american corporate governance index

Failure to Make the Grade

The Institute of Internal Auditors

THE UNIVERSITY OF TENNESSEE KNOXVILLE

NEEL CORPORATE GOVERNANCE CENTER

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Introduction

Corporate governance encompasses all aspects of how an organization is directed and managed — the system of rules, practices, processes, and controls by which it operates. As a result, corporate governance is unique to each organization.

This distinctiveness is part of the reason why many companies may resist legislation and regulations that dictate how they should be run. Indeed, at the heart of the American success story is a free-market system that rewards hard work, ingenuity, innovation, and shrewd decision-making. But that entrepreneurial story must continue to evolve if the United States expects to remain among the world's preeminent economic powers.

Companies are under increasing pressure from investors, regulators, and special-interest groups to demonstrate value and sustainability, particularly in the context of environmental, social, and governance (ESG) metrics. Indeed, sustainable investment in the United States reached nearly $12 trillion in 2018, which accounted for 25.7% of the nation's total assets under management, according to the Global Sustainable Investment Alliance.[1] Investors are seeking assurance that companies are providing not only accurate and transparent accounting of their finances, but are acting ethically while meeting objectives that align with the needs and interests of stakeholders.

A number of well-established indices offer short-term insight into economic performance, consumer confidence, and other aspects of business. Examination of financial reporting and accounting also are well understood. But what is lacking is a comprehensive measure — an index — of the state of American corporate governance, one that examines the effectiveness of interaction between key stakeholders, the board, executive management, internal audit, and others. An index that gauges whether the board and management are acting in the best interest of the company, whether there is a vision toward sustainability, a healthy culture, transparent and accurate disclosures, and effective policies and structures. The Institute of Internal Auditors (IIA) and the Neel Corporate Governance Center at the University of Tennessee, Knoxville's Haslam College of Business have answered the call and are proud to present the inaugural American Corporate Governance Index (ACGI).

[1] *Global Sustainable Investment Alliance Global Sustainable Investment Review 2018.*

Guiding Principles of Corporate Governance

The Guiding Principles of Corporate Governance define core actions and responsibilities that promote successful, ethical, and sustainable corporate governance. They go beyond the publicly observable measures of corporate governance, such as the number of board meetings, biographical information for directors, and executive compensation disclosures, which alone fail to capture the effectiveness of an organization's corporate governance system. Prescriptive solutions have not been proposed because corporate governance does not allow for a one-size-fits-all approach and companies will need to find their own best practices based on the company's age, size, complexity, extent of international operations, etc. The following Guiding Principles reflect a compendium of viewpoints from sources cited in the References section on page 29.[2] Companies should seek legal advice before implementing specific corporate governance policies and procedures to ensure compliance with applicable laws and regulations, including securities exchange listing requirements.

DEFINITION

Corporate governance is the overarching set of policies, procedures, and relationships that enables an organization to establish objectives, set ethical boundaries to the acceptable means with which those objectives will be met, monitor the achievement of objectives, reward successful achievements, and discipline unsuccessful or inappropriate attempts to meet objectives, in order to keep the organization aligned with the needs and interests of its primary stakeholders.

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.

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.

- *Key stakeholders can change over time, and as such, boards should ensure processes are in place to regularly monitor the identification of key stakeholders.*
- *Key stakeholders are those who have a material impact on corporate operations, or on whom the corporate operations have a material impact.*
- *Stakeholders can be external or internal and include communities affected by the company's operations, creditors, customers, employees, regulators, shareholders, suppliers, etc.*
- *When evaluating business success, the company should also evaluate its social and environmental impact and determine whether it aligns with corporate objectives and the interests of key stakeholders.*

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.

- *The board should exhibit sufficient independence and objectivity in fact and appearance. There should be a clear form of leadership for the board that is distinct from management. Each board member should employ healthy skepticism in meeting his or her responsibilities and be willing to challenge the CEO and other board members constructively.*
- *Board members should exhibit high integrity and competence, and provide diverse perspectives in terms of industry expertise, technical expertise, culture, and thought.*
- *Board members should exhibit a commitment of time and active involvement, including preparation for and direct participation in appropriate board, committee, and shareholder meetings. They should be informed on relevant issues, particularly those involving potential or existing crises, and be available to consult with management, as needed.*
- *Board members should receive ongoing education and training to perform their responsibilities, including areas of emerging risk to the company.*
- *Board members should be compensated in a way that encourages alignment with key stakeholder interests.*
- *Executive sessions should be held regularly and often, as they are critical in establishing an appropriate environment of objectivity and candor. These sessions should include independent directors and those outside directors who do not qualify as independent, but exclude members of management.*
- *The board should undergo regular, robust evaluations and, as needed, members should be rotated (including leadership positions within the board) to ensure a balance of company-specific knowledge and new perspectives. Effective board evaluations should lead to improved governance and corporate outcomes.*
- *Shareholders should have fair opportunities to nominate and regularly vote on the retention of board members.*

Principle 4

The board should ensure that the company maintains a sustainable strategy focused on long-term performance and value. This includes:

- *Defining corporate objectives and approving long-term strategic goals.*
- *Evaluating risks, including reputational risks, and seeking to balance risk and reward after considering all relevant stakeholders.*
- *Designing management compensation to align with long-term strategic goals, regularly evaluating performance of the CEO, and overseeing management succession planning.*
- *Ensuring that all employees receive adequate training and are compensated in a way that encourages achievement of corporate objectives.*

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.

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.

- *Each board member should have unrestricted access to management, as needed, to fulfill their responsibilities.*
- *Board members have a responsibility to protect the confidentiality of non-public information.*

Principle 7

The board should ensure corporate disclosures are consistently transparent and accurate, and in compliance with legal requirements, regulatory expectations, and ethical norms.

