Financial Institutions Roundtable

A complimentary webinar series for financial institutions.

Corporate Governance in Today's Environment: A Refresher and Check-Up in the Post "Great Recession" Environment

October 8, 2014

Presented by: **Sonny MacArthur, Partner, Porter Keadle Moore**

Carrie Connell, Senior Manager, Porter Keadle Moore

Porter Keadle Moore

CPAs | Advisors | www.pkm.com

What is Corporate Governance?

- **Sample definitions of "Corporate Governance" via Google:**
  - "*The structure and relationships which determine corporate direction and performance.*"
  - *"The mechanisms, processes and relations by which corporations are controlled and directed including the processes through which the corporations' objectives are set and pursued in the context of the social, regulatory and market environment."*
  - *"The systems and processes an organization has in place to protect and enhance the interests of its diverse groups of stakeholders, such as shareholders, employees, customers, vendors and community."*

What is Corporate Governance?, cont.

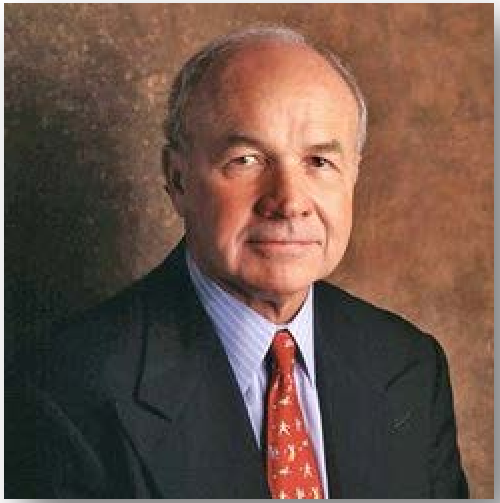
- “*The combination of mechanisms which ensure that management runs the firm for the benefit of one or many stakeholders.”*

- *“The way in which a corporation is directed, administered and controlled.”*

- *“The most fundamental principles of corporate governance are a function of the allocation of power within a corporation between its stockholders and its board of directors.”*

- And so on and so forth. . .

Do You Remember These Guys?



Ken Lay

- Former Enron Executive
- Indicted by a Grand Jury on July 7, 2004 on 11 counts of securities fraud and related charges
- Found guilty on May 25, 2005 on 10 of the 11 counts
- Faced 20-30 years in prison
- Died on July 5, 2006 while vacationing in Snowmass, CO, 3 ½ months before his scheduled October 23rd sentencing.

Do You Remember These Guys?

Jeff Skilling

- Former Enron Executive
- Convicted in 2006 of multiple federal felony charges relating to Enron's financial collapse
- Sentenced to 24 years in federal prison
- In 2013, Department of Justice reduced his sentence by ten years

Do You Remember These Guys?

Bernie Ebbers

- Founder and CEO of WorldCom
- Convicted in 2005 of fraud and conspiracy as a result of WorldCom's false financial reporting
- Currently serving a 25 year federal prison term

Action / Reaction

Enron
Worldcom
Tyco International
Adelphia

Sarbanes-Oxley Act of 2002 was enacted on July 30, 2002

- The law, also known as the “Public Company Accounting Reform and Investor Protection Act” (in the Senate) and “Corporate and Auditing Accountability and Responsibility Act” (in the House) and more commonly called SOX, is a U.S. federal law that set new or enhanced standards for all U.S. public company boards, management and public accounting firms.

- As a result of SOX, executive management must individually certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the oversight role of boards of directors and the independence of the outside auditors who review the accuracy of financial statements.

