CHAPTER 5
GOVERNANCE FACTORS

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 has 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 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 minimise the risk of value destruction.

CHAPTER 5
GOVERNANCE FACTORS

1 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 and 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), in order to exercise their responsibilities effectively, those 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 impacting 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-executives 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.

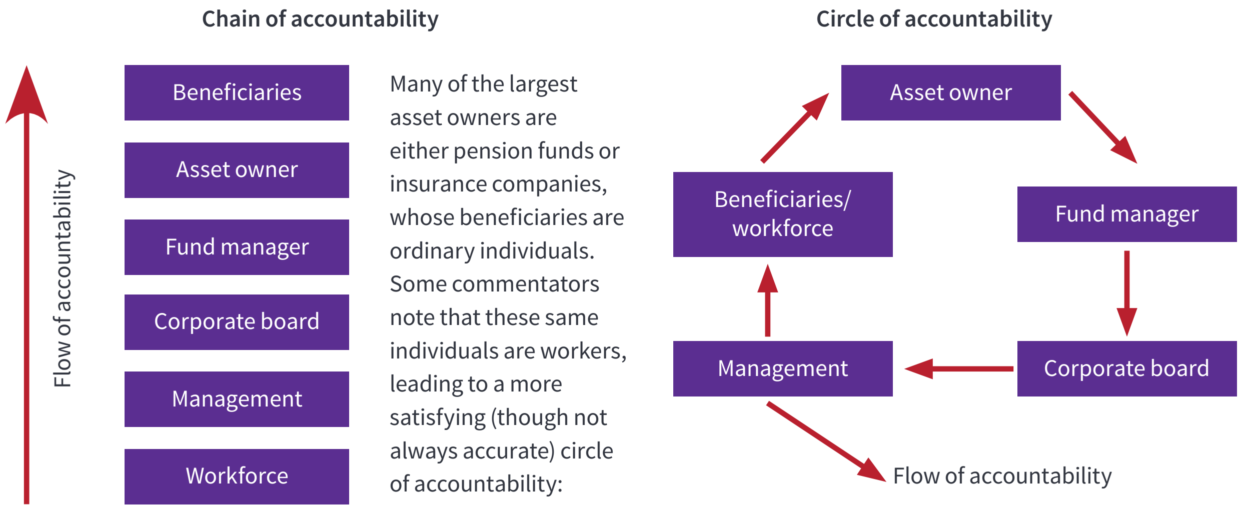
The mixed skillsets of directors are also important, so that discussions and debate are appropriately informed from a range of perspectives and the risk of "group-think" is avoided. Increasing diversity and the range of perspectives in the boardroom, through gender diversity, but also diversity in terms of professional backgrounds and experiences, has been demonstrated to deliver a more challenging culture 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 is 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 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.

Figure 5.1 may help illustrate the flows of accountability through company structures and the investment chain.

Figure 5.1: CHAIN OF ACCOUNTABILITY AND CIRCLE OF ACCOUNTABILITY



Source: Lee, Paul (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. This explains why the first item at many annual general meetings (AGMs) is an 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 the 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 these 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 between 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 by doing what they are instructed to 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 directly the shareholders. There is also a risk that they 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 company directors and management on the other. Corporate governance attempts to ensure that there is greater alignment in the interests of the agents with the owners through incentives, but also through 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 period. The goals ideally include a mix of key performance indicators (KPIs) related to business and share price performance. Often, a significant portion of the incentives come with some form of equity linkage – though this can on occasions make risk management more focused on share prices 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:

1. 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.

2. The **Audit Committee** oversees financial reporting and the audit, delivering accountability in the accounts. The audit committee will also oversee internal audit, where this exists, and unless there is a separate risk committee will have responsibility for risk oversight also.

3. The **Remuneration Committee** (in some markets, this is called the Compensation Committee) seeks to deliver a proper alignment through executive pay.

The roles of these committees are considered more thoroughly in **Section 2**.

2 THE DEVELOPMENT OF A FORMALISED GOVERNANCE APPROACH

5.1.1 Explain the evolution of corporate governance frameworks and key motivators for step change: 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 formalisation of corporate governance and the development of codes. When companies fail and investors lose money, there is often pressure for an improved approach. The Walker Review,[1] following the 2008 financial crisis, and the recent Kingman[2] and Brydon reviews[3] in the wake of Carillion's failure, are examples of this.

→ *See Scandals in Brief for further, and international, discussion.*

Corporate Governance Codes

The world's first formal Corporate Governance Code emerged in the UK 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 was founded and began its work (but before its planned publication), 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.

Much of what the Cadbury Commission recommended is still considered best practice today and has been incorporated in codes and guidelines globally. For example, the committee proposed that every public company should have an audit committee meeting at least twice a year. Notably, at the time it was released, only two-thirds of the largest 250 companies in the UK had such committees at all (although nowadays they are commonplace). The committee'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; whereas others have **single-tier boards**, with some dominated by executive directors (in Japan), some having a combined CEO and chair (most commonly seen in the USA and France), and some lying in between these models (the UK being an example).

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 favours '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, both on behalf of shareholders and other stakeholders.

Companies' willingness to provide thoughtful discussions of differences from guidance varies. Some companies may look negatively on corporate governance as they consider it to be inflexible. Indeed, there can be a risk that investors do 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 advisers 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. On this analysis, the problem of inflexibility arises more from the investor clients' tendency to follow the proxy advisers' recommendations with too little independent judgment about whether that voting recommendation is the right one rather than on 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 Mirror Group and BCCI set 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-privatised utilities led to the **Greenbury report**, which revised the corporate governance code in 1995. It increased the visibility of remuneration structures and pressed towards transparency over the KPIs that drive performance pay and the time horizons over which pay is released (for long-term schemes, this is a minimum of three years).
- The Enron, Tyco and WorldCom scandals in the USA led to the **Sarbanes-Oxley Act** in 2002. This 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 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 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$1.5 billion (£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

Caparo (1984) – Caparo was a steel and engineering business that mounted a takeover of a UK public company, Fidelity, an electrical equipment manufacturer. The takeover followed a series of profit warnings and associated share price decline of more than half. Unfortunately for Caparo, Fidelity's position was much worse than it believed and than its accounts indicated. Caparo sued the auditor for breach of a duty of care

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Polly Peck (1990/1) – Polly Peck was a textile and trading business that grew so rapidly in the 1980s that it joined the FTSE 100 in 1989. A prolific dealmaker, it later emerged that much of its apparent profit arose from the high inflation and associated high interest rates in Turkish Cyprus, where many of its operations were. CEO Asil Nadir fled to North Cyprus in 1993, returning to face trial in 2010. In 2012, he was found guilty of ten charges of theft.

