Corporate Governance

Creating long-term stakeholder value

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5th edition

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Preface

This book covers the relation between various groups of people that have a stake in a corporation, called stakeholders. Understanding this relation is important when defining the set of written and unwritten rules that ensure that the corporation is well governed, in short 'Corporate Governance'. Corporate Governance plays an important role in the economic system. Several studies indicated that a properly functioning Corporate Governance leads to corporations that perform better than others. Amongst others, it secures a long-term profit. But is also ensures that the environment is better respected, that the interests of employees are better protected and the organization is compliant with the law.

The question "What is good Corporate Governance?" is more difficult to answer than the question "Can you give an example of bad Corporate Governance?" The media regularly contain stories about organizations in which Corporate Governance has failed. Some infamous cases are those of Enron, Worldcom, Parmalat and Toshiba. These cases clearly demonstrated the need for a sound foundation in corporate governance. Our conviction is that the scandals are not as black and white as often depicted: we think it is important that the cases are studied in context and that they are extensively discussed. Central questions are for example: "who is to blame?" and "why is that?".

There are many aspects in designing Corporate Governance. In this book we will focus on the economic aspect. As part of this aspect we will discuss internal control and risk management. They are effective means to govern an organization. We will also look at the relevant laws and regulations and the subject of ethics in business.

In chapter one of this book we will provide some definitions. We will elaborate on the concept of shareholders and other stakeholders in chapter two, pointing out the term 'corporate accountability'. As a manager of a corporation, it is not enough to tell your shareholders that you have made a good profit, that you have achieved 'business prosperity'. You are accountable for everything you and your corporation have done to achieve this. *Accountability* implies taking responsibility. You have to be able to explain why you have or have not taken certain actions. This means that you must justify your decisions. Here we enter the field of business ethics. This will be discussed in chapter three, where we also discuss the related area of governance for sustainability

We will see in chapter one: that a corporation has a good Corporate Governance when it can show that it is 'in control'. But how can an organization show that it is 'in control'? There are several viewpoints possible. One viewpoint is the 'narrow' viewpoint that is very much focused on what matters most to shareholders. An organization is in control when it can show that "the reported figures are reliable". We will cover this aspect in chapter four. More specific, we will cover the COSO Internal Control over Financial Reporting (COSO ICF) framework.

A 'broader' viewpoint is that the organization is in control when it properly manages the realization of organizational goals for all stakeholders. We will deal with this subject in chapter five. We will discuss the various steps that need to be taken to ensure that the risks are managed well in line with the framework of COSO Enterprise Risk Management (ERM).

In the end corporate governance is about people working together, which can only happen in a constructive way if adequate information flows are in place. The final chapter covers information systems. We will see that both internal control and enterprise risk management rely heavily on the information systems in the corporation.

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1 Purpose of Corporate Governance

“What is good Corporate Governance? And how do companies get there?”

1.1 Corporate Governance: long term value creation

In many articles and other media we can read about well-known companies whose Corporate Governance hasn’t functioned adequately. Companies such as Enron, Worldcom and Parmalat are among the ones best-known. It is clear for everybody: you should not behave like managers responsible for Enron, Worldcom and Parmalat. But the reverse question is much more difficult to answer: How should you behave when you are responsible for managing a large corporation. Or how to behave when you are one of the many other stakeholders, be it a shareholder, an external auditor, an employee, a supplier. What is good Corporate Governance? And how do companies get there?

There are many definitions of Corporate Governance. Some have an economic focus, others are more concerned with ethics or legal matters. Most of them have in common that Corporate Governance is aimed at ensuring a long-term value creation. According to Emmanuel (et al. 1995), Corporate Governance is aimed at securing the continuity of the firm. Shareholders get their share of the profits, customers get the products or services they want, suppliers have their customer, employees keep their job, management receive their bonuses and the internal revenue service receives the taxes needed to keep our society at the standard we desire.

The Dutch Corporate Governance Code explicitly states that ensuring long-term value creation is the purpose of Corporate Governance: 'The management board should develop a view on long-term value creation by the company and its affiliated enterprise and should formulate a strategy in line with this. Depending on market dynamics, it may be necessary to make short-term adjustments to the strategy.'

Several research findings indicate a positive effect of corporate Governance on the company's performance. For example Ueng (2015) found in a study of 3,068 firms that when firms have better corporate governance policies, they are more likely to perform better. Specifically, when firms have a better board rating, compensation policy, takeover defence strategy, accounting practice, and a formal governance policy, they are more likely to perform better than their counterparts without such corporate governance policies.

1.2 Shareholder and stakeholder value

Some economics take a narrower approach in defining the aim of Corporate Governance. In their view Corporate Governance has the aim of maximizing the shareholder value. According to Milton Friedman (University of Chicago Press, 1962) "There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it … engages in open and free competition, without deception or fraud."

In an article in the Journal of Finance, Shleifer and Vishy (1997) also takes this narrower approach in creating value. This was not uncommon only two decades ago, especially in the United States. Shleifer and Vishy mention: "Corporate governance deals with the way in which suppliers of finance to corporations assure themselves of getting a return on their investment". Note that this definition does not mention the continuity of the firm. Apart from these investors, it does not refer to any other stakeholder in the corporation.

