From Companies to Markets—Global Developments in Corporate Governance

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2121 Pennsylvania Avenue, NW,
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Foreword

Good corporate governance is a basic element for healthy companies and a key to sustainable private sector development. Strong governance fundamentals contribute to better management and more effective boards, leading to enhanced operational efficiency, reduced risk, improved decision making, and increased valuations, among other business benefits.

In recent years, we have seen remarkable progress. Companies, regulators, and legislative bodies in markets at all stages of development acknowledge the value of good governance and the role it plays in heightening investor interest, improving access to capital, and strengthening markets.

This publication, *From Companies to Markets—Global Developments in Corporate Governance*, represents a unique collaborative effort to assess the state of corporate governance around the world in the wake of the 2008 global financial crisis. It draws on the expertise of the IFC Corporate Governance Private Sector Advisory Group and other practitioners in this important field, providing a fascinating and detailed accounting of the range of changes that have taken place in the past few years as the corporate governance agenda has been elevated.

The report highlights notable improvements in board practices, control environment, shareholder protection, and transparency and disclosure. It also points to progress on more effective application, monitoring, and enforcement of corporate governance codes. Importantly, the publication identifies future directions where more work is needed, such as increased commitment at the national level to prioritize the corporate governance agenda.

IFC has long played a leadership role in the corporate governance arena, given the critical link to the World Bank Group's twin goals of reducing extreme poverty and promoting shared prosperity. As the corporate governance landscape changes, IFC's work in this area will continue to evolve to meet new needs and address emerging issues.

This publication makes an important contribution to the global knowledge base on corporate governance and the status of post-financial-crisis governance progress. In addition, the data, information, and analysis provided within these pages will help identify future areas of focus for IFC's corporate governance work.

Today, the world grapples with instability and uncertainty at many levels. Yet, as we look back on what has been accomplished and focus on future goals, we see ever more clearly the enduring value of strong corporate governance—for individual companies, regulatory institutions, and governments.

Darrin Hartzler, Manager
IFC Corporate Governance Group

Preface

In May 2015, the IFC Corporate Governance Group called together 40 experts in the field and members of the IFC Corporate Governance Private Sector Advisory Group. These participants explored key changes in international corporate governance standards and codes of best practice in the wake of the recent global financial crisis and how these changes have helped draw corporate attention to sustainability issues. The group found that many issues that became evident regarding banks in the financial crisis—and led to changes in the governance of banks—also have flowed through into broader corporate governance developments.

This publication arises from the issues and information from these discussions. Specifically, Part A discusses developments from global or regional groups involved in corporate governance. Part B addresses developments in corporate governance practice, and Part C looks at developments in corporate governance codes and standards.

Readers of this publication are likely to be professionals operating in corporate governance or requiring early information on the issues arising in corporate governance and who know that better governance leads to company growth, competitiveness, and more sustainable enterprises.

Acknowledgments

The project team would like to thank those who attended the May 2015 gathering. We are grateful to everyone who took the time to participate at the Practice Group meeting on Corporate Governance Codes and Standards and provided us with insights and information. All responses were instrumental in building the rationale and key thinking points for this publication.

Project Team: Anne Molyneux, Ralitza Germanova, Kiril Nejkov, and Charles Canfield.

Special thanks to Anne Molyneux, the author of this publication, and to project team members Ralitza Germanova, who directed the project and ensured that the initial idea came to fruition, and Kiril Nejkov and Charles Canfield, who provided invaluable detailed advice. In-depth comments came from (in alphabetical order) Michael Amoako-Atuobi, Atiyah Curmally, Alexander Berg, Winfrid Blaschke, Salamat Kussainova, Per Lekvall, Basak Mustu, Chris Pierce, Ansie Ramalho, Sergio Rodriguez, and Roberta Simonetti. Particular thanks to the IFC Corporate Governance Private Sector Advisory Group members (in alphabetical order) Bistra Boeva, George Dallas, Peter Montagnon, Christian Strenger, and Patrick Zurstrassen.

Thanks also to (in alphabetical order) Assylkhan Aitzhanov, Adalyat Abdumanapova, Rosario Carmela G. Austria, Ghita Alderman, Julie Bamford, Stephen Bland, Sarah Cuttarree, Hillary Cheruiyot, Visar Dobroshi, Marina Frolova, Anar Hajizade, Chris Hodge, Yehia El Husseiny, Jonathan Labrey, Min Liu, Karen A. Rocha, Loty Salazar, Sergii Tryputen, Mazen Wathaifi, Han Yi, and Bashar Abu Zarour. Thanks to Shannon Roe for editing support and to Wendy Kelly for designing the publication.

Please note that the comments made during preparatory meetings or in the quotes that appear in this document represent personal opinions and are not necessarily those of the institutions the commentators are affiliated with.

Executive Summary

The purpose of this publication is to collect and make available in one place a statement and reference for key corporate governance changes, especially those occurring since the financial crisis, including new directions and other recent developments. The publication does not seek to reiterate information on all corporate governance regulations and practices but instead focuses only on recent changes. It is in four parts.

Part A: Recent Developments in Global and Regional Corporate Governance Groups—encompasses recent developments from global organizations with the capacity to widely influence corporate governance standards and practices globally or across a number of countries. These organizations include the Organisation for Economic Co-operation and Development (OECD), the Basel Committee on Banking Supervision (BCBS), the International Corporate Governance Network (ICGN) of the investor community, and the European Union. Part A also covers some interesting corporate governance developments in the Nordic countries—Denmark, Finland, Norway, and Sweden.

After the biggest financial crisis since the 1920s, many changes to corporate governance standards were initiated at the global, regional, and national levels. In general, changes relate to corporate governance as a key component leading to market confidence and trust, moving the focus of corporate governance beyond the company level. Changes reflect the following:

- The move to increased regulation, as opposed to voluntary codes, in some areas of corporate governance, to ensure compliance and to ensure that the codes provide for flexibility of application to support company diversity.
- The need for regulators to monitor disclosure on corporate governance codes and practices.
- The need for a long-term view on company affairs and the drivers of such a view, especially in strategy, performance, remuneration incentives, and shareholder expectations.
- Recognition of the importance of understanding the input, business processes, output, and impact of the business model on the company as well as the context it operates within, balancing the power of controlling shareholders.
- Demand for increased transparency from companies and better information, particularly on governance and board effectiveness, related-party transactions, company strategy, risk, performance, and company culture.
- Recognition of the role of investors in corporate governance frameworks and the need for shareholder engagement in company affairs and company/investor communication.
- A shift in emphasis in corporate governance regulations to consider its role and effects on capital markets, not just on individual companies.
- Demands by investors for a "say on pay" and increased focus by the board on risk and risk culture.

Part B: Corporate Governance Developments: Practice Issues—looks at corporate governance developments that have occurred through company-initiated continuous-improvement programs that have been more widely applied and recognized as better corporate governance practices. The key corporate governance changes and new directions are reflected in board practices, the control environment, and shareholder protection. An increased focus on board and director commitment to corporate governance, on the culture in a board, and on board behaviors sets a tone for better corporate governance.

Boards themselves are structuring and using board committees to improve their work, especially in audit, remuneration, and risk, as well as for corporate goverance, director nominations, and succession planning. This has

led to the expectation of an expanded role for independent directors and their contribution to board committees. Most countries have mandated audit committees for listed companies, now requiring appropriate financial skills and increased levels of independence in this committee. Regarding risks, there is an increasing and emerging need to consider other variables in the analysis, adding social and environmental aspects to the economic and financial analysis, which requires new expertise and competences among the board members. Board evaluations also have become accepted practice in most jurisdictions.

Control Environment and Risk

Given the widespread failure of risk management, it is not surprising to see the increased focus on risk oversight and board accountability for risk following the financial crisis—to establish a risk culture and robust risk systems and processes to enable better risk oversight. Many companies have incorporated the "three lines of defense" model, initially developed in the banking and financial sector, into their risk management. These companies expect the board to increase its risk expertise, enlarge its understanding of entity risks and risk tolerance, and set risk appetite limits for the entity—a complex and challenging task, still in its infancy.

There is a greater focus on the role of internal "gatekeepers" in managing risk. In the banking and financial sector and in response to increased regulatory pressure, the role of a chief risk officer (CRO) has been made clearer, and the links internally between risk officers, compliance officers, and internal auditors in supporting and testing internal controls and the overall company control environment have been strengthened.

More broadly in all entities, the role of internal audit is growing and the scope of its mandate extended to cover culture—a new role that leads to changes in governance concerning internal audit. It is becoming less common for the reporting line of internal audit to be to the chief financial officer (CFO) and more common for the chairperson of the audit committee to be ultimately responsible. There is an expectation that the internal auditor will lead an independent, well-resourced function and report directly to the audit committee of the board. There is also an expectation of closer collaboration between the CRO and the board committee overseeing risk. In complex risk environments, there is a rising expectation of a separate risk committee of the board to which the CRO would report. This has been mandated for larger banks in some jurisdictions.

Regulators and international organizations such as the International Organization of Securities Commissions (IOSCO) also are focusing on the role of audit committees to ensure better audit quality. In some jurisdictions, regulators are promulgating AQIs (audit quality indicators) for regulatory use and for audit committees to assess the quality of their external audits. This publication also looks at developments in traditional risk management tools to assist with the management of risk on an enterprise-wide basis. They include, among others, a model to integrate risk into company decision-making processes and a toolkit that IFC developed to enable its officers to better assess the control environment and risk as part of its corporate governance assessments.

Transparency and Disclosure

Tools and frameworks are emerging that facilitate wider reporting on nonfinancial matters. Integrated reporting (IR) is one such development, which incorporates and connects sustainability and nonfinancial reporting with financial reporting. It advocates reporting that gives a concise, holistic picture of company value creation (in the broader sense, beyond mere financial value) and the ability of the company to maintain the creation of value in a sustainable manner. It is based on a new concept of the six capitals—financial, manufactured, intellectual, human, social and relational, and natural capital—that represents the forms of capital or sources that the company employs, transforms, and provides. IR tells the story of which capitals the company relies on, how the company uses these capitals, how it transforms them through its business processes and activities into products and services, and the impact of these product and services.

The auditors' findings will also be more transparent on the external audit as a consequence of a new required external audit report style in which the auditor will disclose key matters that arose during the audit and which the auditor discussed with the audit committee and/or the board.

Shareholder Rights

Shareholder rights have been strengthening in two particular areas: related-party transactions and beneficial shareholders. Companies and boards have been improving policies and practices for related-party transactions and their approval practices. In good practices, shareholders are approving ex ante major related-party transactions, and processes are in place for board review and approval of all other related-party transactions.

In the face of a rise in shareholder engagement with the company on corporate governance matters, there is a need to be able to identify significant shareholders, especially in the light of the prevalence of controlling shareholders. There is and will continue to be a demand for transparency regarding ultimate beneficial shareholders; the veil might

be lifted with regard to ownership behind nominees and intermediaries, trusts, and the like.

Commitment to Corporate Governance

Above all, companies and directors are demonstrating increased commitment to corporate governance and a corporate governance tone/culture set from the top of the company. Commitment to corporate governance is observed by leadership actions in the company, the existence of ethics codes and stronger systems, policies, and practices regarding board evaluation and succession planning, the control environment and risk oversight, and increased engagement between shareholders and the board on corporate governance issues.

Part C: Global Developments in Corporate Governance Codes—reviews how corporate governance codes and standards have developed in diverse countries and in diverse ways, issues that remain common problems, and how sustainable development and integrated thinking about the social, environmental, and economic aspects of the business are being considered and are becoming integrated into corporate governance codes and standards.

Corporate governance codes of best practice reflect the recent changes and new developments in corporate governance standards that look into integrating better board practices, shareholder protection, value creation to all stakeholders, transparency and disclosure, and environment and social considerations. Recently, many reviews of corporate governance codes show that some key issues are mandated and becoming laws or regulations in an attempt to make the codes more effective. Other matters remaining in codes have been updated to follow international good practices. In these reviews, predominantly undertaken in Europe, the "comply or explain" principle, on which many of the codes are based, has been reconsidered and affirmed, but in other regions, such as in Africa, there is less support for the comply-or-explain approach. However, the reviews note increased assessment of the efficacy of mandatory laws, regulations, and codes versus voluntary codes, depending on the legal framework and stage of development of corporate governance in particular jurisdictions.

In some countries, discussions are ongoing concerning the relative merits of a single national code versus individual codes for listed entities, financial institutions, state-owned enterprises, and the like. Increased monitoring, enforcement, and reporting on corporate governance implementation is evident in many countries.

Part D: Conclusion—Since the financial crisis, much has changed in the corporate governance environment at the global, regional, and national levels. Meeting the increased expectations of stakeholders will require renewed efforts by companies to improve their corporate governance, by investors to participate in the betterment of corporate governance in their investee companies, and by regulators to monitor the level of commitment to corporate governance in the companies within their jurisdictions. Importantly, there is now a realization of the contribution that better corporate governance can make to market development, economic growth, and stability.

Acronyms

ACCA: Association of Chartered Certified Accountants
AGM: annual general meeting
AICPA: American Institute of CPAs
ASEAN: Association of Southeast Asian Nations
ASX: Australian Securities Exchange
BCBS: Basel Committee on Banking Supervision
BICG: Baltic Institute of Corporate Governance
BM&F BOVESPA: Brazilian Stock Exchange
CAC: Cotation Assistée en Continu (French stock market index)
CEO: chief executive officer
CFO: chief financial officer
CII: Council for Institutional Investors (United States)
CII-ITC: Centre of Excellence for Sustainable Development (India)
CIIA: Chartered Institute of Internal Auditors
CMA: Capital Markets Authority (Kenya)
CMVM: (Portuguese Securities Market Regulator)
CNMV: Comissão do Mercado de Valores Mobiliários (Portuguese Securities Market Commission)
COBIT: Control Objectives for Information and Related Technology
CONSOB: Commissione Nazionale per le Società e la Borsa (Italian Securities and Exchange Commission)
COSO: Committee of Sponsoring Organizations of the Treadway Commission
CR: corporate responsibility
CRO: chief risk officer
CSR: corporate social responsibility
EC: European Commission
ECGI: European Corporate Governance Institute
ECIIA: European Confederation of Institutes of Internal Auditors
ecoDa: European Confederation of Director Associations
EITI: Extractive Industries Transparency Initiative
ERM: enterprise risk management
ESG: environment, social, and governance
EU: European Union
FCA: Financial Conduct Authority (United Kingdom)
FEE: Fédération des Experts Comptables Européens (Federation of European Accountants)
FRC: Financial Reporting Council (United Kingdom)
FSB: Financial Stability Board
GGP: Global Governance Principles (issued by ICGN)
GM: general manager
GNDI: Global Network of Director Institutes
GRI: Global Reporting Initiative
IAASB: International Auditing and Assurance Standards Board
IBE: Institute of Business Ethics
IBGC: Brazilian Institute of Corporate Governance
IC: internal control
ICAEW: Institute of Chartered Accountants in England and Wales
ICGN: International Corporate Governance Network
ICSA: Institute of Chartered Secretaries and Administrators
IFAC: International Federation of Accountants
IFRS: International Financial Reporting Standards
IIA: Institute of Internal Auditors
IIASB: International Internal Audit Standards Board
IIRC: International Integrated Reporting Council
IoDSA: Institute of Directors in Southern Africa
IOSCO: International Organization of Securities Commissions
IR: integrated reporting
IRM: Institute of Risk Management
ISAs: International Standards on Auditing
ISACA: Information Systems Audit and Control Association
ISO: International Organization for Standardization
IT: information technology
JSE: Johannesburg Stock Exchange
M&A: mergers and acquisitions
MNE: multinational enterprise
NACD: National Association of Corporate Directors (United States)
NAPF: National Association of Pension Funds (United Kingdom)
NGER: National Greenhouse and Energy Reporting (Act—Australia)
OECD: Organisation for Economic Co-operation and Development
OSC: Ontario Securities Commission
PIE: public-interest entity
PRA: Prudential Regulation Authority (United Kingdom)
PRI: UN Principles for Responsible Investment
RAF: Risk Appetite Framework
RMA: Risk Management Association
ROSC: Report on the Observance of Standards and Codes
ROTX: Romanian Traded Index
RPT: related-party transaction
SAICA: South African Institute of Chartered Accountants
SASB: Sustainability Accounting Standards Board
SC: Securities Commission of Malaysia
SEBI: Securities and Exchange Board of India
SEC: Securities and Exchange Commission (United States)
SK: Samruk-Kazyna (sovereign wealth fund of Kazakhstan)
SMEs: small and medium enterprises
SOE: state-owned enterprise
SOFIX: Bulgarian Stock Exchange stock market index
UNDP: United Nations Development Programme
UNHCR: United Nations High Commissioner for Refugees
WEF: World Economic Forum

Recent Developments in Global and Regional Corporate Governance Groups

Corporate governance changes often follow major crises. After the Asian financial crisis of 1997 and after the major collapses arising from the "dot-com bubble" and of Enron and WorldCom in 2002, corporate governance regulations were reviewed and amended at a national level. Since the financial crisis of 2008, many reviews have indicated that poor corporate governance practices might have contributed to the collapse of the financial system. Reviews were instigated initially by the Organisation for Economic Co-operation and Development, the organization responsible for the Principles of Corporate Governance. Since 2008, key changes in corporate governance regulations have continued.

> The financial crisis revealed severe shortcomings in corporate governance. When most needed, existing standards failed to provide the checks and balances that companies need in order to cultivate sound business practices. . . . Failures were closely linked to. . .remuneration/incentive systems; risk management practices; the performance of boards; and the exercise of shareholder rights.
>
> (OECD 2009)

A.1. G20/OECD Principles of Corporate Governance

After the financial crisis, OECD revised its *Principles of Corporate Governance* (the Principles) in cooperation with the G20. The Principles have a proven record as the international reference point for corporate governance and serve as the basis for the following:

- OECD Guidelines on Corporate Governance of State-Owned Enterprises;
- OECD Guidelines for Multinational Enterprises;
- Guidelines on Corporate Governance of Banks, issued by the Basel Committee on Banking Supervision;
- OECD Guidelines on Insurer and Pension Fund Governance and as a reference for reform in individual countries;
- One of the Financial Stability Board's (FSB) Key Standards for Sound Financial Systems, serving FSB, G20, and OECD members;
- Use by the World Bank Group in more than 60 country reviews worldwide (Reports on Observance of Standards and Codes) and IFC to support companies in implementing good corporate governance practices; and
- The ASEAN Corporate Governance Scorecard.

The Principles also form the backbone of IFC's Corporate Governance Methodology, a system for evaluating corporate governance risks and opportunities, which IFC uses to support companies working to improve their governance practices. It is recognized among development finance institutions as the most advanced methodology of its kind and is the basis for a coordinated approach to corporate governance now implemented by 34 development finance institutions, including IFC.

OECD Developments

Changes to the Principles arose out of several peer reviews and research undertaken between 2011 and 2014 relating to the following:

- Board practices, especially remuneration;
- The role of institutional investors in promoting good corporate governance;
- Related-party transactions and minority shareholder rights;
- Board nominations processes and elections;
- Supervision and enforcement in corporate governance; and
- Risk management.

The review process, now completed, led to the launch of *G20/OECD Principles of Corporate Governance* (the Principles) and related *Guidelines in Corporate Governance of State-Owned Enterprises* (the Guidelines) in September 2015. The inclusion of all G20 countries as signatories to

the Principles means their adoption by a wider group of countries, not only OECD members. The review also led to the issuance of the *Corporate Governance Factbook*. All documents share up-to-date information about corporate governance practices in OECD countries and a selection of additional jurisdictions. The Factbook is a useful resource for national governments looking to compare their own frameworks with those of other countries or seeking information about practices in specific jurisdictions.

The major changes to the Principles are a combination of new material that reflects new thinking on corporate governance issues, a new structure to highlight important issues, and additional explanatory material. (See Table A.1.)

The revised Principles[1] were issued in September 2015. Because the Principles not only are adopted by the OECD, G20, and FSB, but also are viewed as a global reference point for corporate governance, many other laws, regulations, codes, and standards globally are under review.

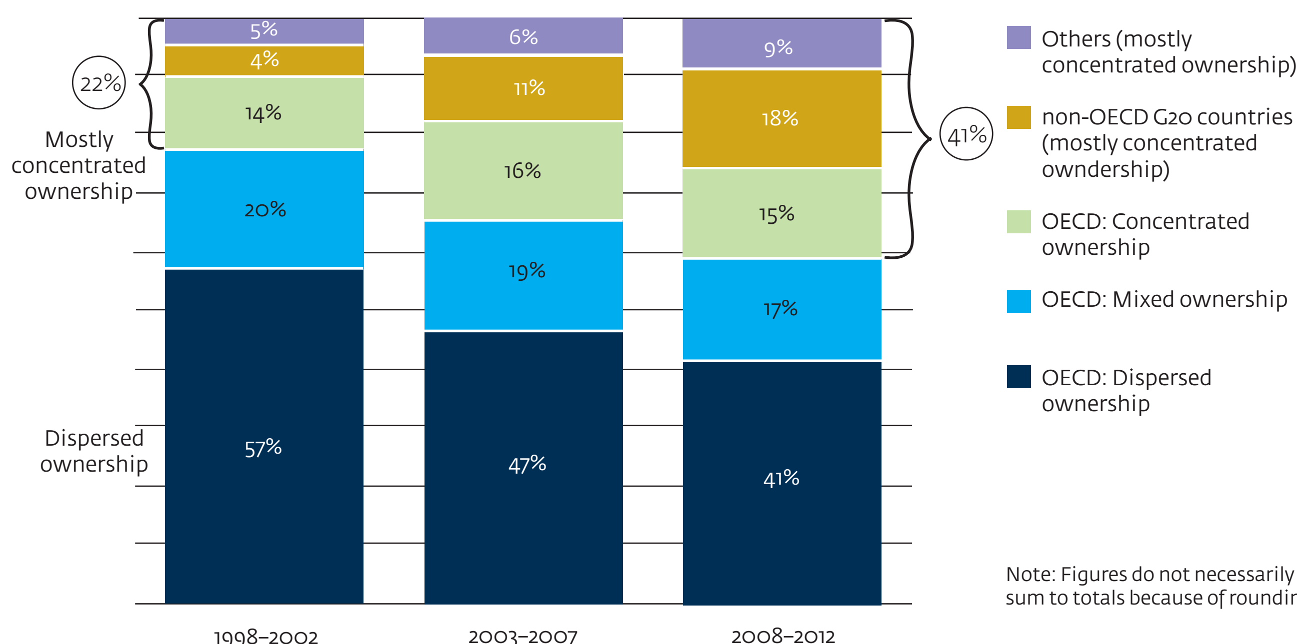
Over the last several years the shape of share markets has changed, as illustrated in Figure A.1. Concentrated ownership rose from about 22 percent to about 41 percent from 1998 to 2012, leading to increased recognition of the importance of controlling shareholders on corporate governance, including family ownership or state ownership. Therefore, the new Principles offer more specific guidance on corporate governance in the presence of controlling shareholders and note the importance of transparency regarding company ownership.

A.2. Basel Committee for Banking Supervision Corporate Governance Principles

In 2012, the Basel Committee on Banking Supervision issued a set of principles to enhance corporate governance

> To address fundamental deficiencies in bank corporate governance that became apparent during the financial crisis, the Basel Committee on Banking Supervision has issued a final set of principles for enhancing sound corporate governance practices at banking organisations. . . . The Committee's guidance assists banking supervisors and provides a reference point for promoting the adoption of sound corporate governance practices by banking organisations in their countries.
>
> (BCBS 2010)

Figure A.1: Market Concentration—Share of Market Capitalization of Country Groups with Different Ownership Structures



Source: OECD calculations based on World Bank data.

[1] For access to the full text of the Principles see: http://www.oecd.org/daf/ca/principles-corporate-governance.htm

Table A.1: Key Changes Reflected in G20/OECD Principles

Part	Topic	Changes
I	**Effective corporate governance framework**	**To enhance the effectiveness of supervision and enforcement of corporate governance:** • increased emphasis on the importance of public, independent supervision and enforcement; • more on governance of regulators; • changing role of stock markets, with the goal of profit maximization and its impact on supervision and enforcement in the market; • additional guidance on corporate governance impact of cross-border listed entities.
II	**Rights and equitable treatment of shareholders and key ownership functions**	**To strengthen the rights and protection of shareholders:** • additional guidance on related-party transactions; • more on concentrated ownership and its impact on corporate governance; • more transparency of ultimate beneficial ownership.
III	**Institutional investors, stock markets, and other intermediaries**	**To introduce a new chapter in the Principles to emphasize the role of institutional investors and stock markets in corporate governance:** • guidance is included on the role of proxy advisers and asset managers in corporate governance—a better approach for global application, including new focus on fee structures, conflicts of interest; • other issues—multiple stock market listings, cross-border impacts, and the application of corporate governance rules.
IV	**Role of stakeholders in corporate governance**	**To update and recognize developments in this area in other OECD and global instruments (remains largely unchanged):** • The revision did recognize the need to include in the corporate governance Principles, actions regarding employees and stakeholders, especially to recognize their role in contributing to the long-term success and performance of a company.
V	**Disclosure and transparency**	**To ensure full and proper disclosure of all material matters:** • many rules are now covered by IFRS, so material can be revised; • recognition of increased importance of nonfinancial reporting; • disclosure of related-party transactions; • clarity about the responsibilities of chairperson versus CEO; • independent audit regulators, high-quality audits, and audit oversight.
VI	**Responsibilities of the board**	**To clarify board responsibilities in special areas:** • oversight of risk management system; • roles and responsibilities of board committees, especially audit and risk committees; • all committees not recommended for all companies, such as risk commitees.

Source: Molyneux, 2015.

within the banking sector. BCBS states its expectations of banks in corporate governance as a market regulator. The BCBS Principles assume the application of OECD Principles, and then add to them where a need appears for additional and specific focus for banks and bank supervision. The assumption is that BCBS Corporate Governance Principles are equally applicable in emerging markets and developed markets, but BCBS recognizes the need for flexibility in application of the Principles, allowing for different markets and diverse size and complexity of bank business models.

In 2014, BCBS undertook a revision of the 2012 principles. The drivers for change in corporate governance guidance were the work done in corporate governance development by others, such as OECD, the Group of Thirty, and the Institute of International Finance. Further, the BCBS has been involved in and is extensively considerate of FSB's thematic peer review findings on risk governance, risk culture, and risk appetite.

BCBS completed development of new guidance on corporate governance, issued in 2015. The Basel 2015 Principles (BCBS 2015)[2] respond to a need for a holistic approach to risk: risk culture, risk appetite, risk competence, and alignment of compensation with risk. Key revisions specifically support the following:

1. Strengthen the guidance on risk governance, including the risk management roles played by business units, risk management teams, and internal audit and control functions (the three lines of defense) and the importance of a sound risk culture to drive risk management within a bank;
2. Expand the guidance on the role of the board of directors in overseeing the implementation of effective risk management systems;
3. Emphasize the importance of the board's collective competence as well as the obligation on individual board members to dedicate sufficient time to their mandates and to remain current on developments in banking;
4. Provide guidance for bank supervisors in evaluating the processes used by banks to select board members and senior management; and
5. Recognize that compensation systems form a key component of the governance and incentive structure through which the board and senior management of a bank convey acceptable risk-taking behavior and reinforce the bank's operating and risk culture.

Corporate governance of banks in the past focused on corporate governance structures. Since the financial crisis, the emphasis has turned more to the achievement of better corporate governance through increased board effectiveness. Therefore, greater emphasis is not just on "fit and proper" people (as individual board directors), but the BCBS also wants to see "fit and proper" applied to the entire board to ensure collective competence. BCBS wants the board collectively to have the skills and experience for adequate oversight and to have the time and the competence to challenge management and truly hold management accountable. The focus is on board effectiveness.

It is important to note that "collective responsibility" of the board refers to the board's duty to the company and to all its shareholders. In its decision making, the board must act in good faith, in the best interests of the company, and within the company objectives. It should perform its duties efficiently and effectively and operate in a financially responsible manner. The decisions of the board are collective decisions and bind the company.

The board is especially expected to play an effective role in risk governance. For example, board supervision of a bank is expected to be effective in at least three areas: risk appetite, risk strategy, and risk oversight and culture. The board is therefore expected to "own" the results in these areas.

Generally, in the Basel Principles, there is a stronger emphasis on ownership and accountability of the bank board and management for bank corporate governance. The revised text expands on the expectations of a bank board regarding board responsibilities for group structures, and a key part is to ensure that subsidiary bank boards are responsible for the integrity of the local subsidiary and for its activities, such as cross-border activities. Supplementary text has been added to ensure that subsidiary board members will oversee the local subsidiary and take full account of local conditions in that oversight, regarding the market and local regulations.

"A healthy banking system is one that not only has a strong relationship between a supervisor and a bank. . .but there has to be a strong relationship between providers of capital, debt, and equity. We shouldn't forget about the role of the creditor, because typically creditors represent around 95 percent of bank funding."

– George Dallas, Policy Director, ICGN

[2] The BCBS "Guidelines: Corporate Governance Principles for Banks" is hereinafter called BCBS Principles or BCBS Guidelines.

> National authorities have taken measures to improve regulatory and supervisory oversight of corporate and risk governance at banks. These measures include developing or strengthening existing regulation or guidance, raising supervisory expectations for the risk management function, engaging more frequently with the board and management, and assessing the accuracy and usefulness of the information provided to the board.
>
> (BCBS 2015)

Other focuses in the revised BCBS Principles relate to protection not only for equity holders but also for debt holders. It also includes details regarding disclosure of information on creditors.

> In discharging these responsibilities, the board should take into account the legitimate interests of depositors, shareholders and other relevant stakeholders. It should also ensure that the bank maintains an effective relationship with its supervisors.
>
> (BCBS 2015)

Finally, expanded materials and a standalone Principle make clear the role of supervisors in ensuring that banks under their supervision have better corporate governance in place. Supervisors are expected to go beyond looking at the structure of corporate governance in banks. BCBS believes they should also look at actual governance behaviors, undertake corporate governance assessments, and engage the board and senior management of banks in addressing governance failures. Furthermore, supervisors are required to hold the board and senior management accountable for the governance of banks and to share information on corporate governance with other regulators. (See Box A.1.)

The supervisory role is not just to assess corporate governance but also to take action, while avoiding taking on the role of a director or shadow director. Assessment of corporate governance practice without reference to any specific tool is difficult. For example, what will be the basis for a supervisor to conclude that corporate governance in a particular bank is good and that directors and management are making reasonable judgments? Supervisors may need to develop specific tools to better assess corporate governance.

Box A.1: Principle 13: The Role of Supervisors

Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

158. The board and senior management are primarily responsible for the governance of the bank, and shareholders and supervisors should hold them accountable for this. This section sets forth several principles that can assist supervisors in assessing corporate governance and fostering good corporate governance in banks.

Source: (BCBS 2015).

Example: United Kingdom

Individual banking regulators have undertaken considerable research on how to strengthen their systems against risk. The regulator in the United Kingdom, the Prudential Regulation Authority (PRA), issued several papers in 2014 and 2015 for consideration in these areas, which include alignment of risk and reward, depositor and policyholder protection, board responsibilities in corporate governance, accountability of individuals in banking, and approach of non-executive directors in banking—all of which echo the changes reflected in the BCBS Corporate Governance Principles.

Experience in the United Kingdom shows that supervisor engagement with a bank board and senior management has a positive effect on corporate governance within the bank. The U.K. regulator is currently reviewing rules for a new regulatory framework.

> We. . .consulted jointly with the. . .PRA. . . on a new regulatory framework for individuals working in banking ("Strengthening accountability in banking: a new regulatory framework for individuals"). The proposals were intended to encourage accountability for decision-making in relevant firms, focusing particularly on senior management, while aiming for good conduct at all levels.
>
> (FCA 2015)

This first consultation paper, quoted above, was followed quickly by another, which focuses on the effectiveness of the board.

> 1.2 Good governance is critical to delivering a sound and well-run business: and at the centre of good governance is an effective board.
>
> 1.3 An effective board is one which understands the business, establishes a clear strategy, articulates a clear risk appetite to support that strategy, oversees an effective risk control framework, and collectively has the skills, the experience and the confidence to hold executive management rigorously to account for delivering that strategy and managing within that risk appetite.
>
> (PRA 2015)

A.3. A Global Investor View

During the financial crisis, regulators asked, "Where were the investors?" Investors were asked to recognize their role in achieving good corporate governance and to step up engagement with their investee companies. Since then, the global investor community, through such institutions as the International Corporate Governance Network, has taken measures and developed tools to aid investors and those in their investment chain to fulfil this oversight role and to facilitate better engagement with companies as responsible investors. Further, diverse national groups have developed "stewardship codes" to formalize for investors, especially institutional investors, expected roles and responsibilities.

A.3.1. ICGN Principles for Investors

Since the financial crisis, the private sector also has seen developments in corporate governance, through global entities such as the International Corporate Governance Network.[3] The ICGN is an investor-led body with some 650 members, two-thirds of which come from the global investor community, representing collectively over $26 trillion in assets under management in 45 countries.

The ICGN's mission is to inspire good standards of corporate governance globally. To this end, it issued the Global Governance Principles (GGP), revised in 2014, with the view that good corporate governance helps develop stronger companies for investors to invest in. The ICGN believes that enhancing the position of specific companies will enhance market efficiency. Many jurisdictions oblige institutional investors to participate in company affairs and to vote their shareholdings.

> The effectiveness and credibility of the entire corporate governance system and company oversight depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in their investee companies.
>
> (OECD 2015b)

Since the recent crisis, the ICGN is refocusing the attention of its members—asset owners and asset managers—not only on the rights of investors but also on their fiduciary responsibilities to their beneficiaries and clients, and on the expectation investors have of companies' corporate governance. Therefore, the revision of the GGP was quite profound. The GGP incorporates a new chapter on investor duties and responsibilities. (See Box A.2.)

In the revised Global Governance Principles, certain issues are underscored and given new prominence. On the investor side, there is new emphasis on the fiduciary duties of investors, their capacity to establish leadership in corporate governance, and their ability to influence asset managers and investee companies to adopt better practices. This follows on an initiative at ICGN to introduce guidance for members on institutional investor responsibilities (ICGN 2013).

