ESSENTIALS
of Corporate Governance

Sanjay Anand

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To my wife

Contents

Foreword

In 1886, a case was heard before the courts that forever changed the landscape of America. The ruling of *Santa Clara v. Southern Pacific Railroad* had the effect of creating a new being: the corporate entity. Although technically fictional and laden with legal jargon, the corporate being thus created has become so powerful that it is now ruling our everyday life.

I question whether, in creating a new entity to engage in societal activities and transactions, these decision makers considered sociological and psychological questions and weighed carefully their all-pervasive ramifications. Did they envision how this "being" would interact with the political and sociological forces of the twenty-first century? Did they consider, like a parent of a young child would, whether the new being would play fair and grow to become a responsible member of the community?

These are no longer fanciful questions. The morphing of knowledge society has changed the business environment as could never be imagined before. Business no longer is regarded as just an economic entity. It now has a ubiquitous role in society. Indeed it is an engine of socioeconomic transformation. Economic growth cannot be sustained without embracing the vast multitudes living in abject poverty and addressing the alarming depletion of our natural environment. With a fifth of the global population below the poverty line and global warming becoming a reality, issues like poverty alleviation and climate change have become the biggest business challenges of our time.

Corporate governance, which had been regarded as essentially an issue of statutory compliance with company law and listing requirements, has now become an instrument that governs the transparency, accountability, integrity, equity, and social responsibility in the decision-making process of the business.

Harsh sentences being meted out to Jeffrey Skillings, Bernie Ebbers, John Rigas, and Timothy Rigas are reminders that public expectations of the conduct of business have risen sharply. Nor are boards expected to be compliant simply through "box ticking." They have to be competitive and responsible. Corporate social responsibility and the triple-bottom-line approach have become today's mantras for business success.

The World Council for Corporate Governance was founded on the core belief of shared prosperity that goes beyond shareholder issues. It was the first one to start the process of engagement with stakeholders as a key to business success. It believes that the real value in a business is created by its customers, employees, suppliers, and the cooperation of civil society. Companies cannot make profit if customers won't buy their products. Linking business goal with larger societal purpose therefore helps align the human resource commitment and provides a significant competitive differentiator.

The World Council has been running various programs to help companies become competitive and improve the professional skills of the boards. Its star program is a five-day Masterclass for Directors. I have had the good fortune of knowing Sanjay as a meritorious participant of one of our Masterclasses when they began. I was deeply impressed by his insight on the issue of corporate governance. Since then I have shared many an international platform where both of us have been slated as keynotes. I am glad he has found time to author such a profound book, which is coming out at a time when the boards face the greatest threats and challenges of our times. I have no doubt that it will benefit readers from all walks of business life and provide a direction for sustainable business success.

Madhav Mehra
President
World Council for Corporate Governance

Preface

Corporations play a valuable role in our communities and in nations around the world. Good Corporate Governance is a union between the financial and personal success of a corporation. Strong profits and good business practices: These two concepts are integrally related, not disconnected from each other.

I could speak for hours about what good Corporate Governance is, and in truth, I often do speak for hours on the subject. Yet to define good Corporate Governance in just one sentence—the words elude me.

Since entering the world of business, I have watched good Corporate Governance develop into a dynamic and broadly encompassing concept. And I pride myself on the idea that I have made my own contribution to this evolution as well.

Good Corporate Governance is the idea of how best to run a corporate entity. It includes the management styles, the accounting principles, the model of ethical behavior, the openness of communication and, of course, the goings-on of the boardroom. Yet there is so much more held within this seemingly simple phrase—an energy of quality business ideals and doing a job to the best of our abilities—that no words can encompass.

While, I do not have just one sentence with which to describe good Corporate Governance. I have thousands of sentences at my disposal to help convey this business concept that is at the zenith of quality corporate life today.

Through my work with the Sarbanes-Oxley Institute, I have traveled all over the world assisting companies and professionals not only in complying with the Sarbanes-Oxley Act, but also in developing sustainable practices of good Corporate Governance.

What I have found eternally fascinating is the variety of policies and practices that are applied in different regions to achieve the same goal. This should tell us something: that good Corporate Governance is not a set of criteria but rather a process and an ideal. It is something that every corporation, in every market, can achieve.

