CORPORATE EXTERNAL AND

RELEVANT TO ACCA QUALIFICATION PAPER P1

CORPORATE GOVERNANCE IS A PROCESS AND A SYSTEM – AND AS WITH ANY SYSTEM, IT HAS MANY PARTS. THE PAPER P1 *STUDY GUIDE* RECOGNISES THIS IN TWO PARTS (A1G AND A1H) AND THE PAPER P1 EXAM COULD ASK ABOUT ANY OF THESE.

Corporate governance is a process and a system – and as with any system, it has many parts. The Paper P1 *Study Guide* recognises this in two parts (A1g and A1h) and the Paper P1 exam could ask about any of these. While each one has a role, they are not all a part of a company's internal structure. Both internal and external actors can have a role in governance. *Study Guide* section A1g is concerned with internal actors; section A1h is more concerned with external actors.

INTERNAL ACTORS (AND EMPLOYEE REPRESENTATIVES)

Directors

The most prominent group of actors in corporate governance are the company's directors. They can be either executive or non-executive directors (NEDs); the numbers and split of executives to NEDs will partly depend upon the regulatory regime of the country. It is generally the case that investors and regulators prefer there to be more NEDs, as their independent scrutiny of the company, its controls and strategies, provide a more robust governance structure. In a unitary board structure, all directors share legal responsibility for company activities and all are accountable to the shareholders. In most countries, all directors are subject to retirement by rotation, where they either step down or offer themselves for re-election (by the shareholders) for another term in office.

Directors are collectively responsible for the company's performance, controls, compliance and behaviour. This means that the board of directors must discuss and agree strategies to maximise the long-term returns to the company's shareholders. They must also comply fully with relevant regulatory requirements that will include legal, accounting and governance frameworks.

Company secretary

In most countries, the appointment of a company secretary is a compulsory condition of company registration. This is because the company secretary has important responsibilities in compliance, including the responsibility for the timely filing of accounts and other legal compliance issues. In addition to this responsibility for compliance with relevant laws and regulatory frameworks, the company secretary often advises directors of their regulatory and legal responsibilities and duties. His or her primary loyalty is always to the company. This means that in any conflict with another member of the company (such as a director), the company secretary must always take the side most likely to benefit the company (rather than any single director).

Technical knowledge is therefore an important part of this role. Because of this, many countries' company law mandates that for a public company, the postholder must be a member of one of a list of professional accountancy or company secretary professional bodies (which includes ACCA). The major roles include:

- maintaining the statutory registers (such as the share register)
- ensuring the timely and accurate filing of audited accounts and other documents to statutory authorities (eg government companies' agencies and tax authorities)
- providing members (eg shareholders) and directors with notice of relevant meetings
- organising resolutions for and minutes from major company meetings (like the AGM); keeping records from these and other meetings.

Studying Paper P1?
Performance Objectives 1, 2 and 3 are linked

GOVERNANCE: INTERNAL ACTORS

Sub-board management

Sometimes referred to (ambiguously) as 'middle' management, managers below board level are a crucial part of the governance system. It is the employees, led by sub-board management, that implement strategies, meet compliance targets and collect the information and data on which board-level decisions are made.

The effectiveness of sub-board management as part of a governance system is partly based on the extent to which organisational activities are controlled and coordinated. Value-adding synergies arise when specialists work to achieve organisational objectives in their own departments and are coordinated by an effective board of senior managers and directors. There is ample scope for 'strategic drift', especially in large organisations, when this vital control and coordination is ineffective.

Employee representatives (trade unions)

The most common way of providing employee representation (to the board) is through a trade union. Trade unions represent employees in a workplace; membership is voluntary and the influence of the union is usually proportional to the percentage of the workplace that are members.

Although often assumed to be in an adversarial relationship with management, trade unions can play a very helpful role in corporate governance. The adversarial assumption is probably unhelpful in many situations, as union members often share the same objectives for the organisation, and share professional and ethical values with management in carrying out the organisational strategy.

In terms of governance, trade unions are able to 'deliver' the compliance of a workforce. If a strategy needs a high level of commitment, a union can help to unite the workforce behind the strategy and ensure everybody is committed to it. This can also mean that management and workforce are seen as united by external stakeholders; this can make the achievement of strategies more likely. By collective bargaining over pay and conditions, agreement usually signifies that the workforce 'buys in' to the agreed strategy or activity.

A trade union can be a key actor in the checks and balances of power within a corporate governance structure. Where management abuses occur, it is often the trade union that provides the first and most effective reaction against it; this can often work to the advantage of shareholders, especially when the abuse has the ability to affect productivity. Unions are often good at highlighting management abuses such as fraud, waste, incompetence and greed, all of which are unhelpful traits in board members.

Linked to the above, trade unions help to maintain and control one of the most valuable assets in an organisation, the employees. Where a helpful and mutually constructive relationship is cultivated between union and employer, then an optimally efficient industrial relations climate exists, thus reinforcing the productivity of human resources in the organisation. In defending members' interests and negotiating terms and conditions, the union helps to ensure that the workforce is content and able to work with maximum efficiency and effectiveness.

THE MOST PROMINENT GROUP OF ACTORS IN CORPORATE GOVERNANCE ARE THE COMPANY'S DIRECTORS. THEY CAN BE EITHER EXECUTIVE OR NON-EXECUTIVE DIRECTORS.

EXTERNAL ACTORS

Shareholders

Shareholders and other investors (eg fixed-return bond-holders) are usually considered the most important external actors in corporate governance. In the agency relationship that exists between shareholders and directors, the shareholders are the principals. They have the right to expect agents (directors) to act in their best economic interests and to observe a fiduciary duty towards them.

