Section 3: Corporate Governance

In this section, we describe and explain how the financial aspects of the firm’s corporate governance system work. As mentioned in the Introduction, we focus on how the interests of senior executives are aligned with the interests of shareholders through the firm’s executive compensation system. We also look at the market performance of the firm in terms of the shareholders’ total return (dividends and stock price appreciation) and performance relative to competitors and market indices like the S&P 500 and the NASDAQ indices.

The board of directors provides the link between the company’s shareholders and the managers who control the company on the shareholders’ behalf. Directors are elected to the board at the annual shareholders’ meeting. Once elected, the responsibilities of board members are typically defined in terms their committee assignments.

For example, Cisco Systems has eight standing committees:

- The Compensation/Stock Option Committee
- The Executive Committee
- The Nomination Committee
- The Audit Committee
- The Investment/Finance Committee
- The Special Stock Option Committee
- The Special Acquisition Committee

As we can see from this list of board committees, corporate governance is a broad topic. In this section, we will focus on the responsibilities of the Compensation/Stock Option Committee. A description of the other seven committees is included as an appendix at the end of this section introduction.
The Compensation/Stock Option Committee (hereafter, Compensation Committee) is responsible for reviewing the compensation arrangements in effect for the Company's executive officers and for administering all the Company's employee benefit plans. This committee has three members – all outside directors.

From an overall financial perspective, the Compensation Committee plays a crucial role in the corporate governance process. The Committee is responsible for linking the financial interests of senior executives with the financial interest of shareholders.

As part of the corporate governance process, the Compensation Committee must develop a plan for converting the firm’s business strategy into the compensation (financial rewards) to be received by senior executives. The input-processing-output approach to corporate governance is presented below.

Instead of referring to the output of corporate governance as executive compensation, we use the term “financial rewards.” If the Compensation Committee has developed a sound executive compensation plan, then the financial rewards accruing to senior executives should be consistent with the financial rewards accruing to shareholders in the form of dividends plus stock price appreciation.

In Chapter14, we describe how the executive compensation plan works at Cisco Systems. In particular, we focus on the CEO’s annual compensation - cash compensation and stock options. We then link the CEO’s cash
compensation and stock options to the stock they actually own in the form of an executive compensation/ownership worksheet.

In Chapter 15, we describe how financial rewards accrue to the shareholders. We focus on the information presented in the stock performance graph included in the proxy statement. We then expand on the stock performance information provided by management by introducing market-based information from the Value Line Investment Survey and information from financial analyst reports on the company.

By the end of Section Three, we will have completed our first journey around the business strategy-management control-corporate accountability loop. Hopefully, this journey will put us in a good position to take another journey around the loop with another company.

Appendix¹

Committees of the Board of Directors

The Executive Committee’s duties include anything permitted by law to be performed by the Board of Directors that does not require the full Board. This committee has three members – the chairman of the board, the vice-chairman, and the chief executive officer (CEO). The Executive Committee provides the most direct link to executive management team of the corporation.

The Nomination Committee is responsible for nominating new members to be considered for the Board of Directors. This committee has three members – the CEO and two outside directors.

The Audit Committee is responsible for reviewing the Company’s financial procedures and controls and for selecting and meeting with the independent accountants. This Committee held four meetings during the last fiscal year. This committee has three members – all outside directors. In Chapter 1, we mentioned that the role of the audit was highlighted as part of the Statement of Management’s Responsibility for the Financial Statements. “Through its Audit Committee, the Board of Directors reviews the company’s accounting practices and financial reports.”
The Special Stock Option Committee has concurrent authorization with the Compensation/Stock Option Committee to make option grants to eligible individuals other than executive officers of the Company. This committee has three members – The chairman of the board, the CEO, and one outside director.

The Investment/Finance Committee reviews and approves the Company's investment policy, real estate acquisitions and leasing, and currency, interest rate and equity risk management policies. The committee also reviews minority investments, fixed income assets and insurance management policies and programs. This committee has four members – the chairman of the board and three outside directors.

The Acquisition Committee reviews acquisition strategies and candidates with management, approves acquisitions and also makes recommendations to the Board of Directors. This committee has four members – the chairman of the board, the CEO, and two outside directors.

The Special Acquisition Committee reviews acquisition strategies and candidates with the management, approves acquisitions valued below a certain dollar threshold and also makes recommendations to the Board of Directors. This committee has three members – the CEO and two outside directors.