2021

american corporate governance index

Grappling with the Fatigue Factor

The Institute of Internal Auditors
Elevating Impact

THE UNIVERSITY OF TENNESSEE KNOXVILLE
NEEL CORPORATE GOVERNANCE CENTER

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Introduction

Managing change and uncertainty that can potentially disrupt achievement of goals is simply part of doing business, and 2021 proved as great a test in this respect as any in recent years. As the toxic effects of a global pandemic continue to stubbornly linger and the fallout from 18 months of business, economic, and social disruption manifests in varied ways, the need for effective governance is clear.

Still, data from this year's American Corporate Governance Index (ACGI) survey point to signs of fatigue as governance improvements seen in 2020 slowed or stagnated across a number of areas examined. This slowdown is understandable, if not anticipated. Indeed, governance gains made amid the chaos of COVID-19's initial onslaught highlighted commendable resilience among publicly traded companies and provided one of the few bright spots in an otherwise distressing year. However, those initial successes have given way to potential slips and setbacks. Grappling with the fatigue factor as wave after wave of pandemic-related ills wash over the economy will be one of the challenges for executive management and boards in the coming year.

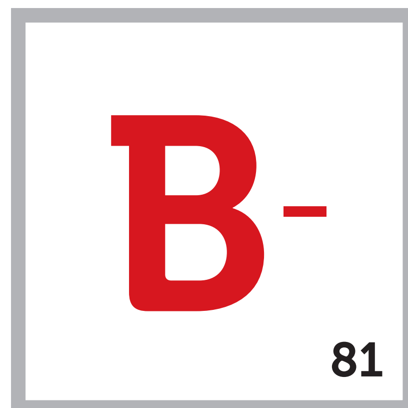
Data from the 2021 ACGI survey signal a number of areas where governance improvements retreated:

- *Companies earning "A" grades in governance dropped to 14% from 19% in 2020.*
- *Potential declines in important employee-related governance measures were noted, such as providing adequate training and compensating in a way that promotes ethical decisions.*
- *Despite increased activism related to social and environmental issues, companies are slow to address the needs of a broad range of stakeholders in their business decisions.*

This final observation is of particular concern because it does not jibe with the level of shareholder, stakeholder, and regulator interest in environmental, social, and governance (ESG) reporting, nor the observations of many survey respondents. Survey participants report growing awareness and focus in their organization on environmental and social issues as well as increased emphasis on diversity, equity, and inclusion in hiring. What's more, formation of new committee- and executive-level positions dedicated to overseeing ESG issues was noted by respondents. As yet, however, this has not shown up in improved governance scores.

Invariably, the increased focus on social and environmental issues will influence governance, both from the perspective of where they fit into the strategic, operational, regulatory, and reporting aspects of governance as well as from the need to provide independent assurance over such matters.

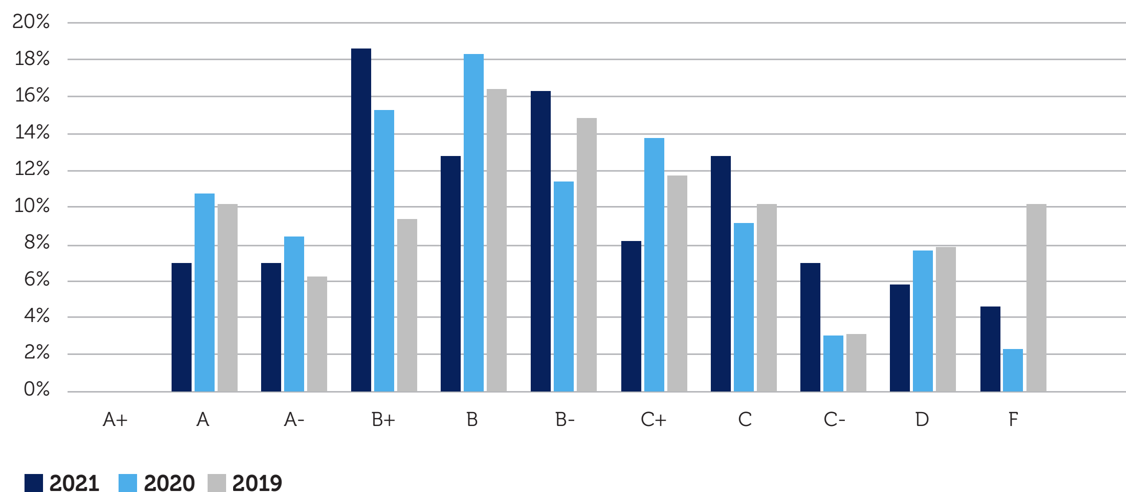
Corporate Governance in 2021



The 2021 overall ACGI score for corporate governance health in the U.S. is a B- (81). Last year, a potential boost in governance quality was seen during the initial wave of COVID-19 in the U.S. (an increase from 79 in 2019 to 82 in 2020). However, this year's score suggests that improvements in governance quality may be stymied as companies deal with the ongoing uncertainty of a global pandemic and the complexity of its fallout on supply chains, talent management, economic and political volatility, and more.

There continues to be significant variation in the overall assessment of corporate governance effectiveness across organizations (Figure 1). Notably, fewer companies scored in the A range in 2021, dropping to 14% from 19% in 2020. Similar to the two previous years, the majority of companies scored in the B and C range of governance performance.

FIGURE 1: DISTRIBUTION OF ACGI SCORES BY LETTER GRADE



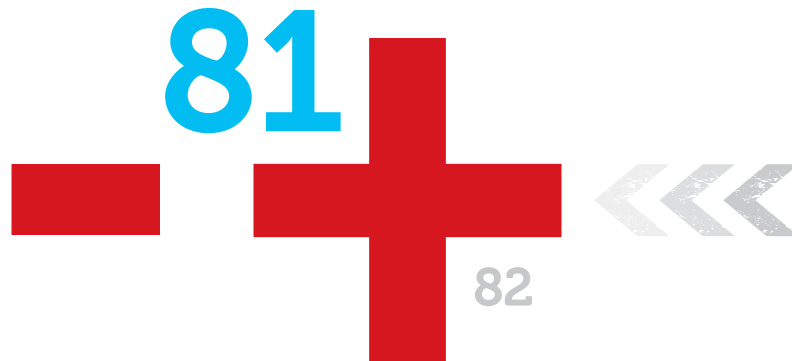
Note: The IIA's American Corporate Governance survey, 2021. Letter grades were assigned by the research team based on analysis of multiple factors. *n*=86 for 2021. *n*=131 for 2020. *n*=128 for 2019.