- *The board should ensure that an independent committee (an Audit Committee or equivalent) with appropriate expertise is responsible for oversight of both internal and external auditors. Internal audit should have direct and unfiltered access to this committee; it should be adequately resourced; and its purpose, authority, and responsibility should be formally defined and consistent with the* International Standards for the Professional Practice of Internal Auditing.
- *The board should oversee the company's assessment of the risk of fraud specifically and ensure that adequate controls are in place to detect and deter fraud.*
- *The board should have in place processes for employees or other stakeholders to report suspected fraud or misconduct to independent members of the board without fear of retaliation.*

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.

- *The board should ensure that the company regularly evaluates the full system of corporate governance to ensure that individual components are operating as expected, and that all components operate in a cohesive manner to achieve corporate objectives.*
- *The board should ensure that corporate governance evaluations encourage the reporting of potential deficiencies at all levels, including within the board, without fear of retaliation.*
- *The board should ensure that the company addresses any deficiencies in a timely manner.*

[2] *Individual quotations and citations are not provided since the intention is to create a summarized set of viewpoints from multiple sources.*

"Is the board getting the full spin on the issue? Or are they getting what management wants them to see?"

Corporate Governance Roles

THE BOARD

- Establishes the organization's tone at the top by setting the risk appetite and ethical boundaries.
- Provides strategic oversight for long-term value creation that keeps the organization aligned with the needs and interests of its primary stakeholders.
- Remains sufficiently informed to provide effective oversight of executive management's activities.
- Holds executive management to account when it fails to meet stated goals and objectives, strays beyond the stated risk appetite, or fails to operate within set ethical boundaries.
- Ensures internal audit is sufficiently resourced and independent from management so that it provides objective assurance and insight.

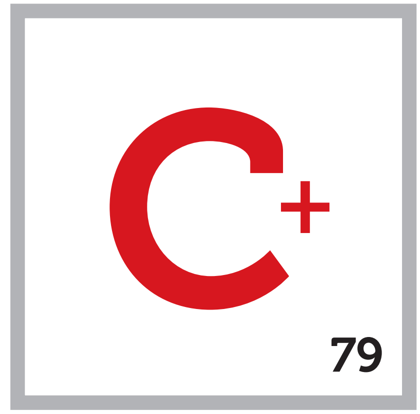
EXECUTIVE MANAGEMENT

- Sets policies and procedures, and establishes relationships that enable the organization to identify, articulate, and meet objectives.
- Establishes and executes strategies, develops budgets, and delegates responsibilities to meet short- and long-term goals that lead to value creation.
- Monitors the achievement of objectives, rewards or mitigates results, and disciplines unsuccessful or inappropriate behavior.
- Keeps the board fully informed on the status of goals and objectives and of risks (internal and external) that could affect the likelihood of achieving goals and objectives.

INTERNAL AUDIT

- Has a chief audit executive (CAE) who reports directly to the Board of Directors, is independent of management, and acts as a resource for the board and executive management by providing objective assurance and insight.
- Enhances and protects organizational value by providing risk-based and objective assurance, advice, and insight.
- Improves operations and supports the achievement of the organization's objectives through an objective, systematic, and disciplined approach.
- Brings a cross-functional, enterprisewide perspective to evaluate and improve the effectiveness of risk management, control, and governance processes.

Corporate Governance in 2019

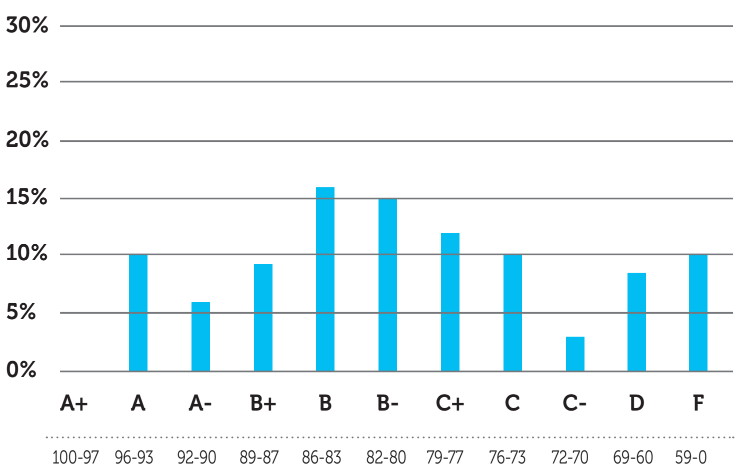


At first blush, an overall ACGI grade of C+ (79) might provide some level of comfort that U.S. companies are slightly above average in corporate governance. But American business has never been about being average. To be sure, the ACGI and its Guiding Principles of Corporate Governance are designed to foster the highest level of corporate governance, which should be the aspirational goal of every organization.

While many popular measures of economic health, such as stock indices, may hover at or near record highs, they offer only a short-term outlook and fail to reflect a more holistic, long-term view of endurance and sustainability. The ACGI gauges the extent to which companies are effectively achieving each of the Guiding Principles. Any rating less than the highest standard, an A+, reflects some level of corporate governance deficiency. It may be beneficial to consider the ACGI rating similar to the way one would consider a restaurant health inspection report. While C+ may be a "passing" score, it is not one that engenders trust in the way food is prepared or handled at the restaurant.

Notably, there is significant variation in the overall assessment of corporate governance effectiveness across organizations (Figure 1). The survey found only 16% of participating companies received a score of A- or better (90 or above) and 10% failed (below 60). That suggests fewer than 2 in 10 companies deliver effective corporate governance at the highest levels, and 1 in 10 has very low-quality governance. The inaugural ACGI survey provides a valuable baseline on the state of corporate governance. It identifies some positive areas, including regulatory compliance, culture, and the value of board independence, as well as areas in need of significant improvement, such as incentivizing long-term strategies.

