CHAPTER – 3

GENERAL FRAMEWORK OF CORPORATE GOVERNANCE
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GENERAL FRAMEWORK OF CORPORATE GOVERNANCE

3.0. Introduction

After a string of various financial crises that have occurred in many companies, especially in advanced countries, the interest in the concept of corporate governance has grown and the corporate governance has become one of the important topics in many advanced and developed economic countries during the past few decades. The interest in the concept of corporate governance has increased by the national and international institutions and organizations, especially after the economic collapses and financial crises that have occurred in several countries of East Asia and Latin America and Russia in the nineties of the twentieth century and after the American financial and accounting collapses in 2002.

The importance of governance has increased because many of the world countries intended to shift to the economic capital systems, which depends heavily on the private companies to achieve high and sustained rates of economic growth. The wide spread of those projects resulted in the separation of ownership from management, and such projects started searching for sources of financing that is less expensive than banking sources. Then they started working in the capital markets and that was helped by the liberalization of financial markets. As a result, private capitals have been transferred across borders in an unprecedented way. The separation of ownership from management led to weakening the control mechanisms in controlling the managers’ behaviors causing financial crises in many companies. The most prominent of those financial crises are those occurred in the countries of Southeast Asia in the late nineties that were followed by a string of financial crises the most notable of which are the crises of Enron and
WorldCom USA in 2001. All that forced the world to pay attention to corporate governance.

The financial problems experienced by many major companies in the world resulted in demanding that there should be a set of regulations, customs and moral and professional principles to achieve the confidence and credibility in the information contained in the financial lists that are required by many users of financial statements, especially the investors in the stock market in light of globalization and internationalization of the capital market and the growth of the projects because of merging several companies, both at the local level or at the international level.

Because of the continuing increased interest of the concept of corporate governance, many institutions analyzed and studied this concept. Some of the most important institutions are International Monetary Fund (IMF), World Bank and Organization for Economic Cooperation and Development, which issued the principles of corporate governance in 1999, which was re-formulated in 2004, and involved the help of all Member States, and non-members of the Organization, and since the approval of the principles of corporate governance in 1999, they became the basis for the initiatives of corporate governance in each of the countries of the Organization for Economic Cooperation and Development or other countries alike, just to develop the legal and institutional frameworks for applying corporate governance in both public and private companies, whether they are current or non-current in the capital markets. That was applied by providing a number of instructions to strengthen corporate governance and efficiency of financial markets and stabilize the economy as a whole. This supports what was affirmed by the World Organization in May 2002 that is the importance of adopting and applying the principles of corporate governance (1).

The financial crisis that hit financial markets in USA and other countries in 2008 threatens the whole world to fall into a depression not happened since 1928. The main reason for this crisis is a flaw in the mechanisms of control and follow-up, both at the corporate or capital markets. That grew the belief of the importance of corporate governance as a tool of control, accountability, and a protection from such crises (2).
Because of the escalation of the global financial crisis in 2008 and because the global financial markets suffered from sharp declines after a significant decline in the American financial markets, the governments intervened in the global economic system to adjust the performance of the great corporations. Then, in October 2008, EU Council (ECOFIN) held a meeting and requested the leaders of major countries to force not only the commercial banks but also those who work in the financial markets to commit to the regulation and supervision.

Most of these collapses are due to administrative and accounting corruption, in general, and financial corruption, in particular, taking into that accounting corruption is, in one of the important aspects, due to the role of auditors and their emphasis on the appropriateness of the financial statements and accounting information contained.

In addition to that, the main reasons for the collapse of the companies is the lack of management to good practice in monitoring and supervision and lack of experience and skill as well as the disruption of financing structures and the inability to generate internal cash flows that are sufficient to the payment of obligations owed, in addition to the lack of transparency and lack of interest in the application of accounting principles that meet the disclosure and transparency and disappear of the accounting information of the actual financial position of the company.

These collapses resulted in the lack of confidence in the various financial markets that let the investors leave the markets, as well as lack of confidence in the offices of the accounting and auditing as a result of lack of confidence in the accounting information contained in the financial statements of different companies. The financial problems experienced by many major companies in the world resulted in the demand that there should be a set of controls, customs and moral and professional principles to achieve the confidence and credibility in the information contained in the financial statements. That has led the world to the attention of corporate governance.
3.1. The Concept of Corporate Governance

3.1.1. Origination and Development of the Concept of Corporate Governance

The concept of corporate governance was originated after the emergence of AGENCY THEORY, which concerns about the separation of companies ownership from the management of these companies and the agency problem arises because the owner (the principal) suffers from the loss as a result of ethics and behavior of the agent and insufficiency of professional care to increase the benefit of the client, and what increases the chances of occurrence of this is that the client has no means of direct control to evaluate the efforts of the agent, and the agent is providing the information and calls it Hazard Moral. This is also related to the problem of adverse selection which arises as a result of the difference in the quantity and quality of information available for each of the principal and the agent appears when the principal cannot observe the performance of the agent directly and verify the results of the decisions. In such cases, the client cannot determine if the agent chooses a suitable alternative or not when making various decisions.

As a result of this conflict of benefits between corporate management and shareholders, the interest in finding the laws and rules to regulate the relationship between the parties in the companies has increases. In 1976, Jensen and Meckling took care of the concept of corporate governance highlighting its importance in reducing or minimizing the problems that may arise from separation of ownership and management, represented by the agency theory. In 1987, the National Committee for deviations in the preparation of financial statements of SEC issued its report called (Treadway Commission), which contains a set of recommendations for applying the rules of corporate governance and what is related to them to prevent fraud and manipulation in the preparation of financial statements by paying attention to the concept of the system of internal and external control audit function strengthen the boards of companies.

The interest of the concept of corporate governance really started when Cadbury Committee formed of the two councils of financial reports and London Market for Stock Exchange, in December 1992, issued its report entitled “The Financial Aspects of
Corporate Governance”. In which the committee ordered that the standards and principles of corporate governance should be followed. The committee has also claimed that following these standards leads to better decision-making and control over the business and that was after a lot of allegations about the lack of confidence in financial reporting by the shareholders in the London Stock Exchange. (5)

Corporate governance took a different dimension after the financial crises and bankruptcy and financial scandals in major U.S. companies at the end of 2001 and at the international level. The report issued by the Organization of Economic Cooperation and Development (OECD 1999) entitled: “Principles of Corporate Governance”, is considered the first international formal recognition of the concept.

The international organizations started issuing many principles and definitions of corporate governance, including the World Bank and the Center for International Private Enterprise emanating from the American Chamber of Commerce in Washington. These organizations held conferences, meetings and seminars to illustrate this concept and work on the publication in other countries. The international organizations disseminated this concept in the Arab countries including Yemen. In 2008, the Yemeni Businessmen Club in cooperation with the Center for International Private Enterprise implemented a two-year intensive program to raise awareness about the importance of corporate governance and improve corporate governance practices within the private sector. A guide to corporate governance was issued in Yemen on March 29, 2010.

