reporting in Capital Markets (Serial: XI, No: 29) issued in 2008 (CMB 2008), effective from 1 January 2009, which requires listed firms to use of International Financial Reporting Standards (IFRSs).

Overall, governance structures of Turkish listed firms are characterized by relatively weak investor protection and minority rights (Durukan et al. 2009), low level of board independence (Ararat et al. 2010; Arslan et al. 2010), family controlled ownership with complex-pyramidal structure, in which family members are CEOs, boards members or top managers (Demirag and Serter 2003), and concentrated ownership (Ararat et al. 2010; Hacımahmutoğlu 2007).

In contrast to agency problems between management and shareholders in a dispersed ownership seen in developed capital markets (e.g. in US or UK), the agency problems is present between the majority shareholders and minority shareholders in developing countries where firms' ownership structure is concentrated. In Turkey, agency problems are more likely to occur between majority or family shareholders and minority shareholders.

The nature of weak investor protection in Turkish capital markets, principally, the limited rights of minority shareholders, discourages investors' entry to capital markets, resulting in a lack of equity culture (IIF 2005). In 2003, CMB issued Corporate Governance Principles of Turkey based on Corporate Governance Principles of OECD employing a "comply or explain" approach in order to solve the issue of the lack of equity by mitigating agency problems among management, minor and major shareholders, improving the public confidence in capital markets, enhancing the transparency and disclosure of financial reporting and developing the overall board structure and composition of Turkish firms. The Corporate Governance Principles of Turkey consist of four sub-sections; shareholders, disclosure and transparency, stakeholders and board of directors sections, recommending that firms disseminate information through various channels (e.g. websites) to reduce information asymmetry and to provide shareholders and investors with accurate, complete, comprehensible and understandable information in a timely manner to assure the transparency and full disclosure of firms (CMB 2003a). In 2004, effective starting from 2005, the CMB required all listed firms to present a Corporate Governance Compliance Report in their annual financial reports, explaining their level of compliance and any reason for failing to comply with the guidelines (CMB 2004). In this report, firms should declare the compliance with corporate governance principles, shareholders voting rights, general meetings, minority rights, dividend policy, firm disclosure policy, insiders, real natural person shareholders, social responsibility, the independency, composition and characteristics of board of directors, risk management and internal control mechanisms, the roles and

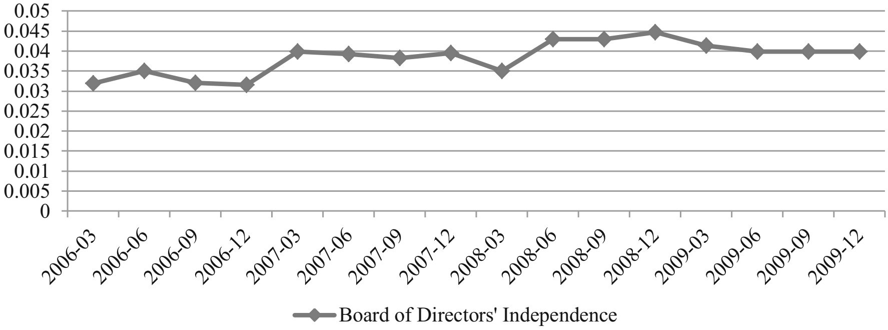

Fig. 15.2 Board of directors' independence in Turkey – quarterly (2006–2009)

responsibilities of board of directors, ethical conduct, the independence, composition and characteristics of the sub-committees and the remuneration of board of directors.

Unlike in most of the developed economies, boards of listed firms on the ISE are described by a lower level of independence and relatively smaller boards and audit committees. On average, the board independence over 2006–2009 period is 3.8 % (see Table 15.1). Figure 15.2 presents the changes in board of directors' independence between the years 2006 and 2009. Even though board independence increased over this period, it is still very low relative to that of developed countries such as US and UK where firms reporting 58 % (Klein 2002) and 43 % (Peasnell et al. 2005) board independence, respectively. It is more likely that independent board members are confined to providing advice and counsel in Turkish firms (Ararat et al. 2010) and they are more likely to be appointed in order to fulfill the compliance with corporate governance principles as a "*display case*", rather than being effective in fulfilling their expected role.

ISE firms have between 3 and 14 directors on the board, on average 6 directors, a relatively small numbers compared to the US firms, where board size range between 6 and 39, on average 12.48 (Xie et al. 2003) and the UK where board size range between 3 and 24, on average 8.01 (Peasnell et al. 2005). Mean of audit committee size is 1.95, suggesting that most ISE firms meet the minimum requirement set by CMB regardless the size of the board of directors or firm itself.

It is also highlighted that the compensation of CEOs in Turkey are tied to accounting-based financial measures, which is a sign of the effectiveness of corporate governance systems (Durukan et al. 2009) in aligning CEOs' and owners' interest. CMB in Turkey recommends the separation of CEO and chairman positions; however, due to the concentrated family ownership in Turkey, CEOs are mostly the family members who holds the chairman position on the board or at least act as a board member. On average, in 16 % of ISE firms CEO position are held by the chairman of the board of directors.

The ownership structure of ISE firms are described by concentrated ownership (Ararat et al. 2010; Hacımahmutoğlu 2007), particularly family controlled

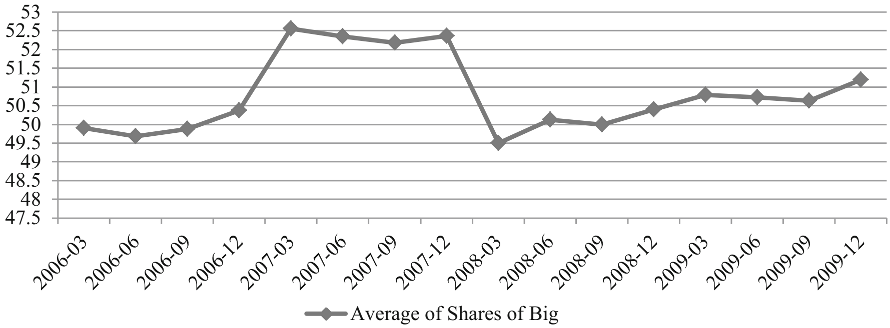

Fig. 15.3 Ownership structure in Turkey – quarterly (2006–2009)

ownership with complex-pyramidal structures where family members are CEOs, boards members or top managers (Demirag and Serter 2003). Also, the owners are often institutional (mostly holdings) blockholders who own more than 20 % of shares. On average, approximately 50.7 % (see Table 15.1) of total shares are held by large shareholders, indicating a concentrated ownership structure in which shareholders have control power over firms. Among those large shareholders 84 % are institutions. Figure 15.3 presents the change in ownership structure between the years 2006 and 2009. As clearly seen in the figure, the concentrated ownership structure was more prominent in the year 2007.

Moreover, in order to assure the accuracy of the financial reports, in 2006, the CMB issued The Communiqué on Independent Auditing Standards in Capital Markets (Serial: X, No: 22), which defines the legal requirements and the independence of auditors, regulates the quality of auditing services by describing their scope, identifies the auditor tenure and introduces auditing standards in line with International Standards on Auditing (ISAs) (CMB 2006). According to the Communiqué, ISE listed firms are required to undergo an independent external audit for the year-end financial reports and audit review for the sixth month quarterly interim financial reports. The other interim reports are not subject to any independent audit.

According to the report of Institute of International Finance (IIF) (2005), the main problem in the application of corporate governance principles in Turkey is the deficiencies in the legal enforcement mechanism. Following the developments in capital markets and improvements in accounting and auditing standards and the introduction of corporate governance principles, the new Turkish Commercial Code has been issued, effective from July, 1, 2012. Whit this new code, all Turkish firms (listed and non-listed) started to prepare their financial reports in accordance with IFRSs and audited (effective from January, 1, 2013). Moreover, corporate governance principles found a wide range of application.

15.3 Data and Methodology

The chapter uses data from all non-financial firms listed in the ISE between the years 2005 and 2009. Firms in the financial sector were excluded from the sample due to different regulations and characteristics of their performance indicators. From this initial sample, firms with different reporting period, missing accounting or market data, corporate governance data were excluded. As the computation of the discretionary accruals requires the change in sales and receivables, the first quarter of 2005 and the first reporting period of the firms that change their reports from single to consolidated, or vice versa, were excluded. The final sample for the measurement of earnings management comprises of 3,067 firm-quarter observations. Additionally, the first quarter earnings management measure is missing in the year 2005. Therefore, in order to solve this imbalance problem in the data, all firm-quarter observations for the year 2005 and observations with extreme discretionary accruals were excluded. The final sample for the analyses comprises of 2,135 firm-quarter observations between the years 2006 and 2009.

All accounting numbers were gathered from financial reports of firms, and market data were downloaded from the ISE website. Corporate governance data were hand-collected for each firm quarter from the company year book, company news files published on ISE website and corporate governance compliance reports issued by firms.

In their study examining the relation between audit committee characteristics and quarterly earnings management, Yang and Krishnan (2005) summed up quarterly discretionary accruals and using a composite measure of discretionary accruals total of absolute values of quarterly discretionary accruals and run the regression yearly. However, this approach does not allow researchers to examine the income-increasing and income-decreasing discretionary accruals. This is because in order to calculate a composite annual discretionary accruals measure, the absolute value of discretionary accruals, which offsets downward and upward earnings management among quarters, are used. Even their approach extends the literature by examining quarterly discretionary accruals, they examined the relation between audit committee characteristics and earnings management annually. So their results cannot be interpreted directly as that audit committee characteristics has an influential effect on quarterly earnings management.

This chapter extends their study and uses an empirical model based on panel regression analysis of discretionary accruals on corporate governance variables and control variables quarterly. The Fama-Macbeth (Fama and Macbeth 1973) two-step panel regression was used to estimate parameters for research model. Fama-MacBeth estimation procedure is suitable for panel data analysis to cope with probable cross-sectional dependence problems in the data set. Also, industry dummies were added to the model to control the role of industry fixed effect. The following regression model was used to examine the impact of corporate governance on earnings management.

$$\begin{aligned} QDA_{it} = {} & \beta_0 + \beta_1\, BOARD\_IND_{it} + \beta_2\, BOARD\_SIZE_{it} + \beta_3\, CEO\_D_{it} \\ & + \beta_4\, ACC\_SIZE_{it} + \beta_5\, INST\_OWN_{it} + \beta_6\, OWN\_CONCT_{it} + \beta_7\, BLOCK_{it} \\ & + \beta_8\, BIG - 4_{it} + \beta_9\, FIN\_DEBT_{it} + \beta_{10}\, SIZE_{it} \end{aligned}$$

Where:

QDA_{it} = Quarterly discretionary accruals in the period (t),
$BOARD\ \_\ INDP_{it}$ = Board of Directors' Independence in the period (t),
$BOARD\ \_\ \mathrm{SIZE}_{it}$ = Board of Directors' size in the period (t),
$\mathrm{CEO\ \_\ D}_{it}$ = CEO duality in the period (t),
$\mathrm{ACC\ \_\ SIZE}_{it}$ = Audit committee size in the period (t),
$\mathrm{INST\ \_\ OWN}_{it}$ = Institutional ownership in the period (t),
$\mathrm{OWN\ \_\ CNCT}_{it}$ = Ownership concentration in the period (t),
BLOCK_{it} = Blockholdership in the period (t),
$\mathrm{BIG} - 4_{it}$ = Year en audit conducted by Big-4 audit firms in the period (t),
$\mathrm{FIN\ \_\ DEBT}_{it}$ = Financial debt ratio in the period (t),
SIZE_{it} = Size of the firm in the period (t).
t = the event quarter, i = the firm.

15.3.1 Measurement of Earnings Management

In this chapter, earnings management is considered as any earnings manipulation within the boundaries of accounting standards. Any other manipulations beyond the accounting standards or artificial entries are assumed as fraudulent financial reporting. Real earnings management is costly to measure and it changes across industries and firms. Therefore, it is not appropriate to study real earnings management in a research design that aims to explore the role of firm specific characteristics (e.g. corporate governance) on earnings management in different industries.

Earnings management was measured based on quarterly discretionary accruals (QDA_{it}). Dechow et al. (1995) and Jones et al. (2008) argue that if total accrual models are not controlled for extreme firm performance, they fail to capture discretionary accruals. Thus, in order to control the model for firm performance, and relax the assumption of all receivables are discretionary, in this study, the Larcker and Richardson Model (2004) adjusted for the Adapted Model (Dechow et al. 2003)[1] was used.

[1] In order to estimate quarterly discretionary accruals, the following models were employed; the Jones Model (Jones 1991), the Modified Jones Model (Dechow et al. 1995), the Adapted Model (Dechow et al. 2003), the Forward Looking Model (Dechow et al. 2003), the Kazsnik Model (Kazsnik 1999), the Larcker and Richardson Model (Larcker and Richardson 2004) and the Kothari et al. Model (Kothari et al. 2005). The Larcker and Richardson (2004) Model adjusted for the Adapted Model (Dechow et al. 2003) provides the most significant coefficient and highest adjusted-R2.

The fitted values of the following regression provide quarterly non-discretionary accruals ($QNDA_{it}$) and the residuals (ε_{it}) are the quarterly discretionary accruals (QDA_{it}).

$$\begin{aligned} QTAC_{it} = \beta_0 + \beta_1\ [(1+k)\Delta SALES_{it} - \Delta REC_{it}]/TA_{i,t-1} + \beta_2\ PPE_{it}/TA_{i,t-1} \\ + \beta_3\ CFO_{it}/TA_{i,t-1} + \beta_4\ BM_{it} + \varepsilon_{it} \end{aligned}$$

Where;

$QTAC_{it}$ = Total quarterly accruals measured by the cash flow approach in the period t scaled by lagged total assets,
$\Delta SALES_{it}$ = Change in sales from period (t−1) to period (t),
ΔREC_{it} = Change in receivables from period (t−1) to period (t),
PPE_{it} = Gross property plant and equipment in the period (t),
CFO_{it} = Cash flows from operations in the period (t),
BM_{it} = Book to Market ratio in the period (t),
k = Proxy that measures the expected changes in credit sales in a given amount of sales and estimated from the following regression; $\Delta REC_{it} = \alpha + k * \Delta SALES_{it}$
$t = \textit{the event quarter},\ i = \textit{the firm}.$

15.3.2 Corporate Governance Variables

Corporate governance is a management mechanism that assures the efficient use of company's assets in the interests of the stakeholders and protects investors from opportunistic behavior (Gillan 2006). It surrounds all the provisions, instruments and mechanisms intended to monitor the activities of management and align the management incentives with all capital lenders (García-Osma 2006), Therefore, all capital market regulations (e.g. independent external audit) to protect the rights of investors, organizational rules, appointment of management roles (e.g. separation of CEO and chairman roles) and ownership structure (e.g. the rate of public shares) that aim to improve the quality of financial reports might be considered as corporate governance mechanism.

The strength of corporate governance on a firm level is related with the effectiveness of the board of directors and the structure of ownership. The effectiveness of the board of directors in performing its monitoring roles is closely associated with the composition and characteristics of board members. Likewise, the effectiveness of ownership structure depends on the rights, the composition and characteristics of shareholders. Thus, this chapter measures the strength of corporate governance based on the following variables;

15.3.3 Board of Directors Independence $(BOARD\_INDP_{it})$

Board of Directors Independence was measured as the proportion of independent directors to the board size (see Klein 2002). A board member is considered independent if the person has (i) no ownership in the firm, (ii) no previous employment in the firm, or its subsidiaries in any capacity except as board member and (iii) no family ties with the owner of the firm. Considering the independence definition, in this chapter, a board member is defined as independent if the person meets all of the criteria above. Board independence data was gathered from several different sources using a retrospective approach.

The size of board of directors $(BOARD\_SIZE_{it})$ and *audit committee* (ACC_SIZE_{it}) were measured as the number of board members in the board and audit committee, respectively.

CEO duality (CEO_D_{it}) was measured by a dichotomous variable that takes the value of 1 if both the chairman and the CEO are the same person, and 0 otherwise.

Institutional ownership $(INST\_OWN_{it})$ was measured by a dichotomous variable that takes the value of 1 if the largest shareholder is an institution and 0 otherwise.

Ownership concentration (OWN_CNCT_{it}) was measured as the percentage of shares held by the largest shareholder.

Blockholdership $(BLOCK_{it})$ was measured by a dichotomous variable that takes the value of 1 if the largest shareholder holds more than 20 % of equity shares, and 0 otherwise.

15.3.4 Control Variables

Earnings management incentives and opportunities differ in accordance with firm specific characteristics. In order to control the effect of external audit $(\mathrm{BIG}-4_{it})$ a control variable measured as dummy variable taking the value of 1 when the firm is audited by BIG-4, 0 otherwise was added into the model. Additionally, the model was controlled for financial debt ratio $(\mathrm{FIN\_DEBT}_{it})$ measured by the proportion of financial debt to total assets and firm size (SIZE_{it}) measured as the natural logarithm of total assets.

15.4 Empirical Results

15.4.1 Summary Statistics

Table 15.1 presents the summary statistics for quarterly discretionary accruals and corporate governance.

Table 15.2 Regression of quarterly discretionary accruals on corporate governance

Variable	Exp. sign	Model 2-1 absolute discretionary accruals $\lvert QDA \rvert_{it}$	Model 2-2 income-increasing accruals (QDA_{it} 0)	Model 2-3 income-decreasing accruals (QDA_{it} 0)
Constant		0.076***	0.064***	0.075***
Test variables				
$BOARD\_IND_{it}$	(−)	0.025***	0.034**	0.018***
$BOARD\_SIZE_{it}$	(+/−)	0.0001	−0.0001	0.0002
CEO_D_{it}	(+)	0.001	0.003	0.00005
ACC_SIZE_{it}	(+/−)	0.001**	0.0001	0.003**
$INST\_OWN_{it}$	(−)	0.006**	0.003	0.007**
OWN_CNCT_{it}	(+/−)	−0.00001	0.00003	−0.00001
$BLOCK_{it}$	(+/−)	−0.005	−0.015	−0.001
Control variables				
$BIG-4_{it}$	(−)	−0.002**	−0.00003	−0.006***
$SIZE_{it}$	(−)	0.019***	0.0003	0.018***
FIN_DEBT_{it}	(+)	−0.002***	−0.001	−0.002***
n		2135	829	1306
Average Adj. R-square		0.1685	0.2287	0.2396

(***), (**) and (*) significant at 1 %, 5 % and 10 % (one-tailed), respectively. n = 2,135 firms-quarter observations after omitting the outliers for QDA_{it} at 1 % and 99 % percentile between the years 2006 and 2009. $\lvert QDA \rvert_{it}$ is absolute quarterly discretionary accruals and QDA_{it} is quarterly discretionary accruals measured by using the Adapted Larcker and Richardson Model, $BOARD\_IND_{it}$, independence of Board of Directors; $\mathrm{BOARD\_SIZE}_{it}$, size of Board of Directors; $\mathrm{CEO\_D}_{it}$, CEO Duality; $\mathrm{ACC\_SIZE}_{it}$, size of the Audit Committee; $\mathrm{INST\_OWN}_{it}$, Institutional Ownership; OWN_CNCT_{it}, Ownership Concentration; $BLOCK_{it}$, Blockholdership, $BIG-4_{it}$ is the dummy variable which takes the value of 1 when the firm is audited by BIG-4 audit firms, 0 otherwise, FIN_DEBT_{it}, Financial Debt to Total Assets; $SIZE_{it}$, size of the firm. Coefficients are estimated by Fama-MacBeth cross-sectional regressions for each quarter

15.4.2 Earnings Management and Corporate Governance

In Table 15.2, Model 2-1 reports that the board of directors' independence has a positive association with absolute quarterly discretionary accruals. Similarly, the significant positive coefficient of audit committee and institutional ownership indicate that firms with larger audit committees and institutional owners have higher quarterly discretionary accruals. Model 2-2 shows that the board of directors' independence is slightly significant, which means that the independence of board of directors is positively associated with income-increasing discretionary accruals. Model 2-3 reports the regression with income-decreasing quarterly discretionary accruals as a dependent variable with the hypothesized board characteristics variables. Of all the variables, only board of directors' independence, audit committee size and institutional ownership are significant.