Understanding the Grade

The ACGI and its Guiding Principles are designed to foster the highest level of corporate governance, which should be the aspirational goal of every organization. Any rating less than the highest standard, an A+, reflects room for improvement.

The Guiding 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, the University of Tennessee's Neel Corporate Governance Center, The Institute of Internal Auditors (IIA), and others.

The index gauges the extent to which companies are effectively achieving each of the Guiding Principles from the perspectives of Chief Audit Executives (CAEs). CAEs are uniquely positioned to provide an independent and objective enterprisewide perspective of the organization. The index goes beyond the publicly observable aspects of corporate governance to provide an internal perspective on the effectiveness of corporate governance throughout the organization. In forming the survey questions that support the ACGI, it is assumed that corporate governance does not allow for a one-size-fits-all approach and that companies will need to find their own best practices based on the company's age, size, complexity, extent of international operations, etc.

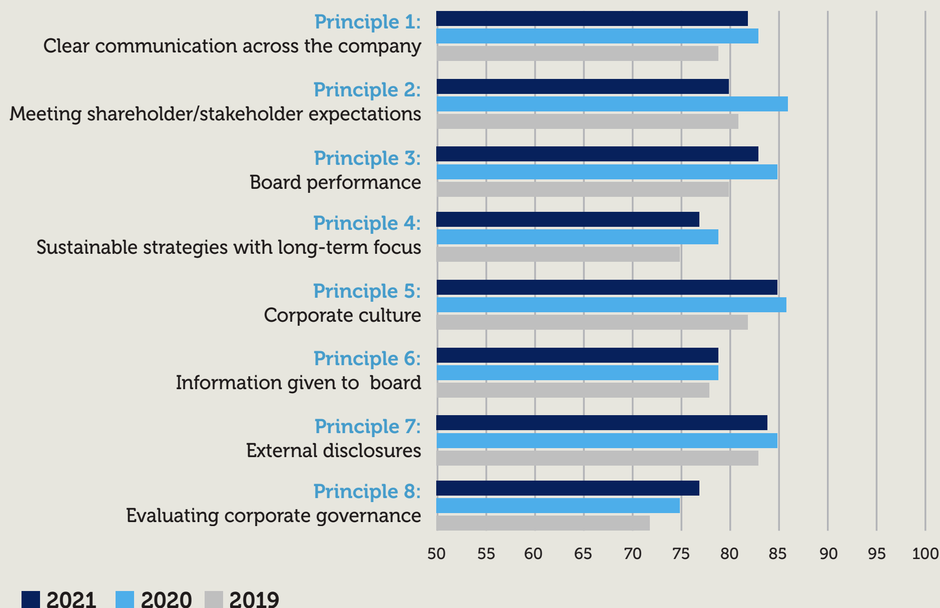


Key Observations

COMPONENTS OF GOVERNANCE STAGNATED OR RECEDED IN YEAR TWO OF COVID-19

While perhaps too early to tell definitely, many of the improvements observed in 2020 either slowed or showed signs of receding to pre-pandemic levels of governance quality. This comes even as shareholders have pressed for increased accountability of environmental, social, and governance issues facing companies, which should have invited continued improvement in governance quality. Seven of the ACGI's eight Guiding Principles scored lower overall in 2021.

FIGURE 2: ACGI SCORES BY PRINCIPLE



Note: The IIA's American Corporate Governance survey, 2021. Scores were assigned by the research team based on analysis of multiple factors. *n*=86 for 2021. *n*=131 for 2020. *n*=128 for 2019.

POTENTIAL DECLINE SEEN IN EMPLOYEE-RELATED GOVERNANCE

Initial workforce disruptions created by COVID-19 have been well-documented, primarily driven by forced employee isolation. Work-from-home peaked in April 2020 when 7 in 10 American workers reported toiling at home, according to Gallup polls. One year later, the U.S. saw the single greatest month of voluntary resignations when nearly 4 million workers left their jobs. That record was topped again in August, September, and November 2021 when more than 13 million combined quit their jobs over those three months, according to U.S. Department of Labor data. What's more, growing employee dissatisfaction appears to be a global phenomenon. The Microsoft 2021 Work Trend Index, a survey of more than 30,000 global workers, found 41% of respondents were considering resigning or changing professions in the coming year. These and other data points suggest potentially profound changes to the employment social contract.

Key Observations

Continued

The 2021 ACGI results reveal declining figures across several employee-related aspects of governance that could lead to future failures in internal controls and risk management if not successfully addressed. In particular, the following components of the ACGI show a decline in employee-related governance and companies' flexibility in resources to address the effects of those declines:

FIGURE 3: EMPLOYEE-RELATED GOVERNANCE

	2021	2020	2019
Employees receive adequate training to complete expected job duties.	**70**	76	70
Employees are compensated and/or incentivized in a way that encourages the achievement of corporate objectives in an ethical manner.	**83**	86	83
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.	**79**	82	76

The pandemic created heightened awareness of employee well-being and its implication on workplace culture in general. This will continue to be a challenge as the pandemic lingers and prolongs uncertainty. Organizations must remain committed to strong employee-related governance as part of their talent management strategy.

