CORPORATE GOVERNANCE: THE BOARD OF DIRECTORS AND STANDING COMMITTEES

The syllabus for Paper F1/FAB, *Accountant in Business*, requires candidates to understand the meaning of corporate governance and the role of the board of directors in establishing and maintaining good standards of governance. Specifically, the *Study Guide* refers to the separation of ownership and control, the role of non-executive directors and two of the standing committees commonly established by public companies. This article provides an introduction to corporate governance and some of the basic concepts that underpin it, and explains the roles of the board, the different types of company director and standing committees.

WHAT IS CORPORATE GOVERNANCE?

The simplest and most concise definition of corporate governance was provided by the Cadbury Report in 1992, which stated: *Corporate governance is the system by which companies are directed and controlled.*

Though simplistic, this definition provides an understanding of the nature of corporate governance and the vital role that leaders of organisations have to play in establishing effective practices. For most companies, those leaders are the directors, who decide the long-term strategy of the company in order to serve the best interests of the owners (members or shareholders) and, more broadly, stakeholders, such as customers, suppliers, providers of long-term finance, the community and regulators.

It is important to recognise that effective corporate governance relies to some extent on compliance with laws, but being fully compliant does not necessarily mean that a company is adopting sound corporate governance practices. Significantly, the Cadbury Report was published in the UK shortly after the collapse of Maxwell Communications plc, a large publishing company. Many of the actions that brought about the collapse, such as the concentration of power in the hands of one individual and the company borrowing from its pension fund in order to achieve leveraged growth, were legal at the time.

The Organisation for Economic Co-operation and Development published its ‘Principles of Corporate Governance’ in 2004. These are:

- *Rights of shareholders*: The corporate governance framework should protect shareholders and facilitate their rights in the company. Companies should generate investment returns for the risk capital put up by the shareholders.
- *Equitable treatment of shareholders*: All shareholders should be treated equitably (fairly), including those who constitute a minority, individuals and foreign shareholders.

Shareholders should have redress when their rights are contravened or where an individual shareholder or group of shareholders is oppressed by the majority.

- *Stakeholders*: The corporate governance framework should recognise the legal rights of stakeholders and facilitate cooperation with them in order to create wealth, employment and sustainable enterprises.
- *Disclosure and transparency*: Companies should make relevant, timely disclosures on matters affecting financial performance, management and ownership of the business.
- *Board of directors*: The board of directors should set the direction of the company and monitor management in order that the company will achieve its objectives. The corporate governance framework should underpin the board's accountability to the company and its members.

TO WHOM IS CORPORATE GOVERNANCE RELEVANT?

Corporate governance is important in all but the smallest organisations. Limited companies have a primary duty to their shareholders, but also to other stakeholders as described above. Not-for-profit organisations must also be directed and controlled appropriately, as the decisions and actions of a few individuals can affect many individuals, groups and organisations that have little or no influence over them. Public sector organisations have a duty to serve the State but must act in a manner that treats stakeholders fairly.

Most of the attention given to corporate governance is directed towards public limited companies whose securities are traded in recognised capital markets. The reason for this is that such organisations have hundreds or even thousands of shareholders whose wealth and income can be enhanced or compromised by the decisions of senior management. This is often referred to as the **agency problem**. Potential and existing shareholders take investment decisions based on information that is historical and subjective, usually with little knowledge of the direction that the company will take in the future. They therefore place trust in those who take decisions to achieve the right balance between return and risk, to put appropriate systems of control in place, to provide timely and accurate information, to manage risk wisely, and to act ethically at all times.
The agency problem becomes most evident when companies fail. In order to make profits, it is necessary to take risks, and sometimes risks that are taken with the best intentions – and are supported by the most robust business plans – result in loss or even the demise of the company. Sometimes corporate failure is brought about by inappropriate behaviours of directors and other senior managers.

As already mentioned, in the UK, corporate governance first came into the spotlight with the publication of the Cadbury Report, shortly after two large companies (Maxwell Communications plc and Polly Peck International plc) collapsed. Ten years later, in the US, the Sarbanes-Oxley Act was passed as a response to the collapse of Enron Corporation and WorldCom. All of these cases involved companies that had been

highly successful and run by a few very powerful individuals, and all involved some degree of criminal activity on their part.

