52 Corporate Governance: Structure and Consequences

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Abstract

We discuss in this chapter important aspects of the corporate governance structure and examine its impact on corporate performance. We especially focus on internal and external control mechanism and discuss how they make corporate governance more effective, enhance the quality of financial reporting, improve the firm's performance, and thus enhance firm value.

With passage of the Sarbanes-Oxley Act in 2002 (SOX), two important changes have taken placed in the internal control mechanism. First, the audit committee has received increased attention; it has been given authority to appoint external auditors and to deal with them directly on accounting issues. Moreover, it has the responsibility to ensure high quality of financial reporting. Second, internal controls have been strengthened to provide an effective monitoring of managerial activities. The main objective of internal controls is to ensure that managerial activities are properly supervised and managers do not use the flexibility provided in the accounting standards to achieve their own goals that are inconsistent with investors' goals. In order to enhance the quality of financial reporting, managers are especially monitored to ensure that they do not engage in policies and activities that result in manipulation of reported earnings.

The SOX has also improved the external control mechanism, provided by external auditors and market controls. The SOX especially focuses on ensuring independence of external auditors by restricting their functions to auditing only and not permitting them to perform advisory and other forms of non-auditing services, with the exception of tax services, so that their independence is not compromised. Additionally, the auditor in-charge is rotated under SOX to ensure his/her independence. We also discuss different anti -takeover control devices, which are triggered when a firm becomes a target for takeover because other firms perceive the target's weak performance as an opportunity for takeover and benefit from it.

Keywords

Audit committee • Board independence • Board size • Corporate board structure • External auditor • External control mechanism • Internal Control Mechanism • Nomination committee • Sarbanes-Oxley act • Two-tier corporate structure • Unitary corporate structure

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C.-F. Lee and A.C. Lee (eds.), *Encyclopedia of Finance*, DOI 10.1007/978-1-4614-5360-4_52,
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52.1 Introduction and Framework for This Chapter

In this chapter, we discuss important aspects of the corporate governance structure and also discuss the rules and regulations, especially introduced by the Sarbanes-Oxley Act 2002, to improve the effectiveness of corporate governance. In Section 52.2, we explain what is meant by corporate governance and discuss its importance in the public companies. Additionally, in this section, we discuss certain aspects of Sarbanes-Oxley Act 2002 which focus on improving corporate governance of the US companies. Important characteristics of corporate structure are discussed in Section 52.3. In Section 52.4, we examine how the corporate governance functions in the US companies and we focus on the role of different committees in making it effective. In Section 52.5, we explain the need for internal control and focus on the requirements under the Sarbanes-Oxley Act 2002. The use of market control mechanism for smooth functioning of corporate governance is examined in Section 52.6, and the effects of corporate governance on firm performance and financial reporting are briefly discussed in Section 52.7.

52.2 Definition and Importance of Corporate Governance

52.2.1 What Is Meant by Corporate Governance?

Corporate governance has been defined from different perspectives in the literature as well as in practice, and these approaches potentially cover a variety of distinct economic phenomena. Schleifer and Vishny (1997) define it from the investors' perspective and describe it as a mechanism in which the capital suppliers assure themselves of getting a return on their investments in corporations.[1] The Office of Economic and Corporate Development (OECD) (1999) describes corporate governance as a system by which business corporations are directed and controlled. This concept of corporate governance includes a corporate governance framework that specifies distribution of rights and responsibilities among different participants in the corporation and a corporate structure that includes the Board, Managers, Shareholders, and other Stakeholders. Additionally, the structure spells out the rules and procedures for making decisions on corporate affairs. Some authors, however, consider corporate governance as a tool that is used to promote corporate fairness, transparency and accountability (e.g. Wofensohn, ex-President of World Bank). Mathiesen (2002) describes it is as a mechanism that investigates how to secure and motivate management by using the incentive system, including contracts, organization designs, legislation, etc.

In order to have a better understanding of corporate governance, we first briefly define the concept of Corporation. Overall, a Corporation is described as an instrument through which capital is assembled for the activities of producing and distributing goods and services and making investments. In other words, it is a mechanism that allows different parties to contribute capital, expertise, and labor, for the benefit of all. This concept of Corporation creates a limited liability for investors, and it separates the corporation from its owners, managers and employees. The limited liability leads to a limited authority for shareholders, which primarily includes the right to elect directors. The directors have the fiduciary responsibility and the management runs the corporation to increase the shareholders' wealth and protect their interests.

Based on the above description of a corporation, we define corporate governance in a broader term as follows: The corporate governance is a mechanism for directing and controlling the corporation, and it includes a governance structure that specifies the distribution of rights and responsibilities of different components of the structure, which consists of the Shareholders, the Board, and the Managers. It provides rules and procedures for making managerial decisions on corporate affairs and on the monitoring mechanism over managerial decisions and activities.

52.2.2 Agency Problem and Corporate Governance

The separation between capital providers and managers gives rise to an **agency problem** in corporations. The agency problem arises because of the conflict of interests among different groups of people working in the corporation, which include the shareholders, the managers, the employees, and the outside parties dealing with corporation, such as, suppliers, creditors, clients, etc. The conflict may be between the stockholders and management, the stockholders and bondholders, and between the majority stockholders and minority stockholders. As a result of this conflict, different groups may not be able to work cohesively to achieve the company's goals. Instead, they may focus on their group's goals at the cost of other groups. Consequently, the agency conflict is not conducive to enhancing the shareholder value in a corporation. Thus, one of the objectives of corporate governance is to minimize the effect of agency conflict on corporate performance so that the company's goal to maximize the shareholders' value is achieved.

[1] Refer to Schleifer and Vishny (1997) for a survey on corporate governance.

52.2.3 Need and Importance of Corporate Governance

Corporate frauds, bankruptcies and other financial catastrophes in 1990s that led to destruction of shareholders' wealth in billions of dollar, loss of jobs, criminal investigation of executives, bankruptcies, etc. generated renewed interest of politicians, regulatory agencies and academics in corporate governance. Typical examples of large corporate failures include Enron, Worldcom, Global Crossing, Bear Stern, Tyco, Adelphia, etc. Among other things, corporate failures highlighted the weaknesses in corporate governance that enabled managers to maximize their own wealth by ignoring the public companies' overall goals of protecting shareholders' interests and maximizing company value. Additionally, the impact of corporate failures on the stock market and country's economy became quite evident and it was realized that weak corporate governance could become hindrance in the smooth functioning of the stock market and it could also jeopardize economic growth in the country.

Recognizing the importance of corporate governance, especially for gaining investor confidence for proper functioning of the stock market, the political leadership, policy makers and regulators decided to develop certain ground rules for smooth functioning of US companies. Their efforts culminated in the passage of the Sarbanes-Oxley Act in 2002.

52.2.4 Impact of Sarbanes-Oxley Act 2002 (SOX) on Corporate Governance

The main objective of SOX is to provide rules and regulations for proper functioning of public companies and to regulate the activities of professionals associated with these companies, which include the financial intermediaries, insurance companies, brokerage houses, accounting and auditing professionals, etc. Moreover, the Act provides control mechanism to improve the corporations' monitoring function to assure the investment community that managerial decision and activities are properly supervised. This Act in fact is the most important legislation after passage of the Securities and Exchange Acts in 1933 and 1934, which for the first time provided rules and regulations to legislate corporate financial activities in the United States.

New rules and regulations contained in the Act for monitoring managerial activities and decisions are designed to ensure that managers do not focus on the short-term goals which might help them to maximize their own compensation, including bonus, and thus enhance their own wealth. The rules are intended to discourage them to engage in earnings manipulation, overstatements, enhanced risk taking, providing misleading information to investors, and an outright fraud. The new control mechanism contained in this Act is designed to provide reliable and up-to-date information on corporate performance to investors on a timely basis. It requires the development of rules and regulations for generation of financial distress information that becomes available to investors well ahead of time so that the shareholders do not have to wait for this information until it is too late and the impact of financial distress is already having its effect on the company's stock price.

52.3 Important Elements of Corporate Governance

52.3.1 Corporate Governance Structure

There are two types of corporate governance structures and these are known as the Unitary Corporate Board and Two-tier Corporate Board.