The Arab countries are considered new to the application of the principles and peaceful practices of corporate governance, and in spite of recent efforts in these countries in this area, there is still a lot for it to be done. When comparing the practice of governance existing in these countries with the internationally-applied standards and principles, the development that should be done appears.
3.1.2. The Concept of Corporate Governance

The concept of corporate governance has been a continuation of the search on enhancement of the companies performance, including, for example, the theory of the institution, agency theory, the separation between ownership and management, ownership structures and financing the institutions, and relationship between management and shareholders and stakeholders and other theories. Because of the association between corporate governance and different areas and aspects, such as management and board of directors and shareholders and stakeholders, many writers and researchers gave different definitions of corporate governance each of which started from the aspect that they think is more important. (6)

Before defining the concept of corporate governance began, it should be noted that there is no exact definition of corporate governance, at the global level, agreed upon among all the economists and lawyers, analysts, and this is confirmed in Corporate Governance Encyclopedia. Also, most of the literature of corporate governance indicates to the absence of standard definition of corporate governance in Arabic but the English term is agreed upon by all economists and legal analysts. (7)

In Arabic, there is no exact term that is equivalent to this concept. It was launched by several labels such as good governance, corporate governance, and prudent management. In the point of view of some economists, it is the method followed by the management authority in the company, the rules that govern companies, the fair administration, the institutional authority in governing the companies or the method applied by the good governance. The definitions of this term have varied, and each term reflects the view of the one who gave the definition. The researchers competed with each other to define corporate governance. But all the definitions did not give a specific clear meaning of corporate governance. However, Researcher attributed the diversity definitions to the association of corporate governance with many regulatory, economic, financial and social issues. This is the issue that affects the society and the economy as a whole.

The concept of corporate governance shifted from the state administration to public joint-stock companies in addition to all aspects of the state such as professional
unions and charities etc. Corporate governance was defined in the scientific fields as the good governance that is applied through a package of laws and rules that lead to the transparency. (8)

In this regard, some have defined corporate governance as:

- Good practice of management authorities, depending on the laws, standards, and disciplined rules that identify the relationship between the company's management on the one hand, and shareholders and stakeholders or parties related to the company, on the other. (9)

- In 1999, OECD defined corporate governance as a system by which business organizations and their control are directed. It identifies the framework of distributions of tasks and responsibilities among the participants in the joint-stock company, such as the Board of Directors, managers, shareholders and other stakeholders. It also establishes rules and provisions to take decisions concerning the affairs of the joint-stock company. In this procedure, the corporate governance gives the appropriate structure through which the company can set its goals and appropriate means to achieve these goals, and to monitor performance. Good corporate governance must provide the board of directors and management with reasonable incentives to achieve the goals that are in the interest of the company (bank) and the shareholders, and it must facilitate the process of effective monitoring to encourage the companies (banks) to use their available resources efficiently. (10)

- OECD also defines corporate governance as “a set of relations among the administrators of the company and the Board of Directors and shareholders and other shareholders”.

- The International Finance Corporation (IFC) defines corporate governance as “the system through which companies administration and control in their work, the corporate governance means the systems that govern relations between the basic objectives that affect the performance, and include elements to strengthen the institution in the long term and determine the responsible and responsibility”. (11)

- The Centre for International Private Enterprise defined corporate governance as “the framework by which the institutions practice their existence. The governance focuses on the relationship among the officers and the members of the board of directors, and
shareholders, stakeholders and government regulations makers and how the interaction between all these parties in supervising the processes of the company”.

- Demirag defined corporate governance as a set of contractual relationships that link the management of companies, shareholders and stakeholders, and that is done through the creation of procedures and structures that are used to manage the affairs of the company and to direct its works to ensure enhancement of the performance, disclosure, transparency and accountability in the company, and to maximize the interest of the shareholders in the long term, taking into account the interests of the different parties. (12)

- The Arab Society of Certified Public Accountants (ASCPA) (2001) defined corporate governance as “a set of responsibilities and practices followed by the Board of Directors and executive management to provide strategic direction and ensure the achievement of the goals, the verification of risk management properly, and the exploitation of the institution resources in a responsible manner”. (13)

- The concept of corporate governance emerged in the last few years as a result of many economic, social and regulatory factors that led to such development. Governance is derived from the ruler or government and it means the discipline, control and governance. Corporate governance means “the system by which the organization works are guided and monitored at the highest level in order to achieve its objectives and meet the necessary standards of responsibility and integrity and transparency”. (14)

In addition, it is “the procedures used by the representatives of stakeholders in the organization to provide oversight of risk and control risk done by the administration”.

- In relation with internal control, corporate governance is defined as the procedures and activities undertaken by the representatives of stakeholder in the organization, in order to control risks and ensure that the Administration applies internal control procedures that are necessary to overcome these risks. The effective corporate governance of the companies ensures the accuracy of financial reports like the one on the internal control procedures, and the report on financial results and the effectiveness of internal control procedures. In other words, it can be defined as the set of principles and procedures that are used to manage the company from the inside, either from the legal aspects, financial aspects or accounting aspects. (15)
- Cadbury’s report (1992) describes corporate governance as follows:
  “The economy of the state/country depends on the increased number and efficiency of the companies, thus the effectiveness that determines the responsibilities of the boards of directors identifies the competitive position of the country and this is the essence of any system of corporate governance”.

  Cadbury Committee gave a simple clear definition in one sentence. It is “corporate governance is the system by which the companies are directed and controlled”. (16)

  Corporate governance is the framework that includes the rules and market practices that determine how the companies, especially IPO companies, make their decisions and transparency that governs the decision-making process in the companies, the extent of accountability that govern the managers and the heads of those companies and their employees and the information they disclose to investors and the protection they offer to small investors,. It also ensures topics related to the law of companies, the laws of the stock, the rules of companies stock exchange, accounting standards that are applied on the listed companies, law of antitrust and laws of bankruptcy. It also includes legislation of the governance and legislative bodies with which the shareholders and companies deal (17). Some consider governance as an extension of privatization, globalization and market economy.

  These definitions show that the corporate governance can be defined, in a narrow perspective, as the relation of the company with the shareholders, or in a broad perspective, it is the relation of the company with everyone, and that corporate governance is a system that is the method practiced by the management authorities in a good way. This system governs the relations between the principal parties that affect the performance in any organization. The system also includes the basic components of the success of the organization and that strengthen it in the long term. In addition, the system identifies the responsibilities within the organization and ensures the rights of all parties related to the organization in a fair way. The concept of corporate governance also creates and organizes the applications and good practices for those in charge of the company's management, so as to maintain the rights of shareholders, bondholders and employees in the company and its stakeholders and others by testing the implementation of the formulas of contractual relations that bind them using the financial and accounting
tools in accordance with the due standards of disclosure and transparency. Corporate governance deals with the practices and how to adjust the performance of the companies and how to raise their efficiency and it deals with a range of measures by which the performance and control of the corporate management, And address the problems caused by this ,and the relations between the parties that govern the work of companies from Inside and outside.