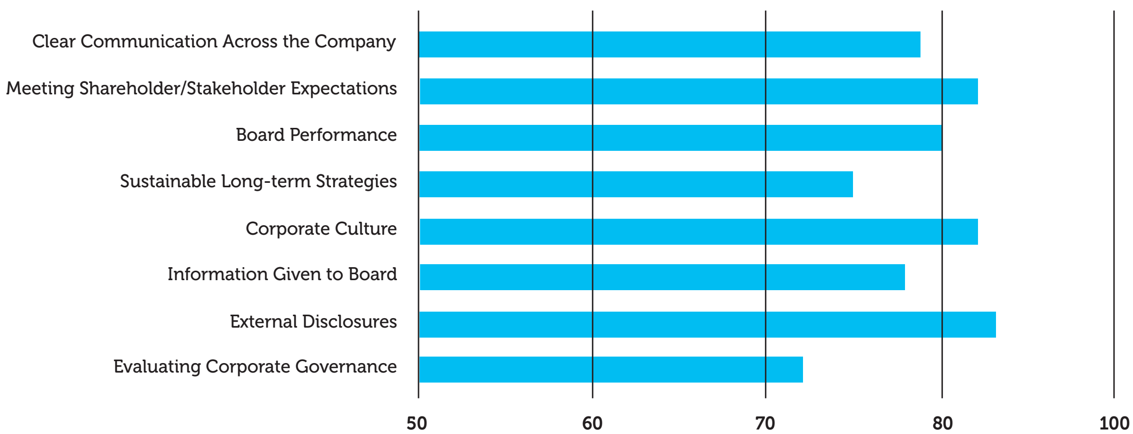
FIGURE 1: DISTRIBUTION OF ACGI SCORES BY LETTER GRADE (n=128)



Observations

The ACGI survey asked a series of questions relating to the eight Guiding Principles of Corporate Governance. Results (Figure 2) reveal variation in corporate governance effectiveness, with scores clustered in the B to C- range.

FIGURE 2: RATINGS FOR GUIDING PRINCIPLES



American organizations tend to do better, albeit not ideally, when it comes to transparency and accuracy of external disclosures. This area received a B (83), the highest score among the Guiding Principles measured.

Meanwhile, corporate culture received a B- (82). While this might seem encouraging at the surface, it still leaves significant room for improvement, consistent with calls from The IIA and other professional organizations for boards to place an increased focus on culture.

The lowest-scoring principles were in maintaining sustainable long-term strategies (C, 75), and evaluating corporate governance (C-, 72). Many of the lowest ratings for individual questions posed to survey respondents came in these two vital areas. The pressure for short-term gains was reflected in answers provided by survey respondents, as well as the poor showing of how companies evaluate corporate governance. The survey found that less than one-quarter of companies formally assess the full system of corporate governance on an annual basis. Evaluations that are either too infrequent or too narrow can easily miss warning signs of potential governance breakdowns.

Perhaps the most troubling finding surrounding board performance relates to the oversight of management, specifically the extent to which board members are willing to offer opinions that are contradictory to or conflict with those of the CEO. When presented with specific scenarios in which the CEO wants to delay reporting negative news, respondents believed that only 64% of board members at their company would push back on the CEO, meaning more than one-third (36%) of board members would not. Similarly, CAEs gave a D (67) to the issue that board members should be asking whether information presented to them is accurate and complete.

Key Findings

In this section, we discuss seven key findings gleaned from analysis of elements examined in the Principles.

10 PERCENT OF INDEX COMPANIES SCORED AN F.

A disturbing number of organizations rated as failing. It can be safely assumed that corporate governance in these organizations is fundamentally flawed or rates so poorly in one or two Principles that it pulls down the overall score. In either instance, 1 in 10 publicly traded companies suffers from significant corporate governance dysfunction. This is bound to be a drag on the nation's economic health and potentially contribute to other problems stemming from poor corporate governance, including unethical behavior; an imbalance in the roles of the board, executive management, and internal audit; and a fixation on short-term gains.

KEY FINDINGS

10 percent of Index companies scored an F.

Many companies are willing to sacrifice long-term strategy in favor of short-term interests.

More than one-third of board members are not willing to offer contrary opinions or push back against the CEO.

Boards fail to verify the accuracy of information they receive.

Independent boards drive stronger governance.

Companies are vulnerable to corporate governance weaknesses or failures.

Regulation does not correlate with stronger governance.

MANY COMPANIES ARE WILLING TO SACRIFICE LONG-TERM STRATEGY IN FAVOR OF SHORT-TERM INTERESTS.

A problematic focus on the short term is reinforced by a second finding related to Principle 4, which states, "The board should ensure that the company maintains a sustainable strategy focused on long-term performance and value." Respondents lacked confidence in their company's ability to remain committed to a long-term strategy. They also expressed concern about whether employees receive adequate training to complete expected job duties, which rated the fifth-lowest score among individual questions.

MORE THAN ONE-THIRD OF BOARD MEMBERS ARE NOT WILLING TO OFFER CONTRARY OPINIONS OR PUSH BACK AGAINST THE CEO.

A possible contributor to why organizations sometimes succumb to short-term interests is that a significant percentage of board members are unwilling to challenge the views of the CEO. More than one-third would acquiesce to a hypothetical CEO who wants to delay reporting negative news.

BOARDS FAIL TO VERIFY THE ACCURACY OF INFORMATION THEY RECEIVE.

Worse yet, CAEs gave a D (67) to board members asking whether information presented to them is accurate and complete. The IIA's recently released report, *OnRisk 2020: A Guide to Understanding, Aligning, and Optimizing Risk*, offers further insight into the quality of board information. Organizations' ability to provide information that is complete, timely, transparent, accurate, and relevant was rated lower by CAEs than by executive management or the board.

INDEPENDENT BOARDS DRIVE STRONGER GOVERNANCE.

One ACGI finding offers positive news on the value of board independence. While no significant difference in ACGI scores was found based on whether the company's CEO also serves as Chairman of the Board (Figure 5), additional analysis establishes that the level of board independence does impact the association between CEO-Chairman duality and strength of governance. Specifically, ACGI scores are lower when CEO-Chairman duality is not compensated by high levels of board independence (Figure 6). Indeed, survey data shows that the ACGI score is stronger, on average, among companies with a higher percentage of independent board members.

