CORPORATE GOVERNANCE REPORTING LEGAL AND REGULATORY ENVIRONMENT IN ETHIOPIA

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ABSTRACT

This paper examined the legal and regulatory environment of corporate governance and financial reporting practices in Ethiopia. After preparing an index for corporate governance items, data were collected from secondary sources using qualitative research through review of legal documents (such as Commercial codes, various proclamations, regulations and directives, etc.). The empirical results of the study has revealed that there is no adequate provision that requires the reporting of the Corporate governance characteristics and issues such as ownership structure, board size, board qualification, training, selection process, tenure period, age limit, internal control systems, audit rotation, and others issues like environment report, labor relation, social responsibility, risk management and the like either in Commercial code of 1960 or in the memorandum and articles of association or other special laws issued for regulating purpose by regulatory bodiesand no mandatory minimum disclosure requirementsof items that should be reported on the annual reports but organizations are disclosing voluntarily.

Key Words: Corporate Governance; Corporate Governance Reporting; Ethiopia; Legal and Regulatory Environment

1. INTRODUCTION

The existences of appropriate and effective legal, regulatory and institutional underpinnings are backbones for a given country's sound corporate governance framework as sound corporate governance framework in turn fosters market integrity, improves economic efficiency and growth as well as builds investor confidence by mitigating agency problem(Gebeyawu, 2012). In the meantime, developing a national financial reporting framework is crucial because without this framework at a national level, it is common to see companies employ different accounting rules or principles or methods which in turn lead to production of different sets of financial statements whichlack the quality of comparability(Addis Fortune, 2009). Wulandari and Rahman (2004,p4) cited that Kothari (2000), Ball (2001), and Benston (2003) have argued that accounting standards on their own are ineffective mechanism of regulation illustrating that infrastructural arrangements for implementing and enforcing standards are also important in giving accounting standards the capability to make accounting information relevant for capital markets and high quality financial reporting regulatory infrastructure make investors perceive financial reports as truthfully reflecting the firm's fundamentals.

Moreover, enhancing the strength of the country's financial architecture will make available quality financial information to facilitate investment decisions and to help reduce the risk of financial crises and corporate failures together with their associated negative economic impacts that have been witnessed in many countries in the world such as USA, Europe, and Asian countries (ROSC Ethiopia, 2007) and make companies transparent to the stakeholders through having a minimum disclosure requirements. Companies' transparency is among the four pillars of corporate governance (Clarke, 2009 as cited by Gebeyawu, 2012). It requires timely disclosures of all relevant and accurate information that reflects the "true and faire view" of the company's financial position and corporate governance. Disclosure requirements comprise both mandatory laws and voluntary codes. In both cases, a strong corporate disclosure regime will have three advantages: (1) enhances companies' transparency, (2) it enables shareholders to make informed decisions and to monitor boards' stewardship towards the company and themselves and (3) it serves as main tools for regulators to supervise and control corporate malpractices for the protection of investors and avoiding market inefficiencies. Therefore, a strong disclosure corporate governance framework assists to attract capitals and foster investors' confidence on the capital markets whereas poor and inadequate corporate disclosure deter the proper functioning of capital markets, raise costs of capitals and result in poor allocations of resources (Jeans et al, 2011, p341-342 as cited by Gebeyawu, 2012, p34).

The share company[1] is one of the forms of business organizations recognized under the Ethiopian Commercial Code. It is established through the issuance of shares to an unlimited number of members as provided for by Articles 304-509 of the Commercial Code. The corporate climate in Ethiopia is changing with the emergence of newer companies with several thousand shareholders who have no control over the company. Nevertheless, publicly held share companies give rise to a host of complex corporate governance issues (e.g. the risk of unfair advantage or exploitation by the managers against dispersed shareholders) (Fekadu, 2010). This paper examined the corporate governance reporting[2]regulatory environment in Ethiopia[3] that are enacted and issued to set minimum mandatory

[1]In this article, Share Company and Corporate Company or entity are used in the same meaning interchangeably.
[2]Corporate governance reporting refers to disclosing corporate governance characteristics and other issues to the annual reports of a reporting entity or simply it is used interchangeably with corporate governance disclosure.

disclosure requirements to make companies transparent to their finance suppliers and other stakeholders.

