FinQuiz CFA PROGRAM EXAM PREP

1. INTRODUCTION

Weak corporate governance in the form of lack of proper oversight by the board of directors, inadequate protection for minority shareholders, and incentives at companies that promote excessive risk taking can be a source of company failures. This is why, the assessment of a company's corporate governance system has increasingly become an essential factor in the investment decision making process.

2. CORPORATE GOVERNANCE OVERVIEW

Corporate governance is defined in various ways. No single definition of corporate governance is widely accepted in practice. Corporate governance can be defined as the system of internal controls (i.e. check and balances) and procedures by which individual companies are managed in an attempt to minimize and manage the conflicting interests between insiders and external shareowners.

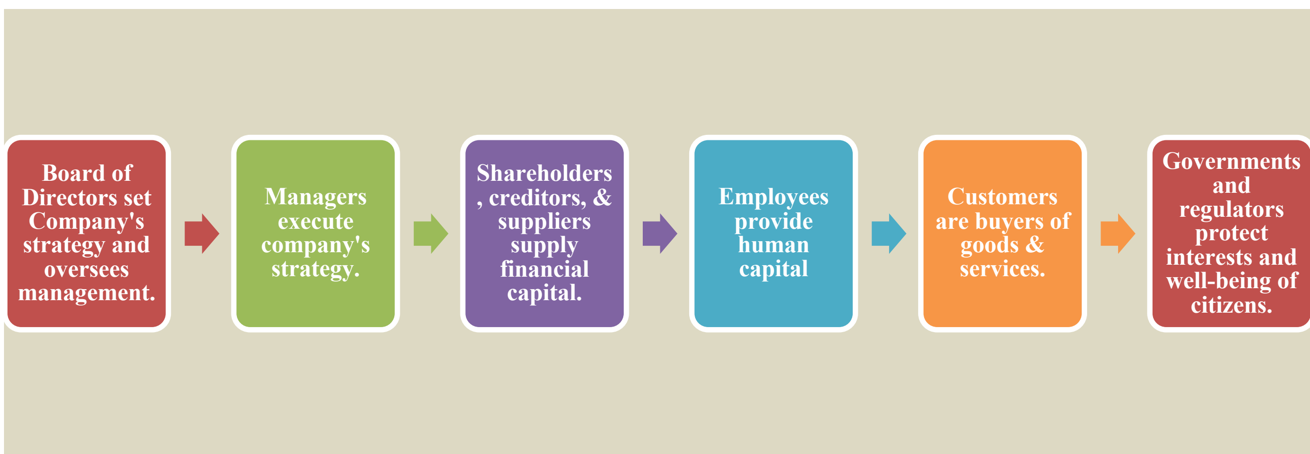
Cadbury Report defined corporate governance simply as "the system by which companies are directed and controlled." The report focused on the responsibilities of a company's board of directors, shareholders, and auditors, with shareholders implicitly identified as the primary stakeholder.

The Organization for Economic Co-operation and Development (OECD) produced the **Principles of Corporate Governance**. According to the OECD, "Corporate governance includes a set of relationships between a company's management, its board, its shareholders, and other stakeholders (notably employees, creditors, and suppliers)."

Corporate governance practices differ among countries and jurisdictions. The corporate governance systems also depend on influence of shareholder theory or stakeholder, as well as historical, cultural, legal, political, and other influences specific to a region.

Shareholder theory: According to Shareholder theory, the most important responsibility of a company's managers is to ***maximize shareholder returns***.

Stakeholder theory: The Stakeholder theory takes into consideration the interests of all stakeholders, including customers, suppliers, employees, and others who have an interest in the company.



The way a company operates is also affected by external forces, such as the legal environment and competition.

Practice: Example 1 Curriculum, Reading 31.

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3. COMPANY STAKEHOLDERS

3.1 Stakeholder Groups

The primary stakeholder groups of a corporation consist of shareholders, creditors, managers (or executives), other employees, board of directors, customers, suppliers, and governments/regulators.

3.1.1.) Shareholders

Shareholders are the owners of a company and the providers of equity financing.

- Shareholders are entitled to a company's net value (i.e. residual value after subtracting all the company's liabilities from its assets).
- In terms of capital structure, shareholders are the most junior class of capital providers as they receive proceeds only after all creditors' claims are paid in case of a company bankruptcy.
- Shareholders are mainly interested in corporate profitability and maximization of the value of a company's equity as their wealth is directly related to the value of the company.
- The shareholders maintain control over the company through their power to elect the board of directors and vote for specified resolutions.

Shareholders that hold larger proportion of company's outstanding shares and thus have sufficient voting power to control the election of the board of directors and to influence the approval or blockage of a company resolution are known as **Controlling shareholders**.

Non-controlling shareholders are the one who hold a much smaller proportion of a company's outstanding shares and thus have limited ability to exercise control in voting activities. They are also known as minority shareholders.

3.1.2.) Creditors

Creditors (including bondholders and banks) are a company's lenders and the providers of debt financing.

- Creditors do not hold voting power and typically have limited influence over a company's operations.
- Creditors are mainly concerned with a company's ability to generate sufficient cash flows to meet its financial (i.e. interest and principal payments) and are not very concerned with company's superior performance.
- Unlike shareholders, they prefer stability in company operations and performance and prefer low risk.
- Creditors usually protect themselves by using covenants, which restrict activities of the borrower.

