UNIVERSITY OF CALGARY

MGST 451

Corporate Governance and Ethical Decision-Making

Lecture 3 – Winter 2019 L01-L03

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Lecture 3 Agenda

1. Board of Directors
   - Duties (i.e. legal obligations)
   - Responsibilities (example: Authorities)
   - Independence of the Board and of each Board Member (from Management and free from conflicts of interest)
   - Elections of the Board Members by the Shareholders
   - Term and Size
   - Committees (Nominations, Compensation, and Audit)
2. Internal Control
3. Internal Audit
4. Dual-class Shares

Board of Directors – Duties (obligations by law)

The Directors have a **fiduciary duty**

- Must act in the interest of the corporation
  - a duty to protect shareholder interests from harm
  - a duty of "fair treatment" for stakeholder interests (ca)

The Directors have a **duty of care**

- Must make decisions with due deliberation (get info + discuss)

The Directors have a **duty of loyalty**

- Must place the interests of Shareholders above their own interest and must avoid conflict of interests

The Directors have a **duty of candor**

- Must ensure that Shareholders are adequately and timely informed

Board of Directors - Responsibilities

- The respective responsibilities of the BoD and those of Management should be explicitly and unambiguously defined and delineated (avoid confusion and ensure accountability).
- Responsibilities (example: summary of CFA Institute booklet)
  - establish corporate values and governance structures;
  - ensure compliance with all legal & regulatory obligations;
  - establish long-term strategic objectives;
  - establish clear lines of responsibility and accountability;
  - hire the CEO, determine the compensation package, and periodically evaluate the officer's performance;
  - ensure to be supplied with sufficient information to make decisions and to monitor management.

Independence of Board Members

‘Executive Directors’ (clearly not independent)

- Management like CEO when members of the Board

Criteria for ‘Independent Director’: no material business or other relationship with (*example, may vary with applicable law/rule*):

- The firm (including Management, former executives or employees, and their family members);
- Whomever can exert significant influence on Management;
- Firm advisors (including external auditor) and their family;
- Whomever has cross-directorship relationship with the firm.

Criteria for ‘Nonindependent Director’

- A Director who is neither an Executive Director nor an Independent Director

Independence of the Board of Director

- At the minimum a Board would require to have a majority of Independent Directors to be viewed as an ‘independent BoD’.
- Other considerations to qualify the independence of a Board
  - Is the Chairperson an Independent Director or not;
  - If the Chairperson is not an Independent Director, has a ‘Lead Independent Director’ be designated and how often the Independent Directors meet by themselves only;
  - Has Committees only made-up of Independent Directors be formed with specific and exclusive responsibilities;
  - Has the Board and its Committees authority to hire independent consultants.

Board of Directors – Elections

- Usually one-share/one vote & who gets the most is elected. +
- Dual-class shares (e.g. Bombardier, Canadian Tire) -
  - The firm has more than one class of shares (e.g. each class A has 10 votes while each class B has 1 vote).
- Majority voting + +
  - Shareholders vote for one Board candidate at a time.
  - Need to receive a majority of the votes to get elected.
- Cumulative voting + +
  - Each shareholder gets a number of votes that reflects its number of share, the number of Directors & voting power.
  - A shareholder can choose to cast all its vote for one Board candidate or spread them around.

Board of Directors – Term and Size

Annual elections +

- All director positions are subject to annual elections.
- Term is therefore for one year.
- It is possible to change all Directors at once.

Staggered elections (i.e. a staggered Board) -

- Term is for multiple years (e.g. three years).
- Per chosen term, a certain proportion of director positions are subject to annual elections on a rotation basis (e.g. one third).
- It is impossible to change all Directors at once.
- Can be argued it provides for better continuity of expertise.

Number of Board Directors (i.e. size)

- Too few: not enough expertise; too many: no ‘ownership’.

Nominations Committee

Roles and Responsibilities

- Recruitment of new Board Members.
  - Qualification and experience relevant to firm’s needs.
- Establish succession plans for Management and the Board.
- Manage the evaluation process of Management and Board.
- US: Develop governance standards of the firm.

