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What is corporate governance?

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What is Corporate Governance?

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The system by which companies are **directed** and **controlled** in the **best interest of shareholders** and other **stakeholders'** (Cadbury report 1992)

Set of relationships between **a company's directors**, its **shareholders** and other stakeholders'

Structure through which the objectives of the **company are set**, and the means of obtaining these objectives and monitoring performance

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Case questions

1. Briefly, provide a history of the company.
2. The Enron debacle created what one public official reported was a “crisis of confidence” on the part of the public in the accounting profession. List the parties who you believe are the most responsible for that crisis. Briefly justify each of your choices.
3. Identify and list the governance principles and guidelines that were breached.
4. Can Audit firms truly be independent consultants?
5. Who was most affected by Enron’s Fall?
6. Identify and list five recommendations that have been made recently to strengthen the audit function after Enron's scandal.

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Case questions

1. What are the corporate governance problems in the case?
2. Whose problems were they and how should they have been resolved?

Corporate governance is therefore

A set of **policies** and **procedures** that are put in place to ensure **accuracy, consistency** and **responsiveness** to key stakeholders; **shareholders**, **regulators** and the **government**

The role of corporate governance

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- To protect shareholders rights,
- To enhance disclosure and transparency,
- To facilitate effective functioning of the board
- To provide an efficient legal and regulatory enforcement

Corporate governance

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PURPOSES

Monitor those in control of company's resources through ensuring;

- ✓ The balance of **power** in the board of directors
- ✓ Fair **remuneration policy** for Executive directors
- ✓ **Delegating the responsibility** of monitoring and managing risks to the board of directors
- ✓ **Address business ethics**, corporate social responsibility and protection of 'whistle-blowers'

OBJECTIVES

Contribute to improved corporate performance and accountability through;

- ✓ **Enhancing controls** by increasing the amount of reporting and disclosure to all stakeholders
- ✓ **Increase the level of confidence** and transparency in company's activities
- ✓ **Ensure that the company** is run in a legal and ethical manner
- ✓ **Build in control at the top** that will cascade down

Benefits of corporate governance?

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- ✓Ensures **corporate success** and economic growth
- ✓Creates **positive impact** of share price
- ✓**Increases investors'** confidence
- ✓Enables companies to raise **capital efficiently and effectively**

Benefits of corporate governance?

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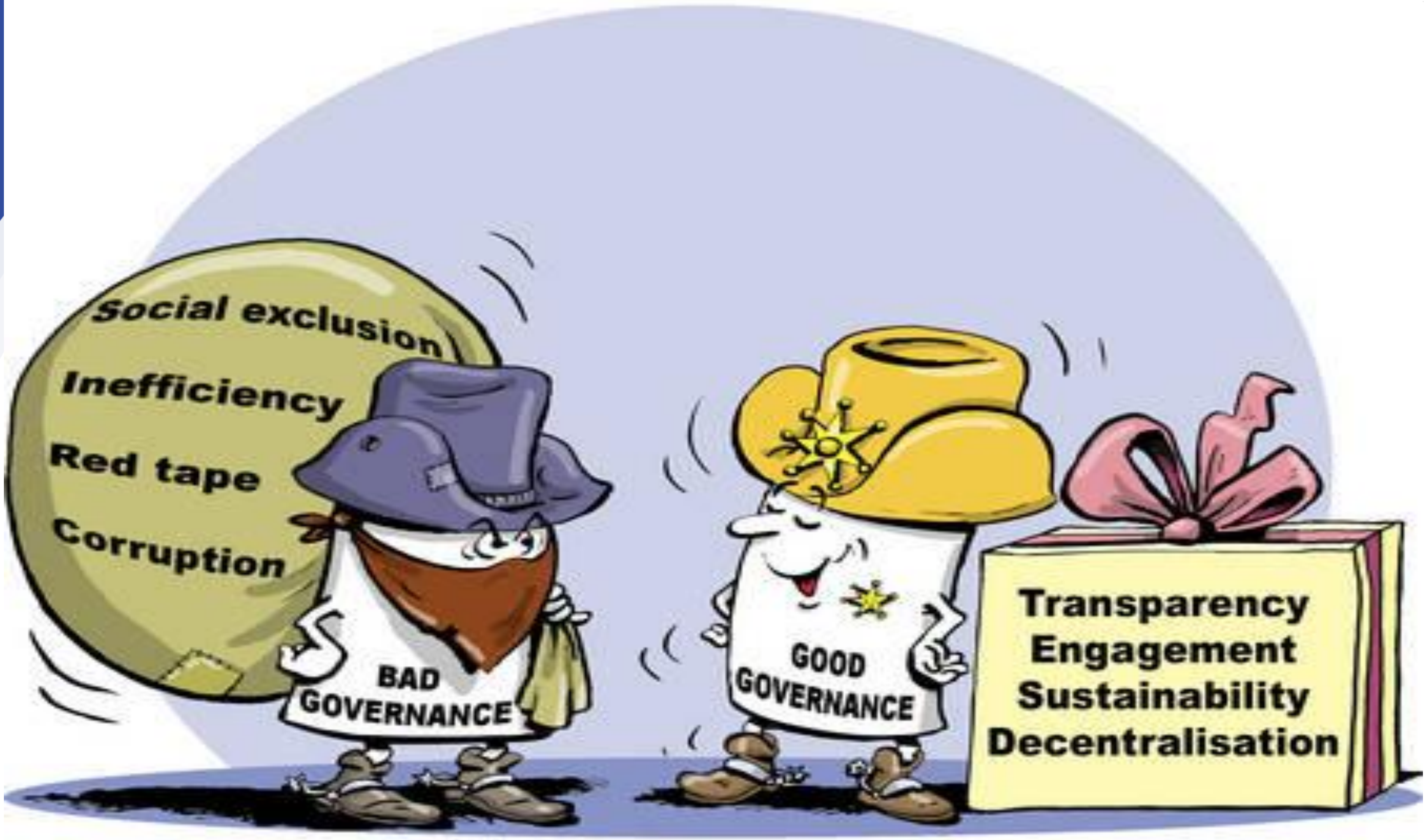
✓Provides **long term sustenance** and **strengthens** stakeholders' relationship.