The method of corporate governance is considered as a means for enabling the community to ensure the appropriateness of companies management in a way that protects investors' funds and lenders, and leads to the creation of securities against corruption and mismanagement, as well as the development of the primary values of the market economy in the community.

The researcher believes that the basic meanings of the concept ‘corporate governance’ are:

- A set of regulations, laws and rules of control over the performance of companies.
- A set of concepts, objectives, management and control, which include appropriate incentives to the Board of Directors and senior management to track the objects which were set for developing the institution and achieving the effective and ongoing follow-up and supervision on the optimal use of its resources efficiently and in high integrity.
- A set of rules under which the company's management is governed and its control according to a specific structure including allocation of rights and obligations among the participants in the management of the company, such as the Board of Directors, executive directors and shareholders.
- The regulation of relations between the Board of Directors, managers, shareholders and stakeholders.
- The emphasis of the issue that companies must be managed for the benefit of shareholders and investors.
3.2 The Importance of Corporate Governance

Corporate governance was recently given a great attention and interest due to a number of cases of administrative and financial failure which occurred many institutions such as major institutions in the United States and East Asia. By studying the reasons that led to this administrative and financial failure, it was found out that the lack of corporate governance system enables the principals who are in charge of managing the organizations, whether they are board of directors or managers or employees, prefer their personal benefit at the expense of shareholders, creditors and other stakeholders such as employees, suppliers and the public.

Furthermore, the globalization and liberalization of international capital markets have given new chances to the investors to make large profits. The investors were to look for institutions that are properly structures and that apply the governance in their
management and allow them to participate in supervision. So, the corporate governance is one of these international standards that govern the national economy. On the other hand, it contribute to ensuring the rights of shareholders in the institution and it is one of the most important mechanisms and standards that contribute to the measurement of the regularity and efficiency of advanced and developed capital markets.

The investors and investment companies are looking for financial markets and companies that apply the principles of corporate governance. Thus, the markets that apply the principles of corporate governance have interested the investors because the investors and investment companies are not willing to bear the consequences of mismanagement and administrative and financial corruption, Then they started to demand corporate governance before they make the decision of funding and supporting the companies and before they participate in the markets (18).

Corporate governance can also play an important role in reforming the financial and administrative aspects of public and private sectors, increasing the investor’s confidence in the financial statements, in activating national investment, attracting the investors, strengthening the banking system and increasing its capabilities, activating the stock market and strengthening the economic development.

Corporate governance is mainly based on the relationship between investors and boards of directors, managers, shareholders and others. It aims at increasing the value of the investment of shareholders to the maximum possible extent in the long run, by improving the performance of institutions, streamlining decision-making. That includes providing incentives and procedures that are at the benefit of the shareholders taking into account the interests of others in the organization.

3.2.1: Importance of Corporate Governance for Companies (19):
Corporate governance is important for companies for the following reasons:

- It raises the economic efficiency of the company by setting principles for the relationship between the corporate managers and board of directors and shareholders.
- It sets the regulatory framework by which the objectives of the company can be identified and achieved by providing appropriate incentives for the members of the board of directors and executive management so as to achieve the objectives of the company, which take into account the interests of shareholders.
- It helps the investors to direct towards the global capital markets and attracts a lot of investors (especially foreign investors) to finance the projects. If the companies do not rely on foreign investment, they can increase the confidence of local investors and thereby increase the capital at a lower cost.

- The companies that apply the rules of governance gain an increase of the investors’ confidence because those rules ensure the protection of their rights, so it is found that the investors in the companies that properly apply the rules of governance may think well before selling their shares in the companies, even when the companies are exposed to crises, so as to enable those companies to withstand during the crises times.

### 3.2.2: Importance of Corporate Governance for Shareholders

- Corporate governance helps in ensuring the rights of all shareholders, such as the right to vote, the right to participate in the decisions of any substantial changes that may affect the company's performance in the future.

- Full disclosure of company performance, financial position and the fundamental decisions taken by senior management helps the shareholders to determine the consequent risks of investment in these companies.

The importance of corporate governance has recently increased in order to achieve economic development, legal immunity, and social welfare of the economies and societies, and this is achieved by the following: \(^{(20)}\)

1. Insuring an adequate degree of trust and confidence for investors and shareholders to achieve an adequate return from their investment and to preserve their rights, especially minority shareholders.

2. Maximizing the market value of the shares and strengthening the competitiveness of companies in the global capital markets, especially because there are new financial tools and mechanisms and because of the mergers or acquisitions or a sale to an anchor investor.

3. Ensuring the efficient implementation of privatization programs and the good direction of their outcome to their optimal use, to prevent any relevant cases of corruption.
4. Providing local or global sources of funding for the companies, whether through the banking system or financial markets, especially because there is an increase of fast transmission of capital flows.

5. Avoiding slipping in the accounting and financial problems and achieving the support and stability of the activity of companies that work for the economy, and preventing the occurrence of collapses in the banking devices or local and international capital markets and helping in achieving development and economic stability.

The good corporate governance requires more disclosure of financial information that can help in reducing the cost of capital. The good corporate governance also helps to attract local or foreign investors and helps to reduce capital flight and helps in fighting corruption. Furthermore, it helps in giving more chances to increase funding and increasing the possibilities of gaining sources at a lower cost. All these increase the importance of corporate governance.

Corporate governance has become more important for the emerging democratic countries, because of the weakness of the legal regime with which the execution of contracts and resolving disputes cannot be done in an effective manner. The poor quality of the information leads to the prevention of supervision and control, helping the spread of corruption and lack of confidence in occurring. But corporate governance helps in making the necessary provisions against corruption and mismanagement, promoting transparency in economic life.

The importance of corporate governance increases in the economies of the developing countries and the countries that are undergoing economic reform where programmes are implemented for development and privatization. These programmes require greater transparency to gain the confidence of investors in the financial markets.

Now it can be concluded that corporate governance is important for the following reasons:

1. There is a need for the separation of ownership and institutions management and monitoring of performance in the light of difference of the objectives between the various parties.
2. Corporate governance contributes in reducing the risks and in improving the performance and chance of development of the markets. It also contributes in increasing the competition of goods and services and developing management and increasing transparency. Also it contributes in increasing the number of investors in financial markets.

3. Corporate governance helps the countries that try to prevent the rampant corruption within the public sector and those that are about to privatize the public sectors.

4. Corporate governance sets the general framework by which the company's goals and the means to achieve these goals are identified.