In 2012, the ICGN introduced for its members a model mandate (ICGN 2012) to be used with asset and fund managers. The mandate requires asset managers to make a statement of commitment to what asset owners expect of their asset managers. It requires active participation and oversight of corporate governance in investee companies as well as transparency. It has proved a most powerful tool and has led to increased engagement with companies on

> *"If the investor voice is going to be strong here, I think it has to start at the end of the chain with the asset owner establishing expectations that are in turn passed on to the asset manager. . . . It is not just about picking stocks. . .but also taking some degree of sense of ownership. . .in terms of monitoring, engagement and intelligent voting."*
>
> *George Dallas, Senior Policy Advisor, ICGN*

[3] See the ICGN website: www.icgn.org.

Box A.2: Global Governance Principles Responsibilities

10.4 Responsibilities
Asset owners should fully align the interests of their fund managers with their own obligations to beneficiaries by setting out their expectations in fund management contracts (or similar instruments) to ensure that the responsibilities of ownership are appropriately and fully delivered in their interests. This should include:

a) ensuring that the timescales over which investment risk and opportunity are considered match those of the client;
b) setting out an appropriate internal risk management approach so that material risks are managed effectively;
c) effectively integrating relevant environmental, social and governance factors into investment decision making and ongoing management;
d) aligning interests effectively through appropriate fees and pay structures;
e) where engagement is delegated to the fund manager, ensuring adherence to the highest standards of stewardship, recognizing a spectrum of acceptable stewardship approaches;
f) ensuring commission processes and payments reward relevant and high quality research;
g) ensuring that portfolio turnover is appropriate, in line with expectations, and managed effectively; and
h) providing appropriate transparency such that clients can gain confidence about all these issues.

Source: (ICGN 2014).

corporate governance. It places increased emphasis on the role of investors, who are encouraged to play an active part in the corporate governance of their investee companies. The asset owner can delegate some responsibilities to asset and fund managers and other service providers, but it cannot abdicate legal accountability. It is for this reason that the mandate for the asset owner to assist in the fulfilment of its legal duties is so critical.

The Global Governance Principles continue the new focus on what investors could do to improve corporate governance and to make demands for increased board effectiveness. They also place more focus on culture and ethics, strategy and opportunities, risk oversight, remuneration, reporting and audit—all issues that were highlighted in the financial crisis.

A.3.2. Stewardship Codes

Increasingly, codes have been introduced for the investor community, to ensure that they do their part in requiring better corporate governance of themselves and their own investment operations as well of their investee companies, including in the areas of the environment, social, and governance (ESG) activities.

Stewardship codes have been introduced globally by the ICGN and in national jurisdictions in Canada, Italy, Japan, Kenya, Malaysia, the Netherlands, South Africa, Switzerland, and Taiwan, China, and are in development in other countries. In some cases, the codes are supported by requirements in regulation; in others they are not.

Individual countries, such as Malaysia, South Africa, and the United Kingdom, and individual entities, such as Eumedion in the Netherlands, have developed and issued voluntary stewardship codes to encourage investor engagement in corporate governance in investee companies. It is too early to gauge the effect of such initiatives, but the expectation is clear: investors, too, have a responsibility for engagement with companies on corporate governance.

"There is legislation behind U.K. ESG initiatives. Section 175 of the U.K. Companies Act requires investors have regard effectively for the entity's environmental and social impact."

George Dallas,
Senior Policy Advisor, ICGN

The UK introduced a Stewardship Code in 2010, updated in 2012, with the view that stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole. In publicly listed companies, responsibility for stewardship is shared. The primary responsibility rests with the board of the company, which oversees the actions of its management. Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities.

(FRC 2012)

Principle 4 in the U.K. Stewardship Code makes it clear that investors who are signatories to the code, currently some 300 signatories, are expected to engage with their investee companies on a range of issues, including ESG matters. (See Box A.3.)

Box A.3: Principle 4 of the U.K. Stewardship Code

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

Institutional investors should set out the circumstances in which they will actively intervene and regularly assess the outcomes of doing so. Intervention should be considered regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional investors may want to intervene include, but are not limited to, when they have concerns about the company's strategy, performance, governance, remuneration or approach to risks, including those that may arise from social and environmental matters.

Source: (FRC 2012).

Similarly, the global body of the institutional investor community, the ICGN, whose members have some $26 trillion collectively under investment, has issued a voluntary code on the "responsibilities of institutional investors," which includes proactive engagement with their investee companies.

> Institutional investors should engage intelligently and proactively as appropriate with investee companies on risks to long-term performance in order to advance beneficiary or client interests.
>
> (ICGN 2013)

ICGN members have been active in their own jurisdictions in engaging with companies on ESG matters, as is evidenced in the comments in Box A.4 from Eumedion, a Dutch collaboration of 70 institutional investors, and the U.K. National Association of Pension Funds (NAPF).

Box A.4: Comments from ICGN Members on ESG Matters

Eumedion also sends an annual focus letter to all Dutch listed companies in October every year, with specific items institutional investors would like to address at all Dutch listed companies. We also discuss company-specific issues with companies, such as company strategies, risk management, corporate governance structure, the quality of financial reporting and sustainability policy, and succession planning. Eumedion then facilitates engagement by drafting a so-called 'ESG scan' containing general information about the company's strategy, its financial policy, the company's objectives, the corporate governance structure, the remuneration policy, the capital structure, risk management, sustainability policy and where we identify best practices and areas where the company concerned can improve its performance.

—Rients Abma, Eumedion,
ICGN Madrid Conference, 2015

Environmental, social and governance (ESG) are the three key factors for investors considering the sustainability and ethical impact of investing in a given company. . . . 90 % of NAPF members agree that ESG factors can have a material impact upon a fund's investments in the longer term.

—Will Pomroy, NAPF,
U.K. Investor Relations Society,
Corporate Governance and Sustainability Conference, 2015

Despite these efforts, two recent studies indicate that the codes established in the United Kingdom under a comply-or-explain regime are honored more in word than in deed. The Financial Reporting Council, in its role of reviewing corporate governance in the United Kingdom (FRC 2015),[4] including the effectiveness of the stewardship code, reported on its findings of a review undertaken in 2014 and published in 2015.

> The FRC acknowledges that the development of a culture of stewardship may take time. However, the FRC is concerned that not all signatories are following through on their commitment to the Code.
>
> (FRC 2015)

[4]The FRC findings are supported by a survey and report on stewardship from the Investment Association of the United Kingdom, which finds that resources devoted to stewardship in asset managers and asset owners have increased some 19 percent in one year to handle increased company engagement activities.

Some jurisdictions have incorporated investor responsibilities into the general corporate governance code.

> Example: Kenya Stewardship Code
>
> In 2014, the Code of Corporate Governance for Issuers of Securities to the Public was finalized. One of the principles set out by the Corporate Governance Code is the need for institutional investors to have transparent, honest and fair practices in their dealings with the companies in which they invest so as to promote sustainable shareholder value and long term success of such companies.[5]
>
> (CMA 2015)

A.4. European Union Developments

Since 2012, after reviews of the financial crisis, the European Commission (EC) has had three major focuses of initiatives in corporate governance: 1) enhancing transparency, 2) improving audit quality, and 3) ensuring greater shareholder engagement and supporting company growth and competitiveness.[6]

A.4.1. Enhancing Transparency

Transparency was the first initiative to be concluded, resulting in the Accounting Directive being amended and changes adopted in April 2014 (effective September 2014). The directive increases the requirements in corporate reporting for large public-interest entities (PIEs). More guidance, in the form of nonbinding guidelines, is expected to be issued to facilitate the disclosure of nonfinancial information by companies, taking into account current best practices, international developments, and related EU initiatives.

> The European Commission welcomes today's adoption by the Council of the Directive on disclosure of non-financial and diversity information by large companies and groups. Companies concerned will disclose information on policies, risks and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity on boards of directors.
>
> (European Council 2014)

Given the assessed benefits of better reporting to large firms, the focus of the directive is on the provision of information relevant to understanding of the development, business model, performance, position, and impact of company activities. Sufficient flexibility has been given to companies to report in a manner and style they consider most useful and most appropriate for that company. Companies may use international, European, or national guidelines, whichever they consider appropriate. The directive gives small and medium enterprises (SMEs) some relief to reduce the burden of reporting costs.

> As regards diversity on company boards, large listed companies will be required to provide information on their diversity policy, such as, for instance: age, gender, educational and professional background.
>
> (European Council 2014)

A.4.2. Ensuring Audit Quality

The European Commission also introduced changes to the Statutory Audit Directive (European Commission 2014c)[7] and its associated regulations in 2014. The changes were introduced to strengthen audit quality across the EU and include the following:

- Mandatory audit firm rotation for public-interest entities;
- New requirements for audit committees (or their equivalent) relating to their oversight of the performance of the audit;
- Additional restrictions on the provision of non-audit services by the statutory auditor to its PIE audit clients;
- New requirements regarding reporting by the statutory auditor; and
- Explanation of the definition of public-interest entities.[8]

[5] The subsequent stewardship code was developed, and legislation for it was awaiting official publication in Kenya as of December 2015.

[6] For details on developments in the EU, see a Guide to Corporate Governance Practices in the European Union: (IFC and ecoDa 2015).

[7] European Commission Directive (2014/56/EU) and Regulation 537/2014 regarding the statutory audits of public-interest entities on statements of annual consolidated accounts are applicable for the first financial year ending after June 17, 2017.

[8] The European Commission issued more guidance in February 2016 in the form of an unofficial opinion, "Q&A – Implementation of the New Statutory Audit Framework."

The global drive for improvement to audit quality has led to several initiatives to improve the comparability and transparency between audits and audit firms (IAASB 2015; FEE 2015), and the European Commission Directive reflects this. (See also Section B.3.4. Audit Reforms.)

A.4.3. Ensuring Greater Shareholders Engagement

The European Commission has focused on a number of initiatives to strengthen shareholders' rights and increase shareholder engagement in company affairs, including corporate governance. Implementation largely has come through the revision of the Shareholder Rights Directive, adopted in July 2015 (European Commission 2014a). Changes affect listed issuers and large companies not listed on a regulated market, and they address the following:

- Improving identification of shareholders;
- Strengthening the transparency rule for institutional investors;
- Better shareholder oversight of remuneration;
- Better shareholder oversight of related-party transactions; and
- Regulating proxy advisers.

> Without EU norms, rules and their application would be different from Member State to Member State, which would be detrimental to the EU level playing field. Without action at EU level the problems are likely to persist and only partial and fragmented remedies are likely to be proposed at national level.
>
> (European Commission 2014a)

The EU has not yet completed the changes to corporate governance it seeks. It has announced forthcoming changes, which will focus on the following:

- Increasing the long-term focus of investors;
- Improving the relationship between corporate governance and market development (European Commission 2015), particularly the development of SMEs, which may lead to application of corporate governance requirements to nonlisted companies;
- Strengthening the desired quality and rigor of explanations under "comply or explain"; and
- More comprehensively involving shareholders in the corporate governance of a company.

Proposal of the Shareholder Rights Directive has prompted much discussion as well as amendments as the directive makes it way through the complicated legislative processes within the EU. Once the process is completed, it would be good for readers to check the final text of the directive. Meanwhile, the key matters raised are discussed in the following sections of this paper.

A.4.3.1. Improving Identification of Shareholders

With the greater focus on having a company engage with its shareholders comes the expectation that these shareholders will be more active in the oversight of their investment. Shareholder engagement best practices involves more than just showing up once a year to attend and vote at the general meeting. Shareholder engagement should include sound and regular dialogue between shareholders and the company on key matters of long-term impact, such as corporate governance, strategy, performance, risk, and company funding structure. However, that requires increased transparency of shareholders, especially shareholdings held through intermediaries. Companies need to know with whom to engage.

Current rules subject investors to transparency requirements when they acquire 5 percent of the voting rights of a company. However, it is not always possible for companies to identify shareholders below this threshold. The Shareholder Rights Directive in its draft form includes provisions to facilitate identification of shareholdings and shareholders, including that the identity of shareholders should be available to the company and its shareholders, and that the company shall provide for a reasonable fee, if any, the list of shareholders holding more than 0.5 percent of shares.

> [The Shareholder Rights Directive's provisions] would significantly improve the exercise of shareholder rights for all shareholders, including retail shareholders. Many problems arise when there is more than one intermediary between the listed company and the shareholder, especially if these are located in different Member States. The proposal would require intermediaries to transmit the voting information from the shareholder to the company and confirm the vote to the shareholder. Shareholders could therefore be certain that their votes have effectively been cast, including across borders.
>
> (European Commission 2014b)

A.4.3.2. Strengthening the Transparency Rule for Institutional Investors

Institutional investors hold a major portion (in some cases more than half) of shares listed on EU markets, and yet they were noticeably absent when it came to participation in company oversight and engagement in the lead-up to the financial crisis. European Commission research in 2010 and 2011 noted the diverse interests and behaviors of asset owners and asset managers. The research also noted that when assets are managed by asset managers there is an increased likelihood of a short-term investment perspective. Asset owners (pension funds, insurers, and others) tend to hold a longer-term view more aligned with their beneficiaries' needs and were more likely to engage with a company on its strategies for longer-term returns, which can increase stock returns by up to 7 percent.

In his keynote speech at an ecoDa conference in 2015, Jeroen Hooijer, acting director of the Directorate-General for Justice and Consumers, European Commission, explained the basis for the drafting of the Shareholder Rights Directive. He also presented its main features.

> *"Besides all the consultations conducted by the Commission, different studies make it clear that stock return can increase by 7 percent with more institutional investors' engagement. Engagement means the monitoring of companies on matters such as strategy, performance, risk, capital structure and corporate governance, having a dialogue with companies on these matters and voting in general meetings."*
>
> *Jeroen Hooijer, Acting Director, DG JUST, European Commission*

To encourage this engagement, the directive requires institutional investors to disclose how they take the long-term interests of their beneficiaries into account in their investment strategies and to explain how they incentivize asset managers and others in the investment chain to act in the best long-term interest of the institutional investor. Asset owners and asset managers are required to explain how they engage with investee companies on a comply-or-explain basis.

A.4.3.3. Better Shareholder Oversight of Remuneration

Recent years have demonstrated repeated mismatches between executive pay and company performance. Remuneration policies and executive pay were not transparent and did not sufficiently incentivize companies to improve management and performance. A review of EU member states' practices revealed that "only 13 EU member states currently give shareholders a 'say on pay'. . . . Only 15 member states require disclosure of the remuneration policy" (European Commission 2014b). The proposed directive aims to create a better link between pay and the performance of a company. It takes the view that to hold management to account for long-term company performance, shareholders need information on and the right to challenge pay, particularly when it is not justified by performance outcomes.

However, much discussion has taken place on this particular topic as the directive makes its way through the European legislative processes, and it continues to be subject to amendments at the time of writing this paper. As of mid-2015, the directive included the following requirements:

- A remuneration report shall be a part of the corporate governance report of companies, and they shall report to shareholders details of
  - how the company determines the remuneration of directors;
  - the role and functioning of the remuneration committee.
- Member states shall establish a policy that the remuneration policy of a company be submitted to a binding vote of the general meeting of shareholders, but that each individual state may make the vote at the general meeting on the remuneration policy advisory only.
- The report shall be put to a vote of the general meeting at least once every three years.

There was much discussion on the rationale behind making a "say on pay" subject to law, when much of corporate governance regulation allows flexibility through the comply-or-explain regime. The Commission was of the view that in the presence of possible conflicts of interests, a stronger stance was required and hence the introduction of law in this area.

A.4.3.4. Better Shareholder Oversight of Related-Party Transactions

The EC directive includes recommendations for strong action for related-party transactions. RPTs—transactions between the company and its management, directors, significant or controlling shareholders, or companies within the same group—have the potential for abuse against the company, its assets, and minority shareholders.

To ensure adequate safeguards for the protection of shareholders' interests, the directive increases transparency of RPTs and independent third-party involvement in the approval of such transactions. The directive requires, in part,

that member states define specific rules for RPTs, including the following:

- A clear definition of related parties and related-party transactions;
- "Related party transactions representing more than 5 percent of the companies' assets or transactions which can have a significant impact on profits or turnover should be submitted to a vote by the shareholders in a general meeting" (European Commission 2014a);
- Where shareholders are involved in RPTs, the conflicted shareholders shall be excluded from the vote;
- Shareholders votes (as above) shall be taken prior to the conclusion of the transaction;
- RPTs that represent more than 1 percent of company assets shall be publicly announced at the conclusion of the transaction. Such announcement shall be accompanied by a report from an independent third party (a supervisory body of the company, an independent third party, or a committee of independent directors) assessing the RPT's terms and conditions and its fairness and reasonableness.
- Special exclusions/conditions may be available for RPTs with wholy owned subsidiaries and recurrent RPTs above 5 percent of company assets and above 1 percent of company assets.

The goal is to give minority shareholders an opportunity to reject material RPTs not in their interest. The meaning of "material" in regard to RPTs is likely to be set by the national regulator or the company, but the International Internal Audit Standards Board Framework provides the following generic definition: "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements."

These regulations concerning RPTs have been quite controversial. In particular, some member states, such as Germany and Finland, oppose a shareholder's vote on material RPTs. As a result, the regulations are expected to be weaker and will allow member states the latitude to interpret how they will apply the minority shareholder vote on RPTs.

> *"I have to say that my sense of where the European Union is coming from. . . . It's been about supporting the regulatory effort and reducing risk in the corporate sector."*
>
> *Peter Montagnon,*
> *Institute of Business Ethics and*
> *IFC Corporate Governance Private Sector Advisory Group*

A.4.3.5. Regulating Proxy Advisers

Another focus of the Shareholder Rights Directive is proxy advisers, because they advise shareholders how to vote their shares and so are powerful. Article 3i requires proxy advisers "to guarantee their voting recommendations are accurate and reliable and based on a thorough analysis of the information available to them." Box A.5 lists items that proxy advisers will disclose on their websites in the preparation of their voting recommendations.

Box A.5: Disclosures of Proxy Advisers

The following are the essential features of the methodologies and models that proxy advisers apply:

- The main information sources they use;
- Whether and, if so, how they take national market, legal, and regulatory conditions into account;
- Whether they have dialogues with the companies that are the object of their voting recommendations, and, if so, the extent and nature thereof;
- The total number of staff involved in the preparation of the voting recommendations;
- The total number of voting recommendations provided in the last year.

Source: (European Commission 2014a).

Such regulations focus on disclosures that proxy advisers will make to their clients and will include any disclosure of conflicts of interest on the part of the adviser. Again, this has prompted considerable discussion and diverse views. France in particular had wanted to see regulation of proxy agencies.

The European Commission sees proxies as having an important role in the engagement of shareholders. The Commission is looking for recommendations of high quality that are accurate and reliable.

There are diverse interpretations of the rationale behind such regulations. One view is that some regulations included in the Shareholder Rights Directive are less about making better companies with better corporate governance and more about making companies more trustworthy and accountable—more about an improved regulatory system.

We may be seeing the early stages of a shift in emphasis in corporate governance regulations and codes. Previously they were about developing good practices within

a company. Now it seems there is a greater emphasis on development of sound, well-regulated markets as well as companies. Companies can no longer have an internal focus only. Performance happens in a context—the company is an integral part of society.

A.4.4. Supporting Company Growth and Competitiveness

A Green Paper issued in February 2015 by the European Commission for consultation on the Capital Markets Union has flagged for consideration the following issues that may affect corporate governance directly or indirectly (European Commission 2015):

- Minority protection of shareholders;
- The efficiency of boards;
- The digitalization of company law and corporate governance;[9] and
- The obstacles in company law or corporate governance to deeper integration of capital markets, and consideration of how to overcome them.

The Commission issued an action plan for these matters in September 2015 (European Commission 2015). Other developments in the Commission's action plan to support company growth, competitiveness, and the promotion of jobs through better corporate governance have yet to be fully considered. They include the following:

- Improving the framework for more efficient and effective financial systems within member states and cross-border;
- Promoting a legal form of corporate governance adapted for SMEs (an expert group has been created to look into this matter); and
- Harmonizing and codifying of EU company law.

Finally, a strategy is in the early stages of development at the European level to establish a digital single market. The strategy has three pillars:

- Better access for consumers and businesses to digital goods and services across Europe;
- Creating the right conditions and a level playing field for digital networks and innovative services to flourish; and
- Maximizing the growth potential of the digital economy.

This strategy could affect corporate governance by requiring greater transparency of companies regarding digitization and data protection. It also may require the facilitation of electronic voting for shareholders.

A.4.4.1. Proposal for Additional Benefits to Long-Term Shareholders

In the proposed European Shareholder Rights Directive, one issue is how to incentivize a long-term perspective in shareholders. France, under the Florange Law introduced in 2014, automatically grants double voting rights from 2016 to shares registered for more than two years, unless two-thirds of shareholders vote to overturn it. In the Netherlands, the Supreme Court of the Netherlands established that companies have the right to offer loyalty shares to those holding shares for a certain time, to promote long-term share ownership, thus also providing shareholder stability in the company.

However, others see this as a market distortion, a transgression of the normally accepted principles of "one share, one vote." Therefore, many do not see it as the way to go. The concept has several unresolved issues:

- How to define "long term view";
- Defining an appropriate long-term holding period;
- Identifying long-term investors/shareholders in funds where individual investors/shareowners in the fund come and go, yet the asset managers may continue;
- Identifying a long-term perspective if shares are lent; and
- Determining appropriate incentives for holding shares for the "longer term."

Those who oppose incentivizing a long-term view in this way argue that it is open to serious abuse from controlling shareholders, as is considered to have occurred with Renault (see Box A.6, page 14). Therefore, ensuring a long-term view as opposed to short-termism does require clear measures that will achieve the desired outcome and not unintended consequences. For example, ecoDa produced a cautionary note regarding possible issues with the directive's proposals (ecoDa 2014). Concerns revolve around conflicts arising between the role of the board and the role of shareholders.

A.4.4.2. Need for Balance in All Initiatives Affecting Corporate Governance

Initiatives that affect corporate governance and transparency are in a state of flux in the EU. Pan-European regulations may not sufficiently recognize particular and diverse issues in individual member states. A balanced recognition

[9] Possible future initiatives for the digitalization of company law and corporate governance could cover a number of areas, such as online registration of companies, electronic submission of documents, electronic voting systems for companies' stakeholders, digital solutions to allow access to more meaningful and comprehensive information on European companies and their structures (European Commission 2015).

Box A.6: Example: Renault 2015

The French government successfully blocked a shareholder resolution at Renault's annual meeting on Thursday that would have prevented it from gaining double voting rights in the company under a recently enacted law, tightening its grip on the auto maker and the state's latest move to assert itself over corporate affairs.

The resolution, which was supported by Mr. Ghosn and opposed by French Economy Minister Emmanuel Macron, sought to keep the current one-share, one-vote governance system. It required a two-thirds majority by Renault shareholders to pass, but the resolution failed, getting 60.5% of the vote.

Source: Excerpt from *The Wall Street Journal*, April 30, 2015.

of the costs of shareholder engagement and of the exercise of shareholders' rights should be weighed carefully against the benefits of more engagement. Overregulation may lead to too much shareholder intervention in the company and stifle innovation and growth. Caution should be exercised in these areas.

"I think corporate governance standards should have a balance. If we put more stringent measures and more controls. . .I think we will kill entrepreneurship and innovation of management."

Mazen Wathaifi,
Commissioner and Secretary-General,
Jordan Securities Commission

A.5. Nordic Corporate Governance Developments

It is not surprising that some of the regulatory developments at the European level are also reflected at the subregional level in the Nordic countries. However, research shows that the four Nordic countries—Denmark, Finland, Norway, and Sweden—have developed a distinctive corporate governance model that has been successful in ensuring shareholder engagement and a longer-term perspective, which the European Commission is striving for in the proposed Shareholder Rights Directive (Lekvall 2014).

The Nordic model differs distinctly from the one-tier model, common in Canada, the United Kingdom, and the United States, where dispersed share ownership is the norm, as well as from the two-tier model, typically used in countries with a German-tradition model. (See Figure A.2.)

[The Nordic model] allows a shareholder majority to effectively control and take a long-term responsibility for the company. The alleged risk of such a system—the potential of a controlling shareholder to abuse this power for her own benefit at the expense of minority shareholders—is effectively curbed through a well-developed system of minority protection. The result is a governance model that encourages strong owners to invest time and money into long-term engagement in the governance of the company to promote their own interest while at the same time creating value for the company and all its shareholders.

(Lekvall 2014)

The Nordic model does seem to work well, even in companies with controlling shareholders, most likely because it is also backed by a strict system of minority protections set out in a range of statutory provisions, as described in Box A.7. (See Box A.8 for an example from Sweden).

Box A.7: Statutory Provisions Backing the Nordic Model

The statutory provisions include ones relating to the following:

- The principle of equal treatment at all levels, which prohibits any company organ from taking any action rendering undue favors to certain shareholders at the expense of the company or other shareholders;
- Extensive individual shareholder rights to actively participate in shareholders' meetings;
- Majority-vote requirements of up to total unanimity for resolutions by general meeting of particular, potential detriment to minority shareholder interests;
- Minority powers to force certain resolutions at the shareholders' meeting, especially on matters regarding shareholders' economic rights;
- Prescriptions for handling related-party transactions strictly on market terms; and
- A generally high degree of transparency toward the shareholders, the capital market, and the surrounding society at large.

Source: (Lekvall 2015).

Box A.8 Example: Sweden

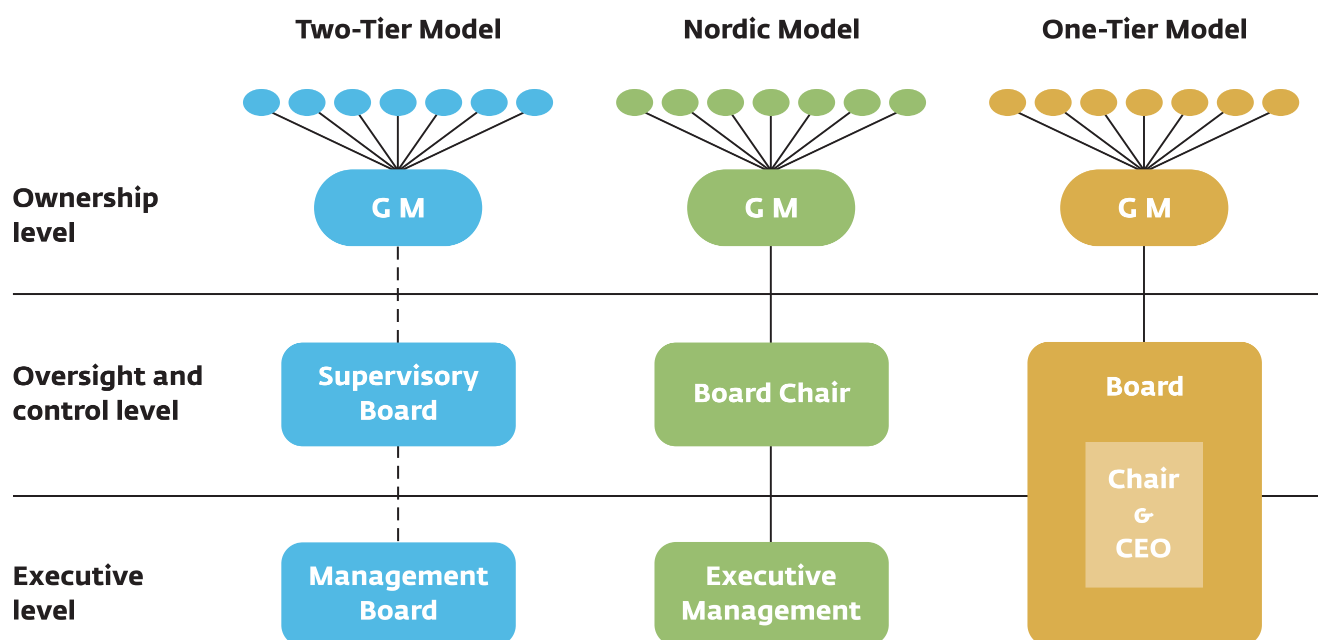
Sweden has a heritage of most public Swedish corporations being dominated by a few large shareholders. This has waned a little in recent times but forms the basis of its current corporate governance model. Sweden does a good job of protecting the rights of minority shareholders, and it favors additional rights for shareholders with a long-term view.

Shareholders also have a role in selecting board nominees and have a role as the nominating group in Sweden.

Nominating groups are not composed of independent directors of the board as in other corporate governance models. Rather, the nominating group typically includes the four largest shareholders. There is no weighting in the vote on shareholders' recommendations. Therefore, any controlling shareholder must get the support of the next two on the nominating group for board appointments. These nominating groups tend to have a long-term view of the company and recommend board appointments accordingly.

Source: (Dent 2012), which provides an in-depth analysis of the Swedish model.

Figure A.2: The Nordic Model as Compared to the One-Tier and Two-Tier Models



The Nordic solution is distinctly different from both of these more widely known models. It is neither a mixture of, nor a compromise between, the two. Instead it differs from both in three fundamental ways:

- It allocates virtually all power to the general-meeting majority by placing this body on top of a hierarchical chain of command in which each company organ is strictly subordinate to the next-higher level in the chain. Hence the solid lines in the figure.
- It vests the board with far-reaching powers to manage the company during its mandate period. Still it may be dismissed by the shareholders at any time and without stated cause, thus ensuring clear subordination to the general meeting and strict accountability to the shareholders.
- It makes a clear distinction between the non-executive board and the executive management function, appointed and dismissed at any time at the sole discretion of the board, again entailing a strict hierarchy that ensures accountability.

Source: (Lekvall 2015).

A.6. Summary of Global Issues

This review of regulatory/global initiatives identified several common threads that continue throughout. However, many good initiatives have been undertaken in national environments and in other global forums that affect the corporate governance environment and should not be ignored. Amendments have taken place to address the following:

- A major shift in emphasis in corporate governance codes and regulations to consider its role and effects on capital markets, not only on individual companies;
- The need for a long-term perspective by investors and management on company affairs, and the drivers of such a view, especially in strategy, performance, remuneration incentives, and value creation to all stakeholders;
- The move to increased regulation, as opposed to voluntary codes, in some areas of corporate governance to ensure application and yet balancing the need for flexibility for company diversity;
- Recognition of the impact of the business model and the presence of controlling shareholders on corporate governance;
- Demand for transparency from companies and better information, particularly on governance and board effectiveness, related-party transactions, company strategy, risk, performance, and company culture;
- The need for regulators to monitor and enforce corporate governance codes and practices;
- Recognition of the role of investors in corporate governance frameworks and the need for shareholder engagement in company affairs and company-investor communication.

> Strong corporate governance standards contribute to productivity in two ways. First, they enable shareholders to exert control over firms, and shareholder value in turn is maximized by raising the firm's productivity. Second, by aligning incentives of firms' managers and owners, they limit risks to investors, incentivizing higher levels of investment and reducing costs of capital for the firm. Key to corporate governance is the transparent access of shareholders to timely and accurate information, accountability of management to strong and independent corporate boards, and auditor independence. In addition to formal standards, informal behavioral norms also play a crucial role in the way businesses are run. High ethical standards among business leaders can contribute to building trust, thereby reducing the cost of capital and compliance.
>
> (WEF 2015a)

A.7. Trends and Future Developments

The OECD work on corporate governance development is ongoing. It is expected to include more peer reviews and amendments to the related corporate governance assessment methodology used by the World Bank and regional roundtables to promote use of the new Principles and to support corporate governance reform.

Regulators and supervisors will increase monitoring and review of corporate governance and may need new sanctions or powers to enable demand for remedial actions in corporate governance. For example, a bank supervisor may wish to restrict bank activities or apply additional capital or liquidity charges while the bank executes corporate governance changes.

There may be more developments arising from a perceived shift in emphasis in corporate governance regulations and codes. At present, there is a greater emphasis on development of sound, well-regulated markets, whereas previously, corporate governance was focused on the development of good practices within the company. (Part C of this publication discusses this broader focus in fuller detail.)

For the investor community, some issues will continue to exercise the minds of investors. The following are some examples:

- ***Minority shareholder rights.*** Investors will continue to be concerned about developments such as double-voting rights to long-term shareholders, as these serve to operate against a minority shareholder.
- ***The introduction of stewardship codes, investor stewardship, and the investor role as an active and responsible corporate owner.*** The development of stewardship codes, such as in Kenya, Malaysia, Taiwan, China, and the United Kingdom, will continue.
- ***The role of culture, risk, and sustainability issues in the investment decision.***
- ***Reporting that investors need and want from companies.***

Corporate Governance Developments: Practice Issues

The financial crisis highlighted the gap that remains between corporate governance principles and corporate governance as implemented and practiced, despite corporate governance regulations, frameworks, codes, and standards. The OECD concluded that the financial crisis, to an extent, could be attributed to failures and weaknesses in corporate governance arrangements (Kirkpatrick 2009). It identified four areas requiring change:

- Board effectiveness and practices;
- Control environment and risk oversight and management;
- Transparency and disclosure; and
- Shareholder rights.

Studies by the Basel Committee for Banking Supervision as well as those by David Walker in the United Kingdom indicated that the practical implementation and effectiveness of corporate governance was inadequate.

Corporate governance codes are often "soft law," largely because corporate governance requires a degree of flexibility so good practices can be applied to companies in different industries, in different markets, and at different stages of development. Typically, companies are allowed to comply or explain. More recently, several countries are moving to mandate those corporate governance areas in which compliance is deemed necessary and important, leaving the remaining corporate governance matters in a code.

This section of the paper will review corporate governance developments related to elements in the IFC Corporate Governance Methodology for evaluating corporate governance risks and opportunities in the areas of board of directors, minority shareholders' rights, control environment, disclosure and transparency, and commitment to good govern- ance practices (IFC 2016b). The following are particular areas where the need for improvement has been identified and that have been the subject of recent change:

- The need for well-functioning, effective boards, leading to changed demands concerning diversity, board committees, board evaluation, and remuneration;
- Strengthening risk governance to ensure greater clarity of the board role in risk and compliance, risk culture, risk appetite, and the behavioral elements related to risk (better risk governance should include increased focus on internal control systems and the internal audit function);
- Demands for increased transparency and disclosure, including 1) environmental, social, and governance reporting, 2) integrated reporting, 3) periodic reporting, and 4) audit report reform;
- The need for stronger shareholder rights in the areas of related-party transactions and regarding transparency of beneficial ownership;
- The need to demonstrate an overall commitment to corporate governance and an appropriate corporate culture for better governance.

