REFORMING CORPORATE GOVERNANCE IN ETHIOPIA: APPRAISAL OF COMPETING APPROACHES

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INTRODUCTION

Good corporate governance is vital to boost investors' confidence, expand the private sector, and stimulate economic growth.[1] In many developing countries, especially in Africa, heightened recognition of lost opportunities to mobilize financial resources on domestic and international capital markets through good corporate governance excited the interest of African Heads of States including Ethiopia, which inspired them to include corporate governance as one of the four thematic areas subject to review under the African Peer Review Mechanism (the APRM).[2]

The Commercial Code of Ethiopia (hereinafter the Commercial Code) contains a number of important provisions that have bearing on corporate governance. The pertinent provisions of the Commercial Code (Arts. 304-509) deal with the legal requirements of establishing a share company, the

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[1] Seward Montgomery Cooper, Corporate Governance in Developing Countries: Shortcomings, Challenges & Impact on Credit, *Modern Law for Global Commerce*, (9-12 July 2007), p 1.

[2] The APRM is a unique mechanism under which 26 African leaders, including Ethiopia, have agreed to submit their respective countries and themselves to review introspectively by their compatriots and review Africa-wide by their peers in selected areas of governance. The selected areas are (i) political governance and democracy, (ii) economic governance and management, (iii) socio-economic development, and (iv) corporate governance. See *Ibid.*

management aspects, the board of directors and its mandates, the auditors, the right of shareholders and the general assembly, the different types of meetings, voting process and voting rights, the right of minority shareholders, auditing and reporting obligations, transparency requirements, the involvement of ministry of trade and industry and grounds of liquidation and dissolution.

However, such provisions are inadequate to address issues in modern corporate governance related to board of directors, rights of shareholders as well as financial reporting, transparency and audit. Accordingly, there are some efforts of reforming corporate governance in Ethiopia. For instance, the Federal Democratic Republic of Ethiopia (FDRE) Ministry of Justice is revising the Commercial Code. A “Voluntary Code of Corporate Governance for Ethiopia” was also adopted by Addis Ababa Chamber of Commerce and Sectoral Associations (AACCSA) on 3 June 2011. These reform initiatives involve both formal (regulatory) and informal (non-regulatory) corporate governance approaches. Nonetheless, the discussion as to which approach of corporate governance would be more effective in the context of Ethiopia is a debatable one. While some scholars propose a voluntary code of corporate governance[3], others argue in favor of a mandatory or regulatory corporate law to address problems in corporate governance.

This article assesses various approaches available to policy makers to reform the corporate governance in Ethiopia. It reviews competing models of corporate governance including shareholder model of common law and

[3] Alemayehu Geda, The Road to Private Sector Led Economic Growth, (Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, 2009), p 111-112.

stakeholder model of European civil law; and the regulatory (formal or mandatory) and non-regulatory (informal or voluntary) approaches of corporate governance. It also critically analyses the suitability of such approaches to an emerging economy like Ethiopia. Although corporate governance is important for all types of business organizations including small and closely held companies in Ethiopia, this article is limited to publicly held share companies whose shares are dispersed among a number of shareholders which give rise to separation of ownership and control that in turn exposes them to agency cost.

1. DEFINITION OF CORPORATE GOVERNANCE

Scholars and practitioners approach to 'corporate governance' from various perspectives. As it is a multidisciplinary subject matter, lawyers, economists, managers, accountants and politicians attempt to define it from their own sides. For instance, corporate managers, investors, policy makers and lawyers define corporate governance as "a system of rules and institutions that determine the control and direction of the corporation and that define relations among key participants of a company."[4] The key participants are the shareholders, the management and the board of directors. Corporate governance is also defined as "the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled."[5] This definition is relatively narrower and mainly focuses on the

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[4] Hussein Ahmed Tura, Overview of Corporate Governance in Ethiopia: The Role, Composition and Remuneration of Boards of Directors in Share Companies, *Mizan Law Review* (2012), Vol. 6, No. 1, p 45-76.

[5] A. Geda, *Supra Note* 3, p 98.

internal structure and operation of the decision making process of a company. In many countries it has been this definition which has been vital to public policy discussions about corporate governance. Typically the Organization of Economic Co-operation and Development (OECD) principles of corporate governance deals with only five topics mainly constituting the internal structure of corporation: the rights of shareholders, equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency and the responsibility of the Board of Directors.

Modern corporate governance may also involve corporate social responsibility with a view to dealing with the interests of various stakeholders including employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.[6] Generally, modern corporate governance refers to all issues related to ownership and control of corporate property, shareholders rights, and management, powers and responsibilities of board of directors, disclosure and transparency of corporate information, the protection of interests of stakeholders in addition to that of shareholders, enforcement of rights and so forth.[7] The major problem in corporate governance lies in a separation of ownership and control as this gives rise to agency costs.

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[6] *Ibid.*

[7] Hussein, *Supra Note* 4. See also Fekadu Petros, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *Mizan Law Review*, (March 2010), Vol. 4, No. 2, p 1-30.

2. THE GENESIS OF CORPORATE GOVERNANCE

The discussion of problems inherent with the separation of ownership and control goes back at least as far as Adam Smith who wrote:

> *The directors of such [joint stock] companies, however, being the managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartner frequently watch over their own…Negligence and profusion, therefore, must always prevail, more or less, in the management of such company.*[8]

The agency problem was later framed in detail by Berle and Means, who were concerned with the rising prevalence of large corporations with diffuse ownership that insulated managers from the concerns of shareholders.[9] According to them, the dispersed shareholders have no choice but to hire managers to manage the company, which has been creating the principal-agent relationship. In effect, an agency problem typically arises from the principal-agent relationship[10] and as such, agents may expropriate the principals' investments. This can occur when the agents have more information and

[8] Adem Smith, The Wealth of Nations, (Cannon Edition Modern Library, New York, 1776), p 790. Cited in Stephen C. Alford, A. C. Fernando, Corporate Governance: Principles, Policies, and Practices, (Pearson Education, 2006).

[9] Adolf Berle and Gardiner Means are considered distinguished scholars in the field of corporate governance based on their seminal work on the separation of company ownership and control. After conducting a study of America's larger companies following the Wall Street crash of 1929, they concluded that the separation of ownership and control is attributable to widely fragmented company ownership. See Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, (1932).

[10] Brian R. Cheffins, Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies, *Oxford Journal of Legal Studies* (2003), *Vol. 23, No* 3, p 4.

knowledge than the principals[11] or when information asymmetry between principals and agents exists.[12]

Moreover, two circumstances that have been the focus of the principal-agent framework can be identified. Firstly, "moral hazard arises when the agent's action, or the outcome of the action, is only imperfectly observable to the principal."[13] For instance, a manager may exercise a low level of effort, waste corporate resources, or take inappropriate risks. Secondly, adverse selection can arise when the agent has some private information prior to entering into relations with the principal. Individuals with poor skills or aptitude will present themselves as having superior ones, people with low motivation will apply for the positions that involve the least supervision, and so forth.[14] Due to this reason, Berle and Means corporate governance study mainly focused on the expropriation of shareholders' assets by managers due to separation of ownership and control.[15] In a nutshell, the divorce between ownership and control brings about the likely considerable free-rider dilemma between agents and principals.[16]

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[11] Yuwa Wei, Comparative Corporate Governance: A Chinese Perspective, (2003), p 43.
[12] Jospeh Heath and Wayne Norman, Stakeholder Theory, Corporate Governance and Public Management: What Can the History of State-Run Enterprises Teach Us in the Post-Enron Era?, Journal of Business Ethics (2004) vol. 53, p 252-253.
[13] Miko Kamal, Corporate Governance and State-owned Enterprises: A Study of Indonesia's Code of Corporate Governance, Journal of International Commercial Law and Technology (2010), Vol. 5, Issue 4, p 207.
[14] Ibid.
[15] Malla Praveen Bhasa, Global Corporate Governance: Debates and Challenges, Corporate Governance: The International Journal of Business in Society (2004), Vol. 4, No. 2, p 7.
[16] Heath and Norman, Supra Note 12, p 252.