INCREASES IN SHAREHOLDER-RELATED ACTIVISM OBSERVED

One of the largest changes in the 2021 ACGI relates to increases in shareholders voicing their concerns through activism, proposals, voting, and litigation. This rebound is perhaps not surprising given that activism ebbed during the 2020 proxy season. The 2021 increase, reflected in fewer companies reporting no shareholder campaigns, is also consistent with increased calls for boards to be held accountable on various environmental and social issues. However, this increase has not yet led to observable improvements in corporate leaders seeking ways to minimize negative impacts on social and environmental issues. What's more, the extent to which companies are considering stakeholder interests when making business decisions saw a small decline year over year, which is the opposite direction from what stakeholders would demand.

FIGURE 4: SHAREHOLDER ACTIVISM

	2021	2020	2019
The company considers a wide range of stakeholder interests when making business decisions.	**84**	87	83
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.	**76**	76	73
The company has not been subject to shareholder proposals, proxy advisor 'against' recommendations, 'vote no' campaigns, proxy fights, or shareholder litigation.	**72**	89	80

COMPANY CHARACTERISTICS ASSOCIATED WITH GOVERNANCE QUALITY EMERGE

With three years of governance quality data now available, some consistencies have emerged relating to correlations between company characteristics and governance quality. The strongest findings are that governance quality is highest among companies:

- That have CEO-Chair duality accompanied by strong board independence.
- Where CAEs report administratively to the CEO or Audit Committee.
- With simple reporting structures and those lacking international operations.

Additionally, limited to the current period of economic uncertainty caused by COVID-19-related business disruptions, companies in **regulated industries** have higher ACGI scores for the second consecutive year.

While data collected since ACGI's inaugural survey in 2019 do not allow us to conclude on the reason(s) or causality for these relationships, a few possibilities should be considered:

- Companies with **CEO-Chair duality** may find that this arrangement provides CEOs additional authority to exercise creative freedoms and execute their strategic vision. However, boards with greater director independence recognize that enhanced governance quality is needed to provide adequate checks and balances in this scenario. Thus, companies with CEO-Chair duality and higher board independence are associated with higher governance quality, on average.
- Companies with stronger governance quality recognize the value of the internal audit function and elevate CAEs to positions where they have direct **administrative reporting access to the CEO and audit committee.** As internal audit's scope of work expands, it is increasingly important that the CAE report to the board entirely. This helps ensure that assurance and advice provided over a range of risk areas is viewed and understood beyond the audit committee.
- Perhaps not unexpectedly, companies with simpler **reporting structures** and those lacking the complexity of **operating internationally** share the benefit of accelerated communication lines, which makes it easier to monitor and improve governance quality throughout the organization.

ESG and Governance

Rapidly growing interest in ESG reporting from shareholders and regulators prompted the addition of two questions to the 2021 ACGI survey. Respondents were asked, “How has an increased focus on environmental and social issues in recent years impacted your company’s overall governance and performance?” and “What specific aspects of corporate governance have proved most effective at your company in overseeing environmental and social issues?”

Based on responses to the first question, the majority of organizations appear to be in the early stages of their ESG journey. CAEs report their companies have dedicated additional resources to monitoring environmental and social issues and have placed increased emphasis on diversity, equity, and inclusion in hiring at all levels (including in appointing directors). While a few CAEs believe the increased focus on environmental and social issues has led to improvements in the company, the vast majority report that it’s too early to know how these changes will affect the company’s governance or performance. Even so, many respondents acknowledge the increased attention has led to a sense of enhanced awareness/visibility and improved transparency within the company.

Another commonly noted change at companies that directly affects governance is the formation of new board committees and executive-level positions dedicated to overseeing ESG issues. While such actions reflect high-level commitment to proper governance over these issues, similar commitments to supporting independent assurance over related policies, procedures, and reporting are critical. This includes the aforementioned need to have internal audit report to the full board.

Respondent comments also suggest additional potential benefits stemming from greater focus on environmental and social issues, including, “improved focus on doing right in more than just economics” and ensuring “strong relationships with key stakeholders in the communities where we operate.” Organizations should consider the impact of separate executive- and board-level roles on the integration of sustainability and ESG thinking across the organization.

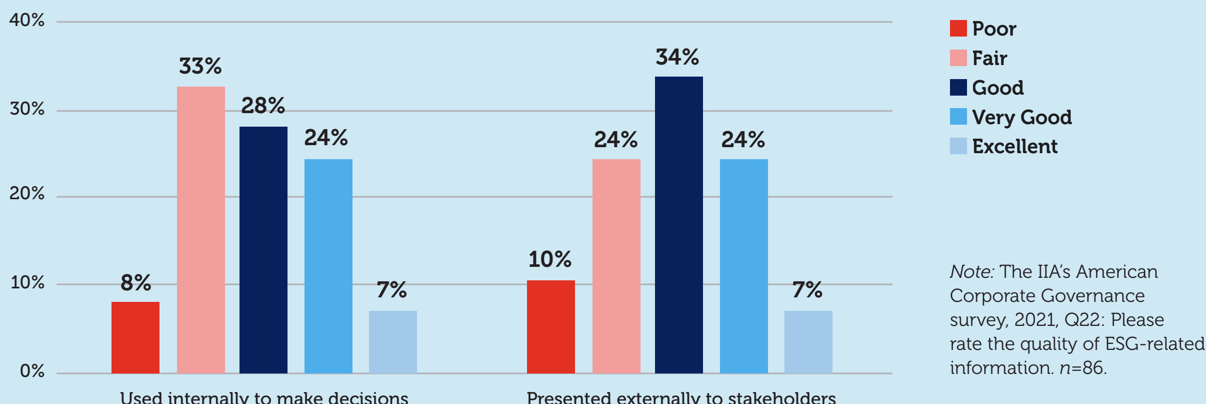
Observations about the increased focus on the environment and social movements reflect potential impacts these issues may have on governance in the future. The second survey question addressed the effectiveness of existing governance conditions in overseeing these areas.

CAEs’ answers to the second question provide a mixed message. While CAEs identified useful insights on characteristics that encourage organizations to look beyond profit and the bottom line, their observations suggest that current conditions could be improved when it comes to analyzing and reporting ESG data.

