Corporate Governance

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the impact of recent guidelines and regulatory changes on corporate governance. Specifically, this lesson will cover:

1. Defining Corporate Governance

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

- Regulatory and market mechanisms
- Roles and relationships between a company's management, its board, its shareholders, and other stakeholders
- Goals for which the corporation is governed

In contemporary business corporations, the main external **stakeholder** groups are shareholders, debtholders, trade creditors, suppliers, customers, and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees.
Much of the contemporary interest in corporate governance is concerned with mitigation of the **conflicts of interests** between stakeholders. Ways of mitigating or preventing these conflicts of interests include the processes, customs, policies, laws, and institutions which have impact on the way a company is controlled. An important theme of corporate governance is the nature and extent of accountability of people in the business.

A related but separate thread of discussion focuses on the impact of a corporate governance system on economic efficiency, with a strong emphasis on shareholders' welfare. In large firms where there is a separation of ownership and management and no controlling shareholder, the principal-agent issue arises between upper-management (the "agent") which may have very different interests, and by definition considerably more information, than shareholders (the "principals"). Rather than overseeing management on behalf of shareholders, the board of directors may become insulated from shareholders and beholden to management. This aspect is particularly present in contemporary public debates and developments in regulatory policy.

TERMS TO KNOW

Corporate Governance

The roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed. Much of the contemporary interest in corporate governance is concerned with mitigation of the conflicts of interests and the nature and extent of accountability of people in the business.

Stakeholders

A person or organization with a legitimate interest in a given situation, action or enterprise.

Conflicts of Interest

Occurs when an individual or organization is involved in multiple interests, one of which could possibly corrupt the motivation for an act in the other.

2. Principles

Contemporary discussions of corporate governance tend to refer to principles raised in three documents released since 1990:

- The Cadbury Report (UK, 1992)
- The Principles of Corporate Governance (OECD, 1998 and 2004)
- The Sarbanes-Oxley Act of 2002 (US, 2002)

The important principles that are addressed in the concept of corporate governance are described in the table below.

Principle	Description
Treatment of Shareholders	Companies must respect the rights of shareholders and beyond that, help them exercise those rights. This is largely done through effective communication and encouraging participation at annual shareholder meetings.
Treatment of Other Stakeholders	Companies should act in a way that respects the social, legal, and market-driven relationships that they have with employees, debtors, creditors, and local communities, among others.
Role of the Board	Board members must have relevant skills and knowledge to review management performance. It needs enough members to provide appropriate levels of independence and commitment.
Integrity and Ethical Behavior	Integrity is a fundamental requirement for corporate officers and board members. Organizations must develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.
Disclosure and Transparency	Organizations should make publicly known the roles and responsibilities of board and management to provide stakeholders with some accountability. They should also have procedures to verify and safeguard the integrity of their financial reporting. Disclosure of material matters should be timely and balanced so that all investors have clear, factual information.

3. Sarbanes–Oxley Act of 2002

The Sarbanes–Oxley Act of 2002 is a federal law that sets standards for all domestic company boards of directors, management and accounting firms. It’s more commonly called Sarbanes–Oxley or SOX.

DID YOU KNOW

The Sarbanes-Oxley Act of 2002 is named after sponsors US Senator Paul Sarbanes (D-MD) and US Representative Michael G. Oxley (R-OH).

Top management must now certify the accuracy of published financial statements. Penalties for fraud are more severe. SOX increased the oversight role of boards of directors and the independence of auditors who review the accuracy of statements.

The bill was passed after major scandals involving Enron and Tyco International. These cost investors billions of dollars and rattled public confidence in the securities markets.

Changes enacted by Sarbanes-Oxley included:

- Establishing the Public Company Accounting Oversight Board in order to provide independent oversight of accounting firms and **audits**.
- Establishing standards for the independence of **external auditors**, including new auditor approval and reporting requirements.
- Mandating that senior executives take personal responsibility for the accuracy of financial reports, including the definition of the relationship between external auditors and corporate audit committees.
- Setting reporting requirements for financial transactions, including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers.
- Restoring investor confidence in securities analysts by requiring disclosure of conflicts of interest.
- Requiring the Comptroller General and the SEC to study and report on the effects of consolidation of accounting firms and role that credit rating agencies play in the markets.
- Defining specific criminal penalties for manipulation of financial records while also providing certain protections for whistleblowers.
- Setting criminal penalties associated with white-collar crimes and recommending stronger sentencing guidelines making failure to certify corporate financial reports a criminal offense
- Requiring that the Chief Executive Officer sign the company tax return.

TERMS TO KNOW

Audits

The verification of the financial statements of a legal entity intended to enhance the degree of confidence of intended users in the financial statements by providing reasonable assurance that the financial statements are presented fairly.

External Auditor

An audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity, other legal entity or organization, and who is independent of the entity being audited.

SUMMARY

In this lesson, you learned that **corporate governance is defined** as the system by which companies are directed and controlled, and concerns the handling of conflicts of interest between and among a company's management, its board, its shareholders, and other external stakeholders. **Principles** of corporate governance regarding ethical behavior, public disclosure, and transparency have emerged from three main sources since 1990, including the **Sarbanes–Oxley Act of 2002**. The Sarbanes–Oxley Act requires managers to certify published financial statements, stiffened penalties for fraud, and increased the oversight role of boards of directors and the independence of auditors, among other changes.

Best of luck in your learning!

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