soleadea

LEVEL 1: CORPORATE FINANCE

Reading 27 (1st out of 6): CORPORATE GOVERNANCE & ESG

Difficulty: **easy**

Benchmark Study Time: **2.5h**

2022

https://soleadea.org/

INTENTIONALLY EMPTY

THIS E-BOOK:

- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep **all** important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g. write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to your study plan and change the Reading's status to **green**:
   (it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

CORPORATE GOVERNANCE – INTRODUCTION

Defining corporate governance

Corporate governance:

- is the system of internal controls and procedures which helps to manage a company,
- establishes the rights and obligations of various groups within an organization,
- is designed to minimize potential conflicts of interest between insiders and external shareowners.

⇨ corporate governance within the investment field has become even more relevant in recent times !

Shareholder vs Stakeholder theory

shareholders = one of the company's stakeholders

stakeholders = involve a broader group of stakeholders, including shareholders

shareholder theory = when the management's primary duty is to maximize the shareholder returns

stakeholder theory = when the company's focus extends beyond the interests of shareholders to other groups' interests, e.g. employees, customers, suppliers, etc.

⇨ countries may adopt either the former or the latter approach or their combination

Company stakeholders

Primary stakeholder groups:

- shareholders
- creditors
- managers (or executives)
- employees
- board of directors
- customers
- suppliers
- governments/regulators

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

shareholders (investors)

- own the company's shares of stock,
- are entitled to receive dividends (thus >> aim at the company's profitability growth),
- have voting power (elect the board of directors, vote for certain resolutions),
- control the company through the board of directors (expected to represent shareholder interests),
- in case of bankruptcy, are paid only after all creditors' claims are settled.

controlling shareholders = hold the controlling stake in the company

minority shareholders = hold the minority stake in the company

creditors (e.g. bondholders and banks)

- provide the company's debt financing,
- no voting power,
- in return for provided capital receive interest and principal payments,
- satisfied with the company's stability.

board of directors

- elected by shareholders to protect their interests (internal monitoring tool of shareholders),
- link between shareholders and managers,
- provide strategic direction,
- monitor company and management performance,
- responsible for a proper governance of the company.

board composition = no set structure or number of directors, preferable: diverse mix of expertise, backgrounds, competencies + age, gender, racial diversity

one-tier (unitary) board of directors = single board of directors (executive + non-executive directors)

two-tier board of directors = supervisory board (non-executive directors) + management (executive) board (executive directors); the supervisory board is separate from the management board

executive (internal) directors = the company's senior managers, i.e. its top employees

non-executive (external) directors = though not the company's employees, they play a relevant role within the company, i.e. provide objective decision making, monitoring, performance assessment

independent director = no material relationship with the company as regards employment, ownership, or remuneration /non-executive!/

board election >> regular vs staggered boards

staggered boards = when directors are divided into classes (typically three) and each year directors for one class only are elected (this way it takes several years to replace the whole board, as opposed to regular election when all directors are elected at the same time for a specified term)

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Company's financial performance: *who cares and why*?

SHAREHOLDERS >>	interested in the company's profitability: the higher the profit, the higher the dividend (when paid)
CREDITORS >>	interested in the company's stability: interest and principal payments are independent of the company's performance
MANAGERS (OR EXECUTIVES) >>	interested in the company's profitability: better salary, bonuses, equity-based compensation, perquisites
EMPLOYEES >>	interested in the company's profitability: better salary, career prospects, working conditions, etc.
BOARD OF DIRECTORS >>	interested in the company's profitability: shareholders' satisfaction + better remuneration and reelection prospects
CUSTOMERS >>	less concerned with the company's financial performance than all above
SUPPLIERS >>	concerned with the company's ability to meet its financial obligations
GOVERNMENTS/REGULATORS >>	considered a stakeholder owing to the collected tax revenues

Functions and responsibilities of the board

- duty of care & duty of loyalty
- guiding and approving the company's strategy (incl. risk profile), then overseeing its execution and monitoring the progress (but implementation is delegated to management!)
- assessing the company's performance + determining relevant courses of action
- overseeing the effectiveness of the company's audit and control systems
- ensuring the implementation of proper corporate governance principles, incl. ethical standards
- monitoring the appropriateness and efficiency of enterprise risk management system
- reviewing proposals for transactions and amendments before they are referred to shareholders
- planning for the company's leadership continuity

Board of directors committees

- consist of several members of the board of directors,
- report to the board,
- examples: audit committee, governance committee, remuneration committee, nominating committee, risk committee, investment committee.

