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AGENCY PROBLEM IN SHARE COMPANIES IN ETHIOPIA: THE LAW AND THE PRACTICE

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Agency Problem in Share Companies in Ethiopia: the Law and the Practice

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Declaration

I hereby declare that this thesis is my original work and that all sources used are properly identified and acknowledged.

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Abstract

Agency theory is a popular theory of corporate governance. It contends that in companies with a dispersed ownership structure, there is a separation of ownership and control as the ownership over the assets of the company rests on the shareholders while the managers have control over the assets. This creates a principal-agent relationship between the shareholders and the management. Inherent in any principal-agent relationship is the understanding that the agent will act for and on behalf of the principal. However, agency problem may also arise due to the conflict of interest between the shareholders and the management. In view of this, effective corporate governance mechanisms are imperative in order to prevent or reduce the misappropriation of the shareholders' investment by the managers.

Accordingly, this study is concerned with agency problem between shareholders and management in share companies in Ethiopia. In particular, it submits empirical evidence on the ownership structure of share companies in Ethiopia to show that there is dispersed ownership structure and thus a serious agency problem. In support of this claim, it raises few practical instances of agency conflict witnessed in share companies in Ethiopia and presents the results of interviews conducted. More importantly, the study tries to identify some of the most effective corporate governance mechanisms used to alleviate agency conflicts. Then, it evaluates whether the law and the practice in share companies in Ethiopia adequately incorporates these mechanisms, and finds that there are loopholes in the law as well as the practice. Finally, the study calls for proper legal and institutional reform to be made to address the problem.

List of Acronyms

AABE	Accounting and Auditing Board of Ethiopia
AACCSA	Addis Ababa Chamber of Commerce and Sectoral Associations
CEO	Chief Executive Officer
IPO	Initial Public Offering of Shares
IFRS	International Standards for Financial Reporting
IASB	International Accounting Standards Board
ISA	International Standards for Auditing
ICPAE	Institute of Certified Public Accountants of Ethiopia
OECD	Organization for Economic Cooperation and Development
NBE	National Bank of Ethiopia
S.C	Share Company
UK	United Kingdom
US	United States

Chapter One

Introduction

1.1. Background of the Study

Corporate governance has been defined and understood in different ways by different writers. In view of that, agency theory is considered as the most popular theory on corporate governance.[1] In essence, the theory is the result of the application of the traditional agency relationship to the governance of modern companies. It was initially raised by Adam Smith and later Berle and Means and Michael C. Jensen and William Meckling.[2] They contended that modern corporations have become a means whereby the wealth of numerous individuals is concentrated into huge aggregates and the control and management over this wealth is surrendered to professional managers.[3] This creates the separation of ownership and control in the companies. While ownership of the assets is vested in the shareholders of the corporation, control over these assets is in the hands of professional managers of the corporation. The separation of ownership and control in turn creates an agency relationship between the shareholders and the management. The shareholders are the principals and the managers are the agents. Under such agency relationship, both parties (the principals and the agents) are assumed to be motivated solely by self-interest.[4] As a result, once the control is left to the managers giving them the free charge of running the corporation, they may use their control over corporate assets to promote their own self- interests at the expense of that of the shareholders.[5] This creates a conflict of interests between the shareholders and those who control the operation of the firm (managers), namely agency problem.

In order to solve or prevent agency problem and make sure that their money is not misappropriated or wasted on unattractive investment, the shareholders (company) may sign a contract with the managers that specifies what the manager does with the funds, and how

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[1] Alan Caldler, Corporate Governance: A Practical Guide to the Legal Frameworks and International Codes, (UK, MPG Books Ltd, 2008), p. 10.
[2] Adolf Berle and Gardner Means, The Modern Corporation and Private Property, (New Brunswick and London Transaction Publishers, 1933), p.4; Adam Smith, The Wealth of Nations, (1776), Book 5, Chapter 1, Part 3 Art.1; Jensen. M.C. and W.H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, Journal of Financial Economics, Vol.3 No.4, (1976), p. 5.
[3] Ibid; John C. Coffee, The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, The Yale Law Journal, Vol. 111, No. 1, (2001), p. 24, available at: (http://www.jstor.org/stable/797515).
[4] Ibid; Jensen M.C. and W.H. Meckling, Supra note 2, p. 5.
[5] Ibid.

the returns are divided between them.[6] Nevertheless, contracts are not able to handle all possible circumstances in managers-shareholders relationship since most future contingencies are hard to describe and foresee.[7] Due to information asymmetry and collective action or free rider problems the shareholder cannot also effectively monitor the management.[8] Consequently, the managers will be left with most of the residual control rights and the discretion how to allocate the investors' funds which in turn gives them an opportunity for self-interested behavior. In view of this, among others, agency theory considers corporate governance as a set of mechanisms that restrict managers' own interests and make them pursue shareholders' interests.[9]

Since then, corporate governance has been redefined by different writers and organizations to emphasize the interests and roles of various stakeholders in the governance of the company. However, governance problems that result from the separation of ownership and control still remain to be the central concern of corporate governance around the world. Especially, in the Anglo-American corporate governance model, focus on the problem was even more exacerbated following the major corporate failures in 200l.[10] Accordingly, in corporate law context, countries adopt different voluntary and mandatory rules and standards (control mechanisms) aimed at countering agency problem. Obvious examples are rules and procedures that enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents.[11]

In Ethiopia, the vast majority of business undertakings are largely dominated by sole proprietorships and family-based private limited companies with few partners.[12] Accordingly, the ownership structure of most companies in Ethiopia is claimed to be highly concentrated.[13]

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[6] Andrei Shleifer and Robert W. Vishny, A Survey of Corporate Governance, Journal of Finance, Vol. 52, No. 2, (June 1997), p. 7.

[7] Ibid; Dr. Ige O. Bolodeoku, Corporate Governance: The Law's Response to Agency Costs in Nigeria, Brooklyn Journal of International Law, Vol. 32 No. 2, (2007), p. 477, available at: http://brooklynworks.brooklaw.edu/bjil/vol32/iss2/4, accessed on 02/04/2018.

[8] Ibid; Stephen G. Marks, The Separation of Ownership and Control, (Boston University, 1999), p. 693

[9] Alan Caldler, Supra note 1, p. 10; Jan Kultys, Controversies about Agency Theory as Theoretical Basis for Corporate Governance, Journal of Economic Law, Vol. 7, No. 4, (2016) p. 615, available at http://dx.doi.org/10.12775/OeC. 2016.034.

[10] Ige O. Bolodeoku, Supra note 7.

[11] John Armour, Henry Hansmann, Reinier Kraakman, Agency Problems, Legal Strategies and Enforcement, Harvard Jhon M.Olin Center for Law, Economics and Business Discussion Paper, No. 644, (2007), p. 3, available at: (http://www.law.harvard.edu/programs/olin_center/); Brian R Cheffins, Does the law matter?: The Separation of Ownership and Control in United Kingdom, ESRC Center for Business Research, University of Cambridge Working Paper No.172, (2000), p.5.

[12]Minga Negash, Corporate Governance and Ownership Structure: The Case of Ethiopia, Ee-JRIF Special Issue on the Ethiopian Economy, Vol. 5 No.1, (2013), abstract.

[13] Ibid.

Share companies comprise the minority of the corporate landscape in the country.[14] Though, in a similar fashion as in most companies the ownership structure of share companies is also claimed to be highly concentrated.[15] However, there have been contentions by some scholars that publicly held share companies with dispersed ownership structures are on the rise due to factors such as initial public offering of shares and limitation on the amount of shareholding.[16] The growing separation of ownership and control in these companies makes them vulnerable to agency problem. In view of this, the study aims to test the claims regarding the concentration and emergence dispersed of ownership structure in share companies. More importantly, it intends to examine the adequacy of the law and the practice in Ethiopia with respect to addressing agency problem.

1.2. Statement of the Problem and Research Questions

Agency problem is not only the problem of developed countries. In fact, it arises in all relationships normally classified as agency relationship. In Ethiopia, the ownership structure of share companies is claimed to be highly concentrated.[17] In view of that, agency problem between the management and shareholders may seem less of an issue. However, the assertion on the ownership structure of share companies has not been the result of scientific study, and as a result, it invites inquiry. Moreover, even in companies with concentrated ownership structure one cannot totally dismiss the possibility that agency problem between the shareholders and the management may arise.

On the other hand, over the past decade, there have been contentions by some scholars that there is an emergence of dispersed ownership structure in share companies in Ethiopia.[18] In particular, they claim that it has become more common to form share companies through initial public offering of shares (IPO) and this has brought the dispersion of corporate ownership among several thousands of shareholders which in turn results in the separation of

[14] Alemayehu Geda, The Road to Private Sector Led Economic Growth, (Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, 2009), p.113
[15] Ibid.
[16] Fikadu Petros, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, Mizan L. Rev. Vol. 4 No. 1, (2010), p.1; Tewodros Meheret, Governance of Share Companies in Ethiopia, in Seyoum Yohannes ed., Starting and Building a Business Association in Ethiopia: The Legal and Institutional Dimensions, Ethiopian Business Law Series, Vol. IV, AAU, School of Law, (August 2011), p.53; Hissien Ahmed Tura, Reforming Corporate Governance in Ethiopia: Appraisal of Competing Approaches, Oromia Law Journal, Vol. 3, No. 1, p.182.
[17] Alemayehu Geda, Supra note 14.
[18] Supra note 16.

ownership and control and thus agency problem.[19] The public offering of shares even after formation [20]and the prohibition on the acquisition of more than five percent of the total shares of banking or insurance companies is also claimed to have the same effect. However, the claim on the emergence of dispersed ownership structure is also hardly supported by reliable empirical evidence. Similarly, the nature and extent of the agency problem on the ground remains unexplored.

In general, a robust corporate governance regime is considered as an effective mechanism in solving or preventing agency problem in companies. In particular, there are specific corporate governance (control) mechanisms designed and used to alleviate the problem. In Ethiopia, the Commercial Code and other relevant laws present basic rules on the corporate governance of share companies. There is, however, a question mark on the suitability and adequacy of these laws when it comes to effectively addressing the complex agency problem issues of the day. Therefore, one must make an inquiry to see if the provisions of the Commercial Code have adequately incorporated the internationally accepted best corporate governance mechanisms used to alleviate agency conflicts. There are also similar questions on the more recent laws in the area, the financial sector in particular, and the practice in the share companies.

Based on the above problem the research will try to answer the following specific questions:

- What is the ownership structure of share companies in Ethiopia? Is there an emergence of dispersed ownership structure?
- Is there agency problem between the management and shareholders in share companies in Ethiopia?
- What are the best corporate governance mechanisms used to alleviate agency problem in companies?
- What is the laws' response to agency problem in Ethiopia? Do the Commercial Code and other relevant laws adequately incorporate the best control mechanisms used to alleviate agency conflicts?
- What is the practice in share companies with respect to implementing control mechanisms adopted in the relevant law of the country and internationally accepted best practices and principles?

[19] Ibid
[20] Fikadu Petros, Supra note 16, p.8

1.3. Objective of the Study

The general objective of the study is to examine the ownership structure of share companies in Ethiopia, to discuss the nature and extent of agency problem in share companies in Ethiopia and to explore the law and the practice with respect to agency problem to determine whether they respond to questions relating to agency problem. In more specific terms the objectives of the research are:

- To examine the ownership structure of share companies in Ethiopia;
- To show the nature and extent of agency problem in share companies;
- To explore the most effective control mechanisms used to solve and prevent agency problem;
- To expound and appraise the effectiveness of the rules of the Commercial Code and other laws relating to agency problem in accommodating the identified mechanisms;
- To explore the practice in share companies with respect to implementing the control mechanisms adopted in the Commercial Code and other laws and international codes and principles;
- To suggest possible solutions to the limitations of Ethiopian laws.

1.4. Significance of the Study

For some time now, agency problem continues to be a very serious problem in the corporate governance of companies. Consequently, numerous researches have been made about this problem as well as the mechanisms used to solve or to prevent it. Nevertheless, except the efforts of few scholars, the problem remains highly unexplored in Ethiopia. As the separation of ownership and control in share companies is claimed to be rising, the existing condition is no longer acceptable. Therefore, this study will have significance as it tries to cast more light on the issue and motivate further research on the subject.

Also, the study will help policy makers, legislators and regulators beware of the nature of the problem and the limitations of our laws in responding to the problem. It will help them make informed and proper policy and legal reforms. It will also have significance for shareholders and other stakeholders in companies in understanding the problem and knowing the successes and limitations of the legal remedies available. The study could also be of some use for judges, lawyers, and academics.

1.5. Scope of the Study

The study is basically concerned with the law and the practice relating to agency problem in share companies in Ethiopia. To be more precise, it is concerned with agency problem between shareholders and management to the exclusion of agency problem between controlling and minority shareholders or creditors. Moreover, the study mainly focuses on corporate governance as a mechanism dealing with the protection of shareholders' investment from the misappropriation of agents or managers; the interests and roles of other stakeholders in the governance of a company are not dealt with as a primary concern.

1.6. Limitation of the Study

An important limitation that this writer wants everyone to take note of while reading this study is the unwillingness of private and governmental institutions to give information. In particular, most share companies and the National Bank of Ethiopia (NBE) were very reluctant to give information as requested. They usually raise the defense of confidentiality, but without any legal or justifiable ground.

1.7. Methodology

The study employs qualitative method of research. It uses the qualitative method to explore the ownership structure of share companies in Ethiopia, to understand the concept of agency problem, identify the best control mechanisms used to alleviate or prevent it and explore the law and the practice relating to agency problem in share companies in Ethiopia.

Data is collected from both primary and secondary sources. Interviews and memorandum and articles of associations of share companies are the primary sources of data. Unstructured interviews are conducted in order to collect the necessary data and information. Secondary sources include books, journals, domestic and foreign legislations, court decisions and other relevant publications. In particular, internationally recognized best practices and principles of corporate governance, such as that of the OECD are consulted. The writer has opted to use the OECD Principles for two reasons. First, the principles provide the experience of not only OECD countries but also non-OECD countries as whole. Second, they mainly focus on the governance problem that result from the separation of ownership and control and the

relationship between shareholders and management which is also the main concern of this paper.[21]

To study the ownership structure of share companies in Ethiopia it is necessary to limit the number of the share companies. Therefore, those share companies registered in Addis Ababa are made the domain for the selection of sample. The sample selection from among these share companies is random. On the other hand, interviewees are selected purposively from officials at NBE, Ministry of Trade and Industry, Accounting and Auditing Board of Ethiopia, share companies, board secretaries, academics, judges, shareholders, advocates etc., based on their experience, position and expertise on the subject.

1.8. Organization of the Study

The study has four chapters.

The first chapter comprises the proposal of the research. It encompasses background of the study, statement of the problem and research questions, objective of the study, scope of the study, significance of the study, methodology, and organization of the study.

The second chapter deals with the relationship of corporate governance and agency problem. It reviews the existing literature on corporate governance in general and agency theory and agency problem in particular. An explanation on how agency problem between shareholders and management arises is made. Important concepts such as agency costs and sources of agency problem are also addressed.

The third chapter starts by exploring the ownership structure of share companies in Ethiopia. It continues by discussing the nature and extent of agency problem between shareholders and management in share companies in Ethiopia. More importantly, after identifying the best control mechanisms used to alleviate agency conflicts, it makes assessment whether the law and the practice in Ethiopia adequately accommodates the identified mechanisms.

Finally, chapter four makes conclusion and recommendation based on the whole discussion.

[21] OECD Principles, Supra note 30, OECD Principles of Corporate Governance and preamble.