2. OBJECTIVES OF THE STUDY

Previous literatures (e.g. Fernando, 2012) argued that developing countries and transition economies lack the required framework to put in place best corporate governance practices. According to him, they need to, inter alia, develop property rights, contract laws, a well-regulated banking sectors, exit mechanisms (bankruptcy and foreclosure), sound securities markets, transparent and fair privatization procedures, independent and well-functioning judicial system, and anti-corruption strategies. As Ethiopia is one of the developing countries in the world, it is hypothesized that it shares these problems. Of course, few researches have been conducted from legal perspective (e.g. Gebeyawu, 2012; Tura,2008 and Negash,2008) and others like APRM(2011) reviewed the overall Ethiopia's governance issues from legal perspective. However, to the knowledge of the researcher, no research has beenconducted from accounting perspective. Therefore, to bridge this gap, this study was conducted to examine the corporate governance and financial reporting legal and regulatory environment in Ethiopia.

3. RESEARCH METHODOLOGY

Data were collected from secondary sources to achieve the objective of the study and qualitative research approach was used based on evidence gathered through review of documents (Commercial code, proclamations, regulations, literatures, laws and manuals which were collected from public and academic libraries, purchased sources from publisher, online sources, and custody of organizations and regulatory bodies.Taking OECD (2004)corporate governance disclosure requirements and UNCTAD Secretariat (2011) into account, index of 51 corporate governance's itemscategorized into five broad subjects (General and Background Information; Board and Management Structure and Process; Financial Transparency; Auditing; and Company Objectives and Corporate Responsibility) were prepared and surveyed for their mandatory or voluntarily legal requirements on the laws and regulations of the country. The researcherread and surveyed for the reporting requirements of these items on laws, Commercial Code and other regulations manually twice to avoid missing of items.

[3] Ethiopia is a country located in the north eastern part of Africa which is known as "Horn of Africa" tending 30 to 150 north of the equator and 330 to 480 east of the Greenwich Meridian and with a total area coverage of the country is 1.14 million square kilo meters. According to World Bank's report of September, 2015, Ethiopia is the second-most populous country in Sub-Saharan Africa with a population of 96.5 million, and population growth rate of 2.5% in 2014 (http://www.worldbank.org/en/country/ethiopia/overview) .

4. LITERATURE REVIEW

The history of Corporate Governance goes far beyond company law (Kumar, 2007) but a few years ago the subject of corporate governance was little known, discussed or read and most of the stakeholders were not aware of the corporate system to be introduced in the corporate management. The greatest emphasis has been heightened in the most industrially developed countries of the world due to serious high profile corporate failures, frauds and malpractices in some of their renowned corporate houses (Das, 2010). Much of the security laws in the United states was put in place following the stock market crash of 1929 and corporate governance systems have evolved over centuries, often in response to corporate failures or systematic crises and the first well-documented failure of governance was the South Sea Bubble in 1970s, which revolutionized business laws and practices in England(Yadav and Khatri, 2009, p23).

The first connotation of 'corporate governance' was used in 1984 by Robert Tricker in the modern literatures(Pierre-Yves and Korine, p. 156 as cited by Belaynew, 2014, p18).However, according to Vijaya(2007,p8), the movement of corporate governance has been activated with the publication of the Cadbury Committee Report in December 1992 and the report laid stress upon the role of Board of Directors, duties of the board and its composition, role of the non-executive directors, the directors emoluments, the control system and the need of the auditors to act with due care.