In the 1970s, due to the emergence of a number of important contributions, agency theory and issues of corporate governance became popular research topics. Ross provided one of the first formalized descriptions of macroeconomic foundations of Agency theory.[17] Alchian and Demsetz examined contracting issues within a firm, noted the shirking problem that arises from the misaligned interests and discussed many of the issues that have subsequently dominated corporate governance research, including imperfect monitoring, labor market discipline of managers, the market for corporate control and issues of efficient compensation design.[18] Jensen and Meckling provided an often-cited definition of agency relationship, formalized the agency cost concept by detailing its components and analyzed the impact of ownership structure on these cost components.[19] Their assertion was similar to that of Berle and Means' work as they state that "the aim of all governance mechanisms is to reduce the agency costs that exist due to the separation of ownership and control especially in large public corporations".[20] Fama and Jensen[21] similarly suggest that "the problem of corporate governance mainly arises in large organizations such as publicly held and listed corporations

[17] S.A. Ross, The Economic Theory of Agency: the principal's problem. *American Economic Review* (1973) Vol. 63, p 134-139.
[18] A. Alchian and H. Demsetz, Production, Information Costs and Economic Organization, *American Economic Review* (1972), *vol.* 62, p 777-795.
[19] Michael C. Jensen and William H. Meckling, Theory of the firm: managerial behaviour, agency costs and ownership structure, *Journal of Financial Economics* (1976), vol. 3, p 305-360.
[20] Carol Padgett and Amama Shaukat, The UK Code of Corporate Governance: Link between Companies and Firm Performance (ICMA Centre Discussion Papers in Finance DP 2005), p 17.
[21] Eugene F. Fama and Michael C. Jensen, Separation of Ownership and Control, *Journal of Law and Economics* (1983), *Vol. 26*, p 301-325.

whose ownership and controls are typically separated".[22] Even though the agency problem typically occurs in a company where shareholders are fragmented includes listed corporations, such a problem may also arise in other types of companies such as small companies, family firms and non-listed companies but the types and the degree of the agency problems would be different.[23]

Furthermore, La Porta *et al* confirm the study of Berle and Means, Jensen and Meckling, and Fama and Jensen. By conducting a series of empirical works on investor protection,[24] La Porta *et al* argue that the nature of corporate governance is absolutely to protect outside investors from the diversion of their assets by insiders.[25] While both controlling shareholders and managers are classified as insiders, La Porta *et al* classify investors and minority shareholders as outsiders.[26] They emphasize that the diversion of outsiders' money by insiders takes place because of an asymmetric information problem between outsiders and insiders. The asymmetric information problem typically occurs as insiders are the company's majority shareholders and controlling

[22] Jochen Zimmermann, Igor Goncharov and Joerg R. Werner, Does Compliance with the German Corporate Governance Code Have an Impact on Stock Valuation? An empirical analysis, *Corporate Governance International*, (2006), vol.14, p 434.
[23] Kamal, *Supra* Note 13, p 208.
[24] Rafael La Porta, Lopez-de-Silanes, Shleifer and Vishny, Legal Determinant of External Finance, *Journal of Finance* (1997), vol. 52; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, "Law and Finance" *Journal of Political Economy* (1998), Vol. 106, p 1152; Rafael La Porta et al, Corporate Ownership around the World, *Journal of Finance (1999), vol.54* ; Rafael La Porta *et al*, Agency Problem and Dividend Policies around the World, *Journal of Finance (1999), vol. 55.*
[25] Simeon Djankov *et al*, The Law and Economics of Self-dealing, *Journal of Financial Economics (2008) Vol. 88*, p 430.
[26] Rafael La Porta *et al*, Investor protection and corporate governance, *Journal of Financial Economics* (2000), Vol.58, p 4.

management do not share the company's vital information they have to the outsiders.[27] Therefore, La Porta *et al* defines corporate governance as "A set of mechanisms through which outside investors protect themselves against expropriation by the insiders."[28]

Generally, the agency problems that occur between principal and agents of a company necessitated the system of corporate governance. In the context of the modern corporation age, a company is normally owned by dispersed shareowners through the capital market[29] who cannot exercise direct control over the company. Besides, there is a major shareholder that often teams up with the company's management in making policies that are inconsistent with the interests of the dispersed owners. Therefore, codes of corporate governance around the world are specifically designed to fill the gap of unbalanced information between investors and companies,[30] to prevent insiders not to divert the outside investors' money to their own gain. Although corporate governance has focused traditionally on the problem of separation of ownership by shareholders and control by management, it is now accepted that firms should respond to the expectations of more categories of stakeholders. The wide range of corporate governance practices include business ethics, social responsibility, management discipline, corporate strategy, lifecycle development, stakeholder participation in decision making processes and promotion of sustainable economic development.[31]

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[27] *Ibid.*
[28] *Ibid.*
[29] Djankov *et al*, *Supra Note* 25.
[30] Steen Thomsen, The Hidden Meaning of Codes: Corporate Governance and Investors Rent Seeking, *European Business Organization Law Review* (2006*), Vol. 7,* p 851, 848.
[31] Fernando, *Supra Note* 8, p 18.

3. MODELS OF CORPORATE GOVERNANCE

Despite variations in terminologies used to describe systems of corporate governance classifications, scholars generally divide the world's systems of corporate governance into two categories. While Cheffins employs the outsider/arm's length and the insider/control-oriented terms,[32] Moerland prefers market-oriented and network-oriented systems to describe the two corporate governance systems.[33] Furthermore, two models are employed to demonstrate the division: the Anglo-American model and the German-Japanese model.[34]

3.1. THE ANGLO-AMERICAN MODEL

This model is labeled as arm's length because, according to Cheffins, the company's shareholders control their shares at a distance by putting their trust in the company's management to run daily activities.[35] It prevails in the common law countries, notably USA and UK, for the reason that most of their large companies are listed in stock markets.[36] The shareholders in these countries' companies are scattered than any other else in the world. And this model is viewed as an outsider model for its key focus is on a company's

[32] Cheffins, *Supra Note* 10, p 3.
[33] Pieter W. Moerland, Alternative Disciplinary Mechanisms in Different Corporate Systems, *Journal of Economic Behavior and Organization* (1995), Vol. 26, p 19.
[34] Marry O'Sullivan, Contests for Corporate Control Corporate Governance and Economic Performance in the United States and Germany, (1978).
[35] Cheffins, *Supra Note* 10.
[36] Moerland, *Supra Note* 33.

shareholders' value and shareholder-management relations, and positions the market as a supervising tool.[37]

There are two major theories that can be used to examine the Anglo-American corporate governance model: the principal-agent or finance model and the myopic market model. According to the principal-agent (finance) model, the maximization of shareholders' prosperity is regarded as a social function of a corporation.[38] The only role of a company in a community in a free market for the company's shareholders is making profits.[39] As a result, the proponents of this theory assert that "other social functions should not hinder the company in realizing its goal, and therefore should be undertaken by other government and charitable organizations."[40] They believe that the performance of the economic structure at large can easily be improved when corporations are managed properly to maximize the value of their shares.[41]

Although the myopic market model also supports the maximization of shareholders' wealth as the key company's goal, it criticizes the financial model for its main concern with the short-term interests of a company's performance, such as short-term return on investment, short-term corporate profits, short term management performance, short-term stock market prices,

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[37] Irene Lynch Fanon, The European Social Model of Corporate Governance: Prospects for Success in an Enlarged Europe, in Paul Ali and Greg Gregoriou (eds), International Corporate Governance After Sarbanes-Oxley (2006) p 424.
[38] Steve Letza *et al*, Corporate Governance Theorizing: Limits, Critics And Alternatives *International Journal of Law and Management,* (2008) *Vol. 50* p 18.
[39] Milton Friedman, The Social Responsibility of Business is to Increase its Profits, (1970) The New York Times Magazine.
[40] *Ibid.*
[41] *Ibid.*

and short-term expenditure.[42] The proponents of this model believe that the finance model neglects the corporation's long-term value and its competitiveness.[43] The myopic market model, as an alternative, suggests that shareholders and managers should be encouraged to share long-term performance perspectives while reforming corporate governance by:

> *[i]ncreasing shareholders' royalty and voice, reducing the ease of shareholders' exit, restricting the takeover process and voting rights for short-term shareholders, encouraging relationship to lock financial institutions into long-term positions and empowering other groups such as employees and suppliers to form long-term relationship with the firm.*[44]

In general, in the Anglo-American model, the corporation's shares are owned by dispersed shareholders; the maximization of shareholders' value is the corporation's principal objective;[45] and a well-developed financial market is placed as a firm's supervising instrument.[46]

3.2. THE CONTINENTAL EUROPEAN OR GERMAN-JAPANESE MODEL

Japan[47] and Continental European countries such as Germany[48] are considered to be representatives of this model.[49] This model is characterized by a close

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[42] Steve Letza and Xiuping Sun, Philosophical and Paradoxical Issues in Corporate Governance, *International Journal of Business Governance & Ethics* (2004), p 32.
[43] Letza *et al*, *Supra Note* 38, p 19.
[44] Letza and Sun, *Supra Note* 42.
[45] Yuan Dujuan, Inefficient American Corporate Governance under the Financial Crisis and China's Reflections, *International Journal Law and Management* (2009), vol. 51, p140-141.
[46] Moerland , *Supra Note* 33.
[47] The Japanese model is the business network model, which reflects the cultural relationships seen in Japanese Keiretsu network, in which boards tend to be large, predominantly executive

relationship between the corporation and its capital providers including shareholders, bankers and other financial institutions. In addition to shareholders, it allows stakeholders to be members of the company's board (a supervisory board) and hence called insider model.[50] It is originated from Germany company structure termed as Codetermination or *betriebliche Mitbestimmung*, which gives an opportunity to the employees to become members of company's supervisory board.[51] In Germany, in a large company, up to half members of supervisory board are elected by the company's employees under the Management Relation Act of 1952 and the Codetermination Act of 1976. There are three types of codetermination in

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and often ritualistic. In this model, the financial institution has accrual role in governance. The shareholders and the main bank together appoint board of directors and the president. It has unique characteristics: the president who consults both the supervisory and the executive management is included and the importance of the lending bank is heightened. See Fernando, *Supra Note* 8, p 55.

