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16 June 2016

Online at https://mpra.ub.uni-muenchen.de/73257/
MPRA Paper No. 73257, posted 24 Aug 2016 14:28 UTC

International Journal of Applied Economic Studies **Vol. 4, Issue 3 June 2016**
Available online at http://sijournals.com/IJAE/
ISSN: 2345-5721

Case Study: Analysis of Corporate Governance and Management Control at Kendallville Bank

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Abstract
The present paper addresses the case study of a financial institution, the Kendallville Bank, developed by The Anti-Fraud Collaboration. The constituents of the Collaboration are the Center for Audit Quality, Financial Executives International, the National Association of Corporate Directors, and The Institute of Internal Auditors. These organisations are concerned with financial reporting fraud deterrence and detection. The case study approaches financial reporting fraud at a multidimensional level. It explores the corporate governance arrangements and management control instruments at place at the Kendallville Bank. The findings are discussed against the theoretical framework of the Agency Theory and the Stewardship Theory. Shortcomings of the arrangements are identified and safeguards are recommended on the background of international corporate governance best practice and academic literature. The risks arising from corporate governance weaknesses are addressed through various risk control procedures. Culture control is acknowledged as a major instrument to improve effectiveness and performance of the bank through a shift in the interpersonal interaction of the Board members, the executive team and the auditors.

Keywords
Corporate Governance, Board Committees, Auditor Ethics, Agency Theory, Stewardship Theory, Change Risk, Culture Control

JEL Classification: A23, G21, G31, G34, M12, M14, M42, M53

Introduction

Corporate governance can be defined as mechanisms by which an organisation is administered and supervised (ACCA, 2012a, p.5). Where the owners of the company (the shareholders) do not participate in the day-to-day business of the company, as is the case in incorporated businesses like the Kendallville Bank (KB), these mechanisms deserve special consideration.

At KB, the assessment of one of the key financial reporting figures, the Allowance for Loan and Lease Losses (ALLL), has been changed. The change results in increased net income, but only due to modification in calculation and not due to improved operations. This change occurs in a deteriorating economic climate which makes the increased net income appear misleading. The change was favoured by Dan Davis, Chief Lending Officer (CLO) and member of the executive team. Executive remuneration at KB partly depends on meeting financial and business targets. With Davis being responsible for loans and leases the arithmetical change of ALLL raises questions of his integrity, with integrity defined as honesty and transparency (Stanwick and Stanwick 2014, p.216).

Thus, the first purpose of this report is to review the corporate governance structures and board of directors in place at KB and to make recommendations against international best practice. The second issue is to evaluate how the management control systems and the culture of KB may need to be changed. With KB currently pursuing acquisition of another bank, the issues raised in this report are crucial for the bank to remain a credible organisation for its own shareholders and that of a prospective acquiree.

Methods

KB is a public company based in USA and thus is subject to the corporate governance provisions of the Sarbanes-Oxley Act (SOX) 2002 and the listing rules of the New York Stock Exchange (NYSE). Besides this legislation and regulations, various corporate governance codes with relevance to the USA were used. These provisions are contrasted against the UK Combined Code and its preceding documents. The audit function is assessed using professional American and European codes of conduct for audit professionals. Academic literature was used to provide the theoretical context and to evaluate the practices at use. The list of references collects all the sources.

Findings and Recommendations

Review of the Executive Team

The executive team at KB is led by Sandra Renwood who is president, CEO and chairman of the board of directors. This personal union is not precluded by the SOX regulations. But it is also not encouraged by American and international corporate governance principles. Even more, ICGN (2014, p.9) discourages that a former CEO becomes chairman after his executive term, let alone during the term. The UN (2006, p.12) claims that separation is considered desirable to prevent one person from incorporating too much power at the top of the organisation. CII (2015, p.6) asks to combine the roles in "very limited circumstances" only. Separation of duties is considered best practice acc. to the Combine Code (FRC 2014, p.7-8).

One of the problems under the current system at KB is that no board meetings without the CEO can be conducted in order to evaluate her performance, as asked for by ICGN (2014, p.10). If that were the case the board probably could be more challenging in assessing the executives and their business conduct.

Recommendations for the Executive Team

The position of CEO and chairman should be separated. In case KB continues to combine these roles, an independent lead director should be deployed, as required by NACD (2008, p.8). He could determine the board agenda, inform the other directors and conduct meetings, all of which is currently made by Renwood. Also, KB should install an annual evaluation of whether the combination is still in the best interest of the company (BRT 2012, p.15). It could also introduce succession planning for the CEO (and other executives), as asked for by UN (2006, p.21) and BRT (2012, p.15).