Maxwell/Mirror Group (1991) – Shortly after media businessman Robert Maxwell drowned in the Atlantic off his yacht, the Lady Ghislaine, it was discovered just how weak the finances of several of his businesses were. In particular, the fraudulent misappropriation of the UK's Mirror Group Newspapers pension scheme was revealed. The Maxwell businesses entered bankruptcy in 1992.

BCCI (1991) – Briefly one of the largest private banks in the world, BCCI was seemingly designed to fall through regulatory cracks, with its main holding companies in Luxembourg and the Cayman Islands, and a web of other business operations run out of Geneva, Kuwait and Cayman. There were long-running concerns about the business – BCCI was barred from buying a US bank, but it did so anyway in 1982 through middlemen. Eventually the regulators moved in and closed the bank down in 1991, thereby revealing the extent to which it had been used to launder money for drug smugglers and terrorists, as well as lending recklessly to legal businesses.

Enron (2001) – A US electricity 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. The CFO was given permission to sidestep the company's code of conduct in order to create and run some of the related party organisations used to take losses off Enron's balance sheet. Its collapse also 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.

HIH (2001) – This Australian insurer collapsed before ever revealing the scale of its multi-million dollar losses for the six months to the end 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).

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

WorldCom (2002) – The internal audit function of this US telecoms 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..

Ahold (2002/3) – 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.

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Parmalat (2002/3) – False accounting spiralled from an initial 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, more than €4bn (£3.4bn) in cash and equivalents on the company's reported balance sheet turned out to be imaginary.

Satyam (2009) – The founder and chair admitted to falsifying the accounts of this India-based 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.

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

Volkswagen (2015) – Volkswagen was revealed to have cheated US emissions tests on its diesel engines through software, so-called 'defeat devices'. Though, on the face of it, this was not a governance scandal, many investors had long been concerned at 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. These groups similarly dominated the board, leading to an insular and unaccountable culture.

Carillion (2018) – Carillion was a leading UK outsourcer, but collapsed in January 2018 when it essentially ran out of money. With just £29m in cash, it owed banks more than £1.3bn and had a £800m pension deficit. The company's problem was that it had contracted aggressively for construction business at levels that left no contingency and only a very limited profit margin. Despite having a £16bn pipeline of contracts, the company collapsed due to a cashflow crisis.

Wirecard (2020) – Wirecard, a hard-driving German fintech and global payments processor, collapsed in June 2020 when long-running allegations of fraud and questionable accounting – fought by German regulators who were meant to have been investigating – were largely confirmed by a special audit. The audit confirmed that some €1.9bn (£1.6bn) was missing from its accounts. It has now become apparent that substantial elements of its business in the Middle East and Asia were no more than an elaborate sham and the core payments processing operations in Europe were barely profitable.

3 SHAREHOLDER ENGAGEMENT AND 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 are not 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 are often bolstered in 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 they 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 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); or
- it affects more than 25% of any of them then 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 in many markets' company laws (excluding USA, for example) is that a company should not issue shares without giving existing shareholders the right to buy a sufficient amount in order to maintain their existing shareholding. Because these rights come before 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 often seek authority at AGMs to issue a relatively small proportion of shares (up to 5% or 10%) non-pre-emptively, i.e. 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 so-called 'soft pre-emption', meaning an allocation equivalent to their existing shareholding but in a less formal, legalistic way (that may enable the issuance to be made more swiftly). Larger issuances are more controversial, as are issues possibly at a price less than the prevailing share price. An example of a particularly unpopular model with defenders of minority shareholder rights are the 'general mandate' resolutions in Hong Kong, 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 pre-existing shareholders.

A final area in which minority shareholders can feel exploited is through 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 when compared to the class of shares that subsequent shareholders can invest in, the ones that are typically more freely traded on the stock market (and those issued freely as compensation to staff, particularly in the case of US technology businesses). It is also the case that, management, which typically directly benefits from multiple voting rights and often voting control, will feel less accountable to the broader shareholder base, with whose interests they are less aligned.

Dual-class shares are often frowned upon by many investors, and are rare outside the USA. 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 organisation for US institutions, has taken a subtle stance on dual-class stock,[4] recognising that it can be useful to have some stability in the early life of companies, but urging it to be subject to sunset clauses so that the dual-classes are unified after at most seven years (which is 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 that there was little likelihood of a dividend, the instruments sold were actually more like warrants than shares.

4 KEY CHARACTERISTICS

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 some reflection of a responsibility to the broader employee base in the name).

The expectation is that the audit and remuneration committees will be populated solely by independent non-executive directors while such directors should form a majority of the nominations committee (the chair should not lead this committee while it is seeking to appoint their successor). Some companies will establish further board committees, either to address ad hoc issues or on an ongoing basis, but 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 usually made up of independent non-executive directors. Where there is no separate risk committee, the oversight of risk issues usually falls under the audit committee's scope. The Code also determines appropriate disclosures to make the workings of the board transparent and to demonstrate their effectiveness to shareholders.

