

Kingdom of Saudi Arabia  
Capital Market Authority

هيئة السوق المالية  
Capital Market Authority



# *Corporate Governance*





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## *Introduction*

Corporate governance is one of the most important issues for all local and international companies at the present time. The global financial crisis, which adversely affected world economy, has put the concept of corporate governance at center stage. Governance rules and regulations around the world aim at minimizing the abuse of shareholder interests by top management. They seek to enhance the performance of the board of directors in companies, promote internal control, monitor the implementation of strategies, identify the roles and responsibilities of shareholders, the board of directors, stakeholders and top management. In addition, they emphasize the importance of transparency and disclosure. Corporate governance is an approach for reform and a new mechanism that would enhance the integrity of financial transactions, by setting parameters that serve the public interest and stakeholders' rights.



## *Why Corporate Governance?*

Companies that apply the principles of corporate governance enhance the level of trust and reassurance of the shareholders with regard to their investments, because it indicates an awareness on the part of executive management and board of directors of the risks facing the company, thus enhancing the ability of the company to manage and limit these risks.

This in turn should help the investor make informed investment decisions, taking into account the other relevant investment criteria. The effective practice of corporate governance by a company helps attracting investors and gaining their trust, because the company gains many advantages in the process, especially a reputation of fairness and transparency to all stakeholders

Investors often turn to experts to manage the companies they invest in, due to their lack of time and the expertise needed to manage those companies. With this in mind, there is a need to implement corporate governance to enhance the owners' confidence in the board of directors and executive management of the company, so that they feel that they are committed to achieve the company's objectives and safeguard and maintain their rights.

The challenges that the company faces in this regard is that expert managers are not, in most cases, owners of the company. So there is a likelihood that a manager may advance his own interests at the expense of the owners'. That's why corporate governance is needed in order to establish roles and responsibilities aiming at the integration and promotion of the relationship between the company management, owners and all stakeholders, in order to establish fairness and transparency.

## *What does Governance Mean?*

Corporate governance is a framework that determines the rights and responsibilities among the various parties, such as the managers, board of directors, shareholders and other stakeholders in the company.

The Organization for Economic Co-operation and Development (OECD) defines corporate governance as "Procedures and Processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making."

# Importance and Benefits of Corporate Governance

Corporate governance is important for many reasons:

1. *The Economy:* corporate governance contributes to the enhancement of the efficiency of the economy, since this will help the stability of capital markets enhance the level of transparency, and attract internal and external investments. In addition, it mitigates the risks facing the economic system.
2. *Companies:* applying governance principles helps companies achieve better performance with effective management and ideal working environment, which in turn would enhance the economic value of the company. In addition, corporate governance helps companies reach the financial markets and have access to the funding needed, at a lower cost. This should help the company expand its activity, minimize risks, and enhance trust with the stakeholders.
3. *Investors and Shareholders:* corporate governance aims to protect loss of investments due to the abuse of power in a manner that is not in the investors' interest. It also aims to maximize the return on investments, shareholders' rights and the investment value. It also limits cases of conflicts of interest, since a company's commitment to implementing the governance



standards activates the role of shareholders participation in making important decisions that have to do with the company management, and knowing all issues relevant to their investments in the company.

4. *Other Stakeholders:* corporate governance aims to build a close and strong relationship between company management, its employees, suppliers, creditors and other parties. Rational governance enhances the level of trust between all involved parties in order to enhance company's performance and achieve its strategic objectives.

# Corporate Governance in the Kingdom of Saudi Arabia

## Shareholders' Rights

The most important axes in corporate governance is that shareholders obtain all privileges pertained to their shares, especially the right to obtain a share of the dividends, the right to obtain a share of the dividends, the right to company assets in case of liquidation, the right to attend and participate in shareholder assemblies and deliberations, the right to vote on its decisions, the right to manage the shares, to monitor the board of directors' performance and file liability suits on its members. They also have the right to ask for information and inquiries that don't compromise the company's interests or conflict with the financial market's rules and regulations.

