What is corporate governance? V4

What is the purpose of this article?

The purpose of this document is to enable founders, CEOs, management, investors, shareholders, boards of directors, advisory boards to create a shared understand of their company’s corporate governance.

This article does not provide tax, legal or financial advice.
You must do your own research and fact-based analysis using current and relevant information.

What are the critical learnings in this article?

1) Corporate governance is broader and deeper than just the board of directors.
2) Discussion around governance is often very silo based and depends upon the specific background of the governance advisors. After company management, its board, and its shareholders have heard from several different advisors, there is often a confusing and disjoint picture of governance with limited shared understanding.
3) You need a shared understanding of the definition of corporate governance, the purpose of corporate governance, and the purpose of the corporation to avoid confusing and conflicting decisions and behaviours.

What is corporate governance?

“Corporate governance involves a set of relationships between a company’s management, board, shareholders and other ecosystem members. Corporate governance also provides the structure and systems through which the company is directed and its objectives are set, and the means of attaining those objectives and monitoring performance are determined”.[1] (See the Further Reading section for a link to the article “What is the Corporate Governance Ecosystem?)

Based on the above definition, there are five aspects to corporate governance:

1) Relationships. The focus is on relationships among different types of people.
2) Directing the company. Appendix 1 provide a sample definition of directing.
3) Setting objectives. People set objectives. The board directors, company management, shareholders, stakeholders and third parties all have different interests and personal objectives. The conflicts of interest need to be understood and managed to agree upon objectives for the board and for management.
4) Determining how to meet objectives. People have to develop plans which reflect what they will do to achieve the objectives. Both the board and management have objectives and plans.
5) Monitoring performance. The performance of people (the board and management) is monitored. Everyone needs to understand the personal consequences of not achieving objectives.

Also implied in the above definitions:

1) Who can make decisions and how are those decisions made?
2) What are the consequences for decision makers who make poor decisions?
3) Who has the authority to act on behalf of the corporation and in what specific situations?
4) Who is accountable for behaviour and outcomes?
5) How are those people who are accountable for execution involved in decision making?

What are the challenges of understanding corporate governance?

Discussion around governance is often very silo based and depends upon the specific background of the governance advisors e.g.

1) Lawyers often start with the Business Corporations Act. Sometimes the legal framework is a social purpose corporation, such as a B Corp., a partnership or a joint venture.
2) Regulators often start with financial risk management guidelines.
3) Accountants often start with quality of financial statements.
4) Consultants have a variety of different points of view.
5) IT (Information Technology) governance advisors have an IT-centric perspective.
6) Private corporations may have unanimous shareholder agreements, which limit the decision making and accountability of the board of directors by reserving certain decisions for the shareholders.
7) Any corporation could have a voting trust comprised of some or all of the shareholders.
8) Financing agreements may have terms and conditions which constrain the company’s decision making and may even provide the financers with decision making authority in certain situations.
9) Values, morals, ethics, company purpose and culture are a critical, but often overlooked, part of corporate governance. Etc.

Often there is a legal perspective of acting in the best interests of the corporation or the shareholders or other members of the company's ecosystem. What does this actually mean? Two example questions, for which I don't have the answers:

1) If climate change is real, should the company reduce or eliminate its impact on global warming, even if that reduces company profits, shareholder dividends, and compensation for the board of directors and C-Suite?
2) Should the company lobby governments to reduce or eliminate environmental laws and standards in order to increase company profits?

After company management, its board, and its shareholders have heard from several different advisors, there is often a confusing and disjoint picture of governance with limited shared understanding.

Sometime there is confusion between a fiduciary(i.e. decision-making board)vs an advisory board.

1) The decision-making board has the authority to make decisions and is accountable for the results of those decisions.
2) The advisory board has no authority to make decision and is not accountable for the actions of the board of directors, C-Suite and others in the company.

What is the purpose of the corporation?

What is the purpose of your corporation? Is it solely to make money for shareholders and the C-Suite? Does the purpose of your corporation help attract and retain the right kinds of employees?

<u>Why have societies and governments put in place the legal and regulatory framework for corporations?</u> Is it to enable the creation of financial wealth for shareholders and the C-Suite? Is it so a "business can thrive and sustain growth while enhancing the wealth of its stakeholders and the well-being of societies in which it operates?"[2]

<u>The U.S. perspective on the relationship between the corporation and society has changed radically since 1981</u>

In 1981: "Corporations have a responsibility, first of all, to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs, and build the economy." "Business and society have a symbiotic relationship: The long-term viability of the corporation depends upon its responsibility to the society of which it is a part. The well-being of society also depends upon profitable and responsible business enterprises."[3]

In 2016: "Core guiding principles: The board approves corporate strategies that are intended to build sustainable long-term value."[5] There is no mention of responsibility to society.