5. Corporate governance helps the economic institutions to attract investors and to support economic performance and competitiveness in the long term by the use of a number of ways and methods through an emphasis on transparency in the transactions of the company, procedures of accounting, financial and accounting auditing.

6. Corporate governance prevents banking crises even in the countries where most of the institutions are not active in the securities markets.

7. The application of corporate governance strengthens public confidence in the validity of the privatization process and helps to ensure the state to achieve a better return on their investments, which in turn leads to more jobs and economic development.

8. Corporate governance prevents the institutions from the confusion between the tasks and responsibilities of executive directors and the board of directors and the responsibilities of its members.

9. Corporate governance helps in evaluating the performance of senior management and strengthening accountability and confidence.

10. Corporate governance enables the companies to obtain financing from a larger number of local and foreign investors.

11. Corporate governance helps in avoiding the problems of accounting and finance, strengthening and stabilizing the activity of the economic companies, preventing the occurrence of collapses in the banks or the local and global capital markets, and helping in achieving the development and economic stability.
Corporate governance achieves economic development and helps in avoiding the financial crises, by consolidating a number of performance criteria which strengthen the economic principles in the markets and detect fraud, corruption and mismanagement. All this results in gaining the customers’ trust and confidence in these markets and helps in stabilizing the markets and reducing excessive fluctuations, so as to achieve the desired economic progress.

3.3: Objectives of Corporate Governance

Corporate Governance seeks to achieve the following main objectives: (21)

- Improving the economic efficiency and increasing the rate of economic growth.
- Increasing the confidence of investors in capital markets which will, in turn, reduce the cost of capital, as well as operating market system effectively.
- Creating incentives and motives for the Board of Directors to pursue the goals that meet the company’s interest.
- Imposing effective control over the company.
- Enabling the company to enjoy a good competitive status with other companies in the capital market in order to attract investors who can strengthen the financial growth of the company.
- Strengthening integrity and efficiency in the financial markets.
- Separating the ownership and management.
- Creating a structure by which the company’s goals, the devices that achieve those goals and monitoring the performance are determined.
- Reviewing and amending the laws that govern the performance of companies which will, in turn, shift the responsibility of control to the company’s board of directors and shareholders who are represented by the constituent assembly of the company.
- Organizing the tasks and responsibilities of executive directors and board of directors and its members.
- Evaluating the performance of senior management and strengthening accountability and increasing the degree of confidence.
• Enabling the companies to gain funding from a large number of local and foreign investors.

Good method of corporate governance helps in supporting the economic performance and competitiveness and attracting investors towards the companies and economy by the following: (22)

1. Strengthening transparency in all transactions and processes of companies and procedures of accounting and financial auditing in a way that enables the company to adjust corruption at any stage.

2. Improving and developing the company's management and assisting the managers and board of directors to build a sound strategy and ensuring making decisions of profit or control depending on sound bases, raising the efficiency of performance.

3. Avoiding banking crises even in the countries where most of the institutions are not active in the securities markets.

4. Strengthening public confidence in the success of privatization and ensuring the country to achieve a better return from their investments, which will, in turn, give more opportunities to work and increase economic development.

5. Ensuring a fair deal for shareholders, workers, creditors and other parties in the case of company bankruptcy.

Additional objectives of corporate governance:
- Enabling the shareholders, employees, creditors and lenders to participate and monitor the performance of the companies.
- Ensuring the auditing of the financial performance and the proper use of the company fund through the integration of the accounting and auditing systems.
- Protecting the assets of the organization, as well as protecting the rights of shareholders and other stakeholders and enhancing their role in monitoring the performance of the organization and maximizing of revenue by adopting standards of transparency in dealing with them, to prevent economic crises.
- Emphasizing obligation to the provisions of law and ensuring the review of financial performance and the presence of administrative structures which make the management accountability possible in front of the shareholders, with the composition of the auditing committee that consists of persons other than the
members of the board of directors. This committee has many tasks, powers and functions that can achieve an independent monitoring.

3.4: Activities of Corporate Governance

Corporate governance is a set of activities and procedures to ensure internal control and strengthen risk management and to make sure that management is applying them to overcome the risks, which will, in turn, contribute to increasing profits, reducing the cost of capital, as well as attracting foreign and local investors, fighting corruption, reducing capital flight. So these activities serve the shareholders and other stakeholders in the company. The activities of corporate governance are:

1. Confirmation of the Internal Control System:

   Corporate governance includes the procedures and activities undertaken by the representatives of the stakeholders in the institution, in order to control risks and ensure that the administration applies the necessary internal control procedures to overcome these risks. Effective corporate governance result in ensuring the accuracy of financial reports such as the reports on internal control procedures and the report on financial results and the effectiveness of internal control procedures.

   The internal control is done through review of previous preventive and analytical auditing by identifying the reasons that could lead to the occurrence of any of the risks. In addition, the internal control examines and assesses the effectiveness and efficiency of internal control systems and other controls and improves and develops these systems in order to identify the causes and factors that lead to the occurrence of these risks and remedy them properly before they occur. Internal control must assist management and provide it with information, especially the areas/places in which risks are expected to occur before risks occur, providing advice and recommendations in periodic reports and following up these reports. (23)

   The internal control plays its role as it is one of the aspects that are responsible for implementing the corporate governance of banks in two trends:

   The first trend: assisting the board of directors, auditing committee and senior management, the parties that are responsible for the implementation of corporate
governance in the performance of their roles effectively through the provision of consultancy services in different positions.

**The second trend:** playing its role in accordance with its task that is following up, analyzing and assessing the risks associated with the institution and the appropriate control through the provision of services in different positions.

2. **Manage and Control Risks:**

   Risk management is an essential part of corporate governance which can be defined as “a system by which the activities of the organization are guided and controlled in the highest level in order to achieve its objectives and meet the necessary standards of responsibility, integrity and transparency”. In other words, it is the procedures used by the representatives of project owners or stakeholders in the project to provide control on risks that the project experience during its work \(^{(24)}\). Some accountants say that the process of improving the economic performance of organizations is done by improving risk management and that this concept should not be considered a negative concept, but it should be considered positive, i.e. the risk is the key to the management of the organization's activities and corporate governance is the organization’s strategic response to the risk. Therefore, an efficient internal control system, in each organization, should consist of the elements that are interdependent and interrelated with each other and represented by monitoring environment, risk identification, information and communication systems and control procedures \(^{(25)}\).

