CORPORATE GOVERNANCE

Driving forces of Corporate Governance Development

- The main, but not the only, drivers associated with the increasing demand for the development of governance were:
  - Increasing internationalization and globalization meant that investors and institutional investors began to invest outside their home countries.
  - The differential treatment of domestic and foreign investors, both in terms of reporting and associated rights/dividends, also the excessive influence of majority shareholders in inside jurisdictions, caused many investors to call for parity of treatment.
  - Issues concerning financial reporting were raised by many investors and were the focus of much debate and litigation. Shareholder confidence in what was being reported in many instances was eroded. Corporate governance development isn’t just about better financial reporting requirements; the regulation of practices such as off-balance sheet financing has led to greater transparency and a reduction in risks faced by investors.
  - The characteristics of individual countries may have a significant influence in the way corporate governance has developed.

- Some corporate scandals and collapses which gave rise to improvement in Corporate Governance;

Definition

- Corporate governance is the system by which companies are directed and controlled. (Cadbury)
- Corporate governance is a set of relationship b/w a company’s directors, its shareholder and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of achieving those objectives and monitoring performance, are determined. (OECD)

Elements in Good Corporate Governance

i. The management, awareness, evaluation and mitigation of risk is fundamental in all definitions of good governance.
ii. Good governance suggests measure a director’s performance by the risk factor (borne by the stakeholders by investing) and not the return factor. E.g. Higher the risk, greater is the return.
iii. Good governance provides a framework for an organization to pursue its strategy in an ethical and effective way and offers safeguards against misuse of resources, human, financial, physical or intellectual.
iv. Good governance is not just about externally established codes; it also requires a willingness to apply the spirit as well as the letter of the law.
v. Good corporate governance can attract new investments (new stakeholders).

Underlying Concepts of Corporate Governance

Governance is based on a series of underlying concepts.

1. Fairness
   - Fairness is described as ‘equitable treatment with all the stakeholders’.
• Equitable does not mean equal, treat every one as much as they deserve, customers, suppliers and even the shareholders should be categorized accordingly and treated on an equitable basis.
• The systems and values that underlie the company must be balanced by taking into account everyone who has a legitimate interest in the company, and respecting their rights and views.

2. **Openness/transparency**
• Transparency means open and clear disclosure of relevant information to shareholders and other stakeholders, also not concealing information when it may affect decisions. It means open discussions and a default position of information provision rather than concealment.
• It includes all voluntary disclosures.
• Circumstances where concealment may be justified include discussions about future strategy, confidential issues relating to individuals and discussions leading to an agreed position that is then made public.

**Exam Focus Point:** Weighing up transparency versus confidentiality may be difficult and it is tested twice. Remember that sometimes there may be valid commercial reasons for keeping information away from those who may use it against the company.

3. **Independence**
• Independence is an important concept in relation to directors.
• Corporate governance reports have increasingly stressed the importance of independent NEDs.
• Independent NEDs should be able to carry out effective monitoring of the company in conjunction with equally independent external auditors on behalf of shareholders.
• NEDs’ lack of links and limits on the time that they serve as NEDs should promote avoidance of managerial capture – accepting executive managers’ views on trust without analyzing and questioning them.

4. **Probity/honesty**
• Good Governance Code defines probity in terms of receipt of gifts or hospitality by trustees. Management should not accept gifts or hospitality which may seem likely to influence their decisions.
• This relate not only to telling the truth, but also not misleading shareholders and other stakeholders by presenting information in a slanted way.

5. **Responsibility**
• It means management accepting the credit or blame for governance decisions.
• The South African King report stresses that the board of directors must act responsively to, and with responsibility towards, all stakeholders of the company. However the responsibility of directors to other stakeholders, both in terms of to whom they are responsible and the extent of their responsibility, remains a key point of contention.

6. **Accountability**
• Corporate accountability refers to whether an organization (and its directors) are answerable in some way for the consequences of their actions.
• The UK Cadbury report stresses that making the accountability work is the responsibility of both parties. Directors do so through the quality of information that they provide whereas shareholders do so through their willingness to exercise their responsibility as owners.

**Exam Focus Point:** The examiner has commented:
'When I say accountability, I mean companies to investors, professionals to their values, business systems to their stakeholders and so forth.'

7. **Reputation**
• There are purely commercial reasons for promoting the organization’s reputation, that the price of publicly traded shares is often dependent on reputation and hence reputation is often a very valuable asset of the organization.

8. Judgement
• It means that the board making decisions that enhance the prosperity of the organization.
• This means that board members must acquire a broad enough knowledge of the business and its environment to be able to provide meaningful direction to it. This has implications on also the way the directors are recruited and trained.
• This means that corporate governance can involve balancing many competing people and resource claims against each other.

9. Integrity
• It means straightforward dealing and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company’s affairs. The integrity of reports depends on the integrity of those who prepare and present them. (Cadbury Report)
• Simply saying, it can be taken as meaning someone of high moral character, who sticks to principles no matter the pressure to do otherwise.
• At times, accountants will have to use judgement or face financial situations which are not covered by regulations or guidance, and on these occasions, integrity is particularly important.

03 Theories on Corporate Governance
1. Agency Theory
2. Stewardship Theory
3. Transaction Cost Theory
4. Stakeholder Theory (defined in ethics, only 03 more to be defined here)