Chapter Two

Corporate Governance and Agency Problem

2.1. Corporate Governance: An Overview

The term corporate governance first gained prominence in 1980s when it was used in the book entitled 'International Corporate Governance' by Robert Tricker.[22] He described corporate governance as a subject "concerned with the way corporate entities are governed […] addresses the issues faced by boards of directors, such as the interaction with top management, and relationships with the owners and others interested in the affairs of the company".[23] Since then, corporate governance has gone through various developments and has become even more prominent around the world. Today, there are different approaches towards its understanding. In general, these various approaches can be characterized as either narrow or broad.[24]The narrow approach understands corporate governance as being concerned with ensuring the firm is run in the interests of shareholders.[25] On the contrary, the broader approach is concerned with ensuring firms are run efficiently in the interests of the society at large.[26]

In view of this, there is no a single generally accepted definition of corporate governance. Rather, there are various definitions which can be characterized within the above mentioned approaches. A well-known example of the narrower approach is provided by Shleifer and Vishny. According to them, "corporate governance deals with the ways [processes, customs, policies, laws and institutions] in which suppliers of finance to corporations assure themselves of getting a return on their investment".[27]An important characteristic of such understanding is that it considers corporate governance as a tool to protect and promote the shareholders' interest; ignoring other interests.[28] In contrast, the broader approach extends the concept beyond the interests of shareholders and includes different stakeholders such as

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[22] Alan Caldler, Supra note 1, p.11; Fikadu Petros, Supra note 16, p. 3
[23]Alan Caldler, Supra note 1, p.11
[24] Franklin Allen, Corporate Governance in Emerging Economies, Oxford Review of Economic Policy, Vol. 21, No. 2, (University of Pennsylvania, 2005), p. 164; Tewodros Meheret, Supra note 16, p.55.
[25] Ibid.
[26] Franklin Allen, Supra note 24, p. 165.
[27] Andrei Shleifer and Robert W. Vishny, Supra note 6, p. 2; Another additional example of narrower definition of corporate governance is provided in the United Kingdom's 1992 Cadbury Report. It defines corporate governance as "system by which companies are directed and controlled"; Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report), (December 1992), Introduction, available at http://www.ecgi.org/codes/documents/cadbury.pdf.
[28]Tewodros, Supra note 16, p. 56

creditors, customers, employees, suppliers, government, communities and etc.[29]The definition in the OECD Principles of Corporate Governance (2004) falls under this purview. It defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders".[30]

The narrow approach to corporate governance prevails in the common law countries, the UK and the US (Anglo-American corporate governance model) in particular.[31] Companies in these countries have a dispersed share ownership structure than anywhere else in the world.[32] Internal (managerial incentives and board of directors) and external (market for corporate control, managerial labor market and monitoring institutions) corporate governance mechanisms are used to ensure the companies are run in such a way that maximizes shareholders wealth.[33] In countries such as Japan, Germany and France (Continental European or German-Japanese model), the broader view of corporate governance prevails.[34]Most companies in this model are characterized by a concentrated share ownership structure.[35] Banks and large family interests are important in the governance structure.[36] Also, substantial cross holdings of shares exist between companies.[37] Nonetheless, despite all the varying approaches, most of today's corporate governance activity is predominantly based on the narrow view.[38]

In Ethiopia, the Commercial Code does not recognize corporate governance in its common parlance. However, given the rules of share company governance incorporated in the Code, one could argue that it is fairly familiar with the concept for its time.[39] It was at the beginning of the century that the term corporate governance has been encompassed into legislations. The banking business and the insurance business proclamations stated corporate governance

[29] Ibid; Franklin Allen, Supra note 24, p. 165.
[30] Organization for Economic Co-operation and Development, OECD Principles of Corporate Governance, (OECD publication Service, Paris 2004), p. 11, available at: www.oecd.org/dataoecd/32/18/315577724.pdf, accessed on 04/09/2018.
[31] Franklin Allen, Supra note 24, p. 164.
[32] Hissien Ahmed Tura, Supra note 16, p.170; Rafael La Porta, Florencio Lopez and Andrei Shleifer, Corporate Ownership Around the World, National Bureau of Economic Research Working Paper No. 6625, (June 1998), Pp. 28-30, available at: http://www.nber.org/papers/w6625, accessed on 04/09/2018.
[33] Franklin Allen, Supra note 24, p. 164.
[34] Id., p. 165.
[35] Rafael La Porta et al, Supra note 32.
[36]Juzhong Zhuang, Some Conceptual Issues of Corporate Governance, Economics and Development Research Center Briefing Notes, No. 3, Asian Development Bank, (June 1999), p. 13
[37] Ibid
[38] Alan Caldler, Supra note 1, p. 10; Franklin Allen, Supra note 24, p. 165
[39] Tewodros, Supra note 13, p. 63

as one of the areas on which the NBE may issue a directive.[40] Accordingly, under both the insurance and bank corporate governance directives, the broader view has been adopted. The directives define corporate governance as "the process and the structure used to direct and manage the business and affairs of a [company] towards enhancing business prosperity and corporate accountability with ultimate objectives of realizing long term shareholders' value as well as customers' and other stakeholders' interest."[41] An element of the broader view is also reflected in the Commercial Code which makes the directors of a company responsible not only to the shareholders but also to creditors and third parties.[42]

Corporate governance is still at its initial phase of development in Ethiopia. Hence, the overall standard of corporate governance is deemed to be inadequate. Some attempts have been made by scholars to show this poor standard. Tewodros Meheret, after examining the legal regime applicable to governance of share companies in Ethiopia by employing different standards finally finds that there are loopholes in the existing law. [43] Minga Negash wrote "the Commercial Code of 1960 does not provide adequate legislative response to complex governance issues of the day".[44] He further argues that "key international conventions, codes and standards are not ratified or adequately incorporated in the Proclamations and […] the Decrees and Directives lack coherence and foresights, and at times suffer from poor drafting".[45] Fikadu Petros puts to test the Commercial Code with reference to protecting the rights of minority shareholders in the context of publicly held companies and finds that there exists a deficit in the law. [46]

Hussein Ahmed Tura critically examines Ethiopia's company law and concludes the law "does not have adequate legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on the composition, independence and remuneration of board of directors in share companies".[47]Asnakench Getnet Ayele, after stating that the overall standard of corporate governance in Ethiopia is inadequate, among the

[40] Banking Business Proclamation, 2008, Art, 14 (4) (c), Proc. No. 592/2008, Fed. Neg. Gaz., Year 14, No. 57 (henceforth Banking proclamation); Insurance Business Proclamation, 2008, Art,15 (4) (c), Proc. No 746, Fed. Neg. Gaz., Year 18, No. 57 (henceforth Insurance proclamation).
[41] Bank Corporate Governance Directives No.SBB/62/2015, Art 2.3; Insurance Corporate Governance Directives No.SIB/42/2015, Art 2.3.
[42] Commercial Code of the Empire of Ethiopia, 1960, Proc. No.166/1960, Neg. Gaz-Extraordinary, Year 19, No.3 Arts., 366 and 367
[43] Tewodros, Supra note 16, p.53
[44] Minga Negash, Rethinking Corporate Governance in Ethiopia, (University of the Witwatersrand, 2008), p.10
[45] Id., p. 2
[46] Fikadu, Supra note 16, Pp. 16-24
[47] Hussien Ahmed Tura, Overview of Corporate Governance in Ethiopia: The Role, Composition and Remuneration of Board of Directors in Share Companies, Mizan Law Rev. Vol. 6, No.1, (June 2012), p. 46.

factors which show such a poor standard, points out three main factors. [48] First, the absence of an adequate legislative framework to regulate modern complex bank governance issues gives rise to inefficient banks.[49] Secondly, political parties' involvement in business enterprises is impeding effective competition by the private sector.[50] Thirdly, inadequate shareholder protection laws and the ineffective judicial system that causes expropriation of shareholders' wealth by denying businesses legal safeguards.[51]

Recently, cognizant of this poor standard of corporate governance in Ethiopia, reforms are being made to develop a more robust corporate governance regime. Among such efforts of reform is the revision of the Commercial Code. It is hoped that the new Commercial Code, when finalized, will address current challenges and promote good corporate governance in Ethiopia. A "Voluntary Code of Corporate Governance for Ethiopia" has also been adopted by Addis Ababa Chamber of Commerce and Sectoral Associations (AACCSA). Furthermore, efforts have been made to revise and enhance the Accounting and Auditing Standards in the country through the enactment of the Financial Reporting Proclamation.[52] We are also beginning to witness more determination by few companies to voluntarily adopt good corporate governance standards and practices.[53]

2.2. Corporate Governance and Agency Theory

Agency theory is a prevailing theoretical framework in studies on corporate governance. First, it was raised by Adam Smith in his wealth of Nations,[54] and later by Berle and Means.[55]Berle and Means contended that the dispersed ownership structure and thus separation of ownership and control in modern corporations have resulted in principal-agent problems.[56] They wrote that: "the separations of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where

[48]Asnakench Getnet Ayele, Revisiting the Ethiopian Bank Corporate Governance System: A Glimpse of the Operation of Private Banks, Law, Social Justice & Global Development Journal (LGD), (2013), abstract.
[49] Ibid.
[50] Ibid.
[51] Ibid.
[52] Financial Reporting Proclamation 847/2014, Federal Negarit Gazeta, Year 20, No. 81, Addis Ababa, 5th December, 2014.
[53]Husien, Supra note 16, p.161; Alemayehu Geda, Supra note 14, p. 113.
[54] Adam Smith, Supra note 2; He wrote in his Wealth of Nations: "Being the managers of other people's money rather than their own, it cannot be expected that they [managers] should watch over it with the same anxious vigilance which [they would] watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company".
[55] Berle and Means, Supra note 1, p. 6
[56]Id., p. 4

many of the checks which formerly operated to limit the use of power disappear".[57] The most cited reference to agency theory, however, comes from Michael C. Jensen and William Meckling. Jansen and Meckling define agency relationship as "a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent".[58] In the context of companies, they contend that the shareholders (principals) hire managers (agents) and then delegate the firm's day-to-day operating decisions to these managers.[59]

According to them, there are essentially two notions in agency theory of corporate governance.[60] First, agency theory reduces corporations to two groups of participants, the shareholders (principals) and the managers (agents) whose divergent interests are clear and consistent.[61] Second, it assumes that humans are rational wealth maximizers and thus disinclined to sacrifice their personal interests for the interests of others.[62] As a result, the managers may not always act in the best interest of their shareholders and may prioritize their self-interest and use the company to collect private benefits.[63]This gives rise to a conflict of interest between the principal (shareholders) and the agent (managers), namely agency problem. In view of this, agency theory contends that managers need to be monitored and controlled in order to ensure that they serve the shareholders' interest[64] and considers corporate governance as a set of mechanisms that restrict managers' own interests and make them pursue shareholders' interests.[65]

There are different critics on agency theory as a theoretical basis for corporate governance. They contend that agency theory is based on simplistic and unrealistic premises. In contrast with agency theory, stewardship theory, for instance, considers managers as good stewards who will act in the best interest of the owners.[66] Further, the theory sees a strong relationship between shareholders' and managers' wealth maximization, and therefore, contends that the

[57]Id., p. 6
[58] Jensen and Meckling, Supra note 2, p. 5.
[59] Ibid
[60] Jan Kultys, Supra note 9, p. 616; Wan Fauziah Wan Yusoff and Idris Adamu Alhaji, Insight of Corporate Governance Theories, Journal of Business and Management, Vol. 1, No.1, (2012), p. 53.
[61] Ibid
[62] Ibid
[63] Talat Afza and Mian Said Nazir, Theoretical Perspective of Corporate Governance: A Review, European Journal of Scientific Research, Vol. 119, No. 2, (2014), p.256.
[64] Alan Caldler, Supra note 1, p. 10.
[65] Jan Kultys, Supra note 9, p. 615.
[66] Wan Fauziah and Idris Adamu , Supra note 60, p. 57.

managers protect and maximize shareholder wealth through firm performance.[67] The market theory, on the other hand, holds that it is irrelevant whether the managers are agents or stewards, because if the companies are not generating enough returns, shareholders will just sell the shares of those companies in the market.[68]Another critic in stakeholder theory dissents to the agency theory's depiction of corporations as a group of two participants. To be precise, it argues that stakeholders such as creditors, employees, customers, suppliers and others are owed a duty of care akin to that of shareholders.[69] There are also other theories critical of agency theory, such as the social contract theory, the political theory, the legitimacy theory, resource dependence theory and etc.[70] Nevertheless, despite all the critics, agency theory remains the most popular theory of corporate governance and has received a great deal of attention almost everywhere.[71]

2.3. Types of Agency Problem

Agency problem is general in nature. It exists in all organizations and relationships normally classified as agency relationships.[72] Within the firm's boundaries, it can be applied to different categories of relationships. Nonetheless, there are basically two types of agency problem in corporations. [73] They are agency problem between the management and the shareholders and between controlling and minority shareholders.[74]Both types of problems have their own conceptual underpinnings and characteristics. Agency problem between management and shareholders arises in companies with dispersed ownership structures (publicly held companies), whereas the one between the controlling and minority shareholders arises in companies with concentrated ownership structures.[75] It must be, however, noted that this paper focuses on share companies whose shares are dispersed among a number of shareholders which give rise to separation of ownership and control that in turn

[67] Ibid
[68] Alan Caldler, Supra note 1, p. 10.
[69] Ibid
[70] For more on these theories see Wan Fauziah and Idris Adamu, Supra note 60 and Talat Afza and Mian Said, Supra note 63.
[71] Alan Caldler, Supra note 1, p. 10.
[72] Common examples of this relationship include shareholders (principal) and corporate management (agent), voters (principals) and politicians (agents), or client (principal) and lawyer (agent). Jansen and Meckling, Supra note 2, p.7
[73]Some literatures state there are, rather, mainly three types of agency problem affecting the interactions and interests of subjects related to company. They are agency problem between: 1) shareholders (owners) and managers, 2) majority shareholders and minority shareholders, and 3) shareholders and stakeholders.
[74]Iain Clacher, David Hillier, and Patrick McColgan, Agency Theory: Incomplete Contracting and Ownership Structure, in H. Kent Baker and Roland Anderson eds., Corporate governance: A synthesis of Theory, Research and Practice, USA, (2010), p. 141.
[75] Ibid

exposes them to agency cost. In other words, it focuses on the agency conflicts between the management and the shareholders.

2.3.1. Agency Problem Between the Shareholders and the Management

In companies with diffused ownership structures (widely held corporations) there are numerous individual shareholders. The upshot of this ownership structure is that the shareholders will surrender the control over the company to the directors and the management.[76] This creates the separation of ownership and control in these companies. While ownership of the assets is vested in the shareholders of the corporation, control over these assets is in the hands of the executives. The separation of ownership and control in turn creates an agency relationship between the shareholders and the management.[77] The shareholders are the principals and the managers are the agents. Under such agency relationship, as mention has already been made, both parties (the principals and the agents) are assumed to be motivated solely by self-interest.[78] As a result, the managers may use their control over corporate assets to promote their own self-interests at the expense of that of the shareholders.[79] For instance, the managers may prefer to focus on short term gains (within their term of employment) than the long term positive gains of the company.[80]

As a result, once the shareholders sink their finances the question that follows is how they can be sure they get returns on their funds from the manager. In most cases, the shareholders and the manager sign a contract that specifies what the manager does with the funds, and how the returns are divided between them.[81] Nevertheless, most future contingencies are hard to describe and foresee, and as a result, contracts are not able to handle all possible circumstances in managers-shareholders relationship.[82]

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[76] Id., p.3; Jansen and Meckling, Supra note 2, p. 5. There are different reasons as to why the shareholders surrender the control over their company to managers. One of such reasons is that the shareholders want to benefit from specialization which they lack. Another reason is the level of share ownership of the shareholders which is very small and as a result they lack motivation to participate in the management. Finally, their large number makes management by the shareholders themselves impractical and thus agency necessary.
[77] Ibid; Pallab Kumar Biswas, Agency Problem and the Role of Corporate Governance Revisited, p. 3, available at: http://ssm.com/abstract=1287185, accessed on 21/07/2018.
[78] Ibid
[79] Jansen and Meckling, Supra note 2, p. 5; F. Fama and Michael C. Jensen (1983), Separation of Ownership and Control, Journal of Law and Economics, Vol. 26, No. 2, p. 304, available at: http://www.jstor.org/stable/725104, accessed on 12/06/2018.
[80] H. Kent Baker and Ronald Anderson, An Overview of Corporate Governance, in H. Kent Baker and Roland Anderson eds., Corporate governance: A Synthesis of Theory, Research and Practice, USA, (2010), p. 3.
[81] Shleifer and Vishny, Supra note 6, p.7
[82] Ibid; Pavel Corner, Three Essays on Corporate Governance and Corporate Finance, (March 2008), p. 8

In order to do away with this problem, the shareholders may reserve for themselves the right to make decisions in the circumstances not fully foreseen by the contract.[83] Anytime something unforeseen happens, they will have the residual control rights and decide what to do. Even so, the problem persists due to information asymmetry. Information asymmetry occurs when one party has more or better information than the other party. In the context of companies, usually, the agent (management) has more information about the state of affairs of the company. The principals (shareholders), often far removed from the operational details of the company, they lack material information and thus are unable to prevent the managers from pursuing their private interest.[84] Consequently, the manager will be left with most of the residual control rights, and therefore, the discretion how to allocate the investors' funds, which gives them a leeway for self-interested behavior.