COMPANIES ARE VULNERABLE TO CORPORATE GOVERNANCE WEAKNESSES OR FAILURES.

The worst performance, with an average score of C- (72), among the eight Principles was 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." This is at the heart of the finding that companies are vulnerable to corporate governance weaknesses or failures.

The majority of respondents reported no formal mechanism for monitoring or evaluating the full system of corporate governance. Fifty-five percent of companies "informally keep an eye on" various corporate governance components, but only 21% audit the full system of corporate governance on an annual basis. When corporate governance is formally evaluated, internal audit performs the evaluation about 75% of the time.

Pre-survey interviews with CAEs, which informed survey questions, suggested that when internal audit evaluates the full system of corporate governance, they consider many of the elements described in the Principles, with a heavy emphasis on the effectiveness of tone at the top, culture, communication, and proper alignment of incentives and corporate objectives.[3] CAEs also reported that, if the evaluation is not conducted by internal audit, it is most often done by the general counsel's office or under the direction of the nominating/governance committee, at which point it is more likely to be a compliance "check-the-box" exercise relative to listing exchange requirements and other laws and regulations.

REGULATION DOES NOT CORRELATE WITH STRONGER GOVERNANCE.

Overall, CAEs assigned the highest score, B (83), to Principle 7, which states, "The board should ensure that corporate disclosures are consistently transparent and accurate, and in compliance with legal requirements, regulatory expectations, and ethical norms."

It is perhaps not entirely surprising that respondents rated this element of corporate governance as one of the most effective, given declining rates of restatements, SEC comment letters, and other public disclosure deficiencies in recent years. The percentage of companies filing restatements of their financial statements declined from approximately 15% in 2006 to less than 7% in 2018.[4] The percentage of companies that received an SEC comment letter on a 10-K filing decreased from 37% in 2010 to 19% in 2016.[5]

However, conformance to regulatory disclosure should not be viewed as synonymous with good governance. This is the foundation for the final finding. The ACGI noted no statistically valid differences among industries that are minimally, moderately, or heavily regulated (Figure 11). The lack of correlation between regulation and corporate governance effectiveness is an area where additional research could provide important insights.

[3] See "Internal Audit's Role in the Evaluation of Corporate Governance: Evidence from the Field," a working paper by Lauren Cunningham, Christie Hayne, Terry Neal, and Sarah Stein. Unattributed quotes displayed in this report are excerpts from in-person interviews with CAEs provided by the Neel Center.

*[4] See Audit Analytics report **"2018 Financial Restatements: An Eighteen Year Comparison."***

[5] See "The SEC Filing Review Process: Insights from Accounting Research," a working paper by Lauren Cunningham and Jacob Leidner.


GUIDING
PRINCIPLES
OF CORPORATE GOVERNANCE

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.*

C+

79

PROGRESS REPORT

Clear communication across the company

Communications between each of the members of senior leadership are clear, actionable, and collaborative.	B-	80
Communications between senior leadership and the board are clear, actionable, and collaborative.	B-	82
Management structures are effective at getting the right information to the right decision-makers in a timely manner.	C	75

OPPORTUNITY FOR IMPROVEMENT:

The greatest area of concern related to Principle 1 is the extent to which management structures are effective at getting the right information to the right decision-makers in a timely manner. Boards must make a concerted effort to exercise professional skepticism with the information they receive and seek independent assurance on its completeness, timeliness, and accuracy.

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-

81

PROGRESS REPORT

Meeting shareholder/stakeholder expectations

The company considers a wide range of stakeholder interests when making business decisions.	B	83
There is a consensus among the board and senior leadership on who the key stakeholders are in your company.	B	86
In your daily jobs, you and other key leadership members are cognizant of the impact your corporate operations have on social and environmental issues and you are actively pursuing ways to minimize any negative impacts.	C	73
The company has not been subject to shareholder proposals, proxy advisor 'against' recommendations, 'vote no' campaigns, proxy fights, or shareholder litigation.	B-	80

OPPORTUNITY FOR IMPROVEMENT:

While organizations do fairly well in identifying stakeholders and considering their interests, the lowest score for Principle 2 relates to whether key leadership members are cognizant of the impact that corporate operations have on social and environmental issues and whether they are actively pursuing ways to minimize any negative impacts. As noted in the introduction, interest in ESG is growing among investors, regulators, and special-interest groups. Poor governance in this area could have a significant impact on organizations.

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-

80

PROGRESS REPORT

Board performance: Monitoring management

Your board has sufficient technical expertise to oversee areas of current or emerging risks.	C+	79
Board members present diverse perspectives when discussing issues.	B	83
Board members are compensated in a way that aligns with long-term strategic goals.	B	84
The board probes into sufficient detail for most topics.	C+	79
Your board members have the necessary time and attention needed to fulfill their responsibilities.	B	83
Your board conducts a thoughtful, robust evaluation of the entire board and/or individual board members on an annual basis.	C+	79
Your board commits, and follows through, to improve upon any weaknesses identified in the annual board and/or committee evaluations.	C+	79
Board members are not afraid to offer opinions that are contradictory to or conflict with those of the CEO.	C	75

OPPORTUNITY FOR IMPROVEMENT:

For Principle 3, the least effective element is the extent to which board members are willing to offer opinions that are contradictory to or conflict with those of the CEO. When presented with specific scenarios in which the CEO wants to delay reporting negative news, respondents believe that only 64% of board members at their company would push back on the CEO. To illustrate, on a board with 11 members, 64% means that seven members would push back on the CEO and four would not. This is particularly troubling in light of the findings on higher corporate governance scores related to board independence (Figure 7). Concerns about sufficient technical expertise of the board and whether the board probes into sufficient detail are consistent with results of *OnRisk 2020,* which finds that boards are overconfident in their organizations' capability to address risks, and that one possible explanation for this overconfidence is board members' failure to critically question information brought to them.