One of the most important mechanisms for shareholders to exercise their voting rights in selecting board members is cumulative voting.

## What is Cumulative Voting? How does it Work?

It is a voting method to select the members of the board of directors. Each shareholder can cast a vote in proportion to the number of shares he owns. So he can use this power to vote for one candidate, or divide it on a

number of candidates without repetition. This method increases the opportunity for minority shareholders to be represented in the board of directors by focusing the cumulative votes on one candidate. For example:

Candidate	First	Second	Third	Fourth	Fifth	Sixth
Investor (A)	110,000		120,000		120,000	
Investor (B)		120,000				

Suppose a company has vacant three seats in the board of directors that are available for voting, then each investor can vote as the following:

Investor (A) has 350,000 shares

Investor (B) has 120,000 shares

Thus, each investor can distribute his votes on the members or focus the vote on one member to ensure that he has a representative in the board of directors:

In this case, investor (B) was guaranteed a representative (second candidate) in the board of directors by focusing all his shares. On the other hand, the cumulative voting system restricted investor (A) and limited his ability to control all the seats.

A shareholder can appoint another shareholder, who is not a member of the board, to represent him in the voting.



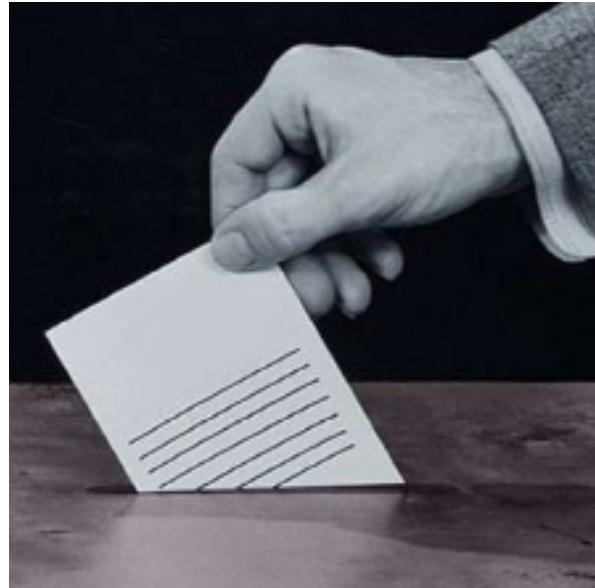
Investors who have a 'legal capacity' and who have the right, by company bylaws, to appoint their representatives in the board, may not vote to choose other people for the membership of the board.

### *Proxy Voting*

Proxy voting has been introduced recently in order to increase and facilitate shareholder participation in the general assembly meetings, and to enhance the adequacy and efficiency at these meetings. There is a need to apply this modern mechanism to be in line with the developments and use the latest technology, which would overcome the obstacles that might get in the way of shareholder participation or hold the assembly. Under this mechanism, the shareholder can exercise his right in voting without physically attending the assembly. In addition, this helps companies to ensure that the quorum is complete and assemblies are held. It also reduces the expenses of listed companies resulting from assemblies not held at specified times.

### *Disclosure, Transparency and Corporate Governance*

Disclosure and transparency are the two most important principles in corporate governance that enable the shareholders to ob-



tain have the information they need in a fair and transparent manner; therefore, public listed companies are required document their disclosure policies, rules and regulations.

Moreover, companies must attach to their financial statements a report from the board of directors that includes: an overview of the company's operations during the past financial year, as well as factors that impact the company's operations which would help investors to better assess company assets, liabilities and financial status. In addition, board of directors' report must also include implementation status of CMA corporate governance

regulations indicating the applied rules, while providing explanation for those that are not applied, if any.

## *The Board of Directors*

Membership of the board of directors entails high responsibilities ,most important core functions of the board are:

- Adoption of the strategic directions and key objectives of the company, and overseeing their implementation.
- Develop and generally supervise the rules and controls for internal monitoring.
- Develop a company governance framework that is not in conflict with the corporate governance regulations, supervise it, monitor its effectiveness and enhance it when needed.
- Formulate clear policies, standards and procedures for board membership and put them into effect after approval by the general assembly.
- Develop a written policy that regulates the relationship with stakeholders in order to protect their rights.

