CHAPTER

5

Governance Factors

LEARNING OUTCOMES

Mastery	The candidate should be able to:
☐	**5.1.1** explain the evolution of corporate governance frameworks: development of corporate governance; roles and responsibilities; systems and processes; shareholder engagement; minority shareholder alignment
☐	**5.1.2** assess key characteristics of effective corporate governance, and the main reasons why they may not be implemented or upheld: board structure, diversity, effectiveness, and independence; executive remuneration, performance metrics, and key performance indicators (KPIs); reporting and transparency; financial integrity and capital allocation; business ethics
☐	**5.1.3** assess and contrast the main models of corporate governance in major markets and the main variables influencing best practice: extent of variation of best practice; differences in legislation, culture, and interpretation
☐	**5.1.4** explain the role of auditors in relation to corporate governance and the challenges in effective delivery of the audit: independence of audit firms and conflicts of interest; auditor rotation; sampling of audit work and technological disruption; auditor reports; auditor liability; internal audit
☐	**5.1.5** assess material impacts of governance issues on potential investment opportunities, including the dangers of overlooking them: public finance initiatives; companies; infrastructure/private finance vehicles; societal impact
☐	**5.1.6** apply material corporate governance factors to: financial modeling; risk assessment; quality of management

1 CORPORATE GOVERNANCE: ACCOUNTABILITY AND ALIGNMENT

☐ **5.1.1** explain the evolution of corporate governance frameworks: development of corporate governance; roles and responsibilities; systems and processes; shareholder engagement; minority shareholder alignment

Corporate governance is the process and structure for overseeing the business and management of a company. From the Latin word for the steering of a boat, *gubernare*, governance incorporates that sense of guiding and controlling. Corporate governance has become more complex as the scale and complexity of companies have grown and as ownership has become more dispersed.

As a result, the role of the board of directors has become more important. The board is responsible for representing the owners of the company and for holding management teams accountable for running the business in the interest of its owners. The effectiveness of the board depends on whether good corporate governance practices are applied. The principles that shape these practices have been developed over the years and codified into corporate governance codes. Increasingly, investors are expecting companies to disclose their corporate governance structures and processes so that external investors and other stakeholders can understand where the company stands on the spectrum of good governance.

The types of issues that investors will address when considering a company's governance include, but are not limited to:

- shareholder rights;
- the likely success of the intended company strategy, and the effectiveness of the leadership in place to deliver it;
- executive pay;
- audit practices;
- board independence and expertise;
- transparency or accountability;
- related-party transactions; and
- dual-class share structures.

This chapter considers the *G* of environmental, social, and governance (ESG) factors, corporate governance, and gives readers insight into the core fundamentals of what the concept means, its history and development, global practices, and how governance analysis is used by investment professionals to deliver value to their clients and beneficiaries and minimize the risk of value destruction.

What is Governance? Why Does It Matter?

Corporate governance is the process by which a company is managed and overseen. There are different rules worldwide—governance grows out of the legal system of the country in which the company is incorporated—but at its heart, governance is about people and processes. Good governance also involves developing an appropriate culture that will underpin the delivery of strong business performance without excessive risk-taking through appropriate conduct of business operations. Good corporate governance should lead to strong business performance and long-term prosperity to the benefit of shareholders and the company's other stakeholders. The corporate culture needs to be supportive of that long-term business success in the interests of all stakeholders.

While at its heart corporate governance is about people (the individuals in the boardroom and how they interact with the individuals outside the boardroom), in order to exercise their responsibilities effectively, board members are supported by processes. These processes bear an increased burden in large and complex companies; at smaller companies there is greater scope for individuals at the top to have direct knowledge across a business, but at larger companies this is impossible. Companies will typically have policies and codes of conduct in place, but they will rely on processes to be confident that those policies are indeed delivered in practice. Investors will judge a company's governance based on the quality of its policies and processes and on the diligence and care with which the board oversees their implementation. Most fundamentally, they will judge governance by the quality and thoughtfulness of the people on the board.

Assessing the effectiveness of corporate governance systems within a firm gives investors insight into the accountability mechanisms and decision-making processes that support all critical decisions affecting the allocation of investors' capital and the likely delivery of long-term value. A company with sound governance is better able to address the key risks that the business faces, including environmental and social issues. Conversely, a company that is failing to manage a key long-term risk (again including environmental and social issues) may have an underlying governance failure that is blocking its ability to address the issue.

In practice, corporate governance comes down to two A's: **accountability** and **alignment**.

These concepts are reflected in many of the core elements of corporate governance standards and investor expectations.

Accountability

People need to be:

- given authority and responsibility for decision-making; and
- held accountable for the consequences of their decisions and the effectiveness of the work they deliver.

Accountability and the Board

Just as people are most effective when they are conscious of being accountable to someone—typically their manager—in the same way, senior executives need to feel accountable to the non-executive directors on their board. In turn, that board will be most effective when its non-executive members feel accountable to shareholders for effective delivery. Therefore, corporate governance has a strong focus on board structure and the independence of directors.

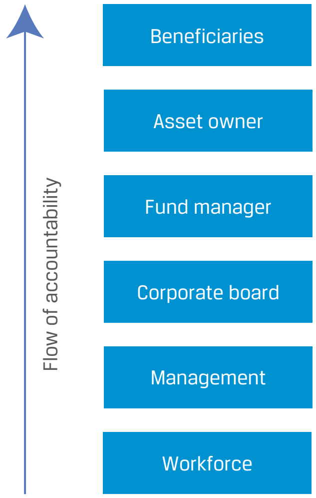
The mixed skill sets of directors are also important, so that discussions and debate are appropriately informed by a range of perspectives and the risk of "groupthink" is avoided. Increasing diversity and the range of perspectives in the boardroom—through gender diversity, but also diversity in terms of professional backgrounds and experiences—has been demonstrated to deliver a more challenging culture and thus the greater accountability that is more likely to enhance long-term value.

The role of the chair of the board is vital in facilitating a balanced debate in the boardroom. Consequently, many investors prefer that the chair be an independent non-executive director. If the chair is not independent, and especially if that individual combines the role of chair with the role of CEO, this situation can lead to an excessive concentration of powers and hamper the board's ability to:

- exercise their oversight responsibilities;
- challenge and debate performance and strategic plans;
- set the agenda, both for board meetings and for the company as a whole;
- influence succession planning; and
- debate executive remuneration.

Exhibit 1 illustrates the flow of accountability through company structures and the investment chain.

Exhibit 1: Chain of Accountability and Circle of Accountability



Source: Paul Lee (2020).

Accountability and Accounts

Accurate accounts are needed for accountability. The annual accounts of the company represent the formal process of the directors making themselves properly accountable to the shareholders for financial and broader business performance, which is why the first item at many annual general meetings (**AGMs**) is acceptance of the report and accounts, often through a formal vote. Hence, the central importance of transparent and honest accounting by companies, and of the independence of the audit of those accounts by the auditor. Again, it is not by chance that the auditor reports formally to shareholders each year and is reappointed annually in most countries at the AGM. The integrity of the numbers that investors look at when assessing business performance is central to their ability to hold management and boards to account. The votes to "discharge" board directors in some countries (such as Germany) effectively absolve them of liability for any actions over the year and are usually dependent on the annual report providing a full, true disclosure of activity in the year and the position at year-end.

Alignment and the Agency Problem

Alignment comes down to the challenge of the agency problem. Since the seminal publication of *The Modern Corporation and Private Property* by Adolf Berle and Gardiner Means in 1932 (seen by many as the starting point for the modern understanding of corporate governance), the **agency problem** has been identified as an inevitable consequence of the separation of ownership and control. The agency problem arises in that the interests of the professional managers—the agents—may not always be wholly aligned with the interests of the owners of the business, and so the company may not be run in the way the owners wish. This challenge is magnified at larger corporations, not least public companies, where ownership is fragmented among many investors owning a small fraction of the company.

Any discussion of the agency problem needs to acknowledge that the issues it raises are not so simple that they can be solved by management and the board simply doing what they are instructed to do by the shareholders. First, it will usually be difficult to discern a single message from the shareholder base of most companies, which will include multiple investors. Even where there is a single shareholder or a clear single message from the shareholders, the duty of directors under the company law of most countries is to care for the success of the company and not of the shareholders directly. There is also a risk that directors will fail in their duty if they simply abdicate their responsibilities and respond thoughtlessly to the input received from shareholders. Promoting short-term share price increases is not the same thing as promoting the long-term success of the business.

Furthermore, there can be agency problems within the investment chain itself, as a disconnect can develop between the interests of fund management firms and individual portfolio managers and those of their clients and/or ultimate beneficiaries. This agency problem is discussed in more detail in Chapter 9.

Nonetheless, the challenge of the agency problem is a risk of some divergence between the interests of shareholders, on the one hand, and the interests of company directors and management, on the other. Corporate governance attempts to ensure that there is greater alignment of the interests of the agents with the interests of the owners, through both incentives and appropriate chains of accountability, to mitigate the potential negative consequences of the agency problem.

Alignment and Executive Pay

With regard to alignment, the major focus in terms of executive pay is always on addressing the agency problem and helping to ensure that executives are not subject to incentives to perform in their own interests and contrary to the interests of the owners. Thus, executive pay structures aim to align the interests of management with those of the owners, usually by creating a balanced compensation package that includes performance-related remuneration based on long-term goals and that vests over a long term. The goals ideally include a mix of key performance indicators (KPIs) related to business and share price performance. Many of the incentives often come with some form of equity linkage—which can, on occasion, make risk management more focused on share price than on the performance of the business itself.

Accountability: Board Committees

The three key committees of the board, usually required by corporate governance codes, are established to respond to each of the key challenges discussed above (accountability and the board, accountability and accounts, and alignment and executive pay). These committees are:

- The **Nominations Committee** (in some markets, this is called the Corporate Governance Committee or some combination of these terms) aims to ensure that the board overall is balanced and effective, ensuring that management is accountable.

- The **Audit Committee** oversees financial reporting and the audit, delivering accountability in the accounts. The Audit Committee also oversees internal audits (where they exist) and is responsible for risk oversight unless there is a separate risk committee.
- The **Remuneration Committee** (in some markets, this is called the Compensation Committee) seeks to deliver a proper alignment of interests through executive pay.

The roles of these committees are considered more thoroughly in the next section.

2 FORMALIZED CORPORATE GOVERNANCE FRAMEWORKS

☐ **5.1.1** explain the evolution of corporate governance frameworks: development of corporate governance; roles and responsibilities; systems and processes; shareholder engagement; minority shareholder alignment

Corporate failures and scandals have been a powerful driver for the formalization of corporate governance and the development of codes. When companies fail and investors lose money, there is often pressure for an improved approach. Examples include the Walker Review,[1] following the 2008 financial crisis, and the recent Kingman[2] and Brydon[3] reviews in the wake of Carillion's failure.

See Scandals in Brief (below) for further (and international) discussion.

Corporate Governance Codes

The world's first formal corporate governance code emerged in the United Kingdom in 1992. The Cadbury Committee had been brought together in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accounting profession to consider what were called "the financial aspects of corporate governance." Its creation followed the Caparo and Polly Peck scandals.

Caparo had mounted a successful takeover bid for Fidelity, only to subsequently discover that Fidelity's profits were significantly overstated. The market had pumped up the share price of Polly Peck for years on the basis of financial reporting that later turned out to be misleading. The Cadbury Committee was created because of the perceived problems in accounting and governance. Once the committee began its work (but before the planned publication of its report), the Maxwell/Mirror Group scandal was beginning to emerge, and the Bank of Credit and Commerce International (BCCI) collapsed spectacularly in the wake of money laundering and other regulatory breaches. It was clear that much needed to change.

1 D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (2009). Available at: https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

2 Financial Reporting Council, *Financial Reporting Council: Review 2018* (2018). Available at: www.gov.uk/government/publications/financial-reporting-council-review-2018.

3 D. Brydon, *Assess, Assure and Inform: Improving Audit Quality and Effectiveness; Report of the Independent Review into the Quality and Effectiveness of Audit* (2019). Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf.

Much of what the Cadbury Committee recommended is still considered best practice today and has been incorporated into codes and guidelines globally. For example, the committee proposed that every public company should have an audit committee that meets at least twice a year. Notably, when the report was released, only two-thirds of the largest 250 companies in the UK had such committees at all (although nowadays they are commonplace). The report's core theme is that no individual should have "unfettered powers of decision"; so, for example, the roles of chair and CEO should not be combined, as they frequently were at the time.

A codified set of guidelines for good governance has grown from the basic concepts of accountability and alignment. Governance differs from country to country based on cultures and historical developments as well as local corporate law. At the most basic level, some countries, including Germany and the Netherlands, have **two-tier boards**, with wholly non-executive supervisory boards overseeing management boards; others have **single-tier boards**, with some dominated by executive directors (as in Japan), some having a combined CEO and chair (most commonly seen in the United States and France), and some lying in between these models (as in the UK).

The Cadbury Code model of recommendations with which companies should comply or explain any non-compliance has also been followed throughout much of the world. It is now highly unusual for any market to be without an official corporate governance code.

Since Japan adopted one in 2015, the USA is now the only major world market that does not have such a code, which is largely a consequence of corporate law being set at the individual state, rather than the federal, level. Most markets adopt the language of "comply or explain," although the Netherlands favors "apply or explain," and the Australians use the blunt "if not, why not?" The thought process, however, is the same: the code expects adherence to the relevant standard or the publication of a thoughtful and intelligent discussion of how the board delivers on the underlying principle. These discussions are gaining increased attention, not least because they offer the board an opportunity to explain how it operates to deliver value to the business on behalf of both shareholders and other stakeholders.

Companies' willingness to provide thoughtful discussions of their divergences from guidance varies. Some companies may look negatively on corporate governance, as they consider it inflexible. Indeed, there can be a risk that investors will approach corporate governance codes with inflexibility, expecting much more compliance than explanation—which is not the code's intent. Sometimes, this apparent inflexibility can arise from a failure of communication, particularly due to the reliance on proxy advisory firms (a highly concentrated group led by ISS and Glass Lewis) to mediate some of the discussions on governance and voting matters. These advisory firms tend to adhere to the details of corporate governance codes in giving recommendations on how their clients might vote. Some argue that it is the role of the proxy adviser to interpret the standards strictly, and it is for the actual shareholder to apply the flexibility that arises from a closer understanding of the specific circumstances of the individual company. Under this analysis, the problem of inflexibility may arise more from the investor client's tendency to follow the proxy adviser's recommendations, with too little independent judgment about whether those recommendations are the right ones, than from the strictness of the recommendations themselves.

