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COMMITTEES OF THE BOARD

Audit commission

International board practice concerning establishing committees on the board is still not spread in Ukraine. The state obliged Ukrainian joint stock companies to establish an audit commission. But the commission is not on the supervisory board. It is not an integral part of the board. Members of audit commission are prohibited to be members of the supervisory board at the same time. Although the audit commission reports to the supervisory board, objectives of the audit commission are narrowed only to controlling financial transactions executed by the management board. Therefore, it is worth of establishing an audit committee with a broader spectrum of functions and equipped with the deepest knowledge on corporate governance mechanisms.

With reference to Sir Robert Smith's recommendations the role of the audit committee is about:

- To monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;
- To review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;
- To monitor and review the effectiveness of the company's internal audit function;
- To make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- To monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant Ukrainian professional and regulatory requirements;
- To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

Audit commission in Ukraine undertakes the role of audit committee only related to items 1, 2, 3. Members of the supervisory boards of Ukrainian companies are common about the conclusion that the level of independence of members of audit commission is very low. 92 per cent of

members of supervisory boards think that members of audit commission are dependent on the company's management.

Under such circumstances a function of the board known as an internal control that should be provided by the audit committee, is not fulfilled by audit commission at all. At the same time when we asked members of supervisory boards for their opinion to be more engaged in selecting and appointing an external auditor we received unexpected answers. Only 28 per cent of directors were certain about increasing their responsibilities for selecting and appointing external auditors. All these let us a chance suppose that directors are disturbed with the lack of independence of internal audit commission and a dictate of the company's management in the field of selecting and appointing an external auditor. But, at the same time, directors are passive in assuming responsibilities in this filed because of lack of appropriate knowledge and qualification.

The structure of audit commissions of the companies in Ukraine is very typical. Thus, almost all members of the audit commissions are insiders from the point of view of their company status. It could be much less painfully for the company if members of the audit commission were the shareholder workers, representing all levels of the company's management and workers in a whole. Regrettably, about 94 per cent of the members of audit commissions in Ukraine are the middle and top level managers whose independence is arguable and whose loyalty to the company's employees is arguable too.

Ukrainian companies could apply a concept of social responsibility toward the audit commission. A wide representation of all groups of employee shareholders would be a way out here. Moreover the audit commission composed in the above method could be quite efficient in protecting interests of employees, i.e. minority shareholders who suffer of the management dictate in Ukraine. But the management dictate is strong and the employee shareholders consolidation is very weak to expect the situation development mentioned above.

Size of audit commissions in Ukraine is from 3 to 7 members. Size of audit commissions in Ukraine does not depend on the size of the supervisory board, i.e. the hypothesis that the larger the supervisory board the larger the audit commission is not proved. Most of companies (75 per cent of the Ukrainian joint-stock companies) elect 5 members on the audit commission. The rest companies establish audit commissions consisting of 3 or 7 members. Probably, Ukrainian practices of audit commissions from the point of view of their compositions are still far from the best ones. This concerns the audit commission member independence. Only about 4 (four!) per cent of the audit commission members are independent. The rest members are the large shareholders, former or

recent employees of the same company or have very close relative relationships with executives. Under such conditions executives have very good chance to influence the activity of audit commission by administrative pressure (about 92 per cent of members of audit commissions in Ukraine are employees, i.e. subordinated to the company executives).

Remuneration of the members of the audit commission is paid monthly as a fixed amount. There are no any bonuses that could tie the motivation of the members of the commission to their performance. Thus, average amount of the remuneration paid to the member of the audit commission annually is USD210. Size of remuneration is fixed at the beginning of the year and could not be changed during a year despite the number of meetings the audit commission held. Such small size of remuneration and very fixed nature of the remuneration make the members of the audit commission quite reluctant to the reliable execution of their duties.

About 6 per cent of members of audit commissions in Ukraine have external advisors. As a rule, these are professionals having expertise in accountancy or finances. The most active members of the audit commissions in getting to services of external advisors are large shareholders or external minority shareholders. Regrettably, all these advisors are informal, i.e. the company is not informed about their existence.

Compensation committee

Another important committee, compensation committee, is established on the supervisory boards only at 10 percent of researched Ukrainian companies. These are companies mainly under control of foreign institutional investors. About 58 percent of companies, controlled by foreign institutional shareholders have compensation committees on the supervisory boards. It is worth of mentioning that this number is even higher than an average number for Germany, France and Italy. At the same time, a comparative advantage of Ukrainian executive compensation practice is erased by the fact that no company in Ukraine discloses the level and structure of executive compensation to shareholders, stakeholder and general public at all. This concerns all sectors of the Ukrainian economy, i.e. banking, manufacturing, services, high techs, mass media. Moreover, this concerns both large and small companies.

We should note that in the wake of recent scandals, a number of countries have moved to enforce better disclosure of board and executive compensation, and a small although increasing number also call for

individual remuneration packages to be published. CEOs and other leading executives and board members are often in a unique position to abuse their position of power and in several countries this has come as a surprise to governments, the public and shareholders. It is therefore important not only to publish individual remuneration but to make the definition as broad as possible so as to avoid better camouflaged pay structures with sub-optimal incentives. The experience indicates that details of the compensation schemes are as important as the overall level in assessing the incentive structure and that remuneration also includes pension schemes, termination benefits and golden parachutes. The last two have become topical in a number of countries (e.g. Germany, France, UK) especially where large termination benefits have been associated with poor company performance.

The Ukrainian practice of disclosing the executive compensation does not exist at all. No company discloses information about the level and structure of executive compensation. This reduces the potential of influence of the compensation committee and the degree of executive monitoring gets weak too.

Lord Cadbury mentioned that executive directors should play no part in decision making on their own compensation (*Cadbury, 1992: para 4.42*). Taking into account that executives are not members of the supervisory board in Ukraine, i.e. it is prohibited by the legislation, we should broaden a term "executive" to "independent". Almost all members of compensation committees (85 percent) at the companies under control of foreign institutional shareholders are independent. That is a strong contribution to performance of the board. It is interestingly, companies, controlled by employees, have not compensation committee on the supervisory boards at all. Probably, it is because of very low number of independent directors on the boards and very stable stickiness of employees to "fixed" compensation contracts to sign with executives that reduce an importance of compensation committee on the supervisory board. Under such circumstances, executives are free to influence decision on the size and structure of their compensation through forcing a personnel department that is subordinated to executives and responsible to developing contracts for executives.

Moving beyond disclosure as a governance tool, in an increasing number of countries there are also moves to find more structural solutions, supported if necessary by guidelines. Compensation or remuneration committees are either being established or strengthened by the inclusion of independent members. For example, both the New York Stock Exchange and Nasdaq have proposed independent compensation committees as part of their listing requirements and codes and principles in many other countries go in the same direction. The Ukrainian practice

of executive compensation has no evidence of an attempt to be undertaken by the stock exchanges, the National SEC, or other regulators toward an establishing the recommendations or requirements concerning the best practices of executive compensation, addressed to the companies. It is hardly possible to suppose that there is no any wish of the regulators of the market of Ukraine for establishing the transparent standards of the executive compensation issue.

Some market participants including executives and large shareholders could be not interested in disclosing the information about the executive compensation. Moreover about 96 per cent of executives of Ukrainian companies do not understand how the disclosure of their compensation size and structure could improve the corporate governance efficiency and at least the company performance. 92 per cent of executives are sure that the disclosure of the executive compensation would lead to conflicts between executives and employees, or even with the minority shareholders. Only 3 per cent of executives of Ukrainian companies completely welcome an idea of the executive compensation disclosure implementation in Ukraine. Shareholders of Ukrainian companies have another point of view on the executive compensation disclosure. Thus, foreign institutional shareholders almost completely support the idea of disclosure of executive compensation. 98 per cent of foreign shareholders are sure about the positive effect of executive compensation. Even employee shareholders share the above point of view. Thus, more than 85 per cent of employee shareholders in Ukraine support the idea to make the executive compensation disclosed. As we noted, international experience of executive compensation system says that most large international companies have a compensation committee of two or more "outside" directors. Although all major decisions related to the top-level pay are passed through this committee, the committee rarely conducts market studies of competitive pay levels or initiate or proposes new incentive plans, and only seldom retains its own compensation experts.

Rather, initial recommendations for pay levels and new incentive plans typically emanate from the company's human resource department, often working in conjunction with outside accountants and compensation consultants. Here, executive compensation responsibility naturally varies with company size and complexity. Very large companies often have a fully staffed "Office of Executive Compensation", headed by a vice president who reports to either the Senior VP of Human Resources or to a VP of Compensation and Benefits. In smaller companies, executive compensation responsibility typically rests with the executive responsible for human resources.

Size of compensation committees in Ukraine is from 3 to 5 members. Size of compensation committees in Ukraine does not depend on the size

of the supervisory board. Most of companies (90 per cent of those companies having compensation committee on the supervisory board) elect 3 members on the compensation committee. The rest companies establish compensation committees consisting of 3 members. Probably, Ukrainian practices of compensation committees from the point of view of their compositions do not meet the international standards. This concerns the compensation committee member independence. Only about 26 per cent of the compensation committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The last two dependence criteria are the most popular in Ukraine.

About 12 per cent of members of executive compensation committees in Ukraine have external advisors. These are professionals with expertise in remuneration having quite rich experience in practice. The most active members of the executive compensation committees in getting to services of external advisors are external minority shareholders whose interests are represented on the board. Probably, getting to services of external advisors they wanted to be more competent in monitoring the executives. Moreover, cooperation of the compensation committee members with external advisors increases the degree of involvement of the directors not only in the executive monitoring process, and also in the strategy development. Regrettably, similarly to the case of audit commission, all these advisors are informal, i.e. the company is not informed about their existence.

