

PART I

LEARNING OUTCOMES, SUMMARY OVERVIEW, AND PROBLEMS

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CHAPTER 1

CORPORATE GOVERNANCE

LEARNING OUTCOMES

After completing this chapter, you will be able to do the following:

- Explain corporate governance, describe the objectives and core attributes of an effective corporate governance system, and evaluate whether a company's corporate governance has those attributes.
- Compare major business forms and describe the conflicts of interest associated with each.
- Explain conflicts that arise in agency relationships, including manager-shareholder conflicts and director-shareholder conflicts.
- Describe responsibilities of the board of directors and explain qualifications and core competencies that an investment analyst should look for in the board of directors.
- Explain effective corporate governance practice as it relates to the board of directors, and evaluate the strengths and weaknesses of a company's corporate governance practice.
- Describe elements of a company's statement of corporate governance policies that investment analysts should assess.
- Explain the valuation implications of corporate governance.

SUMMARY OVERVIEW

- Corporate governance is the system of principles, policies, procedures, and clearly defined responsibilities and accountabilities, used by stakeholders to eliminate or minimize conflicts of interest.
- The objectives of a corporate governance system are (1) to eliminate or mitigate conflicts of interest among stakeholders, particularly between managers and shareholders, and (2) to ensure that the assets of the company are used efficiently and productively and in the best interests of the investors and other stakeholders.
- The failure of a company to establish an effective system of corporate governance represents a major operational risk to the company and its investors. To understand the risks inherent in an investment in a company, it is essential to understand the quality of the company's corporate governance practices.
- The core attributes of an effective corporate governance system are:
 - a. Delineation of the rights of shareholders and other core stakeholders
 - b. Clearly defined manager and director governance responsibilities to the stakeholders

- c. Identifiable and measurable accountabilities for the performance of the responsibilities
- d. Fairness and equitable treatment in all dealings between managers, directors, and shareholders
- e. Complete transparency and accuracy in disclosures regarding operations, performance, risk, and financial position
- The specific sources of conflict in corporate agency relationships are
 - a. Manager-shareholder conflicts—Managers may, for example:
 - Use funds to try to expand the size of a business even when this is not in the best interests of shareholders
 - Grant themselves numerous expensive perquisites that are treated as ordinary business expenses
 - b. Director-Shareholder Conflicts—Directors may, for example, identify with the managers' interests rather than those of the shareholders as a result of personal or business relationships with the manager.
- The responsibilities of board members, both individually and as a group, are to
 - a. Establish corporate values and governance structures for the company to ensure that the business is conducted in an ethical, competent, fair, and professional manner
 - b. Ensure that all legal and regulatory requirements are met and complied with fully and in a timely fashion
 - c. Establish long-term strategic objectives for the company with a goal of ensuring that the best interests of shareholders come first and that the company's obligations to others are met in a timely and complete manner
 - d. Establish clear lines of responsibility and a strong system of accountability and performance measurement in all phases of a company's operations
 - e. Hire the chief executive officer, determine the compensation package, and periodically evaluate the officer's performance
 - f. Ensure that management has supplied the board with sufficient information for it to be fully informed and prepared to make the decisions that are its responsibility, and to be able to adequately monitor and oversee the company's management
 - g. Meet regularly to perform its duties and in extraordinary session as required by events
 - h. Acquire adequate training so that members are able to adequately perform their duties
- An investor or investment analyst must assess
 - a. Board composition and independence
 - b. Whether the chairman of the board is independent
 - c. The qualifications of the directors
 - d. Whether the board is elected on an annual or staggered basis
 - e. Board self-assessment practices
 - f. The frequency of separate sessions of independent directors
 - g. The audit committee and audit oversight
 - h. The nominating committee
 - i. The compensation committee and compensation awards to management
 - j. The use (or not) of independent legal and expert counsel
- Companies committed to corporate governance often provide a statement of corporate governance policies. Analysts should assess: the code of ethics; statements of the oversight, monitoring, and review responsibilities of directors; statements of management's responsibilities with respect to information and access of directors to internal company functions; reports of directors' examinations, evaluations, and findings; board and committee self-assessments; management self-assessments; and training policies for directors.

- Weak corporate governance systems give rise to risks including accounting risk, asset risk, liability risk, and strategic policy risk. Such risks may compromise the value of investments in the company.