1. Agency Theory
• Agency is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent.
• In a corporate context, directors are the agents of shareholders and the company.
• Although shareholders are the owners of the company to whom the board of directors are accountable as agents, the actual powers of shareholders tend to be restricted. They normally have no right to inspect the books of account, and their forecasts of futures prospects are gleaned from the annual report and accounts.
• Corporate governance aim to ensure that directors/managers fulfill their responsibilities as agents by requiring disclosures and suggesting they be rewarded on the basis of performance.
  ➢ Accountability and Responsibilities of Agent:
   • In agency context, accountability means that the agent is answerable under the contract to his principal and must account for the resources of his principal and the money he has gained working on his principal’s behalf.
   • Fiduciary duty is imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflicts of interest.
   • Evan and Freeman argue that management bears a fiduciary relationship to stakeholders and to the corporation as an abstract entity. Adoption of such principles would require significant changes, e.g., ‘stakeholder board of directors’ – with one representative for each of the stakeholder groups and one for the company itself.
  ➢ Duties of Agent:
   • The agent must perform the agreed task against the reward.
• The agent must act strictly in accordance with his principal’s instructions whether favorable or unfavorable, provided legal.
• An agent undertakes to maintain standard skill and care expected of a person in such a profession.
• The agent must perform the task himself and not delegate it to another.
• The agent must not put himself in a situation where his own interests conflict with those of principal.
• The agent must not disclose the principal’s affairs even after the cessation of agency.
• Any benefit, if earned during the period, must be handed over to the principal.
  ➢ Agency Cost:
    • The cost borne and the resources consumed by principal in monitoring and supervising the activities of agents.
  ➢ Agency Problem:
    • In listed companies, the agency problem arises from the principle that the principals (owners) not being able to run the business themselves and therefore having to rely on agents (directors) to do so for them.
    • This separation can cause issues if there is a breach (may be directors are pursuing their own interests) of trust by directors by intentional action, omission, neglect or incompetence.
  ➢ Resolving the agency problem:
    • In order to achieve the objectives of the organization as a whole, various other objectives (individual or departmental objectives) must be achieved, this is said to be alignment of interests.
    • Alignment of interests or goal congruence is accordance b/w the objectives of agents acting within an organization and the objectives of the org as a whole.
    • Alignment of interests may be better achieved by giving managers some profit-related pay. E.g.,
      i. Share Options
      ii. Executive Share Option Plans (ESOPs)
      iii. Profit-related/economic value-added pay
  • Such measures might encourage management to adopt ‘creative accounting’ methods which will distort the reported performance of the company in the service of the manager’s own ends.
  • An alternative approach is to attempt to monitor managers’ behavior, e.g., by establishing ‘management audit’ procedures, to introduce additional reporting requirements, or to seek assurances from managers that shareholders’ interests will be foremost in their priorities.
  ➢ Other Agency Relationships:
    i. Shareholder-auditor relationship
      • The shareholders are the principals, auditors are the agents and the audit report is the key method of communication.
      • The agency problem is that auditors may not be independent of management; they become too close or are afraid that management will not give them non-audit work.
    ii. Other relationships
      • Other significant agency relationships include directors themselves acting as principals to managers/employees as agents.
      • It is a responsibility of directors to make sure that this agency relationship works by establishing appropriate systems of performance measurement and monitoring.
 2. Stewardship Theory
• Stewardship theory is a theory that managers, left on their own, will indeed act as responsible stewards of the assets they control.
• Remember, the asset is transferred physically only and not the ownership.
• This theory is an alternative view of agency theory, in which managers are assumed to act in their own self interests at the expense of shareholders.
 3. Transaction Cost Theory
• This theory is based on the work of Cyert and March and states that the way the company is organized or governed determines its control over transactions.
At the very inception of an org, when it is young and small, it will tend to keep as many transactions as possible in-house (independence) in order to reduce uncertainties about prices and quality. To do this, it will tend towards vertical integration.

But with the passage of time the managers stop behaving rationally and are also opportunistic, i.e., organize their transactions to pursue their own interests and here we need the same goal congruence.

4. Stakeholders Theory
   We will discuss only three stakeholders/stockholders here, rest are discussed above in ethics.
   i. Company Secretary
      The company secretary performs many duties and no specific duty is defined, however we will consider the legal portion.
      Mainly, the company secretary deals with the compliance issues, e.g., arranging meetings at the board of directors, signing, authentication and maintenance of documents and registers and general administrative duties.
      Whatever the duties of secretary, the secretary must be independent but his/her ultimate loyalty is to the company.
   ii. Institutional Investors
      They manage funds invested by individuals (local public) by investing in stock markets, investing in venture capital, or lend directly to companies.
      They can wield great powers over the companies in which they invest.
      UK guidance has placed significant emphasis on the role of institutional investors in promoting good corporate governance by entering into a dialogue with companies based on the mutual understanding of objectives, attending the AGMs, considering companies’ governance arrangements relating to say, board structure and composition.
      Major institutional investors in the UK Pension Funds, Insurance Companies, Investment and Unit Trusts, and Venture Capital Organizations.
      Advantages and Disadvantages:
      According to IAS 19, the funds from which pensions are paid should be held separately from the companies by whom they are employed, similarly, investors should have the opportunity to invest through the medium of insurance companies, unit trusts and investment trusts.
      Institutional investors are normally of such a size that they can influence prices, which makes capital market less competitive.
      These investors tend to avoid shares which are seen as speculative as they have a duty to their customers and invest only in blue chip companies; shares of such companies are relatively expensive.
      Fund managers are accused of short-termism; however, arguably institutional investors have become so influential that they have been forced to adopt a more long-term outlook.
      Means of exercising institutional investors’ influence:
      o One-to-one meeting
      o Voting
      o Focus list – putting companies’ names on a list of underperforming companies.
      o Contributing to corporate governance rating systems – that measure key corporate governance performance indicators such as number of NEDs, role of the board and the transparency of the company.
   iii. Regulators
      Registered
      Commercial
      Statutory
      Federal Level
      Provincial/State Wise
      Lloyds Banking Group, CDC Group Plc, Royal Bank of Scotland
      ACCA, SEC UK
It can be defined as any form of interference with the operation of the free market. This could involve regulating demand, supply, price, profit, quantity, quality, entry, exit, information, technology, or any other aspect of production and consumption in the market.

This category includes government body such as health and safety executives and regulators such as the financial services authorities or others relevant to specific types of industry.

Legislators and regulators affect organizations’ governance and risk management by establishing rules and standards, by conducting inspections and audit. Regulators are particularly interested in maintaining shareholder-stakeholder confidence.

- Costs of Regulation:
  - The potential costs may include the following:
    - Enforcement costs – direct costs of enforcement include setting up and running of the regulatory agencies. Indirect costs are incurred by the firms in conforming to the restrictions.
    - Regulatory capture – this refers to the process where the regulator becomes dominated and controlled by the regulated firms, such that it acts increasingly in the firm’s interests, than consumer.
    - Unintended consequences of regulation – e.g. is the ‘Aversch-Johnson effect’. This refers to the tendency of rate-of-return (profit) regulation to encourage firms to become too capital-intensive and hence minimize their return on capital. Companies try to maximize their asset base so that their return on capital employed is low. In other words, firms regulated in this way have an incentive to choose a method of production that is not least cost, because it involves too high a ratio of capital to labor.

Influence of ownership

- 02 models of ownership has been drawn out b/w the corporate governance systems worldwide in different regimes, although in practice most regimes fall somewhere in b/w the two.