Remuneration of the members of the compensation committee is paid monthly or only one time a year as a fixed amount. There are no any bonuses that could be paid to the members of the executive compensation committee to improve their performance. Thus, average amount of the remuneration paid to the member of the executive compensation committee annually is USD190. Size of remuneration is fixed at the beginning of the year and could not be changed during a year despite the number of meetings the executive compensation committee held. It should be noted that the remuneration of the director for his work as a committee member is in three times lower than his remuneration as the board member in a whole. This is not perspective distribution of remuneration because the work in committees could become as a formal and not motivated duty in Ukraine.

Models of executive compensation setting

Today, there are three models of executive compensation setting in Ukraine. The first model obliges Human Resource Department to develop executive compensation. As soon as it is developed, an executive

compensation plan is brought to the Office of the Head of executive board to approve. If the head is not satisfied with the salary that is stated in the executive compensation plan, he is able to make the head of human resource department for setting the compensation, desirable by the head himself and the rest of executives.

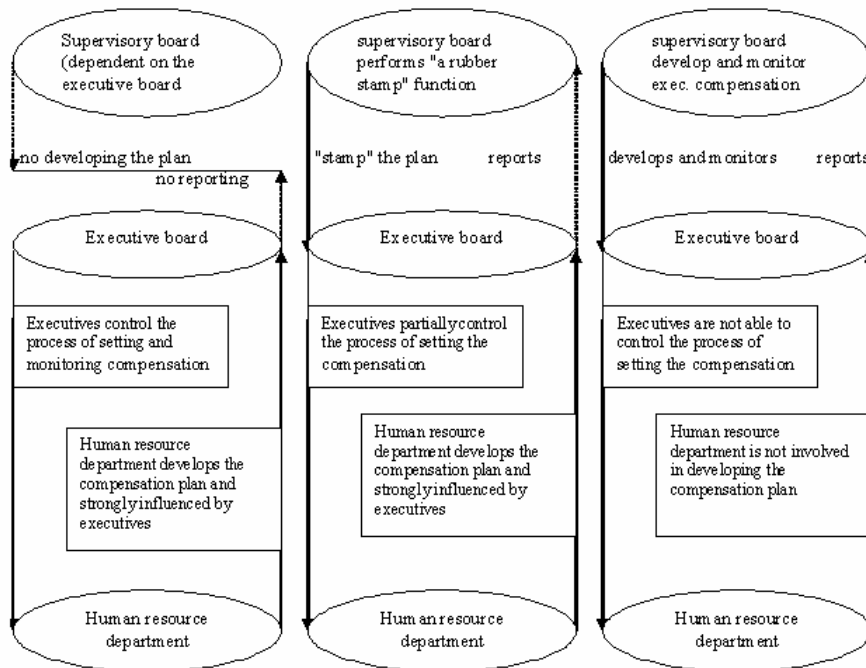


Fig. 5.1. Models of executive compensation setting in Ukraine

Besides this, it should note that executive compensation plan is not approved at the meeting of the executive board, where every member has his own point of view on the plan. The plan can be approved only by the head himself, in ordinary way, as compensation for middle-level managers.

Under such circumstances, the head of executive board is like a dictator, who is able to make any member of the executive board vote for all decisions, as the head likes, under the threat of compensation cut.

Under this model, supervisory board is not involved in developing and approving compensation for executives. The reason, as a rule, is absence of skills at members of the supervisory board how to supervise an executive compensation practice. But the most important reason is strong dependence of members of supervisory board on executives.

The above model is popular in companies, owned or controlled (on

the basis of proxy votes) by executives. Executives have strong levers to manipulate compensation and set it as they want.

The second model is a little similar to the model, discovered above. Human resource department develops an executive compensation plan. But, in contrast to the previous model, an executive compensation plan, as soon as it is developed, is brought to the supervisory board. The main task of the supervisory board is to approve or disapprove the plan. If it is approved, supervisory board gives the plan to the executive board and makes them follow it. If it is not approved, the plan is brought to the human resource department back to enhance it.

Under the second model, supervisory board performs a function of "a rubber stamp". Therefore, performance of executive compensation plan depends rather on skills of human resource department than on skills of supervisory board.

At the same time, the human resource department is still under pressure, when developing the plan, of executives, who can try to force them make the plan more convenient for them. Experiencing a pressure of executives and forcing by supervisory board, the human resource department faces a compromise. Being a socially responsible means to become an enemy for executives who will make the further work of the human resource department terrible.

Therefore, the second model underlines that supervisory board supervises the executive compensation practice indirectly, through stamping the plan. At the same time, executives still save a chance to influence indirectly the process of development of compensation plan.

Under the third model, only supervisory board develops and approves the executive compensation plan. No human resource department takes participation in the process of development of the plan. From this perspective, the third model meets corporate governance principles. Executives are not able to influence the process of development and approving the plan.

As a rule, companies, using the third model, establish a special committee within the supervisory board. This is a compensation committee. Compensation committee is responsible for developing an executive compensation plan.

We could suppose that members of this committee develop the plan autonomously. We asked members of the compensation committees in Ukraine. All they replied that human resource department still participates in the process of development of the plan. As we found, compensation committee develops principles of executive compensation plan, approves compensation instruments. They do this in accordance with the corporate development plan where there are certain figures to tie it to the size of compensation. Moreover, members of compensation

committee choose performance benchmarks, bonus standard, structure of bonus standard. All this information is brought to the human resource department. Human resource department officers should fill the draft of the plan with certain figures to complete. So, even executives try to press on human resource department to obtain more preferable compensation plan, they will not be able to change principles, instruments, and size of compensation.

Finance committee

Finance committees are on the boards at only 3 per cent of researched companies. Motives to establish finance committee on the supervisory board at companies, controlled by various groups of shareholders are different. Thus, financial-industrial groups want to have finance committee on the board to control financial expenditures by executives and to have a strict control over the process of the cash expenditures and cash flows within the group in a whole. Foreign institutional shareholders establish finance committee on the supervisory board to involve directors in strategic financial decision making. Generally, strategic financial decisions are made by executives at the companies, controlled by executives themselves, employees and Ukrainian financial-industrial groups.

Among the Ukrainian companies controlled by financial-industrial groups there are 22 per cent with a finance committee on the supervisory boards. Companies controlled by Ukrainian FIGs are the most active in establishing a finance committee on the supervisory boards. Cash flows within a group is dispersed and the most important task of the members of the finance committee is to keep an eye on the process of the cash generating, distributing and accumulating by the companies engaged in the group. This task is set by large shareholders who want to consolidate all financial resources which are free for a certain time for applying the strategic goals. From this point of view, the finance committee could be like internal auditor acting in the company from inside but set by outside participants, i.e. large outside shareholders.

It is interesting to note that members of the finance committee are mainly independent, i.e. they never worked at the company as executives, they never owned large block of stock of the company, they have no relatives as executives of the company, and so on. About 72 per cent of members of the finance committees at Ukrainian companies are independent. This is a remarkable progress for the Ukrainian practice of the independent directorship under which the majority of members of supervisory boards are not independent.

At the same time, members of the finance committees are not

satisfied with the level of so named “functional independence” in making decisions on the process of the control of cash flows consolidation and distributing. More than 80 per cent of members of the finance committees are sure that the large shareholders whose interests they represent on the supervisory board are inclined “to put their own hands” in the activity of the finance committee too much. Members of the finance committee feel that large shareholders do not trust them completely as directors would like. It is very strange to note for the independent directors where the issue of “a trust” should be not actual. The issue of the director professionalism should be the priority for the large shareholders.

Moreover, the finance committee members in Ukraine are common around the thought that the system of corporate financial statements are not developed in Ukraine enough to let them effectively direct such corporate area as corporate finance. The weakest element of the corporate financial disclosure system is the systematical financial reporting. About 84 per cent of the finance committee members agreed that they have a lack in receiving the financial corporate information on the systematic, smooth basis. From this point of view they are afraid of being not effective in representing interests of shareholders as the well informed directors who should be in a course of the behavior of the management board.

The most members of the finance committees have a rich experience in the field of corporate finance and appropriate education. 78 per cent of the finance committee members graduated with the degrees in corporate finance. 93 per cent of the finance committee members have at least a ten year experience in corporate finance. Their self-assessment is very high. Almost all members of the finance committees in Ukraine are sure that they are qualified enough for being the effective members of the finance committee.

The finance committee by-laws are not well-developed practice in Ukraine. The most companies still prefer to make some notes in the supervisory board by-law concerning an activity of the finance committee. There are 96 per cent of companies where there are finance committees which are regulated by the supervisory board by-law. Only 4 per cent of companies have a separate by-law on the finance committee. As a rule, information containing in the supervisory board by-law and concerning the finance committee does not cover all practices of the finance committee. For example, there are no notes regarding the composition of the finance committee from the point of view of the independent director share on the finance committee or the procedure of their reporting.

The finance committee size at Ukrainian companies is similar to the practices of compensation committee, i.e. from 3 to 5 members. Size of

finance committees in Ukraine does not depend on the size of the supervisory board. At the same time, the size of finance committee depends on the industry the company belongs. Thus, commercial banks have only 3 (in 20 per cent of cases even 2) members in the finance committee. Oil-gas extracting companies have, as a rule, 5 directors in the finance committee. Ukrainian practices of finance committees from the point of view of their composition do not meet the international standards with reference to the director independence. Only about 12 per cent of the finance committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The first two dependence criteria are the most popular in Ukraine.

There are 6 per cent of members of finance committees in Ukraine having external advisors. These professionals have expertise in corporate finances having quite rich experience in practice. The most active members of the finance committees in getting to services of external advisors are majority shareholders. Regrettably, similarly to the case of the executive compensation committee, all these advisors are informal, i.e. the company knows nothing about their existence.

Remuneration of the members of the finance committee is paid monthly as a fixed amount, as in the case of audit commission or as a fixed amount a year as in the case of compensation committee. Bonuses that could tie the motivation of the members of the commission to their performance are absent. Thus, average amount of the remuneration paid to the member of the finance committee annually is USD140. Size of remuneration is fixed at the beginning of the year upon the composing the supervisory board committees and could not be changed during a year despite the number of meetings the finance committee held.