52.3.1.1 Unitary Corporate Governance Structure

The Unitary Corporate Board consists of only one Board of Directors and this board is created to look after the shareholders' interests in the company. The company management headed by the Chief Executive Officer runs the day-to-day affairs of the company, and the Board of Directors provides the monitoring and advisory functions. This type of corporate system is mostly used by companies in the common law countries, and especially in the US and the UK.

Functions of the Corporate Board in this system generally are the following: (1) to fulfill the legal requirements of the corporate charter, (2) to protect shareholders' interests, (3) to counsel and advise management, (4) to review and approve corporate plans and actions, (5) to monitor management activities, (6) to assess management performance, (7) to decide on management compensation, (8) to decide on hiring and firing of top management, and (9) to serve as a link between external auditors and management.

Members of the corporate boards in this system are elected by the stockholders in the annual meeting. The slate for election is, however, prepared by the nominating committee of the existing Board of Directors, and their decision to formulate this slate is significantly influenced by the CEO's recommendations.

52.3.1.2 Two-Tier Corporate Governance Structure

The Two-tier Corporate Structure also known as the Dual corporate system consists of two boards, which are known as the Management Board and the Supervisory Board (Vorstand

and Aufsichtrat respectively in German language). The Management Board is responsible for day-to-day operations of the company, whereas the Supervisory Board takes care of all capital providers' interests instead of focusing on the shareholders' interests, and capital providers include banks, financial institutions, investment companies, other corporations, etc. In view of different focus of this board, appointment of its members need not be based on their impartiality and independence. Instead their appointment is based on their capability to represent the interests of a particular group of capital providers. Thus, their appointment generally reflects the company's financial and commercial relationships.

In addition to the capital providers, the German Supervisor Board also includes a representative of employees so that the employees also have a voice in the Board. The Two-tier Corporate Board System is generally used by the companies in the German speaking countries.

52.3.2 Two-Tier Corporate Structure in the Chinese Firms

The Chinese public companies also follow the Two-tier Corporate Board System, but it differs from the German Two-tier system. Though supervisors in the Chinese firms are appointed by the controlling shareholders, their appointment is generally done by the Chinese government in most companies because the government holds the controlling interest in these companies. It has been observed that the appointment of supervisors is generally done on their political affiliations and contributions. Supervisors in the Chinese companies can be either insiders or outsiders.

A significant difference in the two-tier system in the Chinese companies compared to the German companies is the authority of the Supervisory Board to appoint members of the Management Board. Whereas the German Supervisory Board has the authority to appoint or dismiss the members of the Management Board, the Chinese Supervisory Board has no authority to appoint or dismiss these members. The Chinese Management Board is also appointed by the Chinese government, which is the majority shareholder in most of the companies.

52.3.3 Independence of Corporate Boards

52.3.3.1 Different Types of Directors

The corporate board directors can be classified into the following three categories: insiders (executive directors), outsiders (non-executive independent directors), and grey (directors with some interest in the firms, such as bankers, attorneys, etc.). An important question in this regard is how important it is to have an independent corporate board in the Unitary Corporate Structure? In other words, should a majority of these directors be independent outside directors.

52.3.3.2 Corporate Failures and Corporate Board Independence

The board independence started attracting increased attention only recently after failures of large US corporations. It is argued that an important reason for corporate failures has been the lack of corporate board independence, which resulted in inadequate monitoring of managerial decisions and activities. In most cases, the CEO conducted the company affairs and the board did not provide effective monitoring of managerial decisions and activities. In fact, the corporate board in most cases has been quite passive and existed in form only, and the board members never questioned the managerial decisions. Apparently, the board members in most cases were appointed based on their personal relations with the CEO or based on their interest in the company in some form, which impaired their independence and took away the incentive to question the managerial decisions. Thus, the main force behind their appointment probably has been their loyalty to the appointing authority.

52.3.3.3 Positive Aspects of Corporate Board Independence

It is now commonly recognized that independence is an important factor for the board to be effective. In fact, it is argued that a majority membership of the board should be independent of the CEO, meaning that a majority of board members should be non-executive independent outside directors. Some important arguments supporting the appointment of independent directors are as follows: First, it is argued that independent outside directors are expected to be more effective in monitoring managerial decisions and activities because they will be free of managerial influence, especially the CEO. Second, these directors will be in a better position to provide advice and guidance to the management based on their experience at other firms, and their expertise and experience gained at other companies will prove to be beneficial to the firm. Third, monitoring of managerial decisions and activities by independent board members is likely to improve the quality of financial disclosures. As a result of effective monitoring, managers will refrain from manipulating reported earnings to meet their desired goals, and consequently it will improve the quality of reported information. Fourth, independence of corporate board members will add to the credibility of financial information disclosed by firms, especially earnings announcements. Fifth, effective advice and guidance from independent board members with extensive experience in other firms will enable managers to improve the firm's operating performance. Sixth, better operating performance is likely to result

in better market performance for the firm and this will enhance firm value.

52.3.3.4 Negative Aspects of Corporate Board Independence

Several empirical studies have evaluated whether independent boards will result in better operating and market performance for the firms. These studies, however, provide mixed findings. The lack of empirical evidence supporting the effectiveness of independent corporate boards is probably because of the weaknesses associated with board independence. First, it is argued that the board's effectiveness depends on the reliability of information on which the board makes the decisions. In the absence of executive directors, there is likely to be a higher information asymmetry. The availability of information to the board is likely to be limited. In fact, there will be lack of inside information.

Second, motivation of independent directors to provide effective monitoring and advice is questionable because outsiders are likely to lack motivation to devote time and energy to understand the problems and issues facing the company and find solutions to these issues and problems. Moreover, there is no legal responsibility for outside directors for providing effective monitoring and advice.

Third, their busy schedule may also add to the lack of their motivation to solve the company's problem. It is argued that in addition to taking care of their own company, outside directors serving on several other boards will have very busy schedule, which will have a negative impact on their performance as a director of other companies.

Fourth, their independence may be questionable because their appointment will depend on their relations with the CEO of the firm. Their appointment based on their friendship with the CEO of the firm or based on their obligation to the firm because the firm's CEO serves as a director on their company, will weaken their independence and effectiveness.

52.3.3.5 Ownership Structure and Corporate Board Independence

Independence of outside directors is also likely to depend on the ownership structure of the firm. The majority ownership of the firm can either be in the hands of the controlling shareholders or it can be widely dispersed and there are no controlling shareholders. The first type of firms is known as family-owned and controlled firms. The agency problem differs between the two types of firms. In the family firm, the agency conflict is between the controlling and non-controlling shareholders, whereas the agency problem in the widely dispersed ownership firm is between shareholders and managers.

Independent directors in the family firms are appointed by the controlling shareholders and their loyalty is likely to be with the appointing shareholders and they are not likely to focus on the interest of the minority shareholders. This will result in an ineffective monitoring by an independent board. This situation is likely to provide greater opportunities to the controlling shareholders to usurp formal powers and transfer wealth from the minority shareholders to the majority shareholders. In other words, there will be a greater opportunity for the majority shareholders for opportunistic behavior to enrich themselves at the cost of the minority shareholders.

52.3.3.6 Executive Directors' Need on the Corporate Boards

In order to complete the discussion on corporate board independence, we would like to point out the advantages of the Executive Directors on the corporate boards. Among other factors, the Executive Directors are more knowledgeable in the company affairs, they have better inside information, and they have no time constraint to devote to the company affairs. These advantages suggest that a completely independent corporate board will not be desirable. The presence of Executive Directors on the board will improve the Board's effectiveness.

52.3.4 CEO Duality and Corporate Board Independence

The CEO duality is also considered to be an important aspect of corporate board independence. This aspect of independence deals with the Chairman of the Corporate Board. The Chairman of the Corporate Board can either be the Chief Executive Officer (CEO) or he/she can be an outsider independent director. If both positions of the Chairman of the Corporate Board and CEO are held by a single individual, i.e. when CEO is also the chairman of the corporate board, the situation is termed as CEO duality. An important question facing regulators, corporations, investors and academics is whether CEO duality is good for corporations. Is it good for the monitoring mechanism and will it improve corporate performance? Historically, the CEO duality has been a common practice in the corporate world. An entrepreneur who starts the corporation generally holds both positions in the beginning, and this situation does not create any concern for investors. When corporations become large and ownership gets widely diffused, the CEO duality is considered undesirable because it can weaken the monitoring mechanism or it may not be good for corporate performance. We briefly discuss both positives and negatives of CEO duality.

