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Chapter 1 introduces the book with a well-known example of a breakdown in corporate governance, the failure of the system of checks and balances in the case of HealthSouth. The cause of such failures may be attributed to agency problem, which refers to agents (executives) being more concerned about their self-interests rather than those of the principals’ (owners). Some of the examples of such behaviors may be fraud, manipulation of financial statements, securities fraud, Foreign Corrupt Practices Act violations, illegally backdating stock options, or wrongly inflating (massaging) earnings. In order to minimize the costs associated with such problems, corporate governance is used by organizations as a control and monitoring system.

Referring to previously published studies, authors specify the determinants and the participants in corporate governance systems as board, auditors, customers, suppliers, unions, media, regulators, analysts and investors, surrounded by the efficient capital markets, regulatory enforcement, legal tradition, accounting standards, and societal and cultural values. The fundamental orientation of the firm (shareholder vs. stakeholder perspective) may play an important role in structuring the corporate governance systems. Although there are no universally agreed-upon standards of corporate governance, Cadbury Committee report of 1992 from United Kingdom and the Sarbanes-Oxley Act of 2002 set the current foundation of practices. In addition, the relatively recent Shareholder’s Bill of Rights of 2009 and the Dodd-Frank Wall Street Reform and Consumer Protection Act increased the owners’ rights on organizational issues such as nomination and election of directors and say-on-pay to executives. On top of these, there are several third-party organizations such as the Corporate Library and Risk Metrics Group that publish corporate governance ratings of companies. Also, private equity firms, activist investors and proxy advisory firms have recently started playing more important roles in the governance of companies. The authors conclude Chapter 1 by clarifying the fact that unique structural, cultural and governance features in different settings make it very hard to find a one-size-fits-all approach available to corporate governance. In addition, the authors report the potentially positive relationship between corporate governance and firm performance and specify their approach in the book to be a focus on organizational instead of purely legal aspects of corporate governance.

Chapter 2 discusses international corporate governance. The chapter lists factors that shape the setting of the governance mechanisms. These factors include but not limited to efficiency of local capital markets, the extent to which the legal system provides protection to all shareholders, reliability of accounting standards, enforcement of regulations and societal and cultural values. The chapter continues with explanation of the different national governance
structures using these factors. In United States, which has a shareholder-centric approach to corporate matters, Securities and Exchange Commission (SEC) with assistance from the Financial Accounting Standards Board (FASB) is responsible for ensuring appropriate accounting practices to be adopted by publicly traded companies of which a significant majority is founded in Delaware due to that state’s highly advance legal system for corporate matters. New York Stock Exchange (NYSE), Sarbanes-Oxley Act of 2002 and Dodd-Frank Financial Reform Act of 2010 have different provisions such as boards to have majority of independent directors, ban on personal loans to executives, disclosure of executive compensation and say-on-pay by the shareholders. On the other hand, the United Kingdom, which also adopts a shareholder-centric approach to corporate matters, has been a leader in governance reforms with the recommendations of The Cadbury Report (1992), The Greenbury Report (1995), The Hampel Report (1998), The Turnbull Report (1999) and The Higgs Report (2003). Interestingly, in the U.K., publicly traded companies have the option to explain why they are in noncompliance with the Revised Combined Code when they are, which is known as a practice called “comply or explain.” Germany, with its stakeholder-centric approach, has a dual board of directors structure. First board is the management which is in charge of the daily strategic decisions, while the second board is called the supervisory board, which oversees the activities of the management board. Unlike the U.S. or U.K., the representatives of the workers reserve one third to half of the seats on supervisory boards in Germany. Financial institutions and founding family members are also represented on the supervisory board. In Japan, on the other hand, although there is a unitary board structure, keiretsu is the most popular system in which companies hold shares and seats in companies that they do business with. South Korea has a similar arrangement called chaebol, which refers to groups of affiliated companies. In China state still plays the biggest role, while there is a transition to a capitalistic economic system. In India, there is a stakeholder-centric approach with many reforms yet to be adopted. In Brazil, boards are not required to have a majority of independent members although the country has recently adopted some western-oriented governance practices. Finally, in Russia, there is concentrated ownership with lack of transparency, which creates a favorable environment for corruption to occur.

Chapters 3-5 discuss one of the major players of corporate governance, board of directors. In Chapter 3, authors state that the boards have primarily two types of responsibilities. The first one is the advisory role, which refers to board’s responsibility to consult with management regarding the strategic and the operational direction of the company. The second role is the oversight role, which refers to the responsibility of the board’s members to look after the interest of the shareholders, through monitoring activities. For both the advisory and the oversight roles to be effective, boards need to be independent. Directors are assigned to audit, compensation, governance and nominating committees. Directors are normally elected for one-year terms but in staggered boards they are elected for three-year terms where one third of the boards stand for reelection each year. Directors have fiduciary duties to act in the interests of the shareholders.