Review of the Board of Directors

KB employs a board that consists of eleven non-executive directors. Their task is to monitor the executive team (G20/OECD 2015, p.45). The number of directors lies within a reasonable range, as for example CII (2015, p.7) proposes a number of directors between five and fifteen. The directors are elected to three-year terms, which is suggested by the Higgs Report (2003, p.53). The meetings are conducted on a monthly basis, which represents common practice (Souster 2012, p.6). The directors receive the meeting agenda 10 days in advance, which corresponds to the suggestion in the literature of at least 7 days (Bader 2005, p.5).

Two directors currently serve on board of other financial service institutions. FRC (2011, p.6) asks for the directors to devote enough time to their board responsibilities. Serving on two boards seems reasonable, as research considers three to four directorships to be still appropriate (Bar-Hava et al. 2013, p.27). To monitor the executives, directors have to be independent, otherwise their accountability towards the shareholders of KB may be compromised (NACD 2008, p.7). Independence prevents impairing relationships like business (BRT 2012, p.14) and banking (NYSE 2016, Sec.303A.02). Independence may be affected at KB. Most of the directors are still customers of KB. This may constitute a self-interest threat (UN 2006, p.13), as it may prevent them from making decisions to their own detriment, but which are favourable to the company.

The directors are primarily entrepreneurs from KB's area of operations, thus representing experience and knowledge suitable for banking purposes of KB (BRT 2012, p.13). However, it is questionable, whether owners of local businesses can discharge their duties as directors of KB given the complexity of a publicly listed bank (BRT 2012, p.13). Instead of provide training opportunities, Redwood considers suggesting to those directors who are poorly prepared for board meetings to resign after their term. With the two directors serving at other financial service organisations, the former president of the insurance company and the former senior executive of a listed company, Renwood can dominate the board due to their combined financial proficiency. Such a domination by a group of individuals is alerted by FRC (2014, p.10). Corporate governance best practice calls for at least three committees to support the functioning of the board of directors: the nomination committee, the remuneration committee and the audit committee (G20/OECD 2015, p.48-49). A nomination committee at KB is not mentioned. Renwood considers suggesting to the poor performing directors to resign. In case she evaluates the directors and decides about their board membership on her own, this would contradict best practice as established by ICGN (2014, p.12) and FRC (2014, p.11).

The same is true for the remuneration committee. Renwood reviews the performance of executives on her own, subject to a "structured performance review process". A sophisticated process does not make the remuneration committee unnecessary. Singh, the chairman of the audit committee, is a CPA and thus qualified as financial expert acc. to SOX 2002 Sec.407. However, he retired 10 years ago from public practice. This challenges whether his expertise can be regarded as "recent" acc. to FRC (2014, p.17). Another member of the audit committee regularly receives business loans from KB. FEE (2003a, p.7) questions the independence of audit committee members if they were to receive benefits from the company other than ordinary remuneration.

Recommendations for the Board of Directors

Although the three-year term of the directors is acceptable, no information is provided on the maximum number of terms a director can serve. FRC (2014, p.11) considers that a term of more than nine years jeopardises independence, with any term of more than six years calling for thorough review of the board composition. KB should therefore refresh its board at least every six years. Regarding the independence of the directors, who are customers of the bank, KB should investigate whether these relations are immaterial for both the directors and the bank (NYSE 2016, Sec.303A.02; FRC 2014, p.10). The relationships may be material for "small to mid-sized business owners" comprising the board. If material, the relations should be cancelled or the directors replaced by others. Otherwise KB would violate NYSE (2016, Sec.303A.01) and UN (2006, p.13) provisions, which call for the majority of board directors to be independent, if chairman and CEO are not separated. The lack of specialist proficiency among directors can be mitigated through training, which is encouraged by G20/OECD (2015, p.53) and FRC (2014, p.11). Although Redwood enables discussion, as required by G20/OECD (2015, p.53), the board meetings are rather chatting. KB board meetings should strive for constructive scrutiny as mentioned by NACD (2008, p.7). The bank should install a nomination committee to ensure proper board succession planning and director evaluation considering shareholder interests as called for by CII (2015, p.7). KB also needs a remuneration committee to determine payment of the executive team, as required by corporate governance codes like ICGN (2014, p.16) and FRC (2014, p.11). Regarding the audit committee, KB should try to replace Rob Singh with a financial expert having a more recent expertise. Also, KB should investigate whether the funds borrowed by the committee member were granted "in the ordinary course of business and on arm's length basis" and are immaterial (ACCA 2012b, p.72). Otherwise the member should be persuaded to resign from the committee or to stop borrowing from KB.