The recent credit crisis has brought about renewed concern about corporate governance, specifically in the financial sector. Although the roots of the crisis were mainly financial and originated with adverse conditions in the wholesale money markets, subsequent investigations and reports have called into question the policies, processes and prevailing cultures in many banking and finance-related organisations.

APPROACHES TO CORPORATE GOVERNANCE

Most countries adopt a principles-based approach to corporate governance. This involves establishing a comprehensive set of best practices to which listed companies should adhere. If it is considered to be in the best interests of the company not to follow one or more of these standards, the company should disclose this to its shareholders, along with the reasons for not doing so. This does not necessarily mean that a principles-based approach is a soft option, however, as it may be a condition of membership of the stock exchange that companies strictly follow this 'comply or explain' requirement.

Some countries prefer a rules-based approach through which the desired corporate governance standards are enshrined in law and are therefore mandatory. The best example of this is the US, where the Sarbanes-Oxley Act lays down detailed legal requirements.

THE ROLE OF THE BOARD OF DIRECTORS

Nearly all companies are managed by a board of directors, appointed or elected by the shareholders to run the company on their behalf. In most countries, the directors are subject to periodic (often annual) re-election by the shareholders. This would appear to give the shareholders ultimate power, but in most sectors it is recognised that performance can only be judged over the medium to long-term. Shareholders therefore have to place trust in those who act on their behalf. It is rare but not unknown for shareholders to lose patience with the board and remove its members *en masse*.

The role of the board of directors was summarised by the King Report (a South African report on corporate governance) as:

- to define the purpose of the company
- to define the values by which the company will perform its daily duties
- to identify the stakeholders relevant to the company
- to develop a strategy combining these factors
- to ensure implementation of this strategy.

The purpose and values of a company are often set down in its constitutional documents, reflecting the objectives of its founders. However, it is sometimes appropriate for the board to consider whether it is in the best interests of those served

by the company to modify this or even change it completely. For example, NCR Corporation is a US producer of automated teller machines and point-of-sale systems, but its origins lay in mechanical accounting machines (NCR represents National Cash Register). As cash registers would quickly become obsolete with the emergence of microchip technology, the company had to adapt very rapidly. Whitbread plc originated as a brewer in the 18th century in the UK, but in the 1990s redefined its mission and objectives completely. It is now a hospitality and leisure provider (its brands include Premier Inn and Costa coffee) and has abandoned brewing completely.

The directors must take a long-term perspective of the road that the company must travel. Management writer William Ouchi attributes the enduring success of many Japanese companies to their ability to avoid short-term ‘knee-jerk’ reactions to immediate issues in favour of consensus over the best direction to take in the long-term.

STRUCTURE OF THE BOARD OF DIRECTORS

There is no convenient formula for defining how many directors a company should have, though in some jurisdictions company law specifies a minimum and/or maximum number of directors for different types of company. Tesco plc, a large multinational supermarket company, has 13 directors. Swire Pacific Limited, a large Hong Kong conglomerate, has 18 directors. Smaller listed companies generally have fewer directors, typically six to eight persons.

The board of directors is made up of **executive directors** and **non-executive directors. Executive directors** are full-time employees of the company and, therefore, have two relationships and sets of duties. They work for the company in a senior capacity, usually concerned with policy matters or functional business areas of major strategic importance. Large companies tend to have executive directors responsible for finance, IT/IS, marketing and so on.
Executive directors are usually recruited by the board of directors. They are the highest earners in the company, with remuneration packages made up partly of basic pay and fringe benefits and partly performance-related pay. Most large companies now engage their executive directors under fixed term contracts, often rolling over every 12 months.

The chief executive officer (CEO) and the finance director (in the US, chief financial officer) are nearly always executive directors.