[48] In this model, which is also termed as the *two-tier board model*, corporate governance is exercised through two boards, in which the upper board supervises the executive board on behalf of stakeholders. This approach is more societal oriented. Despite some differences between the German and Japanese models of corporate governance, there are certain significant features to justify their being bracketed together, including:

- Banks and financial institutions have substantial stakes in the equity capital of companies. In addition, cross holding among groups of firms is common in Japan.
- Institutional investors in both countries view themselves long term investors. They play a fairly active role in corporate managements.
- The disclosure norms are not very stringent, checks on insider trading are not very comprehensive and effective, and the emphasis on liquidity is not high. All these factors lead to the efficiency of the capital market.
- There is hardly any system of corporate control in these countries; mergers and takeovers are uncommon. See *Ibid.*

[49] Fanon, *Supra Note* 37, p 425.

[50] *Ibid.*

[51] Gérard Hertig, Codetermination as a (Partial) Substitute for Mandatory Disclosure? *European Business Organization Law Review* (2006), Vol. 7, p 129.

Germany: Full Parity Codetermination, Quasi-Parity Codetermination and One-Third Codetermination.[52]

The insider model is mainly aimed at counteracting the abuse of executive power in shareholder models.[53] The Anglo-American model is criticized for the abuse of executive power as it gives greater power to the executive management who can potentially distort their authority for their own interests at the expense of stockholders and society at large. For instance, exorbitant executive overpayment in which the executive managements are allowed to set their big salaries in a way that does not reflect the performance of the company is one of the areas susceptible to problem of abuse of power by the executive management, which cannot be resolved though the system introducing institutional restraints on managerial behavior such as executive directors, audit processes and threats of takeover, according to proponents of the insider model.[54] They also doubt whether corporate governance reforms such as non-executive directors, shareholder involvement in major decisions and transparency into corporate affairs are in fact appropriate monitoring instruments.[55]

As an alternative, proponents of insider model propose the idea of "managerial freedom with accountability", which involves letting decision-making

[52] Jean J. Du Plessis and Otto Sandrock, The German System of Supervisory Codetermination by Employees, in Jean du Plessis, et al (eds), German Corporate Governance in International and European Context (2007), p 111.
[53] Letza *et al*, *Supra Note* 38.
[54] *Ibid.*
[55] *Ibid*, p 20.

management build up the longer term plans of the company while ensuring the board is strictly responsible to all stakeholders involved in the company.[56] The corporation is seen to have a responsibility to a large number of individuals and groups, who are also considered stakeholders in addition to the company's capital providers.[57] This approach recognizes the existence of non-shareholding company groups, for example employees, suppliers, customers and managers who have a continuing connection with the company.[58]

The major goal of the insider/stakeholder model of corporate governance is to maximize the business's values at large unlike the shareholder's perspective.[59] From the standpoint of stakeholder model, therefore, two groups exist: the primary stakeholders such as minority shareholders, lenders, consumers, employees, suppliers and managers, and the secondary stakeholders including the local community, the media, the court, the government, special interest groups and the general public.[60]

In general, the German-Japanese model is characterized by affording an opportunity for company stakeholders other than shareholders to be on the company board. Moreover, this model recognizes and values the involvement of major shareholders and banks as providers of capital and controllers of the corporations.[61] It is worth noting that these models are merely intellectual

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[56] *Ibid.*
[57] James P Hawley and Andrew T. Williams, Corporate Governance in the United States: The Rise of Fiduciary Capitalism: A Review of the Literature (1996).
[58] Letza *et al*, *Supra Note* 38, p 20.
[59] *Ibid.*
[60] *Ibid.*
[61] Moerland, *Supra Note* 33.

constructs.[62] They are not mutually exclusive of each other with all their complexity. For one thing, the effort to make management, whether American or European, more responsive to other parties outside of management can only serve as helpful discipline on managers.[63] The movement towards more independent directors is also a step forward, whether the goal of the corporation is seen as shareholder profit or stakeholder benefits. The effort now well advanced in Europe to separate the positions of chairman and CEO would probably be seen as beneficial by the shareholders of most American corporations. A point of convergence between the bare shareholder model advanced by Americans and the extreme stakeholder model advocated by Europeans may reside in the notion of "socially responsible corporate governance"[64], a concept that seeks to bring together two important themes that really have not been joined thus far: corporate good governance and corporate social responsibility.

3.3. SUCCESSFUL STRATEGIES FOR DEVELOPING COUNTRIES: ONE SIZE DOES NOT FIT ALL

Corporate governance was long ignored as a matter of importance for developing countries. It remained virtually invisible in those countries until the East Asian financial crises of 1997-1998 drew attention to the problems of "crony capitalism," and their perceived relationship to poor local corporate

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[62] Salacuse, W. Jeswald, *Corporate Governance in the UNECE Region*, (Paper commissioned for the Economic Survey of Europe, the Secretariat of the United Nations Economic Commission for Europe, UN/ECE, Geneva, December 2002), p 52.

[63] *Ibid.*

[64] *Ibid.*

governance practices in several major emerging-market economies.[65] Yet, as the threat to the global financial markets raised by those crises has receded, efforts to significantly improve corporate governance in the developing world have flagged.[66] Indeed, even at the height of the international concern for corporate governance in the emerging market economies,[67] little attention was given to corporate governance in other developing countries, especially the smaller and poorer ones.[68] It is firmly asserted, to this end, that "the tendency to ignore the quality of corporate governance in the developing world is a mistake because the institutions of corporate governance play an essential role in the long-term process of development of a country."[69] Thus, it is argued that "corporate governance should be an important element in developing countries' strategies for growth, financial strength and productive private sectors."[70]

On the other hand, the countries in transition economies face problem of corporate governance in paradoxical situation. Their corporate sector consists of "instant corporations" formed as a result of mass privatization without the simultaneous development of legal and institutional structures necessary to operate in competitive market economy.[71] The business environment is

[65] Charles P Oman, Corporate Governance in Development: The Experiences of Brazil, Chile, India, and South Africa, (OECD Development Centre, Centre for International Private Enterprise, 2003), p 2.
[66] *Ibid.*
[67] Called "emerging" because of the rapid growth of portfolio equity flows thereto in the early 1990s by large institutional investors based mainly in United States and Great Britain, See *Ibid.*
[68] *Ibid.*
[69] *Ibid.*
[70] Salacuse, *Supra Note* 62, p 54.
[71] Fernando, *Supra Note* 8, p 490.

without the set of elements needed for making competitive relationships, which provides an advantage to old, large, dominant companies and discourages entrepreneurship and the appearance of new companies.[72]

The question is, therefore, not on the importance of good corporate governance for developing countries, it is rather how they should introduce it. Is it possible, after all, to reproduce all at once the institutions of developed market economies in transition economies? It is suggested that "merely transplanting these institutions is not possible because there are new conditions and many cultural differences."[73] On the other hand, "to develop entirely new institutions would be an unpredictable adventure for transition economies."[74]

Salacuse strongly suggested that developing countries should examine carefully and critically the entire experience of both North America and Western Europe before adopting their laws and institutions. He put that "Rather than leap to a shareholder or stakeholder model or hastily choose a unitary or two-level board structure, each transition state needs to determine the system of corporate governance most appropriate to its own individual needs and circumstances."[75] In a similar vein, Fernando maintains that: "[they] have to find a way to accept the existing institutional portfolio and to make it work in the specific cultural, historical and economic environment as they

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72 *Ibid.*
73 Slacuse, *Supra Note* 62, p 54.
74 Fernando, *Supra Note* 8, p 490.
75 *Ibid.*

cannot afford the luxury of searching for third system between socialism and capitalism."[76]

Furthermore, Salacuse argues that:

> *Organizations and individuals from western developed countries inevitably press for the adoption by transition economies of "best practices" in corporate governance, best practices that have invariably originated in their own home countries. Those best practices were of course the product of specific national experiences and cultures; factors that may make their adoption by a given transition economy inappropriate or at least difficult without significant adaptation.*[77]

Mere transplantation of Western models of corporate governance, according to Fernando, more often than not, fails to instill or improve corporate governance since these models are not designed for local realities and challenges because of which indigenous groups are then faced with task of adapting the international model to local conditions.[78]

Therefore, policy makers in developing economies would do well to remember that to a large extent western corporate governance systems have evolved over time as a response to periodic and specific financial crises in individual countries in evaluating foreign models of corporate governance.[79] As has been

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[76] *Ibid.*
[77] Salacuse, *Supra Note* 72, p 53.
[78] Fernando, *Supra Note* 8, p 488.
[79] Salacuse, *Supra Note* 62, p 53.

predicted by Salacuse in 2002 that "… while recognizing that those crises have come and gone, they should also remember that others, leading to still further corporate governance reforms, are probably yet to come"[80], the 2008 Financial and Economic Crises has cleared doubts surrounding the importance of good corporate governance for every countries around the world irrespective of their level of economic development.