These issues are discussed in more detail in Chapter 6.

Just as the Caparo and Polly Peck scandals sparked the establishment of the Cadbury Committee, and the Mirror Group and BCCI scandals provided a firm context for the publication and acceptance of its report, later scandals have continued to fuel the development of governance standards around the world:

- In the UK, shocks around pay levels at newly privatized utilities led to the **Greenbury Report**, which revised the UK's corporate governance code in 1995. It increased the visibility of remuneration structures and pressed toward transparency over the KPIs that drive performance pay and the time horizons over which pay is released (for long-term schemes, the time horizon is a minimum of three years).
- The Enron, Tyco, and WorldCom scandals in the USA led to the **Sarbanes-Oxley Act** in 2002. This law lifted expectations for greater integrity in financial reporting and created the Public Company Accounting Oversight Board (PCAOB) as the country's audit standard setter and inspector, establishing a standard for auditor independence and challenge.
- The 2003 failures at Ahold and Parmalat in the Netherlands and Italy, respectively, led to pressure for heightened standards of corporate governance and for both board and auditor independence across Europe. No longer could Europe pretend that Enron represented a problem isolated to the USA.
- The financial crisis of 2008 led to various changes around the world and to a renewed focus on corporate culture and executive pay as well as questions around audit. It also led to the creation of stewardship codes, in the UK initially and then around the world. Most notable of the legislative changes was the **2010 Dodd-Frank Act** in the USA (formally, the Dodd-Frank Wall Street Reform and Consumer Protection Act), which, among its multiple clauses, tightened standards for, and oversight of, banks.
- In Japan, the Olympus scandal of 2011–12 revealed long-running market deceit, whereby more than US$1.5bn (£1.07bn) in losses were hidden, apparently not for personal gain but to maintain the apparent health of the company and jobs for its workforce. When the much larger Toshiba revealed its own scandal of overstated profits in 2015, some felt that there might be something culturally wrong in Japanese companies that sought to hide the truth and failures of governance. The combination of these shocks has helped fuel the rapid advance of Japanese governance standards and also expectations for ESG disclosures across the market.

SCANDALS IN BRIEF

Enron (USA, 2001): An electric utility turned energy-trading business, Enron used a range of off-balance-sheet vehicles and other aggressive accounting techniques to appear hugely profitable, even on projects that had barely begun. Its collapse led to the dismantling of its auditor, Arthur Andersen, which split apart rapidly after some of its staff in Houston were discovered to have shredded documents linked to Enron and the US Securities and Exchange Commission's (SEC) investigation.

Governance failings included weak oversight of the executives (reinforced by the founder, Ken Lay, remaining as executive chair) by the non-executive directors. There were also failures of commission, most clearly the decision to waive the board's own code of conduct to enable the CFO to participate personally in some of the off-balance-sheet structures whose purpose was to facilitate the removal of losses from Enron's accounts.

HIH (Australia, 2001): This insurer collapsed before ever revealing the scale of its multi-million-dollar losses for the last six months of 2000. Having grown rapidly, insured aggressively, and under-reserved, the business had insufficient assets to cover its liabilities by a huge margin: the deficit was estimated to be up to AU$5.3bn (£2.7bn).

The Royal Commission that looked into the HIH scandal concluded that while the board was unusually well qualified (including insurance specialists and accounting experts), the way it operated was subservient to the CEO and failed to offer independent oversight and challenge. Management controlled the board agenda and the information provided to directors—who, in turn, failed to question assumptions and gain an independent view. The board also handled conflicts of interest poorly, or simply ignored them, and had only limited debate on major strategic decisions, including acquisitions.

Tyco International (USA/Bermuda, 2002): When losses mounted from unsuccessful deals by this aggressive Bermuda-incorporated acquisition vehicle, questions were raised about the behavior of CEO Dennis Kozlowski. Allegations centered on inflated profits, but also on ill-gotten earnings by senior management. In the end, the trial of Kozlowski and of CFO Mark Swartz centered on payments of US$150mn (£107mn), which they claimed the board had authorized as their remuneration. They were convicted, but the suggested level of actual theft is believed to have exceeded US$500mn (£359mn).

The culture at Tyco had long been one of lavish lifestyles for corporate leadership using corporate money and perks. Kozlowski had already grown accustomed to this culture prior to becoming CEO and extended it further. Deal-making (some 750 acquisitions in the four-year period up to 2001) became a basis for personal aggrandizement and even personal entertainment. Tyco apparently financed Kozlowski's wife's $2 million birthday party, for example. The board at best turned a blind eye to these behaviors, enabling this wasteful and unhealthy culture to persist.

WorldCom (USA, 2002): The internal audit function of this telecom business uncovered its use of one of the simplest accounting deceits—booking current expenses as capital investment, boosting profits by some US$3.8bn (£2.7bn). A subsequent investigation concluded that, in total, assets were exaggerated by US$11bn (£7.9bn). The fraud was undertaken to hide falling growth in a more challenging market.

At WorldCom, the board's checks and balances worked, although belatedly. An internal audit team uncovered suspicious transactions (or, rather, suspicious accounting treatments of transactions) and raised them with the chair of the audit committee. Though the chair did not immediately call a meeting of the committee, he did invite the internal audit team to discuss the issues directly with KPMG, the external auditor; in the meantime, the internal audit team persisted with its work and uncovered the full scale of the misleading accounting. When the committee was finally called, it confronted the executives leading the finance function with full evidence from the internal audit and with the support of KPMG. Executive departures and public announcements—and an SEC investigation—followed. So did bankruptcy.

Ahold (the Netherlands, 2002–03): Ahold was a Dutch grocery chain that went international through acquisitions, principally in the USA, in part because management had a 15% earnings growth target. Deteriorating performance was hidden through fraud—dubious joint venture accounting, hidden costs, and vendor rebates.

While making decisions to grow internationally, the board failed to ensure that its skills and its processes also developed so that it could oversee the new broader spread of the business. Instead, the US operations faced more limited oversight and challenge than they might have, allowing frauds to develop without being uncovered until they were very substantial.

Parmalat (Italy, 2003): False accounting spiraled from an initial 1990 decision by this Italian milk business to hide losses in its South American operations, mainly through inflating apparent revenues by double billing. In the end, in 2003, more than €4bn (£3.4bn) in cash and equivalents on the company's reported balance sheet turned out to be imaginary.

Parmalat's fraud began the way many frauds begin—accounting sleight of hand to cover up local losses. The fraud got so big because the losses persisted and the fraud was not uncovered for more than a decade, while the scale of the hole in the profits, and the efforts needed to conceal it, snowballed. Again, it appears that board oversight of international operations was less effective than it might have been. Further, audit checks and balances seem to have failed. At the time, Italy had a rule requiring a change in audit firm every nine years. Parmalat sidestepped this rule by changing the parent company's auditor, Grant Thornton, but retaining them internationally. The market missed signals that appear obvious in retrospect, not least Parmalat's reported profit margins being far in excess of peers'.

Satyam (India, 2009): The founder and chair admitted to falsifying the accounts of this IT services company. For around five years, the company had inflated revenues using thousands of false invoices; the auditor had apparently failed to check the bank statements that might have uncovered the fraud. The entire board was removed by regulators, the chair was jailed, and following a lengthy regulatory procedure, the company's auditor, PwC, was banned in 2018 from auditing any Indian public company for two years.

The founder's confession followed a proposed related-party transaction whereby Satyam would buy a real estate company from him. Though announced, the plan was retracted within a few hours after a highly negative response from shareholders—and the news that the World Bank would no longer do business with the company, barring it for eight years. The World Bank alleged that Satyam had provided improper benefits to its staff and had failed to provide proper accounts for its charges. Once problems emerged, as is so often the case, the fraud rapidly unraveled and the founder's losses in real estate ventures were revealed. The board had provided limited oversight and had perhaps believed the myth of the company's success and rapid growth. The extensive fraud was also missed by the audit process.

Olympus (Japan, 2011–12): Following his appointment, new CEO Michael Woodford soon became concerned about the profitability of Olympus. He was ousted but acted as a whistle-blower. Slowly it emerged that the Japanese camera maker had hidden losses for many years, principally through over-priced acquisitions whereby some of the excess fees paid were returned to the company to cover losses and shore up its finances.

Like many Japanese companies, Olympus was run by long-standing executives who had sought to protect the company at all costs, with remarkably few independent checks and balances. They had clearly concluded that hiding losses through convoluted schemes was preferable to honesty about the company's issues and the potential negative consequences for its workforce. Also, the supposedly independent oversight from the statutory auditors failed because they too appear to have lacked independence from the company (or at least enough of them did).

Volkswagen (Germany, 2015): Volkswagen was revealed to have cheated on US emissions tests on its diesel engines through software, so-called defeat devices. Although, on the face of it, this was not a governance scandal, many investors had long been concerned about the lack of accountability at the German company, where the voting shares were predominantly held by the founding families, the local government, and the government of Qatar.

The differential voting rights served to entrench these groups, enabling them to dominate the board. Management was thus able to operate in an insular and unaccountable way. Furthermore, the company's culture was driven by the view that engineers always knew best and that their actions were largely above criticism. The company needed an engineering response to the new diesel regulations, but when it failed to find one that worked on the road, it chose to seek one that at least worked during testing. The board, accustomed to not having to listen to external voices, never felt the need to ask enough questions to uncover the issue.

Wirecard (Germany, 2020): Wirecard, a hard-driving fintech and global payments processor, collapsed in June 2020 when long-running allegations of fraud and questionable accounting were largely confirmed by a special audit. The audit revealed that some €1.9bn (£1.6bn) were missing from its accounts. It became apparent that substantial elements of its business in the Middle East and Asia were no more than an elaborate sham and that the core payments-processing operations in Europe were barely profitable.

One of the most remarkable aspects of the scandal was the way that the press investigation—persistently pursued by the *Financial Times*—was fought at each step by the German regulator, BaFin, which was supposed to be overseeing the business. Apparently, both the regulator and the board were so taken by the opportunity for Europe to build its own fintech star that they failed to spot the red flags about the business and failed to ask enough questions as it expanded overseas. The auditor also failed to identify warning signs, especially around the overseas operations.

SHAREHOLDER ENGAGEMENT AND ALIGNMENT

3

☐ **5.1.1** explain the evolution of corporate governance frameworks: development of corporate governance; roles and responsibilities; systems and processes; shareholder engagement; minority shareholder alignment

Shareholder engagement is the active dialogue between companies and their investors, with the latter expressing clear views about areas of concern (which often include ESG matters). Engagement helps ensure that the board directors are accountable for their actions, which hopefully in time helps to improve the quality of their decision-making.

Engagement is discussed in depth in Chapter 6.

For minority shareholders—which institutional investors will almost always be—a crucial issue is that they not be exploited by the dominant or controlling shareholders. In many cases, protections for minorities are built into company law, and they often exist in listing rules and other formal protections. These protections are usually bolstered by corporate governance codes, but the issues are so fundamental (because they relate to avoiding exploitation of minorities and protection of their ownership rights) that in most countries, minority shareholders benefit from underlying legal protections.

Exploitation of minorities could involve money being siphoned out of the business in ways that benefit the controlling shareholders but not the wider shareholder base, which explains why there are typically higher disclosure requirements around related-party transactions and rights for non-conflicted shareholders to approve them. Minority shareholders will also be unwilling to see the company they invested in change dramatically without their having the chance to vote on the issue. For example, in the UK listing regime, class tests are applied as follows:

- If a transaction affects more than 5% of any of a company's assets, profits, value, or capital, there must be additional disclosures (Class 2 transactions).
- If a transaction affects more than 25% of any of a company's assets, profits, value, or capital, there must be a shareholder vote to approve the deal based on detailed justifications (Class 1 transactions).

Another key area for shareholder protection is pre-emption rights. These rights ensure that an investor has the ability to maintain its position in the company. Fundamental to many markets' company laws (though not, for example, in the USA) is the idea that a company should not issue shares without giving existing shareholders the right to buy an amount sufficient to maintain their existing shareholding. Because these rights come before the prerogative of potential external investors, they are called pre-emptive, and the existence of these rights is why a large equity fundraising by companies is often called a "rights issue."

As rights issues are cumbersome, particularly if a company is issuing a relatively small number of shares, companies typically seek authority at AGMs to issue a relatively small proportion of shares (up to 5% or 10%) non-pre-emptively—that is, without having to offer them fairly to existing shareholders. Investors are usually prepared to grant such authority but with certain protections in place. Even where issues are not on a fully pre-emptive basis, there is usually an expectation that the larger institutional shareholders will be offered a so-called soft pre-emption, meaning an allocation equivalent to their existing shareholding but in a less formal, less legalistic way (which may enable the issuance to be made more swiftly). Larger issuances are more controversial, as are issues at a price possibly less than the prevailing share price. An example of a particularly unpopular model with defenders of minority shareholder rights is the "general mandate" resolutions in Hong Kong SAR, which seek to enable issuance of up to 20% of the share capital, potentially at a discount. There is a clear detriment from such transactions to the existing shareholders.

A final area in which minority shareholders can feel exploited is the mechanism of dual-class shares. Typically, one of the classes is restricted to the founders of a company (or a limited group chosen early in a company's life), who receive multiple votes compared to the class of shares that subsequent shareholders can invest in—the shares that are usually more freely traded on the stock market (and those issued freely as compensation to staff, particularly in the case of US technology businesses). Moreover, management, which typically benefits directly from multiple voting rights and often voting control, will feel less accountable to the broader shareholder base, with whose interests management is less aligned.