The external independent audit is an important firm-level corporate governance mechanism. As auditing by Big-4 audit firms are expected to limit discretionary

Table 15.3 Regression of quarterly discretionary accruals on corporate governance: Big-4 versus Non-Big-4 firms

		$\|QDA\|_{it}$		Model 3-2 income-increasing accruals (QDA_{it} 0)		(QDA_{it} 0)	
Variable	Exp. sign	Big-4	Non-Big-4	Big-4	Non-Big-4	Big-4	Non-Big-4
Constant		0.099***	0.048***	0.091***	0.019	0.094***	0.078***
Test variables							
$BOARD\_IND_{it}$	(−)	0.038***	0.011	0.014	0.025	0.044***	−0.004
$BOARD\_SIZE_{it}$	(+/−)	0.001***	0.0001	−0.0005	0.0002	0.001*	0.0003
CEO_D_{it}	(+)	−0.006**	0.007**	−0.007	0.010*	−0.004*	0.0006
ACC_SIZE_{it}	(+/−)	−0.001	0.003***	0.0003	0.002	−0.002	0.005**
$INST\_OWN_{it}$	(−)	0.007**	0.006*	−0.009	0.002	0.013***	0.003
OWN_CNCT_{it}	(+/−)	0.00002	−0.00003	0.0001	−0.00002	−0.00002	0.00004
$BLOCK_{it}$	(+/−)	−0.007	−0.004	−0.005	−0.015	−0.002	−0.0009
Control variables							
$SIZE_{it}$	(−)	0.005	0.022***	0.003	0.010	0.010	0.019**
FIN_DEBT_{it}	(+)	−0.003***	−0.001	−0.002**	0.0006	−0.004***	−0.003**
Average Adj. R-square		0.1407	0.2472	0.3751	0.4041	0.2195	0.3430

(***), (**) and (*) significant at 1 %, 5 % and 10 % (one-tailed), respectively. n = 2,135 firms-quarter observations after omitting the outliers for QDA_{it} at 1 % and 99 % percentile between the years 2006 and 2009. $|QDA|_{it}$ is absolute quarterly discretionary accruals and QDA_{it} is quarterly discretionary accruals measured by using the Adapted Larcker and Richardson Model, $BOARD\_IND_{it}$, independence of Board of Directors; $\mathrm{BOARD\_SIZE}_{it}$, size of Board of Directors; $\mathrm{CEO\_D}_{it}$, CEO Duality; $\mathrm{ACC\_SIZE}_{it}$, size of the Audit Committee; $\mathrm{INST\_OWN}_{it}$, Institutional Ownership; OWN_CNCT_{it}, Ownership Concentration; $BLOCK_{it}$, Blockholdership, $BIG-4_{it}$ is the dummy variable which takes the value of 1 when the firm is audited by BIG-4 audit firms, 0 otherwise, FIN_DEBT_{it}, Financial Debt to Total Assets; $SIZE_{it}$, size of the firm. Coefficients are estimated by Fama-MacBeth cross-sectional regressions for each quarter accruals, it would be more appropriate to analyze firms audited by Big-4 and Non-Big-4 separately in order to gain more reliable results.

Table 15.3 presents the regression analysis for the research model, as firms audited by Big-4 and Non-Big-4. Regarding the board independence, it is clear that independent board members lack effectiveness in constraining earnings management in Turkey. Instead, firms with independent members on the board have significantly higher absolute discretionary accruals, and this positive relation is particularly significant for firms using income-decreasing discretionary accruals.

In regard to the size of the board, it is clear that this has a significantly positive relation with quarterly discretionary accruals in Turkey, suggesting that firms with smaller boards are more effective in constraining earnings management, because of coordination and communication problems among members in the larger boards means they are less likely to be effective and functional in financial reporting oversight. Firms with larger boards have significantly higher absolute discretionary accruals, and it is important to note that, while this positive relation is significant for Big-4 firms using income-decreasing discretionary accruals, the role of board size is insignificant for Non-Big-4 firms.

According to regression results, CEO duality has contradictory roles on the extent of quarterly discretionary accruals. It has a significantly negative relation with the extent of quarterly discretionary accruals for Big-4 firms, suggesting that in cases where there is CEO duality, and therefore a higher level of discretionary accruals is expected, Big-4 external audit are able to limit earnings management. In contrast, CEO duality has a positive influence on the extent of quarterly discretionary accruals for Non-Big-4 firms, consistent with the proposition of power concentration, which is likely to decrease the control of the board over management activities, and firms with CEO duality are more likely to have higher level of discretionary accruals, particularly if audited by Non-Big-4 audit firms. The negative relation was observed only for Big-4 firms using the income-increasing quarterly discretionary accruals, and the positive relation was found only for Non-Big-4 firms using income-decreasing quarterly discretionary accruals.

For the audit committee size, there is a positive relation between audit committee size and the extent of discretionary accruals, particularly for Non-Big-4 firms using income-decreasing discretionary accruals.

Additionally, for the institutional ownership, there is a significant positive association between institutional ownership and absolute discretionary accruals both for Big-4 and Non-Big-4 firms. This positive association between institutional ownership mainly exists for Big-4 firms using income-decreasing discretionary accruals.

15.5 Conclusion

This chapter aims to present the role of corporate governance on the reported earning numbers of ISE firms. Overall results indicate that the role of the board on quarterly earnings management in Turkey is highly contradictory and it is related with the direction of earnings management and external audit conducted by Big-4.

A board with independent members is likely to be more objective in decision making and it improves the monitoring and controlling activities over management (CMB 2003a). Thus, the existence of independent members in the board is an essential factor that enhances board of directors' effectiveness. However, board independence displays a significant adverse sign, particularly, it is more prominent for Big-4 firms using income-decreasing discretionary accruals, suggesting that firms with independent boards use aggressive income-decreasing earnings management, and that auditing by Big-4 has limited influence in reducing management attempts to use discretionary accruals. A possible rationale for this inverse relation might be the insufficient monitoring ability of independent board members in sample ISE firms. Arslan et al. (2010) suggest that non-artificial separation of independent and dependent board members in Turkish firms and the information asymmetry between independent and dependent members could results in a lower quality of financial information. Also, this inverse relation may be due to the undisclosed social, personal, or financial ties between the controlling shareholder and the independent board members. Another possible explanation is the lower level of independent members. Ararat et al. (2010) claim that in spite of lack of ties with the firm, that fact that independent members are minority on the board may make it difficult to declare a controversial opinion. Therefore, the limited number of independent members, the probable cohesion problems with management, lack of ethical business conduct, and correspondingly the adverse relation found in most empirical studies are issues that call into question the degree to which independent members are truly independent, or the effectiveness of the board independence, in relation to the corporate governance principles of Turkey.

A small board may improve the financial performance, because, according to Jensen (1993) "*When boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control*". So, from this point of view, because of the coordination and communication problems the large boards are less likely to be effective and functional in financial reporting oversight. Board size has a significantly positive relation with quarterly discretionary accruals, implying that firms with larger boards have significantly higher quarterly discretionary accruals, particularly while this positive relation is significant for Big-4 firms using income-decreasing discretionary accruals. The results show that larger boards have a greater tendency to use income-decreasing discretionary accruals in Turkey. Similarly, there is a positive relation between audit committee size and the extent of discretionary accruals, particularly for Non-Big-4 firms using income-decreasing discretionary accruals. Similar to the effect of smaller board size, smaller audit committees may function less effectively and be more susceptible to the CEO control.

Occupation of both CEO and chairman positions by the same person leads to a power concentration, which is likely to decrease the ability of the board to control and monitor management. For listed ISE firm, CEO duality has contradictory roles on the extent of quarterly discretionary accruals. While it displays a significant negative relation with the extent of quarterly discretionary accruals for Big-4 firms, it has a positive relation with quarterly discretionary accruals for Non-Big-4 firms. When the sample was partitioned, it was found that while the negative relation was observed only for Big-4 firms using income-decreasing quarterly discretionary accruals, there was a positive relation between CEO duality and income-increasing quarterly discretionary accruals for Non-Big-4 firms.

There is a positive association between institutional ownership and the extent of quarterly discretionary accruals. Theoretically, institutional investors are more sophisticated and experienced and have more access to timely and relevant information (Balsam et al. 2003), and are therefore, more effective in the control and monitor of management activities in comparison to individual investors (Siregar and Utama 2008). In Turkey, institutional owners are private incorporated bodies which hold large proportion of firm shares, and are therefore more likely to be the controlling shareholder. The high ownership concentration is the primary reason for the likelihood of larger quarterly discretionary accruals for those firms with institutional owners, particularly Big-4 firms using income-decreasing accruals.

There is a dilemma regarding the desirability of higher ownership concentration for ISE firms. On one hand, it is a potentially effective mechanism for monitoring and disciplining management and solving the agency problems (Grossman and Hart 1988). On the other hand, it has potential to exacerbate the agency problem if the interest of controlling shareholder does not align with minority shareholders (Claessens et al. 2002). Similarly, blockholders' ability to exercise control over management is more likely to increase its level of engagement with firm management. For the sample ISE firms, no relation has been observed neither between ownership concentration and earnings management nor between blockholdership and earnings management.

The main contribution of this chapter has been the in-depth investigation of the influence of the board of directors and ownership structure on earnings management from different dimensions in an emerging economy. First, the chapter shows that the impact of firm-level corporate governance mechanisms on discretionary accruals varies according to whether external audit conducted by Big-4 and Non-Big-4 firms. Second, it also provides evidence on the changing role of firm-level corporate governance mechanisms with the direction of earnings management; income-increasing and income-decreasing discretionary accruals, suggesting that while firm-level corporate governance mechanisms might be ineffective for income-increasing firms, they could significantly influence income-decreasing firms. The most important implication of the results is that the role of firm-level corporate governance mechanisms on firms' financial reporting process may change due to the institutional and cultural setting in countries and other firms-specific characteristics. Not all regulations issued in one country will meet the expectations of others; particularly the regulations of developed countries may not suitable for emerging countries. Therefore, while setting new regulations and policies, countries institutional settings should be also considered.

Additionally, this chapter contributes to both the earnings management and corporate governance literature by examining the relation between firm-level corporate governance mechanisms and earnings management on a quarterly basis, both of which have the potential to bring a sharper focus to the relationship. Annual or yearly research designs tend to misspecify in measuring accrual based earnings management, because firms could use both income-increasing and income-decreasing discretionary accruals throughout the year, and these could offset each other in the year-end financial reports. Therefore, yearly estimation of discretionary accruals may fail to capture those discretionary accruals used in interim quarters. Studies examining the role of corporate governance on quarterly earnings management would seem to be limited to a single study by Yang and Krishnan (2005), which focuses on the role of audit committee composition and characteristics on quarterly earnings management. The present chapter methodologically builds on their study with the important difference that rather than considering that the corporate governance structure of firms is fixed throughout the year, quarterly data for corporate governance was used.

Moreover, in the view of the limited literature in Turkey regarding the effectiveness of board of directors and other corporate governance mechanisms, particularly the absence of studies examining its role on discretionary accruals in Turkey, this chapter makes a significant contribution to the Turkish literature by providing empirical findings on the relationship between corporate governance and earnings management. The contradictory results obtained from the existing studies conducted in Turkey, and the research findings of this chapter increase the focus on the uncertainty over the effectiveness of board of directors' composition in Turkey. Turkey is a developing, code-law country with emerging capital markets, and thus displays quite different institutional characteristics relative to developed countries. Corporate governance mechanisms are strongly affected by the legal system and capital market law of each particular country and vary as a result of different institutional environments. Therefore, the findings of prior studies in developed countries are not sufficient to fully explain corporate governance mechanisms and their expected role in Turkey, and the proposed corporate governance guidelines for developed countries may be less effective when applied in Turkish context. This chapter therefore contributes to the literature by providing results on firm-level corporate governance mechanisms and earnings management from an emerging economy, which may have significant implications for future policy implementation and enforcement mechanisms in the particular legal and institutional context of this country. In Turkey, CMB plays an essential role in the regulation of the exchange markets, and makes contributing recommendations. However, the "comply or explain" approach, as an enforcement mechanism does not fit with Turkish Continental Europe model legal framework (Hacımahmutoğlu 2007). Therefore, as a further policy implication, the corporate governance structure of Turkish firms should be strengthened by new regulations taking into account the needs of Turkish firms and the nature of the business culture in the country. Regulators in Turkey should work on how to enhance firms' compliance with corporate governance principles and how to improve the effectiveness of those mechanisms.

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Chapter 16
Current Board of Directors' Practices in Saudi Corporate Governance: A Case for Reform

Faleh Salem Al Kahtani

Abstract This chapter examines the current board of directors' practices in Saudi corporate governance. It highlights a variety of significant aspects of boards of directors, as internal institutions of the corporate governance system. For example, the chapter contains details of the board members' duties, the boards' responsibilities and creation of standards, the separation of the board members' powers, board membership categories, board meetings, board sub-committees (such as audit committees and nomination and remuneration committees) and board members' compensations. All these aspects are referenced from the Corporate Governance Code (hereafter CGC), the Company Law (hereafter CL) and the case law connected to them. The paper's methodology is analytical and adopted a comparative approach with the successful international corporate governance codes, such as the OECD principles of corporate governance, the UK Companies Act, the Cadbury report and the Greenbury report, in order to reform the board of directors' practices in the Saudi corporate governance framework.

16.1 Introduction

The corporate board is believed to be a significant entity of the internal institutional framework for corporate governance (Abdel Aal 2005). Therefore, the board should act appropriately, either toward stakeholder groups (including the shareholder group) or to the corporation. This paper will debate the main research question, which relates to the current practices of the Saudi corporate governance regarding the board of directors. This paper is therefore divided into a number of sections. The first section addresses the board members' duties, and the second considers the board's responsibilities. The creation of the board is examined in Sect. 16.3. The

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_16, © Springer-Verlag Berlin Heidelberg 2014

separation of the board members' powers is emphasized in Sect. 16.4, and board membership categories are discussed in Sect. 16.5. The board meeting is appraised in Sect. 16.6. Next, Sect. 16.7 analyses the board sub-committees by focusing on two substantive committees: the audit committee and the nomination and remuneration committee. The board members' compensations are explored in Sect. 16.8. Finally, a summary is given.

16.2 Board Members' Duties

16.2.1 General Overview

It is thought that due to the extensive power conferred on the corporation directors in addition to managing the corporation, there is an opportunity for directors to depart from the corporation's purposes and mismanage the corporation. As a consequence, international corporate governance principles have composed and identified a variety of board members' duties in order to ensure that these board members are directing the corporation properly and accurately as regards the corporation policies, and are satisfying the corporation targets. In particular, there are company law jurisprudences in which the law clearly states that the association between the corporation and its board members is a principal-agent association which encourages board members to owe the corporation, the well-known expression being 'fiduciary duty' (Kamal 2001). Board members are fiduciary agents; hence, their powers should be implemented not only as required by law, but also for the benefit of the corporation as a whole (Malcolm 1997).

This association between the corporation and the board members, based on the principle-agent association, is not referred to under either the CL or CGC provisions. Moreover, the fiduciary duty is not recognized by these pieces of legislation. This is supported by evidence that the idea of the fiduciary duty is immature in the Middle East. In the US, for example, the use of the term 'fiduciary' is evaded regarding board members of corporations. This is because board members have commitments that are related to the duty of loyalty; a duty to act responsibly with regards to the power they hold and to carry out their duty of care. Accordingly, use of the term 'fiduciary' to define numerous entirely different obligations simply complicates the issue (Al Rimawi 1999).

However, in literature, the fiduciary duty is divided into three major duties, comprising the duty of care, the duty of loyalty and the duty to act within one's power. This is sustained by the OECD principles of corporate governance (2004), which declare that there are two important origins of the fiduciary duty of board members: the duty of care and the duty of loyalty, providing that: "Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders." (p. 59.)

This section will attempt to investigate whether the board members' duties provided for in the CGC and the CL are appropriate for guaranteeing that board members will not disobey the rules, or whether reform is required to enhance the current board of directors' practices in Saudi corporate governance. Accordingly, these duties will be covered by focusing on the duty of care, the duty of loyalty and the duty to act within one's power.

16.2.2 Duty of Care

The duty of care is one of board members' greatest duties in accordance with the power that they have to direct their corporation and to fulfill their responsibilities in the best interests of the shareholders and the corporation, equally. In so doing, board members should carry out their responsibilities with sensible care and skill in terms of making contractual decisions. Accordingly, their duty of care takes place within several international jurisprudences. For example, the UK Companies Act states that it is necessary for people to act with a degree of skill and care that may be reasonably expected from people of their knowledge and experience (Hicks and Goo 1994). The UK Companies Act, therefore, uses a subjective measure to decide whether board members are in violation of the duty of care that they owe to their corporation (Griffin 2006).

In the Saudi case, the board members' duty of care has not been clearly specified in either the CL or the CGC. This simply means that the Saudi regulator finds both pieces of legislation futile when it comes to stipulating the measure of care for the corporation's board members. To put it differently, it is difficult to hold board members responsible for violations of their duty of care under Saudi legislation, even though the CL has identified two primary board member responsibilities; namely civil and criminal liabilities against breaches such as management malpractice and cheating (Al Ghamdi 2007).

Additionally, Article 75 of the CL of 1965 stipulates that the corporation should be bound by all the acts performed by the board of directors within the limits of its competence. The corporation should also be responsible for damages arising from unlawful acts committed by directors in the administration of the corporation. It seems that under this Article, board members are immune when they make mistaken decisions, even if these decisions are made deliberately. Therefore, the Saudi regulator should clarify the board members' liabilities regarding duty of care under the CL, and add this to the CGC. As a matter of fact, the Saudi regulator can adapt the duty of care concept and definition from other international jurisprudences, such as the UK Companies Act of 2006, section 174, clauses 1 and 2 which point out the duty of care clearly and sensibly:

> A director of a company must exercise reasonable care, skill and diligence. This means the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person

carrying out the functions carried out by the director in relation to the company, and the general knowledge, skill and experience that the director has.

16.2.3 Duty of Loyalty

The term ‘duty of loyalty’ is the principle of the fiduciary that the board member has a duty of loyalty, which is defined as the prevention of conflicts of interest and insider trading. It is affirmed that board members are expected to exercise a duty of loyalty toward the corporation and its shareholders. In addition, board members should not indulge in any conduct that would be unfavorable to the interests of the corporation. Consequently, the duty of loyalty is challenged by the well-known conflict of interest within board situations and insider trading (Al Ghazali 2008).

Conflict of Interest Within the Board

Conflict of interest within the board is generally understood to mean any situation that may affect the neutrality of a member’s decisions due to personal interests (both material and moral) or those of his or her relatives (Al Ghazali 2008). In other words, a conflict of interest arises when the board member comes across circumstances where there is the possibility of formal exploitation or stimulus affecting private interest (Demski 2003).

