

Chapter 2

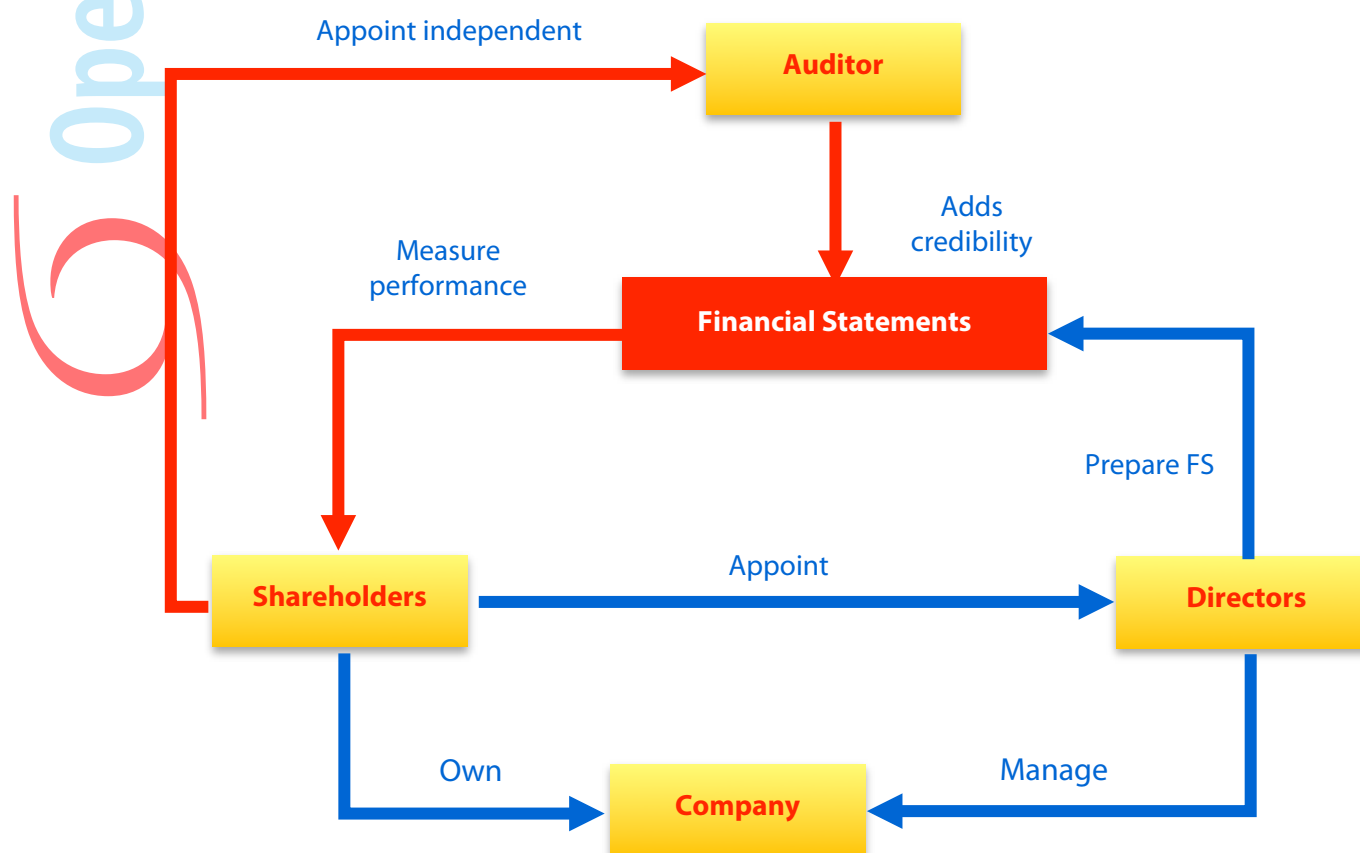
CORPORATE GOVERNANCE

1. Why corporate governance is needed

Corporate governance is the system by which companies are directed and controlled.

The problem with bad corporate governance is that although the shareholders own companies, the day-to-day management and direction of companies is given to the Board of Directors. In large companies many shareholders are relatively passive and the Board of Directors is given more or less free rein to make whatever decisions they wish.

Auditing was instituted so at least once a year, when the financial statements were presented to the members of the company, the auditors would examine them and give some expression of opinion to the members of the company as to whether the financial statements were true and fair. Without that assurance the members of the company really would have a little idea whether or not the information could be relied on. The auditors therefore examine the financial statements and this adds credibility to those statements, the shareholders have a much better idea of the performance of the directors and the company.