This idea—that good Corporate Governance is a universal ideal—was my motivation in writing this book. And for that reason, I have striven to create a text that will be accessible and relevant to all levels, from corporate executives to private citizens, in nations around the world.

I can scan through my memory and play back the events in the good Corporate Governance timeline. From triumphs to scandals, the road has been exciting and eventful. We have come a long way toward stronger business practices, and I look forward to participating in the changes that are yet to come.

I hope this book empowers you to participate as well.

Learning Guide

Here is a summary of each chapter within this book. I have provided this to give you, the reader, some insight not only into what the chapters hold, but also why I chose these particular topics and what their specific relevance is.

I have designed this book to be a resource and reference guide, one that readers can return to time and again to answer their questions about Corporate Governance. The needs and interests of each individual will be different, and these summaries are meant to help you plan your own unique path through the information.

Readers will also find, within the appendixes, several resources that will keep good Corporate Governance concepts at their fingertips. One of my favorite items in this book is the glossary. More than a standard glossary, it provides a quick guide through the terms used most commonly in discussions of Corporate Governance and the world of business.

Chapter 1, Corporations. Before we can understand what Corporate Governance is, we must first understand the concept of the corporation. Chapter 1 provides insight into corporations in terms of their structure and function. This chapter also offers a brief overview of the ongoing debate regarding where a corporation's allegiances lie, and whether corporations are responsible solely to the shareholders or whether they have social responsibilities as well. This is the question at the heart of Corporate Governance because it speaks to the motivations of corporations and their boards in establishing Corporate Governance practices. By first examining why Corporate Governance is important, we will be in a better position to understand its implementation.

Chapter 2, History. Part of understanding where we are in terms of corporate regulation and behavior is understanding where we have been. Chapter 2 provides a brief outline of the history of U.S. corporate structure to arm you with the information you need as we move forward. One striking feature of this history is the noticeable tug-of-war between the government and the corporation. As we move through the decades, we can see a pendulum-like swing between freedom and regulation. In terms of a global perspective, it is important to realize that the U.S. model for corporations is only one of many. Each corporate structure has developed from the framework of the country in which it is situated. Economic pressures, social perceptions, and political events are all instrumental in creating each country's corporate model.

Chapter 3, Shareholders. As the legal owners of the corporation, shareholders have a vested interest in the company's financial performance. After all, it is their investment that will suffer if the corporation is not run in a profitable manner. Shareholders are in an interesting position in terms of Corporate Governance, and much discussion centers on how to best protect them from fraudulent behavior on behalf of the board of directors. Although this is certainly important, it is not the only consideration that Corporate Governance has regarding share owners. Shareholders own the company but are largely removed from the corporation's activities, which are left to the elected board of directors. In a legal sense, shareholders are neither financially responsible nor criminally responsible for the corporation's actions; however, Corporate Governance would see it otherwise. This chapter discusses shareholders, their role in the corporate structure, and their important involvement in Corporate Governance.

Chapter 4, Board of Directors. As the shareholders' representatives within the corporation, the board of directors functions as liaison between the interests of the shareholder and that of the executive. In Chapter 4 we discuss not only the structure of the board, but also how variations on that structure impact its ability to function effectively. The board of directors has many jobs, one of the most important of which is to monitor the executive. As the ones who appoint and evaluate the executive, the board of directors has a significant impact on the direction of the corporation and its ensuing success or failure.

The board also has a strong role to play in terms of Corporate Governance. Within their subcommittees, directors establish, monitor, and evaluate policies regarding financial reporting, remuneration, ethics, and member nomination. These responsibilities, and others of their kind, make the direction of the board of directors vital to a company's Corporate Governance efforts.

Chapter 5, CEO and Chairperson. Next to the board, a corporation's chief executive officer (CEO) is its most influential member. In fact, in some instances the CEO has even more power and authority than the board, but this stems from ineffective directors and a poorly established company hierarchy. In Chapter 5 we discuss the role of the CEO as well as some of the significant areas where problems arise—in particular, compensation and succession. Both how much a CEO makes and the process by which a CEO leaves the company and is replaced are complicated issues that every corporation struggles with.