✓Reduces **perceived risks,** consequently **reduces cost** of capital and enables board of directors to take quick and better decisions


Social exclusion
Inefficiency
Red tape
Corruption
BAD GOVERNANCE
GOOD GOVERNANCE
Transparency
Engagement
Sustainability
Decentralisation

Why is corporate governance needed?

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- Separation of Ownership and Managerial Control - Agency Relationship

- Agency Costs (incentive, monitoring, enforcement costs, and financial losses due to insufficient governance)

- Diversity of stakeholders

Scope of corporate governance

- ✓Risk management and reduction
- ✓Appropriate internal control systems
- ✓Framework to pursue profitable and sustainable strategies
- ✓Guards against misuse of resource
- ✓Accountability to shareholders

Fundamental principles of Corporate Governance

Fairness: Treating all shareholders, including minorities, equitably

Openness/transparency: Providing **accurate** and **timely information** on all material matters; Financial situation and performance

Independence: Free from **undue influence** to the running the affairs of the organization

Contd....

Probity/honesty: In financial and positional reporting

Responsibility: Willingness to **accept liability** for the outcome of governance decisions

Reputation: Developing and sustaining **personal** and organizational moral stance

Cont…

Judgement: The ability to reach and communicate meaningful conclusions

Integrity: Steadfast adherence to **ethical code**, high **moral virtue** and highest standards of professionalism

Accountability: Providing clarity in communication channels

Approaches to Corporate governance

There are two systems for good corporate governance:

Principles-based approach:

Requires companies to adhere to the **spirit of the rule** or **explain why** they haven’t; **comply or explain**

Rules-based approach:

Requires the companies to **comply** or **pay penalties** for non-compliance

Principles-based Vs. Rules-based Approach

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Principle based approach	Rules based approach
Focuses on the objectives of good corporate governance, rather than the mechanisms by which these objectives will be achieved	Places more emphasis on definite achievements rather than their underlying factors and control systems
Emphasises areas of corporate governance to which rules cannot easily be applied	Allows no deviation irrespective of how illogical the situation is
Applies across different legal jurisdiction hence making the governance of a multi-national business more effective	Easier compliance with the rules as they are unambiguous and can be achieved
Works on a comply or explain basis. Any deviation from the specific provisions of codes requiring an explanation	Enforcement can be difficult for situations that are not covered explicitly in the rules

Contn….

