

Title: A Framework for the Construction of a Corporate Governance Index for Trinidad & Tobago

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Abstract: This paper outlines the construction of a corporate governance index for use in Trinidad & Tobago among firms listed on the local stock exchange. The index is constructed in an effort to assist investors and firms to determine the corporate governance status of firms. It will use public information only to gain an unbiased view of the firm's governance climate. The index is also divided into sub indices which cover the following areas: Board Responsibility, Board Structure, Shareholder Rights, Transparency & Disclosure, Audit Committee. Provisions are also made for conglomerates.

Key words: corporate governance, index, Trinidad & Tobago, public information

Section 1: Introduction

Corporate Governance is a topic of great interest in today's financial world. This has been the case since the collapse of American energy company, Enron in 2001. Other major firms followed such as WorldCom, Xerox and Tyco. Trinidad & Tobago has not been immune to such financial disasters and in 2008 experienced distress when the Hindu Credit Union (HCU) collapsed and again in 2009 with the Colonial Life Insurance Company (CLICO) Trinidad Ltd. which experienced a bailout by the Trinidad & Tobago government. Till date Trinidad & Tobago does not have any formal legislation specifically related to Corporate Governance but the Central Bank of Trinidad & Tobago has issued a Corporate Governance guide which firms listed on the Trinidad & Tobago Stock Exchange (TTSE) are supposed to follow. This paper constructs a Corporate Governance Index for companies listed on the TTSE in Trinidad & Tobago in order to facilitate easy measurement and assessment of the corporate governance situation of a particular company in this country. The index will be the further used to calculate a Corporate Governance Index value for Trinidad & Tobago which will be used to determine the state of corporate governance in the country. After the collapse of the two financial institutions in Trinidad & Tobago, local investors, already quite conservative, have become even more so. Trinidad & Tobago suffers from a thinness of trading on the stock exchange because of this investor conservativeness and this index will shed some light to potential investors about some of the riskiness of investing in a particular company. The paper is organized as follows: Section 2 covers the literature in corporate governance and corporate governance index construction, Section 3 deals with the methodology surrounding the construction of the index and Section 4 concludes.

Section 2: Literature Review

2.1 Definitions of Corporate Governance

There are many definitions for corporate governance. Sir Adrian Cadbury in his 1992 Report on the Committee on Financial Aspects of Corporate Governance p.15 says “Corporate Governance is the system by which companies are directed and controlled.” Another definition is, “corporate governance can be defined as the stewardship responsibility of corporate directors to provide oversight for the goals and strategies of a company and foster their implementation.”(Cornelius 2005, p. 12). The OECD Glossary of Statistical Terms website (2010) states that corporate governance refers to “procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.” The Financial Times Lexicon website (2010) defines corporate governance as “How a company is managed, in terms of the institutional systems and protocols meant to ensure accountability and sound ethics. The concept encompasses a variety of issues, including disclosure of information to shareholders and board members, remuneration of senior executives, potential conflicts of interest among managers and directors, supervisory structures, etc.” Brancato and Plath (2003) p.8 say “Corporate governance is defined in this report as a system of checks and balances between the board, management and investors to produce an efficiently functioning corporation, ideally geared to produce long-term value.” Fahy et al (2004) p.163 say “Put in its simplest form, corporate governance is the systems and processes put in place to direct and control an organisation in order to increase performance and achieve sustainable shareholder value.” Kaen (2003) pg 1: “Corporate Governance is about who controls corporations and why”. The definitions all have common features:

(1) Corporate Governance is concerned with monitoring the activities of the firm; (2) Corporate Governance must control the firm’s activities while monitoring them (3) Corporate Governance must protect shareholders. Another important component in Corporate Governance that comes out of the definitions is the importance of board of directors and of monitoring this board.