Chapter 4 is about the selection, compensation and removal of board members. As research suggests, the market of directors is not a munificent one. Directors can be selected among currently active CEOs of other companies, they may be required to have experience or
expertise in certain areas, and may bring in diversity to the board which is shown to increase the
governance quality of the companies. In addition, there are also professional directors whose
full-time careers are being directors of public or private companies. Companies recruit directors
either through the social network of the current directors and executives or with the help of
consulting firms. They are also required to disclose information about the qualifications of their
directors. The concentration in recruiting directors should be on ensuring the fit of a candidate
with a given board of directors. Directors get compensated for their duties by cash and stock
options, depending on the size of the company. Some companies require their directors to
accumulate company shares for the purpose of aligning the interests of the shareholders and
the directors. Although there is not a formal requirement to evaluate individual directors, many
of them get evaluated based on concepts like composition, accountability, amount of information
generated, number of meetings and the quality of relations among the board members and the
executives. Directors can also be asked to leave for many reasons such as personal problems,
lack of effectiveness or mandatory retirement.

Chapter 5 considers the structure of the board and the consequences of that structure. The
board structure refers to the size of the board, background of the directors and their
independence from the executives, number of committees and the compensation of directors.
Companies may have different types of directors such bankers, financial experts, politicians,
and employee representatives serving on their boards. Directors who hold multiple board seats
are referred to as busy directors and previous studies were able to demonstrate that the quality
of governance tends to diminish with the presence of busy directors. In almost 60 percent of the
American companies, the CEO is also the chairman of the board. There is an ongoing debate
about this situation which is referred to as duality. An alternative to duality is to appoint a lead
independent director. Although the results about the effectiveness of the outside directors are
mixed, there is solid evidence for the effectiveness of the fully independent directors. The
authors also discuss the implications of director interlocks, diversity among board members and
conclude the chapter by underlining the fact that females are significantly under-represented on
board of directors of publicly traded companies.

Chapter 6 studies board’s impact on organizational strategy, business models and risk
management. In short, authors state the importance of the board being actively involved in
defining of the strategy, developing and testing the proposed business plan, identifying the key
success indicators and handling of risk on organizational practices. Defining corporate strategy
is by itself the duty of the management. However, board should oversee important connection
between the vision and the mission of the firm and the strategies developed by the executives.
Business plans are developed to demonstrate how the corporate strategy translates into
performance measures. Boards should be constantly asking questions about the applicability of
the business plan developed by the executives while monitoring the progress towards goal
achievement. Through the questions asked by the board, the plans may be modified, which may
lead to better performance outcomes. An important part of a business plan is the key
performance indicators, which may be either in financial (objective) or nonfinancial (subjective)
forms. Companies that are successful in identifying these indicators tend to create higher value
for their shareholder. Most boards today however are not exposed to enough information about
nonfinancial indicators. As a result the quality of the oversight duties preformed by board
members is diminished. The final parts of this chapter include information about risk and risk management and board’s importance with ensuring sound risk management practices. One of the common mistakes executives make is to concentrate on generic risks rather than operational, financial, reputational and compliance risk factors. Therefore, boards should make sure that the strategy development and implementation fits with the risk culture and the amount of risk tolerance in the organizations. In addition, many companies do not have enough knowledge about the risks that they face which makes it almost impossible to account for risk through appropriate risk management skills. Hence, the boards should be highly active in not only oversight of risk management but also the identification of risk factors the organizations face.

Chapter 7 discusses the labor market for executives and CEO succession planning. In a typical market, there is a demand and supply relationship and the corresponding market players. It is the duty of the board members to ensure that the right person is selected for the CEO position. Also, the executive may be less likely to show self-interested behavior as he or she is aware of the fact that there are substitutes in the market. Furthermore, due to the demand and supply relationships in the market, the required compensation for the CEO can be easily identified. The authors provide some interesting statistics for the readers. For example, it is documented that the CEO tenure has been falling in the recent years among the 6,000 CEOs of publicly traded companies. This translates to higher CEO turnover rate. Interestingly, research shows that companies with higher quality governance ratings are more likely to dismiss their CEOs for poor performance. Research also shows that most of the newly appointed CEOs are internal executives. Looking at the CEO succession planning models, companies have four options for replacing their CEOs. They can search for an external candidate, choose to appoint a leading candidate as the president and/or chief operating officer to evaluate his or her performance in a highly ranked executive position, elect to appoint two internal candidates to highly ranked executive positions and let them race, or evaluate an internal and an external candidate together. Surprisingly, many of the publicly traded companies do not have a succession planning. The corporate governance mechanisms of these companies should also play active roles in these processes.