Non-executive directors (NEDs) are not employees of the company and are not involved in its day-to-day running. They usually have full-time jobs elsewhere, or may sometimes be prominent individuals from public life. The non-executive directors usually receive a flat fee for their services, and are engaged under a contract for service (civil contract, similar to that used to hire a consultant).
NEDs should provide a balancing influence and help to minimise conflicts of interest. The Higgs Report, published in 2003, summarised their role as:

- to contribute to the strategic plan
- to scrutinise the performance of the executive directors
- to provide an external perspective on risk management
- to deal with people issues, such as the future shape of the board and resolution of conflicts.

The majority of non-executive directors should be independent. Factors to be considered in assessing their independence include their business, financial and other commitments, other shareholdings and directorships and involvement in businesses connected to the company. However, holding shares in the company does not necessarily compromise independence.

Non-executive directors should have high ethical standards and act with integrity and probity. They should support the executive team and monitor its conduct, demonstrating a willingness to listen, question, debate and challenge.

It is now recognised as best practice that a public company should have more non-executive directors than executive directors. In Tesco plc, there are five executive directors and eight independent non-executive directors. Swire Pacific Ltd has eight executive directors and 10 non-executive directors, of which six are independent non-executive directors.

An individual may be accountable in law as a **shadow director**. A shadow director is a person who controls the activities of a company, or of one or more of its actual directors, indirectly. For example, if a person who is unconnected with a company gives instructions to a person who is a director of the company, then the second person is an actual director while the first person is a shadow director. In some jurisdictions, shadow directors are recognised as being as accountable in law as actual directors.

UNITARY V TWO-TIER BOARDS

The unitary board model is adopted by, *inter alia*, companies in the UK, US, Australia and South Africa. The company's directors serve together on one board comprising both executive and non-executive directors.

In many countries in continental Europe, companies adopt a two-tier structure. This separates those responsible for supervision from those responsible for operations. The supervisory board generally oversees the operating board.

Paper FAB, *Accountant in Business*, focuses mainly on the unitary board system, though knowledge of both models is required for subsequent studies for Paper P1,*Governance, Risk and Ethics*.

KEY POSITIONS

The **chairman** of the company is the leader of the board of directors. It is the chairman's responsibility to ensure that the board operates efficiently and effectively, get the best out of all of its members. The chairman should, for example, promote regular attendance and full involvement in discussions. The chairman decides the

scope of each meeting and is responsible for time management of board meetings, ensuring all matters are discussed fully, but without spending limitless time on individual agenda items. In most companies the chairman is a non-executive director. The **chief executive officer** (CEO) is the leader of the executive team and is responsible for the day-to-day management of the organisation. As such, this individual is nearly always an executive director. As well as attending board meetings in his or her capacity as a director, the CEO will usually chair the management committee or executive committee. While most companies have monthly board meetings, it is common for management/executive committee meetings to be weekly.
The **secretary** is the chief administrative officer of the company. The secretary provides the agenda and supporting papers for board meetings, and often for executive committee meetings also. He or she takes minutes of meetings and provides advice on procedural matters, such as terms of reference. The secretary usually has responsibilities for liaison with shareholders and the government registration body. As such, the notice of general meetings will be signed by the secretary on behalf of the board of directors. The secretary may be a member of the board of directors, though some smaller companies use this position as a means of involving a high potential individual at board level prior to being appointed as a director.

SEGREGATION OF RESPONSIBILITIES

It is generally recognised that the CEO should not hold the position of chairman, as the activities of each role are quite distinctive from one another. In larger companies, there would be too much work for one individual, though in Marks & Spencer, a large listed UK retail organisation, one person did occupy both positions for several years.

The secretary should not also be the chairman of the company. As the secretary has a key role in liaising with the government registration body, having the same person occupying both roles could compromise the flow of information between this body and the board of directors.

STANDING COMMITTEES

The term ‘standing committee’ refers to any committee that is a permanent feature within the management structure of an organisation. In the context of corporate governance, it refers to committees made up of members of the board with specified sets of duties. The four committees most often appointed by public companies are the audit committee, the remuneration committee, the nominations committee and the risk committee.

The *Syllabus* and *Study Guide* for Paper F1/FAB require students to study only two committees. These are the audit committee and the remuneration committee.