Dual-class shares are often frowned upon by many investors and are rare outside the USA (though Volkswagen, as discussed in the Scandals in Brief section, is a European example). They are, however, becoming more visible and more common because of the current success of technology businesses, the founders of which have been keen to retain voting control. The Council for Institutional Investors, the main organization for US institutions, has taken a nuanced stance on dual-class stock,[4] recognizing that it can provide some stability in the early life of a company, but urging that it be subject to sunset clauses so the two classes are unified after, at most, seven years (the time horizon after which academic evidence suggests that dual-class stock will usually have a negative performance impact). Controversially, Snap Inc. (the parent company of Snapchat) took the dual-class stock route further and issued shares without any voting rights at all; indeed, given that the company indicated there was little likelihood of a dividend, the instruments sold were actually more like warrants than shares.

4 CHARACTERISTICS OF EFFECTIVE CORPORATE GOVERNANCE: BOARD STRUCTURE AND EXECUTIVE REMUNERATION

☐ **5.1.2** assess key characteristics of effective corporate governance, and the main reasons why they may not be implemented or upheld: board structure, diversity, effectiveness, and independence; executive remuneration, performance metrics, and key performance indicators (KPIs); reporting and transparency; financial integrity and capital allocation; business ethics

The current iteration of the Corporate Governance Code in the UK was published in 2018. It includes 18 principles under five themes:

- board leadership and company purpose;
- division of responsibilities;
- composition, succession, and evaluation;
- audit, risk, and internal control; and
- remuneration.

These themes are consistent across most of the world's corporate governance codes, as are (largely) the expectations and duties of the three principal board committees that almost all major companies have in place:

- the audit committee (sometimes the audit and risk committee);
- the nominations committee (sometimes the corporate governance committee or some combination of the two); and
- the remuneration committee (or the compensation committee in the USA; some companies also now incorporate into the name some reflection of a responsibility to the broader employee base).

The expectation is that the audit and remuneration committees will be populated solely by independent non-executive directors, and such directors should form a majority of the nominations committee (the chair should not lead this committee while it is seeking to appoint a successor). Some companies will establish other board committees to address issues ad hoc or on an ongoing basis, but they should use appropriate judgment in how those committees should best be populated. For example, most financial services businesses now have a separate risk committee, which is

4 Council of Institutional Investors, *Dual-Class Stock* (2021). Available at: www.cii.org/dualclass_stock.

usually made up of independent non-executive directors. Other companies may have sustainability committees, or committees considering their key operational risks—such as a people committee at companies highly dependent on their workforce or a health and safety committee. Such committees assist the board in overseeing major exposures and in dealing with the workload of oversight. They are not compulsory, and certainly at smaller businesses, this workload is likely to be handled by the audit committee or by the board itself. The Code also determines appropriate disclosures to make the workings of the board transparent and to demonstrate their effectiveness to shareholders.

Published alongside the 2018 Code was a *Guide to Board Effectiveness*, which applies the same structure as the Code under the same five themes. It provides not only guidance but also questions to assist board members in considering whether they are being fully effective in their roles. The guide also provides questions that board members might choose to ask management to gain additional clarity on corporate culture. Almost half of the main body of the guide is taken up with the first theme, board leadership and company purpose—essentially, this theme focuses on culture, strategy, and maintaining appropriate relationships with key stakeholders. While this guide is a UK document that is explicitly aimed at assisting boards, the themes are useful to investors in considering the effectiveness of governance globally.

Board Structure, Diversity, Effectiveness, and Independence

As governance at its core is about people, the key to exercising effective governance is having the right people with relevant skills and experience around the boardroom table, as well as having the right board culture to enable each of them to contribute effectively to boardroom debate.

This goal is easily summarized but difficult to achieve. As can be seen from the case study sample of BHP's annual report disclosures on its board skills and diversity, there are multiple skills that boards seek to have available within the boardroom, often many more than the number of individual directors. If an issue is of high importance to the business, the usual expectation is that more than one person should have knowledge of that issue, because a board will rarely feel comfortable relying on a single perspective, particularly as that person may not always be available. Compromises need to be made, and plans need to be considered for the future to prepare for expected departures from the board—and to respond to unexpected changes (such as death or conflicts of interest). Of course, a board can have access to specialist skills through advice from experts invited to present at board meetings or to provide input in other ways. A question to consider is what skills and experience are regularly needed around the boardroom table and what skills and experience would be better accessed on an occasional, independent advisory basis.

One skill set, or at least depth of understanding, increasingly expected for every board concerns climate change—as highlighted by the specific attention to this issue in the BHP disclosures. Not every board can have a climate scientist, and indeed few boards may actually want one. But all boards need to be competent in dealing with the business complexities of the issues around climate change, so that they can appropriately consider how to adjust their business models and investment approach to reflect the coming scrutiny on greenhouse gas emissions. A company that fails to consider this issue is likely to misspend capital expenditures either currently or in the near future, as it invests in assets that will not have the same value in a carbon-constrained world—having a board with climate change competency could help avoid this waste. To achieve this goal, it is likely that education and training will be needed, for at least some directors. A growing number of appropriate courses are available. Boards may also increasingly have to consider skills and training in other areas, such as environmental and social risk.

As well as training for directors, boards must consider the need for refreshment of skills, which have a half-life and will decrease over time. The needs of the board will also change over time as its strategy evolves, and it is important to keep the skills matrix updated. The issue of director tenure and independence is discussed below.

There are many types of diversity needed for a board to be successful, though the most important is diversity of thought. The other types include diversity of gender, race, age, culture, nationality, economic background, and experience, each of which can also often help to deliver diversity of thought. The aim is to avoid groupthink in the boardroom, which may lead to a lack of questioning and challenge.

While this broad concept of diversity—diversity of thought—is well understood, most diversity initiatives focus on the most visible issues: gender and race. A number of markets now have quotas for female directors (notably Norway, which pioneered the approach, and France), and most are moving toward an expectation that at least 30% of public company directors should be women. The issue of racial diversity has been actively debated in the USA for some years, and the UK's 2017 Parker Review called for at least one non-white director on every FTSE-100 company board by 2021 and on every FTSE-250 board by 2024.[5] A 2022 update of the review (https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/diversity/ey-what-the-parker-review-tells-us-about-boardroom-diversity.pdf) noted that 89 of the FTSE-100 companies had met the goal by the end of 2021 and that some 55% of the FTSE-250 had also already reached the goal. These initiatives gained fresh impetus from the momentum of the Black Lives Matter campaign in 2020, which could mean that more change is likely.

An effective chair brings out the contributions of each board member, which is less visible to outsiders but is a vital part of delivering board effectiveness. Investors can gain some insight into how the chair operates in the boardroom from direct dialogue with the chair and with other board members, but often the clearest indicator is the quality of the individuals on the board overall. Good directors tend not to join boards that do not allow them to contribute effectively, or if they do, they are quick to leave them. The unfortunate consequence of all this for those who invest broadly is that weak boards tend to remain weak and it is difficult to improve them without substantive changes.

Board appraisals (sometimes known as board assessments or self-assessments) are required under many corporate governance codes and can help boards to become more effective by bringing problems to the surface. Some investors are often cynical about these appraisals, as weak boards and weak chairs can relatively easily limit their impact without its being apparent to investors. It is hard to determine whether a board appraisal has been effective—though it has a better chance of succeeding if it is an external process with an independent facilitator rather than simply an internal review. In some markets, both the delivery and the findings of board appraisals are expected to be disclosed, which can help investors gain insight into a company.

5 UK Government, *Ethnic Diversity of UK Boards: The Parker Review* (2017). Available at: www.gov.uk/government/publications/ethnic-diversity-of-uk-boards-the-parker-review.

CASE STUDIES

BHP Annual Report 2021, pp. 82–83: Disclosures on Board Skills, including Specifically on Climate Change Matters and Diversity

Board Skills and Experience

Total Directors	12
Mining Senior executive who has: ▶ deep operating or technical mining experience with a large company operating in multiple countries; ▶ successfully optimized and led a suite of large, global, complex operating assets that have delivered consistent and sustaining levels of high performance (related to cost, returns and throughputs); ▶ successfully led exploration projects with proven results and performance; ▶ delivered large capital projects that have been successful in terms of performance and returns; and ▶ a proven record in terms of health, safety and environmental performance and results.	4
Oil and gas Senior executive who has: ▶ deep technical and operational oil and gas experience with a large company operating in multiple countries; ▶ successfully led production operations that have delivered consistent and sustaining levels of high performance (related to cost, returns and throughputs); ▶ successfully led exploration projects with proven results and performance; ▶ delivered large capital projects that have been successful in terms of performance and returns; and ▶ a proven record in terms of health, safety and environmental performance and results.	2
Global experience Global experience working in multiple geographies over an extended period of time, including a deep understanding of and experience with global markets, and the macro-political and economic environment.	10
Strategy Experience in enterprise-wide strategy development and implementation in industries with long cycles, and developing and leading business transformation strategies.	11
Risk Experience and deep understanding of systemic risk and monitoring risk management frameworks and controls, and the ability to identify key emerging and existing risks to the organisation.	12
Commodity value chain expertise End-to-end value or commodity chain experience – understanding of consumers, marking demand drivers (including specific geographic markets) and other aspects of commodity chain development.	8

Total Directors	12
Financial expertise Extensive relevant experience in financial regulation and the capability to evaluate financial statements and understand key financial drivers of the business, bringing a deep understanding of corporate finance, internal financial controls and experience probing the adequacy of financial and risk controls.	12
Relevant public policy expertise Extensive experience specifically and explicitly focused on public policy or regulatory matters, including ESG (in particular climate change) and community issues, social responsibility and transformation, and economic issues.	5
Health, safety, environment and community Extensive experience with complex workplace health, safety, environmental, and community risks and frameworks.	10
Technology Recent experience and expertise with the development, selection, and implementation of leading and business transforming technology and innovation, and responding to digital disruption.	5
Capital allocation and cost efficiency Extensive direct experience gained through a senior executive role in capital allocation discipline, cost efficiency	11

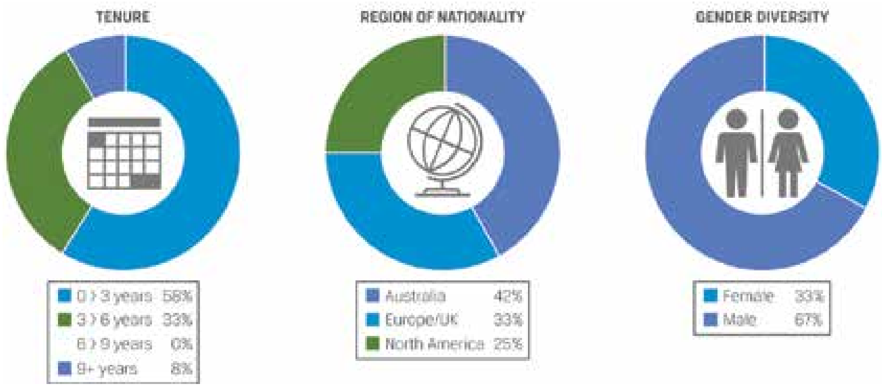
Twelve Directors meet the criteria of financial expertise outlined above. The Risk and Audit Committee Report contains details of how its members meet the relevant legal and regulatory requirements in relation to financial experience.

Board Skills and Experience: Climate Change

"Board members bring experience from a range of sectors, including resources, energy, finance, technology and public policy. The Board also seeks the input of management and other independent advisers. This equips them to consider potential implications of climate change on BHP and its operational capacity, as well as understand the nature of the debate and the international policy response as it develops. In addition, there is a deep understanding of systemic risk and the potential impacts on our portfolio.

The Board has taken measures designed to ensure its decisions are informed by climate change science and expert advisers. The Board seeks the input of management (including Dr Fiona Wild, our Vice President Sustainability and Climate Change) and other independent advisers. In addition, our Forum on Corporate Responsibility (which includes Don Henry, former CEO of the Australian Conservation Foundation and Changhua Wu, former Greater China Director, the Climate Group) advises operational management teams and engages with the Sustainability Committee and the Board as appropriate."

Board Tenure and Diversity (as at 30 June 2021)



Source: BHP (2021).[6]

Board independence is also a key concern. The aim must be to have a board that is independent of the management team and operates with independence of thought so that it can challenge both management and previous decision-making at the company (including prior board decisions).

The ICGN's Global Governance Principles set out an unusually complete investor perspective on independence criteria; these extend and elucidate some of the criteria embedded in standards in various Codes around the world. These criteria suggest that there will be questions about the independence of an individual who:

- had been an executive at the company or a subsidiary, or an adviser to the company, and there was not an appropriate gap between their employment and joining the board;
- receives, or has received, incentive pay from the company, or receives fees additional to directors' fees;
- has close family ties with any of the company's advisers, directors, or senior management;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- is a significant shareholder in the company, or is an officer of, or otherwise associated with, a significant shareholder, or is a nominee or formal representative of a shareholder or the state; and
- has been a director of the company for a long enough period that their independence may have become compromised.

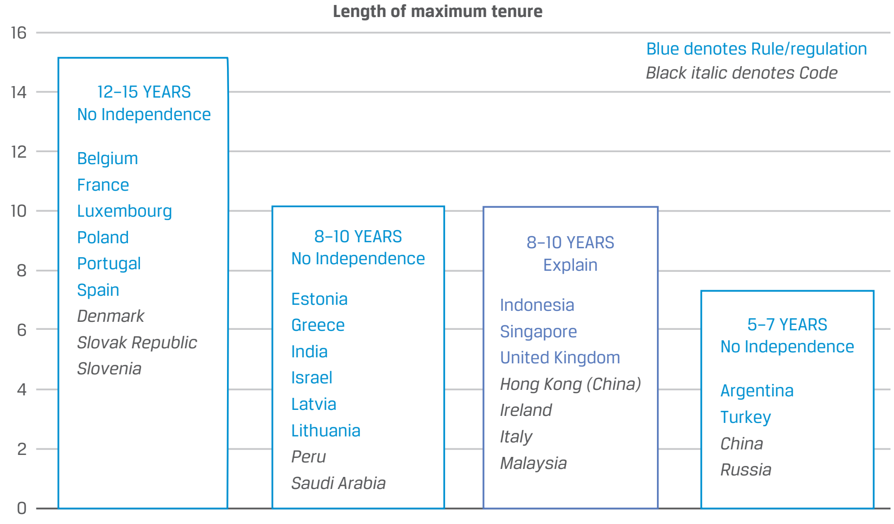
The intent is not to suggest that boards should never include directors whose independence is questioned. Indeed, such individuals may provide useful skills and perspectives. However, every board needs a sufficient weight of clearly independent individuals so that it is able to operate independently and is not subject to bias or inappropriate influence. Investors recognize that independence is a state of mind, and that some individuals can be fully independent notwithstanding some of the issues raised, while others, whatever their appearance of independence, will support only a CEO or a dominant shareholder. One of the challenges for investors is being able to identify both sorts of individuals.