  1. Insider Systems
     - Insider or relationship-based systems are where most companies listed on the local stock exchange are owned and controlled by a small number of major shareholders. The shareholders may be members of the company’s founding families, banks, other companies or the government.
     - There is a manager-ownership concentration and is mostly found in UK.
     - Family companies are the best example of insider structures.
       - Advantages:
         - It is easier to establish ties b/w owners and managers.
         - Decision making process takes place quickly and is effective.
         - The agency problem and the related cost is reduced.
       - Disadvantages:
         - There may be discrimination against minority shareholders w.r.t. for example availability of information and the wealth disclosures.
         - Such family owned and controlled companies tend to avoid monitoring by banks or other large shareholders.
         - Insider systems are more prone to opaque financial statements and misuse of funds.
         - Succession issues may be a major problem.
         - Insider firms may be reluctant to employ outsiders in influential positions and may be unwilling to recruit NEDs.
  2. Outsider Systems
     - Outsider systems are ones where shareholding is more widely dispersed, and there is the manager-ownership separation.
     - These are sometimes referred to as the Anglo-American or Anglo-Saxon regimes, and mostly found in US.
       - Advantages:
         - Adjust the disadvantages of insider systems.
       - Disadvantages:
         - Adjust the advantages of insider systems.
**Principle Based Approach**

- The approach focuses on objectives (shareholders should be treated fairly) rather than mechanism for achieving these objectives.
- A principles-based approach can lay stress on those elements of corporate governance to which rules cannot be applied. These include areas such as the requirement to maintain sound systems of internal control, organizational culture and maintaining good relationship with shareholders and stakeholders.
- One example is Corporate Governance, followed mostly in UK.
- There is a room for explanation if the specific recommendations made by corporate governance codes are not complied with.
  
  - **Advantages:**
  - This approach is resource saving as fewer formalities, less burdensome in terms of time and costs, and reduces the burden of red-tape.
  - This approach is flexible as it allows companies to develop their own approach to corporate governance within certain limits.
  - Enforcement of corporate governance codes is on a comply or explain basis. Explanations of breaches generally include details of how and when non-compliance will be remedied.
  
  - **Disadvantages:**
  - This approach has a subjectivity element which may raise different interpretations.
  - Certain codes of corporate governance may not be complied with, perhaps without explanation, as they are discretion based.
  - Companies cannot maintain standardization.
  - There may be confusion over what is compulsory and what isn’t.

  - **Example:**
  - A principles-based approach to regulating the behavior of motorists might say that motorists should drive safely having regard to traffic and road conditions.

There is a problem with this approach, what criteria can be used to determine when a motorist is not driving safely? The motorist being involved in an accident perhaps, but the accident may have been due to other factors.

**Rules Based Approach**

- This approach place more emphasis on achievements rather than underlying factors and guidelines.
- EMAS environmental management system or Sarbanes-Oxley Act may be the examples.
- Rules based approaches to corporate governance tend to be found in legal jurisdiction and culture that lay great emphasis on obeying the letter of the law rather than the spirit. They often take the form of legislation themselves, notably Sarbanes-Oxley Act.

  - **Advantages:**
  - Adjust the disadvantages of insider systems.
  
  - **Disadvantages:**
  
  - Theoretically it is easy to see whether there has been compliance with the rules, however, it depends on whether the rules are unambiguous and there clarity.
  - Enforcers (regulators, auditors) of this approach may find it difficult to deal with questionable situations that are not covered sufficiently in the rulebook. E.g. Enron – the company kept a number of its financial arrangements off its balance sheet. Although this approach can be seen as not true and fair, Enron could use it because it did not breach the accounting rules the then exist in America.
  
  - Adjust the advantages of insider systems.

  - **Example:**
  - A rules-based approach may specify that motorist should not drive at speeds in excess of 100 km/hr. A problem here is that attention is focused on whether the rules have been broken, and not perhaps on more relevant factors. E.g. a motorist driving on a motorway at 100 km/hr where the motorway was seriously affected by snow might be obeying the law, but would be driving at undesirably fast speed.
  
  - An example from sport of the differences b/w a principles and rules based approach was the clash b/w the Australian umpire Darrell Hair and the Pakistani cricket team in the 4th test in 2006.

The Board
- Board is an executive committee which comprises of Directors and Chairman.
- BODs run the company through meetings, policy making and strategy settings.
- Good corporate governance suggests that the effectiveness of the board is in the point that they should meet regularly.
- Directors/members should have a mix of skills and their performance should be assessed regularly.
  - Roles, responsibilities and duties:
    - To define the purpose of the company and the values by which the company will perform its daily existence and to identify the stakeholders relevant to the business of the company. The board must then develop a strategy combining all 03 factors and ensure management implements that strategy.
    - It is collectively responsible for promoting the success of the company by directing and supervising the company’s affairs.
    - Its role is to provide entrepreneurial leadership of the company, within a framework of prudent and effective controls which enable risk to be assessed and managed.
    - It should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance.
    - It should set the company’s values and standards and ensure that its obligations to its stakeholders and others are understood and met.
- Other tasks include:
  - Monitoring the CEO
  - Overseeing strategy
  - Monitoring risks, control systems and governance
  - Monitoring the human capital aspects of the company
  - Managing potential conflicts of interest
  - Ensuring that there is effective communication of its strategic plans, both internally and externally
  - Types of board:
    - Effective board
      - Strengths:
        - Clear strategy aligned to capabilities
        - Vigorous implementation of strategy
        - Key performance drivers monitored
        - Effective risk management
        - Focus on view of stakeholders
        - Regular evaluation of board performance
    - The rubber stamp
      - Strengths:
        - Make clear decisions
        - Listens to in-house expertise
        - Ensures decisions are implemented
      - Weaknesses:
        - Fails to consider alternatives
        - Dominated by executives
        - Relies on fed information
        - Focuses on supporting evidence
        - Does not listed to criticism
    - The talking shop
      - Strengths:
        - All opinions given equal weight
        - All options considered
      - Weaknesses:
• No effective decision making process
• Lack of direction from chairman
• Failure to focus on critical issues
• No evaluation of previous decisions

iv. The number crunchers
  ➢ Strengths:
  • Short-term needs of investors considered
  • Prudent decision making
  ➢ Weaknesses:
  • Excessive focus on financial impact
  • Lack of long-term, wider awareness
  • Lack of diversity of board members
  • Impact of social and environmental issues ignored
  • Risk averse

v. The dreamers
  ➢ Strengths:
  • Strong long-term focus
  • Long-term strategies
  • Consider social and environmental implications
  ➢ Weaknesses:
  • Insufficient current focus
  • Fail to identify or manage key risks
  • Excessively optimistic

vi. The adrenalin junkies
  ➢ Strengths:
  • Clear decisions
  • Decisions implemented
  ➢ Weaknesses:
  • Lurch from crisis to crisis
  • Excessive focus on short-term
  • Lack of strategic direction
  • Internal focus
  • Tendency to micro-manage