Note that shareholders appoint the independent auditors, they also appoint the directors. The problem is that once directors were appointed, shareholders often didn't take much further interest in what the directors were doing and there were annual gaps between financial statements being issued. This hands-off approach has recently been found entirely inadequate.



and additional safeguards have been instituted to try to ensure that directors act in the best interests of the members of the company. Directors should act for the shareholders but often acted for themselves – the agency problem. In agency terms, the shareholders are the principals and the directors are their agents. Agents should act in the best interests of their principals.

2. Principles of corporate governance

The Organisation of Economic Cooperation Development (OECD) has put forward some principles of corporate governance:

- Corporate governance frameworks should protect shareholders rights, ensuring fair treatment of all shareholders, particularly minority and foreign shareholders. For example all shareholders should have access to the same information.
- The corporate governance framework should also recognize the rights of all stakeholders, not just shareholders, and should encourage active cooperation between the entities and stakeholders in creating wealth, jobs and sustainability of financially sound entities.
- There should be disclosure and transparency.
- The corporate governance framework should ensure that timely accurate information is made available in all material matters.
- Responsibility of the board is also covered, and the corporate governance framework should ensure the strategic guidance of the entity, effective monitoring of management by the board and the board's accountability to the entity and their shareholders. In particular the board should set its own objectives, monitor its own performance and have its own performance assessed.

3. The UK Corporate Governance Code

The OECD principles are put into effect in a variety of ways in different countries. The ACCA has specified that for F8 the UK Corporate Governance Code can be referred to as an example of best practice.

The code states that the purpose of corporate governance is to facilitate effective entrepreneurial and

prudent management that can deliver long-term success of the company. It then goes on to list the main principles of the code:

Main principles

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Relations with shareholders



Comply or explain

The code has no force in law and is enforced on listed companies through the Stock Exchange. Listed companies are expected “comply or explain” and this approach is the trademark of corporate governance in the UK.

Listed companies have to state that they have complied with the code or else explain to shareholders why they haven't. This allows some flexibility and non-compliance might be acceptable in some circumstances.

Leadership

- Every company should be headed by an effective board which is collectively responsible for the longterm success of the company.
- There should be a clear division ... between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision. This means that the roles of CEO and Chairman should not be performed by one person as that concentrates too much power in that person.
- The chairman is responsible for leadership of the board
- Non-executive directors (NEDs) must be appointed to the board and they should constructively challenge and help develop proposals on strategy. NEDs sit in at board meeting and have full voting rights, but do not have day to day executive or managerial responsibility. Their function is to monitor, advise and warn the executive directors.

Effectiveness

- The board should have an appropriate balance of skills, experience, independence and knowledge. In large companies NEDS should be at least 50% of the board; in small companies there should be at least 2 NEDS.
- New directors should be appointed by a Nomination Committee to ensure a formal, rigorous and transparent procedure for their appointment. The Nomination Committee consists of NEDs. This provision is to prevent directors appointing their friends and colleagues to the board and ensures that the best people for the job are considered and appointed.
- All directors should be able to allocate sufficient time to company business
- There should be induction on joining the board and a programme to update and refresh directors' skills and knowledge.
- The board should be supplied in a timely manner with necessary information
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- All directors should be submitted for re-election at regular intervals

Accountability

- The board should present a balanced and understandable assessment of the company's position and prospects.
- The board is responsible for determining the ... significant risks ...and should maintain sound risk management and internal control systems.
- The board should establish formal and transparent arrangements for applying the corporate reporting, risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor. This means that an



Audit Committee (NEDs again) should be established to liaise with both internal and external auditors. Before audit committees, the finance director liaised with auditors, but this was not satisfactory because the finance director was often the person responsible for accounting problems. Therefore auditors were often reporting problems to the person who caused them. The directors are responsible for establishing an internal control system and must review the need for internal audit.

Remuneration

- Levels of remuneration should be sufficient to attract, retain and motivate directors of sufficient quality... but avoid paying more than is necessary.
- A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. In other words, profit related pay is encouraged. Directors should not receive high pay irrespective of company performance.
- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. This means that a Remuneration Committee (NEDs) should be formed to fix directors' remuneration.

Relations with shareholders

One of the problems with achieving good corporate was encouraging shareholders to take an active interest in the company. Too often they did not fully participate at AGMs and would wave through motions. This passive attitude might well have been encouraged by directors to move power towards them and away from members.

