**Corporate Governance**

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1 - Corporate Governance Issues, Concepts and Domain

**1.1 Introduction** 1/1

**1.2 External and Internal Governance of Group Activities** 1/2

Even barter systems have taboos and expected norms

Informal groups develop agreement and act collectively for mutual purpose

* Coordination to achieve collective objective
* Avoid violating expected norms and behaviours
* Internal governance

External governance limits autonomy of enterprise in organisation and activities

Internal governance limits autonomy of individuals in enterprise

**1.3 Feudal Economies and Financial Markets** 1/3

Goldsmiths began to take deposits of valuables

Goldsmiths and merchants established banks

**1.4 Embryonic Corporate Governance Mechanisms** 1/5

Practice of holding and moving physical valuables replaced with banking orders

* Cheques, drafts

Draft system entailed risks

* Depositor owns assets
* Bank is reliable place to hold, sufficient valuables on deposit to settle
* Withdrawer is intended recipient

Initial organisations relied on reputation

* Did not scale for volume and geography
* Joined into collective solutions (London Stock Exchange)

**1.5 Foundations of the Corporate Governance Framework** 1/7

Evolved from land-owning system in Europe

* Land not only economic asset but also source of power and status
* Strict settlement: landowner only owned tenancy for their lifetime
  + Land belonged to estate, not squire
  + Resident agent responsible for
    - Finding tenants, negotiating leases, husbandry covenants, improvements
    - Collection, disbursement, accounting

Estate accounting system

* Emphasis on net cash as revenue
* Invisibility of capital

Canals and Railroads used similar accounting system

Directors seen as agents/trustees

**1.6 External Governance Mechanisms to Facilitate Economic Development** 1/11

Coffee house capital markets

* Jobbers linked investors with capital seekers

Joint stock company

* Permitted shares to be transferred from one owner to another without permission of other owners

Jobbers began to organise flotation of companies and facilitate transfer of shares

**1.7 Protecting the Providers of Capital and Society** 1/15

World is dependent on financial markets

* If investors lose confidence the funding of the economy is put at risk

Bubble Act (1720): prohibited raising of capital in public market except of joint-stock company

* Also prohibited activities except those permitted in charters

Rules for stock exchange members to deal with behaviour of intermediaries

Regulators supervise relationship between companies traded in public markets

**1.8 Listed Company Behaviour – On (Off) the Agenda** 1/18

First known use of term corporate governance Tricker (1976)

* Originally used primarily for company secretary
  + Ensures requirements set out in company law

**1.9 Market Madness, Excess and Trust Lost** 1/21

1990s – growth of stock market

* Executive compensation also escalated

**1.10 Trust – A Fundamental Requirement in Economic Relations** 1/28

All economic transactions require trust

* Even money is intangible without intrinsic value => relies on belief in economic strength, efficacy, honesty

Beliefs necessary for financial markets:

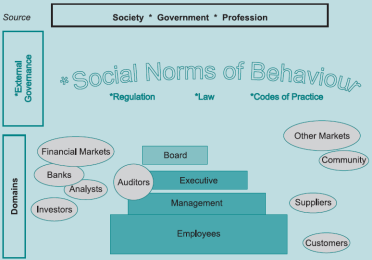
* Issuers of instruments have ability to fulfil obligations
* Instruments are valid and authentic
* Sellers will deliver as agreed
* Purchases will pay as agreed
* Pertinent information about issuer is available and reliable
* Instruments can be accurately valued
* Relevant information is available to all

**1.11 The Domains of Corporate Governance** 1/29

Corporate management is owner’s agent

Corporate governance aim:

* Reliable performance reporting (accounting standards, audits, legal sanctions)
* Reliability through management supervision by board of directors
* Lesser extent: auditors and company executive



**Learning Summary** 1/33

**Review Questions** 1/34

**Case Study** 1/38

2 - External Governance – Law and Regulation

**2.1 Introduction** 2/1

External corporate governance framework

* Rules guidance, controls arising outside organisation
* Intended to influence decisions within organisation
* Laws, regulations, codes of practice, social norms (implicit)

**2.2 External Mandates on Internal Governance** 2/2

Degree of prescription varies by jurisdiction

* France (SARL, SA), Germany (AG, GmbH)
* British/American little distinction; little prescription on internal orgaisation

**2.3 Legal Systems** 2/3

Classification: background, development, sources of law, methodology

* Most widespread: civil, common

Civil law: comprehensive set of statutes and codes

* Highly systematised and structured

Common law:

* Created both by legislation and judged
* Judicial precedents
* Decisions of higher courts bind lower courts

Cross-system influences- mixed legal systems and anomalies

**2.4 Evolutionary Development of Legal and Regulatory Frameworks** 2/6

As financial markets evolve

* Issues arise
* Stimulate development of corporate governance mechanisms to solve issues

Most business and non-business activities carried out by sole traders, partnerships, unincorporated associations but:

* Most economically and socially important organisational entity is the limited liability company
  + Created by statutes called company law or corporation laws

Bubble act (1720)

* Prohibited flotation of shares except chartered (expensive) joint stock company
* Before collapse of South Sea Company (supported by SSC)

Deed of settlement company

* Founder divided shares; transferred title of shares to investors
* Founder and investors were trustees would confer role of operating on directors (usually some were trustees)
* Obsolete; Basis for UK/IE company law

Limited Liability Act 1855:

* Notion of general limited liability for shareholders

1972: European Commission adopted EC company law harmonisation programmre

Associations formed as Partnerships governed separately

* Limited liability partnerships (LLP)
* Structural characteristics of partnership
* Protected from liabilities (in excess of investment)

**2.5 Contemporary Company Law** 2/11

Limited liability companies have legal status separate from their owners

Types of company

* Private unlimited company
* Private company limited by shares
* Private company limited by guarantee
* Public limited company

External governance framework specifies internal governance mechanisms that must be in place

Articles of Association

* Share capital
* Company meetings, director meetings; minutes
* Directors: number, power, remuneration, expenses, appointment, retirement,
* Company accounts, secretary; dividends,

Type of company determines requirements

* Subscribers, directors
* Secretary, Formal qualifications

**2.6 Mandates on Stewardship and Accountability** 2/18

Company officers

* Directors, senior managers, company secretary, auditors (in some cases)
* May bear some legal responsibilities in jurisdictions merely by doing business there

Shareholders

* Legal control and ownership exercised in general shareholder meetings

Board of directors

* Usually elected by shareholders
* Executive (employee) and non-executive

Accountability requirements

* Disclosure of certain information to government and others
* Report and accounts; set of financial statements accompanies by written report

Accounting standard convergence

* IAS, Country GAAP

**2.7 Winds of Change** 2/25

Evolutionary trends in legal mandates: if internal governance allows breach in external framework there will be consequences

* Competition rules (disqualified directors)
* Corporate manslaughter
* External reporting (criminal penalties)
* Increased responsibilities for directors and audit committee
* Director independence and disclosure
* Increasing compliance burden