   According to corporate governance, the authorities that are responsible for risk management are the following:

   1. Board of directors.
   2. Internal audit.
   3. The audit committee.
   4. External auditor.

   Through the definition of governance, we find that it aims to verify the risk management properly through a range of responsibilities followed by the board of directors and executive administration.
Dahmash and Al-Qashi (2004) point out that corporate governance led to the deal with risk management properly. The manner or method by which the companies manage their risks started improving because of the fear of passing ongoing accountability by auditing committees.\(^{(26)}\)

Standard of risk management No. 2120, one of the professional standards of audit issued by IIA in 2008, states that “the internal audit activity should assist the organization to identify and assess the significant risks that the organization face, and contribute to the improvement of risk management and the systems to control the risk”. The internal audit should assess the procedures of corporate governance and information system in the bank.

### 3.5: Beneficiaries of the Corporate Governance System

Companies which are managed well give value to investors, employees and customers, and even the community. Good corporate governance contributes in providing a good environment for business and encouraging local and foreign investors, which in turn increases opportunities for jobs and increasing the welfare of the citizens. Mechanisms of corporate governance mainly protect and ensure the rights of shareholders and all stakeholders associated with the company business by regulating censorship and control on the performance of the company management and the auditor.

There are beneficiaries of corporate governance system, they are four main parties that affect and are affected by the proper application of the concept and principles of corporate governance and they play the main role in the success or failure of corporate governance in the companies and banks. These four parties are as follows: \(^{(27)}\)

1. Shareholders.
2. Board of Directors.
3. Administration.
4. Stakeholders.
1. **Shareholders**: they provide the capital through their ownership of shares in exchange for gaining profits is suitable for their investments, and also getting the cost of the property back in the long run. They have the right to choose the members of board of directors who are appropriate to protect their rights.

2. **Board of Directors**: they represent the shareholders and other parties such as stakeholders. Board of directors chooses the executive managers to whom the authority of the daily management of the business is given, as well as to control their performance. Board of directors formulates the public policy and the way by which the rights of the shareholders are protected.

3. **Administration**: Administration is responsible for the actual management of the institution, providing the board of directors with reports on the performance. It is also responsible for maximizing profits and increasing their values. In addition, It is responsible for disclosure and transparency of the information disseminated to shareholders.

The basic job of the listed companies’ managers is supervising the institution management and doing all the tasks required to achieve the purpose for which the
institution was established. That can be done by offering the board of directors periodic reports including all information of the institution’s activity. Therefore, it can be said that the manager plays a vital role as he/she is responsible for the interest of the institution, investors and shareholders.

4. **Stakeholders**: stakeholders are a group of parties who have interests in the institution, such as creditors, suppliers, customers, workers, employees. It should be noted that these parties have interests that may be different from one party to another. What concerns creditors, for example, is the ability of the institution to repay, while what concerns the workers and employees is the ability of the institution to continue its business.

These parties are important to the bank or the company as they actually fulfill the tasks that help the company in the producing and the provision of goods and services. Without these parties, neither the managers nor the shareholders can achieve the strategies of the company. Clients are the party who buys the product or service, and without the client, there is no need for the company. So, the board of directors should be aware of this fact and be sure of good corporate governance to serve the client and please him. The board of directors should be concerned about the client.

Mohammed (2005) identified the beneficiaries of corporate governance as follows:

1. Current and expected shareholders.
2. Stakeholders (such as creditors and bondholders and banks).
4. Suppliers.
5. The employees and workers.
3.6: Parties Subject to Accountability

The parties that are subject to accountability in front of shareholders and stakeholders are: (29)

1. Board of Directors.
2. Committees of the Board of Directors, particularly the Audit Committee.
3. Senior management.
4. Internal audit department.
5. External audit department.
7. Professional associations and trade unions.

3.7: Limitations of Corporate Governance

The application of good corporate governance depends on two sets of limitations: external limitations and internal limitations that are: (30)

1. External Limitations:

These limitations refer to the general environment of investment in the country, which includes, for example:

- Laws that regulate economic activity, such as: capital market laws, companies and the regulation of competition and prevention of monopolistic practices and bankruptcy.
- The efficiency of the financial sector (banks and capital market) in providing funding for projects.
- The degree of competition between goods markets and factors of production.
- The efficiency of devices and regulatory bodies (the money market and stock market) in the tightening of control over the companies, in addition to the professional association that sets the code of conduct for employees in the market, such as auditors, accountants, lawyers and companies operating in the stock market and others, as well as private institutions of the liberal professions such as offices of lawyers, audit, credit rating and financial and investment consulting. External limitations are important because they ensure implementation of laws and rules that ensure the good management and regulation of the company to decrease the risks, as
well as to reduce the conflict between the social return of the company and its private return.

2. **Internal Limitations:**

The internal limitations include laws and regulations in the company, and include proper management structures that explain how to make decisions in the company and the distribution of responsibilities and powers and duties between the parties in charge of application of the concept of corporate governance, such as the board of directors, management, shareholders and stakeholders, in a way that does not lead to a conflict in interests between these parties, but on the contrary it leads to achievement of the investors’ interests in the long term.

The external and internal limitations can be summarized by the following chart:

Accordingly, we find that the limitations (internal or external) are affected by a range of other factors associated with the economic and social system, awareness of the members of the community and the competitive lawful regulatory environment in the company. At the end, corporate governance leads to increasing confidence in the national economy, the role of capital market and its capacity to mobilize and rates of investment and preserving the rights of minority or small investors. On the other hand, it encourages the growth of private sector and supporting its competitiveness, and helps enterprises to obtain financing and generate profits. It finally, helps in creating chances of works.
### 3.8: Principles of Corporate Governance

As a result of rapid global developments and the succession of failures at various institutions around the world in the last few years and as a result of the present continuous increase in attention to the concept of corporate governance, a lot of international institutions and stock exchanges have started studying and analyzing this issue and formulating a set of rules and principles that govern the proper application of corporate governance.
Examples of these institutions are Organization for Economic Cooperation and Development (OECD), the Stock Exchange in New York, Bank for International Settlements (BIS), represented in the Basel Committee, International Organization of Securities Commissions (IOSCO), but the most accepted and earliest are the principles formulated by (OECD) in 1999, which was reformulated in 2004.

The principles of corporate governance are the rules, regulations and procedures that achieve the best protection and balance between the interests of the corporate managers, shareholders, and other stakeholders associated with it. Through these principles, the goals of corporate governance are achieved. The application of these principles has become a means to strengthen the confidence in the companies listed in the financial market and become an indicator of the level of the commitment to professional rules of corporate governance reached by the corporate management, goodness of management, transparency and accountability and the presence of actions that reduce corruption and that affected the economy and its growth.