3.1.3.) Managers and Employees

Like shareholders and creditors, managers and employees are interested in company's viability and better performance. However, sometime the interests of managers and employees and other stakeholders can conflict, e.g. a takeover offer which might be attractive to shareholders but not to managers due to risk of being fired.

3.1.4.) Board of Directors

Directors (both internal and external) are mainly interested in protecting interest of shareholders and the company while maintaining a good reputation in the business community. Directors are also typically concerned with their exposure to liability for breach of duty. This risk can be mitigated by exercising appropriate levels of control over the company's operations and its management.

Role of Board of directors:
- To protect interests of shareholders;
- To appoint senior management;
- To provide strategic direction to the company;
- To monitor company and management performance.

3.1.5.) Customers

Customers are mainly interested in getting good product and services at reasonable price. Customers may also want ongoing support, product guarantees, and after-sale service. Compared with other stakeholder groups, customers are not very concerned with company's financial performance.

3.1.6.) Suppliers

Suppliers, like creditors, are concerned with a company's ability to generate sufficient cash flows to meet its financial obligations.

3.1.7.) Governments/Regulators

Governments and regulators mainly focus on protecting the interests and well-being of the general public. As the collector of tax revenues, a government can also be considered one of the company's major stakeholders.

Stakeholders in Non-profit Organizations

Non-profit organizations do not have shareholders. Their stakeholders most commonly include board directors or trustees, employees, regulators, society, patrons of the organization, donors, and volunteers. The main interest of stakeholders of non-profit organizations is ensuring that the organization is serving the intended cause and that the donated funds are used as promised.

Practice: Example 2 Curriculum, Reading 31.

3.2 Principal–Agent and Other Relationships in Corporate Governance

A ***principal–agent relationship*** (also known as an ***agency relationship***) is created when a principal hires an agent to perform a particular task or service. The agent is expected to act in the best interests of the principal. When agents (say managers) do not act in the best interests of shareholders (principals), it creates conflict of interest.

3.2.1.) Shareholder and Manager/Director Relationships

In shareholder-owned companies, both directors and managers are agents of shareholders and they are expected to serve in the best interests of the principals (i.e., shareholders).According to traditional shareholder theory, the primary duty of managers is to act in the best interests of shareholders by maximizing equity value. Conflict of interest arises when managers seek to maximize their personal benefits (e.g., remuneration and perquisites) to the detriment of shareholders' interests.

Shareholder and manager (or shareholder and director) interests may differ with respect to risk tolerance which may impact company's long term value. E.g. in some cases, shareholders with diversified investment portfolios may have a relatively high risk tolerance whereas managers and directors have less risk tolerance as they avoid taking risky corporate decision to protect their employment status. Another conflict of interest arises due to "information asymmetry" (unequal access to information) as managers typically have greater access to information about the business and are more knowledgeable about its operations compared with shareholders. Due to this, managers may make strategic decisions that are not necessarily in the best interest of shareholders. Conflict of interest might arise between shareholders and directors when the board is influenced by insiders and thus, they may not properly monitor and control management.

3.2.2.) Controlling and Minority Shareholder Relationships

A conflict between shareholders and directors may occur if directors favor certain influential shareholders (i.e. controlling shareholders) over other shareholders. In such cases, the opinions of minority shareholders are often ignored or given less weight. Controlling shareholders have most influence on electing board if the company has ***straight voting*** (i.e., one vote for each share owned).

The decisions made by controlling shareholders, or their board representatives, may adversely impact company's performance and, consequently, wealth of minority shareholders. Best examples of this conflict of interest would be "Takeover transactions" and "Related Party transactions" where controlling shareholders typically have greater influence than do minority shareholders.

Multiple-class structure: Under a multiple-class structure (typically known as a ***dual-class structure***) there are two share classes. The company's founders, executives, and other key insiders hold share class with superior voting powers which enables the controlling shareholders to mitigate dilution of their voting power when new shares are issued.

3.2.3.) Manager and Board Relationships

Due to problem of "information asymmetry", the board's monitoring role can be compromised as it has to rely on information provided by the management. This conflict is particularly faced by nonexecutive directors who are typically not involved in the day-to-day operations of a company.

3.2.4.) Shareholder versus Creditor Interests

Shareholders typically prefer riskier projects with a strong likelihood of higher return on investment, whereas creditors would likely prefer stable performance and lower-risk activities. Hence, shareholders and creditors have different risk tolerance. Excessive borrowing by the company increases risk of default and thus conflicts with creditors' interest. Similarly, distribution of excessive dividends to shareholders might also conflict with creditors' interests if it impairs the company's ability to pay interest and principal.

3.2.5.) Other Stakeholder Conflicts

- **Conflict between customers and shareholders**: Conflict between customers and shareholders occur if a company charges high price for its products or reduces product safety features to reduce costs.
- **Conflict between customers and suppliers**: Conflict between customers and suppliers occur when due to lenient credit terms offered to its customers, its ability to repay suppliers on time may be negatively affected.
- **Conflict between shareholders and governments or regulators**: Examples of such conflicts may include use of such accounting and reporting practices that reduce its tax burden by showing less taxable income which ultimately reduces taxes receive by the governments or regulators.