Published alongside the new Code was a *Guide to Board Effectiveness*. This applies the same structure as the Code, under the same five themes. It not only provides guidance, but also questions to assist board members when 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 this guide is taken up with the first theme, board leadership and company purpose – essentially, this focuses on culture, strategy and maintaining appropriate relationships with key stakeholders. While this is a UK document which is explicitly aimed at assisting boards, the themes are useful to investors when 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 is easily summarised but difficult to deliver. As can be seen from the case study sample of BHP's annual report disclosure 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. This is because a board will rarely feel comfortable relying on a single perspective, particularly as that single individual 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 provide input in other ways. A question to consider is what skills and experience are regularly needed around the board table and what would be better accessed on an occasional, independent advisory basis.

As well as training for directors, boards must always consider the need for refreshment as skills 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 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 understanding of the concept of diversity – diversity of thought – is understood, most of its initiatives focus on the visible issues of 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 towards an expectation that at least 30% of public company directors should be women. The issue of racial diversity has been an active debate in the USA for some years, and the UK's 2017 Parker Review called for at least one non-white director on every public company board by 2021.[5] This target seems very unlikely to be met as the 2020 assessment found 60% of companies had not met the target. These initiatives have gained fresh impetus through the momentum of the Black Lives Matter campaign in 2020, which could mean that more change is likely.

It is important for the chair to be effective in bringing out the contributions of each board member. This is less visible to outsiders but is a vital part of delivering board effectiveness. Investors can gain some insight into how the chair operates within the boardroom from direct dialogue with the individual and with other board members, but often the clearest indicator is the quality of the individuals on the board overall. Good directors do not tend to join boards which do not allow them to contribute effectively, or if they do, they are quick to leave them. The unfortunate consequence of this for those who invest broadly is that poor boards remain weak and it is difficult to improve them without broad 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 as weaker boards and weaker chairs can relatively easily limit their impact, without this being apparent to investors. It is hard to see 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 approach. In some markets, both the delivery and findings of board appraisals are expected to be disclosed, which can help investors gain insight into a company.

Case study

BHP annual report disclosures on board skills and diversity

Skills and experience

Total directors	11
Mining Senior Executive who has: ▸ deep operating or technical mining experience with a large company operating in multiple countries; ▸ successfully optimised 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 throughput); ▸ 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.	3
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 throughput); ▸ 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.	7
Strategy Experience in enterprise-wide strategy development and implementation in industries with long cycles, and developing and leading business transformation strategies.	9
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.	11
Commodity value chain expertise End-to-end value or commodity chain experience – understanding of consumers, marketing demand drivers (including specific geographic markets) and other aspects of commodity chain development.	6

cont'd...

Case study

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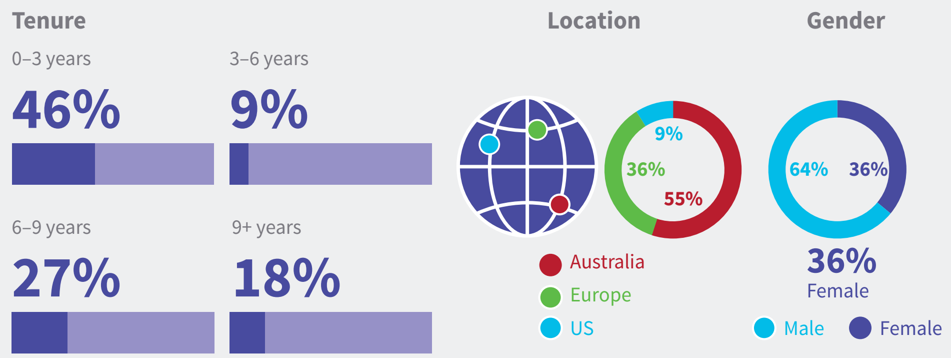
Financial expertise Extensive relevant experience in financial regulation and the capability to evaluate financial statements and understand key financial drivers of the business, bringing a deep understanding of corporate finance, internal financial controls and experience probing the adequacy of financial and risk controls.	11/2[i]
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.	3
Health, safety, environmental and community Extensive experience with complex workplace health, safety, environmental and community risks and frameworks.	7
Technology Recent experience and expertise with the development, selection and implementation of leading and business transforming technology and innovation, and responding to digital disruption.	2
Capital allocation and cost efficiency Extensive direct experience gained through a senior executive role in capital allocation discipline, cost efficiency and cash flow, with proven long-term performance.	7

[i] Eleven directors meet the criteria of financial expertise outlined above. Two of these directors also meet the criteria for recent and relevant financial experience as outlined in the UK Corporate Governance Code, competence in accounting and auditing as required by the UK Financial Conduct Authority's Corporate Governance Rules in DTR7 and the audit committee financial expert requirements under the US Securities and Exchange Commission rules.

Board tenure and diversity (as at 30 June 2019)



Source: BHP (2019).[6]

CHAPTER 5

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 such 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 suggest that there will be questions about the independence of an individual who:

- had been an executive at the company, 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 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 such that it is able to operate independently and is not subject to bias or inappropriate influence. Investors recognise 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 only ever support a CEO or dominant shareholder. One of the challenges for investors is being able to identify both these sorts of individual.

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

The issue of the length of tenure on the board and independence is one generally recognised around the world (though it is not acknowledged even as an issue in some major markets, most notably the US), but where different standards are applied. As can be seen from **Figure 5.2**, from the **2019 OECD Corporate Governance Factbook**, different markets have varying 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.

Figure 5.2: DEFINITION OF INDEPENDENT DIRECTORS: MAXIMUM TENURE

Blue denotes **Rule** or **Regulation**

*Black italic denotes **Code***

12–15 YEARS — **NO INDEPENDENCE**

Belgium
France
Luxembourg
Poland
Portugal
Spain
Denmark
Greece
Slovak Republic
Slovenia

8–10 YEARS — **NO INDEPENDENCE**

Estonia
India
Latvia
Israel
Saudi Arabia

8–10 YEARS — **EXPLAIN**

Indonesia
Singapore
UK
Hong Kong SAR, China
Ireland
Italy
Malaysia

5–7 YEARS — **NO INDEPENDENCE**

Argentina
Turkey
Mainland China
Russia

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 the 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 need to have confidence that the non-executive directors on those committees will do this well and with shareholder interests in mind.