4. CODES OF CORPORATE GOVERNANCE

A number of codes of corporate governance are developed following the recognition of importance of good corporate governance for firm performance and investor and minority shareholder protection at the global level. Broadly speaking, these codes can be classified as mandatory and voluntary. The mandatory code of corporate governance emerged with the introduction of the Sabanes-Oxley Act (SOX) of 2002 in the United States following the collapse of some colossal companies such as Enron, WorldCom and Tyco International in 2001.[81] This law is considered as a foundation tale for the new era of corporate governance in the US. The law requires all companies that have registered equity or debt securities with the Security and Exchange Commission (SEC) to adhere to it. Therefore, the publicly held companies in America have to meet all the requirements contained in the SOX, the so-called

[80] *Ibid.*

[81] In the wake of the disaster on 30 July 2002, the American Congress passed a new law, the Sarbanes-Oxley Act of 2002, which is known as the Public Company Accounting Reform and Investor Protection Act of 2002, which is the most important law reform relating to corporate governance in the US. See Paul S. Atkins, The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation (2003). Available at: http://www.sec.gov/news/speech/spch032503psa.htm [Last visited 18 February 2014].

mandatory model, which means "legally mandated, with penalties imposed on those who fail to comply with the legal rule in question".[82] This means, this law is binding on every listing company in the country and those who fail to abide by it must face penalties prescribed by this law. The proponents of the mandatory system of corporate governance claim that it would be a road to culminate the crucial problem of a corporation.[83]

On the other hand, some countries like UK and Australia are applying the voluntary model of corporate governance. The Australia Stock Exchange Corporate Governance Council clearly states that the Australian Principles of Good Corporate Governance and the Best Practice Recommendation contain a voluntary system which requires publicly held companies that might not comply with the Principles to provide sufficient and reasonable arguments as to why they don't.[84] The Australian system functions on the basic principle of "if not, why not" as opposed to the "one size fits all" approach.[85] The basic concept of the Australia's code is that the market can come to its own conclusions about the significance of non-compliance based on the circumstances of individual companies.[86]

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[82] Anita I. Anand, Voluntary vs. Mandatory Corporate Governance: Towards an Optimal Regulatory Framework, (2005). Working Paper 566, p 4.
[83] The crises were created while companies have been applying the voluntary concept of corporate governance.
[84]ASX Corporate Governance Council, *Corporate Governance Principles, Recommendations*, (August 2007) Available at: http://www.asx.com.au/supervision/pdf/corp_governance_principles_recommendations_2nd_edition.pdf [Last visited 20 May 2013].
[85] *Ibid.*
[86] *Ibid.*

The implementation of the voluntary system in the UK can be observed in paragraph 4 of the preamble of the Combined Code, which states two points. Firstly, listed companies are free to design the form of disclosure statement because the committee does not provide listed companies with a specific form. Secondly, there is no requirement for all listed companies to apply the content of the Code. Where listed companies do not adhere to the Combined Code, they must explain it; which is known as the "comply or explain" approach.[87] In the UK the philosophy of the "comply or explain" approach is to pay attention to smaller listed companies. This approach takes into account that there are many small listed companies for which the substance of the Code might not be suitable.[88] Therefore, the smaller listed companies are allowed to conduct their business under the other model by giving substantial reasons.[89] To put it briefly, the UK Combined Code and the Australian model provide that not all of listed companies need the same model.

The debate on mandatory and voluntary models is in essence not about which would be most suitable to apply to corporations at large. These are the two perspectives that aim to deal with the laws that are needed to support the agency problems facing companies with shareholdings that are fragmented. From a practical point of view, the Sarbanes Oxley Act of 2002 is a product of the "law matters" thesis, which essentially contends that law is important to protect shareholders, especially minority shareholders, from insider

[87]The Combined Code on Corporate Governance (July 2003), http://www.frc.org.uk/documents/pagemanager/frc/Web%20Optimised%20Combined%20Code%203rd%20proof.pdf [Last visited 20 February 2014].
[88] *Ibid.*
[89] *Ibid.*

expropriation.[90] The critical goal of the "law matters" thesis is to promote capital markets and economic growth, which can be achieved by upholding shareholders' property rights.[91] This thesis, therefore, considers minority shareholders as primary players of capital markets.

5. CORPORATE GOVERNANCE IN ETHIOPIA

Currently Ethiopia has a number of companies formed by sale of shares to the wider public. The emergence of publicly held share companies in the country in turn gives rise to multitude of complex corporate governance issues. Ownership separates from control of dispersed shareholders and goes into the hands of few managers. In such situation, agents (managers) may expropriate the principals' (shareholders') investments as they have more information and knowledge than the principals. By the same token, in share companies where there exist few block holders, minority shareholders could be exploited in the hands of such block holders.

The emerging separation of ownership and control in the Ethiopian share companies has recently attracted the attention of a number of scholars to discuss 'corporate governance' from various perspectives. For instance, Minga Negash observes that "… weak corporate laws are serious voids for complying with international corporate governance standards."[92] Asnakech Getnet finds

[90] Troy A. Paredes, Corporate Governance and Economic Development, (Washington University, 2005), p 57.
[91] *Ibid.*
[92] Minga Negash, Corporate Governance and Ownership Structure: the Case of Ethiopia, *Ethiopian e-journal for Research and Innovation Foresight (Ee-JRIF)* (2013), Vol 5, No 1, p 33-50, Special Issue on the Ethiopian Economy.

that the overall standard of corporate governance of private banks in Ethiopia is inadequate due to the poor legislative framework, political party's involvement in business enterprises, inadequate shareholder protection laws and the ineffective judicial system as well as absence of an organized share market in Ethiopia.[93] Moreover, Hussein Ahmed critically analyses the Ethiopian company law in light of international best practices; and he finds that "the legal framework governing company governance in Ethiopia does not sufficiently address issues related to the roles, composition and remuneration of boards of directors in share companies."[94] He further observes that "the governance powers of nonexecutive directors are not clearly provided separately from the management duties of company executives"; and that "there is no legal provision expressly articulating the need for the independence of directors." He has also identified some legal and practical challenges surrounding the directors' remuneration in the Ethiopian share companies. Similarly, Fekadu Petros shows the deficiency of the Commercial Code in protecting the rights of minority shareholders in the context of publicly held companies where separation of ownership and control prevails.[95] Besides, Tewodros Mehiret discusses various issues related to governance of share companies in Ethiopia.[96] Likewise, Dr. Alemayehu Geda has conducted a research entitled "The Road to Private Sector Led Economic Growth" in

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[93] Asnakech Getnet Ayele, "Revisiting the Ethiopian Bank Corporate Governance system: A Glimpse of the Operation of Private Banks",) *Law, Social Justice & Global Development Journal* (2013), Vol. 1 (LGD).
[94] Hussein, *Supra Note* 4.
[95] Fekadu, *Supra Note* 7.
[96] Tewodros Meheret , 'Governance of Share Companies in Ethiopia', in Seyoum Yohannes (eds.), "Starting and Building a Business Association in Ethiopia: The Legal and Institutional Dimensions", *Ethiopian Business Law Series* (2011), Vol. IV, AAU, School of Law, p 53.

which he suggests the adoption of voluntary code of corporate governance in Ethiopia.[97]

These prior works are of paramount significance in identifying the problems related to corporate governance in the Ethiopian context; and they also suggest possible solutions for the future legal and policy interventions. This article is also a kind of contribution to the subject matter at hand. It deals with issues that have not been addressed so far by making specific reference to the appraisal of competing approaches for reforming corporate governance in share companies in Ethiopia.

Before dealing with issues of reform of corporate governance, the foregoing sub sections briefly review some of the deficiencies in the existing legal frameworks regarding the governance of share companies in Ethiopia.

