Chapter 5

CORPORATE GOVERNANCE

CHAPTER OBJECTIVES

- After exploring this chapter, you will be able to:
  1. Explain the term *corporate governance.*
  2. Understand the responsibilities of the board of directors and the major governance committees.
  3. Explain the differences between the following two governance methodologies: "comply or explain" and "comply or else."
  4. Identify an appropriate corporate governance model for an organization.

Defining Corporate Governance

- The system by which business corporations are directed and controlled
  - Managers accountable to:
    - Owners
    - Public interest or stakeholders
- Corporate governance is about the way in which boards oversee the running of a company by its managers, and how board members are in turn accountable to shareholders and the company.
- The owners of the corporation supply equity or risk capital to the company by purchasing shares in the corporation.
- Poor corporate governance weakens a company's potential and at worst can pave the way for financial difficulties and even fraud.
- Well governed companies outperform other companies and attract investors

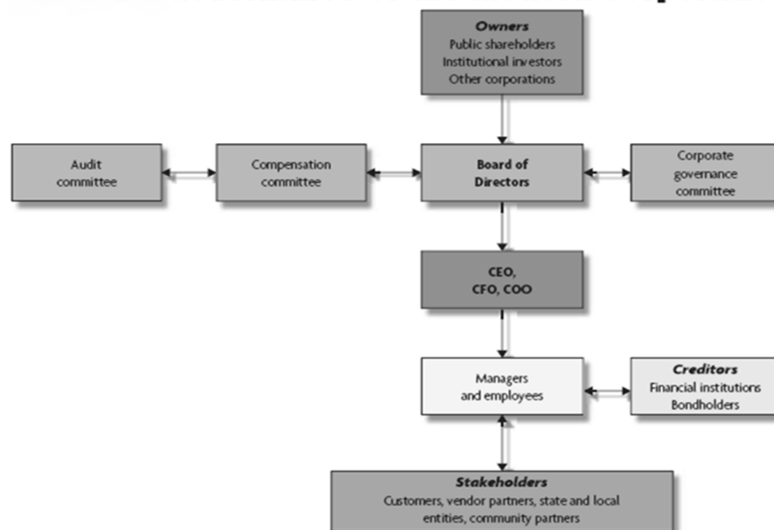
Responsibilities of the Board of Directors and the Major Governance Committees (1 of 2)

- **A board of directors** is a group of individuals hired to oversee governance of an organization.
  - Elected by vote of the shareholders at the annual general meeting (AGM), the true power of the board can vary from institution to institution from a powerful unit that closely monitors the management of the organization, to a body that merely rubber-stamps the decisions of the chief executive officer (CEO) and executive team.
  - Typically made up of inside and outside members—inside members hold management positions in the company, whereas outside members do not.
- The **audit committee** is an operating committee staffed by members of the board of directors plus independent or outside directors.
  - The committee is responsible for monitoring the financial policies and procedures of the organization, specifically:
    - Accounting policies
    - Internal controls
    - Hiring of external auditors

Responsibilities of the Board of Directors and the Major Governance Committees (2 of 2)

- The **compensation committee** is an operating committee staged by members of the board of directors plus independent or outside directors.
  - It is responsible for setting the compensation for the CEO and other senior executives.
    - Compensation typically consists of a base salary, performance bonus, stock options, and other perks.
- The **corporate governance committee** represents a more public demonstration of the organization's commitment to ethical business practices.
  - It monitors the ethical performance of the corporation and oversees compliance with the company's internal code of ethics and any federal and state regulations on corporate conduct.

Governance of the Modern Corporation



Source: Adapted from Fred R. Kaen, *A Blueprint for Corporate Governance* (New York: AMACOM, 2003).