vii. The semi-detached
  ➢ Strengths:
  • Strong focus on external environment
  • Intellectually challenging
  ➢ Weaknesses:
  • Out of touch with the company
  • Little attempt to implement decisions
  • Poor monitoring of decision-making
  ➢ Appraisal of the performance of board:
  • Appraisal of the board's performance is an important control over it, aimed at improving board effectiveness, maximizing strengths and tackling weaknesses.
  • The UK Corporate Governance Code guides that the appraisal should be formally carried out once in a year.
  • Ideally this process should be by an external third party. If the review is carried out internally, board members may be asked to assess performance using a questionnaire based on the best practice of an effective board.
  • In order to be conducted effectively, the appraisal of the whole board will need to include:
    o A review of the board's systems (conduct of meetings, work of committees, quality of written documentation)
• Performance measurement in terms of the standards it has established, financial criteria, and non-financial criteria relating to individual directors
• Assessment of the board’s role in the organization (dealing with problems, communicating with shareholders)

- The Higgs report provides a list of the criteria that could be used:
  - Performance against objectives
  - Contribution to testing and development of strategy and setting of priorities
  - Contribution to robust and effective risk management
  - Contribution to development of corporate philosophy (values, ethics and CSR)
  - Appropriate composition of board and committees
  - Responses to problems or crises
  - Are matters reserved for the board the right ones?
  - Are decisions delegate to managers the right ones?
  - Internal and external communication
  - Board fully informed of latest developments
  - Effectiveness of board committees
  - Quality of information
  - Quality of feedback provided to management
  - Adequacy of board meetings and decision-making
  - Fulfilling legal requirements

Corporate governance arrangements in different jurisdictions:

1. Unitary Board

- A unitary board, with both executive and outside directors, is responsible for both the overall performance of the enterprise and its conformance with strategies, polices and codes. In other words, one single board comprising both executive and non-executive directors.
- It is mostly operated in the UK and USA.
  - Advantages:
    - All participants (EDs and NEDs) in the single board have equal legal responsibility for management of the company and strategic performance.
    - If all the directors attend the same meetings, the independent directors are likely to get access to all the information and knowledge of the company.
    - Better and quick decision making may end up.
    - Better relationship b/w different types of directors.
    - The presence of independent directors may result in on the spot check and balance, feedback, monitoring and questioning the actions and decisions of executive directors.
  - Disadvantages:
    - There is a chance of collusion b/w EDs and NEDs.
    - In the UK the combined code does not mention a particular number of NEDs, so a dominating factor may exist and EDs may influence NEDs, if on a single board.
    - The role of independent director is too much demanding and it is awkward to ask a NED to be both manager and monitor.
    - The NEDs may not be able to obtain sufficient knowledge because of the time requirements.
    - There is no clear and formal separation of the board.
    - The unitary board system makes no specific provision for employees to be represented on the management board, other than by the people who employ them.
    - In the unitary board system, the general meeting is the only place where shareholders grievance or concern can be heard.

2. Multi-tier boards

- Some jurisdictions take the split b/w the executive and independent directors to the furthest extent.
  - Corporate governance arrangements in Germany:
    - Institutional arrangements in German companies are based on a dual board.
      1. Supervisory board
• It has workers’ representatives and stakeholders’ management representatives.
• It does review the company’s direction and strategy, although no executive function, and is responsible for safeguarding stakeholders’ interest.
• It must receive formal reports of the state of the company’s affairs and finance and approves the accounts and may appoint committees and undertake investigations.
• The board should be composed of members who, as a whole, have the required knowledge, abilities and expert experience to complete their tasks properly and are sufficiently independent.
• The members are elected by the shareholders and the employees will also elect them.
  ii. Management/executive board
• This board, composed entirely of managers, will be responsible for the day-to-day running of the business and is appointed and supervised by the supervisory board.
  ➢ Corporate governance arrangements in Japan:
• In Japan there are 03 different types of board of director.
  i. Policy boards – concerned with long-term strategic issues
  ii. Functional boards – made up of the main senior executives with a functional role
  iii. Monocratic/Symbolic boards – with few responsibilities and having a more symbolic role
  ➢ Advantages:
  ➢ Adjust the disadvantages of unitary board systems.
  ➢ Disadvantages:
  ➢ Adjust the advantages of unitary board systems.

Directors
• The directors need to have a relevant expertise in industry, company, functional are and governance. The South African King report, reporting within a racially-mixed region, stresses the importance also of having a good demographic balance.
  ➢ Induction of new directors:
• A detailed guidance on the development of an induction programme tailored to the needs of the company and individual directors. (Remember: the list below is not exhaustive)
  i. Build an understanding of the nature of the company, its business and its markets
   o The company's culture and values
   o The company's products or services
   o Group structure/subsidiaries/joint ventures
   o The company's constitution, board procedures and matters reserved for the board
   o The company's principal assets, liabilities, significant contracts and major competitors
   o Major risks and risk management strategy
   o Key performance indicators
   o Regulatory constraints
  ii. Build a link with the company's people
   o Meetings with the senior management
   o Visits to company sites other than headquarters, to learn about production and services, meet employees and build profile
   o Participating in board's strategy development
   o Briefing on internal procedures
  iii. Build an understanding of the company's main relationships including meetings with auditors
   o Major customers and suppliers
   o Major shareholders and customer relations policy
   ➢ Continuing professional development:
• To remain effective, directors should extend their knowledge and skills continuously.
• The Higgs report suggests that professional development of potential directors ought to concentrate on the role of the board, obligations and entitlements of existing directors and the behaviors needed for effective board performance.
• Significant issues that professional development should cover on a regular basis include:
  o Strategy
Management of human and financial resources
- Audit and remuneration issues
- Legal and regulatory issues
- Risk management
- The effective behaviors of a board director such as influencing skills, conflict resolution, chairing skills and board dynamics.
- The technical background of the company's activities

This report suggests that a variety of approaches to training may be appropriate including lectures, case studies and networking groups.

1. Executive Directors
- They have a dual role, 1st in the company, 2nd in the board.
- It is the responsibility of the directors to satisfy themselves that they have appropriate information of sufficient quality to make sound judgments.

