

عرض لمقدمة دراسة وتوضيح سبب اختيارها مع الإشارة الى
اهم ما يجب أخذه بالاعتبار عند كتابة المقدمة.
بالإضافة الى كتابة مشكلة بحثية

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مهارات بحثية 3



سوف نستعرض معكم المقدمة
والبنود المرتبطة بها

Chapter
03

مقدمة:

الدراسة المختارة: Corporate Governance in Saudi Arabia: Overview and Empirical Investigation
الباحثة: PhD – Victoria University – Australia – 2006 - Khalid Hamad Al-Turki

- تم اختيار مقدمة هذه الدراسة للأسباب التالية:
- لأنها تقدم خلفية واضحة عن موضوع حوكمة الشركات في المملكة.
 - توضح السياق التشريعي والتنظيمي الذي نشأت فيه المشكلة البحثية.
 - تربط بين الأدبيات العالمية والسياسات المحلية.
 - تحدد نطاق الدراسة بوضوح.

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تحليل عناصر المقدمة وفقاً لما ورد في المحاضرة:

نجد أن المقدمة تضمنت:

* تحديد المشكلة

- تمت الإشارة إلى ضعف تطبيق آليات الحوكمة في البيئة السعودية آنذاك.

* أهمية المشكلة

- تم توضيح أهمية الحوكمة في تحسين الشفافية وتقليل تعارض المصالح.

* عرض الدراسات السابقة

- استعرضت المقدمة الأدبيات الغربية وربطتها بالواقع السعودي.

* تحديد الأهداف

- أوضحت أن الهدف هو دراسة واقع الحوكمة واختبار أثرها تجريبياً.

أرى أنه كان يمكن إبراز الفجوة البحثية بصورة أكثر تحديداً وربطها مباشرة بالسؤال البحثي.

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صياغة مشكلة بحثية

* العنوان المقترح: أثر نضج الحوكمة الاستراتيجية على جودة الأداء المؤسسي في المؤسسات غير الربحية السعودية
* صياغة المشكلة:

شهدت المؤسسات غير الربحية خلال السنوات الأخيرة توسعا ملحوظا في حجم الأنشطة والموارد المالية، بالتزامن مع تطورات تنظيمية تهدف إلى تعزيز مبادئ الحوكمة والشفافية والمساءلة. ورغم وجود أطر تنظيمية واضحة .. إلا أن مستوى تطبيق الحوكمة الاستراتيجية يختلف من مؤسسة لأخرى، سواء من حيث وضوح الأدوار، أو فاعلية مجلس الإدارة، أو وجود أنظمة رقابية داخلية فعالة. تكمن المشكلة في أن العديد من المؤسسات تلتزم شكليا بمتطلبات الحوكمة، دون أن ينعكس ذلك بالضرورة على جودة الأداء المؤسسي أو تحقيق الأثر الاستراتيجي المستدام. كما أن الدراسات المحلية ركزت غالبا على الجوانب التنظيمية أو الامتثال النظامي، دون تحليل العلاقة بين نضج الحوكمة الاستراتيجية ونتائج الأداء الفعلية.

بناءً على ذلك، تتمثل مشكلة الدراسة في التساؤل التالي:
إلى أي مدى يؤثر مستوى نضج الحوكمة الاستراتيجية في المؤسسات غير الربحية السعودية على جودة الأداء المؤسسي؟

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استكمال - صياغة مشكلة بحثية

- وينبثق عن السؤال السابق تساؤلات فرعية تتعلق بـ:
 - مدى وضوح الأدوار والمسؤوليات.
 - مستوى استقلالية مجلس الإدارة.
 - فاعلية أنظمة الرقابة الداخلية.
 - انعكاس ذلك على مؤشرات الأداء المؤسسي.

تهدف هذه الدراسة إلى سد فجوة معرفية تتعلق بربط الحوكمة بالأداء الاستراتيجي في القطاع غير الربحي السعودي، وتقديم إطار تحليلي يمكن أن يساهم في تحسين جودة الممارسات الإدارية.

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متطلبات المقدمة:

- أهم ما يجب أخذه في الاعتبار عند كتابة مقدمة الدراسة:
- أن تكون المقدمة مناسبة في الطول.
- أن تثير القارئ للمشكلة دون حسمها بالكامل
- أن توضح المجال الذي تنتمي إليه المشكلة.
- أن تتصل مباشرة بعنوان الدراسة.
- أن تبرز الفجوة المعرفية بوضوح.
- أن تبين أهمية الدراسة والجهات المستفيدة منها.
- أن تكون مترابطة منطقيًا ومتدرجة من العام إلى الخاص.
- أن تستعرض الجهود السابقة دون إسهاب.

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الخاتمة:

يتضح من خلال هذه المهمة أن مقدمة الدراسة تمثل الأساس الذي يُبنى عليه البحث العلمي، إذ تُهيئ القارئ لفهم المشكلة وتبرز أهميتها والفجوة المعرفية المرتبطة بها. كما أن وضوح المشكلة وتحديد الأهداف بدقة يعكس وعي الباحث ومنهجيته في معالجة موضوعه. وعليه .. فإن إتقان كتابة المقدمة البحثية يعد خطوة جوهرية لضمان اتساق الدراسة وقوتها العلمية، ويُعد مؤشراً على نضج الباحث وقدرته على صياغة بحث منظم ومترابط.

شاكر لكم جهودكم .. والسلام عليكم ورحمة الله وبركاته



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FACULTY OF
BUSINESS & LAW

School of Accounting & Finance

**CORPORATE GOVERNANCE IN SAUDI
ARABIA: OVERVIEW AND EMPIRICAL
INVESTIGATION**

A Thesis Submitted for the Degree of

DOCTOR OF PHILOSOPHY

At
Victoria University

By

KHALID HAMAD AL-TURKI

BSc. In Accounting, King Saud University (Saudi Arabia)
MAcc (Master of Accountancy), Gonzaga University (U.S.A.)

2006

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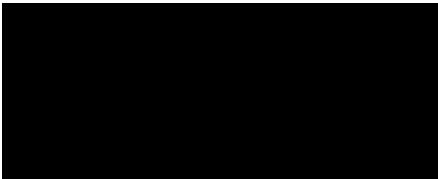
**BSc. In Accounting, King Saud University (Saudi Arabia)
MAcc (Master of Accountancy), Gonzaga University (U.S.A)**

2006

DECLARATION

This work has not previously been accepted in substance for any degree and is not being concurrently submitted in candidature for any degree. This thesis is the result of my own investigations, except where otherwise stated. Other sources are acknowledged giving explicit references. A bibliography is appended.

Signed

A black rectangular box redacting the signature of the candidate.

(Khalid Al-turki – Candidate)

Date

15-11-06

DEDICATION

**This Thesis Is Dedicated With All My Love And Respect
To My Parents, My Brother, My Sisters, My Wife And My
Beloved Children, Tala, Hamad and Alwaleed**

ACKNOWLEDGEMENT

I am grateful to Allah almighty for his guidance and blessings of my efforts during the course of this study.

Then, I wish to express my special appreciation to a number of individuals and organizations that have invaluable contributed to this thesis.

First, special thanks go to my supervisor, Professor Robert Clift, to whom I owe greatly for his sustained interest and help as well as friendly encouragement during my study at Victoria University, Melbourne.

Second, I would like to extend my deepest gratitude to the government of Saudi Arabia for the financial assistance provided by King Saudi University (Al-Qassim University, hereafter) without which this thesis would never have been written.

Third, I would like to stress my gratitude to all members of the College of Economics and Administration (my home college) for their continuous support. Sincere thanks go to Dr Obaid Al-Motairy, Head of Accounting Department, for his kindly support and encouragement, and all members of the Accounting Department.

Fourth, special thanks go to all those who helped me in the course of my fieldwork in Saudi Arabia to gather the needed data for this study.

Most importantly, I would like to emphasise the heartfelt debt I owe to my mother and father for their love, prayer, encouragement and support, and to all my family members in Saudi Arabia for their encouragement and moral support.

Very lovely thanks are due to my beloved family here with me in Australia, to my lovely wife for her care, patience and understanding. She sacrificed a great deal and worked so hard to provide the right environment for the success of my research. My love also goes to my children, Tala, Hamad and Alwaleed, who gave me enormous joy and pleasure by just being here.

ABSTRACT

The primary objectives of this thesis are: (i) to review the ongoing practices of corporate governance in six developed and emerging markets that represent a broad and diverse sample that varies in terms of historical, legal, economic and cultural systems; (ii) to assess comprehensively the effectiveness of corporate governance in a unique developing country, Saudi Arabia; and (iii) to identify whether there are significant differences in the perceptions among the involved four samples (board of directors' members, chief executive officers 'CEOs', audit committee members and shareholders) towards the four mechanisms of corporate governance investigated in this study, namely: shareholders' rights; board of directors; audit committees and internal audit; and disclosure and transparency.

A mail-out questionnaire methodology was used. The populations in this study have been divided into two categories: (i) the entire board of directors' members, chief executive officers and audit committee members of the 71 listed Saudi joint stock companies; and (ii) 400 randomly selected shareholders.

Saudi joint stock corporations generally were found to be doing relatively well in allowing shareholders to exercise some shareholders' rights such as secure registration, sharing in profits and participating in general meetings. Minority shareholders, however, seem to encounter difficulties in understanding their rights, calling special shareholders' meetings, putting issues on meeting agendas, obtaining timely information and taking little part in the process of selecting directors. The size and composition of boards varied widely among Saudi joint stock corporations. The boards were generally weak in performing some of their functions and the independence of independent directors was questionable. They also tend not to have independent board committee for remuneration and nomination. Although the existence of an audit committee was mandatory in all listed Saudi corporations, the number of members in those committees was less than four. Virtually all the audit committees had accounting or finance specialists; are chaired by an independent director; take minutes of committee meetings; and had written rules governing the overall audit function. Audit committees, however, were weak in approving the appointment and replacement of the internal audit head and in discussing with him related matters; reporting on audit committee's activities provided at annual shareholder meeting; and accessing relevant information. Sample firms performed relatively poorly in the areas of information disclosure and transparency, particularly in relation to matters such as disclosing material foreseeable risk factors, providing channels for disseminating information for fair, timely and cost-efficient access to relevant information by users, disclosing governance structures, disclosing the remuneration of the board members and disclosing the financial and operating results of the company in the English language. Firms also were not yet making full use of web sites to disclose information in a timely fashion and to enhance transparency.

The mean values of the responses obtained from the first two samples (board of directors and CEOs) were higher than the mean values of the responses obtained from the last two samples (audit committee members and shareholders). That was a clear indication that the board of directors' members and the chief executive officers were more confident about the effectiveness of corporate governance in Saudi joint stock corporations than the audit committee members and the shareholders.

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CHAPTER ONE:

INTRODUCTION

1.1. BACKGROUND

The subject of corporate governance has attracted increasing attention on both sides of the Atlantic in recent years (Aguilera and Jackson, 2003). Corporate governance is now the subject of much discussion in boardrooms, classrooms and the media (Cheffins, 1999).