Principle 4

***The board should ensure** that the company maintains a sustainable strategy focused on long-term performance and value.*

C

75

PROGRESS REPORT

Incentivizing performance with sustainable long-term strategies

The company's objectives and long-term strategic goals are clearly communicated to, and well-known across the company.	C+	77
The board is willing to discipline and take corrective action when necessary by replacing key members of senior leadership and/or adjusting compensation structures.	C+	78
Your company is not willing to sacrifice long-term strategy for the benefit of short-term interests.	D	67
Your company has sufficient resources (time and money) to appropriately respond to crises or disruptions as they arise, without cutting corners or sacrificing long-term performance.	C	76
Employees receive adequate training to complete expected job duties.	C-	70
Employees are compensated and/or incentivized in a way that encourages the achievement of corporate objectives in an ethical manner.	B	83

OPPORTUNITY FOR IMPROVEMENT:

In Principle 4, respondents identified two key areas needing improvement: the company's willingness to avoid sacrificing long-term strategy for the benefit of short-term interests, and the extent to which employees receive adequate training to complete expected job duties. Successfully addressing these issues falls primarily on senior management, but boards also must reinforce their commitment to long-term performance and value.

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-

82

PROGRESS REPORT

Corporate culture

Your board and CEO embody a strong "tone at the top" in your organization that would pass any ethical test.	A-	91
Your board consciously thinks and talks about the company's culture.	C	74
"Tone at the top" is communicated to and consciously embodied across all levels of the company.	C+	78
The company has not been accused of ethical issues (e.g., sexual harassment, unfair working conditions, environmental issues, etc.)	B+	87
Management would take appropriate action if a policy, procedure, or workplace rule violation was detected.	B	83

OPPORTUNITY FOR IMPROVEMENT:

The least effective element of Principle 5 is the extent to which the board consciously thinks and talks about the company's culture. Respondents are reasonably confident that the board and senior leadership embody appropriate "tone at the top," but they have less confidence that the tone is maintained at lower levels or across geographic locations.

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+

78

PROGRESS REPORT

Information given to the board

Your board does not prefer for management to handle bad news on their own; nor do they prefer that management selectively report information to the board to protect the board's potential liability.	C+	77
Your board members ask whether the information presented to the board is accurate and complete.	D	67
Your CEO does not heavily filter or water down "bad" news before it goes to the board.	B-	81
Board members are given all the necessary information for effective oversight.	B+	87
Board members are given sufficient time to thoughtfully review all materials prior to board meetings.	B+	87
The board protects proprietary information given to the board.	D	69

OPPORTUNITY FOR IMPROVEMENT:

For Principle 6, the least effective element is the extent to which board members ask whether the information presented to the board is accurate and complete. Additionally, 9% of respondents acknowledged that, in the preceding 12 months, there has been a cybersecurity breach related to information given to the board; and only 47% of respondents believe that their boards are required to use either corporate emails or board portals to protect proprietary company information. This is a particularly troubling finding in the era of rampant cyberattacks and an increasing focus on data protection. Although not addressed directly in our survey, to the extent that management is concerned about the boards' loose protection of company information, managers may consciously or subconsciously withhold certain relevant information from the board.

Principle 7

The board should ensure *corporate disclosures are consistently transparent and accurate, and in compliance with legal requirements, regulatory expectations, and ethical norms.*

B

83

PROGRESS REPORT

External disclosures

Public information is accurate, adequate, complete, representative, timely, and transparent.	B+	89
Employees are familiar with how to report violations of law or policy.	C+	78
The internal audit function is adequately staffed, in terms of both the number of staff and expertise of the staff.	C+	77
Information submitted to hotlines or fraud reporting lines is followed through effectively.	A-	90
An officer or employee (all levels and locations) would be protected from retaliation for reporting a suspected violation of a policy, procedure, or workplace rule.	A-	90
The company has not been under investigation by the SEC or other governmental or regulatory authorities.	B+	87
The company has not experienced restatements, cybersecurity breaches, or unremediated material weaknesses or significant deficiencies.	C	73

OPPORTUNITY FOR IMPROVEMENT:

Despite being one of the most effective principles of governance, there are still areas of improvement for Principle 7. Respondents reported that they believe only 78% of employees (across all levels and locations) are familiar with how to report violations of law or policy. Respondents also expressed concern about whether the internal audit function is adequately staffed, in terms of both the number and expertise of staff.

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.*

C-

72

PROGRESS REPORT

Evaluating corporate governance

Corporate governance is regularly and consciously discussed in your company.	C	73
The board seeks out feedback on whether corporate governance is operating effectively at the company.	C-	72
The company formally evaluates the full system of corporate governance on a regular basis.	C-	70

OPPORTUNITY FOR IMPROVEMENT:

For Principle 8, all elements performed poorly. CAEs only weakly agreed that corporate governance is regularly and consciously discussed in their company. Respondents were also tepid in their confidence about the board's actions to seek stakeholder feedback on the effectiveness of corporate governance, and if the company formally evaluates the full system of corporate governance on a regular basis. Without effective evaluations, organizations can easily miss warning signs of weaknesses or vulnerabilities that can lead to governance breakdowns.

"I don't know how you change the tone (culture), but I look at prior generations and I don't think everyone was given severance agreements every time they committed fraud."

Additional Findings

To evaluate the extent to which the ACGI sample is potentially representative of the population of U.S. publicly traded companies, the survey group was compared with all publicly traded companies, along the dimensions of company size (revenue), industry, and publicly observable corporate governance features.

That comparison found that corporate governance scores are, on average, higher for larger companies (Figure 3), which may be due to access to additional resources and more mature governance structures in place. This is an area where additional research could provide important insights. The ACGI did not identify any significant differences among industry groupings, though companies in Trade, Accommodation, and Food industries scored lower than any other industry (Figure 4).