  - Appraisal of the performance of individual directors:
    - Criteria that could be applied for appraisal of individual directors include the following:
      - Independence – free thinking, avoids conflict of interest
      - Preparedness – knows key staff, organization and industry, aware of statutory and fiduciary duties
      - Practice – participates actively, questioning, insists on obtaining information, undertakes professional education
      - Committee work – understands process of committee work, exhibits ideas and enthusiasm
      - Development of the organization – makes suggestions on innovation, strategic direction and planning, helps win the support of outside stakeholders

  - Retirement by rotation:
    - Directors are often required to retire from the board and seek re-election, generally once every 03 years; MD may be exempted from such provisions.
    - The provisions may be enshrined in law, but the company's constitution or articles prescribe the rules on rotation.
    - However, retirement by rotation allow shareholders a regular opportunity to vote directors out of office.
      - Advantages:
        - It is an important mechanism to ensure director accountability by shareholders.
        - Compulsory retirement of directors forces directors and shareholders to consider the need for the board to change over time.
        - Compensation paid to directors for loss of office under their service contracts will also be limited.

2. Non-Executive Directors
- They have no executive or managerial responsibilities.
- NEDs should provide a balancing influence, and play a key role in reducing conflicts of interest b/w management (including executive directors) and shareholders.
- They should provide reassurance to the shareholders that management is acting in the interests of the organization.

  - Characteristics:
    - Upholds the highest ethical standards of integrity and probity
    - Supports executives in their leadership of the business while monitoring their conduct
    - Questions intelligently, debates constructively, challenges rigorously and decides dispassionately
    - Listens sensitively to the views of others inside and outside the board
    - Gains the trust and respect of other board members
    - Promotes the highest standards of corporate governance and seeks compliance with the provisions of the Code
      - Roles and responsibilities:
        - NEDs should provide assistance to, and challenge the direction of, strategy.
        - NEDs should scrutinize the performance of executive management (including chairman and CEO) in meeting goals and objectives and monitor the reporting of performance.
NEDs should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust.

NEDs play a key role in people management i.e. determining appropriate levels of remuneration and in the appointment, removal of senior managers in succession planning.

**Exam Focus Point:** The P1 exams so far have demonstrated the importance of NEDs as central figures in corporate governance. So you need a good understanding of Who they are, What they do, what are the benefits and the associated problem.

- Appraisal of the performance of NEDs:
  - Higgs suggested the following issues to be considered;
    - Preparation for meetings
    - Attendance level
    - Willingness to devote time and effort to understand the company and its business
    - Quality and value of contributions to board meetings
    - Contribution to development of strategy and risk management
    - Demonstration of independence by probing, maintaining own views and resisting pressure from others
    - Relationships with fellow board members and senior management
    - Up-to-date awareness of technical and industry matters
    - Communication with other directors and shareholders
  - Advantages:
    - They may have external experience and knowledge which executive directors do not possess, e.g., they may be executive directors of other companies and have experience of approaching corporate governance, internal controls or performance assessment.
    - NEDs can provide a wider perspective as they are not involved deeply in detailed operations.
    - Good NEDs are always a comfort factor for stakeholders.
    - There are certain roles NEDs are well-suited to play, e.g., 'father-confessor' (being a confidant for the chairman and other directors), 'oil-can' (intervening to make the board run more effectively) and as 'high sheriff' (if necessary taking steps to remove the chairman or chief executive).
    - Appointing NEDs ensures compliance with corporate governance regulations of codes.
    - They are meant to provide the strong, independent element on the board.
  - Disadvantages:
    - Practically, NEDs are linked to a company in a number of ways, as suppliers or customer for example; as a consequence they may lack independence.
    - High-caliber NEDs may attract towards the best-run companies rather than those who are in more need of input from them.
    - It may be easy to dismiss the views of NEDs as irrelevant to the company's needs so they may face difficulty in imposing their views upon the board.
    - NEDs have limited time to devote to the role
    - NEDs can damage company performance by weakening board unity and avoid taking risky investments.
    - NEDs may have lack of knowledge of, as well as interest in, the company.
    - Cross directorships usually results conflict of interest, where an executive director of company A is a NED of company B, and executive director of company B is a NED of company A, are a particular threat to independence. This is often increased by cross-shareholdings, where directors being concerned with their own interest rather than shareholders.
    - NEDs fail to maintain their independent status by taking part in company's schemes, e.g., share option schemes or PRP schemes.

**Relationships with shareholders and stakeholders**

- Relationships with shareholders:
  - A key aspect of the relationship is the accountability of directors to shareholders. This can ultimately be ensured by requiring directors to submit themselves for regular re-election.
The board should as a whole should use a variety of means for ascertaining major shareholders’ opinions, for example face-to-face contact, analysts or brokers; briefings and surveys of shareholders’ opinions.

The AGM is the most important formal means of communication, and the governance guidance suggests that boards should actively encourage shareholders to attend AGMs.

- Relationships with stakeholders:
  - The Hampel committee that although relationships with stakeholders were important, making the directors responsible to other stakeholders would mean there was no clear yardstick for judging directors’ performance.
  - Companies should behave ethically and have regard for the environment and society as a whole.
  - The OECD guidelines stress that corporate governance frameworks should respect the rights of stakeholders and promote/permit ‘performance enhancing mechanisms’ for stakeholder participation, e.g., employee representation on the board, employee share ownership and etc.
  - Companies should support voluntary and statutory measures that minimize the externalization of costs to the detriment of society at large.

**Board Committees**

- The main board committees are:
  i. Audit Committee – of independent NEDs should liaise with external audit, supervise internal audit, and review the annual accounts and internal control.
    - It comprises wholly or maximum number of NEDs.
    - This committee can handle the task of other committees, if they are not in place.
    - Role and functions:
      - The committee should review all the reports published including the annual accounts, thereby assessing the judgments made about the overall appearance and presentation of the accounts and key accounting policies.
      - The committee is responsible for removal, appointment and setting remuneration of the external auditors.
      - Consider and solve threats to independence with regard to external auditor.
      - Acting as a forum of liaison b/w the external auditors, the internal auditors and the finance director.
      - Helping the external auditors for any necessary information or dealing with any special reservations.
      - Monitoring the adequacy of internal control systems including legal compliance and ethics.
      - Each year the committee should be responsible for reviewing the company’s statement on internal controls prior to its approval by board.
      - The committee’s role is ongoing; it needs to see that actions are taken as appropriate.
  ii. Nomination Committee – responsible for recommending the appointments of new directors to the board.
    - It comprises wholly or maximum number of NEDs.
    - Role and functions: The nomination committee needs to consider;
      - The balance b/w executives and independent non-executives
      - The skills, knowledge and experience possessed by the current board
      - The need for continuity and succession planning
      - The desirable size of the board
      - The need to attract board members from a diversity of backgrounds
      - Whether NEDs are spending enough time on their duties and other issues relating to re-election and reappointment of directors, also membership of board committees.
      - The nomination committee should regularly review the structure, size and composition of the board, and keep under review the leadership needs of the company.
      - Nomination of the board and advertisement for the board should be independent and free from bias.
      - Directors should from diversified backgrounds (demographic balance), like directors with international experience, lawyers, accountants, consultants, directors of private companies, seniors from government sectors or charities and auditors.
iii. Remuneration Committee – responsible for advising on executive director remuneration, policy and the specific package for each director.