Nowadays the stakeholder approach is the leading principle. Several well-known American CEO's claimed in august 2019 that not the shareholder but the stakeholder value should be the aim of the company. In a statement of the so called Business Round Table they mention: 'major employers are investing in their workers and communities because they know it is the only way to be successful over the long term. These modernized principles reflect the business community's unwavering commitment to continue to push for an economy that serves all Americans.' This statement was signed by several CEO's, for example the CEO of Amazon (Jeff Bezos) and Apple (Tim Cook).

In several Corporate Governance codes the stakeholder value is also the leading principle. Besides the Dutch Corporate Governance Code the UK Code states that:

'Companies do not exist in isolation. Successful and sustainable businesses underpin our economy and society by providing employment and creating prosperity. To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit. Accordingly, a company's culture should promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders.

Simply said, the goal is long term shareholder value. In trying to reach that goal, the interests of the other stakeholders must be taken into account. Implicitly this definition implies that the interests of the other stakeholders are not – or at least not necessarily - aligned with the interests of the shareholders. It may be in the interest of the shareholders to split the firm in pieces and sell these pieces one by one to the highest bidder. And the other stakeholders do not necessarily have the means to stop that, as long as their interests have been 'taken into account', whatever that may mean.

When we look at the directors report of Shell (annual report Shell, 2018) we see that Shell claims not to be oriented at the shareholder only: 'Our ongoing work to provide more and cleaner energy should increase recognition of the positive contributions that Shell can make to society over the decades ahead. But our success in achieving these goals will depend largely on whether society trusts us.

Investors invest in companies they trust, governments allow trusted companies to operate and consumers buy products from people they trust. Trusted companies are also likely to attract and retain the brightest minds, helping to ensure the lasting vitality of the business. Trust is clearly a virtuous circle. The question is, how can companies create and keep it? We believe this can only be achieved by everybody demonstrating unquestionable integrity every day, in every way and everywhere we work. Unquestionable integrity is essential for earning and maintaining the trust of customers, investors and wider society.

In doing this, the Board believes that taking into account the interests of all stakeholders — shareholder, government, customers and society — is important in achieving the long-term interests of Shell and its shareholders.'

One aspect of corporate governance is establishing a good relation between the company and the stakeholders. In this book we call this the 'external governance'. Another important aspect is the governance within the company, the 'internal governance'. Two important concepts will be discussed further on that are strongly related: internal control and enterprise risk management. The board of directors of an enterprise should control the employees in the organization – for example by setting boundaries to the amount of risk each employee is allowed to take. Managing to ensure that this system of boundary setting and risk management is properly working is called internal control.

2 Stakeholders in Corporate Governance

"The task of the board of directors is to find the feasible region determined by stakeholders"

2.1 Customers

No firm can exist without its customers. Although their formal influence may be limited, their informal influence is big. Especially when exercising their option not to buy from the firm. In the literature on Corporate Governance, this group is less visible than several of the other groups of stakeholders that we will distinguish.

According to well-known economists such as Drucker and Porter, a company can only survive in the long term when it satisfies the customer needs. The company should adapt strategies to create long term customer value.

Nowadays the influence of not following the changed customer habits is visible in the retail sector. Companies like Vroom & Dreesman have gone bankrupt. They didn't adapt to customers who shop mostly online. On the other hand companies like Amazon have flourished because of this same trend.

2.2 Shareholders

The shareholders of listed corporations have taken the opportunity to participate in the profits of the firm without taking responsibility for the operations. They have limited liability and therefore limited involvement in the company's affairs. That involvement includes the right to elect directors and the fiduciary obligation of directors and management to protect their interests.

There is one potential major downside in separating ownership and control. Management can have goals and interest that are (partly) different than shareholders. This problem is often called: the agency problem.

In large companies there is almost always a separation of ownership and control. Fama and Jensen (1983) explain that a separation is common and effective due to the specialization of management and risk bearing functions. According to Fama and Jensen (1983) this separation is effective and 'agency costs' are limited when shareholders focus on: resource utilization and structuring of contracts. They will also be able to monitor the performance of decision agents and implementation of rewards. The management of the company should focus on ratification; the choice of the decision initiatives. They should also be responsible for the implementation; the execution of ratified decisions.

Shareholders are not a homogeneous group. The group of shareholders ranges from private persons, who can only have a few shares in a corporation, to institutions such as pension funds that own a significant portion of the shares.

There are systematic differences in ownership concentration across countries. Ownership is typically dispersed in the United Kingdom and the United States. The OECD study (Factbook CG 2019) shows a shift in dispersed ownership in the United States and the United Kingdom: the largest 20 institutional owners on average hold more than 30% of the capital in listed companies. Most corporations are controlled by large shareholders in continental Europe, Asia, and Latin America (Donelli ea. 2013).

Some private companies have major shareholders. Let us take Heineken as an example. In the 2018 annual report it is stated that there the shares are distributed as follows:

50,0057% Owned by Heineken Holding N.V.