The concept of conflicts of interest within the board came into legal existence in the eighteenth century, when the US court of law assumed the prohibition statute in a conflict of interest case, notwithstanding the operation’s objectivity or wrongness (Marsh 1996). Soon afterwards, the UK House of Lords followed the US’ attitude towards the board member’s conflict of interest case (Pennington 1989). After this, the conflict of interest situation was not taken to be obstructive, as the case was deemed effective as long as it was agreed on by a majority of disinterested board members (Block et al. 1993). Current international practice is in support of certifying some conflict of interest cases. However, this support is dependent on particular restraints that should be implemented. Otherwise, board members found to be in breach of a conflict of interest will be considered guilty and punished, either by having a fine imposed upon them or by being given another sentence for their breach (Demski 2003).

Endorsements of conflicts of interest within the board (i.e. the duty of loyalty) by board members differ across various international legal structures. In some European legal structures, the preparation against breaches of conflicts of interest involves precise recompense for the corporation for the damage that occurs as a consequence of the conflict of interest within the board by the board member. Moreover, breaches of conflicts of interest within the board in the US and the UK are stricter than the compensation in some of the European legal structures, as stated above, because the US and the UK instruct a particular disclosure and transparency measure when there is a submission involving a conflict of interest within the board situation (Enriques 2002).

Conflicts of interest between board members and their corporations can occur in several ways, such as when there is a submission between corporations and their directors, or when there is a submission between the corporations and third parties, while at the same time a board member has a personal interest in the matter (Enriques 2002). It is argued that decisions taken in support of the corporation should be made exclusively for the profit of the corporation. Sensibly, these decisions taken should not be made with a view to obtaining particular personal subsidy for the board members and top executives. For example, the conflict of interest situation may occur when board members are selling their own property to their corporation, or because they are discussing a contract under which their corporation will fund them (Pettet et al. 2009).

There is a debatable viewpoint regarding conflicts of interest. This argument considers that those on the board who are likely to have a conflict of interest are notably the non-executive members, since they are not wholly independent. For instance, non-executive members often possess shareholdings and options in the corporation (Enriques 2002). Moreover, non-executive members may encounter a conflict of interest when taking a director's post in two competing corporations, as their responsibilities for one may conflict with those for another. It appears that non-executive members, who participate either commercially or for private gain by being non-executive members of a competing corporation, would be in danger of being found to be in abuse of their duty of loyalty. Therefore, they should cease any conduct that purposely harms the corporation (Pettet et al. 2009).

It is estimated that non-executive members are those who are encouraged to occupy the board and the board sub-committees' seats, either by the Saudi legislator or other international corporate governance legislators (Article 12-C of the Corporate Governance Code 2006). Therefore, being a non-executive member does not prevent the occurrence of conflict of interest cases which cannot be tackled in the absence of strong regulations governing these cases. Conflicts of interest within the board in the Saudi case, however, do not contest the argument that non-executive members are the most vulnerable to conflicts of interest within the board. This is obvious, as the board members, either executive or non-executive, in the law cases that will be analyzed in this section were in breach of conflict of interest within the board.

In particular, Saudi legislation has established the meaning of conflict of interest from the enacting of the CL of 1965. As a consequence, the clauses regulating conflicts of interest within the board found under the CGC are derived from Articles 68 and 69 of this law without modification. As a new restraint by the compulsory Article 10-B of the CGC, the corporation board should create a written rule that concerns any corporation assets and the illogical disposal of them stemming from dealing with related groups, and this should resolve conflicts of interest within the board and treat any probable submissions of the conflicts of interest of the board members.

Furthermore, Article 18-A of the CGC affirms that a board member may not have any interest, whether directly or indirectly, in the transactions or contracts made for the account of the company, except with authorization from the ordinary general meeting, which is to be renewed annually. Transactions made by way of public bidding are, however, excluded from this restriction if the board member has submitted the best offer. In particular, the board member should declare to the board any personal interest he or she may have in the transactions or contracts made for the account of the company. Such declarations should be recorded in the minutes of both the corporation general meeting and the board meeting. The interested board member may not participate in voting on the resolution to be adopted in this respect. More to the point, the board chairman must inform the ordinary general meeting, when it convenes, of the transactions and contracts in which any board member has a personal interest. Such communication must be accompanied by a special report for the company's external auditor. However, section 175 Articles 1 and 2 of the UK Companies Act outline conflicts of interest as follows:

> A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).

A well-known legal case of conflict of interest concerned a decision by the board chairman and the board members of the Saudi Chemical Company to purchase 15 % of the shares of one of the company's subsidiary groups without informing the company's general meeting, despite the chairman having an interest in the transaction. In addition, the Saudi Chemical Company failed to announce that the transaction was associated with a related group, either on its website or on the stock exchange website. As a result, the Capital Market Authority Board imposed a fine of $13,333 dated 2009 on the board chairman and each board member. The verdict was in connection with Article 28 of the Listing Rules (2004), which indicates that: "The directors of a company should exercise their powers and carry out their duties in such a way as to serve the interest of the company."

It is suggested that the fines enforced by the Capital Market Authority Board on each board member should have been higher. The board chairman, particularly, should have been fined $26,666, because he had an aggregate interest in the transaction and is supposed to be responsible for safeguarding the shareholders' interests. The sentence also seems strange in light of the fact that the board chairman was prevented from participating in the listed corporation's board meetings for a period of time, as this punishment is stipulated in the Capital Market Law (hereinafter CML). Article 59-A- of the CML (2003) assures that "Barring the violating person from acting as a broker, portfolio manager or investment adviser for such period of time as is necessary for the safety of the market and the protection of investors."

In this case, the Capital Market Authority Board punished the board chairman and the board members for being in breach regarding the conflict of interest situation. The board chairman and all the board members were not actually conducting insider trading, which is regulated by Article 50-A of the CML. Rather, they were simply trying to hide the transaction, because they did not first obtain authorization at the ordinary general meeting to complete the transaction. In addition, the board chairman was served by the board members to conduct this transaction because he had a personal interest, as stated above.

Nevertheless, Article 18-B of the CGC confirms that board members may not, without annually renewed authorization from the ordinary general meeting, participate in any business or enterprise that is in competition with the company, or engage in any commercial activities conducted by the company. Otherwise, the company has the right either to claim damages from them or to consider the operations they have conducted for their own account as having been conducted for the account of the company.

A classic law case concerned the *Methanol* Chemicals Company general meeting, which dismissed a board member suspected of a conflict of interest in 2008. In fact, the removal was enforced after the suspended board member was given a period of 3 months in which to finish his private competing application that was completed against the company's works, but failed to do so. The removal of the board member by other board members was consistent with Article 18-B of the CGC. It is astonishing that the board members of the *Methanol* Chemicals Company dismissed the board member on the grounds of conflict of interest due to having prior permission to act, as he had indeed obtained this from the company's ordinary general meeting. This notwithstanding, the decision was made without any interference from the Capital Market Authority Board. However, it appears that the Capital Market Authority Board should have imposed a fine on the removed board member.

Altogether, with regard to Articles 18-A and 18-B of the CGC, it can be supposed that the CGC has made some exceptions that are not counted as a conflict of interest within the board, as follows:

I. When the board member has received prior permission from the corporation's ordinary general meeting to act, which should be renewed on a yearly basis.
II. When the board member informs the board and the shareholders about any private undertakings and commercial agreements that he or she has accomplished for the corporation.
III. When the board member is the primary bidder through the general bidding.

It can be noted that the issue of informing the other board members and shareholders regarding conflicts of interest has been discussed internationally. For example, the declaration of a board members' interest has been conditioned under section 177, Article 1 of the UK Companies Act. It upholds that if a company's board member is in any way, either directly or indirectly, interested in a planned submission with the company, he or she must announce the nature and the extent of his or her interest to the other board members.

In particular, the CGC exclusions are strongly disputed, as they reflect good corporate governance practices. As Prairie (2007) maintained, the general bidding exception to be completed by board members when they are the optimal bidders is an unnecessary exception by the Saudi legislator. Prairie further stated that board members' offers in general bidding are undoubtedly likely to be the most successful offers to win the general bidding, because the board members are expected to be familiar with the corporation's information and affairs. It is consequently observed that these exceptional terms are not needed at all, as they damage equality and accountability, thereby permitting a monopoly by the board members. Additionally, the CGC has meaninglessly opened a door to board members to trade in their corporations' contracts. For this reason, it is considered that these exceptional terms should be removed from the CGC in order to avoid misrepresentation by the board members and top executives.

This is in accordance with the idea that the avoidance of conflicts of interest within the board (i.e. the duty of loyalty) would be accomplished by the board members being prevented from either going into a conflict of interest with the corporation or competing with the corporation (Shane 1999).

Once again, the conflict of interest permits unlawful monopoly by board members. The following instance is an example of conflicts of interest within the board. The *Herfy* Company announced its ordinary general meeting agenda, with the meeting due to be held on 29th March 2012. The general meeting agenda consisted of several issues, the most important of which was the approval of the transactions and contracts to be made with related groups during 2011, and licensing for the following year, including the approval of land leases and the rental of residential buildings worth an annual $208,000 from the chief executive, who was also a board member. The chief executive owned 20 % of the corporation's share capital and was therefore one of the corporation's major shareholders. Form this example, the conflict of interest within the board is very obvious; the chief executive stood to make private interest on his own behalf with the approval of the corporation's ordinary general meeting. In reality, there was no excuse for him to trade and take advantage of the company where he was the chief executive and held a significant number of shares.

Insider Trading

It is known that when board members trade in the securities of a company in which they are an insider, their actions are subject to rules under numerous diverse legal concepts. However, the board members have a fiduciary duty to this corporation, so if they practice information expected as a consequence of their inside capability for personal return, they are obliged to disclose their advantages to the corporation (Yoran 1972). In particular, Franks (1981) suggested that insider trading takes place when board members do not gain direct benefit from some other party to a contract. Instead, the board members use their knowledge and experiences to buy or sell shareholdings in the company or to deal on the stock exchange. Both Saudi legislation and Article 50-A of the CML have identified and defined insider trading as:

> Information obtained by the insider and which is not available to the general public, has not been disclosed, and such information is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a security related to such information, and the insider knows that such information is not generally available and that, if it were available, it would have a material effect on the price or value of such security.

The UK Companies Act, however, makes no mention of insider trading except that it refers to what was stated under section 52 of the Criminal Justice Act of 1993. This act defined this situation as follows:

> An individual who has information as an insider is guilty of insider dealing if, in the circumstances including when [the acquisition or disposal in question occurs on a regulated market, or that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary] he deals in securities that are price-affected securities in relation to the information, and if he encourages another person to deal in securities that are (whether or not that other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned above or he discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession to another person.

Section 61 of the UK Criminal Justice Act further stipulates that the Secretary of State or the Director of Public Prosecutions has the right to consent to the handover of the insider dealing to the prosecution. It states that:

> An individual guilty of insider dealing shall be liable - on summary conviction, to a fine not exceeding the statutory maximum or imprisonment for a term not exceeding six months or to both; or on conviction on indictment, to a fine or imprisonment for a term not exceeding seven years or to both.

It is vital, when analyzing Saudi law cases, to understand how the Capital Market Authority Board and the Committee for the Resolution of Securities Disputes (hereinafter CRSD) are able to detect insider dealing. The first legal case of insider trading was issued by the CRSD, issued decision, No. 289-L-D1-2008, dated 8th July 2008, which punished a board member of the Saudi Hotels and Resorts Company with a combined punishment that prohibited the defendant from working with listed corporations for 3 years and imposed a fine of $26,666. The punishment was in accordance with Article 59-A of the CML, which stipulates that:

> If it appears to the Capital Market Authority that any corporation or person has engaged, is engaging or is about to engage in acts or practices constituting a violation of any provisions of the Capital Market Law, or the regulations or rules issued by the Capital Market Authority, or the regulations of the stock exchange, the Capital Market Authority Board shall have the right to bring a legal action before the Committee for the Resolution of Securities Disputes to seek an order for the appropriate sanction that includes barring from working with companies whose securities are traded on the stock exchange.

This case, furthermore, corresponds to Article 59-B of the CML:

> The Capital Market Authority Board may request the Committee for the Resolution of Securities Disputes to impose a fine upon any corporation or person responsible for the violation of the Capital Market Law, its Implementing Regulations and the regulations of the stock exchange. The fine that the Committee for the Resolution of Securities Disputes

> can impose shall not be less than $2.666 and shall not exceed $26.666 for each violation committed by the defendant.

In fact, while chairman of the Saudi Hotels and Resorts Company board; the defendant purchased a large number of shares from another corporation that was being taken over by the Saudi Hotels and Resorts board. Hence, he bought these shares in accordance with his position. Furthermore, he was the main official undertaking the negotiations, and signed on behalf of the aforementioned company. As a result, the punishment was in line with Article 50-A of the CML, which advocates that:

> Any person who obtains, through family, business or contractual relationship, inside information is prohibited from directly or indirectly trading in the security related to such information, or to disclose such information to another person with the expectation that such person will trade in such security.

It is thought that the sentence and the fine were lawful as they punished the chairman of a listed corporation; a harsh punishment that was appropriate to his malpractice, imposed in a way that reflected his position regarding obvious insider trading. Nevertheless, the CRSD should have forced the company's chairman to repay the interest he gained from the transaction, but it did not do so.

The second legal case of insider trading was issued by the CRSD, issued decision, No. 323-L-D1-2008, dated 11th November 2008, demanding that a board member of the *Gassim* Agricultural Company repay the interest he accrued, comprising approximately $899,299, to the Capital Market Authority. The defendant was also prohibited from working in a listed corporation for 3 years and fined $26,666. The board member was sentenced in accordance with Articles 59-A and 59-B of the CML. Article 3-M of the Merger and Acquisitions Regulations provides further definition:

> Such an insider trading would arise if the director had, directly or indirectly, an interest (including his shareholding in the offeree company, if the director is a director of the offeror company, or his shareholding in the offeror company, if the director is a director of the offeree company) or duty (including where the director of the offeror company holds a position of a director or a manager of the offeree company, and where the director of the offeree company holds a position as a director or a manager of the offeror company) which is material and which conflicts or may conflict with the interests of the company.

Thus, the defendant was a board member of the *Gassim* Agricultural Company. He purchased a large number of shares in another corporation when it was being taken over by *Gassim* Agricultural Company. He obtained these shares for six family members (his sons and daughters) in accordance with this submission. Consequently, the punishment was in pursuant to Article 50-A of the CML, and the sentence and fine are surely lawful. This case also confirms that insider trading can extend to board members' relatives even if the board members have nothing to do with the dealing themselves, because they are committing fraud and not considering the company's and the shareholders' interests at all in favor of their relatives' interests.

The most significant case of insider trading was the final verdict of the CRSD, dated 17th August 2009, which pronounced a combined punishment against a board chairman of the *Bishah* Agriculture Development Company. The punishment comprised a combination of imprisoning him for a period of 3 months, forcing him to repay to the Capital Market Authority a total amount of money equal to $14,050, fining him $26,666 and preventing him from working with listed corporations for 3 years. The board member in question was guilty of insider trading in this company by selling and purchasing shares while being the board chairman of this company. The verdict of the CRSD was in accordance with Article 50-A of the CML. Significantly, this was the first time that the punishment of imprisonment had been applied by the CRSD. There was strong rejection regarding this punishment by corporate governance observers in Saudi Arabia, who considered that the CRSD should not apply the punishment of imprisonment. That is to say, they believed that as the CRSD is a quasi-judicial committee, it should not be allowed to impose harsh punishments such as imprisonment.

By law, Article 57-C of the CML provides the CRSD the right to sentence individuals who have caused a lot of damage to the stock exchange, and who have committed insider trading, to imprisonment for a certain determined time of not more than 5 years, as is usually mentioned in the final verdict of the case. However, Article 59-B of the CML offers the CRSD the right to impose a criminal sanction like imprisonment in order to resolve any violation of the CML and the Implementing Regulations. In fact, the final verdict of the CRSD was given after allowing the accused person a period of 30 days to appeal in front of the Appeal Committee for the Resolution of Securities Conflicts, which he failed to do. As a matter of fact, the defendant submitted the case before a general *Shari'a* court to be sued, but the court refused to accept and file the case. The case was rejected because the general *Shari'a* court is not responsible for these kinds of capital market cases, and because the Saudi regulator has assigned these kinds of cases to be heard by the CRSD. In addition, the defendant did not accept the idea that his case would be seen by the CRSD, which is a quasi-judicial tribunal. The defendant also refused to repay three times the sum he obtained from the transaction to the Capital Market Authority. In contrast, Article 64 of the CML provides the individual who has committed insider trading with a way to avoid imprisonment. It concludes that:

> A person charged with violation of insider trading may avoid proceedings before the Committee for the Resolution of Securities Disputes by reaching an agreement with the Capital Market Authority pursuant to which he agrees to pay the Capital Market Authority a sum not exceeding three times the profits he has realized, or three times the losses he has averted by committing the violation. Such arrangement shall be without prejudice to any compensation awardable as a result of the violation.

This case reveals the seriousness with which the CRSD treats any detected malpractice carried out by the board members or top executives of listed corporations. It holds that the violated board chairman deserved the combined punishment, as he breached lawful clauses of the CML. It seems that imprisonment can sometimes be a significant punishment used to tackle any irresponsible conduct that harms capital market equity, but it should be accomplished and imposed by the

Saudi Criminal Prosecution rather than the CRSD. Significantly, the punishment of imprisonment, as stated above, can be obviously found in other international jurisprudence against insider trading, such as UK jurisprudence.

16.2.4 Duty to Act Within the Powers

The board members' duties are essential corporate governance aspects because the board members in several jurisprudences hold extensive power. In addition, the board members' legal responsibilities are subject to being increased because of these duties in the company presentation (Yuwa 2006). However, the board members' extensive powers are in accordance with significant restrictions, such as those enforced by law, those enforced by the corporation constitution and those enacted by the general meeting determinations (Grantham 1993). In this regard, it can be seen that the board members' powers in the UK have been clearly limited under the UK Companies Act, which emphasizes the duty of directors to act within their powers. It provides that the board members' powers should be in line with the corporation management subject to the UK Companies Act provisions, the corporation articles of association and any resolution generated by the corporation's general meeting. Section 171, clauses A and B of the UK Companies Act insists that "A director of a company must: act in accordance with the company's constitution, and only exercise powers for the purposes for which they are conferred."

Comparably, Article 72 of the CL has recognized the board members' delegation and limitation of powers. It confines the board members' powers to the CL provisions, to the corporation's articles of association and to a resolution enacted by the corporation's general meeting. It also limits the board members' powers with regard to financial matters. It reads that with due regard to the prerogatives vested in the general meeting, the board of directors enjoys full powers in the administration of the company. The board should be entitled, within the scope of its capability, to delegate one or more of its board members to perform an act or certain acts. Nonetheless, the board of directors may not sell or mortgage property or the place of corporation, or relieve the debtors of the corporation from their obligations, unless so authorized in the corporation's articles of association and the provisions of the CL.

In particular, Article 13-B of the CGC gives the board of directors the right to delegate one or more of its responsibilities to other groups to fulfill. For instance, the board of directors can delegate some of its work to its sub-committees, such as the audit, nomination and remuneration committees. Nevertheless, permitting the board to delegate some of its responsibilities in accordance with Article 13-B does not mean that the supervision of these sub-committees and their works is decreased. It has been advised that the board must summarize the general procedures for founding such committees, demonstrating their responsibilities and supervision by the board. Specifically, the sub-committees must inform the board about their submissions and results in order to ensure that the delegated culpabilities are perfectly in place.