6 BHP, *Annual Report 2021* (2021). Available at: https://www.bhp.com/investors/annual-reporting/annual-report-2021.

Most investors would prefer that a company acknowledge that an individual will not be perceived as independent (for one of the various reasons) but will nevertheless bring real value to the business, rather than assert that the individual remains fully independent notwithstanding some obvious challenge(s). As ever, the way a board approaches an issue in its disclosures will determine how shareholders consider it.

The issue of length of tenure on the board and independence is generally recognized around the world (though it is not acknowledged as an issue in some major markets, most notably the USA), though different standards are applied. As can be seen in Exhibit 2 (from the OECD Corporate Governance Factbook 2019), different markets have different expectations as to how long it takes for independence to erode. Investors may often seek to apply a single global standard, while companies may expect that their local standard will be respected.

Exhibit 2: Definition of Independent Directors: Maximum Tenure



Blue denotes Rule or Regulation. *Black italic denotes Code.*

The countries that apply an “Explain” standard are essentially asserting a rebuttable presumption that the relevant individual is not independent; if a company wishes to argue that the individual remains independent notwithstanding their tenure, an explanation is needed, which shareholders may or may not accept.

Source: OECD (2019).[7]

Executive Remuneration

Pay is where the clearest conflict of interest between management and shareholders occurs. As (in public companies at least) it is not possible for investors to negotiate pay directly with management, shareholders need to rely on remuneration committees to do so effectively on their behalf, and they need to have confidence that the non-executive directors on those committees will negotiate well and with shareholder interests in mind.

7 OECD, *OECD Corporate Governance Factbook 2019* (2019). Available at: www.oecd.org/corporate/corporate-governance-factbook.htm.

There is a broader challenge, however: the directors' obligation is to the success of the individual company, while shareholders, in most cases, have an eye to the broader market. Therefore, while shareholders may be more concerned about a ratcheting effect of increased pay across the market as a whole (often driven by companies seeking to respond to pay benchmarks and remain competitive in terms of remuneration), directors will want to ensure the best possible candidate is appointed to their company, which may tempt them to pay up for the given individual. Often, many of the arguments about executive pay arise directly from this difference between the mindsets of the board and the shareholders.

While pay levels differ in different markets, the pay structures for top executives are broadly similar. In brief, executive pay structures in much of the world come in four categories:

- fixed salary, usually increased annually;
- benefits, including pension (typically calculated as a percentage of the salary, often at a more generous rate than is enjoyed by the wider employee base);
- annual bonus; and
- share-linked incentive (usually in the form of a long-term incentive plan, or LTIP).

While the scale of fixed salaries, and the way in which they increase (often ahead of inflation in general wages), can be controversial, most attention is focused on the variable incentives: the bonus and equity-linked portions. Bonuses are typically calculated on the basis of annual performance against metrics (often called key performance indicators, or KPIs) set at the start of a year; they are paid in cash at the end of the year—though increasingly some of the bonus is deferred for a further two or three years, often into shares that are released only at the end of the deferral period. The KPIs for bonuses will predominantly be financial metrics (usually profit-related), but often around 20% of the KPIs concern personal performance or non-financial measures, including ESG factors. Investor expectations on this matter have shifted notably in the last few years, and it is now a predominant view that at least a portion of the bonus should be driven by such ESG metrics—typically, factors that are closely aligned with the strategic aims of the business.

The longer-term equity rewards usually measure performance over at least three years and are typically paid out in shares that must be held for a further period (currently the expected minimum overall period, including the performance period and lock-up thereafter, is five or more years). Performance for these schemes is usually measured by broad-brush financial metrics, typically a combination of total shareholder return (TSR) and earnings per share (EPS).

While this brief discussion may sound complex, it is a significant simplification, as can be seen by looking at the multiple pages devoted to remuneration in an annual report.

Trust, or a lack of it, has driven much of the problem with executive reward. This issue has developed because of failures of understanding between investors who see ongoing payments for poor performance and corporations that find shareholders voting against schemes they have supported for years or have previously indicated they will support. Companies are faced with various views from investors, many of which are incompatible and so strongly held that they allow little flexibility. The fear of significant votes against a board's remuneration proposals leads many companies to produce a compromised structure, rather than something the directors fully believe will drive value in the business. This action can lead to a further escalation of quantum (the amount paid to executives, aggregated across all forms of remuneration), as a compromised structure means that executives lack confidence they can deliver what is needed to unlock the company's full potential. The higher quantum also leads to media and investor attention, and tension between the company and its shareholders is likely to escalate.

Disputes also arise from other differences in mindset. Investors tend to look for pay outcomes that match the corporate performance they enjoy as shareholders, and they are unlikely to oppose even the most generous packages when share price performance is strong (though there is increasing evidence that US companies in particular are testing the boundaries of this shareholder indifference to quantum—for instance, the 34% shareholder opposition in the say-on-pay vote at Apple's 2022 AGM, where the company's generous executive rewards raised concerns for shareholders, even given its stellar business and share price performance). Companies tend to consider performance within the business itself (seeing the share price as a function of market sentiment as much as business performance), and directors believe they need to honor contractual obligations, paying out according to the terms of the agreed incentives. This situation can sometimes lead to a disconnect in expectations: the reward that is due under the contractual incentives may seem excessive to shareholders because it does not reflect the market performance of the shares.

Overcoming these differing perspectives is necessary, but as yet no proposed alternative structure has gained sufficient traction among both investors and companies to become the universal solution to the problem.

Discussions about executive pay are also complicated by concerns about fairness and the extent to which executive pay outcomes far exceed the experience of ordinary people, as exemplified by the pay ratio disclosures now mandated by some markets (notably the UK and the USA). These disclosures compare the remuneration of the CEO with that of the firm's average-paid worker and reveal very sizable differences, often hundreds to one. While investors will often have sympathy for companies that are keen to have the best leadership, the growing tensions about income and wealth disparity make the question of fairness, as exemplified by pay ratios, an issue that is increasingly hard to ignore. These considerations are part of what is now driving the debate about the overall quantum of executive pay.

5 CHARACTERISTICS OF EFFECTIVE CORPORATE GOVERNANCE: TRANSPARENCY, CAPITAL ALLOCATION, AND BUSINESS ETHICS

☐ **5.1.2** assess key characteristics of effective corporate governance, and the main reasons why they may not be implemented or upheld: board structure, diversity, effectiveness, and independence; executive remuneration, performance metrics, and key performance indicators (KPIs); reporting and transparency; financial integrity and capital allocation; business ethics

Reporting and Transparency

Principle N of the 2018 Corporate Governance Code states:

> *"The board should present a fair, balanced and understandable assessment of the company's position and prospects."*[8]

The starting responsibility for the oversight of company reporting sits with the audit committee, but as Principle N indicates, this responsibility is shared by the whole board. The phrase "fair, balanced and understandable" was arrived at after considerable debate and has led many companies to undertake a rigorous restructuring of their processes and reporting. Reporting and transparency are led first by the management team and then overseen by the audit committee and the board as a whole. Independent challenge then comes from the auditor.

Investors often learn much about the management team from their reporting. That is especially true where a company appears to be masking a weakening performance. One way in which this masking is sometimes done is through alternative performance metrics (APMs). These measures are adjusted forms of the accounting standard–approved measures of performance, often referred to as "adjusted" or "underlying." Their use sometimes indicates a management that is keen to flatter performance rather than admit a failure to generate better performance, as the omission of elements through these adjustments may be difficult to justify objectively. Investors are particularly wary when the APM calculations vary from one reporting period to another. A further indicator of an attempt to obscure an issue is where numbers in the narrative disclosures of the annual report do not entirely tally with the numbers revealed in the financial accounts in the back half of the report.

One area where there is a particular danger of inconsistency between the narrative and the financial reporting, and currently a major concern to many institutional investors, is climate change. Too often, the fine words in the narrative reporting in response to the Task Force on Climate-related Financial Disclosures (TCFD) and other reporting standards are not reflected in changes to the associated financial reporting. The International Accounting Standards Board (IASB), which sets the International Financial Reporting Standards (IFRS) for most of the world, has recently commented that material climate issues should be reflected in financial reporting, and the Principles for Responsible Investment (PRI) and other institutions have called on companies and their auditors to ensure that this reporting is delivered in practice.[9]

The area of reporting on environmental and social factors is rapidly developing. New Zealand and the UK were the first countries to mandate that all large public companies must report according to TCFD standards, but they will not be the last.

In collaboration with the International Organization of Securities Commissions (IOSCO), the IFRS Foundation announced at COP26 the formation of a new International Sustainability Standards Board (ISSB). (IOSCO, the international body that brings together the world's securities regulators, is recognized as the global standard setter for the securities sector; COP26, held in 2021, was the 26th UN global summit to address climate change.)

The ISSB will develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs and will consolidate the Climate Disclosure Standards Board (CDSB, an initiative of CDP) and the Value Reporting Foundation (VRF, which houses the Integrated Reporting Framework and the SASB Standards) into the IFRS Foundation.

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8 Financial Reporting Council, *TheUK Corporate Governance Code*. Available at: www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf.

9 Principles for Responsible Investment (PRI), *Accounting for Climate Change* (2020). Available at: www.unpri.org/sustainability-issues/accounting-for-climate-change; See also Flying Blind: The Glaring Absence of Climate Risks in Financia Reporting. Available athttps://carbontracker.org/flying-blind-pr/.

This new body will have a multi-location structure, drawing together many of the disparate groups independently seeking to set sustainability reporting standards. It aims to ensure that the different needs of the various regions are reflected as the standards are developed.

The advent of ISSB provides the potential for unprecedented uniformity based on a consistent common standard of high-quality sustainability reporting, assessment, and analysis.

A strong audit committee should strictly oversee the reporting process to ensure fair and balanced reporting, preventing these sorts of discrepancies from occurring. A strong and challenging auditor, assisted by regulations, should also intervene to prevent any misleading of investors. Auditors also have a specific duty to highlight any apparent inconsistencies between the financial statements and other reporting by the company.

The European Securities and Markets Authority (ESMA) published a set of guidelines on the use of APMs in 2015.[10] These guidelines require consistency, with the APMs not to be disclosed more prominently than the official measures and with a full reconciliation between the two. Unfortunately, enforcement of these standards is variable.

In a similar way, in December 2019 the IASB published an *Exposure Draft on Primary Financial Statements*, which would allow the disclosure of a management-preferred measure of performance on the face of the income statement—but only alongside the permitted standard measures and with a full reconciliation between them.[11] The IASB continues to consider how best to respond to the feedback it has received. It remains to be seen how effectively companies will respond to any new standard.

See the section titled "Corporate Governance and the Independent Audit Function" for a detailed discussion of audit and the challenges that arise in that area.

Financial Integrity and Capital Allocation

The key concern active shareholders usually have about a company's strategy is capital allocation (the way a company applies its financial resources to generate the most value over the long term). Key questions to be asked include how much of its cash flow does it distribute to shareholders and how much does it reinvest in existing or new business activities. It is rare for a company to have large enough resources to pursue every opportunity it identifies, and so capital allocation is as much about what a company will *not* do as about what it will. These investment decisions are crucial—whether a company can successfully deliver on them will determine the returns the company receives over future years.

Often, in part, capital allocation is a function of history: a company retains a legacy business operation, even a sizable operating business, when the opportunity for the company as a whole has in fact moved on. Shareholders can be more clear-minded than management about disposing of older businesses or operations—often, perhaps, because they may not understand the full complexities that would be involved in fully moving on from the legacy activity nor be fully aware of the consequences for stakeholders. Even where the issue is not a legacy activity, most companies have to make decisions that will see their business operations diverge over time. Conglomerates are now firmly out of favor, and most investors prefer to invest in focused businesses—with

10 European Securities and Markets Authority (ESMA), *ESMA Guidelines on Alternative Performance Measures* (2015). Available at: www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-alternative-performance-measures.

11 IFRS Foundation, *Exposure Draft and Comment Letters: General Presentation and Disclosures (Primary Financial Statements)* (2019). Available at: www.ifrs.org/projects/work-plan/primary-financial-statements/comment-letters-projects/ed-primary-financial-statements/.

investors themselves providing diversification across their portfolio holdings. The crucial decision for the boards of such companies is how to allocate capital among the various businesses and make the most of the opportunities they have identified. Even where there is no active investor pressing for a different approach to capital allocation, the board may need to have an active dialogue with the shareholder base because different decisions about which business opportunities to pursue will appeal to different investors. In particular, some of the capital allocation options may require a change in the dividend payout to ensure that more resources can be retained for reinvestment in the business.

In a similar way, the capital structure of a company is a crucial area of debate within the boardroom and between the board and shareholders. Companies without debt on their balance sheets are often thought to be inefficient and failing to deliver the full extent of possible returns—failing to maximize return on equity. However, the 2008 financial crisis—and the more recent challenges to business resilience arising from the COVID-19 pandemic—reminded all investors that there is a danger in seeking to load companies with excess debt in order to generate greater returns on the remaining equity capital. That danger is the risk of insolvency if interest rates rise and/or if there is a downturn in the business. Having a sustainable capital structure means there must be some compromise between the extremes of maximizing returns on equity in the short term and making the company entirely robust to a downturn. Unless the company is operating in a highly volatile business (where the gearing is operational rather than financial), the board should seek to optimize the capital structure by taking on some debt.

A key financial resilience question that boards will need to answer is how they strike a balance between full resilience and maximizing short-term returns. Many shareholders will be willing to sacrifice some short-term returns so the business will be strong enough to survive a downturn. The experience of the COVID-19 pandemic has reminded investors and company boards that having such a buffer is good stewardship of a business in the long term. But the prudent balance is delicate: most shareholders would not wish businesses to be so financially secure that they could cope with any financial crisis. The multiple fundraisings by companies during the pandemic demonstrated this point in practice: good businesses with long-term futures were refinanced.