Corporate governance received more attention due to a series of corporate failures that affected not only those directly connected with the companies concerned (i.e., directors, shareholders and auditors) but also those affected by its existence like employees, customers, suppliers and the environment. The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in England (Iskander et al., 1999).

The Asian financial crisis, which started with the devaluation of the Thai baht in July 1997, brought to the foreground the common occurrence of weak corporate governance which had allowed companies to engage in excessive over-leverage, some of which were aided by implicit state guarantees. The concepts of transparency, disclosure and accountability were largely ignored in the lead-up to the crisis as investors assumed a short-term outlook in order to derive increasing profits from the steadily rising regional financial markets.

The issue transcends national boundaries. Both the United States and Europe have had their share of questionable management decisions leading to the loss of billions of dollars, including Enron Corp. and Long Term Credit Management in the United States and Morgan Grenfell in Europe (Chambers, 2002). Australia has also not been immune as evident from the recent collapses of One.Tel Ltd and HIH Insurance Limited, a telecommunications and an insurance company, respectively. These are but a few of the more recent well documented cases that highlight the increasing importance of effective corporate governance. The financial crises in Asia,

Russia, United States and Australia, amongst others, have shown that a lack of regard for core values of corporate governance does have a negative impact globally. Countries, markets and companies that have not been able to survive or that have fared badly in a crisis have one thing in common: poor corporate governance standards (Keong, 2002). Those financial crises showed that even strong economies lacking transparent control, responsible corporate boards and shareholder rights collapse quite quickly as investor's confidence erodes.

Empirical evidence (Fremond et al., 2002) suggests that good corporate governance increases the efficiency of capital allocation within and across firms, reduces the cost of capital for issuers, helps broaden access to capital, reduces vulnerability to crises, fosters savings provisions and renders corruption more difficult.

A careful study of corporate governance is important at the present time in Saudi Arabia because the future will be even more competitive than it is now. In emerging market economies the business environment lacks many elements needed for a competitive market and a culture of enforcement and compliance (Iskander et al., 1999). Saudi Arabia needs to take a long hard look at the way other countries' systems work and keep their own under review.

To remain competitive in a changing world, Saudi corporations must innovate and adopt their corporate governance practices so that they can meet new demands and new opportunities. The Saudi government also has an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow the Saudi market to function effectively and to respond to expectations of shareholders and other stakeholders. The way these principles should be adopted is the responsibility of the government and the market participants.

1.2. OBJECTIVES OF THE STUDY

The main aims of this thesis are: (i) to review the ongoing practices of corporate governance in six developed and emerging markets that represent a broad and diverse sample that varies in terms of historical, legal, economic and cultural systems; (ii) to assess comprehensively the effectiveness of corporate governance in a

unique developing country, Saudi Arabia; and (iii) to identify whether there are significant differences in the perceptions among the involved four samples (board of directors' members, chief executive officers, audit committee members and shareholders) towards the four mechanisms of corporate governance investigated in this study, namely: shareholders' rights; board of directors; audit committees and internal audit; and disclosure and transparency.

Saudi is a unique developing country because: (i) little is known about corporate governance in this country since this thesis, to the author's best knowledge, is the first to assesses comprehensively corporate governance practices in Saudi Arabia; (ii) Saudi Arabia has never had typical institutions (outside influences) of corporate governance, has never had a Code of corporate governance best practices and has never adopted the Principles of Corporate Governance that have been developed by the Organization of Economic Cooperation and Development (OECD) (1999, 2004), the International Monetary Fund (IMF), the World Bank and others; (iii) the influence of Islam, given that Saudi Arabia is the heartland of Islam, the birthplace of its history, the site of the two holy mosques and the focus of Islamic devotion and prayer.

This thesis is among the few comparable studies that have been conducted using developing or transition country data to analyse corporate governance systems and one which will add to the growing pool of scattered cross-country evidence. Example studies in the literature investigating corporate governance in developing countries are those with respect to Russia (Blasi and Shleifer, 1996; Black, 2001), Czech and Slovak Republics (Claessens, 1997; Claessens et al., 1996), China (Xu and Wang, 1997), a cross-section of transition economies (Aoki and Kim, 1995; Gray and Hanson, 1993), India (Chhibber and Majumdar, 1999; Khanna and Palepu, 1998; Sarkar and Sarkar, 1999; CII, 1998; Choudhury, 1999), Korea (Black, Jang and Kim, 2003) and others.

The assessment of the effectiveness of corporate governance is the outcome of the assessments of four corporate governance mechanisms, namely: shareholder rights; board of directors; audit committees and internal audit; and disclosure and transparency. As the intensity of adoption of these mechanisms in the Saudi publicly

traded, joint stock, corporations increases corporate governance becomes more effective.

In other words, it is an objective to provide evidence from a developing and emerging Islamic economy, Saudi Arabia, on the role of shareholders, board of directors, audit committees and disclosure and transparency in enhancing the effectiveness of corporate governance in the Saudi joint stock corporations.

The characteristics of the four mechanisms of corporate governance being discussed in this thesis will be adopted from the recommendations of some international organizations such as the Organization of Economic Cooperation and Development (OECD) (1999, 2004), the International Monetary Fund (IMF), the World Bank, the Treadway Commission (1987), the Cadbury Committee (1992), the Blue Ribbon Committee (1999), The International Corporate Governance Network (ICGN) and other recommendations. However, more emphasis will be given to the OECD (1999, 2004) Principles of Corporate Governance since the OECD Principles have been widely accepted by many countries, organizations and regulators around the world and because the Principles were intended to assist non-members, too, as it has been stated by the OECD (1999: p.11) that;

The Principles are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.

The International Corporate Governance Network (ICGN) in their Statement on Global Corporate Governance Principles that was adopted in 1999 applauds the OECD Principles as a declaration of minimum acceptable standards for companies and investors around the world. The ICGN (1999: p.1) stated:

The ICGN applauds the OECD Principles as a declaration of minimum acceptable standards for companies and investors around the world. Much of the document reflects perspectives promoted by ICGN representatives serving on the OECD's Ad Hoc Task Force on Corporate Governance, relying on the draft principles under discussion at the ICGN. The ICGN welcomes the OECD Principles as a remarkable convergence on corporate governance common ground among diverse interests, practices and cultures.

The World Bank also assists its client countries in the assessment of their corporate governance institutional frameworks and practices by preparing country corporate governance assessments using the OECD (1999) as a benchmark. The activities of the World Bank in corporate governance focus on the rights of shareholders, the equitable treatment of shareholders, the treatment of other stakeholders, disclosure and transparency and the duties of board members.

Since the publication of the OECD Principles in 1999, they have become the most widely accepted corporate governance benchmark and have influenced the drafting of other codes issued by international organizations, countries, companies and stock exchanges. Therefore, as has been said earlier, a special emphasis will be given to these principles as a benchmark to the Saudi corporate governance practices.

1.3. CONTRIBUTION TO KNOWLEDGE

This thesis differs from the related literature in several ways: by investigating the effectiveness of corporate governance; firm-level issues; all listed Saudi firms; no typical institutions (outside influences) of corporate governance; and religion effects.

First, most of the empirical literature on corporate governance has focused on the relationship between corporate governance and performance (Durnev and Kim, 2002; Klapper and Love, 2002; and Gompers et al., 2003), shareholder rights and performance (Holthausen et al., 1999; and Claessens et al. 2002), board of directors and performance (MacAvoy et. al., 1983, 1999; Black, 2000; and Burton, 2000), audit committee and performance (Wild, 1994; Klein, 2002; Vafeas and Theodorou, 1998) and disclosure and transparency and performance (Leuz et al. 2000; and Healy et al. 1999)

However, few authors have investigated the effectiveness of corporate governance and its elements discussed in this study, namely: shareholder rights, board of directors, audit committees and disclosure and transparency. In the Saudi Arabia case, it was thought to be too early to link corporate governance to firm performance because corporate governance in Saudi is still developing. Moreover, Saudi Arabia has not adopted any international recommendations or principles and, furthermore, Saudi has not yet produced its own best practices of corporate governance. Corporate

governance in Saudi Arabia seems to be weak and the focus at this stage should be towards assessing corporate governance practices, helping regulators, organizations and corporations in understanding what has been meant by good corporate governance and providing the Saudi economy with some recommendations to develop and enhance corporate governance.

Second, previous authors have shown that better legal protection for investors is associated with higher valuation of listed firms relative to their assets or changes in investments (Claessens et al., 2002; La Porta et al., 2002; Wurgler, 2000), higher market value (La Porta et al., 1997) and larger listed firms in terms of their sales and assets (Kumar et al., 1999). Rajan and Zingales (1998) and Demirgüç-Kunt and Maksimovic (1998) also found that industries and firms that had better legal protection for investors rely more on external financing to fund their growth. Although these studies provide valuable insights into the effects of regulatory environments on stock markets, valuation and corporate financing, they do not address firm-level issues such as how corporate governance affects individual firm valuation within a country and they do not assess the effectiveness of corporate governance mechanisms.

Third, the data source for this study is all listed Saudi firms, both large and small, which enhances the generalizability of this study. The other researchers on emerging markets, however, either use a small single-country sample (Black, 2001) or multi-country samples that contain only the largest firms in each country (Durnev and Kim, 2002; Klapper and Love, 2002).

Fourth, the most widely known guidelines and principles of corporate governance are those developed by three international organizations, namely, the World Bank, the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development Principles of Corporate Governance (OECD) (PCSU, 2000). Countries adopting corporate governance rules more or less follow the standards set by those organizations. However, Saudi Arabia is not one of these countries and does not adopt or follow any of these organizations. Although some authors have investigated corporate governance in developing markets, this study will be the first to investigate how good corporate governance is in a developing

country that does not adopt the corporate governance principles and does not have typical institutions (outside influences) of corporate governance.

Finally, this study could be classified as the first study investigating how religion (Islam) affects the adoption of such principles. Islam guides not only the lives of the people, but also the policies and functions of the government, which, in turn, regulate and impose corporate governance.

1.4. RESEARCH METHODOLOGY

The research methodology is a very important step in the research design process. The use of a particular methodology for a research project depends on the scope, purpose, target, population, etc. of the study as well as the resources available to the researcher. It is essential, therefore, that in order to achieve their objectives, researchers adopt the right methodology and select the right data collection techniques through which they can collect the required data within their available resources (Gill and Johnson, 2002).

In the process of the construction of the methodology, the author considered various factors that best reflect corporate governance practices in Saudi Arabia. The choice of the variables is based on the corporate governance mechanisms, namely: shareholders' rights, board of directors, audit committees and internal audit and disclosure and transparency.

Survey methodology currently is the most common approach used in a variety of fields ranging from economics and political science to environmental studies, marketing research, voting behaviour and health, among others, to study empirically the characteristics and interrelations of sociological and psychological variables (Roberts, 1999; Marsh, 1982; Young, 1996). The great advantage of this method is that it allows us to measure the attitudes and behaviours of large populations (e.g., country, state or city) by questioning a relatively small number of people, who are chosen through statistical/probabilistic procedures. Surveys, indeed, provide an efficient and economical means of determining facts about the economy and about people's attitudes, expectations and behaviours.