Enterprise act

* Individual participating in hard-core cartel a criminal offence

Corporate manslaughter

* Previously , required intrinsic link of director/senior manager
* Corporate killing: result of management failure

Sarbanes-Oxley

* Executives must certify adequacy of internal controls

**2.8 Barriers to Improvement** 2/28

Accounting harmonisation

* IAS: 2000: EC announced requirement in 2005
* Singapore
* Australia will converge country-GAAP

Complex webs of law and external oversight

* UK Five authorised professional accountancy bodies
* UK regulation of company reporting includes:
  + Parliament, Government, EC, Financial Reporting Council, Accounting Standard Board, Urgent Issues Task Force, Financial Reporting Review Panel, Stock Exchange, Financial Services Authority, Accountancy Foundation, International Accounting Standards Board, Confederation of British Industry, Law Society, Financial Accounting Standards Board (USA: US-GAAP)

**Learning Summary** 2/33

**Review Questions** 2/34

**Case Study** 2/39

3 - Codes of ‘Best Practice’ and Norms of Behaviour

**3.1 Introduction** 3/1

Code of best practice – set of non-binding principles, standards, practices

* Recommended by distinguished body
* Relate to internal governance
* Explicit but non-mandatory

Issues

* Company probity (honesty)
* Accountability
* Risk management
* Influence
* Executive compensation

Best known:

* Treadyway / COSO
  + Improve corporate accountability
* Cadbury
  + Improve boardroom functioning

1985: Treadway Commission (sponsored by COSO)

* After American corporate frauds
* Examined fraudulent financial reporting
* Internal control practices

1991: Cadbury Commission

* After collapse of Polly Peck, BCCI

**3.2 External Pronouncements about Internal Governance Practices** 3/4

Treadway report

* Accountants view: internal financial control
* Three objectives
  + Efficient and effective operations
  + Accurate financial reporting
  + Compliance will all laws and regulations
* Components
  + Control environment (foundation of internal control system)
  + Risk assessment
    - Identification and analysis by management (not internal audit)
  + Control activities
    - Policies, procedures to verify objectives and risk mitigation
  + Information and communications
    - To employees
  + Monitoring

Cadbury Contributions

* Framework of principles to help boards achieve intent behind laws mandating company reporting
  + Board of directors
    - Power, division of responsibilities, access to secretary, sufficient non-executives, procedures for advice
  + Non-executive directors
    - Majority independent, formal selection process, specified terms of office
  + Executive directors
    - 3 years maximum, compensation disclosure, remuneration committee
  + Reporting and controls
    - Balanced view, objective relationship with auditors, audit committee, effectiveness of internal control
  + Compliance with Code

Principles (rather than rules)

* Substance should have precedence over form
* Framework of standards; customised implementation to achieve objectives

Entire system of Internal control

* Balanced; not just financial

**3.3 The Theory Behind Best Practice Recommendations** 3/8

Cadbury report influenced many subsequent reports

* Strengthened audit committee (only independent directors)
* Split chairman and chief executive roles
* Ensure independent directors have access to external legal advice
* Highlight importance of skills and competence
  + Chairman, secretary, independent directors

Subsequent reports focus on:

* Abuse by management
* Need for better information on management

Agency relationships

* Principal agent problem
* Adverse selection
  + Agent misrepresents abilities
* Moral hazard
  + Lack of effort
* Information asymmetries
* Board of directors
  + Theory: Directors monitor agents
  + Practice: management may influence selection of board of directors

**3.4 ‘Best Practice’ Corporate Governance Reform – Narrow in Focus** 3/11

Most best practice (beginning with Cadbury) focus on board of directors

* Address natural weakness in chain of board-management relationships
* Strengthen independence of director
* Mandate practices by board to improve services

Following publication of Cadbury, UK mandated that companies disclose extent of compliance

* London Stock Exchange issued “comply or explain”

Combined Code

* Provisions to encourage interaction between institutional investors and companies

Turnbull

* Boards should report annually on their risk assessment and decision-making processes

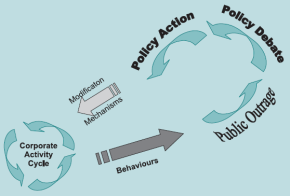
Myners

* Pension funds not professionally managed
* Recruit, delegate externally, or improve ability

**3.5 Around the World – Inconsistencies in Reports** 3/15

UK most active in developing recommendations

Different emphasis in other countries

* Preda (IT) – maximise shareholder returns
* Peters (NL) – good balance between shareholders and other stakeholders
* Vienot (FR) – common interest of all stakeholder for company to remain in business and stay profitable
* Greater transparency
* Environmental concerns

**3.6 Norms, Expectations and Behaviours** 3/18



When implicit social norms are insufficient

* Stimulate development of more formal mechanisms

Example Short-termism:

* Perception: Capital markets place excessive weight on short-term performance
* Evidence: market anticipate future results but responds negatively to short-term signals
* Alternative explanation:
  + Managers believe short-term markets and therefore under-invest
  + Managers concerted with personal risks and costs
  + Share options to solve problem
    - Massive remuneration packages
* Market myopia => under-investment => Share options
* Corporate greed => market loss => controls on management

Sarbanes Oxley

* Regulators acted quickly because it was politically expedient

Assumption that all managers motivated by corporate greed

Bad-apples:

* Capital markets flow to highest risk-adjusted returns
* Bad apples had lower cost of capital => abnormal returns
* Impossible benchmark
* Accounting manipulation matter of self-preservation

**3.7 Stimuli for Changes in External Governance** 3/23

**Learning Summary** 3/27

**Review Questions** 3/28

**Case Study** 3/34

4 - Boards of Directors: The Lynchpin

**4.1 Introduction** 4/1

Boards failed in duties of four elements (law, regulations, codes, norms)

Recent additions to external governance frameworks have increased director responsibility

* May not overcome current problems

**4.2 The Basis for the Board of Directors** 4/2

Evolving role includes growing list of mandatory tasks

Historic role was hiring/firing top management

Self-regulating club:

* Governance based on personal integrity
  + Exclusion the height of humiliation
* Director role: ‘getting along’- not financial literacy
* Comfortable life; management did all the work

**4.3 Shaking the Foundations of the Established Order** 4/5

1973: Rolls-Royce; 1986: Guinness; 1991: BCCI

* Abuses – e.g. “rent-a-face”

Cadbury (1991):

* Improve accountability of all member of a board of directors to owners
* Improve rule of law within company through board of directors

**4.4 Legal Responsibilities of Directors** 4/10

UK Legal Liabilities for directors:

* First: duty to company and company health
* In case of insolvency: duty shifts to protecting creditors
* Errors in judgement do not give rise to liability but negligence may
* Must disclose interest in equity or debt; insider dealing prohibited