- It comprises wholly of NEDs.
  - Role and functions:
  - In order to be effective, the committee needs both to determine the organization’s general policy on the remuneration of EDs and specific remuneration packages for each director.
  - Any form of bonus provided to directors should be related to measurable performance or enhanced shareholder value.
  - There should be full transparency of directors’ remuneration, including pension rights, in the annual accounts.
  - While setting the package, the committee should take account the position of their company relative to other companies and the packages should be revised from time to time.
  - The committee should consider the fact that the package should be attractive enough to motivate and retain directors, thereby taking into account shareholders’ interests.
  - The committee should also consider the individual performance and the board’s performance as a whole, while revising or setting package.
  - A package may include basic salary, bonus – performance related pay, share, share options, benefits in kind.
  - The committee should also consider that, the service contracts are not too long, and then have to be terminated prematurely, the perception often arises that the amounts paying off directors for the remainder of the contract are essentially rewards for failure. Most corporate governance guide that service contracts above 12 months should be considered carefully and ideally be avoided.
  - The remuneration policy, the arrangements for individual directors, duration of contracts with directors, and notice periods and termination payments to be disclosed in the annual report.

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<thead>
<tr>
<th>Remuneration Structure</th>
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<tbody>
<tr>
<td>Executive Directors</td>
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<tr>
<td>Remuneration Committee</td>
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<td></td>
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<tr>
<td>Non-Executive Directors</td>
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<td></td>
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<tr>
<td>Full board or the shareholders should determine the remuneration of NEDs within the limits prescribed by Articles of Association</td>
</tr>
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</table>

iv. Risk Committee – responsible for overseeing the organization’s risk response and management strategies. Comprises of mix directors, maximum EDs are preferred.

- Role and functions:
  - Approving the organization’s risk management strategy and risk management policy
  - Reviewing reports on key risks prepared by business operating units, management and the board
  - Monitoring overall exposure to risk and ensuring it remains within limits set by the board
  - Assessing the effectiveness of the organization’s risk management systems
  - Providing early warning to the board on emerging risk issues and significant changes in the company’s exposure to risks

**Chairman**

- Leads the board of directors.
  - Responsible for:
  - Running the board and setting its agenda
  - Ensuring the board receives accurate & timely information
  - Ensuring effective communication with shareholders
  - Ensuring that sufficient time is allowed for discussion of controversial issues
  - Taking the lead in board development
  - Facilitating board appraisal
  - Encouraging active engagement by all the members of the board
GOVERNANCE, RISK & ETHICS

- Reporting in (chairman’s statement) and signing off accounts

Chief Executive Officer (CEO)

- Leading the management team at and below board level.
- The CEO is the senior executive in charge of the management team and is answerable to the board for its performance.
  - Responsibilities:
    - The CEO is responsible for running the organization’s business and for proposing and developing the group’s strategy and overall commercial objectives in consultation with the directors and the board.
    - The CEO is also responsible for implementing the decisions of the board and its directors and its committees, developing the main policy statements and reviewing the business’s organizational structure and operational performance.
    - The CEO will examine major investments, capital expenditure, acquisitions and disposals and be responsible for identifying new initiatives.
    - The CEO will make recommendations to the board committees on remuneration, executive remuneration and terms of employment.
    - The CEO will be responsible for managing the risk profile in line with the risk appetite accepted by the board. The CEO has ultimate ownership of the control systems and should take the lead in establishing the control environment and culture.
    - Part of the CEO’s role will be to deal with those interested in the company. The CEO will also be concerned with other major stakeholders who impact upon the company’s operations, e.g. important customers.

Chairman vs. CEO

- Chairman is appointed (recruited), whereas CEO is elected among directors.
- Chairman is part-time, whereas CEO is full-time.
- Good governance says, Chairman should be a NED, whereas CEO is an ED.

Division of responsibilities: Chairman and CEO – WHY?

- It is a matter of fact that both jobs are demanding roles and ultimately the idea that no one person would be able to do both the jobs well.
- Having the same person in both roles means that unfettered power is concentrated into one pair of hands, the board may be ineffective in controlling the chief executive if it is led by the chief executive.
- The separation of roles avoids the risk of conflict of interest.
- CEO cannot be held truly accountable for management, by the board, if it is held by the CEO.
- Directors may not be sure that the information they are getting is sufficient and objective enough to support their work as the chairman should put pressure on the CEO if he/she believes that the board is not receiving sufficient information to make informed decisions or the CEO is not providing adequate information.
- Separation enables compliance with governance best practices and hence reassures shareholders.
- Time management is a particular issue since a chief executive has operational level tasks, whereas a chairman has board related tasks.
- Above all, there are physical and mental limitations.
- Good governance suggests that separate appraisal of the performance of the Chairman and the CEO should be carried out by the NEDs, which cannot be done if they are the same.
- The case of Marks & Spencer in the UK would be of good illustration of how sensitive an issue can be if the same person is acting as CEO and chairman.

Corporate Governance Codes

- Major governance includes the UK Combined Code, the South African King report and the Singapore Code of Corporate Governance.
  1. Major governance codes – UK
i. The Cadbury Report – Corporate governance responsibilities and Code of Best Practice
   • The directors are responsible for the corporate governance of the company, including the preparation of the financial statements.
   • The shareholders are linked to the directors via the financial reporting system.
   • The auditors provide the shareholders with an external objective check on the financial statements.
   • Other concerned users, particularly employees are indirectly addressed by the financial statements.
   ➢ Provisions:
   • The BODs should meet on a regular basis and monitor executive management. Matters such as acquisitions, mergers or disposal should be automatically referred to the board.
   • The posts of Chairman and CEO should be held by different people.
   • There should be at least 03 NEDs on the board.
   • There should be an audit committee, comprising of NEDs, in the company.
   • The annual report should present a balanced and understandable assessment of the company’s position, including the company’s ability to continue as a going concern.

ii. The Greenbury Code – Remuneration Committee
   • The remuneration committee should set/determine executive directors’ remuneration, comprising solely of NEDs, and that the length of service contracts should be limited to one year.

iii. The Hampel Report – Best Practice
   • Listed companies should provide their corporate governance structure in the annual reports.
   • The accounts should explain their policies, there is a leeway if departure from best practice.

iv. The Turnbull Report – Risk Management & Internal Controls

v. The Smith Report – Audit Committee

vi. The Higgs Report – NEDs

vii. Combined Code

➢ Benefits of the UK Corporate Governance Code – Shareholders view:
   • The suggestions in respect of the AGMs are helpful to shareholders, e.g., the directors of various board committees be available at the AGMs to answer shareholders questions.
   • Another emphasis is placed on directors monitoring and assessing internal controls in the business on a regular basis, which would increase shareholder confidence.
   • With regards to directors, they are asked to submit to re-election every 03 years, make disclosure in the financial statements about their responsibilities and going concern of the company. Hence make the directors more accessible to shareholders.
   • The existence of an audit committee may also lead to shareholders having greater confidence.