The principles of corporate governance formulated by some international institutions, such as the IFC of the World Bank and the Bank for International Settlements (BIS), represented in the Basel Committee, the Organization for Economic Cooperation and Development, will be explained. The principles formulated by the Organization for Economic Cooperation and Development will be explained in details because they are the most accepted and earliest. They were formulated by OECD in 1999 and reformulated in 2004, as indicated below:

3.8.1. Principles of the International Finance Corporation

In 2003, the IFC of the World Bank formulated orientations, rules and standards that are deemed essential for supporting the corporate governance in the various institutions, whether pecuniary or non-pecuniary, on four levels as follows:

1) Accepted practices for good governance.
2) Additional steps to ensure good new governance.
3) Essential contributions to improve good local governance.
4) Guidance.
3.8.2. Principles of the Basel Committee of International Banking Supervision (Basel Committee)

Because of the importance of the role of banks as a financial intermediary in the economy, the sensitivity of banking institutions towards the difficulties resulting from ineffective corporate governance and the urgent need to insurance and protection of savings, the Basel Committee of International Banking Supervision, in 1999, formulated instructions special for governance in the banking and financial institutions that can be summarized as follows: (33)

1. Members of the board of directors must be eligible for their posts having a clear understanding of their role in corporate governance and able to practice good governance in the affairs of the bank.
2. The board of directors must accept and watch the strategic goals and institutional values of the bank by communication through the organizational structure of the bank.
3. The board of directors must formulate and apply clear lines of responsibility and accountability along the organizational structure of the institution.
4. The board of directors must ensure that there is appropriate oversight by senior management of the bank in accordance with the policies of the board of directors.
5. Both board of directors and administration must efficiently use the outcomes of internal auditor and external auditors and internal audit committee.
6. Mechanism must be set for effective cooperation between the board of directors, auditors and senior management.
7. There must be a strong internal control system including the functions of internal and external audit and risk management independent from the lines of work taking into account the appropriateness of the authorities with responsibilities (Checks & Balances).
8. There must be a special supervision on risks centers in the locations where a conflict of interests raises, including working relationships with borrowers associated with financial institutions and major shareholders and senior management, or decision makers in the institution.
9. There must be financial and administrative incentives for senior management that achieve the work in a peaceful manner, and also for managers or employees, whether in the form of compensation or upgrades or other elements.

10. There must be a proper flow of information internally and externally.

3.8.3. Principles of the Organization for Economic Cooperation and Development

I. The Emergence of Principles:

The Organization of Economic Cooperation and Development is one of the most organizations, which focused on the concept of corporate governance. The Organization for Economic Cooperation and Development has formulated principles on corporate governance in response to the invitation of the organization council meeting at ministerial level on 27-28 April 1998 to do side by side with national governments and international institutions and the private sector. Since 1999, these principles became the basis for the principles of corporate governance in OECD countries or other countries. They were also approved by the Financial Stability Forum as one of the major twelve criteria of the appropriate financial systems. In addition, they were used by the World Bank in the framework of the efforts made to improve corporate governance in emerging markets\(^{(34)}\).

The meeting of the Council for Economic Cooperation and Development agreed at the ministerial level in 2002 to do a survey of developments in OECD countries to assess the principles. This task has been assigned to the representatives of OECD countries, the World Bank, the Bank of International Settlements, the International Monetary Fund as observers. The Financial Stability Forum and the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) were invited as temporary observers. The meetings included experts from a number of countries that participated in the Regional Round Tables of corporate governance in Russia, Asia, South-Eastern Europe, Latin America with the support of the Global Forum for Corporate Governance and other countries outside the Organization. On a large scale, the discussions were done with the leading group and some other parties such as business sector, investors and local and international professional groups, trade unions, civil society organizations and international bodies.

A project for formulating the principles was shown on the Internet to receive comments and discussions. This really led to getting a large number of responses that
have been published on the web site. Based on what was done by the organization of discussions and consultations, it was concluded that there was a need to re-amend the principles which in turn would lead to taking the developments and interests into account and keeping reviewing these principles, in order to maintain a non-binding approach based on principles which recognize the need to adaptation the implementation according to the different legal and economic and cultural conditions of any country.

Some of these amendments are as follows:

1. Expanding the role of shareholders in the areas related to establishing compensation for executive management and appointing the members of board of directors;
2. The need to check existence of a mechanism to address the expected conflicts and contradictions of interests;
3. The need to recognize and protect the rights of other stakeholders;
4. The need for a system that can receive complaints in the company;
5. Protecting those who report early for violations;
6. Focusing on the responsibilities of the auditor in front of the shareholders;
7. Achieving the transparency for investors who have the form of financial institutions, particularly with regard to the way of applying their property rights;
8. Achieving accountability for the responsibility of the board of directors in front of the shareholders;
9. Achieving the responsibility of the board of directors for compliance with the rules of conduct and ethics;
10. The company managers must have competence in the field of governance and independence in appreciating the matters of the company;
11. Focusing on existence a minimum level of disclosure and transparency and their requirements, particularly with regard to the preparation of financial statements and internal control and the role of the board of directors in achieving disclosure and applicable accounting standards and the integrity of the external audit process; and
12. Focusing on existence of effective control systems to reduce the chances of negative effects resulted from a conflict of interests.\(^{(35)}\)
II. Characteristics of Principles:

These principles were formulated to help the organization in assessing and improving the legal institutional regulatory framework of governance in their countries. The principles focus on companies that are trading securities, whether financial companies or non-financial companies. They were meant to be concise, understandable and accessible to the international community and not to be a substitute for government or quasi-governmental initiatives or private sector initiatives to put more details of the best practices of corporate governance.

Corporate governance is one of the main elements in improving economic efficiency and economic growth in addition to strengthening investor confidence and also includes a set of relationships among company management, board of directors, shareholders and other stakeholders. It focuses on the problems of governance that arise from the separation of ownership and management. Therefore, the principles should be complementary to a more extensive method of checks and balances process, and include some other issues of decision-making processes in the company, such as environmental, ethical or anti-corruption concerns.

The objective of developing these principles is to help the OECD countries and other countries to evaluate and improve the legal institutional regulatory framework of corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, and companies and other parties that have a role in developing good corporate governance. These principles were mainly developed for governance of companies listed in the financial markets. In addition, these principles are a useful tool in improving corporate governance of companies listed in the financial markets and other companies. These principles have become common rules and necessary for developing good practices of corporate governance in OECD countries and other countries.

The principles are not binding, and are not meant to provide ready recipes, but they rather seek to identify objectives and suggest various means to achieve them and meant to be a reference point. The policy makers can use these principles when they choose and develop legal and regulatory frameworks of corporate governance that reflect the economic social legal cultural conditions. These principles are naturally developed and
they must be reviewed when there are significant changes in the conditions. The companies must work to meet the new demands in order to retain their competitiveness in the market.

**Figure No. (3.4)**
Principles of Corporate Governance

![Principles of Corporate Governance Diagram]

The principles developed by OECD are divided into six main principles, each is divided into detailed principles that lead to achieving the main principle and they are as follows: (OECD: 2004) (36)

1- Ensuring the Basis for an Effective Corporate Governance Framework
2- The Rights of Shareholders
3- The Equitable Treatment of Shareholders
The corporate governance framework 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.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

The Second Principle: The Rights of Shareholders

The corporate governance framework should protect and facilitate the exercise of shareholders’ rights.