**4.5 Who are the Directors?** 4/12

Not undischarged bankrupt or disqualified

* E.g. convicted of offense

Age limits, maximum and minimum

**4.6 Expected Boardroom Practices** 4/12

Greenbury Committee

* Need for remuneration committee

Hampel Report

* **Combined Code**: Cadbury and Greenbury
* London Stock Exchange: comply or explain
* Better director training
* Balancing the board
  + At least one-third independent directors
* Splitting chairman and chief executive
  + Except with clear and compelling reason
  + Named senior independent non-executive director in annual report
* Improved information for the board
* Open process of board appointments
  + Nominating committee (majority non-executive directors)
* Director remuneration
  + Sufficient but not excessive
  + Linked to corporate and personal performance
  + Reported to shareholders
  + Shareholder approval for long-term incentive plans
* Accountability and audit
  + Maintain and review Internal control system
  + Review all controls
  + Consider internal audit function
  + (Recommended only): audit committee of 3+ independent directors

**4.7 Follow-on Recommendations and Mandates** 4/15

Turnbull

* Create risk-based approach to establishment of internal control system
* Review system effectiveness

Smith

* Good practice for audit committee
* Encapsulates good audit practices but does **not** address new areas
  + Environmental, ethics, community accountability, non-financial measures
* Misses Cadbury vision of non-financial internal control
* Received little attention

Higgs

* Review of non-executive director role

Conclusions

* Number of board meetings and attendance published in annual reports
* Non-executive directors should meet annual without chairman or executive directors
* Senior independent director should be available to shareholders
* Pool of directors candidates broadened
* Non-executive directors to receive comprehensive induction
* Non-executive director to serve maximum of two three-year terms

Issues:

* Risk of undermining unitary nature of British boards
* No objective evidence for requirements

New UK Combined Code

* Included Higgs Review recommendations
* Business leaders complained

SarBox – rules-based approach

* Legalistic response to corporate scandals
* Example: detailed requirements for audit committee member

**4.8 The State of Play in the Boardroom** 4/20

Corporate governance reform movement seeks to:

* Create model of governance by board of directors that never existed using
* Recommendations that have not been tested

Heat of attention targeted on the boardroom

* Rest of corporate governance system is being ignored

**Learning Summary** 4/22

**Review Questions** 4/22

**Case Study** 4/28

5 - Internal Controls and Accountability

**5.1 Introduction** 5/1

Focus of external corporate governance law, regulation and best-practice code on boardroom

Only a few consider

* How internal rules, guidance and controls determine actions/behaviours

Tendency to segregate internal governance mechanisms into functional enclaves

* Accounting, HR, operations
* Don’t attempt to achieve objectives collectively

Disconnect between external governance mandates and internal governance system

**5.2 Foundations of Enterprise Accountability and Control** 5/3

Pacioli – father of accounting

* Summa – first description of double-entry bookkeeping

Charge/discharge accounting (CDA) – landed estates

* Emphasis on cash transactions (not asset/liability balances)
* Often segregated by sub-agent
* Useful as check on receipts/payments made by steward; not as profit/loss account

Modern Cost Accounting

* Josiah Wedgwood: costs and allocation for materials and labour

Modern Internal Control

* DuPont: fixed-asset accounting system with departmentalised business operation structure
* ROI calculation
* Flexible budgeting, uniform performance criteria
* GM improvements
  + Fundamental architecture for many internal governance systems
  + Strategies, business models, structures, operating methods have changed

**5.3 Information and Decisions – A Theoretical Model of ‘Control’** 5/10

Control: alternate definitions

* Power and domination
* Collecting information to manage activities to achieve desired outcome
* Formal and informal processes that guide individual behaviour in a corporate setting

Conditions:

* + Objectives
  + Measurable output
  + Predictive model
  + Corrective action possible

**5.4 From Theory to Application** 5/11

Process is out of control when variation is beyond capacity of corrective action

Human dimension acts as complicating factor

Theoretical model requires objectives (e.g. profit)

* Model tests performance against objective
* Corrective action improves the outcome
* Sophisticated modelling may be required
  + Surrogate goals may approximate effect when primary objective is not (yet) measurable

**5.5 Internal Predictive Models – Informal and Formal Mechanisms** 5/14

Informal models based on experience and intuition

* Some people may be able to use well
* but average person achieves better results with formal models

**5.6 External Recommendations about Internal Control** 5/15

Treadway calls for essential components in internal control system

* Control environment
  + Foundation providing discipline and structure
* Risk assessment
  + By management (not internal audit)
* Control activities
  + Policies, procedures to achieve objectives, mitigate risks
* Information and communication
* Monitoring

*Few mechanisms fit theoretical control model!*

**5.7 Internal Governance – Guide, Support, Control and Account for Decisions** 5/15

Highly complex infrastructure

* Diverse set of mechanisms to guide, constrain behaviour
  + Social influence (norms, values)
  + Informal guidelines (understanding)
  + Training
  + Formal rules and procedures

**5.8 The Human Dimension – Unexpected Responses** 5/16

Purpose of internal governance is

* Guide individual behaviour toward objectives
* Prevent undesirable behaviours

Internal governance mechanisms may encourage behaviour inconsistent with objectives

Major branches of psychology provide different assumptions to governance theories

* Behaviourism, Cognition, Neuroscience

Assumptions about Reinforcement

* Rewards and punishment can encourage desired behaviour
* Dysfunctional behaviour when means are more important than the ends
  + Negative attitudes, cynical behaviour if results unobtainable

**5.9 Gaming and Manipulation** 5/20

People may game a performance management system

* Buffer resources, defer achievements, manipulate data

**5.10 Budgets Up Close** 5/20

Where budgets are static, with high stakes

* Managers routinely game the budget system

Where budgets are interactive and flexible

* Manipulation is much more limited

Multiple uses

* Internal governance mechanism
* Allocation of scarce resources
* Setting objectives for resources use
* Roles
  + Forecasting, planning, decision support
  + Coordination, communication
  + Motivation, performance evaluation

Pressure to deliver budget performance causes conflict

* Holders and bosses, between units

Decentralised organisation – budget holder may have wide latitude in how they achieve budget results

Budget paradox

* Challenging target must carry risk that it will not be achieved
* Forecast should not be based on risky stretch target

Budget as decision support tool inconsistent with performance motivator tool

Setting budgets involves negotiation

* Limited resources
* Status, personal aims, objectives
* More political in complex organisations

Budget process may function differently depending on whether

* Status defines authority or authority defines status

**5.11 A Lesson about Governance Mechanisms** 5/25

Internal corporate governance is a system – not process or function

* Must be understood and managed as a whole (not in silos)

**Learning Summary** 5/27

**Review Questions** 5/29

5.63 internal governance mechanisms:

* budgeting, reward, performance appraisal, performance measurement and communication distribution

5.65 The focus of external corporate governance law, regulation and ‘best practice’ recommendations has been on the boardroom. Each contribution has increased the pressure on boards of directors and added to their tasks

This work may have improved matters, but the initiatives have overlooked an important area – how external mandates translate into internal governance mechanisms.