Respondents express an average rating of “Good” as it pertains to ESG-related information used internally to make decisions and presented externally to stakeholders. For 41% of respondents, they assess the quality of ESG-related information used internally to make decisions as “Poor” or “Fair.” Fewer than one in three CAEs would rate ESG-related information being used internally or presented externally as “Very Good” or “Excellent.” In contrast, when CAEs evaluate the quality of the company’s public disclosures more broadly (see Principle 7), they score the company as 92 out of 100, on average. This disparity suggests that increased accountability is needed to ensure higher quality ESG information is available to both decision makers and stakeholders.

This points to the urgency for organizations to get a better handle on identifying, collecting, and verifying data pertaining to ESG reporting. New ESG reporting requirements, particularly as they relate to climate change, are no longer a matter of “if” but “when” for publicly traded companies. Organizations should consider making ESG not a separate matter but an integral part of overall, enterprise performance monitoring (EPM) that is both internal and external. Internal audit must then provide necessary advice and assurance over such efforts.

FIGURE 5: QUALITY OF DIFFERENT TYPES OF ESG INFORMATION



Note: The IIA's American Corporate Governance survey, 2021, Q22: Please rate the quality of ESG-related information. *n*=86.

KEY THEMES FOR SOUND ESG GOVERNANCE

There was a strong upside to this question. CAEs provided valuable insights into the characteristics that promote strong governance over ESG-related matters. They identify components of a potential framework on which to build strong governance and leadership over ESG.

Transparency: Respondents emphasize the importance of organizations communicating in a transparent and timely manner with employees and other stakeholders. One company formed a community response team that is responsible for external communications. "We have to walk the talk and be willing to engage in uncomfortable conversations."

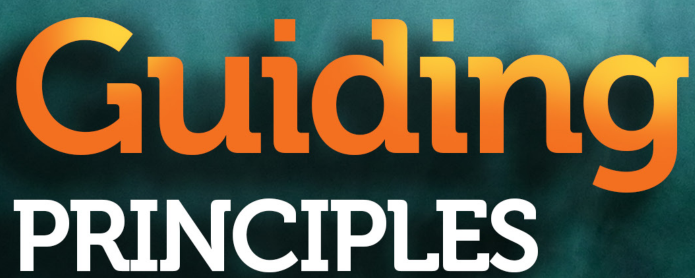
Culture: It is equally important to define which environmental and social issues are important to the company's stakeholders and make them part of the corporate culture, particularly as they relate to decision making within the C-suite and boardroom. This starts with the CEO's external and internal messaging and carries through to employee resource groups, with the aim of creating buy-in on these issues at all levels of the organization.

Expertise: Once the company has defined which aspects of environmental and social issues are important, it must be willing to train employees and bring in appropriate expertise when needed to evaluate and monitor the company's adherence to its stated goals.

FIGURE 6:
ESG LEADERSHIP FRAMEWORK

Accountability: Many respondents emphasize the importance of leveraging established and respected governance frameworks that help delineate clear lines of responsibility and reporting within the company over ESG. Here, CAEs often responded analytically, describing the need to clearly define risks and materiality, and implement processes that will ensure routine and rigorous incident reporting and investigations. There should be tools in place to accurately collect data needed to measure performance, including adequate role segregation (i.e., segregate information providers from approvers). Overall, companies should ensure that policies and assurance activities align with the risks and strategic goals of the company. These accountability steps are particularly important as an increasing number of companies voluntarily release annual sustainability reports and incorporate ESG-related key performance metrics into everything from executive compensation contracts to shareholder reports.

Leadership over ESG: The most cited best practice is the establishment of specific ESG leadership within the C-suite and/or board to ensure that environmental and social issues are part of strategic discussions. Here, many respondents pointed to newly created roles in the C-suite or the formation of committees within the C-suite and the board. An emphasis was placed on ensuring that whoever is in charge is cross-functional with access to information across the company. When committees are formed, ensure that the committee membership is diverse enough to represent the various viewpoints that should be critically discussed when making strategic decisions. One respondent also emphasized the importance of regular communication between executive management and the board outside of scheduled meetings. Another noted that a financial commitment boosts the chances of successful governance over ESG. "Money talks. If a company spends money on the issue and establishes a separate function with appropriate authority and status within the organization, it will get traction quickly."



The Guiding Principles of Corporate Governance define core actions and responsibilities that promote successful, ethical, and sustainable corporate governance.[1] 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 enable 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.

[1] The principles reflect a compendium of viewpoints from the sources cited here. Individual quotations and citations are not provided since the intention is to create a summarized set of viewpoints from multiple sources.

GUIDING PRINCIPLES

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.

- *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 that 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.*

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.