Larry Fink, in his 2018 letter to CEOs, said "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate…..Without a sense of purpose, no company, either public or private, can achieve its full potential…..And ultimately, that company will provide subpar returns to the investors"[4]

The purpose remains fixed while operating practices, cultural norms, strategies, tactics, processes, structures, and methods continually change in response to changing realities. [5]

What is the purpose of corporate governance?

The purpose of corporate governance is to enable the achievement of the purpose of the corporation, consistent with the corporations' values, morals, and ethics.

Corporate governance manages the broad set of conflicts of interests which arise. The OECD governance definition starts with relationships: within corporate leadership, as well as stakeholders and third parties. Any relationship has the potential for conflict of interest, because company ecosystem members may have different or conflicting interests. For example, how should both profits and costs be allocated among the ecosystem members, including: CEO, C-Suite, shareholders, employees, and society. This conflict become acute in cases of poor profits or losses.

Perhaps the greatest conflict of interest is deciding the degree to which the corporation extracts value from society versus creating value for society. An example is the decision on whether to whether to replace local community employees with lower-cost offshore staff which may benefit the off-shore communities or retain the employees in order to sustain local communities.

What are some of the different contexts for a board of directors?
1) A two-tier board (a management board and a supervisory board) in Germany, and some other European countries
2) A certified B Corporation in the United States
3) Crown corporations in Canada
4) Corporations with a Golden Share
5) Multi-class shares
6) Shareholders voting trust
7) Unanimous shareholders agreement in a private company. Etc.

What are your next steps?
Define the words/concepts you're using, in a glossary. I've seen major confusion when the same words mean different things to different people.
#1 Survey the board of directors, C-Suite, advisory board(s), and key other members of your company's ecosystem to determine what they perceive to be:
1) The purpose of your corporation.
2) Your company's corporate governance.
3) The purpose of your company's corporate governance.
4) Your board of directors' decision-making model.

#3 Analyze the surveys to identify the implication on value creation.
#4 Agree upon: the purpose of your corporation, your definition of corporate governance, the purpose of corporate governance, and the board's decision-making model.
#5 Review and revise corporate governance documents, processes, and technology to align with #4
#6 Review other governance within your company, to align with #4 and #5 above,

Footnotes:
[1] Based on "G20/OECD Principles of Corporate Governance", 2023 Page 6. I changed "stakeholders" to "other ecosystem members", https://www.oecd.org/en/publications/2023/09/g20-oecd-principles-of-corporate-governance-2023_60836fcb.html
[2] Dr. Didier Cossin, Boon Hwee Ong, Sophie Coughla, "Stewardship fostering responsible long-term wealth creation", IMD, Global Board Center 2015, https://www.imd.org/globalassets/board-center/docs/stewardship_2015.pdf
[3] Ralph Gomory and Richard Sylla, "The American Corporation", April 2013, page 6, The Wall Street Journal http://online.wsj.com/public/resources/documents/50b74ca9c91e6TheAmericanCorporation11292012.doc.pdf
[4] https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter
[5] Page 17 The five most important questions you will ever ask about your organization (2008) by Peter F. Drucker, Jim Collins et al, I adapted.

Further reading
What is the corporate governance ecosystem?
http://koorandassociates.org/corporate-governance/what-is-the-corporate-governance-ecosystem/What is the purpose of your company?
http://koorandassociates.org/corporate-governance/what-is-the-purpose-of-your-company/
How can the board of directors create value?
https://koorandassociates.org/corporate-governance/how-can-the-board-of-directors-create-value/
Is your company planning to fail?
https://koorandassociates.org/avoiding-business-failure/is-your-company-planning-to-fail/

APPENDIX 1 Sample definition of directing the company
In the context of corporate governance, "directed" refers to the guidance, oversight, and strategic leadership provided to a company by its board of directors and senior management. Specifically:
1. Strategic direction: The board of directors sets the overall strategic direction and goals for the company, guiding its long-term vision and objectives.
2. Decision-making: "Directed" implies that key decisions about the company's operations, investments, and policies are made or approved by the board and executive leadership.
3. Oversight: The board provides oversight of management's actions and performance to ensure they align with the company's goals and stakeholder interests.
4. Policy setting: The board establishes and approves corporate policies, procedures, and guidelines that govern how the company operates.
5. Resource allocation: Direction includes decisions on how to allocate the company's resources to achieve its objectives effectively.

6. Risk management: The board directs the company's approach to identifying, assessing, and managing various risks.
7. Ethical standards: Direction involves setting and maintaining ethical standards and corporate culture.
8. Ecosystem relations: The board guides how the company interacts with and balances the interests of various ecosystem members, including shareholders, employees, customers, and the community.

In essence, "directed" in corporate governance means that the company is guided and managed in a structured, purposeful manner by its leadership, rather than operating without clear guidance or oversight. This direction aims to ensure the company operates efficiently, ethically, and in alignment with its stated objectives.