This means that the board has the right to delegate some of its jurisdictions to one or more of its sub-committees, thus fulfilling its role. In general, therefore, it appears that board sub-committees are not able, under any circumstances, to restore the board, because the latter shoulders the critical responsibility for the corporation's submissions and contracts, even if the board sub-committees are significant and are seen to be performing well (CGC 2006). Nevertheless, this right of the board is delimited by notable aspects; the delegation of determined work should be within the board's jurisdiction and should be based on the duration and form of operations. Otherwise, the delegation is null and void (Al Urban 2006).

On the other hand, Article 18-C of the CGC recommends that a company may not grant any cash loan whatsoever to any of its board members; nor may it guarantee any loan contracted by a member with a third party. Arguably, the CGC clause is fair, as it safeguards the shareholders' capital and secures the corporation's financial position in terms of random and superfluous private mortgages to the board members. Specifically, it is said that a corporation mortgage is open to abuse by a board member. The mortgage may be at an idealistically low rate of interest, and therefore mask compensation or a gift.

The prohibition against rendering a cash mortgage is clearly evident under section 197, Article 1 of the UK Companies Act, which asserts that a company must not offer a loan to a company's board member or one of its holding companies. The company may also not provide an agreement or security regarding a loan made by any person to such a board member, unless the submission has been ratified by a determination of the company's members.

16.3 Board Responsibilities

The Saudi regulator recognizes the significance of the board of directors as a body whose fundamental mission is to drive the corporation in order to achieve its social and commercial targets (Al Muneef 2006). This is obvious when reviewing the CGC and the CL provisions, which pay considerable attention to board responsibilities, and, in addition, guard the interests of the corporation, as well as those of the shareholders. It is also apparent that the Saudi regulator views the board as a good way of enhancing corporate governance practices among exchange and listed companies. Thus, Saudi consideration agrees with international corporate governance principles, which regard the board as the first means of applying good practices. The OECD principles of corporate governance maintain that:

> The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Moreover, the Cadbury report (1992) refers to the effectiveness of the board:

> Tests of board effectiveness include the way in which the members of the board as a whole work together under the chairman, whose role in corporate governance is fundamental, and their collective ability to provide both the leadership and the checks and balances which effective governance demands.

The board, in particular, has the freedom to oversee executive management, and with that, it should also consider the significant corporation functions and enhance its value on behalf of the shareholders. Furthermore, the board should observe all tasks completed by executive management with the intention of replying to any submitted enquiries from the shareholders (Heath and Norman 2004). The board, by way of illustration, acts as a watchdog by either accepting or refusing the corporation's policies, such as incentive schemes and contracts that would provide support to the executive managers instead of acting on the shareholders' behalf (Solomon and Solomon 2004). The board quality is specifically a demanding element, side by side with the corporate governance framework, which achieves strategic business flexibility (Hussain and Mallin 2003).

Nonetheless, Articles 10 and 11 of the CGC both assign several responsibilities to the board of directors in terms of running the company as a going concern. These board responsibilities are as follows: Firstly, the board members' jurisdictions are clearly stated in the company's articles of association. Additionally, these jurisdictions must be completed in a way that is liable and in good standing. The board decisions should depend on satisfactory information from the company's executive administration or from any other trust sources. This in fact goes together with demanding the duty of good faith from the board member. Comparably, this has been stated under section 172, Article 1 of the UK Companies Act, which reveals that "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole."

Secondly, Article 11-C of the CGC states that all the board members should act on behalf of both the shareholders' and the company's interests, so they should avoid isolation from the shareholders, either individually or as a group. It is therefore obvious that the Saudi regulator has a significant role in relation to the board and the board members' behavior, as the board members should avoid any segregatory conduct towards shareholders, specifically when obtaining information and annual accounts, as well as when voting at the corporation's general meeting.

Thirdly, Article 11-F of the CGC statuses the new board members should be trained – by the board if necessary – to ensure adequate awareness of their jurisdictions. The Saudi legislator pays great attention to the Cadbury report. It advises, in its suggestions for training new board members, that they should be entitled to attend various internal and external training programmes, and should be given an introduction to the corporation's interactions. It does not matter whether they are executive, independent or non-executive board members, as long as they do not have previous board experience. Board members are expected to be highly skilled in order to accomplish their obligations reasonably and properly (Carcello 2009). Certainly, a board which is comprised of highly skilled members such as lawyers, accountants and economists is able to gain several advantages on the corporation's and the shareholders' behalf (Filatotchev and Boyd 2009). In practice, the majority of listed companies announce on the exchange's website and on their own websites any vacant board member seats. Moreover, these listed companies have recently asked for highly qualified board members who are knowledgeable of the CL, the CML and the Implementing Regulations, including the CGC. This method is clearly supported by Article 29 of the Listing Rules, which advises that good-standing auditors, financers and accountants should occupy the board seats. For example, the *Nama* Chemicals Company lately advertised that due to the expiration date of the current board of directors, the company desires board members who are familiar with the above-mentioned regulations.

Fourthly, Article 10-A of the CGC shapes that the board must consent to and direct the company's technical policies. Therefore, the board:

1. Arranges a complete policy for the company, the primary work plans and the rule of risk management, as well as evaluates these policies regularly.
2. Highlights the most suitable capital formation of the company, identifies the company's financial aims as well as ratifies its budgets.
3. Expresses the basis capital costs of the company and acquirement with disposal of assets.
4. Sets the targets to be achieved and monitors the operation of these targets as well as the overall performance of the company.
5. Examines the managerial and purposeful formation of the company on a periodic basis.
6. Annually reviews the usefulness of internal control by ensuring the reliability of financial and accounting proceedings, including the preparation of financial reports.

Finally, Article 10-B-1 of the CGC assumes that the board creates a written policy that legalizes the relationship with all the beneficiaries of stakeholders, in addition to securing their rights. Clearly, this official objective of the CGC showcases the extent to which it has promulgated a diversity of worldwide corporate governance standards, as having a clear and positive relationship with all the stakeholder groups is one of the major OECD principles of corporate governance. The OECD states that:

> The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and sustainability of financially sound enterprises.

In this respect, section 172, Article 1 of the UK Companies Act points out that:

> A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company

maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of the company.

Furthermore, such an approach should be clearly written down by the corporation board in terms of creating a legalized relationship with all the stakeholder groups. This can inspire the board to respect its statutory and contractual obligations for the benefit of all stakeholders; namely the shareholders, lenders, suppliers, borrowers, employees and society as a whole. Article 10-E of the CGC insists that this written policy, importantly, includes the following:

(a) Mechanisms for compensating the stakeholders in respect of breaching their rights under contract law.
(b) Tolls for resolving grievances or disagreements which occur between the company and its stakeholders.
(c) Frameworks for sustaining a satisfactory association between consumers and suppliers and ensuring the confidentiality of related information.
(d) A code of behavior that should be agreed with accurate professional and ethical principles for the company's executives and employees.

16.4 Board Creation Standards

In corporations worldwide, there are two common board systems. First, the dual board is separate in civil law countries, such as France and Germany. This board is divided into two bodies (two-tier). The former is the supervisory body, whose members are selected by shareholders in the corporation's general meeting, thus directing business decisions. The latter is the administrative body, which is charged by the supervisory body to carry out the business of the corporation. The dual board has clear advantages; namely, the distinction between the executive and non-executive members and the differentiation between the position of the board chairman and that of the chief executive. The dual board considerably assists all the benefitting stakeholders by permitting them to have their representatives sit on the board, which empowers the stakeholder groups to look after their interests (Maassen and Bosch 1999).

Secondly, and most importantly, the unitary board (one-tier) is extensive in common law countries, such as the UK, US, Canada and New Zealand. This board consists of executive, non-executive and independent members who should be appointed by the shareholders at the corporation's general meeting. Additionally, those board members' liabilities cover all the corporation's activities. It is worth observing that independent enquiries and a disconnection between the supervision with the administrative purposes are found in this board (Fannon 2005).

Regarding Saudi corporations' boards, most have adapted the unitary board, although the CGC and the CL give no preference as to board structure. Nevertheless, Article 15-C of the CGC advocates that board structures should be tested by the board's nomination and remuneration committee, which can make alterations if necessary. Subsequently, the board structures should be regulated by the CGC, thus lessening the possibility of any ambiguity and wrongdoing in this respect.

Article 12 of the CGC also acknowledges that the number of board members, which ought to be not more than 11 and not less than 3, should be clearly stated in the corporation's articles of association. This point is debatable, as Article 64 of the CL outlines just the minimum number, which is three board members, and leaves the maximum number open. In contrast, section 154, Article 2 of the UK Companies Act stipulates that public corporations should have at least two directors. As in the Saudi case, however, the maximum number is not defined. Arguably, insisting that the maximum number of board members should be no more than 11 is an innovative clause in the CGC, mimicking the international corporation board seats regulations, especially those found in the US (Charkham 2005). In practice, the listed corporations are obstructed by this CGC clause, as the number of their board seats fluctuates between 7 and 11. For instance, Al-Riyadh Development Company's board has ten members.

16.5 Separation of Board Members' Powers

It is becoming increasingly difficult to ignore the fact that spreading board members' powers across multiple members improves a corporation's targets, chiefly affecting its disclosure and transparency to all market contributors. It also makes the supervision undertaken by the board members more efficient. It is important to note that separating the roles of chairman and chief executive is considered good corporate governance practice, as it minimizes potential conflicts of interest. International corporate governance principles have recognized the importance of spreading the board members' powers, specifically those of the board chairman and the chief executive. For instance, the OECD principles of corporate governance presume that:

> Separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management.

More to the point, the Cadbury report (1992) recommends that there should be a division of accountabilities at the head of the corporation and that the character of the board chairman should, theoretically, be separate from that of the chief executive. Speck and Tanega (2005) remarked that the Cadbury report highlights that the board chairman should not be chief executive at the same time. As a matter of fact, the Cadbury report's recommendation was a consequence of the fact that in corporations where corporate governance was not applied correctly, it was easy to find individuals in the role of both board chairman and chief executive simultaneously, and thus in a position to suppress all board debate. It has been said that the separation of the board chairman and the chief executive posts in a single corporation has noteworthy effects on the corporation (Brickley et al. 1997).

Article 78 of the CL used to permit an individual to be both board chairman and chief executive simultaneously. However, this trend has since changed somewhat. Article 12-D of the CGC prevents the combination of this essential position with other executive positions on the board or top management positions in the corporation; namely the chief executive officer, managing director or general manager. It can be argued, therefore, that the separation of the overseeing mission and the managing mission inside the corporation set out by the CGC constitutes an imperative advantage. Furthermore, this ensures accountability and strong values, because the responsibilities of the top executives allow them to handle a diversity of obligations, including signing on behalf of the corporation, formatting commercial agreements and selling or purchasing the corporation's products. Consequently, it appears that by carrying out these responsibilities in accordance with the board controlling equipment and the spreading of the board members' powers, members would not be open to suspicion of corruption, malpractice and conflicts of interest in board situations.

Having identified the challenge to the separation of the board chairman position and other board executive positions posed by international corporate governance principles (including those of Saudi Arabia), Article 78 of the CL conceded that the corporation's board and the shareholders are equally in charge of selecting the board chairman, the chief executive and other members. However, this approach is ignored by the majority of listed companies, where the family and the government are seen to be the major shareholders or the corporations' owners. For example, *Al Sorayai* Group is a paradigm of the family listed company; the positions of board chairman and chief executive are held by the same individual family member. Government influences can be seen in the National Industrialization Company, in which the board chairman and chief executive functions are handled by one person. Regarding the separation of the board chairman and other board executive positions, it seems that the effectiveness of the concentrated ownership structure is obvious, as can be appreciated from the two examples above. It seems vital to engage in further explanation about the ownership structure concerning the Saudi practice of the separation of the board chairman and other board executive positions.

There are two significant global ownership structures. The former is the dispersed ownership structure found in common law country corporations, such as the UK and the US (Coffee 1999). The dispersed ownership structure is defined as when corporation shares are extensively owned by the public, and additionally when the management of the corporation has a smaller shareholding, which leads, to some extent, to what is frequently a nominated division of ownership and control. This corporation can thus be expected to have a dispersed ownership structure. The comprehensive nature of the dispersed ownership structure in common law countries is due to several successful factors, including the efficient general legal system, the influential corporate governance regime, the capable security market and finally strict disclosure and transparency requirements. The second ownership structure is that of concentrated ownership, where a small number of shareholders hold the highest proportion of shares. The concentrated ownership structure, specifically, can be understood in developing countries' corporations, including those of Saudi Arabia. It can be argued that the extension of the concentrated ownership structure in less-developed countries' corporations is a consequence of numerous factors, including the complicated general legal systems, the fledgling corporate governance regimes, the weak securities markets and the shortcomings in the conditions for disclosure and transparency (Kaur and Kaur 2009).

Bearing this in mind, there is a mirror association between a country's political and legal arrangements and its companies' ownership structures. Certainly, the latter ownership structure and other corporate governance shortcomings would be anticipated if a government were unfair, weak and undemocratic (Satkunasingam and Shanmugam 2004). However, there are also non-political circumstances that affect ownership structure, such as economic enhancement, technological progress, cultural change and legal reform (Roe 2003). It could be supposed that all these circumstances fit the Saudi context regarding ownership structure and corporate governance aspects. In particular, the Saudi ownership structure is without doubt concentrated ownership based on rich families and government effectiveness (Al Ajlan 2005).

The Saudi government has been the greatest investor in a variety of leading Saudi listed corporations. Stock exchange statistics estimate that Saudi government investment comprises approximately 45 % of the listed companies' shareholdings, and accounts for 8.8 billion shares with a market capitalization of $155.92 billion. Saudi government investment in the leading listed companies, which have been seen to be an operative cause in converting ownership to the concentrated model, is made by the governmental institutional investors; namely, the Public Investment Fund, the Public Pension Agency and the General Organization for Social Insurance. These bodies have invested on behalf of the Saudi government in a variety of listed corporations, such as SABIC and STC. They sometimes own a large percentage of the listed corporations' shares, as these corporations are considered by the government to be on-going concerns. Thus, the government can assure its investments when investing in these corporations through its institutional investors.

On the other hand, in the Saudi market, rich families invest in several listed corporations, and these families always withdraw potential opportunities to recoup on the listed corporations' affairs. Furthermore, a number of family enterprises, which used to be small ventures owned by rich families, have since converted to listed corporations. These listed family corporations can be seen in several stock exchange sectors, such as energy, agriculture, cement and transport. They are usually named after the founding family's name; for example, the *Halwani* Company, *Fitaihi*-Group, *Al Abdullatif* Industrial Investment Company, *Othaim* Company and *Zamil* Industrial Investment Company.

Returning to the impact of rich families and the government on the Saudi ownership structure, several corporate governance issues are endangered by the ownership patterns. The most likely corporate governance issues to be debated are the following:

1. Separation of the board chairman's position and other board executive positions.
2. Appointment and removal of board members.
3. Determined time of the board member in the board seat.
4. Unlimited board memberships.

In this regard, Articles 12-B and 12-H of the CGC discuss the fact that the corporation general meeting should appoint and re-appoint board members for the duration provided for in the corporation's articles of association. This duration should not exceed 3 years. In addition, board members should not appear as board members of more than five listed companies at the same time. The rich families in question have kept the majority of the transmitted listed corporations' shareholdings from their foundation in the stock exchange. Thus, these families' members have occupied these listed corporations' board seats for an undetermined period of time, and generally have positions on more than five listed corporations' boards simultaneously. Accordingly, members of these rich families are in breach of Articles 12-B and 12-H of the CGC. However, no law case or fine has been issued either by the Capital Market Authority Board or the CRSD (as judicial entities of the Saudi Capital Market) with regard to these families' members who are in breach. This approach can also be argued by the fact that in some countries, politicians and rich families are easily able to obtain business and positions. This is what happens in the vast majority of Saudi listed corporations, and absolutely fits the Saudi context.

It is also apparent that the Saudi government influences Articles 12-B and 12-H of the CGC, as the government is the major shareholder/owner of some brand listed corporations. Accordingly, the government places its representatives in these corporations' board seats regardless of their period of office, as well as placing representatives on the boards of more than five listed corporations. The evidence from Article 65 of the CL obviously shows that the listed corporations' boards' governmental representatives have the power to hand out board seats for undetermined periods.

There is expected debate concerning the ability of the government to enforce its representatives in the listed corporations' board seats for unspecified durations. Supporters of the governmental influences claim that due to the government owning large shareholdings in some listed corporations, it should have more than enough votes to elect and re-elect its representatives in these corporations' boardrooms. For example, the Saudi government appointed five out of the nine members in the Saudi Arabian Mining Company because the government owns 50 % of the shares in this company. Opponents of the governmental influences urge that allowing the board members to avail themselves of an unspecified mandate and duration deteriorates the board members' enthusiasm for corporation involvement. This results in a diversity of corporate governance aspects, as the majority of these corporations' boards' chairmen, members and chief executives are nominated by the government. As a result, it can be said that the government has more dominant power based on its investments and its board representatives. Hence, other shareholders will not have the same power as the government in these corporations. In particular, board members who are not appointed by the government will not be able to challenge the opinions of the elected board members in terms of decision-making.

Therefore, Article 65 of the CL, which permits the government to place its representatives for an undecided time and mandate, is not in line with good corporate governance practices. Thus, it should be removed from the CL in order to avoid being misused by government agencies. Article 12-H of the CGC, which does not allow board members to hold positions on more than five listed corporations' boards simultaneously, should at least be the reference for this matter, even if over five memberships are not recommended as an optimal practice.

16.6 Board Membership Categories

The CGC identifies three categories of board membership; specifically executive members, non-executive members and independent members. First, Article 2 of the CGC defines that the board executive members should have full-time administrative positions in the corporation and obtain monthly salaries. In this regard, the Cadbury report highlights significant elements with reference to the definition of executive members, such as the fact that their contracts should not exceed 3 years' duration without shareholders' endorsement. In addition, there should be full transparency and disclosure regarding the executive members' income. These conditions cannot be found under the CGC; therefore amendment of the CGC in accordance with these conditions is needed in order to achieve good corporate governance practices.

The precise role of the executive member is open to debate. The role of executive members is significant, alongside non-executive and independent members of the board of directors, in achieving optimal corporation performance. This is due to the fact that executive members are usually knowledgeable and experienced in terms of the corporation's affairs and investment opportunities. It is, however, argued that the executive members do not assess strategic decisions much more effectively than the non-executive members. This is due to the fact that the executive members are unlikely to challenge the chief executive strategic decision making during board meetings (Westphal and Zajac 1998).

Secondly, Article 2 of the CGC maintains that the non-executive board members neither have full-time administrative position in the corporation nor earn monthly salaries. In this respect, the Cadbury report (1992) outlined important issues with regard to the decision that non-executive membership should not be determined for a long period and that they should be independent of the corporation, apart from their payments and their shares. They should also be independent of management and free from any business or other association which could substantially conflict with the application of their independent judgment. Again, these conditions are not established under the CGC, so it should be amended in accordance with these conditions.

Article 12-C of the CGC indicates that non-executive members should occupy the largest number of board seats. Article 11-G of the CGC designates that non-executive members should additionally receive information about the corporation's submissions in a satisfactory manner, thus enabling them to enforce their jurisdictions efficiently. The general notion of placing non-executive members on the board is that, again, they do not have a full-time career in the corporation, so are not reliant on the corporation for their livelihood. As a result, non-executive members should not be influenced by other board members, including the chief executive, as they earn very little from the corporation. Therefore, they do not jeopardize their reputation or their total income capability by getting involved in any corporation mismanagement. Non-executive members, moreover, formulate independent judgments within the board; yet, they not only play a regular administrative role in the management of the corporation, but also exercise an intensive care purpose.