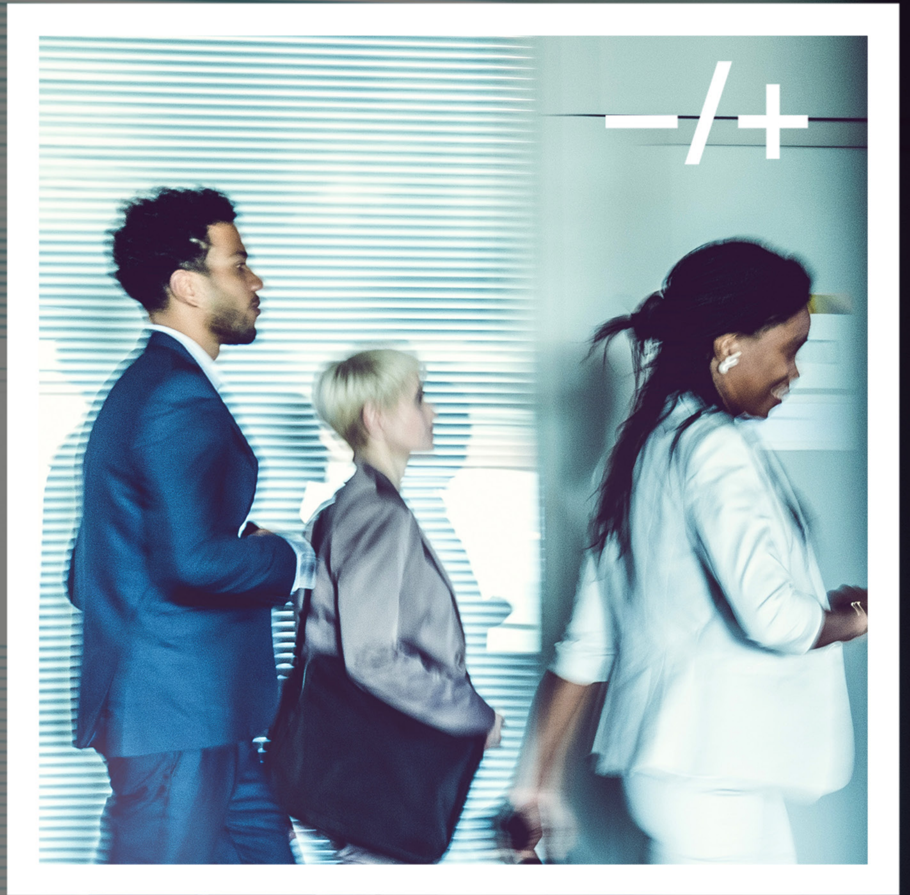
EXECUTIVE MANAGEMENT

- 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-term goals and long-term strategies 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 an internal yet independent resource for the board and executive management by providing objective assurance, advice, 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.

The interaction, communication, and alignment among these supporters of corporate governance are vital to an organization's overall success.



ACGI SCORING BY PRINCIPLE

Principle 1

	2021	2020	2019
Effective corporate governance requires regular and constructive interaction among key stakeholders, the board, management, internal audit, legal counsel, and external audit and other advisors.	**82**	**83**	**79**
Communications between each of the members of senior leadership are clear, actionable, and collaborative.	83	85	80
Communications between senior leadership and the board are clear, actionable, and collaborative.	85	86	82
Management structures are effective at getting the right information to the right decision-makers in a timely manner.	77	79	75

OPPORTUNITY FOR IMPROVEMENT:

For the third consecutive year, 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. In times of crisis, such as the COVID-19 pandemic, delays in timeliness of information transfer could affect not just profits and long-term growth, but also employees, customers, vendors, and other key stakeholders. Of note is a potentially unsettling trend where communications between members of senior leadership may be weakening, perhaps due to the ongoing pandemic-induced strain.

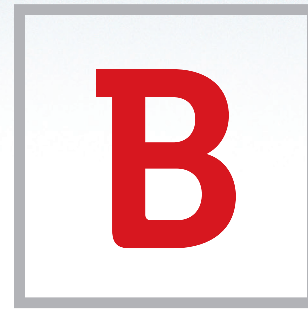
Principle 2

	2021	2020	2019
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.	**80**	**86**	**81**
The company considers a wide range of stakeholder interests when making business decisions.	84	87	83
There is a consensus among the board and senior leadership on who the key stakeholders are in your company.	87	89	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.	76	76	73
The company has not been subject to shareholder proposals, proxy advisor 'against' recommendations, 'vote no' campaigns, proxy fights, or shareholder litigation.	72	89	80

OPPORTUNITY FOR IMPROVEMENT:

Principle 2 experienced one of the biggest declines compared to prior year, with the largest shift in 2021 related to increases in shareholders voicing their concerns through activism, proposals, voting, and litigation. This increase in shareholder activism is perhaps not surprising given that activism decreased during the 2020 proxy season. The increase in activism in 2021 is also consistent with increased calls for boards to be held accountable on various environmental and social issues. Perhaps disappointingly, this increased activism has not yet led to observable improvements in the extent to which key leadership members are regularly cognizant of and actively pursuing ways to minimize negative impacts at their companies. Also observed is a small decline in the extent to which the company is considering a wide range of stakeholder interests when making business decisions, which is the opposite of what stakeholders would demand.

Principle 3



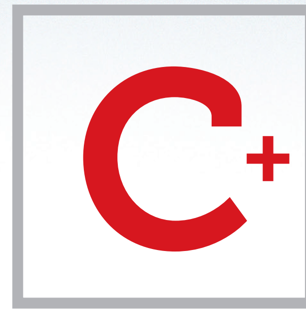
	2021	2020	2019
Board members should act in the best interest of the company and the shareholders while balancing the interests of other key external and internal stakeholders.	**83**	**85**	**80**
Your board has sufficient technical expertise to oversee areas of current or emerging risks.	85	86	79
Board members present diverse perspectives when discussing issues.	84	86	83
Board members are compensated in a way that aligns with long-term strategic goals.	83	86	84
The board probes into sufficient detail for most topics.	82	84	79
Your board members have the necessary time and attention needed to fulfill their responsibilities.	86	89	83
Your board conducts a thoughtful, robust evaluation of the entire board and/or individual board members on an annual basis.	83	86	79
Your board commits, and follows through, to improve upon any weaknesses identified in the annual board and/or committee evaluations.	84	86	79
Board members are not afraid to offer opinions that are contradictory to or conflict with those of the CEO.	76	76	75

OPPORTUNITY FOR IMPROVEMENT:

For Principle 3, the least effective element continues to be 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 65% of board members at their company would push back on the CEO. This is relatively consistent with only 66% in 2020 and 64% in 2019.

Other changes to Principle 3 reflect that board governance improvement seen between 2019 and 2020 appears to be stalled. This potential waning is consistent with boards having more responsibilities than ever before, and potentially being fatigued as the pandemic carries on for a second year. On a positive note, the 2020 improvement in technical expertise over current or emerging risks held steady in 2021. As boards look to diversify their boardrooms across a variety of dimensions, a continued focus on the relevant technical expertise that each member brings to the table will be important for both offering diverse perspectives and having the expertise to monitor and advise on key risks.