Moreover, shareholders of widely held corporations own only small portions of the company's shares and thus have limited legal rights to monitor the management effectively. They could use voting as an effective monitoring mechanism but they are often faced with collective action or free rider problems. [85] Monitoring is not costless. It requires the ability to collect, analyze, process, and utilize information. More often than not, the costs of monitoring the management exceed the expected return to the shareholder.[86] Not only that, all the shareholders of a company will share in the benefits of monitoring while the monitoring shareholder bears the monitoring costs alone. In other words, the monitoring shareholder gains only a fraction of the total return and even that is small relative to the cost incurred. As a result, the shareholders will remain apathetic to monitoring as they normally have little incentive to do so.[87]

2.3.1.1. Agency Costs

Agency costs are costs of mitigating the divergence of interest between the managers and the shareholders.[88] These costs are incurred by both the shareholders and the managers. On the one hand, there is a general assumption that an agent like the principal is a utility maximizer. It is, therefore, necessary that the shareholders follow up the managers' performance and

[83] Shleifer and Vishny, Supra note 6, p. 8
[84] Ige O. Bolodeoku, Supra note 7, p. 477.
[85] Stephen G. Marks, Supra note 8, p. 693; Collective action problem is a situation in which all individuals would be better off cooperating but fail to do so because of conflicting interests between individuals that discourage joint action. *See* http://en,wikipedia.org/wiki/Collective-action-problem, accessed on 21/10/2018.
[86] Ige O. Bolodeoku, Supra note 7, p. 478
[87] Ibid; Stephen G. Marks, Supra Note 8, p. 694
[88] Jansen and Meckling, Supra note 2, p. 5; Iain Clacher et al, Supra note 74, p. 142

ensure that appropriate reward system is set to induce the managers to good performance.[89]On the other hand, it is not economically expedient for the managers to take the total value added to the company.[90] If so, it would be hard to imagine why the shareholders would engage the managers. Therefore, the managers have to act upon the shareholders interest otherwise they would simply be unnecessary cost.[91] Agency costs constitute the combination of the costs of these measures and the residual loss arising despite administering them.

In nutshell, as succinctly put by Jansen and Meckling agency costs are the sum of monitoring costs, bonding costs, and residual loss.[92] Monitoring costs are the expenditures paid by the principal to measure, reward and control an agent's behavior.[93] They include the costs of audits, compensation, hiring, training and ultimately firing of managers.[94] Initially, monitoring costs are borne by shareholders, but they will ultimately be covered by the managers as their compensation will be adjusted to cover these costs.[95] Bonding costs are the costs of setting up and working according to the monitoring system.[96] Bonding costs are incurred by the agents and they may be either financial or non-financial. They include the cost of additional information disclosures to shareholders. Despite monitoring and bonding, the interest of managers and shareholders are still not likely to be fully aligned.[97] Therefore, there are still agency losses arising from conflicts of interest. These are known as residual loss.

2.3.1.2. Sources of Agency Problem

As mention has already been made, agency problems arise due to the divergence of interests between shareholders and the managers. As such, the conflicts are limitless in nature.[98] However, both theoretical and empirical research has developed four key areas: moral hazard,

[89] Ige O. Bolodeoku, Supra note 7, p. 473
[90] Id., p. 474
[91]Issam Mf Saltaji, Corporate Governance and Agency Theory: How to Control Agency Costs, Internal Auditing and Risk Management Series, Vol. 8, No. 4, (December 2013), p. 51; Iain Clacher et al, Supra note 74, p. 142
[92] Jansen and Meckling, Supra note 2, p. 6.
[93] Ibid; Issam Saltaji, Supra note 92, p. 50
[94] Jansen and Meckling, Supra note 2, p. 6
[95] Ibid; Issam Saltaji, Supra note 92, p. 50; Patrick McColgan, Agency theory and Corporate Governance: A Review of the Literature from a UK Perspective, University of Strathclyde, (May 2001), p. 5.
[96] Ibid; Iain Clacher et al, Supra note 74, p. 143.
[97] McColgan, Supra note 96, p.7
[98] Id., p.12; Iain Clacher et al, Supra note 74, p. 144

earnings retention, time horizon, and risk aversion.[99] In the next sub-sections, a brief discussion is made on these main areas.

2.3.1.2.1. Moral Hazard Agency Conflicts

Moral hazard arises because managers and owners have different objectives. At times, the decision by the agent may not be based on what is considered right, but on what provides the highest level of benefit for him/her, hence reference to morality. The essence of moral hazard is that in widely held companies where managers do not own substantial shares of the company, the manager has more incentive to consume private perquisites[100] than to invest in positive net present value (NPV) projects.[101] Or, they may choose to invest but in assets best suited for their personal skills which will increase their value to the company and the costs of replacing him/her, eventually giving them more power over the company and allowing them to collect high levels of compensation.[102] Moral hazard also includes actions such as lack of managerial effort or shirking.[103]

2.3.1.2.2. Retention of Earnings Agency Conflicts

Managers prefer to retain earnings, whereas shareholders prefer higher levels of cash distributions.[104]Managers' benefit from retained earnings as the growth in the size of the company will give them more power, greater prestige, more remuneration and ability to control the board.[105] However, this may be ultimately damaging to shareholders wealth. There is a risk of over investment and earnings retention reduces the need for outside financing, a potentially important monitoring function.[106]

[99] Ibid
[100] Ibid; private perquisite consumption includes an incidental payment, benefit, privilege, or advantage over and above regular income.
[101] NPV is a measurement of profit calculated by subtracting the present value of cash outflows (including initial cost) from the present values of cash inflows over a period of time. McColgan, Supra note 96, Pp.7-9; Iain Clacher et al, Supra note 74, Pp. 144-45
[102] Ibid
[103] Ibid.
[104] Id., p. 146; Id., p.10
[105] Ibid.
[106] Ibid.

2.3.1.2.3. Timing of Cash Flows Agency Conflicts

Cash flow timing also creates agency problem between managers and shareholders. Shareholders are presumed to be concerned with all long term cash flows of the company.[107] Conversely, the management may only be concerned with company cash flows for their term of employment. This leads to a bias in favor of short term projects at the expense of long term more productive projects.[108] The extent of the problem increases as the top management draw near retirement or plan to leave the company as quitting managers will not be around to reap the fruits of long term investments.[109]

2.3.1.2.4. Managerial Risk Aversion Agency Conflicts

The managers and the shareholders have different risk preferences. In most cases, the managers' income is highly dependent on firm's performance. When the firm engages in highly uncertain ventures, it may lead to poor performance and eventually bankruptcy.[110] Such event will severely affect the income and the reputation of managers. Therefore, the managers may seek to avoid investment decisions which increase the risk of the company and pursue investment and financing policies that minimize the risk of their companies' equity.[111]

2.3.2. Agency Problem Between Controlling and Minority Shareholders

Agency problem between controlling and minority shareholders arises in companies with concentrated ownership structures. In companies with concentrated ownership structures there are controlling shareholders. As a result, in contrast with the dispersed ownership model, there is no clear separation of ownership and control. The reason for this is, since controlling shareholders are likely to have a financial stake which is large enough to motivate them to keep a careful watch on what is going on around the company, they tend to be efficient monitors than dispersed shareholders.[112] More importantly, they own enough equity and hence legal rights to exert substantial influence over managers. Nevertheless, the controlling shareholders may use this advantaged position to impose their own interest at the

[107] Ibid.
[108] McColgan, Supra note 96, p.11
[109] Ibid
[110] Id., p.12
[111] Iain Clacher et al, Supra note 74, p.147
[112] Fikadu, Supra note 16, p. 12-13

expense of the interest of minority shareholders.[113] This gives rise to a conflict of interest between majority and minority shareholders. Several studies have showed that this type of agency problem arises in countries following the civil law model where share ownership is more concentrated and minority shareholders protection is poor.[114]

[113] Ibid; Mike W. Peng and Steve Sauerwald, Corporate Governance and Principal-principal Conflicts, (2012), p. 660.
[114] Iain Clacher et al, Supra note 74, p. 151

Chapter Three

Agency Problem in Share Companies in Ethiopia: the Law and the Practice

Share Company is one of the forms of business organizations recognized by the Commercial Code. The Code defines it terms of capital and assets. It goes as: a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company, and the members are only liable to the extent of their shareholding.[115] This definition and other provisions of the Code disclose some significant characteristics of Share Company. Accordingly, Share Company has transferable shares (sometimes subject to shareholders' agreement) which enable the shareholders to transfer part or all of their shares without affecting its existence. It is independent from its shareholders and thus its existence is not dependent on the continuing life of its owners. It has also a limited liability, and as a result, the shareholders have no direct liability with respect to the actions of the company. They are liable only to the extent of their contributions.

3.1. Ownership Structure of Share Companies in Ethiopia

The vast majority of business undertakings in Ethiopia are different forms of small size firms.[116] These small size firms are largely dominated by sole proprietorships and family-based private limited companies with few partners.[117] Besides, the business sector is dominated by state owned enterprises, political party affiliated companies and family affiliated and controlled private limited companies.[118] The small size firms and private limited companies are owned and controlled by limited number of families and their close circle of partners.[119] The state owned enterprises and political party owned companies, on the other hand, are respectively owned and controlled by the government and organizations affiliated to the ruling party.[120] Due to this situation, as in many developing countries, the ownership structure of the vast majority of firms in Ethiopia is believed to be highly concentrated.

[115] Commercial Code, Art., 304.
[116] Alemayehu Geda, Supra note 14, p. 104
[117] Ibid.
[118] Minga Negash, Supra note 12, abstract
[119] Ibid; Alemayehu Geda, Supra note 14, pp. 103-105
[120] Ibid.

In comparison with other forms of business organizations, share companies in Ethiopia are less in number.[121]As aptly stated by Alemayehu, they are the exception rather than the rule.[122] Recently though, there is an increase in the rate of share companies' formation.[123] The rise is mainly attributed to the suitability of share companies for business endeavors which require a large amount of capital. Through the instrumentality of public offering of shares it is possible to mobilize a large amount of capital from the public. [124] The restructure of some state owned enterprises into share companies (through privatization) and the relevance of Share Company for some types of business undertakings such as banking and insurance is also believed to have somehow contributed to the same effect.

A more interesting development related with share companies is, however, regarding their ownership structure. For some time now, there have been contentions by some scholars that there is an emergence of dispersed ownership structure in share companies.[125] To be precise, there are claims that the formation of share companies through the initial public offering of shares (IPOs) have resulted in the emergence of share companies with dispersed ownership structures (publicly held share companies) and the themes incidental to it.[126]The offering of shares to the public even after formation is also believed to have brought the same effect.[127] The central theme of these assertions is that the public offering of shares has resulted in the dispersion of share ownership among several thousands of shareholders in the company which in turn results in the separation of ownership and control and thus the traditional agency problem.[128]

Especially in the insurance and banking share companies, there are some developments that add to the above claim. One of these developments is the prohibition on the acquisition of more than five percent of the total shares of banking or/and insurance share companies.[129] According to Mr. Efrem, a senior legal expert at National Bank of Ethiopia (NBE), the

[121] Alemayehu Geda, Supra note 14, p.106; Interview with Yosef Alemu, Director of Share Companies, Chambers and Sectorial Associations Affairs Monitoring and Support Directorate at the Ministry of Trade and Industry, June 28, 2010
[122] Alemayehu Geda, Supra note 41, p.106
[123] Interview with Yosef Alemu, Supra note 121; until July 2010 E.C, there are around one thousand share companies in Ethiopia.
[124] Fekadu Petros, Supra note 16, p.14.
[125] Fikadu Petros, Supra note 16, p.1; Tewodros Meheret, Supra note 16, p. 53; Hussien Ahmed, Supra note 16, p. 182.
[126] Ibid.
[127] Fikadu Petros, Supra note 16, p.8
[128] Ibid; Tewodros Meheret, Supra note 16, p. 53; Hussien Ahmed, Supra note 16, p. 182.
[129] Banking Business Proclamation, Supra note 40, Art., 11 (1); Insurance Business Proclamation, Supra note 40, Art., 12 (1).

prohibition was intended to protect the financial sector from the unnecessary influence and control of individual shareholders.[130] Nevertheless, it has allegedly brought the effect of dispersing the ownership of the said share companies, making almost every shareholder a minority. Another development is the continuous and high increase in the capital requirement for share companies engaged in the banking and insurance businesses.[131] In a bid to reach the required capital, the companies have been forced to offer shares to the public at lower rates of quantity.[132] This is also believed to have dispersed the share ownership base of these companies among several thousands of shareholders.

However, despite the claims and developments, the ownership structure of share companies in Ethiopia is not suitably known. Of course, it is widely claimed that the ownership structure of companies in Ethiopia including share companies is highly concentrated. However, this assertion has not been an outcome of a scientific study. Rather, it may be either the result of the direct application of scholars' characterization of the developing world with concentrated ownership structure or a conclusion based on the mere observation of the companies. By the same token, among the scholars who claim there is emergence of dispersed ownership structure in share companies only Fikadu submits empirical evidence.[133] Nevertheless, despite Fikadu's evidence, there still remains a query on the ownership structure of share companies as a whole.

In the following, the writer has tried to explore the ownership structure of share companies in Ethiopia. To this end, the writer has randomly selected thirty share companies which comprise 10 percent of the total three hundred four registered in Addis Ababa. For each company, the writer collected data on its largest shareholder. Apart from this, the writer, however, did not correct for possibilities where the shareholder may indirectly (in the name of entities or relatives he/she controls) own shares of the company or pyramidal and other ownership patterns. Accordingly, Table 1 presents the summary of share ownership structure for each company.

[130] Interview with Efrem Baraki, Senior Legal Expert at the National Bank of Ethiopia, July 11, 2010.
[131] Ibid; Even though it is yet to be official, the NBE has informed share companies in the banking business to increase their capital to two billion birr by 2020.
[132] Interview with Efrem Baraki, Supra note 130; Interview with Adefres Wesene, Vice Managing Director of Berehan Insurance, July 5, 2011; Interview with Zeray Gebremedhin, Executive Assistant and Board Secretary of Wegagen Bank and A Former Head of the Legal Department at National Bank of Ethiopia, April 22, 2010
[133] Fikadu Petros, Supra note 16, p. 15.

No.	Name of the Company	No. of Shareholders	holding of largest shareholder in %
1	Addis International Bank S.C**	10279	4.3
2	Alpha Education and Training S.C*	1959	40
3	Awash Insurance S.C**	1283	4.3
4	Bis Vegtables and Fruits Agro Industry S.C*	600	1.5
5	City University College S.C*	19	85
6	Dalol Oil S.C*	7	14.2
7	Dashen Brewery S.C*	5	50
8	Dera Trading S.C*	12	53
9	Etjubba S.C*	10	10
10	Ethio Life and General Insurance S.C**	1320	4.8
11	Habesha Cement S.C*	16500	33.3
12	Habesha Construction Materials and Development S.C*	2104	2.1
13	Heineken Breweries S.C*	5	99.9
14	Infra Silicate and Construction Materials Manufacturing S.C *	6	69
15	Jacaranda Integrated Agro Industry S.C*	2500	2.5
16	Kolfe Kidus Raguel Addis Hiywot S.C*	624	0.2
17	Limalimo Transport S.C*	114	2.6
18	Maya International School S.C*	11	51
19	Nestle Waters Ethiopia S.C*	5	48.8
20	Oda S.C*	403	8.7
21	Premeire Switch Solutions*S.C	15	33.3
22	Saygin Dima Textile S.C*	5	60
23	Sheba Travel Service	8	52
24	Shola S.C*	110	15
25	Sunshine Chemical	473	5.3

	Factory S.C*		
26	Timret Agro Industry S.C*	1465	3.9
27	Yenegew Sew Education S.C*	223	2.4
28	Yetebaberut Beherawi Petroleum S.C*	267	12
29	Zebidar Brewery S.C*	5	99.9
30	Zemen Bank S.C**	3824	1.9

Source: data collected from Ministry of Trade and Industry* and the respective companies**

There is no consensus regarding the standard used to determine whether the ownership structure of a company is dispersed or concentrated. Most consider a company to have a controlling shareholder or a concentrated ownership structure if a single shareholder's voting rights (shareholding) in the firm exceed ten percent.[134] Others consider a company's ownership structure as concentrated if a single shareholder holds at least five percent of the equity ownership within the company.[135] At times, the standard is even extended to fifty percent taking into account the majority vote rule (fifty plus) required to pass most decisions in companies.[136] In Ethiopia, the banking and insurance proclamations state that a person who holds directly or indirectly two percent or more of the total subscribed capital of a bank/insurer is considered as an influential shareholder.[137] However, this is a very low standard compared to the ones already stated and has a different purpose in mind in protection of the financial sector from the influence of shareholders.