Shareholders incur agency costs in monitoring the activities and actions of agents (directors). These are the costs of monitoring and checking on directors' behaviour. Examples of agency costs are attending relevant meetings (AGMs and EGMs), studying company results and analysts' reports, and making direct contact with companies through investor relations departments. When a shareholder holds shares in many companies, the total agency costs can be prohibitive; shareholders therefore encourage directors' rewards packages to be aligned with their own interests so that they feel less need to continually monitor directors' activities.

The Paper P1 *Study Guide* considers two types of shareholder: small investors and institutional investors. Small investors are individuals who hold shares in unit trusts, funds and individual companies. They typically buy, hold or sell small volumes and tend to have fewer sources of information on companies than institutional investors. They also often have narrower and less robust portfolios, which can mean that agency costs are higher, as the individuals themselves study the companies they have invested in for signs of changes in strategy, governance or performance.

Institutional investors are by far the biggest investors in companies, and they dominate the share volumes on most of the world's stock exchanges. Pension funds, insurance companies, unit trust companies and similar financial institutions hold large numbers of shares in individual funds with each fund being managed by a fund manager. Individuals, either directly or through investment products (such as pensions or endowments) buy into investment funds that are then managed, by selectively buying, holding or selling shares and other investments. When the fund grows or reduces in value, the member gains or loses value as a result. Fund managers do have some influence over the companies that they hold shares in, with greater influence obviously being associated with higher proportionate holdings. Fund managers need to be aware of the performance and governance of many companies in their funds, so agency costs can be very large indeed. To reduce these, they make use of information from several sources on the companies and also seek to have directors' benefit packages aligned with their own interests as much as possible.

Stock exchanges

Shares are bought and sold through stock exchanges. Each of the main international stock exchanges keeps an index of the value of shares on that exchange; this is the most frequently quoted 'number', referring to the total value of the shares on that exchange. In London, for example, the FTSE All Share (Financial Times Stock Exchange) index is a measure of all of the shares listed in London. In New York, it is the Dow Jones index and in Hong Kong, it is the Hang Seng index.

The value of any share on a stock exchange is calculated continuously, based on the demand and supply of that share. Demand for shares is driven by the expected future returns on that share which, in turn, is driven by expected company performance. Information suggesting an increase in performance will tend to increase demand for a given share; anything suggesting a deterioration in performance will cause fewer shares to be demanded. The price of a share rises and falls with supply and demand until the equilibrium price is achieved (when the same number of shares is supplied and demanded). Any change in supply or demand will then move the equilibrium price (ie the share price on the stock exchange).

SHAREHOLDERS AND OTHER INVESTORS (EG FIXED-RETURN BOND-HOLDERS) ARE USUALLY CONSIDERED THE MOST IMPORTANT EXTERNAL ACTORS IN CORPORATE GOVERNANCE. THIS IS BECAUSE IT IS THEIR AGGREGATE INVESTMENT THAT IS THE EQUITY OF A COMPANY AND WHO, COLLECTIVELY, HAVE OWNERSHIP RIGHTS OVER THE COMPANY.

In addition to listing, pricing and transacting share buying and selling, stock exchanges can also have a role in the governance of the companies listed on the exchange. Listing rules are sometimes imposed on listed companies and in many cases, listing rules concern governance arrangements not covered elsewhere by company law. In the UK, for example, it is a stock exchange requirement that listed companies comply with the Combined Code on Corporate Governance: not a legal requirement but a stock exchange requirement. Other listing rules concern reporting behaviour. In a rules-based jurisdiction, the law underpins corporate governance and reduces the need for stock market listing rules.

Auditors

Most Paper P1 candidates will know about the role of auditors from studying Paper F8. The most obvious role of audit in corporate governance is to report to shareholders that, having audited the company's accounts, the accounts are accurate ('a true and fair view' is the term used in some countries). Audit is also a legal requirement in compliance with company law as a condition of company registration and the granting of limited liability.

In addition to a normal audit, however, auditors perform a vital service to shareholders in highlighting issues in the governance and reporting of the company. A qualified audit report, while being a serious matter for a company, is also an important signal to markets about the company. Some auditors also offer additional services to clients and these sometimes include social and environmental advice and audit.

Regulators and governments

In addition to company law and listing rules, some companies and industrial sectors are subject to further external control by government-appointed regulators or by governments themselves. This usually applies to companies or sectors involved in areas considered strategically or politically important by governments; these include the control of monopolies or the supply of utilities (such as water or energy). In some countries, this also applies to military equipment and medical supplies. When this is the case, regulation typically applies to pricing and supply contracts.

In some countries, many large companies are owned, directly or indirectly, wholly or partially, by the host government. Nationalised companies are part of the economic fabric of many developing countries but tend to feature less prominently in more developed countries. It is generally believed that the profit motive, created by the agency relationship in a conventional shareholder–director arrangement, creates and stimulates greater economic efficiency than in nationalised companies.

Governments control corporate governance through the imposition of legislation and the enforcement (through a judiciary) of common and statute laws. Although governments usually have a range of political and social objectives in mind when controlling business, they also rely heavily on tax revenues levied on company profits and, where relevant, sales and other transaction taxes. One reason for the deregulation of much economic activity is the need to increase tax revenues and create employment by gaining the economic efficiencies offered by competition and executive reward packages that are aligned to added shareholder value.

GOVERNMENTS CONTROL CORPORATE GOVERNANCE THROUGH THE IMPOSITION OF LEGISLATION AND THE ENFORCEMENT OF COMMON AND STATUTE LAWS. ALTHOUGH GOVERNMENTS USUALLY HAVE A RANGE OF POLITICAL AND SOCIAL OBJECTIVES IN MIND WHEN CONTROLLING BUSINESS, THEY RELY ON PROFIT, SALE, AND TRANSACTION TAXES.

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