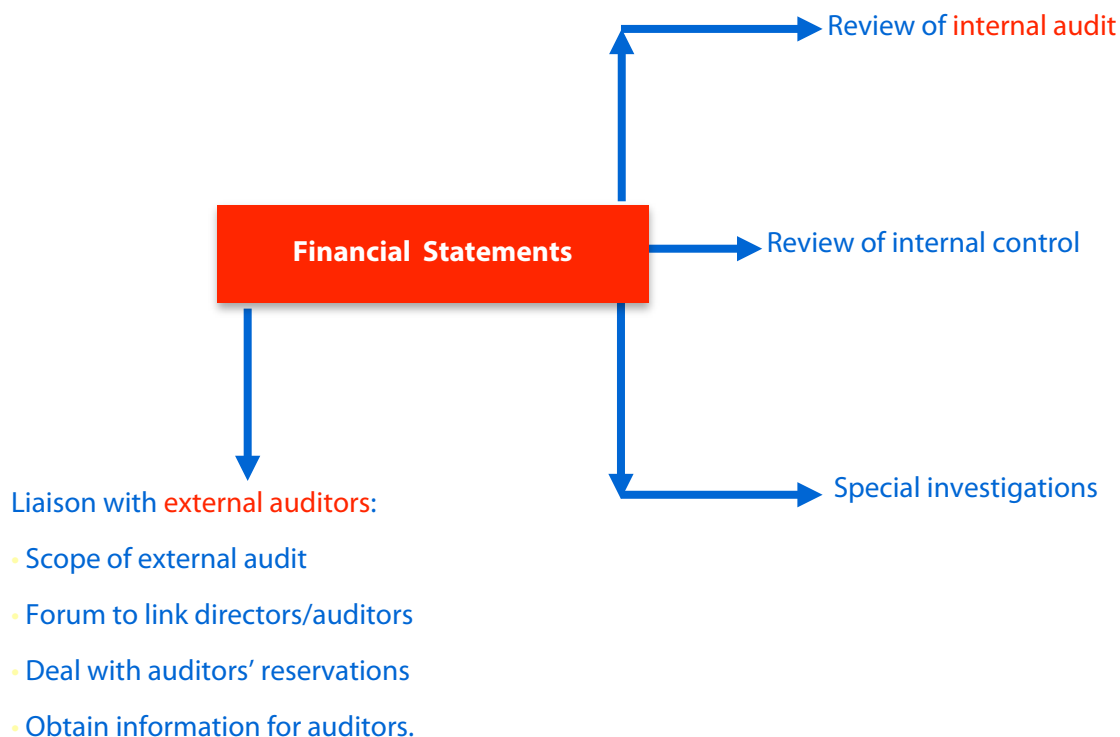
The code therefore specifies:

- There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.
- The board should use the AGM to communicate with investors and to encourage their participation.



4. The role of the audit committee

The audit committee is now very important part of corporate governance.



The committee should be dominated by non-executive directors. The functions are as follows:

- They will review the work of internal audit. Companies don't have to have an internal audit department, but corporate governance rules now stated that management should keep the need for internal audit on the review.
- The audit committee will review the system of internal control. Corporate governance now imposes on management the requirement that they implement a system of internal control.
- From time to time the audit committee may launch special investigations. For example, if a fraud had been discovered within the organisation the audit committee may ask for a report on how it happened and how to prevent it in the future.
- Liaison with external auditors. It used to be that external auditors would communicate almost exclusively with the finance director, but of course the finance director may not be sufficiently independent of the finance function and the system of internal control. Now, the audit committee will set the scope for the external audit. They act as a forum to link directors and auditors. Auditors will typically write to the audit committee about any problems they may be having on the audit or obtaining all the information they require. If the auditors are worried in some way about the financial statements they will raise those concerns with the audit committee.
- If the auditors can't find information in any other way and feel perhaps they are being obstructed, they can go to the audit committee and explain the problem and the audit committee can try and investigate on their behalf.



Liaise on the process of appointing auditors and setting their fees. (Note that the external auditors are appointed by members in general meeting, but the audit committee is likely to make recommendations.)

5. Small entity exemptions

Many countries have legislation which exempts small entities from the requirement to be audited. The main justification for this is that the managers and directors are likely to be the owners so therefore the need for independent monitoring of management doesn't arise. Besides that, these small entities often have simple trading, simple records and limited internal controls which management can anyway override. In such environments, auditing the financial statements is seen as an unnecessary expense.

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