Administration committee

The rest committees on the board, popular in the Anglo-Saxon world, are not developed in Ukraine too. Administration committees are not popular on the boards of Ukrainian companies. About 4 per cent of researched companies have on the boards an administration committee. The reason of so low popularity of administration committee on the supervisory boards in Ukraine is very contrasting to those, made previously. Ukrainian companies, whoever controlled them, want to have well-performing administrators on the supervisory boards. But the market for directors in Ukraine has a lack of directors, who could effectively administer the work of the board from the point of view of its various roles, i.e. strategic, control and service.

Foreign institutional shareholders are the most active in establishing

the administration committee. About 24 per cent of companies controlled by foreign institutional shareholders established the administration committee on their supervisory boards. It is obviously to recognize that the weak interest of Ukrainian companies to the administration committee will have a very negative influence on the corporate governance performance.

One of the most important disadvantages of corporate governance in Ukraine is a very weak degree of the internal regulation and control. The world practice in the internal regulation and control says that the companies should meet the specifics of corporate governance attributed to them through developing a set of internal statements. These are statements on committees of the supervisory board, executive compensation, internal control and many others. This work should be done and headed by independent members of the supervisory board who should work as members of the administration committee. It is a paradox that Ukraine, as a country where corporate governance is still in transition to the international best standards has still no firm demand for those people who will professionally and independently do the work regarding turning the chaos into the order.

More than 90 per cent of members of the administration committees of the supervisory boards of Ukrainian companies have a right imagination of what they need to do as the administration committee members. 96 per cent of respondents find the development of the system of statements of internal control as the most important task of the committee.

Regrettably, only 38 per cent of members of the administration committees in Ukraine find their work satisfactory. The main obstacle on the way to effective work of the administration committee is a strong resistance not only from the members of the management board, i.e. executives. The most surprising is the fact that members of the administration committee feel resistance from their colleagues, i.e. members of the supervisory board. Under such circumstances it is hardly possible to hope for an effective work of the board. Moreover, the supervisory board can not be considered as a team of colleagues.

Probably, members of the supervisory boards in Ukraine are so resistant to the work of the administration committee because the committee's efforts very often make the members of the supervisory board behave in another way that is not comfortable for the members of the board. Besides that a well-ordered work of the supervisory board facilitated by the administration committee could require the supervisory board members for the new skills. It could be a very strong test for the directors' professionalism. Most of directors do not want to have an exam for their ability to work on the supervisory board. Probably it is because

most of directors realize that this exam will not be taken successfully.

It should be noted that the most members of the administration committees have quite long experience in the field of business administration. 82 per cent of the administration committee members in Ukraine have at least a ten year experience in corporate administration. At the same time their education is not appropriate to their experience. Only 18 per cent of the administration committee members graduated with the degrees in corporate administration. They obtained their degrees either abroad or in Ukraine after the crash of the USSR. Before the year 1991 the Ukraine educational institutions did not offered the degrees in corporate administration at all. Despite that, the self-assessment of the administration committee members is very high. 89 per cent of members of the administration committees in Ukraine are sure that they are qualified enough for being the effective members of the administration committee.

The administration committee by-laws are not well-developed practice in Ukraine too as in the case of the finance committee. The most popular document adopted at the joint-stock companies in Ukraine and discovering the role of the finance committee is the supervisory board by-law. There are 98 per cent of companies where there are administration committees which are regulated by the supervisory board by-law. Only 2 per cent of companies with the administration committees on their boards have a separate by-law on the administration committee. From the point of view of the administration committee functions disclosing, information containing in the supervisory board by-law and concerning the finance committee does not cover all practices of the administration committee. Generally, there are no notes regarding the composition of the administration committee from the point of view of the independent director share on the administration committee, the procedure of their reporting, their remuneration. The exclusive functions of the administration committee are not written in the supervisory board by-laws not completely.

Size of administration committees in Ukraine is from 3 to 5 members. Size of administration committees in Ukraine does not depend on the size of the supervisory board. Most of companies (85 per cent of those companies having administration committee on the supervisory board) elect 3 members on the administration committee. The rest companies establish administration committees consisting of 3 members. Probably, Ukrainian practices of administration committees from the point of view of their compositions do not meet the international standards. This concerns the administration committee member independence. Only about 11 per cent of the administration committee members are independent. The rest members are the large shareholders, former

employees of the same company or have very close relative relationships with executives. The second criterion of dependence is the most popular in Ukraine.

External advisors do not provide services to the members of administration committees in Ukraine at all. This is quite unusual practice in contrast to the interests of other committee members in services of external advisors. Probably, the administration committee work requires quite confident approaches to the documents regulating the supervisory board work. Moreover, administration committee is helped remarkably by the appropriate departments of the company responsible for the documentary turnover within the company.

Remuneration of the members of the administration committee, as in the case of the above considered committees is paid monthly or only one time a year as a fixed amount. There are no any bonuses that could be paid to members of the administration committee. Average amount of the annual remuneration paid to the member of the administration committee is USD160. Size of remuneration to be paid to the committee members is fixed at the beginning of the year and could not be changed during a year despite the number of meetings of the administration committee. Size of the remuneration paid to the members of the administration committee is larger than the remuneration to the members of the rest committees at Ukrainian joint stock companies.

Shareholder committee

Shareholder committee is not popular at Ukrainian joint stock companies. It is quite surprisingly because of frequent cases of violation of the minority shareholders' rights by majority shareholders and executives. This situation can be explained by two reasons. The first is unwillingness of majority shareholders to take into account interests of minority shareholders. The second factor is the very low degree of knowledge of minority shareholders on the major mechanisms of protecting their rights. One of these mechanisms is establishing and participation on the board's shareholder committee.

Only 4 per cent of researched Ukrainian joint stock companies have a shareholder committee on the board. It is interesting that all these companies do not experience agent conflicts and are very transparent. About 90 per cent of these companies are under control of foreign institutional shareholders. There are no shareholder committees at companies under control of employees and executives. Employees do not establish shareholder committee on the boards of companies, controlled by them, because they are strongly concerned with responsibility of the company to employees (employment, wages, etc.) and weakly concerned

with outside shareholders interests and institutions (stock market, capital structures, stock price, etc.). Executives prefer not to establish shareholder committees because absence of shareholder committee allows executives absorbing a total control of the company and follow their own interests without a threat to be discovered and executed by shareholders.

Members of the shareholder committee are common about the main reason of their activity, i.e. establishing and maintaining the best ways of communication of the company with its shareholders. That task is undertaken by 98 per cent of members of shareholder committees in Ukraine. Besides that, members of the shareholder committee find reasonable to make their utmost to maintain interest of the minority shareholders. Thus, about 72 per cent of members of the shareholder committees in Ukraine keep on the above task very thoroughly.

Majority of the members of shareholder committees in Ukraine find reasonable to direct activity of those people who are responsible for preparation the main event of the company corporate life, i.e. the general shareholder meeting. As a rule, executives, i.e. management board members are responsible for preparing under direction of the members of shareholder committee. About 72 per cent of the members of the shareholder committees in Ukraine think that they are obliged to direct executives when preparing the general shareholder meeting. They found such kind of work as a fulfillment of an executive monitoring function that is very important not only for large shareholders, but also for the minority shareholders. Probably, under such strong inclination of the shareholder committee to develop the measures to protect rights of the minority shareholders it could be starting point for corporate governance best practices in Ukraine to develop these practices through the shareholder committees. It is interesting to note that the minority shareholders rely on the shareholder committee very much. Thus, about 86 per cent of the minority shareholders consider the shareholder committee as an efficient mechanism of their rights protection. But this concerns only those companies where the shareholder committees exist. Minority shareholders of companies without the shareholder committee on the supervisory board are much less inclined to consider the shareholder committee as an efficient mechanism of the minority shareholder rights protection. Probably, it is because of the weak degree of information available to the minority shareholders of such companies regarding the role of the shareholder committee.

62 per cent of the shareholder committee members in Ukraine have at least a ten year experience in the shareholder relationship administering. At the same time their education is not appropriate to their experience as in the case of the administration committee members. Only 11 per cent of

the shareholder committee members graduated with the degrees related to the shareholder relationships administration. Mainly such degrees are in corporate governance. They obtained their degrees either abroad or in Ukraine at the beginning of the third millennium when the Ukrainian high-schools introduced degrees in corporate governance. Before the year 1991 the Ukraine educational institutions did not offered the degrees in corporate governance. The shareholder committee by-laws are not applied in Ukraine at all in comparison to the similar by-laws on the finance or administration committees. The most developed practice is through adopting some notes on the shareholder committee in the supervisory board by-law. There are 91 per cent of companies where there are shareholder committees which are regulated by only formal clauses written in the supervisory board by-law. These “formal clauses” concern such aspects of the shareholder committee activity as procedure of the electing to the shareholder committee, procedure of the work of the shareholder committee and procedure of decision making at the meetings of the shareholder committee. Only 2 per cent of companies with the shareholder committees on their boards included in the supervisory board by-laws more detailed and advanced practices of the shareholder committee. The list of such kind of practices is composed of the exclusive functions of the shareholder committee, the proportional representation of the various groups of shareholders on the shareholder committee, reporting to the shareholders. At the same time, like the finance and administration committees there are no any references in the supervisory board by-laws regarding the role of the independent directors on the shareholder committee.

The shareholder committee size at Ukrainian companies is similar to the practices of most other committees, i.e. from 3 to 5 members. Size of shareholder committees in Ukraine does not depend on the size of the supervisory board. At the same time, the size of shareholder committee depends on the ownership concentration.

Thus, the higher degree of ownership concentration, the higher number of members in the shareholder committee. Ukrainian practices of shareholder committees from the point of view of their compositions do not meet the international standards with reference to the director independence. Only about 6 per cent of the shareholder committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The first two dependence criteria are the most popular in Ukraine.