2.2 Importance of Corporate Governance

Having a good legal framework is important for an economy and the firms operating in it. But it is also important for the firms to realize that their performance can be measured and reported to shareholders and to the public in general. The first group of firms that should be targeted therefore, will be those

firms listed on the stock exchange/s in an economy. For Trinidad & Tobago such firms will be considered when preparing the Corporate Governance. This is because those firms are required by law to report certain aspects of their performance and daily activities to their shareholders. In Trinidad & Tobago the TTSE rules state that firms must disclose: their Balance Sheet, Profit & Loss Account, full name & description, registered address, registrar's address, names and addresses of all the company directors, date of incorporation and a brief history of operations, structure of authorized and issued capital, recent capital history, dividend history, special conditions related to company share transfers (Trinidad and Tobago Stock Exchange Rules 2004, Trinidad and Tobago Central Depository Rules 2002).

In the USA the prevailing Corporate Governance legislation is the Sarbanes-Oxley (SOX) Act of 2002. This piece of legislation clearly states the number of directors a firm should have – and states how many should be independent, their terms of service, remuneration elements and many other stipulations ensuring that the firms will function in a proper Corporate Governance environment. The SOX Act is heavily criticized (Wade 2002) on the basis that it is too stringent to allow complete compliance. Other important corporate governance guidelines include the OECD Principles of Corporate Governance (2004), the Corporate Governance Guide published by the London Stock Exchange (August 2004) and the guide produced by the New York Stock Exchange (November 2004). Locally, the Central Bank of Trinidad & Tobago has issued a Corporate Governance Guideline, first in May 2006 and then a revised version in May 2007. Even though the Corporate Governance guideline is meant to be just a guide for Corporate Governance procedures, firms are required to satisfy the criteria of having at least two independent directors. The other elements, though strongly recommended, are not mandatory. Firms listing on the TTSE are required to disclose enough information to allow the public to make a proper judgement about their state of affairs before making an investment.

The legislation and guides listed above all outline the responsibilities of the board, the structure of the board – including the number of independent directors, shareholder rights, the level of required disclosure, what is expected of the audit committee and the audit process. Therefore, these can be considered to be the main aspect of Corporate Governance.

2.3 Corporate Governance indices

Corporate Governance indices have been developed by many companies and researchers. However, the majority of these are relevant only to developed economies. This is a flaw that is quickly being corrected

since developing economies also need to have proper Corporate Governance measures. Of the notable Corporate Governance indices that have been formulated are the following: the Corporate Governance index developed by Ananchotikul (2008), the index developed by Black, Jang and Kim (2003a and 2003b), the FTSE-ISS Corporate Governance index (2005), the Gompers, Ishii and Metrick (2003) index, the Corporate Governance Index developed by Khanna et al (2001), and by Klapper and Love (2002). Of these, only the index developed by Ananchotikul (2008) was specifically formulated for developing countries.

According to Cornelius (2005) the FTSE and ISS have partnered to create a Corporate Governance Index. According to their publication there are five major aspects of Corporate Governance that a firm should prepare for: (1) Compensation systems for Executive & Non Executive directors (2) Executive and non executive stock ownership (3) Equity structure (4) Structure and independence of the board (5) Independence and integrity of the audit process. Although the FTSE ISS index is very well thought out and relevant, it is only constructed for developed economies and this is a major flaw in the index.

Gompers et al (2003) construct an index by adding one point for every firm for every provision by the firm that restricts shareholder rights and by extension, increases managers' power. Sub indices are also created: delay, protection, voting, other, state. The index totals 28 provisions in all, 24 of these are exclusive to them.

Black et al (2003a, 2003b) constructed a Corporate Governance based on a survey carried out by the Korea Stock Exchange. They have six sub indices: shareholder rights, board of directors, outside directors, audit committee, internal auditor, disclosure to investors, ownership parity. They allow each sub index to carry a maximum value of 20 with the overall Corporate Governance having a maximum value of 100. If a firm does not report on a particular question it is not considered as a part of the value, in this manner this index differs from others, particularly from Ananchotikul (2008) who uses the zero value to indicate that there is a lack of a corporate governance measure that should have been included by the firm. The authors excluded subjective questions from the construction of the index (these were taken to be questions where the managers were asked to offer an opinion). The authors had 38 survey elements which were usable for constructing the Corporate Governance after they eliminated certain aspects of the survey which would not have contributed to the index such as subjective questions, questions not directly related to Corporate Governance, questions with ambiguous answers, with high overlap, minimal variation between firms, few responses.