A. Basic shareholder rights should include the right to:
   1. Secure methods of ownership registration.
   2. Convey or transfer shares.
   3. Obtain relevant and material information on the corporation on a timely and regular basis.
   4. Participate and vote in general shareholder meetings.
   5. Elect and remove members of the board.
   6. Share in the profits of the corporation.

B. Shareholders should have the right to participate in, and to be sufficiently informed
on, decisions concerning fundamental corporate changes such as:

1. Amendments to the statutes, or articles of incorporation or similar governing documents of the company.
2. The authorization of additional shares.
3. Extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.
4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders.
according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

F. The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

The Third Principle: The Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same series of a class should be treated equally.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.

2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.

3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

4. Impediments to cross border voting should be eliminated.
5. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

The Fourth Principle: The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. Performance-enhancing mechanisms for employee participation should be permitted to develop.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

The Fifth Principle: 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.
A. 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.
   8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.

This principle is achieved through the following (37):

1. Accurate disclosure.
2. The appropriate timing to disclosure.
3. Comprehensive disclosure.
4. Check the information disclosed.
5. Providing channels of information delivery to users.

The Sixth Principle: The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.

A set of instructions that are taken into account for the application of the principle responsibilities of the board is: (38)

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfill certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2. Monitoring the effectiveness of the company’s governance practices and making changes as needed.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

5. Ensuring a formal and transparent board nomination and election process.

6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

7. Ensuring the integrity of the corporation’s accounting and financial reporting.
systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

8. Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.

2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

3. Board members should be able to commit themselves effectively to their responsibilities.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

According to what was mentioned earlier, it can be seen that these principles are a useful tool in improving governance of the companies listed in the financial markets and other companies. These principles have become common rules and necessary for developing good practices of corporate governance in OECD countries and other countries. The most important objectives behind the development of principles of corporate governance are providing a conceptual and applied framework to ensure corporate governance, increasing the awareness about the best application of principles of corporate governance, increasing the level of understanding of the relation between the corporate governance, economic growth and financial stability.

Principles of corporate governance require the interaction between external and internal systems and professional standards issued. The company should also provide transparency and disclosure and provide investors and the public with all the necessary information needed by the investor when making his investment decision. Moreover,
these rules play an important and significant role in achieving control and highly professional work to recognize the financial crises expected occur and prevent them from happening.

2.9. Elements of the Corporate Governance Principle Effectiveness

The principles of corporate governance require the presence of the elements that must be available and they are essential so that the economic unit can apply corporate governance. These elements are as follows: (39)

1. The existence of laws and pieces of legislation that concern the rights of shareholders, as the right to vote and elect the board of directors and the external auditor and that concern about the organization of the board of directors and its characteristics in terms of the emphasis on independence and stating the duties and responsibilities of the board of directors and the responsibilities of executive management and the rights of shareholders and their duties.

2. The existence of the audit committee in the company which its members have independence and are highly qualified and well experienced, so that the committee primarily makes sure that the company meet the requirements of the executive management, external auditing and financial reporting procedures in terms of the honesty and quality.

3. The existence of internal administrative systems that are highly efficient and effective, such as the personnel system. The disclosure system provides the information and disclosures required for stakeholders.

4. Defining the powers and responsibilities of each member of the company, and continuously reviewing and modifying if necessary that make those who belong to the company know the limits of their works and what is required from them, in order to serve the company and achieve its objectives.
3.10: Accounting Dimensions of Corporate Governance and Parties Responsible for the Application of Corporate Governance

3.10.1: Accounting Dimensions of Corporate Governance

The accounting dimensions of corporate governance are as follows: (40)

1. Accountability and accounting monitoring that takes two directions:
   - Accountability and monitoring of the higher administrative levels to lower administrative levels.
   - Accountability and monitoring which is between the board of directors and shareholders and stakeholders in the economic unity.
2. Commitment to the application of accounting and auditing standards.
3. The role of internal audit.
4. The role of the external auditor.
5. The role of audit committees.
6. Achieving the disclosure and transparency.
7. Earnings management.
8. Evaluating the performance of economic units.

Accounting dimensions of corporate governance are represented in the following three stages:

1. Stage of control on accounting work and it includes two types, pre-control and post-control on the accounting work.
2. Stage of the actual practice of accounting work, beginning with the obligation to apply accounting standards and assessment and follow-up performance and earnings management, and ending with disclosure of the result of this practice in the form of reports and financial statements.
3. Post-practice stage which includes the roles of audit committees and external review and what is achieved of confidence and credibility in the accounting information disclosed.
3.10.2. Parties Responsible for the Application of Corporate Governance

There are a lot of parties that are considered to be in charge of the application and implementation of corporate governance. Many academic scholars, researchers and international organizations agreed that there are four main parties responsible for the implementation of corporate governance which are:

1. Board of Directors
2. Internal Auditor.
3. External Auditor.
4. The Audit Committee.

This shows the close link between the accounting and audit, including means of financial disclosure and the rules and principles of corporate governance, and there is agreement that the governance as a new legislation has an impact on the quality of financial disclosure within the following: (41) Audit Committee, Board of Directors, Internal Auditor, External Auditor.

1. Audit Committee:

At present, the audit committees receive great interest of the international scientific specialized bodies and researchers, especially after the failures and financial turmoil in major international companies, and that is because of the role that can be played by audit committees as a tool of corporate governance in increasing accuracy and transparency in the financial information disclosed by companies.

There is no specific definition of the audit committees to date as the definitions vary from company to company. Some defined audit committee as “a sub-committee of the board of directors of the company, which shall be limited only to the non-executive members who have a high degree of independence and experience in accounting, audit, financial reporting and reviewing internal and external audit processes and reviewing the commitment of the rules of corporate governance in the company”. (42)

Most of the studies and references, if not all, that are specialized in corporate governance have emphasized the need to audit committees in the economic units that seek to apply corporate governance and noted that the presence of audit committees is a key factor to assess the levels of governance applied in the economic governance.

In order to be effective, the audit committee should have the following main elements:
- Independence: it requires that the committee is comprised of a majority of board of non-executive directors who have the ability to exercise appreciation and judgment in an independent way from administration.

- The financial expertise and experience: the members of audit committee must have financial expertise and experience as the function of the audit committee in the preparation of financial reports is a superintendence function.

- Good understanding of business risks, operations, financial reporting and controls: The members of audit committee must have a good understanding of business risks, operations, financial reporting and controls. The experiences should be also appropriate to the position of the institution. There should be expertise of the law of corporate and administrative business guidance.

The audit committees play a vital role in ensuring the quality of financial reporting and the achievement of confidence in the accounting information as a result of its supervision of the operations of internal and external audit and resistance to pressure and interventions of the administration on the audit process. Moreover, some point that the declaration of economic unit for the formation of an audit committee has an impact on the movement of its shares in stock market.