In view of these, the writer has used ten percent shareholding as a standard to determine whether the ownership structure of the enlisted share companies is concentrated or dispersed. The idea behind using ten percent is that this is the most widely accepted standard as shown above, and is usually enough to induce shareholders to proactively monitor the company's governance in order to safeguard their investment.[138] Managers and boards of directors are also more likely to take into account the preferences and interests of these shareholders. It may also enable the shareholders to take action, either directly or indirectly, over the company's decisions such as the election of board members or replacement of poor

[134] Rafael La Porta et al, Supra note 32, p. 10.
[135] http://lexicon.ft.com/Term?term=ownership-concentration.
[136] Alemu Taye, Protecting Minority Shareholders in Ethiopian Share Company Law: the Practice in Bahirdar, (Unpublished LLM Dissertation, Bahirdar University), (June 2015), p. 10; Fekadu Petros G., Ethiopian Company Law, (2nd ed., Fareast Trading Plc), (February 2004), p. 229
[137] Banking Business Proclamation, Supra note 40, Art., 2 (15); Insurance Business Proclamation, Supra note 40, Art., 2 (15).
[138] Rafael La Porta et al, Supra note 32, p. 10

management with their voting power. Moreover, in some parts of the Commercial Code, shareholders owning ten percent of the total capital of a company are given some important rights which enable them to take action to protect their investment. For instance, according to Article 391(2) of the Code shareholders representing ten percent of a company's capital have the right to call shareholders general meeting. They also have the right to request investigation into the position of the company and reduction of remuneration of directors.[139] Accordingly, the ownership structure of share companies in Ethiopia as a whole is concentrated. The average ownership of the largest shareholder is 29.03 percent. Moreover, 60 percent of the share companies have a controlling shareholder.

3.2. Separation of Ownership and Control and Agency Problem in Share Companies in Ethiopia

In the preceding section we have seen that the ownership structure of share companies in Ethiopia in general is concentrated. However, what is equally discernable is that not a small amount of share companies have also a dispersed share ownership structure. Forty percent of the selected thirty share companies have no controlling shareholder or have a dispersed share ownership structure. Moreover, a majority 53 percent of the total thirty share companies have a more dispersed or less concentrated ownership structure than what they previously had.[140] In the financial share companies this is allegedly due to the five percent limitation on shareholding and the continuous increase in capital requirement, whereas in non-financial share companies it is the result of public offering of shares to increase capital or the transfer of part/whole ownership of the companies.[141]

On the other hand, the number of share companies with a more concentrated or less dispersed ownership structure than what they previously had is only ten percent.[142] The remaining share companies have a similar ownership structure. As a result, the implication is that as we move forward to the future, the ownership structure of share companies in Ethiopia becomes more dispersed or less concentrated. This is where most scholars claim on the emergence of dispersed share ownership structure in Ethiopia becomes apposite.

[139] Commercial Code, Art., 353 (7) and 381
[140] They include: Alpha Education and Training (53), Bis Vegetables and Fruits Agro Industry (4.6), Habesha Cement (60), Habesha Construction Materials and Development (2.4), Jacaranda Integrated Agro-Industry (3.3), Kolfe Kidus Raguel Addis Hiwot (1.2), Oda (10), Sunshine Chemical Factory (7.2), Nestle Waters Ethiopia (48.8), Yenegew Sew Education S.C (5.9), Timret Agro Industry (4.1), Limalimo Transport (3.7)and all of the enlisted financial share companies.
[141] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130
[142] They include: Zebidar Brewery (57), Yetebaberut Beherawi Petroleum (6.2), and Shola (1.5).

In the previous chapter, we have seen that in companies with a dispersed ownership structure separation of ownership and control and agency problem are bound to ensue.[143] Thus, one can conclude that there is a potential agency problem between the shareholders and the management in share companies with a dispersed ownership structure in Ethiopia. According to the comments of different stakeholders, this is also the case on the ground. For instance, Mr. Yosef Alemu, notes that: "there is no question on whether there is agency problem in share companies [non-financial] in Ethiopia; we know for fact that there are members of the management who use the company against the interest of the shareholders".[144] Moreover, Mr. Sintayehu Zeleke, a lawyer and a former judge at the federal high court, contends that there is agency conflict between the management and the shareholders in share companies in Ethiopia; however, it usually goes undetected or unpunished as it is done concertedly and with greater precaution.[145] He continues: in financial share companies, the tenacity of the regulation by the NBE has somehow reduced the problem, and as a result, it rarely goes unnoticed or unpunished if it arises at all.[146] These suggestions are supported also by other shareholders, scholars and lawyers.[147]

But, evidences suggest that agency problem between shareholders and management is not only the problem of widely held share companies in Ethiopia. In fact, it also arises in share companies with a concentrated ownership structure, though in a lesser extent than in those

[143] There are some postulations behind this assertion which can rightly be applied to Ethiopian share companies. For instance, an important element of agency theory is that it reduces corporations to two groups of participants; the shareholders (principals) and the managers (agents) whose divergent interests are clear and consistent. Here, one may say this is not totally true in case of Ethiopian share companies as the Commercial Code states that only shareholders can be members of the board, and sometimes the chairperson of the board is also general manager of the company. Meaning, there are no two groups as such; both the principals (shareholders) and the agents (members of the board and the general manager) are the same-shareholders (principals). Although this contention looks right on its face, it is wrong as the shareholders act in a different capacity after the become board members or general manager; they are functional agents of the remaining shareholders. They also have different responsibilities and interests as agents which will ultimately divide the two groups within the company. Moreover, agency theory contends that in companies with a dispersed share ownership structure the shareholders surrender the control over the company to the management for three reasons. First, the shareholders want to benefit from specialization which they lack. Second, the level of share ownership of the shareholders is very small and as a result they lack motivation to participate in the management. Third, the large number of shareholders makes management by the shareholders themselves impractical and thus agency necessary. Without much need for explanation, one can see that these suppositions are also right for Ethiopian share companies with dispersed share ownership structure as they are basically founded on the number of the shareholders which the former have.

[144] Yosef Alemu, Supra note 121.

[145] Interview with Sentayehu Zeleke, A Former Judge at the Federal High Court, July 6, 2010.

[146] Ibid.

[147] Zeray Gebremedhen, Supra note 132; Interview with Zekarias Kenea, Associate Professor at Addis Ababa University, College of Law and Governance, October 13, 2011; Interview with Eleni Kebede, Senior Attorney and Board Secretary at Habesha Cement, October 12, 2011; Interview with Efrem Baraki, Supra note 130; Interview with Bedru Hamza, Shareholder at Kolfe Kidus Raguel Addis Hiwot S.C, September 21, 2011.

with a dispersed ownership structure.[148] For instance, Mr. Mulusew Deres, a judge at the federal high court trade bench, after stating that agency problem is common in almost all share companies in Ethiopia, argues that it is more serious in non-financial share companies with a dispersed ownership structure.[149] Here, the problem basically arises due to the separation of ownership and control that occurs as a result of the insufficient monitoring of the management by the controlling shareholders and the broad information asymmetry that exists between the owners and the managers of these companies.[150]

Different reasons have been made responsible for exacerbating agency problem in Ethiopian share companies. First, the poor corporate governance standard in the country has created a suitable environment for self-interested behaviors of the managers and directors.[151] Most share companies in Ethiopia have not put in place a robust corporate governance system capable of preventing or solving agency conflicts. Second, the weak regulation of share companies that operate in the country has exposed the shareholders to exploitation.[152] This is particularly the case in non-financial share companies. Third, shareholders lack of motivation and knowledge to closely monitor the management has left the later without a watchdog.[153] Given the small amount of share they have, shareholders are expected to be indifferent towards the company. Moreover, most shareholders do not understand the complex authority structure of companies and how they operate. This has made agency conflicts by the management trouble-free.

3.2.1. Instances of Agency Problem Witnessed in Share Companies in Ethiopia

From what has already been noted, it is beyond dispute that there is agency conflict in share companies in Ethiopia. However, there have not been enough practical evidences that suggest the extent and nature of the problem on the ground. In what follows, the writer has explored some of the practical instances of agency conflict witnessed in share companies in Ethiopia. It is hoped that they will serve as an illustration of the problem at large.

[148] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130; Sentayehu Zeleke, Supra note 145; Interview with Mulusew Deres, Judge at the Federal High Court Trade Bench, July 13, 2010.
[149] Mulusew Deres, Supra note 148.
[150] Ibid; Efrem Baraki, Supra note 130; Yosef Alemu, Supra note 121; Sentayehu Zeleke, Supra note 145; Zekarias Kenea, Supra note 147.
[151] Ibid
[152] Ibid
[153] Ibid.

3.2.1.1. Zemen Bank

In 2016, the Senior Vice President and Vice President for International Banking of Zemen Bank were suspended and then removed by the NBE from the management of the bank.[154] The removal was based on the allegation that they have been involved in a clean loan approval process in which they are believed to have a close relationship with the borrowing company.[155] The NBE in its letter makes reference to different cases of loan approval, and cites conflict of interest as a rationale for the removal.[156]In the case in which the Vice President for International Banking was implicated, it was claimed that he favored the borrowing company (FAME IMPEX trading plc.) by giving preferential treatment when allocating hard currency due to the personal relationship with its managing director.[157] The Senior Vice President was also suspended on the grounds of the same allegations. He was accused of extending clean loan to the borrowing company (Pioneer Agro Industry plc.) due to his close acquaintance with a former board chairman of the Bank and a majority shareholder of the plc.[158]

In February 2012, the then board chairman of Zemen Bank was banned from taking any executive post in the financial sector following a serious accusation over an alleged conflict of interest between the bank and Access Real Estate S. C, where he was a CEO and board chairman.[159] At the time, the chairman was accused of using his power at the bank to finance the projects of the Access Real Estate S. C. This and the aforementioned activities of the officials represent the traditional cases of agency conflict where the managers use their control over corporate assets to promote their own self-interests at the expense of that of the company and the shareholders.

3.2.1.2. Sky Bus Transport System S.C

Sky Bus Transport System S.C fired its general manager claiming that he harmed the interest of the company by engaging in activities that are beyond his power.[160] In particular, the

[154] Efrem Baraki, Supra note 130; Samrawit Tasew, National Bank of Ethiopia Pulls Red Card on Two Zemen Bank Vice Presidents, Addis Fortune, available at https://addisfortune.net/articles/nbe-pulls-red-card-on-two-zemen-bank-vice-presidents/; Dawit Endeshaw, Zemen Bank Laying Foundations Amid Turmoil, Addis Fortune, available at https://addisfortune.net/articles/zemen-bank-laying-foundations-amidst-turmoil/.
[155] Ibid
[156] Ibid
[157] Ibid
[158] Ibid
[159] Ibid
[160] Interview with Fiseha Gebrewahed, Legal Advisor at Sky Bus Transport System, October 3, 2011.

company alleged the general manager, without the knowledge and authorization of the board and against the interest of the company, concluded a contract for the purchase of seven ill-equipped buses in which he kept for himself 70,000 dollars in commission.[161] Consequently, the general manager brought a court action claiming the termination is unlawful since the contract was sanctioned by the board and he has not taken any commission whatsoever.[162] After careful deliberation, the court decided the contract was sanctioned by the board, but the general manager kept the commission without the board's authorization.[163] This is a typical case of moral hazard agency conflict, in particular lack of managerial effort or shirking. According to the decision, the board knew that the buses to be purchased do not possess the required quality and the general manager was to take a commission, but they endorsed the contract anyway and did not care to take action.

3.2.1.3. Yetebaberut Beherawi Petroleum S.C

In 2008 E.C, shareholders owning 25% of Yetebaberut Beherawi Petroleum S.C complained to the Ministry of Trade and Industry that one of the directors of the company is competing against the company by becoming a partner of a rival company.[164] They claimed the director is a commercial representative or agent of Oil Libya Ltd and has even made the company lose tender so that the later could win.[165] The Ministry conducted its own investigation on the matter and found out that the director was in fact working with the rival company.[166] It also summoned the parties and held a discussion on the complaint. During the discussion the director admitted that he has been working as a commercial representative or agent of a rival company, but denied any wrongdoing and the claim relating to the tender.[167] At any rate, this is against article 355 of the Commercial Code which prohibits directors not to compete against the company either on their own behalf or on behalf of third parties unless authorized by shareholders general meeting.

[161] Ibid.
[162] Ibid; Sky Bus Transport System S.C vs. Behailu Assefa, Federal High Court Civil File Appeal No. 146834
[163] Ibid
[164] A Compliant Letter Written by Shareholders Owning 25% of the Company to the Ministry of Trade and Industry, March 15, 2008; Yosef Alemu, Supra note 121.
[165] Ibid
[166] Ibid.
[167] Ibid.

3.3. Mechanisms Used to Alleviate Agency Problems: the Law and the Practice in Share Companies in Ethiopia

Among others, corporate governance is a set of mechanisms used to ensure shareholders get a return on their investment and thus address agency problem. Within this system of governance, there are ranges of particular control mechanisms used to prevent and/or alleviate agency conflicts. However, as there are different understandings and models of corporate governance around the world, the nature, type and purpose of the control mechanisms may be different within each model or legal system. In the following section, the writer has explored some of the most effective control mechanisms used to alleviate agency conflicts without resorting to a single system of corporate governance model. Meanwhile, an attempt is also made to explicate and assess the law and the practice in share companies in Ethiopia with respect to adequately accommodating the identified mechanisms.

3.3.1. The Board of Directors as a Mechanism to Alleviate Agency Problems

Agency problem stems from the fact that the possessors of decision rights (managers) can adopt strategies or policies which negatively affect the wealth of the residual claimants (shareholders).[168] Therefore, the managers can only be trusted after they have been put under the control of the principals with mechanisms that aim at reducing agency conflicts. In view of this, the corporate board is seen as an effective mechanism in reducing agency problem.[169] The owners of a company will transfer the management and control responsibilities to the board. Then, the board will delegate the management function to agents, retaining the ultimate control function which enables it to monitor the later. In Ethiopia, the Commercial Code fails to specifically incorporate the supervisory roles of the board. All matters relating to directors in the Code appear under a section that is dedicated to the management. The duties of directors enlisted under Article 362 of the Code are also related with the responsibilities of management than control. However, from the reading of Article 363 (2), it appears that the law assumes the board may delegate management responsibilities to one or more agents and retain supervisory powers.[170]

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[168] Gregory Francesco Maassen, An International Comparison of Corporate Governance Models: A Study on the Formal Independence and Convergence of One-tier and Two-tier Corporate Boards of Directors in the United States of America, the United Kingdom and the Netherlands, (2002) , p.47

[169]Ibid; OECD Principles, Supra note 30, Principle VI and p. 12.

[170]In the financial sector, however, the role of the board as a supervisor of the executive is properly recognized and outlined; Bank Corporate Governance Directives, Supra note 41, Art., 10.4; Insurance Corporate Governance Directives, Supra note 41 Art., 10.4.

What is more, there are additional factors that are critical for the success of the board in monitoring the management and alleviating agency problems. Among others, it must be setup with the necessary structure, composition, responsibilities and etc. In what follows, an in-depth analysis is made regarding these factors and the law and the practice in share companies in Ethiopia with respect to the same issue.

3.3.1.1. Structure

Structure is one of the critical issues regarding the board. There are basically two board structures around the world: one tier (unitary) and two-tier board. [171] In the unitary structure all the directors participate in the management. It is entrusted with the direction, control and management of the company.[172] Within itself, the unitary structure may have directors with a supervisory and managerial function though not as formal as in the two-tier structure. In the two-tier board structure there are two boards: the supervisory and the executive board.[173] The executive board manages the day to day operation of the company, whereas the supervisory board is responsible for monitoring the management.[174]

There is no hard and fast rule regarding the structure of the board. There are different suggestions based on the legal system concerned. In view of mitigating agency conflicts, however, it is considered vital for a company to have the roles of decision management and decision control separated so that the performance of the management can be monitored and evaluated independently and objectively.[175] Accordingly, some scholars disapprove the one-tier board structure based on the claim that it is negatively associated with the separation of decision management and decision control.[176] Others argue that one-tier board structure shall not be inherently associated with ineffective boards. Rather, there are some important features it must include. First, it must be composed predominantly of non-executive directors, which are more effective than executive directors in monitoring and overseeing the management.[177] Second, there must be a separation of the roles of the general manager and

[171] OECD Principles, Supra note 30, Annotations to Principle VI, p. 58; Tewodros Meheret, Supra note 16, p.86.
[172] Ibid.
[173] Ibid; Gregory F. Maassen, Supra note 168, p. 48
[174] Ibid.
[175] Gregory F. Maassen, Supra note 168, pp. 49-51.
[176] Ibid.
[177] Ibid; OECD Principles, Supra note 30, Annotations to Principle VI (E). A non-executive director is also known as an outside director. However, strictly speaking, an outside director is a director who is not an employee or shareholder of the company, whereas a non-executive director is a director who is not a member of the executive team. The first terminology is used in US while the later is common in UK.

the board chairperson which will enable the board to have an independent leadership structure and increase accountability. [178]

With regard to the two-tier board structure, its effectiveness in mitigating agency problems is hardly disputed.[179] This is based on the suggestion that decision management and decision control are formally separated in two-tier board structure. In particular, two-tier board structure clearly separates the legal obligations of executive and supervisory directors, and as result, the latter will be able to have independent view of the actions of management.[180] It also formally separates the roles of the general manager and board chairperson.[181] There will not be a dual role of the general manager as a board chairperson. This prevents conflict of interest and too much power being concentrated on the same hands.

