TONE at the TOP®

Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

Issue 109 | February 2022

Maintaining Excellence in Corporate Governance

The first year of the COVID-19 pandemic created myriad challenges for organizations, but findings from a respected survey provided a glimmer of hope amid the gloom. Incremental improvements in key 2020 governance measures appeared to show organizations rallying to focus on improving how they operated. However, a year later, the same survey finds the quality of governance may be stagnating as organizations deal with unrelenting pandemic disruptions and uncertainty.

The Institute of Internal Auditors' and Neel Corporate Governance Center's 2021 American Corporate Governance Index (ACGI), which surveyed chief audit executives (CAEs) on their organizations' performance on eight Guiding Principles of Corporate Governance, saw grades dip in seven of the eight categories compared to the previous year. Overall, the ACGI score slipped one point from 82 to 81, but maintained its B- rating.

Key Takeaways in ACGI Results

While the overall scores appear to reflect some weariness from executive leadership, there were findings that boards ought to consider as they plan for the coming year:

Internal audit can have a beneficial impact on governance quality. The annual ACGI survey, now in its third year, has accumulated sufficient data to identify some correlations between company characteristics and governance quality. One of the most notable is the indication that governance quality is highest among companies where CAEs report administratively to the CEO or audit committee. Internal audit is designed to provide independent, objective information to leadership, and this reporting structure reinforces that role. What's more, because internal audit can provide assurance over a wide range of risk areas, it is preferable that the CAE report to the full board so that all members benefit from internal audit's insight and advice.

Strong governance quality was also associated with companies that had:

- Strong board independence accompanying a CEO-board chair duality.
- Simpler reporting structures and no international operations.

Shareholder activism is not to be ignored. The number of U.S. public shareholder activism campaigns jumped 28% during the 2021 proxy season from the 2020 season, returning to pre-pandemic levels after a decline, according to one assessment. ACGI survey results revealed there were significantly fewer companies that had not experienced a shareholder campaign during the year than was the case in 2020. Contrary to this spike in reported shareholder activism, the index saw a slight decline year over year in the likelihood of organizations considering a wide range of shareholder interests in their business decisions. This flies in the face of considerable changes in economic, political, and social environments given the disruptions of the past two years.

About The IIA

The Institute of Internal Auditors, Inc. is a global professional association with more than 210,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

The IIA

1035 Greenwood Blvd.
Suite 401
Lake Mary, FL 32746 USA

Complimentary Subscriptions

Visit www.theiia.org/Tone to sign up for your complimentary subscription.

Reader Feedback

Send questions/comments to Tone@theiia.org.

"Many shareholders are seeking a role in shaping the future, and boards may need to balance a broader, more diverse range of sometimes competing stakeholder interests in making decisions," according to a Deloitte report published in *The Wall Street Journal*.

Board members should be aware of this trend and consider how best to address issues that might draw activist interest to their organizations. Their internal audit function can offer independent assessments and assurance on critical concerns that may be subject to potential shareholder activism before issues arise, minimizing the possible impact and giving organizations more time for decision-making on emerging problem areas.

Keep an eye on ESG. For corporate boards, the 2021 proxy season was an inflection point when it came to environmental, social, and governance (ESG) issues, according to the National Association of Corporate Directors' 2022 Governance Outlook. There were numerous shareholder activism campaigns focused on environmental concerns throughout 2021, and ESG considerations are expected to remain in the forefront in 2022. "All companies, regardless of their sector, are experiencing increased investor scrutiny on how they approach this issue," according to a Morrow Sodali survey in 2021.

According to the ACGI, while some CAEs report that their companies' vigilance on environmental and social issues has led to improvements, the vast majority say it's too early to tell if their organizations' efforts are affecting governance or performance. Many companies have created board committees or executive-level positions that oversee ESG considerations. Boards should remember that their internal audit function is well- positioned to offer valuable independent assessments of many issues that fall under the ESG umbrella.

Unfortunately, good communication on ESG may be lacking in many companies. CAEs did not have strong faith in the quality of different types of ESG information at their organizations. A total of 41% thought the quality of ESG information used internally for decision-making was fair or poor. Another 31% called this data very good or excellent, and 28% thought it was good. When it came to information presented externally to shareholders, 34% thought it was fair or poor, 31% found it very good or excellent, and 34% deemed it good. These numbers point to room for improvement that internal audit can help organizations achieve.

Employee-related governance may need strengthening. The ACGI results found that employees were less likely to receive adequate job training and slightly less likely to receive incentives to achieve corporate objectives in an ethical manner. Companies were also slightly less likely to have sufficient time and money to address crises without cutting corners and/or sacrificing long-term performance. If these areas are not reinforced, companies could be making themselves vulnerable to future failures in risk management and control.

QUESTIONS FOR DIRECTORS

» Has our organization experienced greater shareholder activism in the last year, and if so, how have we responded?

» Has our company done a good job of anticipating and addressing shareholder concerns? Has our approach changed in recent years?