Principle 4



	2021	2020	2019
The board should ensure that the company maintains a sustainable strategy focused on long-term performance and value.	**77**	**79**	**75**
The company's objectives and long-term strategic goals are clearly communicated to, and well-known across the company.	76	80	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.	79	81	78
Your company is not willing to sacrifice long-term strategy for the benefit of short-term interests.	73	70	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.	79	82	76
Employees receive adequate training to complete expected job duties.	70	76	70
Employees are compensated and/or incentivized in a way that encourages the achievement of corporate objectives in an ethical manner.	83	86	83

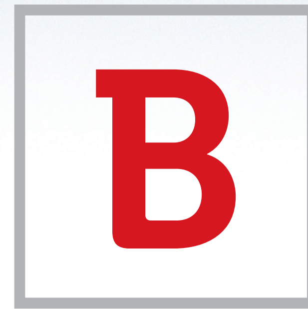
OPPORTUNITY FOR IMPROVEMENT:

For Principle 4, governance quality failed to rise above the C+ level for the third year in a row. As it relates to a variety of issues affecting the governance of the long-term strategic direction of the company, potential improvements observed during 2020 have reverted back to pre-pandemic levels. The one area that showed an improvement from 2020 is the company's focus on long-term strategy, which is a trend that will be welcomed by many groups that promote sustainability.

However, the ability to communicate that long-term strategy across the company, the quality of training given to employees, and the incentive systems in place for employees to achieve corporate objectives in an ethical manner may be waning. Successfully addressing these issues will fall primarily on executive management.

Fewer companies report having sufficient resources (time and money) to effectively respond to crises and disruptions as they arise. This, in turn, may be contributing to declines observed in messaging, training, and incentive systems, as companies struggle to thrive amid constantly shifting and evolving public health risks, and increasing disruptions in supply chains and labor availability.

Principle 5



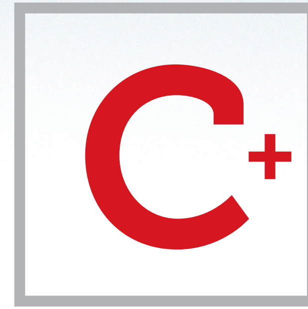
	2021	2020	2019
The board should ensure that the culture of the company is healthy, regularly monitor and evaluate the company's core culture and values, assess the integrity and ethics of senior management, and, as needed, intervene to correct misaligned corporate objectives and culture.	**85**	**86**	**82**
Your board and CEO embody a strong "tone at the top" in your organization that would pass any ethical test.	93	94	91
Your board consciously thinks and talks about the company's culture.	75	78	74
"Tone at the top" is communicated to and consciously embodied across all levels of the company.	80	82	78
The company has not been accused of ethical issues (e.g., sexual harassment, unfair working conditions, environmental issues, etc.).	89	90	87
Management would take appropriate corrective action if a policy, procedure, or workplace rule violation was detected.	87	88	83

OPPORTUNITY FOR IMPROVEMENT:

Relative to other principles, Principle 5 stayed fairly steady in 2021 compared to 2020. The weakest component of Principle 5 continues to be the extent to which the board consciously thinks and talks about the company's culture. The extent to which the company's tone at the top, which is set by the CEO and the board, spreads through the rest of the organization, breaks down at the middle management level. This becomes clear in analysis of responses to four survey questions relating to tone at the top. Respondents rate how tone at the top is communicated to and consciously embodied across all of executive management at a B+ on average (88). However, that score wanes quickly, with middle management earning a B- (80) and rank and file employees earning a C- (72). There are similar concerns for whether tone at the top is embodied across all geographic regions, earning only a C (75).

Boards consciously thinking and talking about the company's culture with executive management should lead to natural improvements in the circulation of tone at the top through the rest of the organization because it reinforces its importance for the board. Conversations with CAEs suggest that evaluating culture throughout the organization is difficult, but possible. Surveys alone are not likely to be sufficient. It requires integrating internal auditors' visits (onsite or virtual) throughout the organization. Given that many companies have expanded telecommuting policies or made remote operations permanent, this is one governance measure that internal audit and boards should continue to keep a close eye on in 2022.

Principle 6



	2021	2020	2019
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.	**79**	**79**	**78**
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.	82	77	77
Your board members ask whether the information presented to the board is accurate and complete.	69	68	67
Your CEO does not heavily filter or water down "bad" news before it goes to the board.	81	82	81
Board members are given all the necessary information for effective oversight.	91	90	87
Board members are given sufficient time to thoughtfully review all materials prior to board meetings.	90	89	87
The board protects proprietary information given to the board.	64	69	69

OPPORTUNITY FOR IMPROVEMENT:

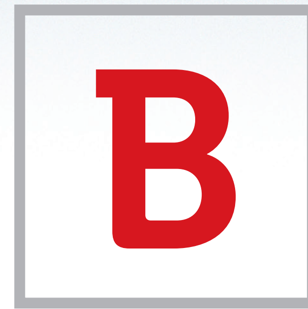
Principle 6 is largely stagnant relative to the past two years. Principle 6 continues to have two elements scoring in the D range: the extent to which board members ask whether information it receives is accurate and complete, and the extent to which the board protects proprietary information given to the board.

Fourteen percent of respondents acknowledged that, in the preceding 12 months, there has been a cybersecurity breach related to information given to the board. This is an alarming increase compared to only 4% in 2020. Further, only 35% of respondents believe that their boards are required to use either corporate emails or board portals to protect proprietary company information, which is comparable to 37% reported in 2020.

Perhaps more troubling is that 23% of CAEs are aware of a cybersecurity or IT data breach outside of information given directly to the board, suggesting that attacks on companies are fairly common. This figure is also consistent with what was reported in 2020, suggesting that this is not an isolated event period.

Although not addressed directly in the ACGI survey, to the extent that executive management is concerned about boards' loose protection of company information, there exists a risk that managers may consciously or subconsciously withhold certain relevant information from the board. This further emphasizes the importance of boards proactively asking whether information they receive is accurate and complete, and improving security over information given to boards.