5.1. BOARD OF DIRECTORS

Although the Commercial Code and other relevant laws provide for the formal structure of corporate governance, they do not adequately address issues related to boards of directors in the governance of share companies. Some of the main deficiencies in the law with respect to boards of directors can be summarized as follows:

- Even if non-executive directors play a significant role in providing independent and objective guidance and direction of management and company, the Commercial Code and other relevant laws do not require companies to have independent non-executive directors and do not

[97] A. Geda, *Supra Note* 3, p 98-112.

distinguish the roles of the board from that of the management.[98] Besides, the law does not define independence of board of directors.

- The Commercial Code does not prescribe any formal qualifications for directors of companies as a result of which even incompetent and mediocre persons can become member of boards of directors;
- It does not provide for separation of the roles of a chief executive officer (CEO) and board Chairperson;
- Besides, the law does not require companies to have various board committees. While many committees on corporate governance have recommended in one voice the appointment of special committees for nomination, remuneration and auditing,[99] the existing legal framework does not address the importance of such committees in the context of Ethiopian share companies:
- The existing legal framework does not clearly address issues related to directors' remuneration such as transparency, pay for performance and process for determination. In addition, the amount of remuneration of a bank directors set by Directives No.SBB/49/2011 to be 50,000 (Fifty Thousand) Birr per annum is criticized for not consulting global best experiences and failing to align the interests of directors with those of the stakeholders, and for not taking into account risks and liabilities involved in the board room and the impact of ineffective compensation on the independence of the board from the management.[100]

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[98] Hussein, *Supra Note* 4.
[99] Fernando, *Supra Note* 8, p 24.
[100] Hussein, *Supra Note* 4.

5.2.PROTECTION OF MINORITY SHAREHOLDERS

One of the purposes of effective corporate governance is to protect minority shareholders from abuse, whether from managers with little ownership interest or controlling shareholders who dominate management. Some of minority rights protections are provided under the Commercial Code. For instance, voting by proxy is stipulated under Arts. 398 (1) and 402. The minimum percentage required for shareholders to call general meetings is 10% of the capital under Art. 391 (2). Likewise, the pre-emptive right of shareholders to buy newly issued shares in proportion to their shareholding is explicitly provided under Arts. 345 (4) and 470 (1). Similarly, the OECD Principles of Corporate Governance provide for such requirement on minority rights as reflected in the Annotations.[101]

Normally, there are two alternative mechanisms of minority rights protection: cumulative voting and minority representation in the board of directors. Cumulative voting relates to voting during board elections in which the votes of the contending groups will be multiplied by the number of the board seats and calculated for the contenders' nominees in accordance to the proportion of each group's summed up votes and believed to avoid a majority-take-all outcome.[102] The means envisaged under Art. 352 does not seem to ensure proportional minority shareholder representation. Art. 352 of the Commercial Code which provides for proportional representation in a board reads: "where there are several groups of shareholders with a different legal status, the

[101] Annotations to OECD Principles, p 42.
[102] Fekadu, *Supra Note* 7, p 19.

articles of association shall provide for each group to elect at least one representative on the board of directors." The message of this provision is not clear. Particularly, it is not clear with what it meant by legal status and whether the law is referring to the class of shareholders under Arts. 335, 336 and 337 of the Code. In other words, it seems to require a situation where shareholders are divided into several groups with each shareholder having some internal relationship by which to identify with its group and vote in concert. Nevertheless, this cannot be expected in share companies with numerous shareholders that are counted in thousands although it may be easier to realize in a closely held company.

The derivative suit mechanism, i.e., the right to initiate suits against directors or third parties on behalf of the company is not provided in the Commercial Code. However, it appears that the drafter of the provisions (Professor Escarra) had initially drafted the provisions in Art. 364-367 with the aim of providing for derivative suit mechanisms. This seems evident from his *exposé des motifs* in which he states:

> *These very important provisions regulate the liability of directors and the procedure for enforcing this liability by individual or class action. These articles ... represent a sufficiently simple and precise statement of one of the most complex problems in company law, i.e., the action which can be brought by each shareholder in the case where the fault of the directors has prejudiced the company's property as well as his own property.*[103]

[103] Peter Winship, Background Documents of the Ethiopian Commercial Code of 1960, (Addis Ababa, Faculty of Law, Haile Sellassie I University, 1974), p 64. It is more probable that the

If a remedy is to be sought from the directors themselves, as they work on behalf of a company, it would be difficult to enforce claims on behalf of the company.[104] In this case, directors may decline the legitimate claims of a company against third parties due to collusion with outside business partners or in return for some illicit considerations.[105] Consequently, the right to take action on behalf of the company should pass to individual shareholders[106] subject to defined conditions in order to prevent abuse of rights wherever any shareholder deems that the company should be taking legal proceedings against directors or some third party, but neither the board nor the general meeting does so. The OECD Principles incorporate this element:

> *Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated.*[107]

original rules Prof. Escarra drafted were later changed either by prof. Jauferet who replaced him upon his sudden death without completing the drafting, or by the Codification Commission.

[104] Tom Hadden, Company Law and Capitalism, (2nd eds., London: Weidenfeld and Nicholson 1977), p 277.

[105] *Ibid.*

[106] *Ibid.*

[107] Annotations to OECD Principles, p 41.

It is worth noting that the derivative suit mechanism stipulated under Art.365 of the draft revised Code states that:

1. Actions for damages suffered by the company as a result of a tort committed by directors in the performance of their duties shall be instituted in the interest of the company by the board of directors.
2. One or more shareholders may institute action in the interest of the company after serving a formal notice to the board of directors to which they fail to react within a time limit of thirty days. The applicants would have the ability to sue for damages for injury suffered by the company. In the event of a verdict in favor of the Company's claim, damages shall be awarded to the company.

Thus, the Draft Commercial Code fills the deficiency of the existing Code regarding the derivative suit mechanism. Moreover, Art. 416 (2 to 5) of the Commercial Code provides for a right of shareholder to challenge decisions of the General Meeting. In addition, when fundamental changes are made to the objects or nature of the company or the transfer of the head office abroad, minority shareholders are accorded the right to withdraw from the company under Art. 463 of the Code. What's more, the "one share one vote" right is provided in the Commercial Code under Arts. 145 (3) and 407 (2).

By and large, although the Commercial Code incorporates the aforementioned rights which are believed to minimize minority shareholders' exploitation by managers or block holders, it also lacks other rights such as the right to proxy voting by mail; the derivative suit mechanism, and cumulative voting or proportional representation of minorities on board of directors. The requirement under Art. 401 which obliges shareholders to deposit their shares prior to Shareholders' meeting also reduces the minority rights protection. Hence, the law is insufficient in shareholder protection due to the fact that the rights lacking under the Commercial Code are the most important ones which can minimize minority shareholder exploitation by managers or block holders. Moreover, the absence of stock markets affects the exit rights of minority shareholders.

5.3. DISCLOSURE AND TRANSPARENCY

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.[108] It has also been argued that the lack of transparency arising from inadequate disclosure allowed significant problems to build up in the financial and corporate sectors. For instance, when the financial condition is deteriorated in East Asian countries, the inability of investors and creditors to determine sound financial institutions and corporations due to the lack of transparency resulted in investors being reluctant to hold shares while creditors became reluctant to overturn maturing short-term debts for fear of an imminent loss.[109] It was believed that this has

[108] OECD Principles of Corporate Governance, Principle V (2004).
[109] Pik Kun Liew, The (Perceived) Roles of Corporate Governance Reform in Malaysia: The Views of Corporate Practitioners, (University of Essex, WP No. 06-02, April 2006), p 5.

contributed significantly to the erosion of investor confidence and in part exacerbated the crisis.[110]

In this regard, the Commercial Code contains basic rules relating to accounts record keeping. Under Art. 63 (1), all persons and business organizations carrying on a trade must keep such books and accounts as are required in accordance with business practice and usage, having regard to the nature and importance of the trade carried on. Petty traders may be exempted from keeping accounts. Art. 63 (1) is intended to be the basic legal requirement for record keeping by regulated persons. The requirement may be supplemented by more detailed requirements applying to particular forms of enterprise, but the basic legal requirement applies to all forms of business organizations.

The Commercial Code also states that "any trader shall keep a book of account where he shall make a daily record of his daily dealings and must, once a month reconcile the proceeds of such dealings".[111] Moreover, "traders must also prepare, at the end of each financial year, an assets and liabilities account and a profit and loss account".[112] Besides, "all books and accounting documents must be preserved for at least ten years".[113] However, there are no additional rules on accounting record-keeping for joint ventures, partnerships or companies (though there are more detailed requirements concerning the format of company accounts).