52.3.4.1 Positive Aspects of CEO-Duality

There are several positive aspects of CEO Duality, which make it desirable under certain circumstances. First, when the positions of chairman of corporate boards and CEO are held by a single individual, there is a lower conflict and the

individual is able to devote his/her full energies to the job and there are less diversions resulting from the conflict between the chairman and CEO. Consequently, we can expect an improvement in the corporate performance and also in the board effectiveness. Second, the CEO is not concerned about any antagonism from the corporate board and especially from the board chairman. Thus, this situation is likely to result in a better working environment which will be conducive to the operating and market performance of the firm. It is generally observed that the CEO duality performs a useful function in small firms and also in the firms where ownership is concentrated in a few hands.

52.3.4.2 Negative Aspects of CEO-Duality

As the corporations become large and there is no concentration of ownership, monitoring of managerial activities becomes more important. In order to provide effective monitoring over managerial decisions and activities and to ensure that management are working in the best interest of shareholders, it is important for corporate boards, especially the board chairman, to be independent of the CEO. It is argued that in the case of large corporations, CEO duality is not likely to be conducive to ensure the shareholders' interests. Instead, the CEO duality is likely to empower the CEO to make decisions which may not be in the best interest of shareholders and instead the managers will be more concerned to enhance their own interests and personal wealth. In order to ensure that management is not working against the shareholders' interest, an effective monitoring mechanism will be needed and one important aspect of this mechanism will be an independent corporate board, headed by an independent chairman. Furthermore, the CEO duality is likely to aggravate the agency problem.

52.3.4.3 CEO Duality and Institutional Shareholders

The institutional investors, especially CALPERS (California Public Employee Pension Fund), are especially against CEO duality because they are concerned that CEO duality would impair board independence which will not be conducive to enhance the shareholders' value. Some corporations agree with CALPERS and have given the responsibilities of the board chairman and Chief Operating Officer to two separate individuals, whereas other corporations believe that CEO duality is in the best interest of the firm because it results in better performance. The latest trend is, however, toward splitting the responsibilities of the board chairman and CEO.

52.3.5 Specialization of Independent Directors

Will specialization of independent directors on the corporate boards improve the board's effectiveness? Examples of specialization of independent directors are bankers, attorneys, accountants, academics, etc. The Sarbanes-Oxley Act requires that at least one audit committee member be a financial specialist. This means that at least one independent director should be a specialist. A question arises whether independent directors with specialization improve the effectiveness of the corporate boards. It can be argued that some specializations will be beneficial in improving the board's effectiveness. For example, a banker on the board will enable the board to provide an effective advice on dealing with banks on financing and other financial transactions, and he/she will also provide an effective monitoring function. Similarly, legal specialization will be beneficial with regard to the legal affairs of the company. Agrawal and Chadha (2005) provide evidence that a financial expert in an audit committee is likely to limit the likelihood of restatements.

52.3.6 Appointment of Directors: Investors' Activism in Nominating Them

Directors in the unitary corporate governance system are elected by the shareholders in the annual meeting. The existing board of directors prepares a slate for election of directors and this slate is sent to the shareholders in the proxy statement. The slate is prepared on the basis of nominations of directors by the existing board or by the Chief Executive Officer. The shareholders also have the option to nominate directors, but the Board is under no obligation to include nominations from the shareholders on the slate for election of directors.

The nominated directors are elected by shareholders by a simple majority. The shareholders have the right to vote for or against the nominated director. If he/she director fails to obtain a simple majority, he/she is not elected. The existing board has the right to re-nominate the defeated director for re-election.

This process of nomination has been criticized by the activists because it does not give any right to investors to nominate a director unless the existing board approves it. This issue has been debated for a long time. After a careful consideration of the issue, the SEC issued a new rule in 2010 that investors with 5% shareholdings have the right to nominate a director on the board (with or without the approval of the existing board). This rule was challenged in the court by the US Chamber of Commerce and Business Roundtable; they charged that the rule was arbitrary and capricious, violated the Administrative Procedure Act and the SEC failed to properly assess the rule's effect on "efficiency, competition and capital formation" as required by law. The US Court of Appeals for the District of Columbia Circuit rule in 2011 that the SEC rule was issued without an appropriate cost-benefit analysis of the rule. The court asked the

SEC to reconsider this issue and evaluate costs and benefits involved in allowing investors to nominate directors.

52.3.7 Corporate Board Size

One of the important characteristics of a corporate board is the board size. What is an optimal size of a corporate board? This issue has been extensively discussed in the literature and practice, and there is no consensus on this issue. Most of the discussion on this issue has been focused on whether a small or a large board is more effective. It is generally argued that the board should be small enough to conduct the business effectively, yet it should be large enough so that different individuals can be assigned to different committees and different viewpoints can be presented in the board.

52.3.7.1 Large Versus Small Corporate Boards

It is argued that a large board has more capabilities for problem solving and it allows individuals to be more effective in their committee assignments because they are not likely to be over-burdened with such assignments. Jensen (1993) on the other hand, argues that keeping the board small will help in improving the firm performance, and he is of the opinion that if a board gets beyond seven or eight members, it is less likely to function effectively and this situation would make it easier for the CEO to control the board. Lipton and Lorsh (1992), further argue the norms of behavior in large boards can become dysfunctional, and that the large boards lack group cohesiveness.

52.3.7.2 Corporate Board Size and Firm Performance

Hermalin and Weisbach (2003) provide empirical evidence that the board size is negatively related to both firm performance and the quality of decision making. Similarly, Yermack's (1996) findings also show a negative relationship between the firms' market valuation and board size. Eisenberg et al. (1998) document an inverse relation between the board size and profitability for small and mid-size companies in Finland. Carline et al. (2002) provide similar evidence for the UK firms. But, Van Ees et al. (2003) find no evidence on the relationship between the board size and firm performance in Netherlands.

52.4 Functioning of Corporate Boards

In this section, we discuss how the US corporate boards work in actual practice, and we cover the topics of committee structure, meeting frequency, busy boards, and gender participation.

52.4.1 The Committee Structure

In order to be effective, corporate boards function through several committees. Some of these committees are permanent committees, while others are ad-hoc committees. The corporate boards are required to have at least the following three permanent committees: audit committee, compensation committee, and nomination committee. We discuss the important aspects of these three committees.

52.4.2 Audit Committee

Prior to SOX, it was optional for firms to establish an audit committee in the firm. The main function of the audit committee prior to SOX was to serve as a link between the CEO and external auditors. The committee primarily provided advice to the management and assisted the management in resolving the differences between auditors and management. The nature of audit committee has drastically changed with the passage of SOX. It is now mandatory to have an audit committee and SOX has mandated certain functions and responsibilities of this committee, and the SEC provides the rules to improve disclosures related to this committee. The NYSE and NASDAC sponsored the Blue Ribbon Committee in response to an increasing sense of urgency surrounding the need for responsible financial reporting. Based on the recommendations of this committee, the stock exchanges now also require the establishment of an audit committee by all registered US companies.

Under the revised rules, the audit committee's primary function is to oversee the firm's financial reporting process, and to prevent fraudulent accounting statements. Thus, the audit committee plays a critical role in financial reporting by overseeing and monitoring the management's decisions and activities and by supervising independent auditors' participation in the financial reporting process. The audit committee is also entrusted with the responsibility of resolving differences between outside auditors and management with regard to application of the Generally Accepted Accounting Principles. In order to do so, the committee is required to meet regularly with the firm's outside auditors and internal financial managers to review the corporation's financial statements, audit process, and internal accounting controls.

It is argued that the new dynamics of the capital markets have presented the companies with an increasingly complex set of challenges. An important challenge is that the companies are under increasing pressure to meet the earnings expectations. Regulators and investors have become increasingly concerned about inappropriate "earnings management", the practice of distorting the true financial performance of the company. The changes in the market

and the increasing pressures on companies to maintain positive earnings trends have highlighted the importance of strong and effective audit committees. Thus, the audit committee now plays a critical role in the financial reporting system by overseeing and monitoring the management, and also by supervising independent auditors' participation in the financial reporting process.