PROBLEMS

1. Which of the following *best* defines the concept of corporate governance?
 - A. A system for monitoring managers' activities, rewarding performance, and disciplining misbehavior.
 - B. Corporate values and governance structures that ensure the business is conducted in an ethical, competent, fair, and professional manner.
 - C. A system of principles, policies, and procedures used to manage and control the activities of a corporation so as to overcome conflicts of interest inherent in the corporate form.
2. Which of the following is an example of a conflict of interest that an effective corporate governance system would mitigate or eliminate?
 - A. A majority of the board is independent of management.
 - B. Directors identify with the managers' interests rather than those of the shareholders.
 - C. Directors have board experience with companies regarded as having sound governance practices.
3. Which of the following *best* describes the corporate governance responsibilities of members of the board of directors?
 - A. Establish long-term strategic objectives for the company.
 - B. Ensure that at board meetings no subject is undiscussable and dissent is regarded as an obligation.
 - C. Ensure that the board negotiates with the company over all matters such as compensation.
4. Which of the following is *least likely* to be useful in evaluating a company's corporate governance system for investment analysis purposes?
 - A. Assess issues related to the board, managers, and shareholders.
 - B. Review the company's regulatory filings and financial information provided to shareholders.
 - C. Flag items such as egregious use of insider transactions for users of the financial statements.
5. The objectives of an effective system of corporate governance include all of the following *except*:
 - A. ensure that the assets of the company are used efficiently and productively.
 - B. eliminate or mitigate conflicts of interest among stakeholders.
 - C. ensure complete transparency in disclosures regarding operations, performance, risk, and financial position.
6. All of the following are core attributes of an effective corporate governance system *except*:
 - A. fairness and accuracy in identifying inherent conflicts of interest.
 - B. clearly defined governance responsibilities for managers and directors.
 - C. delineation of shareholders and other core stakeholders' rights.

7. All of the following are examples of conflicts of interest that an effective corporate governance system should address *except* relationships between:
 - A. managers and shareholders.
 - B. managers and directors.
 - C. managers and institutional analysts.
8. All of the following are true of an effective system of corporate governance *except*:
 - A. the system must be continually monitored especially with changes in management and the board.
 - B. a single system of effective corporate governance applies to all firms worldwide.
 - C. there are a number of common characteristics of all sound corporate governance structures.

The following information relates to Questions 9–14.

Jane Smith, CFA, has recently joined Zero Asset Management, Inc. (Zero) as a board member. Since Smith is also outside council for Zero, she is already very familiar with Zero's operations and expects to begin contributing good ideas right away. Zero is a publicly traded investment management firm that historically focused on mutual fund management. Although there is current market opportunity to add a new type of mutual fund, the board recently decided against adding the fund. Instead, the board decided to expand its business to include a hedge fund operation within the existing corporation.

Bill Week, CEO of Zero, has publicly stated that he is willing to bet the company's future on hedge fund management. Week is the founder of Zero, as well as Chairman of the board, and maintains a controlling interest in the company.

Like the rest of Zero, the firm's new hedge fund is quantitatively driven and index based. The fund has been set up in a separate office with new systems so that the analysts and managers can create a unique hedge-fund culture. Trading and execution are the only operations that remain with Zero. The fund is run by one of Zero's most successful portfolio managers.

Smith learns that although none of the board members sit on other companies' boards, most have at one point or another worked at Zero and so they are very familiar with Zero's operations. A board member has attempted to make the health insurance and retirement concerns of the board members an agenda item, without success to date. Smith eagerly anticipates the next board meeting as they are always in a luxurious setting.

At the board meeting, Smith asks a number of questions about Zero's corporate governance system. The board becomes concerned by Smith's questions and decides to hire an independent consultant to review their corporate governance responsibilities. The consultant starts his analysis by stating that a corporate governance system relies upon checks and balances among managers, directors, and investors. Smith asks if Zero has the proper systems in place. The consultant says that he has looked at conflicts of interest and has one more area to review in order to verify that the board is meeting its major objectives. Concerned about the company's stock price, Smith asks the consultant what work he has done concerning Zero's corporate disclosures for investment professionals. The consultant indicates that he has reviewed Zero's regulatory filings for clear and complete information, as well as the company's policies regarding related party transactions.

9. All of the following indicate Zero's board's lack of independence *except*:
 - A. personal relationships.
 - B. service of the outside counsel as a board member.
 - C. lack of interlocking directorships.