Review of the Internal Audit

Internal audit is considered a major instrument of the board of directors to ensure proper corporate governance (COSO 2013, p.4). The internal audit function is led by Janet Lee who is a CPA and thus a professional, as recommended by FEE (2003b, p.11). However, contrary to FEE (2003, p.50) and FRC (2014, p.17), the function reports to Kmetko, CFO instead of the audit committee. The audit plan is developed on annual basis which is in compliance with IIA (2012, p.9). It focuses on operational efficiency and weaknesses in loan underwriting, which is due to Kmetko's participation in design and development of the audit plan. This involvement of CFO and the reporting line to CFO compromises the oversight and scrutiny that are at heart of internal audit (G20/OECD 2015, p.49). Janet Lee is also unable to assert the need for training regarding the new ALLL approach. This hampers her professional due care (IIA 2012, p.6).

Recommendations for the Internal Audit

The function should report to the audit committee and retrieve its role as "authority in an entity" (COSO 2013, p.4) to ensure oversight over the executive team instead of being subordinate to the needs of CFO. The responsibility for the development of the audit plan should lie with head of function Janet Lee (IIA 2012, p.9). Further, the plan should be more risk-related (FEE 2003, p.52). Janet Lee tried to discuss the new ALLL with Kmetko from the viewpoint of operating effectiveness. Her inquiry would have carried more weight if made in view of the risks.

Review of the External Audit

External audit of financial statements provides shareholders with assurance that the statements give a true and fair view of the company and were prepared by management in accordance with reporting and legal standards (ACCA 2012b, p.352). Close liaison of external auditors with the audit committee and thus with the board of directors is encouraged (ACCA 2012b, p.45). KB is audited by PLN with Pat LaSalle being leading audit partner for four years. LaSalle maintains friendly relations with members of the executive team. This constitutes a familiarity threat, compromising LaSalle's independence. AICPA (2015, p.28) argues that an auditor can become sensitive to the client's needs if the auditor's "close friends" are employed by the client. Furthermore, with Jennifer Watkins as the engagement team senior manager and LaSalle's direct report PLN employs an auditor with limited competence on banking clients. This does not impose a threat under AICPA (2015, p.106) as long as there is another knowledgeable team member. Although LaSalle initially intended to support Watkins, she had to focus on another engagement with a new client, resulting in a poor audit at KB.

Recommendations for the External Audit

PLN will have replace LaSalle the next year. No listed company is allowed to be audited by an accounting firm if the audit has been performed by the same audit partner for five years acc. to SOX 2002 Sec.203. PLN has to install safeguards against the familiarity threat like a quality control review of the work performed by LaSalle. It could also discuss this issue with the audit committee (ACCA 2012b, p.61). PLN could also replace LaSalle by another lead partner without ties to the executives, but with enough expertise and time to support the audit team, because LaSalle is too preoccupied with further engagements.

Discussion of the Corporate Governance at Kendallville Bank

The agency theory argues that the agents (the management) can pursue their own interests to the detriment of their principals (the shareholders) (Solomon and Solomon 2004, p.17). This can happen in case of adverse selection and information asymmetry. Adverse selection occurs if the agent chosen is deviant from what is required by the principal (Eisenhardt 1989, p.60). Information asymmetry follows from the agents' information advantage over the principal given the agent's involvement in day-to-day operations (Shapiro 2005, p.264). This is intensified if the agent is subject to moral hazard – if he is able to hide his action from the principal (Caillaud and Hermalin 2000, p.2).

It cannot be argued that Davis has been deviant from the outset. Instead, KB have benefitted from his managerial skills for years. But when pushing for the change of ALLL he prepared memos for approval by the loan review officer and Kmetko which either did not mention the change at all (2nd meeting) or contained only short explanations (3rd meeting). All the details were included in the exhibit of which his was aware that in will not be examined neither by the loan review officer, nor by Kmetko. During the external audit stage he delayed to deliver ALLL documentary and to answer auditor's questions, so that the audit was completed without scrutinising ALLL. These techniques point toward information asymmetry deployed by Davis and his ability to hide his knowledge.