8 per cent of members of shareholder committees in Ukraine have external advisors. They are professionals representing various shareholder associations and unions. The most active members of the

shareholder committees in getting to services of external advisors are external minority shareholders whose interests are represented on the board. Getting to services of external advisors they tried to be more competent in protecting their own rights and rights of other minority shareholders. Similarly to the case of other supervisory board committees all these advisors are informal, i.e. the company is not informed about their existence.

Remuneration of the members of the shareholder committee is paid monthly as a fixed amount or monthly. There are no any bonuses that could tie the motivation of the members of the shareholder committee to their performance. Thus, average amount of the remuneration paid to the member of the shareholder committee annually is USD130. Size of remuneration is fixed at the beginning of the year and could not be changed during a year despite the number of meetings the shareholder committee held.

Policy committee

A policy committee is the most popular committee on the boards at Ukrainian companies. Almost 25 per cent of researched companies have a policy committee on the board. Policy committee is the most popular on the boards of the companies under control of foreign institutional investors, Ukrainian financial-industrial groups and Ukrainian investment companies and funds. The higher concentration of ownership structure the higher likelihood of establishing a policy committee on the supervisory board. It is because controlling shareholders want to have a total control of strategic directions of the company's development through a very simple mechanism to establish - a policy committee. As in the case of finance committee, only foreign institutional shareholders establish policy committee mainly to develop strategic directions, and only next to control its execution by executives, i.e. members of the executive board.

Companies, controlled by Ukrainian financial-industrial groups, executives and employees, prefer to delegate a function to develop strategic decisions to executive board. It is interestingly to know a mode of strategic involvement of policy committee at Ukrainian companies. The deepest mode of strategic involvement, i.e. helping formulating strategy, was demonstrated by policy committees of those companies under control of foreign institutional shareholders (3 replies) and with dispersed ownership (1 reply). The deepest mode of strategic involvement of supervisory boards is at companies, controlled by Ukrainian financial-industrial groups is monitoring (4 replies).

Table 6.3. *Mode of strategic involvement of the members of supervisory boards in Ukraine*

Involvement in strategy	Frequency
Review	12
Discuss	12
Approve	10
Ratify	9
Decision-taking	9
Monitor	9
Define strategic framework	5
Guide	4
Help formulate	4

Number of respondents, i.e. members of policy committees - 12

Supervisory boards at companies under control of executives are involved in strategic process only from the stage of strategy discussion (1 reply). This proves that shareholder executives are inclined to adsorb corporate control through preventing the establishing a policy committee or through delegating as weak as possible involvement in strategy process to policy committee. Surprisingly, but we found that directors of those companies, where there are no policy committees are involved in strategy process too. They do this at the ordinary meetings of the supervisory boards or at the general annual meeting of shareholders.

Regrettably, it is worth of mentioning that involvement in strategy is considered by most directors when meeting on the board, only as approving the strategy (38 respondents). 7 respondents consider their involvement in strategy through helping formulating the strategy, and 3 of them are not the policy committee members. Obviously, supervisory boards have a lack of organizational change to let all members apply their knowledge and motivation on committees of the board.

Shareholders of Ukrainian companies wanted the supervisory board members to be much more involved in the strategy development. About 84 per cent of the large institutional shareholders wanted to see the more activity of the members of supervisory board in the strategy development. Besides that minority shareholders wanted the supervisory board to perform more activity in that way too. This point of view is supported by the large number (72 per cent) of minority shareholders of Ukrainian companies. Thus, we can note a comparative higher interest of the large institutional shareholders in forcing the supervisory board members play more active role in the strategy development. This support an idea issued before that the higher concentration of ownership structure the higher

likelihood of establishing a policy committee on the supervisory board. Probably, the large institutional shareholders, both foreign and Ukrainian, have to rely on the strategic function of the supervisory board much more than the minority shareholders who are, as a rule, individual shareholders. The main reason is a higher interest of the large institutional shareholders in the financial results of the company activity, the higher degree of realizing an importance of the strategy development and implementation, and much better imagination of what the role and place the company takes at the market.

The policy committee by-laws are not well-developed practice in Ukraine despite the fact that the policy committee is the most popular committee on the supervisory boards in Ukraine. The most popular document adopted at the joint-stock companies in Ukraine and discovering the role of the policy committee is the supervisory board by-law. There are 91 per cent of companies where there are administration committees which are regulated by the supervisory board by-law. Only 9 per cent of companies with the policy committees on their boards have a separate by-law on the policy committee.

From the point of view of the policy committee functions disclosing, information containing in the supervisory board by-law and concerning the policy committee does not cover all practices applied by the members of the policy committee. Generally, there are no notes regarding the composition of the policy committee from the point of view of the independent director share on the policy committee, the procedure of their reporting to shareholders, their remuneration, requirements to the candidates on the policy committee. The exclusive functions of the policy committee, like in the case with the finance, administration and shareholder committees are not written in the supervisory board by-laws not completely.

Size of policy committees in Ukraine is from 3 to 5 members similarly to the practices of the rest committees. Size of policy committees in Ukraine does not depend on the size of the supervisory board but it slightly depends on the type of controlling owner. Most of companies (90 per cent of those companies having policy committee on the supervisory board) elect 3 members on the policy committee. The rest companies establish policy committees consisting of 5 members. There is only one exclusion, i.e. companies owned by executives. These companies have policy committees consisting at least at possible members (2 members!). This makes the policy committee as a formal body taking into account that all strategic decisions are made by executives as members of management board.

Ukrainian practices of policy committees from the point of view of their compositions do not meet the international standards. This concerns

the policy committee member independence. Only about 2 per cent of the policy committee members are independent. The rest members are the large shareholders, former employees of the same company or have very close relative relationships with executives. The first two dependence criteria are the most popular in Ukraine.

External advisors, as in the case of administration committee, do not provide services to the members of policy committees in Ukraine at all. Probably, policy committee members do not need any external advisors because they, committee members, are mainly former executives supposing that that they professionalism is very high to work without any external help.

Remuneration of the members of the policy committee is paid monthly as a fixed amount, as in the case of audit commission or as a fixed amount a year as in the case of most committees of the board. Bonuses that could tie the motivation of the members of the policy committee to their performance are absent. Thus, average amount of the remuneration paid to the member of the policy committee annually is USD140. Size of remuneration is fixed at the beginning of the year upon the composing the supervisory board committees and could not be changed during a year despite the number of meetings the finance committee held.

Roles of the board

Reviewing social responsibility is a role of members of the board of those companies under control of foreign institutional shareholders. Besides this, reviewing social responsibility is undertaken by members inside of policy committee. Companies, where there is the policy committee on the board, review social responsibility in general way. Contacts and discussions on the topic of social responsibility with stakeholders, employees, minority shareholders are not undertaken by members of policy committee.

Social responsibility is considered rather as "environmental protection". Obviously, but reviewing social responsibility requires establishing a special committee on the supervisory board. In our sample companies, social responsibility is a role of policy committees, which are not familiar with its role in details.

Generally, hypothesis on committees of the board has been approved. That means that committees of the supervisory board are demanded more by foreign institutional shareholders. Thanks to this, boards are multi-role performers, i.e. strategy, control and service.

Table 6.4. *Roles of the supervisory boards in Ukraine*

Roles	Number of respondents positively answered
Involvement in strategy	44
Hire, appraise and fire executives	4
Converse with shareholders/stakeholders	4
Development of corporate vision	7
Responsibility for ethical framework	2
Ensure corporate survival	3
Determine risk position	2
Lead strategic change	3
Review social responsibilities	2
Understand current and forthcoming legislation	4

Number of respondents – 50

It is very interesting to know that only 2 per cent of companies under research have all four committees popular in Ukraine (an executive committee, an administration committee, a shareholder committee and a policy committee). From the point of view of the Jay Conger classification of the roles of the board of directors, i.e. strategic, monitoring and advising, the supervisory boards in Ukraine are rather advisors than strategists and monitors. Almost 92 per cent of the members of supervisory boards believe that their main task is to give the competitive advices to the management board members. They support such behavior saying that through advising to the management board members the supervisory board members transmit the most important ideas from shareholders and executives. This, by their beliefs, strengthens the mutual trust and understanding between shareholders and executives.

At the same time, the supervisory board members would like to be much more involved in the strategic decision making. Such decision was supported by 76 per cent of the supervisory board members.

Concerning the monitoring to be taken by the supervisory board members over the activity of the management board the Ukrainian practices of corporate governance narrate on the lack of wishing to get into the conflicts between these boards.

Supervisory board members have no enough incentives to monitor the activity of the management board if the company is controlled by the large shareholder who elected their representatives to supervisory and management boards.

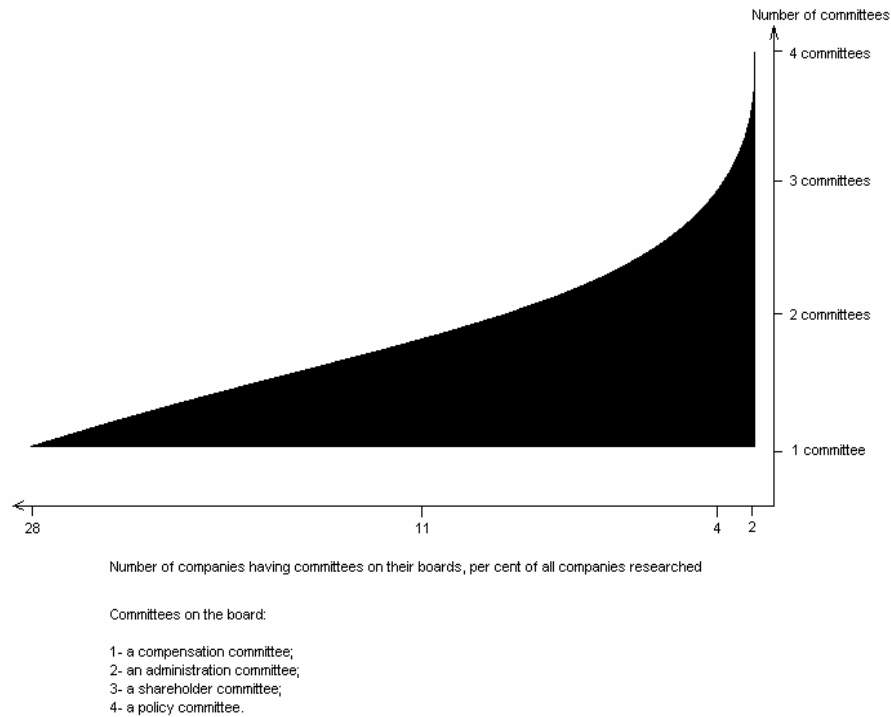


Fig. 6.3. *Distribution of committees at Ukrainian joint stock companies*

Companies, where the corporate ownership is dispersed are not effective in the establishing the supervisory board which could behave as a team rather than a group of contestants. A system of internal control is weak and monitoring functions are lost in the fight for the dominant role on the board. Minority shareholder rights are not taken by the supervisory board members as something to fight for because the reward for possible efforts is not sufficient or does not exist at all. More than 70 per cent of supervisory board members are not paid for their work at all. The last incentive, i.e. personal reputation, is still not a factor that could influence the behavior of the members of supervisory boards of Ukrainian joint-stock companies.