In Ethiopia, the Commercial Code adopts a one-tier board structure. Article 347 (1) states that a company shall have not less than three or more than twelve directors who shall form a board of directors. Nevertheless, the Code has no adequate provisions that ensure the separation of decision management and decision control. To be precise, it has no provision that requires the majority of the board members to be non-executive.[182] Moreover, the separation of the roles of the general manager and the board chairperson in share companies is argumentative. Some argue that there is no separation of the roles of the general manager and the board chairperson in share companies as Article 348 (4) of the Code has allowed the general manager to be a member and chairperson of the board.[183] They specifically cite the Amharic version of the Article which reads: ዋና ስራ አስኪያጁ የኩባንያው ሰራተኛ ነው አስተዳዳሪም ላይሆን ይችላል።

Others argue that the Amharic version is a misinterpretation of the English version of the article which better reflects the intention of the lawmaker.[184]The English version states that the general manager is an employee of the company and may not be a member of the board. As a result, they contend that there is separation of the roles of the general manager and the

[178] Id., pp. 50-52; Id., Annotations to Principle VI (E), p. 63.
[179] Gregory F. Maassen, Supra note 168, pp. 56-57.
[180] Id., p. 59.
[181] Id., pp. 56-57.
[182]Rather, from the responsibilities entrusted to the directors under article 362, it appears that the Code anticipates a board dominated by executive directors. On the other hand, from article 363 (2), it appears that the law assumes that one or more agents members of the board will be delegated with executive responsibilities, and as a result, the board may be predominantly comprised of non-executive directors.
[183] Interview with Tewodros Meheret, A Lawyer and A Former Staff at Addis Ababa University College of Law and Governance Studies, December 19, 2011.
[184] Fikadu Petros, Supra note 136, p. 151.

board chairperson in share companies as the general manager cannot be a member of the board and vice versa.[185] However, the problem with this kind of argument is that it is inconsistent with Article 363 (2) of the Code which states that the articles of association should determine whether all board or one/more board members are managers or agents of the company. According to this article, the articles of association of the company should appoint one or more members of the board (which may include the chairperson) as the managers or agents of the company. In order to at least reduce this inconsistency, one critic argues that Article 363 (2) shall be understood as requiring the declaration of whether there is a managing director with both supervisory and managerial powers.[186] However, this writer believes that this may not be an ideal way of interpretation because it still allows the head of the management to sit in the board and supervise its own performance.

At any rate, it must be noted that the decision control task of the board to monitor and to discipline the management is weakened when the general manager and board chairperson positions are combined.[187] Moreover, permitting the general manager to have the two positions results in conflict of interests not to mention the special influence it offers to the former over the board, particularly when the directors are less knowledgeable and unmotivated.[188] Therefore, it is more tenable to disallow the manager from being a director and vice versa.

When we come to the banking and insurance share companies, a different arrangement has been adopted on the same issue. The banking and insurance proclamations prohibit an employee of the company (which includes any person appointed or hired by the company) from becoming chairperson of the board.[189] Consequently, the general manger who is an employee of the company cannot assume the board chairperson position and vice versa. Further, the directives on board remuneration and number of employees who sit on the board of insurer/bank totally prohibit employees of the company from being appointed as a

[185] Ibid; Zekarias Kenea, Supra note 147.
[186] Tewodros Meheret, Supra note 16, p. 88.
[187] Ibid; Gregory F. Maassen, Supra note 168, p.50; OECD Principles, Supra note 30, Annotations to Principle VI (E), pp. 63-64.
[188] Position of the Business Community on the Revision of the Commercial Code of Ethiopia, Addis Ababa Chamber of Commerce and Sectoral Associations, (July 2008), p. 23.
[189] Banking Business Proclamation, Supra note 40, Art., 15 (4); Insurance Business Proclamation, Supra note 40, Art., 16 (4).

director.[190] According to this stipulation, executives within the company cannot be a director (executive director) of the company, and as a result, all board members are non-executive directors.

Some critics argue that such prohibition by the directives is unlawful as the proclamations have already allowed the employees of the company to be elected as directors and relayed the issue to the directives only for the later to fix the maximum number of the employees who can sit on the board.[191] Others argue that the directives have not violated the proclamations as they have fixed the maximum number to be zero.[192] In the opinion of this writer, the later argument is not acceptable because the proclamations have sufficiently indicated that employees may be elected as directors. This is discernable from the expression '*…the maximum number of employees of a bank/insurer who may be elected.'*[193] At any rate, the wisdom of making all directors non-executive and totally prohibiting employees of the company from board membership is disputable. It totally neglects the views of executive directors who are better informed than non-executive directors on the affairs of the company, and requires the executives of the company to implement a decision which they have no or little knowledge of.

Here it would be appropriate to discuss the practice in non-financial share companies regarding the separation of decision control and decision management. In almost all share companies, the board is predominantly comprised of non-executive directors.[194] Cases in point are Oda S.C, Habesha Cement S.C, and Sky Bus Transport System S.C.[195] Relating to the separation of the roles of the general manager and the board chairperson; the argument which states that the general manager may be a board member prevails. There is a practice to appoint a general manager from among the directors or to elect the general manager on the board.[196] In addition to membership, the general manager may also have the dual role of

[190] Limits on Board Remuneration and Number of Employees Who Sit on Bank Board (as amended) Directive No., SBB/67/2018, Art., 5; Limits on Board Remuneration and Number of Employees Who Sit on Insurer Board (as amended) Directive No. SIB/67/2018, Art., 5

[191] The proclamations state that the National Bank may issue a directive on the maximum number of employees of a bank/insurer who may be elected and serve as members in the board of directors of the bank/insurer; Banking Business Proclamation, Supra note 40, Art., 14 (4) (f); Insurance Business Proclamation, Supra note 40, Art., 15 (4) (f); Fikadu Petros, Supra note 136, p. 148.

[192] Efrem Baraki, Supra note 130.

[193] Banking Business Proclamation, Supra note 40, Art., 14 (4) (f); Insurance Business Proclamation, Supra note 40, Art., 15 (4) (f).

[194] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130

[195] Interview with Feyera Etsa, General Manager of Oda S.C, July 10, 2010; Eleni Kebede, Supra note 147; Fiseha Gebrewahed, Supra note 160.

[196] Ibid.

general manager as chairperson. The case of Habesha Cement S.C, Jacaranda Integrated Agro Industry S.C and Infra Silicate and Construction Materials S.C where the general managers were/are also board members and/or chairpersons can serve as example to this effect.[197] However, this sort of practice by the share companies, even though arguably lawful, is not commendable as it fails to separate the decision control from decision management which in turn weakens the independence of the board in monitoring the management.

3.3.1.2. Composition

Composition is another important aspect of the board. It is essentially about who should be on the board, and what requirements he/she must fulfill. A critical requirement regarding the composition of the board is the independence of directors. It is strongly advocated that, at least, non-executive directors either in the one-tier or two-tier (supervisory) boards be independent.[198] It has been revealed that independent directors are more effective in objectively evaluating the performance of the management and protecting shareholders' interests.[199] An independent director is someone who is independent in character and judgment and who does not have any financial or non-financial relationship that might compromise that independence.[200]Among others, employment relations, material business relations, family ties, cross directorships and etc., are considered as relationships that compromise the independence of directors.[201] In Ethiopia, there are no provisions ensuring the independence of directors. In contrast, only members of the company are allowed to be directors to the total exclusion of outside directors which are considered to be more independent.[202]

Another point of interest regarding the composition of the board is the competence and personal qualification of directors. Needless to say, competence and qualification are very much needed for someone to become a director of a company. From agency perspective, it is also understood that only a board comprised of competent and personally qualified directors would have the necessary facility to objectively and independently monitor and supervise the

[197] For instance, Article 9 the Memorandum of Association of Infra Silicate and Construction Materials S.C appoints the same general manager and board chairperson; Eleni Kebede, Supra note 147; Yosef Alemu, Supra note 121.
[198] Gregory F. Maassen, Supra note 168, p.58; OECD Principles, Supra note 30, Annotations to Principle VI (E), p. 63.
[199] OECD Principles, Supra note 30, Annotations to Principle VI (E), p. 64.
[200] Alan Caldler, Supra note 1, p. 70.
[201] Id., pp.70-71; Tewodros Meheret, Supra note 16, pp. 93-94
[202] Commercial Code, Art., 347 (1)

management. Unfortunately, the Commercial Code has no provisions ensuring the competence and qualification of persons to be appointed as directors. Conversely, as just noted above, it states only shareholders of the share company are eligible to be elected on the board.[203] Once again, this is atypical provision as it prohibits the company from employing outside expertise when needed. For instance, a company formed by five or ten shareholders may need to employ an outside director as they may not have the required level of competence to effectively manage the company.

In the banking and insurance proclamations there are stipulations with respect to the competence and personal qualification of persons to be appointed as directors. They require directors to be persons with honesty, integrity, diligence and good reputation to the satisfaction of the NBE.[204] They also state some cases that would make a certain person ineligible for board membership. Accordingly, a director convicted of any offence involving a breach of trust or fraud is prohibited from being appointed as a director.[205] By the same token, a director who has directly or indirectly participated in the management of a bank/insurer that wind up, whether in Ethiopia or abroad, can only be director with the approval of the NBE.[206] Further, more detailed directives have been issued on this issue. Accordingly, at least seventy five percent of board members shall hold a minimum of first degree or equivalent, directors shall have adequate experience in business management, preferably in banking/insurance businesses, or shall take trainings, and a person shall be financially sound,[207] and at least thirty years old to be appointed as a director.[208]

The practice on the board composition of share companies in Ethiopia can be seen from two perspectives. In case of non-financial share companies, more often than not, directors are appointed based on their associations with some dominant parties (shareholders, directors and

[203] Ibid.
[204] Banking Business Proclamation, Supra note 40, Art., 14 (1); Insurance Business Proclamation, Supra note 40, Art., 15 (1).
[205] Id., Art, 15 (1); Id., Art, 16 (1)
[206] Id., Art, 15 (2); Id., Art, 16 (2)
[207] The directives outline some of the factors that should be taken into account in the assessment of the financial soundness of persons to be appointed as directors of financial share companies. They include: whether he/she or the legal person in which he/she is a director or CEO or senior executive officer or owner: 1) has instituted bankruptcy proceedings or declared bankrupt, whether in Ethiopia or elsewhere, or his/her or the company' assets have been sequestrated because of bankruptcy or been foreclosed by a bank due to failure to repay loan; 2) has been convicted of default on repayments of bank or other credits or tax payment; 3) carries non performing loans 4) whether the person's minimum net worth at the time of acquisition of shares is at least greater than shares acquired or to be acquired from a financial institution; Requirement for Persons with Significant Influence in Bank Directive No., SBB/54/2012, Art., 5.3; Requirement for Persons with Significant Influence in Bank Directive No SIB/32/2012, Art., 5.3.
[208] Id., Art, 5.1 and 5.2; Id., Art., 5.1 and 5.2

members of the top management) in the company.[209] The requirements of competence and personal qualification are rarely considered as a priority to say the least. It is only in few companies that the nomination committee or the shareholders general meeting through a directive will set fitness criteria for persons to be appointed as directors.[210] Otherwise, the trend is for everyone to try and appoint a director that will serve and protect his/her personal interest in the company.[211] In the worst cases, this may even go as far as personally picking a director without the approval of shareholders' general meeting. For instance, in 2007, the chairman of Ayat S.C was accused by shareholders and then scolded by the Ministry of Trade for personally appointing seven directors out of the total nine.[212] Due to this situation, at times, competent and qualified persons are excluded only because they are not linked to some influential persons in the company.[213]

The independence of the persons to be appointed as directors is also hardly an issue at all.[214] If a certain director of a share company is found to be independent (ignoring his/her shareholding) it is more likely to be a coincidence than intent. As already mentioned there are cases in share companies in Ethiopia where directors are appointed due to their association with some influential persons in the company; ultimately compromising their independence.[215] This is where the case of Oda S.C whose current board chairman is also the CEO of Awash insurance S.C, a majority shareholder of Oda, becomes relevant.[216]

In contrast, in case of share companies engaged in the banking and insurance businesses, the competence and personal qualifications of persons to be appointed as directors is given a priority.[217] This is courtesy of the legal requirement to this effect. Though, there is a similar kind of fuss among persons of interest in these companies too to appoint their own associates on the board.[218] Some of them have even drawn the NBE into action. For instance, in 2010

[209] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130
[210] The practice in Habesha Cement S.C where the nomination committee sets competence criteria for persons to be elected as directors and Mesalemia Area Traders Union S.C where the shareholders general meeting has issued the Board of Directors Nomination and Election Execution Directive can be taken as an illustration; Eleni Kebede, Supra note 147.
[211] Yosef Alemu, Supra note 121.
[212] Ibid; A Compliant Letter Written by 17 Shareholders of the Company to Ministry of Trade and Industry, January 26, 2007, available at the Ministry of Trade and Industry.
[213] Yosef Alemu, Supra note 121.
[214] Yosef Alemu, Supra note 121; Eleni Kebede, Supra note 147; Efrem Baraki, Supra note 130.
[215] Ibid.
[216] Feyera Etsa, Supra note195. According to Mr. Feyera the chairperson is the shareholder of the company in himself.
[217] Efrem Baraki, Supra note 130
[218] Ibid; Zeray Gebremedhen, Supra note 132; Adefres Wesene, Supra note 132.

E.C, it has cancelled Nib Insurance's shareholders general meeting resolution regarding the election of directors.[219] The cancellation was based on the allegations of twenty eight shareholders (17% owners) that two candidates are unlawfully rejected by the nomination committee of the company.[220]

3.3.1.3. Board Committees and Term of Office

Nowadays, it has become common to setup different committees in the board in order to improve and support its performance. In general, these board committees are categorized into two: the management support or operating committee and monitoring or oversight committee.[221] The first types of board committees are meant to integrate decision management and decision control in the board. Examples of operating committees are the executive committee, the strategy committee and the finance committee, and most often, they are dominated by executive directors.[222] The second types of board committees are concerned with the protection of shareholders' interests by providing objective and independent review of corporate decisions.[223]Audit committee, compensation committee and nomination committee are examples of oversight committee.[224] In majority of cases, the composition of these board committees is dominated by independent non-executive directors.[225]Accordingly, they are another controlling mechanism used to ensure the separation of decision management from decision control, assist the board in overseeing and monitoring the affairs of the company and thereby alleviate agency problems.

When we come to Ethiopian share companies, there are no board committees required by the Commercial Code. However, the boards of share companies engaged in banking and insurance businesses are required to have committees including, but not limited to, audit, risk and compliance and human resource affairs committees.[226] Each committee is required to comprise at least three directors.[227] By and large, the committees have the characteristics of

[219] Ibid.
[220] Ibid.
[221] Gregory F. Maassen, Supra note 168, p.53.
[222] Ibid.
[223] Ibid.
[224] Id., p.54; OECD Principles, Supra note 30, Annotations to Principle VI (E) (1), p. 65; Alan Caldler, Supra note 1, p.71.
[225] Ibid.
[226] Bank Corporate Governance Directives, Supra note 41, Art., 10.4.10; Insurance Corporate Governance Directives, Supra note 41, Art., 10.4.10.
[227] Id., Annex III; Id., Annex III

an oversight board committee.[228] However, there are no provisions that ensure the independence of directors to be appointed in the committees.