AUDIT COMMITTEE

This committee should be made up of independent non-executive directors, with at least one individual having expertise in financial management. It is responsible for:

- oversight of internal controls; approval of financial statements and other significant documents prior to agreement by the full board
- liaison with external auditors
- high level compliance matters
- reporting to the shareholders.

Sometimes the committee may carry out investigations and may deal with matters reported by whistleblowers.

REMUNERATION COMMITTEE

This committee decides on the remuneration of executive directors, and sometimes other senior executives. It is responsible for formulating a written remuneration policy that should have the aim of attracting and retaining appropriate talent, and for deciding the forms that remuneration should take. This committee should also be made up entirely of independent non-executive directors, consistent with the principle that executives should not be in a position to decide their own remuneration.

It is generally recognised that executive remuneration packages should be structured in a manner that will motivate them to achieve the long-term objectives of the company. Therefore, the remuneration committee has to offer a competitive basic salary and fringe benefits (these attract and retain people of the right calibre), combined with performance-related rewards such as bonuses linked to medium and long-term targets, shares, share options and eventual pension benefits (often subject to minimum length of service requirements).

PUBLIC OVERSIGHT

Public oversight is concerned with ensuring that the confidence of investors and the general public in professional accountancy bodies is maintained. This can be achieved by direct regulation, the imposition of licensing requirements (including, where appropriate, exercising powers of enforcement) or by self-regulation. As the US operates a rules-based system of governance, these responsibilities are discharged by the Public Company Accounting Oversight Board, which has the power to enforce mandatory standards and rules laid down by the Sarbanes-Oxley Act. In the UK, regulation is the responsibility of the Professional Oversight team of the Financial Reporting Council.

SAMPLE QUESTIONS

Candidates may find it useful to consider questions on this topic identified in examiner's reports as well as the pilot paper. As past question papers are not made available, the following questions are included in this article as examples of typical requirements. It must be emphasised that these questions are not taken from the actual question bank.

Sample question 1:

LLL Company is listed on its country's stock exchange. The following individuals serve on the board of directors:

Asif is a non-executive director and is the chairman of the company.
Bertrand is the CEO and is responsible for the day-to-day running of the company.
Chan is a professional accountant and serves as a non-executive director.
Donna is the finance director and is an employee of the company.
Esther is a legal advocate and serves as a non-executive director.
Frederik is the marketing director of a manufacturing company and serves as a non-executive director.

Which of the following is the most appropriate composition of directors for LLL Company's audit committee?

A Chan, Donna and Esther
B Asif, Bertrand and Frederik
C Asif, Esther and Frederik
D Chan, Esther and Frederik

The correct answer is D. Executive directors should not serve on the audit committee. This eliminates options A and B. Option D is the best choice, as the audit committee should have at least one director with expertise in finance.

Sample question 2:

Which of the following is a duty of the secretary of a listed public company?

A Maintaining order at board meetings
B Clarifying the terms of reference of the board meeting
C Ensuring that all directors contribute fully to discussions at board meetings
D Reporting to the board on operational performance for the last quarter

The correct answer is B. Options A and C are responsibilities of the chairman, while option D is the responsibility of the CEO.

Sample question 3:

The board of directors of JJJ Company has decided to increase the basic salary of its chief executive officer by 20% in order to bring her pay into line with those occupying similar positions in the industry.

This action will achieve which of the following purposes?

A Improve the prospect of retaining the chief executive officer
B Increase the productivity of the chief executive officer by at least 20%
C Motivate the chief executive officer to achieve long-term targets
D Create greater job satisfaction for the chief executive officer

The correct answer is A.

The basic pay offered by a company serves as a beacon to attract applicants, and can also deter the present incumbent of a position from seeking opportunities elsewhere, especially if they perceive themselves to be underpaid at present.

A substantial pay increase is unlikely to achieve a significant increase in productivity or increase long-term motivation (though pay increases can have a short-term impact

on motivation). Job satisfaction is derived from factors other than remuneration, such as challenges inherent in the work and the nature of the tasks performed.

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