52.4.2.1 Establishment of an Audit Committee

We highlight the rules and regulations for the establishment of audit committees and their functions and composition, and also discuss whether specialization of the audit committee member will improve the committee's effectiveness. We also briefly discuss the role of the audit committee in maintaining the complaint channels in the firm.

The term "audit committee" is defined as a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer (SOX). If no such committee is established, the entire board of directors serves as the audit committee.

52.4.2.2 Functions of an Audit Committee

The audit committee is responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the firm. The registered public accounting firm shall report directly to the audit committee, and it will have to resolve disagreements between management and the auditor on financial issues and reporting.

The audit committee is required to pre-approve all auditing services to be provided by an external auditor. These services may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for the purposes of State law and also non-audit services to be provided by the auditor of the issuer. It is also required to pre-approve all non-audit services, including tax services, if they are not specifically prohibited to be performed by an auditor of the issuer.

52.4.2.3 Waiver of Pre-approval of Non-audit Services

The pre-approval requirement is waived with respect to the provision of non-audit services for an issuer, if the aggregate amount of all such non-audit services provided to the firm constitutes not more than 5% of the total amount of revenues paid by the firm to its auditor during the fiscal year in which the non-audit services are provided, or such services were not recognized by the firm at the time of the engagement to be non-audit services. The performance of such services is promptly brought to the attention of the audit committee of the firm and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

The audit committee may delegate to one or more designated members of the audit committee who are independent directors of the board of directors, the authority to grant pre-approvals. The decision of any member to whom authority is delegated shall be presented to the full audit committee at each of its scheduled meetings. The registered public accounting firm that performs audit for the firm is required to report to the audit committee all critical accounting policies and practices used, all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm. Moreover, the public accounting firm is also required to report any other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

52.4.2.4 Independence of an Audit Committee

The SOX requires that each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent. In order to be considered to be independent, a member of an audit committee may not, other than in his/her capacity as a member of the audit committee, the board of directors, or any other board committee in the firm, accept any consulting, advisory, or other compensatory fee from the firm. Moreover, the audit committee shall not be affiliated in any way with the firm or any of its subsidiaries.

The SEC is, however, authorized to exempt a particular relationship with respect to audit committee members, as it determines appropriate in light of the circumstances. This exception implies that all members of the audit committee may not be independent.

Under the revised listing standards of the NYSE, AMEX, and NASD, under exceptional and limited circumstances, companies may appoint to their audit committee one director who is not independent if the Board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the Board disclose, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Small companies are, however, exempt from disclosing reasons for non-independence of a committee member. All companies are, however, required to disclose whether audit committee members are independent or not.

52.4.2.5 Financial Expertise in an Audit Committee

The SOX requires that at least one member of the committee shall be financial expert. Furthermore, it requires that the issuer should disclose whether or not, and if not, the reasons for not having at least one member who is a financial expert. The term “financial expert” is defined through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of the firm. The individual shall come from a position involving the performance of the function that shows an understanding of generally accepted accounting principles and financial statements, and experience in the preparation of auditing of financial statements of generally comparable firms, and the application of such principles in connection with the accounting for estimates, accruals, and reserves or experience with internal accounting controls. The individual should an understanding of the audit committee functions.

52.4.2.6 Disclosures on Audit Committee

The SEC adopted new rules and amendments to its current rules to require that companies include in their proxy statements certain disclosures about their audit committees and reports from their audit committees. The firms are required to inform the shareholders of the audit committee’s oversight with respect to financial reporting and underscore the importance of that role in the proxy statement. This disclosure should include that (1) the audit committee has reviewed and discussed the audited financial statements with management, (2) the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61, as may be modified or supplemented, and The audit committee has received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, as may be modified or supplemented, and has discussed with the auditors the auditors’ independence. The companies must disclose in their proxy statements whether their audit committee is governed by a charter, and if so, include a copy of *the charter as an appendix to the proxy statement at least once every 3 years. This should help investors to understand the role and responsibilities of the audit committee*.

52.4.3 Nominating/Governance Committee

The purpose of the Corporate Governance/Nominating Committee is to assist the Board in identifying qualified individuals to become Board members, nominate directors to serve on the board and board committees. Additionally, this committee also assists the Board in assessing the Board effectiveness and it may also make recommendations to the Board for any improvements in the company’s corporate governance.

52.4.3.1 Composition of a Nominating Committee

The committee generally consists of at least three directors. The chair as well members of the committee are appointed by the Board and they serve at the Board’s discretion. All members of the committee are generally expected to be independent outside directors.

52.4.3.2 Responsibilities of a Nominating Committee

Authority and responsibilities of this committee are as follows: (1) to organize search for individuals who are qualified to become members of the board, (2) to retain a search firm to assist the committee in the search process for qualified candidates to become directors, (3) to evaluate the suitability of potential candidates based on the qualifications of the candidates and the board’s needs based on the current board’s composition, board’s need for expertise, diversity, and balance between inside and outside independent directors, (4) to make recommendation to the Board on individual candidate for nomination, and (5) to keep itself abreast of trends and best practices in corporate governance, and review the company’s corporate governance guidelines periodically.

52.4.3.3 Meetings and Attendance by the Company Officers

The committee is required to meet at least two times a year, or more often, if circumstances require. The committee may invite to its meetings any director or officer of the company to assist it in performing its responsibilities.

52.4.3.4 Annual Report

The committee shall conduct and present to the Board an annual performance evaluation of the committee. The committee shall review annually the adequacy of the committee’s charge and recommend any changes that it deems appropriate to the Board for approval.

52.4.4 Compensation Committee

Traditionally, companies were not obligated to have compensation committees, and it was open to the board as a whole to perform the duties of the compensation committee. As a practical matter, most boards did not have compensation committees. But lately the need for this committee is being increasingly felt and laws/regulations in some states are making it a mandatory committee. Legislation or regulation in many jurisdictions requires that a compensation committee be established and maintained, and that the majority of members be independent.

52.4.4.1 Need for Expertise on Compensation Committee

While financial expertise and experience is required for an audit committee, there is no such requirement for the compensation committee. In actual practice, however, knowledge and experience in compensation and human resources issues is considered helpful for the committee to discharge its functions. Some firms also consider committee member's qualifications to recognize investor sentiment toward particular sort of compensation arrangement.

52.4.4.2 Responsibilities of a Compensation Committee

The committee's responsibilities are decided by the board and they are generally disclosed by the company so that all concerned have a better understanding of the role of compensation committee in the organization. Generally, the Board's mandate should be substantially broader than simply dealing with establishing senior management compensation levels.

The compensation committee can be assigned the following functions: (1) to establish CEO compensation, (2) to develop compensation philosophy for the company, (3) to assist with and review the compensation discussion and analysis, (4) to oversee equity compensation grant policy, (5) to assist the board in assessing and evaluating the CEO's performance, review and recommend the CEO's compensation, including salary, incentives benefits and other perquisites, (6) to recommend to the board the amount, determination and payment of remuneration t to directors, (7) to report executive compensation as required in public disclosures statements, (8) to retain and terminate outside experts to deal with compensation issues, and (9) to evaluate shareholder proposals related to executive compensation.

A tool for the committee in reviewing the structure of their company's incentive programs is risk taking by the management, and the committee should discourage programs that involve excessive risk taking.

52.4.4.3 Compensation Committee Procedures

It is important that suitable procedures are developed and implemented so that the compensation committee can function effectively and perform useful function in the organization. The corporate secretary can be helpful in formulating these procedures.

52.4.5 Frequency of Corporate Board Meetings

The number of times a board meets varies from company to company depending on the nature of business, complexity of business, role of CEO, and general policy of the companies. There is no optimal number of meetings which a board should follow. It is, however, important that the board meetings are sufficient enough to deal with important issues of the board. If the meeting frequency is low, important issues will not get the Board's attention as they deserve. In this case, the board will be making decisions without fully considering pros and cons of the issue under discussion.

52.4.6 Corporate Board Meetings and Board Effectiveness

The effectiveness of the Boards also depends on an appropriate frequency of its meetings. If the Board is not meeting when decisions need to be made, the CEO will make these decisions without the Board and this will impair the Board's effectiveness. The CEO will also not be happy if proper advice and counsel is not available when needed and this will force the CEO to make his/her decisions.