What is more, banking and insurance share companies are required to have a nomination committee, but not within the board.[229] The members of the committee are elected from and by the shareholders.[230] Reportedly, the reason that necessitated the setup of the committee outside the board was the NBE's lack of confidence in the integrity of board members.[231] They say putting directors in charge of the nomination committee is like putting the fox in the henhouse.[232] The NBE's concern regarding the integrity of the committee's members is commendable except for its failure to guarantee the integrity of the shareholders themselves. It has not set a mechanism to ensure their independence. The likes of the above mentioned instance of upheaval with regard to the nomination of directors may be taken as one illustration to this effect. This writer is of the opinion that it would have been wiser to compose the committee with independent directors than just trying to throw it away from the board.

There are a handful of practices with regard to board committees of share companies in Ethiopia. In majority of non-financial share companies there are no formal board committees.[233] For instance, share companies such as Mesalemia Area Traders Union, Etjubba, Kolfe Kidus Raguel Addis Hiwot and Sky Bus Transport System have no formal board committees.[234] However, there is a tendency to share responsibility in accordance with the expertise of the directors.[235] In the remaining non-financial share companies, there are board committees with different responsibilities.[236] They mainly include business committee, finance committee, operation committee, marketing committee and human resource

[228]Ibid; the audit committee is entrusted with the objective of providing "independent oversight of the [company's] financial reporting and internal control system and ensuring checks and balances within the [company]". The risk and compliance committee has the objective to "oversee senior managements' activities in managing credit, market, liquidity, operational, legal and other risk and to ensure that the risk management process is in place and functioning". The human resource committee is responsible for "providing formal and transparent proposal on the employment of senior management members if he/she is ineffective, errant or negligent in discharging his responsibilities and on the overall benefits systems of the bank".
[229] Bank Corporate Governance Directives, Supra note 41, Art., 6.1.4 and 8; Insurance Corporate Governance Directives, Supra note 41, Art., 6.1.4 and 8.
[230] Ibid.
[231] Efrem Baraki, Supra note 130.
[232] Ibid.
[233] Ibid; Yosef Alemu, Supra note 121; Eleni Kebede, Supra note 147
[234] Ibid; Fiseha Gebrewahed, Supra note 160.
[235] Ibid.
[236] Ibid; for instance: Oda, Heineken, Habesha Construction Materials and Development and Habesha Cement share companies have board committees.

committee.[237] The responsibilities and nature of these committees is, however, more of management support than oversight. The oversight audit and remuneration committees are only integrated into the finance and human resource committees respectively.[238]

Further, other common committees set up in non-financial share companies are the supervision committee and the nomination committee.[239] Most often, the committees are setup outside the board, and their members are elected from and by the shareholders. The supervision committee is primarily entrusted with the responsibility of supervising whether the performance of the management and the board is in line with statutes and objectives of the company and the law.[240] The responsibilities of the nomination committee extend from accepting applications/nominations and counting votes during election to setting competence criteria for persons to be elected as directors.[241] It is usually set up at ad-hoc level a year or six months before board election.[242]

Agency conflicts are often exacerbated when directors cannot be removed from office in deserving circumstances. Thus, in most legal systems, there is a trend to limit the term of office of directors in order to enable the shareholders appoint new directors after evaluating their performance. [243] In our case, Article 350 (3) of the Commercial Code states that the term of office of directors cannot exceed three years. However, a director may be re-elected subject to a stipulation to this effect in the memorandum of association.[244] The Code does not limit the number of times a director may be re-elected. Therefore, strictly speaking, one can say that the term of office of directors is not limited. On the other hand, the term of office for directors of share companies engaged in banking and insurance businesses is six years.[245] The general meeting of shareholders however, if so wishes; may re-elect a maximum of one-third of the directors for one more term only.[246]

[237] Ibid; Fiseha Gebrewahed, Supra note 160.
[238] Yosef Alemu, Supra note 121.
[239] Ibid.
[240] Ibid; Eleni Kebede, Supra note 147.
[241] Ibid.
[242] Ibid.
[243] Tewodros Meheret, Supra note 16, p. 95; For instance, Article 420 of the OHADA Uniform Act Relating to Commercial Companies and Economic Interest Groups states the term of office of directors shall not exceed six years in case of appointment during the existence of the company.
[244] Commercial Code, Art., 350 (4)
[245] Bank Corporate Governance Directives, Supra note 41, Art., 10.1.4 and 8; Insurance Corporate Governance Directives, Supra note 41, Art., 10.1.4.
[246] Id., Art., 10.1.5; Id., Art., 10.1.5

In practice, the term of office of directors is one of the very problematic issues in share companies in Ethiopia. This is especially true in case of non-financial share companies. Directors are not removed in deserving circumstances. In fact, at times, self-interested directors stay in office for a long period of time without any fruitful contribution to the company.[247] This happens in two ways. Firstly, there are cases where the directors stay in power after the expiry of their term of office without re-election. For instance, the board of directors of Hiber Sugar S.C stayed in power until late 2009 E.C even though their term of office was expired in the early 2008 E.C.[248] Secondly, there are cases where the same board stays in office for a long time by being re-elected multiple times. This may not seem wrong on its face, but the problem is that the directors stay on power despite the fact that they are showing a very poor performance. Moreover, re-elections are not made regularly and there is a big question mark on its integrity.[249] The case of Kolfe Kidus Raguel Addis Hiwot S.C where the same board stayed on power for twenty years despite showing a very poor performance is a typical example of such instances.[250] To make matters worse, the articles of association of the company limits the term of office of directors to three years with a chance to be re-elected only twice.[251]

3.3.1.4. Fiduciary Duties

As already noted somewhere, the nature of the relationship between shareholders and directors is an agent-principal relationship. Hence, the directors are fiduciaries and hold a position of special trust and confidence with respect to the shareholders. In view of this, they have fiduciary duty which requires them to act in the interests of the shareholders and not to profit from their fiduciary position without the express consent of the shareholders.[252] There are essentially two key elements of the fiduciary duty of directors: the duty of care and the duty of loyalty.[253] The duty of care requires the directors to act on a fully informed basis, in good faith, with due diligence and care.[254] Here, the standard reference is the behavior that a reasonably prudent person would exercise in similar circumstances.[255] The duty of loyalty

[247] Yosef Alemu, Supra note 121.
[248] Hiber Suger S.C vs Metasebia Melaku et al, Federal First Instance Court, File number 847560.
[249] Yosef Alemu, Supra note 121.
[250] Ibid; Bedru Hamza, Supra note 147.
[251] Ibid.
[252] Alan Caldler, Supra note 1, p. 58
[253] OECD Principles, Supra note 30, Annotations to Principle VI (A), p. 59
[254] Ibid.
[255] Ibid; Tewodros Meheret, Supra note 16, p. 100.

requires the supremacy and prevailing of the interests of shareholders over the boards.[256] It enshrines the implementation of other principles of governance such as restriction of self-dealing, monitoring related party transactions and equitable treatment of shareholders.

In our case, the general fiduciary duty of directors which requires them to act in good faith and in the best interest of the shareholders is not properly articulated in the Commercial Code. However, given the nature of the relationship between shareholders and directors one may rightly say that the directors have fiduciary duty. This may be inferred from Article 2209 of the Civil Code which requires an agent to act in the exclusive interest of the principal and not drive any benefit without the latter's knowledge. Yet, the Commercial Code has incorporated the duties of care and loyalty of directors. Not only article 364 requires the directors to act with a care due from an agent, but also, it makes them responsible for showing that they have exercised due care and diligence. The requirements of acting on informed basis and in good faith are, however, overlooked. By the same token, the standard of care that must be due from the directors is not set. Therefore, one may need to employ Article 2211 of the Civil Code which requires an agent to show the same degree of care as a *bonus pater familias*.[257]

Also, the Commercial Code imposes some obligations on directors in order to advance their duty of loyalty towards the shareholders. Accordingly, directors cannot be a partner in rival companies nor can they compete against the company either on their own behalf or on behalf of third parties.[258] They are also prohibited from making self dealings and/or related parties transactions without the prior approval of the board of directors and notification to the auditors and/or the NBE.[259] Except in case where the company has engaged in banking business, directors other than bodies corporate are also forbidden from borrowing money from the company, obtaining an overdraft in current account or have any obligation guaranteed in respect of business transacted with third parties.[260]

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[256] Gebeyehu Simachew, A Critical Analysis of the Ethiopian Commercial Code in Light of OECD Principles of Corporate Governance,(LLM Dissertation at University of London), (2012), p. 36, available at http://www.abyssinialaw.com/blog-posts/item/1471-ethiopian-share-company-law-in-light-of-oecd-principles-of-corporate-governance.
[257] Tewodros Meheret, Supra note 16, p. 99
[258] Commercial Code, Art., 355.
[259] Id., Art., 356 (1) (2); Bank Corporate Governance Directives, Supra note 41, Art., 12.2.1; Insurance Corporate Governance Directives, Supra note 41, Art., 12.2.1.
[260] Commercial Code, Art., 357.

In practice, the fiduciary duty of directors is seldom taken seriously by share companies. The Commercial Code states that directors shall be responsible for exercising the duties imposed on them by law, the memorandum or articles of association and resolutions of meetings.[261] Nevertheless, the writer has tried to review the statutes of some share companies and most of them are silent regarding the fiduciary duty of the directors.[262] Even the ones which have tried to address the concern only state the obligation of the directors not have a conflict of interest with the company.[263] They fail to specifically and clearly deal with the issue. Further, as one noted, most directors of Ethiopian share companies either do not fully understand and/or live up to their fiduciary duty.[264] The fiduciary duty requires the directors to always work in good faith, with due care and diligence, for the interest of the shareholders, and not put their personal interest ahead. However, this is scarcely the case on the ground to say the least.[265] The previously discussed practical instances of agency conflict can be taken as an illustration to this effect.

3.3.2. Compensation as a Mechanism to Alleviate Agency Problems

Compensation is considered as one of the most effective mechanisms in reducing agency problems. If it is right, it can align the interests of the management with the interests of the shareholders.[266] Empirical research in US, Germany and Japan corporate governance models has proved that there is a significant positive association between incentive payment and company performance.[267] It is also revealed that satisfied managers are less likely to expropriate company resources and more induced to act in the shareholders' interest.[268]

There are different forms of compensation. The major types take four forms: salary, performance linked remuneration, stock options and long term compensation plans.[269] Salaries are considered as the least effective mechanism in giving the management an incentive to make value maximizing decisions.[270] This is perhaps because salaries are due

[261] Id., Art, 364 (1)
[262] For instance, the statutes of Dalol, Limalimo Transport, Hiber Sugar, Ayat, and Mesalemia Area Traders Union share companies have no provision dealing with the fiduciary duties of directors.
[263] The Articles of Association of Zebidar Brewerey S.C, Art, 24, available at the Ministry of Trade and Industry.
[264] Yosef Alemu, Supra note 121.
[265] Ibid; Zekaraias Kenea, Supra note 147; Efrem Baraki, Supra note 130.
[266] Ige O. Bolodeoku, Supra note 7, p. 508.
[267]Shleifer and Vishny, Supra note 6, p. 13; Patrick McColgan, Supra note 96, p. 40.
[268]Shleifer and Vishny, Supra note 16 p 12: Pallab Kumar Bishwas, Supra note 77, p.12.
[269]Patrick McColgan, Supra note 96, p. 40.
[270] Id., p. 41; Shleifer and Vishny, Supra note 7, p. 13.

despite the performance of the managers. Moreover, salaries are likely to be determined by factors such as the labor market, the company's size and the managers' position. Performance linked remunerations provide an improved mechanisms for aligning the interest of the managers with the shareholders and alleviate agency problems.[271] It works as a payment of compensation upon the attainment of certain pre-established performance criteria. The problem with this form of compensation is, however, the managers may focus on determining variables of these compensation plans, neglecting other aspects of performance.[272]

Stock options are proved to be the most effective compensation mechanism in aligning the interest of shareholders and managers.[273] It is an arrangement where the company gives the management the right to buy shares at a fixed price at a given time in the future. It encourages the management to make decisions which increase the value of the company because the higher the value of the firm is, the higher the value of the options for the managers will be. Long term incentive plans may take many forms. Their common feature is the award of certain incentive upon the achievement of long term performance criteria.[274]

In Ethiopia, the law has recognized the need to compensate the directors. Accordingly, the articles of association and the shareholders general meeting are given the mandate to determine the amount of the compensation to be paid to directors.[275] The compensation may be in the form of fixed annual remuneration or/and a specified share in the net profits of a financial year.[276] The amount of share in the net profits of a financial year is limited to ten percent.[277] Such an arrangement of the Code is commendable as it has somehow linked the compensation of the directors to the company's performance. Hopefully this will serve as a guiding carrot that drives the directors to make value maximizing decisions. On the contrary, it is regrettable that the amount of fixed annual remuneration is neither capped nor aligned to the interests of the shareholders and the company. It creates an enormous opportunity for the directors to collect a huge amount of remuneration despite poor performance.

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[271] Ibid.
[272] Ibid.
[273] Patrick McColgan, Supra note 96, p. 42.
[274] Id., p. 43.
[275] Commercial Code, Art., 353 (1)
[276] Commercial Code, Art., 353 (1) and (2) (3).
[277] According to article 353 (4) of the Commercial Code the ten percent share is calculated after deduction of: (a) amounts allocated to reserve funds provided by law or the articles of association; (b) the statutory dividend, where provided in the articles of association or where not provided, a sum representing 5% of the paid up value of shares which have not been redeemed; (c) amounts allocated to reserve funds established by resolution of a general meeting; (d) amounts carried forward.

Apart from this, empirical evidences suggest that most share companies in Ethiopia do not have predetermined policies on the remuneration of directors.[278] Most often, the remuneration of the directors is fixed just by the general meeting of shareholders or a remuneration committee set up to this effect without any policy base. However, in the absence of remuneration policy, it would be hard for the shareholders to align the remuneration of the directors with the long and short term interests of the company. Moreover, directors of some share companies in Ethiopia are practically paid additional forms of remunerations other than what has been stated in the Code. They mainly include: monthly allowances and other benefits in kind.[279] The monthly allowances are paid to cover incidental costs related with membership. The benefits in kind are awarded as a token of gratitude by the shareholders. A case in point is Mesalemia Area Traders Union S.C where the ad-hoc remuneration committee decided to award the directors a car and two shops of their own choice in addition to their annual remuneration (which extends from 600,000 to 100,000 each).[280] The problem is, however, in the absence of a clear policy, these types of additional benefit serve no purpose to the shareholders in terms of aligning their interests with the directors than squandering their money.