B.1. Board Effectiveness and Practices

Laws, regulations, and codes provide direction for boardroom conduct. However, ultimately it is up to each individual director and all directors of a board collectively to contribute, to function well, and to be effective in fulfilling their obligations.

Board structures and procedures to fulfill these obligations vary both within and among countries. There is no single right way to be an effective board, so advice on this subject has been predominantly in the nature of guidance rather than prescriptive rules—guidance from regulators and

> *"Critical to strong corporate governance are its implementers —the boards of directors. . . . [A]s fiduciaries, all [duties] are clearly aimed at one overarching obligation—and that is to faithfully represent the interests of shareholders. . . . To that end, you have significant oversight responsibilities with respect to executive management and for the overall direction of the company. As directors, you play a critical role in setting the appropriate tone at the top, are expected to be guardians of the company's assets, and are relied upon by both shareholders and the capital market."*
>
> *Luis A. Aguilar,*
> *(U.S.) SEC Commissioner,*
> *Boardroom Summit, New York, October 14, 2015*

Box B.1: FRC Guidance on Board Effectiveness

An effective board develops and promotes its collective vision of the company's purpose, its culture, its values and the behaviours it wishes to promote in conducting its business. In particular, it

- provides direction for management;
- demonstrates ethical leadership, displaying—and promoting throughout the company—behaviours consistent with the culture and values it has defined for the organisation;
- creates a performance culture that drives value creation without exposing the company to excessive risk of value destruction;
- makes well-informed and high-quality decisions based on a clear line of sight into the business;
- creates the right framework for helping directors meet their statutory duties under the Companies Act 2006, and/or other relevant statutory and regulatory regimes;
- is accountable, particularly to those that provide the company's capital; and
- thinks carefully about its governance arrangements and embraces evaluation of their effectiveness.

Source: (FRC 2011).

> In addition to the industry-specific risks of banking, bank directors also need to concern themselves with the full range of internal and external risks that any organization faces. Banks are subject to more intense public scrutiny than most industries, especially after the financial crisis, so their directors carry a higher degree of risk to their personal reputation than do the directors of companies in lower-profile sectors.
>
> (Westlake 2013)

private sector entities. For example, the Financial Reporting Council, charged with oversight of corporate governance in the United Kingdom, issued guidance on an effective board. (See Box B.1.)

Much of the guidance that is available is generally applicable to all companies. Other guidance, such as IFC's *Guidance for the Directors of Banks* (Westlake 2013), has a particular focus on subsets of corporate governance. (See Table B.1.) Corporate governance codes and other documents advocate good practices while allowing for flexibility of application.

This paper focuses on recent developments considered to contribute to board effectiveness in four key areas: 1) the composition of the board, including board diversity; 2) the

Table B.1: Board Effectiveness Initiatives

Country	Issuing Institution	Effectiveness Instrument	Year Issued
Global	IFC	Focus 11: Guidance for Directors of Banks	2013
Australia	ASX	Corporate Governance Principle 2: Structure the board to add value	2014
Canada	Crown Corporations	Assessing Board Effectiveness	2008
Estonia	BICG	Guidance on Board Effectiveness—SOEs	2013
Latvia	BICG	Guidance on Board Effectiveness—SOEs	2013
Lithuania	BICG	Guidance on Board Effectiveness—SOEs	2013
United Kingdom	FRC	Guidance on Board Effectiveness—SOEs	2011
United Kingdom	ABI	Report on Board Effectiveness	2012

Source: Molyneux, 2015.

role of board committees in the effective functioning of a board; 3) board evaluations; and 4) remuneration.

> Corporate governance can never stand still. Our expectations of boards change constantly—especially in our hypercompetitive and turbulent times. What was acceptable behaviour a decade ago is often now viewed very differently.
>
> (Heidrick & Struggles 2014)

B.1.1. Board Effectiveness: Composition and Diversity—The Right Mix

The corporate governance reform agenda continues to evolve. The financial crisis reviews found, among other issues, that some bank boards were composed mostly of men and were not sufficiently independent or diverse in composition or thinking. A survey by Spencer Stuart indicates an increase of independent directors on boards (Spencer Stuart 2015). For example, independent directors make up 88.3 percent of Swiss boards, 62.0 percent of Swedish boards, and 58.1 percent of South African boards. There are lower representations of independent directors on boards in emerging markets, such as Russia (35 percent) and Turkey (33 percent).

> . . .[I]ndependence and financial sector expertise alone do not suffice as [what David Walker called] an "important counterweight to. . .executive or board 'groupthink.'" One way is to identify and test the group's paradigm, which may be assisted by having directors with varied professional disciplines and perspectives.
>
> (Lawton and Nestor 2010)

The lack of people with banking industry experience and knowledge and risk expertise on bank boards led to a more widespread review of board composition (Ladipo and Nestor 2009). A board's purpose is to govern and to make decisions, so its composition should be structured to support the exercise of independent, objective judgment. A good board listens, contributes, challenges, and when necessary pushes back.

In many jurisdictions high-quality independent decision making is underpinned by some well-recognized good practices:

- A balance of executive and non-executive directors in the one-tier board system;
- A sufficient number or fixed percentage of independent directors;[10]
- Diversity in board composition;
- Competence—ensuring that directors and the board collectively have appropriate knowledge, expertise, and experience, including use of a board-experience-and-skills matrix; and
- Separation of roles of CEO and chairperson.

> In my experience I've found that the best boards are also the most diverse boards. They can offer a depth and breadth of insight, perspective and experience to CEOs that non-diverse boards simply cannot. When I mention diversity, I'm addressing more than age, ethnic and gender diversity, but also diversity is skills, competencies, philosophies and life experiences as well.
>
> (Myatt 2013)

B.1.1.1. Board Effectiveness: Composition and Commitment

Board composition is seen as an issue of competence as well as of diversity. Globally, companies looking at board appointments and the composition of the board now consider the scale and nature of the entity's activities and look for an appropriate number of directors who have a range of relevant and diverse skills, expertise, experience, and background. They also seek directors who can understand the issues arising in the organization's business, provide insight, and add value.

It is important to carefully consider the types of skills and experience required on the board in light of the board's needs. Backgrounds that are in demand in today's environment include the following:

- industry-specific knowledge
- executive leadership
- financial expertise

[10] For IFC's indicative definition of an independent director, see Appendix A. However, different jurisdictions may define "independence" in various ways. An independent director should be capable of independent, objective decision making.

> Appointing directors who are able to make a positive contribution is one of the key elements of board effectiveness. Directors will be more likely to make good decisions and maximise the opportunities for the company's success in the longer term if the right skill sets are present in the boardroom. This includes the appropriate range and balance of skills, experience, knowledge and independence. Non-executive directors should possess critical skills of value to the board and relevant to the challenges facing the company.
>
> (FRC 2011)

- global experience and contacts
- operations/business model
- governance/committee experience/regulatory
- strategy development
- risk management
- technology/IT/social media/IT security
- marketing/public relations
- corporate social responsibility
- government relations
- human resources and compensation
- mergers and acquisitions

According to a survey by Deloitte Center for Corporate Governance and the Society of Corporate Secretaries (Deloitte 2012), directors identified industry experience as the skill or experience most important for a director to contribute to the board's success and effectiveness in the near future. More recently, a PricewaterhouseCoopers survey of board directors indicated that directors surveyed think financial expertise (91 percent), industry expertise (70 percent), and operational expertise (66 percent) are the three most valued skills (PwC 2015a).

> It is important that a number of board members bring experience in the company's industry area to bear, so that they understand the competitive environment in which the company operates and have the ability to ask management industry-specific questions.
>
> (Watson 2015)

> An effective board of directors is at the heart of the governance structure of a well-functioning and well-governed corporation.
>
> (OECD 2011)

Skills and experience are only half the story. Personal characteristics are also important and help build the group dynamic. Personal characteristics can be both creative and productive, but they also can be destructive in unfavorable circumstances. It is wise for boards to consider personal interactions and each individual's integrity, courage, strategic perspective, innovative and analytical thinking, communication skills, accountability, capacity to influence and mentor, and willingness to be an active participant on the board and to be a team player.

The Basel Committee on Banking Supervision's revised Corporate Governance Principles (BCBS 2015)[11] emphasizes the importance of the board's collective competence as well as the obligation of individual board members to dedicate sufficient time to their mandates and to keep abreast of developments in banking. BCBS demands that the board is "fit and proper" as a group.

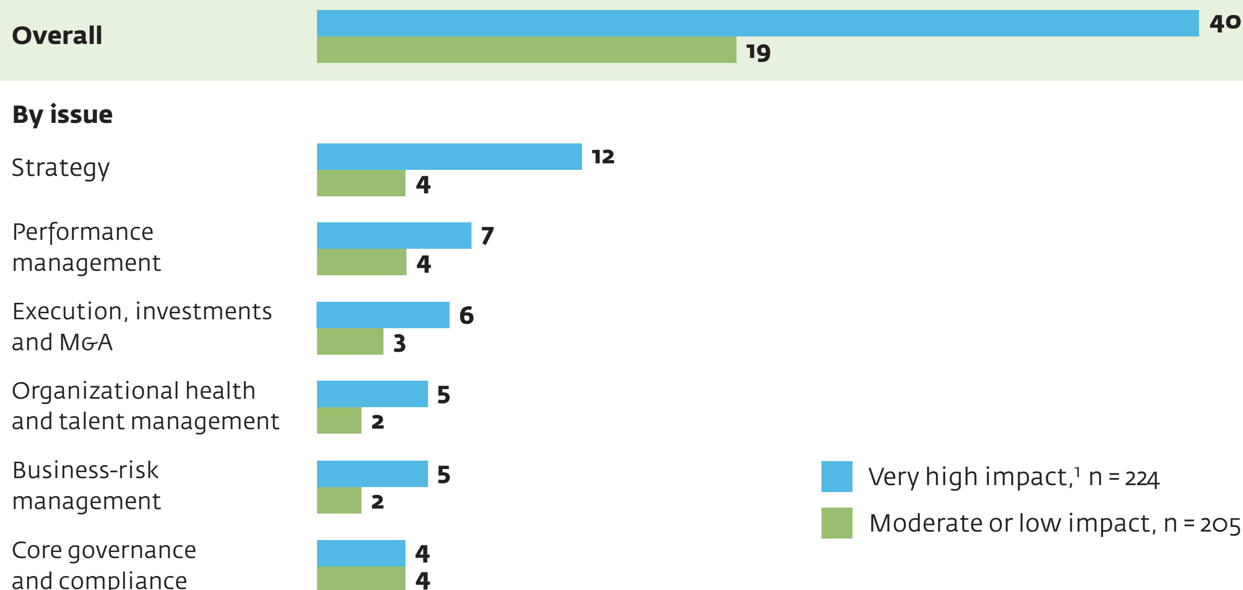
Other studies have determined that an effective board now spends more time in deliberations than it did previously as a way to better understand the company, its industry, and its strategies. A McKinsey study (McKinsey 2013) indicated that high-impact boards and directors invest more time per year in total, and especially on strategy, performance management, mergers and acquisitions, organizational health, and risk management, than prior to the financial crisis. (See Figure B.1.)

B.1.1.2. Board Effectiveness: Diversity

Since the financial crisis, the spotlight has also been on the need for diversity in board composition—to achieve diversity of thinking as well as diversity of competences, behaviors, and experience. Because most boards in the west have been composed of middle-aged white males, the diversity debate has focused on the contribution women can make to boards and, more controversially,

[11] See also Part A of this publication, Section A.2.

Figure B.1: Time Commitment of Boards



Source: April 2013 McKinsey Global Survey of 772 directors on board practices.

the perceived need to establish quotas for the representation of women on boards.

Areas of diversity include age, race, gender, cultural experience, and national and international experience. Of the directors surveyed by PricewaterhouseCoopers in 2015, 49 percent view adding diversity to the board as important, and 45 percent believe it leads to enhanced board effectiveness (PwC 2015a). Shareholders and stakeholders are demanding a change to more gender-representative boards, and in some countries quotas or targets have been set. (See Table B.2.)

Example: Norway

Norwegian law requires all companies with more than 5,000 employees to have at least 40 percent of their board members be women. In operation since January 2006, the law imposes sanctions for noncompliance after January 2008.

Table B.2: Gender Quotas or Targets

Country	Quota/Target %	Achievement (expected date)	Current Figures %
Belgium	33	2017	15
France	40	2017	25
Italy	20	2013	11
Netherlands	30	2015	19
Norway	40	2008	39
Spain	30	2020	13.5
United Kingdom	25	2015	18

Source: (Heidrick & Struggles 2014).

Example: Morocco
In Morocco, a directive from the central bank (Bank Al Maghrib) requires at least one-third of board members to be independent and board composition to demonstrate diversity of expertise as well as gender diversity.[12]

• Benefits of Boardroom Diversity

Recent research indicates that diversity of all kinds, including of talent, is associated with diversity of thought and better business performance. More particularly, a study for the Conference Board of Canada (Carter and Wagner 2011) indicates that diversity, including women, on boards is linked to better business performance, such as the following:

- Strong financial performance;
- Ability to attract and retain top talent;
- Heightened innovation;
- Enhanced client/customer insight;
- Strong performance on nonfinancial indicators; and
- Improved board effectiveness.

These findings are supported by another extensive research piece by Credit Suisse Research Institute, which indicates that companies with women on the board have consistently higher return on equity over a six-year period (Credit Suisse 2012). The arguments for greater numbers of women on boards (Bart and McQueen 2013) include the following:

- Boards make decisions that affect the company, the community, and the country, half of which are women. It is important that boards relate to their customers, clients, and consumers.
- Diverse age, race, gender, and cultural experience bring diverse perspectives.
- Diversity on the board gives a company access to a wider pool of board talent with appropriate skills, competences, and experiences.
- Experts indicate that woman have different approaches and responses to risk, are more independent, and more frequently hold a longer-term view.
- Women on boards and in senior management build better workplace relations and make better decisions, because they ask more questions and are less likely to nod through decisions.

"It is important to comment on the lack of female independent directors. We have seen progress in this area, but there is clearly considerable room for progress. The best approach would be to professionalise practices and train directors."

Patrick Zurstrassen,
IFC Corporate Governance Private Sector Advisory Group and Honorary Chair, ecoDa

• Position of Women on Boards

Two key surveys of the incidence of women on boards (Credit Suisse 2015; MSCI 2014) indicate that there is change afoot but that change is slow and considerably varied. Increases have come predominantly in markets where regulations have required it or targets have been set for change. According to the MSCI survey (MSCI 2014), women hold 17.3 percent of all directorships globally. Yet in Brazil, paradoxically where the Novo Mercado is focused on good corporate governance, women made up only 6.0 percent of directorships of surveyed companies, below the emerging-markets average of 8.8 percent.

In a GMI Ratings study (GMI 2013), South Africa ranked fifth in the world in 2013, with 17.9 percent female representation on the boards of 59 companies, which has since grown to over 20.0 percent. In South Africa, it has been mandatory for companies to disclose the percentage of female employees in senior management. According to a European Commission Factsheet (European Commission 2013), women represent 11.9 percent of board members of the largest companies listed on the Romanian ROTX and 11.6 percent of board members of companies on the Bulgarian SOFIX. Both of these levels were below the European average representation of women on boards at the time. Figure B.2 illustrates the wide range of representation of women on boards.

B.1.2. Board Effectiveness: Board Committees

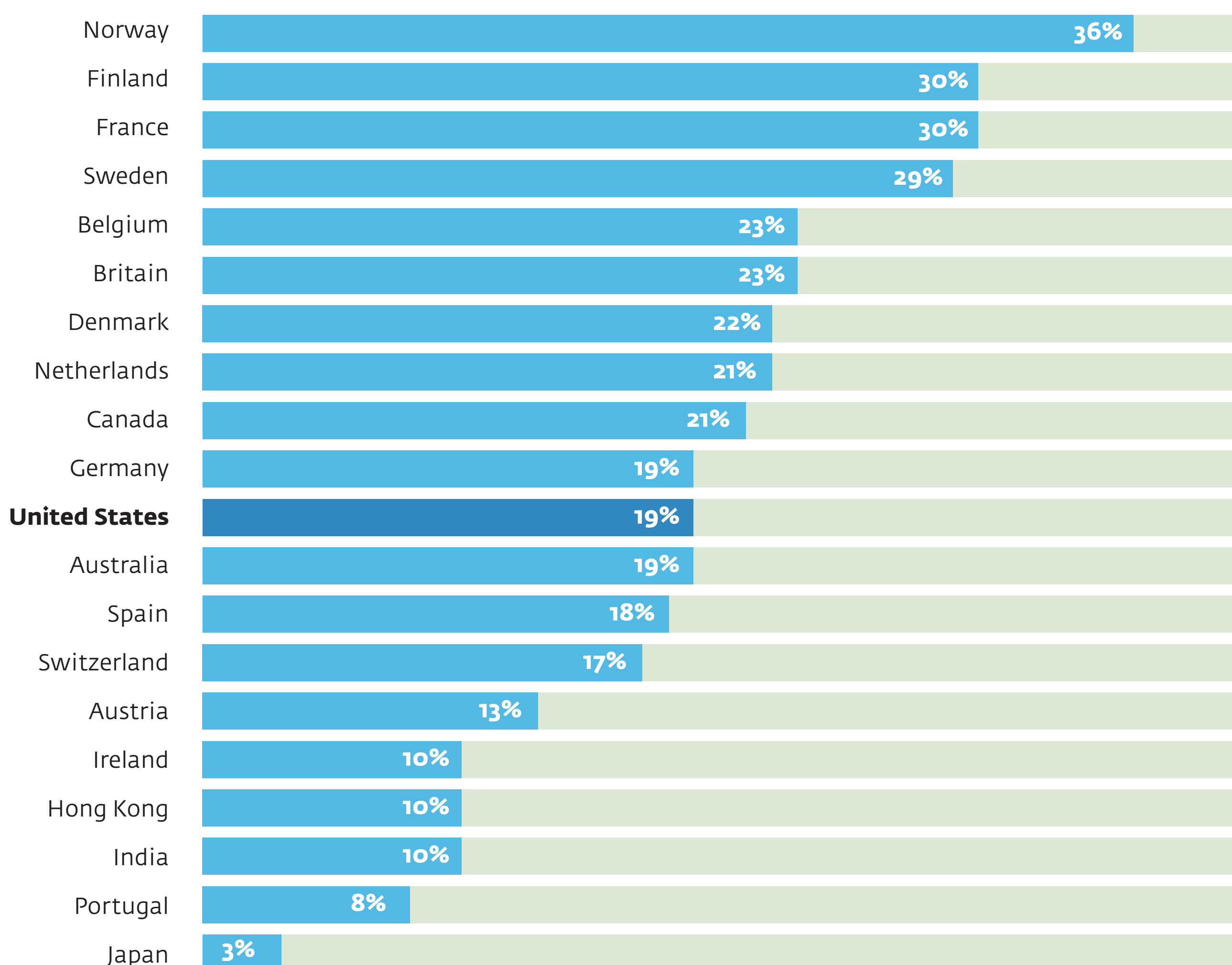
Corporate governance frameworks have used board committees extensively. So this part of the paper will focus only on new, better practices that have emerged recently.

In most jurisdictions, law and regulations allow boards to form board committees to more effectively handle the board workload and apply particular expertise to boardwork areas. However, while the board may make use of committees to assist consideration of particular issues, the board retains the responsibility for the final decisions.

In the 2015 revision of the Corporate Governance Principles, the OECD more closely links the role of independent non-executive directors and board committees, especially where there is potential for conflict of interest. (See Box B.2, page 24.)

[12] Bank Al Maghrib, Directive (D No. 1/W/2014 in Articles 5-10), "On the governance of credit institutions," October 2014.

Figure B.2: Prevalence of Women on Boards—By Country



Source: Catalyst

Board demands continue to increase as markets globalize, regulation becomes more complex, and companies grow. The use of board committees can be an effective method of dealing with these challenges. The need to delegate oversight to specialist board committees is evident. Appropriate committees should support the board's ability to accomplish the following:

- Handle a greater number of issues more efficiently by allowing experts to focus on specific areas and provide board recommendations;
- Develop subject-specific expertise on the company's operations, such as financial reporting, risk management, and internal controls;
- Enhance the objectivity and independence of the board's judgment, insulating it from potential undue influence of managers and controlling shareowners, in such key areas as remuneration, director nomination, and oversight controls.

B.1.2.1. Good Practices for Board Committees

The following good practices for board committees have evolved and are currently in use:

- The right to establish board committees to facilitate operations of the board can be found in Company Law, regulation, codes, or company articles.
- Some committees in some jurisdictions are mandated in law or regulation (for example, an audit committee).

Box B.2: From OECD Principle VI

E.2. **Boards should consider setting up specialised committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.**

127. Where justified in terms of the size of the company and its board, the use of committees may improve the work of the board. In order to evaluate the merits of board committees it is important that the market receives a full and clear picture of their purpose, duties and composition. Such information is particularly important in the many jurisdictions where boards have established independent audit committees with powers to oversee the relationship with the external auditor and to act in many cases independently. Audit committees should also be able to oversee the effectiveness and integrity of the internal control system. Other such committees include those dealing with nomination, compensation, and risk. The establishment of additional committees can sometimes help avoid audit committee overload and to allow more board time to be dedicated to those issues. Nevertheless, the accountability of the rest of the board and the board as a whole should be clear. Disclosure need not extend to committees set up to deal with, for example, confidential commercial transactions.

Source: (OECD 2015a).

- A board charter is in place for each board committee. It is communicated on the company website and includes discussion of the purpose, duties and responsibilities, mandate/authority, and composition (including required member expertise) of the committees. It will also provide information on committee processes (such as for a quorum, on meeting notices, and minutes and reporting responsibilities).
- Areas where board committees are frequently used are audit, board nomination, corporate governance, remuneration, and risk. Board committees are less evident for strategy and other areas in some jurisdictions. However, in France, some 60 percent of CAC 40 companies have a strategic committee (Ernst & Young 2014). There also is an increase in the prevalence of risk committees, with 22 percent of companies globally now having a board-level risk committee; in Singapore, 42 percent of all companies have a risk committee of the board, and the incidence of board-level risk committees is even higher in financial institutions, with 67 percent having a standalone board risk committee (Deloitte 2014).
- There is early evidence of the rise of corporate social responsibility (CSR)/ethics committees at the board level. For example, 44 percent of CAC 40 companies have an ethics/CSR committee (McKinsey 2013).
- Most committees are prescribed to comprise three or more members, at least a majority of whom are independent, non-executive directors.
- Leadership of board committees is usually an independent, non-executive director.
- Committee tasks, processes, and performance and accountability are outlined in the committee charter.
- Committee members should have access to appropriate support, relevant people, information, advice, and professional development to assist their work.
- Committee work and the contributions of individual directors to the committee should be annually evaluated.
- Other directors, who are not members of the committee, and management may be invited to attend committee meetings and present or elaborate on issues as a regular pattern or from time to time. These attendees have observer status only and should not participate in committee decisions.

Caveat: It is important that board committees do not lead to the following:

- Fragmentation of the board;
- Usurping authority and accountability of the board or of management; or
- Taking on the day-to-day tasks of management.

The board can prevent board committees from falling into these traps by having a clear charter and mandate for each committee, competent committee members who have an understanding of their role and its limits, and regular reporting to the board.

B.1.2.2. Audit Committee Developments

OECD research of developed member countries and emerging-market countries indicates that most jurisdictions now require an independent audit committee. Traditionally, audit committees have been a key component of corporate governance regulation, and now more than two-thirds of jurisdictions require listed companies to establish an independent audit committee. (See Figure B.3.) However, the emphasis on the importance of their work has increased. (See Box B.3.)

A full or majority independence requirement (including the chairperson) is common, and 100 percent independent members of an audit committee is required or recommended in Brazil, Canada, the Czech Republic, Finland, Ireland, Italy, Mexico, Switzerland, Turkey, the United Kingdom, and the United States.

Box B.3: Audit Committee Key Roles in the EU

The key roles of the audit committee, as prescribed in the relevant EU Directive (2006/43/EC), include to:

a) monitor the financial reporting process;

b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;

c) monitor the statutory audit of the annual and consolidated accounts; and

d) review and monitor the independence of the statutory auditor or audit firm.

Source: (EU 2006).

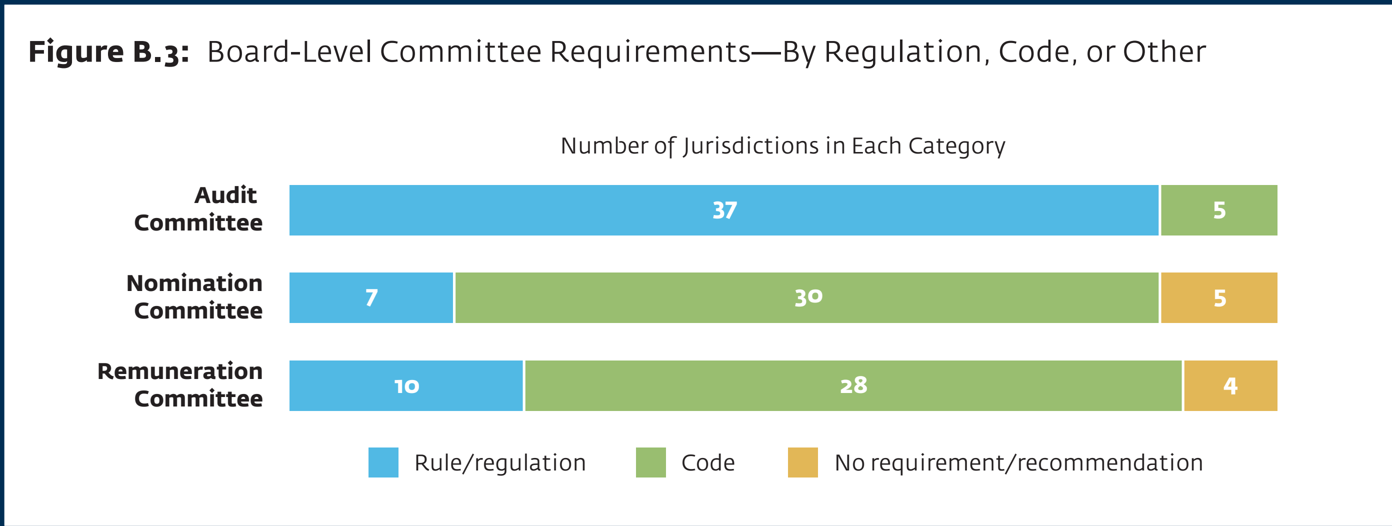
"I think most audit committees recognize that they have an increased responsibility for oversight of the financial reporting process and the external auditors, and they're taking that responsibility seriously. They're more engaged in their work and in their interactions with auditors. Audit committee agendas have expanded, and we are having deeper conversations with the external auditors and internal auditors and the CFO—and our conversations are very risk-oriented."

Michele Hooper, Audit Committee Chair, PPG Industries, President and CEO, The Directors' Council

Following a spate of corporate failures between 2002 and 2004 and the 2008 financial crisis, the expectations, responsibilities, and workload of the audit committee have expanded considerably in recent years.[13] They now include the following:

- Increased oversight of compliance;
- An increased communication role with the external auditor, especially to discuss the audit report findings and the key audit matters—for example, mandated in Sarbanes-Oxley Act of 2002 and in the EU Directive 2006/43/EC, and required by International Auditing and Assurance Standards Board (IAASB)-issued new audit standards in ISA 700 series;
- Direct role in the appointment, compensation, and retention and oversight of the work of the external auditor, including a review of the audit plan (as occurs in Australia, Canada, and the United Kingdom);

Figure B.3: Board-Level Committee Requirements—By Regulation, Code, or Other



Source: (OECD 2015b).

[13] A valuable document on the newly expanded role of the audit committee is the KPMG Audit Committee Guide, 2015, and the associated webcast organized with the NACD and the Center for Audit Quality and aired on September 29, 2015. For information, see www.kpmg-institutes.com.

- In the absence of a separate risk committee, oversight of internal controls, internal audit, and risk management systems;
- An increased expected or mandated role in the establishment and oversight of policies for related-party transactions and the review and recommendation for board approval of material related-party transactions;[14]
- Clarity of independence and expertise required by audit committee members;
- Demand from investors and regulators for increased transparency and reporting from audit committees (for example, the new standard on audit reporting from IAASB, ISA 700, has been issued);
- Increased interfaces with regulators (securities and banking), stock exchanges, and independent audit oversight bodies to improve audit quality;
- Focus in particular jurisdictions on issues particular to their jurisdiction:
  - Japan: The Financial Services Agency introduced in 2013 a revised audit standard that facilitates in-depth discussion between the auditor and the audit committee;
  - United Kingdom: The Financial Reporting Council requires audit committees to provide more detailed reports to shareholders, particularly in relation to risks faced by the business;
  - India: The Securities and Exchange Board of India (SEBI) has made several amendments to regulation and requirements of audit committee members, particularly following the Satyam Computers Case in 2008. It introduced Clause 49 into SEBI Listing Rules and intensified the details on audit committees regarding independence, its responsibility for independent judgment, and responsibilities in the face of controlling shareholders. Previously, many independent directors may not have been considered "independent" according to globally accepted definitions. (See Box B.4.)

According to an annual KPMG survey of some 1,500 audit committee members in 35 countries, three-quarters of audit committee members said the time required to carry out their duties has increased moderately (51 percent) or significantly (24 percent); and half said that, given the audit committee's agenda, time, and expertise, their role is becoming "increasingly difficult" (KPMG 2015).

Audit committees and their work have become important to the effectiveness of boards and of corporate governance. KPMG asked audit committee members what they believe they need to be more effective (KPMG 2015), and they responded as follows:

- 43 percent: better understanding of the business (strategy and risks);
- 38 percent: greater diversity of thinking, background, perspectives, and experiences;
- 34 percent: more "white space" time on the agenda for open dialogue;
- 33 percent: additional expertise—technology;
- 31 percent: greater willingness and ability to challenge management.

Box B.4: Satyam (India)—Importance of Independence on Board Committees

An independent director resigned on 25 December 2008, stating that she had voiced reservations about the transaction during the board meeting, but had failed to cast a dissenting vote to ensure that her views were put on the record. It transpired that the compensation package of one of the independent directors was more than seven times that of the other independent directors and well above the market rate. It turned out that he was undertaking consulting work for the company, something that should have barred him from being an independent director.

Source: (OECD 2012).

"In many developed markets, especially in the two-tier board system, boards tend to be large and committees are needed to make board work more effective. In Germany, for example, big companies have boards of about 20 members. You cannot work with 20 people on audit matters. So I support a strong recommendation to have committees for detailed work, especially in audit and risk."

Christian Strenger, Deputy Chairman, IFC Corporate Governance Private Sector Advisory Group, and Academic Director, Centre for Corporate Governance, HHL Leipzig

[14] In the one-tier board systems in India, Singapore, the United Kingdom, the United States, and many other jurisdictions, the role of an independent reviewer of RPTs is undertaken by the audit committee of the board, composed of independent directors. In the two-tier system, such as in Chile and Italy, it is a committee of directors (disinterested parties) that undertakes this role.

B.1.3. Board Effectiveness: Board Evaluations and Succession

Board evaluation has become a more widespread practice. Nearly three-quarters of European companies participate in an annual board evaluation (Heidrick & Struggles 2014). Some countries have moved further and mandated an external, independent board evaluation once every three years. A key development is that there is the expectation that this evaluation will lead to plans for improvements to board performance and better planning for board refreshment and succession.

Board evaluation has a number of possible interpretations. It may mean an evaluation of each individual director, an evaluation of the board as a whole and how it operates, or an evaluation of board committees—or a mix of these. Investors have looked to boards to evaluate their performance with a view to constant improvement in practices and board effectiveness. Investors see it as a testament to a board's commitment to corporate governance.

> Over time, a board may become complacent or may need new skills and perspectives to respond nimbly to changes in the business environment or strategy. Regular and rigorous self-evaluations help a board to assess its performance and identify and address potential gaps in the boardroom.
>
> (CII 2014)

When making voting decisions about directors, shareholders attach importance to the detailed disclosure of the board evaluation process.[15] Disclosures about how the board evaluates itself, identifies areas for improvement, and addresses them provide a window into how robust the board's process is for introducing change.

Heidrick & Struggles published a report (Heidrick & Struggles 2014) that reviewed corporate governance data, including board evaluation practices and reporting, from over 400 companies across 15 diverse European jurisdictions. The following are key findings of the report:

- 70 percent of boards surveyed undergo a performance evaluation annually.
- 78 percent of boards were evaluated in the last two years, up from 75 percent in 2009.
- The board chairperson and/or the board members themselves are responsible for the evaluation.
- 21 percent of entities use external consultants to facilitate the board evaluation.[16]

The Heidrick & Struggles report indicates that there is little clarity as to who should lead a board evaluation. When chairpersons were asked who should lead a board evaluation, 41 percent said the board should lead it, and 30 percent said the CEO should do so. Conversely, when the same question was asked of board members, 53 percent said the chairperson should lead the evaluation, and 33 percent said it should be the board itself. Other options, such as an evaluation led by a committee or an external consultant, were mentioned much less often.

Evaluations may use diverse tools and may take the form of questionnaires, open discussions, one-to-one interviews of directors, or a combination of these methods. In any event, directors do believe board and director assessments are helpful. The Global Network of Director Institutes (GNDI), a network of member-based director associations from around the world, describes the global perspective for good governance in its guiding principles and believes that board performance evaluations can lead to better boards and better corporate governance. (See Box B.5, page 27.)

In the 2004 version of the OECD Principles, there was little reference to board evaluations, and only as a voluntary, recommended practice. In the intervening 11 years to 2015, pressure built for board evaluations to become the norm. The revised Principles make it clear that board evaluation is a way to ensure continual board development, with the goal of achieving an independent board capable of objective judgment. Board evaluation is now a corporate governance priority. (See Box B.6, page 28.)

Box B.5: Global Network of Director Institutes Principle 12

GNDI Principle 12 states:

The board's performance (including the performance of its chair, the individual directors and, where appropriate, the board's committees), needs to be regularly assessed and appropriate actions taken to address any issues identified.

Source: (GNDI 2015).

[15] The Council for Institutional Investors (CII) in the United States undertook a survey of its members in 2013 and 2014. This information on what shareholders value comes from that survey.