Practice: Example 3 Curriculum, Reading 31.

4. STAKEHOLDER MANAGEMENT

Stakeholder management involves identifying, prioritizing, and understanding the interests of stakeholder groups so that a company can manage relationship with these groups in a better way.

4.1 Overview of Stakeholder Management

Companies should try to balance the interests of their various stakeholders so that the impact of conflicts can be reduced. These interests can be balanced by the help of legal, contractual, organizational, and governmental infrastructure that defines the rights, responsibilities, and powers of each group.

- The legal infrastructure defines rights established by law and provides a legal recourse for any violation of these rights. Since legal infrastructure is established by law, it is not under the control of company.
- The contractual infrastructure defines and secures the rights of company and its stakeholders in the form of contractual arrangements. Companies have control over these arrangements.
- The organizational infrastructure refers to internal systems, governance procedures, and practices adopted and controlled by the company in managing its stakeholder relationships.
- The governmental infrastructure refers to regulations imposed on companies.

Practice: Example 4 Curriculum, Reading 31.

4.2 Mechanisms of Stakeholder Management

Stakeholder management and governance practices involves managing the interests of all stakeholders by taking various measures as discussed below.

4.2.1.) General Meetings

General meetings (also known as general assemblies) enable shareholders to participate in discussions and to vote on major corporate matters and transactions that are not delegated to the board of directors. Annual general meeting (AGM) are usually held by the companies at the end of their fiscal year. General meetings and the underlying right to exercise vote are among the most widely used practices adopted by companies in mitigating agency problems and their associated risks.

Key objectives of AGM:

- To present shareholders with the annual audited financial statements of the company;
- To monitor and have an overview of company's performance and activities,
- To addresses shareholder questions.
- To exercise their voting rights on major corporate issues
- To elect the director, discharge directors of their duties, appoint external auditors, or vote on the remuneration of the board and/or top management. Approval of financial statements and the election of directors and auditors require only a simple majority votes. Material decisions require a supermajority vote, such as two-thirds or 75% of votes, to be passed. Such special resolutions may include amendments to bylaws, voting on a merger or takeover transaction, or waiving pre-emptive rights.

Depending on the ownership structure, supermajority requirements are beneficial for minority shareholders as it makes it harder for majority shareholders to influence corporate decisions at the expense of minority shareholders.

Extraordinary general meetings are held when significant resolutions requiring shareholder approval are proposed. These resolutions may include proposed material corporate changes, such as amendments to the company's bylaws or rights attached to a class of shares, mergers and acquisitions, or the sale of significant corporate assets or businesses.

Proxy voting is a process that enables shareholders to authorize another individual (for example, another shareholder or director) to vote on their behalf in their absence.

Cumulative voting (unlike straight voting) enables each shareholder to accumulate and vote all his shares for a single candidate in an election involving more than one director. Under this voting process, minority shareholders are usually represented by at least one director on the board. However, it is not compatible with ***majority voting standards*** for director elections in which the ownership of shares are widely dispersed.

In some countries, minority shareholders are granted rights to protect their interests in acquisitions. For example, "sell out" rights allow minority shareholders who have voted against a merger offer to force a bidder with more than 90% of the target's voting rights to buy their shares at a fair price upon the deal's approval.

Practice: Example 5 Curriculum, Reading 31.

4.2.2.) Board of Director Mechanisms

Board of directors are elected by shareholders to provide broad oversight of the company. The board is obligated to perform in best interest of shareholders and ensuring proper governance of the company. The board's performance is monitored by the shareholders through their voting rights and participation in general meetings. The board, in turn, appoints the top management of the company and oversees and monitors management's performance. The board also supervises the company's audit, control, compliance, and risk management functions.

4.2.3.) The Audit Function

The audit function refers to systems, controls, and policies/procedures in place to examine the company's operations and financial records. It is an integral component of any governance structure as it limits insiders' discretion with regard to the use of company resources and to its financial reporting and it mitigates incidents of fraud or misstatements of accounting and financial information.

- Internal audits are conducted by an independent internal audit function or department.
- External auditors are conducted by external auditor who conducts an annual audit of the company's financial records to provide reasonable and independent assurance of the accuracy of financial statements and their fair representation of the financial position of the company. External auditors are typically recommended by an audit committee or, in some jurisdictions, by the board.
- The financial statements and auditors' reports are reviewed and confirmed by the board and then presented to shareholders for approval at the AGM.

4.2.4.) Reporting and Transparency

There are various sources of financial and non-financial information (e.g. information about company's operations, its strategic direction or objectives, audited financial statements, governance structure, ownership structure, remuneration policies, related party transactions, and risk factors) available to shareholders. These sources include annual reports, proxy statements, disclosures on the company's website, the investor relations department, and other means of communication (e.g., social media). Such information facilitates shareholders to

- reduce the extent of information asymmetry between shareholders and managers;
- assess the performance of the company and of its directors and managers;
- make informed decisions in valuing the company and deciding to purchase, sell, or transfer shares; and
- vote on key corporate matters or changes.