There is a broader challenge with this, though: 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 structure of the pay for top executives is 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 (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 focuses on the variable incentives, the bonus and equity-linked portions. Bonuses are typically calculated based on annual performance, against metrics (often called key performance indicators or KPIs) set at the start of a year, and paid in cash at the end of the year – though increasingly some of this is deferred for a further two or three years, often into shares that are only released at the end of the deferral period. The KPIs for bonuses will predominantly be financial metrics (usually profit-related) but will often include around 20% that is attributable to personal performance or non-financial measures including ESG factors. The longer-term equity rewards usually measure performance over at least three years and are typically paid out in shares which 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 measures, usually a combination of total shareholder return (TSR) and earnings per share (EPS). While this may sound complex, it is a significant simplification, as can be seen by the multiple pages of an annual report that a remuneration report now tends to represent.

Trust, or a lack of it, has driven much of the problem with executive reward. This has developed because of failures of understanding between investors who see ongoing payments for failure and corporations that find shareholders voting against schemes that they have supported for some years or have previously given indications that 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 form of compromised structure, rather than something which the directors fully believe will drive value in the business. This can lead to a further escalation of quantum (the amount paid to executives, aggregated across all forms of remuneration) as the compromise structures mean executives lack confidence that they can deliver what is needed to unlock the full potential. The higher quantum also leads to media and investor attention, and tension is likely to escalate between the company and its shareholders.

Disputes also arise from other differences in mindset. Investors tend to look for pay outcomes that match the corporate performance that they enjoy as shareholders, and are unlikely to oppose even the most generous packages when share price performance is strong. 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 that they need to respond to contractual obligations, paying out according to the terms of the agreed incentives. This can sometimes lead to a disconnect in expectations because the reward that is due under the contracted incentives may feel undue 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 structures have gained sufficient traction among both investors and companies to become the 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. This is exemplified by the pay ratio disclosures now mandated by some markets (notably the UK and USA). These compare the remuneration of the CEO with that of the firm's average-paid worker, and reveal very sizeable 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 exemplified by pay ratios an issue that is increasingly hard to ignore.

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 the principle indicates this is a whole board responsibility. The phrase 'fair, balanced and understandable' was delivered after considerable debate and has led many companies to undertake a rigorous restructuring of their processes and reporting. Reporting and transparency is 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.

The starting responsibility for the oversight of company reporting sits with the audit committee, but as the principle indicates this is a whole board responsibility. The phrase 'fair, balanced and understandable' was delivered after considerable debate and has led many companies to undertake a rigorous restructuring of their processes and reporting. Reporting and transparency is 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 may appear to be masking weakening performance. One way in which this is sometimes done is through alternative performance metrics (APMs). These are measures that 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 to admitting a failure to generate better performance, as the elements omitted 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 where an attempt may have been made 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, have 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 this is delivered in practice.[9]

A strong audit committee should strictly oversee the reporting process and ensure that these sorts of discrepancies do not occur to ensure fair and balanced reporting. A strong and challenging auditor, assisted by regulations, should also intervene to limit any misleading of investors. They 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 require consistency, with the APMs not to be disclosed more prominently than the official measures and 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 alongside the permitted standard measures and with full reconciliation between them.[11] It remains to be seen what the final outcome of this consultation will be, and how effectively companies will respond to any new standard.

→ *See Section 6 of this chapter 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 most value over the long term). Key questions to be asked include how much of its cashflow does it distribute to shareholders and how much does it reinvest into existing, or new, business activities. It is rare for a company to have large enough resources to pursue every opportunity that it identifies, and so capital allocation is as much about what a company will not do as what it will pursue. These investment decisions are crucial as whether they are successfully delivered will determine the returns the company makes over future years.

Generally, capital allocation is a function of history: a company retains a legacy business operation, even a sizeable operating business, when the opportunity for the company as a whole has in fact moved on. Shareholders can be more clear-minded about disposing of older businesses or operations than management – often perhaps because they may not understand the full complexities that would be involved in fully moving on from the legacy activity, nor are fully aware of the consequences for stakeholders. Even where the issue is not a historic legacy, most companies have to make decisions which over time will see their business operations diverge. Conglomerates are now firmly out of favour and most investors prefer to invest in focused businesses – with investors themselves providing diversification across their portfolio holdings. The crucial decision for the boards of such companies is how they allocate capital between the different businesses and make the most of the opportunities they have identified. Even where there is not an active investor pressing for a different approach to capital allocation, the board may need to have active dialogue with the shareholder base because decisions about which business opportunity to pursue will appeal to different investors. In particular, some of the capital allocation options may require a change in the dividend pay-out to ensure 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 its shareholders. Companies without debt on their balance sheets are often thought to be inefficient and failing to deliver the full extent of possible returns, maximising 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 maximising returns on equity in the short term and making the company entirely robust from a downturn. Unless the company is operating in a highly volatile business (where the gearing comes from operational gearing rather than financial), the board should seek to optimise the capital structure by taking on some debt.

A key financial resilience question which boards will need to answer is how they strike the balance between full resilience and maximising short-term returns. Many shareholders will be willing to sacrifice some short-term returns in order for the business to 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 balance of prudence is delicate: most shareholders would not wish businesses to be so financially secure that they can cope with any financial crisis. The multiple fund-raisings by companies during the pandemic demonstrates this 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 these 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 on an ongoing basis and is likely to raise significant questions among shareholders even while they may welcome the immediate cash payments. But the opposite circumstance, of a low dividend pay-out 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 offence wherever in the world it may be involved in corruption. For example, both the US's Foreign Corrupt Practices Act and the UK's Bribery Act have extraterritorial effect; the UK Act also explicitly requires companies 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 this, and companies aspiring to be responsible world citizens and enjoy ownership on the public markets are likely to need to go further. Companies need to operate whilst 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 as 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 licence to operate in a market or as a business as a whole.An ethical approach to business will encompass such issues as:

- corporate culture and having a set of expected behavioural standards for all staff, not tolerating inappropriate behaviours;
- 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 behaviour, including avoiding collusion with rivals or other anti-competitive activity;
- avoiding bribery and corruption, and fraudulent behaviour;
- 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 recognising that tax avoidance, not just evasion, can be inappropriate; and
- acknowledging that a company's reputation is a valuable asset which can be harmed by unethical or inappropriate behaviour 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 which are well-publicised 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 if need be. 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 that 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.