Polling Question #1

- Is your Institution:
  - Public
  - Non-Public

Along Comes The Great Recession

LEHMAN BROTHERS

Merrill Lynch

BEAR STEARNS

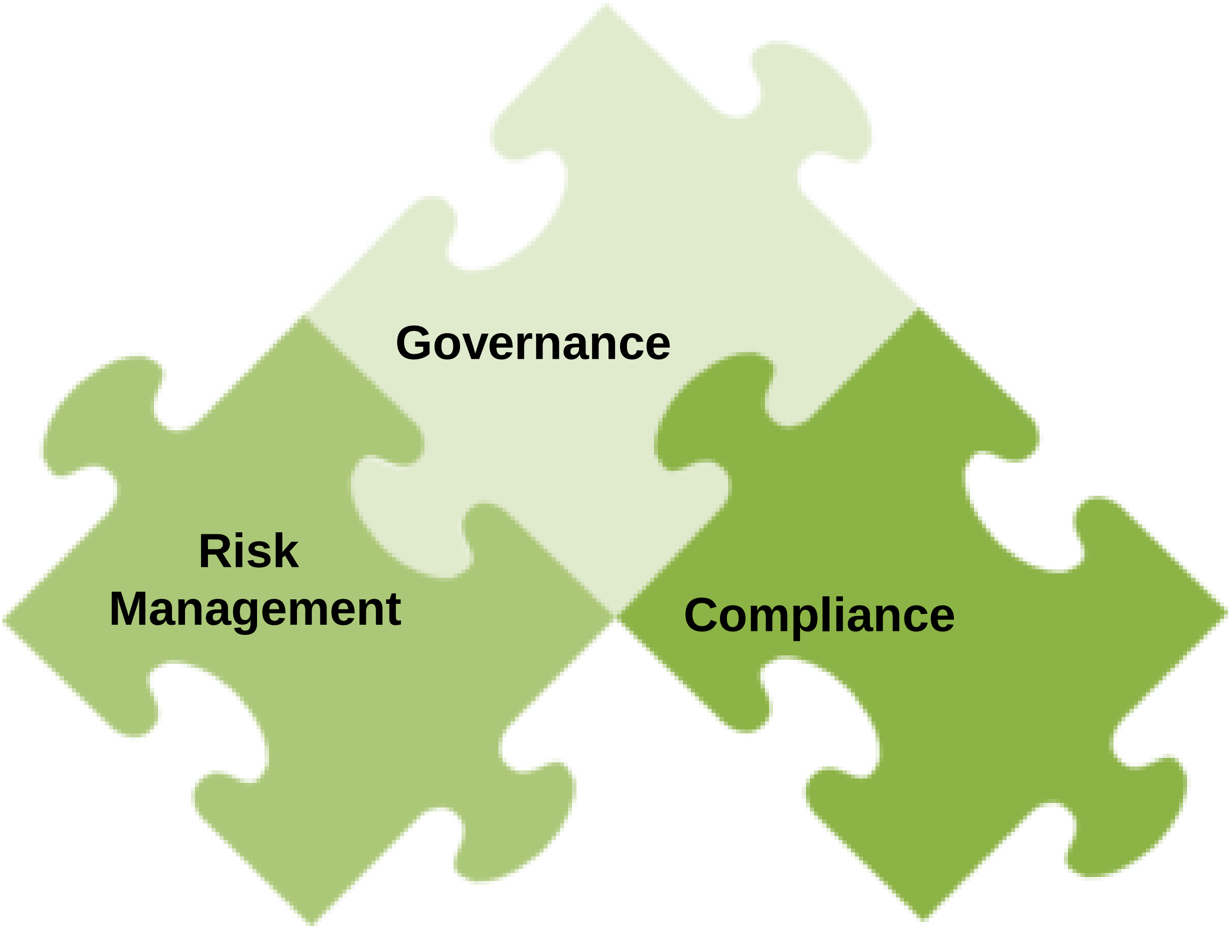
WACHOVIA

Washington Mutual

Action / Reaction

- With the passing of the “Great Recession” there has again been an increase in activism among shareholders and increased scrutiny surrounding corporate governance from the regulators.
- Boards and executive teams are more focused on corporate governance than ever before.
- Governance is only **one piece** of the puzzle!

Governance, Risk & Compliance



Polling Question #2

- **Since the "Great Recession," has your company placed a greater emphasis on Corporate Governance?**
  - Yes
  - No
  - About the Same
  - Unsure

Governance, Risk & Compliance, cont.