4.2.5.) Policies on Related-Party Transactions

Typically, directors and managers are required to disclose any actual or potential, or direct or indirect, conflict of interest they have with the company, as well as any material interests in a transaction that may affect the company. Generally, such transactions or matters are voted on by the board (or shareholders) excluding the director (or shareholder) holding the interest.

4.2.6.) Remuneration Policies

Managers' incentive plans are typically variable in nature based on corporate or stock price performance e.g. profit sharing, stocks, or stock options. However, if managers can improve their personal gains at the expense of the company while limiting their exposure to

weak stock performance, then stock-based remuneration does not serve its purpose. Therefore, incentive plans that discourage either "short-termism" or excessive risk taking by managers are becoming more popular these days. Granting of shares, rather than options, to managers and restricting their vesting or sale for several years or until retirement may also be useful. In a long-term incentive plan, either the entire or partial payment of remuneration is delayed until company strategic objectives (typically performance targets) are met.

Regulators require companies to base remuneration on long-term performance measures and to include clawback provisions. Under these provisions, managers are required to pay back remuneration if certain events, such as financial restatements, misconduct, breach of the law, or risk management deficiencies, are observed.

4.2.7.) Say on Pay

Under "**say on pay** "shareholders can vote on executive remuneration matters. This allows shareholders to express their views on remuneration-related matters and helps in limiting the discretion of directors and managers in granting themselves excessive or inadequate remuneration. The scope and impact of *say on pay* varies across countries and companies. However, since shareholders often have limited involvement in a company's strategy and operations, board is considered to be better suited to determine remuneration matters.

4.2.8.) Contractual Agreements with Creditors

Bond or loan **indenture** is one of the provisions that protect creditors' interests and provide legal recourse to them. An indenture is a legal contract that describes the structure of a bond, the obligations of the issuer, and the rights of the bondholders. It also include **covenants** which are the terms and conditions of lending agreements, enabling creditors to specify the actions an issuer is obligated to perform or prohibited from performing. Companies are also typically required to provide periodic information (including financial statements) to ensure that covenants are not violated and there is no risk of default.

Another tool used by creditors to protect their interests is *Collaterals*, which represent assets or financial guarantees available to lenders in case issuer is unable to meet its obligations.

Companies often hire a financial institution to act as a ***trustee*** and monitor the issue on behalf of a class of bondholders. For unsecured bondholders, credit committees are also established once a company files for bankruptcy. Such committees are expected to represent bondholders throughout the bankruptcy proceedings and protect bondholder interests in any restructuring or liquidation.

4.2.9.) Employee Laws and Contracts

Employee rights are primarily secured through **labor laws**, which define the standards for employees' rights and responsibilities and cover such matters as labor hours, pension and retirement plans, hiring and firing, and vacation and leave. In most countries, employees have the right to create unions. Another tool to protect employees' right is **Employment contract**, which specifies an employee's various rights and responsibilities. Employment contracts typically do not cover every situation between employees and employers.

Company's relationship with employees can be managed by using **Human resources policies**. Effective human resources policies cover matters such as recruitment of high-quality employees while providing remuneration, training/development, and career growth to improve employee retention. Employee stock ownership plans (**ESOPs**) can also be used to help retain and motivate employees. As part of an ESOP, a company establishes a fund consisting of cash and/or company shares which are granted to employees after certain vesting periods.

Codes of ethics and business conduct also serve an important role in managing the relationship between employees and the company. Typically, a compliance or corporate governance officer (or a board committee) is hired by the company to implement these codes, receive violation reports, and resolve ethical matters.

By better managing its relationships with its employees, a company can mitigate legal or reputational risks, motivate its employees in fulfilling their responsibilities toward the company and to act in the company's best interests.

4.2.10.) Contractual Agreements with Customers and Suppliers

Contractual Agreements with Customers and Suppliers specify the products and services underlying the relationship, the prices or fees and the payment terms, the rights and responsibilities of each party, the after-sale relationship, and any guarantees. Contracts also specify actions to be taken and recourse available if either party breaches the terms of the contract.

4.2.11.) Laws and Regulations

Companies are required to follow and comply with all the laws and regulations developed by the governments

and regulatory authorities. Many regulatory authorities also obligate publicly traded companies to comply with the corporate governance codes. Publicly traded companies, in turn, are generally required to annually publish corporate governance reports describing their governance structure and explain any deviations from guiding principles. Companies normally seek to adopt internal governance and compliance procedures and adhere to the relevant financial reporting and transparency requirements imposed by regulators.

Practice: Example 6 Curriculum, Reading 31.

5. BOARD OF DIRECTORS AND COMMITTEES

5.1 Composition of the Board of Directors

The structure and composition of a board of directors vary by company and geography, company size, structure, and complexity of operations. The board must be comprised of a diverse mix of expertise, backgrounds, and competencies. In addition, diversity in age, gender, and race is also preferred.

A board is typically structured in following two ways.