The connection between internal governance and the achievement of the objectives intended by the external governance framework has never been addressed. Many issues involved with the management of internal governance would benefit from research to see what works in practice. Innovation would help boards influence better internal practice and to help management overcome problems caused by the segregation of the various governance mechanisms into functional enclaves where technical specialists work independently of the other functions

The functional enclaves (eg finance, manufacturing, marketing, logistics) should consider how the techniques that they develop within their own function might work together with the other functions. It would also be helpful if they consider how they jointly might be able to develop better ways to balance conflicting objectives such as employee satisfaction and profit maximisation. Also, only rarely is the

role of the boardroom or executive management considered in the management of functional co-ordination and other governance mechanisms.

**Case Study** 5/37

6 - Risk Management

**6.1 Introduction** 6/1

Four types:

* Hazards (fire, injury, death, contamination)
* Financial (costs/benefits of assets/liability/transaction will change)
* Operational
* Strategic

**6.2 How the Understanding of Risk Developed** 6/3

Pascal, Fermat, Paccioli

Leibniz, Bernoulli

**6.3 Implications of Risk – Sudden Shifts in Value** 6/6

Majority of sudden positive shifts: alliances, mergers, acquisitions

Majority of negative shifts: failure to adapt to changes, customer mismanagement, poor investor relations

**6.4 The Multiple Dimensions of Risk** 6/7

Downside

* Insurance replaces possibility of large cash outflow with certainty of a small one

Upside risk

* Replacement of destroyed assets with better models

**6.5 Deep Muddy Waters** 6/9

Quantitative and qualitative judgements

Arbitrary risk classifications

**6.6 Risk Management – Like Holding Eels** 6/13

Jurisdictional issues

Confusing tight control and bureaucracy with risk management

* New laws, regulations => unprecedented compliance challenge
* Basel II, Patriot Act, SarBox

Ineffective Risk Management Leadership

* E.g. Coca Cola

Effective Risk Management Leadership

* E.g. Johnson & Johnson (tamper-resistant packaging)

**6.7 Risk in the Strategic Context** 6/17

Treadway Report

* Risk assessment by management (not internal audit)
* Narrow focus of downside risk

Conflicting objectives of upside and downside risk

* Profit centres versus cost centres (marketing / compliance)

Overlaid risk controls

* Obsession with control rather than critical success factor

Understanding risk in the strategic context

* The critical success factors must be clear and well understood
* Risks to CSFs must be identified and managed

**6.8 Being Real and Prepared** 6/21

Decide how much risk can be afforded and tolerated (emotionally)

Explicitly assume or lay off risks

Contingency planning for crisis

* Business continuity planning

Paradoxes

* There is more information about downside risks than upside

**Learning Summary** 6/25

**Review Questions** 6/26

**Case Study** 6/30

7 - Financial Market Supervision and Control

**7.1 Introduction** 7/1

Reasons for interest in financial markets:

* External governance either explicitly or implicitly about money
* Contains examples of well developed and innovative external governance

**7.2 The Money System – Financial Markets** 7/2

Originally financial markets developed to broker between those with capital needs and those with money to invest

* Over time became more focused
* Insurance, collective pensions
* Ancillary businesses including accountants and lawyers

Initially expensive and inefficient

* Higher entry barriers
* Big Bang (1986): deregulation
  + Mandates to more competitive trading, elimination of rules
  + Demarcation in financial system segments began to blur

**7.3 Understanding ‘The City’ – Capital Markets** 7/5

Deposits in banks and money market are primary source of short-term capital

* Take deposits in retail accounts and borrow wholesale funds

Primary source of long-term capital is savings of private individuals

* Also accumulated at financial institutions (e.g. pension funds)

Building societies (savings and loans) collect money from individuals and direct to capital markets (and private mortgages)

Capital market function

* Forum for raising and investing money
* Exit mechanism for those who have participated in raising capital

Primary market: debt or equity issues are arranged

Secondary market: sale of equity, debt instruments: exit route

Liquidity – when there are enough buyers and sellers in a market it is liquid; makes market more attractive (exit route)

Relatively few primary market transactions take place in formal capital market (most private)

Financial instruments:

* Long-term: note, bond
* Short-term: notes, commercial paper
* Combination of debt and deferred ownership: convertible bond

Derivative:

* Financial instrument the value of which is derived from the value of another asset

Multiple capital markets:

* Stock exchanges (shares and bonds)
* Banking and money markets (short-term credit instruments)
* Euromarket: market for professionals who trade in Eurocurrency (telephone, computer, fax)

**7.4 Markets, Derivatives, Regulation . . .What is the Relevance?** 7/11

Financial markets full multiple needs:

* Funding government, production, commerce
* Facilitating investment
* Expediting infrastructure development
* Investment conversion
* Currency exchange
* Risk mitigation mechanisms

**7.5 Financial Regulation – Solutions to Perceptions of Market Problems** 7/11

Rationale for regulation

* Systemic risk
  + Stable financial system stimulates growth but prone to periods of instability
* Asymmetric information
  + Insiders know more than outsiders
* “bad money”
  + Gresham’s law: bad money drives out good money

Originally self-regulating to provide investors with confidence

* Few markets still organised this way
  + Exception: Baltic Exchange – restricted to experts who trade in bulk shipping cargos

Issuing a report and audited financial statements is a modern practice (1933, US)

* Provide consumer protection and economic stability
* Over time increasing controls

1970s argument that too many restrictions caused market inefficiencies

* Thatcher, Reagan deregulated financial markets
* Were able to allocate capital and risk better

Deregulation problems

* Banks engaged in business for which they had insufficient understanding, skills and risk management experience
* Regulation was fragmented
  + Regulators knew how to regulate experienced participants, not inexperienced players, nor how to communicate internally

**7.6 The Simple Lesson about Strategic Change** 7/17

Strategic change usually requires new governance system guidance and capabilities

**7.7 A New Focus for Financial Market Governance** 7/17

Focus on crime (BCCI)

* Foreign bank secrecy and confidentiality laws to obstruct law enforcement

Pressure for change

* US: coordinated regulation for sharing financial information (loosening confidentiality and privacy laws)
* Market regulation should encourage liquidity
  + Confidence that counterparties will complete all obligations

**7.8 Current National Models of Financial Supervision** 7/20

Integration of regulators

* Historically divided along sector and national lines
* Rationale: Structure of regulator should reflect organisation of environment being regulated
* Reduce regulatory arbitrage

**7.9 Supra-national Authorities** 7/21

Bank for International Settlements

* Forum for central bank cooperation
* Research contributing to financial stability
* Publishes statistical material
* Reserve management and gold transactions
* Emergency financing

EU Financial Services Action Plan

* Ensure single market for wholesale financial services
* Open and secure retail markets
* State-of-the-art market rules and supervision

**7.10 Design of an Integrated Regulator – The UK Financial Services Authority** 7/23

Financial Services Authority (FSA) – independent body created by the Financial Services and Markets Act (FSMA 2000) – single legal framework

FSA Objectives

* Maintain confidence
* Promote public understanding
* Secure consumer protection
* Address financial crime

New features:

* Single authorisation, compensation system; authority and prosecution power, independent tribunal
* Non-governmental agency paid by fees of those regulated
* Board of directors appointed by Treasury

New responsibilities

* Mutual society registration
* Unfair terms in consumer contracts
* General insurance and mortgage lending
* Lloyd’s insurance market
* Code of market Conduct
* Recognised overseas investment exchanges

FSA Strategy

* Main aim to achieve four objectives
* Risks that hindered obtaining objectives

FSA: Implementing Strategy

* Consultations with range of stakeholders
* Probability and impact assessment
* Designed Performance measurements

FSA: Separation of Duties

* Investigation and recommendation functions separate from decision making
* Regulatory Decisions Committee (RDC)
  + Enforcement, authorisation and supervisory decisions
  + Report to FSA Board
  + Monitored by consumer panel

FSA: QA and Internal Audit

* Independent reviews
* Reviews risk management framework

Securities Institute

* Provides training to financial services industry

FSA: publication of risk-based approach for own objectives

Importance:

* FSA assessment of risks determines intensity of regulatory programme
* Actions determined by risk assessment
* High reliance on senior management responsibility
* Risk assessment key factor deciding on individual firm’s capital ratio

**Learning Summary** 7/31

**Review Questions** 7/32

**Case Study** 7/37

8 - Governance and Financial Market Economics

**8.1 Introduction** 8/1

Financial markets

* sensitive to information
* Communication and computation intensive

Market regulation and company law developed as national/local affairs

External governance reflected local nature

**8.2 Financial Market Economics – Structural Variation** 8/2

Structural differences

* Relative size
* Turnover within markets
* Extent to which companies use capital markets for funding
* Market liquidity
* Ownership concentration
* Types of owners

Variations in Market Size, Liquidity, Breadth

* US, UK, large liquid
* Germany - smaller percentage of companies listed, lower liquidity
* NL few multinationals skew data
* Switzerland – well developed

Share Ownership Patterns

* Germany: small group of shareholders
* UK, US: fragmented ownership
* Households, pension funds, mutual funds

Shareholder involvement in Corporate decisions and monitoring

* Germany: major shareholders involved
* UK, US: arms length

Markets for corporate control

* UK, US: hostile takeovers common
* Germany, NL: never

**8.3 Research and Debate about Governance Effects on Capital Markets** 8/6

Agency theory assumptions

* Directors act on behalf shareholders; employ management, monitor agent
* Without supervision agents act in self-interest
* Principal and agent have different goals
* Information asymmetry
* Monitoring is expensive

Generic approach to principal-agent:

* Control approach: few investors have influence (conflict with minority interests)
* Arm’s length: shareholders elect independent directors (requires good external reporting, assumes incentives work)

**8.4 Trade-offs in Supervision – Choices for Investors, Companies and Society** 8/8

Stakeholders with controlling interests can engage in dialogue with management

* Requires great wealth
* Difficult for investors to diversify

Diversified ownership

* High monitoring costs
* Greater risk of management inefficiency, misappropriation

Concentrated ownership

* Difficult to dispose of stake
* Additional economic incentives (rent) reduces returns for minority stakeholders
* Benefit: wise counsel, strategic advice, better efficiency

Fragmented ownership leads to greater liquidity; liquidity stimulates fragmentation (unproven)

**8.5 Corporate Supervision – Legal Context Variation** 8/11

National company law similarities

* Corporate structures, documents required, capital requirements, board requirements, annual meetings, reporting

Differences:

* Way laws mandate supervision
* Employee representation
* Shareholder rights (non-voting, low/high voting, founders shares, total votes per shareholder)
* Ease for minority to initiate resolution

**8.6 Supervisory Approach – Answers Not Clear Cut from Practice** 8/14

Market-based supervision (UK, US)

* Capital markets provide objective valuation of financial instruments
* If management fails, stock will drop and others will take over
* Issues: disclosures, accounting standards, auditing and regulation of participants
* Board of directors crucial: board composition, election of directors, committee structures, director duties
* Significant conflict of interest: regulation attempts to eliminate
* Institutional investors more likely to sell shares than supervise management

Enterprise-oriented (Germany)

* Capital market supervision not developer and lightly enforced
* Law around enterprise structure and management
  + Supervisory board and management board

Shortcomings

* Anglo-American: board members influenced by management; little representation from employees, suppliers or community

Supervisory board structure (single, dual) appears unrelated to market liquidity

Supervisory board meeting frequency

* Significant variation – one-tier boards appear to meet more frequently

Many countries mix the approaches

* NL enterprise-oriented but securities law similar to UK

**8.7 Contextual Influences in Markets** 8/22

Low shareholder protection ⬄ large controlling interests

Gaps in regulatory coverage

* OTC trading (restricted to regulated financial institutions) more flexible and innovative

Variation in governance structures not surprising however

* EU attempting to stimulate convergence to reduce national barriers between investors and markets
* Subsidiarity principle:
  + EU sets standards but leaves specific regulation to member countries

**8.8 A Lesson from the Economic Failures** 8/27

Pan-national capital markets outside the traditional exchanges

* Eurocurrency, Eurobond, OffEx

Failure of economic experiments

* Assume economic reforms can create efficient markets without an accompanying
  + Reform of external governance framework and
  + Political institutions in those countries

Efficient market requires that contracts and property rights be enforceable

* No examples of well-developed market system not embedded in developed political system
* Subtle problems: political support exchanged for monopoly rights, protection from competition

**8.9 Power, Culture, Cycles, Psychology and . . .** 8/29

Two mechanisms to create balanced set of sanctions and incentives

* Checks and balances limiting strong players
* Federalism where different levels of governance limit each other

Governance mechanisms include cultural influences

* Japan: no legal requirement to consider interests of suppliers, employees and creditors --- yet they do!

Role of psychology in market cycles

**Learning Summary** 8/31

**Review Questions** 8/32

**Case Study** 8/38

9 - External Reporting Need vs. Delivery

**9.1 Introduction** 9/1

Single aspect of corporate governance receiving most attention is external reporting

* Entire industry including secondary players such as data processing and risk management

Statements are artificial representation of transactions

* Degree of inaccuracy should remain in acceptable level
* Errors in judgement, negligence, manipulation

Investors, lenders, analysts, directors and audit committee need reliable information for decisions

**9.2 The Need for Accountability – Birth of a Profession** 9/2

Cathedrals built with audit houses

1334 auditors appointed to oversee

government finances

1844 Companies Act required annual appointment of auditors

1845 Deloitte, 1854 Cooper

1960 Big Eight

**9.3 A Drive Towards Standardisation** 9/7

Accounting standards began in US after Securities Act (1934)

Generally Accepted Accounting Principles

1973: Financial Accounting Standard Board in US for financial statements.. used for US GAAP