- ***Governance*** is the oversight role and the process by which companies manage and mitigate business risks.
- ***Risk management*** enables an organization to evaluate all relevant business and regulatory risks and controls and monitor mitigation actions in a structured manner.
- ***Compliance*** ensures that an organization has the processes and internal controls in place to meet the requirements imposed by governmental bodies, regulators, industry mandates or internal policies.

Governance, Risk & Compliance, cont.

Governance
- Document Process and Risks
- Define and Document Controls
- Assess Effectiveness of Controls
- Disclosure & Certification of Compliance Processes
- Remediate Issues

Risk Management
- Identify and Categorize Risk
- Assess Risk
- Mitigate Risk
- Report on Containment of Risk

Compliance
- Document Process and Risks
- Define and Document Controls
- Assess Effectiveness of Controls
- Disclosure & Certification of Compliance Processes
- Remediate Issues

Corporate Governance, cont.

- **The Board's oversight responsibilities should include:**
  - Providing clarity around the direction and values of the organization,
  - Providing advice and direction to management,
  - Constructively challenging management,
  - Approving policies and transactions, as necessary or dictated by policy.

Corporate Governance, cont.

- Monitoring management’s activities,
- Overseeing the performance of the organization, including it’s progress toward achieving strategic objectives,
- Protecting stakeholders’ interests

▲ **The Board of Directors and management set the tone for the corporate governance environment throughout the organization.**

Corporate Governance, cont.

- Similar to shareholder activists and other regulatory bodies, banking regulators are also focused on corporate governance.

- Corporate Governance is one component in the overall risk management model presented by the banking regulators.

FDIC

Office of the Comptroller of the Currency
U.S. Department of the Treasury

UNITED STATES FEDERAL RESERVE SYSTEM

FDIC Risk Management Process

Polling Question #3

- **Are governance discussions with your primary bank regulator within the context of risk management as described in the previous slide?**

  - Yes
  - No
  - Our regulator does not discuss corporate governance with us

Corporate Governance, cont.

- **Key Principles/Actions by the Board when establishing the corporate governance environment:**

  1. **Demonstrates a commitment to integrity and ethical values.**

     a.) ***Sets the tone at the top*** – the board and management demonstrate through their directives, actions and behavior the importance of integrity and ethical values within the organization.

     - *Mission and value statements*
     - *Standards or codes of conduct*
     - *Policies and procedures*
     - *Operating principles*
     - *Directive, guidelines and other supporting communications*
     - *Attitudes and responses to deviations from Standards of Conduct*
     - *Informal and routine actions and communication of leaders at all levels of the organization*

Corporate Governance, cont.

b.) Establishes Standards of Conduct – the expectations of the board and management concerning integrity and ethical values are defined in the entity's standards of conduct and are understood throughout all levels of the organization.

– *The Standards of Conduct guide the organization in behavior, activities and decisions in the pursuit of strategic objectives by:*

- Establishing what is right and wrong
- Providing guidance for navigating what lies in between, considering associated risks
- Reflecting governing laws, rules, regulations, standards and other expectations that the organization's stakeholders may have, such as corporate social responsibility

Corporate Governance, cont.

c.) Evaluates adherence to the Standards of Conduct – processes are in place to evaluate the performance of individuals against the organization's expected Standards of Conduct.

– *Lack of adherence could stem from situations such as:*

- Tone at the top does not effectively convey expectations regarding adherence
- Performance goals that create incentives or pressures to compromise ethical behavior
- Inadequate channels by which employees can safely voice questions and concerns
- Inadequate process for investigation and resolution of alleged misconduct

Corporate Governance, cont.

d.) Addresses deviations in a timely manner – deviations from the organization's expected Standards of Conduct are identified and remedied in a timely and consistent manner.

- *Depending on the severity of the deviation, the employee may be issued a warning and provided coaching, put on probation or terminated.*

Corporate Governance, cont.