One of the most critical decisions in many social research investigations is the selection of the appropriate type of survey. However, the researcher has chosen the mail-out questionnaire survey method as the best method for this study relying on very few simple rules that made this decision easier. The researcher has used this judgment to balance the advantages and disadvantages of different survey types. In the decision process, the researcher asked a number of questions that guided this decision (see Chapter 6: Section 6.4.1).

The populations in this study have been divided into two categories: the entire (71) listed Saudi joint stock companies and 400 randomly selected shareholders. The subjects have also been classified into four groups: board members; chief executive officer CEO; audit committee members; and shareholders.

All questions in this instrument were constructed according to the Five-Point Likert Scale with a value of 1 indicating that the respondent strongly disagrees with a factor or statement and the highest number, 5, indicating that the respondent strongly agrees with a factor or statement based on the actual practice. The use of the standardised questions in this study allowed the findings from a number of respondents to be summarised, and this was also facilitated by the use of questions, which are amenable to numerical analysis such as rating scales. The Likert scale allows the respondent to choose one of five degrees of feeling about a statement from strong approval to strong disapproval. The questions were in the form of statements that seemed either definitely favourable or definitely unfavourable toward the matter under consideration.

The questionnaire has been divided into four parts, namely: shareholder rights, board of directors, audit committee and internal audit and disclosure and transparency, preceded by some short demographic (general) questions in order to provide sufficient motivation for the respondents to complete and to reduce the possibility of boredom which might induce the respondent to give up. The demographic questions have also been used in this questionnaire to break down the data when the survey was complete.

The pilot test was conducted to assure the clarity and effectiveness of the survey questions and to test the reliability and validity in order to revise the survey

prior to final administration. To determine the effectiveness of the present survey questionnaire, the author pre-tested it before actually using it. The pilot test helped to determine the strengths and weaknesses of the survey concerning question format, sequence, wording, order, layout, validity, reliability and other matters.

Validity and reliability, the two major issues that a researcher must take into consideration when he or she uses a data gathering or measurement instrument, have been checked. The validity determines whether the research truly measures that which it was intended to measure or how truthful the research results are. In other words, does the research instrument allow the researcher to hit "the bull's eye" of the research objective. Reliability, on the other hand, is concerned with the accuracy and precision of a measurement procedure.

1.5. LIMITATIONS OF THE STUDY

The study has several limitations that should be taken into consideration at all levels of the research and analysis. First, the study was intended to evaluate the effectiveness of corporate governance in the Saudi joint stock corporations based on four mechanisms of corporate governance, namely: shareholders' rights, board of directors, audit committees and internal audit and disclosure and transparency. Other mechanisms that may be related to the effectiveness of corporate governance were not considered.

Second, the study focuses on the effectiveness of corporate governance of Saudi joint stock corporations. It does not deal with proprietorships, partnerships and close-held companies.

Third, the survey questionnaire reflects only the views, experiences and opinions of the targeted groups (board of directors, chief executive officers, audit committee members and shareholders) in Saudi joint stock corporations, which were restricted by the choice of questions used.

Fourth, the ANOVA test was based on an overall mean of a number of variables used for each corporate governance mechanism. Hence, the researcher is treating each variable as being of equal importance which might be debatable.

Fifth, any generalisation derived from the study's results is restricted to Saudi Arabia; cultural differences, social, accounting, corporate governance and investment environment distinctiveness from other countries may prevent wider generalisations.

Sixth, although tests for non-response bias were carried out using firm characteristics of industry and category of respondent and using late responses as a proxy for non-responses, the research lacks some other explicit controls for responder bias such as 'social desirability response bias'. Finally, other difficulties encountered in the study will be noted throughout the remaining chapters.

1.5. OUTLINE OF THE REMIANING CHAPTERS

This thesis is organized into nine chapters. The present chapter provides a background of the study, the objectives, research methodology and limitations of the study.

Chapter 2 provides an overview to corporate governance, including: definition of corporate governance; who sets corporate governance; the trends in corporate governance in a number of developed and developing countries, with emphasis that corporate governance of a particular country reflects its history, culture, regulatory structures and capital market characteristics.

Chapter 3 provides a background on the Saudi Arabian economy and development of corporate governance in the country by: discussing the development of the Saudi economy, highlighting the country's constitution, legislation and five-year development plans; providing some important facts relating to the Saudi Arabian oil and non-oil economy; clarifying that Saudi Arabian corporate governance is governed by four bodies: the Ministry of Commerce, the Saudi Arabian Monetary Agency (SAMA), the Saudi Stock Exchange (Tadawul) and some professional bodies; and explaining how Islam effects corporate governance in Saudi.

Chapter 4 investigates four mechanisms for effective corporate governance in Saudi Arabia. The chapter starts by developing a "four-legged chair" model that supports responsible, reliable, fair, accountable and transparent corporate governance system. Shareholders, board of directors, audit committees and disclosure and

transparency are the four legs of the chair, supporting the one top goal of producing an effective corporate governance system in a firm.

Chapter 5 provides an overview of the theories, hypotheses and the literature that have been conducted in the field of corporate governance. The author relies on two related theories: the no one size fits all theory and the agency theory. The chapter finally introduces the hypotheses involved with this research.

Chapter 6 focuses on the methodology used to examine the effectiveness of corporate governance in Saudi Arabia. The chapter starts by providing different types of research methodologies and then concludes that the written survey method was the most appropriate methodology to be used in this study. Some characteristics, rules, ethics, strengths and weaknesses of survey research methodology were also discussed. The chapter is then divided into six major sub-sections, each of which discusses a different major step in administering the survey methodology used in this thesis.

The results of the study are detailed in Chapters 7 and 8. The analysis in the seventh chapter concentrates on the exploratory data analysis focusing on univariate and bivariate data analyses. The author looks at four main groups of techniques when considering the exploratory data analysis approach, which are frequencies, cross-tabulation, measuring location (central tendency) and measuring dispersion (spread). Chapter 8 relates to the hypotheses testing which could be referred to the second type of analysis, the confirmatory data analysis.

Chapter 9 presents a brief summary of the overall study and highlights its findings. Furthermore, a number of recommendations and suggestions for further research are provided.

CHAPTER TWO:

CORPORATE GOVERNANCE OVERVIEW

2.1. INTRODUCTION

In our new millennium, the world is experiencing an unprecedented transition. The winds of sweeping changes have been reshaping the world politics, economies, environment, culture, and many other aspects. The end of the Cold War and the ensuing proliferation of the market economy, the resurgence of the world economic prowess, the economic conglomeration of Europe, the rise, fall and recovery of some economies, the rapid advancement in technology and the explosion of e-commerce are some of the highlighted events the world has been witnessing over recent decades. One of the significant implications of all these changes is that they pose a big challenge to business enterprises, particularly for those in developing countries and large global corporations that operate beyond national borders and play multiple functions with increasing power and influence. (Vernon, 1971; Ohmae, 1990; Korten, 1996; Karliner, 1997; Morss, 1997; and Clarke, 1998).

Monks and Minow (1995) defined a corporation as a mechanism established to allow different parties to contribute capital and expertise, for the maximum benefit of all of them. Oliver et al. (2003) suggested that corporations be governed by a system of checks and balances to make sure that their actions do not incur losses to the shareholders and stakeholders.

Corporations exist in different cultures with different norms and standards. It is therefore critical to recognize that managers, employees, business partners and other corporate stakeholders make decisions and choices that draw upon their cultural background and identity-group perspectives (Thomas and Ely 1996). The corporate governance of a particular country reflects its history, culture, regulatory structures and capital market characteristics (Keong, 2002). As a Saudi

academic, this thesis will be about a system by which companies are directed, controlled and operate in Saudi Arabia.

In this chapter, an overview of corporate governance is carried out including: definition of corporate governance; who sets corporate governance; and the trends in corporate governance in a number of developed and developing countries.

2.2. DEFINITION

The etymology of “governance” comes from the Latin words *gubernare* and *gubernator*, which refer to steering a ship and to the steerer or captain of a ship. The word “governance” comes from the old French “gouvernance” and means control and the state of being governed (Farrar, 2001).

Corporate governance has succeeded in attracting a good deal of public interest because of its importance for the economic health of corporations and the welfare of society, in general. However, the concept of corporate governance is defined in several ways because it potentially covers many activities having direct or indirect influence on the financial health of corporate entities. As a result, different people and organizations have presented different definitions, which basically reflect their special interests in the field.

Milton Friedman (2002), an economist and Noble laureate, said that corporate governance is to conduct the business in accordance with owners or shareholders’ desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs. This definition is based on the concept of market value maximization that underpins shareholder capitalism.

The Organization for Economic Co-operation and Development (OECD) (1999) defined corporate governance as the system by which business corporations are directed and controlled. According to them the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, and spells out the rules and

procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and also provides the means of attaining those objectives and monitoring performance.

The World Bank (1999) defined corporate governance from two different perspectives. From the standpoint of a corporation the emphasis is put on the relationships between the owners, management board and other stakeholders (the employees, customers, suppliers, investors and communities). Major significance in corporate governance is given to the board of directors and its ability to attain long-term, sustained value by balancing these interests. From a public policy perspective, corporate governance refers to providing for the survival, growth and development of the company, and at the same time its accountability in the exercise of power and control over companies. The role of public policy is to discipline companies and, at the same time, to stimulate them to minimize differences between private and social interests (World Bank, 1999).

Monks and Minow (2001: p.1) defined corporate governance

(Corporate governance) is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the board of directors.

An article published in the June 21, 1999 issue of the *Financial Times* quoted J. Wolfensohn, President of the World Bank, as saying that “Corporate Governance is about promoting corporate fairness, transparency and accountability”.

According to some other authors, corporate governance means doing everything better, improving the relationships between companies and their shareholders, improving the quality of outside directors, encouraging people to think long-term, ensuring that the information needs of all stakeholders are met and ensuring that executive management is monitored properly (Monks and Minow 2001; Keong, 2002; Chambers 2002; and Charkham 1995).

Gregory (2001) in her very-well-done comparison study entitled, “International Comparison of Corporate Governance Guidelines and Codes of Best Practice: Developed Markets,” described corporate governance as,

“Corporate Governance refers to that blend of law, regulation, and appropriate voluntary private-sector practices which enables the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interests of stakeholders and society as a whole” (Gregory, 2001, pp. i).

According to Olin (2001) corporate governance is a broad term that encompasses rules and market practices that determine how companies make decisions, the transparency of their decision-making processes, the accountability of their directors, managers and employees, the information they disclose to investors and the protection of minority shareholders. From the author’s point of view, corporate governance can be defined as the set of rules and incentives by which the management of a company is directed and controlled in order to maximize the profitability and long-term value of the firm.

In Saudi Arabia, the contractual governance of management behavior, as one example, is necessarily incomplete and direct monitoring will be underprovided (Al-tweejri, 2002). Hence, management is in the position to seize residual control rights and may appropriate the shareholders’ investment returns. If left unregulated, shareholders will under-provide finance and companies will not be able to take advantage of all value enhancing investment opportunities. Thus the codification of corporate governance into national law or codes of best practice in Saudi Arabia becomes a necessary and effective means of alleviating under-investment and limiting the implied agency costs.