According to Ananchotikul (2008) the major aspects of Corporate Governance are: board structure, board responsibility, conflict of interest, shareholder rights, disclosure & transparency. She constructs a firm Corporate Governance index for firms in Thailand which uses only information available from public sources such as company disclosure reports, annual reports, company websites, stock exchange of Thailand databases. Up to 87 criteria are analyzed. The values for Ananchotikul (2008)'s index range from 0 to 100 with 100 being the perfect Corporate Governance score and 0, the worst. The interesting part about this index is the fact that it uses only publicly available information. This, the author states, is favourable to using the survey collection method for Corporate Governance data since firms instantly believe that they are being judged on the appropriateness of their Corporate Governance structures. This may lead to inaccurate reporting or self selection where only firms with good Corporate Governance structures will be likely to report values. Ananchotikul (2008) uses a weighted average of the sub indices to create a composite Corporate Governance Index. The weights assigned are as follows: board structure – 20%, conflict of interest – 25%, board responsibility – 20%, shareholder rights – 10%, disclosure & transparency – 25%.

The Heidrick and Struggles biennial study (2001 – 2009) first rated firm in ten European countries: Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain, Sweden, Switzerland, the UK and then expanded to include Austria, Denmark and Finland. These countries are rated on Corporate Governance with a maximum rating of 16 being allowed. The company ratings are used to produce a country average, and the country averages are used to create an overall European rating. The study uses only published information and especially, the annual reports of the companies. The working style of the board, board composition and the disclosure of the firm were considered to be the three driving forces in Corporate Governance in a firm.

Khanna et al (2001) report on several Corporate Governance Indices. In particular they mention the Credit Lyonnais Securities Asia (CLSA) Corporate Governance Index. The index was constructed using a 57 question survey of which 70% was based on facts while 30% required the analyst's opinion. The questions were all answered in the yes/no form and where Corporate Governance information was not available the answer 'no' was used since a lack of information about governance indicates poor governance and should be treated as such. The questionnaire used to formulate the index was broken up into seven parts: fiscal discipline, accounting transparency/disclosure, board independence, board

accountability, responsibility, equitable treatment of shareholders, social awareness. One of the limitations of this questionnaire is its reliance on analyst opinion.

Klapper and Love (2002) developed a Corporate Governance Index using the CLSA questionnaire data as well as Worldscope data and use six components of the index: management discipline, transparency, independence, accountability, responsibility, fairness. The components are not studied as sub indices since they each have overlapping parts. This index has a maximum value of 100 and a minimum value of zero.

Overall the Corporate Governance Indices have some common themes: Shareholder Rights are important in all cases and almost all the authors (Khanna et al 2001, Black et al 2003, Ananchotikul 2008, Gompers et al 2003) have a sub index devoted to Shareholder Rights. Another major focus is that of the board of directors of a firm. This is shown in two ways – the emphasis on responsibilities of the board of directors (Ananchotikul 2008, Black et al 2003, Cornelius 2005, Khanna et al 2001, Klapper and Love 2002) and the emphasis on the structure of the board (Ananchotikul 2008, Black et al 2003, Cornelius 2005, Khanna et al 2001). Transparency is also very important to a good Corporate Governance system since transparency inspires shareholder confidence in the firm Anandchotikul (2008), Black et al (2003), Khanna et al (2001), Klapper and Love (2002). Another major element of Corporate Governance is that of the audit committee's performance. After the crash of the Arthur Andersen accounting firm, the audit process has been under strict scrutiny. The index constructed by Black et al (2003) includes a sub index on the audit committee and the FTSE ISS Index also includes a sub index on the audit committee (Cornelius 2005) while Klapper and Love (2002) have a component titled 'accountability'. The literature points to these aspects of governance as the most important to the proper functioning of a firm. These components were also important in the construction of the Corporate Governance Index for Trinidad & Tobago.