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CORPORATE RELATIONSHIPS AND POSSIBLE CONFLICTS

Principal-agent (agency) relationship

principal → HIRES → agent

to perform tasks or services

on behalf of the principal & to the benefit of the principal

agency

should be based on trust and obligation but often generates conflict

Possible principal-agent conflicts

shareholders ⇄ managers/directors

a potential shareholder-manager/director conflict may arise owing to e.g.:

different objectives	
aim at long-term profit	aim at short-term benefit (bonus, perk)

divergent risk tolerance	
higher >> to maximize profit opportunities	lower >> to protect their employment status

information asymmetry	
external shareholders have little access to information	insiders have greater access to information

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Other possible conflicts:

- controlling vs minority shareholders

Minority shareholders' interests are often disregarded. They have limited or no influence on the company's matters like director appointments, takeovers, related-party transactions. All these issues affect the minority shareholders' wealth and straight voting is always to their disadvantage.

> dual-class structure = when there are two share classes, i.e. with voting vs non-voting/limited-voting power, and thus some shareholders are able to control the company thanks to owning shares with the superior powers (multiple-class structure is when more than two share classes are involved)

- manager vs board

Conflict is possible when managers provide limited information to the board (non-executive directors).

- shareholder vs creditor

Shareholder often have a higher risk tolerance because they appreciate higher return potential. Creditors are more risk averse because the poorer the company's performance, the higher the default risk. Also, excessive borrowings or dividend payouts may be a bone of contention.

- customers vs shareholders

Increased price or decreased quality to reduce costs may seem appealing to shareholders but customers won't be so happy about it …

- shareholders vs governments/regulators

A company may decide to apply accounting and reporting practices that can reduce taxes. Obviously, this is no good news to the tax authorities.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

STAKEHOLDER MANAGEMENT

Defining stakeholder management

Stakeholder management consists in identifying, prioritizing, and understanding the interests of stakeholder groups and then managing the company's relationships with these groups.

corporate governance and stakeholder management framework = reflects the company's legal, contractual, organizational, and governmental infrastructure which defines the rights, responsibilities, and powers of each group

⇨ communication and engagement with the various stakeholders should be important to every company !

Mechanisms of stakeholder management

The following practices attempt to manage the interests of various stakeholders:

- general meetings,
- board of directors,
- audit function,
- company reporting and transparency,
- related-party transactions,
- remuneration policies,
- contractual agreements with creditors,
- employee laws and contracts,
- contractual agreements with customers and suppliers,
- laws and regulations,

though the principles applied vary across companies, countries, and jurisdictions.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

general meetings = shareholders' voting rights are exercised

annual general meeting (AGM) = has to be hold within a certain period following the end of the fiscal year, purpose: present the company's annual audited financial statements, present the company's last year performance, address shareholder questions

extraordinary general meetings = can be called throughout the year for various purposes when shareholder approval is required (amendments to corporate bylaws)

proxy voting = when a shareholder authorizes another person, e.g. another shareholder, to vote on his or her behalf during a meeting s/he cannot attend

cumulative voting (≠straight voting) = when a shareholder is allowed to accumulate all his or her shares to vote on a single candidate when the election involves more than one director;
result: the likelihood of being represented by at least one director grows for the minority shareholders

sell-out rights = protect the minority shareholder interests in acquisitions, i.e. if the minority shareholder voted against the merger >> the exercised right forces the bidder with over 90% of the target's voting rights to buy his or her shares at a fair price upon the deal's approval

board of directors

Act as a link between shareholders and managers and an internal monitoring tool of the shareholders, who – in turn – monitor the board's performance when they exercise their voting power and participate in general meetings.

primary duties: duty of care, duty of loyalty

audit function

internal audit = when audit is conducted by an independent internal audit department

external audit = when an annual audit of the company's financial statements is conducted by an external body to provide reasonable and independent assurance of their accuracy

result: both are independent and thus limit the likelihood of fraud or misstatement of financial records and accounting information