Principle 7



	2021	2020	2019
The board should ensure that corporate disclosures are consistently transparent and accurate, and in compliance with legal requirements, regulatory expectations, and ethical norms.	**84**	**85**	**83**
Public information is accurate, adequate, complete, representative, timely, and transparent.	92	93	89
Employees are familiar with how to report violations of law or policy.	82	82	78
The internal audit function is adequately staffed, in terms of both the number of staff and expertise of the staff.	74	76	77
Information submitted to hotlines or fraud reporting lines is followed through effectively.	90	89	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.	91	91	90
The company has not been under investigation by the SEC or other governmental or regulatory authorities.	90	90	87
The company has not experienced restatements, cybersecurity breaches, or unremediated material weaknesses or significant deficiencies.	70	76	73

OPPORTUNITY FOR IMPROVEMENT:

Principle 7 remains one of the most effective principles of governance, which is perhaps not surprising, given that many facets of this area of governance are based on policies and processes that have been in place and evolving since the Sarbanes-Oxley Act of 2002.

An area of potential concern emerging from Principle 7 is a further decline in ensuring that the internal audit function is adequately staffed, in terms of both the number of employees and the relevant expertise they offer. Pandemic-related cutbacks were seen in 2020 among internal audit functions, primarily in smaller organizations. However, more recent surveys of risk management leaders suggest senior executives and boards desire a broader scope for internal audit services. The IIA's *OnRisk 2022: A Guide to Understanding, Aligning, and Optimizing Risk* reports that respondents overall "feel that their current assurance services are adequate but suggest some improvements in assurance reporting."

Increased incidences of restatement, cybersecurity, or internal control issues also were noted in data from the ACGI survey, which could reveal weaknesses with the external reporting system.

Principle 8

	2021	2020	2019
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.	**77**	**75**	**72**
Corporate governance is regularly and consciously discussed in your company.	80	78	73
The board seeks out feedback on whether corporate governance is operating effectively at the company.	77	75	72
The company formally evaluates the full system of corporate governance on a regular basis.	72	71	70

OPPORTUNITY FOR IMPROVEMENT:

Principle 8 still remains one of the least effective principles of governance in 2021, but importantly, the trends from 2019 to 2021 suggest that this principle is improving. The importance of this principle to the quality of the overall governance system within a company cannot be overstated. Without routine and open discussions about corporate governance and without effective evaluations, organizations risk missing warning signs of weaknesses or vulnerabilities that can lead to governance breakdowns.

Companies can continue to improve upon Principle 8 by recognizing that governance is an overarching set of policies, procedures, and relationships that extends beyond the boardroom. The boardroom is, of course, a critical element of governance, but there are many other aspects of internal governance that occur at the management level, and across all geographic locations. Effective governance systems outside of the boardroom ensure that issues are identified in a timely manner and that correct information is provided to the right people at the right time.

Additional Findings

To evaluate the extent to which the 2021 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 sample companies tend to be larger and more mature, with a greater representation from regulated industries, compared to the population of U.S. companies traded on major U.S. stock exchanges.

As far as variation in ACGI scores among these factors, no significant differences in corporate governance scores were found across company sizes in 2021 (Figure 7). ACGI scores are higher for younger companies than for more mature companies in 2021, which is opposite of the relation observed in 2020 (Figure 8).

Consistent with last year, 2021 ACGI results are significantly different between regulated industries and unregulated industries. Specifically, financial services, transportation, utilities, and mining industries have a higher ACGI grade, on average, compared with the remaining industries (Figure 9). Additional research is needed to understand the relationship between governance and regulation, but it may reflect the importance of regulation during times of great uncertainty, e.g., the current COVID-19 environment of 2020 and 2021.

FIGURE 7: COMPANY SIZE (TOTAL REVENUES)

	POPULATION	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
< $1 billion	61%	35%	80	26%	82	26%	76
$1 - $10 billion	10%	44%	80	41%	80	51%	79
> $10 billion	30%	21%	83	33%	86	23%	82

Note about 2021 differences: The average ACGI for the > $10 billion companies is not statistically different from the companies with < $10 billion in revenues (two-tailed p-value > 0.10). Caution should be taken if trying to conclude that one group is different from the other.

FIGURE 8: NUMBER OF YEARS COMPANY HAS BEEN PUBLIC

	POPULATION	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
< 10 years	30%	14%	84	17%	81	n/a	n/a
11 – 20 years	11%	19%	82	21%	82	n/a	n/a
> 20 years	59%	67%	80	62%	83	n/a	n/a

Note about 2021 differences: The average score for companies > 20 years old is statistically lower than the average score for remaining companies (two-tailed p-value < 0.10). We note that this is opposite of the relation observed in 2020, the first year in which we collected this data.

Additional Findings

Continued

FIGURE 9: INDUSTRY

	POPULATION	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
Financial Services	22%	30%	84	28%	86	32%	79
Manufacturing	38%	25%	80	27%	79	25%	79
Transportation, Utilities, & Mining	12%	24%	81	9%	85	16%	78
Other	28%	21%	76	36%	81	27%	81

Note about 2021 differences: The average ACGI scores for Financial Services and Transportation, Utilities, & Mining ("Regulated" industries) are significantly higher than for all other industry groups (two-tailed p-value < 0.05).

The existence of a CEO-Chairman duality was considered in light of a continuing push from investors to separate these roles. Board independence also was considered. These are common subjects 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, for the third year in a row, ACGI scores are higher for sample companies where the company's CEO also serves as Chairman of the Board (Figure 10), particularly where the CEO-Chairman duality is paired with strong board independence (Figure 11). No significant differences in ACGI scoring along the dimension of board independence alone was noted (Figure 12).

FIGURE 10: CEO-CHAIRMAN DUALITY

	POPULATION	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
Dual CEO-Chairman	30%	35%	83	39%	85	38%	80
Separate CEO-Chairman	70%	65%	79	61%	81	62%	78

Note about 2021 differences: The average ACGI for dual CEO-Chairman is statistically higher compared to companies with a separate CEO-Chairman (two-tailed p-value < 0.10).