A Corporate Governance is multi-disciplinary subject and a large number of Committees, scholars, authors, researchers and organizations (e.g. only to mention few of them: Cadburry Committee, 1992; OECD, 2004; Bansal, 2005; Sithapathy and Iyer, 2006; Kumar, 2007; Rao, 2007; Vishwanadham et al, 2007; Brennan and Solomon, 2008; Government of South Australia, Office for Recreation and Sport, 2008; Chauhan, 2009; Das, 2010; Lal, 2010; Verries et al, 2010; APRM, 2011; Fermando, 2012; Prabhash et al, 2012; and Sharma, 2015) have defined it from deferent perspectives. This fact was reflected by Rao(2007, p27) stating that "corporate governance actually has multiple meanings, which includes: a legal meaning , depending on the country where a firm resides or operates; the processes by which companies are directed and controlled; encouragement of company's compliance with codes; a field in economics, which studies the many issues arising from the separation of ownership and control; the framework of rules, relationships, systems and processes within and by which fiduciary authority is exercised and controlled in corporations."

For instance, Cadbury Committee (1992), in its historical report on The Financial Aspects of Corporate Governance paragraph 2.5, defined corporate governance as follows:

> "Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth (OECD, 2004, p11). The structures and process of corporate governance are not universally same in all countries. Various countries have adopted different structures and processes in governing their companies depending on suitability for social culture, economic environment, government policy, capital and money market systems, etc. but one thing is common that the board of directors has been recognized as the heart of the structure of corporate governance and the board processes have been accepted as the most important process of governance (Das, 2010, p8). According to Yadav and khatri (2009, p7-8), participants involved in corporate governance include the regulatory body (e.g. the Chief Executive Officer, the board of directors, management and shareholders. Other stakeholders who take part in corporate governance include suppliers, employees, creditors, customers, and community at large.

"Disclosure is important because reporting is widely viewed as the most effective tool that regulators have to encourage better corporate governance. Reporting puts information in the hands of the markets. And markets and investors make investment decisions based on this information. The markets function best when they have access to sufficient information to properly assess governance. Good information helps the markets ascertain the degree to which companies respond to shareholder needs; it reveals risks, and shows the quality of future cash flows" (UNCTAD, 2011, p10). According to the best known and commonly used Principles of Corporate governance of OECD (2004), the corporate governance framework should 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. As per the requirements of this principle, disclosure should include, but not be limited to, material information on: (1) the financial and operating results of the company; (2) Company objectives; (3) Major share ownership and voting rights; (4) Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board; (5) Related party transactions; (6) Foreseeable risk factors; (7) Issues regarding employees and other stakeholders; and (8) Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

Although disclosure regulatory practices vary significantly internationally, with some markets relying primarily on regulatory instruments and others relying on stock exchange listing rules (UNCTA ISAR, 2001), across the globe, corporate governance and financial disclosure requirement by companies becomes mandatory (Belaynew, 2014) through adopting code of corporate Governance.

However, Ethiopia lacks national code of corporate governance (APRM, 2011). Previous studies have also showed the prevalence of weakness in in Ethiopian laws on corporate governance issues in general. For example, the study conducted by Negash(2008)examined and addressed the issues of corporate governance in Ethiopia and found that the legal and constitutional instruments, among others, did not provide adequate enabling environment; key international conventions and standards are not ratified; political parties own substantial number of business enterprises and operate in key sectors of the economy; ownership concentration through pyramid structure introduces particular problems of agency and creates crony capitalism; investor and creditor protection laws are inadequate; and the absence of organized equity market is a serious void.

5. EMPIRICAL FINDINGS AND DISCUSSIONS

The governance structure of a given country protects the investors from expropriation by managers and other governing bodies of the organization. Of course, in different jurisdictions, the rules protecting investors come from different sources, including company, security, bankruptcy, takeover, and competition laws, and also from stock exchange regulations and accounting standards" (La Porta et al, 2000 as cited by Sharma, 2015). "As in many other African countries, the concept of corporate governance has just been introduced and is in its infancy in Ethiopia and there is no national corporate governance code in Ethiopia" (APRM, 2011, paragraph 457).