Principle based approach	Rules based approach
Disclosure requirements means that investors can decide if they agree that departure from the code is appropriate	Favoured in legal jurisdictions that lay great emphasis on obeying the letter of the law rather than the spirit of the law

Principles-based approach- Key principles

✓Provides broad guidelines supplemented by limited specific requirements

✓Focus on objectives rather than mechanism of implementation

✓Application to areas where rules cannot be applied

✓Application across different legal jurisdictions

✓Comply or explain non-compliance

Advantages of principles-based approach

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- ✓ Avoids inflexible rules
- ✓ It is less costly in terms of time and expenditure .. Reduction of too much red tape
- ✓ Allows scope for development and unusual developments
- ✓ Emphasis on investor judgement (it puts emphasis on investors making up their own minds about what businesses are doing)
- ✓ Promote ethical behavior with integrity being particularly important
- ✓ Underpin investor confidence

Disadvantages of principles-based approach

- ✓ Different companies may not use principles consistently therefore there is no room for comparison
- ✓ Confusion over what is compulsory and what is not
- ✓ Inadequate explanation of non-compliance
- ✓ Investors misunderstand significance of non-compliance

Advantages of rules-based approach

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- ✓ Compliance is easily visible
- ✓ Ensures consistent application by companies
- ✓ Gives stakeholders confidence that compliance has been achieved
- ✓ Convey and reinforce the requirements relating to governance in local statutes and listing rules
- ✓ Assist companies in minimizing risk, especially financial, legal and reputation risks, by ensuring appropriate systems of financial control are in place

Disadvantages of rules-based approach

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- ✓ Takes no account of organization's situation, size or complexity of business
- ✓ Lack of flexibility for non-compliance that is not organization's fault
- ✓ Focus on aspects of governance that are easily verifiable rather than those that cannot be governed by rules
- ✓ May be difficult to deal with situations that are not in the rules
- ✓ Compliance may be costly, particularly for smaller companies

Which way to follow?

The decision to choose principles-based or rules-based for a country depends on;

- Dominant ownership structure (bank, family or listed companies)
- Legal system and its power/ability
- Government structure and policies
- State of economy

Contn….

- Culture and history
- Levels of capital inflow
- Global economic and political climate

Where is Kenya?

Contn….

- ✓ Chasebank.

The internal governance mechanisms

- Ownership Concentration (shareholders, institutional investors)
- Board of Directors (insiders vs. outsiders, diversity; strategic control vs. financial control)
- Executive Compensation (salary, bonuses, long-term incentive compensation)

Different types of companies

Listed companies: They raise capital on stock markets and institutional investors. Separation of ownership from management. Reputation and integrity matters

Family/private companies: Ownership and management within family members. No corporate governance issues unless when sourcing for funds or looking for institutional investors

Contd'

Not-for-profit organizations: Funded by well wishers for specific societal needs. Corporate governance issues focus on whether funds were spent appropriately

Public institutions: Owned and controlled by governments. Meant to provide essential services to the citizens at a subsidized amount. Aimed at achieving **efficient, economic** and **effectiveness**

Shareholders

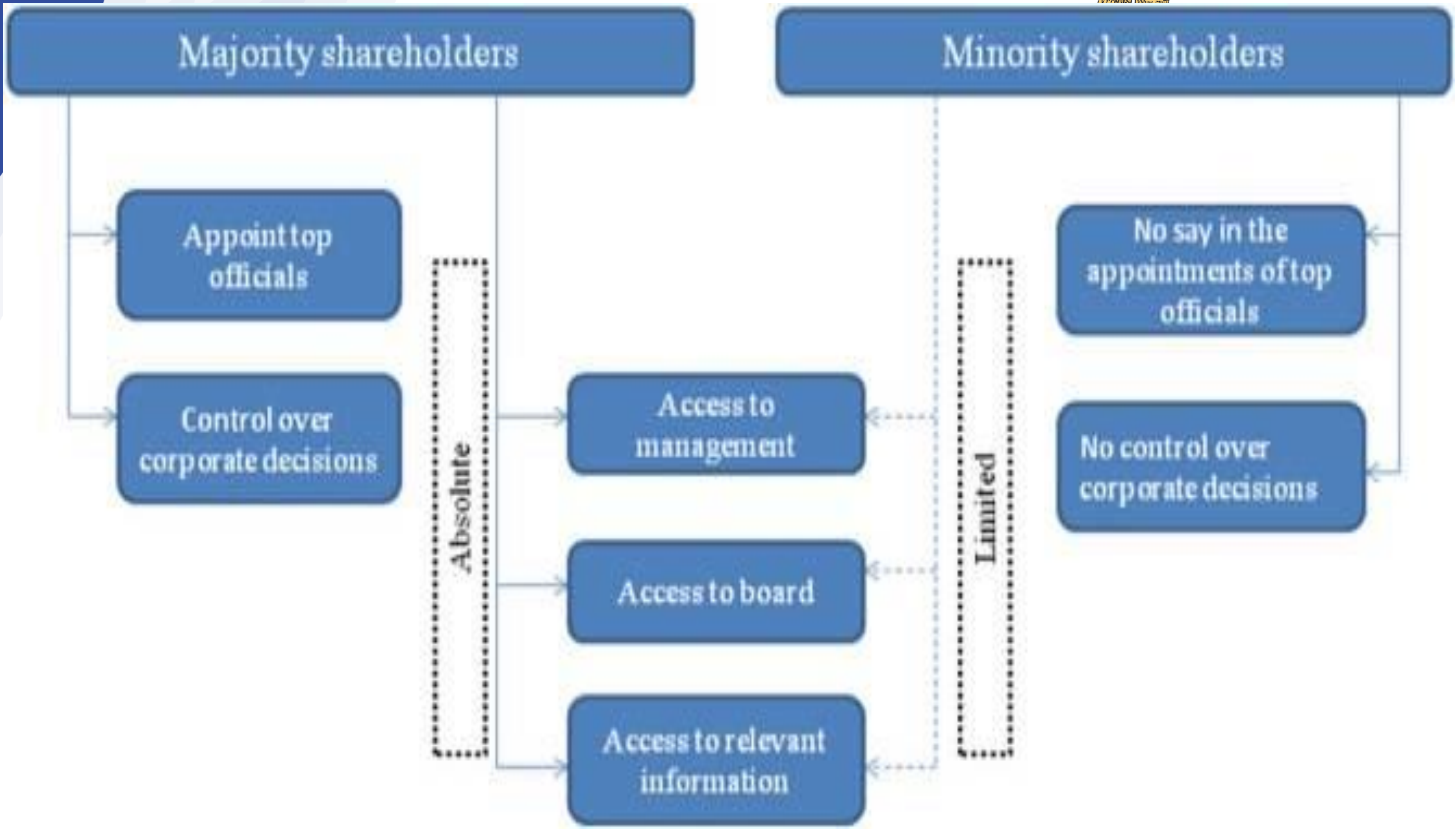
The owners of an incorporated business are known as **shareholders**. The corporation must be operated in a manner that best benefits its shareholders. A shareholder can be a person, company or other entity. It's any entity that owns at least one share of a company's stock.