[110] Ibid.
[111] Commercial Code of Ethiopia, Proclamation No.166/1960, Art.66 (2), Neg.Gaz. Extraordinary Issue No.3.
[112] Commercial Code of Ethiopia, Art. 67 (2)
[113] Commercial Code of Ethiopia, Art. 69

Furthermore, the Commercial Code holds the directors responsible for the preparation of financial statements, including consolidated financial statements for group of companies and for ensuring that an audit of the financial statements is regularly conducted.[114] Besides, Art. 362 of the Code requires board of directors to keep accounts and books; submit the accounts of the auditors and an annual report of the company's operations including a financial statement to the meetings. Moreover, the Code deals with duties and responsibilities of auditors under Arts. 368 - 387. Specifically, it provides for the appointment of auditors[115], duties of auditors[116], powers of auditors[117] and liability of auditors.[118] As it is provided under Art. 374, auditors have the following duties:

- audit the books and securities of the company;
- verify the correctness and accuracy of the inventories, balance sheets and profit and loss accounts;
- certify that the report of the Board of Directors reflects the correct state of the company's affairs; and
- carryout such special duties as may be assigned to them.

The auditors are civilly liable to the company and third parties for any fault in the exercise of their duties which occasioned loss.[119] In addition, an auditor

[114] Commercial Code of Ethiopia, Arts.446 and 45.1
[115] Commercial Code of Ethiopia, Arts. 368-371.
[116] Commercial Code of Ethiopia, Arts. 374-377.
[117] Commercial Code of Ethiopia, Arts. 378-379.
[118] Commercial Code of Ethiopia, Arts. 380.
[119] Commercial Code of Ethiopia, Arts. 380 (1).

who knowingly gives or confirms an untrue report concerning the position of a company or fails to inform the public prosecutor is criminally responsible.[120]

Nevertheless, the provisions for both preparation and audit of financial statements require improvement. In provisions for preparing financial statements, there is no requirement to comply with accounting standards, and the financial statements required to be produced are only balance sheet, and profit and loss account.[121] In provisions for audit, there is no requirement to comply with auditing standards, no specified qualification of auditors,[122] and no audit requirement for private limited companies with 20 or less shareholders. Nonetheless, there are two convincing points justifying the audits of all private limited companies. In the first place, the limited liability status granted to a company is meant to be accompanied by a mechanism of assuring the credibility of the financial affairs of a company and such mechanism can only be provided through audit.[123] Secondly, there may be private limited companies which, even though they have less than 20 members, are large enough to be public interest entities.

Another area of the Commercial Code which needs reconsideration is the issuance of shares to the public. Share companies are allowed to issue shares to the public, but there is no regulation for the issuance of these shares.[124]

[120] Ibid, Art. 380 (2).
[121] In comparison, IFRS require income statement, balance sheet, cash flow statement, and statement of changes in equity or statement of recognized gains and losses.
[122] Qualification would be provided by defining auditors as those holding a practicing license issued in accordance with the country's legislation governing accountancy.
[123] Report on Observance of Standards and Codes (ROSC)-Ethiopia, (World Bank and IMF, Nov. 2007), P 6.
[124] Ibid.

Regulating public issue of shares protects the public interest by enabling the detection and rectification of frauds, errors and omissions before the information goes public.[125] Preferably, regulation requirements would include an audit report on the financial information to be included in the prospectus and registration, and approval of the prospectus, with a regulator, before its release to the public.[126]

The banking industry is one of the financial sectors facing relatively strict oversight from its regulator, the National Bank of Ethiopia (NBE). The Banking Business Proclamation No.592/2008 deals with financial records and external audit inspection under its part six in which it has put additional disclosure requirements on commercial banks. Art. 23 (1) of the Proclamation provides that the NBE may direct banks to prepare financial statements in accordance with the *international financial statements standards*, whether their designation changes or they are replaced, from time to time. The problem in this provision is that '*International Financial Statements Standards'* is not defined, and there are no accountings standards set or adopted in Ethiopia. It further states that all banks must keep records as are necessary to: exhibit clearly and correctly the state of its affairs; explain its transactions and financial position; and enable the NBE to determine whether the bank had complied with these requirements.[127] For each type of transactions, all banks must register and keep documents. Art 24 of the Proclamation also deals with appointment of external auditors in all banks and that should be approved by

[125] Ibid.
[126] Ibid.
[127] Banking Business Proclamation, Art.23 (a-c), Proclamation No.592/2008, Fed.Neg.Gaz. 14th year, No.57.

the NBE. Pursuant to Art. 26 (1) of the Proclamation, the duties of external auditor include reporting his/her audit findings and conclusions, carried out on the basis of *international auditing standards*, to the shareholders of the bank and the NBE.

Moreover, this Proclamation deals with disclosure of information and inspection of banks. Art. 28 (1) of the Proclamation provides that "every bank shall, within a time period to be determined by the NBE, send to the NBE duly signed financial statements and other reports as prescribed by it." Besides, it stipulates in sub Art. 2 that "every bank shall exhibit at every place of its business, including its branches, in a conspicuous place throughout the year, a copy of the last audited balance sheet and profit and loss account in respect of all of its operations; cause such balance sheet and profit and loss account, together with the notes thereto, to be published in a newspaper of wide circulation." The exhibition and publishing of financial statements must occur within two weeks after the annual shareholders' meeting.[128]

By the same token, Art. 15 of Micro-financing Business Proclamation No.626/2009 provides for the *financial records and disclosure of information*". Thus any micro-financing institution must:[129]

a) prepare its financial statements in accordance with *acceptable accounting standards*;

[128] Banking Business Pr oclamation, Art.28 (3).
[129] Micro Financing Business Proclamation, Art.15 (1), Proclamation No.626/2009, Fed.Neg.Gaz. 15th Year, No.33.

b) keep such records as are necessary to exhibit clearly and correctly the state of its affairs and to explain its transactions and financial position and to enable the NBE to determine whether the micro financing institution had complied with the provisions of this Proclamation and directives issued by the NBE; and

c) register and keep documents for each type of transaction in accordance with directives of the NBE.

In addition, any micro financing institution shall, within a time period to be determined by the NBE, submit to it duly signed financial statements and mother reports as prescribed by it; and exhibit at all branches, in a conspicuous place throughout the year, a copy of the last audited balance sheet and profit and loss statement.[130] Furthermore, any micro financing institution shall, where it appears likely that it cannot meet its obligations to its depositors or other creditors or it may have to suspend payments to depositors or other creditors forthwith notify the NBE of the full facts of the situation and also provide such other information as the NBE may request.[131]

The Micro-financing Business Proclamation also stipulates for the *Appointment of External Auditors* under Art.12 that "every micro financing institution have to appoint an external auditor satisfactory to the NBE". Where it is without an external auditor, it must immediately notify such fact to the NBE.[132] The duty of an external auditor of a micro financing institution shall be to report his audit findings and conclusions, carried out on the basis of

[130] Micro Financing Business Proclamation, Art.15 (2).
[131] Micro Financing Business Proclamation, Art.15 (3).
[132] Micro Financing Business Proclamation, Art.12 (1).

accepted auditing standards, to the shareholders of the institution and the NBE.[133] The external auditor shall also be required to submit the management letter to the NBE. Nevertheless, *accepted auditing standards* is not defined in the Proclamation.

On the other hand, auditors for insurance companies are not subjected to any additional requirements other than the provisions of the Commercial Code. The Proclamation for Licensing and Supervision of Insurance Businesses No.86/1994 states that the balance sheet, profit and loss account and revenue account of every insurer shall be audited annually by an auditor; and the auditors for insurance companies shall have powers, functions and duties; and be subjected to liabilities and penalties under the Commercial Code.[134] There are no other regulations for auditors of insurance companies.

Furthermore, there is no accounting and auditing standards set in Ethiopia and there is no law or regulation that has set or requires accounting standards in preparation of financial statements.[135] Some laws require Generally Accepted Accounting Principles (GAAP) to be applied or Accepted Accounting and Auditing Standards (AAS).[136] However, in all cases, GAAP and AAS are not defined. Even though OFAG (Office of the Federal Auditor General) directed all auditors to conduct audits in compliance with ISA (International Standards

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[133] Ibid Art.13 (1).

[134] Licensing and Supervision of Insurance Business Proclamation, Art.18 Proclamation No.86/1994 Ne.Gaz, No.46.

[135] Ethiopia – Accounting and Auditing ROSC, Supra Note 123, p 6.