1) **One-tier:** A one-tier structure consists of a single board of directors, composed of executive and non-executive directors. Executive (also called "internal") directors are employees, typically senior managers, of the company. Non-executive (also called "external") directors are not employees of the company. One-tier boards are common in United States, the United Kingdom, and India. They provide objective decision making, monitoring, and performance assessment. An independent director is a specific type of non-executive director that does not have a material relationship with the company with regard to employment, ownership, or remuneration.
2) **Two-tier**: A two-tier structure consists of two separate boards: (1) a supervisory board, which is primarily composed of non-executive directors, and (2) a management (also called executive) board, which is composed of executive directors. The supervisory board oversees the management board. Employee representatives are typically elected by the company's employees and could make up half of the supervisory board in large companies. The supervisory and management boards are independent from each other. Two-tier boards are common in Germany, the Netherlands, Finland, and China.

When CEO also serves as chairperson of the board, it is referred to as **CEO duality**. In order to avoid CEO duality problem, companies can appoint a lead independent director. The lead independent director generally has the authority to request and oversee meetings of all independent directors. Duality is not applicable in two-tier structures that prohibit the members of the management board from serving on the supervisory board. In these models, the chairperson of the supervisory board is typically external, and the CEO usually chairs the management board.

In **Staggered boards** directors are typically divided into ***three classes*** that are elected separately in consecutive years, that is, one class every year. Under this structure, shareholders need several years to replace a full board; hence, this election process limits their ability to effect a major change of control at the company.

5.2 Functions and Responsibilities of the Board

Two major responsibilities of directors include **duty of care** and the **duty of loyalty**. According to the OECD's Principles of Corporate Governance, **duty of care** "*requires board members to act on a fully informed basis, in good faith, with due diligence and care*." As per OECD, the **duty of loyalty** "*is the duty of the board member to act in the interest of the company and shareholders*". *The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders*."

Duties of Board of Directors: A board of directors does not typically engage in the company's day-to-day activities. Major duties of directors are as follows:

- They delegate the implementation of the company's strategy to senior management;
- They oversee the execution of the strategy;
- They establish milestones to monitor the progress in reaching the objectives.

- They review corporate performance and determine relevant courses of action accordingly.
- They select, appoint, and terminate the employment of senior managers (or the management board in case of a two-tier structure).
- They ensure leadership continuity though succession planning for the CEO and other key executives.
- They ensure the effectiveness of the company's audit and control systems.
- They ensure that the company adopts and implements proper corporate governance principles and complies with all applicable internal and external laws and regulations, including ethical standards.
- They ensure that the company has an appropriate enterprise risk management system in place, whereby risks are identified, mitigated, assessed, and managed appropriately.
- They review any proposals for corporate transactions or changes, i.e. major capital acquisitions, divestures, mergers, and acquisitions.

5.3 Board of Directors Committees

Board of Directors Committees are developed to delegate board responsibilities to committees. Despite the delegation of responsibilities, overall board remains ultimately responsible to shareholders and is not discharged of its liabilities to shareholders. The composition of a board committee varies depending on its scope of responsibilities.

Although board committees may vary by organization, some of the most common committees are discussed as follows.

5.3.1.) Audit Committee

Role of audit committee includes the following:

- Monitors the financial reporting process, including the application of accounting policies;
- Ensures the integrity of financial statements;
- Supervises the internal audit function and ensures its independence and competence;
- Presents an annual audit plan to the board and monitors its implementation by the internal audit function.
- Recommends the appointment of an independent external auditor and proposes the auditor's remuneration.

Both internal and external auditors report their findings to the audit committee, which in turn proposes remedial action for highlighted matters[1].

5.3.2.) Governance Committee

Governance committee is responsible for ensuring proper corporate governance is the company. The committee monitors the implementation of the governance policies and standards as well as the compliance with the applicable laws and regulations throughout the company. In case of flaws or breaches of laws/regulations, it also recommends remedial actions. In some companies, the governance committee is also responsible for overseeing an annual evaluation of the board to ensure alignment of board's structure and activities with the governance principles.

5.3.3.) Remuneration or Compensation Committee

The remuneration or compensation committee develops and proposes remuneration policies for the directors and key executives and presents them for approval by the board or by shareholders. The committee is also responsible for managing contracts of managers and directors as well as in setting performance criteria and evaluating the performance of managers. The remuneration committee also establishes human resources policies for the company, sets and oversees the implementation of employee benefit plans (including insurance, pension, severance benefits, and retirement plans).

5.3.4.) Nomination Committee

The nomination committee is responsible for establishing nomination procedures and policies, including the criteria for board directors, the search process, and the identification of qualified candidates for director positions. It is also responsible for evaluating independence of directors.

5.3.5.) Risk Committee

The risk committee oversees establishing enterprise risk management plans and monitors their implementation. It also supervises the risk management functions in the company, receives regular reports, and reports on its findings and recommendations to the board.

5.3.6.) Investment Committee

The investment committee of the board reviews material investment opportunities (e.g. large projects,

[1] Some regulators require audit and the compensation committees to be composed of independent directors only.

acquisitions, and expansion plans, as well as divestures or major asset disposals) proposed by management and considers their viability for the company. The committee critically evaluates management assumptions underlying investment prospects, monitors the performance of investments, and reports its findings to the board. The committee is also responsible for establishing and revising the investment strategy and policies of the company.

Other specialized committees include compliance committee, an ethics committee, a human resources committee, or a health/environmental/safety committee.

Practice: Example 7 Curriculum, Reading 31.

