Corporate Governance and Its Interpretations

Checklist Description

This checklist outlines definitions of corporate governance and their interpretation.

Definition

Corporate governance is the system by which organizations are directed and controlled. The defects of poor corporate governance have recently been very visible in financial institutions around the world. Since the endorsement of Sarbanes–Oxley, companies have set up audit committees, added financial experts to their boards, improved financial whistle-blowing capacity, and enhanced corporate transparency in financial statements and shareholder disclosures. However, are there any benefits from all of these requirements and best practices, and do they pay any dividends?

For good corporate governance to work, open and honest communication is necessary, with transparent policies and practices, clear lines of authority, and strong internal controls and audit functions, backed by a board that can act with clear independence from management.

A board has to identify with the business and its competition, focus on strategic problems and risk management, and establish high, yet pragmatic, standards of performance. The board directs the plans of the company but does not manage the company. The board must pick first-rate people to run the business while retaining its role to confront, evaluate, and hold managers accountable.

To do this, the board must develop and approve a strategic plan, establish specific and measurable goals, establish risk parameters (which should be reviewed regularly in light of the strategic objectives), encourage and preserve open lines of communication, select competent management, measure managers' performance, and hold management responsible using compensation and continued employment.

In contrast, management has the responsibility to implement the board's strategy, risk tolerances, and policies; keep directors fully informed; deal with the day-to-day operations of the business and its staff; and operate the information systems, procedures, and reports that keep the lines of communication open.

The costs of poor corporate governance have been very evident in the present financial crisis. Firms that engage in unscrupulous and risky behavior will generally fail, while those that have enhanced corporate governance will have higher valuations, greater profitability, and better sales. The recent market turmoil suggests that buying shares in firms that score highly in corporate governance may yield positive returns.

Advantages

- Good corporate governance is part of good risk management. It brings problems and concerns to light, allowing them to be addressed promptly.
- Good corporate governance helps businesses to focus on strategic issues and risk management, and establishes realistic standards of performance.
- Decision-making is improved by thorough analysis under good corporate governance. Management is held accountable, and management compensation is linked to shareholder value.
- The board can select good managers to run the business while maintaining its role to challenge, measure, and hold managers responsible.

Disadvantages

- A board that lacks independence may not be willing to address poor performance by a line of business or even hold the management accountable.
- The dual loyalty that many board members feel to the management and to the institution is normally resolved in favor of the institution.

Action Checklist

- Risks need to be reviewed periodically in light of the strategic objectives and margins of the business.
- How strong is the audit committee, and does the audit committee charter reflect the committee's areas of competence?
- Conduct a self-assessment periodically to help match expectations and actions.
- How effective is the risk-assessment program, how successful is the internal governance control, and are managers held accountable?
- Does the board and/or audit committee receive adequate and timely information from the internal and external audit staff?
- Does the relationship between board and management reflect their independent roles?

Dos and Don'ts

Do

- Set up an effective and independent corporate governance program.

Don't

- Don't cut back on good corporate governance programs because of reduced margins—objective opinions may help to resolve problems.

More Info

Books:

- Colley, John L., Jacqueline L. Doyle, George W. Logan, and Wallace Stettinius. *What is Corporate Governance?* New York: McGraw-Hill Professional, 2005.
- Mallin, Christine. *Corporate Governance*. 4th ed. Oxford: Oxford University Press, 2012.
- Monks, Robert A. G., and Nell Minow. *Corporate Governance*. Malden, MA: Blackwell Publishing, 2004.

Websites:

- European Corporate Governance Institute (ECGI): www.ecgi.org
- Global Corporate Governance Forum (GCGF), International Finance Corporation (IFC): www.gcgf.org
- International Corporate Governance Network (ICGN): www.icgn.org

See Also

Best Practice

- Improving Corporate Profitability Through Accountability

Viewpoints

- The "Comply or Explain" Approach to Improving Standards of Corporate Governance
- Regulation, Corporate Governance, and Boardroom Performance Must Be Shaken Up If We Are to Avoid Another Financial Crisis

Checklists

- Defining Corporate Governance: Its Aims, Goals, and Responsibilities

Finance Library

- Governance and Risk: An Analytical Handbook for Investors, Managers, Directors, and Stakeholders

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