2.3. CODES OF GOOD CORPORATE GOVERNANCE

Codes of good corporate governance present a comprehensive set of norms on the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, as well as the selection, remuneration and dismissal of directors and top managers. The codes serve to improve the overall corporate governance of corporations,

especially when legal environments fail to ensure adequate protection of shareholders' rights (OECD, 1999; Aguilera et al., 2000; Keong, 2002).

An important factor affecting the issuance of the codes is the issuer (Sullivan, 2000). Issuers can be stock exchanges, governments, director associations, manager associations, professional associations or investors. Differences in who issues the code denote differences in the enforcement of the codes. For instance, government and stock market issuers might exert coercive pressure for the adoption of the codes of good governance, whereas associations and investors might apply normative pressures for adoption (Sullivan, 2000).

2.3.1. Who sets the codes of corporate governance?

The majority of countries adopting corporate governance rules more or less follow the standards and guidelines of corporate governance set by three international organizations: the Organization for Economic Co-operation and Development Principles of Corporate Governance (OECD), the World Bank and the International Monetary Fund (IMF).

2.3.1.1. The Organization for Economic Co-operation and Development (OECD)

In 1998, the Organization for Economic Co-operation and Development (OECD) established an Ad-Hoc Task Force on Corporate Governance to develop a set of non-binding core principles on corporate governance that reflected the views of its 30 member countries.¹ The Task Force concluded its work in April 1999. The Principles and associated recommendations were subsequently approved by the OECD and endorsed by ministerial level representatives of member nations at their annual meeting on May 26 and 27, 1999.

The OECD principles of corporate governance are general guidelines for regulating the entity (Fremond et al., 2002). According to the OECD Task Force

¹ Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States

that drafted them, the Principles were devised with four fundamental concepts in mind: responsibility, accountability, fairness and transparency. The OECD principles are primarily concerned with listed companies. They are organized into five sections, (I) the rights of shareholders, (II) the equitable treatment of shareholders, (III) the role of shareholders in corporate governance, (IV) disclosure and transparency and (V) the responsibilities of the board (OECD, 1999).

2.3.1.1.I. The Rights of Shareholders

The rules emphasize that shareholders have secure ownership, the right to full disclosure of information, voting rights and participation in decisions concerning fundamental corporate changes such as the sale or modification of corporate assets including mergers and new share issues. Markets for corporate control should be efficient and transparent and shareholders should consider the costs and benefits of exercising their voting rights (OECD, 1999).

2.3.1.1.II. The Equitable Treatment of Shareholders

“All shareholders of the same class should be treated equally” (OECD, 1999: p.19), including minority and foreign shareholders and should have the opportunity to obtain effective redress for violation of their rights. This principle emphasizes the protection of minority and foreign shareholders rights with full disclosure of material information. It ensures the setting up of systems that keep insiders, including managers and directors, from taking advantage of their roles, insider trading is prohibited and members of the board and managers should be required to disclose any material interest in transactions (OECD, 1999).

2.3.1.1.III. The Role of Stakeholders in Corporate Governance

In addition to the shareholders, the OECD also recognizes the right of stakeholders. The principles stress that stakeholders (in particular creditors, employees and consumers) play an integral part in shaping the decisions of a company. Principle III states that,

...the corporate governance framework should encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises (OECD 1999: p. 35).

Employees are usually the important stakeholders that determine how companies perform and take decisions. Thus the corporate governance framework must ensure that the rights of stakeholders are protected by law and respected. Stakeholders participating in the corporate governance process should have access to relevant information (OECD, 1999).

2.3.1.1.IV. Disclosure and Transparency

The OECD principles ensure that “...timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company” (OECD, 1999: p.21) including board of directors and their remuneration. The guidelines also specify that annual audits should be performed by independent auditors in accordance with high quality standards of accounting, financial and non-financial disclosure. Channels for disseminating information should provide fair, timely and cost efficient access to relevant information by users (OECD, 1999).

2.3.1.1.V. The Responsibilities of the Board

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, shareholders and stakeholders (OECD, 1999: p. 22).

These include concerns about corporate strategy, risk, executive compensation and performance, as well as accounting and reporting systems. Board members should act on a fully informed basis, in good faith, with due diligence and in the best interests of the company and its shareholders. The Board should also ensure compliance with applicable laws and take into account the interests of the stakeholders. Finally, the Board should be able to make objective judgments on corporate affairs, independent from management (OECD, 1999).

The OECD principles are not binding. Their purpose is to serve as a reference point. They are evolutionary in nature and should be reviewed in light

of significant changes in circumstances (OECD, 1999). The Principles are primarily intended to provide assistance to governments as they pursue their own efforts to evaluate and improve the legal, institutional and regulatory framework that affects corporate governance. They also provide guidance and direction for stock exchanges, investors, corporations and other parties that have a role in developing good corporate governance.

The OECD Principles were based on different views from a number of various developed countries. Thus, they represent a basic consensus on corporate governance requirements and describe existing rules, rather than propose radical changes. As a result, the OECD Principles are an excellent starting point for the examination of a sound framework in emerging countries. The principles mainly focus on publicly traded companies. However, to the extent they are deemed applicable, they may be also useful for non-traded companies, such as privately held and state-owned enterprises. In brief, the OECD Principles emphasize that good corporate governance can be achieved through a combination of regulatory and voluntary private actions.

2.3.1.2. The World Bank

The Financial Stability Forum, the G7 (Canada, France, Germany, Italy, Japan, UK and USA)², the G20 (G7 plus Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey and EU)³ and the G22 (G7 plus Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa and Thailand) have emphasized the role of minimum standards and codes in strengthening international corporate governance.

At the international level, standards enhance the transparency, identify weaknesses that may contribute to economic and financial vulnerability and foster market efficiency and discipline. At the national level, standards provide a benchmark to identify vulnerabilities and guide policy reform. To serve best these

² Russia joined as full participant in 1998, which marked the establishment of the Group of Eight (G-8).

³ G20 was formally established at the G-7 Finance Ministers' meeting on September 26, 1999 (www.g20.org).

two objectives, the scope and application of such standards need to be assessed in the context of a country's overall development strategy and tailored to individual country circumstances (Fremond et al., 2002).

The World Bank has always encouraged developing countries to adopt international best practices and implement legal and regulatory reforms. It is not in the business of setting standards or creating codes, rather it gives necessary support on national, regional and global levels (Iskander et al., 1999).

At the national level, the World Bank has supported a series of country self-assessments that identify strengths and weaknesses in corporate governance that helped countries to establish priorities. The objective of the assessments is to strengthen regulatory reform and enforcement while fostering private voluntary actions. This is consistent with the Bank's comprehensive development framework that emphasizes good corporate governance as a key factor in development effectiveness. The framework stresses the importance of the private sector (local and foreign), as a major player in the development process. It also calls for the participation of stakeholders in the design and implementation of a comprehensive reform strategy (Iskander et al., 1999).

At the national level, the World Bank has co-sponsored with other multinational agencies (e.g., OECD) a series of round-tables addressing government officials, legislators, regulators, local and foreign firms, investors and rating agencies to help craft a consensus for reform. The World Bank has worked closely with the OECD to broaden the corporate governance beyond OECD countries (Iskander et al., 1999).

2.3.1.2.1. The Report on Observance of Standards and Codes (ROSC)

The corporate governance team of the Private Sector Advisory Services Department (PSAS) after consultations with a number of emerging market governments uses the OECD Principles as the benchmark in the assessment process. The OECD Principles were agreed upon by a large number of countries (30) of varied legal, economic and cultural traditions and after extensive consultation with the World Bank, the IMF and representatives of the business

community from Japan, Germany, France, UK and the US, as well as international investors, trade unions and other interested parties. As such, they represent the minimum standard that countries with different traditions could agree upon, without being unduly prescriptive.

To assess countries, the World Bank has produced a questionnaire in the form of a template. It is structured along the five chapters of the OECD Principles. The objective of having the template is to facilitate the gathering of information necessary to formulate a diagnostic of the institutional framework underlying corporate governance, as well as prevailing practices and enforcement. For each OECD Principle, a set of questions has been prepared to assess the compliance of the country under assessment. Most of the questions could be answered in “yes” or “no”, to allow benchmarking (Fremond et al., 2002).

The template includes a section on the ownership structure of the assessed country because this is an important determinant of corporate governance practices. It endeavors to identify pyramid structures, cross-shareholdings and business groups and gathers information on the divergence between cash flow rights and voting rights. While the OECD Principles are mainly concerned with the rights of shareholders and stakeholders, disclosure and the responsibilities of insiders, the template also addresses the issue of institutional capacity (Fremond et al., 2002).

The format of the assessments allows for systematic benchmarking across countries and regions. It is divided into four parts: (i) executive summary; (ii) capital market overview and institutional framework; (iii) principle by principle review including policy recommendations; and (iv) institutional strengthening.

2.3.1.2.2. Insolvency and transparency in codes of corporate governance

The World Bank has emphasized the inclusion of insolvency and creditors rights besides transparency in codes/rules of corporate governance.

2.3.1.2.2.1. Insolvency and creditors rights

In an effort to improve the stability of the international financial system after the South East Asian Crisis, the World Bank led an initiative to identify principles and guidelines for meaningful insolvency systems and for the strengthening of related debtor-creditor rights in emerging markets.

Insolvency systems provide a pre-determined set of rules and institutions concerned with the recognition of insolvency, the resultant liquidation or rehabilitation of the insolvent firm and the allocation of the financial consequences between the stakeholders. The insolvency systems also permit lenders to price risk more accurately and encourage cash flow lending rather than relationship or politically directed lending and discipline managers to allocate scarce resources efficiently.

2.3.1.2.2.2. Transparency in accounting and auditing systems

In order to have transparent, timely and reliable corporate financial reporting and as part of the Reports on the Observance of Standards and Codes (ROSC) initiative, the World Bank is undertaking reviews of compliance with accounting and auditing standards in a number of countries. It is intended to provide a basis for comparing practice in the countries reviewed to both national and international accounting and auditing standards which, in turn, will facilitate cross-country comparison and the design of programs to strengthen corporate financial reporting. More specifically, the objectives of the review are to assess the comparability of national accounting and auditing standards with International Accounting Standards (IAS) and International Standards on Auditing (ISA), respectively; and the degree to which corporate entities comply with established accounting and auditing standards in the country.

Furthermore, the International Finance Corporation (IFC), being a member of the World Bank Group, has also promoted better corporate governance by requiring that the firms in which it invests, practise sound corporate governance and insist on proper internal controls and reporting. This applies particularly on developing stock and bond markets (Iskander et al., 1999).

2.3.1.3. International Monetary Fund (IMF)

The IMF is an international organization of 184 member countries. It was established in 1945 to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment (IMF).

In addition to the IMF's contribution in the Report on Observance of Standards and Codes (ROSC) of the World Bank, the IMF has developed codes of good practice mainly for the transparency of governments' fiscal and monetary policies.

2.3.1.3.1. Greater Fiscal Transparency

The IMF is encouraging its member countries to implement a Code of Good Practices on Fiscal Transparency. The Code stresses: responsibilities of government should be clear; information on government activities should be provided to the public; budget preparation, execution and reporting should be undertaken in an open manner; and fiscal information should attain widely accepted standards of quality and be subject to independent assurances of integrity. The Code sets out what governments should do to meet these objectives in terms of principles and practices.