New horizons of the board committee development

Weak development of the supervisory board practices in Ukraine accentuates attention of the market participants and regulators on solving several problems. One of the most important problems is a weak

professional qualification of the supervisory board members to work on the particular committees effectively.

Probably the way out here is through the uniting efforts of both boards in Ukrainian companies – supervisory and management boards. The Russian practices of the supervisory board committees allow the committees to be established with membership of the representatives of both boards, i.e. supervisory and management boards. Executives are much more professional from the point of view of the tactics of the business running and they are much better informed about the company market position and performance than the supervisory board members. Therefore, executives could bring to the board committees not only the expertise of the day-to-day operations. They would bring the information and reduce the asymmetry of information between the boards.

Ukrainian legislation does not regulate the issue of the board committees in a whole content. Therefore, there are no any obstacles for the shareholders to consider the reasonability of establishing the mixed board committees. The only step the shareholders should do is the writing the appropriate notes in the charter of the company and by-laws on supervisory and management boards.

There could be quite strong of such an idea at the members of supervisory and management boards. 68 per cent of the supervisory board members in Ukraine are sure that an inclusion of the management board members on the board committees could be very positive decision. The most supervisory board members (74 per cent) think that such membership could create the spirit of the team working between two boards. 62 per cent of the supervisory board members who supported an idea of the mixed committees are sure that the next important incentive of such decision could be an improvement of the informational transparency of the company and reducing asymmetry of information between two boards. The management board members also have quite positive point of view on the issue of the mixed committees. There are 59 per cent of the management board members in Ukraine who support the idea of the mixed committees. The main reasons of such decision from the point of view of the management board members are the improvement of the strategic process (54 per cent of agreed respondents), increase in the objectivity of the performance of the management board members (46 per cent of agreed respondents). At the same time we could note that the wishes of the supervisory board members toward the establishing the mixed committees are still behind the knowledge accessible to the supervisory board members on the best practices of the board committees accepted and applied internationally.

The supervisory board members in Ukraine do not see the difference in principles of the mixed committee composition with participation of

executives. Thus, 82 per cent of the supervisory board members are sure that the executives should be the members of the compensation committee. The main argument in the favor of such decision is the supposition by the supervisory board members that executives are well-familiar with the compensation practices. Certainly, executives are well-familiar with the executive compensation practices, but such point of view erodes on of the functions of the supervisory board, i.e. control function. It is because the executive compensation is an object of the control. This means that executives can not take part in control of their own compensation.

The most unexpected results have been received in the part of the participation of executives in the audit committee. Thus, about 46 per cent of supervisory board members support an idea of membership of executives on the mixed audit committee. As a result, an executive could have a direct influence on the process of the external auditor appointment and observe the internal control at the company. Even they could rule the process of the audit commission activity – the body responsible for the audit of the activity of the management board, i.e. executives themselves. Under such circumstances the management dictate that is so popular in Ukraine now and concerning the dictate in the sphere of the employee shareholder relationships could spread toward the relationships of executives with the rest groups of shareholders. As a result an idea of corporate control sculptured by *Berle* and *Means* could die soon.

Therefore, it is obviously to note that the Ukrainian joint-stock companies are not recommended to introduce the practice of the mixed board committees, i.e. with the membership of the supervisory and management board members. It could be the wrong decision leading to the most painful maladies – the corporate control loosing.

One of the worst board committee practices is through composing quite complicated committees from the point of view of its possible functions. Thus, Ukrainian joint-stock companies establish such a committee as finance and strategy committee. This committee is a combination of separate finance and policy committees considered above. Probably, there are some threats to the best corporate governance practices through establishing such complicated committees. First of all, it is hardly possible to compose such complicated committee with professionals in specific spheres. Else the committee would require not less than 5 members. Moreover, only one member would be taken for a competent member in the specific issues considered by the committee. Under such conditions a productive team working of the committee would turn into the “guru’s speeches” when each member would take him for the only expert in the committee. The same situation is about another complicated committee as compensation and nomination when functions

regarding executive compensation and director nomination are concentrated in the hands of the same people.

One more problem that could be solved in the way of improving performance of the supervisory board committee development in Ukraine is development a system of by-laws that could be very specific to the need of each committee. Probably, accounting such criterion as the committee member independence should be considered from various positions if the concept of the director independence is applied to the board committee practices. Thus, it is quite acceptable to have not a majority of independent directors on the policy or shareholder committees. At the same time, it is extremely important to have the whole independent audit, executive compensation or nomination committees. The by-law on the supervisory board in a whole does not consider such peculiarities. These peculiarities could be accounted only by separate committee by-laws. Moreover, there is much work to do in the way of improving accountability of the board committee members in Ukraine. The most companies do not require the committees provide the supervisory board in a whole with a written reports on their work during a year. As a rule, committees report rather informally personally talking to the head of the supervisory board. From this practice it is hardly possible to move in the way of the incentive based remuneration to directors.

Probably, the cornerstone of the new paradigm of the board committee practices could be based on the broader meaning of the term “director independence”. Just saying that the director independence is a medicine for all pains the board committees in Ukraine suffer, is not a way out. Weak transparency could not provide Ukrainian boards with all benefits of improvement in the director independence.

At the same time “independence” should be considered from the broader term as “independence of mind”. This could contribute to a free discourse inside of the board room. Moreover, independence of mind could give a chance to hope for an independent decision making by each director. This could turn the board of directors to the interests of all shareholders with intention to account these interests and balance them.

Generally speaking, the supervisory board committees in Ukraine need more accountability, transparency and, that is the most important, professionalism to be the representatives of the shareholders.

Exhibits

Exhibit 1. Board committees in Europe

The three principal types of committee have all increased in number since our previous survey. The audit committee is still the most common. It is found in

80% of companies surveyed and is usually the first committee to be established, followed by the remuneration committee, which showed a 60% growth two years ago and is now found in 78% of companies in our sample.

Nomination committees ensure that directors are selected using independent and professional procedures. They show the fastest growth, from a low of 24% in the 1999 survey, to nearly 60% in our 2003 sample.

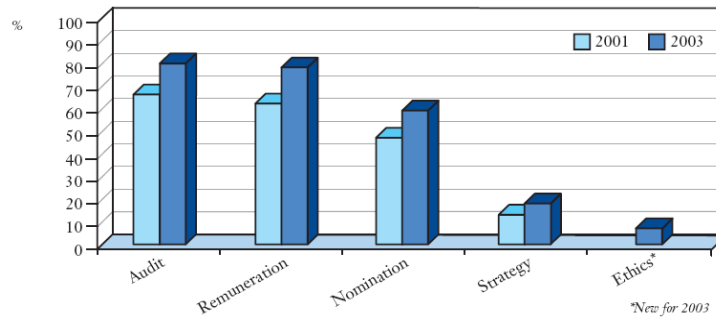


Fig. 6.4. Proportions of companies with each type of committee

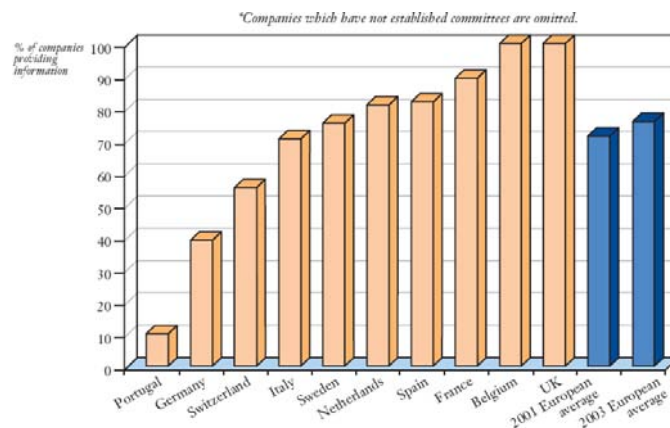


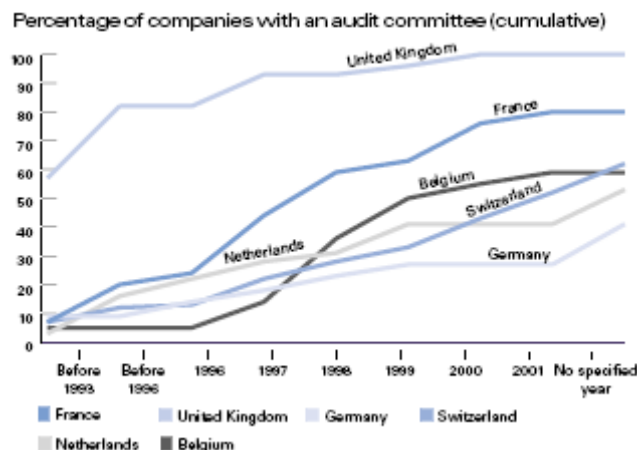
Fig. 6.5. Disclosure of composition of committees

76% (compared with 72% in 2001) of companies who have committees list their committee members, allowing shareholders and the public to gauge the independence of these members.