The Corporate Governance structure of Corporate Governance of Share companies in Ethiopia varies depending on the ownership structure of the company. That means, if the company is privately owned, the company will have the following governance structure: Shareholders, Board of directors and managements in accordance with the requirements of the Commercial Code while if government (public) owned, according to Article 10 of Proclamation 25/1992, Public Enterprises of Ethiopia shall have the following organizational arrangements: (a) A supervising authority, (b) Board of Directors, and (c) management. In private owned Companies in Ethiopia; however, under Ethiopian company law, Corporate Companies are under the governance of Shareholders' General Meeting, Board of Directors, Executive officers and Auditors. The shareholders general meeting is an apex governance body in the corporate governance structure of Ethiopian Share Companies. Shareholders' General meeting makes decisions on behalf of the shareholders who are the principal or owners of the Company. It is provided with this power under Ethiopian law and the following is stipulated under Article 388 of the Commercial code: "*a general meeting of shareholders properly established and conducting its business in accordance with the law, acts on behalf of all shareholders. Decisions of a general meeting bind all shareholders whether absent, dissenting, incapable or having no right to vote both in on general and special meetings."* Under Ethiopian law, Shareholders' meetings may be general or special (Art. 390/1/). General meetings are again of two types: ordinary or extraordinary and comprise shareholders of all classes (Art.390/2/) while special meetings comprise only shareholders of a specific class (Art.390/3/).

As indicated under Article 347 of the commercial code, "*Only members of a company may manage the company; a company shall have not less than three nor more than twelve directors who shall form a board of directors and where the memorandum of association does not specify the number of directors but fixes only a maximum and a minimum, the meeting of subscribers Shall decide the number of directors to be appointed."* Therefore, only member of shareholders are eligible for board membership election and executive officers cannot be member of board of directors in Ethiopian Corporate Governance context.

The survey and analysis of the legal documents revealed that Ethiopia has its own legal and regulatory framework by which its corporate entities are being governed. Corporate Organizations in Ethiopia are being governed and regulated by the 1960 Commercial Code, memorandum and article of associations, and other laws or industry specific laws (such proclamations, regulations, directives and Codes) which are enacted and issued. Therefore, the major law that governs the establishment, operation and winding up of corporate organizations in Ethiopia is the 1960's Commercial Code of Ethiopia or simply Commercial Code. This code is an apex law in governing commercial activities in the country.

The 1960 Commercial code is organized into books and the books are divided into Titles and the titles are again sub-divided into articles and sub-articles. Generally, the commercial Code comprises 6 books. The books are again divided into titles which again categorized into chapters and divided into articles and sub-articles. 3. The commercial code of 1960 requires the board of director of the corporate company requires limited number of corporate governance items to be reported to the shareholders.

Accordingly, Article 446 of the code requires only, balance sheet, profit and loss account, and total amount of remuneration of the directors and auditors, and proposals for the distribution of dividends, if any. However, according to secondary sources, the Commercial Code has been under revision and modernization in collaboration among Ministry of Justice, Ministry of Trade, Legal system Research Institute and The French Development Agency (Legal Vice Presidency – The World Bank, 2004) but there are no indications from stakeholders as to when the new Code will be operational (APRM Report, 2011) and the researcher has learned that the revision process is not finalized until the end of June 2015.

The second legal framework for the governance of the share company is the memorandum and article of associations which are derived from the Commercial code and work under its ambit. In addition to the Commercial code and memorandum and article of associations, various Proclamations, Regulations, Directives, Codes, Memorandum and articles of Associations, procedures and guidelines have been issued by legislators, regulators, board of directors and management of the share company at different times to cope up with the political, economic and social development of the global, national and specific conditions at company level. For example, in addition to the commercial code, the Ethiopian Parliament has enacted Proclamations No. 592/2008 to provide for banking business which empowers National Bank of Ethiopia to regulate the financial sector and the ability to issue directives and accordingly the National Bank of Ethiopia has issued 61 directives up to 2014 for banking business only. Insurance Companies by Proclamation No. 746/2012, Micro Finance Institutions by Proclamation No. 626/2009, and Public Enterprises are governed by Proclamation No. 25/1992. Hiring, managing, occupational Safety, Health and Working Environment, and firing of human resources of share companies are governed by Labor Law, Proclamation No. 377/2003(as amended). Ethiopia has also promulgated a Proclamation on Trade Competition and Consumers Protection (Proclamation No. 813/2013) which shall apply to any commercial activity or transaction in goods or services conducted or having effect within the Federal Democratic Republic of Ethiopia(Art.4 of the this proclamation) but no requirement is provided for the reporting of the corporate governance issues in this regard on the annual reports of companies.