Section 3: Methodology

The Corporate Governance Index for Trinidad & Tobago (CGITT) will be constructed for the firms listed on the TTSE. The CGITT runs from 0 to 100 where higher values indicate better corporate governance. The questions used to construct the index were formulated using the Corporate Governance Guide issued by the CBTT (May 2007), the TTSE Rules (2004) and the TTCD Rules (2002). These rules and the CG Guide all indicate what a firm must do in order to have a good corporate governance profile. The CGITT uses these to construct the index so that both the investors and the firms themselves can easily determine if the firm's corporate governance framework is lacking relative to what the regulators expect to be in practice. The information for the index will be collected from public sources including the Annual Reports of companies, their disclosed financial statements, information listed on the TTSE website and on their own company website and from the newspapers. Many other studies make use of surveys targeted at firms to formulate corporate governance indices. However, a problem noted in the literature (Ananchotikul 2008) with using such survey responses, is that the problems of self selection, inaccurate responses and a poor response rate exist. The self selection problem arises when companies who report may be those who have good corporate governance systems in place; in this case only good corporate governance reviews will be given. In other cases firms may report inaccurate information – what they consider to be the correct answer instead of what is actually taking place in the firm. Finally, some firms may not respond at all. This poor response rate is a problem that is especially true in developing countries such as Trinidad & Tobago. It is for these reasons that the CGITT is constructed using only information from public sources.

The index will be constructed using 93 questions for non-conglomerate firms and 95 questions for conglomerate firms. A distinction is made between the two since the TTSE has many conglomerate firms listed and the CBTT Guide included some specific guidelines for conglomerates and including these questions is important in accurately determining the corporate governance situation for the conglomerate firms. The questions are all stated for answer in the Yes/No form where the answer 'Yes' is given a value one, and the answer 'No', zero.

The CGITT is broken up into five sub-indices which measure the major components of corporate governance: (A) Board Responsibility (B) Board Structure (C) Shareholder Rights (D) Transparency & Disclosure (E) Audit Committee and each of the questions falls into one of the identified categories. The sub index 'Board Responsibility' has 30 questions for non-conglomerate firms and 32 for conglomerates,

Board Structure has 10 questions, Shareholder Rights has 8 questions, Transparency & Disclosure has 31 questions and Audit Committee, 14. Each of the sub indices is weighted to produce the final CGITT. The weights are as follows: Board Responsibility – 30%, Board Structure -15%, Shareholder Rights – 20%, Transparency & Disclosure – 20%, Audit Committee – 15%. The weights are used to indicate the importance of each of these components to the overall CGITT. Board Responsibility was given the largest weight since this is the most important component to corporate governance; the conglomerate-specific questions are included here since they directly deal with the responsibility of the conglomerate board.

If firms did not report on a particular part of the CGITT the value zero was given for that question (this is with the exception of the non conglomerate firms' lack of responses to conglomerate questions). This is in keeping with the literature (Khanna et al 2001, Ananchotikul 2008) since the absence of reporting on a corporate governance element indicates poor governance. The CGITT is formed as a composite index which is produced by finding the weighted average of each of the sub indices. This means that for each of the five sub indices the firm's total for that sub group is divided by the sub index total and then multiplied by the weight to get that company's sub index value. Finally, all the sub index weights are summed to get the CGITT value. This method follows what was done by Ananchotikul (2008). The complete list of questions in each of the sub indices is included in the Appendix to this paper.

A country index will also be constructed using an average of the index values for each of the firms listed on the TTSE to determine Trinidad & Tobago's corporate governance status in general.

Section 4: Conclusion

The Corporate Governance Index constructed in this paper for Trinidad & Tobago is expected to assist in encouraging investors to confidently invest in stocks of firms. A major problem in Trinidad & Tobago is the lack of individual investor activity on the stock market. The stock market remains thin due to lack of frequent trading and this is mainly due to the behaviour of local investors who far prefer risk free investments due to their lack of understanding of the behaviour of the capital market in general, and the stock market in particular. This is especially true since the financial distresses experienced by the HCU and CLICO. This index will assist investors in determining which companies are the safest for investment and perhaps trading and investment in the stock market in Trinidad & Tobago may be positively affected by this. The index also captures the major aspects of governance that an investor may wish to see at a glance in the form of the sub indices. The CGITT may also encourage firms to practice proper corporate governance habits in an effort to improve their CGITT values.