Exhibit 2. Audit committee practices in Europe

In the United Kingdom, the Cadbury report recommended that boards of listed companies set up audit committees as long ago as 1992. It is therefore unsurprising that the survey shows that audit committees are more established in the United Kingdom than in the rest of Europe.

Overall, 67% of respondents had established audit committees. Audit committees were found to be most widespread in the United Kingdom where all respondents reported the existence of such a committee. The extensive use of audit committees was also reported in France (80%), Belgium (59%) and Switzerland (62%). Perhaps as a result of the two-tier board structure, only 41% of German respondents and 53% of Dutch respondents had established audit committees.



In the United Kingdom, only 18% of audit committees had been established later than 1995. Interestingly, 57% of respondents had established their committees prior to 1992, and thus before the Cadbury recommendations. The rest of Europe did not reach this level until 2000. This may reflect the power of institutional investors in the United Kingdom, or the similar nature of the United Kingdom and US governance models (note, since 1978, the New York Stock Exchange has required all listed companies to have audit committees composed solely of independent directors.) The growth in popularity of audit committees elsewhere in Europe is generally uniform. However, the number of French companies with audit committees can be seen to rise sharply following the initial impact of the Viénot report.

Similarly, in Belgium, the number of companies having audit committees can be seen to rise sharply following the recommendations of the Federation of Belgium Companies and the Cardon Commission report.

It is noticeable that in Germany and the Netherlands, the two countries operating two-tier boards, the popularity of audit committees lags behind other European countries. It has been suggested that this is probably because the implementation of independent and objective board committees is regarded as less important where supervisory boards exist.

In France, the Viénot committee report lists the principal responsibilities of the audit committee:

- Business analysis.
- Overseeing the audit of the financial statements.

- Ensuring that accounting methods are consistently applied.
- Verifying the statutory auditors. independence and objectivity.
- Validating the work carried out by the financial department and statutory auditors, particularly the accounting methods chosen to consolidate the accounts.

The Combined Code also addresses the duties of the audit committee which, in its view, should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors.

Also, where the auditors supply a substantial volume of non-audit services to the company, the Combined Code recommends that the audit committee keep the nature and extent of such services under review and seek to balance the maintenance of objectivity and value for money.

We asked whether audit committees had formal written charters setting their responsibilities. In the United Kingdom, all respondents had established a charter describing the audit committee responsibilities. By contrast, in Switzerland and France, 68% and 58% of respondents respectively had an audit committee charter, while in Germany the proportion having an audit committee charter was even less (40%).

	France	United Kingdom	Germany	Switzerland	Netherlands	Belgium
The adequacy of the system of internal control and risk management	88%	95%	70%	92%	100%	91%
The quality of the accounting policies, judgements and disclosures	94%	100%	80%	97%	100%	91%
Consideration of the independence and objectivity of external auditors	67%	93%	90%	81%	88%	75%
Consideration of the proposed scope of the external auditors work	61%	93%	80%	70%	88%	75%
The process for monitoring compliance with relevant laws and regulations	48%	79%	70%	92%	59%	82%
Consideration of the scope, authority, and resources of internal audit	45%	86%	60%	84%	71%	67%
Consideration of the need for internal audit where no such function exists	24%	14%	20%	57%	59%	42%
Reviewing the work of internal audit and verify that their recommendations are implemented	52%	82%	30%	81%	71%	73%
The interim financial statements and the process used to prepare them	79%	93%	40%	73%	82%	83%
The preliminary announcement and financial reporting package	76%	100%	90%	73%	88%	77%
Non-financial information included in the annual report, or otherwise made public	30%	71%	40%	54%	35%	15%

Clearly most European audit committees are responsible for overseeing the scope and results of the audit and the independence and objectivity of the auditors.

However, audit committees in Belgium and France appear less likely to oversee both internal and external audit than their counterparts.

Across Europe, most audit committees review of the preliminary announcement, financial reporting package and interim statement. The exception is Germany where few audit committees (40%) review the interim financial statements. The reasons for this are not clear.

Interestingly, a significant number of United Kingdom respondents had audit committees whose remit included the examination of non-financial information included in the annual report or otherwise released to the public. This may well reflect the importance attached to these areas in recent initiatives such as the Turnbull report and the proposals for the reform of company law. Alternatively, it may suggest a higher take up of initiatives such as ISO 14001 (Standard for environmental management systems) and EMAS (EcoManagement and Audit Scheme) than elsewhere.

Most corporate governance codes include some recommendations concerning the composition of audit committees. In the United Kingdom, the Combined Code recommends that the audit committees should comprise at least three directors all of which should be non-executives and the majority independent. Similarly, the Brussels Stock Exchange recommends that audit committees should comprise at least three non-executive directors whose authority and duties are clearly stated at the time of their appointment.

In France, the Viénot Committee recommended that at least one third of audit committee members be independent (i.e., must neither be employees nor part of the senior management of a company). The AFG report, which is less influential than the Viénot report, recommended that the audit committee should comprise at least three nonexecutive directors, one of which must be independent.

The draft Swiss Code recommends that the audit committee should be comprised of non-executive, and preferably independent, members. Furthermore, a majority, including the chairman, should have experience of finance and accountancy. By contrast, the recommendations in Germany and the Netherlands are less specific. The Peters report (Netherlands) recommended that audit committees should be comprised of supervisory board members, whilst the German Code of Corporate Governance recommends that audit committees should have at least three, but no more than five members. The rules governing how audit committees are established in Germany are embodied in the Companies Act, but the implementation itself is not mandatory.

Across Europe, the most frequently encountered audit committees comprise between three and four members. Only in Germany are larger audit committees equally as popular.

In France, Switzerland and the United Kingdom, audit committees were approximately a third of the size of the board. Turning to two-tier boards, audit committees were 29% as large as supervisory boards in Germany, but around 60% the size of supervisory boards in the Netherlands.

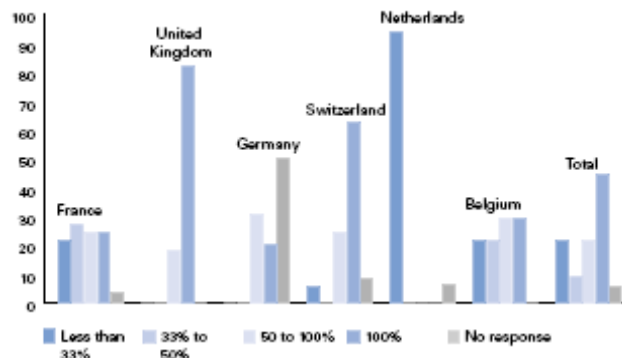
The audit committee is responsible for overseeing the financial reporting process and increasingly often, the effectiveness of the system of internal control and risk management. In carrying out its duties, the audit committee may need to challenge the judgement of management or take positions that may be contrary to those of the executive directors. Because of this supervisory or oversight role, independence is an essential quality for audit committee members.

Audit committee size



All United Kingdom respondents had audit committees comprised solely of non-executive directors, and in each case the majority of members were, as the Combined Code recommends, considered independent (82% of audit committees comprised exclusively independent non-executive directors while 18% of audit committees had a majority of independent members.) In Switzerland, which has as yet no code in this area, 62% of audit committees consist exclusively of independent directors. In Belgium, even fewer audit committees were wholly independent, even though the Viénot Committee recommended that at least one third of audit committee members be independent, the results from France were mixed. Some progress has been made with 24% of audit committees consisting entirely of independents. However, there are still many committees (21% of respondents) where the independent representation amounts to less than one third of the members.

Independent director representation on audit committees



As audit committees are sub-committees of the supervisory board in two-tier board regimes, one would expect that they would consist exclusively of independent directors.

However, this is not the case. In fact, relatively few audit committees are predominantly independent. We believe this peculiarity arises because chief

executive officers, finance directors and internal auditors often attend audit committee meetings and have therefore been reported as members. Intriguingly, in Germany there was a high rate of nonresponse to the question (50%).

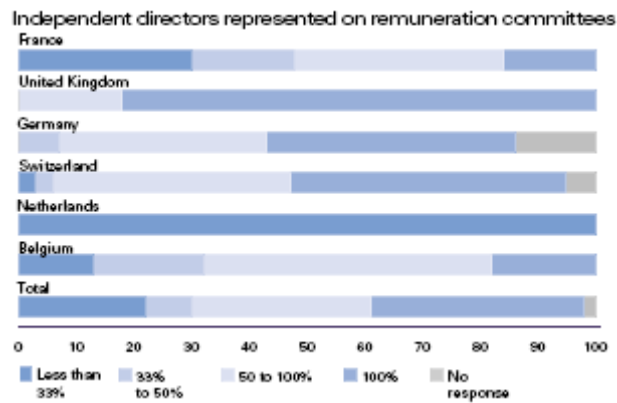
Exhibit 3. Remuneration committee practices in Europe

In the United Kingdom, the Combined Code recommends that to avoid potential conflicts of interest, boards should set up remuneration committees of independent non-executive directors to make recommendations to the board, within agreed terms of reference, on the company's framework of executive remuneration and its cost; and to determine on their behalf specific remuneration packages for each of the executive directors, including pension rights and any compensation payments. The Combined Code goes on to recommend that remuneration committees should consist exclusively of nonexecutive directors who are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Similarly, in Belgium, remuneration committee are considered good practice and should comprise only nonexecutive directors. Where no remuneration committee is established, the non-executive directors should decide on the principles of executive remuneration.



In France, Viénot recommended that remuneration (or compensation) committees should have a majority of independent directors among their members (note, for audit committees Viénot recommended that independent directors comprise 33%). The AFG proposed that remuneration committees comprise at least three nonexecutive directors, one of which must be independent. The draft Swiss Code also recommends that a majority of the remuneration committee should consist of independent nonexecutive directors.