In 2002, the average S&P 500 board met 7.5 times, whereas it met 8.2 times in 2001. It is, however, reported that the frequency of the board's meeting goes down if the board committees are effective.

52.4.7 Busy Directors

Individual outside directors generally serve on the Boards of several different corporations. It has lately been observed that sometimes a director serves on four or five boards of different companies. If a director serves on more than four company Boards, he/she can be considered a busy director. An important question arises whether a busy director can be effective on any Corporate Board and whether he/she can perform a useful function on the Board and make a contribution to improve the Board's monitoring and advisory functions to enhance firm value.

52.4.7.1 Executive of One Company Serving as a Director of Another Company

The directors are generally executives of another company. In addition to their job as an executive, they have to attend the board meetings of other companies. Why a director would serve on many boards and not have enough time for his/her company? It is generally believed that these executives accept the director's position either because of personal relations with the executives of the company in which they accept the position or they accept the position to create goodwill for their company. It is conventional wisdom that directors will have less time to devote to the work of the board of any company on which he/she serves if he/she is a director on several corporate boards. If majority of directors on a Board are busy, this would mean that the Board will not

be effective. Therefore, directors should the consequences if the Board consists of several busy directors.

52.4.7.2 Limit on the Number of Directorships for a Director

Should there be a limit on the number of boards on which a director can serve? It is difficult to develop any general rule to define when a particular can be considered as a busy director and what should be the limit on the number of busy directors on a single Board. It is, however, investors' right to know about the composition of the Board and characteristics of the board members. The corporations should be encouraged to disclose information on the board composition and provide as much information on the directors as possible.

52.4.8 Diversity: Female Directors

Historically most directors have been middle-aged male directors in the companies, and only in exceptional cases directors were females or belonged to an ethnic minority community. Lately, there has been awareness that diversity in Corporate Boards is desirable because it can result in several advantages for the corporation. In more recent times, gender diversity on the Board and its workforce has become a key governance issue. Some argue that it is only equitable that the gender balance on the board is addressed and redressed given that half of the population consists of female whereas the majority of Board members in a typical Board are males.

52.4.8.1 Female Directors and Board Structure

In addition to the gender balance, it is argued that female directors are considered to bring more strength to the boardroom because of their different life experience, their way of thinking, their patience, their way of dealing with people and their cool behavior in dealing with the situation. Others argue that the main benefit of women being on the boards is the in-depth discussion in the board, which generally results in a more consensus situation.

52.4.8.2 Trend in Female Directors on Company Boards

The awareness of female directors on the Board has been noticed in several western industrialized countries. An early exponent of women's representation in the boardroom was Norway; there is an enforced quota of 40% female directors on boards of all publicly listed Norwegian companies since 2008. Spain has also introduced an equality law in 2007 requiring companies with 250+ employees to develop gender equality plans, and the legislation will become effective in 2015, which will require the Spanish companies to ensure that 40% of board members are female. The Dutch Code of Corporate Governance (2008) also advocates that the Supervisory board shall aim for a diverse composition in terms of such factors as gender and age. Similarly, the German Corporate Governance code (2009) requires the Supervisory Board to have respect for diversity when appointing the members of the Management Board. The UK Corporate Governance Code (2010) also encourages the Board to consider the benefits of diversity, including gender. This Code urges companies to have a well-balanced Board.

Diversity should, however, not be for diversity's sake. Instead, it should be for the benefit of the company, its shareholders and other stakeholders. The ultimate goal should be better monitoring and better firm performance.

52.5 Internal Controls and Corporate Boards

52.5.1 Importance of Internal Controls

Companies generally institute internal controls to provide effective monitoring over employees' activities, and these internal controls are developed to ensure that employees are following the company's policies, managerial decisions are consistent with the best interests of shareholders, corporate activities do not violate the country's laws, and that there is no collusion among managers and employees to defraud the firm. Larger corporations especially require numerous analyses and reports to assure that there is compliance with the company's policies, that protection is provided against human weaknesses, errors and irregularities, and that assurance is given to independent auditors on the accuracy of internal control system so that the scope of the audit work can be minimized. In the absence of adequate and effective internal controls, there is a danger of fraud, non-conformity with company policies, misrepresentation to managers for decision making, and misrepresentation to investors by management. These negative aspects of weak internal controls may result in financial difficulties for the firm, they may have a negative impact on the firm performance, and consequently they may have a negative impact on the stock prices, and firm value. In the severe cases of inadequacy and unreliability of internal controls, there may a danger of corporate failure.

52.5.2 Administrative Versus Accounting Controls

We generally distinguish between two types of internal controls and these are the administrative controls and accounting controls. The administrative controls consist of the firm's plan of organization, procedures, and tests

concerned with the decision making processes. The administrative controls become the starting point for accounting controls, which deal with safeguarding of assets, reliability of financial records, conformity with the accounting standards, and reasonable assurances on the accuracy and reliability of reported information. It is important that accounting internal controls are effective, and the following two conditions are the basic requirements to make these controls effective: First, there should be an effective management leadership, a good organization structure is developed, and an appropriate budgetary process is established. Second, sound accounting practices are developed in the firm.

52.5.3 Historical Perspective on Internal Controls

Historically, companies have not been required to certify whether internal controls exist in the firm and whether they are effective. But given the importance of internal controls for reliability of information to investors and danger of bankruptcy in case of inadequacy of internal controls, which may have a negative impact on smooth functioning of the financial markets and ultimately economy of the country, the policy makers and regulators could not leave it to the shareholders and managers to ensure that proper internal controls are developed in the companies. Therefore, from time to time, the policy makers and regulators had to intervene and develop rules and regulations to ensure the development of effective internal controls in the companies.

In 1977, the Foreign Corrupt Practices Act was enacted, which required the management to provide a report on the existence and reliability of internal controls in the financial statements. Despite these certifications, the weaknesses in internal control systems resulted in fraudulent reporting in several corporations and consequently there have been corporate failures. Later the Treadway Commission was established and it issued a report on the factors that led to fraudulent financial reporting and also made recommendations to deter firms to make fraudulent reporting. These recommendations especially included strengthening of internal controls to reduce the occurrence of such reporting. Following the Treadway Commission Report, the Committee of Sponsoring Organizations (COSO) was formed to develop an integrated framework of internal control.

In 1992, the COSO released guidance for designing and implementing effective internal controls, and argued that there would be potential benefits of having effective internal controls, which would include effective and efficient operations, enhanced reliability of financial reporting, and compliance with laws and regulations. There was, however, no mandatory reporting of internal control weaknesses except when there was a change in auditors.

52.5.4 Internal Controls Under Sarbanes-Oxley Act (SOX), 2002

Despite the Foreign Corrupt Practices Act and COSO regulations, weaknesses in the internal control led to several corporate failures in 1990s, which included Enron, Worldcom, Tyco, etc. The 2002 Sarbanes Oxley Act (SOX) once again emphasized the importance of internal control systems and it required all companies to institute internal controls and provide management assessment on the effectiveness of these controls. In addition, the SOX requires the large accelerated filers (firms with 750 million US dollars and above capitalization) and the accelerated filers (firms between 75 and 750 million US dollars capitalization) to provide an attestation from an external independent auditors on the managerial assessment of the internal controls' effectiveness. This Act has two important sections on internal controls and these are sections 302 and 404. We discuss the important aspects of these sections to highlight the requirements on internal controls under the current laws.

52.5.4.1 Section 302 of SOX on Internal Controls

Section 302 describes the corporate responsibility for financial reports, and requires among other things a quarterly self-assertion by the CEO/CFO, under personal liability, disclosing significant material financial information to the stakeholders and investors. The assertion should be included in the company's 10Q and 10 K, but no supporting documents or certification of independent examination is required under this section. The important aspects of this section are that the principle executive officer or the principal financial officer certifies that he/she has reviewed the report. Additionally, their statement should include that based on the knowledge of the signing officer, the report does not contain any untrue statement or there is no omission of a material fact, and that the financial statements and other financial information included in the report fairly present in all material respects the financial condition and the results of the operation of the issuing company. The signing officer is also required to state that he/she is responsible for establishing and maintaining internal controls, and he/she has designed such internal controls and has evaluated the effectiveness of these controls. Furthermore, he/she should present the conclusion about the effectiveness of internal controls and all significant deficiencies in the design or operation of internal controls.