FIGURE 3: COMPANY SIZE (TOTAL REVENUE)

	POPULATION	SURVEY	ACGI
< $100 million	25%	2%	70
$100 m - $1 billion	36%	24%	77
$1 - 10 billion	31%	51%	79
> $10 billion	8%	23%	82

Note about differences: The average ACGI for the > $1 billion companies is statistically higher than the companies with < $1 billion in revenues (one-tailed p-value < 0.10). Additionally, the average ACGI for the > $10 billion companies is statistically higher than the companies with < $10 billion in revenues (one-tailed p-value < 0.10).

FIGURE 4: INDUSTRY

	POPULATION	SURVEY	ACGI
Financial	20%	32%	79
Manufacturing	35%	25%	79
Trade, Accommodation, and Food	9%	10%	74
Transportation and Utilities	5%	13%	78
Other	31%	20%	81

Note about differences: The average ACGI for the industries are not statistically different from one another, except for Trade, Accommodation, and Food, which is statistically lower than all other industries surveyed.

The existence of a CEO-Chairman duality was considered in light of a continuing push from investors to separate these roles. Board independence and number of board meetings also were considered. These are common items of discussion among proxy advisors when making voting recommendations on board elections, and something that is prescribed by listing exchange requirements for certain committees.

Contrary to concerns about CEO-Chairman duality, no significant differences in ACGI scores were found based on whether the company's CEO also serves as Chairman of the Board (Figure 5). As noted in the findings section, additional analysis found that the level of board independence does impact the association between CEO-Chairman duality and ACGI scores. Specifically, ACGI scores are lower when CEO-Chairman duality is not compensated by high levels of board independence (Figure 6).

FIGURE 5: PUBLICLY OBSERVABLE ASPECTS OF CORPORATE GOVERNANCE: CEO-CHAIRMAN DUALITY

	POPULATION	SURVEY	ACGI
Dual CEO-Chairman	29%	38%	80
Separate CEO-Chairman	71%	62%	78

Note about differences: The average ACGI for dual CEO-Chairman is not statistically different from separate CEO-Chairman. Caution should be taken if trying to conclude that one group is different from the other.

FIGURE 6: PUBLICLY OBSERVABLE ASPECTS OF CORPORATE GOVERNANCE: CEO-CHAIRMAN DUALITY

	POPULATION	SURVEY	ACGI
Dual CEO-Chairman without a compensating Independent Board	10%	11%	74
CEO-Chairman compensated by an Independent Board	19%	27%	83
Separate CEO-Chairman	71%	62%	78

Note about differences: The average ACGI for dual CEO-Chairman without a compensating Independent Board is statistically lower than the dual CEO-Chairman compensated by an Independent Board and the separate CEO-Chairman (one-tailed p-value < 0.05). Here, a board is considered to have compensating board independence when board independence is greater than the population median (86%) or when the respondent identifies a Lead Independent Director.

Survey data shows that the ACGI score is stronger, on average, among companies with a higher percentage of independent board members (Figure 7), but does not vary significantly with the number of meetings held per year (Figure 8).

FIGURE 7: PUBLICLY OBSERVABLE ASPECTS OF CORPORATE GOVERNANCE: BOARD INDEPENDENCE

	POPULATION	SURVEY	ACGI
High % of Independent Members	50%	59%	80
Low % of Independent Members	50%	41%	77

Note about differences: We split the sample using the median percentage of independent board members from the population for fiscal year 2018 (86%). The difference in average ACGI scores between the high and low groups is statistically significant (one-tailed p-value < 0.10).

FIGURE 8: PUBLICLY OBSERVABLE ASPECTS OF CORPORATE GOVERNANCE: NUMBER OF BOARD MEETINGS PER YEAR

	POPULATION	SURVEY	ACGI
4 meetings per year	37%	34%	77
5 – 7 meetings per year	52%	46%	79
8 or more meetings per year	11%	20%	81

Note about differences: The average ACGI is not statistically different across categories related to the number of board meetings. Caution should be taken if trying to conclude that one group is different from another.

A number of non-public aspects of corporate governance were also considered.

Results show corporate governance is stronger for companies where the administrative reporting line for internal audit is directly to the CEO, with no potential filtering from other members of senior management (Figure 9). Second, perhaps not surprisingly, companies score significantly lower in the ACGI when their reporting structures are moderately or highly complex (Figure 10). This is an area where additional research could provide important insights.

FIGURE 9: NON-PUBLIC ASPECTS OF CORPORATE GOVERNANCE: ADMINISTRATIVE REPORTING LINE FOR INTERNAL AUDIT

	SURVEY	ACGI
CEO	21%	82
CFO	57%	78
General Counsel	8%	77
Other	14%	NA

Note about differences: The average ACGI for companies where the CAE reports administratively to the CEO is statistically higher than the average ACGI for companies where the CAE reports administratively to the CFO or General Counsel (one-tailed p-value <0.10)." An index score is not provided for "Other" because it comprises disparate groups.

FIGURE 10: NON-PUBLIC ASPECTS OF CORPORATE GOVERNANCE: MANAGEMENT REPORTING STRUCTURE

	SURVEY	ACGI
Fairly Simple: If a material issue were to arise, it could be escalated to the CEO very quickly, within a matter of one or two reporting lines	79%	80
Moderately Complex: If a material issue were to arise, it would take a little longer to get to the CEO; several reporting lines would be involved, but it would be straightforward to know how to escalate	17%	78
Highly Complex: If a material issue were to arise, it would require complex navigation of reporting lines to get to the CEO	4%	69

Note about differences: The average ACGI for Fairly Simple reporting structures is statistically higher than the average ACGI for Moderately Complex and Highly Complex reporting structures (one-tailed p-value < 0.10).