[16] Another study, on board evaluations in India, by C. Pierce, may be found at http://tinyurl.com/jrqm2gd.

Several national codes or regulations require or expect board evaluations and/or related disclosures, and in most countries it is a recommended practice. However there is no one-size-fits-all approach; there are many different ways for countries and companies to approach evaluations.[17]

Evaluations may be formal or informal, undertaken internally or facilitated externally, more focused on qualitative issues, or more quantitative. Usually an evaluation is a mix of these styles. It is important to be clear as to what is being evaluated: the board as a whole, board committees, individual directors, or all of these. Other focuses of evaluation may be board structure, policies and processes, or the board's role in the company's strategy, risk, financial leadership, shareholder interface, and so on.

Box B.6: OECD Principle VI.E.4 as Revised in 2015

Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.

129. In order to improve board practices and the performance of its members, an increasing number of jurisdictions now encourage companies to engage in board training and voluntary board evaluation that meet the needs of the individual company. Particularly in large companies, board evaluation can be supported by external facilitators to increase objectivity. Unless certain qualifications are required, such as for financial institutions, this might include that board members acquire appropriate skills upon appointment. Thereafter, board members may remain abreast of relevant new laws, regulations, and changing commercial and other risks through in-house training and external courses. In order to avoid groupthink and bring a diversity of thought to board discussion, boards should also consider if they collectively possess the right mix of background and competences.

130. Countries may wish to consider measures such as voluntary targets, disclosure requirements, boardroom quotas, and private initiatives that enhance gender diversity on boards and in senior management.

Source: (OECD 2015a).

B.1.3.1. Good Practices in Board Evaluations

Evaluations will vary from company to company and within a company at different times in the company's development. Evaluations should consider the specific context of the company. Nevertheless, below are some recognized good practices that are emerging:

- Trust in the credibility and confidentiality of the evaluation is a key factor for its success, regardless of who manages the process (IFC 2011). Also, confidentiality and transparency are critical to the process.
- It is important to have board members' full understanding of and commitment to quality corporate governance and the evaluation.
- The goal of an evaluation is to improve the performance of the board and the company itself.
- Leadership of the evaluation process is key—usually led by the chairperson.
- Evaluations should be a regular feature of board practices. Most companies undertaking board evaluations do so annually; some companies, where they are not mandated otherwise, may undertake an evaluation once every three years.
- Evaluations may be best completed in time for discussion at the board strategy session, thus any actions may be incorporated into the strategy.
- Prior to an evaluation, all board members should know how they will be assessed (that is, the topics for evaluation), the process, and the way they will be measured.
- Performance metrics should be developed over time.
- Questionnaires, open discussion, and one-to-one discussions are the most widely used approaches.
- Questionnaires should be carefully drafted, probably in collaboration with the chairperson, and reviewed by all those being evaluated, prior to finalization.
- Evaluations should cover key topics: board composition and structure, dynamics and functioning (including leadership and teamwork), role clarity, governance of strategy and risk, board accountability and oversight role, board decision making, board advice role, individual characteristics of directors (vision, contributions, behaviors, time availability, preparation, particular skills), chairperson's role, board functioning (notices, meeting processes, proactivity), and communication. An evaluation of

[17] Appendix B provides a list of diverse jurisdictions' approaches to board evaluations.

board committees should cover issues pertinent to that particular committee.

- Evaluation results should remain confidential and be analyzed, distributed to board members, and discussed in an open and non-confrontational manner.
- Any evaluation should focus on the improvement of board performance and thus should lead to the development of an action plan to address issues arising.
- The process itself should be reviewed for improvements.
- Disclosure of the evaluation goals and process should be communicated to shareholders in the annual report, included in the company code of corporate governance, and placed on the company website.

Cautionary notes:

- Board evaluations can be a sensitive issue to some people. It is important to be aware of this possibility and to deal with sensitivities.
- Evaluations may expose board weaknesses that, if not attended to, may provide information for a later litigation process.
- Safeguards should be built into the system to protect both the company and individual directors.
- It is essential for any independent evaluator to be experienced in board evaluations, be seen to be independent and fair, and be respected for his or her approach.
- The evaluation may destroy board collegiality if it is not handled well and if directors' comments on peers are too harsh or ill-considered.
- Careful consideration should take place before management is included in the evaluation process. The presence of management may constrain directors' comments.

B.1.3.2. Succession Planning and Evaluations

It is most important that boards of directors are prepared for resignation and/or retirement of its members. Succession planning for the board and for board committees should follow the board evaluation process. As part of board evaluation, an evaluation of the skills and competences within the current board should be measured against future expected requirements of the skills and competences within the board. This provides a readily available profile of a new board member, should one be required on short notice. The board should continually ensure that it has the right set of skills, talents, and attributes represented.

> *"Board evaluation, if it is conducted in a rigorous manner, when it flows on to and is linked with individual director development plans and with board succession planning and when the results are disclosed, is a valuable tool. Investors can feel the board has the future of the board safely in hand."*
>
> *Anne Molyneux, ICGN Board*

A well-prepared board will develop a succession plan that provides guidance on identifying and sourcing potential board members who can fulfill key requirements. This succession plan helps the organization appoint new directors quickly in a structured manner, allowing the board to continue its business without disruption, meeting any business challenges that are encountered.

B.1.3.3. Evaluation Disclosure

Investors need to know whether a board is effective, and good corporate communication can do much to convey the board's message to investors and other stakeholders on outcomes that arise from evaluation. So important is it that the Council of Institutional Investors in the United States has developed its own guidelines explaining its expectations of board evaluation disclosures. (See Box B.7.)

Box B.7: Excerpt from CII "Best Disclosure: Board Evaluation"

Investors value specific details that explain who does the evaluating of whom, how often each evaluation is conducted, who reviews the results and how the board decides to address the results. This type of disclosure does not discuss the findings of specific evaluations, either in an individual or a holistic way, nor does it explain the takeaways the board has drawn from its recent self-evaluations. Instead, it details the "nuts and bolts" of the self-assessment process to show investors how the board identifies and addresses gaps in its skills and viewpoints generally.

Source: (CII 2014).

B.2. Control Environment and Risk

The control environment is defined as including internal control systems, internal audit functions, compliance functions, and risk governance.

B.2.1. Risk Governance Developments

According to a report by the Financial Stability Board (FSB 2013a), many boards did not pay sufficient attention to risk management or set up effective structures, such as a dedicated risk committee, to facilitate meaningful analysis of the firm's risk exposures and to constructively challenge management's proposals and decisions.

The financial crisis of 2007–2008 called into question several fundamentals of corporate governance, including risk governance. One particular focus was the robustness and effectiveness of risk oversight processes, which had been an ever increasing issue evidenced by major corporate collapses (Enron, WorldCom, Ahold, HIH) since 2002. The OECD's fact-finding analysis of the financial crisis (OECD 2009a) enhanced the focus on risk. (See Box B.8.)

Box B.8: OECD on Risk Management

Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often kept separate from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.

Source: (OECD 2009).

At the time, corporate governance standards and codes typically either did not cover risk governance and oversight or they did so inadequately. Today that has changed. Many codes, such as the G20/OECD Principles, have introduced or strengthened risk-related requirements. (See Box B.9.)

A review undertaken by the American Institute of CPAs (AICPA) in 2015 (Beasley et al. 2015), the sixth in its series, finds that over the most recent decade there have been escalating demands for organizations to strengthen their enterprise-wide risk oversight processes. Data were collected in the fall of 2014 from over 1,000 AICPA members in CFO roles and in board roles requiring financial expertise. The following are key findings:

Box B.9: OECD Principle VI.D.1, as Revised in 2015

The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

108. An area of increasing importance for boards and which is closely related to corporate strategy is oversight of the company's risk management. Such risk management oversight will involve oversight of the accountabilities and responsibilities for managing risks, specifying the types and degree of risk that a company is willing to accept in pursuit of its goals, and how it will manage the risks it creates through its operations and relationships. It is thus a crucial guideline for management that must manage risks to meet the company's desired risk profile.

Source: (OECD 2015a).

- 59 percent believe that the volume and complexity of risks have changed "extensively" or "mostly" in the last five years.
- 65 percent were caught off guard by an operational surprise "somewhat" to "extensively" in the last five years. This percentage is even higher for large companies and public companies.
- 68 percent of boards of directors are asking "somewhat" to "extensively" for increased senior executive involvement in risk oversight. This is even higher for large companies (86 percent) and for public companies (88 percent).

Even prior to the financial crisis, the Basel Committee on Banking Supervision viewed banks as having insufficient board oversight of senior management, inadequate risk management, and unduly complex or opaque bank organizational structures and activities. Since the crisis, the BCBS has focused on revising and reissuing its Corporate Governance Principles for Banks (BCBS 2015). Risk and risk oversight was central to the revision.

In 2015, the International Corporate Governance Network updated its Corporate Risk Oversight Guidelines to enable the investor community to assess the effectiveness of a board in overseeing risk governance. (See Box B.10.)

> [BCBS] expects the board to be responsible for overseeing a strong risk governance framework. . .an effective risk culture. . .a well developed risk appetite. . .and well defined responsibilities for risk management.
>
> (BCBS 2015)

Box B.10: Excerpt from ICGN's Guidance on Corporate Risk Oversight

- The risk oversight process begins with the board. The unitary or supervisory board has an overarching responsibility for deciding the company's strategy and business model and understanding and agreeing on the level of risk that goes with it. The board has the task of overseeing management's implementation of strategic and operational risk management.
- Corporate management is responsible for developing and executing a company's strategic and routine operational risk program, in line with the strategy set by the board and subject to its oversight.
- Shareholders, directly or through designated agents, have a responsibility to assess and monitor the effectiveness of boards in overseeing risk at the companies in which they invest and to determine what level of resources they will dedicate to this task. Investors are not themselves responsible for risk oversight at corporations.

Source: (ICGN 2015).

Further, many other surveys by public sector players and private sector groups confirmed the poor risk practices in the lead-up to the financial crisis. A 2011 survey (McKinsey 2011) revealed that only 14 percent of board time was spent on business risk management and that only 14 percent of those surveyed had a complete understanding of the risks their company faced. Figure B.4 (on page 32) indicates, across many jurisdictions, the regulations in place relating to risk. It also reveals how few countries clearly explain board responsibilities in risk oversight.

Responsibility for establishing and overseeing the company's enterprise-wide risk management system usually rests with the board as a whole and is prescribed in company law and/or listing rules, except in a small number of jurisdictions where this is not clearly stated (OECD 2015b).

With all these pressures for change, banking and securities and other regulators and parties globally have been reviewing their requirements regarding risk. Changes in attitudes toward risk (the new normal) include the following:

- Increased understanding and expectations of particular roles in risk governance, especially 1) the board role in setting risk culture, risk framework, and risk appetite; and 2) the chief risk officer and his role in the risk function;
- Need for changes to enterprise-wide risk models to better focus on 1) effective internal controls based on entity risks; 2) a strong, independent internal audit function; and 3) a greater focus on IT risk.

> Risk management must respond to "the new normal"—an environment of continual regulatory change and ever more demanding expectations.
>
> (Deloitte 2015)

Nonfinancial companies are emulating the changes that financial institutions have seen in attitudes and practices in risk management. An example is CSR Limited, a building products company in Australia and New Zealand that is committed to dealing with business risks and has developed a framework for doing so.

> [I]t is CSR's policy to have a common framework across the company to identify, quantify, manage and monitor business risks. CSR is committed to reinforcing effective business risk management as a key element in its strategic planning, decision making and execution of strategies.
>
> CSR Limited website: www.csr.com

B.2.2. Board Role in Risk and Risk Culture

Risk management should be a feature of all businesses. Companies take risks to generate returns. All parties in a company—the board, senior management, business units, and employees—have a role in risk.

The board is responsible for ensuring that a framework is in place to adequately deal with the complexities of the business's risk environment. However, this does not

Figure B.4: Risk Governance Requirements of Listed Companies, by Country

Jurisdiction	Board Responsibilities for Risk Management	Implementation of the Internal Control Risk Management System	Board-Level Committee		Chief Risk Officers
			Risk Management Role of Audit Committee	Establishment of Separate Risk Committee	
Argentina	C	C	L/R	C	C
Australia	C	–	–	C	–
Austria	L/C	L	L[a]/C[a]	–	–
Belgium	L	L	L	–	–
Brazil	–	–	–	–	–
Canada	–	–	–	–	–
Chile	–	R	R	R	–
Czech Republic	C	C	–	–	–
Denmark	–	–	–	–	–
Estonia	–	–	–	–	–
Finland	C	C	C[a]	–	–
France	–	–	L	–	–
Germany	L/C	L/C	L/C	–	–
Greece	–	–	C	–	–
Hong Kong SAR, China	C	C	C	–	–
Hungary	L/C	L/C	–	–	C
Iceland	–	–	C	–	–
India	L/R	L/R	L/R	R	–
Indonesia	L/C	–	–	C	–
Ireland	C	C	C	–	–
Israel	–	R	L[a]	–	L[b]
Italy	C	C	L	C	C[b]
Japan	L	L	–	–	–
Korea, Rep.	C	–	–	–	–
Lithuania	–	–	C[a]	–	–
Luxembourg	–	–	C	–	–
Mexico	L	–	L	–	–
Netherlands	C	C	C[a]	–	–
New Zealand	C	C	–	–	–
Norway	C	L/C	L[a]	–	–
Poland	–	L/C	L[a]	–	–
Portugal	–	–	–	–	–
Saudi Arabia	–	–	–	–	–
Singapore	C	C	C	C	C
Slovak Republic	–	–	–	–	–
Slovenia	C	C	C[a]	–	–
Spain	–	L/C	L[a]/C[a]	–	–
Sweden	C	C	–	–	–
Switzerland	L	C	C[a]	–	–
Turkey	L	L	–	L	–
United Kingdom	C	C	C[a]	–	–
United States	R	L/R	L[a]/R[a]	–	–

C = recommendation by codes or principles; **L** = requirement by law or regulations; **R** = requirement by the listing rule; **–** indicates absence of a specific requirement or recommendation.

a. Risk management is explicitly included in the role of the audit committee. (In the United States, this is applicable only for NYSE-listed companies.)

b. Internal auditors are in charge of risk management. (In Israel, the board of directors of a public company is required to appoint an internal auditor in charge of examining, among other things, the propriety of the company's actions regarding compliance with the law and proper business management.)

Source: Based on (OECD 2015b).

indicate that the board role is passive. The board should ensure that all business risks are identified, evaluated, and suitably managed. Actual management of many of these tasks rightly falls to management in the course of day-to-day operations. In a world of increasing complexity and uncertainty, boards must oversee and govern risk more assiduously than ever before.

Enterprise risk management (ERM) is a structured, consistent, and continual process across the entire company (usually large companies) for identifying, assessing, responding to, and reporting opportunities and threats that affect the achievement of the company's objectives. There are several ERM frameworks to guide company practices, such as ISO 31000:2009 Risk Management Principles and Guidelines and the COSO (Committee of Sponsoring Organizations of the Treadway Commission)[18] 2013 ERM Integrated Framework.

> [The] board should retain final responsibility for oversight of the company's risk management system and for ensuring the integrity of the reporting systems. Some jurisdictions have provided for the chair of the board to report on the internal control process. Companies with large or complex risks (financial and non-financial), not only in the financial sector, should consider introducing similar reporting systems, including direct reporting to the board, with regard to risk management. Companies are also well advised to establish and ensure the effectiveness of internal controls, ethics, and compliance programs or measures to comply with applicable laws, regulations, and standards, including statutes criminalizing the bribery of foreign public officials, as required under the OECD Anti-Bribery Convention, and other forms of bribery and corruption.
>
> (OECD 2015a)

> 85 percent of respondents reported that their board of directors currently devotes more time to oversight of risk than it did two years ago. The most common board responsibilities are to approve the enterprise-level statement of risk appetite (89 percent) and review corporate strategy for alignment with the risk profile of the organization (80 percent).
>
> (Deloitte 2015)

ERM standards establish a structure for risk management activities within an organization. However, they often focus too much on the role of individuals or groups in the ERM framework. The ISO 31000 model of risk governance is underpinned by the view that all entities want to achieve their objectives, but many internal and external factors affect those objectives, causing uncertainty about whether the organization will achieve its objectives, and the effect this uncertainty has on its objectives is "risk." ISO 31000 links key risks and the risk management process to an organization's strategic objectives.[19] (See Figure B.5, page 34.)

B.2.2.1. Current Good Board Practices in Risk Management

The board role in risk is one of governance and oversight. The role of senior management in risk is to operate the business within the risk appetite and limits set by the board and to identify, assess, prioritize, manage, monitor, and report on risk to the board. Each role should be clearly defined and distinguished.

> Deficiencies in risk management point directly to deficiencies in board oversight.
>
> (IFC and ecoDa 2015)

The board has certain obligations regarding risk including the following:

- Clearly understand its oversight role in risk and be sufficiently active in fulfilling this mandate, especially in setting the company tone or attitude toward risk.
- Determine and ensure the establishment of an enterprise-wide risk management framework and ensure its effective operation, including ensuring that the board and company organization and policies are appropriate and that the company provides adequate resources for addressing risk.

[18] COSO is a private sector initiative, jointly sponsored and funded by American Accounting Association (AAA), American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), Institute of Management Accountants (IMA), and The Institute of Internal Auditors (IIA).

[19] A handy comparison between ISO 31000 and the COSO ERM Framework is available at www.theiia.org.

Figure B.5: Enterprise Risk Management Framework

Enterprise-wide risk management is affected by a multitude of structural, organizational, and managerial conditions

Source: (IFC 2012).

> The role of the board of directors in enterprise-wide risk oversight has become increasingly challenging as expectations for board engagement are at all time highs.
>
> (COSO 2009)

- Ensure that the board has a collective/shared view of its responsibilities in risk oversight and its limitations and that it tasks a board committee (audit or risk committee) to specialize in risk oversight.
- Ensure that collectively the board's members have sufficient knowledge, skills, and experience to assess the entity's risks.
- Ensure that each director individually understands the company's business and has an adequate appreciation of the nature, types, and sources of risks faced by the company, including
  - identification of the most significant risks;
  - the possible effects on shareowner value of deviations to expected performance ranges;
  - potential effects and impacts on other companies' stakeholders (including the community and the environment);
  - how the company will manage a crisis;
  - the importance of stakeholder confidence.
- Ensure appropriate levels of awareness throughout the company.
- Promote, determine, or define the company's risk culture, capacity, tolerance, and appetite within the company.
- Ensure the development, dissemination, and publication of risk management policy and procedures.
- Ensure that the risk culture and appetite is communicated throughout the company.
- Regularly receive, review, and discuss reports on risk performance and management within the company, across all risk categories and all business units, to better understand risk interconnectivity and compounding effects.
- Monitor and review management's risk responses and ensure that they are sufficient and appropriate.

- Ensure that risk frameworks and systems are regularly tested for robustness, resilience, and effective contingency plans.
- Ensure that senior management and employee remuneration incentivize strong and appropriate risk management.
- Disclose key risks and report on risk management frameworks to investors.

Indicative of the change that has occurred in a short period, a survey (Heidrick & Struggles 2014) found that 94 percent of directors of European listed companies now believe that the board's capacity to consider the acceptance of appropriate risks is important.

B.2.2.2. Board Role in Risk Appetite—A Work in Progress

Arising mainly from the financial crisis and from the determination of the Financial Stability Board to improve risk governance, in many jurisdictions a board is expected to determine the risk appetite for the company. For example, the U.K. Corporate Governance Code requires a board to be responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives (FRC 2012).

Further, the FSB, the body doing the most to influence changes in the banking and insurance industry, issued a paper (FSB 2013b) detailing the roles of the board, a risk management committee, the risk management department, the chief risk officer, and others (chief financial officer, chief executive officer, and chief internal auditor) in risk oversight.

Typically, the board establishes the risk appetite framework and approves the risk appetite statement. Normally, the senior risk committee member or chief risk officer will present a draft statement to the board for its discussion, amendment, and approval. Once approved, the risk appetite framework process cuts in, and the institution's risk appetite is assigned to the appropriate person(s) or group(s) and cascaded down through the organization.

> Simply put, risk appetite is defined as the amount of risk (volatility of expected results) an organization is willing to accept in pursuit of a desired financial performance (return). The concepts of risk appetite and risk tolerance are often used interchangeably, but they have distinctly different meanings.
>
> (RMA 2013)

COSO's definition of risk appetite is similar to that of the U.K. Corporate Governance Code, but it does not locate accountability for determining the risk appetite. It defines it as "the amount of risk, on a broad level, an organisation is willing to accept in pursuit of value. Each organisation pursues various objectives to add value and should broadly understand the risk it is willing to undertake in doing so."

COSO sees risk appetite in the context of the risk levels currently prevailing in the organization, and it sees the company attitude toward risk as set in the finite boundaries of estimated risk capacity or the total risks a company could take before risking the viability of entire company. Ideally, COSO sees risk appetite as depicted in Figure B.6.

Figure B.6: COSO View of Risk Appetite

Source: (Garlick 2015).

Box B.11: Example: Lack of Clarity about Risk Appetite

In February 2008, the board of the French bank Société Générale learned that one of its traders had lost $7.2 billion. Jerome Kerviel, the trader in question, had approval to risk up to $183 million. Since 2005, however, Kerviel had apparently ignored his limits and took on exposures as high as $73 billion—more than the market value of the entire firm. Société Générale's board, managers, risk management systems, and internal controls failed to detect, much less halt, the reckless bets. When finally discovered, the failure in risk governance and management had cost Société Générale and its shareholders clients, money, and reputation. Similar failures of risk governance feature in scandals at UBS and Baring, with the latter failing to survive.

Source: (IFC 2012).

It is important for all involved with risk to understand the organization's risk appetite. Box B.11 provides an example of a situation where risk appetite was not clear to a bank operative. Box B.12 defines some key terms.

Although risk appetite is a simple concept, boards are having difficulty setting risk appetite statements for their entities and distinguishing risk capacity from risk tolerance. A risk appetite statement should be a qualitative and quantitative statement of the acceptable risk levels of an institution. Apparently it is easier to set a risk appetite statement when the risks are quantifiable rather than when the risks are social or affect the environment.

Box B.12: Risk Terminology: Key Definitions

Risk terminology can be difficult. For clarity, key terms are defined below:

- Risk capacity—the absolute risk that can be taken by the company, any risk beyond which would lead to the company collapse and would have an impact on the financial structure of the entity and its key strategies.
- Risk appetite—acceptable amount of risk taken in pursuit of value (a board view).
- Risk tolerance—the variability (maximum or minimum levels) of acceptable risk in a risk type or in each business unit.

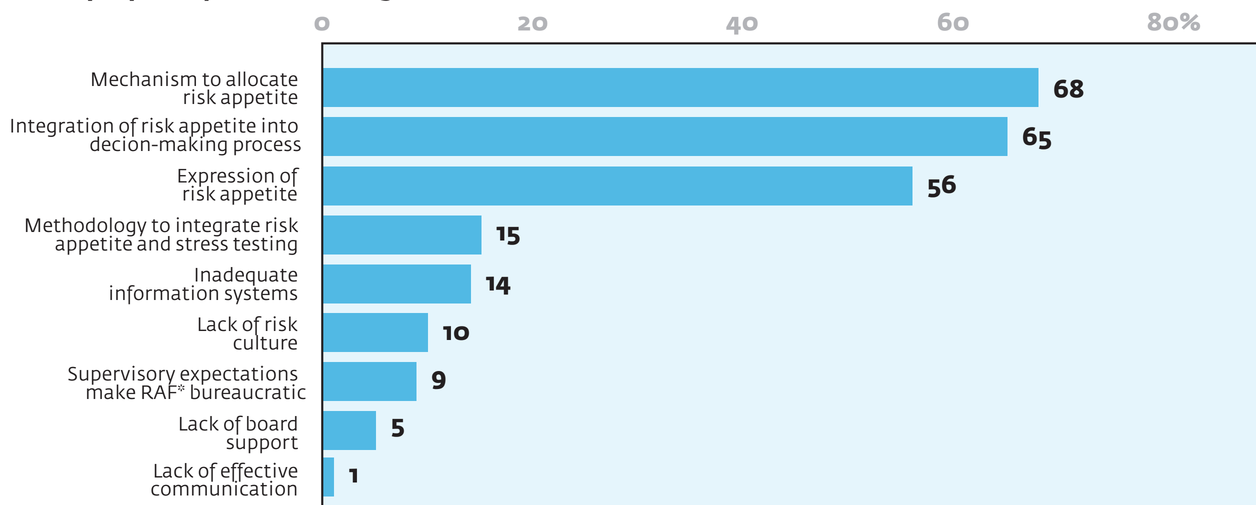
Source: Based on (COSO 2012).

B.2.2.3. Risk Appetite Statements by the Board: Evolving Good Practices

Many companies have found it particularly challenging to cascade risk appetite statements into the practical realities of the organization. In a survey of financial entities with risk appetite statements (PwC 2015a), the top three challenges facing surveyed institutions include the following (also see Figure B.7):

- Effectively allocating risk appetite across the organization;
- Incorporating risk appetite into decision making; and
- Articulating risk appetite through metrics and limits.

Figure B.7: Challenges to Risk Appetite Implementation



* RAF = Risk Appetite Framework.

Source: (PwC and IACPM 2014).

An Oliver Wyman study of the risk appetite statements of 65 financial institutions in 2015 found "a clear convergence towards a common understanding of the critical role risk appetite should play in the way banks manage earnings volatility, capital and liquidity" (Oliver Wyman 2015). In the same year, a Towers Watson survey found that 84 percent of respondents (from insurance) had a documented risk appetite statement in 2015, compared to 74 percent in 2012 and 59 percent in 2010 (Towers Watson 2015).

The insurance industry acknowledges that it is trying to apply risk appetite frameworks and statements to its practices, but more work is needed to link its risk appetite to business operations. Many in the industry now have a firm foundation in place to advance risk appetite frameworks.

The following describe what a risk appetite statement should be:

- Linked with objectives;
- Stated with sufficient precision in qualitative and quantitative terms;
- An aid to determining acceptable risk tolerances;
- Supported by facilitating alignment (of people, processes, and infrastructure);
- An enabler for monitoring risk.

Developments evident in financial institutions are also affecting risk frameworks and risk management practices in nonfinancial companies. A study of EU energy companies (electricity, natural gas) and entities in advanced industries (high-tech and assembly companies) shows similar developments in risk as are taking place in financial institutions (McKinsey 2012). Boxes B.13 and B.14 provide examples of disclosure of risk appetite and risk framework.

B.2.2.4. Risk Culture

To move risk governance and risk management to the new and higher levels expected does require strong leadership within the company. The board should set the "tone from the top." A company culture of risk awareness and risk acceptance is necessary for growth. To achieve a good risk culture, this tone from the top has to be supported by many other drivers, such as clarity regarding company values and ethics, expectations of employee behaviors, incentives that are aligned with the appropriate behaviors, and enterprise-wide training and development programs. (See Figure B.8, page 38.)

A risk culture develops from the mindsets and behaviors of individuals and groups within the company and it may be just that—very individual. Therefore, a company must work hard to establish and promote its own culture of ethics, values, and behaviors in how it approaches risk. Mindsets and behaviors within the company are critical to effective risk governance and risk management and will flavor attitudes toward risk governance, risk ownership, and the consideration of risk in decision making.

Box B.13: Risk Appetite Disclosure: Standard Chartered Bank

We have a clear statement of risk appetite which is aligned to the Group's strategy; it is approved by the Board and informs the more granular risk parameters within which our businesses operate.

Source: Standard Chartered Bank, Annual Report—Risk Review (2013).

Box B.14: Risk Framework Disclosure: Commonwealth Bank of Australia

A key purpose of the [Risk] Committee is to help formulate the Group's risk appetite for consideration by the Board, and agreeing and recommending a risk management framework to the Board that is consistent with the approved risk appetite..

This framework, which is designed to achieve portfolio outcomes consistent with the Group's risk return expectations, includes:

- The Group Risk Appetite Statement;
- High-level risk management policies for each of the risk areas it is responsible for overseeing; and
- A set of risk limits to manage exposures and risk concentrations.

The Committee monitors management's compliance with the Group risk management framework (including high-level policies and limits). It also makes recommendations to the Board on the key policies relating to capital (that underpin the Internal Capital Adequacy Assessment Process), liquidity and funding and other material risks. These are overseen and reviewed by the Board on at least an annual basis. Such a review took place in the 2014 financial year. The Committee also monitors the health of the Group's risk culture, and reports any significant issues to the Board.

Source: Annual Report, Corporate Governance Statement, Commonwealth Bank of Australia (2014).

Figure B.8: Elements of Risk Culture

Source: (IRM 2012).

Risk culture is a term describing the values, beliefs, knowledge, attitudes and understanding about risk shared by a group of people with a common purpose, in particular the employees of an organization. This applies to all organizations from private companies, public bodies, governments to not-for-profits.

(IRM 2016)

It requires great effort to ensure internal compliance with an established risk culture. Some companies have introduced initiatives focused on risk conduct, including better training, tighter internal controls and discipline for rogue behavior, greater accountability for individual roles and responsibilities, remuneration linked to performance metrics reflecting risk, and more frequent risk and controls reviews. The development of appropriate risk cultures in banks is an ongoing focus for banks and bank regulators at this time and for other entities wanting to upgrade their risk governance. Deloitte has identified the importance of an appropriate risk culture in defining its Risk Intelligent Model (Deloitte 2013).

B.2.3. Control Environment Developments: IFC Tools

When looking at a particular investment, investors want to see that the company has the right strategy in place and is capable of identifying and dealing with risks that may prevent the achievement of that strategy. They want to know that the company has in place people, policies, and processes to control the entity and its risks. This is called the *control environment*.

IFC has developed a toolkit to assist its corporate governance officers and its investment function in assessing the corporate governance of an entity. One of the five areas that the toolkit covers is the control environment, which includes a company's internal control system, internal audit function, risk governance management system, and compliance function.

> *"[W]hen IFC, as do the other 34 [development finance institutions] looks at a company, we're looking at the governance of these functions."*
>
> *Charles Canfield, Principal Corporate Governance Officer, IFC*

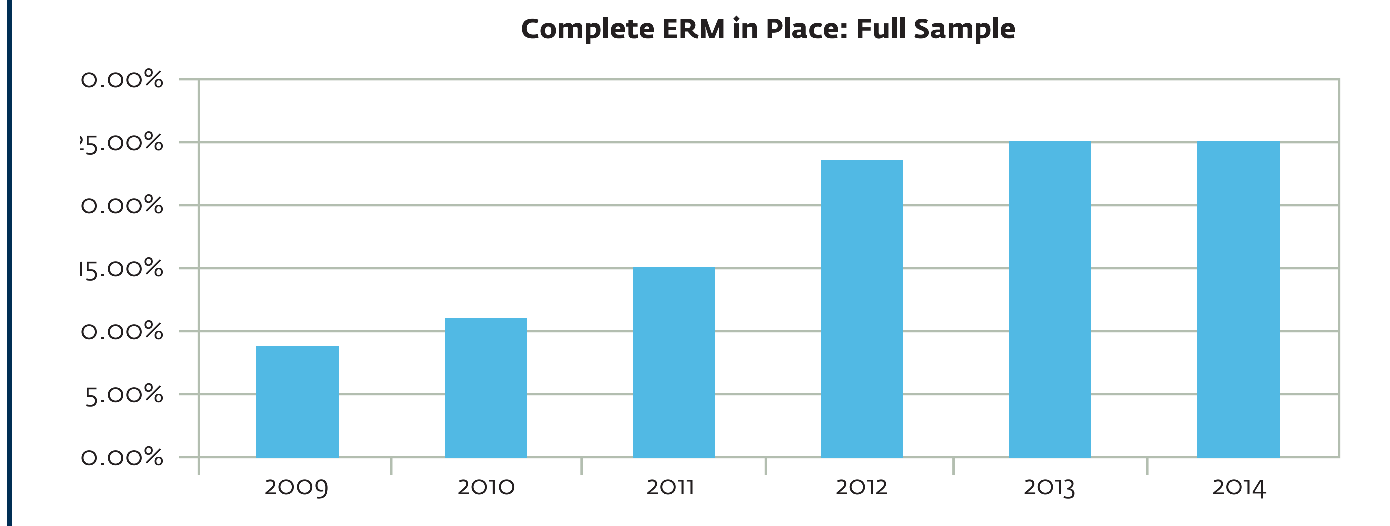
IFC has developed a progression matrix and uses it to establish where a particular company is in its functions and systems for risk and control. From there, the methodology helps establish next steps for progressive development of a holistic control system.

B.2.3.1. IFC's Control Environment Progression Matrix

IFC corporate governance assessments focus not only on the policies and processes as documented in company literature but also on the functioning reality of these areas. The financial crisis led to new rules, regulation, and guidance in risk and the control environment, and IFC determined

> *"In summary, the approach of the IFC corporate governance methodology and the tools is on structure and functioning of the respective organs that affect corporate governance; therefore, all of the control environment tools have been organized to include 1) progression matrix tools for analyzing committees, functions, and systems (audit committee, risk management committee, internal audit function, internal control system, risk management function, and compliance function); 2) progression matrix tools for analyzing function leaders (chief risk officer, chief internal auditor, and chief compliance officer); 3) IFC model documents (charters/bylaws, terms of reference, and job descriptions); and 4) summary guidance of relevant current best practice."*
>
> *Charles Canfield, Principal Corporate Governance Officer, IFC*

Figure B.9: Growth of ERM, 2009–2014



Source: (Beasley et al. 2015).

it could not look at the control environment as it had previously when assessing the corporate governance of possible investments. IFC updated its methodology and developed a toolkit to deal with this.

Within this matrix methodology, IFC initially determines whether the entity meets the minimum level acceptable for IFC to invest (Level 1) or if the entity is more advanced and on Level 2, 3, or 4, closer to international best practices. Level 4 is international best practices. The tools assisting the corporate governance personnel in the field include matrixes for assessing function leaders, whom they report to, the details of their jobs and duties, and their level of independence. For the toolkit—and related to the control environment—IFC developed many model documents, including the following:

- Internal audit department bylaw;
- Compliance department bylaw;
- Risk management function bylaw;
- Terms of reference and job descriptions for function leaders (chief risk officer, chief of internal audit, chief compliance officer); and
- Risk management committee matrix.

