CHAPTER 5
Corporate Governance

Chapter Summary

This chapter examines the challenges in maintaining an ethical culture within an organization. What policies and procedures should be put into place to ensure that the company conducts itself in an ethical manner, and what should be the consequences when evidence of unethical conduct is found? The chapter begins by explaining and defining corporate governance and how it should be organized in a firm. It discusses the roles and responsibilities of different executives, as well as major governance committees and the Board of Directors. Further, the two methodologies, “comply or explain” and “comply or else” are differentiated.

Learning Objectives

After studying this chapter, the student should be able to:

1. Explain the term corporate governance.
2. Explain the respective roles of the Chief Executive Officer (CEO), Chief Financial Officer (CFO), and Chief Operating Officer (COO).
3. Understand the responsibilities of the Board of Directors.
4. Explain the responsibilities of the major governance committees.
5. Explain the differences between the following two governance methodologies: “comply or explain” and “comply or else.”
6. Identify an appropriate corporate governance model for an organization.

Extended Chapter Outline

Objective 1: Explain the term corporate governance.
1.1. The opening Frontline Focus case shows how a paralegal is faced with making ethical decisions in dealing with lawsuits.
   1.1.1. Corporate governance is the system by which business corporations are directed and controlled.
   1.1.2. 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.
   1.1.3. The owners of the corporation supply equity or risk capital to the company by purchasing shares in the corporation.

Objective 2: Explain the respective roles of the Chief Executive Officer (CEO), Chief Financial Officer (CFO), and Chief Operating Officer (COO).
2.1 Stockholders should elect members of the board or directors, the BoD then should elect a chairman
2.2 First step in a policy of disregarding the corporate governance model is the decision to merge the roles of chief executive officer (CEO) and chairman of the board into one individual
2.2.1 In favor of merging CEO and Chairman – Efficiency
2.2.2 Against merging two roles – Ethics – no checks and balances

**Objective 3: Understand the responsibilities of the Board of Directors**

3.1 **Board of directors** is a group of individuals hired to oversee governance of an organization.

3.2 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.

3.3 Typically made up of inside and outside members – inside members hold management positions in the company, whereas outside members do not.

**Objective 4: Explain the responsibilities of the major governance committees.**

4.1 The **Audit Committee** is an operating committee staffed by members of the board of directors plus independent or outside directors.

4.1.1 Responsible for monitoring the financial policies and procedures of the organization

4.1.1.1 Accounting policies

4.1.1.2 Internal controls

4.1.1.3 Hiring of external auditors

4.2 The **Compensation committee** is an operating committee staged by members of the board of directors plus independent or outside directors.

4.2.1 Responsible for setting the compensation for the CEO and other senior executives

4.2.1.1 Compensation consists of base salary, performance bonus, stock options, and other perks

4.3 The Corporate Governance committee represents a more public demonstration of the organization’s commitment to ethical business practices

4.3.1 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

**Objective 5: Explain the differences between the following two governance methodologies: “comply or explain” and “comply or else.”**

5.1 In 1992 Sir Adrian Cadbury led a committee in Great Britain to address “Financial Aspects of Corporate Governance” in response to public concerns over directors’ compensation at several high-profile companies in Great Britain

5.2 In 1994, Mervyn King led a committee that published the “King Report on Corporate Governance”

5.2.1 King Report incorporated a code of corporate practices and conduct that looked beyond the corporation itself, taking into account its impact on the larger community

5.2.2 Known as “King I” went beyond the financial and regulatory accountability upon which the Cadbury Report had focused

5-2
5.2.3 Recognized as advocating the highest standards for corporate governance, the committee released a second report eight years later – “King II”

5.2.4 King II recognized the need to move the stakeholder model forward and consider a triple bottom line as opposed to the traditional single bottom line of profitability

5.2.5 King II reported companies must “comply or explain” or “comply or else”

5.3 “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.

5.4 “Comply or Else” is a set of guidelines that require companies to abide by a set of operating standards or face stiff financial penalties

**Objective 6: Identify an appropriate corporate governance model for an organization.**

6.1 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

6.2 Truly effective boards should follow six steps:
   6.2.1 Create a climate of trust and candor
   6.2.2 Foster a culture of open dissent
   6.2.3 Mix up roles
   6.2.4 Ensure individual accountability
   6.2.5 Let the board assess leadership talent
   6.2.6 Evaluate the board’s performance

6.3 Walter Salmon developed a checklist of 22 questions to assess the quality of a board of directors in a 1993 *Harvard Business Review* article

6.4 Simply maintaining a checklist of items to be monitored on a regular basis is not enough

6.5 A fiduciary responsibility is ultimately based on trust

6.6 A commitment to good corporate governance makes a company both more attractive to investors and lenders, and more profitable

**Key Terms**

**Audit Committee:** 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 the accounting policies, internal controls, and the hiring of external auditors.

**Board of Directors:** A group of individuals hired to oversee governance of an organization. Elected by vote of 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.

**Compensation Committee:** An operating committee staffed by members of the board of directors plus independent or outside directors. The committee is responsible for setting
the compensation for the CEO and other senior executives. Typically, this compensation will consist of a base salary, performance bonus, stock options, and other perks.

“Comply or Else”: A set of guidelines that require companies to abide by a set of operating standards or face stiff financial penalties.

“Comply or Explain”: A set of guidelines that require companies to abide by a set of operating standards or explain why they choose not to.

Corporate Governance: The system by which business corporations are directed and controlled.