6. FACTORS AFFECTING STAKEHOLDER RELATIONSHIPS AND CORPORATE GOVERNANCE

Both market and non-market related factors can affect stakeholder relationships and corporate governance.

6.1 Market Factors

Market factors include those that relate to capital markets. These factors include shareholder engagement and shareholder activism.

6.1.1.) Shareholder Engagement

Shareholder engagement involves a company's interactions with its shareholders to discuss financial and strategic matters. Example includes annual shareholder meeting and analyst calls.

6.1.2.) Shareholder Activism

Shareholder activism refers to strategies used by shareholders to create a change within a corporation or modify a corporation's behavior. Besides social or political considerations, the primary motivation of activist shareholders is to increase shareholder value. Activist shareholders may use different tactics (i.e. proxy battles (fights), propose shareholder resolutions, raise public awareness on issues of contention, shareholder derivative lawsuits[2]etc) in an attempt to pressurize the management.

Hedge funds using shareholder activism as a method of investment have been a big talking point in the industry in recent years. Unlike regulated investment entities, hedge funds are loosely regulated (e.g. not subject to limitations on leverage or ownership of distressed or illiquid securities) and can thus pursue a greater range of activist opportunities.

6.1.3.) Competition and Takeovers

In Corporate Takeovers shareholders of a company can hire and fire management to achieve better resource utilization. Corporate takeovers can be pursued in several different ways as discussed below.

- **Proxy contest (or proxy fight).** In a proxy contest, shareholders are persuaded to vote for a group seeking a controlling position on a company's board of directors.
- **Tender offer**: Managerial teams can also be displaced through a tender offer, in which shareholders can sell their interests directly to the group seeking to gain control.

Board members and managers try to maximize shareholders' wealth in order to secure their employment status. However, the threat of loss of employment can have negative implications for a company's corporate governance practices if the company chooses to adopt anti-takeover measures, such as a staggered board or a shareholder rights plan (also known as a ***poison pill***) to reduce the likelihood of an unwanted takeover. Staggering director elections can dilute the value of shareholder voting rights by extending the term that each director serves and eliminating the ability of shareholders to replace the entire board at any given election. **Shareholder rights plans** enable shareholders to buy additional shares at a discount if another shareholder purchases a certain percentage of the company's shares. These plans are designed to increase the cost to any bidder seeking to take over a company.

Practice: Example 8 Curriculum, Reading 31.

[2]Shareholder derivative lawsuits are legal proceedings initiated by one or more shareholders against board directors, management, and/or controlling shareholders of the company.

6.2 Non-market Factors

Non-market factors include company's legal environment, the role of the media, and the corporate governance industry, that can have an impact on stakeholder relationships and corporate governance.

6.2.1.) Legal Environment

The legal environment in which a company operates can significantly influence the rights and remedies of stakeholders.

- In **civil law systems**, laws are created primarily through statutes and codes enacted by the legislature. The role of judges is generally limited to rigidly applying the statutes and codes to the specific case brought before the court.
- In **common law systems**, laws are created both from statutes enacted by the legislature and by judges through judicial opinions. In common law systems (unlike civil law), shareholders and creditors have the ability to appeal to a judge to rule against management actions and decisions that are not expressly forbidden by statute or code.

Shareholder disputes are usually more complex than disputes involving creditors, as the latter are straightforward and therefore are more easily determinable by a court.

6.2.2.) The Media

The media, through its ability to spread information quickly and shape public opinion, have significant influence on the company's corporate governance and stakeholder relationships. Social media can be used by the stakeholders to protect their interests or enhance their influence on corporate matters.

6.2.3.) The Corporate Governance Industry

Owing to increased importance and relevance of corporate governance among investors, the demand for external corporate governance services has grown considerably in recent years. The external corporate governance services are provided by corporate governance industry. Corporate governance industry is relatively concentrated and therefore they have considerable influence in corporate governance practices, and in turn, corporations are generally pressured to focus on ratings and recommendations produced by the corporate governance industry.

7. CORPORATE GOVERNANCE AND STAKEHOLDER MANAGEMENT RISKS AND BENEFITS

Depending on their nature and magnitude, unmanaged conflicts of interest and weak control over a company's operations may expose the company to various risks, such as legal, regulatory, reputational, or default risks. By effectively managing the interests of stakeholder groups and instituting adequate levels of control, corporate governance can assist the company in better managing its relationships, achieving superior levels of efficiency in operations, and improving financial performance.

7.1 Risks of Poor Governance and Stakeholder Management

A weak control environment can promote misconduct and hampers the company's ability to identify and manage risks. The negative implications of poor corporate governance affect all stakeholders, including company's shareholders, managers and employees and even society and the environment.

7.1.1.) Weak Control Systems

In a company with weak control systems or inefficient monitoring tools, such as poor audit procedures or insufficient scrutiny by the board, one stakeholder group may benefit at the expense of the company or other stakeholders. This could consequently have an adverse effect on the company's resources, performance, and value.

7.1.2.) Ineffective Decision Making

When the quality and quantity of information available to managers are superior to those available to the board or shareholders (i.e. information asymmetry) and company does not have sufficient monitoring tools, then management may make ineffective decisions that are detrimental to long-term value of the company (e.g. taking excessive risks or focusing on creating short-term performance or stock price increases).