FIGURE 11: CEO-CHAIRMAN DUALITY, AFTER CONSIDERING BOARD INDEPENDENCE

	POPULATION	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
Dual CEO-Chairman without a compensating Independent Board	16%	16%	81	13%	82	11%	74
Dual CEO-Chairman compensated by an Independent Board	14%	19%	85	27%	86	27%	83
Separate CEO-Chairman	70%	65%	79	61%	81	62%	78

Note about 2021 differences: The average ACGI for dual CEO-Chairman compensated by an Independent Board is significantly higher than the other two groups (two-tailed p-value < 0.05). The dual CEO-Chairman without a compensating Independent Board is not statistically different from the separate CEO-Chairman. Here, a board is considered to have compensating board independence when board independence is greater than the population median (86%).

FIGURE 12: BOARD INDEPENDENCE

	POPULATION	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
High % of Independent Members	50%	66%	81	68%	82	59%	80
Low % of Independent Members	50%	34%	81	32%	82	41%	77

Note about 2021 differences: We split the sample using the median percentage of independent board members from the population (86%). There is no statistical difference between high and low independence groups (two-tailed p-value > 0.10). Caution should be taken if trying to conclude that there is a correlation between board independence and ACGI in 2021.

A number of non-public aspects of corporate governance were also considered. For the third consecutive year, results show corporate governance is stronger for companies where the administrative reporting line for internal audit is directly to the audit committee or CEO, with no potential filtering from other members of executive management (Figure 13). This is an area where additional research is needed to examine the quality of corporate governance and internal audit work. Perhaps not surprisingly, for the third year in a row, companies scored significantly lower in the ACGI when their reporting structures are moderately or highly complex (Figure 14).

FIGURE 13: CAE ADMINISTRATIVE REPORTING LINE

	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
Audit Committee	12%	81	11%	84	4%	88
CEO	22%	86	14%	84	21%	82
CFO	55%	78	59%	81	57%	78
Other (e.g., General Counsel, Chief Risk Officer)	12%	n/a	16%	n/a	18%	n/a

Note about 2021 differences: The average ACGI for companies where the CAE reports administratively to the audit committee or CEO is statistically higher than the average ACGI for companies where the CAE reports administratively to the CFO (two-tailed p-value < 0.05). An index score is not provided for "Other" because it comprises disparate groups.

Additional Findings

Continued

FIGURE 14: MANAGEMENT REPORTING STRUCTURE

	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 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.	76%	82	60%	84	79%	80
Moderately or Highly Complex. If a material issue were to arise, it would take longer to get to the CEO; several reporting lines would be involved, and for some, it would require complex navigation of reporting lines to get to the CEO.	24%	76	40%	79	21%	76

Note about 2021 differences: The average ACGI for Fairly Simple reporting structures is statistically higher than the average ACGI for Moderately or Highly Complex reporting structures (two-tailed p-value < 0.05).

For the second consecutive year, ACGI scores are highest in heavily regulated companies (Figure 15). ACGI scores also are highest in companies with no operations outside the U.S. (Figure 16). While not directly addressed in the survey, these changes compared to 2019 could be attributed to the current pandemic and economic environment.

FIGURE 15: EXTENT OF REGULATION

	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
Minimally Regulated	14%	80	14%	80	16%	80
Moderately Regulated	41%	79	46%	82	35%	79
Heavily Regulated	45%	82	40%	84	49%	79

Note about 2021 differences: The average ACGI for Heavily Regulated companies is statistically higher than the ACGI scores for Minimally and Moderately Regulated companies (one-tailed p-value < 0.10).

FIGURE 16: EXTENT OF OPERATIONS OUTSIDE OF THE U.S.

	2021 SAMPLE	2021 ACGI	2020 SAMPLE	2020 ACGI	2019 SAMPLE	2019 ACGI
We do not operate outside the U.S.	33%	84	20%	83	30%	78
Minimally outside the U.S.	21%	79	16%	84	20%	79
Moderately outside the U.S.	21%	79	39%	80	18%	80
Heavily outside the U.S.	26%	80	25%	81	32%	78

Note about 2021 differences: The average ACGI is statistically higher for companies with no operations outside the U.S., relative to companies with minimal, moderate, or heavy reliance on operations outside the U.S. (two-tailed p-value < 0.05).

Demographics

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, 136 surveys were attempted, 86 completed all questions related to the ACGI formulation, and 83 additionally completed all company demographic questions. The survey was conducted from August 1, 2021, through August 31, 2021. 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

- *10.5 years of direct access to the board and/or audit committee*
- *51 years of age*
- *68% male*

SELF-ASSESSMENT OF CORPORATE GOVERNANCE QUALITY

In addition to questions that form the basis of 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.*

Respondents believe a peer reviewer would assign their organization an average score of 80, which is similar to their calculated score.

Consistent with prior years, respondents are optimistic about their corporate governance quality compared with their peers (Figure 17). Fifty percent believe their company's peer review score would be higher, or significantly higher, than their peers, while only 9% believe their company's peer review score would be lower than their peers. We do, however, observe that their calculated ACGI score is positively correlated with their perception of their corporate governance quality relative to their peers. CAEs who perceive their quality to be lower than peers do have lower ACGI scores, on average, relative to CAEs who perceive their quality to be higher than peers.

FIGURE 17: SELF-ASSESSMENT OF CORPORATE GOVERNANCE QUALITY

	%	ACGI
Lower than my peers	9%	67
The same as my peers	41%	79
Higher than my peers	48%	84
Significantly higher than my peers	2%	92

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 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 aggregated to produce a score ranging from 0 – 100 for each sub-principle, 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. Rounding difference may arise between the sub-principle and principle levels.

This year's index is based on survey responses from 86 CAEs working in companies of various sizes, complexities, and industries. The IIA and the Neel Corporate Governance Center are committed to providing an unbiased examination of the data, and sharing insights about the factors that influence corporate governance over time.

RECOVERY: 78%

Acknowledgments

In 2018, The Institute of Internal Auditors (IIA) 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 210,000 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 2021 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 Chaired Professor of Accounting 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 associate 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.

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 210,000 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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