B.2.4. Risk and the Control Environment: Other Developments

Both private sector and public sector initiatives emerged following the financial crisis. Below are some of these other developments in the risk and control environment.

B.2.4.1. COSO Developments

Increasingly, companies understand that they do need to be proactive in risk governance and management, and often to achieve this goal they turn to the prevailing risk frameworks to support their initiatives. An AICPA survey in the United States on the establishment and full use of enterprise risk management shows the remarkable increase in an ERM application since 2009—since the financial crisis showed the importance of holistic risk frameworks to an enterprise. (See Figure B.9.)

In 1998, the Committee of Sponsoring Organizations of the Treadway Commission—a United States-based organi-

> The 2013 revision produced big changes to the internal controls framework. The revised Internal Control Integrated Framework (COSO IC Framework), beyond accounting controls and financial controls, which had been the focus of most regulatory revision in the 2000s, the new COSO IC Framework addresses operating and compliance controls. Also, of note, the new COSO IC Framework recognizes the business case for better controls and ties them to strategy and objective setting. Namely that internal controls should allow the organization to achieve better operational, reporting and compliance objectives.
>
> (IRM 2016)

zation comprising individuals from the Institute of Internal Auditors and various large accounting firms and professional organizations—introduced a framework for internal controls. In 2004, it introduced the Enterprise Risk Management-Integrated Framework. COSO revised its ERM Framework in 2013 and released a new Integrated Internal Control Framework. Such is the pace of change!

Figure B.10 illustrates the COSO framework. The revised framework included detailed changes in the expectations of board oversight and company management of the following:

- The control environment;
- Risk assessment;
- Control activities
- Information and communication; and
- Monitoring activities.

The new framework on internal controls provides additional advice on key issues:

- Internal controls should be risk based (based on the particular prioritized risks facing the entity, deduced from a risk assessment).
- Information and communication throughout the entity on risk and internal controls is very important and should start from the top and reach to the bottommost rung of employees in the entity.
- Any internal control system should be actively monitored and regularly tested, and this means having a good, independent internal audit function that can test controls and make recommendations for improvement.

B.2.4.2. IT Controls Developments

Because of the widespread use of technology and an increased concern regarding privacy rules and data security, there is a new emphasis on the governance of technology and the internal controls it requires. Information Systems Audit and Control Association (ISACA) has developed a standard system of guidance, COBIT 5 (Control Objectives for Information and Related Technology), which addresses how to control IT within an entity. It is good guidance on the management of the reality of "big data" and helps with managing disclosures.

> *"Sarbanes-Oxley accepts COBIT 5 as a basis, even the King III Report, people who work with King III, have said that COBIT 5 is a good standard to use. . . . It basically sets a system for how one should set IT controls . . . . That's very important, because if you think of what's the number-one issue companies are facing these days, it's cyber security."*
>
> *Charles Canfield, Principal Corporate Governance Officer, IFC*

B.2.4.3 Internal Audit Developments

Again, the financial crisis has been the impetus for a major change in how boards and entities should view the internal audit function, the governance and use of internal audit. The internal audit function is now viewed more as an internal corporate governance gatekeeper and less as an entity policeman.

The International Internal Audit Standards Board in 2013 released a revision to the International Standards for the Professional Practice of Internal Auditing (IIA 2016), following consideration and approval by the International Professional Practice Framework Oversight Council. (See Box B.15.)

Box B.15: IIASB Standard 2110

2110 Governance

The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organisation;
- Ensuring effective organisational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organisation; and
- Coordinating the activities of and communicating information among the board, external and internal auditors and management.

2110.A1

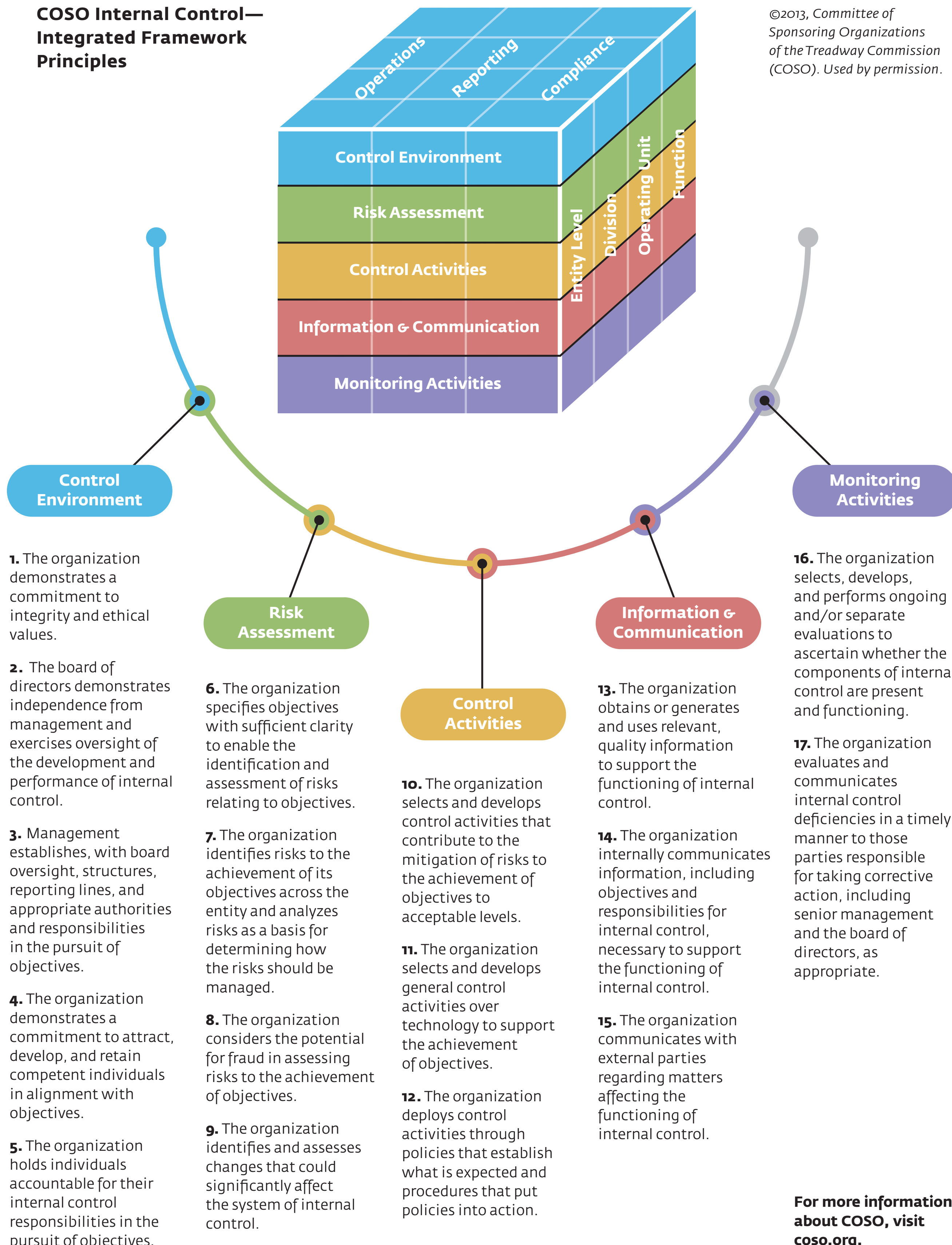
The internal audit activity must evaluate the design, implementation and effectiveness of the organisation's ethics-related objectives, programmes and activities.

2110.A2

The internal audit activity must assess whether the information technology governance of the organisation supports the organisation's strategies and objectives.

Source: (CIIA 2016).

Figure B.10: COSO Framework



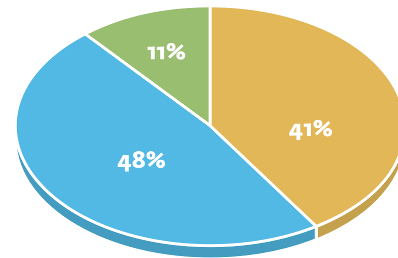
Source: www.coso.org.

Individual standards or codes setters are also looking to revise and upgrade the role of the internal auditor, with the aim of improving corporate governance. Research undertaken in 2012 by the European Confederation of Institutes of Internal Auditors (ECIIA 2012) indicates that the internal audit function is considered mandatory in 41 percent of European corporate governance codes. (See Figure B.11 and Table B.3.)

At the end of 2015, the Financial Reporting Council in the United Kingdom was working on updating its guidance for audit committees to reflect the new Corporate Governance Code. This guidance is expected to cover the role of internal audit in some detail.

These codes and activities highlight the key role that internal audit can play in supporting the board in ensuring adequate oversight of internal controls and the effectiveness of corporate governance. The implications for internal

Figure B.11: Mandatory versus Recommended Internal Audit Function in EU Corporate Governance Codes



- 41% of the codes consider an internal audit function mandatory
- 48% of the codes strongly recommend the presence of an internal audit function
- 11% of the codes do not have a specific requirement or recommendation about internal audit

Source: (ECIIA 2012).

Table B.3: Examples of Code Provisions Regarding Internal Audit

Country	Name of Code/Document	Extract of Comment
Finland	Finnish Corporate Governance Code 2010	The company must disclose the manner in which the internal audit function of the company is organized. The disclosure must include the organization of the internal audit function and the central principles applied to internal audits, such as the reporting principles, and the organization and working methods of the internal audit function, e.g. the nature and scope of the company operations, the number of personnel and other corresponding factors.
France	Recommendations on Corporate Governance March 2011	The audit committee is responsible for the following: oversight of statutory and internal audits, the assessment of the work of internal auditors, the selection of statutory auditors, and checking the independence of internal auditors.
Italy	Corporate Governance Code December 2011	The issuer shall establish an internal audit function. The internal audit function shall report to the board. The internal control and risk management system involves each of the following corporate bodies depending on their related responsibilities: board of directors, that shall provide strategic guidance and evaluation on the overall adequacy of the system…and internal audit, entrusted with the task to verify the functioning and adequacy of the internal control and risk management system. Internal audit function has a central position in the control system, that is charged of the "third level" of control. The internal audit function should be absolutely independent.
Latvia	Principles of Corporate Governance and Recommendations on their Implementation 2010	The board shall perform certain tasks, including timely and qualitative submission of reports, ensuring also that the internal audits are carried out and the disclosure of information is controlled.

Source: (ECIIA 2012).

audit are that there will be more interface between the audit committee of the board and internal audit and between internal audit and the external auditor. Further, the internal auditor may have an expanded role in supporting the board in challenging strategy, risk management, and internal controls.

B.2.4.4. Expectations of the Internal Audit Function

In corporate governance good practices, a robust internal audit function should have a charter for its activities that delineates its scope of work and accountabilities. It should be an independent function, independent of management structures, and be objective. To undertake its work, it should be adequately resourced and have access to, respond to, and report directly to the audit committee of the board or to the board itself. The audit committee should ensure that the internal audit function is well resourced, review with it its annual workplan, respond to internal audit recommendations, and fulfill the board's accountability to provide assurance about the way the company is managing the risks and controls. (See Box. B.16.)

The transition of the role of an internal auditor—from merely being a checker or tester of internal controls and providing assurance on them, to being a trusted adviser—is not easy. It will require the internal audit profession to develop and broaden the skills of their internal auditors.

Box B.16: Chief of Internal Audit

IFC recognized the best practice of establishing a separate board-level audit committee to help the full board govern this area and also a Chief of Internal Audit. . .to assist management with the implementation of an internal audit function. One can see that the ultimate goal is for the board to take adequate responsibility in overseeing this important function. Therefore, the IFC tools focus on quality of and the structure and functioning of internal audit functions in the following respects:

- purpose, establishment, and scope of work;
- qualifications and competencies of the internal audit staff;
- resources, responsibilities, and authority;
- independence and accountability;
- reporting;
- relationship with management and the risk management department; and
- quality control and evaluation.

Source: IFC Control Environment Toolkit.

A study by Protiviti (Rossiter 2011), which examined the role of internal auditors as perceived by internal auditors, pointed to these skills developments.

B.3. Demands for Transparency and Disclosure—ESG Issues

Organizations are seeing a continuing demand for disclosure of all matters, financial and nonfinancial, material to the investment decision. Financial reporting is reasonably well developed, but nonfinancial reporting is still developing. In recent times, the investor community has been asking for changes in corporate reporting to include better disclosure of the company's business model, its strategy, performance, and risks.

> *"In a market place where major companies exist where up to 80 percent of the market value of the organization is accounted for by intangible rather than financial or physical assets, a new corporate reporting framework was needed."*
>
> *Jonathan Labrey,*
> *Chief Strategy Officer, IIRC*

Sustainable development reporting is now a new norm and has been included in some national corporate governance requirements and codes. South Africa is a case in point.

> *"[T]he Global Footprint Network shows that we are using the resources of the earth at one and a half times [faster] than they can be replenished."*
>
> *Ansie Ramalho,*
> *King IV Practice Leader,*
> *Institute of Directors in Southern Africa*

B.3.1. Sustainability and ESG Reporting

As with systems in nature, businesses are resilient when they are able to adapt to new circumstances and to continually create and deliver value to all stakeholders. This involves considering both the risks and the opportunities presented in the global context, where environmental and social aspects are ultimately what allow and affect the company's financial performance and value creation. To consider the context also means understanding that businesses do not exist in a vacuum but rather are part of their environment, and that success is measured in the larger context.

The Report of the Brundtland Commission (Brundtland 1987) is the origin of much thinking on business resilience and sustainability.

"A company which is at odds with the society from which it derives its franchise is clearly not going to survive in the long run."

Peter Montagnon, IFC Corporate Governance Private Sector Advisory Group and Associate Director, the Institute of Business Ethics, United Kingdom

Sustainable development is the development that meets the needs of current generations without compromising the ability of future generations to meet their own needs.

(Brundtland 1987)

The financial result of entities is an outcome of something: it results from the transformation of something, essentially natural capital (resources) and human capital (labor), through intellectual capital and technology. Therefore, investors are keenly interested in information concerning a company's approach to these areas. A recent study (PwC 2015c) indicates that 71 percent of investors would decline an investment based on an ESG assessment and ESG risk. The same study found that 97 percent of the major institutional investors (global large pension funds and asset managers) expect that demands for responsible investment—with a focus on the impact on ESG matters—will increase in the next two years. Thus the pressure is for companies to be more transparent in their strategy and approach regarding environmental, social, and governance matters.

Attempting to build and maintain trust and to better attract funding, companies have become more transparent and are disclosing far more than previously, particularly in the diverse areas of corporate responsibility, sustainability, and ethics. The disclosure is increasing, in part, as a response to demands coming from regulations and because companies recognize the value of being more transparent. Customers, suppliers, employees, governments, and investors are all demanding more and better nonfinancial disclosure from companies, which includes issues related to the environment, social, and governance issues.

In some countries all or some sustainable development matters are enshrined in company law or other related laws or regulations. Other jurisdictions have chosen simply to advocate for some ESG inclusion in publicly available information. Table B.4 presents a nonexhaustive working document of some national initiatives requiring or advocating ESG transparency and reporting.

There is a broad question as to whether sustainability measures should be included in corporate governance codes. (See Part C of this paper.) Regardless of the regulatory requirements, companies should take into account the interests of stakeholders and report on those issues, as required in the OECD Principles. The risks to the company of insufficiently incorporating the stakeholder perspective into governance arrangements could be considerable.

Reports that focus on nonfinancial issues are often called "sustainability reports." In the last decade, global initiatives such as the Global Reporting Initiative (GRI) developed a set of guidelines that was gradually adopted all over the world. Recently, the effort has been to develop a framework for a unique report that integrates and, it is hoped, connects the whole set of corporate information, giving investors and all stakeholders a rounded picture of a company's performance.

Whether in compliance with regulations or through voluntary initiatives, a major shift is taking place in corporate reporting to include ESG information. In the 1990s, ESG/sustainability initiatives and reporting was virtually unknown, but by 2000, ESG/sustainability reporting had become commonplace and was focused on corporate accountability and performance. Between 2000 and 2010, several different standards and codes were developed to give form and structure to ESG activities and reporting. By 2013, more than 10,000 corporations and other organizations had issued ESG reports.[20]

The movement is trying to show the importance and contribution of all kinds of capital to corporate value creation and performance. These include financial capital, manufactured capital, intellectual capital, human capital, social and relational capital, and natural capital. These "capitals" form the basis of the integrated reporting initiative. To be explicit, understanding the companies' dependencies and impacts on all these capitals, and how they are connected, is as important as it is to understand and report financial performance.

Sustainability reporting is an intrinsic element of integrated reporting, which is a more recent development that combines the analysis of financial and nonfinancial information and is an attempt to solve the company problem of how to report on ESG matters. (See Section B.3.2. Integrated Reporting.)

[20] See the website Corporate Register.com: http://www.corporateregister.com/ (last accessed October 1, 2013).

Table B.4: National Initiatives in ESG Transparency

Year	Country	Requirement/ Recommendation	Comment
2007	Australia	NGER Act	Companies are required to provide data on greenhouse gas emissions and energy consumption and production.
2011	Brazil	BM&F BOVESPA Stock Exchange adopted the initiative "Report or Explain"	Stimulating listed companies to inform if they publish a sustainability report and, if not, to explain why.
2014	Brazil	CVM Instruction 522/2014 (Brazilian SEC)	Determines information regarding social and environmental policies and information disclosure.
2014	Brazil	Brazilian Central Bank (Resolution 4.327)	Determines the existence and implementation of a social and environmental responsibility policy to deal with environmental and social risks.
2010	Canada	Environmental Reporting Guidelines issued by the securities regulator	Determines the environmental information to be disclosed.
2007	China	Environmental Information Disclosure Act	Requires some mandatory and some voluntary disclosures and is supported by guidance issued by the Shanghai and Shenzhen exchanges.
2008 and 2012	Denmark	Amendment to the Danish Financial Statements Act	Requires an evaluation of the ESG achievements in last financial year and a statement of expectations of the future. Updates for mandatory requirements on human rights and climate change.
2014	Europe	Directive 2014/95/EU on disclosure of nonfinancial and diversity information, updating the Accounting Directive 2013/34/EU	Requires disclosure in the management report of large businesses of environmental, social, and employees aspects, respect for human rights, anti-corruption and bribery issues, and diversity in the board of directors.
2001	France	Loi Fabius	Investors are required to disclose in their annual reports the extent to which they take SEE information into account.
2010 and 2012	France	Grenelle Law II, Art. 224, 225	Investment companies and managers must disclose how they integrate ESG in their investment decisions.

(continued on page 46)

(continued from page 45)

Table B.4: National Initiatives in ESG Transparency

Year	Country	Requirement/ Recommendation	Comment
2012	Indonesia	Securities Regulation 47/2012	Provides that every company has social and environmental responsibility.
2005	Japan	Mandatory Greenhouse Gas Accounting System	Mandatory reporting of greenhouse gas emissions for companies.
2008	Malaysia	CSR Disclosure Framework	Malaysian stock exchange requirement for disclosure of CSR activities.
2014	Malaysia	Code for Institutional Investors	Guidance on institutional investors' stewardship to deliver sustainable long-term value to beneficiaries.
2011	Singapore	Sustainability Reporting	A voluntary guide for listed companies on sustainability reporting issued by the stock exchange.
2009	South Africa	King III Code	Requires integrated reporting that incorporates sustainability considerations.
2011	United States	Sustainability Accounting Standards Board (SASB)	SASB is established to develop accounting standards in sustainability for approximately 80 industries in 10 sectors.

Source: Molyneux, 2015.

Box B.17: OECD Principle V.A.2

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:

2. Company objectives and non-financial information.

75. In addition to their commercial objectives, companies are encouraged to disclose policies and performance relating to business ethics, the environment and, where material to the company, social issues, human rights and other public policy commitments. Such information may be important for investors and other users of information to better evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

76. In many countries, such disclosures are required for large companies, typically as part of their management reports, or companies disclose non-financial information voluntarily. This may include disclosure of donations for political purposes, particularly where such information is not easily available through other disclosure channels.

77. Some countries require additional disclosures for large companies, for example net turnover figures or payments made to governments broken down by categories of activity and country (country-by-country reporting).

Source: (OECD 2015a.)

> *"Long-term financial performance depends on the efficient and productive management of resources not currently measured by traditional accounting methodologies—human, intellectual, social and relationship, and natural capitals. The financial capital market system is insufficient to guard against the multi-faceted and interconnected risks of the future and hence an inclusive market system should be adopted."*
>
> *Jonathan Labrey,*
> *Chief Strategy Officer, IIRC*

The OECD Principles recognize the need for disclosure and transparency, and the general principle has not changed in the recent revision of the Principles. (See Box B.17.) Nevertheless, the trend toward an increased expectation for more and better nonfinancial information—to complement the traditional financial information provided—is reflected in additional specific disclosure recommendations.

A 2013 KPMG survey reviewing a period of 20 years, encompassed some 4,100 companies across 41 countries in the Asia-Pacific, Americas, Middle East and North Africa, and Europe regions (KPMG 2013). It shows that corporate responsibility (CR) reporting, or reporting on sustainability, has become standard company practice. (See Box B.18.)

B.3.1.1. The Company Rationale for Sustainability Reporting

Each company will approach sustainability differently, as each company's business model and activities vary. In 2013, Ernst & Young collaborated with the Center for Corporate Citizenship at Boston College in a survey of corporate professionals on the value to companies of sustainability reporting—beyond relating to firm financial risk and the firm licence to operate (Ernst & Young 2014). The results reveal that companies see ESG/sustainability reporting as contributing to their competitive advantage by improving company reputation (more than 50 percent), leading to increased employee loyalty, more reliable company information, and better refinement of the corporate strategy (more than 30 percent). Other studies (Cheng et al. 2014) also indicate that firms ranked highly for sustainability reporting have improved access to capital.

Box B.18: KPMG Corporate Responsibility Reporting Survey

Over half of reporting companies worldwide (51 percent) now include CR information in their annual financial reports. This is a striking rise since 2011 (when only 20 percent did so) and 2008 (only 9 percent).

To report or not to report? The debate is over.

Companies should no longer ask whether or not they should publish a CR report. We believe that debate is over. The high rates of CR reporting in all regions suggest it is now standard business practice worldwide. The leaders of G250 companies that still do not publish CR reports should ask themselves whether it benefits them to continue swimming against the tide or whether it puts them at risk.

Source: (KPMG 2013) Executive Summary.

> *"We are looking for greater transparency so that companies can be compared, not only on financial terms, on the stock price, but also on the contribution that the organisation is making to society."*
>
> *Patrick Zurstrassen,*
> *IFC Corporate Governance Private Sector Advisory Group*
> *Honorary Chair, ecoDa*

B.3.1.2. Sustainability Reporting—Rules and Tools

Many of the various guidance tools in the area of sustainability establish principles and standards for company application. Some instruments focus on application approaches by the company committed to sustainability. Some may be used for assessment of company sustainability activities. Other instruments focus on company reporting of sustainability activities. Some are more focused on the environment or on human rights. The number of tools, frameworks, and approaches available may lead to confusion about what and how a company should report on ESG matters. Many more approaches have been developed at industry and national levels. Nevertheless, the plethora of tools have seen increased use, and many have been revised for new trends and developments. Table B.5 on page 48 provides a sample of instruments developed for global applicability. In addition, references, such as a publication from the International Federation of Accountants (IFAC 2016), are available for accounting for sustainability.

B.3.1.3. Trends in Sustainability Reporting

Many surveys have been conducted on sustainability reporting. The following are common findings:

- Sustainability reporting is growing.
- Tools to support sustainability reporting are still growing.
- The CFO has a key role in reporting on sustainability, building on the CFO's traditional role in reporting.
- Employees are emerging as a driver for sustainability reporting.

Table B.5: Global Instruments Addressing Sustainability

Instrument	Year of Introduction/Revision	Development
OECD Guidelines for Multinational Enterprises (MNEs)	Issued in 1976; revised in 2000 and 2011	Provides principles for responsible business conduct in employment, industrial relations, human rights, environment, information disclosure, anti-bribery, competition, taxation.
UN Global Compact – 10 Principles	Issued in 2000	A set of principles voluntarily used by many businesses committed to aligning their strategies with UN principles in human rights, labor, the environment, and anti-corruption.
UN Principles for Responsible Investment (PRI)	Issued in 2006; In 2014, endorsed by 1,250 institutional investors	Principles endorsed by institutional investors to incorporate sustainability issues into their investment decision.
International Corporate Governance Network Guidance on Integrated Business Reporting	Issued in 2015	Guidance to companies on investor expectations of corporate reporting, financial and nonfinancial, including environmental and social issues.
Global Reporting Initiative G4 Sustainability Reporting Guidelines	Issued in 2013	Guidelines for companies on the presentation of sustainability information, covering economic, environmental, and social aspects of company activities.
Equator Principles	Issued in 2003 and revised in 2013; by 2014, adopted by 80 financial institutions in 34 countries covering 70% of international project finance debt in emerging markets	Developed by financial institutions as a financial industry benchmark for assessing environmental and social risks in projects.
UN Guiding Principles on Business and Human Rights	Issued in 2011 by UNHCR and focused largely on MNEs; in 2015, published a stock taking of implementation in EU of the Guiding Principles	Developed by the UN, encourages businesses to incorporate in their strategy and operations policies and procedures to safeguard human rights.
Integrated Reporting Initiative *(See detail of Integrated Reporting in Section B.3.2, below)*	Framework issued in 2013	Developed by International Integrated Reporting Council to facilitate harmonized and holistic financial and nonfinancial corporate reporting.

Source: Molyneux, 2015.

- Sustainability rankings and ratings matter to company executives and are reviewed by investors.
- There is a trend to integrate triple-bottom-line elements of the economic, environmental, and social impacts of business into company reports, as discussed below.

B.3.2. Integrated Reporting

"To achieve a holistic picture of a company's total strengths and to offer investors a sufficient basis for making investment decisions, the following elements are vital:

- *Identification of the most relevant, material aspects of the business model, strategy, and governance and how they are interrelated;*
- *Describing the expected impact and measuring and monetizing impacts.*

"Despite the notion that monetization will be quite subjective for certain issues, it is important to describe the material value drivers and their impacts as precisely as possible so that investors can appreciate their value."

Christian Strenger, Deputy Chairman, IFC Corporate Governance Private Sector Advisory Group, and IIRC Board

Views such as those expressed in the quote from Christian Strenger, above, led to the integrated reporting initiative, introduced by the International Integrated Reporting Council in 2010.[21] The IIRC is a market-led organization incorporating the expertise and experience of organizations in 25 to 30 countries in corporate reporting. The IIRC is a coalition of businesses, investors, regulators, and standard setters as well as the accountancy profession. The IIRC's mission is to enable IR to be embedded into mainstream business practice in the public and private sectors. Its vision is to make a lasting contribution to financial stability and sustainable development, brought about by the adoption of IR as the global reporting norm.

The IIRC assists companies with organizing and rationalizing their ESG disclosures and reports. It also helps them ensure that they are linked into the more traditional financial reporting, to give a holistic picture of value creation in a company's business model, strategy, and risks. (See Box B.19.)

Integrated reporting] is a process that results in communication by an organization, most visibly a periodic integrated report, about value creation over time. Intellectual capital is organizational, knowledge-based intangibles, including intellectual property, tacit knowledge, systems, procedures, and intangibles associated with the brand and reputation.

(IIRC 2015)

Box B.19: What is IR?

IR is a process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation. An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.

(IIRC 2015)

While the annual report remains the most important information source for investors, the reports in their present form do not provide a sufficiently true and fair picture of the company. This is due to the intensive weight factors like ESG, brand values, customer and employee loyalty, market position (concept of capitals) that increasingly impact the long-term viability of the business models: for example, 'Intangible Assets' today account for over 80 per cent of S&P 500's market value.

Investors clearly recognize this and expect companies to explain their business model and the management concept as well as to state their strategy and their execution plans. Investors are much more interested in how the company generates value rather than only concentrating on the return.

The keen interest of investors in non-financial issues is explained by their fiduciary duty to pursue opportunities for sustainable outperformance. A recent analysis of the impact of ESG confirmed that companies with higher ESG-standards benefit from lower cost of capital [and] higher share price performance.

(Strenger 2015)

[21] The IIRC website, www.iirc.org, has considerable information on the IR Framework and current applications of integrated reporting.

The goal of IR is for the data and information flows from businesses operating in complex regulatory and business environments to be allied with efficient capital allocation and to portray—clearly and concisely—the whole position of the business and how it creates value. However, it is not easy to move from a corporate reporting model, based on reporting of historical financial information, to more forward-looking corporate reporting, which includes financial as well as nonfinancial information.

> *"It should be stressed here that the point goes far beyond 'putting the information together,' but that is absolutely essential to link it and to make the connection, showing the whole picture of businesses' activities."*
>
> *Roberta Simonetti, Brazilian Institute of Corporate Governance*

In 2009, the King Report on Corporate Governance in South Africa included a requirement for integrated reporting. As a result, the South African Integrated Reporting Committee issued a guidance document, and the idea was taken up more broadly in 2010. It was decided that an international framework was needed, with the aim of having it become the corporate reporting norm for the private and public sectors. Thus the IIRC was born under the chairmanship of Mervyn King, who also chairs the King Committee on Corporate Governance in South Africa.

B.3.2.1. The Integrated Reporting Concept

The idea behind integrated reporting is easy to understand. The IIRC views reporting as complex, and the burden of corporate reporting has actually lead to an obscuring of a true picture of value creation. So it is difficult to communicate how an organization creates value when looking only through the prism of financial reporting, even historic financial reporting. More was required.

Example: World Bank Integrated Reporting

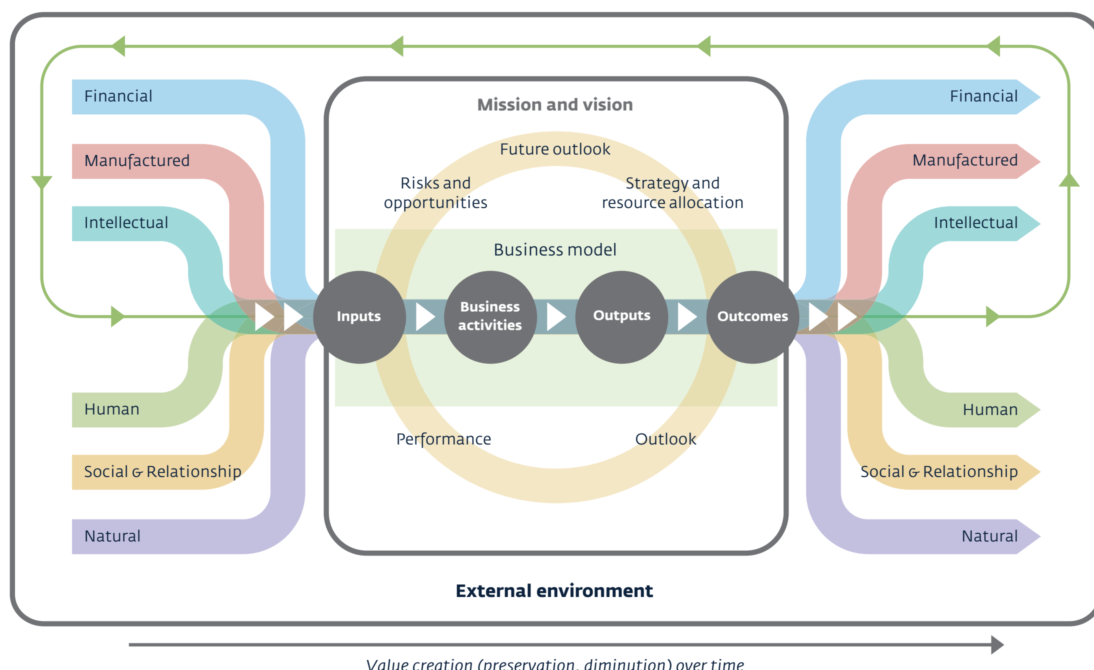
The World Bank, as a development bank and financial institution, is implementing integrated reporting in its own right, to test whether the principles of integrated reporting can be applied to public sector organizations.

IR challenges the silos that have developed historically in corporate reporting, which separate financial and nonfinancial information and allow information to be disconnected from the strategy of an organization. Such compartmentalizing of information is a drawback in a world of greater interconnectivity and interdependence.

The purpose of integrating reporting is to improve and increase the flow of productive investment, to release resources to the businesses, leading to future economic growth within a context of respect for sustainable development.

IR is an inclusive concept, and one of the most important elements and principles of IR is the idea of six capitals: financial, manufactured, intellectual, human, social and

Figure B.12: Integrated Reporting Concept



Source: (IIRC 2015).

relational, and natural capital. These capitals contribute to value creation in the long term, as shown on the right-hand side of Figure B.12. The IR concept is to look at a company from a larger perspective, not just through the financial prism that led to the chronic real-world effects on the economy and the misallocation of capital.

B.3.2.2. Summary of IR's Main Elements

The IR Framework demands that an organization be able to articulate its strategy, its value-creation model, and its uses of various capitals to create value over the medium and long term. Box B.20 provides a high-level summary of the requirements, principles, and main elements of the IR Framework.

Box B.20: High-Level Summary of Requirements for an Integrated Report

Key Requirements

- An integrated report should be a designated, identifiable communication
- A communication claiming to be an integrated report and referencing the Framework should apply all the key requirements (identified using bold italic type), unless the unavailability of reliable data, specific legal prohibitions or competitive harm results in an inability to disclose information that is material (in the case of unavailability of reliable data or specific legal prohibitions, other information is provided)
- The integrated report should include a statement from those charged with governance that meets particular requirements (e.g., acknowledgement of responsibility, opinion on whether the integrated report is presented in accordance with the Framework)—and if one is not included, disclosures about their role and steps taken to include a statement in future reports (a statement should be included no later than an entity's third integrated report referencing the Framework)

Guiding Principles

- **Strategic focus and future orientation** – insight into the organisation's strategy
- **Connectivity of information** – showing a holistic picture of the combination, inter-relatedness and dependencies between the factors that affect the organisation's ability to create value over time
- **Stakeholder relationships** – insight into the nature and quality of the organisation's relationships with its key stakeholders
- **Materiality** – disclosing information about matters that substantively affect the organisation's ability to create value over the short, medium and long term
- **Conciseness** – sufficient context to understand the organisation's strategy, governance and prospects without being burdened by less relevant information
- **Reliability and completeness** – including all material matters, both positive and negative, in a balanced way and without material error
- **Consistency and comparability** – ensuring consistency over time and enabling comparisons with other organisations to the extent material to the organisation's own ability to create value

Content Elements

- **Organisational overview and external environment** – What does the organisation do and what are the circumstances under which it operates?
- **Governance** – How does an organisation's governance structure support its ability to create value in the short, medium and long term?
- **Business model** – What is the organisation's business model?
- **Risks and opportunities** – What are the specific risk and opportunities that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
- **Strategy and resource allocation** – Where does the organisation want to go and how does it intend to get there?
- **Performance** – To what extent has the organisation achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?
- **Outlook** – What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
- **Basis of preparation and presentation** – How does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?