Improper remuneration policies for management can also have adverse implications for the company, e.g. in the form of deterioration of shareholders' wealth, negatively impacting corporate performance, and affecting the interests of other stakeholders, such as employees, customers, or creditors.

7.1.3.) Legal, Regulatory, and Reputational Risks

Compliance weaknesses or lack of proper reporting practices may expose the company to legal, regulatory,

or reputational risks. These risks can have significant associated costs, particularly for publicly listed companies which are subject to scrutiny by investors, analysts, and other market participants.

7.1.4.) Default and Bankruptcy Risks

The company may be exposed to bankruptcy risk if poor corporate performance results in a debt default.

7.8 Benefits of Effective Governance and Stakeholder Management

A good governance structure increases company's operational efficiency, improves its control processes, financial performance, and helps in lowering levels of risk.

7.2.1.) Operational Efficiency

A balanced governance structure with adequate internal control mechanisms helps ensuring proper monitoring and control of corporate decisions and activities, which in turn helps in mitigating risk and improving the operational efficiency of the company.

7.2.2.) Improved Control

Good governance practices helps the company in exercising effective control at all corporate levels, from shareholders to the board of directors and management. These practices can help identify and manage risk at early stages. Moreover, companies can enhance controls by proper functioning of a company's audit committee and the effectiveness of its audit systems.

7.2.3.) Better Operating and Financial Performance

Good governance and stakeholder management can help a company in improving its operating performance and reduce the costs associated with weak control systems. Enhanced corporate governance could also allow the company to improve its decision-making process. By use of proper remuneration policies, companies can motivate managers to make decisions that help in creating corporate value.

7.2.4.) Lower Default Risk and Cost of Debt

Effective corporate governance structure can reduce investors' perceived credit risk of a corporation, thus potentially lowering the corporation's cost of debt. Business and investment risk can also be mitigated.

Practice: Example 9 Curriculum, Reading 31.

8. ANALYST CONSIDERATIONS IN CORPORATE GOVERNANCE AND STAKEHOLDER MANAGEMENT

Analysts should consider following things while assessing a company's corporate governance or stakeholder management system:

- Company's ownership and voting structure among shareholders;
- Shareholders' representation on this company's board;
- Main drivers of the management team's remuneration and incentive structure;
- Significant investors in the company;
- Shareholder rights at the company relative to peers;
- The company's effectiveness in managing long-term risks, such as securing access to necessary resources, managing human capital, exhibiting integrity and leadership, and strengthening the long-term sustainability of the enterprises

8.1 Economic Ownership and Voting Control

Dual-class Structures: In Dual-class structures, voting power is decoupled from ownership. In these cases, common shares may be divided into two classes, one of which has superior voting rights to the other. For example, Class A carries one vote per share and is publicly traded whereas another share class (for example, Class B) carries several votes per share and is held exclusively by company insiders or family members. Dual-class companies tend to trade at a discount to their peers.

- Another mechanism used to separate voting control from economic ownership is when one class of stock (held by insiders) elects a majority of the board; outside shareholders who hold a different share class would then be entitled to elect only a minority of the board. Technically, each share carries equal voting rights, but with this structure, the insiders retain substantial power over the affairs of the corporation because they control a majority of the board.

Benefits of dual share systems: It promote company stability and enable management to make long-term strategic investments, insulated from the short-term pressures of outside investors.

Opponents of these structures believe they create conflicts of interest between the providers of capital and the management of the business.

Investors with long time horizons should consider the motivations of the controlling stockholders, generational dynamics, succession planning, and the relationship between the board and management.

8.2 Board of Directors Representation

Investors should consider directors' independence, tenure, experience, and diversity before investing in a company. For example, if the board has multiple directors engaging in related-party transactions with the company, its share is considered risky due to risk of conflict of interest. If directors have long periods of service to a company, they offer valuable experience and expertise, but if the board composition is dominated by such long-tenured members, it may have a negative impact on the board's diversity and adaptability.

8.3 Remuneration and Company Performance

Assessment of the suitability of a remuneration plan for a particular company is a subjective exercise and is highly dependent on industry and geographic norms. Analysts should take into account following things:

A. **Plans offering little alignment with shareholders.** If incentive plan offers only cash-based payouts and no equity and management have no significant stake in the company, there may be a misalignment of incentives between executives and investors.
B. **Plans exhibiting little variation in results over multiple years**. If performance-based award is provided to managers but these are paid every year regardless of the company's results, then investors should have concerns about the rigor of the performance hurdles underlying the awards.
C. **Plans with excessive payouts relative to comparable companies with comparable performance.** In such cases, investors should try to understand the reasons behind such difference.
D. **Plans that may have specific strategic implications.** Some remuneration plans contain payouts based on achieving specific milestones, such as regulatory approval of a product, completion of an acquisition, or achievement of specific cost reductions. In addition, some companies offer high post-employment pay arrangements tied to the sale of the company. These factors are not necessarily negative features, but investors should assess whether the milestones driving the incentive plan align with the company's objectives or not.
E. **Plans based on incentives from an earlier period in the company's life cycle.** If the company's business have matured and competition have limited the opportunity for market share gains, then companies should be more focused on disciplined capital allocation. If the financial incentives in the remuneration plan are based purely on revenue growth, then this should be a point of concern for investors and thus, investors should try to understand such potential misalignment of interests.