21,78 % Owned by other companies

The interesting case is that Mrs. de Carvalho-Heineken owns 52.63% of the shares in Heineken through the Heineken Holding N.V. and L'Arche Holding S.A. In that respect, Heineken does have some characteristics of a family-owned business, which is seen by the company as one of the cornerstones for its success. By owning just over 50% of the shares in a company that in turn owns just over 50% of the shares of Heineken, she effectively controls the company, whilst she "only" owns 25% of the shares.

According to the study of the OECD in 2019 (Factbook CG 2019) in half of the world's publicly listed companies, the three largest shareholders hold more than 50% of the capital. And in three-quarters of the world's public listed companies, the three largest owners hold more than 30% of the capital.

Apart from the difference in size, the goals of each shareholder in owning the shares can be very diverse. The "classic" shareholder sees his stock as a long term investment that will provide him or her with an annual dividend stream and/or a growth in the stock price. But sometimes a private person only buys a single share to be able to draw specific attention to a specific topic in the general meeting of shareholders: "Why are you not paying attention to the environment?" A group of investors that is typically taken more seriously is formed by activist shareholders who view their investment as a medium-term investment at best and who want to sell the firm for the highest price – if necessary piece by piece – to anyone who wants to pay that price. So-called hedge funds are the most visible representative of this group. There is quite a debate about whether their shareholder activism unlocks hidden value in the corporation, or squeezes cash and assets out of the corporation without improving business performance.

2.3 The board of directors

Role of the board of directors

The board of directors of the firm faces the challenging task of balancing the wishes of several stakeholders. They act on behalf of the shareholders. But they won't just do what the shareholders want. First of all some of their goals can be different from the goals of the shareholders. This is known as the agency problem. Furthermore it is not always easy to determine what the 'best interest' for shareholders is. If the executive directors do not listen well enough to the firm's employees (or simply pay them low wages so they can pay out more dividends) an unmotivated work force (or even a work force on strike) may endanger shareholders value. If the directors raise the prices of the products, and therefore the profit on each product, this may at first be seen as beneficial to the shareholders. However, customers won't like it and if they stop buying the product for that reason, the shareholder is hit.

The role of the board of directors is explained in several Corporate Governance Codes. According to the Dutch Code 2016 the task of the board is to formulate a long term value creation strategy for the stakeholders and monitoring the realization of this strategy. In the UK CG Code is mentioned that the board 'should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned.' In chapter five of this book we will explain how to set up an enterprise risk management system to ensure that the corporate goals are met.

The board of directors is also accountable for disclosing information in the annual report. The board informs the shareholders and other stakeholders regarding the realization of company goals and the monitoring of risks. US listed companies should also disclose the effectiveness of the internal control structure and procedures. According to the Sarbanes Oxley Act (SOX, 2002) the CEO and the CFO are responsible for disclosing this assessment. This assessment is also known as an 'in control statement'.

In short the board roles are:

- formulating purpose, strategy and values;
- organizing the execution of the strategy;

- monitoring execution and risks;
- reporting & evaluation.

Several subcommittees of the board are mentioned in the different codes. These committees have different responsibilities. For example, according to the SOX act 2002 the audit committee is responsible for 'overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer'. The audit committee has also a role in the selection of the independent auditor and analysing the annual audit findings of this auditor. The remuneration committee should oversee remuneration policies and practices to support strategy and promote long-term sustainable success.

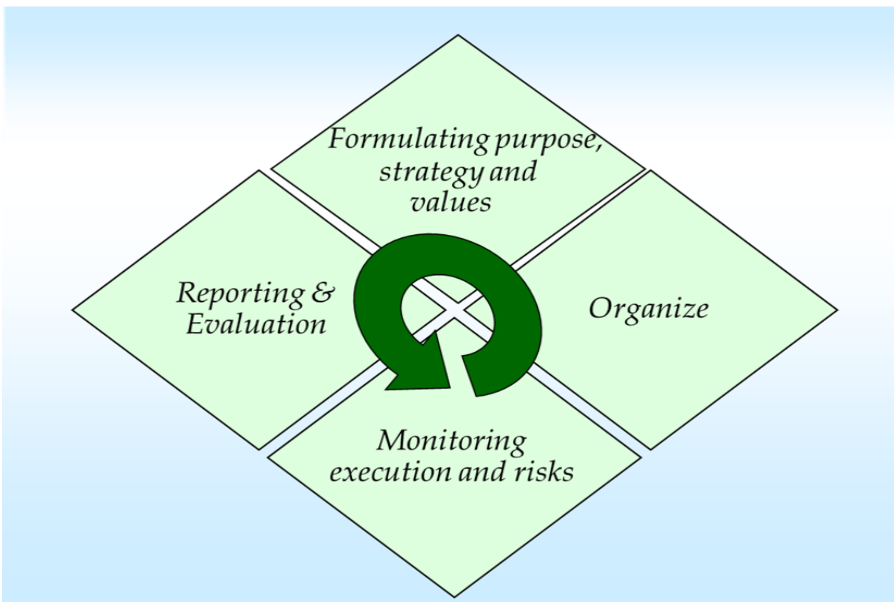

Figure 1: Board roles