2. Demonstrates independence from management:

a.) Establishes oversight responsibilities – the Board identifies and accepts it oversight responsibilities.

- *The Board understands the following:*
  - the business
  - the expectations of stakeholders, including customers, employees, investors, and the general public
  - the legal and regulatory requirements and related risks
- *Oversight structures of the Board may be comprised of the following:*
  - Nomination / governance committees
  - Compensation committee
  - Audit committee
  - Risk committee
  - Compliance committee

Corporate Governance, cont.

b.) Applies relevant expertise – the Board defines, maintains and periodically evaluates the skills and expertise needed among its members to enable them to ask probing questions of senior management and to take commensurate actions*.*

– *Capabilities of all board members should include:*

- Integrity and ethical standards
- Leadership
- Critical thinking and problem-solving skills

Corporate Governance, cont.

– *The Board is expected to include more specialized skills and expertise as needed, such as:*

- Financial accounting and reporting
- Legal and regulatory
- Information systems and technology
- Incentives and compensation

Corporate Governance, cont.

c.) Operates independently – the board has sufficient number of members who are independent from management and objective in evaluations and decision making.

- *Independence is demonstrated in the board member’s objectivity of mind, action, appearance and fact.*
- *The Board should be actively engaged at all times and be prepared to:*
  - question and scrutinize management’s activities
  - present alternative views
  - address obvious or suspected wrongdoing

Corporate Governance, cont.

d.) Provides oversight of the System of Internal Control – the Board retains oversight responsibility for management's design, implementation, and conduct of internal control.

Corporate Governance, cont.

3. <u>Establish, in conjunction with management, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of strategic objectives.</u>

- ***a.) Consider all structures of the entity*** – management and the Board should consider the multiple structures used including operational, financial, compliance and outsourced service providers to support the achievement of strategic objectives.

Corporate Governance, cont.

b.) Establishes reporting lines – management designs and evaluates lines of reporting for each entity structure to enable execution of responsibilities and flow of information to manage the activities of the organization.

- *Variables to consider when establishing and evaluating organizational structures include the following:*
  - Nature, size and geographic dispersion of the business
  - Risk related to the entity's strategic objectives and business processes, which may be retained internally or outsourced
  - Interconnections with outsourced service providers and other strategic business partners

Corporate Governance, cont.

c.) Defines, assigns and limits authorities and responsibilities - management and the Board delegate authority, define responsibilities and use appropriate processes and technology to assign responsibility and segregate duties at the various levels of the organization.

- *Board of Directors – retains authority over significant decisions and management oversight*
  - Senior Management – establishes directives, guidance, and control to enable management and other personnel to understand and carry out their responsibilities
  - Management – guides and facilitates the execution of senior management's directives
  - Personnel – understands the entity's standard of conduct, assessed risks to objectives, and the related activities at their respective levels of the organization
  - Outsourced Service Providers – adheres to management's and the Board's definition of the scope of authority and responsibility for all non-employees engaged.

Corporate Governance, cont.

4. Demonstrates a commitment to attract, develop and retain competent individuals in alignment with strategic objectives.

a.) Establishes policies and practices – policies and practices reflect expectations of the competence necessary to support the achievement of strategic objectives.

– *Policies and practices may include:*

- Requirements and rationale – i.e. new laws and regulations
- Skills necessary to support the achievement of the organization's objectives – i.e. knowledge of technology platforms underpinning business processes
- Defined accountability for key business functions – i.e. CFO's responsibility for financial reporting
- Basis for evaluating shortcomings – i.e. formalized performance reviews

Corporate Governance, cont.

b.) Evaluates competence and addresses shortcomings – the Board and management evaluate competence across the organization in in outsourced service providers and address shortcomings, as necessary.

- *The Board evaluates the competence of the CEO and, in turn, management evaluates competence across the organization.*
- *The organization defines competence requirements, as needed to support objectives*

Corporate Governance, cont.

c.) Attracts, develops and retains individuals – the organization provides the mentoring and training needed to attract, develop and retain competent personnel and outsourced service providers to support the achievement of strategic objectives.