The Code of Good Practices on Fiscal Transparency is based on four general principles:

- ❑ *Clarity of Roles and Responsibilities.* The government sector and/or its public sector agencies should be distinguished from the rest of the economy. Policy and management roles within the public sector should be clear and publicly disclosed. There should be a clear legal and administrative framework for fiscal management.
- ❑ *Public Availability of Information.* The public should be provided with full information on the past, current and projected fiscal activity of the

government. A commitment should be made to the timely publication of fiscal information.

- *Open Budget Processes.* The budget documentation should specify fiscal policy objectives, macroeconomic framework and policy basis for the budget as well as identifiable major fiscal risks. Budget information should be presented in a way that facilitates policy analysis and promotes accountability. Procedures for the execution and monitoring of approved expenditure and for collecting revenues should be clearly specified. There should be regular fiscal reporting to the legislature and the public.
- *Assurance of integrity.* Fiscal data should meet accepted data quality standards and fiscal information should be subjected to independent scrutiny. There should be mechanisms in place which provide assurances to the public about data integrity.

2.3.1.3.2. Code of Good Practices on Transparency in Monetary and Financial Policies

The IMF has developed a Code of Good Practices on Transparency in Monetary and Financial Policies. The design of good transparency practices in the Code rests on two principles. First, monetary and financial policies can be made more effective if the public knows the goals and instruments of policy and if the authorities make a commitment to meeting them. Also good governance calls for central banks and financial agencies to be accountable, particularly where the monetary and financial authorities are granted a high degree of autonomy.

The Code was developed in the context of the development of standards and codes for public disclosure and transparency practices designed to strengthen the international monetary and financial system. It calls for greater transparency of commercial banks, securities firms, insurance firms, central banks etc.

An increasing number of countries are taking the next step of participating in a fiscal module of a *Report on Observance of Standards and Codes* (ROSC), which the IMF and the World Bank have developed as a means of assessing the

extent to which countries meet the requirements of standards and codes in core areas and providing information to the public. Fiscal ROSCs comprise a summary description of practices prepared by the IMF staff based on the completed questionnaire, together with a staff commentary including recommendations for improvement. When fiscal ROSCs become out of date, a ROSC reassessment will be done to replace the original ROSC.

As of March 2003, 48 ROSC fiscal transparency modules have been published on the IMF website, and 11 have published updates. Around 20 new or revised fiscal transparency ROSCs are planned for each year (IMF, 2003).

2.4. CORPORATE GOVERNANCE WORLD WIDE

In the late 1990's, the issue of corporate governance has received more global attention than it would have in the light of a series of corporate failures (Iskander et al., 1999). Furthermore, the recent crises and bankruptcies faced by various firms in different countries, including East Asia, Russia, United States, United Kingdom, Australia and others raises a question: what went wrong?

Those failures, amongst others, have shown that a lack of regard for core values of corporate governance does have a negative impact globally. Countries, markets and companies that have not been able to survive or that have fared badly in a crisis have one thing in common: poor corporate governance standards (Keong, 2002).

Over the last decade a number of reports has been commissioned into the subject of corporate governance and as a result a number of codes of best practice has emerged. The purpose of these codes of best practice is to increase transparency and accountability in the manner in which companies are governed. By 2004, thirty-seven countries had issued codes of good governance (Appendix 5). This excludes other developed and emerging countries that are in the process of issuing their Code of Good Practice for Corporate Governance. A complete list of these countries can be found at the World Bank, OECD, and European Corporate Governance Networks.

Since this is the first empirical study investigating corporate governance in Saudi Arabia, it will provide a comparative analysis of corporate governance, as an issue of concern in some developed and developing countries. It will provide a general perspective of what the trend has been in the last two decades in order to benefit from those countries in the development of the Saudi's corporate governance rules and codes of good governance practice. Six countries have been identified and classified into three groups based on the state of development of their corporate governance, similarities of their economic environment to that of the Kingdom of Saudi Arabia and the possibility of Saudi Arabia benefiting from their established organizations. The three groups are as follows:

- ✓ The United States of America and United Kingdom;
- ✓ France and Germany; and
- ✓ Korea and Malaysia.

2.4.1. The United States of America

In the United States of America each company is incorporated under the laws and jurisdiction of one of the states. Expectations and requirements of companies vary from state to state (Tricker, 1984).

Between 1880 and 1930, the United States experienced a 'corporate revolution' and the 'outsider/arms-length' system of ownership took shape as part of this process (Means, 1962). According to Bishop (1994), corporate governance in the USA has its roots in the public stock markets of the late 19th century. American shares are mostly owned by individuals. These individuals typically hold a tiny slice of the equity of a firm which gave them little incentive to incur the costs of monitoring managements. Throughout the 19th century, there were isolated examples of companies with widely dispersed shareholdings and well-developed management. Industrial enterprises almost invariably were privately held with family control being very much the norm (Lamoreaux, 1955). Lamoreaux added that a merger wave that peaked at the turn of the 20th century heralded a distinct change in approach. The mergers were often financed in part by public offerings of shares which served to disperse share ownership among a wide range of investors. The process of consolidation thereby created situations

where those making managerial decisions did not own a substantial shareholding block (Lamoreaux, 1955).

Change was also evident in large companies that remained family-dominated. By the end of World War I, family members were typically working closely with salaried executives rather than attempting to manage their own businesses (Chandler, 1990). Despite the trends affecting US business enterprises, the family did not disappear completely from the corporate landscape. In the mid 1990's in over one -fifth of America's largest one thousand public companies, the founding family retained significant influence (Cheffins, 2001). Nevertheless, in "The Modern Corporation and Private Property," it was mentioned that while the law treated shareholders as a company's owners, delegation of managerial authority to professionally trained executives was common practice and there was true "separation of ownership and control" (Berle and Means, 1932).

The first code of good governance in the United States appeared in the late 1970's. It denoted the transition from the conglomerate merger movement of the 1960s to empire-building behavior by management through hostile takeovers (Aguilera, 2003).

In the context of charges and counter charges surrounding the takeover movement, the Business Roundtable (BRT) issued a report in January 1978 entitled: "The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation". The Business Roundtable Report chaired by Austin, CEO of Coca-Cola, turned out to be a claim for the legitimacy of private power and the enforcement of accountability. The Report stated that the directors' main duties are: overseeing the management and board selection and succession; reviewing the Codes of Good Governance Worldwide, the company's financial performance and allocating its funds; overseeing corporate social responsibility and ensuring compliance with the law (Charkham, 1995).

In the U.S., when an investor is unhappy with the manner in which management deals with the business of the company, he/she dumps his/her shares. This is called the "Wall Street Walk". Results from a poll in *Investor's Business Daily* found that only one in 13 Americans have high confidence in the honesty

and integrity of corporate chief executives and chief financial officers (Investor's Business Daily, May 12, 2003).

In the United States and other developed markets, the main methods of solving agency problems are the legal protection of minority investors, the use of Boards of directors as monitors of senior management and an active market for corporate control, "takeovers." The strength of these methods is determined by securities regulations, corporate laws, charter provisions, etc. However, the recent corporate failures of Enron, WorldCom, Global Crossing, Adelphia, Qwest, etc. have obviously shown that sometimes rules, laws, market discipline and use of Boards can all fail, if not effectively and properly implemented.

Rules, regulations, laws and provisions are set to define the power of corporate governance. Firms, in turn, have wide latitude in setting the rules for shareholder voting and the election of Board of directors, duties and responsibilities of Board of directors, the effectiveness of Boards, etc. If they choose, managers can use this leeway to make it more difficult for shareholders to exercise any influence or control (Stein, 1988).

According to Bhidé (1994) and Bishop (1994), the USA regulatory model for protecting investors is the most comprehensive and well enforced in the world. The origins of the system can be traced to the extensive losses suffered by the public during the crash of 1929. Responding to the outrage of voters, Congress passed the Securities Exchange Act of 1934 and created the Securities Exchange Commission to regulate the stock exchanges conduct.

Over the years, Congress has also sought to protect investors by regulating the financial institutions that manage funds. For example, the Investment Company Act 1940, which followed the collapse of Investment Trusts, set minimum levels of diversification for mutual funds and precluded them from holding more than 10 per cent of a company's stock.

The Sarbanes-Oxley Act (2002) '*the Act*', which became law on July 2002, included several corporate governance related provisions, along with new corporate disclosure requirements and auditor regulatory and securities law

enforcement measures (John et al, 2002). Most of the provisions related to board structure and function required for implementation the Securities and Exchange Commission (SEC) rule-making, which has for the most part now been completed. However, certain important provisions relating to audit committees are to be effectuated through the self-regulatory process of stock market listing standards (mandated by new “national market system” provisions) (John et al, 2002; and Antin et al, 2002).

The New York Stock Exchange (NYSE) has submitted to the Securities Exchange Commission (SEC) (initially on August 16, 2002 and amended on October 7, 2002 and March 12 and April 4, 2003) proposed listing requirements which create a wide-ranging set of corporate governance standards, supplementing the standards it had already established (which related primarily to audit committees and shareholder approval requirements) (John et al, 2002). They include provisions intended to satisfy the requirements regarding audit committees mandated by the Act. As proposed, listed companies will be required as a general rule to comply with many of these requirements within six months following the Securities and Exchange Commission (SEC) approval of the proposed requirements but will not be required to comply with the new requirements regarding board and committee composition until 18 months after SEC approval (subject to extension of this deadline in certain circumstances) (Antin et al., 2002).

The NASDAQ Stock Market (Nasdaq) has also submitted to the SEC (initially on October 9, 2002 and amended on March 11, 2003) more than 25 new corporate governance requirements for listing, supplementing its pre-existing listing standards (which also related primarily to audit committees and shareholder approval requirements). Generally, they cover the same subjects as the NYSE proposals and they include provisions intended to satisfy the requirements regarding audit committees mandated by the Act (PricewaterhouseCoopers, 2003).

2.4.1.1. Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF)

The Teachers Insurance and Annuity Association College Retirement Equities Fund TIAA-CREF (2000) believed certain principles were the benchmark of an equitable and efficient corporate governance structure. According to TIAA-CREF (2000), good corporate governance must be expected to maintain an appropriate balance between the rights of shareholders, the owners of the corporation, and the need of the board and management to direct and manage the corporation's affairs free from non-strategic short-term influences.

TIAA-CREF (2000) believed that good governance practices are important to encourage investments in countries and companies in a global economy where gaining access to capital markets is increasingly seen to be very competitive. As a consequence, there are now accepted principles of global corporate governance, such as those employed by the OECD, the IMF and the World Bank. These principles recognize that not every country needs to adopt a "one-size-fits-all" code of practice. Therefore, the TIAA-CREF believed that shareholders might reasonably expect country and company practice to include the following characteristics in their developments of good practice (TIAA-CREF, 2000).