52.5.4.2 Section 404 of SOX on Internal Controls

The section 404 deals with Enhanced Financial Disclosures and it consists of two subsections, i.e. 404(a) and 404(b). The subsection 404(a) requires that each company's annual report should include an internal control report containing the management's assessment of the effectiveness of ICFR,

whereas the subsection 404(b) requires the companies to have the auditor evaluate the effectiveness of the

There are three important reporting requirements under this section. First, the report should state that the management of the issuing company is responsible for establishing and maintaining adequate internal controls and procedures for financial reporting. Second, the report should contain management's assessment as of the end of the most recent fiscal year on the effectiveness of the company's internal controls and procedures for financial reporting. Third, it should contain a statement that the company's independent auditor has attested to and reported on the management's evaluation of the internal controls and procedures for financial reporting.

52.5.4.3 Applicability of Sections 302 and 404 of SOX

Both subsections 404a and 404b, became effective for accelerated and large accelerated filers ($75 million and above) in November 2004. Subsection 404(b) became effective in December 2007 for non-accelerated filers (less than $75 million), and they are exempted from subsection 404(b) under the D9dd-Frank Act 2010. Reporting of management self-assessment under subsection 404(a) is considered sufficient for smaller companies.

52.5.4.4 Criticism of Section 404 (b)

The main criticism of subsection 404(b), especially for non-accelerated filers, is based on the costs involved in meeting the requirements. Two surveys have been undertaken to evaluate such costs. One survey is undertaken by the Financial Executive Institute (FEI) and the other by the CPA firms. The FEI survey results report that audit fees increased 39% for the first year after SOX and average total cost was reported to be $4.36 million for the largest US companies (over five billion in revenues), and the details of the compliance costs by components is as follows: internal cost = 1.34 million; external cost = 1.72 million, and auditor fee = 1.30 million. The survey results show that all respondents believe that costs associated with compliance of section 404 exceeded the benefits.

The survey results conducted by the accounting firms D&T, E&Y and PWCoopers reported that the implementation cost for section 404 on average per company was estimated to be approximately $7.3 million, which represented 1/10th of 1% company revenues. On an average, audit fees were estimated to be approximately one-quarter of the total implementation costs per company, which means 1/40th of 1% of the company's revenues. The survey results further reported that the year-two implementation costs were expected to decrease approximately 46% compared to year-one costs, suggesting substantial non-recurring start up and "learning curve" costs. Approximately $1.9 million or 26% of the total cost is comprised of section 404 audit-related fees. It represents about .09% of the average revenue of the total sample companies. On average, each company identified 348 deficiencies and remediated 271 deficiencies and was expected to remediate an additional 77 deficiencies.

52.5.4.5 Response to Criticism of Section 404 (b) of SOX

CalPERS (California Public Employees' Retirement System) expressed the views that the costs associated with SOX are paid by the shareholders and not by the management. It was therefore the shareholders' choice to support this cost if internal controls deliver better governance and management. It has been further argued that these costs are not significant compared to the losses suffered by investors. 55% of respondents believe that section 404 gives investors and other external users more confidence in a company's financial reports (83% respondents of large companies). In general, companies applaud the added focus on internal controls, but many respondents believe that the level of details required is impractical and bureaucratic. They argued that the support was right on, but the execution to the level of detail that was required was much more than necessary.

52.5.4.6 Auditing Standards and Internal Controls

The PACOB implemented Sarbanes Oxley Act Section 404 on internal control system by issuing Auditing Statement No. 2 on October 7, 2003. In April 2006, issued another auditing standard No. 4, which describes the steps to be used by auditors when a company voluntarily engages them to report on whether a material weakness, previously identified in the section 404 report. The main objective of this standard is to obtain reasonable assurances as to whether the previously reported material weaknesses still exist. The auditor's work is focused on whether the controls specified by management were designed and operating effectively.

52.6 External Controls and Corporate Governance

52.6.1 Two Types of External Controls

External controls over the managerial decision making process and activities are provided by external independent auditors and by the market control mechanism. We highlight a few important aspects of external controls by independent auditors, and especially discuss anti-takeover devices developed by the management.

52.6.2 External Independent Auditors

Under agency theory, external independent auditors play an important role to ensure that managers are reporting information to investors that is accurate and reliable. Moreover, independent auditors also ensure that all assets in the firm are properly accounted for and there is no misappropriation of funds by the managers to maximize their own wealth.

The Securities and Exchange Acts of 1933 and 1934 require that all companies that listed with the SEC and are publicly traded on the stock exchanges should have an independent auditor to attest to the accuracy and reliability of the financial information contained in the financial statements.

52.6.2.1 External Auditor's Functions

The SOX has clearly defined functions and responsibilities of independent auditors. The main function of the auditor is to provide attestation of the financial information provided by the management to investors, in the financial statements. The main objective is to provide reliability to the reported information. Other functions include reviewing of the client's accounting books, accounting policies and principles to ensure that accounting and principles are applied consistently, there are no inaccuracies and/or misrepresentations, and that the financial reports are comprehensive.

After reviewing the client's accounting books, auditors form their opinion with regard to the accuracy, comprehensiveness, and firm's financial difficulties which may create problems in the future. Auditors may issue one of the following opinion: clean (unqualified) opinion, qualified opinion, going concern opinion, adverse opinion, and no opinion.

52.6.2.2 Hiring of Auditors and Communication with the Firm

Under new regulations, the audit committee and not the management hires external independent auditors. External auditors also report back to the audit committee; they discuss the findings of their audit work and also their differences with the managers on accounting policies and procedures with the audit committee.

52.6.2.3 Independence of Auditors

Independence of auditors is considered important under SOX. In order to ensure independence, the SOX regulations prohibit external auditors to perform any non-audit services, except for tax services. Moreover, the regulations require rotation of the partner-in-charge of the audit so that cozy relationship the auditor and client firm is avoided. Thus, there are two important issues with regard to the impairment of independence and these are the non-audit services, and being too long on the job.

52.6.3 Market Control Mechanism

The corporate control market, which relates to takeover threats of firms that are not creating value for investors, plays an important role in monitoring managerial behavior and this has a significant impact on corporate governance. Weak performance makes these firms the targets for takeovers by corporate raiders as well as by other successful firms. These takeover threats serve as market control over managerial performance and firm performance. This market control mechanism serves as a useful function to keep the managers focused on the firm's overall goal of maximizing firm value for investors.

52.6.3.1 Anti-takeover Devices

Being aware of these threats, managers, especially entrenched managers, take necessary steps to avoid takeovers. Thus, managers along with the Board of Directors, especially when the Boards are independent, work toward building defenses to protect their companies from the threat of hostile takeovers. In order to do so, they develop anti-takeover devices, which are also known as shark repellents in the market. These devices, however, sometimes render management and the Board of Directors less accountable.

We first discuss important anti-takeover defenses, and also evaluate the role of independent boards in the development of such devices.

Green Mail

This refers to a transaction between a large shareholder and a company in which the shareholder agrees to sell his stock back to the company, usually at a premium, in exchange for a promise not to seek control of the company for a specified period. This device is used when someone buys a large stake in the company and begins to make his presence known, perhaps by making noises about trying to take over the company. The management offers to buy him out at a substantial bonus over the market price of the stock. This way the raiders achieve huge profits without even having to make a bid for the company, and managers are able to keep their jobs, and the main losers are the shareholders. The passage of this device reflects the Board's neglect of the shareholders' interests. The shareholders should be able to decide whether purchase of shares should be allowed.

Anti-greenmail measures prevent such arrangements unless the same repurchase offer is made to all shareholders or approved by a shareholder vote.

Blank Check

It refers to the authority given to the Board of Directors to issue a preferred stock. The board of directors determines the voting, dividend, conversion, and other rights for this stock.

While it can be used to enable a company to meet the changing financial needs, its most important use is to implement poison pills or to prevent takeover by placing this stock with friendly investors. This technique is thought to discourage accumulation of large blocks of stock, but the net effect on the shareholder wealth is unclear.

Supermajority

It limits the shareholders' ability to amend the governing documents of the corporation. A supermajority vote is needed to change charter/make amendments to the bylaws, total elimination of the ability of shareholders to amend the bylaws, or the ability of directors to amend the bylaws without shareholders' approval.