In the Netherlands all remuneration committee members are supervisory board members and therefore, independent from management. Clearly, respondents did not believe this to be the case. We believe this is because executive directors and others often attend remuneration committee meetings and have therefore been reported as members.



With the exception of France and the Netherlands, respondents from most countries had remuneration committees comprising a majority of independent directors. It is not clear why so many French respondents had not followed Viénot's recommendations nor why Dutch respondents had remuneration committees that contained so few independent directors.

All but five United Kingdom respondents had remuneration committees that were wholly comprised of independent non-executive directors.

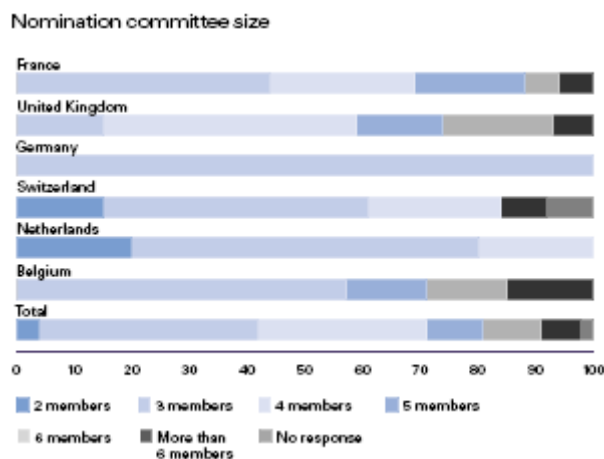
Exhibit 4. *Nomination committee practices in Europe*

It is important that boards maintain an appropriate mixture of skills, experience and objectivity. One approach to making board appointments, which makes clear how appointments are made and assists boards in making them, is through nomination committees charged with the responsibility for proposing to the board, in the first instance, any new executive or non-executive directors.

As long ago as 1992, the Cadbury report recommended that companies establish nomination committees, but did not make this part of its Code of Best Practice. Nevertheless, in 1998, this recommendation was incorporated into the United Kingdom's Combined Code with the proviso that such committees may not be appropriate for small boards.

Nomination committees are also encouraged by corporate governance codes in Belgium, France, Germany, and the Netherlands. In Switzerland, it is likely that nomination committees will be encouraged for large public companies.

Our survey revealed that nomination committees are most widespread in the United Kingdom where 96% of respondents reported the existence of such a committee. Elsewhere, nomination committees were not used extensively, though 39% of French respondents, 32% of Belgium respondents and 22% of Swiss respondents reported the existence of such committees. Perhaps as a result of the two-tier board structure, only 16% of Dutch respondents and 9% of German respondents had established nomination committees.



The Combined Code recommends that a majority of nomination committee members should be non-executive directors and that the chairman should either be the chairman of the board or a non-executive director. The Belgium recommendations are similar to those in the United Kingdom. Both codes are silent on the question of independence.

In France, the Viénot report goes further in recommending that independent directors should account for at least one third of the committee and that the chairman of the board should be a member of the committee, but not its chairman.

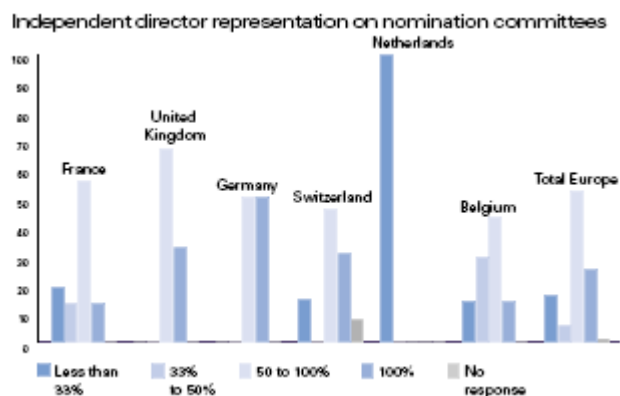
More specifically, Viénot goes on to recommend that the nomination committee should draw up a plan for succession of the executive directors - including the chief executive officer.

In the Netherlands, the Peters report recommends that, like audit and remuneration committees, nomination committees should be comprised of supervisory board members.

The average number of nomination committee members varies from country to country, however, most committees have between three and five members. Generally nominations committees were larger in the United Kingdom than elsewhere.

Only respondents from Switzerland and the Netherlands had nomination committees with two members. Conversely, in Germany, practices were uniform, with 100% of respondents having nomination committees comprising three members. To put this in perspective, out of the 60 nomination committees surveyed, only two were in Germany. Turning to the independence of nomination committee members, it can be seen from the chart below that the various corporate governance recommendations have been adopted in some countries, but not in others.

France, Belgium, Switzerland and the Netherlands reported nomination committees with a minority of independent directors. It is distressing that nearly 20% of French respondents have nomination committees comprising less than one-third independent directors and therefore do not follow the Viénot recommendations.



Switzerland has no established code in this area. By contrast, respondents from the United Kingdom appear to have little difficulty in complying with the Combined Code recommendations - in each case a majority of committee members are non-executive directors, while a third of respondents had nomination committees comprised solely of non-executive directors.

In Germany, 50% of respondents had nomination committees comprised exclusively of independent directors. In the Netherlands, one would expect all nomination committee members to be supervisory board members and therefore independent from management. The reason why all Dutch respondents reported nomination committees with less than one third independent representation is unclear but may be because executive directors and others often attend nomination committee meetings and have therefore been reported as members.

Exhibit 5. Key committees in Australia

Audit Committee. The findings with respect to audit committees were generally positive. The vast majority of companies had an audit committee (239 companies (95.6%). This finding is consistent with prior research that showed that approximately 90% of Australian listed companies had an audit committee. The average size of audit committee was 3.36, with a range in size from two to seven. Of the 239 companies that had an audit committee, 175 (73.2%) had an independent chairperson. With respect to the overall audit committee independence, 66 (27.6%) were completely independent, 79 (33.1%) were comprised of a majority of independent members, 72 audit committees (30.1%) did not have an independent majority, and in 22 instances (9.2%) the audit committee did not contain a single independent member.

Remuneration Committee. The findings with respect to remuneration committees were also positive. One hundred and ninety five companies (78%) had a formal committee, meeting separately from the full board that determined executive remuneration. The average size remuneration committee was 3.42, with a range in size from 1 to 11. Of the 195 companies that had a remuneration committee, 148 (75.9%) had an independent chairperson. With respect to the overall remuneration committee independence, 59 (30.3%) were completely

independent, 72 (36.9%) were comprised of a majority of independent members, 50 remuneration committees (25.6%) did not have an independent majority, and 14 remuneration committees (7.2%) did not contain a single independent member.

Nomination Committee. While there were significantly fewer nomination committees than either audit or remuneration committees, their compositions and independence levels were similar. Less than 1/3rd of the companies had a formal nomination committee (77, 30.8%). The average size of nomination committee was 3.64, with a range in size from two to nine. Of the 77 companies that had a nomination committee, 54 (70.1%) had an independent chairperson. With respect to the independence of the nomination committees, 22 (28.6%) were completely independent, 34 (44.2%) were comprised of a majority of independent members, 18 nomination committees (23.3%) did not have an independent majority, and in three instances (3.9%) the nomination committees did not contain a single independent member.

Exhibit 6. Board roles and committees in the USA

The Center for Effective Organizations (CEO) of the University of Southern California's (USC) Marshall School of Business and Mercer Delta Consulting, LLC first joined forces in 2003 to conduct a national survey of corporate Directors in the largest U.S. corporations. They received responses from 221 Directors. Twelve percent (12%) of the respondents are CEOs/Chairs, 3% inside Directors, 72% outside Directors, 4% CEOs/Non-Chairs, 3% nonexecutive Chairs, 5% Lead Directors, and 2% other. The Directors served on an average of 2.5 Boards. Their analysis suggests the respondents come from approximately 200 of the 1,000 largest publicly traded companies in the United States. Directors who sit on more than one Board were asked to fill in the survey for the largest U.S. company on which they serve as Director. Results of the survey were compiled and analyzed jointly by Mercer Delta and USC.

To simplify presentation of the results, survey responses that fell in the category of 4 or 5 on a 5-point scale were interpreted as positive/favorable responses. These include responses of "4 = effective" and "5 = very effective" on the effectiveness scale and "4 = to a great extent" and "5 = to a very great extent" on the extent scale as illustrated below. Throughout this report, for each question that used a 5-point scale, "percent favorable" represents the total percentage of Directors who responded favorably to a particular question by choosing either a 4 or 5.

Authority and Fiduciary Oversight

When asked to rate their Boards on providing fiduciary oversight, Directors generally expressed positive views of how effectively their Boards are operating. The table below presents the results. The lowest rating is on ethics, but it still receives a relatively high score. When compared to the USC's historical data on these topics, the ratings were very similar to the effectiveness ratings in prior years.

Rate the effectiveness of the Board in the following areas:	Very Ineffective	Ineffective	Somewhat Effective	Effective	Very Effective	% Favorable (% of Directors who responded Effective/Very Effective)
Monitoring the firm's financial performance	1%	1%	4%	41%	53%	94%
Representing the interest of shareholders	1%	0%	5%	45%	49%	94%
Advising during major decisions such as mergers or acquisitions	1%	1%	10%	41%	46%	87%
Ensuring ethical behavior within the company	0%	1%	11%	51%	36%	87%

Strategic Oversight

The survey results reveal that strategic oversight is an area where there is room for improvement. Only 63% of the Directors responded favorably when asked to rate their Boards' effectiveness in shaping long-term strategy. This is an improvement over the 2003 results (55%) but still a low number. The results are similar for identifying threats and opportunities critical to the future of the company.