1991 UK six accounting bodies formed Auditing Practices Board (APB)

**9.4 External Accountability Today – GAAP Financial Statements** 9/9

Balance sheet- financial position at point in time

Income Statement – activities that occurred with assets

Funds flow – links the balance sheet at beginning and end of period

UK: balance sheet highest importance

US: income statement more emphasis

Footnotes perhaps most revealing

**9.5 Accounting and Reporting – Its Use and Purpose** 9/12

Accounting different by country due to varying needs

* Where government owns many enterprises: highly uniform accounting
* Concentrated wealth: little public disclosure
* High debt funding: creditor orientation
* US, UK: large investing public, strong regulatory agencies, complex accounting => support investor needs

**9.6 Auditing the Financial Accounts** 9/14

Audit: independent examination and expression of an opinion on the financial statements of enterprise

Performed by registered accountants (five professional bodies in UK)

UK has much higher per capita rate of licensed accountants than US

Evolution

* Statistical sampling
* Notion of materiality
* Introduction of analytics

Risk-based audit

* Developed by Arthur Anderson
* Traditional approach: test for errors, malfeasance, process failure
* Risk-based approach: determination of key organisational processes, corroborated by examining risk areas
* Assumptions:
  + Management designed the processes to ensure functions are performing as expected
  + Processed will produce accurate financial information
    - Except in rare cases of manipulation or latent flaws
* Assessment:
  + How management obtains satisfaction that processes are working properly
  + Forming opinion of financial statements based on management assumptions
  + Ensure that information from processes is properly recorded

**9.7 The Audit Committee – Overseer of the Auditors** 9/18

Charged with responsibility for company’s financial statements

* Monitors integrity of financial statements
* Review internal financial control system
* (optional) assess risk management system and non-financial control systems

Should include at least three members (non-executive directors)

* Higgs: chairman should not be a member

**9.8 The Many Kinds of Audit** 9/20

External financial audit

* Examination of financial statements by independent public account
* Intended for outsiders
* Objective: express opinion on truth/fairness of statements

Internal auditing

* By employees of the company on behalf of direction and management
  + Some outsourcing
* Can reduce the cost of external audits
* Assist in preventing fraud and improving performance
* Usually at least dotted line to board

Operational audits

* Develop standards of operation
* Measure performance

Types of audit

* Customer satisfaction
* Compliance
* Investigation
* Social, ethical environmental
* Strategic

Foreign corrupt practices act (US 1977)

* Prevent illegal payments to foreign officials

Environmental audits

* Compliance with environmental requirements
* Effectiveness of environmental management system
* Assess risks from materials and practices
  1. **Patterns in Frauds and Accounting Manipulations** 9/26

Restatements can occur due to:

* mathematical mistakes, oversight or misinterpretation
* changes in accounting principles

If intent was to deceive then effect can be devastating

US restatements 1987-1997

* more than have overstated revenues fictitiously or prematurely
* understated allowances for receivables
* overstated inventory, property, plant and equipment

Increase from 1997-2001

* Increase in restatements: 92 to 225
* Market capitalization of companies restating grew

**9.10 Is One Audit Methodology Superior to Another?** 9/30

Risk-based method assess internal financial controls with management questionnaire

* Greater reliance on management’s analysis then previously
* Less substantial testing of financial controls and accounting processes

Some might argue Data manipulation easier. However BCCI, Maxwell Barings audited with traditional mechanisms

**Learning Summary** 9/31

**Review Questions** 9/32

**Case Study** 9/37

10 - Definition Inconsistency and System

Improvement

**10.1 Introduction** 10/1

Internal governance system develops in even simple corporate entities

Over time society develops external corporate governance framework in response to actions that violate norms of behaviour

Both internal and external can be:

* Formal/informal
* Mandatory/non-mandatory

Many references to corporate governance designate only subset of it

Many focus on best practice corporate governance

* Targeted at listed companies
* Focus on board of directors and external reporting

**10.2 The Term ‘Corporate Governance’** 10/2

First uses referred to company secretary

* Maintain statutory registers
* Ensure filings are made
* Send meeting notices to members and auditors
* Supply company report to all entitled

Many who use the term are focused on shareholder protection

**10.3 Corporate Governance – An Inconsistent Notion** 10/4

Tricker: Corporate governance is concerned with the way that corporate entities are governed, as distinct from the way businesses with those companies are managed. Corporate governance addresses the issues facing board of directors such as the interaction with top management and relationships with the owners and other interested in the affairs of the company.

Cadbury expands on Tricker and adds strategic aspects of board role

Many definitions published since then. Great range of meanings

* Differences in purpose of company
* Differences in importance of shareholders relative to other stakeholders

Some international differences but also differences in same tradition (e.g. American)

Most uses of the term are without an explicit definition

**10.4 The Challenge of Definitional Ambiguity** 10/9

In the absence of a definition, the reader must infer the meaning

* Infer the definition from context

**10.5 Variation in ‘Domain’, ‘Aspects’ and ‘Specificity’** 10/14

Common threads in the definitions

* Most do address issues that would benefit from improved understanding and better methodologies
* Strategic and operational guidance and control mechanisms
* Relationships between shareholders, directors and management

Domain

* Internal, external, legal framework

Aspect

* Risk management, relationships, authority, responsibility

Specificity

* Degree to which instructions are given

**10.6 Does Variation in Definitions Really Matter?** 10/16

Yes. Corporate governance improvement efforts guided by different definitions would look for and address different problems.

**10.7 Guiding Corporate Governance Analysis** 10/18

Contributing to the observed problems with corporate governance is confusion about what it means

**10.8 Rethinking Governance System Improvement** 10/19

Corporate governance is a complex system. It should be views as a system.

Historic approach to corporate governance focused on individual decision making

System approach – most of the variation in performance is produced by system factors

* Dividing a system will change its nature
* Necessary to describe both the separate functions and their method of interconnections

Dynamics

* Dynamic systems change over time as parts interact to create series of evolving system conditions
* Conditions existing in a system influence both the decision making and behaviour of operators within system
* Feedback structures exist in human systems
* A social system is embedded in the day-to-day context where people make decisions and take actions
  + Changing the people is unlikely to change the observable behaviours or performance
* Dynamic behaviour is complex and the design rarely succeeds based on rule-of-thumb and experience

**Learning Summary** 10/22

**Review Questions** 10/22

**Case Study** 10/28

11 - Reality in the Face of Prescription

**11.1 Introduction** 11/1

A bad apple can spoil a barrel of fruit

* Specatular finanical fraud does enormous harm to markets

2002: Accouting irregularities cased loss of confidence in reporting

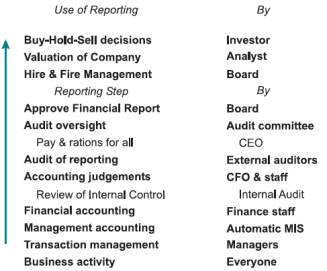
Prescriptions were additions, not redesign, to governance framework

Return of confidence indicated perception mandates corrected problem

Current focus:

* Stop symptoms: fradulent individual decisions
* Not: system of financial reporting, audit and management practice

Bottom-up look at system:



**11.2 Lack of Trust – Symptom or Problem** 11/3

1997-2002: 145 increase in restatements

Everyone, including experienced professionals, deeply concerned about trust in financial reporting