A Classified or Staggered Board

Directors are placed into different classes and they serve overlapping terms. Since only a part of the board can be replaced each year, an outsider who gains control of a corporation may have to wait a few years before being able to gain control of the board. This slow replacement makes a classified board a crucial component of the delay group of provisions, and one of the few provisions that clearly retains some deterrent value in modern takeover battles (Daines and Klausner, 2001). Most states, however, do not allow staggered boards after 2009.

Directors' Duties

This provision allows directors to consider constituencies other than shareholders when considering a merger. These constituencies may include, for example, employees, host communities, or suppliers. This provision provides board of directors with a legal basis for rejecting a takeover that would have been beneficial to shareholders.

Golden Parachutes

These are the severance agreements that provide cash and non-cash compensation to senior executives upon an event, such as termination, demotion, or resignation following a change in control. They do not require shareholders' approval. Such payments are generally intended to deter takeovers by increasing their costs. But these parachutes also ease the passage of mergers through contractual compensation to the managers of the target company (Lambert and Larcker, 1985).

Silver Parachutes

They are similar to Golden Parachutes in that they provide severance payments upon a change in corporate control, but differ in that a large number of a firm's employees are eligible for these benefits.

Poison Pill

It provides the holders with special rights in the case of triggering event, such as a hostile take-over bid. If a deal is approved by the Board of Directors, the poison pill can be revoked, but if the deal is not approved and the bidder proceeds, the pill is triggered. Typically, poison pills give the holders of the target's stock other than the bidder the right to purchase stock at a steep discount. This makes the target unattractive or dilutes the acquirer's voting powers.

Bebchuk (2003) is aiming to use the bylaws to force a change on the issue of takeover defenses, especially the poison-pill bylaw provisions. He argues that this provision denies the shareholders the right to make their own decisions, and proposes that the poison-pill provisions be approved by a two-third majority of directors and they should expire within 3 years.

52.6.4 Anti-takeover Devices and Independent Outside Directors

Some argue that because of reputational concerns and fear of lawsuits, outside directors are likely to represent shareholders' interests effectively (Bhagat et al., 1987). On the other hand, it is argued that outside directors are more likely to be align themselves with the top management than shareholders, not only because the top management has great influence over those who sit on the board but also because non-management directors typically hold a trivial portion of the stock of the firm.

Brickley et al. (1994) examined how the shareholders react to poison pill when the corporate board is independent or not independent. If outside directors represent the shareholders' interest, the likelihood of using a poison pill to harm shareholders should decrease with the fraction of outsiders on the board. In this case, investors should react positively to the poison pill. In contrast, if outside directors represent managerial interests, the likelihood of using a poison pill to harm shareholders will not vary with the fraction of outsiders on the board. In this case, stock market's reaction will not depend on the board composition. They find a significant positive relation between the stock market reaction to the adoption of poison pills and the fraction of outside directors on corporate board. The results suggest that outsiders represent shareholder interests.

52.6.4.1 Poison Pill and Firm Performance

Do poison pills affect operating performance of the firm? A widely held view is that poison pill negatively affects firm performance. Danielson and Karpoff (2006) examine whether poison pills improve operating performance, and their findings suggest that firms experience modest operating

performance improvements during the 5-year period after pill adoption. These improvements occur for a wide range of firms, and are unrelated to specific adoption years or whether firms invest heavily in R&D. Their findings are, however, at odd with the widely held view that poison pills negatively affect firm performance.

52.6.5 Role of Institutional Investors in Corporate Governance

The main institutional investors are the pension funds, insurance companies, and investment companies. The institutional investors are especially concerned with the election of directors and they believe that they should have a right to nominate directors because they hold significant shareholdings in the company. In the case they have no say in nomination of election of directors, they express their concerns about corporate governance by selling their shares, which may not be good for the stock price of the company.

Institutional investors can provide a good monitoring over managerial activities because of strong shareholding. Additionally, they can play also a positive role in mitigating the agency problem. Their substantial influence on the company's management can be used to align management interests with those of the shareholders. Thus, they can reduce the agency problem by possessing resources and expertise to monitor the managerial and provide oversight functions. In this regard, Stapledon (1996, p. 17) writes that monitoring by institutional shareholders fits within a broad tapestry of devices and market forces which operate to reduce the divergence between the interests of managers and shareholders. Diamond (1984) believes that institutional investors can solve the agency problem because of their ability to take advantage of economies of scale and diversification, and by demanding greater accountability from management. Chung et al. (2002) argue that there will be less opportunistic earnings management in firms with more institutional investor ownership because the institutions will either put pressure on the firms to adopt better accounting policies, or they will be able to unravel the earnings management.

It is also argued in the literature that Institutional investors' intervention can produce higher financial returns. Institutional activism can bring financial rewards, as more efficient monitoring of company management aligns shareholder and manager interests and thus helps to the maximize shareholder wealth. Agrawal and Knoeber (1996) also emphasize that the involvement of institutional investors can have a positive effect on corporate financial performance. Bethel et al. (1998) also report that active blockholders lead to enhanced shareholder value.

Some authors have expressed the view that institutional shareholding may result in an increase in information asymmetry. It is argued that institutions can have access to privileged information, which will create an asymmetry between themselves and smaller shareholders. Institutions are actually not the shareholders, instead they represent the principals who are the shareholders. This situation thus creates an added agency problem. Not only does the shareholder (individual pension fund member) have to worry about the possible divergent objective of investee company management but they also have to worry about the activities of the pension fund managers. In fact, some authors argue that institutional shareholders support management instead of shareholders. In fact, Davis and Kim (2007) report that although mutual funds are no more likely to vote with management of client versus non-client firms, there is a positive relation between business ties and the propensity of mutual funds to vote in favor of management proposals. Pound (1988) argues that institutional investors have a tendency to help entrenched management by voting with the management team. Consequently, institutional shareholding may result in negative impact on the firm's long-term performance.

Institutional shareholdings may also lead to short-term profit maximization in order to make their returns look as healthy as possible in the short run. They may therefore pressure companies to focus on short-term profits rather than long-term profits. This can be detrimental to long-term company survival, as companies need to invest in long-term projects in order to ensure they grow and prosper in the long run.

52.7 Impact of Corporate Governance on Firm Performance and Disclosures

52.7.1 Firm Performance and Corporate Governance

The main objective of corporate governance is to monitor managerial activities and provide advice to management to improve firm performance so that shareholders' interests are protected and firm value is enhanced. Therefore, a question of interest is what type of corporate governance can achieve these goals. It is generally argued that an independent corporate will be more effective and enhance firm performance.

52.7.2 Problems Associated with Managers-Shareholders' Conflict

Though firm is influenced by several factors, but the most important factor is the managers-shareholders' conflict, which gives rise to the following three problems:

52.7.2.1 Free Cash Flow Problem

Shareholders would prefer that free cash flow is distributed in the form of dividends to them, but managers would prefer investing cash flows over the payment of dividends, even in

the absence of profitable investment prospects. Managers' preference is motivated by power, prestige, and higher salaries that, on average, are associated with managing a larger firm.

52.7.2.2 Risk Problem

Shareholders can diversify their risk through their portfolio choice, but managers cannot do so because they have a significant human capital investment in the firm. Thus, shareholders are willing to undertake risky projects. Managers are generally risk-averse than shareholders, and they are unwilling to undertake risky projects.

52.7.2.3 The Horizon Problem

Managers, on average, are more myopic than shareholders in making their decisions, because of the pressure to produce immediate results. "Short-termism" may drive managers away from necessary maintenance and R&D expenditures, and high-technology investment that are bound to have a longer payback period.

Because of these conflicts, some authors argue that managers may not invest in profitable projects which have long horizons. Consequently, the conflict is likely to result in lowering the operating performance of the firm in the long run. To overcome these problems, corrective action is needed to focus managers' attention on the main goal, i.e. to maximize shareholders' value through better performance. Broadly speaking, two types of mechanism are used to improve firm performance thus enhance firm value, and these are: monitoring of managers by corporate boards, proper advice and guidance by corporate boards, and development of incentives by the corporate boards to properly align managers interests with shareholders' interests.