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Appendix

Corporate Governance Index Trinidad and Tobago and Sub-indices

QUESTIONS	Maximum Score for Sub- Index	Weight
<p>A. <u>Board Responsibility</u></p> <ol style="list-style-type: none"> 1. Has the board stated its business objectives? 2. Is the board able to show a strategic guideline? 3. Has the board established the qualification and competence of the CEO or MD? 4. Has the board consulted the supervisors when assessing senior management? 5. Does the board approve major activities such as loans, liquidity, investment, insurance underwriting? 6. Does the board ensure and approve that the compensation of senior management members and key personnel is in keeping with the institution's culture? 7. Does the board ensure that Senior Management has stated policies and procedures to ensure that their activities are in keeping with the approved business strategy? 8. Does the board approve the company's methods of control and ensure that they are functioning properly? 9. Does the board ensure that there is an effective form of risk management in place? 10. Does the board understand the statutory obligations of the financial institution? 11. Does the board ensure that the compliance of these obligations is fulfilled? 12. Does the board monitor financial performance of the firm? 13. Does the board establish standards of conduct and ethical behaviour for persons in the organization? 14. Does the board communicate with supervisors and convene meetings when they are requested? 15. Is the board informed of reports issued by the supervisors and ensures that their recommendations are implemented? 16. Does the board self-assess periodically? 17. Does the board report to shareholders on the financial condition of the company? 18. Does the board consult the shareholders when deciding on activities which will influence them? 19. Does the board report significant & material information to the shareholders? 20. Does the board report shareholder agreements that might affect their investment decisions? 21. Does the board submit compensation reports to shareholders for approval before such compensation packages are implemented? 	<p>30 for non conglomerates, 32 for conglomerates</p>	<p>30%</p>

<p>22. Does the board have a formal program for new directors and persons identified as possible successors to senior management and for other critical functions within the firm?</p> <p>23. Does the succession program cover key characteristics and nature of the industry?</p> <p>24. Does the succession program cover the financial regulatory system?</p> <p>25. Does the succession program cover the institution's strategic plans, operations and management structure?</p> <p>26. Does the succession program cover the control structure – including the role of the internal and external auditors?</p> <p>27. Does the succession program cover fiduciary duties and responsibilities of directors?</p> <p>28. Are potential successors familiar with the laws, regulations, codes, and guidelines governing the institution's operations?</p> <p>29. Are potential successors allowed to have or subject to continued training concerning products, risks, opportunities, emerging trends, industry developments, new laws?</p> <p>30. Does the board have a staggering term process for the board of directors subject to performance and eligibility for re-election?</p> <p><u>Questions for Conglomerates Only</u></p> <p>31. Is the Board of a parent company of a financial institution within a financial group informed of all material risks and matters that affect the entire group?</p> <p>32. Has the parent company board established adequate reporting structures for the subsidiaries to make sure that there is adequate oversight of the activities of the subsidiary?</p>		
<p><u>B. Board Structure</u></p> <p>1. Are at least two board members independent?</p> <p>2. Is the chairman of the board a different person from the CEO of the company?</p> <p>3. Is the division of their responsibilities clear?</p> <p>4. Are all the board members in keeping with the fit and proper guideline?</p> <p>5. Does the firm define "independence" clearly?</p> <p>6. Does the firm have a conduct review committee?</p> <p>7. Does the firm have a remuneration committee?</p> <p>8. Does the firm have a compensation committee?</p> <p>9. Does the firm have a nomination committee?</p> <p>10. Does the firm have a risk management committee?</p>	10	15%
<p><u>C. Shareholder Rights</u></p> <p>1. Does the firm hold an annual general shareholder meeting?</p> <p>2. Does the firm use the one-share-one-vote rule?</p> <p>3. Does the firm send out notices of general meetings to shareholders at least one week in advance?</p> <p>4. Does the firm allow proxy voting?</p> <p>5. Does the firm allow cumulative voting?</p>	8	20%