- Appropriate structures of accountability of the company to its owners.
- Independent oversight of managers and accounts (including independent audits of financial statements based on high quality accounting principles).
- Fair and equitable treatment for all shareholders (an issue that can be particularly relevant when there is a controlling shareholder).
- Fair voting processes that in practice assure disclosure of all facts material to each vote being taken, and that enable shareholders to exercise their ownership rights in relation to their economic interest.
- Prohibition of insider trading and abusive insider trading.
- Open, efficient, and transparent markets for corporate control.
- Timely disclosure of financial and operating results of the company, material developments and foreseeable risk factors, and matters related to corporate governance. Disclosures related to corporate governance should

include interested party transactions and any capital structures or arrangements that enable certain shareholders to obtain control disproportionate to their equity ownership; significant information about board members and key executives, including their compensation; and information describing governance structure and policies.

- Regulatory and legal recourse if principles of fair dealing are violated.

2.4.1.2. The California Public Employees Retirement System (CalPERS)

The CalPERS, America's largest public pension fund managing assets of more than US\$143 billion (Carlson, 1998), was established in 1932 as a defined benefit plan. A defined benefit plan is a retirement program that sets a benefit calculated on a formula, often a percentage of final average pay, times years of service based on retirement age.

The CalPERS began their corporate governance program in the early 1980's, as a direct response to the takeover frenzy in corporate America. It began simply as objections by a few share-owners to certain company actions that were considered to be self-serving. Companies created anti-takeover devices and procedural obstacles that were viewed more as protecting the corporate status quo than serving the long-term interests of shareowners (Carlson, 1998).

The CalPERS strongly believes that each market throughout the world should adopt corporate governance principles that are appropriate for that market. Ideally, these principles should be developed by the market's participants themselves, through cooperative action and consensus (see CalPERS).

The CalPERS defined corporate governance to be the relationship among valuable participants in determining the direction and performance of corporations (Carlson, 1998). The primary participants are shareholders, company management and the board of directors. The definition does not expressly mention other stakeholder groups (the community, company employees, suppliers, and customers). In CalPERS' point of view, companies that operate with long-term shareowner returns, as the primary goal, will ultimately also reward other stakeholders.

In late 1989, CalPERS began working closely with the US Securities and Exchange Commission (SEC). This relationship led to the 1992 reform of executive compensation disclosure and proxy solicitation reforms (Carlson, 1998). In early 1997, the CalPERS Investment Committee approved CalPERS' Global Governance Principles. In late 1999, the CalPERS Investment Committee analysed other newer global governance principles (see CalPERS).

In March 1996, CalPERS' Board formally adopted its International Corporate Governance Program (Gillan, 1997). As the first step in implementing this program, in December 1996 the Board adopted a set of Global Governance Principles. The Principles focus on 6 basic concepts that are fundamental to free and fair markets throughout the world (Gillan, 1997). Moreover, the Principles reflect the core of what the corporate/shareholder relationship should be. Specifically, the 6 Global Principles are: (i) accountability; (ii) transparency; (iii) equity; (iv) voting method improvements; (v) code of best practices; and (vi) long-term vision (CalPERS, 1999). Those principles (CalPERS, 1999) are:

- Directors should be accountable to shareholders, and management accountable to directors. To ensure this accountability, directors must be accessible to shareholder inquiry concerning their key decisions affecting the company's strategic direction.
- Information about companies must be readily transparent to permit accurate market comparisons; this includes the notion of some globally accepted minimum accounting standard.
- Investors – even minority and foreign investors – must be treated equitably and upon the principle of one share/one vote.
- Proxy materials should be written in a manner designed to provide shareholders with the information necessary to make informed voting decisions. Similarly, proxy materials should be distributed in a manner designed to encourage shareholder participation. All shareholder votes, whether cast in person or by proxy, should be formally counted; vote outcomes should be formally announced.

- Each market should adopt its own Code of Best Practices; and, where such a code is adopted, companies should disclose to their shareholders whether they comply with it.
- Finally, CalPERS believes that corporate directors and management should have a long-term strategic vision, which at its core emphasizes sustained shareholder value. In turn, despite differing investment strategies and tactics, shareholders should encourage corporate management to resist short-term behavior by supporting and rewarding long-term superior returns.

Carlson (1998: p. 34) stated,

In my opinion, effective governance is essential to the healthy growth of capitalism. The present system in the United States and internationally must continue to change in order to survive in the dynamic capital markets of the world economy. Our world cannot afford corporate owners who do not recognize themselves to be responsible with the same tenacity and ingenuity they employ to assert their shareowner rights. We are indeed at a critical, and exciting, place in the development of corporate governance.

2.4.1.3. Blue Ribbon Commission on Director Professionalism (NACD Report)

The Report of the National Association of Corporate Directors (NACD) was issued in 1996 and then reissued in 2001. The NACD argues that governance practices ought to be designed to promote a culture of “professionalism” for boards of directors and board members. The NACD Report (2000) recognizes that board practices are evolving and believes that they will continue to evolve in the direction it suggests. The Report’s recommendations are purely voluntary (Gregory, 2001; NACD, 2000).

The NACD (2000: p.1) Report stated,

A primary goal of the board, the CEO, and the audit committee is to create and maintain an audit committee that adds value to the board and the corporation. To add value, audit committees should oversee the organization’s reporting, control, and audit processes. These tasks should be the essence of their purpose, the philosophy underlying selection of their committee members, and the focus of their processes.

2.4.1.3.1. *The BRT Report*

The Business Roundtable (BRT) released a revised “Principles of Corporate Governance” in May 2002. The principles discussed in the Report are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance and also to serve as guideposts for the public dialogue on evolving governance standards (BRT, 2002).

The Business Roundtable (2002) supports the following guiding principles.

- Boards of directors should select and oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
- Managements should operate the corporation in an effective and ethical manner in order to produce value for stockholders.
- Management is responsible for producing financial statements that fairly present the financial condition and results of operations of the corporation, and making timely disclosures to investors.
- Boards and their audit committees should engage an independent accounting firm to audit the financial statements prepared by management and issue an opinion on those statements based on Generally Accepted Accounting Principles.
- It is the responsibility of the independent accounting firm to ensure that it is, in fact, independent, employs highly competent staff and carries out its work in accordance with Generally Accepted Auditing Standards.
- The corporation has a responsibility to deal with its employees in a fair and equitable manner.

2.4.1.4. Other Committees

Several Committees have been established in the US including the “Report of the National Commission on Fraudulent Financial Reporting” (commonly known as the Treadway Commission) strengthening the professionalization of the

independent auditor (Treadway Commission, 1987), “Report to the Public Oversight Board of the SEC Practice Section” (see Public Oversight Board), “The Advisory Panel on Auditor Independence” (American Institute of Certified Public Accountants (AICPA), 1994) and the “Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee” that was approved by the NYSE Board of Directors in August 2002 (NYSE, 2002).

The US market is a notable example in terms of applying corporate governance rules. According to the Nikkei Newspaper, June 15, 2003, about 36 Japanese corporations, as an example, adopted the US-style corporate governance structures. The move toward US-style governance, allowed under amendments to Japan’s Commercial Code in April 2003, involves establishing three committees – audit, nominating and compensation. Many high profile international firms, such as Sony Corp., Mitsubishi, Hitachi Ltd. and Toshiba Corp. have made the changes to enhance their corporate image to overseas investors. Japanese firms who adopt US governance systems do so to enhance earnings, transparency and oversight of their operations by relying more on outside board members (Nikkei Newspaper, June 15, 2003).

According to a report in the Financial Times, June 5, 2003, the United States is continuing to up-date its corporate governance. The New York Stock Exchange (NYSE) in June 2003 adopted ten new rules that were being called the exchange’s most sweeping governance up-date in 30 years. The rules were drafted to bring the NYSE’s own governance practices in line with the requirements of its 2,500 listed companies (see NYSE).

2.4.2. United Kingdom

Tricker (1984) did a detailed historical study of the development of corporate governance in the United Kingdom since the Industrial Revolution. In his view, the evolution of the concept stems from the mid-nineteenth century, in particular, from the Companies Acts of 1855 and 1862. The developments that led to the corporate concept are threaded far back through the evolution of British trade and industry: indeed back to mediaeval England with the importance of

individualism, freedom and self-regulation, contrasting with the more prescriptive rule of law in continental European countries.

Under British company law, each company is treated as an independent legal entity, irrespective of ownership or the locus of decision-making. The separation of ownership and control occurred later than it did in the US (Berle and Means, 1932). It began in the final few years of the 19th century when the British industrial and commercial firms first made a strong move towards public ownership, as dozens carried out initial public offerings (Prais, 1976).

With many British public companies, the one who founded the firms retained a sizeable percentage of the shares and played an important role in corporate decision-making. A commitment to personal ways of management was, therefore, perpetuated (Okochi et al., 1984).

Empirical studies of ownership and control patterns in the UK illustrate that there was a relative decline in the importance of family control of business as the 20th century progressed. Statistical data compiled in 1951 showed that there was a clear divorce between control and ownership for very large companies and that a “managerial evolution” was taking place (Florence, 1961). Florence said that between 1936 and 1951, the number of “very large” industrial and commercial companies that had an investor who controlled 20 percent or more of the voting equity fell from one out of three to less than one out of five. By the early 1960s, a number of firms Florence categorized as “owner-controlled” had ceased to qualify for inclusion in the group and it may be that the progressive erosion of family influence meant that by 1970 it would make little sense to talk of British personal capitalism.

As of 1970, forty-four of the UK’s 100 largest manufacturing companies were either “family companies” (thirty) or were controlled by a non-British parent company (fourteen) (Channon, 1973). By the late 1980s, share ownership patterns were in fact moving closer towards the dispersed pattern evident in the US (Scott, 1990) as noted in the ownership patterns of the 200 largest industrial companies and the 50 largest financial businesses in the UK as of 1988.

Scott (1990) attributed this shift primarily to the decline of family control in UK companies. Clearly, then, by the time the 1980s drew to a close, “personal capitalism and family ownership had been swept away” and Britain had moved to a US-style corporate governance system with ownership separated from control.

The US and UK systems are characterized by active stock markets and the separation of ownership and control with some regrouping of ownership interests in the hands of institutional investors (Roe, 1994). There is a market for corporate control and a preference for boards dominated by non-executive directors (Whitman, 1999). The separation of ownership and control began after 1918 and is more pronounced in the US and the UK than in other countries (Berle and Means, 1932).

However, many significant companies in the United Kingdom remained under family control for longer periods and there were delays in the development of a professional managerial class (Cheffins, 1999).

2.4.2.1. The Cadbury Report 1992

The Cadbury Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance (Cadbury Report, 1992). It was then followed by the Committee on the Financial Aspects of Corporate Governance. The committee issued a draft report for public comment on 27 May 1992. Its final report, taking account of submissions made during the consultation period and incorporating a *Code of Best Practice* was published on 1 December 1992 (Chambers 2002; Cadbury Report, 1992; and Gregory, 2001).

The Code of Best Practice is directed to the boards of directors of all listed companies registered in the UK, and is enforced by a disclosure mechanism: listed companies have to report on their implementation of the Code's recommendations. The Stock Exchange and public opinion exercise pressure to ensure optimal follow-up of the Code rules (Cadbury Report, 1992).