Although shareholders don't play an active role in the everyday business operations, they do have certain rights and duties that will be defined in the company's bylaws. Generally, shareholders have the right to:

Shareholders’ Responsibilities

- ✓ **Attend general meetings** (AGM)
- ✓ Inspect the **corporation's books** and records
- ✓ Appointment of **directors** and **auditors**
- ✓ Sue the **corporation for wrongs** committed by directors or officers
- ✓ Approve **the sale of company’s assets** and **participate in the proceeds** of the company liquidates
- ✓ Agree to **merger** or **consolidation deals**
- ✓ Receive a **portion of any dividends** issued by the company

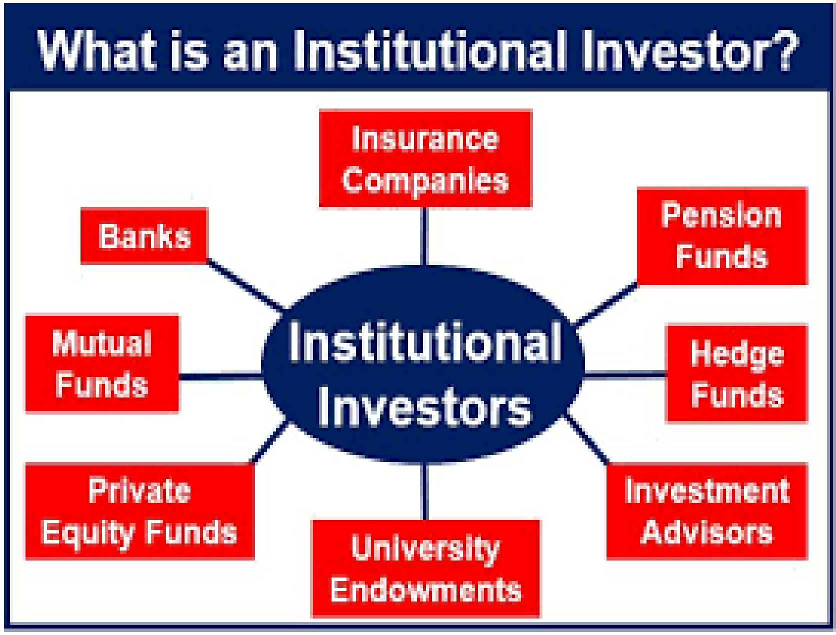
Majority vs. Minority shareholders



Institutional Investors

Are financial institutions that invest large amounts of money in securities, commodities and foreign exchange markets, on its own behalf or on the behalf of its customers

They are major players in the long-term investment market



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