There is a fine balance between the CEO who stays too long and the ones who leave too fast; the CEO whose resignation is voluntary and the one whose dismissal is demanded; and, of course, between overcompensating a CEO at the expense of the board and compensating sufficiently to draw viable talent. These issues are explored in this chapter to provide a background as we move forward to the core issues of Corporate Governance.

Chapter 6, Good Corporate Governance: An Introduction. Searching for the words to define Corporate Governance is a difficult task. This chapter seeks to elucidate this complex topic in order to make it clear that while Corporate Governance may have one definition today, it is an ever growing and evolving topic.

Instead of focusing on Corporate Governance as a phrase with a concrete definition, it is much more effective to think of it as a state of mind, a concept that is fluid and adaptable to the changing face of commerce.

Of course, this does not mean that there are no clear principles of Corporate Governance. It does mean, however, that as interested members of the business world, we have to be prepared to change our own impressions of the concept and adapt as it grows.

Chapter 7, Signs of Trouble. When a corporation falls to ruin, either by negligence or corruption, it is rarely the result of one isolated, short-term event. Instead, these situations arise as the consequence of months, or more often years, of neglect and ineffective governance on the part of the board of directors. In Chapter 7 we discuss several indicative events that point toward problems with the board of directors and its governance strategies. Although lengthy, this list is certainly not exhaustive. For as many boards and corporations that are in existence, there are as many opportunities for failed governance.

Reading this chapter will provide the bedrock for understanding why good Corporate Governance is important and the circumstances in which reforms are required.

Chapter 8, Changes Made through Corporate Governance. When a corporation elects to evaluate its Corporate Governance policies in an effort to improve itself, it is making a strong move forward. It is important to remember, however, that statistically speaking, good Corporate Governance does not necessarily correlate to high financial success for the company. Certainly there are instances in which companies are deemed highly successful in terms of their bottom line but have dismal records of Corporate Governance. Similarly, other companies are the shining examples of Corporate Governance but cannot manage to keep their heads above the financial waters. Although this fact may seem counterintuitive, it is not. Corporate Governance is only one of many components of a successful corporation. While good Corporate Governance will certainly not harm a company, it is not enough to create success. It is instead more useful to think of Corporate Governance as a means of facilitating prosperity rather than creating it.

Of course, companies that do not exhibit efforts toward improving their Corporate Governance, although they may be successful for a time, are at greater risk of falling to scandal, corruption, or negligence. In Chapter 8 we discuss the changes made through Corporate Governance that improve a corporation's ability to function effectively, thereby facilitating success.

Chapter 9, Regulations and Strategies for Corporate Governance. After garnering all of the necessary background information about corporations and their structure, it is time to delve into the issue at hand: Corporate Governance. Chapter 9 (as well as Chapter 10 for an international perspective) explains the principles of Corporate Governance, including the ways in which these principles impact all relevant parties. As the concept of Corporate Governance has grown in importance and spread in awareness, several leading sets of guidelines have been created.

Ideally, Corporate Governance will spread to create universal coherence in corporate practices. This does not mean that we expect every country, economy, or business to be run the same, but rather that each will adhere to a set of best principles and adapt them to their unique circumstances, thereby facilitating success while protecting rights.

The regulations discussed in Chapters 9 and 10 seek to guide countries and corporations in establishing their own good Corporate Governance policies. Throughout these guidelines, similar themes of integrity, accountability, stakeholder protection, and strong board independence can be seen.

Understanding these guidelines and the way that each one fits in creating a ubiquitous culture of good Corporate Governance is an important step in recognizing the importance of best practices and their implementation in individual corporations.

Chapter 10, International Corporate Governance. We begin our discussion of international Corporate Governance with an overview of its importance and the key concepts involved. As the global marketplace expands, it is becoming increasingly rare for companies and corporations to operate solely within the confines of one nation.

What is more common is for there to exist international partnerships, international subsidiaries, and foreign outsourcers. Further growing in popularity is the establishment of truly international corporations, whose existence is based between the borders of two or more countries.

When we speak of Corporate Governance, we are speaking of the corporation's efforts as a whole, not simply those efforts that are applied