2. Board of Directors:

Board of Directors is the highest authority in the company that has the all the necessary powers to take decisions and actions needed to achieve the interest of shareholders who have authorized the board of directors. The board of directors manages the company according to the authority granted by the general assembly of shareholders. As soon as a member is elected to be in board of directors, the member becomes a representative of all shareholders in the company.

The board of directors is the most important mechanism of corporate governance because it represents the top of the framework of corporate governance. The main task of the board of directors is to reduce costs arising from the separation of ownership and decision-making power. The board of directors is generally responsible for raising the level of success in the companies, guidance and direction for the company.

Fama and Jensen have confirmed that the shareholders’ delegation of responsibilities to internal control of the board of directors makes the board of directors at
the head of the authority to control the decisions in the institutions. Despite the fact that the board of directors delegates most of the administration jobs and the decisions control to the senior management, it retains final control over the jobs and includes the authentication and supervision on the important decisions.\(^{(43)}\)

There is no particular system of good corporate governance that can be applied in all countries and companies as the corporate governance practices differ among companies depending on the different circumstances, and vary more among countries. Corporate governance should have the feature of flexibility and development but the requirements imposed by the market such as transparency and investor protection impose the countries and companies to test the system of governance and to move towards the provision of guarantees required and sought by investors and other stakeholders. The most important of these guarantees is adequate disclosure and transparency and this will be achieved if there are boards of directors having the ability to perform their supervisory functions effectively and efficiently.\(^{(44)}\)

A well-application of governance by the company is a necessity for the success and continuation of the company over the long term, so the members of the board of directors should have obligation to ensure the administrators of their institutions get adequate training on the principles of corporate governance and their application and the expertise should not be limited to members of board of directors only.

The role of the board of directors is one of the most important roles in applying corporate governance because the board of directors does the functions of supervision and control and has the ability to think strategically and formulate plans and goals and the ability to modify the plans and objectives flexibly more than any other unit. The board of directors also has the ability to show the decisions and advise the executive management about the important issues. The board of directors has expertise and experience in the activity of the institution especially because all the information about the company comes to the board of directors.

3. **Internal Audit:**

   Internal audit has been defined as “an independent evaluation function in the organization/institution that aims to serve the institution by examining and evaluating its various activities”. The aim of the internal audit is to help the members of the
institutions in implementing their responsibilities effectively by providing them with data and analytical information and by handling studies and providing appropriate advice and recommendations about the activities that have been audited. (45)

There must be an appropriate system of internal audit in the institution that is normally implemented in the internal audit section. The internal audit, especially the accounting audit, is one of the most important elements and components of internal control system. Audit system aims at assessing the systems concerned for the protection of the assets and property of the institution, controlling and directing its operations and examining whether the administration meets efficiency in conformity with the objectives desired. The internal audit is one of the rings of internal control that is working to provide the management with continuous information. The internal audit is also a set of procedures that arise in the company for the purpose of verification of the application of administrative and financial policies and the internal audit department does an independent evaluative function arising in the system designated to examine and evaluate the activities of the institution. The internal audit serves the company as a whole, all the employees, board of directors, audit staff, shareholders and other various parties.

This type of audit is called internal because it is a part of the internal administrative system of the institution carried out by a selected staff of the employees who have special competence and wide knowledge about all aspects of the institution activities and methods of functioning in its various units and sections. (46)

Within the concept of corporate governance, the concept of the internal audit extends going beyond the traditional role confined to services of traditional assurance to include counseling services and the governing role that can be played by the internal audit in many types of counseling by value adding to improve the organization's operations. That means that the profession can add a value by providing an assessment about the reliability of data and processes in specific regulative areas. This concept includes all areas of traditional audit that relate to the audit of the compliance, financial and operational audit and the new issues of assurance relating to risk and control management. (47)
The role of the internal audit function in the application of good corporate governance can be clarified by focusing on the issues that became necessary to the obligation to apply the governance. The important of these issues are:

- Extending the procedures that evaluate the intangible aspects of control such as integrity and ethical values.
- Designing special procedures that reasonably ensure a discovery of what may happen, like cases of intentional material misstatement in all the work issues in the company.
- Expansion in the assessment of the reasonableness of responsibility of the company and the extent of commitment to implement the substantive goals in that regard through the study of the adequacy of policies and programs implemented.
- Participating as a consultant member in the risk management processes and the expansion of operations to evaluate the risk and the adequacy of methods and control procedures applied in the confrontation of all the risks that make occur in the company, and providing the level of assurance or certainty about the adequacy of the risk management.

It is clear that the internal audit department is a department or team of consultants or practitioners who provide independent and objective services to the internal audit or provide consulting services to the institution administration designed to add a value and improve its operations. The internal audit services help the institution to achieve the objectives by providing a systematic and logic entrance to assess and improve the effectiveness of risk management processes and control operations and monitor the implementation of corporate governance principles. The internal audit is also responsible for achieving the objectives of internal control which includes monitoring the adequacy and effectiveness of operations and the safety of financial reporting.

4. **External Auditor**

The concept of the external audit is a review conducted by a body independent from the project. It is not subject to the supervision of management, but it does its own duty as an agent of the shareholders especially in the listed companies and it takes into account the application of the basic law and the Companies Act by the company administration.
The external audit is done by chartered accountant and independent of the economic unit that reviews the assertions or statements. The external auditor’s independence is the basis of the audit review process. The function of the external audit conducted on the basis of external supervision where the auditor is independent so that the auditor remains neutral on the financial statements. The external auditor’s responsibilities are summarized by examining the financial statements, the books, the records and internal control systems and giving the technical neutral opinion in the data presented to the auditor. The external auditor also examines the works of internal auditors as a part of the examination and evaluation of internal control systems. The external auditor also should inform the management of institution about the weaknesses or deficiencies in the internal control system.

The role of the external auditor is strengthening confidence and credibility about accounting information through giving the neutral technical opinion in the sincerity of the financial statements prepared by the economic units by the report prepared with the financial statements by the external auditor. The role of external audit has become an essential and effective in the field of corporate governance because it reduces conflict between owners and management of economic unity, as well as it reduces the problem of information asymmetry and reduces the problem of moral deviation in the economic units.

3.11. Summary:

To sum up, corporate governance is the process of organizing and arranging the relationship between company management and behavior, shareholders and related parties and the makers of government regulations and the process monitoring and evaluating performance at various levels in order to benefit all the parties. The protection of the rights of shareholders and other stakeholders can not be achieved without the financial information that enables the external parties to control the actions of company administration and assess its efficiency. The related parties also will not be able to make decisions without the required information. The financial reporting is one of the main pillars of the application and activation of the corporate governance.
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