## *Classification of Board Members*

The board of directors should preserve the required level of independence in making decisions to achieve company objectives and its shareholders. Therefore, the majority of board members must be of non-executive status, and the number of independent members must not be less than two, or one third of the members, whichever is greater.

*Executive member:* a board member who works full-time to manage the company, or who receives monthly or annual salary from it.

*Non-executive member:* a board member who does not work full-time to manage the company, nor receive monthly or annual salary from it.

*Independent member:* a board member who is fully independent. Examples of what constitutes non-independent are the following:

- To own 5 per cent or more of the shares of the company or its subsidiaries.
- To represent a person with legal capacity who owns 5 per cent or more of the shares of the company or its subsidiaries.
- To have been during the previous two years a senior executive working for the

company or its subsidiaries.

- To be an immediate relative of one of the board members in the company or its subsidiaries.
- To be an immediate relative of a senior executive in the company or its subsidiaries.
- To be a board member of a subsidiaries, and is nominated for membership in board of directors of the holding company.
- To have been employed during the past two years by parties associated with the company or its subsidiaries, like CPA's and major suppliers, or to have been an owner of controlling shares in one of those parties during the past two years.

## *Responsibility of the Board of Directors*

The board of directors is fully responsible of the company, even if it formed committees or delegated other parties or individuals portion of its responsibilities. Therefore, the board should avoid authorizing general or indefinite delegations, it should clearly define the responsibilities of the board of directors in the company bylaws.

The board of directors should diligently dis-



charge its duties in a responsible, serious manner and in good faith. Every member of the board of directors represents all shareholders, so he should be committed to achieve the company's general interests, not interests of the group or party he represents or that voted for his appointment in the board.

## *Board of Directors' Committees and their Independence*

Several committees emerge under the company's board of directors to assist it in performing its tasks and functions efficiently. Committee members are often themselves board members. These committees study specific topics and submit their findings or decisions to the board. In addition, the board of directors supervises the progress of each individual committee.

### *The Audit Committee*

A committee formed of non-executive board members, and is made up of at least three individuals, one of whom is specialized in financial and accounting.

The tasks of the audit committee include overseeing the internal audit department in the company, reviewing the internal control system, and preparing a written report of its findings.

It also reviews internal audit reports and follow up on the implementation of corrective actions taken with regard to the notes contained therein, recommends to the board of directors the appointment and dismissal of CPA's, determines their fees, follows up on their work, reviews the audit plan with the

CPA's and provide their feedback, reviews CPA feedback on the financial statements, and perform follows ups in this regard, and reviews the preliminary and annual financial statements prior to submission to the board of directors. In addition, it reviews the accounting policies used and provides its feedback or recommendations to the board of directors in this regard.

### *Nominations and Rewards Committee*

A committee formed from the board members. Its functions include: recommendation to the board of directors for nominations to the board membership in accordance with the established policies and standards, annual review of the appropriate skills needed for membership of the board, preparation of a description of the capabilities and qualifications required for membership, and identification of weaknesses and strengths in the board of directors with proposals for addressing them in a manner that is consistent with the interests of the company.

The recommendation may include training of all or part of the members in specific technical and administrative aspects.

The committee should annually reassure itself of the independence of independent members, and

develop clear policies for the compensation and bonuses of board members and senior executives. The use of criteria linked to performance should be taken into account when developing those policies.

## *Conclusion*

The Governance culture aims to enhance the role and responsibilities of the owners, board members and executive departments for the purpose of increasing the confidence of investors and stakeholders, raising transparency level, and minimizing potential risks that the company may be exposed to.

This culture helps companies reaching the markets, increasing their competitiveness, and enhancing the rates of efficiency, which reflects on the economy's strength and well-being.







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