For directors of banking and insurance share companies the law provides a different set of remuneration plans. The remuneration on the whole constitutes allowance and compensation which are respectively due monthly and annually.[281] Allowance refers to money paid from the account of the company to cover incidental costs related to board membership.[282] Compensation is any money other than allowance that is paid to directors from the company's net profit or any other source.[283] In terms of amount, annual compensation is limited to hundred fifty thousand (150,000.00) birr, whereas allowances are limited to ten thousand (10,000) birr in a month. [284] The companies are prohibited from paying any other benefits than the already stated.[285]

[278] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130; Feseha Gebrewahed, Supra note 160.
[279] Yosef Alemu, Supra note 121.
[280] The ad-hoc committee was appointed by the shareholders general meeting to fix the amount of remuneration of the board; The Minute of the Ad-hoc Remuneration Committee to Decide the Remuneration of Directors, December18, 2005.
[281] Limits on Board Remuneration and Number of Employees Who Sit on a Bank Board (as amended) Directive No., SBB/67/2018, Art., 2.2, 2,3 and 4; Limits on Board Remuneration and Number of Employees Who Sit on a Insurer Board (as amended) Directive No., SIB/67/2018, Art., 2.2, 2,3 and 4.
[282] Id., Art., 2.2; Id., Art., 2.2
[283] Id., Art., 2,3; Id., Art., 2,3
[284] Id., Art., 4.1 and 4.2; Id., Art., 4.1 and 4.2
[285] Id., Art., 4.3; Id., Art., 4.3

Previously, the remuneration of directors of banking and insurance companies was governed by the Commercial Code. As a result, directors were paid excessive amount in terms of fixed annual remuneration and net share in profits.[286] The upshot of such remuneration was that a chaos was being created as a result of the unhealthy competition shareholders make to be elected as a director.[287] It was also heavily criticized by minority shareholders of the companies. According to the NBE, in order to regulate this problem, it was imperative to rescind the existing remuneration system and issue the new directives.[288]However, the directives have become the subject of a continuing debate and fierce criticism among academics and practitioners. Those who are against the directives claim that it has set a very small amount of remuneration given the intricacy of the responsibilities the directors have to shoulder and the liability they may sustain.[289] On the contrary, others argue that the directive has taken the right path in dealing with shareholders who seek the position for the benefits and ensuring industrial peace in the sector.[290]

In view of mitigating agency conflicts, the remuneration system adopted by the directives is hardly justifiable. The amount of the remuneration set is not enough let alone satisfying and inducing the directors to act in the shareholders' interests.[291] This is worrying given the presumption that less satisfied managers are more likely to engage in self-interested activities. Apart from fixing the maximum amount, the directives also seem unconcerned about the manner of the remuneration. It has set the maximum amount whatever the source and mode of payment is, and prohibited any sort of payment other than the ones already stated. As noted above, stock options and performance linked remunerations are the most effective mechanisms in aligning the interests of the shareholders with the directors. As a result, it would have been wiser if the law has used performance linked remunerations to correlate the compensation of the directors to the company's performance. [292]

What is more, by setting a flat rate of remuneration for all share companies, the directives have deprived the shareholders an effective control mechanism. It would have been wiser if the law was flexible enough to allow the companies set the remuneration of their directors

[286] Efrem Baraki, Supra note 130; According to a survey conducted by the NBE, the highest paid director earned one million birr annually, whereas the lowest paid was 102,000.00 birr; Husien Ahmed, Supra note 16. p.70
[287] Ibid.
[288] Husien Ahmed, Supra note 16. p.71
[289] Zekarias Kenea, Supra note 147.
[290] Efrem Baraki, Supra note 130.
[291] Zekarias Kenea, Supra note 147.
[292] Ibid.

based on their respective circumstances.[293] Needless to say, the size and performance of share companies engaged in the financial sector are not the same. By the same token, the level of responsibilities and contributions of the directors to the company, and the amount of compensation needed to induce the directors to good performance cannot be uniform. This calls for a remuneration mechanism which is flexible enough to embrace the circumstances of each company and its director.[294]

3.3.3. Enforcement of Managerial Duties as a Mechanism to Alleviate Agency Problems

It is widely understood that the establishment of enforcement mechanisms of managerial duties serve as an effective means of mitigating agency conflicts. In this manner, it is possible for shareholders to enforce many duties of directors, obtain redress for grievances and thus reduce agency problems.[295] The enforcement mechanisms may take two forms: enforcement through private rights of action and enforcement by the government. In private enforcement mechanism the shareholders may bring derivative and class action suits in cases where the directors violate their duties.[296] This mechanism requires a well defined right of the shareholders to this effect. In government (public) enforcement, managerial duties are enforced directly by the government or an institution established to this effect. This basically extends to regulating the actions of the companies and the directors through the use of government authority.

Oppressed minority mechanism which gives shareholders the right to challenge the decisions of the management or the general meeting is a key private enforcement mechanism.[297] It basically includes: derivative suit against the directors and action against the general assembly's resolutions.[298] Derivative suit enables the shareholders to bring action in their own name or in the name of the company when the directors fail to exercise their duties properly. In Ethiopia, the Commercial Code fails to set out the derivative suit mechanism. Article 367 indicates that shareholders who have been injured by the fault or fraud of directors may bring action in their own name. But, it fails to extend this right of the shareholders to bring action on behalf of the company or other shareholders. It also fails to

[293] Ibid.
[294] Ibid.
[295] Stephen G. Marks, Supra note 8, p. 703.
[296] OECD Principles, Supra note 30, Annotations to Principle III (A) (2), p. 42.
[297] Ibid; Fikadu Petros, Supra note 16, p. 20;
[298] Ibid

include the right of shareholders to bring action when they are indirectly injured by the fault or the fraud of directors.

Rather, the Code gives the right to sue the directors to the company given the adoption of a resolution to this effect by the vote of shareholders representing one fifth of the company's capital.[299] This right of the company is exercisable where the directors fail to take all steps within their power to prevent or to mitigate acts prejudicial to the company which are within their knowledge.[300] After the adoption of the resolution, it is only in case where the company fails to institute proceedings within three months that the shareholders who voted for the resolution are allowed to jointly institute proceedings.[301] In addition, under Article 416(2) the Code has incorporated the other private enforcement mechanism in shareholders right to bring action against general assembly's resolutions. It allows the shareholders to challenge resolutions adopted by general meetings of shareholders contrary to the law, memorandum or articles of associations.

Nevertheless, the use of private enforcement mechanisms has not been productive on the ground.[302] There are different reasons for this. Obviously, the Commercial Code's failure to properly incorporate the shareholders' right to bring derivative and class action against the directors is the main one.[303] Another reason is the extensive information asymmetry problem that exists in share companies.[304] Shareholders are not well informed about the affairs of the company and what really goes on in the board rooms. This very well decreases their chance of detecting any mismanagement, and even if they come to know, they may decide against suing the directors for lack of material evidence.[305] On top of that, most shareholders of share companies own only a trivial amount of share and thus are generally apathetic towards the company.[306] Pursuing the directors requires a great deal of cost and time, and given the diminutive stake of the shareholders, it may not be a profitable option. More often than not, the costs of going after the directors exceed the expected return to the shareholder.

[299] Commercial Code, Art., 365; However, within such arrangement it would be difficult to enforce directors' duties as a remedy is sought from the directors themselves since they work on behalf of the company. See Fikadu Petros, Supra note 16, p. 20.
[300] Commercial Code, Art., 364.
[301] Commercial Code, Art., 365 (4)
[302] Sintayehu Zeleke, Supra note 145; Mulusew Deres, Supra note 148; Yosfe Alemu, Supra note 121.
[303] Ibid.
[304] Ibid.
[305] Ibid.
[306] Mulusew Deres, Supra note 148; Zekarias Kenea, Supra note 147; Efrem Baraki, Supra note 130.

Relating to public enforcement mechanism, the Ministry of Trade and Industry is entrusted with the responsibility of regulating share companies that operate in the country. In view of this, it has been given some powers by the Commercial Code and other relevant laws.[307] One of such powers is the power to conduct investigation on share companies. Such investigation may be carried out by the initiation of the ministry itself, at the request of the shareholders representing at least one tenth of the shares or up on the order of the court.[308] The Ministry may appoint inspectors to conduct the investigation where it has good reason to believe that the operations of the company are such as may reveal fraud on creditors, acts prejudicial to a class of shareholders, illegal or fraudulent activities, or acts which constitute offences against the law. To the implementation of its duties, the ministry has established the 'Share Company, Chambers and Sectorial Association Affairs Monitoring and Support Directorate'.[309] There are two teams in the directorate, and among these, the responsibility of monitoring share companies rests on the 'share company monitoring and support team'.[310]

Nevertheless, the Ministry has not been successful in curbing illegal and fraudulent activities in companies, and shareholders are sometimes subjected to the exploitation of some self-centered managements. Mr. Yosef Alemu, head of the directorate, mentions the limited power given to the Ministry as the main reason behind its failure to take action.[311] He contends that the Commercial Code has given a very small power to the Ministry and this has made it powerless when it comes to monitoring the governance of the companies and taking action when necessary. Investigation is the only meaningful power of the Ministry (related with monitoring governance of share companies), and the action it may take after the investigation is not even stated.[312] To remedy this problem, the Ministry has drafted the "Share Company's Monitoring and Support Proclamation", but it is yet to be ratified as there is no consensus on the need.[313]

Even though what has been noted by the director is relevant, it does not reflect the whole picture. Of course the power given to the Ministry is very much limited as most of its powers are procedural. Even after investigation there is also no mention of any sort of administrative

[307] Commercial Registration and Licensing Proclamation, 2016, Proc. No. 980, Fed. Neg. Gaz., Year 22, No. 101.
[308] Commercial Code, Art., 381 and 383.
[309] Yosef Alemu, Supra note 121.
[310] Ibid.
[311] Ibid.
[312] Ibid; The Ministry is also given the power to reduce the remuneration of the directors up on the application of shareholders representing not less than 10% of the capital; Commercial Code, Art. 353 (7)
[313] Ibid.

sanctions the Ministry may impose up on the finding of actions contrary to the law. This has made the Ministry toothless. Nevertheless, the Ministry has not been able to successfully exercise the power it already holds.[314] There have been an abundance of complaints of illegal, prejudicial and fraudulent activities submitted by shareholders, but the Ministry has not exerted enough effort in order to investigate and respond to these complaints. Moreover, the Ministry does not possess the required institutional fitness to effectively monitor the illegal and fraudulent activities in share companies. Monitoring share companies that operate in the country is a huge task, but the Ministry has given such task to a team of five people as if it is effortless. It is obvious that with such organizational structure and human resource, it is impossible for the Ministry to discharge its responsibilities as stipulated in the Commercial Code or beyond. In sum, the implication is that there seems to be lack of determination from part of the Ministry to address the problem with the manpower available and to employ the required manpower to be able to effectively tackle the problem.

A more robust regulation system has been adopted on the insurance and banking share companies in Ethiopia. Particular and detailed proclamations and directives have been issued on different aspects of these companies. Frequent mechanisms of reporting and inspection have also been adopted. The regulation by the NBE is so tenacious that some even have the audacity to call it draconian.[315] The tenacity of the regulation is, however, due to the important role the banking and insurance sectors play in the economy of the country.[316] Anyhow, this strong regulation system has somehow prevented or reduced the agency problem witnessed in other share companies.[317] Any agency conflict by the management is more likely to be detected if it arises at all.

3.3.4. Disclosure and Transparency Standards as a Mechanism to Alleviate Agency Problems

The timely and accurate disclosure of material information regarding the company is another mechanism of preventing or mitigating agency conflicts. It addresses one of the main causes of agency problems- information asymmetry.[318] Transparency and disclosure provides the shareholders with the necessary information to enable them to assess the effectiveness of the

[314] Eleni Kebede, Supra note 147; Sintayehu Zeleke, Supra 145; Zekarias Kenea, Supra note 147.
[315] Zekarias Kenea, Supra note 147.
[316] Efrem Baraki, Supra note 130.
[317] Mulusew Deres, Supra note 148.
[318] Pavel Körner, Supra note 82, p. 12.

board and the management in governing the company. As also noted by one commentator, the failures of governance can often be linked to the failures to disclose, making disclosure and transparency standards essential instruments of reducing agency problems.[319] Accordingly, the disclosure shall include, but not limited to, material information on the financial and operating results of the company, major shareholding and voting rights, related party transactions, remuneration policy for directors and key executives, foreseeable risk factors and governance policies and structures.[320] The information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.[321] Annual audits should be conducted by an independent, competent and qualified auditor so that the financial statements represent the financial position and performance of the company.[322]

In Ethiopia, the Commercial Code and the Financial Reporting Proclamation provide the rules related to financial disclosure in share companies. According to the Code the financial statements required to be reported only cover balance sheet and profit and loss account.[323] Income statement, cash flow statement, and statement of changes in equity or statement of recognized gains and losses are not included.[324] There are also no requirements to comply with accounting and auditing standards in preparing financial statements and audits.

The Proclamation, however, has tried to enhance the disclosure standard by addressing these and other loopholes. It requires financial statements to be prepared using International Standards for Financial Reporting (IFRS) issued by the International Accounting Standards Board (IASB) or its successor.[325] By the same token, it requires audits to be prepared using International Standards for Auditing (ISA) issued by the International Federation of Accountants or its successors as adopted, adapted or amended by the Accounting and Auditing Board of Ethiopia (hereinafter the AABE).[326] The Proclamation sets a five years

[319] Tewodros Meheret, Supra note 16, notes 130.
[320] OECD Principles, Supra note 30, Annotations to Principle V.
[321] Ibid
[322] Ibid.
[323] Commercial Code, Art, 419 (1), 446 (2) and 448 (2)
[324] Ethiopia, Accounting and Auditing, Report on the Observance of Standards and Codes, November 2007, p. 6
[325] Financial Reporting Proclamation, 2014, Art., 5 (1), Proc. No. 847, Fed.l Neg. Gaz., Year 20, No. 81 (henceforth the Financial Reporting Proclamation).
[326] Id., Art, 12 (1)

time frame for compliance by reporting entities with its provisions.[327] However, four years have already lapsed and the standards are yet to be put in practice by the companies.[328]

Another relevant point here is the independence, competence and qualification of auditors. The Financial Reporting Proclamation requires auditors to be independent and avoid conflict of interest.[329] On top of that, the Code, the Banking and Insurance Proclamations exclude persons who are perceived to be not independent from being auditors of a company.[330] Moreover, the Proclamation states that the "Institute of Certified Public Accountants of Ethiopia (ICPAE)" which will be responsible for certifying accountants and auditors shall be established by a regulation.[331] Nevertheless, the Institute has not been established yet and its responsibilities are bestowed on another institution established by the proclamation, the AABE. Accordingly, the AABE is empowered to register, certify and monitor accountants and auditors in accordance with the directive issued to this effect.[332] In addition, it has the powers and duties of licensing and accreditation of auditors,[333] monitoring financial statements and reports,[334] making quality assurance review of auditors,[335] conducting inquiry or investigation and imposing administrative sanction in case where there is a violation of the law.[336] However, according to Mr. Worku Alemu, the execution of the AABE is not pleasing as it has been short time since its formation and it lacks the required qualified human resource to do so.[337]

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[327] Id., Art., 54.
[328] Interview with Worku Alemu, Director of the Customers and Stakeholders Directorate at the Accounting and Auditing Board of Ethiopia, November 13, 2011
[329] Financial Reporting Proclamation, Supra note 323, Art., 33 and 34
[330] Article 370 (1) of the Code excludes the following persons:
(a) founders, contributors in kind, beneficiaries holding special benefits, directors of the company or of one of its subsidiaries or of its holdings company;
(b) spouses or relatives by consanguinity of affinity to the fourth degree inclusive, of the persons mentioned above
(c) Persons who receive from the persons mentioned in sub-art. (1), a salary or periodical remuneration in connection with duties other than those of an auditor; Article 24 (1) and 25 (1) Banking and Insurance Proclamation also exclude: a) a shareholder, director or employee of that company b) a spouse or relative by consanguinity or affinity to the first degree to a person falling within the categories provided under paragraph (a); or c) a firm of auditors of which any partner or a staff member falls within the categories provided under paragraph (a) or (b).
[331] Financial Reporting Proclamation, Supra note 306, Art., 2 (4) (5) and (9)
[332] Ibid; Establishment and Determination of the Procedure of Accounting and Auditing Board of Ethiopia Council of Ministers Regulation, 2014, Proc. No. 332, Fed. Neg. Gaz., Year 21, No. 22, Art.,16 and the ff (henceforth AABE Regulation).
[333] Financial Reporting Proclamation, Supra note 323, Art., 18 and 26.
[334] Id., Art., 24
[335] Id., 25; AABE Regulation, Supra note 313, Art., 26
[336] Id., Art., 36; Id., Art., 30
[337] Worku Alemu, Supra note 328.