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

transparency and reporting

Shareholders have access to information through various sources ranging from financial statements through investor relations department to social media. All this to:

- reduce the information asymmetry
- assess the board's and management's performance
- make informed investment decisions
- vote on key corporate matters

related-party transactions

Any conflicts of interest, including related-party transactions, have adequate policies established that ensure e.g. disclosure of a conflict of interest or material interest in the related-party transaction. These policies often require that such situations be voted on, excluding the director or shareholder holding the interest – to ensure s/he does not take an advantage of the situation at the expense of the interests of the company or other shareholders.

remuneration policies

incentive plans = include profit contingent on the company's or stock price performance, e.g. granting shares but with restrictions on vesting or sale (to discourage "short-termism" or excessive risk taking by managers and to delay some part of payment until the company's objectives are met)

say on pay = enables shareholders to vote on executive remuneration and is meant to reduce the potential conflict between shareholders (principal) and directors/managers (agents)

mandatory non-binding say on pay = when the board is required to enable shareholders to vote on executive remuneration plans but then is not obliged to abide by the result of the vote

non-mandatory advisory say on pay = when shareholders present their view on executive remuneration in form of a suggestion

⇨ executive remuneration plans need to align the interests of managers with those of shareholders !

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

contractual agreements with creditors

indenture = legal contract describing the bond's structure, the issuer's obligations, the rights of the bondholder

covenant = specifies what the issuer must do and cannot do

collateral = guarantees the repayment beyond the issuer's promise to repay, e.g. in form of other assets or financial guarantees

⇨ collaterals and covenants are used by creditors to secure against the company's default risk

employee laws and contracts

Employees' rights and responsibilities are specified in the labor law. At an individual level, an employee's rights and responsibilities are specified in the employment contract. Companies assign a compliance or corporate governance officer or a board committee to ensure the code of ethics compliance and appropriate business conduct. In certain countries, employees can be represented on the board of directors (e.g. in Germany). In Japan, the consensus between the management and employees is stresses when it comes to decision making.

labor law = specifies employees' rights and responsibilities

employee stock ownership plans (ESOPs) = when the company sets up a fund to grant employees shares with certain vesting periods as a motivational trigger

contractual agreements with customers and suppliers

Companies enter into contractual agreements specifying:

- prices/fees for customers, payment terms for suppliers,
- after-sale relationship,
- guarantees,
- rights and responsibilities of each party

laws and regulations

As a rule, companies do their best to adopt internal governance and compliance procedures and abide by the relevant laws and regulations, e.g. on financial reporting and transparency.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

CORPORATE GOVERNANCE: FACTORS, RISKS, AND BENEFITS

Market factors

- shareholder engagement = the company's interactions with its shareholders, e.g. shareholder meetings, not just annual but regular, more frequent
- shareholder activism = shareholders' efforts (incl. lawsuit) to make some changes within the company or modify its behavior, esp. to increase shareholder value; often hedge funds are involved
- competitive factors:
  - proxy contest (aka. proxy fight) = when shareholders are persuaded to vote for a group seeking to gain control of the board of directors
  - tender offer = when shareholders sell their interest directly to the group seeking control
  - hostile takeover = when a company wants to acquire another company without consent of its management

⇨ market factors affect stakeholder relationships and corporate governance !

Non-market factors

- law (different jurisdictions depending on a country)
- media (quick info dissemination, influence on corporate matters)
- corporate governance industry (external corporate governance services for investors providing ratings and recommendations of companies)

⇨ non-market factors affect stakeholder relationships and corporate governance !