- *The commitment to competence is supported and embedded in the human resource management processes for attracting, developing, evaluating and retaining the right fit of management and other personnel.*

- *Plans and prepares for succession – senior management and the Board develops plans for executive management and board succession.*

Corporate Governance, cont.

5. <u>Holds individuals accountable for their responsibilities in the pursuit of strategic objectives.</u>

a.) Enforces accountability through structures, authorities and responsibilities - management and the Board establish mechanisms to communicate and hold individuals accountable for performance across the organization and implement corrective action as necessary.

- *The Board and senior management have responsibility for establishing "tone at the top", which helps establish and enforce accountability, morale and a common purpose through:*
  - Clarity of expectations from the Board and senior management addressing such issues as:
    - Integrity and ethics
    - Conflict of interest
    - Illegal or improper activities

Corporate Governance, cont.

- Guidance provided by management through its philosophy and operating style, as expressed in the form of:
  - *State of mind*
  - *Formality*
  - *Persistence*
  - *Other attitudes toward corporate governance*
- Control and information flow
  - *Communicating how decisions are made*
  - *Soliciting and acting on 360-degree feedback on performance*

Corporate Governance, cont.

- Upward and other communication channels for employees to feel comfortable reporting violations of ethical standards
  - *Anonymous or confidential communication channels are made available*

- Alignment of individual goals and performance with the entity's objectives

- Management's response to deviations from expected standards and behaviors
  - *Notices, terminations and / or other corrective actions that ensue from failing to adhere to organizational standards*

Polling Question #4

- Does your company have policies and procedures for reporting suspected fraud or violations of ethical standards?

  - Yes
  - No
  - Unsure

Corporate Governance, cont.

b.) Establishes performance measures, incentives and rewards – management and the Board establish performance measures, incentives and other rewards as appropriate for responsibilities at all levels of the organization.

- *Senior management and the Board establish performance measures, incentives and other rewards appropriate for responsibilities at all levels of the organization, considering both the short-term and longer-term strategic objectives of the entity.*

c.) Evaluates performance measures, incentives and rewards for ongoing relevance – management and the Board align incentives and rewards with the fulfillment of responsibilities in the achievement of strategic objectives.

Corporate Governance, cont.

d.) Considers excessive pressures – management and the Board evaluate and adjust pressures associated with the achievement of objectives as they assign responsibilities, develop performance measures and evaluate performance.

- *Pressures can positively motivate individuals to meet the expectations of conduct and performance, both in the short and long term.*
- *Pressures can also cause employees to fear the consequences of not achieving objectives and circumvent processes or engage in fraudulent activity or corruption.*

Corporate Governance, cont.

– *Excessive pressures are most commonly associated with:*

- Unrealistic performance targets, particularly for short-term results
- Conflicting objectives of different stakeholders
- Imbalance between rewards for short-term financial performance and those for long-term focused stakeholders

Corporate Governance, cont.

e.) Evaluates performance and rewards or disciplines individuals – management and the Board evaluate performance including adherence to the standards of conduct and expected levels of competence and provide rewards or exercise disciplinary action as appropriate.

- *The Board evaluates the performance of the CEO, who in turn evaluates the performance of senior management, and so on.*
- *At each level, adherence to standards of conduct and expected levels of competence are evaluated, and rewards are allocated or disciplinary action is exercised as appropriate.*

- Compensation and other rewards are awarded on the basis of performance evaluation, competencies, and skill acquisition, as well as available market pricing information, with the goal of retaining performers and encouraging attrition of lower-end performers.

QUESTIONS?

Sonny MacArthur, Partner
smacarthur@pkm.com
404-420-5631

Carrie Connell, Sr. Audit Manager
cconnell@pkm.com
404-420-5910

Sign up for our next Webinar!

- **"Strategies for Year End Tax Planning"**
  - **Wednesday, November 19, 2014**
    - **(3:00 - 4:00 pm EST)**
  - **Register: http://www.pkm.com/news/cfo-roundtable/**