Finally, Article 2 of the CGC confirms that the independent board members enjoy full independence. Accordingly, there are official regulations which are emphasized in the CGC as breaching this independence:

1. If the member owns a controlling interest or holds the position of senior executive for 2 years in the company or in one of its subsidiaries.
2. If the member has ownership of 5 % or more of the company or its group by the board member or a representative of a legal entity which owns 5 % or more of the company or its group.
3. If the member is a board member of any company within the body of the company of which the member is scheduled to be a member of its board.
4. If the member has been an employee and a partner of the company or a partner of any other company including external auditors or senior suppliers for 2 years.
5. If the member is a relative (namely father, mother, wife, husband or child) of any board member or senior executive of the company or one of its subsidiaries.

The definition of the independent board member is still a doubtful concern among both legislators and the judiciary. This is supported by Brudney (1982), who emphasized that:

> No definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as the persons whose compensation he is asked to assess.

It is almost impossible to verify the independent nature of a company board member in Saudi Arabia. In particular, Article 15-C considers that the corporation board nomination and remuneration committee plays a significant role in terms of inspecting the independence of the board members. In addition, the (Capital Market Authority) general department of corporate governance pays great attention to this matter when reviewing the listed corporation boards' annual reports. Recent statistics from the general department of corporate governance show that there are 1,108 listed corporation board members: 606 independent members, 356 non-executive members and 146 executive members.

16.7 Board Meeting

Saudi board meetings are encouraged to be open to debate in order to support the board supervisory tasks as regards the listed corporation's dealings. As Al Urban pointed out, an open discussion brings to bear the facts and deals with management malpractice if and when it is uncovered. Nevertheless, Article 16 of the CGC has incorporated the following ideas on board meetings:

(A) The board arranges its meetings at the request of the board chairman who can convene the board for an immediate meeting following a written request by at least two board members.
(B) The board should minute the meeting discussions by reporting the agreeing and disagreeing votes.
(C) The board members should have plenty of time to fulfill their duties including preparation for the board and the board sub-committees' meetings.
(D) The board members should receive the board documentations in a suitable and timely fashion before the meeting, to enable them to study this material.

It could be argued that the CGC does not stipulate how many corporation board meetings must be held. This overlooked aspect is, in practice, under the board chairman's command in a variety of listed corporations, and its neglect has been seen as a disadvantage within the CGC, as it leaves the number of the corporation's board meetings during the fiscal year unspecified and weakens the board's overseeing role. This could lead to board executive members having ultimate power in the corporation, and thus the possibility of serious management misdemeanours. It is consequently recommended that the number of corporation board meetings should be incorporated into the CGC as a binding clause that should be taken into account by all listed corporations.

In addition, Article 80 of the CL specifies that meetings of the board of directors are valid only if attended by at least half of the directors, provided that the number of those present is not less than three, unless the corporation's articles of association provide for a higher number. In addition, the resolutions of the board must be adopted by a majority vote of the directors present or represented. In case of a tie, the chairman's vote carries, unless the corporation's articles of association provide otherwise. These prerequisites do not exist in the CGC; therefore, they should be added due to their necessity in terms of the board members' civil and criminal liabilities when shareholders litigate against board members.

16.8 Board Sub-Committees

16.8.1 General Overview

It is noteworthy that the CGC has comparatively benefitted from transnational corporate governance principles; chiefly the Cadbury report aspects on the formation of board sub-committees. In particular, the Cadbury report states that:

> The effectiveness of a board is buttressed by its structure and procedures. One aspect of structure is the appointment of committees of the board such as the audit, remuneration and nomination committees.

In addition, the mandatory Articles 12, 13, 14 and 15 of the CGC can be seen to encourage the setting up of board sub-committees. It is proposed under Article 13-A of the CGC that the board creates a sufficient number of committees pursuant to the corporation circumstances and requirements, as these sub-committees will support the board in carrying out its duties. Therefore, it is possible to criticize the scope of the CGC regarding this obligation; the CGC stems from this obligation in order to enable the corporation to determine which kind of committees are significant for its business dealings along with its general size and the magnitude of its operations. However, the CGC strongly states that there should be two obligatory sub-committees established by the board; explicitly the audit committee and the nomination and remuneration committee. This can be understood from Article 13-B of the CGC when it states: "The board shall approve by laws – all of the committees of the board, including inter alia, the audit committee, nomination and remuneration committee."

As a consequence, in addition to ensuring the formation of the board sub-committees – mainly the audit committee and the nomination and remuneration committee – Article 9-D of the CGC specifies that the corporation's board annual reports should contain the forenames of the chairmen and members of the board sub-committees, as well as the approximate number of their regular meetings.

16.8.2 Audit Committee

The idea of creating a board audit committee came into existence in 1978, when the New York stock exchange required all listed corporations to have a board audit committee comprising independent members. The idea also arose when the 1987 American Treadway Commission report settled that the board audit committee had a critical role to play in ensuring the integrity of US corporations' boards' annual statements (Cadbury report 1992).

It is understood that the audit committee aims to monitor the corporation's missions. It is therefore significant, as it constitutes a major internal supervision and auditing tool that improves and directs the decisions made by the board. The audit committee works for the benefit of the board by fulfilling an essential watchdog function that ensures accountability inside the corporation as well as protecting investors (Rezaee, Olibe and Minmier 2003). Additionally, Baruch (1980) stated that the audit committee's role is to observe the consistency of the corporation's accounting and auditing procedures, thereby safeguarding shareholders' interests.

It is expected that a productively operating audit committee will result in quite a few advantages. These advantages are assumed to include promoting the quality of financial statements, establishing a climate of self-control that lessens the chance of fraud, and empowering non-executive members to make independent decisions, play a constructive part and support the task of the finance director and external auditors (Cadburt report 1992).

The Saudi legislator, who took the significance of the audit committee into consideration even before passing the recent CGC, incorporated a piece of legislation (The Ministry of Commerce and Industry, Royal Decree, No. 903, dated 23rd January 1994) that actively encouraged listed corporations to establish an audit committee as one of the board sub-committees, based on its advantages in developing good accounting and auditing practices. This legislation also provided guidelines on the standards regarding an audit committee's membership and overall character, in terms of the choice of external auditors in the listed corporations. Article 14 of the CGC, in principle, has defined four compulsory elements in terms of structuring the audit committee membership:

(A) The audit committee must contain at least three members.
(B) The audit committee members should be non-executive and independent members.
(C) The audit committee members should have satisfactory qualifications and skills in the accounting, auditing and finance professions.
(D) The audit committee members should not have either direct or indirect interests in the corporation's submissions and contracts.

It is obvious that the requirement for an independent audit committee can be noted in Article 13-C of the CGC rather than in the previous legislation mentioned, as independent and non-executive members are highly encouraged to be members of the audit committee. This methodology means that audit committee members fulfill their obligations and submit their reports subjectively and without any prejudice from the board executive members.

A recent legal case concerned the existence of independent members on the board and its audit committee. *Banque* Saudi *Fransi* was found not to have any independent members on its board or its audit committee. As a result, the Capital Market Authority Board, (Issued Decision, No. 6-36-2011, dated 11 December 2011) fined the bank $13,333 in accordance with Article 12-E of the CGC. It contended that: "The independent members of the board of directors and its audit committee shall not be less than two members, or one-third of the members, whichever is greater."

This legal case clearly demonstrates that the Capital Market Authority Board is concerned about implementing good corporate governance practices in listed corporations' boards and audit committees. The presence of independent members is highly recommended by the CML and the Implementing Regulations. *Banque* Saudi *Fransi*, however, violated a binding clause of the CGC, so the condemnation was legislative. This legal case was, significantly, the earliest verdict regarding a board sub-committees' affairs. It is, however, suggested that the Saudi capital market does not have enough capable individuals to fulfill the character of effective independent members.

In this respect, a number of corporate governance studies have found that weakness in an audit committee is more likely if it does not have strong accounting, auditing and finance expertise. Empirical research suggests that there is a strong link between accurate financial accounts and an audit committee that has highly qualified professionals in accounting, auditing and finance. This ideology can be found under Article 29 of the Listing Rules, which advocates that highly qualified members in accounting, auditing and finance should occupy the board's sub-committee seats. It can also be seen in Article 14-A of the CGC, which includes the provision that one of the audit committee members, should be an expert in financial and accounting substances.

Conversely, the Saudi regulator makes no mention of inviting experienced non-members of the audit committee to attend audit committee meetings when necessary. In particular, Al Mataz (2007) indicated that outsider expertise in accounting, auditing and finances (i.e. people who are not board non-executive or independent members) should be part of the board audit committee in order to effectively achieve targets. This trend can be found in the Cadbury report, when it advises that:

> Membership of an audit committee is a demanding task requiring commitment, training and skill. The directors' concerned need to have sufficient understanding of the issues to be dealt with by the committee to take an active part in its proceedings. This is why committees should, if it is appropriate and within their power, be able to invite outsiders with relevant experience to attend meetings.

It can be further argued that audit committee members usually work part-time, namely as non-executive and independent members. This means that they do not have a strong relationship with the corporation staff, whereas board executive members often work full-time and certainly have a direct relationship with corporation staff (Monks 2001). This is one of the disadvantages of the Saudi audit committee, which may not protect shareholder interests in the face of mismanagement and negligence by board executive members (Al Twaijry et al. 2002).

Recent evidence suggests that the vast majority of the audit committees of listed corporations have failed to enforce one or more clauses of Article 14 of the CGC. For example, the corporation's general meeting, depending on recommendations from the board, forms the standards for selecting the audit committee members and defining the duration of their membership and their work plans. In practice, the listed corporations' boards usually nominate the audit committee members who should comprise an independent commission benefitting shareholders, and this election is usually carried out without the authorization of the corporation's general meeting.

The Capital Market Authority Board recently charged the Basic Chemicals Industries Company, imposing a fine of $13,333 because the company board failed to propose to the company ordinary general meeting the rules that should be in place for selecting the audit committee members, their membership duration and the audit committee approaches. In the second case, the Capital Market Authority Board penalized the *Taboo* Cement Company, which was charged with the same violation. The verdicts were in accordance with Article 14-B of the CGC:

> The general meeting of shareholders shall, upon a recommendation of the board of directors, issue rules for appointing the members of the audit committee and define the term of their office and the procedure to be followed by the committee.

In these cases, the fines issued were legislative because they were taken from the mandatory CGC provision. Nevertheless, the violated corporations' boards should form the audit committee and outline its responsibilities. They should also appoint audit committee members with regard to the relevant article of the CGC. The fines that were imposed by the Capital Market Authority Board, however, should have been $26,666 rather than $13,333, as the companies in question violated a significant CGC provision.

Then again, Article 14-C of the CGC has highlighted several essential functions of the audit committee, stating that it:

1. Assists and plans a written statement to the internal audit system and then controls the corporation's internal audit system in addition to certifying its usefulness.
2. Advocates the discharge and appointment of external auditors with their remunerations to the board.
3. Examines jointly with the external auditor the corporation audit plan.
4. Checks the external auditor's comments in the board's annual financial report and then provides opinions regarding this report.

These functions can be traced back to the Cadbury report. Nevertheless, there are a number of significant summits that should be regulated and added to the CGC from the Cadbury report concerning how the audit committee could accomplish its work successfully. For example, the Cadbury report affirms that the audit committee examines the half-year and annual reports before submission to the board, with major concern regarding any changes in accounting standards and adherence to stock exchange and legal requests. In addition, many virtual aspects have been specified under the Cadbury report. For instance, the report stipulates that the audit committee should meet at least twice a year, the external auditor and the finance director should regularly attend the audit committee meetings and other board members should have the same right. Nonetheless, the audit committee and the external auditor should have at least one exceptional meeting without these parties in order to ensure that there is no unsettled concern. From this discussion, it can be suggested that these essential clauses should be brought to the CGC in line with their professionalism for the formation of the board audit committee. The Saudi audit committee is principally a new experience. Therefore, the promulgation of successful international practices is needed in order for the audit committee to reach an adequate level of performance.

Alternatively, Article 14-C of the CGC provides the audit committee with the right to appoint and discharge the external auditors. It does not enforce any negative impediments, either by the board members or by the top managers, which would meet the external auditors when carrying out their obligations to the corporation and its shareholders. Article 230-4 of the CL has taken a valuable step towards the effective functioning of the external auditors. It also demonstrates that any board member, executive or employee who tries to obstruct the external auditors will be sued. It is thought that this clause should be codified under the CGC, as it ensures the usefulness of the external auditors regarding the fulfillment of their duties.

16.8.3 Nomination and Remuneration Committee

It is said that the board of directors cannot resolve the remuneration of the board executive members without a possible conflict of interest. In addition, the board members' remuneration should be taken into account in corporate governance progression, because the supervision of the corporation's popularity can have a contradictory consequence on determination within the corporation. Specifically, the interpretation which several US and UK corporations have settled on is the creation of a remuneration committee. This committee should consist of non-executive directors, who do not have personal financial interest, and adopt executive directors' remuneration on their behalf; it should refer directly to the shareholders for its pronouncements, whilst advancing the broader concern of the corporation. In other words, the speculative meaning of the remuneration committee is obvious, because if this sub-committee does not perform properly within the corporation, the executive members will reward themselves financially, which is not always in the interest of shareholders (Conyon and Peck 1998).

This notwithstanding, it is indicated that executive directors' compensation should be in line with the suggestions of the remuneration committee, which should consist predominantly of non-executive directors. Still, the independence of the nomination and remuneration committee can be held in doubt, as this sub-committee is established by the corporation board. It is additionally simultaneously in charge of handing out board members' compensations. It can be questioned in what manner the nomination and remuneration committee could prevent board members from deciding what their remuneration would be (Cadbury report 1992).

Nonetheless, Article 15-C of the CGC outlines the nomination and remuneration committee's prerogatives, stating that it:

1. Advises the appointment of a new board member who should hold a position of honor and honesty.
2. Updates the description of the essential capabilities and qualifications that are required for board membership.
3. Decides the strong points and weaknesses of the board as well as board construction and suggests remedies.
4. Examines the independence of the board's non-executive and independent members.
5. Ensures the absence of any conflicts of interest within the board.
6. Forms identifiable procedures regarding the board members' and top executives' remuneration.

In particular, the CGC overlooks an essential point with respect to the appointment of board members to the nomination and remuneration committee. This is that a board member should not be a public employee unless he or she has been appointed by the government as a governmental representative inside the board. This is so as to prevent outside pressure on the board member to gain advantage, either statutory or otherwise, and to prevent conflicts of interest. This point of view, principally, should be regulated under the CGC and should be part of the nomination and remuneration committee's responsibility.

While Article 14-A of the CGC has stipulated that the audit committee members should not number fewer than three, it makes no mention as to how many members should comprise the nomination and remuneration committee. This reflects good international practice, apart from this clause. In this respect, the Greenbury report (1995) insists that the remuneration committee should have three non-executive members, or at least two on the occasion of small corporations. The remuneration committee, however, should state, in its report to shareholders, any reason why this committee should consist of fewer than three members. Consequently, the CGC would gain an advantage when reforming its guidelines with regard to this overlooked aspect, in accordance with the Greenbury report suggestion.

Furthermore, the CGC does not stipulate anything about how the sub-committee members should be compensated. This is a major worry in terms of outstanding members of this sub-committee. The good practice containing this tendency would be derived from the Greenbury report's recommendation, which suggests that the members' indemnifications of the remuneration committee should typically be of an arrangement of stationary payments fixed by the board, entirely within the limits agreed in the corporation's articles of association, which should indicate the amount of time they dedicate to the corporation's undertakings.

16.9 Board Members' Compensations

The board members' indemnification is a statutory right based on the principle of no free fee for doing business. The function of the board members resembles the agent's function; acquiring an advantage for their agency's actions as long as these activities are legitimate (Al Jeber 2007). It is worth observing the UK Combined Code, which outlines the remuneration level – there is no piece of Saudi legislation representing this idea. Section 1 of the UK Combined Code affirms that:

> Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Board members' remunerations have recently caught the attention of the Saudi legislator. This is due to the fact that these remunerations used to comprise 10 % of the corporation's yearly net profits. There was, furthermore, a ministerial resolution, No. 1071, dated 5th May 1992, which used to be the second reference that measured board members' remunerations. Significantly, this ministerial resolution emphasized that the maximum non-executive and independent members' remunerations should be $53,333 for each member, as well as $800 fees for attending board meetings.

This ministerial resolution was unfortunately ignored by the vast majority of listed corporations. It is nevertheless debated, because it did not highlight a maximum level of remuneration for executive members, which should be a concern owing to their superior level of remuneration compared with that of non-executive and independent members. The Saudi Consultative Council, which has legislative power over the commercial and corporate rules, recently reviewed the maximum level of the board members' yearly compensation and declared that it should be no more than $133,333 for each member, including, significantly, executive members. Time will tell whether executive members will be paid no more than this maximum level of remuneration. This is a problematic area, because many worldwide financial markets have failed to set a limit for executive compensation, as governments are not willing to fix basic pay levels or even to supervise rates of increase in compensation in the private sector of market economies. In addition, checking the remuneration by non-executive and independent board members appears to have been entirely ineffective in this regard (Davies 2000).

On the other hand, Article 17 of the CGC gives no suggestions as to the maximum level of compensation for board members. In theory, it reassures the listed corporations before awarding the board members indemnification to submit a written record encompassing any such proposed compensation, which then needs to be voted on by shareholders during the corporation's general meeting. The CGC further requires that the corporation's articles of association describe the way in which board members are rewarded compensation – this may take various forms, such as salaries, bonuses and attendance payments.

Therefore, the Saudi model of distributing remuneration encounters some obstacles concerning the remuneration of directors and top executives. It is argued that a major difficulty that has been faced by international corporations is the tying of the remuneration of their directors and top executives to their actual presentation. Therefore, there is an international push to instigate 'say on pay' procedures in order to permit shareholders to remark on planned remunerations of directors and top executives (Tomasic 2011).

The CGC, in particular, advocates that the corporation board's annual report should include the board members' remunerations as part of its significant disclosure and transparency requirements. An investigation of 50 Saudi listed corporations' boards' annual reports reveals that the board members' remunerations are not clearly declared (Al Mataz 2007). This investigation finding is not surprising because of the ambiguity of almost all, if not all, listed corporations regarding their board members' compensations.

In addition to demonstrating and recognizing the practice of rewarding the board members, the Saudi Cable Company was chosen as an example in this regard. In 2009, this company distributed board members' remunerations of $2,809,000. Moreover, two executive members were given the largest proportion of this, being awarded $2,595,000 between them. Subsequently, the rest of money, totalling $214,000, was paid to four non-executive members. Importantly, these significant figures do not take into account the executive members' salaries and the non-executive members' meeting attendance payments. It is therefore suggested that these payments are examples of corruption within a substantial number of listed corporations. Worse, it seems that the Saudi Cable Company mentioned above is not prominent amongst these, and is one of the worst performing in the exchange. Given this company's board members' remunerations, how much remains to the shareholders and other benefitting groups of the corporation?

It is worth observing that even though the Capital Market Authority Board does not interfere directly in the compensations of listed companies' board members, the Capital Market Authority Board sent an official reminder to *Al Ahsa* Development Company about its breaching of Article 43 of the company's articles of association, as well as Article 74 of the CL. This Article stipulates that after distribution of a dividend of not less than 5 % of the company's capital to shareholders, the company can distribute the board members' compensations. Any determination of the compensation made in violation of this restraint is null and void. In brief, this company was making a loss, while at the same time distributing compensations to board members without distributing any profits to shareholders in accordance with its general meeting resolution No. 21, dated 4th May 2010.