[136] For instance, Public Enterprises Proclamation 25/1992, Art.27 requires state-owned enterprises to keep books of accounts following generally accepted accounting principles (GAAP), and proclamation No.626/2009, Art.12 requires micro financing institutions to keep books of accounts following Accepted Accounting Standards.

on Auditing), for auditing standards, the directive met resistance from auditors on the argument that it is impossible to apply ISA in the absence of accounting standards, as a result of which it was subsequently withdrawn.[137] Moreover, there are no penalties set for the noncompliance with the requirements of accounting and financial reporting. For instance, the Commercial Code does not set penalty for noncompliance with provisions for keeping accounting records, preparing financial statements, or filing and publication of the financial statements. Similarly, the laws and directives of insurance companies and state-owned enterprises have no penalties for noncompliance with accounting and other annual financial reporting requirements.

6. REFORMING CORPORATE GOVERNANCE IN ETHIOPIA

The preceding sections show that the overall standard of corporate governance in Ethiopia is inadequate. Thus there are certain efforts from the side of the government and private sectors to update the legal and institutional frameworks for corporate governance in the country. To this end, revision of the 1960 Commercial Code is underway by the FDRE Ministry of Justice, which is a vital part of improving and upgrading of corporate governance standards in Ethiopia. In cognizant of the fact that a certain level of standardized accounting and auditing is a prerequisite for corporate governance, the AACCSA PSD-Hub in cooperation with the Office of the Federal Auditor General and the Ethiopian Professional Association of Accountants and Auditors (EPAAA), is undertaking important work to

[137] Ethiopia – Accounting and Auditing ROSC, *Supra Note* 123.

standardize the accounting and auditing practices in the country.[138] The Ministry of Trade and Industry (MoTI) is also modernizing and computerizing the Company Register, which is another important input and requirement for engendering good corporate governance in collaboration with the PSD-Hub Program and the business community.[139] There is also an ongoing discussion on the establishment of a risk-capital trading institution, which has direct implications for corporate governance.[140] These reform efforts indicate that the importance of corporate governance in Ethiopia is well understood by stakeholders including the government. However, as these reform initiatives are not yet finalized, there remain debates regarding the tenability of reform initiatives particularly on the approaches being followed.

6.1. DEVELOPMENT POLICY CONSIDERATIONS FOR CORPORATE GOVERNANCE

The corporate governance reform should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. Moreover, corporate governance law reform in Ethiopia should consider key development policy aspects which match with the country's plans for poverty reduction and wealth creation.[141] In other words, the corporate governance framework should be developed with a view to its

[138] A. Geda, Supra Note 3, p 102.
[139] Ibid.
[140] Ibid.
[141] Dr. Gabor Bruszt and Zekrie Negatu, Draft Project Document for Development of Corporate Governance in Ethiopia, (AACCSA, June 2009), p 19. The AACCSA in consultation with the Government of Ethiopia and through support from the Swedish International Development Agency (SIDA), launched an ambitious private sector led initiative to institutionalize corporate governance in Ethiopia.

impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets in the country.[142] The need to adopt best corporate governance principles and practices should also target the creation of vibrant share companies that would undertake corporate social responsibilities and act as active and integrated partners in the national development objectives of the country. Moreover, in preserving a company's sustainability, board of directors should be able to ensure the fulfillment of the company's social responsibility. To achieve these objectives, board of directors should have a clear and focused written planning in meeting the company's social responsibility.[143]

6.2. APPROACHES TO REFORM CORPORATE GOVERNANCE IN ETHIOPIA

6.2.1. Shareholder vs. Stakeholder Models of Corporate Governance

As a developing country, Ethiopia should find a way to accept the existing institutional portfolio of corporate governance and make it work in its specific cultural, historical and economic environment as it cannot afford the luxury of searching for third system between socialism and capitalism. Thus it should carefully and critically examine the entire experience of both the North America and the Western Europe with a view to looking for principles to be adapted to its local needs. Rather than leaping to a shareholder or stakeholder model or hastily choosing a unitary or two-level board structure, the country

[142] *OECD Principles of Corporate Governance*, principle I.A (2004).
[143] For instance, *Indonesia's Code of Good Corporate Governance, National Committee on Governance*, (2006).

needs to determine the system of corporate governance most appropriate to her own individual needs and circumstances. Organizations and individuals from western developed countries inevitably press for the adoption by transition economies of "best practices" in corporate governance, best practices that have invariably originated in their own home countries.[144] Those best practices are of course the product of specific national experiences and cultures, factors that may make their adoption by a given transition economy like Ethiopia would make inappropriate or at least difficult without significant adaptation. In evaluating foreign models of corporate governance, policy makers in Ethiopia have to note that, to a large extent, western corporate governance systems have evolved through time and as a response to periodic and specific financial crisis in individual countries.[145]

The best approach that would fit the reality of Ethiopia is, therefore, to selectively adapt/adopt the best experiences from both Anglo American and European Civil Law systems of corporate governance. This is will be tenable for two reasons. Firstly, different corporate governance systems are converging to a greater extent.[146] A point of convergence between the bare shareholder model advanced by Americans and the extreme stakeholder model advocated by Europeans, may reside in the notion of *socially responsible corporate governance* which look for possibility of combining '*corporate good governance*' and '*corporate social responsibility*'.[147] Secondly, some scholars have determinedly advised the transition economies like Ethiopia that

[144] Salacuse, *Supra Note* 62, p 52.
[145] *Ibid.*
[146] *Ibid.*
[147] *Ibid.*

"merely transplanting laws and institutions is difficult for the reason that there are new conditions and many cultural differences"[148] and "to develop entirely new institutions would be an unpredictable adventure for transition economies". [149]

Therefore, Ethiopia is expected to carefully adopt experiences of both models of corporate governance to her own local circumstances rather than wasting its time and resources to develop entirely new institutions of corporate governance. This would inevitably enable it to combine the concepts of *good corporate governance* and *corporate social responsibility.* Doing so will not be a difficult task as the Commercial Code is eclectic from its very beginning. To this end, in the *Exposé des Motifs* of the Code, professor Escarra explains the selection of best foreign laws while he was drafting the share company's part of the Code:

> *The goal to attain is to encourage one day investment of Ethiopian savings in large broad based enterprises [….]. This is why, without taking into account the so called preference to be given to this or that model in the Continental or the Anglo American legal system, I had always in mind the interest of Ethiopia and I have selected the solutions which I believe to be the best no matter where they come*

[148] Id, p 72.
[149] Fernando, *Supra Note* 8, p 490.

from, on condition that they may be applied to Ethiopian conditions, if not immediately, at least within a reasonable time.[150]

Accordingly, professor Escarra has selected rules which he believes to be best to satisfy the interest of Ethiopia without taking account of the preference to different models in the Continental or the Anglo American legal system. By the same token, the approach to be followed in the process of reforming corporate governance of share companies in the country should be similar to the one followed by Professor Escarra. So long as the principles of corporate governance to be adopted in the country can bring the desired effect, it does not matter where they come from. In this manner, both the existing systems of corporate governance can be strengthened and new mechanisms can be introduced.

6.2.2. Regulatory vs. Non-regulatory Approaches to Corporate Governance

As it has been ascertained earlier, there are two basic approaches to assure managerial devotion to the interests of a company and its shareholders, which are classified as mandatory and voluntary approaches. The mandatory approach relies upon formal rules and institutions backed by the coercive power of the state's legal system.[151] On the other hand, the voluntary approach emphasizes the market mechanism and contractual arrangements such as incentive compensation schemes involving stock and non-stock options, and

[150] Peter Winship, *Commercial Code of Ethiopia (1960) Book II. Expose Des Motifs.* (Addis Ababa, HSIU, Faculty of Law, 1970), p 5.
[151] Salacuse, *Supra Note* 62, p 14.

efficient capital markets as means for inducing desired management behavior.[152] Although both approaches are needed to achieve optimal systems of corporate governance, an important question for policy makers is what the appropriate balance should be.[153] The voluntary approach had many advocates and even seemed to be in the dominance until the recent financial scandals and their negative impact on securities markets.[154]

In voluntary system of corporate governance, companies will be expected to "comply or explain" i.e., prove and report full compliance with the national code or explain deviation from it.[155] It is worth mentioning that a code entitled "The Voluntary Code of Corporate Governance for Ethiopia" was adopted on 3 June 2011 under the auspices of AACCSA. The adoption of the Code, without doubt, can be taken as a good step towards introducing standards of good corporate governance in Ethiopia in a detailed and comprehensive manner. It can be a point of reference for companies which are willing to adopt and apply the principles and practices contained in the Code voluntarily. The Code adopts best principles and practices regarding the boards of directors, rights of shareholders and corporate disclosure and transparency.