Decisions regarding share buybacks and the issuance of shares are key elements of these overall capital structure decisions and should be considered as such by both boards and shareholders. Similarly, considerations with regard to the payment of dividends to shareholders need to encompass decisions about what is a sustainable level of capital to support ongoing business success. Paying dividends beyond the cash flow from the business is clearly not sustainable and is likely to raise significant questions among shareholders, even though they may welcome the immediate cash payments. But the opposite circumstance—a low dividend payout ratio—is also likely to cause concerns, especially if the company already has significant cash on its balance sheet. This latter circumstance has proved central to disagreements between several Japanese companies and their shareholders over recent years

Business Ethics

A company needs to abide by the laws of its home country (formally known as its country of incorporation), and a multinational group must act within the laws of any country in which it operates. In some respects, such as bribery and corruption, many jurisdictions impose extraterritorial laws, meaning that a company can be guilty of an offense anywhere in the world it is involved in corruption. For example, both the USA's Foreign Corrupt Practices Act and the UK's Bribery Act have extraterritorial effect; the latter also explicitly requires every company to maintain procedures to ensure that no bribery is carried out by agents or others on its behalf.

Many companies, particularly those based in legalistic environments, tend to believe that obedience to the law is sufficient. However, many investors expect more than that, and companies aspiring to be responsible world citizens and to enjoy ownership on the public markets will need to go further. Companies need to operate while being conscious of business ethics and broader responsibilities to stakeholders and communities. By doing so, they are more likely to prosper in the long term, not least because a failure to deliver on these ethical aims may lead to a breakdown in relations with one or more key stakeholders. At its extreme, an ethical failure might lead to a loss of license to operate in a market or even as a business. An ethical approach to business will encompass such issues as:

- corporate culture and having a set of expected behavioral standards for all staff, not tolerating inappropriate behaviors;
- treating employees fairly by upholding high standards in health and safety, human rights, and avoiding modern slavery;
- offering value to customers and avoiding discriminatory or other exploitative behavior, including avoiding collusion with rivals or other anti-competitive activity;
- avoiding bribery and corruption, and fraudulent behavior;
- paying suppliers appropriately and promptly, and not seeking unfair benefit from any dominant negotiating position;
- developing appropriate relationships with local communities close to relevant business operations, and being ready to enter into dialogue on any key concerns they may have;
- approaching any regulatory or political lobbying activity honestly (including ensuring that the lobbying is not inconsistent with the company's publicly stated approach to particular issues) and without seeking unfair advantage;
- seeking to pay a fair and appropriate level of tax by approaching tax compliantly and recognizing that tax avoidance, not just tax evasion, can be inappropriate; and
- acknowledging that a company's reputation is a valuable asset that can be harmed by unethical or inappropriate behavior by the business or its staff.

Usually, the audit committee is asked to oversee business ethics as part of its broader risk remit, but different companies address these issues through different structures. A company with a robust ethical approach and culture will have robust whistle-blowing procedures in place that are well publicized to staff and to which all employees (and perhaps others, such as contractors and suppliers) have access. These procedures will allow any concerned party to raise issues with people of appropriate seniority and independence, so that any apparent failure to live up to the asserted ethical standards can be identified and addressed promptly. Typically, these whistle-blowing processes will be overseen by the audit committee (and sometimes by the risk committee or other appropriate board-level group), so non-executive directors can assure themselves of the independence of the process and have confidence that the company is living up to the standards that the board expects.

In practice, the approach to business ethics within a company is, like corporate culture, generally difficult for outsiders to discern, as it will always be a challenge for both non-executive directors and shareholders to have real insight into the matter.

6 STRUCTURAL CORPORATE GOVERNANCE DIFFERENCES IN MAJOR WORLD MARKETS

☐ **5.1.3** assess and contrast the main models of corporate governance in major markets and the main variables influencing best practice: extent of variation of best practice; differences in legislation, culture, and interpretation

The division between the supervisory board and the management board marks one of the fundamental structural differences in governance globally. The so-called two-tier boards are seen, for example, in Germany, the Netherlands, Scandinavia, and China; the single-tier (also called unitary) boards are more typical of the UK, the USA, Japan, France, and most of the rest of the world. But this structural difference covers other differences; for example, there are multiple forms of the single-tier board:

- In the USA and France, a single executive sits on the board and often bears the responsibility of both chair and CEO (though this long-held tradition of combining the two very different roles is declining in the USA, with around half of S&P 500 companies now having an independent chair). In Australia, the CEO is usually the board's single executive director (and does not usually chair the board), but is typically not subject to election by shareholders.
- In Japan, there is usually a single-tier board dominated by executive directors, with only a small handful of non-executive directors (not necessarily independent).
- In most other countries, single-tier boards have a few executive directors and a majority of non-executives (most of whom are independent), one of whom acts as chair.

By contrast, supervisory boards are all largely constituted in the same way, with all members being non-executives. In some cases, however, they are not perceived as independent, as some members may be direct representatives of major shareholders or representatives of employees, and in some cases the chair of the supervisory board is the former CEO of the company (though this tradition is slowly being abandoned).

No one model of corporate governance is better than the others. They are creatures of the legal histories and cultures of the countries in question. Best practices have been identified and incorporated into global initiatives such as the **ICGN Principles** and the **Organisation for Economic Co-operation and Development (OECD) Principles**. In the same vein, investors will often expect companies to adopt international best practices and go beyond local standards in country-specific codes. The **OECD's Corporate Governance Factbook** is a good source for details on the governance structures and approaches in 49 jurisdictions. Inevitably, the following brief survey covers a much smaller set of geographies and highlights the unusual features in the governance of a handful of leading markets.

Corporate Governance in Australia

Australia has a single-tier board structure, with just a single executive director (often called the managing director instead of, or as well as, CEO). This individual is typically not subject to election by shareholders, who vote on the appointment of the non-executive directors annually. Boards are also relatively small in comparison to public companies in most other major markets, with six or seven directors being typical. While some companies have moved to annual elections for all directors (other than the CEO), many still face re-election only every third year.

The Australian bluntness of their version of comply or explain—“if not, why not?”—can be reflected in a sometimes-combative relationship between companies and their shareholders. Australia was one of the first countries to make superannuation (pension) saving compulsory in order to increase that form of saving to meaningful levels, so the “super funds” are now significant. They increasingly seek to wield their influence forcefully, and a number of organizations—in particular, the Australian Council of Superannuation Investors (ACSI)—help them present shared views to companies.

Investors have a strong influence on Australian companies, as can be seen in the case of the mining company Rio Tinto in 2020. The CEO and two other senior executives were ousted following a public outcry after the company destroyed the Juukan Gorge site (caves that showed evidence of continuous human habitation for 46,000 years and were considered sacred by the local Puutu Kunti Kurrama and Pinikura peoples) to develop it for iron ore mining. Despite the company’s having a license to take these actions, the public outcry and the concerns expressed by both politicians and investors made it impossible for the company not to take action against top executives.

Shareholder resolutions are relatively common in Australia, with only US companies facing more such proposals. The reason is partly because Australian law has been interpreted in a relaxed way, and partly because of the strength and organization of the shareholders. The approach can be seen in the appointment of directors, where law and regulations are deemed to mean that only a minimal shareholding is needed to make a proposal, provided the notice period for proposing a candidate has been followed. Though the thresholds for other shareholder resolutions are higher—5% of the issued capital or 100 shareholders—campaigners using social media find it relatively easy to reach the required number of shareholders.

Corporate Governance in France

While there is scope for two-tier boards in France, the vast majority of French boards are single-tier and led by a combined chair/CEO, sometimes still referred to as the Président-Directeur Général (PDG). Standards require that 40% of the directors be female and that around a third of the board be employee representatives, ensuring that the stakeholder voice is clearly heard in the boardroom. French law takes conflicts of interest particularly seriously, and shareholders are invited to vote on related-party transactions (often multiple resolutions in a single year), even those of relatively small value.

Two aspects of French governance are particularly unusual and worthy of discussion: the requirement for joint auditors and the existence of double voting rights for some shareholders. With regard to the audit, France is the only major market to require two audit firms to look at financial statements rather than the usual one firm; these firms are generally one of the Big Four (Deloitte, EY, KPMG, and PricewaterhouseCoopers, or PwC) and one from the next tier of firms. Some consider this requirement controversial, as it is seen as possible for issues to fall between the cracks between the two firms; however, the proponents of this approach suggest that there are likely to be fewer issues missed because there are more pairs of eyes considering the key concerns. The duplication of work effort (and cost) is minimized, as the only entity audited by both joint auditors is the top company and the consolidated accounts—the firms split the audit of the rest of the business units between them (with the smaller firm typically covering less than half). The staggered rotation of the audit firms provides continuity despite the requirement for regular changes of audit firm.

Under 2014's so-called Florange Act (named after a steelworks in northern France that closed and became a symbol of the risk of further industrial decline), unless there is a two-thirds shareholder vote to the contrary, French companies can award double voting rights to long-standing shareholders, defined as those who have held shares in a particular way for at least two years. The structure of this requirement means that few institutional investors qualify (certainly those outside France do not). Even a long-standing pension fund or insurance investor may find its continuity of ownership perceived as having been affected by such normal practices as a change of custodian or fund manager or by a stock-lending program. Thus, in practice, these double voting rights are perceived as a mechanism to establish management control, or control by majority shareholders, and to limit the influence of minority shareholders.

The controversial nature of the Florange Act and the potential long-term consequences of its double voting rights are illustrated in two cases.

First, at Renault: the French government was a 15% shareholder and failed to persuade the company's management and its business partner, Nissan, not to propose an opt-out from the Florange Act at its 2015 AGM. Instead, shortly before the AGM, the French government bought an additional near-5% stake in the company—enough to defeat the opt-out from the law, having given the French state double voting rights for its shareholding, which it soon reverted to the 15% level. In retrospect, this maneuver (agreed to by Emmanuel Macron, the economy minister at the time) is seen as one of the moments when the partnership between Renault and Nissan began to break down.

The second example is Vivendi, the French media conglomerate. Businessman Vincent Bolloré effectively secured his control of the company in 2015, when he was able to defeat a resolution to opt out of the Florange Act. At the time, his shareholding in Vivendi was just under 15%, and while a majority of shareholders supported the opt-out, it failed to gain the necessary two-thirds majority. As a result, Bolloré's shareholding soon gave him 20% of the votes (and more since then), which proved sufficient for him to gain full control of the company and to radically reshape its strategy.

Corporate Governance in Germany

The two-tier board structure in Germany distances shareholders from the operations and from holding management accountable. Shareholders appoint half the members of the supervisory board, and the other half are appointed from among the workforce. All supervisory board members are charged with acting in the best interests of the corporation. This inclusion of workers in the boardroom is called co-determination; in theory, it enables boards to make longer-term decisions and to gain staff support even for difficult decisions. Certainly, German business has been highly successful over the last 70 years, and many world-leading German companies have been built. Anecdotal reports, however, tend to suggest that there are usually meetings of the supervisory board without the workforce members in attendance (where many of the crucial discussions happen) and that the full board meetings are more formalized.

As shareholders vote on the appointment of half the supervisory board—which, in turn, is responsible for the appointment of the management board—the supervisory board, but not the management board, is accountable to shareholders. This sense of distance between the management board and shareholders is increased by the co-determination structure, which allows management to feel at least as accountable to other stakeholders as it does to shareholders. A symbol of the distancing of shareholders from decision-making is the position on remuneration: the German code on corporate governance, the Kodex, insists that shareholders vote on management remuneration structures through advisory votes only, with the actual decision-making resting with the supervisory board.

The independence of thought on the supervisory board has been improved by a move away from the former tradition of an outgoing executive becoming the chair of the supervisory board. Helpfully, from an independence perspective, German law (s. 100(2) of the Aktiengesetz, or German Stock Corporation Act) now requires a two-year gap between departure from the management board and joining the supervisory board, unless the individual is elected after having been nominated for the role by 25% of shareholders. The Kodex confirms that any such individual should not be regarded as independent and that no more than two former members of the management board should be on the supervisory board.

It is intended that strategies be developed by the supervisory board and the management board working together, though the management board is usually expected to initiate the thought process. Principally, the role of the supervisory board is to hold the management board to account, and all major transactions (according to the Kodex, these "include decisions or measures that fundamentally change the company's net assets, financial status or results of operations") need the supervisory board's approval. The supervisory board structure thus keeps shareholders one step further away from holding management to account.

The most controversial item in the Kodex is in Principle 7:

> *"The Supervisory Board Chair should be available—within reasonable limits—to discuss Supervisory Board–related issues with investors."*[12]

This sentence was opposed by a number of leading supervisory board chairs. In contrast to many countries, in Germany it can, in practice, be difficult for shareholders to meet with the chair (and all but impossible to meet with any other members of the supervisory board). This challenge of access is slowly improving, but investors do rely on the goodwill of the individual chair.

Corporate Governance in Italy

Italy has a single-tier board structure, with typically a single executive director and an independent chair. An unusual feature of Italy's governance framework arises from its history: most company shareholder bases have been dominated by a single shareholder or group of shareholders (often led by the state, local or national, or the founding family or, in some cases, by the country's major financial institutions). The dominance of these shareholder groups could mean that the nomination and election of the boards of such companies would be entirely in their hands, leaving minority shareholders feeling unrepresented and facing wholly non-independent boards. To reassure minority shareholders that their interests would be represented, the *voto di lista* approach was developed: a designated portion of the board (typically around 30%) is reserved for minority shareholders only. Shareholders with a minimum level of shareholding (usually 1%) have the ability to propose a slate (i.e., a group) of directors, and typically there is more than one slate. The slate with the most votes is the dominant one, and the chair is appointed from it; the slate with the next most votes is considered the successful minority slate and fills the board roles designated for minority investors. The Italian investor association Assogestioni organizes minority slates for board elections each year.