Finally, we considered the extent of regulation and foreign operations. There is no significant variation in the ACGI based on the extent of regulation under which the company operates (Figure 11) or the extent of operations outside of the U.S. (Figure 12). As noted earlier, the lack of correlation between regulation and corporate governance effectiveness is an area where additional research could provide important insights.

FIGURE 11: EXTENT OF REGULATION

	SURVEY	ACGI
Minimally	16%	80
Moderately	35%	79
Heavily	49%	79

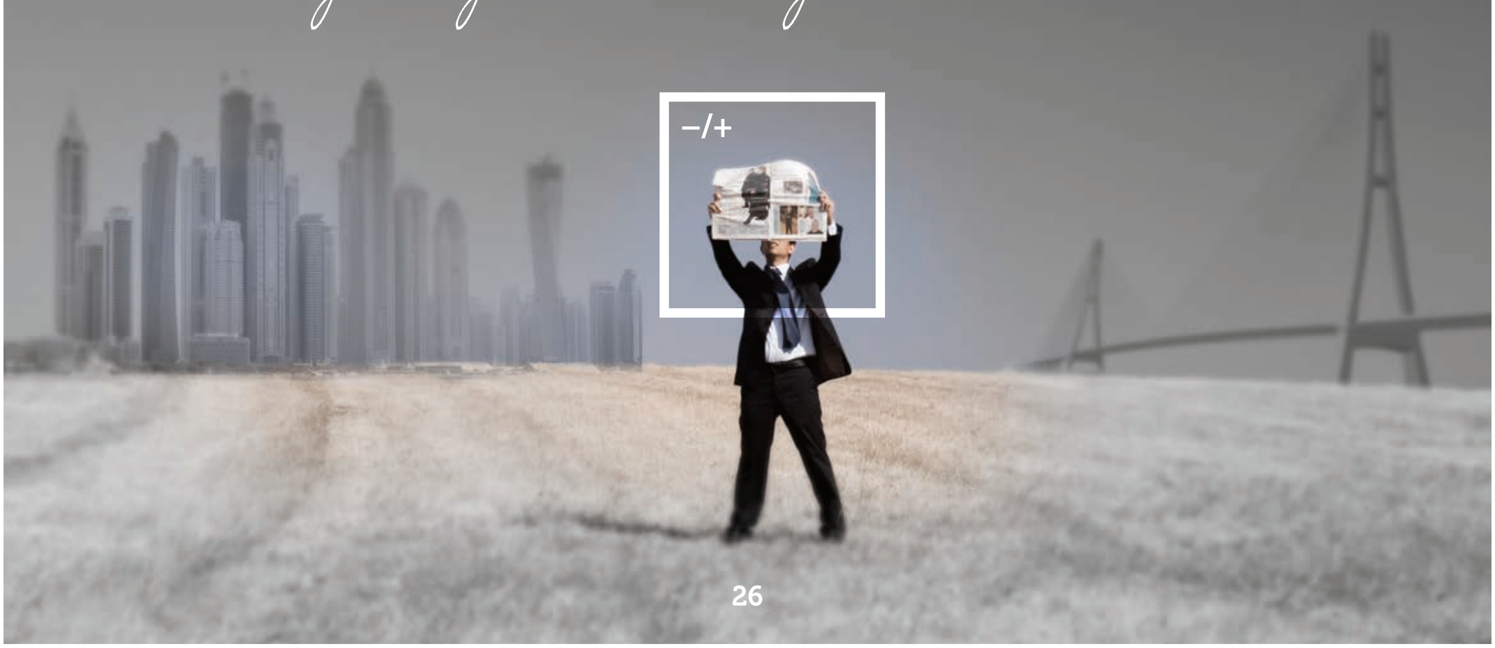
Note about differences: The average ACGI is not statistically different across categories related to the extent of regulation. Caution should be taken if trying to conclude that one group is different from another.

FIGURE 12: EXTENT OF OPERATIONS OUTSIDE OF THE U.S.

	SURVEY	ACGI
We do not operate outside of the U.S.	30%	78
Minimally	20%	79
Moderately	18%	80
Heavily	32%	78

Note about differences: The average ACGI is not statistically different across categories related to the extent of foreign operations. Caution should be taken if trying to conclude that one group is different from another.

"How does the board feel when all this information is presented to them and the reality is, they don't necessarily understand it all?"



Survey Participants

The ACGI provided screening questions in the survey to ensure that each participant represented a publicly traded company and that each respondent personally had direct access to the board and/or audit committee. Of those participants that met the screening criteria, 143 surveys were attempted, and 129 of those were completed. One participant did not answer a sufficient number of questions to generate an Index score, resulting in a final sample of 128 survey respondents. The survey was conducted from August 5, 2019, through September 22, 2019. The information below provides more information about the ranges of experience levels and types of organizations represented by the participants who completed the survey.

PARTICIPANT DEMOGRAPHICS

- ***10.3 years*** *of direct access to the board and/or audit committee*
- ***50 years*** *of age*
- ***57%*** *male*

Self-assessment of Corporate Governance Quality

In addition to questions that are the basis for the ACGI score, survey respondents were asked to:

1) *Consider how an external peer reviewer would report on their own corporate governance quality (scoring from 1 – 100).*

2) *Report how they perceive their corporate governance quality compares with peer companies.*

The score respondents believe a peer reviewer would assign their organization an average of 78. Overall, respondents are optimistic about their corporate governance quality compared with their peers. Fifty-eight percent believe their company's peer review score would be higher, or significantly higher, than their peers, while only 15% believe their company's peer review score would be lower, or significantly lower, than their peers.

FIGURE 13: SELF-ASSESSMENT OF CORPORATE GOVERNANCE QUALITY

	%	ACGI
Significantly lower than my peers	2%	42
Lower than my peers	13%	68
The same as my peers	27%	76
Higher than my peers	48%	83
Significantly higher than my peers	10%	89

Index Methodology

The ACGI is designed to be a reliable barometer of American corporate governance and to provide insight into how companies perform in key areas based on Guiding Principles of Corporate Governance, developed in partnership between the Neel Corporate Governance Center and The IIA. These Principles are based on a compendium of relevant guidance and principles advanced by experts in the field, including the National Association of Corporate Directors (NACD), the New York Stock Exchange, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the Business Roundtable, the Investor Stewardship Group, UT's Neel Corporate Governance Center, The IIA, and others.