5 STRUCTURAL DIFFERENCES

5.1.3 Assess and contrast the main models of corporate governance in major markets and the main variables influencing best practice: major markets; 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, between these so-called two-tier board structures seen, for example, in Germany, the Netherlands, Scandinavia and China, and the single-tier (also called unitary) boards that 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, as 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 largely constituted in the same way, with all members being non-executives. In some cases however, they are not independent, as there 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 former 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 in 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 contained in country-specific codes. The **OECD's Corporate Governance Factbook** is a good source for detail 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, to increase that saving to meaningful levels, so the 'super funds' are now significant. They increasingly seek to wield their influence forcefully and a number of organisations help them present shared views to companies, including in particular the Australian Council of Superannuation Investors (ACSI).

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 public outcry after the company destroyed the Juukan Gorge site (caves which showed evidence of continuous human occupation for 46,000 years and were considered to be sacred by the local Puutu Kunti Kuurama and Pinikura people) to develop the site for iron ore mining. Despite the company having a licence 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.

Shareholder resolutions are relatively common in Australia, with only US companies facing more such proposals. This is partly because Australian law has been interpreted in a relaxed way, and also as a reflection of the strength and organisation of the shareholders. The approach can be seen with 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 the number of shareholders threshold in particular relatively easy to reach.

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 President Directeur General (PDG). Standards require that 40% of the directors be female, and around a third of the board should 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.

Beyond this, 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, and these are usually one of the Big Four firms (Deloitte, EY, KPMG and PricewaterhouseCoopers or PwC) and one from the next tier of firms. Some consider this controversial as it is seen as possible for issues to potentially 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 minimised as the only entity that is 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 typically the smaller firm 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 was a two-thirds shareholder vote to the contrary, French companies would award double voting rights to long-standing shareholders, defined as those who have held shareholdings in a particular way for at least two years. The structure of this requirement means that few institutional investors (certainly from institutions outside France) qualify – even a long-standing pension fund or insurance investor may find its continuity of ownership is perceived as having been affected by such normal practices as a change of custodian, or of fund manager, or by a stock-lending programme. Thus, in practice these double voting rights are perceived as a mechanism to establish management control, or that of major shareholders, and 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 of the legislation at the 2015 AGM. Instead, shortly before the AGM, the Government bought an additional near-5% stake in the company, which proved enough to defeat the opt-out from the Act, so securing the French state with double voting rights for its shareholding, which it soon reverted to the 15% level. In retrospect, this manoeuvre (agreed by then Economy Minister Emmanuel Macron) 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 shortly gave him 20% of the votes (and more since), which proved sufficient for him to gain effective 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 and in theory, it enables boards to take 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 companies have been built. Anecdotal reports tend to suggest though that there are usually meetings of the supervisory board without the workforce in attendance, where many of the crucial discussions happen, and that the full supervisory board meetings are more formalised.

As shareholders vote on the appointment of half of the supervisory board, which in turn is responsible for the appointment of the management board, the supervisory board are accountable to them, rather than the management board. 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 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 in the supervisory board has been improved by a move away from the former tradition that an outgoing executive became 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 indicates that there needs to be 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 for the strategy to be developed by the supervisory board and 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, though 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 from holding management to account.

The most controversial term of 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 phrase was opposed by a number of leading supervisory board chairs, and in contrast to many countries 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. The unusual feature of the country's governance framework arises from its history where 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, and in some cases the major financial institutions in the country). The dominance of these shareholder groups could mean that the nomination and election of the boards of such companies was entirely in their hands, leaving minority shareholders feeling unrepresented and facing wholly non-independent boards. To reassure minorities that their interests would be represented, the *voto di lista* approach was developed: a designated portion of the board (typically around 30%) 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 that gains the most votes is the dominant one and the chair is appointed from it; the slate with the next amount of votes is taken as the successful minority slate and fills the board roles designated for minority investors. The Italian investor association Assogestioni organises minority slates for the board elections each year.

An issue arises at companies where there is a broad institutional investment base and only a limited shareholding by the 'major' shareholder, where there is a chance that the *voto di lista* approach could lead to the slate intended as the 'minority' one gaining more votes than the one intended to be dominant. In such situations unusually the proxy agencies will recommend that their clients support the slate intended to be the dominant one so that it provides the chair and the bulk of board seats as intended; in usual circumstances the proxy agency recommendation is that clients support the Assogestioni minority slate to assure some board participation by independent directors.

The other unusual feature of the Italian governance structure is that there are elections for statutory auditors, these are not the independent auditors, 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. These are again appointed by a *voto di lista* slate process and form a further protection for minority shareholders.

Both the boards and the statutory auditors are elected for multi-year periods, usually five years, and are not subject to re-election in the intervening period. Though it 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, which are in addition to the independent audit firm that assures 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 three-year rotation. In theory, these 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 formed an independent challenge role somewhat equivalent to independent non-executive directors, their scope to do so was limited by a narrowly defined role and in practice also by the questionable independence of some.

Since the changes to governance introduced by the third 'arrow' of Abenomics (the moves towards economic liberalisation and renewal under former Prime Minister Shinzo Abe), increasing numbers of companies in Japan have moved away from the statutory auditor approach and have instead adopted the alternative structure of a 'board with committees', which is similar to the board structure 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 strong rivalry 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 for the first time in 2015 and revised in mid-2018, is on the independence of non-executive directors rather than the value that 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 is changing over time and a greater understanding of the role of the non-executive director is developing. At the time of writing, there are renewed moves to further update the Japanese Corporate Governance Code, with it likely that a requirement of 30% female board membership will be introduced.