10. Which of the following is the most effective action for the board to take to address their oversight responsibilities concerning the hedge fund's proxy voting?
 - A. Establish corporate values and governance structure for the company.
 - B. Establish long-term strategic objectives that are met and fully complied with.
 - C. Perform adequate training so that employees are able to perform their duties.
11. Which of the following omissions best describes a corporate governance shortcoming of Zero's board of directors? The board's failure to:
 - A. address the potential conflicts of interest between managing the firm's hedge fund and its mutual fund business.
 - B. meet the market opportunity for a new kind of mutual fund.
 - C. establish the hedge fund operation in a separate corporation.
12. Given that Zero's directors all previously worked at the company, which of the following would you recommend for a more effective system of corporate governance?
 - A. Ensure that assets are used efficiently and productively and in the best interests of investors and stakeholders.
 - B. Eliminate or mitigate conflicts of interest among stakeholders, particularly between managers and shareholders.
 - C. Identify and measure accountabilities for the performance of the board's responsibilities.
13. Which of the following best describes the objectives of Zero's board that the consultant has not yet reviewed? The board should ensure:
 - A. that the assets of the company are used efficiently and productively and in the best interests of the investors and other stakeholders.
 - B. that material foreseeable risk factors are addressed and considered.
 - C. compliance with applicable laws and take into account the interest of stakeholders.
14. Which of the following is the most critical activity that an analyst can engage in to assess the quality of the corporate governance system at Zero, among those that the consultant did not review?
 - A. Look for vague references to off-balance-sheet or insider information.
 - B. Identify the responsiveness of the board to shareholder proxy votes.
 - C. Evaluate the quality and extent of financial information provided to investors.

The following information relates to Questions 15–19.

Shelley Newcome is the new CEO for a publicly traded financial services company, Asset Management Co. (AMC). Newcome is new to the corporate governance requirements of a publicly traded company, as she previously worked for a family office that invested in private equity.

At her first board meeting, the company's first in six months, she asks a director what the objectives of corporate governance should be. The director tells her that the most important objective he can think of is to eliminate or mitigate conflicts of interest among stakeholders.

One of Newcome's first steps as CEO is to fly to New York City in order to address a group of Wall Street analysts. Newcome is happy to discover that AMC provides her, and other senior management, with a company jet to attend such meetings.

At the opening of the meeting, Newcome is surprised to hear that most of the analysts are extremely interested in learning about AMC's corporate governance system. One analyst indicates that he has studied several of AMC's competitors and found that they share a set of

critical and core attributes. The analyst goes on to note that like its competitors, AMC has included in its corporate governance system the following attributes: the rights of shareholders and other core stakeholders are clearly delineated; there is complete transparency and accuracy in disclosures regarding operations, performance, risk, and financial position; and identifiable and measurable accountabilities for the performance of responsibilities. The analyst also says that in order to verify that the board is meeting its major objectives he has looked at AMC's conflicts of interest and has one more area to review.

Newcome then asks the analyst why his corporate governance evaluation of AMC is so important. The analyst responds by saying that his decision whether or not to invest in AMC, and ultimately the long-term performance of the company, is dependent upon the quality of AMC's managers' decisions and the skill they use in applying sound management practices.

Closing the meeting, Newcome is delayed by one analyst who complains about the difficulties of flying these days and how he has to get to the airport hours ahead of time. The analyst goes on to say that he reviewed AMC's regulatory filings and was happy to see that the company does not spend its money on frivolous perquisites like executive jets.

15. Which of the following would *best* complete the objectives of corporate governance for the CEO?
 - A. Ensure that assets of the company are used efficiently and productively and in the best interests of investors and other stakeholders.
 - B. Clearly define governance responsibilities for both managers and directors.
 - C. Establish clear lines of responsibility and a strong system of accountability and performance measurement in all phases of a company's operations.
16. On the basis of the Wall Street analyst comments about AMC's corporate governance system, which of the following would be *most* effective for AMC to attract investors' interest?
 - A. Implement a corporate governance system in which business activity is encouraged and rewarded, and that leads to innovation.
 - B. Establish a corporate governance system that overcomes inherent conflicts of interest since they represent a major operational risk to investors and the continued existence of the company.
 - C. Provide full transparency of all material information on a timely basis to all investment analysts.
17. Which of the following is a core attribute that the Wall Street analyst left out of his analysis of AMC?
 - A. Corporate governance systems rely on checks and balances among managers, directors, and investors.
 - B. Fairness in all dealings between managers, directors, and shareholders.
 - C. Complete, accurate, and transparent disclosure of loans to private equity funds.

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18. Based on the information provided in the case, which of the following corporate disclosures could investment professionals use to evaluate the quality of the corporate governance system at AMC?
- A. Inclusion of all vague references to off-balance sheet or insider transactions in board minutes.
 - B. Failure to disclose executive perquisites such as the use of corporate jets by senior management.
 - C. Provide other compensation that has not been disclosed to investment analysts.
19. Which of the following is an example of a corporate governance responsibility that AMC's board of directors has failed to meet?
- A. Ensure that the board adequately monitors and oversees the company's management.
 - B. Ensure that management has supplied the board with sufficient information for it to be fully informed.
 - C. Meet regularly to perform its duties.