Research suggests that the board of directors is one of the instruments suitable to monitor the management to counteract such problems (Hill and Jones 1992, p.132). "Check-the-box" mentality (CCG 2010, p.26) prevails during board and committee meetings at KB, at which the executives' recommendations are usually accepted. Explanations provided by Davis are even perceived to be educational by the board members. Employees performing crucial supervisory tasks like internal audit cannot challenge the predominance of executives, too. Under the agency theory the mechanisms of corporate governance at KB can be considered ineffective.

The stewardship theory considers managers as stewards who align their interest with that of their principals (Arthurs and Busenutz, 2003, p.9). Under this assumption, the board of directors empowers the management rather than monitors it (Muth and Donaldson 1998, p.6). The executive team enjoys working for KB. Renwood ensures that organisational objectives like growth, profitability and shareholder return are pursued. This behaviour of executives corresponds to the assumptions of the stewardship theory (Madison 2014, p.15). However, boards may be blinded by the admiration for their executives (Choo and Tan 2007, p.205), as is the case with Davis. His winning personality and his perceived professional infallibility make the board and even the other executives accept his propositions. Therefore, the stewardship theory fails to address executive misconduct because it places an undue reliance on their integrity.

Discussion of Management Control and Culture at Kendallville Bank

Businesses operate under risky conditions (Sax 2015, p.10). In order to nevertheless achieve its objectives, businesses have to implement management control processes by which management can make employees pursue its goals (Berry et. al. 2005, p.18). One of such business risks is the change risk. It occurs when change is to be implemented and can materialise if the change is complex and affects performance (Roberts et al. 2003, p.24). The change in ALLL can constitute change risk. In the following Davis' behaviour will be evaluated to show in which different ways risk can be addressed. Results controls are implemented to achieve target goals (Reeves and Woodward 1970, p.38). This can lead to behavioural displacement, inducing behaviour that was not intended by the organisation (Wilson and Gilligan 2005, p.753). The manipulation of ALLL performed by Davis shows that the desirable net income increase can be achieved by dubious means.

Action controls require close supervision of the tasks performed (Ho et al. 2011, p.80). They are rather suitable for repetitive tasks with a low degree of personal initiative, than for a finance executive officer. Furthermore, they can be bypassed through gamesmanship with the perpetrator "outgaming" the system, for example via accounting manipulation as done by Davis, to make his action appear in line with the requirements (Brand 2013, p.73). Personal controls focus on the employee's ability to align his personal goals with that of the organisation. This can be enhanced through training, resources and influence distribution towards the employee (Sands 2006, p.144). Davis as a highly skilled and empowered manager could not be prevented from manipulating ALLL, rendering personal controls ineffective.

Cultural controls aim at monitoring employees through social interaction with others in the organisation (Sorsanen 2009, p.12). Such an influence can be exercised through a strongly promoted adherence to the corporate code of conduct and the "tone at the top" (Higgoda 2012, p.11). The strong position of the executive team at KB makes the management the gravitation point of the bank. Although a colleague-friendly attitude is maintained there is a clear "chair of command". Although KB complies with SOX 2002, its code of conduct is rather a lip service as it only requires employees to certify to have read and followed the code. There is neither an ethics committee at KB (UN 2006, p.17), nor a promotion of the whistleblower hotline among employees. This constitutes a non-collectivist, high power distance culture with controls being regarded as inferior (Madison 2014, p.12).

In order to prevent further misconduct through the implementation of cultural controls, the culture at KB as described above has first to change. Emphasis must be placed on corporate governance control instruments. Also, strong commitment to corporate governance values at the top of the organisation is necessary to fill the new environment with life. After this shift in culture KB will be better equipped to face business risks.

Conclusions

This report reveals several drawbacks at the corporate governance structure of KB. These weaknesses hinder proper control of the executive team placing an undue reliance on the integrity of its constituents. This makes KB vulnerable for failure should the executives transgress. Following improvements to KB's corporate governance structure are suggested to ensure supervision of the executive team:

- separation of chairman and CEO duties at the top
- election of an independent chair to lead the board of directors
- skilled enhancement programmes for the directors
- committee staffing with independent and skilled directors
- introduction the nomination, remuneration and ethics committees
- division of responsibilities between management and oversight function
- regular evaluation of directors and executives by the board
- enforcement and promotion of the code of conduct
- introduction and oversight of safeguards for the external audit
- awareness enhancement of whistleblower system in place and whistleblower protection

Besides these reforms KB should strengthen its management control through the implementation of culture controls. Culture controls appear most suitable to address risks imposed by the executives. The successful implementation of these controls make a shift in culture at KB necessary: away from a high power distance culture with few formal controls towards an environment in which management oversight is welcomed to the benefit of the corporation.

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