Although the **zaibatsu**[i] 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 dead weights on fresh strategic thinking and innovation. It is for this reason that the Japanese Corporate Governance Code includes provisions that discourage the maintenance of cross-shareholdings (there is a specific principle, 1.4, discussing cross-shareholdings and in effect, requiring the disclosure of a policy to reduce them over time). The other main focus in the code is increasing independence on Japanese boards, requiring at least one independent non-executive 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 from 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 came to the negotiating table. Instead, the Dutch firm successfully argued that the board owed duties as strong to stakeholders, particularly employees, as it did to shareholders, and argued that the value offered to shareholders was unattractive (though the shareholders themselves largely and often publicly disagreed) and 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 from 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. Though in some ways, shareholders got the bulk of what they wanted in the end. Subsequently, the company sold off its speciality chemicals business, focusing on paints and coatings, and returned the bulk of the proceeds to shareholders.

As with other countries with supervisory board structures, the shareholders appoint the supervisory board in the Netherlands 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 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 country and remain so long after the dismantling of most of the **Stichting structures**,[ii] 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 case also shows that other than in the case of a takeover, the influence of shareholders is strong: the longer-term outcome of the disputes 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 controlled by the Wallenbergs through the mechanism of dual classes of shares with

i **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.

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

differential voting rights – a feature of Swedish governance, which 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, 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, 23.6% of the votes); and
- Electrolux (16.4% of the shares, 28.4% of the votes).

Investor AB argues that its investments, and its voting influence, enable it to avoid short-term pressures and 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, Sweden has developed an unusual structure whereby the nomination committee at companies is not in fact a committee of the board, but is instead appointed from among the shareholders – with the largest shareholders invited to participate in the order of their shareholding until the committee is fully populated. This nominations committee proposes to the AGM a board (which may include no more than a single executive and should be in the majority independent non-executive directors) and a chair of the board for shareholder approval. The outcome of this is reasonably positive: skilled and generally well-balanced boards. The Wallenberg family still appears in many Swedish boardrooms, frequently providing the chair. In contrast to most countries, 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 individual proposed director.

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

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 – not to have a code of its own. The reason is a fundamental issue of 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 law led to a race to the bottom for company standards between the states, competing with each other 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 corporations in the USA. 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. The leading among these are:

1. The Commonsense Corporate Governance Principles, first published in July 2016 and revised in October 2018. These 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 also 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 were created by a coalition of investors (a number of them in common with those involved in creating the Commonsense Corporate Governance Principles). They are also more about the relationship of US companies with their shareholders rather 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 set out in detail the approach of the CII – the pre-eminent representative of long-term investors in the USA – on the full range of corporate governance issues. These 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 subject to 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 USA creates rules in statute that reflect pre-existing expectations set down as principles in other markets. There are two examples under the Dodd-Frank legislation:

1. There is a resolution to consider executive remuneration, usually referred to as the 'say on pay' vote. Under Dodd-Frank, such a resolution must be put to shareholders 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 favour such votes to be held on an annual basis.

2. The 'access to the proxy' standard permits shareholders that fulfil 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 been rarely 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 dialogue would have been highly unusual just a few years ago.

6 WHY AUDIT MATTERS AND WHAT MATTERS IN THE AUDIT

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 out the proceeds, rather than being given the scope to renew their mandate for a further period. This sometimes included an expected independent oversight of these accounts. The industrial revolution (from circa 1760 to 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 endeavour, 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, providing the shareholders with assurance that the numbers they were presented with 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 is there certainty that there is no fraud within the business. Auditing is a sampling process trying 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 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, both as to 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 metaphor, sniffer dog-like – behaviour.

Reviewing financial statements and annual reports

The auditor checks and assures the financial statements in detail; their role in relation to the words and numbers in the more discursive front half of the annual report is less stringent. The auditor must read this segment and should comment if they discover something that is inconsistent with what they have learned through the process of the audit, especially with inconsistencies with numbering in the financial reporting. Any such comments are typically not visible to the shareholder because they will usually be addressed and changes made before the annual report is published – as will any significant issues the auditor identifies in the financial statements. This means that the outcomes of the audit are largely invisible to shareholders – although the new enhanced auditor reports (detailed below) give more insight into the process.

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 (consulting work and tax advice, principally) to the companies that they audit, despite the obvious risks raised from conflicts of interest. As they spend so much time within a business and interact closely with the finance department, auditors can build closer relationships with the management of the companies they audit than they do 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 move to work at companies that 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 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 audit clients. This can be seen within the EU: for example, EU law now provides not only a list of non-audit services that are the only ones an audit firm may provide to audit 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 also proposed much more separation between the audit and non-audit arms of the accountancy firms so that audit is much less likely to be influenced by other concerns.[13]

Another important question surrounds behavioural independence. There is a natural tendency for individuals to seek consensus, and for people to want to avoid disagreement or even confrontation with those with whom they spend time. These natural human behaviours 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 scepticism 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 both run contrary to the frequent mindset that the audit firm should be efficient in its work, fit 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 being unwilling to give up valuable non-audit services contracts, there is a sub-optimal level of competition. While prior to the rule changes it was frequently argued that auditor changes might lead to issues being missed, either in the last year of a departing auditor or the first of a new auditor, the reported impact has been positive: companies which have changed auditors have found the refreshed perspectives valuable yet challenging.

Sampling and audit work

The sampling process that underlies audit work has been mentioned previously, however technological and AI developments may see this 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 occasions though, it seems that the budget for the audit does more to determine the work undertaken rather than the activity being driven by 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 the discussion of disclosures of performance materiality below). In this, the external auditor leans on the work of internal audit (the company's own assessment process of risks and the quality of reporting, also discussed below), and well-run audit committees sensibly coordinate the work of internal and external audit so that they get an appropriate level of assurance across the company.