The issuance of the Cadbury Committee Report in the United Kingdom marked the importance of corporate governance in the UK. The Cadbury Report, sometimes referred to as the *Magna Carta of Corporate Governance* (Gregory, 2001), which became very popular and widely accepted, deliberately challenged the effectiveness of voluntary regulation and British corporate democracy (Stiles et al., 1993). The recession in 1990 as well as a series of high-profile corporate failures, in which the weakness of internal corporate control was clearly a contributing factor, raised the issue of corporate accountability both in the public mind and in the House of Commons (Monks et al., 1992).

The Cadbury Report was issued because of concern about the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards, which the users of the company reports sought and expected (Stiles et al., 1993; Charkham et al., 1999; and Cadbury Report, 1992). It also emphasized the need for independent directors, larger shareholder involvement, and the establishment of audit, compensation and nomination committees (Charkham et al., 1999). Moreover, sanctions were introduced to ensure that companies listed in the London Stock Exchange would comply with the Code.

The Cadbury Report's recommendations are highly codified, allowing both companies and stakeholders to benchmark best practices, as well as to be emulated by other agencies. The main principles of the Cadbury Report (Cadbury Report, 1992) comprise the following.

- Shareholders have a right and an obligation to exercise responsibilities. Owners should back management striving for long-term growth and intervene when problems arise.
- Existing UK Codes of Best Practice should be strengthened not weakened.
- Periodic review and up-dating of best practice guidelines should continue and reviewing bodies should include investors based outside the United Kingdom.
- The structure of the Board should be built upon the twin concepts of independence from management and accountability to shareholders. The following qualities are necessary to ensure a fully accountable and independent board: a separate Chairman and Chief Executive Officer with the

role of Chairman held by an independent director and a majority of independent directors. The U.K. corporations should certainly comply with Cadbury's recommendation that there be at least three non-executive directors on a board and that a majority of those non-executives should be independent directors. Key committees such as the audit, compensation and nomination committees composed exclusively of independent directors. Appropriate training for independent directors who face increased responsibilities associated with monitoring key functions such as audits, executive performance and compensation and corporate strategy. A properly focused board with directors occupying no more than two seats on other boards if they are employed full-time (i.e., a CEO at another company) or three if they are not (i.e., a retired CEO).

- Best practices in the UK should include several elements to strengthen management accountability to corporate owners through the director-shareholder relationship.

In May 1995, an implementation report was published, which indicated a considerable degree of compliance by larger corporations. Later reports complained about the administrative and others burdens resulting from the code, especially for the smaller companies.

The Cadbury Report was eventually followed by the Greenbury Commission Report (on director and executive remuneration), the Hampel Commission Report and the Combined Code of the Committee on Corporate Governance of the London Stock Exchange.

2.4.2.2. The Greenbury Report 1995

In 1995, a report was published by a Study Group into Directors' Remuneration (known as the 'Greenbury Report'). This report contained a code of best practice for determining and disclosing the remuneration of company directors. The Greenbury Code includes the following key recommendations (Greenbury, 1995).

- The compensation committee should be composed exclusively of independent members.
- Companies should annually outline their compliance with the Greenbury Code, including explanations if they do not comply.
- The annual compensation committee report should disclose pay details for all executive directors, including pension provisions, incentive pay, option plans, performance measurements, severance agreements and comparisons with similar companies.
- Executive pay should not be "excessive."
- Employment contracts should extend for no longer than one year so as to rule out multi-year golden handshake payouts in the event that an executive is dismissed or the company taken over.
- New long-term incentive plans should replace, not supplement, existing stock option plans.
- Performance-related pay should "align the interest of directors and shareholders," while performance criteria should be "relevant, stretching and designed to enhance the business." Upper limits should always be considered.
- Executive stock option awards should be phased rather than given all at once, and options should never be awarded at a discount.

A distinctive feature of the British corporate governance system is that it strongly resembles its counterpart in the United States. Both countries have well-developed equity markets, with most major business enterprises being quoted on a stock exchange and sharing an "outsider/arms-length" system of ownership and control (Moerland, 1995).

2.4.2.3. The Hampel Report 1998

In January 1998 the Committee on Corporate Governance, which was established to review the implementation of the Cadbury Report and to pursue any relevant matters arising from the Greenbury Report, published its final report, known as the "Hampel Report."

The Hampel Report (The Hampel Report, 1998: 7.3) noted,

We intend to produce a set of principles and code of good corporate governance practice, which will embrace Cadbury and Greenbury and our own work. We shall pass this to the London Stock Exchange. We suggest that the London Stock Exchange should consult on this document, together with any proposed changes in the Listing Rules.

2.4.2.4. Other Committees

In mid 1998 the London Stock Exchange published a new code of corporate governance best practice, which drew on the Cadbury, Greenbury and Hampel Reports. This code became known as the 'Combined Code' (Combined Code, 1998). In December 1999, the provisions of the Combined Code were adopted by the Irish Stock Exchange, which annexed the Code to its Listing Requirements. As a result, Irish listed companies are now required to report on how they have applied the principles of the Combined Code or, where they have not applied the principles, to justify any instances of non-compliance in their annual reports (OECD, 2002). It is then a matter for shareholders and others to evaluate such explanations. The Combined Code sets out Principles of Good Governance under such headings as Directors, Directors' Remuneration, Relations with Shareholders, Accountability and Audit, Internal Control and Audit Committees (OECD, 2002).

Following the publication of the Combined Code the Institute of Chartered Accountants in England & Wales (ICAEW) established a Committee charged with the task of providing guidance to company directors on the implementation of those principles of the Combined Code relating to internal control and risk management (ICAEW). The Committee published its report, known as the 'Turnbull Report' in September 1999 (Turnbull Report, 1999).

As a result of a series of high profile corporate failures in the U.K. and the U.S.A. in early 2002 (Enron, Worldcom etc.), the UK Government asked the UK Financial Reporting Council (FRC) to develop further the guidance on audit committees provided in the Combined Code (OECD, 2002). The FRC-appointed committee reported in January 2003. The committee's report sets out guidance to assist the boards of companies required to comply with the Combined Code in

making suitable arrangements for their audit committees. The report also includes proposals for amendments to the Combined Code itself and includes a specimen audit committee charter. In reading the report, readers should note that compliance with the bold typeface content of the report is necessary in order to comply with the provisions of the Combined Code. As with the provisions of the Combined Code, non-compliance must be accompanied by an explanation as to the reasons for non-compliance (see FRC).

In January 2003, the 'Review of the Role and Effectiveness of Non-Executive Directors' ('The Higgs Report') was also published. This review was commissioned by the UK Secretary of State for Trade and Industry and the Chancellor. The report includes a number of recommended changes to the Combined Code, including the insertion of additional material in relation to company boards and non-executive directors (Higgs Report).

2.4.3. France

The move towards an increased focus on corporate governance by French and German companies is a recent phenomenon (Whittington and Mayer 2000). The use of the conglomerate form, the internal organization of the firm based on the multi-divisional structure, and the diversification in many related and unrelated business activities characterized companies in France at least until the mid-1990s (Richter 1997; Whittington and Mayer 2000). This organizational structure was broadly similar to its counterparts in the U.K. and the U.S. (Chandler 1990).

With the increase of private companies, the opening of markets to international investors, and a shortage of equity financing, France has engaged in a vigorous debate about corporate governance over the past decade. Michel Albert, former managing director of the French National Planning Office (1992), lays the foundation for the French debate by arguing that any system of corporate control is tied to social values. According to Albert, France has basically to choose between the Rhine Model (Germany) and America's freewheeling liberal system. He concludes, not unsurprisingly, that France's social and economic

system is better suited to the German model. Implementing the German system in France would require few structural or attitudinal changes (Brean et al., 2003).

Corporate governance in France has often been described as an uncomfortable mixture of the American and German models (Brean et al., 2003). Company presidents (président directeur-générale, PDG) have held near dictatorial control over their boards and companies, leading to justified criticism about the ineffectiveness of control mechanisms (Helderman, 2000).

The executive management of French companies can exist in two different forms. The first one, which is the most commonly used by the listed companies, is based on the dominant power of the “President Directeur General” (PDG) who is CEO and Chairman at the same time. The second is the option of a two-tier board, a system similar to that adopted in Germany (EkonomiHgskolan, 2004).

Several factors have combined to lead market players to become concerned about corporate governance. Principal among them are privatization, the increasing presence of foreign shareholders - American pension funds in particular - the emergence in France of the pension fund concept, the desire to modernize the Paris financial market and the publication of the Viénot Report (AFG-ASFFI).

2.4.3.1. The Viénot Report (I)

The French employers' association CNPF (Conseil National du Patronat Français) and the private business association AFEP (Association Française des Entreprises Privées) have entrusted a corporate governance committee to review the principal issues concerning the membership, powers and operation of the boards of directors of French listed companies, to review related problems and the various solutions proposed and to draw the conclusions detailed in the Viénot Report (Viénot Report I, 1995).

The Viénot Report has attracted wide attention and was commented on in the press at large. However, the report did not propose substantial changes in

present practices and the implementation of its recommendations has lagged. There has been no official follow-up in terms of a compliance report.

The Viénot Report acknowledged as an essential part of the French system, the principle that,

whatever a board's membership and procedures may be, its members collectively represent all shareholders and it must at all times put the company's interests first" (Viénot Report, 1995: p.4).

The report affirmed that a board controlled by a majority shareholder, must be particularly attentive to avoid any conflict of interest, take all interests into due account and ensure the transparency of information provided to the market" (Viénot Report, 1995: p.14).

The committee report stated that implementation of its recommendations is necessary to consolidate investor confidence in the bodies governing the companies they are asked to invest in" ((Viénot Report, 1995: p.3).

Without such an implementation of fairly basic recommendations, French corporations cannot expect to maintain investor confidence.

The main recommendations of the Viénot Report (Viénot Report, 1995) are as follows.

- Boards should participate in decisions of strategic importance to a company.
- Each board should have a minimum of two independent directors.
- Cross-shareholding should be eliminated as quickly as possible.
- Companies should "avoid including an excessive number" of reciprocal directors on boards, and reciprocal directors should not serve on each other's audit or compensation committees.
- Each board should have a nomination committee that includes at least one independent director and the company chairman.
- Firms should disclose annually how it is organized to make decisions.

- Each board should have audit, compensation and nomination committees, and should indicate annually how many meetings the committees had. Each committee should be composed of at least three directors, one of whom should be independent. Neither executives nor employee directors should serve on the audit and compensation committees.
- Directors should "own a fairly significant" number of their company's shares.
- Executive directors should join no more than five boards other than their own.

However, compliance with the Viénot Report is entirely voluntary, and there is no requirement by the stock exchange or any regulatory body to disclose whether or to what extent a company adopts Viénot principles.

2.4.3.2. The Viénot Report (II)

The second Viénot Report was issued in 1999 by the Mouvement des Entreprises de France (MEDEF) [formerly CNPF] and the Association Française des Entreprises Privées (AFEP) (Viénot Report, 1999). The Report recommends that boards of public companies that have a single-tier board structure should be allowed to separate the post of *président du conseil d'administration* into separate chairman and CEO positions (Gregory, 2001). Gregory (2001) concluded that the Report also calls for expanded disclosure to shareholders as to:

- executive remuneration policy.
- stock options schemes.
- the total amount of directors' remuneration.
- individual directors' remuneration for attendance at board meetings.