8.4 Investors in the Company

Analysts should analyze the composition of investors in a company before investing in it. If a company has cross-shareholdings (i.e. when a company, particularly a publicly listed, holds a large, passive, minority stake in another company), it protects management from shareholder pressures because in cross-shareholding arrangement there is an implicit guarantee that the owner of the shares will support management on all voting issues. In effect, these shareholdings act as ***takeover defenses***.

Similarly, the presence of a sizable affiliated stockholder (such as an individual, family trust, endowment, or private equity fund) can protect a company from the effects of voting by outside shareholders.

If a company has a provision in its corporate charter whereby any changes to the charter must be approved by two-thirds of outstanding shares, then it is virtually impossible for any measure to pass without the support of the foundation. This single minority shareholder most likely holds the power to block the votes of the majority and thus, may create conflict of interests.

It is highly important for analysts to consider market context before assessing the potential effects of affiliated stockholders. E.g. the presence of activist shareholders can meaningfully and rapidly change the investment thesis for a company. Experienced activists, together with short-term-oriented investors who follow their activities, can create substantial turnover in a company's shareholder composition in a short amount of time.

8.5 Strength of Shareholders' Rights

Analysts should also evaluate whether the shareholder rights of a particular company are strong, weak, or average compared with other companies.

In a number of developed markets regulatory agencies or stock exchanges have adopted governance codes which are implemented on a "comply or explain" basis

(in other words, they are voluntary in nature). Companies are required to explain in a public disclosure any deviation from the code. Analysts should evaluate the reasons behind such deviations.

8.6 Managing Long-Term Risks

Analysts should analyze how a company manages various issues, such as long-term environmental risks, management of human capital, transparency, and treatment of investors and other stakeholders. Poor and inadequate management of long-term risks have negative impact on share value of the company.

Practice: Example 10 Curriculum, Reading 31.

9. ESG CONSIDERATIONS FOR INVESTORS

ESG integration (sometimes referred to as ESG investing) involves consideration of environmental, social, and governance factors in the investment process. ESG integration can be implemented across all asset classes, including equities, fixed income, and alternative investments. ESG integration enables investors/analysts to have a more comprehensive understanding of a company's risks. Sustainable investing (SI) and responsible investing (RI) are sometimes used interchangeably with ESG integration.

Socially responsible investing (SRI) refers to investing in companies and industries that are not in opposition to an investor's moral or ethical values, such as weapons or tobacco.

Impact investing seeks to achieve targeted social or environmental objectives along with measurable financial returns by investing in a company or in projects. Impact investing can be executed through various asset classes and investment vehicles. Examples include venture capital investing, investment in climate bonds and green bonds by investors who want to advance low-carbon initiatives. Climate bonds and green bonds are issued to finance climate improvement projects, such as the development of infrastructure and alternative energy projects.

9.1 ESG Market Overview

Owing to growing popularity of ESG based investing, the amount of global assets under management (AUM) dedicated to ESG integration has substantially increased. It is difficult to estimate the true size of the ESG investment universe as ESG mandates are defined and implemented by managers and investors in many different ways.

Universal owners: Universal owners are long-term investors, such as pension funds, that have significant assets invested in diversified portfolios. Owing to large size and scope of their investment portfolios, they are highly influenced by economic growth and costs associated with environmental damages. These investors believe that sustainable global economic growth is essential to successful investment performance. This is why, universal owners tend to positively influence the way companies conduct business to minimize exposure to ESG-related costs.

9.2 ESG Factors in Investment Analysis

Environmental factors that are generally considered material in the investment analysis process include natural resource management, pollution prevention, water conservation, energy efficiency and reduced emissions, the existence of carbon assets, and adherence to environmental safety and regulatory standards.

Social factors considered in ESG integration are generally related to human rights and welfare concerns in the workplace, product development, staff turnover, worker training and safety, employee morale, ethics policies, and employee diversity and community impact. Minimizing social risks can lower a company's costs (e.g., through higher employee productivity and reduced litigation potential) and reduce its reputational risk.

9.3 ESG Implementation Methods

ESG mandates can be implemented through several methods, including negative screening (also referred to as exclusionary screening), positive screening, best-in class, thematic investing, and impact investing.

- **Negative screening** involves excluding companies engaged in fossil fuel extraction or production, or excluding companies that violate accepted standards in such areas as human rights or environmental concerns. Negative screening is the most common ESG investment strategy.

- **Positive screening and best-in-class approaches** invest in companies with favorable ESG aspects, i.e. companies with policies that promote human dignity through employee rights, workplace well-being, and concern for the safety of customers. The best-in-class approach seeks to identify the best ESG-scoring companies in each industry. Best-in-class approaches do not exclude any industries but instead focus on finding the best representation within each sector.
- **Thematic investing strategies** typically consider a single factor, such as energy efficiency or climate change. This approach is typically based on secular economic or social trends. Two common trends include increased demand for energy and water, as well as the availability of alternative sources of each.

Practice: Example 11 Curriculum, Reading 31.

Practice: CFA Institute's end of Chapter Questions and FinQuiz Questions.