Corporate governance legal and regulatory requirements are disseminated under various regulatory bodies in Ethiopia. Accordingly, Public Enterprises[4] are governed by Public Enterprises Proclamation (Proclamation No. 25/1992) which comprises provisions related to requirements to be met before establishment(Art.5), necessity of issuance of regulation to establish(Art.6), organization and

[4] Are organizations which are a wholly state owned establishedto carry on for gain manufacturing, distribution, service rendering or other economic and related activities (Art.2/1/ of Proclamation No.25/1992)

management(Art.10), powers and duties of the supervising agency(Art.11), establishment , procedures of the meeting, powers and duties, and Liabilities of the board (Art.12 – 15), powers and duties, responsibility and liability and agency of General manager(Art. 16 – 18), the amount of capital needed(Art.19), name of the Enterprise and Trade mark(Art.23 – 26), Accounts and establishment of reserve funds of Enterprise(Art.27- 31), appointment of auditors, obligation to cooperate to auditor, and powers, duties and liabilities of auditors(Art.32 -34), amalgamation and division(Art.35 – 38), and dissolution and winding –up from (Art.39 – 45) and the powers and duties of the council of Ministers related to Public Enterprises.

The financial institutions are regulated and supervised by National Bank of Ethiopia. Ethiopia's Financial Institution system includes Banks, Insurance and Micro finance Institutions (NBE, 2014). National Bank of Ethiopia – an apex bankis empowered by Sub-article 5(7) of the proclamation No. 591/2008 which states National Bank of Ethiopia " license and supervise banks, insurers and other financial institutions" and the following three proclamations also provide mandate to NBE to regulate and supervise through: (i) A Proclamation to Provide For Banking Business (Proclamation No. 592/2008); (ii) A Proclamation to Provide for Insurance Business (Proclamation No746/2012) and (iii) Micro Financing Business Proclamation (Proclamation No. 626/2009). In addition to these proclamations, National Bank of Ethiopia has issued plenty of directives to Bank, Insurance and Micro finance Businesses. According the list of directives on the websites of National bank (www.nbe.gov.et last accessed on 10/03/2015), 59 directives for banks, for insurance and for microfinance business have been issued up to the end of 2014.

However, in line with the conclusion of ROSC Ethiopia(2007), there are no extra requirements in these laws or directives for preparation of annual financial statements and formats and contents of annual reports. The provisions of the proclamations and directives require for preparation of annual financial statements for banks, insurance and Micro finance institutions companies are those provided in the Commercial Code but Commercial Code of 1960 has no requirement for compliance with any defined accounting standards. As observed, some corporate governance items are requested to be reported by financial institutions to National Bank of Ethiopia but National Bank of Ethiopia doesn't subsequently pass on this information to the public.

Even though there is no national corporate governance code in Ethiopia's governance legal system, in 2009, the privatization and Public Enterprise Supervising Agency (PPESA) has issued the Code of Corporate Governance which has six sections and deals with Board and Board members, Audit Systems, Shareholders, Stakeholders, Disclosure and Code of Conduct and Ethics. In October, 2013, the Addis