It appears that the board members' compensations of almost, if not all, the listed corporations are considered arbitrarily, and should be less than their current massive proportions. For instance, 33 Saudi listed corporations in 2011 distributed compensation equal to $32,000,000 to their board members while making a loss.

Why should an individual (i.e. a board member) be able to gain in one fiscal year a total amount of money that would not be obtained over the course of the whole lifetime of a normal person? If these remunerations are actually deserved, then talking about the distribution of social justice and social profits is pointless. These indemnifications raise a critical question about the board members' loyalty. In general, therefore, it seems that the Saudi board members' remunerations bear a resemblance to other global corporations' board members' compensations based on the huge amounts of money paid. It is clear that these global compensations are, to some extent, justified, as they result from global corporations' productivity, whereas some Saudi listed corporations pay immense remunerations despite making a loss, as in the examples above.

16.10 Conclusion and Recommendations

16.10.1 Conclusion

This paper has analyzed the current board of directors' practices in Saudi corporate governance. The major aim was to study the board of directors in addition to clarifying a variety of indispensable features related to the board. The board duties, interpreted in Sect. 16.2, were shown to be the duty of care, the duty of loyalty and the duty to act within the power. The duty of care has not been explained in either the CGC or the CL. Therefore, the duty of care can be promulgated to Saudi legislation from other international companies' jurisprudences, such as the UK Companies Act. In addition, the duty to act within the constraints of their powers is mentioned briefly in the CGC and the CL. However, the board of directors is entitled to delegate some of its work to other board members and sub-committees, such as the Audit Committee and the Nomination and Remuneration Committee. Unless delegated pieces of work are determined in terms of length and specific power, they are null and void. The CGC also introduces a beneficial clause regarding the duty not to exceed their powers, which seeks to prevent corporations from providing cash mortgages to board members or certifying cash mortgages to board members via a third party. This is designed to protect the capital of both shareholders and corporation.

On the other hand, the duty of loyalty has been put in question by conflicts of interests within the board and insider trading. A conflict of interests is defined as a position that would strain the impartiality of members owing to personal benefits, both material and moral, or those pertaining to their relatives. Non-executive board members are observed to have a conflict of interests within the board when they hold positions on various corporations' boards and have options and shares in those corporations. As regards the Saudi situation, the law cases which have been introduced in this section prove that conflicts of interests were experienced by both executive and non-executive board members. The CGC has sought to manage conflicts of interests within the board by proposing three significant objectives. It advises that the board should create a written policy that controls the related groups and resolves any conflict of interests when it arises. It also excludes board members from either competing or trading in the corporation's commercial transactions. On the other hand, the CGC has needlessly provided the following points of exception:

1. When the board member has established prior approval from the corporation's general meeting to do so, subject to annual renewal.
2. When the board member notifies the board and the shareholders about any secret activities and commercial contracts that are concluded for the corporation.
3. When the board member is the best bidder through public bidding.

Critics of the CGC's exceptions argue that it is wrong to allow board members with conflicts of interests to compete and trade in the corporation's affairs where they can submit the optimal offer through public bidding, as detailed insider knowledge of the corporation and its activities makes their offer the most likely to win a general bidding contest. The futility of this exception signifies the need for this clause of the CGC to be amended by the Capital Market Authority Board in order to inspire good corporate governance practices.

The second matter open to challenge is insider trading which contravenes the meaning of duty of loyalty by the board members. Insider trading is defined as information obtained by the insider that is not available to the general public, has not been disclosed, and whose release and availability would have a material effect on the price or value of a security related to such information; furthermore, that the insider knows that such information is not generally available and that, if it were available, it would have a material effect on the price or value of such security. It is thought that insider trading is very difficult to prove and investigate, although a number of bodies are in a position to both prove and prevent it. These include the Capital Market Authority Board, the General Department of Corporate Governance, the CRSD, a corporation's board Nomination and Remuneration Sub-Committee and the Saudi National Anti-Corruption Commission. Law cases relating to insider trading were particularly described and evaluated in this section. The CRSD imposed fines and prevented the violating board members from working with listed corporations for 3 years. The CRSD also forced these board members to pay back to the Capital Market Authority the venture that was gained in accordance with their insider dealings. It is worth observing that the CRSD issued a penalty of imprisonment against the chairman of the *Bishah Agriculture Development Company*'s board because he was litigated against for breach of duty and insider trading. This case has been debated by Saudi corporate governance observers. They argue that the CRSD should not have the right to pass prison sentences since this constitutes a criminal sanction, which should not be imposed by a quasi-judicial committee such as the CRSD. Instead, penalties should be imposed by the Saudi Criminal Prosecution, which is responsible for determining criminal sanctions. Similarly, UK law has assigned insider dealing to the Criminal Prosecution Service.

The board's responsibilities were discussed in Sect. 16.3. It was argued that these responsibilities should be included in the corporation's articles of association and that board members had a duty to fulfill their responsibilities effectively. Moreover, board members should not distinguish between major and minor shareholders when gathering information, making decisions and producing the board's annual report. In addition, the board is responsible for all the corporation's policies including the financial plan, the budget, the performance strategy, the internal audit plan and the financial annual statements. In particular, the board should develop the relevant policies to regulate relationships with the different stakeholder groups, namely the suppliers, consumers, lenders, shareholders and the whole of society.

The creation for boards was considered in Sect. 16.4. It was noted that the CGC insists that the minimum number of board seats should be 3 and the maximum 11. The dual and unitary board forms were covered. Although neither the CGC nor the CL advise any board restriction, as a consequence of the adoption of the Anglo-American corporate governance model by the Saudi regulator some listed corporations have unitary boards comparable to US corporations.

Section 16.5 focused on the separation of the powers held by board members. Saudi Arabia adopted this method following the Cadbury report, which suggested a separation of the board members' powers. The CGC naturally favors the separation of the board's chairman and chief executive positions. Since the separation of the board members' powers is affected by the Saudi ownership structure, this was thought to merit discussion and a presentation of the definitions of dispersed and concentrated ownership. Dispersed ownership implies that the corporation's shareholdings are owned by a large number of shareholders. The reasons for the spread of this ownership structure in developed markets are based on competent general legal orders, effective corporate governance systems, capable securities' markets and stringent disclosure and transparency requests. By contrast, in the concentrated ownership structure the corporation's shareholdings are held by a major or a small number of shareholders. This type of ownership has flourished in emerging markets because of their problematical general legal structures, inexperienced corporate governance systems, weak securities markets and inadequacies in the settings for disclosure and transparency. Concentrated ownership structures are to be expected where the government is undemocratic and unfair. However, it may also be found in situations of economic improvement, technological advancement, cultural variations and legal modifications.

In the Saudi case, the ownership structure has been influenced by the Saudi rich families and the Saudi government. The government holds 45 % of the shares listed on the Saudi exchange. The shares total 8.8 billion and the capitalization amounts to $155.92 billion. The government has formed many institutional funds that invest in several Saudi listed corporations and owns these shares through its institutional funds. There are many governmental funds and the main institutional investors in Saudi Arabia comprise the Public Investment Fund, the Public Pension Agency and the General Organizations for Social Insurance. It has been argued that the rich families used to own small ventures which were transferred to listed corporations, and were then able to keep a significant number of shareholdings inside those corporations. These listed family corporations are active in different stock exchange sectors, including energy and communication.

The argument against the Saudi ownership structure is that the CGC provides the listed corporations' articles of association that should state clearly the appointment and removal of the board members and their length in office. The board member should not join the board for more than 3 years although this is subject to renewal. Board members should not occupy board seats in more than five listed corporations at the same time. The practice of these lawful clauses is undermined by the influence held by rich families and the government. Rich families usually nominate board members for an unlimited period of time, and they often represent more than five listed corporations simultaneously. In contrast, the government usually influences the appointment and removal of board members in the listed corporations where it holds a significant number of its shareholdings. The supporters of government ownership argue that the government has more than enough votes to replace its representatives in those listed corporations' boards. In the case of the *Saudi Arabian Mining Company* the government was able to elect five out of nine of its board members on the basis of its ownership of 50 % of the company's shares. Opponents of the government and rich families' impact on the ownership structure argue that permitting the board members to work for an indeterminate mandate and time weakens the board members' contribution to the corporation. In particular, the shareholders' representatives on the board would not be able to challenge those sent by the government and the rich families when making decisions given the power imbalance.

The categories of board membership were examined in Sect. 16.6. The CGC recognizes the implications surrounding the presence of executive, non-executive and independent members on the listed corporations' boards. It was demonstrated that a corporation board's Nomination and Remuneration Committee plays a major role in selecting non-executive and independent members to join the corporation's general meeting. The Capital Market Authority's General Department of Corporate Governance also carries out an important task when evaluating listed corporations' boards' annual reports in order to check for non-executive and independent members.

The board sub-committees were the focus of Sect. 16.8. The CGC is flexible in terms of encouraging the board to decide what kinds of co-operative committees should be created. However, it advises that the board should at least establish an Audit Committee and a Nomination and Remuneration Committee. These co-operative committees need to be stated clearly in the board annual report. Although the board can delegate some of its jurisdictions to be managed by the co-operative committees, it still has ultimate responsibility for any delegated work undertaken by them. The Capital Market Authority Board has mandated Articles 13, 14 and 15 of the CGC, which are related to board sub-committees, good auditing and accounting measures and which are expected to be feasible in listed corporations. However, the Audit Committee should contain at least three members, both non-executive and independent, who are experts in finance, auditing and accounting, to be part of this committee. Specifically, the audit committee is accountable for checking the usefulness of the internal audit system, charging and discharging the external auditors, examining jointly with the external auditors the corporation's audit plan and the board's annual report. The Capital Market Authority Board has recently begun to list companies in breach of Audit Committee requirements as stated in the CGC. However, it does not indicate whether the external auditors encounter difficulties from board members or corporation employees when carrying out their duties. The Nomination and Remuneration Committee's remit was also outlined, including recommending new board members, updating the required certificates for board membership, discussing the board's strengths and weaknesses, checking the independence of non-executive and independent members, ensuring the absence of conflicts of interest and proposing board members' compensations.

Board members' compensation was debated in Sect. 16.9. Saudi board members' compensation arrangements are in a very poor state. The Consultative Council recently evaluated remuneration as not more than $133,333 per member, including, surprisingly, executive members. The CGC indicates that the board members' compensation policy should be stated in the corporation's articles of association. Compensations can be awarded as salaries, bonuses and attendance payments. The CGC does not define the maximum amount for remunerations, but states as a condition that they should be approved by the general meeting and included in the board's annual report.

16.10.2 Recommendations for the Reform and Improvement of Saudi Board of Directors

Board members should be highly and appropriately qualified in finance, law, management and economics. Accordingly, the CGC should make this a mandatory condition for all board members and top executives. Board members and top executives should be trained in a designated institute of directors as found in the UK but which has yet to be established in Saudi Arabia. The institute of directors would take on a range of useful roles and responsibilities, including raising awareness of the advantages of corporate governance among directors and top executives and enhancing their management skills.

Moreover, even though the CGC supported the separation of the roles of board chairman and chief executive, this step has not been fully translated into practice, largely due to the presence of the rich families and the government ownership pattern throughout the vast majority of listed corporations. Hence the Capital Market Authority Board should make greater efforts to ensure this regulation is implemented, in order to minimize the negative influence exerted by the rich families and the government on the nomination of board members for an indeterminate period of time and board mandate. On the other hand, a clear classification of the board members' duties including the duty of care, the duty of loyalty and the duty to act within their powers would inspire the board members to control the corporation responsibly and to behave truthfully and accountably to all the groups beneficial to the corporation. Therefore, the CGC should comprise requirements to clearly profile these duties.

Further, the CGC exceptions regarding conflicts of interest within the board under Article 18 of the CGC should be cancelled by the Capital Market Authority Board as these concessions allow board members to compete and trade in their corporations' submissions. In contrast, the Committees for the Resolution of Securities Disputes should not have the right to imprison individuals in breach of the regulations on conflict of interests and insider trading. Good practice regarding this fundamental principle is exemplified in the UK Companies Act, which transmits these deeds to be a matter for the Criminal Prosecution Service.

The CGC should enact specific points to define executive members: they should not hold positions for more than 3 years without the shareholders' agreement and there should be full transparency and disclosure of the board executive members' revenue. These significant points can be regulated based on the Cadbury report.

The Saudi board meeting aims to be an open discussion, yet the CGC does not frame noteworthy criteria for board meetings. Questions to be addressed include how often board members should meet, how many members should be present at a meeting for it to be legally acceptable, and how many votes should be combined to shape the board's final decision The CL specifies that the meeting of the board of directors shall be valid only if attended by at least one half of the directors, provided that the number of those present shall not be less than three, unless the corporation's articles of association provide for a higher number. In addition, the resolutions of the board shall be adopted by a majority vote of the directors present or represented. In the event of a tie, the chairman's vote shall carry, unless the corporation's articles of association provide otherwise. None of these requisites appear in the CGC. In view of their significance in civil and criminal liabilities when shareholders litigate against board members they should be transmitted under the CGC.

In order to give the board of directors more power to fulfill its duties and responsibilities effectively, the CGC should suggest several board sub-committees such as a risk committee, a finance and investment committee, a quality committee and a workforce committee to operate alongside the aforesaid Audit and the Nomination and Remuneration committees.

The CGC does not comment on inviting experienced non-members to join the audit committee meeting as required. This good practice, suggested in the Cadbury report, should be promulgated by the CGC. It is one of a number of noteworthy items from the Cadbury report that the CGC would be well advised to consider. Others include the stipulation that the audit committee should meet at least twice a year, that the external auditor and finance manager as well as other board members should frequently join the audit committee meetings, and that the audit committee and the external auditor should have at least one special meeting without the above-mentioned groups in order to eliminate any confusion over members' concerns.

The CGC should also highlight difficulties, which should not be presented when the external auditors review the corporation's information and annual report. The CL takes a valuable step towards the active operational role of the external auditors. It also validates that any board member, executive or employee attempting to hinder the external auditors will be sued. It is thought that this clause should also be adopted by the CGC.

In addition, the CGC omits to mention how many members the Nomination and Remuneration Committee should consist of. This is not in line with the recommendations for good practice found in the Greenbury report, which calls for three non-executive members. In addition, it is of concern that the CGC does not discuss how the Nomination and Remuneration Committee members should be rewarded. Again, guidance on good practice may be gleaned from the Greenbury report's recommendations that committee members be compensated with fixed lump sum payments determined by the board within the limits agreed in the corporation's articles of association and which should reflect the amount of time they commit to corporation business.

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Chapter 17
Heading Towards Good Governance: A Case Study of the Chinese Commercial Banks

Dr. Jing Bian

Abstract Chinese banking industry has experienced significant improvements over the last few years. These developments not only reflect on the industrial structure as a whole, but also on the level of performance of individual banks. Examining the development of the Chinese banking industry; corporate governance, as a major concern, has simultaneously evolved. Given the rapid development of the financial system, and the lack of relevant laws and regulations, corporate governance of the Chinese banking industry still needs to be further enhanced; in particular, further improvements of corporate governance have been hindered by various existing problems in this area; for instance, the incomplete legal framework, inefficient enforcement structure and a weak corporate disclosure regime. This Chapter, taking Chinese commercial banks as the example, aims to examine the relevant issues of corporate governance. Firstly the Chinese banking industry is studied. Following that, the regulatory frameworks for commercial banks and the banking regulators are introduced. Thirdly, approaches adopted by the Chinese banking sector to enhance corporate governance are examined in detail. Finally, a conclusion is drawn based on the observation of this research.

17.1 Introduction

The developments of the Chinese banking industry have attracted a lot of attention in recent years. These developments not only reflect on the industrial structure as a whole, but also on the level of performance of individual banks. Furthermore, the developing strategy of the Chinese banking industry is not limited to the domestic level, but is also aimed at the international expansion. On July 6, 2012, Industrial and Commercial Bank of China (ICBC) and the Bank of East Asia (BEA)

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_17, © Springer-Verlag Berlin Heidelberg 2014

concluded ICBC's acquisition of an 80 % interest in BEA (U.S.A.), and became the controlling shareholder of latter (ICBC 2012). The acquisition indicated that the overseas expansion of Chinese banks has stepped into a new stage. Looking back at the development of the Chinese banking industry; corporate governance, as a central issue, has improved significantly over the last few years. However, given the rapid development of financial system and the lack of relevant laws and regulations, corporate governance of the Chinese banking industry still needs to be further enhanced; in particular, further improvements of corporate governance have been hindered by various existing problems in this area; for instance, the inefficient legal framework, weak enforcement structure and an inaccurate corporate disclosure regime.

The development of corporate governance in the Chinese banking sector is tightly associated with the economic reform. This chapter examines the approaches adopted by the Chinese commercial banks, targeted at improving corporate governance in banking sector. The first part of the paper illustrates the structure of the Chinese banking industry. Secondly, the paper examines the development of the legal regime with regards to corporate governance and financial regulators in China. Thirdly, taking the concept of corporate governance, corporate social responsibility (CSR) and information disclosure regime as examples, this paper analyzes different approaches adopted in order to enhance corporate governance in the banking industry. Last but not least, conclusions are made based on this study.

17.2 The Chinese Banking Industry

The Chinese banking institutions perform a unique role in the socialist market economy. Today, the function of Chinese banks has already evolved from the simple deposit taking and loan issuing to providing diversified products and delivering more sophisticated financial services. The Chinese banking industry itself has also expanded significantly in the last few years. Figure 17.1 below illustrates the total assets and liabilities of banking institutions from 2003 to 2011. As at the end of end-2011, the total assets of China's banking institutions increased to RMB113.3 trillion; total liabilities rose to RMB106.1 trillion[1]

The banking industry in China composes of different groups of banks.[2] The policy banks refer to the China Development Bank, Export–import Bank of China, and Agricultural Development Bank of China.[3] The Industrial and Commercial

[1] CBRC Annual Report (2011), p. 24.

[2] The latest lists of domestic banking institutions can be found at China Banking Regulatory Commission website: http://www.cbrc.gov.cn.

[3] The policy bank in China were established according to Decision of the State Council on Reform of the Financial System, in order to separate policy finance from commercial finance and to solve the problem of national specialized banks executing dual function. The National Development Bank,handles policy loans and discount business for key national construction projects (including

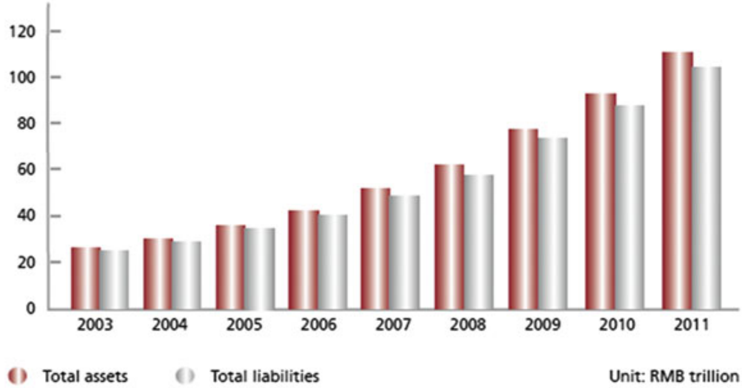

Fig. 17.1 Total assets and liabilities of banking institutions (2003–2011) (Source: CBRC Annual Report 2011, p. 25)

Bank of China, Agricultural Bank of China, Bank of China, Bank of Communications, and China Construction Bank are the large commercial banks.[4] The joint-stock banks; for instance, the China Citic Bank Corporation, China Everbright Bank, Huaxia Bank, China Bohai Bank, and Shenzheng Development Bank and others are playing an increasingly important role in the national economy. Moreover, the rural banks and city commercial banks are important components of the Chinese banking industry. Furthermore, the Postal Banking of China provides various banking services.

