

# Corporate Governance

## Chapter 2

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### Learning Objectives

- ✦ Describe the role and responsibilities of the board of directors in corporate governance
- ✦ Understand how the composition of a board can affect its operation
- ✦ Discuss trends in corporate governance
- ✦ Explain how executive leadership is an important part of strategic management

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### Role of the Board of Directors

#### ✦ Corporation

↳ a mechanism established to allow different parties to contribute capital, expertise and labor for their mutual benefit

- ✦ The corporation is governed by the *board of directors* that oversees *top management* with the concurrence of the *shareholders*.

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## Role of the Board of Directors

- ✦ **Corporate governance**
  - ↳ refers to the relationship among the board of directors, top management and shareholders in determining the direction and performance of the corporation

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## Responsibilities of the Board

Effective Board Leadership

Strategy of the Organization

Risk vs. Initiative

Succession Planning

Sustainability

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## Responsibilities of the Board

- ✦ **Due care**
  - ↳ the board is required to direct the affairs of the corporation but not to manage them
- ✦ If a director or the board as a whole fails to act with due care and, as a result, the corporation is in some way harmed, the careless director or directors can be held personally liable for the harm done.

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## Role of the Board in Strategic Management

- ✦ **Monitor** developments inside and outside the corporation
- ✦ **Evaluate and Influence** management proposals, decisions and actions
- ✦ **Initiate and Determine** the corporation's mission and strategies

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## Board of Directors' Continuum

FIGURE 2-1 Board of Directors' Continuum



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## Members of a Board of Directors

- ✦ **Inside directors**
  - ↳ typically officers or executives employed by the corporation
- ✦ **Outside directors**
  - ↳ may be executives of other firms but are not employees of the board's corporation

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## Members of a Board of Directors

### ✦ Agency theory

- ↳ states that problems arise in corporations because the agents (top management) are not willing to bear responsibility for their decisions unless they own a substantial amount of stock in the corporation

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## Members of a Board of Directors

### ✦ Stewardship theory

- ↳ proposes that, because of their long tenure with the corporation, insiders (senior executives) tend to identify with the corporation and its success

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## Members of a Board of Directors

### ✦ Affiliated directors

- ↳ not employed by the corporation, handle legal or insurance work

### ✦ Retired executive directors

- ↳ used to work for the corporation, partly responsible for past decisions affecting current strategy

### ✦ Family directors

- ↳ descendants of the founder and own significant blocks of stock

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## Codetermination: Should Employees Serve on Boards?

### ✦ Codetermination

- ↳ the inclusion of a corporation's workers on its board, began only recently in the United States
- ✦ Although the movement to place employees on the boards of directors of U.S. companies shows little likelihood of increasing, the European experience reveals an increasing acceptance of worker participation on corporate boards.

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## Interlocking Directorates

### ✦ Direct interlocking directorate

- ↳ when two firms share a director or when an executive of one firm sits on the board of a second

### ✦ Indirect interlocking directorate

- ↳ when two corporations have directors who serve on the board of a third firm

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## Interlocking Directorates

### ✦ Interlocking directorates

- ↳ useful for gaining both inside information about an uncertain environment and objective expertise about potential strategies and tactics

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## Nomination and Election of Board Members

- ✦ **97%** of U.S. boards use nominating committees to identify potential board members
- ✦ **Staggered boards**
  - ↳ only a portion of board members stand for re-election when directors serve more than one year terms

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## Nomination and Election of Board Members

- ✦ Criteria for a **good director** include:
  - ↳ Willingness to challenge management when necessary
  - ↳ Special expertise that is important to the company
  - ↳ Available for outside meetings to advise management
  - ↳ Expertise on global issues
  - ↳ Understands the firm's key technologies and processes

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## Organization of the Board

- ✦ The size of a board in the United States is determined by the corporation's charter and its by-laws, in compliance with state laws.
- ✦ Although some states require a minimum number of board members, most corporations have quite a bit of discretion in determining board size.

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## Organization of the Board

- ✦ The average large, publicly held U.S. firm has 10 directors on its board
- ✦ The average small, privately-held company has four to five members.

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## Organization of the Board

- ✦ **Lead director**
  - ↳ consulted by the Chair/CEO regarding board affairs and coordinates the annual evaluation of the CEO
- ✦ 96% of U.S. companies that combine the Chairman and CEO positions had a lead director.

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## Organization of the Board

- ✦ The most effective boards accomplish much of their work through committees.
- ✦ Although they do not usually have legal duties, most committees are granted full power to act with the authority of the board between board meetings.

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## Evaluating Governance

### ✦ S&P Corporate Governance Scoring System

- ↳ Ownership Structure and Influence
- ↳ Financial Stakeholder Rights and Relations
- ↳ Financial Transparency and Information Disclosure
- ↳ Board Structure and Processes

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## Avoiding Governance Improvements

- ✦ Multiple classes of stock
- ✦ Public to private ownership
- ✦ Controlled companies

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## Trends in Corporate Governance

- ✦ Boards shaping company strategy
- ✦ Institutional investors active on boards
- ✦ Shareholder demands that directors and top management own significant stock
- ✦ More involvement of non-affiliated outside directors
- ✦ Increased representation of women and minorities

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## Trends in Corporate Governance

- ✦ Boards evaluating individual directors
- ✦ Smaller boards
- ✦ Splitting the Chairman and CEO positions
- ✦ Shareholders may begin to nominate board members
- ✦ Society expects boards to balance profitability with social needs of society

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## The Role of Top Management

- ✦ **Top management responsibilities**
  - ↳ involve getting things accomplished through and with others in order to meet the corporate objectives.
  - ↳ are multidimensional and are oriented toward the welfare of the total organization

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## Executive Leadership and Strategic Vision

- ✦ **Executive leadership**
  - ↳ the directing of activities toward the accomplishment of corporate objectives, sets the tone for the entire corporation
- ✦ **Strategic vision**
  - ↳ description of what the company is capable of becoming

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Executive Leadership and Strategic Vision

✦ Transformational leaders

↳ provide change and movement in an organization by providing a vision for that change

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Executive Leadership and Strategic Vision

Characteristics of effective CEOs include:

1. The CEO articulates a strategic vision for the corporation.

2. The CEO presents a role for others to identify with and to follow.

3. The CEO communicates high performance standards and also show confidence in the followers' abilities to meet these standards.

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Managing the Strategic Planning Process

✦ Strategic planning staff

↳ charged with supporting both top management and the business units in the strategic planning process

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## Managing the Strategic Planning Process

**Strategic planning staff responsibilities** include:

1. Identify and analyze company-wide strategic issues, and suggest corporate strategic alternatives to top management
2. Work as facilitators with business units to guide them through the strategic planning process

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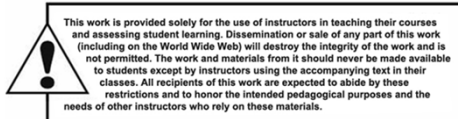
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