2.4.3.3. The Marini Report

At the instigation of Prime Minister, Alain Juppé, Senator Philippe Marini in July 1996 issued a parliamentary report proposing sweeping reforms in French corporate law. The report came one year after the Viénot Committee concluded that no major legislative changes were needed. Marini's policy paper contained

proposals addressing corporate governance matters, including measures to place various Viénot recommendations into law. The main recommendations of the Marini Report (Marini Report , 1996) are as follows.

- Boards should be permitted in law to name committees with autonomous powers.
- Companies should have the legal right, but not obligation, to separate the offices of chairman of the board and chief executive officer without having to adopt a two-tier board structure.
- Corporations should have to release detailed lists of its owners to all investors.
- Notices of meetings should be issued one month, rather than 15 days, before shareholder meetings.
- Shareholders who prefer not to vote themselves should be able to assign their voting rights to an independent entity rather than to management.
- Directors would be permitted to serve on no more than five boards.

2.4.3.4. AFG-ASFFI

France's fund management association, the Association Française de la Gestion Financière (AFG-ASFFI) adopted a report in 1998 (up-dated in October 2001) with best practice recommendations that go further than the Viénot Report I (1995) and the Marini Report (1996) and propose even tougher steps, such as stricter standards of independence for directors, greater disclosure, and an end of poison pill-style takeover defences (see AFG-ASFFI).

2.4.3.5. The Bouton Report

In April 2002, Bertrand Collomb, Chairman of the Association Française des Entreprises Privées et Association des Grandes Entreprises Françaises (association of French private-sector companies and association of major French corporations) (AFEP-AGREF), and Ernest-Antoine Seillière, Chairman of MEDEF (Mouvement des Entreprises de France), requested a working group chaired by Daniel Bouton, President of Société Générale Bank in France, to re

examine the application in France of corporate governance principles (Bouton Report, 2002).

According to the Bouton Report (2002), the working group that was set up was charged with examining the following:

- improving the workings of company bodies for management or the supervision of management, in particular the audit committee;
- the adequacy of accounting standards and practices;
- the quality of financial information and communication;
- the effectiveness of internal and external controls (by auditors and regulators);
- relations between companies and the various categories of shareholders; and
- the role and independence of various other market players, such as banks, financial analysts, rating agencies, etc.

2.4.4. Germany

From the prosperity of the empire during the Wilhelmine Era (1890-1914), Germany plunged into World War I (1914-1918) followed by the Great Inflation of the early 1920s. Then, after a brief period of prosperity during the mid -1920s, came the Great Depression, which destroyed what remained of the German middle class and paved the way for the dictatorship of Adolf Hitler (1933-45) and World War II (1939-1945) (Kaes, 1994; and Allen, 2002).

The first several years after World War II were years of bitter penury for the Germans. Their land, their homes, and their property lay in ruin. As Germany's post-war economic and political leaders shaped their plans for the future German economy, they saw in ruin a new beginning, an opportunity to position Germany on a new and totally different path (Kaes et al., 1994).

Later, in the 1990s, economic forecasters have been projecting a longer lasting recovery in Germany, sparked off by strong export growth. Up to now, however, so-called external shocks impede an acceleration of growth. This leads to a pattern of very short and flat economic waves (Directorate General for Economic and Financial Affairs, 2002).

Corporate governance has become a highly charged issue in Germany after years of wars, inflations and depressions. After wide-ranging talks with the parties concerned and with academics, the German government has recommended a package of changes for the reform of corporate governance (Seibert, 2002).

The debate about corporate governance has become more important after the collapse of some major German firms such as Flowtex, Comroad and Philipp Holzmann International GmbH (Germany's biggest construction company employing 17,000) in 1999 (Transparency International, 2001), but that alone was not adequate ground.

Rather, the inflexible structure of shareholdings is gradually falling away and the shareholder structure is becoming more international, the influence of foreign institutional investors and their expectations are growing, a better stock market culture is developing, the investment behaviour is changing, the return on German share investment is becoming more attractive and financial intermediaries are reacting to these changes. For the legal and political framework, this means that against a background of institutional competition, there is growing pressure for changes and adaptation of some German company laws, stock market laws and accounting laws (Seibert, 2002).

German corporate governance principles maintain the old suspicions to a significant degree. Both the Stock Corporation Act (Aktengesetz or AktG), the principle statute governing German corporations, and the statutory accounting principals set out in the Commercial Code (Handelsgesetzbuch or HGB) reflect a concern for protecting the interests of shareholders of a corporation (Aktiengesellschaft or AG) against those of directors and officers (Hutter et al., 2002). An AG must, for example, build up hidden reserves, segregated from its distributable retained earnings, as an additional “equity cushion” helping to ensure that the company can satisfy its creditors (Hutter et al., 2002). Nevertheless, the corporate governance regime of Germany has undergone significant changes during the past years (Seibert, 2002).

In Germany, effective regulations on corporate governance have been missing until now (Waclawczyk, 2002). In most of the other countries with a free

market economy, a code of conduct with generally accepted principles is already in existence. These principles enable investors to check and to judge systematically a corporation in regard to its corporate governance (Waclawczyk, 2002).

As a result, rapid change pertaining to corporate governance now figures as a global economic fact of life in Germany. In recent years, the downturn in the financial markets as well as a number of corporate scandals have spurred efforts by legislators, regulators and stock exchanges to improve corporate governance standards in companies whose shares are publicly traded (Hutter et al., 2002).

German corporate governance principles have a different origin from those of the US, England and other common law jurisdictions. Recent years have seen a measure of convergence between German and Anglo-American principles of corporate governance, as borders between capital markets have grown increasingly porous (Hutter et al., 2002).

The G8⁴ nations are seeking the International Monetary Fund (IMF) and the World Bank to assess the extent to which countries are embracing their corporate governance standards and practices. They view new and improved governance practices as a key to spurring prosperity and jobs by strengthening corporations' abilities to compete for global capital (Davis, 1999).

In Germany, the legislature, regulatory bodies and securities exchanges have clearly made significant progress in modernizing corporate governance. Just as clearly, there remains room for additional improvement. More pressing, perhaps, than a need to simplify the mechanics of effecting board resolutions or obtaining shareholder consents is the need to further increase corporate transparency. Potential investors considering a purchase of shares and existing shareholders considering their votes at a shareholder meeting require adequate and accurate information. It may be expected, therefore, that the focus of future corporate governance reform in Germany will be the establishment of more demanding disclosure duties, backed up with credible deterrents for directors and

⁴ Canada, France, Germany, Italy, Japan, Russia, UK and USA

officers who knowingly or recklessly disseminate false or inadequate information (Hutter et al., 2002).

2.4.4.1. Control and Transparency in Business (KonTraG)

Due to both the internal pressure of mismanagement in German public companies and the external change caused by the globalisation of capital markets, the corporate governance discussions in Germany have resulted in much effort to create a system of regulations to make Germany more attractive to local and international investors. In addition to this, the regulations are intended to stem the criticism of numerous aspects of German corporate governance, such as poor alignment with shareholders' interests, the lack of transparency within German management and poor co-operation between the management and board of directors (Waclawczyk, 2002).

A wide discussion also resulted, relating to the effects of the introduction of the Euro⁵ on shares with nominal value. Proposals have been submitted to Parliament. Recently, the German government had approved the law on control and transparency in business (KonTraG). The law was approved in March 1998 by the Bundestag, parliament's lower house (Ferrarini, 2000).

A summary of the regulations in the KonTraG is as follows (Ferrarini, 2000).

- Repurchase of a company's own shares will be allowed under strict conditions (previously forbidden).
- Shares with multiple voting rights would not be further allowed.
- There would not be a mandatory reduction in the number of members of the supervisory board, while members may continue to sit on ten boards.
- Minority claims against directors would be made more accessible, by reducing the threshold to 5 percent. (Previously 10 percent).
- The supervisory board, not the management board, will appoint auditors.
- The influence of the banks is somewhat curbed: banks may not vote as proxy holders if voting in their own name for more than 5 percent of the shares.

⁵ On January 4, 1999 the Euro was successfully implemented in a big-bang approach in the German security market.

2.4.4.2. German Code of Corporate Governance (GCCG)

In January 2000, a German panel of governance scholars, shareholder activists and corporate executives issued a set of corporate governance guidelines referring to the OECD Principles and encouraging companies to be more transparent on governance and compensation (Gregory, 2001).

The Berlin Initiative Group, comprising academics and professionals, on 6th June 2000, issued the German Code of Corporate Governance (GCCG). It highlights the standards of good management and supervision for companies which develop their value creating activities in and from Germany and contains recommendations for the arrangement of the regulatory framework for managing and supervising a company. The Code, which is directed primarily towards large, listed public stock corporations, is not only intended to promote the quality of company management, but at the same time also serves as a source of information for foreign investors seeking a compact introduction into the basic principles of corporate governance in Germany (Tüngler, 2000).

The GCCG is not intended to provide suggestions for reform, but rather suggestions which complement and describe the existing law. The reason for this concentration on existing law is the consideration that improvement can be brought about within the framework of the GCCG (GCCG, 2000).

The GCCG suggests that each company take the recommendations of the report and have a checklist in its annual report that states which guidelines were adopted and which were not and the reasons for that (GCCG, 2000).

2.4.4.3. DSW Guidelines

The Deutsche Schutzvereinigung Für Wertpapierbesitz (DSW), Germany's largest shareholder organization, has successfully worked towards the adoption of legislative changes to German corporate law that should promote positive corporate governance principles through the new Control and Transparency Law.

Furthermore the Deutsche Schutzvereinigung Für Wertpapierbesitz had the following proposals to be followed by German companies as a minimum benchmark for good corporate governance (DSW).

- Prohibiting supervisory board members from simultaneously sitting on a competitor's board.
- Prohibiting conflicts of interest among supervisory board members.
- Eliminating interlocking ownership.
- Ensuring the independence of the corporate auditor.
- Requiring greater accountability and transparency on banks that vote their beneficial shares through greater proxy voting disclosure on the part of German banks including providing public notice when voting against management.
- Providing more advanced notice of Annual General Shareholders meeting.
- Proxy voting to be simplified

2.4.4.4. Corporate Governance Rules for German Quoted Companies

The Code of Best Practice for German Corporate Governance was drawn up by the Frankfurt Panel on Corporate Governance in July 2000. The Rules of the Code of the German Panel on Corporate Governance serve as general guidelines for Corporate Governance of quoted German companies. Quoted companies are all enterprises whose shares are officially listed on a German stock exchange or traded over-the-counter. The Rules and respective adjustments to the specifics of the individual company shall be published on the Internet. In addition, their acceptance and implementation shall be communicated in the Annual Report (German Panel on Corporate Governance, 2000).

2.4.4.5. Baums Commission Report 2001

The German government appointed a government commission to draw up proposals for making German corporate governance more transparent for both domestic and foreign investors and for strengthening confidence in the management of German corporations (Baums Commission Report, 2001). The