Nevertheless, this writer contends that voluntary approach of corporate governance cannot be a reliable system to effectively control the corporate

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[152] Ralph K Winter, State Law, Shareholder Protection, and the Theory of the Corporation, *Journal of Legal Studies* (1977), vol.6, p 251; Michael C. Jensen and William H. Meckling, The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics* (1976), Vol.3, p 305; Henry G. Manne, Mergers and the Market for Corporate Control, *Journal of Political Economy* (1965), Vol. 73, p 110.
[153] Salacuse, *Supra Note* 62, p 14.
[154] *Ibid.*
[155] Bruszt and Negatu, *Supra Note* 141, p 11.

frauds in the context of booming of share companies in Ethiopia. First of all, voluntary code of corporate governance is normally adopted in countries where markets play strong disciplinary roles for companies unwilling to apply principles of good corporate governance voluntarily. For instance, the basic concept of the Australia's voluntary code is that the market can come to its own conclusions about the significance of non-compliance based on the circumstances of individual companies.[156]

However, a disciplinary role of the market in Ethiopia is insignificant as the number and size of companies are very small. There is also weak culture of competition in the business community in general and among companies in particular. Furthermore, companies do not seem to apply principles and best practices of corporate governance voluntarily. For instance, share companies engaged in banking business, despite tight regulation of the NBE, are not free from frauds as evidenced by their former top executives being criminally prosecuted.[157] This shows a difficulty of regulating and controlling financial frauds in companies by employing a soft law. Therefore, both weak market and the conduct of Ethiopian companies point to the ineffectiveness of voluntary code to ensure good corporate governance in the country.

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[156] *ASX Corporate Governance Council, Corporate Governance Principles Recommendations*, (August 2007) http://www.asx.com.au/supervision/pdf/corp_governance_principles_recommendations_2nd_edition.pdf [Last visited 17 February 2014].

[157] For instance, on May 6, 2011 witnesses testified against Awash International Bank's Leikun Brehanu, former president, and nine other former employees who had been brought up on charges of mishandling letters of credit and approving a little over 6.1 million dollars in credit outside of the bank's foreign currency procedures. See Addis fortune, volume 12 No.575, (May 8, 2011).

Furthermore, the experiences of other countries which have already adopted voluntary codes of corporate governance support an argument that voluntary codes cannot prevent companies from misbehaving and ending up in crisis. For example, in the United States giant companies such as Enron, WorldCom and Tyco International were collapsed in 2001 while they were applying the voluntary system of corporate governance.[158] As a result, the American Congress had to adopt a mandatory code of corporate governance that culminated in the Sarbanes-Oxley Act of 2002, which is known as the *Public Company Accounting Reform and Investor Protection Act of 2002*.[159] Accordingly, publicly held companies in the US must meet all requirements contained in the Act, which prescribes formal rules and institutions backed by penalties imposed on companies that fail to comply with the legal rule in the Act.[160] One of the proponents of this system argues that:

> *The world needs a strict corporate governance regime, which is able to eliminate fraud, corruption and other misdeeds and practices; soft law and requiring a company to hire a number of non-executive directors, for instance, would not prevent corporate failures as evidenced from the experience of Enron and WorldCom, though*

[158] Paul S. Atkins, *The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation*, (2003) <http://www.sec.gov/news/speech/spch032503psa.htm> [Last visited 20 February 2014]. This is considered as a foundation tale for the new era of corporate governance.

[159] Larry E. Ribstein, "Market vs. Regulatory to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002" *Journal of Company Law* (2002), Vol. 28, No. 1, p 3.

[160] Anita I. Anand, Voluntary vs. Mandatory Corporate Governance: Towards and Optimal Regulatory Framework (2005) press Legal Series. Working Paper 5664.

these companies had non-executive directors, they were unable to prevent these companies from falling into bankruptcy.[161]

From a practical point of view, the Sarbanes Oxley Act of 2002 is a product of the *law matters* thesis, which essentially contends that law is important to protect shareholders, especially minority shareholders, from insider expropriation.[162] The critical goal of the *law matters* thesis is to promote capital markets and economic growth, which can be achieved by upholding shareholders' property rights.[163]

Similarly, there is no convincing reason and circumstance to rely on a voluntary code of corporate governance, which is proved to be a failing mechanism even in countries where vibrant markets play crucial disciplinary roles. Therefore, the appropriate approach of corporate governance to be adopted in Ethiopia should be the mandatory one. In other words, the government has to adopt principles of good corporate governance in a legislation which binds all companies and appropriate penalties should be imposed on those companies fail to comply with the law. Supporting this idea, paredes assets as follows:

If the goal is to protect shareholder interests from the abuses and mismanagement of directors and officers, and similarly to protect minority shareholders from the opportunism of controlling

[161] Atkins, *Supra Note* 158.
[162] Paredes, *Supra Note* 90, p 1-5.
[163] *Ibid.*

> *shareholders, developing countries generally should turn to a mandatory model of corporate law instead of a market-oriented corporate governance system.*[164]

The other related issue here is whether it is necessary to overhaul the Commercial Code with a view to incorporating best principles of good corporate governance, carefully and selectively in the forthcoming revised Commercial Code or enact independent corporate governance legislation. It is possible to follow either of the two approaches since it is possible to realize the expected objectives alike if similar principles and rules are to be adopted likely in either Commercial Code or independent corporate governance legislation. As the Commercial Code is currently under the process of revision, it will be cost efficient to incorporate such principles together with appropriate penalties to be imposed on companies that fail to comply with the law in the Code itself.

Moreover, the possibility of capital market development in the country with a future stock exchange and a broader category of corporate financial instruments should be taken into consideration. It should also be noted that the law is a dynamic subject which changes in light of new economic and social developments in the Ethiopian business environment and in accordance with experiences and evaluations of its practice.

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[164] *Ibid.*

7. CONCLUSION

As a public policy issue, corporate governance emerged in 1932 by Adolf Berle and Gardiner Means. They pointed to the increasing dispersion of corporate shares among a growing number of persons, who, because they were numerous, widely scattered and had relatively small interests were not able to exercise control over the company they owned.[165] They discovered that a total separation between ownership and control creates agency cost, i.e., a risk of the agent (managers) working for their own interest at the expense of the principal (shareholders).

Different countries have approached to the agency cost prevalent in modern public companies through various mechanisms. While continental European countries devised dual board structure in companies in which minority shareholders and other stakeholders could be represented in the supervisory board; common law countries, notably the United Kingdom and the United States, address the agency problem by requiring sufficient disclosure on the affairs of companies and by infusing independent outside directors in unitary board of directors who have little or no conflict of interests with the management. Independent directors are in a position to supervise the managers or block holders in the best interests of the shareholders and the company.[166] Moreover, they have empowered minority shareholders to initiate derivative suits against a felonious board of directors or its members.[167] Besides, the existence of stock market serves as a disciplining instrument not only through

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[165] Berle and Means, *Supra Note* 9.
[166] Salacuse *Supra Note* 62, p 48.
[167] Rafael La Porta *et al*, Law and Finance, *Journal of Political Economy (2000), Vol.*106, p 1113-1142.

its regulatory role but also indirectly by facilitating exit for minority shareholders from underperforming or oppressing companies.[168] In addition, in economically advanced countries, market disciplines corporate managers through mechanisms such as hostile takeovers for corporate control.

Currently, there is a tendency towards separation of ownership and control in Ethiopian share companies. Given this prevalent situation, there is a need to be cautious that shareholders may be subjected to exploitation in the hands of corporate managers or block holders. However, this study finds that the legal framework pertinent to corporate governance in the country is inadequate to protect shareholders from undue exploitation of managers and/or block holders in the context of publicly held share companies. Cognizant of this problem, the Ethiopian government and private sectors are undertaking certain corporate governance reform initiatives including the revision of the Commercial Code by the FDRE Ministry of Justice and adoption of voluntary code of corporate governance by AACCSA in June 2011. Nonetheless, reforming the legal and institutional frameworks alone cannot be a panacea for the problems unless it is carried out in light of the country's short and long term economic and social development objectives.

Therefore, Ethiopia should carefully examine the entire experience of various countries with a view to looking for principles of good corporate governance to be adopted for its local needs. Rather than leaping to a shareholder or stakeholder model, the country should determine a system of corporate

[168] *Ibid.*

governance most appropriate to her own individual needs and circumstances. It should also note that one size does not fit all.

Moreover, Ethiopia should predominantly adopt a mandatory law of corporate governance to protect shareholders (and other stakeholders) from the abuses and mismanagement of directors and other corporate officers or to sufficiently protect minority shareholders from the opportunism of controlling shareholders and to promote the accelerated economic development. This is in line with the *law matters* thesis. On the other hand, there are no adequate market institutions for the non-regulatory system of corporate governance to be relied on in the Ethiopian context. It is also worth noting that most countries which had earlier adopted market oriented corporate governance such as the United States are making a paradigm shift towards the regulatory corporate governance system after facing repeated cases of corporate scandals which culminated in widespread financial and economic crisis. Therefore, there is no a convincing justification for Ethiopia to rely on such a failing neoliberal aspect of corporate governance approach.