2. Major governance code – South Africa
   • The King report differs in emphasis from other guidance by advocating an integrated approach to corporate governance in the interest of a wide range of stakeholders – embracing the social, environmental and economic aspects of a company’s activities. The report encourages active engagement by companies, shareholders, business and the financial press and relies heavily on disclosure as a regulatory measure.

3. Major governance code – Singapore Code of Corporate Governance
   • The Singapore Code of Corporate Governance takes a similar approach to UK’s Combined Code with the emphasis being on companies giving a detailed description of their governance practices and explanation for any deviation.
   • It requires companies to have procedures for whistle-blowing.

4. Major governance code – Sarbanes-Oxley Act (USA)
   • The Sarbanes-Oxley legislation came into existence after the Enron scandal in 2001 in USA. It adopts a rule-based approach to governance.
   ➢ Provisions:
i. PCAOB – The Public Company Accounting Oversight Board
   - The Act set up a new regulator, PCAOB, to oversee the audit of public companies that are subject to the securities law.
   - The Board has powers to set auditing, quality control, independence and ethical standards for registered public accounting firms to use in the preparation and issue of audit reports on the financial statements of listed companies. The board has also inspection and disciplinary powers over firms.

ii. Auditing Standards
   - Audit firms should retain working papers for at least 07 years.
   - As part of the audit they should review internal control systems to ensure that they reflect the transactions of the client and provide reasonable assurance that the transactions are recorded in a manner that will permit preparation of the financial statements in accordance with GAAP.

iii. Non-Audit Services
   - Auditors are expressly prohibited from carrying out services other than audit.
   - Provision of other non-audit services is only allowed with the prior approval of the audit committee.

iv. Quality control procedures
   - Audit firms should have quality control standards in place such as 2\textsuperscript{nd} partner review.
   - There should be rotation of lead or reviewing audit partners every 05 years.

v. Auditors
   - Auditors should discuss matters such as critical accounting policies, possible alternative treatments, the management letter and unadjusted differences with the audit committee.

vi. Audit committee
   - Audit committees should be established by all listed companies.
   - All members should be independent and therefore not accept any consulting or advisory fee from the company. At least 01 member should be financial expert.
   - Audit committees should be responsible for the appointment, compensation, oversight and dealing with the complaints of auditors.

vii. Corporate responsibility
   - The CEO and CFO should verify the appropriateness of the financial statements.
   - If the company has to prepare a restatement of accounts due to material non-compliance with standards, the CEO and CFO should forfeit their bonuses.

viii. Off balance sheet transactions
   - There should be appropriate disclosure of material off-balance sheet transactions and other relationships (not included in accounts but that impact upon financial conditions, results, liquidity or capital resources).

ix. Internal control reporting
   - Annual report should contain internal control reports that state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
   - Annual reports should also contain an assessment of the effectiveness of the internal control structure and procedures for financial reporting.
   - Auditors should report on this assessment.

x. Whistle blowing provisions
   - Employees of listed companies and auditors will be granted whistleblower protection against their employers if they disclose private employer information to parties involved in a fraud claim.

   ➢ Impact of Sarbanes-Oxley Act:
     - The biggest expense involving compliance that companies are incurring is fulfilling the requirement to ensure their internal controls are properly documented and tested.
     - The Act also formally stripped accountancy firms of almost all non-audit revenue streams that they used to derive from their audit clients.
     - The Act also has a significant international dimension. There were complaints from about 1500 non-US companies, whose shares are listed in the US that the new legislation conflicted with local corporate
Governance customs, and following intense round of lobbying from outside the US, changes to the rules were secured.

- Many companies delisted from US Stock markets and moved towards other markets such as LSE.
  - Criticisms of Sarbanes-Oxley Act:
    - Since America is such a significant influence worldwide, arguably SOX may influence certain jurisdictions to adopt a more rules-based approach.
    - Directors may be less likely to consult lawyers in the first place if they believe that legislation could override lawyer-client privilege.
    - The increased compliance costs and the relevant documentation associated with SOX implementation have distracted companies' form improving information flows to the market and then allowing the market to make well-informed decisions.
    - The Act is rigid and is wastage of resources, especially in time of strong competition.
    - The Act was implemented in the USA without considering the small listed companies.
    - Since it's an Act, so it has to be complied with, no leeway for explanation.
  - UK Combined Code vs. USA SOX:

<table>
<thead>
<tr>
<th>UK guidance</th>
<th>US guidance</th>
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<tbody>
<tr>
<td>All type of internal control including financial, operational and compliance</td>
<td>Internal control over financial reporting</td>
</tr>
<tr>
<td>Smith report states this should consist of independent NEDs, at least 01 having relevant and recent financial experience</td>
<td>Should consist of independent directors, one of whom should be a financial expert</td>
</tr>
<tr>
<td>Ethical guidance states lead audit partner should be rotated at least every 05 years, other key audit partners at least every 07 years</td>
<td>Rotation of lead partner required every 05 years</td>
</tr>
<tr>
<td>No equivalent guidance</td>
<td>Companies should adopt a code of ethics for senior financial officers</td>
</tr>
<tr>
<td>Audit committee should review non-audit services provided by auditor to ensure auditor objectivity and independence is safeguarded.</td>
<td>Auditors forbidden by law from carrying out a number of non-audit services</td>
</tr>
<tr>
<td>Accountability bodies state that executing transactions or acting in management is not compatible with being an objective auditor.</td>
<td>Other services (custody, preparing accounting records) cast doubts on objectivity</td>
</tr>
<tr>
<td>Accountants should include statement of responsibility of management for internal controls. Also disclosure that there is a process for identifying, evaluating and managing risks and how board has reviewed this</td>
<td>Accountants should include statement of responsibility of management for internal controls and financial reporting and accounts should also include audited assessment of financial reporting controls</td>
</tr>
<tr>
<td>Under UK legislation directors are required to state in directors’ report that there is no relevant audit information that they know and that auditors are unaware of</td>
<td>Certification of appropriateness and fair presentation of accounts by CEO and CFO</td>
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</table>