Two Governance Methodologies

- **Comply or explain** is a set of guidelines that require companies to abide by a set of operating standards or explain why they choose not to.
- The Cadbury report argued for a guideline of comply or explain, which gave companies the flexibility to comply with governance standards or explain why they do not in their corporate documents.
- The vagueness of what constitutes an acceptable explanation for not complying and the ease of the explanations could be buried in the footnotes of an annual report (if they were even there at all).
- This vagueness raised concerns that comply or explain would not do much to help corporate governance.
    - The report concluded that comply or explain offered no real deterrent to corporations.
- **Comply or else** is a set of guidelines that require companies to abide by a set of operating standards or face stiff financial penalties.
- The Sarbanes-Oxley Act of 2002 incorporates this approach

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THE SARBANES-OXLEY ACT OF 2002

- Because reliance on corporate boards to police themselves did not seem to be working, Congress passed the Public Accounting Reform and Investor Protection Act of 2002, commonly known as the **Sarbanes-Oxley Act**, which is enforced by the Securities and Exchange Commission (SEC).
    - The act applies to over 15,000 publicly held companies in the United States and some foreign issuers.
    - In addition, a number of states have enacted legislation similar to Sarbanes-Oxley that apply to private firms.
    - Some private for-profts and nonprofits have begun to hold themselves to Sarbanes-Oxley standards even though they are not necessarily subject to its requirements.

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THE SARBANES-OXLEY ACT OF 2002

- Sarbanes-Oxley strived to respond to the scandals by regulating safeguards against unethical behavior.
- Because one cannot necessarily predict each and every lapse of judgment, no regulatory "fix" is perfect. However, the act is intended to provide protection where oversight did not previously exist.
- Sarbanes-Oxley seeks to provide oversight in terms of direct lines of accountability and responsibility.

THE SARBANES-OXLEY ACT OF 2002

- The following provisions have the most significant impact on **corporate governance** and boards:
  - Section 201: Services outside the scope of auditors—prohibits various forms of professional services that are determined to be consulting rather than auditing.
  - Section 301: Public company audit committees (requires independence), mandating majority of independents on any board (and all on audit committee) and total absence of current or prior business relationships.
  - Section 307: Rules of professional responsibility for attorneys—requires lawyers to report concerns of wrongdoing if not addressed.

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- Section 404: Management assessment of **internal controls**—requires that management file an internal control report with its annual report each year in order to delineate how management has established and maintained effective internal controls over financial reporting.
- Section 406: Codes of ethics for senior financial officers (required).
- Section 407: Disclosure of audit committee financial expert—requires that they actually have an expert.

- Sarbanes-Oxley includes requirements for certification of the documents by officers. When a firm's executives and auditors are required to literally sign off on these statements, certifying their veracity, fairness, and completeness, they are more likely to personally ensure their truth.

THE SARBANES-OXLEY ACT OF 2002

- One of the most significant criticisms of the act is that it imposes extraordinary financial costs on the firms—the costs are apparently even higher than anticipated.
  - In response, one year after its implementation, in May 2005, the Public Company Accounting Oversight Board (PCAOB) released a statement publicly acknowledging the high costs and issuing guidance for implementation "in a manner that captures the benefits of the process without unnecessary and unsustainable costs."
  - The PCAOB now advocates a more risk-based approach where the focus of internal audit assessments is better aligned with high-risk areas than those with less potential for a material impact.

Identify an Appropriate Corporate Governance Model for an Organization

- ❖ To be considered effectively governed, organizations must have mechanisms in place that oversee both the long-term strategy of the company and the appointment of those personnel tasked with the responsibility of delivering that strategy
- First step in disregarding the corporate governance model – merge the roles of chief executive officer (CEO) and chairman of the board into one individual
  - ➢ In favor of merging – efficiency and conflict minimized
  - ➢ Opposed to merging – governance needs checks and balances
- Truly **effective** boards should follow six steps:

1. Create a climate of trust and candor
2. Foster a culture of open dissent
3. Mix up roles
4. Ensure individual accountability
5. Let the Board assess leadership talent
6. Evaluate the Board's performance

Identify an Appropriate Corporate Governance Model for an Organization

- Simply maintaining a checklist of items to be monitored on a regular basis is not enough.
- Corporate governance is about managers fulfilling a fiduciary responsibility to the owners of their companies
- **Fiduciary responsibility** - based on trust
- Key Safeguards
  - ➢ Properly constituted boards
  - ➢ Separation of the functions of chairperson and CEO
  - ➢ Audit committees
  - ➢ Vigilant shareholders
  - ➢ Financial reporting and auditing systems
- A commitment to good corporate governance makes a company both more attractive to investors and lenders, and more profitable.

❖ **Review Questions:**

1. Discuss the responsibilities of the Board of Directors and the major governance committees.
2. Define corporate governance and briefly explain the two governance methodologies.