Concerning non-financial disclosure the Commercial Code requires companies to keep at their head office a register of shareholders,[338] disclose shareholdings between parent and subsidiary companies,[339] and keep register of its directors and managers with particulars as to their civil status, profession, and any directorship held in other companies.[340] Apart from these, the Code has overlooked the main elements of non-financial disclosure such as major shareholding and voting rights, related party transactions,[341] remuneration policy for directors[342] and key executives, foreseeable risk factors and governance policies and structures. However, these elements are better addressed in the banking and insurance proclamations and directives. The Proclamations require companies to make available at their head offices free of charge, to any interested person their share registers that show the names and voting rights of their shareholders.[343] By the same token, the Bank and Insurance Corporate Governance Directives require the companies to disclose related parties transactions to the NBE (not to shareholders though) within fifteen days from the date of the transaction specifying the name, type of transaction and amount involved and post on their website the basic governance structure of the company.[344]

Another important concern with regard to disclosure and transparency is the dissemination of relevant information through timely and cost efficient channels.[345] The Commercial Code has not adopted an effective channel for disseminating information to the shareholders and the public. It only requires the companies to keep registers in the company or/and at the Ministry of Trade and Industry. The Banking and Insurance companies are, however, required to cause

[338] Commercial Code, Art., 331
[339] Id., Art., 344
[340] Id., Art., 359 (1)
[341] Art 356 of the Commercial Code requires notice given to auditors regarding any dealings made between a company and its director and another concern where one of the directors of the company is owner, partner, agent, director or manager of such concern. It, however, fails to include the relatives of the directors and managers and controlling shareholders.
[342] However, Article 361 of the Code requires the balance sheet submitted to the annual general meeting to show total amount of remuneration, allowances, annuities, retirement benefits and benefits in kind given to the directors. It also requires the remuneration of directors to be included in the report on the state of the company's activities and affairs. See Commercial Code, Art., 446 (3)
[343] Banking Business Proclamation, Supra note 40, Art., 10(2) (5); Insurance Business Proclamation, Supra note 40, Art., 11 (2) (5).
[344] Bank Corporate Governance Directives, Supra note 41, Art., 2.11 and 12.2; Insurance Corporate Governance Directives, Supra note 41, Art., 2.11 and 12.2; according to the Directives a related party means an influential shareholder, a director, a chief executive officer, or a senior executive officer of the company and/or the spouse or relative in the first degree of consanguinity or affinity of such shareholder, director or officer or a business organization or an entity in which influential shareholder, a director, a chief executive officer, or a senior executive officer of the company and/or the spouse or relative in the first degree of consanguinity or affinity influential shareholder, a director, a chief executive officer, or a senior executive officer of the company and/or the spouse or relative in the first degree of consanguinity or affinity owns 10% or more interest as a shareholder or serves as a director, chief executive officer or a senior executive officer.
[345] OECD Principles, Supra note 30, Annotations to Principle V (E), p. 56.

the auditor's report, statement of comprehensive income and expense accounts, balance sheet and profit and loss account to be published in a newspaper of wide circulation and uploaded on their website.[346]

Having said this, it is worthwhile to discuss the practice regarding disclosure and transparency in share companies in Ethiopia. To start with, there is a massive information asymmetry in share companies.[347] This is particularly the case in non-financial share companies. Shareholders do not have access to material information related with financial and non-financial affairs of the company. Most often, companies are not willing to disclose relevant and accurate information to the shareholders. When the shareholders personally request for information they are usually refused.[348] They cannot also access information from the register at the Ministry of Trade and Industry as the information that is required to be kept there is hardly submitted timely if at all.[349] There are companies such as Habesha Cement which try to disclose information to shareholders through shareholders' departments and their website, but they are exception.[350]

When we come to financial disclosure, not small numbers of share companies in Ethiopia are not regularly audited by external auditors.[351] Here, the case of Kolfe Kidus Raguel Addis Hiwot S.C where it lasted for twenty years without being externally audited could be taken as an example.[352] Moreover, financial statement reports and audits are not prepared in accordance with international standards of accounting and auditing.[353] The financial statements and audits are too general and highly dependent on the internal audit findings of the company. The ethics[354] and independence of external auditors is also usually questionable.[355] They are seldom appointed after a transparent selection process.[356] The

[346] Banking Business Proclamation, Supra note 40, Art., 28 (2); Insurance Business Proclamation, Supra note 40, Art., 29 (2); Bank Corporate Governance Directives, Supra note 41, Art., 12.2.5 and 8; Insurance Corporate Governance Directives, Supra note 41, Art., 12.2.5

[347] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130; Bedru Hamza, Supra note 147.

[348] Ibid.

[349] Ibid.

[350] Ibid; Eleni Kebede, Supra note 147.

[351] Ibid; Worku Alemu, Supra note 328.

[352] Bedru Hamza, Supra note 147.

[353] Ibid; The Financial reporting proclamation requires companies to prepare financial statements and audits in accordance with international standards of accounting and auditing, but it is yet to be put in practice. In 2010, only Oromia International Bank has prepared financial reports and audits as required by the proclamation.

[354]The Office of the Federal Auditor General enacted the "Ethiopian Code of Ethics for Professional Accountants" on December 2009. It is basically the adoption of the Code of Ethics prepared by the International Federation of Accountants (IFAC), but enough has not been done on its application; Worku Alemu, Supra note 309.

[355] Yosef Alemu, Supra note 121; Efrem Baraki, Supra note 130; Worku Alemu, Supra note 328.

number of qualified professional accountants or auditors in Ethiopia is also low in relation to the size of the companies.[357] Due to this situation, the sector is dominated by few professionals or firms. As a result, at times, financial statement and audit reports are not prepared in time before general meeting of shareholders for the later to make decisions accordingly.[358] This is particularly the case in financial share companies.[359]

[356] Ibid.
[357] Ibid.
[358] Ibid.
[359] Efrem Baraki, Supra note 130.

Chapter Four

Conclusion and Recommendation

4.1. Conclusion

In modern companies where dispersed ownership structure prevails, agency theory contends that separation of ownership and control and thus agency problem between shareholders and management are bound to ensue. This calls for an effective corporate governance system in order to prevent the misappropriation of the shareholders' investment by the management and align the interests of the two. Such has been among the prevailing theoretical frameworks of corporate governance around the world. In Ethiopia, the ownership structure of majority of share companies in general is concentrated, whereas there are not small amount of share companies with a dispersed ownership structure. However, the agency problem between shareholders and management arises in all sorts of share companies in Ethiopia, though it is more serious in extent in share companies with a dispersed ownership structure. Poor corporate governance system, shareholders lack of knowledge and motivation to effectively monitor the management, information asymmetry and poor regulation of the companies by the Ministry of Trade and Industry are considered as some of the main reasons behind the problem.

Accordingly, agency problem is an important concern in share companies in Ethiopia warranting an effective response by the corporate governance regime of the country. Nevertheless, the Commercial Code and other relevant laws to corporate governance fail to adequately incorporate some of the important control mechanisms used to mitigate agency conflicts that arise between the shareholders and the management. In particular, the board as a monitoring and controlling entity is not adequately set up with the required structure, composition, committees and duties. The compensation system adopted by the Commercial Code is not flawless while that of financial share companies is unacceptable by many standards. The shareholders are not equipped with the necessary rights to enforce the duties of the directors, and the Ministry of Trade and Industry is hopeless in its regulation of non-financial share companies. The disclosure and transparency standards adopted are also not good enough to convey honest and timely information to the shareholders. On top of all this, the practice in most share companies does not comply with the age-old Commercial Code let alone with best principles and international standards.

The problems related with agency conflicts and its poor regulation in share companies is already very serious and shows no signs of stopping. The quality of the existing corporate governance system is however, hardly sufficient to meet the problem with equal strength. This very well decreases the confidence of the public to invest in share companies and the role the companies can play in the overall economy of the country. Therefore, in order to restore the confidence of the public in investing share companies and enable the companies to play their true role in the economy of the country; an incorporation of effective and sufficient control mechanisms both at national and company level is not a choice, but a necessity.

4.2. Recommendations

Based on the aforementioned discussion, the writer would like to make the following recommendations:

1. The separation of decision control and decision management must be ensured in share companies. The confusion between the Amharic and English versions of Article 348 (4) of the Commercial Code regarding the separation of the general manager and board chairperson roles should be resolved by the lawmaker as prohibiting the general manager from becoming board member and vice versa. Moreover, it should be provided that the board shall be predominantly comprised of non-executive directors.
2. Article 5 of the directive on board remuneration and number of employees who sit on the board of insurer/ bank which totally prohibit employees of the company from being appointed as a director shall be deleted. For one reason, it is against the banking and insurance business proclamations which have already allowed the employees of the companies to be board members. For another, it has the effect of making all directors of banking or insurance share companies' non-executive. Since non-executive directors always have less information than the management, they should comprise only the majority of the board, not its entirety.
3. To increase the objectivity and independence of board members in evaluating and monitoring the performance of the management, provisions ensuring the independence of the majority of the directors should be incorporated in the Commercial Code. By the same token, minimum requirements on the competence and personal qualification of directors should be stipulated.
4. In order to assist the board with the protection of shareholders' interests by providing objective and independent review of corporate decisions, at least, the audit, remuneration

and nomination board committees shall be mandatory requirement for all share companies. A mechanism to ensure that the committees are dominated by independent non-executive directors should also be put in place.

5. The fiduciary duties of directors shall be properly articulated in the Commercial Code. In particular, directors shall be required to act on fully informed basis and in good faith. The standard of care that must be due from the directors should also be set in the Commercial Code as the behavior of a reasonably prudent person.
6. Share companies should have clear and predetermined remuneration policies that align the remuneration of the directors with the short and long term interest of the company. Moreover, the flat rate remuneration system adopted for directors of financial share companies should be revised. Instead of following the one fits all approach, the directives should focus on setting a reasonable, flexible and performance based remuneration system that accommodates the circumstances of each company and its director. The companies should be allowed to fix the amount of the remuneration to be paid for their directors based on predetermined performance criteria, the nature and complexity the directors' responsibility, the managerial market and etc.
7. Shareholders should be empowered with the necessary rights to enforce the duties of the directors. In particular, the Commercial Code should adopt the derivative suit mechanism to enable the shareholders bring action in their own name or in the name of the company when the directors fail to exercise their duties properly.
8. The Ministry of Trade and Industry is not discharging its responsibility of monitoring and supervising non-financial share companies. As a result, changes must be made with respect to the legal and institutional framework on the regulation of non-financial share companies. In particular, the powers of the Ministry enshrined in the Commercial Code and other relevant laws are not sufficient to effectively regulate and supervise the non-financial share companies that operate in the country. Therefore, the Ministry should be endowed with more powers especially with respect to monitoring and supervising the governance of the companies. More importantly, it should be empowered to impose administrative sanctions against the companies and their managers or directors in case where there is a fraudulent activity or a violation of the law. This may be produced through an independent legislation or in the upcoming new Commercial Code. Moreover, the Ministry should be strengthened with the necessary human capital in terms of expertise and number.

9. The five years time frame set for reporting entities to fully comply with the Financial Reporting Proclamation is set to expire shortly. Therefore, the Accounting and Auditing Board of Ethiopia should ensure the compliance of share companies with financial statement and audit standards adopted in the proclamation. It should also properly discharge its duties of monitoring financial statements and reports, making quality assurance review of auditors, and conducting inquiry or investigation on reporting entities. To this effect, the government must reinforce the board with the required human resource.
10. In order to solve problems related with the competence and personal qualification of accountants and auditors, the 'Institute of Certified Public Accountants of Ethiopia' which was supposed to be established with the responsibility of certifying accountants and auditors should be established very shortly.
11. The Commercial Code should incorporate the main elements of non-financial disclosure such as major shareholding and voting rights, related party transactions (including the relatives of the directors and managers and controlling shareholders), remuneration policy for directors and key executives, foreseeable risk factors and governance policies and structures. It should also adopt timely and cost efficient channels of disseminating information to the shareholders such as publication of information on newspapers and uploading on the companies' website.
12. The Ministry of Trade and Industry should ensure that share companies submit important and timely financial and non-financial information to its registry. The share companies themselves should also provide information when required by the shareholders. To this effect, they should establish a specialized body such as the shareholders department within the company.

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Annex I

Interview guides prepared for directors, general managers and shareholders

Personal Detail of Respondent

Name of the Respondent (if he or she consented)_____

Type of the Study: A Master Thesis in Law (LL.M Thesis)

Title: **Agency Problem in Share Companies in Ethiopia: the Law and the Practice**

Objective of this Interview: To gather information on the law and the practice in share companies in Ethiopia with respect to agency problem and to suggest possible solutions based on the findings, you are kindly requested to respond to the interviews as your information will be helpful for effective accomplishment of the study and as it will be kept confidential and analyzed anonymously unless you consented for the disclosure of your identity and personal views.

Thank you, in advance, for your co-operation

Guiding questions:

1. Is there agency problem between the management and shareholders in your company? If yes, what are the reasons that give raise to the problem?
2. Is there a separation of the roles of the general manager and the board chairperson in your company?
3. Are the majority of directors in your company non-executive?
4. Do you have a predetermined independence and competence and personal qualification criteria for persons to be elected as directors of your company?
5. Are there board committees in your company? What are their names and responsibilities? Are their members independent?
6. Is the term of service of directors of your company limited?

7. How are the directors of your company remunerated? Do you have a predetermined remuneration policy to align the interests of the company and the directors?
8. Are shareholders of your company effective in enforcing managerial duties in case directors engage in unlawful activities? What are the challenges?
9. How do you evaluate the regulation of non-financial share companies by the Ministry of Trade and Industry? What are the drawbacks?
10. Does your company make the disclosure of material and accurate information to the shareholders? What specific methods do you use?

Annex II

Interview guides prepared for officials of the NBE and the Ministry of Trade and Industry

Personal Detail of Respondent

Name of the Respondent (if he or she consented) _____

Type of the Study: A Master Thesis in Law (LL.M Thesis)

Title: **Agency Problem in Share Companies in Ethiopia: the Law and the Practice**

Objective of this Interview: To gather information on the law and the practice in share companies in Ethiopia with respect to agency problem and to suggest possible solutions based on the findings, you are kindly requested to respond to the interviews as your information will be helpful for effective accomplishment of the study and as it will be kept confidential and analyzed anonymously unless you consented for the disclosure of your identity and personal views.

Thank you, in advance, for your co-operation

Guiding questions:

1. Is there agency problem between the shareholders and the management in share companies in Ethiopia? What is its extent and nature? What are the reasons that give raise to the problem?
2. Is there the separation of the roles of the general manager and the board chairperson in the Commercial Code?
3. Are the majority of directors of share companies in Ethiopia non-executive?
4. Do you think that directors of share companies in Ethiopia are elected based on merit?
5. Is the remuneration of directors in share companies in Ethiopia performance based?
6. What are the drawbacks of the remuneration system adopted by the Commercial Code and the financial sector?

7. Do you think that the term of office of directors of share companies in Ethiopia should be limited?
8. Are shareholders of share companies in Ethiopia effective in holding directors responsible when they engage in harmful activities to the company? If no, why?
9. Do you think that shareholders of share companies in Ethiopia are well-informed about the affairs of their company? If no, why? If yes, how?
10. What are the problems related with financial and non-financial disclosure in share companies in Ethiopia?
11. Do you think that your institution is properly discharging its responsibility in regulating share companies? What are your challenges?
12. How do you respond to reports of fraudulent activities in share companies by shareholders?
13. Do you have enough human resource in terms of expertise and number to be able to effectively monitor the share companies?

Annex III

Interview guides prepared for officials of the Accounting and Auditing Board of Ethiopia

Personal Detail of Respondent

Name of the Respondent (if he or she consented) _____

Type of the Study: A Master Thesis in Law (LL.M Thesis)

Title: **Agency Problem in Share Companies in Ethiopia: the Law and the Practice**

Objective of this Interview: To gather information on the law and the practice in share companies in Ethiopia with respect to agency problem and to suggest possible solutions based on the findings, you are kindly requested to respond to the interviews as your information will be helpful for effective accomplishment of the study and as it will be kept confidential and analyzed anonymously unless you consented for the disclosure of your identity and personal views.

Thank you, in advance, for your co-operation

Guiding questions:

1. Is the financial reporting proclamation fully put in to practice by share companies? What are the challenges?
2. Are financial statements and audits of share companies in Ethiopia prepared accordance with accounting and auditing standards?
3. Are the financial reports and audits prepared in share companies in Ethiopia reliable and accurate? If no, what are the problems?
4. Are there enough qualified accounting and auditing professionals in Ethiopia?
5. Do you think that your institution is properly discharging its responsibility of regulating reporting entities? What are your challenges?
6. What are the problems related with financial disclosure in share companies in Ethiopia?

Annex IV

Interview guides prepared for Judges and Academicians

Personal Detail of Respondent

Name of the Respondent (if he or she consented) _____

Type of the Study: A Master Thesis in Law (LL.M Thesis)

Title: **Agency Problem in Share Companies in Ethiopia: the Law and the Practice**

Objective of this Interview: To gather information on the law and the practice in share companies in Ethiopia with respect to agency problem and to suggest possible solutions based on the findings, you are kindly requested to respond to the interviews as your information will be helpful for effective accomplishment of the study and as it will be kept confidential and analyzed anonymously unless you consented for the disclosure of your identity and personal views.

Thank you, in advance, for your co-operation

Guiding questions:

1. Is there agency problem between the shareholders and the management in share companies in Ethiopia? What is its extent and nature? What are the reasons that give raise to the problem?
2. What are the legal remedies available in order to prevent or solve agency problem in share companies in Ethiopia? Are these remedies effective and adequate?
3. Do you think that the board is setup with the ideal structure, composition, committees and duties in light of the problem? How about the practice in the share companies?
4. Are shareholders of share companies in Ethiopia endowed with the necessary right in order to protect their interest and the interest of their companies from fraudulent managers? What are the practical problems in this respect?

5. Do you think that the remuneration system adopted in the Commercial Code is effective in aligning the interests of shareholders and directors? How about the one adopted for directors of banking and insurance companies?
6. How do you rate the regulation of share companies in Ethiopia? What are the problems on the ground in this respect?
7. How do you evaluate the transparency and disclosure standard adopted for share companies in Ethiopia? What are the successes and limitations?
8. Do you think that there is information symmetry between shareholders and the management of share companies in Ethiopia? If no, why? If yes, how?