To what extent is the Board effective in the following areas?	Very Ineffective	Ineffective	Somewhat Effective	Effective	Very Effective	% Favorable (% of Directors who responded Effective/Very Effective)
Shaping long-term strategy	1%	6%	29%	47%	16%	63%
Identifying possible threats or opportunities critical to the future of the company	0%	4%	31%	46%	18%	64%

Responsibility to Stakeholders

We asked the Directors how responsible they feel to various classes of stakeholders. Sixty-two percent (62%) of Directors said that they owe the most duty to long-term shareholders. One quarter (25%) of Directors feel they owe the most duty to employees and less than one quarter to other stakeholders.

As a Board member, how responsible to the following groups do you feel?	Owe No Duty To		Owe Some Duty To		Owe Most Duty To
Long-term shareholders	0%	0%	7%	31%	62%
Institutional investors	1%	2%	18%	54%	24%
Employees	0%	1%	19%	55%	25%
Government/regulators	1%	10%	31%	40%	19%
Communities where company operates	1%	13%	41%	35%	10%
Top management team	0%	10%	31%	40%	19%

Committees

The vast majority (95%) of the Directors responded favorably when asked to rate the extent to which their Boards' committee assignments utilize the skills and experiences of Board members.

To what extent:	To a Very Small Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent	% Favorable (% of Directors who responded To a Great Extent/To a Very Great Extent)
Do committee assignments effectively utilize the skills and experience of Board members?	0%	0%	5%	55%	40%	95%

Board and Committee Membership

The survey revealed that Directors now feel they have significantly greater control over the choice of new Directors than the Chair/CEO. As shown in the table below, over two-thirds feel that this decision is most influenced by the Nominating/Governance Committee, compared to 14% who indicate the CEO has the most influence.

Who has the most influence in determining nominees for the Board?	
Nominating/Governance Committee	71%
CEO	14%
Full Board	8%
Non-Executive Chair/Lead Director	5%
Shareholders.....	1%
Other	1%

Exhibit 7. Functions of the supervisory boards in the Russia banking sector

Supervisory Boards (SB) struggle to define their proper function. SBs appear to see themselves at par with or of greater importance than the ultimate governing body of a company, the GMs. In the surveyed banks for example, a number of SBs felt it was their duty to approve additional issuances of the banks' shares (40%) and annual financial statements (12%) as well as to select external auditors (14%). In some cases, the SB elects and dismisses its own members. On a positive note, the SBs of surveyed banks consider initiating unscheduled audits as one of their key functions.

However, the findings above may be partially explained by the particular shareholding structure of the respondent banks: most of the surveyed banks have relatively concentrated ownership with SB members representing all major shareholders.

The meetings of the Supervisory Boards thus become almost identical to a General Meeting of Shareholders and roles get confused. In such cases, however, it is then easy to leave minority shareholders out of the process.

The struggle of the SB to define its function is also evident when asked about the operational characteristics and role of the SB. As chart below shows, 40% of SBs participate in day-to-day management activities together with the Management Board but only half of the banks consider that the role of the SB is to serve as a check and balance on the management.

This clearly contradicts the Basel Committee's view on removing the SB from operational duties. Furthermore, over 30% of the banks do not or only partially agree with the notion that it is the SB's function to set the long-term

direction of the bank and an even higher percentage does not include the SB in defining the bank's mission. At the same time, a significant portion of SBs do not feel at all or even partially responsible for the overall soundness of the bank (38%). Such blurred borders of responsibility distort the principle of separation of duties and create unclear lines of accountability throughout the organization.

Another indicator of the role SBs see themselves performing is the size of financial transactions which are subject to SB approval. Generally, SBs approve financial transactions exceeding in value either 25% of the banks' capital (46%) or 25% of the banks' total assets (36%) which is reasonable. Some banks have set up fixed thresholds for this purpose. At the same time, however, 14% of bank's SBs also approve smaller, immaterial transactions, i.e. below 20% of the banks capital.

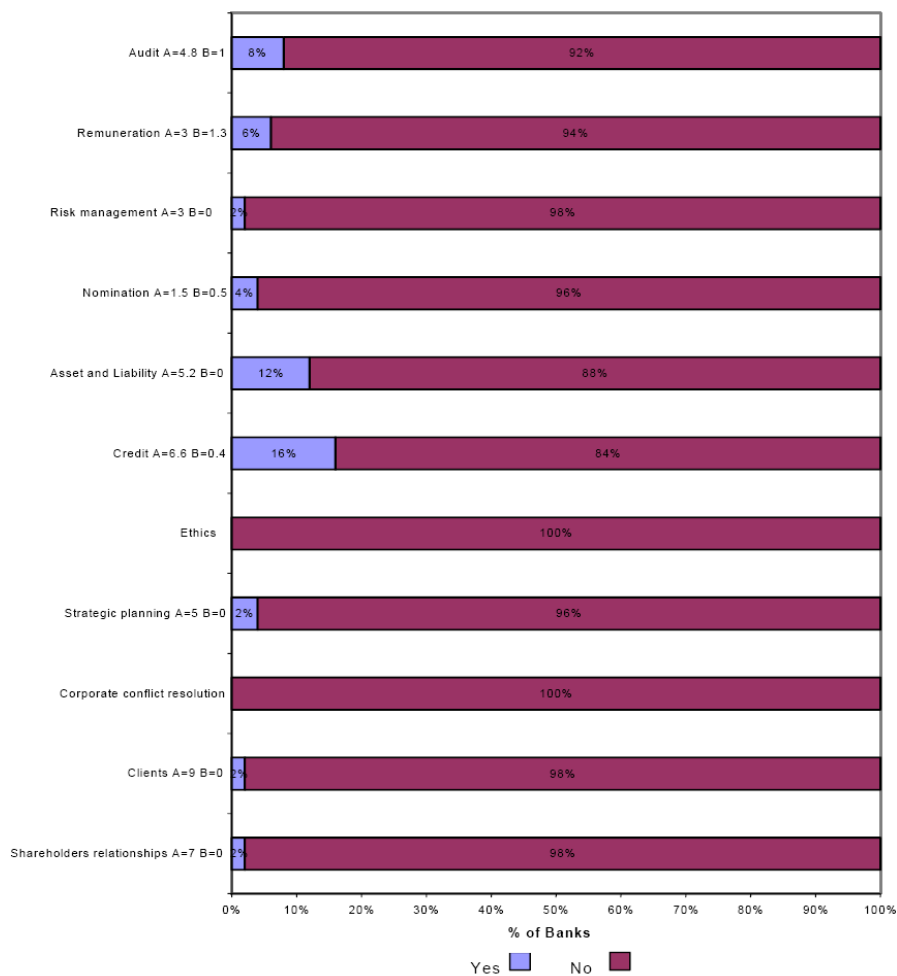


Fig. 6.6. Supervisory board committees in Russia

**Characteristics and Role of the Supervisory Board
(multiple choice)**

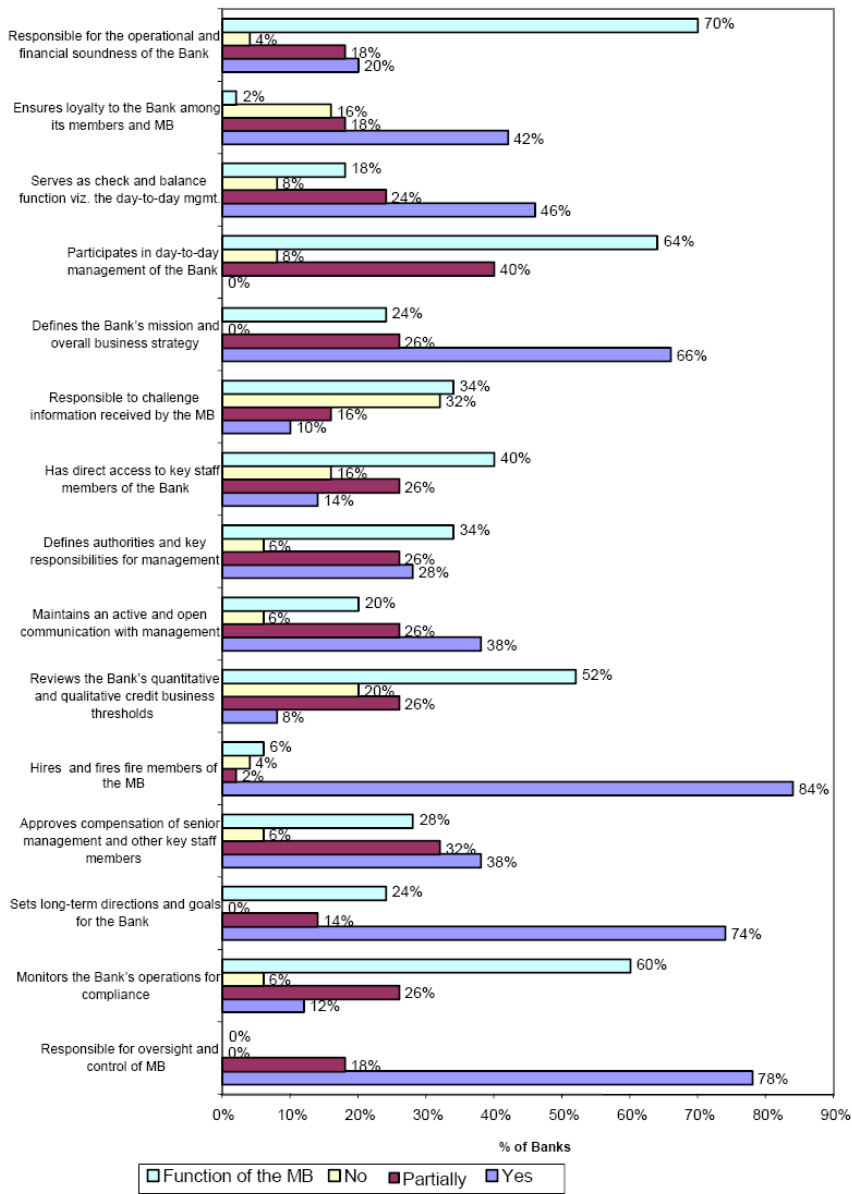


Fig. 6.7. Functions of the supervisory board