Potential areas of concerns

- The extent to which Board Members sit on multiple boards and their attendance record (‘busy boards’).
- The extent to which senior executives sit on each other’s boards (‘interlocked boards’).
- Is the Board really overseeing Management (‘captured board’)

Compensation Committee

Roles and Responsibilities

- Ensure that the incentives provided to Management (i.e. compensation and other rewards) are structured and calibrated in a way to enhance the firm profitability and value.
- Ensure that remuneration packages offered to Management are commensurate with responsibilities & firm performance.
- Develop performance goals for Management and monitor actual performance relative to targets.
- Establish mechanisms to recover incentive awards if earned by Management through fraud.
- Oversee compensation of nonexecutive employees.
- Hire consultants as needed.

Audit Committee

Roles and Responsibilities

- Ensure that financial information reported to Shareholders is complete, accurate, reliable, relevant, and timely.
- Ensure financial statements are prepared according to the relevant accounting standards and that the regulatory disclosure requirements are complied with.
- **Select and supervise the independent external auditors**, and ensure the external audit is conducted in accordance with the relevant audit standards.
- **Monitor the internal control processes**.
- **Oversee the performance of the internal audit function**.
- Oversee compliance, ethics and whistleblower hotlines.

Internal Control

- Any organization requires 'internal controls' in place to insure that its resources are utilized toward its goals in an efficient manner (rather than lost, misappropriated or squandered).

Transaction level: mechanisms to ensure proper transactions

- E.g. goods provided to a client are invoiced and payment obtained while goods or services received trigger a supplier invoice which is verified before being paid.

Organizational level: to ensure proper reporting and compliance

- E.g. all activities of the firm are properly and timely reported in its financial statements.

The controls are often built-in the approved procedures of the firm (budget, segregation of duties, accounting, etc.)

- See https://en.wikipedia.org/wiki/Internal_control

Example of internal control: Authorities

	M&A	Budget	CAPEX	Expenditures	Cash
Shareholders	Mergers Absorptions	-	-	-	-
Board	Acquisitions Disposals	Yes	20+	50+	100+
CEO + CFO	-	-	20	50	-
CEO + XYZ	-	-	10	25	-
CEO	-	-	5	10	-
CFO	-	-	2	5	100
XYZ	-	-	2	5	-
. . .	-	-	-	Per rank	Treasurer

(in millions of dollars)

Internal control : Authorities

Mechanism is ‘designed’

- M&A and budget: in the statutes of the company
- Transactions limits: decided by the Board of Directors

Mechanism is implemented

- All transactions need to be properly documented + authorized per authorities (i.e. a signature on paper or electronic)
- To avoid unduly delaying transactions, an officer can delegate his/her authority to a direct subordinate for a short time

Compliance with mechanism is verified periodically

- By the internal audit function and by external auditors
- Degree of compliance is reported to the Board of Directors and Shareholders along with the ‘quality of internal controls’.

Internal Audit

The internal audit function nowadays typically reports directly to the Audit Committee of the Board of Directors.

- It is staffed according to the size of the firm and an annual audit plan is usually approved by the Board of Directors
- Sometimes mandated by regulations (e.g. banks)
- Monitors the quality/comprehensiveness of internal control
- Verifies that internal control mechanisms are complied with
- Assess quality of risk management and corporate governance
- Occasionally discovers fraud through its audits
- Submits reports + recommendations to the Audit Committee
- Follow-up corrective action by management
- See https://en.wikipedia.org/wiki/Internal_audit

Dual-class Shares

- Equal economic interest in the firm (e.g. same dividends), but unequal voting rights (e.g. Google, Facebook, Bombardier).

Advantages (for the owners of multiple-vote shares)

- Can raise capital while minimizing loss of control;
- Facilitate intergenerational control from founder to heirs;
- Facilitate compliance with Canadian ownership requirements.

Disadvantages (for the owners of single-vote or no-vote shares)

- Controlling shareholders can extract private benefits and excessive compensation (another layer of agency problems).

Coattail provision (required in Canada since 1987)

- Single-vote or no-vote shares can be converted into full-voting shares in the event a takeover offer for the firm is received.