**11.3 Policy Response – Punish the Individual** 11/5

Sarbanes-Oxley

1. Establish public company accounting oversight board

2. Auditor independence

3. Corporate responsibility

4. Enhanced financial disclosures

5. Analyst conflicts of interest

6. Commission resources and authority

7. Studies commissioned

8. Corporate and criminal fraud accountability

9. White-collar crime penalty enhancements

10.Corporate tax returns

11.Corporate fraud and accountability

Very long to-do list:

* Responsibilities for management, audit committees, finanical statement preparation
* New entity to oversee auditors
* Management responsible for accuracy of reporting
  + Criminal penalties
* More frequent communications
* New communications tools
* Resturucture of sell-side firms (brokers, investment banks)

**11.4 Policy Response – Tinker with the Board** 11/6

Public pressure on policymakers – response:

* More prescription for boardrooms
* Publish individual wrongdoers
* Not redesign – prescriptive and additive to external governance framework

New requirements for independence (majorit of directors)

* Americans: mandatory
* UK/ASX: comply or explain (markets can assess signficance)

Independence:

* ASX: not employed 3+ years, not substantial shareholder, not advisor, consultant 3+ years, no contract ...

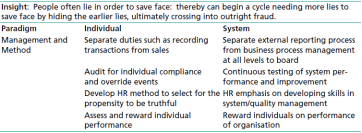
**11.5 Independence – Reality from the Individual Perspective** 11/8

UK: boards have majority of employees, US: not common (CEO only)

**11.6 The Different Assumptions in a System Paradigm** 11/9

Historic approach: Individual matters

System approach: variation in performanc from system factors, not individuals



**11.7 Statistical Evidence on the Governance System** 11/10

Deming recommends statistical analysis as primary tool to identify system problems

Independence and performance

* No corerlation betwen proportion of outsiders and company performance
* Non-executive directors selected for accomplishments => very busy

Share ownership of directors:

* Less likely to pay greenmail
* Troubled firms restructure faster
* Avoid excessive CEO packages
* More prompt to terminate poorly performaing CEO

Restating companies lost $100B in GAO study; less than 0.2% of market capitalisation of exchanges

* Data suggest problems may have begun before downterm
* Questions need to be asked about how and why they are occurring

No Acceptable failure rate has been set

**11.8 Bottom-up Exploration of the Reporting Process** 11/13

Quality management uses bottom-up analysis to locate source of problem

* After it has been found with statistical testing

Financial data from business process => MIS => General Ledger => financial statements

Legitimate differences between MIS and financial statements

* Different purpose
* Different structure (cut-off period, organisational boundaries)
* Different accounting principles (IAS, Country GAAP)
* Different judgements (prudent, aggressive)
* Confidential information removed

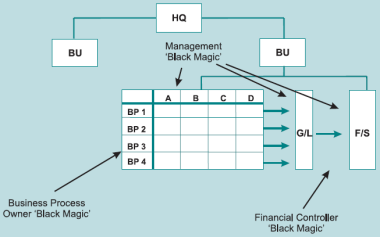
CFO role

* Planning strategy
* Forecasting performance
* Monitoring measurement
* Judgements and adjustments

Symptoms of issues in finance departments

* High staff turnover
* Slow closes (not up to the job or manipulations)
* High sales outstanding
* Poor management structure (audit reports to CFO => no separation of duties)
* Unexplained cash flow or earnings adjustments
* Use of spreadsheets => arithmetic formula errors
* High consultancy spend
* Illogical responses to questions

**11.9 Illegitimate Differences – Financial Statement ‘Black Magic’** 11/16



Illegitimate differences

* Inappropriate management adjustments
* Manipulation of data to disguise operational reality
* Phantom transactions
* Failure to book legitimate transactions

Auditors have limited resources

* Focus on best opportunities
* Little resources review established procedures
* Judgement areas and points of data input and transfer
* Period-end (time pressure)

Locating black magic

* Three stages
  + Verify every transaction and calculation
  + Testing documented processes, samples
  + Risk-based: how management determines organisational processes
    - Scrutinise risks is areas of black magic
    - **Clear definition of who is responsible**

**11.10 Boardroom Functions in Company Reporting** 11/19

Audit committee which is part of board of directors

Typical view of Board roles

* Vision, mission values
* Strategy and structure
* Delegation to management
* Responsibilities to others

Appointment of non-executive directors is amateurish

* Often not formal interview
* Ignorance of personal liability

Consensus cultures are boardroom norm

* Meetings controlled by CEO (who board should monitor)
* CEO only accountable to board for appearance

Diversity in boardroom

* Few minorities, women, foreigners
* Requirement for previous experience with large companies

**11.11 Disconnects from the Internal System** 11/23

Enron presented a fantastic track record with year-over-year growth

* Flood of new entrants reduced margins
* Led management to innovative means of increasing reported profits
* Audit committee has financial expertise and experience
* Board followed rules regarding independence, remuneration, expertise..
* Internal audit reported to board

Board set requirements but did not follow up

Internal governance and board activities must fit together

Few failures begin as fraud – poor internal governance practice

Bias of directors toward:

* Material from external auditors
* Reports from normal chains of command
* Fiancial performance indicators

Variance in consideration of non-financial data

Little risk information and analysis

Director confidence in internal controls highest where they had least contact

Implications:

* Effeicve risk control not achieved through external audits (focus on financial controls)
* Reliance on normal chains:
  + Easily manipulated data; unreliable unless confirmed independently
  + Particulaly when internal audit doesn’t report directly to board

Focus of every audit committee on current-period financials

* Not risk management or internal controls

## Key Points

Paper: Key concepts and definitions

Key regulatory reforms (eg SOX, Cadbury, etc) and what they are about, and how and where they apply and the implications of their use

Limited liability => governance to environment

Principal / agent => governance of shareholder over management

Overreaction of legislation to correct problems perceived by public

Excessive focus on board; punish individual

External governance usually detached from internal

internal: budgets, performance, rewards

internal governance based on GM/DuPont, strategy has evolved since

budgets should be flexible, interactive

6:

consider upside as well as downside risk

mandated risk control requirements are typically bureaucratic

quantitative methods may be inappropriate for unpredictable risk

crisis management: communicate quickly, reassure, look for opportunity

7:

Problems in financial markets: systemic, asymmetry, bad money

De-regulation: Big bang attracted capital: other regimes had to emulate

encouraged activity for which organisations were unqualified

Integration pools expertise and reduced arbitrage

8:

differences in shareholder protection, control corporate manager make regulatory convergence difficult

Control approach versus arms-length

board structure (single,dual) little influence on market

9:

risk-based approach relies more heavily on management

some recent scandals of firms audited with risk-based approach. However previous failures also of other approaches

problem is getting worse (more and larger companies involved)

FAQ: Credit crisis

Trends in best practices

definition of cg; internal/extern gov; system

D07:

Internal g: mechanisms that corporate entities use to organise, coordinate, govern activity of people in org

External: mech society seeks to influence behaviour of corp from outside

Gov: set of policies, rules, controls and norms to guide corporate activities

Corporate: group of people acting as an individual

System: complex whole that cannot be subdivided

CG is a complex structure of interacting functions. Will require new assumptions and tools

Deming: 94% of performance from system. Historic focus on individual must change. QM concepts alternative paradigm.