At companies with a broad institutional investor base and only a limited shareholding by the "major" shareholder, there is a chance that the *voto di lista* approach could lead to the slate intended as the minority slate gaining more votes than the one intended to be dominant. In such unusual situations, the proxy agencies will recommend that their clients support the slate intended as the dominant one, so that

12 Regierungskommission, *Deutscher Corporate Governance Kodex* (2020). Available at: https://dcgk.de/en/home.html.

it provides the chair and the bulk of board seats as intended. In most circumstances, the proxy agency recommendation is that clients support the Assogestioni minority slate to ensure some board participation by independent directors.

Another unusual feature of the Italian governance structure is that there are elections for statutory auditors. These auditors are not the independent auditors, who are charged with assessing the accuracy of the financial statements. Rather, the statutory auditors have a legal role to affirm the legality of certain actions by the board. Usually, one of the three to five proposed candidates is a lawyer and another is a former (financial statements) auditor. Statutory auditors are also appointed through a *voto di lista* slate process and form an additional protection for minority shareholders.

Both the boards and the statutory auditors are elected for multi-year periods, usually five years, and are not eligible for re-election in the following period. Though this approach provides a clear planning horizon, it can lead to challenges in the last year of a mandate, as there may be a sense of a weaker board that does not wish to bind its successor inappropriately. There is of course no reason why the same board should not be reappointed for a second mandate, but this happens less frequently than might be assumed.

Corporate Governance in Japan

Many companies in Japan (and also in markets such as Taiwan and South Korea) enjoy the structure of having statutory auditors (*kansayaku*), who are in addition to the independent audit firm that ensures the accuracy of the accounts. There is typically a small odd number of statutory auditors (usually three or five), each of whom is appointed individually by shareholders, typically on a four-year rotation. In theory, these auditors are independent individuals, but in many cases, this independence may be questionable as many come from family companies or the lending banks, which can have a close relationship with large companies. While in some ways these statutory auditors serve an independent challenge role somewhat equivalent to independent non-executive directors, their scope to do so is limited by their narrowly defined role and also by the questionable independence of some.

Since the changes to governance introduced by the third "arrow" of Abenomics (the moves toward economic liberalization and renewal under former Prime Minister Shinzo Abe), some companies in Japan have started moving away from the statutory auditor approach and have instead adopted the alternative structure of a "board with committees," similar to board structures seen elsewhere in the world, with non-executive directors. This move has created some challenges, as there has not been a tradition of non-executive directors in Japan, and the culture of loyal and lifetime service to single companies and of strong rivalries within industries has halted the development of a body of non-executives ready to offer advice and challenge a range of businesses. The focus in the Japanese Corporate Governance Code, introduced in 2015 and revised in mid-2018, is on the independence of non-executive directors rather than on the value they can bring to companies through their insights. This focus purely on independence has led to the appointment of some individuals whose value in a business boardroom might be doubted, but this focus is changing over time and a greater understanding of the role of the non-executive director is developing.

Although the *zaibatsu*[13] conglomerates that dominated the Japanese economy for decades were officially dismantled after 1945, the culture of family groups of companies held together by cross-shareholdings persisted. There was a perception that these cross-shareholdings acted as deadweights on fresh strategic thinking and innovation.

13 *Zaibatsu* is a Japanese term meaning "financial clique" and refers to industrial and financial business conglomerates in Japan, usually family controlled, whose influence and size allowed control over significant parts of the Japanese economy up until the end of World War II.

For this reason, the Japanese Corporate Governance Code includes provisions that discourage the maintenance of cross-shareholdings (a specific principle, 1.4, discusses cross-shareholdings and, in effect, requires the disclosure of a policy to reduce them over time). Another main focus in the code is on increasing independence on Japanese boards by requiring at least two independent non-executive directors to be in place on every board, even where the statutory auditor model is still in use.

Corporate Governance in the Netherlands

The 2017 contested takeover bid for Dutch chemicals firm AkzoNobel by US rival PPG put corporate governance in the Netherlands firmly in the spotlight. While in most countries, the bid—certainly the revised terms offered by PPG after its initial and second approaches were rebuffed—and the strong support for discussions from significant shareholders would have led to active negotiations, AkzoNobel never even came to the negotiating table. Instead, the Dutch firm successfully argued that the board owed as strong a duty to other stakeholders, particularly employees, as it did to shareholders, and further argued that the value offered to shareholders was unattractive (though the shareholders themselves largely and often publicly disagreed) and that the protections for staff were insufficient.

AkzoNobel declined to hold an extraordinary general meeting (**EGM**) proposed by several shareholders that would have considered ousting the supervisory board chair, Antony Burgmans. A May 2017 court decision by the Enterprise Chamber backed the board's understanding of Dutch corporate governance, including both its basis for not entering into discussions on a deal despite investor support and its decision not to hold the proposed EGM. Burgmans finally departed the board ahead of the 2018 AGM. In effect, the court decision backed the board's stance on the bids, and the company also benefited from significant political support—further takeover protections for all Dutch companies have since been proposed. In some ways, however, shareholders got the bulk of what they wanted in the end. Subsequently, the company sold off its specialty chemicals business, focusing instead on paints and coatings, and returned the bulk of the proceeds to shareholders.

As with other countries with supervisory board structures, shareholders in the Netherlands appoint the supervisory board and are kept at a distance from holding management accountable for performance and strategy. The AkzoNobel case demonstrates that shareholders do not necessarily come first in the Dutch corporate governance model and that other stakeholder interests must be taken into account. That is particularly true in the case of takeovers, which have long been a sensitive issue in the Netherlands and remain so—long after the dismantling of most of the Stichting structures,[14] which were able to keep shareholders at arm's length if there was a hostile bid, securing the role of management and the supervisory board. But the AkzoNobel example also shows that, other than in the case of takeovers, the influence of shareholders is strong: the longer-term outcome of the dispute was board change and a significant streamlining of the company and return of value to shareholders.

Corporate Governance in Sweden

Governance in Sweden has been shaped by the dominance of major shareholders in the registers of many leading companies. Most prominent of these is the Wallenberg family vehicle, Investor AB. Investor AB is itself a public company but is controlled

14 *Stichting* is a legal structure that can be used for any purpose. In the context of corporate governance and control, it usually refers to an organization that itself owns the shares in the underlying company and issues depositary receipts to the market. Investors would buy these instead of shares, meaning that they would not enjoy all the rights of legal shareholders.

by the Wallenbergs through the mechanism of two classes of shares with differential voting rights—a feature of Swedish governance that persists at many businesses despite its controversial nature. Investor AB's ownership of other Swedish companies includes, among others:

- Atlas Copco (16.9% of the shares and 22.3% of the votes);
- ABB (12.2% of the shares and votes);
- AstraZeneca (3.9% of the shares and votes);
- SEB (20.8% of the shares and votes);
- Ericsson (7.7% of the shares and 23.6% of the votes); and
- Electrolux (16.4% of the shares and 28.4% of the votes).

Investor AB argues that its investments, and its voting influence, enable it to avoid short-term pressures and to build these businesses for the long term.

This dominance of the share capital, and particularly of the votes, could lead to Investor AB being able to appoint the bulk of corporate boards in Sweden and having even more disproportionate influence than it already does. To mitigate this dominance, Sweden has developed an unusual structure whereby a company's nominations committee is not a board committee but is instead appointed from among the shareholders—with the largest shareholders invited to participate in descending order of their shareholdings until the committee is fully populated. At the AGM, this nominations committee proposes a board (which may include no more than a single executive, with independent non-executive directors in the majority) and a chair for shareholder approval. The outcome of this procedure is reasonably positive: skilled and generally well-balanced boards. The Wallenberg family still appear in many Swedish boardrooms, frequently providing the chair. In contrast to most countries, in Sweden the proposed board is usually put forward as a single slate, meaning that shareholders have a vote on the board as a whole rather than votes on each proposed director.

Similar structures and approaches can be found in other Scandinavian markets.

Corporate Governance in the UK

The UK issued the world's first Corporate Governance Code, and the current, 2018 version—overseen by the regulator Financial Reporting Council—goes further than most others. In particular, it focuses more attention on board behaviors and corporate culture than do other Codes. Of course, it does set expectations for:

- board skills and structure;
  - the UK discourages combined chair/CEO roles and expects chairs to be independent at appointment;
  - independent non-executive directors should compose the majority of the board, though there should be at least two and preferably three or more executive directors;
- audit and risk (the board is charged with considering the company's emerging and principal risks, including ESG risks, and making a statement regarding the viability of the business over at least a three-year period from the date of the accounts);
- remuneration;
  - the UK has detailed expectations around pay, in theory linking executive pay to performance and limiting the scope of payments for failure (long-term schemes need to be genuinely long term);

- these expectations are layered with extensive corporate law disclosure standards that apply to large UK-incorporated companies, which means that generally UK annual reports are the most coherent and informative in the world.

The UK Code's focus on board behaviors and corporate culture is much more in-depth than that of other Codes around the world and really makes the UK stand out. The second Principle of the current Code is particularly striking in this regard: "The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture." The second provision reinforces this message: "The board should assess and monitor culture. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action."

This focus on culture means that the Code places particular emphasis on a company's *workforce*, a deliberately chosen term intended to include not only those directly employed by the company but also workers more generally. Boards are expected to explain their approach to investing in and rewarding their workforce. They are also expected to stay informed about the views and attitudes of the workforce through one of three mechanisms: a director appointed from the workforce, a formal workforce advisory panel, or a non-executive director who serves as a liaison to the workforce. The last mechanism is by far the most popular; workforce directors remain highly unusual in the UK and are part of only some already fairly idiosyncratic boards (such as those at Frasers Group and JD Wetherspoon). The link to the interests of the workforce is also seen in the Code's standards on pay: the remuneration committee is expected to take account of workforce pay and culture in its consideration of executive pay, and there is a specific expectation that executive pension rates be aligned with those of the general workforce.

UK governance standards are also, in effect, set by best practice groupings, with some degree of regulatory and political backing. Most notable among these are the Hampton-Alexander Review and the Parker Review, which are pressing, respectively, for greater female representation on boards and for each board to include at least one director from a minority ethnicity. The initial goal of the former has nearly been reached (broadly, 30% female board membership); more remains to be done to reach the initial goal set by the latter.

Corporate Governance in the USA

The USA stands out in terms of governance. Now that Japan has introduced its own Corporate Governance Code, the USA is the only major market—and almost the sole country—without a Code of its own. The reason is a fundamental issue in US politics: the relationship between the federal government and the individual states. Corporate law is a matter for the states, and so there is no scope for a federal set of rules to govern corporations. Indeed, the fact that each state has its own corporate laws led to a race to the bottom for company standards among the states, competing with one another for the tax revenue from incorporating businesses. This race was comprehensively won by the small state of Delaware, which is now home to more than half of all publicly traded US corporations. The decisions of the Delaware courts are therefore of disproportionate importance to US corporate life.

In the absence of countrywide US governance standards, there have been various attempts to establish market-led best practices, of which these are the leading ones:

1. The Commonsense Corporate Governance Principles, first published in July 2016 and revised in October 2018. These principles were created by a coalition of company representatives, including the leadership of Berkshire Hathaway, BlackRock, General Electric, General Motors, JPMorgan Chase, and Verizon Communications, along with representatives of the largest US investors. These principles focus mostly on the inner workings of corporate governance, board effectiveness and accountability, and alignment through pay.
2. The Investor Stewardship Group's (ISG) Corporate Governance Principles for US Listed Companies, which came into effect at the start of 2018. As the name suggests, these principles were created by a coalition of investors (a number of whom were involved in creating the Commonsense Corporate Governance Principles). These principles are also more about the relationship between US companies and their shareholders than about their internal governance. The ISG has also produced a set of Stewardship Principles—in effect, the reciprocal responsibilities of investors in response to these corporate responsibilities.
3. The Corporate Governance Policies of the Council of Institutional Investors (CII). These policies set out in detail the approach of the CII—the pre-eminent representative of long-term investors in the USA—to the full range of corporate governance issues. These policies are less a set of principles and more an indication of the likely positions of CII members on issues that might go to a shareholder vote or be the subject of a public policy debate.

In combination, the first two initiatives represent a corporate governance code as it would be understood elsewhere in the world.

With reference to governance, what *is* regulated on a federal level in the USA is securities law: hence, the importance of the US Securities and Exchange Commission (SEC) and the rules it sets. For example, the SEC sets requirements for the independence and skills of members of the audit committees of companies listed in the USA. These standards were set by the Sarbanes-Oxley Act. Typically, the SEC creates rules based on statutes that reflect pre-existing expectations set down as principles in other markets. Here are two examples under the Dodd-Frank legislation:

1. There is a resolution to consider executive remuneration, usually referred to as a say-on-pay vote. Under Dodd-Frank, such a resolution must be put to a shareholder vote at least every third year, though shareholders must also be offered a vote on whether they wish to have a "say on pay" more frequently; most institutional investors favor holding such votes annually.
2. The "access to the proxy" standard permits shareholders that fulfill certain criteria to add a candidate to the company's formal proxy statement, avoiding the cost and administrative complexity of mounting a full proxy fight over board membership.

In practice, the access-to-the-proxy right has rarely been used. However, the combination of these two rights has led to a positive dynamic in company–shareholder relations. More companies are now making non-executive directors—particularly an independent chair where there is a lead independent director—available for shareholder meetings. Such a dialogue would have been highly unusual just a few years ago.

CORPORATE GOVERNANCE AND THE INDEPENDENT AUDIT FUNCTION

7

☐ **5.1.4** explain the role of auditors in relation to corporate governance and the challenges in effective delivery of the audit: independence of audit firms and conflicts of interest; auditor rotation; sampling of audit work and technological disruption; auditor reports; auditor liability; internal audit

The modern concept of the auditor evolved from the financial scandals of another era.

The earliest trading businesses of the 17th century (perhaps most famously, the Dutch East India Company, or VOC) were established for a specific trade journey or a set period, after which they needed to account for their performance and share the proceeds before being allowed to renew their mandate for a further period. This procedure sometimes included an expected independent oversight of the accounts. The Industrial Revolution (circa 1760–1840) saw for the first time the creation of many more large-scale corporations that sought to raise capital from outside parties. As many of these companies were expected to have an ongoing life beyond a set period or a particular endeavor, finance providers started to insist that management account for their use of this capital at least annually, leading to requirements for both annual reports and accounts and an AGM.