<p>6. Does the firm allow voting by any electronic means? (such as email, text message)</p> <p>7. Does the firm have a clearly disclosed dividend policy?</p> <p>8. Does the firm state why the dividend is set a particular value?</p>		
<p><i>D. Transparency & Disclosure</i></p> <p>1. Does the full board meet in accordance with the stipulations in the company's by-laws and articles?</p> <p>2. Has the central bank requested more frequent board meetings?</p> <p>3. Do all directors meet when the board meets?</p> <p>4. Does the firm state the attendance of individual directors at meetings?</p> <p>5. Do the directors honour their commitments to the committees and sub-committees of the board?</p> <p>6. Does the firm state the attendance of individual directors at their committee meetings?</p> <p>7. Are documents concerning the agenda, board minutes and papers forwarded to directors prior to meeting and with enough time to allow perusal of such documents?</p> <p>8. Is the meeting attendance recorded?</p> <p>9. Does the board keep a record of how persons attended the meeting – in person, via phone or other technology?</p> <p>10. Are minutes taken at each Board meeting?</p> <p>11. Do the minutes record which board members abstained from voting on a particular issue/s?</p> <p>12. Does the chairman maintain control at all board meetings?</p> <p>13. Does the chairman do so without dominating the discussions?</p> <p>14. Does the chairman stimulate debate by ensuring that each member contributes to the discussion?</p> <p>15. Does the chairman guide discussions but make sure that disagreements and discussions are resolved?</p> <p>16. Does the chairman ensure that the decisions made are properly understood and properly recorded?</p> <p>17. Does the company maintain a website?</p> <p>18. Is the annual report available for download from the company website?</p> <p>19. Does the website or annual report contain information on the biography of directors?</p> <p>20. Does the company disclose its Balance Sheet within 4 months at the end of the financial year?</p> <p>21. Does the company disclose its Profit and Loss Account within 4 months at the end of the financial year?</p> <p>22. Does the company disclose the full name of the company as well as a description of their business?</p> <p>23. Does the company disclose their registered address?</p> <p>24. Does the company disclose the address of their registrar?</p> <p>25. Does the company disclose the names and addresses of their directors?</p> <p>26. Does the company disclose their date of incorporation?</p>	31	20%

<p>27. Does the company give a brief history of their operations? 28. Does the company disclose the structure of authorized and issued capital? 29. Does the company disclose a recent capital history? 30. Does the company disclose dividend history? 31. Does the company state special conditions related to company share transfers?</p>		
<p>E. <u>Audit Committee</u></p> <p>1. Does the firm have an Audit Committee? 2. Are there at least 3 directors on the Audit Committee? 3. Is the chairman of the Audit Committee independent? 4. Are the majority of the members on the Audit Committee independent? 5. Has the Audit committee ensured that an independent audit firm is hired to audit the management’s financial statements? 6. Has the Audit Committee been able to review the financial statements and issue a report to the board before the statements have been approved? 7. Does the Audit Committee monitor management and staff compliance with policies, laws, regulations and guidelines? 8. Does the Audit Committee review investments and transactions that may adversely affect the institution? 9. Does the Audit Committee supervise audits to ensure that both internal and external auditors are acting independently of management? 10. Does the Audit Committee ensure that audits are risk based and comprehensive? 11. Does the Audit Committee monitor the efforts of management to correct shortcomings identified by internal and external auditors? 12. Does that Audit Committee ensure that the risk management function is independent and comprehensive? 13. Does the Audit Committee pursue meetings with the full board to discuss matters of concern to this committee? 14. Does the Audit Committee review returns that the CB specifies?</p>	14	15%
OVERALL COMPANY INDEX	93 for non conglomerates, 95 for conglomerates	100%