Sir Donald Brydon's recent independent review into the quality and effectiveness of audit proposes that audit committees produce an annual audit and assurance plan which discloses the committee's expectations for overall assurance of company reporting, including both internal and external audit, 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.[3]

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 sampling a proportion of them. A number of independent software firms have developed packages that deliver this, though these currently seem to be more focused on the small and mid-sized end of the corporate market rather than on larger businesses. The challenge with any approach to assessing every transaction is then spotting anomalies among this barrage of data, and not just checking that the numbers add up. The technology potentially removes the need to sample, not the need to consider intelligently the information that is delivered. This remains a work in progress.

Enhanced auditor reports

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

- **Scope of the audit** – how many parts of the company the audit has covered and in what depth. Typically, an audit will only apply full audit to the largest segments (usually geographies, but sometimes business segments), it will apply tailored audit procedures to others, and some 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 the quantitative measure of materiality: the level of transaction or valuation below which the auditor spends little time. For the biggest companies this can be a surprisingly large number (US$500m (£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 performance materiality number (the level below the materiality threshold that the auditor uses in practice in its audit procedures, to avoid problems arising when the numbers analysed are aggregated), as this 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 organisation or one whose controls should perhaps be enhanced, which can be a useful insight for investors.

- **Key audit matters** – the 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 the auditor chooses 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 or not 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 if 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 Brydon Review of audit are adopted – indeed, Sir Donald Brydon in his independent review proposes that auditors should do a lot more to inform investors and the market as a whole. He emphasises the importance of this role for auditors by using inform as one of the three words in the title of his final report, "assess, assure and inform".[3]

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 (this includes many foreign companies because they have US listings of either their equity or debt) may not in any way limit the liability of the auditor. Even where audit firms enjoy the benefit of limited liability partnership status (meaning that all the partners are no longer exposed to risk because of a potential failure by one of their partners), the individuals who are directly responsible for any failure, and especially the audit partner themselves, can face losing everything. This risk is seen as significant in part because auditors are often one of the few deep-pocketed players if and 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 though is less clear because most of these cases are settled before they come anywhere near to judgment. Most of those 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. It can be outsourced, but most of the time, the internal audit function 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). Its function is largely a risk management role, seeking to ensure that the company's procedures and expected behaviours are delivered in practice, and trying to uncover misbehaviour or problematic management.

Internal audit has highly variable status in different businesses – and indeed, it does not exist at all in some organisations. Where it is deployed most effectively, it is a tool for both the executive team and the non-executive directors to gain confidence and comfort about the delivery on the ground, helping the company operate more effectively and efficiently. It can help the board feel closer to real operations, something that is a significant challenge for modern, large multinational businesses. There is a step change taking place in internal audit, involving directing the work towards helping the board and senior managers protect their organisation's assets, reputation and sustainability. The Internal Audit Code of Practice[14] 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 step change.

7 IMPACT OF GOVERNANCE ON INVESTMENT OPPORTUNITIES

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.

Of the three ESG factors, governance is the element most often taken into consideration by traditional investment analysts. A 2017 CFA Institute ESG survey showed that 67% of global respondents take governance into consideration in their analysis and investment decision-making (up from 64% in 2014); ahead of environment and social factors (both on 54%).[15] In the EMEA region, the number of analysts indicating that they take 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 that they reviewed showed a positive correlation between governance and corporate financial performance; and
- 58% of environmental studies and 55% of social studies showed the same correlation.[16]

Similarly, in mid-2016, one UK investment manager estimated that companies with good or improving corporate governance had tended to outperform companies with poor or worsening governance by 30 basis points per month on average in the prior seven years.[17] Environmental and social factors had also demonstrated their ability to guide investors towards better performing companies and away from poorly performing companies, but the dispersion in performance was about half as large.

Good governance is fundamental to a company's performance, both in terms of 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 they will also approach environmental and social issues with the right long-term mindset and so 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 case of Enron (where the company's market value fell from US$60bn (£43bn) in December 2000 to zero in October 2001) is bracing.

The special investigation committee's report reads:

> *"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."*[18]

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 and so may see significant value eroded, 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 and 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), and value can be lost as easily. The building blocks for understanding good governance – accountability and alignment, and governance being at its heart about people (allowing boards to get the right mix of skills and experience in the boardroom, and an array of different perspectives) – can be applied to any situation.

While 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 typically true in many infrastructure vehicles – this reduces the risk of misinformation and a lack of responsiveness, but does not in itself remove all governance risks. Particularly, given the highly indebted nature of many such investments, the margin of error is not always great 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 study

Theranos Board

In 2014, around the time it was raising money from private market investors at a valuation that confirmed it – at least temporarily – was a so-called ‘unicorn’ (a private company valued at more than US$1bn (£718m), the company, that 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 construction company Bechtel Group
- William Frist, 62 — former heart and lung transplant surgeon prior to 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, 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 services backgrounds rather than medical or scientific experience, with an average age (less the executives) of 73. There were more former secretaries of state in their 90s on the board than people with medical training. None had expertise, or even basic experience, of 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 operation of a dual share class 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. This suggests that the board was not operating as effectively as it might have been. Perhaps that shouldn’t be surprising. Wall Street Journal investigative reporter, John Carreyrou, in his striking account of the Theranos story *Bad Blood*, reports 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.”

cont'd...

Case study

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

In retrospect, the Theranos board incorporates many red flag warning signals that something might have been 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 board table to enable the views of the appropriately skilled individuals on the board to be heard? This is about behaviours and so is inevitably harder to identify from outside; nonetheless, there are often indicators suggesting that the board dynamic is not as effective as it might be.

Theranos is not the only unicorn to experience governance challenges impacting 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 impacting 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 capitalisation at listing when investors baulked at several governance issues, including the dominant decision-making position of the founding CEO, Adam Neumann (which even persisted after his death as his wife was to be handed the choice of his successor should he die) 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. A financial adviser in a striking *Financial Times* article about the company's downfall is particularly insightful on its governance and Neumann's management style is reported as saying: "How do you go from succeeding by not listening to succeeding by listening?".[19]

Few governance failures are as extreme in their destruction of value as Theranos or WeWork, and few boards are as lacking in diversity and the relevant skill set as the Theranos board was. There is good evidence of the beneficial effect of diversity in academic literature. Carter, Simpkins and Simpson's 2003 study of Forbes 1,000 firms finds 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).[20] Bernile, Bhagwat and Yonker's 2017 study concludes 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.[21] In addition, while diverse boards take less financial risk, "this behaviour does not carry over onto real risk-taking activities", with diverse boards investing more in research and development (R&D). Overall, their study finds that greater heterogeneity among directors leads to higher profitability and firm valuations, on average.