The failures and downright frauds of the UK's 1840s railway boom (an early investment bubble) saw minority shareholders suffer significant losses. The law was changed in response to the inevitable outcry, requiring an audit of the annual accounts by an independent party, thus providing shareholders with assurance that the numbers presented to them were true and fair.

The concept of the audit has not changed: the auditor is there to provide an independent pair of eyes assessing the financial reports prepared by management, and to provide some assurance that those reports fairly represent the performance and position of the business. There is no absolute assurance that the numbers are correct, nor certainty that there is no fraud within the business. Auditing is a sampling process that tries to identify anomalies that can then be followed up. According to the 1896 UK Court of Appeal judgment re Kingston Cotton Mill (No. 2)—following yet another corporate failure, this time when the auditor had taken a management assertion on inventory at face value—auditors should be watchdogs, not bloodhounds. There has been an ongoing debate following every corporate failure since, as to both whether the watchdogs were asleep on the job and whether we ought to expect a little more bloodhound-like—or perhaps, to use a more modern simile, sniffer dog–like—behavior from auditors.

Reviewing Financial Statements, Annual Reports, and Wider Reporting (Including Sustainability Reports)

Despite the lack of global uniformity in ESG reporting standards, companies increasingly seek to burnish their sustainability credentials by publishing detailed reports that have been independently assured by auditors.

The auditor independently examines and provides third-party assurance of the financial statements, affirming that the detailed information is free from material misstatement and inconsistencies. As a result of an audit, stakeholders may evaluate and improve the effectiveness of governance, risk management, and control over the subject matter.

This assurance work may be conducted by leading audit firms or by smaller groups of alternative assurance providers that specialize in ESG matters. Investors need to read the assurer's report carefully to understand what ESG standards have been achieved in practice and then consider what additional weight they can place on the sustainability reporting. The intention in sustainability reporting is to encourage organizations to go beyond the fundamental duty of legal compliance.

The key elements of an ESG audit that investors should consider include the scope—business strategy, policies, and operations; the timeline covering when the assessment is being carried out, and which periods are being reviewed; and how the audit is conducted, including information on checks and balances to ensure as much accuracy as possible. Although the auditor's work is often procedural, providing limited substantive assurance, a well-conducted ESG audit fosters an increase in the confidence that both current and future investors can place in reported ESG data and analysis.

Audit methods include:

- third-party certification of data and information included in the ESG report;
- provision of an independent guarantee that both data and analysis are credible and accurate; and
- attestation that published communication from management details how activities are transparently reported for ESG issues.

Examples of issues that can be evaluated in an ESG audit include:

- environmental standards, and management systems;
- energy-saving initiatives;
- facilities, water, and waste management, including recycling activities;
- product development and manufacturing processes, and efforts to reduce waste in all stages of production;
- plans for monitoring carbon emissions and mitigating or even eliminating production of toxic waste (the way the company's supply chain moves goods to customers, emissions from transportation vehicles, and fuel use can be assessed);
- use of hazardous materials in products;
- compensation for community impacts and environmental damage due to location of facilities;
- corporate transparency;
- performance on social issues related to human rights, diversity, labor standards, and working conditions; and
- remuneration policies for employees.

Assurance of ESG reporting is currently entirely voluntary and (in contrast to the financial audit) is not based on a single set of universally accepted regulatory standards. E, S, and G data are largely drawn from several organizations that expend considerable resources in developing and setting comprehensive global standards. These standards are focused on identifying and evaluating ESG risk factors that are financially important to companies.

Disclosures and frameworks can be quite detailed, yet not uniform. It is important to differentiate between management system standards and those that simply offer guidance on reporting about sustainable activities. In the case of the latter, these standards are not designed for certification purposes or for regulatory or contractual use; thus, any offer to certify, or claims of certification, would be a misrepresentation of the intent and purpose—and a misuse—of audit.

The Independence of Audit Firms and Conflicts of Interest

The independence of the audit firm is critical. Large audit firms, including the Big Four, typically offer non-audit services (consultancy work and tax advice, principally) to the companies they audit, despite the obvious risks arising from conflicts of interest. As they spend so much time within a business and interact with the finance department, auditors can build closer relationships with the management of the companies they audit than with the non-executive directors on the audit committee to whom they report, or the shareholders for whom they formally perform their work. Audit firm staff also sometimes will later work at companies they have audited. Investors often assess potential conflicts of interest by looking at how much an audit firm is being paid for its audit work versus its consultancy work and whether a company has a policy to limit this risk, though this issue is not the only sign of conflicts.

Regulators have intervened to remove the most obvious conflicts of interest, which has led to a significant decline in recent years of the scope for auditors to provide non-audit services to their clients. This trend can be seen within the EU. For example, EU law now not only provides a list of non-audit services that are the only ones an audit firm may provide to clients, but also places a monetary limit (calculated in relation to the audit fee) on their overall value. The UK's Competition and Markets Authority has proposed much more separation between the audit and non-audit arms of accountancy firms, so that audit is much less likely to be influenced by other concerns.[15]

Another important question surrounds behavioral independence. There is a natural tendency for individuals to seek consensus and for people to want to avoid disagreement or even confrontation with those they spend time with. These natural human behaviors run counter to the very role of the auditor, which must be to question and challenge the information that the audited entity provides. Every member of the audit team must work to avoid succumbing to such tendencies, and the audit partner overseeing the whole process needs to ensure that skepticism has been maintained throughout. In particular, there must be enough time allowed for questions to be pursued fully, and enough scope for additional staffing if necessary. These ideas both run contrary to the frequent mindset that the audit firm should be efficient in its work, adhere to a timetable dictated by the company, and keep within a budget that allows the firm to generate a profit. In practice, it is not always easy for investors to be confident that the audit has been done as thoroughly as they might wish.

Auditor Rotation

The concentration of the audit market makes it more difficult to address the issues of auditor independence and effectiveness. In the EU, public companies are obliged to change auditors after 20 years at most (and to tender the audit after 10 years). With the incumbent barred from competing after 20 years and the other audit firms sometimes unwilling to give up valuable non-audit services contracts, there is a sub-optimal level of competition. Prior to the rule changes, it was frequently argued that auditor rotation might lead to issues being missed, either in the last year of a departing auditor or in the first year of a new auditor, but the reported impact has been positive: companies that have changed auditors have found the refreshed perspectives valuable yet challenging.

15 Competition and Markets Authority, *Statutory Audit Services Market Study: Final Report* (2019). Available at: www.gov.uk/cma-cases/statutory-audit-market-study.

Sampling and Audit Work

The sampling process that underlies audit work has been mentioned previously; however, technological and AI developments may see this process change. Significant effort should go into assessing what is an appropriate level of sampling to gain a good insight into the accuracy of the underlying numbers, and also into assessing the output of that sampling. On occasion, though, it seems that the budget for the audit does more to determine the work undertaken than the need for clarity of assurance. The depth of sampling is highly dependent on the auditor's assessment of the quality of the company's own systems and financial controls (see below for a discussion of disclosures of performance **materiality**). In this matter, the external auditor leans on the work of the company's internal audit (the company's own process for assessing risks and the quality of reporting, also discussed below), and well-run audit committees sensibly coordinate the internal and external audits so they can get an appropriate level of assurance across the company.

Sir Donald Brydon's recent independent review of the quality and effectiveness of audit proposes that every audit committee produce an annual audit and assurance plan that discloses the committee's expectations for overall assurance of company reporting, including both internal and external audits, which should make this coordination more apparent and perhaps more effective. Under Sir Donald's proposals, shareholders would be invited to provide input into the development of this plan.[16]

In theory at least, the world of big data is changing the sampling approach, and the leading audit firms are exploring methods of using technology to consider every single transaction rather than merely sampling a proportion of them. A number of independent software firms have developed packages that deliver this capability, though these firms currently seem to be more focused on the small and mid-sized end of the corporate market than on larger businesses. The challenge with any approach to assessing every transaction is spotting anomalies in this barrage of data, not just checking that the numbers add up. The technology potentially removes the need to sample—but not the need to consider intelligently the information that is delivered. This area remains a work in progress.

Enhanced Auditor Reports

Shareholders today have more insight than ever before into the work of auditors because of the new enhanced auditor reports. Originated in the UK, enhanced auditor reports have now been adopted globally. These reports include three crucial elements:

- **Scope of the audit:** This element concerns how many parts of the company the audit has covered and in what depth. Typically, an auditor will apply a full audit to the largest segments (usually geographies, but sometimes business segments) and will apply tailored audit procedures to others, but some segments may be ignored altogether.
- **Materiality:** While materiality is a qualitative concept and should vary depending on the significance of the issue and its circumstances, in practice the disclosure tends to focus on a quantitative measure of materiality: the level of transaction or valuation below which the auditor spends little time. For the biggest companies, this number can be surprisingly large (US$500m, or £359m, is not unusual). Of more interest to investors are the levels of materiality applied to the different segments and—where it is disclosed—the

16 D. Brydon, *Assess, Assure and Inform: Improving Audit Quality and Effectiveness; Report of the Independent Review into the Quality and Effectiveness of Audit* (2019). Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf.

performance materiality number (the level below the materiality threshold that the auditor uses in its audit procedures to prevent problems from arising when the numbers analyzed are aggregated). The performance materiality number indicates the extent to which the auditor trusts the company's financial systems: 75% of the overall materiality threshold is typical, whereas anything around 50% to 60% suggests a low level of confidence in the company's financial controls. Such lower levels of performance materiality might indicate a highly devolved organization or one whose controls should perhaps be enhanced, which can be a useful insight for investors.

- **Key audit matters:** The third element concerns a handful of key areas of judgment in the accounts. While the areas covered will rarely come as a surprise to investors, the way in which these issues are discussed and what auditors choose to highlight in their open discussion can reveal interesting and important insights. The best auditor reports not only highlight the key areas of judgment but also indicate whether the company's reporting on them is conservative, neutral, or aggressive. This so-called graduated audit adds real value to investors' understanding of the company's reported performance.

These enhanced auditor reports upgrade prior practice, where the sole piece of insight was the auditor's opinion on whether the financial statements represented a true and fair view of the company's performance and position at the end of the financial year. When an annual report was published, it would be quick work to find out whether an auditor had given a negative opinion. Auditors' past unwillingness to provide much insight was driven by their fear of litigation in the case of a corporate failure. Investors learned that auditor reports were not worth reading—a lesson that now needs to be unlearned. Investors have much to learn from these enhanced auditor reports if they can begin to navigate the tone and specialist language used in them (or if auditors could begin to make them more accessible to the general user). These reports may be further enhanced if some of the proposals in the independent Brydon Review are adopted—indeed, Sir Donald's review proposes that auditors do a lot more to inform investors and the market as a whole. He emphasizes the importance of this role for auditors by using *inform* as one of the three key words in the title of his final report: "assess, assure and inform."[16]

Auditor Liability

One reason that auditors give for not providing more than they are strictly required to, in terms of the audit or auditor reporting, is liability. In most markets, the auditor has unlimited liability. Indeed, the US SEC has established a rule that any company subject to its jurisdiction (which includes many foreign companies that have US listings of either their equity or their debt) may not in any way limit the liability of the auditor. Even where audit firms enjoy the benefit of a limited liability partnership (meaning that all the partners are no longer exposed to risk because of a potential failure by one of the partners), the individuals who are directly responsible for any failure, especially the partner involved, can face losing everything. This risk is seen as significant, in part, because auditors are often among the few deep-pocketed players when there is a corporate failure, and so they are regularly included in lawsuits. The extent to which the courts would attribute liability to the individuals and their firms, however, is less clear, because most of these cases are settled before they get anywhere near a judgment. Most of the settlements are private, and so it is unclear whether, in practice, the liability risk is as large as the profession tends to indicate.

Internal Audit

Internal audit should not be confused with external audit. The latter can be outsourced, but most of the time, internal audit is part of the company itself, with a formal reporting line to the executive team (though usually with a dotted line to the audit committee). It functions largely as a risk management tool, used to ensure that the company's procedures and expected behaviors are delivered in practice and to uncover misbehavior or problematic management.

Internal audit has a highly variable status in different businesses—indeed, it does not exist at all in some organizations. Where it is deployed most effectively, internal audit is a tool for both the executive team and the non-executive directors to gain confidence and comfort about the company's delivery on the ground, helping the company operate more effectively and efficiently. It can help the board feel closer to the real operations—a significant challenge for modern, large multinational businesses. There is a sea change taking place in internal audit, involving directing the work toward helping the board and senior managers protect their organization's assets, reputation, and sustainability. The Internal Audit Code of Practice,[17] issued by the Chartered Institute of Internal Auditors in January 2020, is, in effect, a pathfinder for the profession to help it deliver fully on this promised change.

8 CORPORATE GOVERNANCE AND THE INVESTMENT DECISION-MAKING PROCESS

- ☐ **5.1.5** assess material impacts of governance issues on potential investment opportunities, including the dangers of overlooking them: public finance initiatives; companies; infrastructure/private finance vehicles; societal impact
- ☐ **5.1.6** apply material corporate governance factors to: financial modeling; risk assessment; quality of management

Of the three ESG factors, governance is the one most often considered by traditional investment analysts. A 2017 CFA Institute ESG survey showed that 67% of global respondents took governance into consideration in their analysis and investment decision-making (up from 64% in 2014), ahead of environmental and social factors (both at 54%).[18] In the EMEA region, the number of analysts indicating that they took governance into account was 74%.

The primacy of governance is logical. Academic research indicates that of the three ESG factors, governance has the clearest link to financial performance. Friede, Busch, and Bassen's 2015 meta-study on ESG and financial performance notes that:

- 62% of the studies they reviewed showed a positive correlation between governance and corporate financial performance; and

17 Chartered Institute of Internal Auditors, *Internal Audit Code of Practice: Guidance on Effective Internal Audit in the Private and Third Sectors* (2020). Available at: www.iia.org.uk/media/1691066/internal-audit-code-of-practice-report.pdf.

18 CFA Institute, *Environmental, Social and Governance (ESG) Survey* (2017). Available at: https://www.cfainstitute.org/-/media/documents/survey/esg-survey-report-2017.ashx.