» Are we leveraging internal audit's independent assurance and advice to identify and assess shareholder activism, as well as ESG risks/opportunities?

» Does our full board routinely hear internal audit findings, recommendations, and reports?

Fighting the Fatigue

While pandemic fatigue is an understandable response to a challenging time, boards should be alert not only to backsliding on corporate governance, but also to the need to take proactive steps to advance quality in this area. Additionally, they should consider how well their companies are anticipating and addressing shareholders' calls for greater accountability and change—especially regarding ESG concerns. Boards can turn to their internal audit function for valuable and objective assurance and advice on the best way to succeed in their efforts to enhance the quality of corporate governance.

Figure 1 - Source: PwC's 2021 Annual Corporate Directors Survey

Guiding Principles of Corporate Governance

Principles	2021	2020	2019
Principle 1: Effective corporate governance requires regular and constructive interaction among key stakeholders, the board, management, internal audit, legal counsel, and external audit and other advisors.	B- (82)	B (83)	C+ (79)
Principle 2: The board should ensure that key stakeholders are identified and, where appropriate, stakeholder feedback is regularly solicited to evaluate whether corporate policies meet key stakeholders' needs and expectations.	B- (80)	B (86)	B- (81)
Principle 3: Board members should act in the best interest of the company and the shareholders while balancing the interests of other key external and internal stakeholders.	B- (83)	B (85)	B- (80)
Principle 4: The board should ensure that the company maintains a sustainable strategy focused on long-term performance and value.	C+ (77)	C+ (79)	C (75)
Principle 5: The board should ensure that the culture of the company is healthy, regularly monitor and evaluate the company's core culture and values, assess the integrity and ethics of senior management, and, as needed, intervene to correct misaligned corporate objectives and culture.	B (85)	B (86)	B- (82)
Principle 6: The board should ensure that structures and practices exist and are well-governed so that it receives timely, complete, relevant, accurate, and reliable information to perform its oversight effectively.	C+ (79)	C+ (79)	C+ (78)
Principle 7: The board should ensure that corporate disclosures are consistently transparent and accurate, and in compliance with legal requirements, regulatory expectations, and ethical norms.	B (84)	B (85)	B (83)
Principle 8: Companies should be purposeful and transparent in choosing and describing their key policies and procedures related to corporate governance to allow key stakeholders an opportunity to evaluate whether the chosen policies and procedures are optimal for the specific company.	B (84)	B (85)	B (83)

About the ACGI

The ACGI, now in its third year, is a collaborative effort by The Institute of Internal Auditors and the Neel Corporate Governance Center. It surveyed 86 chief audit executives (CAEs) of publicly listed U.S. companies on how well their organizations performed on meeting eight Guiding Principles of Corporate Governance (see the box on previous page). The results can help boards, audit committees, and other stakeholders gain perspective on common governance problem areas.

The index is based on responses to a survey of CAEs or those best positioned for an independent, unbiased, and enterprisewide assessment of a company's governance practices. The Guiding Principles are based on a compendium of relevant guidance and principles advanced by experts in the field. The index gauges the extent to which companies are effectively achieving each of the Guiding Principles. It goes beyond the publicly observable aspects of corporate governance to provide an internal perspective on the effectiveness of corporate governance throughout the organization.

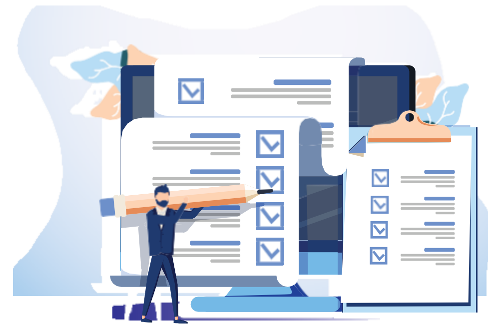
[1] *2021 U.S. Shareholder Activism Review,* Sullivan & Cromwell LLP, December 20, 2021.

[2] *"Boards Can Prepare for Expected Wave of Activism,"* Chris Ruggeri, Maureen Bujno, Joel Schlachtenhaufen, and Annie Adams, *The Wall Street Journal CFO Journal.*

[3] *NACD 2022 Governance Outlook,* 2021.

[4] *"Recent Shareholder Activism Trends,"* Shearman & Sterling LLP, posted on Harvard Law School Forum on Corporate Governance, November 29, 2021.

[5] *Institutional Investor Survey 2021,* Morrow Sodali, May 11, 2021.



Quick Poll Question

Given the effects of the pandemic, how has the quality of corporate governance fared in your organization in the past year?

- ◯ Improved
- ◯ Unchanged
- ◯ Worsened
- ◯ Don't know

Visit www.theiia.org/Tone to answer the question and learn how others are responding.

QUICK POLL RESULTS

Is corporate governance in your organization healthy enough to manage new risk challenges, such as ESG?

15%	We do not manage
9%	I don't know
54%	We may struggle a bit
23%	Yes, absolutely

Source: Tone at the Top December 2021 Survey.