Source: (IIRC 2015).

> *"The Framework is a tool for the better articulation of strategy, and to engage investors on a long-term journey to attract investment that will be crucial to achieving sustained, and sustainable, prosperity."*
>
> *Mervyn King, Chairman, IIRC, and IFC Corporate Governance Private Sector Advisory Group*

B.3.2.3. Benefits for the Company

Research by corporate reporting communications firm Black Sun Plc indicates that integrated reporting has considerable benefits to the company (Black Sun 2015). For example:

- 92 percent of organizations interviewed see an increased understanding of value creation as a benefit of IR.
- 71 percent see a benefit to the board of a better understanding of how an organization creates value.
- 87 percent of providers of financial capital have a better understanding of the organization's strategy.
- 79 percent of providers of financial capital have greater confidence in the long-term viability of the business model.
- 79 percent of management participants report improved decisions based on better management information.

> *"Good practices in integrated reporting are emerging and, whilst to report in an integrated manner is challenging, it allows companies to tell the story of their strategies and risks in a holistic manner which is comprehensible to readers, investors and stakeholders alike."*
>
> *Anne Molyneux, ICGN Board*

Other studies (such as KPMG 2014) show that better business reporting, especially on sustainability issues, is productive, and integrated reporting is becoming a trend.

> *"Prior research has established a relationship between disclosure and a firm's corporate valuation and cost of capital. Our research shows that firms with better integrated reports do enjoy higher equity valuations."*
>
> *Lee Kin Wai, Associate Professor of Accounting, Nanyang Business School, Singapore*

Research conducted by Nanyang University in Singapore[22] found a positive correlation between the application of IR and share performance. The Nanyang University study reviewed 100 South African companies listed on the Johannesburg Stock Exchange, where integrated reporting has been mandated under King III over the most recent three years, on an apply-or-explain basis.

The Nanyang University study used stringent research methods, and the researchers themselves were surprised by the findings. They found an observed roughly 9 percent increase in share price as a result of companies' applying IR.[23]

In the pilot stage of development of the IR Framework in 2014, the IIRC closely observed 100 or more companies applying the framework, with the result that they appeared to be much better at understanding and articulating their organization's strategy and business model. According to Jonathan Labrey, IIRC chief strategy officer, pilot study participants reported that IR has been very helpful to them not only in managing risks internally but also in delivering value by explaining to internal stakeholders, particularly employees, how they should fulfill their responsibilities and their role in executing the strategy.

B.3.2.4. IR Country Developments—South Africa

Sustainability/triple-context reporting has been mandated on an apply-or-explain basis through King II and King III, the South African corporate governance code. Many South African companies were early adopters of IR as a means of reporting in an integrated way on financial and sustainability matters as required by Johannesburg Stock Exchange

> The survey shows that among those organizations that produce high quality and authentic integrated reports, there is a strong awareness of the concept of integrated thinking and how it benefits the organization. . . . To date few organizations seem to be using the capitals model outlined in the [IR] Framework to identify and manage their capitals, but there does seem to be an awareness of the six capitals and that these contribute to the value creation process.
>
> (SAICA 2015).

[22] The study of South African companies by Gillian Yeo, Lee Kin Wai, and Thiruneeran of Nanyang Business School is important to the development of IR in Singapore and has been followed by other initiatives by the Institute of Chartered Accountants of Singapore and ACRA, the Accounting and Corporate Regulatory Authority of Singapore.

[23] Statistics provided by J. Labrey in discussions at IFC Codes and Standards Review Group, May 2015.

(JSE) Listing Rules in 2010 (on an apply-or-explain basis). Therefore, South Africa has been watched as a leader in IR development as well as in governance and culture, where South Africa has had a particular focus on sustainable development.

Many studies, such as one by KPMG (Hoffman 2012), have examined the South African story of integrated reporting. A recent study issued by the South African Institute of Chartered Accountants (SAICA 2015) produced the following findings:

- Several of the top 100 JSE listed companies and leading state-owned entities have recognized the benefits of integrated thinking.
- Over 70 percent of entities confirmed that integrated reporting has been a driver for achieving integrated thinking.
- Over 70 percent of executives and non-executive directors surveyed felt that decision making at management and board levels had improved as a result of integrated thinking.

B.3.2.5. IR Developments—Other Countries

Other developments are taking place in integrated reporting. Regulators or business organizations have convened laboratories and networks in different markets to look at the practical challenges of corporate reporting and how integrated reporting can facilitate a better dialogue between companies and investors. Integrated reporting is accelerating in some countries and is becoming a driver of social and economic development.

Example: Malaysia

Integrated reporting is part of the capital markets master plan of Malaysia. In its Corporate Governance Blueprint 2011, the Securities Commission of Malaysia includes a chapter on disclosure and transparency. The master plan it presents recommends that companies promote effective disclosure of nonfinancial information. It states that part of the plan will “Establish a taskforce to review developments in integrated reporting and to promote awareness and its adoption by companies” (SC 2011).

Example: Japan

In Japan, there are now 180 companies practicing integrated reporting. One of the key accelerators of the shift to IR has been the development of the Japanese stewardship code and most recently a corporate governance code. Investors in Japan believe they can use integrated reporting as the information architecture to underpin high-quality dialogue between the board of the company and institutional investors.

Example: India

Recently, the Securities and Investment Board of India asked the Confederation of Indian Industry (CII)—that is, the business community—to develop a roadmap for the implementation of integrated reporting in the Indian market. The CII established the Centre for Excellence for Sustainable Development, which, in partnership with the IIRC, introduced integrated reporting to India and set up IR Lab India, the country-level network, a collective of companies, investors, regulators, accounting firms, and academics, to practice and advocate in India, and to bridge with IIRC and country networks (CII-ITC 2016).

Example: Brazil

The Brazilian Commission for Monitoring IR is a group of individuals who seek to discuss and foster the voluntary adoption of integrated reporting in Brazil. This initiative, although it is recognized and encouraged by the IIRC, is completely independent and the responsibility of its members. The commission has working groups on five fronts: knowledge management, communication, pioneer reporters, investor engagement, and academy.

B.3.2.6. IR—A Final Word

The shift from silo reporting to integrated reporting is a journey that is unfolding. However, it is very consistent with the work that the World Economic Forum (WEF) does every year in relation to the key worldwide risks facing the global economy. Last year, the WEF Global Risks Report found that no country, industry, or organization can deal with risks on its own or in isolation. It is also not possible to isolate financial and nonfinancial risks or country risks, because we live in an interconnected world.

Klaus Schwab, who chairs the World Economic Forum, said that these interconnected risks require collective thinking and responses as well as new systems and processes for understanding them. In the World Economic Forum’s 2015 report (WEF 2015b), for the first time it was recognized that the highest-ranking risks are actually nonfinancial, placing further pressure on policymakers, businesses, and investors to understand, measure, manage, and disclose the impact of these risks on businesses, their business models, and their value creation.

It is most important to note that the Integrated Reporting Initiative is but one of a number of initiatives that aim to make company activities more transparent, more accessible, and more useful to the reader. Such initiatives emphasize the real importance of a company’s activities to life and the social system it operates within. Some initiatives have focused on establishing the basis for business activities, such as the UN Global Compact’s 10 principles in the areas of human rights, labor, the environment, and anti-corruption.

The OECD has established principles for large multinational enterprises (OECD 2014c) to ensure responsible business conduct. Some initiatives focus on a particular group, such as investors, the target of the Principles for Responsible Investment. Others, such as the standards developed by the Global Reporting Initiative (GRI 2013), have developed reporting models and focus on reporting of wider company activities. All are worthy of consideration in the transparency and reporting of nonfinancial company performance.

B.3.3. Periodic Reporting: Is Less More?

In the aftermath of the financial crisis, many investigations into its causes discovered short-termism among banks and public companies as a contributor. Several reviews[24] in the United Kingdom and Europe considered quarterly reporting of financial information as contributing to a short-term perspective, to the detriment of a longer-term view. In many situations around the world, decisions were made to maximize financial results in the short term and had severe consequences in other dimensions, with a rebound effect that ultimately affects the financial result in the medium or long term.

The Kay report (Kay 2012) points out that overly frequent reporting encourages businesses and investors to make short-term decisions that sacrifice long-term returns and might increase risks in general and have other impacts on society and the environment. The Kay report included persuasive examples of U.K. companies, including Marks & Spencer, BP, Imperial Chemical Industries, Royal Bank of Scotland, Halifax Bank of Scotland, and Glaxo, that steadily moved to and suffered from greater short-termism at the expense of long-term investment and the sustainability of the company.

Kay suggests that too rigid reporting requirements can promote an excessively short-term focus by companies, investors, and market intermediaries; incentivize earnings management; and impose unnecessary regulatory burdens on companies—without providing useful or meaningful information for investors. Kay considered quarterly earnings results to be too short a snapshot of performance to properly inform investors. The key is to achieve a right balance between short-term and long-term perspectives and not to have a reporting cycle drive business decisions.

> Overall we conclude that short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain. . . . Recommendation 11 recommended that mandatory quarterly reporting obligations on quoted companies in the form of Interim Management Statements . . .should be removed.
>
> (Kay 2012)

In Europe in 2013, post-financial-crisis reviews resulted in amendments to the Transparency Directive (initially passed in 2007) to remove the requirement for listed companies to publish quarterly financial reports, a requirement that many see as a stimulus to short-termism. This amendment was implemented in the United Kingdom in 2014 and is being adopted in various EU member states. National stock exchanges are allowed to impose stricter reporting requirements than the directive proposed.

However, not all markets have been willing to remove quarterly reporting. The United States continues to lead on quarterly reporting. Singapore, which introduced mandatory quarterly reporting in 2003, continues to require it. Studies from the academic and economic research community are mixed in their support for quarterly reporting. Two recent German studies on mandatory quarterly reporting suggest the following:

- It does not reduce information asymmetry, but rather causes firms to deviate from their prior investment strategy (Kajuter et al. 2015).
- It affects firms' business decisions, and firms with quarterly earnings information show greater manipulation of real activities; it is also associated with decreased levels of long-term operating performance (Ernstberger et al. 2015).

In Germany, Porsche resisted issuing quarterly information, even at the expense of being excluded from prestigious stock market indexes (Wagenhofer 2014). In 2009, the Anglo-Dutch consumer goods company, Unilever, moved away from quarterly reporting in favor of semi-annual reporting. The chief executive officer, Paul Polman, argued that the move would help the firm focus on a longer-term investment perspective.

Conversely, a number of earlier studies (Fu et al. 2012; Kanodia and Lee 1998; Gigler et al. 2014) found that a higher reporting frequency is associated with lower information asymmetry and a lower cost of capital. These studies identified information benefits to the market of quarterly reports, positing that more frequent reporting

[24] In 2009, the Walker Review of corporate governance in U.K. banks and other financial institutions investigated the failures of governance, particularly in the Royal Bank of Scotland and the Halifax Bank of Scotland.

increases the timeliness of financial information and thus helps improve transparency and monitoring.

It is clear that the debate on the benefits or otherwise of quarterly reporting is not concluded. Yet we already see regulators and companies moving away from quarterly reporting to limit short-term management decision making and behavior. The discussions at the EU confirmed a view that investor protection is already sufficiently guaranteed by the requirement for firms to publish market-moving information immediately. However, companies themselves may wish to continue to report quarterly, if they see it as beneficial to investors and to the company position in the market.

B.3.4. Audit Reforms

Reviews of the financial crisis (Hidalgo 2011) have led to recent revisions to the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB), the global audit standards setter. The reviews have prompted several jurisdictions to amend their requirements of auditors and of audit committees to ensure increased transparency on external audit findings and activities. Thus standard setters and regulators introduced a series of requirements designed to enhance understanding of the audit process, including critical judgments made during the audit.

> *"This is a watershed moment in corporate reporting as it is a long time since the audit report format was amended. The IAASB and other regulators and audit oversight groups in the EU, the UK and the US and in many other countries wished to address the perception that the audit report style and content was not useful to investors."*
>
> *Anne Molyneux, IAASB Consultative Advisory Group and ICGN Board*

> While users of the financial statements have signaled that the auditor's opinion on the financial statements is valued, many have called for the auditor's report to be more informative and relevant.
>
> (IAASB 2015a)

B.3.4.1. IAASB Reforms

The IAASB audit report reforms are intended to increase transparency and enhance the informational value of the auditor's report. (See Box B.21.) Countries that apply ISAs

Box B.21: Benefits of Changes to the Auditor's Report

Changes to auditor reporting will also have the benefit of:

- Enhanced communications between investors and the auditor, as well as the auditor and those charged with governance
- Increased attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report
- Renewed focus of the auditor on matters to be communicated in the auditor's report, which could indirectly result in an increase in professional scepticism.

Source: (IAASB 2015b).

will apply the new standards issued by IAASB, adapted to local environments. (See Box B.22, page 56.)

B.3.4.2. Regional and National Audit Reforms

Regional and national initiatives to take up the new audit report requirements have been and are occurring at the time of writing this publication. (See Table B.6, page 56.)

Different countries and regions may interpret new audit requirements in diverse ways, and some have added requirements. For example, Dutch law adds restrictions on the provision of non-audit services by external auditors; in Spain, the law, which implements Directive 2014/56/EU and Regulation (EU) No 537/2014, includes a mandatory rotation period for external auditors of ten years (plus four more in case of joint audit reports), in line with EU audit provisions.

B.3.4.3. Corporate Governance Changes Resulting from Audit Reforms

In the application of audit reforms in the EU and the United Kingdom, some effects have been evident. The new report format provides the key audit matters that the auditor considers in the course of the audit, and it provides for investors points, which facilitate dialogue with boards and audit committees. External auditor oversight has come into focus, and the role of audit committees is subject to new pressures and demands, including the following:

- Expanded need for "financial expertise" on the audit committee, to include knowledge of audit approaches;
- Increased need for independence of the committee;
- Demand for increased transparency of the auditor-appointment process, especially where auditor rotation has been mandated;

Box B.22: The New Audit Report

What's New About the IAASB's Auditor's Report?

Mandatory for audits of financial statements of listed entities, voluntarily application allowed for entities other than listed entities:

- New section to communicate **key audit matters** (KAM). KAM are those matters that, in the auditor's judgment, were of most significance in the audit of the current period financial statements
- Disclosure of the **name of the engagement partner**

For all audits:

- **Opinion section** required to be **presented first**, followed by the Basis for Opinion section, unless law or regulation prescribe otherwise
- Enhanced auditor reporting on **going concern**, including:
  - Description of the **respective responsibilities of management and the auditor for going concern**
  - A separate section **when a material uncertainty exists** and is adequately disclosed, under the heading "Material Uncertainty Related to Going Concern"
  - New requirement to **challenge adequacy of disclosures for "close calls"** in view of the applicable financial reporting framework when events or conditions are identified that may cast significant doubt on an entity's ability to continue as a going concern
- Affirmative **statement about the auditor's independence** and fulfillment of relevant **ethical responsibilities**, with disclosure of the jurisdiction of origin of those requirements or reference to the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants*
- **Enhanced description of the auditor's responsibilities** and key features of an audit. Certain components of the description of the auditor's responsibilities may be presented in an appendix to the auditor's report or, where law, regulation or national auditing standards expressly permit, by reference in the auditor's report to a website of an appropriate authority

Source:(IAASB 201.5b).[25]

Table B.6: Regional and National Audit Reforms

Year	Organization	Initiative
2011–2014	IAASB	Review and reissuance of ISA 700 series of standards to require jurisdictions applying ISAs to introduce new elements to the auditor's report (termed a "long form report" in the EU and the United Kingdom).
2013	U.K. Financial Reporting Council	Changed the requirement to expand the audit report to include an overview of the scope of the audit, showing how this addressed audit risk and materiality considerations. Described the risks that had the greatest effect on: • the overall audit strategy, • the allocation of resources in the audit, • directing the efforts of the engagement team. Provided an explanation of how the FRC applied the concept of materiality in planning and performing the audit.
2014	EU Directive on Statutory Audit	EU Directive on Statutory Audit (Directive 2014/56/EU) was amended to incorporate changes as proposed in the IAASB new standards and transposed by 2016 into EU member states' regulations.
2011–2013	Public Company Accounting Oversight Board (United States) Proposals	Development and drafting of new proposals to enhance the content of the auditor's report.

Source: Molyneux, 2015.

[25] More information on audit report changes is available at http://www.iaasb.org/new-auditors-report.

> *"In the Netherlands, the longer form auditor's reports have been well received. They give greater insight into the auditor's work from the investor's perspective."*
>
> *Rients Abma, Managing Director, Eumedion*

- Demand for increased transparency about audit committee activities, especially regarding discussions with the auditor and internal auditor; and
- Increased focus of regulators on audit quality and effective audit oversight and supervision.

In the United Kingdom, the corporate governance corporate governance code requires audit committees to report on significant audit matters and how these were addressed.

A KPMG survey provided valuable discussions of consequential developments for audit committees. It found that three-quarters of audit committee members surveyed said that the time required to carry out their responsibilities has increased moderately (51 percent) or significantly (24 percent), and half said that their role is becoming increasingly difficult. According to the report, "Views on audit reforms are mixed. . .there's still room for auditors to offer more insight" (KPMG 2015).

> *"Effective audit committee oversight is essential to investor protection and the functioning of our capital markets. . . . The way audit committees exercise their oversight of independent auditors has evolved and it is important to evaluate whether investors have the information they need to make informed decisions."*
>
> *Mary Jo White, Chair, U.S. Securities and Exchange Commission (SEC 2015)*

B.4. Shareholder Rights: RPTs and Beneficial Ownership

Two of the areas that have undergone review in the process of strengthening shareholder rights are related-party transactions and beneficial ownership. This section examines changes affecting those two areas as well as current thinking regarding good practices.

B.4.1. Related-Party Transactions

One of the corporate governance challenges companies must deal with is to ensure that all shareholders are protected in the face of related-party transactions. RPTs can be beneficial, but they are subject to conflicts of interest and are potentially abusive to some shareholders. The OECD recognizes the importance of RPTs and has introduced two guidance papers on the topic (OECD 2009b; OECD 2012). Based on a director's fiduciary duty to the company, widespread and diverse actions have strengthened shareholder positioning against abusive related-party transactions. Sound definitions of RPTs have been introduced in most jurisdictions. Some specific RPTs are prohibited; more frequently, various companies and jurisdictions have introduced approval requirements for material RPTs and increased disclosure requirements.

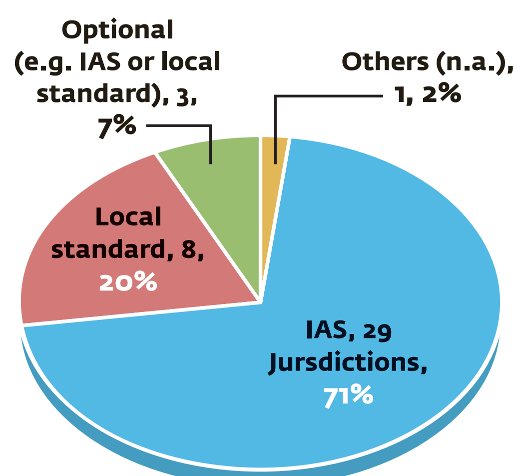
B.4.1.1. RPT Prohibitions

Usually addressed in corporate law and in regulations, RPTs are recognized as a regular business aspect that may or may not be abusive. However, particular RPTs—such as loans between the company and directors—have been prohibited in several jurisdictions. Some RPT prohibitions are in place in France, India, the Republic of Korea, Turkey, and the United States.

B.4.1.2. RPT Disclosures

Almost all jurisdictions have introduced International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), including IAS 24 Related Party Transactions Disclosures or a local standard similar to IAS 24, as illustrated in Figure B.13. IAS 24 stipulates some information on RPTs to be disclosed. Further, an interesting IOSCO survey of disclosures to investors (IOSCO 2015) indicates that of 37 IOSCO jurisdictions, some 26 have requirements in place for timely disclosure of material RPTs and usually stipulate a set time frame for disclosure (from two to seven days is the norm).

Figure B.13: RPT Disclosures in Financial Statements



The number of jurisdictions in each category and percentage share out of all 41 jurisdictions

Source: (OECD 2015b).

Thus, under IAS 24, companies must disclose at least annually, in their financial statements (or in the notes to the financial statements), any transaction with directors, senior executives, or controlling or significant shareholders and their related parties, including close family members, associates, and related entities (companies, trusts, private entities, and so on). Apart from annual disclosure, the *OECD Corporate Governance Factbook* indicates that one-third of all surveyed jurisdictions require immediate public and shareholder disclosure of significant RPTs and the RPTs' terms and conditions.

All disclosure aims to provide shareholders with sufficient information to assess the magnitude and impact of RPTs on the company. The quality of RPT disclosures has been identified as problematic, and in some countries (such as Canada, Ireland, Malaysia, Singapore, and the United Kingdom) guidance has been issued to ensure quality RPT disclosures. (See Box B.23.)

B.4.1.3. RPT Approvals

The majority of jurisdictions require all RPTs to be approved by the board in aggregate. However, practices regarding board review and approval of specific RPTs vary. Good practices include the following:

- RPT policy established and publicly available on the company website;
- Thresholds set for material RPTs requiring ex ante board approval and/or shareholder approval;
- Abstention of conflicted parties from decision making regarding RPTs;
- Review of RPTs' terms and conditions by independent board members, and recommendation made to the board;
- Independent formal valuation of RPTs;
- RPTs documented and monitored by the board and reviewed by the external auditor; and
- Specific material RPTs subject to shareholder approval process.

Where shareholder approval of specific RPTs is required as a complement to board approval processes, it is usually ex ante and only applied to large transactions and/or transactions not on market terms and conditions. Some jurisdictions specifically prohibit conflicted shareholders from voting on RPT resolutions.

Box B.23: Comparison of Uninformative and Informative Statements

For example, a generic and uninformative disclosure describing bank management of RPTs follows:

The audit committee reviews and approves all material related party transactions in which the bank is involved or which the bank proposes to enter into.

A more informative statement would be as follows:

The bank's management team discusses all related party transactions. In considering related party transactions, management will assess the materiality of related party transactions on a case-by-case basis with respect to both the qualitative and quantitative aspects of the proposed related party transaction. Related party transactions that are in the normal course are subject to the same processes and controls as other transactions, that is, they are subject to standard approval procedures and management oversight, but will also be considered by management for reasonability against fair value. Related party transactions that are found to be material are subject to review and approval by the bank's audit committee which is comprised of independent directors.

Source: Examples taken from (OSC 2015).

B.4.2. Beneficial Ownership

Investors need to know the parties that own individual stakes in the companies in which they wish to invest. From 2002 to 2012, concentrated ownership of companies grew in OECD and non-OECD countries from 22 percent of listed entities to 41 percent of listed entities, making it of particular interest.

The presence of controlling shareholders may dissuade smaller investors from investing in a company. Minority shareholders may feel vulnerable if investing alongside a controlling shareholder. The corporate governance dynamics are likely to change in the presence of controlling shareholders. Therefore, many parties have an interest in establishing the identities of the other parties controlling the entity.

Given the plethora of intermediaries (such as trusts, nomi-

> Investor confidence in financial markets depends in large part on the existence of an accurate disclosure regime that provides transparency in the beneficial ownership and control structures of publicly listed companies. This is particularly true for corporate governance systems that are characterised by concentrated ownership.
>
> (OECD 2013b)

nee companies/accounts, chains of corporate vehicles) that may be interposed, it is often difficult to distinguish ultimate beneficial owners and thus company control. Also, the issue may be purposefully opaque.

In all markets—especially emerging markets where state and family controls of businesses and perhaps pyramidal control structures are prevalent, and because such structures in the past have been used to the detriment of minority shareholders—a strong regulatory environment is important. Information on ownership is also important and should be adequate, accurate, and current. As companies are expected to engage more with shareholders and shareholders and institutional investors are encouraged to take a regular interest in the affairs of their investee companies, both company and shareholders need to know the identity of significant shareholders. Therefore, regulators have been introducing enhanced disclosure and enforcement regimes to ensure that the ownership structure of the entity is transparent, even in market environments where there is dispersed share ownership. (See also Section A.4.3. Ensuring Greater Shareholder Engagement.)

B.4.2.1 Disclosure of Beneficial Ownership

Controls to prevent opportunistic behavior by controlling shareholders or large block holders are generally in place in company law or listing rules. In an environment characterized by control and insider coalitions in companies, the EU has long recognized the importance of mandatory disclosure of significant shareholdings.[26]

> Article 9 [of the Directive] provides that investors will be required to disclose the acquisition or disposal of shareholdings in listed companies whose securities are admitted to trading on a regulated market, based on thresholds starting at 5% continuing at intervals of 5% until 30% of the voting rights.
>
> (European Commission 2014a)

Notifications are required within four trading days. However, stricter reporting and disclosure rules were introduced recently to uncover ultimate beneficial owners of companies. Italy requires detailed ownership and control information of significant shareholders and requires the ultimate controlling shareholder to make shareholding notifications above 2 percent, including long and short positions. There is evidence that institutional investors keep their positions just below the 2 percent level to hide ownership, and the regulator, CONSOB (Commissione Nazionale per le Società e la Borsa), is reviewing the regulation in the light of such actions, recognizing that the global norm of 5 percent is higher and more flexible.

Also, emerging markets with a prevalence of controlling-shareholder structures and the use of control-enhancing structures, such as China, Indonesia, and Malaysia, have also introduced regulation on disclosure of beneficial ownership.[27] Since the G-8 Summit in June 2013, G-8 countries have introduced stricter measures to improve transparency of beneficial owners to build trust and transparency in companies, to facilitate cross-border investment, and to prevent fraud, money laundering, and tax evasion. Other countries have followed. (See Box B.24, below, and Table B.7, page 60.)

Now brokers, dealers, banks, insurance companies, investment companies, parent holding companies, and others have stronger obligations to report ultimate beneficial ownership. Even particular industries have established initiatives to ensure transparency of beneficial owners of companies. The Extractive Industries Transparency Initiative is an example, and it has developed a model beneficial ownership form for members' use. (See Box B.25, page 61.)

Box B.24: Reporting Example: Indonesia

[Bapepam-LK is the Indonesian Capital Market Supervisory Agency.]

According to Bapepam-LK Rule No. X.K.6 regarding the obligation to submit an annual report, listed companies are required to annually disclose and report information regarding significant direct shareholders who own 5% or more of the company's shares.

This information becomes also available on the website of the Indonesia Stock Exchange (www.idx.co.id). Bapepam-LK Rule No. X.M.1 requires all significant direct shareholders who own 5% or more of the outstanding shares to send a report containing information about the shareholding to the Indonesian Capital Market Supervisory Agency. . .within ten days from the transaction date.

Source: (OECD 2013b).

[26] See Directive 88/627/EEC. The rules regarding beneficial owners were amended in 2004 and implemented in 2007.

[27] Other examples may be found in regulatory developments in China and Malaysia and other emerging markets. Indeed, Malaysia's disclosure system is extensive and detailed.

B.4.2.2. Beneficial Ownership Rules and Enforcement

Disclosure rules themselves do not necessarily imply accurate and compliant disclosure practices. Rules should be supported by proper oversight, monitoring, and enforcement, and the effectiveness of the rules depends largely on the enforcement capabilities of regulators. However, enforcement regimes and mechanisms vary significantly when it comes to beneficial ownership rules.

Most jurisdictions devote considerable resources to enforcement in this area. Public enforcement may be both formal and informal, and in Italy it can involve imposition of fines, suspension of voting rights, or more informally a request for updating of information or a reprimand. In the United States, the SEC may remind delinquent filers of their obligations and suggest that they provide information voluntarily forthwith. In Malaysia, formal public enforcement mechanisms are used and are typically made up of

Table B.7: Beneficial Ownership Rules

Country	Source	Amendment to Beneficial Ownership Rules
Canada	G-8 Action Plan 2.0	• In 2014, determined an Action Plan to implement the measures as have the United Kingdom and the United States (see below).
Denmark and Norway	FATF response	• By 2013, Denmark and Norway committed to a public registry of beneficial ownership information.
United Kingdom *(also expected to affect Isle of Man, Guernsey, Jersey, Bermuda, and the Cayman and British Virgin Islands)*	Department of Business Innovation and Skills—Transparency and Trust Project and draft Bill	• Implement a central registry of company beneficial ownership information accessible to the public under Disclosure and Transparency Rules of Part 22 of the Companies Act 2006. • Companies will be required to maintain a register of beneficial owners. • Information on the beneficial owners' full name, date of birth, nationality, country or state of usual residence, residential address, service address, date on which they acquired the beneficial interest in the company, and details of that beneficial interest and how it is held. • Beneficial owners will be required to inform the company of any changes to the information recorded in the register of beneficial owners. • Issuance of new bearer shares is prohibited as is also the use of corporate directors prohibited.
United States	Securities and Exchange Commission	• Require filing with the SEC under Schedule 13 D pursuant to the Securities and Exchange Act of 1934; filings with the SEC will be provided to the company and the issuer's exchange. • When a person or group of persons acquires beneficial ownership of more than 5% of a voting class of a company's equity securities registered under Section 12 of the Securities Exchange Act of 1934, they are required to file a Schedule 13D with the SEC within 10 days of achieving the 5% level. • Information required is similar to that required in the United Kingdom (see above). • Since the introduction of the new regulations, the SEC has reviewed companies on compliance with the regulations—34 companies had been charged with noncompliance as of September 2014.
Other	G-8 Action Plan	Other G-8 implementing countries are France, Germany, Italy, Japan, and Russia. In May 2015, the EU required its member states to establish a beneficial ownership registry by 2016.

Source: Molyneux, 2016.

Box B.25: Example: Extractive Industries Transparency Initiative

In many cases, the identity of the real owners—the "beneficial owners"—of the companies that have acquired rights to extract oil, gas and minerals is unknown, often hidden behind a chain of corporate entities. This opacity can contribute to corruption, money laundering and tax evasion in the extractive sector.

Eleven EITI countries, **Burkina Faso**, **the Democratic Republic of Congo**, **Honduras**, **Kyrgyz Republic**, **Liberia**, **Niger**, **Nigeria, Tajikistan**, **Tanzania**, **Togo and Zambia**, are now taking part in the pilot and will disclose the identity of the real owners behind the extractive companies operating in their countries. **Mongolia**, **Myanmar**, **Norway**, **the Philippines**, **Sierra Leone**, and the **United Kingdom** have also expressed an interest and are undertaking work on beneficial ownership.

Source: (EITI 2016).

fines and imprisonment, or the matter may be brought before the High Court, depending on the breach.

Private enforcement by one or more shareholders through derivative suits is less likely, as such suits have high litigation costs, involve great uncertainty, and are based on minority shareholders' access to beneficial ownership information.

Increasingly, IOSCO, as the global securities market regulator, calls for national securities regulators and other enforcement bodies to cooperate in this area. IOSCO has established memorandums of understanding for exchange of information and support.

The challenge, not yet fully resolved by disclosure requirements, is to find the right mix of national and international, public and private, formal and informal enforcement mechanisms in this area. This is a work in progress in the corporate governance spectrum.

B.5. Commitment to Corporate Governance Developments

One of the key tenets of the IFC Corporate Governance Methodology Framework is that companies and shareholders demonstrate their commitment to corporate governance and to implementing high-quality corporate governance policies and practices, beyond the minimum required in law or regulations. The levels of commitment to corporate governance in a company may vary from the most basic to rather advanced levels incorporating best practices.

In looking at and assessing the commitment of a company to corporate governance, it is not only about where the company is but also about the ways in which the company and its leadership may foster good corporate governance in company attitudes, practices, and personnel. This is a program to move corporate governance practices to a higher, better place.

According to the IFC Corporate Governance Progression Matrix (IFC 2016b),[28] commitment is normally demonstrated if particular policies and procedures are in place and operating in the company. These include the following:

- A comprehensive company charter or articles of association will include strong shareholder protection provisions and statements referring to the equitable treatment of shareholders. The charter will also make a clear distinction between the powers and authorities of the shareholders (especially at the AGM), the directors, and management or executive groups. The charter will also make a commitment to transparency of company governance and activities and to disclosure of information on these.
- The company has in place a written and published code of ethics or conduct approved by the board and also applicable to the board and all management.
- There is a designated company officer responsible for ensuring compliance with all laws and regulations and company corporate governance policies.
- The company will have a written and published code of corporate governance and an annual calendar of corporate events and will periodically check company compliance with its own corporate governance code and report this to shareholders.

In global best practices, commitment to corporate governance includes incorporating changing corporate governance best practices into the company code of corporate governance, ensuring quality financial reporting, accounting and auditing (internal audit and external audit), and comprehensive shareholder information and broad engagement practices.

The new interest in corporate governance commitment and culture stems from the realization that a flawed culture is

[28] The matrix is a part of the IFC Corporate Governance Methodology, adhered to by IFC itself for its investments and by many other development institutions.

a common factor in corporate disasters. The challenge is how to adapt board mandates and traditional corporate governance approaches to enable boards to articulate and embed strong values that shape behaviors throughout the company. Boards need to assure themselves that the values they want are the ones they actually have. Traditional governance does not address culture and is very process driven.

A new approach to corporate governance is required, one that recognizes the importance of values and culture in creating and preserving value. The actions of the board to ensure recognition of the value of corporate governance throughout the company—and the ways the board fosters and mobilizes corporate governance through tools, initiatives, and training—are becoming subject to scrutiny. Commitment to corporate governance is demonstrated through policies, processes, and actions to embed corporate governance in company activities and values—in its culture.