Governance failings lead to fines and additional liabilities, as well as litigation and other costs. Revenues also 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 of these effects harm security values. Governance analysis should be a core component of valuation practice.

8 INCORPORATING GOVERNANCE INTO INVESTMENT AND STEWARDSHIP PROCESSES

5.1.6 Apply material corporate governance factors to: financial modelling; risk assessment; quality of management.

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 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 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 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 is most typically done through recognising 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 such that past underperformance, on which the company is valued in the market currently, is reversed and the valuation can be enhanced by stronger performance and an expectation for more positive performance in the future.

Many governance issues lend themselves to stewardship dialogue with companies, not least because many of them will be directly addressed in the AGM agenda. Investors will be obliged to take a view on them (for many investors this is why governance has a lengthier heritage than environmental and social issues – particularly as in many markets the obligation to consider voting decisions actively has been long-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.

Thus, there is a natural driver at least annually for engagement on these issues – though investors are increasingly keen to avoid the critical point of all such discussions occurring 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, 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 to gain assurance that the economy can prosper through good governance such that the 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 relevant people accountable for their decisions.

3. Accountability is reflected in sufficient oversight of management, so that the 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 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. This 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. The Cadbury Code in the UK 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, and single-tier boards are more typical of the USA, the UK, Japan, France and most of the rest of the world. The USA and France generally have a single executive on the board, often acting as both chair and CEO. Japanese single-tier boards are dominated by executive directors with only a small handful of non-executives; most unitary boards sit between these models.

11. Audits focus on close attention and assurance of the financial statements. However, they only entail 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.

CHAPTER 5

SELF-ASSESSMENT

These self-assessment questions are provided only to enable you to test your understanding of the chapter content. They are not indicative of the types and standard of questions you may see in the examination.

Questions

1. **What are the 'two As' that lie at the heart of corporate governance?**

   (a) Advocacy and alignment.

   (b) Advocacy and argument.

   (c) Accountability and advocacy.

   (d) Accountability and alignment.

2. **Which of the following is NOT a reason why the role of the chair of a company board is so important?**

   (a) The chair sets the agenda for board discussions.

   (b) The chair helps ensure all directors make their full contribution.

   (c) The chair will usually also be CEO.

   (d) The chair leads the process of selecting and appointing new directors.

3. **Which of the following is NOT a board committee expected to be established at all companies?**

   (a) Audit.

   (b) Risk.

   (c) Nominations.

   (d) Remuneration.

4. **Which of the following scandals did NOT help set the context for the creation of the first corporate governance code?**

   (a) Polly Peck.

   (b) Enron.

   (c) Mirror Group Newspapers.

   (d) Caparo.

5. **What was the model created by the Cadbury Code for adherence to its principles, still followed in the UK code?**
   (a) If not, why not.
   (b) Comply or else.
   (c) Apply and explain.
   (d) Comply or explain.

6. **Which element of executive pay is most likely to include some metric based on ESG performance?**
   (a) Salary.
   (b) Benefits.
   (c) Annual bonus.
   (d) Long-term incentive or share scheme.

7. **Which of the following is NOT typically seen as a driver of concern regarding an individual director's independence?**
   (a) A family tie to an executive.
   (b) Recent senior role in a firm that provides advisory services.
   (c) Receiving share options in the company.
   (d) Not having been on the board for long enough fully to understand the business.

8. **What US legislation led to the creation of the Public Company Accounting Oversight Board (PCAOB)?**
   (a) Glass-Steagall Act.
   (b) Sarbanes-Oxley Act.
   (c) Dodd-Frank Act.
   (d) Accountable Capitalism Act.

9. **What were the two major scandals in Europe in 2003 that led to a reassessment of the continent's approach to governance?**
   (a) Ahold and Parmalat.
   (b) WorldCom and Tyco.
   (c) HIH and Satyam.
   (d) BCCI and Caparo.

10. Which area of ethical corporate behaviour is most likely to be subject to extraterritorial legislation?

(a) Anti-corruption.

(b) Employee health and safety.

(c) Supplier payments.

(d) Lobbying activities.

11. Which is the only major country that does NOT, as of 2020, have a corporate governance code?

(a) Japan.

(b) France.

(c) UK.

(d) USA.

12. Which statement outlines the distinction between the auditor's role in relation to the financial statements and to the rest of the annual report and accounts?

(a) Assurance on the financial statements, report on inconsistencies in narrative reporting.

(b) Guarantee accuracy of the financial statements, report on inconsistencies in narrative reporting.

(c) Assurance on the financial statements and on narrative reporting.

(d) Assurance on the financial statements and on numbers within narrative reporting.

13. How long can an audit firm remain in the role at an EU public company?

(a) 5 years.

(b) 7 years.

(c) 10 years.

(d) 20 years.

14. Which of the following is NOT one of the three key elements of disclosure in the new enhanced auditor's reports?

(a) Scope.

(b) Materiality.

(c) Scepticism.

(d) Key audit matters.

15. Which of the following is NOT likely to be considered a G factor by a sovereign debt investor?

(a) Corruption.

(b) Rule of law.

(c) Regulatory effectiveness.

(d) Proportion of investors that are PRI signatories.

CHAPTER 5

SELF-ASSESSMENT **ANSWERS**

1. **d.**
2. **c.**
3. **b.**
4. **b.**
5. **d.**
6. **c.**
7. **d.**
8. **b.**
9. **a.**
10. **a.**
11. **d.**
12. **a.**
13. **d.**
14. **c.**
15. **d.**

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