Risk and benefits

risks of poor governance:

- weak control systems (e.g. poor audit procedures or insufficient scrutiny by the board)
- ineffective decision making (caused by e.g. information asymmetry between the managers and shareholders or bad executive remuneration policy)
- legal and regulatory risks (compliance weakness leads to possible lawsuits or investigations)
- reputational risk (caused by e.g. badly managed conflicts of interest)
- default and bankruptcy risks (poor corporate governance can hinder the company's financial position and its ability to meet debt obligations)

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

benefits of good governance:

- operational efficiency (owing to clearly defined and delegated duties)
- effective control at all corporate levels
- better operating and financial performance (thanks to e.g. improved decision-making process or proper remuneration policies)
- lower default risk or cost of debt (mitigated by e.g. a well-functioning audit system, creditors' rights protection, control of information asymmetry)

⇨ BAD CORPORATE GOVERNANCE >> when one group benefits at the expense of another

⇨ GOOD CORPORATE GOVERNANCE >> aligns: interests of managers and directors = interests of shareholders (while balancing the interests of the company's stakeholders)

ESG CONSIDERATIONS

ESG = Environmental + Social + Governance

ESG considerations for analyst

- economic ownership and voting control (consider: e.g. dual share system)
- board of directors representation (consider: e.g. directors' experience and expertise)
- remuneration and company performance (consider: e.g. remuneration plans disclosure, any warning signs? e.g.:
  - plans offering little alignment with shareholders?
  - plans showing little variation in results over multiple years?
  - plans with excessive payout compared to comparable companies with comparable performance?)
- investor composition (consider: cross-shareholdings, affiliated stockholders, shareholder activism)
- strength of shareholders' rights (as compared to other companies >> are they weak, strong, average?)
- management of long-term risks (consider: transparency)

⇨ analyst should take corporate governance into consideration before making an investment decision !

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

ESG considerations for investors

Why environmental and social factors should be considered for investment analysis:

- scarcity of natural resources
- climate change
- global economic and demographic trends
- societal evolution

⇨ ESG factor is considered material when the factor is believed to influence the company's long-term business model.

environmental factors considered material:

- natural resource management
- pollution prevention
- water conservation
- energy efficiency and reduced emissions
- existence of carbon assets
- adherence to environmental safety and regulatory standards

social factors considered material:

- human rights
- welfare concerns
- product development
- community impact
- employee training/morale/diversity, etc.

⇨ taking care of these social factors reduces the company's legal and reputational risks !

Terms related to ESG

- sustainable investing (SI)
- responsible investing (RI)
- ESG investing
- socially responsible investing (SRI)

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Approaches to ESG implementation

negative screening = excluding those companies or sectors that disregard ESG aspects (most often applied!)

positive screening or **best-in-class** strategy = including investments with favorable ESG aspects

thematic investing = focuses on investing in companies within a specific thematic field, e.g. climate change

impact investing = seeks to achieve targeted social or environmental objectives along with measurable financial returns through engagement with a company or by direct investment in the company (or its projects)

ESG integration (aka. ESG incorporation) = the aim is to identify risks and opportunities related to ESG factors and see how a company is handling them before making an investment decision

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

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Summarizing key concepts:

☐ Defining corporate governance

My summary:

☐ Shareholder vs Stakeholder theory

My summary:

☐ Primary company stakeholders

My summary:

☐ Company's financial performance: *who cares and why* ?

My summary:

☐ Functions and responsibilities of the board

My summary:

☐ Board of directors committees

My summary:

☐ Principal-agent (agency) relationship

My summary:

☐ Possible principal-agent conflicts

My summary:

☐ Stakeholder management

My summary:

☐ Mechanisms of stakeholder management

My summary:

☐ Market vs non-market factors

My summary:

☐ Risks of poor corporate governance

My summary:

☐ Benefits of good corporate governance

My summary:

☐ ESG considerations (analysts)

My summary:

☐ ESG considerations (investors)

My summary:

☐ Approaches to ESG implementation

My summary:

Reviewing formulas:

$$Q_D = f(P, I, P_A, \ldots)$$

Write down the formula:

$$E_P = \text{own-price elasticity of demand} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in price}} = \frac{\frac{\Delta Q}{Q}}{\frac{\Delta P}{P}} = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

Write down the formula:

$$E_I = \text{income elasticity of demand} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in income}} = \frac{\Delta Q}{\Delta I} \times \frac{I}{Q}$$

Write down the formula:

$$E_C = \text{cross-price elasticity of demand} = \frac{\%\text{ change in quantity demanded}}{\%\text{ change in the price of another good}} =$$

$$= \frac{\frac{\Delta Q}{Q}}{\frac{\Delta P}{P}} = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

Write down the formula:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

✔ Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
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25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	

TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	