52.7.3 Monitoring by Corporate Boards and Firm Performance

It is generally argued that proper monitoring of managerial activities is expected to improve firm performance, and some authors argue that outside independent directors will provide more effective monitoring of managerial activities to achieve the objective of enhancing firm value.

52.7.3.1 Independent Corporate Boards and Firm Performance

It is argued that outside directors, who are supposed to take care of shareholders' interest, can discipline management better, and thus provide a more effective monitoring. An effective monitoring is expected to results in a higher level of sales, fewer employees' turnover, higher labor productivity, lower selling and general administrative expenses, etc. Cumulatively, these factors are expected to result in better firm performance.

Empirical evidence is, however, mixed on the role of independent directors in improving firm performance. Though some findings suggest that independent boards are positively associated with firm performance, others indicate that there is no significant association or negative association. It is argued that the appointment of independent directors would send a positive signal to the market on firm performance. Rosenstein and Wyatt (1990) evaluate market reaction to the announcements of outside board appointments, and find significant positive excess returns around the days of the announcements. They interpret their findings to show that the announcements of appointment of an outside director are associated with an increase in the shareholders' wealth. Fosberg (1989), however, reports no relationship between the outside directors and various variables used to gauge firm performance. In fact, to the contrary, he finds that firms with non-majority of independent directors had a mean ROE 1.1% greater than the firms with majority of independent directors. Overall, the findings show that the presence of outside directors does not enhance firm performance.

Fama and Jensen (1983) argue that the executive directors will have a positive impact on the firm performance. Inside executive directors are an important source of firm-specific information, and their inclusion on the board can lead to a more effective decision-making process. Morck et al. (1988), however, maintain that, when there is a high level of inside ownership, the executive directors may use their voting power to maintain their jobs (entrenchment) and maximize their benefits by designing their compensation packages. This will not enhance firm performance.

Findings by Hermalin and Weisbach (1991), however, show no significant association between firm performance and inside directors. They argue that inside and outside directors have their respective advantages and disadvantages. If each board is optimally weighted between insiders and outsiders, board composition will have no effect on firm performance. Rosenstein and Wyatt (1990), however, detect different market reaction to different levels of insider managerial ownership. Reaction is significantly negative when inside directors ownership is less than 5%. The reaction is significantly positive when the inside ownership level is between 5% and 25%. The reaction is insignificant when ownership percentage exceeds 25%. They interpret their findings to suggest that at low levels of inside ownership, the market infers that the addition of an inside director is likely to be an attempt to entrench the existing management, i.e. the existing CEO and hand-picked successor. Thus, negative reaction at the moderate level of inside ownership, where managerial interests are closely aligned with those of the outside shareholders, the expected benefits of the

specialized knowledge provided by an inside manager outweigh the expected costs of increase managerial entrenchment. Thus, a positive reaction at high levels of inside ownership, where insiders may have the voting power to insulate themselves from the scrutiny of outsiders, costs of the appointing insiders offset the benefits.

52.7.3.2 Financial Expertise on the Corporate Board and Firm Performance

The SOX requires that one of the outside directors on the audit committee should have accounting or financial expertise, but there is no direct requirement of expertise of outside directors on the corporate boards. The audit committee requirement indirectly implies that at least one outside director on the board should have financial expertise. Will financial expertise of independent directors lead to better firm performance? It is generally argued that the effect of independent director with expertise will depend on the nature of his/her expertise. It is generally expected that independent directors with expertise are likely to make the board more effective.

52.7.4 Alignment of Managers' Interests with Shareholders' Interests and Firm Performance

Corporate boards also motivate managers to enhance firm performance by aligning their interests with those of the shareholders. The common technique used for this purpose is providing ownership of the stocks to managers.

Alignment of interests is also possible through compensation system. The use of stock options in the compensation structure is expected to align the managers' interests with that of shareholders.

52.7.5 Financial Disclosures and Corporate Governance

Managers try to achieve different objectives through disclosures, especially voluntary disclosures, which may include the following: to send positive signals to the market, to create positive image for the company, to confirm or rebut existing information in the market, and to counteract rumors. Meaningful, reliable and timely disclosure must meet the following criteria: accuracy, reliability, appropriateness, completeness, clarity, and timeliness. Reliability of disclosures is important to provide credibility to information so that it can be used in the decision making process.

52.7.5.1 Transparency in Disclosures

Bushman et al. (2004) emphasize that transparency is an important aspect of disclosures. They argue that Information disclosed by management is an output from a multifaceted system whose components collectively produce, gather, validate, and disseminate information. They further differentiate between three aspects of transparency and these are: the financial transparency, the governance transparency, and the risk transparency.

Financial transparency refers to the comprehensiveness (intensity) of financial information disclosed and the timeliness of these disclosures. Comprehensive disclosures should meet the following three criteria:

First, *obfuscation* should be avoided. It is argued that disclosures can result in *obfuscation* when managers possess more private information and they are less forthcoming with their overall disclosures (including voluntary disclosures), and it creates higher information asymmetry. In case disclosures are not comprehensive, it is feared that analysts may be inclined to follow firms with more private information than publicly available information because potential rewards would be higher (Barth et al., 2001). Consequently, this type of information will have lower reliability.

Second, disclosures should not be *opaque*. Many firms are guilty of providing *opaque* (hard to understand and explain) disclosures, and such disclosures are not suitable for investment decisions, especially, when information relates to special purpose entities, stock option expensing, intangible assets and research and development.

Third, disclosures should be *timely*. The main issue involved in the timeliness of disclosure relates to disclosure of losses. Should they be disclosed without any time delay or with delay? Similarly, when gains should be disclosed? The timeliness of disclosures of gains and losses is referred to as *accounting conservatism*. Conservative accounting is generally provides more timely and reliable information. The reliability and timeliness of disclosures in turn determine the disclosure quality, and the disclosure quality builds credibility of disclosures in the financial markets.

52.7.5.2 Factors Influencing Transparency

Transparency of disclosures is influenced by the following factors: (1) monitoring effectiveness of the corporate boards, (2) ownership structure, and (3) political economy.

An effective corporate board should result in more comprehensive and timely information disclosures, which should be useful to investors to make informed judgments. What is an effective corporate board? An independent board, a board with expertise, or a board with not very busy directors. The number of meetings is reasonable to discuss different issues. Empirical evidence shows that independent boards are associated with higher voluntary disclosures. Chen and Jaggi (2000) show that there is a positive association between a higher percentage of independent directors and financial disclosures in Hong Kong firms.

The corporate ownership structure also plays an important role in disclosure transparency. There is no strong incentive for management to high transparency in disclosures when ownership is concentrated in the hands of family members, who are also control the firm's management. Transparency in disclosures is, however, important in firms with diffused ownership because public disclosures by the firms provide more reliable and cost-effective information to the shareholders.

The political economy represents a range of institutional arrangements that capture important relations between the government and economy, and these are: concentration of political power (autocracy), state corporate ownership (non-banks), state bank-ownership, costs of entry imposed on start-up firms, and risk of appropriations. It is argued that these factors also play an important in transparency of corporate disclosures.

52.7.6 Corporate Governance, Risk Assessment and Risk Disclosures

Risk assessment and risk disclosures have recently started receiving increased attention of managers, corporate boards, and also auditors. Without an effective risk assessment, companies are unable to prioritize and efficiently deploy their resources and develop reliable monitoring activities. Risk assessment includes both an evaluation of the inherent risks (e.g. impact and likelihood analysis), and an evaluation of the effectiveness of management's controls and risk management activities.

The goal of an effective risk assessment process is to identify coverage gaps and develop plans to remediate coverage deficiencies before they are exposed. The corporate board has multi-dimensional responsibilities in steering top management towards the right risk choices. The board should monitor the risk situation of the company systematically to identify and evaluate multiple sources of risk, and the following guidelines in the process of risk evaluation: (1) Take a portfolio view of corporate risks, (2) Be apprised more specifically of the major risks (for major risk combinations) that could significantly alter business perspectives, (3) Evaluate the way in which management has embedded risk management within the corporation, asking organizational questions, such as "do we need a chief risk officer", "how risk is being evaluated?"

Corporate disclosures should be in compliance with legal regulations and administrative rules, and additional it disclose risk information voluntarily which is not covered by the regulation but is important for investors to make their decisions.

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