Culture is intangible, hard to measure, and different from country to country and from company to company. Yet it remains a foundation of good corporate governance and involves the board and management team in building and demonstrating it. A corporate governance culture includes norms, mores, traditions, rules, values, and standards of behavior—written and unwritten—for how a company and the individuals within it do business. A good corporate governance culture will have companies following good governance practices, not just to the letter but also in spirit. According to Grant Thornton, nine in ten business leaders believe culture is important to a robust governance framework, and directors generally agree that it is the board that needs to foster this culture (Grant Thornton 2015).

> The governance of individual companies depends crucially on culture. Unfortunately, we still see examples of governance failings. Boards have responsibility for shaping the culture, both within the boardroom and across the organisation as a whole, and that requires constant vigilance. This is not an easy task.
>
> (FRC 2015)

The U.K. Financial Reporting Council pledged to work in 2015 to develop best practices in corporate culture, behavior, values, and ethics and to provide assurance of that culture in the boardroom and throughout companies. The FRC has been monitoring explanations of deviations from the U.K. Code since 2012 and will continue to do so. It is expecting to continue to develop guidance in several areas to ensure that best practices—such as guidance on succession planning and the role of the nomination committee—are embedded in a company's corporate governance system.

Others too have expressed the desire to see corporate culture change to improve corporate governance and address better behavior and more targeted performance incentives for company individuals. The revised G20/OECD Principles provides guidance for stock exchanges, investors, and regulators in developing commitment to good corporate governance. Further, the ICGN, the Institute of Business Ethics, and the Institute of Chartered Secretaries developed a report on identifying indicators of corporate culture and for identifying warning signs of poor behavior (ICGN, IBE, ICSA 2015).

> Strengthening corporate culture is increasingly seen as a means of reducing risk, especially by regulators whose primary focus is to protect the market and the public from corporate "disasters."
>
> (ICGN, IBE, ICSA 2015)

The European Commission's recommendation on the quality of corporate governance reporting indicates that reporting on corporate governance should improve, especially when there is noncompliance with the relevant code under a comply-or-explain regime. Explanations should describe the manner of and reasons for departure, how the decision to depart from the code was taken, when the company envisages compliance with the code, and how it took other actions to meet compliance with the spirit of the code.

Increasingly, commitment to corporate governance development and a good corporate governance culture is observed and measured by a company's actions in setting

> The quality of explanations provided by companies when departing from corporate governance codes [is deficient]. In this respect, a large majority of respondents to the Green Paper were in favour of requiring companies to provide better quality explanations in case of departures.
>
> (European Commission 2014b)

high standards, actively promoting awareness of the importance to the company of good practices, openly assessing those practices (praising good practices and rooting out poor practices), and exhibiting strong leadership and courage in supporting best practices. This can be achieved in a variety of ways:

- Leadership efforts to set values and principles to underpin a corporate governance-aware culture. Leadership establishes the tone at the top, acts accordingly, and fosters a culture of responsibility, accountability, transparency, and fairness.
- Good corporate governance culture in an entity is set through ethical codes, policies, and practices, creating sound upward-feedback channels, applied consistently even through challenging times.
- Comprehensive and regular communication of expected values and behaviors.
- Periodic reviews of practices and the internal culture of the organization, including, but not limited to, the internal auditor.
- Regular corporate governance and board evaluation to ensure efficiency and effectiveness of board nomination and succession plans and corporate governance policies, leading to a program of related development initiatives, including an assessment of the robustness of discussion, debate, and deliberation in the boardroom.
- Ensuring that a complete corporate governance system is in place in the entity and operating in a holistic and linked manner.
- Ensuring and observing cohesion between the three key players in corporate governance—the shareholders, the board, and the executive—within an entity, including that shareholder engagement is constructive and productive and based on ongoing relationships.
- At a minimum, compliance with the applicable corporate governance code and stepping beyond this in corporate governance best-practice areas that are not regulated by code, such as increased board diversity, quality audit and risk oversight practices, comprehensive disclosures, and transparent remuneration practices.

B.6. Trends and Future Developments in Practices

Observers of corporate governance practices have identified the following trends and future developments:

- Increased boardroom diversity—including age, gender, ethnic, background, and experience—is recognized as valuable and is a focus for the future. Note that diversity includes gender but goes beyond it to include different approaches and perspectives, which together contribute to a robust board and a resilient company, capable of dealing with an increasingly complex environment.
- Expectations of increased performance and responsibilities will further challenge audit committees to devote more time to committee activities and to communicating with the internal auditor and external auditor.
- A global trend is to require some board evaluation, with the objective of leading to better practices and board succession planning. Some jurisdictions are expected to mandate board evaluation and/or reporting of board evaluations.
- Companies are expected to increase board knowledge, time and attention to effective risk oversight on an enterprise-wide basis, risk appetite, and the development of risk culture.
- The role of the internal auditor is changing from that of an internal reviewer/checker of the effectiveness of internal controls to that of a trusted adviser; internal auditors will increase their skills and experience to meet the demands of the new environment.
- Activities to support an increased focus on company sustainability will continue. That means the board needs a more holistic view that takes into account environmental, social, and economic issues in strategic ways.
- Demand for reporting on material nonfinancial company matters will continue to increase, and models for how to successfully report on these wider company matters will continue to develop and be applied.
- The new audit report style should lead to increased communication between the audit committee and the external auditor and should encourage better shareholder engagement with the board on audit matters.
- The effects of auditor rotation and of tendering of audits as now required are too new to show an impact.
- Regulations and practices regarding related-party transactions and transparency of beneficial owners are expected to develop further.
- There is an increasing focus on corporate culture and on development of indicators of good culture and warning signs of a poor culture that may lead to aberrant behavior.

Global Developments in Corporate Governance Codes

Corporate governance codes became commonplace in developed and emerging economies from 1992 to 2010, following publication of the Cadbury Report in 1992 and finalization of the first Combined Code on Corporate Governance for the United Kingdom in 1998. In 1999, the OECD issued a set of principles for OECD country application, which also have been more widely adopted.

During this time, several codes were issued and revised, sometimes more than once. The OECD Principles were revised in 2004 and again in 2015. The U.K. Combined Code was revised and reissued in 2003, 2010, and 2014. South Africa introduced its first corporate governance code, King I, and is now looking to introduce a fourth version of the code, King IV. Other countries in the developed markets and in the emerging economies have adopted and revised codes of corporate governance. There is much to learn from the experiences of countries as they strive for better corporate governance though codes.

Corporate governance codes of best practice are sets of nonbinding recommendations aimed at improving and guiding the governance practices of corporations within a country's specific legal environment and business context. These codes are typically based on principles and focus on country-specific issues. They can differ in their focus or scope and be more or less detailed. Whether intended to restore investor confidence or to support a better investment climate, codes of best practice have now been adopted in many countries as a way to introduce international standards and adapt them to the local environment.

(IFC/GCGF 2005)

C.1. Stocktaking of Key Issues for Corporate Governance Codes

Originally, corporate governance codes were developed as complementary to laws and regulations in the area of corporate governance. Codes were established and allowed to be applied in a flexible manner so as not to constrain companies in their freedom to realize strategies and create value. This flexibility, which became known as a comply-or-explain regime, allowed companies to comply with the code requirements in various ways, and if not, to explain why they had not applied the particular requirement—the most common approach.[29]

"As a rule, compliance with. . .codes is not mandated by law, but they are important tools for encouraging private sector commitment to good corporate governance. . . . To be effective, codes must reflect the level of best practices that can be handled and implemented by a country's companies, along with a certain level of measured aspirations toward high standards."

Ralitza Germanova, Corporate Governance Officer, IFC

Understanding of and approaches to codes differ according to the legal traditions and frameworks in which they are set. They also vary according to the perspectives, legal backgrounds, and assumptions that countries, companies, and individuals bring to corporate governance codes.

In a recent analysis (Berg 2015) of corporate governance codes applicable in all countries and a review of all types of companies, the World Bank found some 112 codes

[29] The comply-or-explain approach allows companies to comply with the corporate governance code or robustly explain why they have not complied and how they have met the goals of the principle. South Africa, on the other hand, requires the apply-and-explain approach, whereby companies must apply the code of corporate governance and explain how they do so—a major difference in approaches. In some countries, such as the United Kingdom and Malaysia, "stewardship codes" have been introduced, which aim to enhance the quality of engagement between asset owners, asset managers, and companies to help improve long-term risk-adjusted returns to shareholders. In the United Kingdom, the code sets out a number of areas of good practice to which the FRC believes institutional investors should aspire. It also describes steps that asset owners can take to protect and enhance the value that accrues to the ultimate beneficiary.

applying to listed companies. The analysis of these codes set out to ascertain the various approaches prior to considering the question: What does it mean for a code to work?

An initial challenge was to determine what could be considered a code. Could it be only those that called themselves a code, or should other instruments, which are not called codes but operate as a code, be included? For example, Clause 49 in India is the equivalent of a corporate governance code even though it is not termed a code, and it is included in the database.

Of the 112 codes, some 27 were purely voluntary with no link to regulatory frameworks, 8 were fully mandatory, and 7 countries appeared to have some level of mandatory provisions. All other codes in the database are variations on the comply-or-explain theme that companies and countries are trying to make work.

> *"In our experience, [some 'comply or explain' codes] do work in different settings, in Latin America with concentrated ownership, with family ownership. . . . What the paper is trying to do. . .is to look at some of the ways that securities regulators are working to make their 'comply or explain' codes work better."*
>
> *Alexander Berg, Senior Financial Sector Specialist, World Bank*

C.2. Regular Reviews of Codes and Frameworks

Since the financial crisis in 2008, a spate of code revisions has emerged to address perceived shortcomings in corporate governance. Codes have been and are being revised more regularly, following research, discussion, public consultations, and roundtables. Then changes are introduced after clearly delineating the issues. The website of the European Corporate Governance Institute (ECGI)[30] cites 14 code revisions since January 1, 2015. Table C.1 on page 66 provides examples of recent code development.

These code developments and the discussions about their development have informed our understanding of the place of corporate governance codes in encouraging better corporate governance practices. From the revisions, we can observe issues in code reviews. Consultation documents and field experience indicate that the revisions have been prompted by the following:

- Adjustments made to better balance the corporate governance requirements in law, regulation, and codes;
- Addressing perceived shortcomings of the comply-or-explain regime in some environments;
- Identification in local and in other jurisdictions of new and better practices that countries wish to introduce;
- Changes in laws and regulations affecting corporate governance code provisions, such as changes in EU laws and regulations requiring changes in member states' codes;
- Local issues arising from particular company problems or local demands;
- Necessity to address shortcomings observed in company responses to code provisions.

C.3. Mandating Corporate Governance: An Unfinished Debate

As the development of corporate governance codes has matured, much time has been devoted to discussion about distinguishing what should be placed in law or regulation and what should be in codes, which have more flexible options in application.

Many countries have recently revised company, securities, and banking laws and securities listing rules to address issues that had arisen in the particular jurisdiction. Their rationale for moving an item from a code to law or regulation is that it is a matter of importance that cannot be left to choice or interpretation and so should be mandatory. These issues are then removed from corporate governance codes. In general, new and higher standards have been set.

According to Stephen Bland of the BCBS Corporate Governance Task Force, Bank of England, new guidance on corporate governance from the Basel Committee aims at effectively dividing areas between where the BCBS thinks the board of directors needs to ensure things and other areas where it needs to oversee and be satisfied with. "Oversee and be satisfied with is a slightly higher test than oversee, which can imply just to look at," says Bland. "But oversee and be satisfied with is our minimum test."

Some jurisdictions have observed that the local environment is such that companies are not applying the principles established in codes, and legislators and regulators believe they will do so only if the matter is legislated or regulated. However, finding the balance and appropriate mix of law and regulation and "soft law" or code application is challenging.

[30] The ECGI, an international scientific nonprofit association, provides a forum for debate and dialogue between academics, legislators, and practitioners, focusing on major corporate governance issues and thereby promoting best practice. Its primary role is to undertake, commission, and disseminate research on corporate governance. Information on ECGI work may be found at www.ecgi.org.

> Codes are typically 'soft law'—companies are not required to implement the rules, but are required to disclose to the market when they do not do so (the so-called 'comply or explain' approach). This approach has a number of benefits in terms of flexibility for listed companies, in that it allows and encourages an appropriate balance for different types of companies.
>
> (Berg 2015)

It is difficult to distinguish what should be in a code from what should be in law. There are some areas where the matter clearly should be in law or regulation. For example, the requirement to have accounts audited or that an auditor must be appointed or that notices for the AGM must go out by a certain number of days prior to the AGM are issues almost always placed in law or regulation. These matters have to be complied with in all circumstances.

However, that the roles of chairperson and CEO should be separated is likely to be in a code, because there may be circumstances where separation is not possible or not desirable, such as when a CEO departs or there is a crisis. There are other similar issues. For example, whether—and the conditions under which—boards should establish board-level risk committees needs to be flexible. Similarly, the principle that a chief executive should not go on to become chairperson of the same company is a good one, but it may not always be right in practice.

Table C.1: Code Revisions

Country / Economy / Organization	Date	Nature of Activity
OECD – CG Principles	Sept. 2015	Revised and reissued
OECD – SOE Guidelines	Sept. 2015	Revised and reissued
ICGN – CG Principles	Oct. 2014	Revised and reissued
Australia	Mar. 2014	Recommendations revised
Brazil	Nov. 2015	IBGC Brazilian Code revised (5th edition)
Bulgaria	Feb. 2012	Revised and reissued
Canada	Jan. 2013	Guideline reissued
Denmark	Nov. 2014	Recommendations revised
France	June 2013	Listed entities code reissued
Germany	June 2014	Code amended
Hong Kong SAR, China	Dec. 2014	Revised code
Italy	July 2014	Code revised and reissued
Japan	June 2015	First code introduced
Kenya	May 2016	Code revised and gazetted
Netherlands	May 2015	Revision announced
Norway	Oct. 2014	Code revised and reissued
Singapore	May 2012	Code revised and reissued
South Africa	Jan. 2016	Code revision ongoing
Spain	Feb. 2015	Code revised and reissued
Sri Lanka	Sept. 2013	Code revised and reissued
Sweden	Sept. 2015	Draft revised code issued
Switzerland	Sept. 2014	Code revised and reissued
Turkey	Jan. 2014	Code revised and reissued
United Kingdom	Sept. 2014	Code revised and reissued

Source: Based on information available at www.ecgi.org.

"I think what is suitable for a code is behaviour where you are looking for a gradual change over time, an innovation. I will give an example. Board evaluation came into the UK CG Code gradually and the result was that over time we have seen the beginnings of an industry that is able to evaluate boards. . . . It is not possible to suddenly say all boards should be evaluated by an external evaluator because there may be nobody to do it. Through the code process you can guide and steer practices."

Peter Montagnon, IFC Corporate Governance Private Sector Advisory Group and Associate Director, Institute of Business Ethics, United Kingdom

C.3.1. Example: Audit Committees

Various commissions and inquiries (such as the 1999 Blue Ribbon Commission and the Sarbanes-Oxley Act of 2002 in the United States and the 2004 Higgs review in the United Kingdom)—often held after fraud cases such as Polly Peck, Enron, Royal Ahold, and Parmalat—expanded the expectations of the audit committee. Now having an audit committee is a widespread and accepted practice. Audit committees are mandated through laws and regulations in many jurisdictions. According to the OECD, more than two-thirds of jurisdictions require listed companies to establish an independent audit committee, and a full or majority independence requirement is common (OECD 2015b).

"The notion of audit committees is not new and was introduced into a code first and then into several other national codes until audit committees became a commonplace mechanism of corporate governance, now often required in law. Especially in the last quarter of the 20th century, audit committees came to an understanding of their role and developed expertise for that role."

Anne Molyneux, ICGN Board

Increasingly, the relevance of a code-based, comply-or-explain approach to markets where there is a high level of family ownership will be reviewed. Codes are relevant and useful in dispersed-ownership markets, but experience shows they do not work so well elsewhere (see the discussion below on the Jordan and Turkey experiences). Code content needs to be adapted to suit the ownership circumstances and to include more focus on the risk that shareholders will be expropriated by the controlling shareholder rather than being expropriated by the management. The principal/agent problem is different. In particular, it is an issue when family groups or governments spin off subsidiaries to avoid transparency and to avoid relinquishing ultimate control. The corporate governance community is aware of these issues, which are reflected in the following discussion, yet it remains without comprehensive solutions.

C.3.2. Jordanian Securities Commission: A Regulator's View

For many years, Jordan has been on a program of capital market reforms, heightened in recent times, especially since 1997, under a restructuring process. The corporate governance changes commenced with the issuance of a 2004 corporate governance Report on the Observance of Standards and Codes (ROSC) based on the OECD Principles. In response to the ROSC recommendations, the Amman Stock Exchange introduced a code of corporate governance that contained both mandatory and voluntary provisions. Mandatory provisions were based on laws and regulations. The voluntary provisions were based on international practices and international standards. The voluntary implementation used the comply-or-explain approach to allow flexibility and to familiarize companies and their management with the new rules of corporate governance and create a culture of corporate governance in the market, since this concept was new.

Lessons learned from implementation demonstrated to capital market regulators the reluctance of companies to apply better practices. The regulators concluded that change to a mandatory approach was necessary, because the Jordanian corporate governance culture is still emerging. Resistance came from family-dominated companies, particularly with regard to cumulative voting rights, related-party transactions, the separation of the chair and CEO roles, and board committees. Jordanian companies do not want outsiders on the board or mechanisms that may touch benefits from the company.

The Jordanian Securities Commission has tried many ways to build understanding of the value of corporate governance, including in family-owned companies. For instance, the JSC held educational workshops and seminars on the benefits of corporate governance and to build awareness of the code and its provisions. These initiatives met with resistance. The JSC instituted a scorecard system especially for banks to increase awareness of corporate governance provisions, rules, and practices and to assess the level of corporate governance implementation in the banking sector, but family-dominated banks still resist. In 2014, the Central Bank of Jordan issued a mandatory code of corporate governance.

The JSC established an independent unit to follow up companies' implementation of and compliance with corporate governance provisions. One of the main challenges the Jordan Securities Commission faced concerned voluntary rules. The commission does not have the power of law to enforce compliance or sanction noncompliance. The JSC dealt with this by making amendments to the law. Even so, some companies resisting the introduction of corporate governance code provisions argue that they contradict Company Law. These alleged contradictions are currently under review, with a recommendation to enhance the powers of the JSC for corporate governance development, monitoring, and enforcement. The goal is to make application of corporate governance codes provisions mandatory.

The experience in Jordan indicates that guidance, encouragement toward good practices, and a voluntary code is sometimes insufficient. It does appear that there is more work to be done to develop awareness of the benefits of corporate governance and implementation of corporate governance codes in Jordan.

"Our mechanism will move to mandatory [code application]. We realized that companies will not comply unless you have mandatory power and you have to oblige these companies and impose sanctions on noncompliance. Less than 50% actually of companies complied with the [voluntary] provisions of the code."

Mazen Wathaifi, Commissioner, Jordanian Securities Commission

C.3.3. Turkey: Use of Scorecards to Encourage Implementation

In Turkey, many elements of good corporate governance have been made mandatory, but Turkey is finding that even this is not enough, as implementation of the nonmandatory principles is still an issue. Most of the time, the substance of a company's disclosure—on how to address these principles that the company has failed to implement—is unsatisfactory and repetitive. A scorecard may be required to encourage better corporate governance culture for the publicly traded companies.

The code in Turkey has both mandatory and nonmandatory rules. Most mandatory rules in Turkey are about board disclosure requirements and general assemblies. The code states the minimum number of independent board members, the number of committees, and which committees are mandatory. Also in the code is Turkey's definition of an independent director, which must be applied.

"Currently in Turkey, we're debating the effectiveness of that because it [mandatory regulation] doesn't talk much about the effectiveness of executive relationships, such as the quality of the board meetings and the independent board members. The regulation doesn't say anything about those, so we were thinking the scorecard can be the solution. Of course, this only applies to the publicly traded companies where we can demand more information for the interests of shareholders."

Basak Mustu, Corporate Governance Association, Turkey

Turkey has a similar problem as Jordan with resistance of family-owned companies to implementing good corporate governance practices. Recent research on corporate governance in family businesses found that about 80 percent understand the advantages of corporate governance but believe that it is not mandatory for them, or does not constitute an urgency for the company in the short term. They do understand the use of corporate governance and that it is good for the company and improves decision making. However, half did not comply with the requirement to have an independent director. Generally, they remain reluctant to share power, have no family constitution, and have not considered how the company will pass to the next generation.

A United Kingdom View

Some jurisdictions have the luxury to assume deep knowledge of and commitment to corporate governance by both companies and regulators. They also operate in a market that has dispersed shareholders and is structured differently from many emerging markets. The United Kingdom is one with a diversified share ownership and with a longevity in the benefits of corporate governance. However, the

"We had the same example in Germany [as in Turkey and Jordan] where we had items that were very important. We tried to solve them via the code, via comply or explain. Companies just didn't comply satisfactorily and the issues were legislated. That's a missed opportunity for many important governance items where, in most countries, to get a law passed takes a long time. So legislating isn't the preferred way but if companies don't want to listen, that's what they get."

Christian Strenger, Deputy Chairman, IFC Corporate Governance Private Sector Advisory Group and Academic Director, Centre for Corporate Governance, HHL Leipzig

situation with Jordan and Turkey suggests that in corporate governance one size does not fit all, especially in the presence of family-owned companies and/or where there are controlling shareholders.

A View from Germany

Not all developed economies have a favorable environment for a comply-or-explain approach to codes. If elements of the market such as family companies do not want to listen, then maybe a mandatory approach is the way, at least for important items.

C.3.4. West Bank and Gaza: A Nonmandatory Approach

The corporate governance code of West Bank and Gaza was introduced in 2009 and is a hybrid code composed of both mandatory and voluntary rules. The mandatory rules in the code are already stated in other laws and regulations. Local regulators believe it is very difficult to move to a fully mandatory code, as there is concern regarding how the application of the code should be monitored and by whom. Corporate governance is seen as a competitive advantage to companies that apply the code well. If the code is made mandatory, this capacity for a competitive edge is removed.

> *"As a regulator, there is the reputational risk of monitoring many corporate governance issues, some mandatory and some voluntary, and there is the practical problem of enforcement. I think it's better to leave room for competition between companies to develop best practices in corporate governance in their companies."*
>
> *Bashar Abu Zarour, Director, Research and Development, Palestine Capital Markets Authority*

C.3.5. Kazakhstan: A Sovereign Wealth Fund View of "Comply or Explain"

Samruk-Kazyna (SK), the sovereign wealth fund of Kazakhstan, was created in 2006 to improve the efficiency and effectiveness of industrial state-owned companies, mostly oil and gas companies, and companies in transportation, communications, electricity production and distribution, mining, and chemicals. The SK group included 593 companies in 2014, according to the annual report for that year. SK has its own law, "On National Wealth Fund," applicable to it and its group (KazTransGas Aimak 2015).

The prime minister chairs the board of SK, and 40 percent of its members are independent. The boards of SK portfolio companies comprise independent directors (the new corporate governance code recommends up to 50 percent) and representatives of shareholders. The changes in corporate governance approaches in SK are a part of a national program to become one of the top 30 developed nations of the world by 2050, an ambitious transformation program of SK, launched by the president of the country on October 6, 2014.

In 2014, SK, with assistance from the OECD, developed a corporate governance code that applies to SK and to the companies where SK has more than 50 percent interest, directly or indirectly. The code consists of seven chapters and two parts: Main Principles and Annotations—rules and provisions that will force implementation of the code. The code includes chapters devoted to 1) interaction between SK and the government as shareholder of SK; 2) clarification of the relationships between SK and its portfolio companies; 3) sustainable development; 4) shareholders' rights; 5) board and executive management effectiveness; 6) risk management, internal control, and audit; and 7) transparency. Since government is the sole shareholder of SK, the code made clear the relationships with the government, between the government and the board, and between the board and Samruk-Kazyna. It also clarified the director nomination process for the board of directors and for CEOs of portfolio companies.

> *"We had discussions about comply or explain. Our normal practice is to put compulsory items in legislation. We decided to use the comply or explain approach in the code. The code was approved by the government in April 2015."*
>
> *Salamat Kussainova, Director, Corporate Governance, SWF Samruk-Kazyna*

SK is a member of the International Forum of Sovereign Wealth Funds, which has agreed that its members will apply the Santiago Principals of governance, issued in 2008, in the way they operate as an institutional investor. Therefore, when drafting a corporate governance code, Samruk-Kazyna had to ensure the code's alignment and compliance with the Santiago Principles.

C.4. Diverse Approaches: Is "Comply or Explain" Appropriate?

Discussion on the effectiveness of the comply-or-explain model for corporate governance codes commenced in 2008, and in 2009, Riskmetrics published a report indicating its appropriateness. Yet the debate continues. In the discussions for the development of the Shareholder Rights

Directive in the EU, the effectiveness or otherwise of the comply-or-explain model for corporate governance application within Europe received much attention (EU 2014).[31]

> Companies often do not provide adequate explanations. This makes it difficult for investors to make informed investment decisions.
>
> (European Commission 2014d)

Despite gradual improvement in the way companies in EU member states apply corporate governance codes, perceived shortcomings persist in the application of the comply-or-explain principle. Some observers see it as ineffective because of the poor quality of explanations and because it provides a rather soft option, which proved in the financial crisis that it could not be trusted.

One result of this ineffectiveness was a demand for more prescriptive regulation. Directive 2013/34, the Accounting Directive, included such regulation. It prescribes the format for disclosure for big companies, listed or nonlisted. However, the debate also led to an expectation that the comply-or-explain regime will be the subject of guidance to improve the quality of explanations, especially ones related to deviations. It is expected that explanations will be sufficiently informative and clear and should do the following:

- Explain the manner in which the company deviates;
- Describe the reasons;
- Describe the decision process;
- Specify the timing; and
- Describe the measure taken instead of compliance.

In Europe, member states must define their corporate governance monitoring systems to ensure adequate code adherence and explanations. Several EU member states have revised their corporate governance codes and/or issued guidance on how to apply a comply-or-explain regime well and are monitoring code application.

> *"The comply or explain practice accommodates the wide diversity of business models operating across the many legal jurisdictions that make up the European Union."*
>
> *Patrick Zurstrassen, IFC Corporate Governance Private Sector Advisory Group and Honorary Chair, ecoDa*

For example, Portugal revised the mandatory Corporate Governance Code in 2013, and the new regulation emphasized the importance of comply-or-explain provisions. However, the CMVM[32] reports that in 2011 only "53% of the non-compliance with the 'comply or explain' rules is explained by the company and accepted by the CMVM" (Glass Lewis 2013). The new regulation brings the comply-or-explain provision to the forefront, outlining an acceptable explanation and level of compliance.

The Netherlands has established a corporate governance code monitoring committee and in 2013 for the first time reported on compliance with the Dutch corporate governance code and on the quality of explanations for deviations from the code where given.

In February 2012, the Financial Reporting Council in the United Kingdom issued a guidance paper, "What Constitutes an Explanation Under 'Comply or Explain,'" which is the subject of monitoring in 2015.

> *"I would like to remind both companies and investors that simply complying without giving due consideration to what is appropriate and relevant reduces the flexibility that this approach aims to achieve. To this end, further work will be conducted during the rest of this year to monitor companies' explanations when they are not compliant with the Code."*
>
> *Win Bischoff, FRC UK Chairman (at the Grant Thornton Governance Dinner, May 1, 2015)*

The message is that explanations need to be more robust and will be subject to scrutiny in the future. Despite all the discussion on the comply-or-explain regime, it will continue in its current state. While most countries have adopted the comply-or-explain approach to corporate governance codes, its true meaning has been diversely interpreted. Which is the "right" or most effective approach? Practice suggests there is no one right way to implement or apply codes of corporate governance.

Countries and companies may have been under a misapprehension regarding comply or explain. It really means to comply with a code and apply its principles or to explain why the principle has not been applied. Yet the debate over the right approach to comply or explain has persisted.

The Dutch in the Tabaksblat Report moved on to an

[31] Directive 2013/34/EU requires that annual financial statements and related reports include a corporate governance statement that refers to the corporate governance code applied and provides an explanation of which parts of the code the entity departs from and the reason for doing so.

[32] The CMVM is the Portuguese Securities Market Regulator. For more information, see www.cmvm.pt.

apply-or-explain approach, and King III in South Africa followed the Dutch tradition to ensure clarity on the need to apply the principles of the codes. The United States has gone rather further into a comply-or-else approach by introducing legislation and regulation for key corporate governance areas; the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 have regulated many corporate governance practices and disclosures. In Germany, company law requires an annual statement of compliance with the German corporate governance code.

Throughout the United Kingdom and Europe, there has been intense debate on the effectiveness of the widely used comply-or-explain regime for code application.[33] In particular, the EU wants a set of regulations that uniformly regulates company law and corporate governance at the supranational level, a goal at odds with a code allowing flexibility of application. ecoDa (the European Confederation of Director Associations) recognizes the importance of corporate governance and of the comply-or-explain mechanism to promote good governance and published in 2015 its report on practices in the EU under comply or explain (ecoDa/Mazars 2015). Box C.1 provides excerpts from the report.

Box C.1: Excerpts from the ecoDa/Mazars Report

Although adaptations to code requirements might have taken longer than anticipated to occur, there seems to be a clear trend throughout Europe that compliance is increasing, be it at a different degree from one Member State to another, with overall a significant difference between the larger companies that lead the pack and the small and mid cap listed companies.

We fully agree with the statement of the EC that more attention should be given to the promotion of high quality explanations as a critical success factor for an effective self-regulatory regime.

Source: (ecoDa/Mazars 2015).

Applying the comply-or-explain principle poses some questions and presents some difficulties in achieving harmonization, as there may be diverse code provisions at a national level, application may be voluntary, and provisions may not be explicit as to how to apply the provisions. Also, monitoring and enforcement of code application is varied. Further, explanations when provided have been of a range of quality, depending on the level of company commitment to corporate governance transparency.

Recent diagnostic work and discussions with client country counterparts indicate that there is considerable dissatisfaction with the practical implementation of corporate governance codes in many countries, and significant experimentation by securities regulators around the world who are working to improve the quality of code implementation.

(Berg 2015).

C.5. Code Principles, Practices, and Effectiveness

The debate on how to achieve an outcome of better and more effective corporate governance continues. Some recommend that codes not become too detailed or complex and remain at the principle level, allowing for diverse company and country approaches. Others suggest that more code provisions should be included in regulations to ensure application and that more guidance to support application is required. Still others question the validity of a comply-or-explain-style code in the presence of controlling shareholders.

"The principles should almost be motherhood and apple pie statements. . . . The principle is so obvious and must be followed. . . . Then. . .an organization [must] explain how you are applying the principle."

Chris Pierce, Global Governance Services

A principle might be that the responsibilities and accountabilities within the organization should be disclosed. If then this is the nature of the principle, the guidance will mention documents referring to it, such as the articles and memorandum of association and the board charter, and these documents should be disclosed. An organization chart would also be required.

In developed markets, it is often acceptable to apply principles, as opposed to more detailed rules in codes. However, some practitioners with emerging-market experience report

[33] This has been the subject of several papers, including EU research into how EU member states apply the comply-or-explain concept, resulting in the EU recommendation on the quality of corporate governance reporting, Recommendation 2014/208/EU, FRC UK, Comply or Explain. Also, an essay for the 20th anniversary of the U.K. Combined Code, 2012, and an ICAEW article ask, "When is comply or explain the right approach?"

that using principles instead of detailed rules is not always a successful approach.

> *"Emerging markets need guidelines for applying the principles. . . . I think to update them and to make them really future proof, you need guidance."*
>
> *Christian Strenger, Deputy Chairman, IFC Corporate Governance Private Sector Advisory Group*

Below are some examples of different experiences with the comply-or-explain concept in practice.

C.5.1. Kenya: Law and Regulation versus Code under Comply or Explain

It is helpful to learn from the experience of Kenya in its comply-or-explain debate. The Capital Markets Authority, established in 1989, had led many corporate governance initiatives, one of which included the introduction in 2002 of corporate governance guidelines similar to a code. Recent activities show that Kenya is distinguishing between elements that should be in law or regulations and other matters to be placed in a code.

Between 2012 and 2014, Kenya moved toward putting in place a corporate governance code with World Bank and IFC support. The code was finalized in April 2016. In the process, Kenya realized that it did not want to put all the corporate governance requirements on an apply-or-explain basis. Code provisions of high importance were put into corporate governance regulations. The code will be on an apply-or-explain basis, and essential provisions will be in the public offers and listing regulations on a mandatory basis. Kenya wishes to move corporate governance from box-ticking to effectiveness.

> *"One of the recommendations in the corporate governance code is the need for institutional investors to actively participate in management. The code calls for the establishment of a stewardship code for institutional investors—that is work in progress."*
>
> *Hillary Cheruiyot, Legal Officer, Capital Markets Authority, Kenya*

C.5.2. South Africa: Principles versus Practices

The South African King III Code current principles include that the board should consist of a majority of non-executive directors, a majority of whom are independent. This is not really a higher-level principle but rather a detailed practice. The real goal is to achieve a balanced and effective board—the higher-level principle. In reality, adherence to the stated practice in King III regarding independent directors may result in a majority of independent directors who are not able to challenge management effectively. Industry knowledge is sometimes sacrificed in the name of independence; therefore, independent directors may not have sufficient knowledge of the business. This is not a desirable outcome, but it would fulfill the code requirements—a box-ticking exercise. South Africa in drafting King IV wishes to move on to a code based on principles and outcomes and less focused on practices.

> *"Differentiating very clearly between what is a principle and what is a practice can actually help us be rid of the mind-set of box ticking in corporate governance. At the moment we implement the practices and say we have good corporate governance. If you have principles that are setting out objectives to achieve sound corporate governance in place, then it is not about input (practices implemented). It is rather about whether the objective and desired outcome has been achieved."*
>
> *Ansie Ramalho, King IV Project Lead, Institute of Directors in Southern Africa*

C.5.3. Comply or Explain in the Presence of Controlling Shareholders

It also is useful to think of the practicality of comply or explain where you have controlling shareholders. Its effectiveness in markets where controlling shareholders prevail is limited by the very power of controlling shareholders in the company.

C.6. Different Types of Codes versus a Standardized Approach

As codes have come into wider use, diverse code types have blossomed. There are now codes for listed entities, for banks and financial institutions, for family-owned companies (listed and unlisted), for small businesses, and for state-owned enterprises. Each of the codes in Table C.2 has a particular subset focus.