Focus on both functions and interconnections.

codes of practice:

- Treadway/COSO: internal financial control (environment, risk, actitivities, information, monitoring)

- Cadbury: board of directors (principles, balanced: non/financial) responsibilities

- Combined: (Hampel: Greenbury/remuneration + Cadbury) encourage interfaction with institutional investors

- Turnbull: annual board report on risk assessment

- Smith: audit committee (little attention: nothing new, financial focus) indep, 1 member fin exp

- sel, eval, remun of external a, review internal, monitor f/s; no env, eth, commun; little whstl-blw

- HIggs: non-executive director (no objective evidence)

- New UK combined: includes Smith&Higgs

- SOX: highly regulated

prereq for viable financial market:

* issuers will fulfil obligations;
* financial instruments are valid
* sellers will deliver
* purchasers will pay
* all information about issuers are available/reliable
* financial instruments can be valued accurately
* all information is available to all

external gov fw: laws, regulations, codes of practice, social norms

Audit function: objective, unbiased opinion vs. consultative services

External reliance on internal audit depends on no conflict of interest for internal audit

Non-financial information can indicate future financial performance

Board history: small, club, self-regulating, getting along

Board trends: more independence, frequent meetings, responsibility, disclosure

Director appointment: determine responsibility, legal, technical training

Internal govern: investments, risks, compliance, people mgmt, project mgmt, recruit/motivate

Restatements: accounting method change, errors, fraud

MIS, F/S misalignment: purpose, structure, acct principles/GAAP, judgements, confidentiality

FSA: director independence: employee (5Y), bus relation, famil, cross-director, shareholder, 9Y-board

LSE: 1/3 board independent

Revised combined code: legal advice available to audit committee

Agents(stewards of estate) versus trustees (deed of settlement)

Laws provide the framework; regulations fill in the detail.

Laws are passed by legislative bodies (these tend to be parliament or congress in democracies, and decrees by kings, dictators, politbureaus in non-democratic societies). Regulations are developed by civil servants who administor the laws.

Treadway report

* Accountants view: internal financial control
* Three objectives
  + Efficient and effective operations
  + Accurate financial reporting
  + Compliance will all laws and regulations
* Components
  + Control environment (foundation of internal control system)
  + Risk assessment
    - Identification and analysis by management (not internal audit)
  + Control activities
    - Policies, procedures to verify objectives and risk mitigation
  + Information and communications
    - To employees
  + Monitoring

Cadbury Contributions

* Framework of principles to help boards achieve intent behind laws mandating company reporting
  + Board of directors
    - Power, division of responsibilities, access to secretary, sufficient non-executives, procedures for advice
  + Non-executive directors
    - Majority independent, formal selection process, specified terms of office
  + Executive directors
    - 3 years maximum, compensation disclosure, remuneration committee
  + Reporting and controls
    - Balanced view, objective relationship with auditors, audit committee, effectiveness of internal control
  + Compliance with Code

Greenbury Committee

* Need for remuneration committee

Hampel Report

* **Combined Code**: Cadbury and Greenbury
* London Stock Exchange: comply or explain
* Better director training
* Balancing the board
  + At least one-third independent directors
* Splitting chairman and chief executive
  + Except with clear and compelling reason
  + Named senior independent non-executive director in annual report
* Improved information for the board
* Open process of board appointments
  + Nominating committee (majority non-executive directors)
* Director remuneration
  + Sufficient but not excessive
  + Linked to corporate and personal performance
  + Reported to shareholders
  + Shareholder approval for long-term incentive plans
* Accountability and audit
  + Maintain and review Internal control system
  + Review all controls
  + Consider internal audit function
  + (Recommended only): audit committee of 3+ independent directors

Turnbull

* Create risk-based approach to establishment of internal control system
* Review system effectiveness

Smith

* Good practice for audit committee
* Encapsulates good audit practices but does **not** address new areas
  + Environmental, ethics, community accountability, non-financial measures
* Misses Cadbury vision of non-financial internal control
* Received little attention

Higgs

* Review of non-executive director role

Conclusions

* Number of board meetings and attendance published in annual reports
* Non-executive directors should meet annual without chairman or executive directors
* Senior independent director should be available to shareholders
* Pool of directors candidates broadened
* Non-executive directors to receive comprehensive induction
* Non-executive director to serve maximum of two three-year terms

Issues:

* Risk of undermining unitary nature of British boards
* No objective evidence for requirements

New UK Combined Code

* Included Higgs Review recommendations
* Business leaders complained

System approach:

Statistical & bottom-up approach?

Separate process from top to bottom, system testing, HR skills on QM, org-based reward

corporate governance system has some significant structural weaknesses which need to be fixed.

Most of the information published by companies and provided to boards of directors is obtained via the chain of command (CCI) within the company.

CCI has been implicated in most of the accounting restatements and sudden corporate collapses. So it should be on the corporate governance reform agenda.

CCI presents a ‘structural’ weakness when that information is used to evaluate the performance of those who are required to provide it.

- vulnerable to management manipulation (natural incentive performance-related pay, job security, advancement, avoiding sanctions).

providing decision makers with more reliable information obtained from independent sources

removes both opportunity and incentive to manipulate

‘whistleblower's hot line’ maintained by independent directors on a board. (e.g. email, post and/or telephone)

cash flows reported directly by banks to an accounting function for reconciliation,

staff within the accounting function is hired and overseen by an independent director or an outside organisation

This OCC cash flow data could be reported separately from and reconciled to the reports prepared by management.

Separate the duties within the finance function from top to the bottom

responsibility for accounting is completely separated from budgeting, forecasting and day-to-day management.

accountability function might report directly to the non-executive chairman or a director for ‘accountability’

External:

Establishing sources of key OCC data for use by auditors and boards.

This would be data which was collected outside the chain of command and reported or collated externally.

Some might be generally available in aggregate and detail accessible to internal and external auditors.

Regulators, consumer reporting or bond rating agencies or commercial entities, establish data warehouses

certain key data are recorded by the other side of the transactions in which the organisation engages.

- Consumer satisfaction or complaints (the person making a complaint would lodge it in the database) both organisation and complainer report

- Aggregate reports could provide information about the number, type and disposition of complaints.

- Potentially useful because these measures can be an indicator of future performance in many sectors.

Debt: Creditors (e.g. a lender or a party receiving a loan guarantee) records transaction and organisation (i.e. the debtor) record pay downs on and releases of the debt. (how real estate mortgages are recorded in many countries)

Some incentive for creditors to make reports. Reclassifying the priority of creditors in a bankruptcy

Unreported debt implicated in significant proportion of the accounting restatement and corporate collapses.