Apart from the above, the foreign fund related banks actively participate in the Chinese economy; for example, the Standard Chartered Bank (China), HSBC Bank

capital construction and technical transformation). The Agricultural Development Bank of China (ADBC) to undertake policy loans for State reserve in grain, cotton and edible oil, for contract-purchasing of farm and sideline products, and agricultural development, and to appropriate fiscal funds for supporting agriculture and to supervise their use as an agent. The China Import–export Credit Bank (CIECB) supplies buyer's and seller's credits for importing and exporting of large scale mechanical and electrical equipment, etc. See Decision of the State Council on Reform of the Financial System, Guofa [1993] No. 91, promulgated date: 25 December 1993, part 2.

[4] "Commercial banks" means enterprise legal persons that are established in conformity with the law and take in deposits from the general public, grant loans, handle settlements, etc. See Law of the People's Republic of China on Commercial Banks, promulgated date: 10 May 1995, revised date: 27 December 2003, Article 2. According to Article 3 of this law, the commercial banks may engage in the following business: taking deposits from the general public; granting short-term, medium-term and long-term loans; handling domestic and foreign settlements; handling the acceptance and discounting of negotiable instruments; issuing financial bonds; acting as an agent for the issue, honouring and underwriting of government bonds; buying and selling government bonds and financial bonds; engaging in interbank lending; buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange; engaging in the business of bank cards; providing letter of credit services and guaranty; acting as an agent for the receipt and payment of money and acting as an insurance agent; providing safe deposit box services, etc.

(China), Citibank (China), Deutsche Bank (China), BNP Paribas (China), Industrial Bank of Korea (China), etc. According to the China Banking Regulatory Commission (CBRC), as the end of 2011, there were 5 large commercial banks, 12 joint-stock commercial banks, 144 city commercial banks, 212 rural commercial banks, 190 rural cooperative banks, 2,265 rural credit cooperatives, 1 postal savings bank, 4 banking assets management companies, 40 locally incorporated foreign banking institutions, 66 trust companies, 127 finance companies of corporate groups, 18 financial leasing companies, 4 money brokerage firms, 14 auto financing companies, 4 consumer finance companies, 635 village or township banks, 10 lending companies and 46 rural mutual cooperatives.[2] These institutions together, facilitate the development of national economy.

17.3 The Legal Framework and Banking Regulators

The importance of the banking industry means that to achieve good corporate governance the best scientific methods and approaches have to be used. In the past few years, different approaches have been introduced to improve the corporate governance regime. In this part of the paper, the effects and implications will be examined with details.

The enactment of the Company Law in 1993 and the Securities Law in 1998 provided principles and guidelines for corporate governance in China (Company Law 1993; Securities Law 1998). However, with the development and reform of the Chinese economy and financial system there were numerous new issues needed to be dealt with; among different matters, reduction of the Non Performing Loan (NPL) was one of the key concerns. According to the domestic accounting standards at that time, in 1998 the Chinese banking system had an NPL ratio of 25 %, by international accounting standards this would have put the rate at higher than 40 % (Zhou 2007). This was a great cause of concern. Consequently in February 2002, the second National Financial Work Conference set out plans to strengthen financial supervision and to proceed with financial restructuring.[9] Following this, the Chinese government made plans to reform the financial institutions; the approaches adopted such as lowing NPLs, allowing foreign investment in the state banks as strategic investors, opening up the financial sector to foreign investors by the end of 2006, and listing state banks on exchanges, have all promoted the transformation towards good corporate governance.

It is impossible to develop the corporate governance regime without suitable regulators. Financial regulators play an important role with regard to the improvement of corporate governance in China. The People’s Bank of China (PBOC) is the central bank in China. On 1 December 1948, the PBOC was established; and in September 1983, the PBOC’s status was confirmed by the State Council; the Law of the People’s Republic of China on the People’s Bank of China legally confirmed the

PBOC's central bank status.[5] Furthermore, the China Banking Regulatory Commission (CBRC) regulates and supervises banking institutions and their business operations.[6] Based on the Commercial Bank Law of the People's Republic of China,[7] the Regulation of the People's Republic of China on the Administration of Foreign-funded Banks,[8] and other laws and regulations, these banking regulators oversee the activities of banking institutions.

17.4 Approaches Adopted to Enhance the Corporate Governance

The Chinese banking industry has attempted numerous methods of seeking a better governance structure; for instance, introducing and redefining the concept of corporate governance, promoting CSR, enhancing the corporate disclosure regime, reforming the ownership structure and improving supervision of the board directors and other senior executives. The ownership structure reform can be viewed as one of these important steps to improving corporate governance of banking institutions. The diversification of shareholders, through overseas listing and involvement of the foreign institutional investors, boosted the reform towards good governance. Though the actual impact of the foreign entry is still to be precisely determined from an economic perspective; there should be no doubts concerning the benefits on the aspect of enhancing corporate governance.

Nevertheless, although there have been substantial developments, problems such as the lack of protection for minority shareholders, absence of transparency and inaccurate corporate disclosure, have attracted numerous criticisms. A call for further scientific and responsible improvement has emerged; for instance, to address the financial inclusion and CSR. In this part of the paper, selected issues on promoting good corporate governance will be examined.

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[5] See PBOC website, http://www.pbc.gov.cn/publish/english/952/index.html, last accessed: 11 July 2012. Law of the People's Republic of China on the People's Bank of China, promulgated date: 18 March 1995, effective date: 18 March 1995, revised date: 27 December 2003.

[6] The main functions of the CBRC are: to formulate supervisory rules and regulations governing the banking institutions; to authorize the establishment, changes, termination and business scope of the banking institutions; to conduct on-site examination and off-site surveillance of the banking institutions, and take enforcement actions against rule-breaking behaviours; to conduct fit-and-proper tests on the senior managerial personnel of the banking institutions; to compile and publish statistics and reports of the overall banking industry in accordance with relevant regulations; to provide proposals on the resolution of problem deposit-taking institutions in consultation with relevant authorities. See CBRC website, http://www.cbrc.gov.cn/english/info/yjhjj/index.jsp, last assessed: 17 July 2012.

[7] Promulgated date: 10 May 1995, amended on 27 December 2003, and came into force on 1 February 2004.

[8] Promulgated date: 8 November 2006, came into force on 11 December 2006.

17.4.1 A New Concept of Corporate Governance

After the recent financial crisis, it has been broadly accepted that corporate governance is one of the essential methods to maintain financial system stability. However, as a concept, there has not been a universal definition on what is corporate governance. Corporate governance involves different elements; for instance, the regulatory and market mechanisms, the relationships between a company's management, its board, its shareholders and other stakeholders, and the goals and aims for which the corporation is governed.

In 2004, the Guidance on the Corporation Governance Reform and Supervision of Bank of China and China Construction Bank set out requirements for corporate governance: the two pilot banks shall establish a standard shareholders' general meeting, a standard board of directors, a standard supervisory board and a standard system of senior management respectively; the shareholders' general meeting, board of directors, supervisory board and the system of senior management of the two pilot banks shall be established upon the principles of separate establishment, separation of the three powers, effective constraint and coordinated development in accordance with the requirements of a modern corporate governance structure.[9] This Guidance primarily illustrated the scope of corporate governance for banking institutions.

Problems identified from the recent financial crisis, for instance, inadequate risk management, opaque bank organizational structures and activities, and lack of oversight of the senior management have resulted in a searching for a new improved definition of corporate governance. Drawing on the experiences from international best practices the Chinese government and banking regulators have numerous inputs on the developing of corporate governance. One of the key concerns in China is improving the corporate governance of banking institutions from a framework building-up to a more advanced level with a feature of clear structure, responsibilities and accountability.

A newly developed recognition is contained in the Guidelines on Corporate Governance of Commercial Banks (Consultative Version).[10] In this consultative document, "corporate governance of commercial banks" is defined as the relationships among the general meetings of shareholders, the Board of Directors, the Supervisory Board, senior management, shareholders and other stakeholders, which includes "checks and balances" mechanisms as part of the organizational structure, division of responsibilities and duty requirements, as well as such operating mechanisms as the decision-making, implementation, monitoring and incentives and disciplines.[11] It further states that to establish a sound corporate governance of a commercial bank, at least the following shall be consisted: a complete organizational structure; clear division of responsibilities; scientific

[9] ibid, or (Zhou, 2007).

[10] CBRC, 25 July 2011, consultative version.

[11] ibid, Article 3.

development strategy; values and codes of conduct as well as social responsibilities; effective risk management and internal control; rational incentives and discipline mechanisms; and a well-established information disclosure system.[12] Clearly, this consultative version, take reference from the OCED and Basel Committee principles, which introduced a new concept of "corporate governance" with the notion of "stakeholders"; therefore, it can better reflect the banks' duty of protection of the depositors and banking employees (CBRC 2011).

17.5 Corporate Social Responsibility

The CSR has been addressed by the Chinese banking industry gradually. While this issue has been recognized earlier in other countries, it has been argued that the literature on CSR in China or on CSR from a Chinese perspective is rather limited (Whelan 2007). However, this has changed significantly. Law and regulation have put more emphasizes on this issue; Company Law Article 5 promulgated that when undertaking business operations, a company shall comply with the laws and administrative regulations, social morality and business morality; it shall act in good faith, accept the supervision of the government and the general public, and bear social responsibilities.[13] This is the early time that Chinese law addressed the CSR issue, before the enforcement of this law the concept of CSR was not clearly presented.

The Opinions on Strengthening the Social Responsibility of Banking Financial Institutions is one of the important legal documents in this area.[14] It points out that the banking financial institutions' fulfillment of their social responsibility is a must for building a harmonious society[15]; fulfilling social responsibility is an important path for banking financial institutions to improve their competitiveness.[16] It also requires that all banking institutions shall adopt appropriate forms to issue social responsibility reports in light of their actualities; major banking financial institutions shall issue annual social responsibility reports on a regular basis.[17] In this Opinion it also sets out the general requirements for the social responsibility of banking institutions, including: protecting the legitimate rights and interests of shareholders and treating all shareholders equally, maintaining to the people-oriented principle and attaching importance to and protecting the legitimate rights

[12] ibid, Article 7.

[13] Company Law of the People's Republic of China, promulgated date: 29 December 1993, revised date: 27 October 2005; effective date: 1 January 2006.

[14] No.252 [2007] of the General Office of China Banking Regulatory Commission, issued date: 5 December 2007, effective date: 5 December 2007.

[15] ibid, Part 1

[16] ibid, Part 2

[17] ibid, Part 3.

Strategy and Profile

Overview of ICBC
Responsibility Brand
Milestone in Responsibility
Responsibility Promotion
Responsibility Exchanges
2011 Highlights
Assessment from Third Parties

Economic Performance

Operating Results and Value Creation
Promoting Steady and Healthy Development of the Real Economy
Supporting the Coordinated Development of Regional Economies
Supporting the Strategic Key Industries of the State
Boosting the Development of Small and Micro Enterprises
Enhancing the Financial Services Related to "Agriculture, Rural Areas and Farmers"
Promoting the Economic Development in Ethnic Minority Regions
Serving the Construction of Low-income Housing
Speeding up Overseas Expansion, Enhancing Global Services

Environmental Performance

Promoting Green Credit, Supporting Low-carbon Economy
Advocating Green Finance, Promoting E-banking
Implementing Green Office, Promoting Energy Saving and Consumption Reduction
Promoting Green Concept, Boosting Environmental Protection Cause

Social Performance

Dedication to Repaying Society to Build a Charity Bank
Caring for Employees to Build a Harmonious Bank
Operating with Good Faith to Create a Creditworthy Bank
Vigorously Serving Customers to Build a Brand

Fig. 17.2 Section of 2011 corporate social responsibility report of the Industrial and Commercial Bank of China Limited (ICBC)

and interests of employees; operating the business in good faith and protecting the legitimate rights and interests of financial consumers; combating against unfair competition, commercial bribery and money-laundering activities and creating a good market competition order; saving resources, and protecting and improving the natural ecological environment; improving community-based financial services and enhancing community development; and caring for social development and supporting the public welfare undertaking.[18] Figure 17.2 below gives an example of the CSR report for a Chinese banking institution. It can be seen from the chart that the key contents of this report have broad coverage with the emphasis on the economic, environment and social performance.

Along with the banking regulators, the self-regulatory body plays an important role in this aspect too. To 2012 the China Banking Association (CBA) has published the Social Responsibility Report of China's Banking Sector for four

[18] ibid, Part 3.

consecutive years.[19] On 5 December 2008 the CBA issued the first-ever social responsibility report of China's banking sector. CBA's Guidelines on the Corporate Social Responsibility of Banking Institutions of China set out more detailed requirements for the banking institutions.[20] It states that the Guidelines is applied to the banking institutions which have the corporate status in China, including commercial banks, urban credit cooperatives, rural credit cooperatives and other financial institutions that are legally established within the territory of the People's Republic of China and receive public deposits; policy banks; financial assets management companies; petty loan companies, etc.[21] It further defines the concept of "Corporate Social Responsibility", i.e., the economic, legal, ethical and charitable responsibilities that the banking institutions shall bear to their shareholders, employees, consumers, business partners, government, communities and other interested parties and for enhancing the sustainable development of society and the environment. [22] Article 3 also elaborates that the CSR of banking institutions shall at least cover the following aspects: economic responsibility, which requires the institutions to maintain a fair, safe and stable competition order and use high-quality professional operations to continually create economic values for the country, shareholders, employees, customers and the general public, conditioned upon abiding by the law; social responsibility, which requires the institutions to follow the business operation notions meeting the requirements of social ethics and public welfare, actively protect the public interests of consumers, employees and community members, advocate charitable responsibility, actively dedicate themselves to activities for the public good, build up social harmony and promote social development; and environmental responsibility, which requires the institutions to support the industrial policies and environmental protection policies of the state, save resources, protect and recover the ecological environment and support the sustainable development of the society.[23]

The above legal requirements which aim to promote a scientific development and enhance the harmonious and sustainable growth of the economy, society and the environment, have significantly encouraged responsible business in the banking industry. The Shanghai Pudong Development Bank voluntarily published the first corporate social responsibility report in 2006; in 2008 the American Chamber of Commerce in Shanghai awarded this bank A Special Recognition for Exceptional and Longstanding CSR Achievements from 2006 to 2008.[24] Another example is the Industrial Bank which became China's first "Equator Bank" in October 2008, and

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[19] The reports can be found at CBA website, http://www.china-cba.net/list.php?fid=65. Last accessed: 12 December 2012. The CBA is the self-regulatory organization for the Chinese banking institutions. It was established in 2000. At the end of November 2012, the CBA has 168 member banks and 2 observer banks.

[20] China Banking Association, issued date 12 January 2009, effective date: 12 January 2009.

[21] ibid, Article 2.

[22] ibid, Article 3.

[23] ibid, Article 3.

[24] See Shanghai Pudong Development Bank website, http://www.spdb.com.cn/docpage/c511/200605/0519_511_13975.aspx, last accessed: 5 April 2013.

took the lead in the promotion of rational and sustainable development (Industrial Bank 1988). Industrial and Commercial Bank of China has been awarded the Best Social Responsibility Organization of the Year and Best Green Finance of the Year by the CBA in 2011.[25] In 2011 the CBRC also actively communicated with the United Nations Environment Program Finance Initiative and IFC's Environment and Social Development Department.[26]

It can be seen from the above analysis that the CSR has been steadily addressed by the Chinese banking industry. However, it must be admitted that, there are some cases in China where the fulfillment of CSR has been questioned; in particular, with regards to issuing loans to projects which may have a high environmental risk. The CSR is not merely a legal responsibility, but also an ethical one requiring co-operation from different sectors. For the next step for further developing the corporate social responsibility in China, a focus on green credit and financial inclusion is needed. A further development shall balance shareholder value and public welfare. Appropriate facilitation shall be given to the enhancement of the financial service in rural branches, in order to ensure customers in the remote rural areas have access to the services. The CBRC is currently drafting of Administrative Measure of Implementing Corporate Social Responsibility by the Banking Institutions; CSR will be included in the supervision system.[27] A new regime is under construction.

17.6 Corporate Disclosure

Corporate disclosure is one of the core issues of corporate governance. This area has been significantly improved in China along with the development of the Chinese financial system. George A. Akerlof discussed the theory of information asymmetry, which occurs when the seller has more information about a product than the buyer (Akerlof 1970). Under this theory, the banks possess more information than the general public, bank customers, and other stakeholders. It is necessary to have adequate information available which aims to eliminate this imbalance. Therefore, a commercial bank should be adequately transparent to its shareholders, depositors, stakeholders and other market participants, in order to maintain financial stability.

In practice, banks should disclose relevant and valuable information that supports the key areas of corporate governance. This issue has been addressed in

[25] See ICBC website, http://www.icbc-ltd.com/ICBCLtd/About%20Us/Awards%20%20Rating/2011/, last accessed; 4 April 2013.

[26] CBRC, 2011 Annual Report, Part 7.

[27] "Conference on Corporate Social Responsibility of Banking Industry and Central Stated Owned Enterprises Held in Beijing, Representatives from Global Financial Institution Discussed the Corporate Social Responsibility (Yinhangye yu Yangqi Shehui Zeren Yantaohui zai Jing Zhaokai Quanqiu Jinrong Daibiao Gongshang Qiye Shehui Zeren)", *Legal Daily (Fazhi Ribao),* 10 January 2012.

different economies and internationally. The Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance established the general guidelines for disclosure and transparency. The 1999 Principles set down a framework for the disclosure issue; for instance, the basic contents of disclosure: the financial and operating results, the company objectives, foreseeable risk factor, etc.[28] However, it has been argued that the follow up work to implement the principles was confined to the developing and transitional countries (TUAC Secretariat 2004). The Principles of 2004 have improved the regime, these set down the disclosure principles: the basic contents of disclosure; information should be prepared and disclosed to high quality standards; an annual audit should be conducted by an independent, competent and qualified auditor; external auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care; disseminated information should be provided equally, in a timely and be cost efficient manner; corporate governance framework should be complemented by an effective approach designed to ensure that there are no material conflicts of interest.[29]

Today the general disclosure requirements for commercial banks should not be mainly concentrated on the asset side, detailed organizational and governance structures, operational policies, ownership, voting rights, and related party transactions should be included. The lessons learned from the latest financial crisis have put more focus on transparency and disclosure. To improve risk management and governance and strengthen transparency and disclosure regime has become more important. In 2011 the Basel Committee on Banking Supervision issued the Pillar 3 Disclosure Requirements for Remuneration to support an effective market discipline, to allow market participants to assess the quality of a bank's compensation practices, and to contribute to promote a greater convergence and consistency of disclosure on remuneration.[30]

The Chinese disclosure regime for the commercial banks has been set up under different legal documents. Interim Measures for the Information Disclosure of Commercial Banks established earlier requirements.[31] It required that commercial banks had to disclose information in the light of the principle of truth, accuracy, completeness, and comparability.[32] As for content, it required that the commercial banks should disclose their financial statements, all kinds of risk management conditions, corporate governance, and annual major matters.[33] Furthermore, the commercial bank's financial statements should consist of accounting statements, notes to accounting statements, and financial situation statements.[34] Moreover, the

[28] The OECD Principles of Corporate Governance (1999).

[29] The OECD Principles of Corporate Governance (2004).

[30] See BIS website, http://www.bis.org/publ/bcbs197.htm. Last accessed: 12 May 2013.

[31] PBCO, [2012] No. 6, promulgated date: 15 May 2002, repealed on 3 July 2007.