In Chapter 8, the authors discuss about executive compensation and incentives. Executive compensation has been a source of controversy. The components of executive compensation are annual salary, annual bonus, stock options, restricted stocks (time based), performance shares, perquisites, contractual agreements and benefits. Some of these components are short term based while others are long term based. The right mixture of short-term and long-term incentive based pay systems are warranted for organizational success. It is the board’s job to determine the level and the mixture of compensation. Obviously what the compensation committee wants is to pay the right amount to attract the right person for the job. Most of the time boards get input from compensation consultants and benchmarks. Research shows that larger companies and those with weak governance systems tend to pay more to their executives. Another important issue is the inequity between the CEO and the other executive officers and the average employees pay, which may result in lower morale and performance. The ongoing debate about pay-for-performance resulted in several legal changes such as the
increase proxy disclosure of 2006, acts about say-on-pay such as the Say-on-Pay Bill of 2007 and the Dodd-Frank Financial Reform Act of 2010.

In Chapter 9 authors discuss the positive and negative effects of executive ownership on firm outcomes. Interestingly, the findings about the impact of equity ownership by executives on organizational outcomes are inconsistent. Some companies now have target ownership plans which require the executive to hold a minimum equity amount. The purpose of executive equity ownership is to ensure the alignment of the interests of the executives and the shareholders. While that is the purpose, in some cases it results in an opposite outcome where the executives get involved in situations such as manipulation of financial accounting records, option grants and release of information. In order to avoid fraudulent situations such as insider trading, executives of publicly traded companies are typically faced with certain restrictions regarding the sale and accumulation of company stocks.

Chapter 10, titled as “Financial Reporting and External Audit” is about the board’s role regarding the assurance of the integrity of the financial statements. The audit committee of a board has the legal responsibility to oversee the accounting practices, perform the internal audit function, and deal with the external auditor. One of the members of this committee is required to qualify as a financial expert. This committee should set quality, transparency and internal control standards. Approximately 5 to 12 percent of the publicly traded companies in United States restate their earnings each year due to errors in revenue and expense recognition, misclassification of items, mistakes in the accounting procedures related to equities, income, taxes, acquisitions and investments, capital assets, inventory, reserves and allowances and liabilities. These restatements are either due to human error or fraud. External auditor, on the other hand, assesses the validity and the reliability of the financial statements of the publicly traded companies. The external audit process starts with a preparation, followed by a review of the accounting estimates and disclosures, fraud evaluation, assessment of internal controls, communication with the audit committee and ends with the expression of the opinion. Both the internal and the external audit processes are impacted by not only the industry standards but also by the legal developments such as the Sarbanes Oxley act of 2002.

In Chapter 11, the authors discuss another type of market, which is the market for corporate control. Similar to market for executives, where the players face the typical market dynamics, companies experience change in ownership with the pressure from market for corporate control. According to this market, the stock price of a company reflects its management’s performance. Corporate control market consists of mergers and acquisitions and reorganizations. These can happen either in friendly ways or in hostile ways. Financial synergies, need for diversification, change in ownership, empire building, hubris, herding behavior and compensation incentives are some of the reasons for acquisition activities. Regarding the impact of acquisitions on organizational outcomes, companies with fundamentally weak performances, the ones in an industry with heightened merger activities, or the ones with low debt levels, strong cash flows and in possession of valuable assets are more likely to be acquired. In general, the shareholders of the target firms rather than the acquirer firms experience more value for such deals. On the other hand, some target companies do not like to be taken over so they put in
antitakeover defense mechanisms in place such as poison pills, dual-class shares and staggered board structures.

In Chapter 12, authors turn the reader’s attention to institutional shareholders and activist investors. Shareholders differ in terms of investment horizons, objectives, activity levels and size. A blockholder is a shareholder that owns a substantial amount of shares in a company. Blockholders can be individuals or institutions while the majority of the current blockholders of publicly traded companies happen to be institutional investors. Institutional investors such as mutual funds, pension funds and hedge funds hold almost 70 percent of the shares of the publicly traded companies. Most of the time, these institutional investors exercise their proxy voting rights with the help of proxy advisory firms such as the RiskMetrics/ISS Group. These advisory firms provide guidance on issues such as director election or executive compensation. While some institutional investors are passive, others may choose to adopt an active approach towards corporate governance matters. Publicly traded companies also deal with shareholders like pension funds, hedge funds, social responsibility and stakeholder funds. Different shareholders have different agendas and the new trend to address these agendas is to have shareholder democracy present in publicly traded companies.

In Chapter 13, authors discuss corporate governance ratings. The chapter starts by discussing credit ratings done by credit-rating agencies such as Moody’s, Standard & Poors and Fitch, the governance ratings performed by RiskMetrics/ISS group, GovernanceMetrics International and The Corporate Library. These rating agencies make use of different quantitative methods and qualitative approaches. On top of these companies, academicians also developed their own rating systems. The investors are urged to pay attention to all of these ratings but also cautioned about the predictive ability of the evaluations done by these various bodies.

The authors finalize this highly informative book by summarizing their work and offering conclusions in Chapter 14. They highlight the fact that, testing in corporate governance is still remains to be insufficient and the current focus on the features of corporate governance should be turned towards the functions of corporate governance. As the title of the book suggests, they state that corporate governance matters but the question they ask is “how” and “when.”