International guidelines/governance code

1. OECD – Organization for Economic Co-operation and Development
   - It is an international guideline based on an extensive consultation with member countries, and developed a set of principles that countries and companies should work toward achieving.
   - The OECD has stated that its interest in corporate governance arises from its concern for global investment. Having a common set of accepted principles is a step towards achieving this aim.
   - The principles set by OECD are non-binding and are to provide assistance to governments, institutional and regulatory framework for corporate governance in their countries.
Principles – grouped into 05 broad areas:

i. The rights of shareholders

- Right to participate and vote in general meetings of the company, elect and remove members of the board.
- Right to obtain relevant and material information on a timely basis.

ii. The equitable treatment of shareholders

- All shareholders of the same class of shares should be treated equally.

iii. The role of stakeholders

- Rights of stakeholders should be protected, access to relevant information on a regular and timely basis.
- Stakeholders should be able to freely communicate their concerns about legal or ethical issues.

iv. Disclosure and transparency

- Timely and accurate disclosures must be made of all material matters regarding the company.
- The company’s approach to disclosure should promote the provision of analysis or advice that is relevant to decisions by investors.

v. The responsibilities of the board

- The board is responsibility for the strategic guidance of the company and for the monitoring of management.
- Board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interests of the company and its shareholders.
- The board should treat all shareholders fairly and exercise independent judgment in assigning independent NEDs to appropriate tasks.

2. ICGN Report – International Corporate Governance Network

- Its aim is to enhance the guidance produced by the OECD.
- The purpose is to provide practical guidance for boards to meet expectations so that they can operate efficiently and compete for scarce capital effectively. The ICGN believes that if investors and companies establish productive communication on governance issues, the prospects for economic prosperity will be enhanced.

- 04 Broad areas:

  i. The Board

- The structure of boards will depend on national models
- Boards should be responsible for guiding corporate strategy monitoring performance and etc.
- Directors should have appropriate skills, knowledge and experience, demonstrate independent judgment and fulfill their fiduciary duties.
- Directors should be re-elected at least once every 03 years.
- Chairman should not be the former CEO and committees should be established.
- There should be a formal process for evaluating the work of the board and individual directors.

  ii. Shareholders

- Companies should act to protect shareholders’ rights to vote. Shareholders should be able to vote on removing individual directors and auditors. Shareholders should have the right to put resolutions that are advisory or binding on a board of directors.
- Major changes to shareholders wealth or shares should not be made without prior approval of shareholders.
- Institutional shareholders should be able to discharge their fiduciary duties to vote and consult with management.
- Shareholders should be able to take action against inequitable treatment.

  iii. Audit and Accounts

- The company should aim to excel in the financial returns it achieves.
- There should be full disclosure of ownership, voting rights and etc.
- The audit committee should oversee the company’s relationship with the external auditor.

iv. Ethics and Stakeholders
Corporations should implement a code of ethics and conduct their activities in an economically, socially and environmentally responsible manner.

The board is responsible for determining, implementing and maintaining a culture of integrity.

Companies should have procedures for monitoring related party transactions and conflicts of interest.

The board should be responsible for managing successful and productive relationships with the corporation’s stakeholders.

- **Significance of international codes:**
  - Codes like OECD or ICGN represent international consensus.
  - Although these codes are not binding, but there principles are implemented on a national level by some countries.
  - The OECD principles have also been used by World Bank for assessing corporate governance frameworks and practices in individual countries.

- Compliance costs for companies operating in many jurisdictions will decrease if international codes are followed at national level.

- The development of international codes should also be seen in the context of the development of robust financial reporting rules.

- **Limitations of international codes:**
  - International principles represent a lowest common denominator of general, fairly bland, principles.
  - Any attempt to strengthen the principles will be extremely difficult because of global differences in legal structure, financial systems, ownership structures, culture and economic factors and much more.
  - As international guidance has to based on best practice in a number of regimes, development will always lag behind changes in the most advanced regimes.
  - The codes have no legislative power, so non-binding.

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Exam Focus Point: Although you can quote from local or international codes when answering questions, the examiner has recommended that all P1 students should read the Corporate Governance Code.

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**Reporting on corporate governance**

- It is considered a best practice to state whether the organization has compiled with governance regulations and codes, give specific disclosures about the board, internal control reviews, going concern status and relations with stakeholders.

- The emphasis in principles-based corporate governance is on complying or explaining.

- The LSE requires the following general disclosures:
  - A narrative statement of how companies have applied the principles set out in the UK Corporate Governance Code, providing explanations which enable their shareholders to assess how the principles have been applied.
  - A statement as to whether or not they complied throughout the accounting period with the provisions set out in the UK Corporate Governance Code. Listed companies that did not comply throughout the accounting period with all the provisions must specify the provision with which they did not comply, and the reasons for non-compliance.

- **Reporting requirements:**
  - The corporate governance reports suggest that the directors should explain their responsibility for preparing accounts. They should report that the business is a going concern, with supporting assumptions and qualifications as necessary.

- Further statements may be required depending on the jurisdictions, such as:
  - Information about the BODs
  - Brief reports on the committees
  - An explanation of Directors’ and auditors’ responsibilities in relation to accounts
  - Information about relation with auditors
  - The strategy for delivering the objectives of the company
  - A statement on relations and dialogue with stakeholders
  - A statement that the company is a going concern
A statement that the directors have reviewed the effectiveness of internal control
- Sustainability reporting
  - Voluntary disclosure:
    - Examples include a CEO’s report, a social/environmental report, CSR report, additional risk or segment data.
    - Advantages of voluntary disclosure:
      - Disclosures covering wider areas should give stakeholders a better idea of the environment. This should enable investors to carry out a more informed analysis of the strategies the company is pursuing, reducing information asymmetry between directors and shareholders.
      - Voluntary information can be focused on future strategies and objectives, giving readers a different perspective to compulsory information.
      - The voluntary disclosures a company makes can be determined by consultations with major equity investors such as institutional shareholders on what disclosures they would like to see in the accounts.
      - Voluntary information provides investors with further yardsticks to judge the performance of management. Its disclosure demonstrates that managers are actively concerned with all aspects of the company’s performance.

SUGGESTIONS AND FEEDBACK APPRECIATED

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