CAEs are uniquely positioned to provide an independent and objective enterprisewide perspective of the organization. The ACGI itself is calculated using responses to a Principles-based governance survey of chief audit executives (CAEs) at companies listed on U.S. stock exchanges. Survey respondents answered questions anonymously by indicating their level of agreement or disagreement with specific statements and scenarios.

The questions and scenarios were developed based on in-depth interviews with leading CAEs and built around the Guiding Principles of Corporate Governance. A key tenet underlying the ACGI and the accompanying Guiding Principles is that corporate governance affects a company not only in the boardroom or C-suite, but throughout the organization. The more that companies increase their scale and geographic reach, the more difficult it is for boards and executive leadership to directly guide and oversee corporate governance across all levels of the organization. Therefore, questions are designed to capture the effectiveness of corporate governance enterprisewide. Responses to each question are combined to form an aggregate score using a scale of 0 – 100, which is then translated into a letter grade of A through F. The score for each principle is an equal-weighted average of each of the sub-principles, or elements.

This year's inaugural index is based on survey responses from 128 experienced CAEs working in companies of various sizes, complexities, and industries.

The IIA and the Neel Corporate Governance Center are committed to conducting the survey annually, providing an unbiased examination of the data, and sharing insights about the factors that influence corporate governance over time.

Guiding Principles
of Corporate Governance References

"Corporate Governance: An Overview of Public Company Requirements" (2011), by Morgan Lewis.

"Corporate Governance Principles for US Listed Companies" (2018), by Investor Stewardship Group.

"Enterprise Risk Management—Integrating with Strategy and Performance" (2017), by COSO.

"G20/OECD Principles of Corporate Governance" (2015), by Organisation for Economic Co-operation and Development (OECD), which comprises 20 countries/groups, including the U.S.

"Internal Auditing's Role in Corporate Governance" (2018), by The Institute of Internal Auditors.

"Internal Control — Integrated Framework" (2013), by Committee of Sponsoring Organizations of the Treadway Commission (COSO).

"It's Time to Adopt *The New Paradigm*" (2019), by Wachtell, Lipton, Rosen & Katz.

"Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies" (2011), by National Association of Corporate Directors (NACD).

"King IV Report on Corporate Governance for South Africa" (2016), by Institute of Directors in Southern Africa, a non-profit company.

"NYSE: Corporate Governance Guide" (2014), by New York Stock Exchange.

"Open Letter: Commonsense Principles 2.0" (2018), by a group of business and investment leaders.

"Principles of Corporate Governance" (2016), by Business Roundtable.

"Report of the NACD Blue Ribbon Commission on Building the Strategic-Asset Board" (2016), by NACD.

"Requirements for Public Company Boards: Including IPO Transition Rules" (2016), by Weil, Gotshal & Manges LLP's Public Company Advisory Group.

"Reviewing Your Board: A guide to board and director evaluation" (2018), by Australian Institute of Company Directors.

"The UK Corporate Governance Code" (2018), by United Kingdom Financial Reporting Council.

"21st Century Governance and Audit Committee Principles" (2007), by Corporate Governance Center, Kennesaw State University; Neel Corporate Governance Center, the University of Tennessee, Knoxville; Enterprise Risk Management Initiative, North Carolina State University; and Culverhouse School of Accountancy, The University of Alabama.

Acknowledgments

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In 2018, The Institute of Internal Auditors and the Neel Corporate Governance Center at the University of Tennessee's Haslam College of Business in Knoxville, Tennessee, began collaborating on an ambitious project to develop principles and an annual index to measure the quality and effectiveness of corporate governance among publicly held companies in the United States. With more than 200,000 members worldwide, including over 66,000 in the United States, The IIA is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. The Neel Corporate Governance Center was founded in 2003 in the wake of corporate scandals that preceded the Sarbanes-Oxley Act. Its mission is to conduct and disseminate nationally recognized research on corporate governance with a focus on public policy. Instrumental in developing the 2019 American Corporate Governance Index (ACGI) are Terry L. Neal, Ph.D., CPA, Director of Corporate Governance, and Lauren M. Cunningham, Ph.D., CPA, Director of Research at the Neel Center. Neal is the Richard L. Townsend Distinguished Accounting Professor and head of the Department of Accounting and Information Management. His research, which has been published in top-tier academic journals, primarily addresses issues related to corporate governance and auditor independence, with a particular emphasis on the role of the audit committee as a corporate governance mechanism. Cunningham is an assistant professor in the Department of Accounting and Information Management. Her research, which focuses on the effects of audit, corporate governance, and regulatory oversight on financial reporting quality, also has been published in top-tier academic journals and presented at the U.S. Securities and Exchange Commission's Division of Economic and Risk Analysis as well as conferences internationally.

"When you say success of the corporation, it is not just whether or not it made more money or less, [or] if the stock went up or down. What's the impact on the world?"

About The IIA

The Institute of Internal Auditors (IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 200,000 members from more than 170 countries and territories. The association's global headquarters is in Lake Mary, Fla., USA. For more information, visit www.globaliia.org.

About the University of Tennessee Neel Corporate Governance Center

The Neel Corporate Governance Center at the University of Tennessee, Knoxville's Haslam College of Business was founded in 2003 following the wake of corporate scandals that preceded the Sarbanes-Oxley Act of 2002. Its mission is to conduct and disseminate nationally recognized research on corporate governance with a focus on public policy. The Neel Corporate Governance Center maintains a close connection with professionals through its Distinguished Speaker Series, which regularly hosts corporate executives, board members, regulators, and other industry leaders.

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