Ababa Chamber of Commerce and Sectoral association (AACCSA), taking the initiation, has launched the Institute of Ethiopian Corporate Governance (EICG). This institution has prepared a corporate governance code which is entitled as "Ethiopian Code for Corporate Governance" and waiting for approval as per the head of Institute. The next development in the history of corporate governance in Ethiopia is, in October 2014, Ethiopian Chamber of Commerce and Sectoral Associations (ECCSA) has developed and published a two version documents (i.e. Versions for Trading & Services Types of Businesses and Versions for Manufacturing Types of Businesses) as a Model Code of Ethics for Ethiopian. Similarly, in 2015, the National Bank of Ethiopia, has issued Bank Corporate Governance Directive No. SBB/62/2015 taking the following facts into consideration, as indicated in the preamble of the directive; corporate governance plays a vital role in maintaining the safety and soundness of financial system in general and banking sector in particular; corporate governance gives way to balanced risk taking and enhances business prudence, prosperity and corporate accountability with ultimate objective of realizing long term shareholders' value, as well as customers' and other stakeholders' interest, and the National Bank of Ethiopia should ensure whether banks are soundly and prudently managed and directed.

According to section 3(3.1), the directive shall be applicable to all banks operating in Ethiopia even though its applicability to banks owned by the government, as per sub-section 3.2, may be with due consideration of other applicable laws. The directive is of 14 total pages and divided into 15 parts: the short title of the directive; the definitions of some terms, the scope of application; the general principles, Board of directors' size and composition; General meeting of the shareholders, representation and voting by proxy; Nomination Committee; Conduct of Board Election by Authorized Bodies; Board; Qualifications and Training; Meetings. Responsibilities of the Board of the bank; Description of Authority; Exit report of outgoing board; Responsibilities of CEO; Disclosures; Transitional Provisions; Applicability of Other laws; effective date of the directives; and 3 annexes (about Key performance indicators, Code of conduct; Audit Committee, Risk and Compliance Committee, Human Resource Affairs Committee, meeting of these committees and the minimum required policies, and guidelines).

The NBE's directives on corporate governance introduced the establishment of audit committee for the first time in financial sector and Nomination Committee who are: elected from and by shareholders, composed of not less than five shareholders, hat directly accountable to shareholders independent from the board of the bank, and shall not have a seat on the board of the bank (Art.6.1.4), at national level. Moreover, it clearly stated the minimum board size and the board composition in terms of gender and core competencies in banking business (Art.5). The Code also stipulates separate responsibilities for board of directors (Art.10.4) and chief executive officer (Art.11). Regarding the corporate governance items, the code requires commercial banks to submit any related party loan/foreign currency transactions, bank's fixed assets and technology transactions of material nature to itself (Art. 12.2.1) and to post the list of board members, including their qualification, experience and board subcommittees (Art.12.2.3a) and basic organizational structure, including line business structure on their websites (Art. 12.2.3b). However, these corporate items are very few in number and they are not also required to be disclosed in the annual report which is the main source of information for shareholders and other stakeholders in Ethiopia.

6. CONCLUSIONS

The objective the study is to access the corporate governance legal and regulatory framework in Ethiopia and various legal documents and academic literatures and other online sources have been reviewed. The results of the study has shown that there is no provision that requires the reporting of the Corporate governance characteristics and issues such as board size, board qualification, training, selection process, tenure period, age limit, and accounting and auditing standards to comply with is available in the Commercial code of 1960 and there is no adequate corporate governance reporting requirements on the model memorandum and articles of association developed by the Ministry of Trade. Moreover, other laws issued for regulating purpose of the corporate organization also fail to specify corporate governance items that should be reported on the annual reports. As stated by APRM(2011, paragraph 457), "there is no national corporate governance code in Ethiopia." However, the study found that, to mitigate these problems, Ethiopia is making a move toward having a national corporate governance code.

This study in line with Gebeyawu (2012)recommend that formulating and establishing appropriate and effective legal, regulatory and institutional framework are a prerequisite for good corporate governance in Ethiopia as the existence of good corporate governance framework in general and corporate governance and financial reporting requirements in particular within the country will enhance the transparency of the organizations to their shareholders and other stakeholders which inturn increases the confidence of the finance and resource suppliers. Realizing the role of stock exchange in corporate governance, Ethiopia should make fruitful the effortsthat are being undertaken to establish it in the country.

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