- 58% of environmental studies and 55% of social studies showed the same correlation.[19]

Similarly, in mid-2016, one UK investment manager estimated that companies with good or improving governance tended to outperform companies with poor or worsening governance by 30 basis points per month, on average, in the prior seven years.[20] Environmental and social factors also demonstrated their ability to guide investors toward better-performing companies and away from poorly performing ones, but the dispersion in performance was about half as large.

Good governance is fundamental to a company's performance, in terms of both long-term shareholder value creation and the creation of broader prosperity for society and all stakeholders. If a company delivers good governance, it is more likely to approach environmental and social issues with the right long-term mindset and thus avoid, or effectively manage, significant risks and seize relevant opportunities. Failures can be devastating to shareholders and other capital providers. The description of the board's failings in the Enron case (where the company's market value fell from US$60bn, or £43bn, in December 2000 to zero in October 2001) is bracing, as seen in this excerpt from the special investigation committee's report:

> *Oversight of the related-party transactions by Enron's Board of Directors and Management failed for many reasons. As a threshold matter, in our opinion the very concept of related-party transactions of this magnitude with the CFO was flawed. The Board put many controls in place, but the controls were not adequate, and they were not adequately implemented. Some senior members of Management did not exercise sufficient oversight and did not respond adequately when issues arose that required a vigorous response. The Board assigned the Audit and Compliance Committee an expanded duty to review the transactions, but the Committee carried out the reviews only in a cursory way. The Board of Directors was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it. Enron's outside auditors supposedly examined Enron's internal controls but did not identify or bring to the Audit Committee's attention the inadequacies in their implementation.*[21]

Governance matters because the wrong people—or just not enough of the right people—around the boardroom table are less likely to make the best decisions, resulting in the likelihood of significant value erosion and a failure to address key risks, including environmental and social issues. And if the interests of management and shareholders are not aligned, there is also a risk of value erosion for stakeholders generally.

Thus, companies with poor governance risk destroying value—or at least adding less value than they might have done. These issues are as true of private companies as they are of public companies: governance, good or bad, is not the exclusive preserve of the public company or the exclusive concern of the public equity investor. Governance is just as much an issue in private equity investments and infrastructure vehicles (including public finance initiatives), where value can be lost as easily. The building blocks for understanding good governance—accountability and alignment,

19 G. Friede, T. Busch, and A. Bassen, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies," *Journal of Sustainable Finance & Investment* 5, no. 4 (2015): 210–33. Available at: www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917.

20 Hermes Investment Management, *ESG Investing: It Still Makes You Feel Good, It Still Makes You Money* (2016). Available at: www.hermes-investment.com/wp-content/uploads/2018/10/hermes-esg-investing.pdf.

21 W. C. Powers, R. S. Troubh, and H. S. Winokur, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation* (2002). Available at: http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf.

with governance being, at its heart, about people (allowing boards to get the right mix of skills and experience and an array of perspectives in the boardroom)—can be applied to any situation.

Some will say that governance is less of an issue in private equity because investors are directly represented on the board, and the same is often true in many infrastructure vehicles. Although this factor reduces the risk of misinformation and a lack of responsiveness, it does not, in itself, remove all governance risks. Indeed, given the highly indebted nature of many such investments, the margin for error is not always large, and so failure can be swift if it does occur, often overwhelming even more responsive governance structures. Certainly, as the following brief case studies (on Theranos, Uber, and WeWork) indicate, there are significant risks to consider from failures of governance within private businesses.

CASE STUDIES

Theranos Board

In 2014, around the time Theranos was raising money from private market investors at a valuation that confirmed it was—at least temporarily—a so-called unicorn (a private company valued at more than US$1bn, or £718m), the company, which claimed to be reinventing blood testing with exclusive technology, had the following board of directors:

- Elizabeth Holmes, 30 — founder, CEO, and chair
- Sunny Balwani, 48 — president and COO (former software engineer)
- Riley Bechtel, 62 — chair of the board of the construction company Bechtel Group
- William Frist, 62 — former heart and lung transplant surgeon before becoming a US senator
- Henry Kissinger, 90 — former US secretary of state
- Richard Kovacevich, 70 — former CEO of Wells Fargo
- James Mattis, 63 — retired US Marine Corps general
- Sam Nunn, 75 — former US senator and chair of the Senate Armed Services Committee
- William Perry, 86 — former US secretary of defense
- Gary Roughead, 61 — retired US Navy admiral
- George Shultz, 93 — former US secretary of state

Thus, overseeing an innovative blood-testing technology company was a board where the non-executive directors were exclusively male, mostly with military or foreign service backgrounds rather than medical or scientific experience, and with an average age of 73 (excluding the two executives). There were more former secretaries of state in their 90s on the board than people with medical training. None had any expertise, or even basic experience, in blood testing.

The degree of oversight offered by this board of the management and operations was always likely to be limited, and its influence was further hindered by the company's dual-class share structure that saw the founder hold 99% of the voting rights. In addition, it appears that the board met infrequently, and several directors had poor attendance rates. All this suggests that the board was not operating as effectively as it might have been. Perhaps that should not be surprising. The *Wall Street Journal* investigative reporter John Carreyrou, in his striking account of the Theranos story, *Bad Blood*, notes that Elizabeth Holmes told someone interviewing for a job at the company in 2011: "The board is just a placeholder. I make all the decisions here."

In the end, all of the US$700m (£503m) invested in the business was lost (together with its largely theoretical estimated valuation of US$10bn, or £7.1bn) when the company was revealed to have falsified test results and misled investors about the nature and effectiveness of its technology.

In retrospect, the Theranos board's many red flags indicated that something was amiss—at the very least, the board could have been better designed to deliver effective oversight of an early-stage, high-risk technology business with unproven leadership. The red flags at other boards may be less obvious, but the two key questions that investors will always need to ask are:

1. Is there the right mix of skills and experience, and *enough* of the right skills and experience, to properly oversee the next stage of development of this business? If there are obvious gaps, investors need to consider how those gaps might best be filled.
2. Is there the right dynamic around the boardroom table to enable the views of the appropriately skilled board members to be heard? This question is about behaviors, which are inevitably harder to identify from outside; nonetheless, there are often indications that the board dynamic is not as effective as it might be.

Theranos is not the only unicorn to experience governance challenges that affected its estimated value.

Uber, the transportation network company, felt obliged to change its governance practices in the wake of a series of damaging scandals that were affecting its growth. The founder CEO's responsibilities were reallocated, preferential voting rights were adjusted, and the board's independence was strengthened.

In 2019, WeWork was obliged to abandon its planned initial public offering (IPO)—and its valuation plummeted from the intended capitalization at listing—when investors balked at the company's approach to several governance issues, including the dominant decision-making position of the founding CEO (which would persist even after his death, when his wife was to be handed the choice of his successor) and related-party deals with the CEO. While these governance issues were addressed in the latter stages of the planned IPO process, they were enough to raise broader questions in investors' minds, including the crucial ones about business model and the absence of a clear path to profitability. In a *Financial Times* article about the company's downfall, a financial adviser who is particularly insightful on the company's governance and the CEO's management style is reported as saying, "How do you go from succeeding by not listening to succeeding by listening?"[22]

Few governance failures are as extreme in their destruction of value as Theranos and WeWork, and few boards are as lacking in diversity and the relevant skill set as the Theranos board was. There is good evidence in the academic literature of the beneficial effect of diversity. Carter, Simkins, and Simpson's 2003 study of the *Fortune* 1000 firms found statistically significant positive relationships between the presence of women or minorities on the board and firm value, as measured by Tobin's q (a valuation measure based on the ratio between a company's market value and the replacement cost of its assets).[23] Bernile, Bhagwat, and Yonker's 2017 study concluded

22 E. Platt and A. Edgecliffe-Johnson, "WeWork: How the Ultimate Unicorn Lost Its Billions," *Financial Times*, 20 February 2020. Available at: www.ft.com/content/7938752a-52a7-11ea-90ad-25e377c0ee1f.
23 D. A. Carter, B. J. Simkins, and W. G. Simpson, "Corporate Governance, Board Diversity, and Firm Value," *Financial Review* 38, no. 1 (2003): 33–53. Available at: https://doi.org/10.1111/1540-6288.00034.

that diversity in the board of directors reduces stock return volatility (consistent with diverse backgrounds working as a governance mechanism) and that firms with diverse boards tend to adopt policies that are more stable and persistent (consistent with the board decisions being less subject to idiosyncrasies).[24] In addition, while diverse boards take less financial risk, "this behavior does not carry over onto real risk-taking activities," with diverse boards investing more in research and development (R&D). Overall, their study found that greater heterogeneity among directors leads to higher profitability and firm valuations, on average.

Governance failures lead to fines and additional liabilities, as well as litigation and other costs. Revenues fall as trust is eroded and customers boycott the company or buy from competitors, and profits fall as additional cost burdens are placed to mitigate future risks. All these effects harm security values. Governance analysis should be a core component of valuation practice.

Integrating Governance into Investment and Stewardship Processes

Different fund managers integrate governance factors into their investment decision-making in different ways. For many, it is a threshold assessment—a formal minimum criterion to consider *before* they will consider making an investment at any price. Often, it is talked about as quality of management, which, despite the name, is never simply an assessment of the CEO and CFO but, rather, of the overall team and the governance structure by which they oversee the company and (hopefully) drive the success of the business.

For others, it is a risk assessment tool, which may represent the level of confidence about future earnings or the multiple on which those earnings are placed in a valuation—or it may be reflected less in full financial models and more in a simple level of confidence in the valuation range or investment thesis.

If the analysis of corporate governance is specifically built into valuation models, this analysis is most typically done by recognizing negative governance characteristics by way of adding a risk premium to the cost of capital or raising the discount rate applied. Others regard weak governance as an engagement and investment opportunity—the logic being that governance can be improved through active dialogue with management and proxy voting, so that past underperformance, on which the company is currently valued in the market, is reversed and the valuation can be enhanced by stronger performance and an expectation of more positive performance in the future.

Many governance issues lend themselves to stewardship dialogue with companies, not least because many of these issues will be directly addressed in the AGM agenda. Investors will be obliged to take a stance on them (for many investors, that is why governance has a longer heritage than environmental and social issues—particularly because in many markets, the obligation to consider voting decisions actively is well established). In almost every market, investors will be faced annually with voting decisions on at least the following:

- accepting the report and accounts;
- board appointments;
- the appointment of the auditor, and perhaps their fees; and
- executive remuneration.

24 G. Bernile, V. Bhagwat, and S. Yonker, "Board Diversity, Firm Risk, and Corporate Policies," *Journal of Financial Economics* 127, no. 3 (2018): 588–612. Available at: https://doi.org/10.1016/j.jfineco.2017.12.009.

Thus, there is a natural driver, at least annually, for engagement on these issues—though investors are increasingly keen to avoid the critical points of all such discussions during the AGM season (largely April to June in the Northern Hemisphere, July in Japan, and September to November in the Southern Hemisphere). To avoid this problem, dialogue is held throughout the year, with the conclusions reached in the dialogue reflected in the voting.

Engagement is covered in depth in the next chapter.

Thus far, this chapter has considered the *G* in ESG as meaning corporate governance. While many may see corporate governance as an issue particularly for public equity investments, in fact many investments across the asset classes are in company structures in one form or another. Therefore, corporate governance concerns will have relevance for many investments, including, for example, fixed income, private equity, property, and infrastructure. The intent of this chapter is to discuss corporate governance at a level whereby its relevance across this broad range of asset classes is apparent, and the analysis can be applied and tailored as appropriate.

However, there is one asset class where the *G* of ESG will always have a very different meaning. In the sovereign debt arena, *G* means the effectiveness of the governance and robustness of the state and its institutions, the approach to the rule of law, and the general business environment (including such issues as competition and anti-corruption). In effect, the concern is about gaining assurance that the economy can prosper through good governance, so that sovereign debt obligations can continue to be covered. ESG-minded investors are increasingly integrating the analysis of these issues into their broader financial analysis of sovereign credits.

KEY FACTS

1. Corporate governance is the process by which a company is managed and overseen. It is framed by local law and culture, and almost all countries now have a formal but non-binding corporate governance code to set standards and expectations.
2. However, within these formal frames, governance comes down to people and how they interact; they need information and they need to be able to make the relevant people accountable for their decisions.
3. Accountability is reflected in sufficient oversight of management so that management is encouraged, pressed, and challenged to efficiently deliver for the long-term good of the business.
4. Alongside accountability sits alignment as the other core tenet of good governance. This tenet is seen most clearly in the area of pay, where the aim is an alignment of the interests of management with those of the long-term shareholder. It means that long-term value creation in the business is reflected as a reward to individual managers.
5. To deliver these two main aims of accountability and alignment, each board is expected to establish three independent and effective committees to cover the crucial areas of nominations, audit, and remuneration.
6. Corporate governance codes and guidelines, and the laws that underpin them, typically get changed in reaction to scandals in individual companies. In the UK, the Cadbury Code was the world's first governance code and was used as a model for many others.
7. The scandals frequently feature excessive, acquisitive growth and ambition, combined with overconfident management and boards that practice little challenge.
8. Effective boards need a mix of skills and experience across their membership, and a boardroom culture that enables those different perspectives to be brought to bear on the key issues facing the company. Independence matters—independence of thought, most of all—but knowledge and expertise also matter.
9. Good boards ensure that the company operates in an ethical and appropriate way and has a corporate culture that is conducive to long-term value creation in the interests of all stakeholders.
10. Two-tier boards are typical in Germany, the Netherlands, Scandinavia, and China; single-tier boards are typical in the USA, the UK, Japan, France, and most of the rest of the world. In the USA and France, boards generally have a single executive member, often acting as both chair and CEO. Japanese single-tier boards are dominated by executive directors, with only a handful of non-executives; most unitary boards lie somewhere in between these models.
11. Audits focus on close attention to, and assurance of, the financial statements. However, they entail only a limited requirement to read other material published alongside the financial statements and disclose inconsistencies.
12. The new enhanced auditor reports offer more valuable insights into the work of the auditor and also, potentially, into the quality of the controls and reporting at the audited company.