[32] ibid, Article 5.

[33] ibid, Article 8.

[34] ibid, Article 9.

accounting statements disclosed by a commercial bank should consist of the statement of assets and liabilities, the profit statement (profit and loss statement), the statement of owners' equities change, and other relevant supplementary statements.[35] As can be seen from these requirements, the document built the fundamental structure of the disclosure regime for commercial banks.

Measures for the Information Disclosure of Commercial Banks further enhanced the disclosure requirements. [36] It requires the commercial banks to disclose credit risk status, liquidity risk status, market risk status, operating risk status etc.[37] Furthermore, each type of risk shall be illustrated by commercial banks in four aspects: risk monitoring ability of the board of directors and senior management; policy and procedure of risk management; system of risk measurement, inspection, and information management; and information of internal controls and overall audit.[38] Regarding the corporate governance, the Measures states that, the general meeting of shareholders during the year, structure of the board of directors and its working performance, structure of the board of supervisors and its working performance, structure of the senior management and members' profiles, and the layout of bank departments and branches shall be disclosed; meanwhile, the work of independent directors shall be separately disclosed by commercial banks.[39] Furthermore, the Measures requires that at least the following contents shall be included in the annual material events disclosed by commercial banks: the names of the ten major shareholders and changes thereof within the report period; any increase or decrease of registered capital, division or merger; and other important information that should be known to the general public.[40]

It should be noted that the financial regulators in China adopt a mandatory disclosure system in different dimensions for the listed companies; for instance, in terms of internal control. Compilation Rules for Information Disclosure by Companies Offering Securities to the Public No.26 – Specific Provisions on Information Disclosure by Commercial Banks set out the requirements for the listed commercial banks, which they are required to comply with, in addition to the provisions set by the China Securities Regulatory Commission on information disclosure concerning the relevant periodic reports, interim reports, etc.[41] According to Article 3 in a periodic report a commercial bank shall disclose its main accounting data over the previous 3 years by the end of the reporting period, including the total assets and their structure, total liabilities and their structure, total deposits and their structure, total loans and their structure, inter-bank borrowings, net capital and its structure (including core capital and subsidiary capital), net

[35] ibid, Article 10.

[36] CBRC, [2007] No. 7, promulgated date: 3 July 2007, effective date: 3 July 2007.

[37] ibid, Article 19.

[38] ibid, Article 20.

[39] ibid, Article 21.

[40] ibid, Article 22.

[41] Promulgated date: 25 July 2008, effective date: 1 September 2008.

risk-weighted assets, and loan loss reserves.[42] Article 4 requires that in a periodic report a commercial bank shall disclose the main financial indexes over the previous 3 years by the end of the reporting period, including the asset profit margins, the capital profit margins, the capital adequacy, the core capital adequacy, the non-performing loans ratio, the ratio of deposits to loans, the liquidity ratio, the loan ratio of a single top client, the loan ratio of the top ten clients, the migration ratio of pass loans, the migration ratio of OAEM loans, the migration ratio of substandard loans, the migration ratio of doubtful loans, the provisioning coverage ratio, and the cost-income ratio.[43]

Risk disclosure is an important part for promoting the good corporate governance. Under this document a commercial bank is required to disclose the following information in a periodic report: credit risk status, liquidity risk status, market risk status, operating risk status etc.[44] The Rules also requires that in the event of any change of the risk status of a commercial bank that has a significant effect on the business operation or profitability of the company, the commercial bank shall timely make an announcement.[45]

It can be seen from the above analysis that the disclosure regime for the Chinese banking institutions has been primarily established and performs important roles. On the other hand, after the recent financial crisis regulatory structure has been enhanced; for instance, risk management has been put in a highly important position. In 2010 the Basel Committee on Banking Supervision issued the Principles for Enhancing Corporate Governance in the banking sector.[46] These principles draw on experiences from earlier lessons and are intended to assist banking organizations in enhancing their corporate governance frameworks and assist financial supervisors in supervising the banking institutions. The principles revised previous guidance and focus on the areas such as board practices, senior management, risk management and internal controls, compensation, complex or opaque corporate structures, and disclosure and transparency. Together with the improvement of the Chinese banking industry, the Chinese banking regulators may base on the latest development and international best practices, design and adopt a new set of principles.

17.7 Conclusion

In the last 30 years, the Chinese banking industry has made rapid progress. Nevertheless, some problems remain, which mainly concentrate on: a limited degree of marketization, low competitiveness of the industry, imbalance of the

[42] ibid, Article 3.

[43] ibid, Article 4.

[44] ibid, Article 16.

[45] ibid, Article 24.

[46] Issuing date: 4 October 2010.

development of different banking groups and a weak rural banking system. Focusing on the corporate governance, internal control, risk management, and transparency should be further improved and enhanced.

It can be seen in the Chapter, that with the gradual improvement of the socialist market economy and the deepening of the economic reform, the corporate governance of the banking industry is being further enhanced. Various approaches have been introduced; for instance, reforming the ownership structure, defining the concept of corporate governance, promoting corporate social responsibility and enhancing the information disclosure regime. Nevertheless, the establishment of a framework is not of itself sufficient. Importantly, to fulfill the legal requirements, a strong enforcement system and compliance culture is needed. Another important issue is that the Chinese banking industry should aim towards the long term development and combine their local specification with international best practices.

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Part IV
Final Words

Chapter 18
Corporate Governance: An International Perspective the Summing Up

Kiymet Tunca Caliyurt and Samuel O. Idowu

Corporate governance is the milestone of sustainable business

18.1 Introduction

Putting in place a good system of governance is part of the actions taken by modern corporate entities to ensure a culture which encourages sustainable business. The issue of a good system of governance has become extremely important globally over last 20 or so years simply because of the incidence of some socially unacceptable practices which were going to totally erode investors' confidence in financial reporting, for example financial fraud, economic crises, false accounting etc. which has resulted in the need for shareholders' rights and interests to be protected. Since any failure in taken responsible actions in this regard would undoubtedly make it impossible for businesses to expand and grow, understandably investors would be wary to invest in the global capital markets and listed companies run and managed by non-owner directors.

Of course, it has mentioned time and time again that there is no consensus about the definition of corporate governance and how the system of governance is carried in countries around the world. Thus each country has its own definition and

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6_18, © Springer-Verlag Berlin Heidelberg 2014

governance code put in place by related institutions in these countries. The most common definitions of corporate governance are those ones put in place by the following organizations:

- OECD (the Organization for Economic Cooperation and Development),
- UNDP (the United Nations Development Programme),
- USAID (the United States Agency for International Development),
- the World Bank and the
- European Union.

According to the Cadbury Report (1992) of the UK, Corporate governance was briefly defined, as "the system by which companies are controlled and directed". It specifically focuses on publicly listed companies and how directors' powers are exercised and the process of effecting directors' accountability to the company's owners and equity shareholders. As mentioned in many of the preceding chapters, good corporate governance should be based generally on following principles;

- rule of law
- transparency
- effectiveness
- efficiency
- responsiveness
- accountability
- nondiscrimination
- predictability
- participation

The philosophy of corporate governance in a broader sense aims to benefit society in every possible way, one of which is to enable everyone to have access to timely, accurate, reliable and sufficient information for making investment and other decisions.

As Kilic and Uyar have mentioned in their chapter, firms in recent years have been evaluated using criteria which are not dependent only on financial performance, but also on their social responsibility and environmental performance. Many organizations have understood that information provided by financial reporting alone no longer satisfies the needs of the shareholders, employees, customers, suppliers, communities and other stakeholders of the twenty-first century but these stakeholder groups are more interested about information on the overall organizational performance, which takes cognizance of the triple bottom line. So, companies now tend to make disclosures about their corporate social and environmental activities in addition to the annual mandatory financial information provided in the annual report and accounts.

Esendemirli and Saygili have stated in their chapter that globalization trends in the processing and use of financial information provided by global companies in different industrial sectors address issues which focus on the financial systems, stock markets' rules on financial disclosure and consequently influence consumers and investors' behavior. The international flow of funds has increased along with significant developments in communication and information technologies. For instance, the McKinsey Global Institute (2011) reported that cross border capital flow amounted to US$4.4 trillion and global foreign investment assets reached a historical peak of US$96 trillion in 2010. Developed and developing countries seek ways to attract global investors, in order to achieve continuous economic growth through capital markets. However, investors like to invest in well governed economies and companies. If a country wants to be a station for capital flow, it should pay adequate attention to international corporate governance principles and encourage companies operating within the country to comply with these principles. Many chapters in the book amplified this.

18.2 Important Issues for a Successful Corporate Governance System

One cannot overemphasize that certain issues are extremely important for an entity to be perceived as having in place a well structured system of governance. It is expected that all responsible business leaders in today's world should understand and pay attention to these issues. The following factors are good prerequisites that give shape and focus to a good corporate governance model.

18.2.1 Company Reputation and Intangible Assets

It is easily understood from the preceding chapters from around the world that an effective system of corporate governance helps to improve a company's reputation. Corporate reputation is also expressed in the literature in terms of concepts such as "organizational prestige," "identity," "image," and "brand", they are what accountants call intangible assets. They increase the value of the firm and prospective buyers of the firm would pay a price which is over and above the individual value of assets for them, they are very valuable indeed. It has been argued that they would lead to the following situation occurring:

- May facilitate complex, long-term stakeholder management which, in turn, ought to enhance a firm's ability to outperform its competitors,
- May provide a competitive tool against the competitors,
- May make it easier to improve customers' loyalty and trust in firms and what they do.

Even though good reputation has different dimensions for example financial soundness, wise use of corporate assets, value creation in long term investments, social and environmental responsibility, people management, quality of management, product and service quality and innovation, since it is generally understood that management will usually focus on the values of both tangible and intangible fixed assets when calculating a firm's value. However, intangible assets have become extremely important for companies' reputation. Companies' managers are expected to pay adequate attention to intangible assets in the ledger, understanding that in the IFRS (IAS 38 on Intangible Assets) which requires firms to recognize and measure their intangible assets carefully. This shows the great importance now attached to these assets in the corporate world.

Esendemirli and Saygili have mentioned in their chapter that shareholders, potential investors, suppliers, loan creditors and tax authorities use financial and operating results of public companies in making their decisions. Thus, investors and other primary stakeholders in public companies have suffered losses as a result financial reporting deficiencies by unscrupulous managers of corporations in terms of the accuracy, reliability, materiality, sufficiency and timeliness of the financial information put in the public domain. Consequently, the annual reports and accounts of these irresponsible and fraudulent companies may not be so effective in reflecting significant aspects of public companies (Mallin 2005). Reports are outcomes of the events which have taken place over the last 12 months in companies; therefore the corporate system preparing these reports should be carefully designed to ensure that users of these final reports are not misled.

18.2.2 The Importance of Minority Representatives in Board

The shareholder group is a very special group among stakeholders, members of the group value good governance to a great extent, understandably because of their financial investments in their companies. The Enron scandal has made many investors to be wary and nervous of being taken for a ride again! Lawmakers of many countries have revised capital market boards' regulations and trade codes to ensure that companies are now more accountable to their shareholders than ever before.

The most important problem in good governance is how to protect the rights of shareholders, especially minority shareholders. The preceding 17 chapters of the book have clearly demonstrated that there are now many new trade/governance codes, Securities and Exchange Commission's regulations and new provisions protecting minority shareholders. Good governance should give the same rights to each share and all shareholders who have the right and qualification to vote at general meetings of their companies.

18.2.3 IFRS Is a Good Way to Provide Good Governance to SMEs

The IFAC wants to extend the IFRS application to include the SMEs and support all 120 member countries in this way; then that action would be most welcome by everyone. IFRS standards are the most widely used accounting standards in the world; which probably explains why the EU wants these IFRS to apply to all SMEs. However most of the SMEs in many countries are still not applying the IFRS in reporting their activities. In 2005, the EU passed a regulation which requires SMEs to take on board the requirements of the IFRS in reporting their activities. To do this, the EU was intending to encourage good governance in SMEs in order to discourage corruption and inefficiencies. Additionally, the IFRS have helped reporting companies to become more transparent, accountable and the financial reports they prepare to be understandable, comparable and standardized for easy use by their stakeholders. IFRS contribute to address issues relating to agency problems by setting the rules for disclosing capital allocation and performance monitoring (Brown 2011). The expected benefits of using IFRS in accounting disclosures are; improvements in transparency, comparability and quality of information with reduced preparation costs. Therefore countries which are adopting the IFRS would at the end of the day be able to lower the weighted average cost of capital through increasing investor confidence in capital and financial markets (Tarca 2012).

18.2.4 Board Reconstruction and Audit Committee

Organizing a fair and an effective board of directors in public companies is a good response to what modern stakeholders want. Kahtani in Chap. 16 notes that international corporate governance principles require members of the board to be responsible for a variety of things in order to ensure that the companies they run are properly governed and meeting all their responsible targets. In particular, there is company law jurisprudences in which the law clearly states that the association between the corporation and its board members is a principal-agent association which encourages board members to owe the corporation, the well-known expression of ‘fiduciary duty’ (Kamal 2001). Board members are fiduciary agents; hence, their powers should be implemented not only as required by law, but also for the benefit of the corporation as a whole (Malcolm 1997). However in some countries this association between the corporation and the board members, based on the principle-agent association, is not referred to under either the Commercial Law or Corporate Governance Code provisions. Moreover, the fiduciary duty is not recognized by these pieces of legislation. It is very clear that in cases like this, the board should consist of experienced and well-educated members with the necessary qualifications to sit on the board.

Esendemirli and Saygili have also stated that through literature review, they discovered that having independent members on board and the presence of audit committee seem to be the most important aspect promoting transparency and full disclosure practices. In addition, the number of meetings held the financial literacy of members of the board and audit committee members are all important factors which impact on transparency and full disclosure of activities by a company. However, having independent outsiders directors on boards and audit committees seem to be the most important feature for sound corporate governance applications. The following are some of the board composition requirements:

- There should be independent and non-executive board members on the board.
- In many countries, there is a quota for women members on the board.
- There must be transparent procedure regarding the selection process.
- There should be an audit committee set up by the board which should consist of at least two persons who have background in accounting and auditing.

Normirah and Haslinda in their chapter have pointed out that "*every Board should have a good proportion of executive directors and independent directors. A listed company must ensure that at least two directors or one-third of its Board (whichever is the higher) are independent*."

18.2.5 The Importance of Internal and External Audit

According to the Securities and Exchange Commission regulations, internal and external audit are generally compulsory for public companies. Non-audited financial statements are not valid for any use. Before the well publicized Enron and WorldCom scandals, it was said that that external auditors were independent auditors in comparison with internal auditors. However, some serious scandals have been uncovered by internal auditors so internal auditors have actually gained reputation that they deserve. So we recommend that companies whether public or private must recognize the importance to their internal auditors for good governance purposes. It is crucial to strengthen the functions of the internal audit department through improvements in the scope, staffing, work practices, reporting and communication line. As mentioned by Koutoupis in his chapter, it is necessary to upgrade the role of the external auditors mainly regarding the focus on the internal controls review. It is a good practice to have in place the mandatory certification of the system of internal controls by the external auditor. We consider also as a good practice to periodically review the adequacy of internal controls of listed companies by a different external audit firm periodically (i.e. perhaps every 3 years).

18.2.6 Good Relationship Among Lawmakers and Their Audit Departments

It is very important to have a good relationship and good communication between the following regulators and their investigation bodies in business in order to develop good governance in business environment.

- Securities and Exchange Commission
- Public Companies Oversight Board
- Ministry of Finance
- Social Security Administration
- Insurance Association of Turkey
- Banking Regulation and Supervision Agency

Irregularities and red flags noticed in any type of audit performed by any of above institutions should be passed on to other institutions in order to prevent material misstatements in the financial statements which could mislead users of these financial reports. . .

18.2.7 Corporate Governance and Culture

International corporate governance codes may sometimes not be suitable for all countries' application. For this reason, before taking on board compulsory corporate governance principles, countries should be given, a settling-in period in order to enable related parties to come to terms with the requirements of the new codes and this period should be supported with trainings.

This is more so with in the case of developing countries which may face many challenges when being asked to transplant law and regulations put together by regulators based in the developed countries that may be oblivious to circumstances in many of these developing nations. What is therefore being suggested here is that before transplanting regulations to countries, all related parties should be asked for their views and comments on the new regulations and they should have given enough time to absorb them before the rules become effective.

18.2.8 Top Management Attitude Towards Good Governance

It is the responsibility of a company's senior managers institute good corporate governance practices. Sorour writing from Egypt has noted that "*Top Management particularly, politicians and professionals have to institute and promote good governance and integrity environment as a foundation for creating a favourable* *investment climate. Government and corporate leaders must.* He in fact sums up what is required in the following bullet points:

- *Live and openly be seen to be role-model in integrity in all their dealings,*
- *Make morally and ethically correct decisions regardless of the cost or difficulty,*
- *Hold on to the vision of clean government and business,*
- *Be courageous in sharing their sentiments and recommendations,*
- *Have clear values to guide them so as to take bold decisions,*
- *Have the courage of owning their mistakes and learning from them.*"

The above are powerful issues which would encourage economic progress and a sustainable future for countries, companies and all stakeholders of these countries.

18.3 Some Perspectives Taken by the Book

There are some common views and perspectives shared by contributors of chapters in the book from 12 countries from in, Europe, Asia and Africa. They have all clearly noted that international institutions, business, business leaders, stakeholders and regulators have understood the importance of good corporate governance. Our world is now a global village, international trade flourishes all over the village especially more recently in terms of e-business, capital now flows from one country to another more easily than ever before, NGOs are especially more active than they used to be, investors and shareholders aware of the legal rights than they have ever been, global social networks are fast and efficient and communicate widely from very small issues to bigger ones, everyone uses these social networks from the man in the street in Rwanda to the US President, all business actors should act responsibly and sustainably and take their decisions in line with national and international rules on corporate governance.

Corporate governance applications in countries around need time, training, economic stability to carefully understand and absorb its basics. Otherwise corporate governance rules will not work effectively and it might even fail everyone. Some of the chapters in the book especially those ones from Europe have demonstrated that, harmonizing the EU financial and governance regulations have shaken European companies to the core. Additionally, the financial crises which have affected many EU countries have badly shaken confidence in many nations' economies. There had been a few bad experiences all over the place, but there are a great many lessons to learn from all these bad experiences and as people say, "what does not break a nation, makes the nation".

Corruption and greed are two social ills we all need to pull together our resources to fight. Greed and corruption have led to many of the scandals noted in some of the preceding chapters our corporate scene will be a lot successful without both of them. In many disclosure methods using different names like CSR reports, sustainability reports, corporate citizenship reports etc., there is no room to disclose a company's prevention approaches and applications these social ills. We propose that a company's disclosure systems and their regulators investigating systems should be capable of determining the indicators which show the following:

- how company prevent and integrate fraud prevention in its systems,
- state the method installed for preventing, investigating and reporting fraud

18.4 Closing Remarks

Finally, we close the book with a positive note that our world has drastically transformed over the last few decades, albeit with a few challenges which we are gradually overcoming. The few challenges have actually enabled a few countries to emerge as prospective world powers of tomorrow, countries such as China, India, Brazil and South Africa are positioning themselves as prospective members of the league of world power nations, so it has not all been about doom and gloom. In fact all the three versions of the South African King Report on corporate governance have been applauded worldwide as a major contribution to corporate governance development.

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S.O. Idowu and K.T. Çaliyurt (eds.), *Corporate Governance*,
DOI 10.1007/978-3-642-45167-6, © Springer-Verlag Berlin Heidelberg 2014

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