Given the breadth of entities that corporate governance codes may apply to, it is not surprising that there would be interest in achieving some uniformity or standardization of codes. Recently, a few countries have looked into developing one code that is applicable to a variety of companies (listed, unlisted, banks and financial institutions, small, family-owned, or state-owned). For example, Mauritius and Nigeria have been attempting to bring some standardization to codes and corporate governance application across diverse types of companies and sectors. Such an approach presents challenges, as discussed below.

Table C.2: Codes with a Subset Focus

Country / Organization	Date	Nature of Code
OECD	2015	SOE Guidelines
Basel Committee	2015	Corporate Governance Guidance for Banks and Financial Institutions
Global organization	2012	Practice of Corporate Governance in Microfinance Institutions
Australia	2013	Corporate Governance Guidance for Charities
Brazil	2014	Good Practices for Closed Societies
Brazil	2015	Corporate Governance Guide for Cooperatives
Baltic States	2010	Corporate Governance Guidance for Government-Owned Enterprises
Colombia	2009	Corporate Governance Guide for Closed Societies and Family Companies
France	2009	Corporate Governance Code for SMEs
Ireland	2013	Corporate Governance Code for Credit Institutions and Insurance Undertakings
Nigeria	2014	Corporate Governance Code for Banks and Discount Houses
United Arab Emirates	2011	Corporate Governance Code for SMEs

Source: Molyneux, 2016.

"Principles are regarded as being of a higher order than practices. All public interest enterprises (PIEs) in Mauritius will be required to apply all of the principles contained in the Code and to explain in their annual reports how these principles have been applied."

Chris Pierce,
Global Governance Services

Example: Mauritius Experience

The Code of Corporate Governance of Mauritius, proposed in 2015, is believed to be the first code that takes a new approach to corporate governance. It has an emphasis on corporate governance principles that can be applied by a wide variety of entities and clearly distinguishes principles from practices.

In short, this is an apply-and-explain approach to a corporate governance code, which has standardized the corporate governance principles to be applied to several categories of companies in Mauritius. The principles of the code must be applied by all entities that come under the following definitions: companies listed on the Stock Exchange of Mauritius, banks and nonbank financial institutions, large public companies, state-owned enterprises, and large private companies. All other companies should give due consideration to the principles of the code and disclose in their annual reports the extent to which they have applied the principles.

The benefits of this approach are that it is believed to be easier to understand and simpler in style. The apply-and-explain approach allows for flexibility of application in diverse company circumstances. By focusing on principles, the code can be more concise and succinct.[34] However, for those entities requiring some guidance or support for code explanation or implementation, this may yet prove challenging.

C.7. Code Application Monitoring, Enforcement, and Scorecards

In general, some monitoring of corporate governance codes has emerged. Recent OECD research (OECD 2013a; OECD 2014a) into monitoring and enforcement arrangements for corporate governance—especially in listed entities, across 27 jurisdictions participating in the OECD corporate governance committee—illustrates this point.

It is important to note that those issuers of national

[34] The draft Mauritian Code is available at http://tinyurl.com/nhw3c42.

At least 29 institutions in 24 jurisdictions issue a national report reviewing adherence to the corporate governance code by listed companies in the domestic market. National regulators review and publish such reports in 10 jurisdictions, 8 of which review and publish the report regularly, at least annually or once in two years. Approximately half of the jurisdictions adopting the 'comply or explain' system have established a formal mechanism under which national authorities regularly analyse and report regarding listed companies' disclosures on adherence to the code.

(OECD 2015b)

corporate governance reports may be public institutions, including regulators, or other private institutions. Nineteen jurisdictions have national regulators that monitor and report on their activities with regard to corporate governance. France, Hong Kong SAR, China, Italy, the Netherlands, Singapore, Sweden, and the United Kingdom are some of the countries and economies that regularly review and report on corporate governance code adherence.

However, the coverage and frequency of monitoring reports varies significantly across jurisdictions. Experience of the World Bank in emerging markets, especially through its ROSC program, finds that monitoring and enforcement of corporate governance and corporate governance disclosures is less than in the developed countries.

Some countries and regions are trying to enforce codes and code requirements through the use of questionnaires, scorecards, awards, and other mechanisms. There are several steps to successful monitoring and enforcement. Below are some examples of "a start."

"Many regulators, especially low capacity regulators, don't really enforce corporate governance code requirements and because it's not enforced, attempts by companies to understand and be aware of good practices are diminished. Requirements to comply or explain will encourage companies to at least make the initial disclosure, even if that disclosure is not very good, even if the comply or explain statement is not very appropriate. It's a start."

Kiril Nejkov, Corporate Governance Officer, IFC

Example: Latin America

In Latin America, the use of questionnaires provides a basis for monitoring and enforcement. Requiring companies to complete a questionnaire—rather than making a single statement—about compliance encourages companies to think; it encourages them to take note of specific provisions where they may not be in compliance. In Colombia, companies produce a report based on their code disclosure statements. It shows what's working and what's not working and provides good and useful information for regulators.

"IFC has been successfully instrumental in incentivising corporate governance change through the development and application of national scorecard assessments of corporate governance code application."

Ralitza Germanova, Corporate Governance Officer, IFC

IFC has delivered several programs related to implementation of corporate governance codes and scorecards to assess implementation. Scorecards are a way to encourage compliance, assessing companies' governance practices and providing opportunities for systematic improvement. In 2005, IFC published a toolkit that sets out a step-by-step approach to develop, implement, and review a corporate governance code. A supplement on building scorecards was published in 2014.[35] IFC has undertaken 15 scorecards since 2008 and supported 45 code development projects out of 95 codes, laws, and regulations developed with IFC support in 30 countries.

"In Vietnam, IFC provided technical support to three corporate governance scorecards between 2009 to 2012, which assessed corporate governance in listed companies. The scorecard reports led to reviews of legislation and regulations related to corporate governance, amendments in 2012 to the corporate governance code, and to disclosure rules. Scorecards are a most effective tool to promote change."

Anne Molyneux, ICGN Board

Example: The ASEAN Regional Corporate Governance Scorecard

The ASEAN corporate governance scorecard is a joint initiative of the ASEAN Capital Markets Forum and the Asian Development Bank. It covers the five areas of the

[35] IFC work on Corporate Governance Scorecards, including a toolkit and a supplement is available at: http://tinyurl.com/zmffzw5.

OECD 2004 Principles. Six countries—Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam—participate in this initiative. The corporate governance scorecard provides a common benchmark on the corporate governance practices within the ASEAN region and allows country-to-country comparability. Most countries have shown improvement in corporate governance practices over the period.

To date, there has been healthy transparency and a little international competition in corporate governance improvement. As of 2015, the plan was to publish the 50 ASEAN listed companies with the best corporate governance scores. Scorecards throughout Asia have been a positive impetus for corporate governance change. National scorecards, the forerunners of the ASEAN scorecard, were successful in achieving change in the corporate governance regulatory frameworks and in getting corporate governance on the companies' agendas. However, the reaction to the scorecard system in ASEAN is not all positive.

> *"Some companies complain that the requirements of the ACGS [ASEAN scorecard] are more than what is currently required by the rules, laws, or regulations of the Philippines. So they say they have difficulty complying and sometimes they feel that it is impossible for them to comply with the best practices espoused by the scorecard. The most challenging philosophy for companies to understand is that corporate governance requirements really would go beyond the requirements of national legislation."*
>
> *R. C. Austria, Securities Counsel, Corporate Governance Division, Securities Commission, the Philippines*

C.7.1. Code Monitoring

It is important to take into consideration the possible negative aspects of reporting on the outcomes of corporate governance monitoring and enforcement activities. For instance, regulators may report that corporate governance in a particular company is "good," and then that company rated with "good corporate governance" may have a major and public corporate governance failure. This then could lead to considerable reputational risk for the assessing institution, particularly if it is a regulator.

> *"Many countries find it difficult for a securities regulator, both legally and culturally, to intervene in a company, to interview them on CG matters. In Indonesia for example, the securities regulator inspects companies—approximately one-third of the listed companies every year. Most countries' regulators do not have that power, intention or level of resources to undertake that kind of active investigation."*
>
> *Alexander Berg, Senior Financial Sector Specialist, World Bank*

In general, monitoring and enforcing corporate governance is difficult (OECD 2013a)[36] and is likely to remain so, because so many corporate governance practices are internal to the company and are therefore unobservable externally or verifiable from disclosure regimes. Many of those who monitor corporate governance do not have the capacity, time, or resources—and sometimes the right, as exists for banking regulators—to go into a company, develop relationships with company directors, observe board workings, and inspect the actual working of corporate governance within that company. To verify the application of comply-or-explain codes remains a problem. Lack of priority for monitoring and enforcement of corporate governance is explained thus:

- Some countries do not have a designated public authority for corporate governance oversight as exists in the Financial Reporting Council in the United Kingdom.
- In emerging markets, there appear to be challenges in funding corporate governance monitoring and enforcement, either by public or private institutions. It is an expensive business to produce a report. Not all countries can afford to do so.
- In monitoring and enforcing corporate governance code practices, regulators may face reputational risks as well as resource constraints.

On the positive side, monitoring and enforcement—as seen through the use of scorecards—have led to the following:

- Heightened awareness and greater visibility of provisions and better practices;
- Greater investor insight into corporate governance in potential investees and investee countries;
- A systematic way to review corporate governance developments within companies and countries and across regions;

[36] The OECD review finds that a lack of independence and/or resources constrains the ability of many securities regulators to supervise and enforce corporate governance standards.

- More integration and harmonization of laws, regulations, and codes for better corporate governance implementation;
- Companies motivated to enhance their corporate governance practices beyond the minimal requirements of laws and regulations;
- Engagement of shareholders and stakeholders in the corporate governance debate through roundtables and discussions on the results; and
- Assessment of corporate governance progress year to year.

C.7.2. Code Reviewing

In the absence of consensus on how to effectively monitor and enforce corporate governance code application, some countries are reviewing what should be mandated in law or regulation. Important elements are being moved to law or regulation. Some countries are moving away from the comply-or-explain regime completely. Others are moving the other way.

Example: Mexico

Mexico is one of a few countries that actually completely got rid of its comply-or-explain code, because it moved so many provisions into a Company Law in 2008 and considered the code in its old form as no longer necessary. This may be a false choice, as codes exist because you cannot always mandate all corporate governance provisions.

Example: The Philippines

The Philippines is set to come out with a new code of corporate governance by 2016 wherein it will shift to the comply-or-explain approach entirely. At present the code is composed of both mandatory provisions and voluntary, advisory, or directory provisions.

No one approach is deemed appropriate for all environments, and debates still continue on the efficacy of the comply-or-explain regime. Whatever the approach, the key is that it be monitored and publicly reported to encourage corporate governance development and to ensure that the philosophy of the corporate governance framework is adhered to.

C.8. Integration of Sustainable Development/ESG into Codes

As the global commitment to sustainable development continues to trend upward on the agendas of governments and private enterprise, the requirements also escalate for transparency on ESG[37] or responsible investment issues. This subject has been increasingly included in corporate governance codes.

> The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
>
> (OECD 2015a, Principle IV)

Behind this high-level Principle (G20/OECD Principle IV) stands an increasing awareness of the importance of sustainability, and sustainability thinking, to the long-term success of companies, as it also relates to the success of the whole civilization.

Some codes addressed the need for greater nonfinancial information for investors and are now incorporating sustainability/ESG issues—a set of issues that have a material impact on the long-term success of the company and, potentially, investment returns. Companies are including consideration of ESG issues in their business model, particularly in their thinking on strategy and risk.

C.8.1. The Banking Sector

As recently as 2007, ESG or sustainability was still dealt with separately from corporate governance, even if the two had become progressively more overlapping. Since then law and regulations and national corporate governance codes have referred increasingly to sustainable development matters, moving to an integrated corporate governance view.

> *"There are three areas where we do regard banks' directors as being responsible individually to ensure delivery of corporate governance elements. Those three areas are bank strategy, agreement of the bank's risk exposure and the tone from the top of the Board of Directors on risk culture and sustainable development."*
>
> *Stephen Bland,*
> *BCBS Corporate Governance Task Force,*
> *Bank of England*

The British Companies Act 2006 requires directors "to act in the interests of shareholders, but in doing so, have to

[37] Many terms are used to describe sustainable development. Each is slightly different from the others and alone could be the subject of another whole paper. Terms such as ESG, CSR, and CR are not directly interchangeable or identical. For simplicity, this part of the report uses "ESG" or "sustainability" to reflect all components of these terms.

pay regard to the longer term, the interests of employees, suppliers, consumers, and the environment" (UK 2006).

The EU in its 2014 directive on nonfinancial and diversity information requires large public interest companies with more than 500 employees, about some 6,000 companies, to disclose information in their annual reports on policies, risks, and outcomes on environmental and social issues. These issues shall include employee information, information on respect for human rights, on anti-corruption and bribery issues, and the diversity in their board members. The directive itself allows for flexibility in the manner and style of these disclosures, and companies may use international, European, or national guidelines in fulfilling these responsibilities. Table C.3 provides examples of various regulatory and code approaches to ESG and corporate governance.

The investor community, driven largely by the interests of their clients and beneficiaries, particularly pension funds with a long-term horizon, also have been at the forefront of demanding information on ESG matters and integrating ESG into their investment decisions. However, the integration of ESG matters into corporate governance codes is still

Table C.3: ESG and Corporate Governance Codes

Country	Instrument	Requirements
Australia	Corporate Governance: A guide for fund managers and corporations	Stewardship guidance for determining an approach to corporate governance, voting, and other issues, including national greenhouse gas, energy consumption, and other ESG disclosures.
Brazil	SEC Regulation and Brazil Stock Exchange rules	Securities rules requiring information related to the social, environmental, and corporate governance dimension of a company. The Code of Best Practices issued by the Brazil Institute of Corporate Governance has multiple references to ESG matters.
Bulgaria	Bulgarian Code for Corporate Governance	Under the comply-or-explain approach, companies should take into consideration the interests of stakeholders in accordance with principles of transparency, accountability, and business ethics. Companies are encouraged to balance development of the company with economic, social, and ecological development.
Denmark	Amendment to the Danish Financial Statements Act	Mandatory ESG disclosure for companies and investors on corporate social responsibility, CSR implementation methods, and an evaluation on what has been achieved in CSR in the past year. The rules apply to both companies and institutional investors.
India	CSR Voluntary Guidelines	Encourages businesses to formulate a CSR policy and provide a roadmap for CSR initiatives, aligned with their business goals.
Indonesia	Securities Regulation 47/2012	Requires every company to have social and environmental responsibility policy.
Jamaica	Code of Corporate Governance – Best Practice	Encourages all company management to act ethically and responsibly and charges all boards to ensure that the company is a good corporate citizen. It encourages listed companies to report against the code provisions in their annual reports.
Malaysia	Stewardship Code for Institutional Investors	Gives guidance on the effective exercise of stewardship responsibilities to ensure delivery of sustainable long-term value to their beneficiaries.

Source: Based on information from the Principles for Responsible Investment website: http://www.unpri.org/.

a growing phenomenon. Countries exemplifying integration of sustainable development and corporate governance into codes are Brazil, South Africa, and Spain.

C.8.2. ESG and the Link to Corporate Governance

Sustainability relates to corporate governance in that it is a duty of directors to be aware of the opportunities and risks of the environment to the company, including the natural, economic, and social environments. This responsibility will then affect the composition of boards, as they should incorporate individuals who have some knowledge and experience in ESG areas, so the board can better determine the company position and deal with sustainability issues as they arise.

Sustainability issues will affect business relations with stakeholders, the entity's products and services, and the outcomes of the company being in business. Sustainability issues should be incorporated in risk management assessments, and internal audit should check the effectiveness of management of sustainability issues.

For several years, sustainability issues have been the focus of separate codes, such as the global UN-backed Principles for Responsible Investment, the UN Global Compact, the OECD Guidelines for Multinational Enterprises, the Global Reporting Initiative, the German Sustainability Code, and others. Disparate initiatives are increasingly coalescing to integrate sustainability thinking into corporate governance codes, into law and regulation, and into company responsibilities and reporting.

In recognizing this change in corporate accountability for ESG issues globally, a mix of regulation and voluntarism is evident. As noted, countries such as Brazil, South Africa, and Spain are incorporating ESG issues into their codes. Investor groups are incorporating ESG into their stewardship codes as a consideration of the investor's fiduciary duty. Regulators too are encouraging consideration of ESG issues from a company stewardship perspective.

C.8.2.1. South Africa

Influenced by African value systems, such as ubuntu (a concept that we are all connected in our humanity), King III set the tone for integrating sustainability into the corporate governance code. Mervyn King has pointed out that, for an investor to make an informed assessment, the old format of the annual report that mainly focused on financial information and the short-term horizon is no longer adequate. Therefore, King III recommended integrated reporting to enable investors to make an informed assessment of the company's long-term sustainability.

In South Africa, corporate governance takes the view that companies contribute to sustainable development. It is a notion of inclusivity and is not necessarily aligned with the notion of shareholder primacy. There is a reliance on capitals other than financial capital, and you cannot say that the provider of financial capital is the most important stakeholder.

"In South Africa we see the function of corporate governance codes quite widely. In fact, we define corporate governance as effective leadership on an ethical foundation. Ethics in turn is defined broadly as including corporate citizenship and sustainability considerations. The South African view is that there is a symbiotic relationship between society and business—an interdependency and therefore for business to succeed, society should prosper. Business and society should co-exist by finding the place where value for business and value for society intersect."

Ansie Ramalho, King IV Project Lead,
Institute of Directors in Southern Africa

"It is aspirational but if you agree there is an interdependency between society and business and if in theory it makes sense that these two things need to meet and move along together, then we need to find a way to do it. It is critical that all corporate governance codes move in this direction."

Ansie Ramalho, King IV Project Lead,
Institute of Directors in Southern Africa

The forthcoming King IV code, currently in development, incorporates the idea that, through principles, companies will be required to disclose how they have integrated sustainability considerations into their strategy and into the ways they have mitigated their impact on the environment and society. The premise of this approach is that sustainable development is a source of both risk and opportunity for companies.

The South African corporate governance framework is supported by another code for investors, the Code for Responsible Investing in South Africa, to ensure better incorporation of environmental, social, and governance issues in decision making and ownership practices. It is also supported by Regulation 28 to the Pension Funds Act, which requires trustees of pension funds to consider a responsible investment approach and to take into account material ESG factors in all asset classes, not just equity. Thus the South African approach to the incorporation of sustainability is a mix of code and regulatory approaches.

C.8.2.2. Spain

Since 2015, Spain has been reviewing its company law and its corporate governance code. In the revisions to company law, the following amendments strengthen corporate governance issues:

- New powers to encourage shareholder participation in company affairs, especially the AGM;
- Increased transparency of remuneration policies; and
- Required board involvement in sustainability issues. Company law established a non-delegable power of the board to approve the corporate social responsibility policy.

The Corporate Governance Code was revised in parallel with the company law amendments and is a voluntary code based on the comply-or-explain principle. Principle 12 encourages a wider view of corporate governance, incorporating consideration of stakeholders, the environment, and the broader community. Corporate responsibility issues, absent in the previous code, is now the object of express recommendations in the code, with the aim of defining minimum content of the policy of the company regarding sustainability (targets, commitments, practices, and so on), as well as its evaluation and dissemination. (See Box C.2.)

The directors of a company should now report (or explain why they do not do so) on ESG developments in its directors' report and specify the goals of the ESG policy; the corporate strategy with regard to sustainability, the environment, and social issues of the company; and the mechanism for supervising nonfinancial risk, ethics, and business conduct. Thus Spain has introduced ESG issues into corporate governance.

Box C.2: Excerpts from the Spanish Corporate Governance Code Report

The Board of Directors should perform its duties with unity of purpose and independent judgement, according the same treatment to all shareholders in the same position. It should be guided at all times by the company's best interest, understood as the creation of a profitable business that promotes its sustainable success over time, while maximising its economic value.

In pursuing the corporate interest, it should not only abide by laws and regulations and conduct itself according to principles of good faith, ethics and respect for commonly accepted customs and good practices, but also strive to reconcile its own interests with the legitimate interests of its employees, suppliers, clients and other stakeholders, as well as with the impact of its activities on the broader community and the natural environment.

Source: (CNMV 2015).

Key to the success of Spanish initiatives is that the company law includes the duty of directors to have a corporate responsibility policy, which previously had been in the corporate governance code but was moved to the law. The corporate governance code now requires transparency on this legal duty. This provides a combination of pressures for ESG initiatives. The Spanish experience shows us that there are several steps that a country could follow to improve sustainability initiatives:

- Identify sustainability or ESG as an important issue for companies for long-term growth.
- Identify which institutions are responsible for sustainability policies, if it is to be set in law or regulations or codes, and involve them in the sustainability debate.
- Ask companies to apply disclosure and transparency measures in line with the company's professed ESG policies and practices, including disclosing the communication channels on their practices to stakeholders.
- Perhaps consider seeking assurance on sustainability activities so as to build confidence in the market in sustainability information.
- Be aware that there are several platforms for addressing the sustainability topic. Each country may have different mechanisms for sustainability improvement.
- Institutional investors, civil society, corporate governance codes, and regulation can combine to demand information from companies on environmental, social, and governance policies and initiatives.

C.8.2.3. Brazil

The 5th edition of the Corporate Governance Best Practices Code issued by the Brazilian Institute of Corporate Governance brings new perspectives. Besides the full review of established practices, the new code 1) is more principle based than prescriptive, as the previous version was; 2) stimulates reflection before its effective application; 3) emphasizes ethics and ethical behavior; and 4) valorizes and uses the capital language, as in the integrated reporting initiative.

A new section introducing the code deserves to be read upfront. It states the premises of the code and highlights the responsibility of the corporate governance agents in a new context, with themes such as sustainability, complexity, different stakeholders' perspectives and interests, and long-term value creation. It brings a thoughtful approach to the

decision-making process, the organization's identity (purpose, mission, vision, values, and principles) and ethical deliberation, the role of corporate governance agents, and how to use the code.

> The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
>
> (OECD 2015a, Principle IV)

C.8.3. Practical Challenges of ESG Inclusion in Codes

Several standards are available as possibilities for applying sustainability disclosures. The Global Reporting Initiative has issued its standards, with particular standards for certain industries. The United States is developing sustainability reporting standards through the Sustainability Accounting Standards Board; SASB's mission is to develop and disseminate sustainability accounting standards that help public corporations disclose material and information that is useful to investors for decision making. There are industry standards for sustainability issues such as the UNDP Strategy for Supporting Sustainable and Equitable Management of the Extractive Industries. Countries requiring such disclosures might consider which, if any, of these standards its constituents should report against.

A member of the IFC Corporate Governance Private Sector Advisory Group, Bistra Boeva, conducted research in Bulgaria, prompted by the 2016 applicability of the EU directive on nonfinancial information. Her research raises several issues, and she believes consideration should be given to the following matters:

- Corporate governance codes should incorporate ESG requirements.
- Clarification is likely to be required as to who are an entity's stakeholders, as sustainability is usually considered in terms of the entity's stakeholders.
- Discussions at the IFC and OECD levels indicate there is little cohesion on definitions of stakeholders.
- Better understanding of the current corporate governance requirements and ESG practices and links between corporate governance and sustainability is necessary.
- If ESG issues are included in a code, the code may need to move from generalities to more specific issues and include specifics such as supplier and supply chain relationships:
  - ESG issues perhaps should be specifically included in required disclosures mentioned in the corporate governance code;
  - Some consideration would be required regarding who would write the ESG disclosures, what skills and competences the writer(s) should possess, and what standards should be applied in writing the disclosures;
  - Some consideration may be given to including statements regarding board responsibilities for ESG initiatives and disclosures, which may include responsibilities for ESG strategies and for systems to measure and report on ESG activities.

A debate during an IFC Practice Group meeting on codes and standards brought out differing opinions on whether sustainable development matters should be included in corporate governance codes. One view was that business has to be cognizant of sustainability issues, and yet it is also charged with being profitable—two goals that are not the same but are connected. Another view was that reporting sustainability is a challenge!

Nevertheless, the trend is evident. Countries and companies are including ESG issues in corporate governance laws and regulations, corporate governance codes, separately into stewardship codes for investors, and even in individual investor statements on the company's approach to ESG. However, it is clear there is not one approach but rather a number of diverse approaches to bringing corporate governance and ESG issues closer together.

Despite a general acceptance of sustainability as a core issue for the future in corporate governance, there remain issues and conflicts yet to be resolved. Investors have a fiduciary duty to look after the beneficiaries for whom they are investing. Some of them see their fiduciary duty as including sustainable development. Others do not.

> *"The investor community would be uncomfortable with sustainability if it infers that the company's purpose was not necessarily commercial success. If we start to intermingle sustainability with corporate purpose, then I think many investors are going to get a bit nervous, even if they embrace, as I think most investors do, the core ideologies of sustainability."*
>
> *George Dallas, Senior Policy Advisor, ICGN*

C.9. Summary

We are seeing evidence that the development and application of corporate governance codes and of scorecards are having an effect in improving corporate governance practices. However, recent reviews and analyses of the existing codes are bringing forth several lessons, such as the following:

- Distinguish carefully between matters that should be mandated in law or regulation and matters that are better placed in codes. Place in codes issues and behaviors that may take time to change and in which a degree of flexibility is required or which are aspirational in nature.
- Develop an understanding of the variations, effectiveness, and nuances of the different comply-or-explain approaches. Consider the local environment and ascertain which code style is appropriate for it. Consider also the environment in which comply or explain is set, before determining whether to use high-level principles (with additional separate guidance) or principles with a greater degree of detail. Avoid confusion.
- Consider the likely effectiveness of comply or explain where there are controlling shareholders or where the rule of law is weak.
- Challenges to the use of comply or explain in corporate governance codes are likely to remain in the future. (See Box C.3.)

Box C.3: Comply-or-Explain Codes: Benefits and Costs

Comply or explain codes present a number of well known potential benefits. Relative to a fully mandatory system, they are flexible; by allowing companies to opt out of the code provisions, the comply or explain approach reduces the regulatory burden, and 'one size fits all' is avoided. However, many studies of the impact of corporate governance codes mention a variety of potential challenges. These include:

- Lack of influence/awareness of codes (especially voluntary codes)
- Lack of adoption of code provisions
- Poor quality of code disclosure statements
- Lack of attention paid to code compliance by shareholders
- Lack of monitoring, supervision, and enforcement by securities regulators and stock exchanges

Source: (Berg 2015).

To address the concerns outlined in Box C.3, a paper (Berg 2015) inspired by recent World Bank diagnostic work and discussions with client country counterparts proposes several steps that securities regulators can take to revitalize their corporate governance codes:

- Clarify the comply-or-explain requirement.
- Enforce corporate governance disclosures.
- Improve how companies comply or explain.
- Report on code compliance.
- Consider active enforcement of the quality of disclosure statements.
- Move from a comply-or-explain requirement to a mandatory regulation.
- Adopt a stewardship code.

C.9.1. Key Findings

The following points capture some of the key findings of the research for this publication:

- Codes exist because not all corporate governance good practices can be mandated.
- Many codes have been supplemented by guidance on specific matters in local jurisdictions.
- Code application should be regularly monitored, reviewed, and reported on to encourage code implementation. Increased monitoring is evident.
- Codes may continue to be high-level principles. However, if this is so, many companies and markets may need the support of increased guidance on how to approach each corporate governance principle in practice and in diverse types of enterprises.
- Codes should be reviewed, with the aim of developing better practices and making better adjustments to local market issues.
- The concept of sustainable development and its place in corporate governance needs to be better understood by companies, investors, and regulators globally, and sustainable development should be included in requirements in corporate governance codes.
- There is an increasing consensus that boards should have a responsibility for setting values that determine how the company interacts with and affects the society it operates in, but some investors with fiduciary duties to beneficiaries are nervous about this issue.
- Scorecards, awards, and other mechanisms should be encouraged, to provide an incentive for companies to target better corporate governance.

C.9.2. Trends and Future Developments in Codes and Scorecards

The global community interested in corporate governance should expect the following future developments:

- Pressure for more effective application of corporate governance principles and practices, requiring more and better guidance to assist with implementation and a focus on corporate governance outcomes;
- A wider debate concerning what should be mandated in laws and regulations as opposed to being included in codes, traditionally a "softer" approach;
- A closer review of the comply-or-explain model for application of corporate governance principles, including greater variation in its use than previously practiced;
- More monitoring, enforcement, and reporting activities regarding corporate governance code application, including increased use of scorecards;
- More codes being amended to incorporate ESG activities and reporting; and
- Increased monitoring of the success of steps to standardize corporate governance codes so they are applicable across diverse sectors.

Conclusion

Research for this publication included an examination of recent developments of such corporate governance groups as OECD, BCBS, and ICGN as well as the EU, with particular notice of developments in corporate governance in the Nordic countries and in emerging markets. One result of the research was confirmation that significant and widespread changes have occurred in the wake of the financial crisis of 2008. Areas of corporate governance practice that have seen noteworthy changes are the control environment and risk, transparency and disclosure, shareholder rights, increased commitment to good corporate governance, and the examination and strengthening of corporate governance codes.

From the magnitude and breadth of change in corporate governance depicted in this publication, it is evident that companies and boards of directors are, or soon will be, expected to respond to new or greatly enhanced standards of corporate governance. They will be required to continually monitor their corporate governance and its effectiveness, to be prepared to change and adapt to new regulations and adopt better practices, and to respond to increased scrutiny and investor engagement.

Overall, these developments in corporate governance improve the quality of information available to the board, boost the performance of management, and enhance the company's awareness of and attention to risk—all of which should benefit the company and support the achievement of its objectives in the long term.

It is highly likely that such developments will continue as market regulators notice the benefit of corporate governance to market development and to economic growth and stability. This is the new normal in corporate governance.

Appendixes

Appendix A: IFC Indicative Independent Director Definition

Appendix B: Board Evaluation Requirements

Appendix A: IFC Indicative Independent Director Definition

"Independent Director" means a Director who has no direct or indirect material relationship with the Company other than membership on the Board and who:[1]

(a) is not, and has not been in the past five (5) years, employed by the Company or its Affiliates;

(b) does not have, and has not had in the past five (5) years, a business relationship with the Company or its Affiliates (either directly or as a partner, shareholder (other than to the extent to which shares are held by such Director pursuant to a requirement of Applicable Law in the Country relating to directors generally), and is not a director, officer or senior employee of a Person that has or had such a relationship);

(c) is not affiliated with any non-profit organization that receives significant funding from the Company or its Affiliates;

(d) does not receive and has not received in the past five (5) years, any additional remuneration from the Company or its Affiliates other than his or her director's fee and such director's fee does not constitute a significant portion of his or her annual income;

(e) does not participate in any share option [scheme]/[plan] or pension [scheme]/[plan] of the Company or any of its Affiliates;

(f) is not employed as an executive officer of another company where any of the Company's executives serve on that company's board of directors;

(g) is not, nor has been at any time during the past five (5) years, affiliated with or employed by a present or former auditor of the Company or any of its Affiliates;

(h) does not hold a material interest in the Company or its Affiliates (either directly or as a partner, shareholder, director, officer or senior employee of a Person that holds such an interest);

(i) is not a member of the immediate family (and is not the executor, administrator or personal rep resentative of any such Person who is deceased or legally incompetent) of any individual who would not meet any of the tests set out in (a) to (h) (were he or she a director of the Company);

(j) is identified in the annual report of the Company distributed to the shareholders of the Company as an independent director; and

(k) has not served on the Board for more than [ten (10)] years.[2]

For purposes of this definition, "material interest" shall mean a direct or indirect ownership or voting shares representing at least [two percent (2%)][3] the outstanding voting power or equity of the Company or any of its Affiliates.

[1] Some jurisdictions have legal definitions for independent directors which may or may not be as stringent as IFC's definition. If such a definition exists, consult with the Corporate Governance Group as to whether such definition would be appropriate. If, for a particular reason, the Investment Department intends that the IFC Nominee Director be deemed to be an Independent Director, consult with the Corporate Governance Group (www.ifc.org/corporategovernance).

[2] Depending on the availability of qualified independent directors in a particular country, the term could be shortened to seven (7) years. Consult with the Corporate Governance Group if this is an issue.

[3] Consult with local counsel as to the relevant percentage, if any, specified by local law (which may apply to publicly listed or unlisted companies, or both). For example, in the United Kingdom, a shareholder is treated as having a material (disclosable) interest in a publicly listed company if it holds 3% of the shares; in the United States, the equivalent threshold is 5%.

Appendix B: Board Evaluation Requirements

Country	Source Instrument Requiring Evalution	Companies Affected	Requirements
Australia	ASX Corporate Governance Principles and Recommendations and ASX Listing Rules	Listed companies SEC Regulation and Brazil Stock Exchange rules	It is the role of the board nominating committee to ensure the development and implementation of a process for evaluating the performance of the board, its committees, and directors. Companies should report in annual report or corporate governance statement against this Principle.
Brazil	IBGC Code of Best Practices	Recommended for all companies and organizations	An annual formal evaluation of the board, individual directors, and the CEO. Disclosure to shareholders of the process and results.
India	Companies Act 2013	Large listed public companies	Report on the annual evaluation of the board, board committees, and individual directors.
	Equity Listing Agreement (2014)	Listed companies	Monitor and review the board evaluation framework.
Singapore	Corporate Governance Code	All companies – all listed companies must disclose how each principle of the code is applied.	Principle 5 recommends that there should be a formal assessment of the effectiveness of the board of directors as a whole and the contribution by each director to the effectiveness of the board.
South Africa	King III Code of Corporate Governance 2009	All entities in South Africa on an apply-or-explain basis	The evaluation of the board, its committees, and the individual directors should be performed every year. Annual evaluations of the board, its committees, and directors (including evaluations of the chairperson, CEO, and other executive directors) should be performed by the chairperson or an independent service provider. The overview of the process should be disclosed in the integrated report.
United Kingdom	Code of Corporate Governance	Listed companies	The board should undertake a formal and rigorous annual evaluation of its own performance, its committees, and individual directors.
		Large companies	Performance evaluation to be undertaken by an external independent evaluator at least every three years.
United States	NYSE Listing Rules	Listed companies	Boards to address performance evaluations in their corporate governance guidelines; annual performance evaluation of board committees to be in committee charters.

Source: Molyneux, 2015.

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APRIL 2016