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G 20/ OECD Principles of Corporate Governance – Comments by Eddy Wymeersch

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Abstract

In this public consultation, the OECD seeks to benefit from a wider input from the public in order to achieve a statement optimally reflecting ideas developed in the numerous studies and reflections about the future of private companies and the way these should be managed. The Principles are addressed to policy makers: apart from the case when the principles have been translated in legal rules, some of the Principles are to be included in the companies' corporate governance codes, but other remain in the status of unwritten standards. Only legal rules are fully binding.

In general the Principles deal with prominent corporate governance issues and indicate for most of these a way forward, which looks convincing. The present paper focuses on the issues where the Principles could usefully be complemented by issues which came forward more recently, or can be considered lacunae in the present presentation.

The Principles are adressed to private companies traded on public markets, but are equally of importance for the many unlisted companies, and even other bodies – such as the state owned economic enterprises which exercise central functions in our societies, eg the railways. The corporate governance principles may be equally applicable to these entities and a similar reflection as developed in the Principles would be of great importance.

According to the accounting directive companies will include the corporate governance statement in their management report. That statement shall be included as a specific section of the management report and shall contain at least the information listed in article 20 of that directive. Some of this information will be subject to external review by the auditor.

The author welcomes your comments at eddy.wymeersch@ugent.be

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G 20/ OECD Principles of Corporate Governance –

Comments by Eddy Wymeersch

In this public consultation, the OECD seeks to benefit from a wider input from the public in order to achieve a statement optimally reflecting ideas developed in the numerous studies and reflections about the future of private companies and the way these should be managed. The Principles are addressed to policy makers: apart from the case when the principles have been translated in legal rules, some of the Principles are to be included in the companies' corporate governance codes, but other remain in the status of unwritten standards. Only legal rules are fully binding.

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Legal v voluntary standards

The Principles addresses three functions in private companies; management function, financial function, and broader economic, environmental and societal interest. The way these functions are organised and exercised is a matter for national systems. In most western economic systems, the essential features of the management and the fianncial functions are dealt with in the legal or regulatory system. The governance instruments serve here a complementary role, leaving wide discretion to national preferences and traditions. The choice between binding legal requirements and more flexible, often self-regulatory instruments allows for great diversity in solutions,allowing adaptation to specific questions, but may lead to less effectiveness, and even for some regulatory competition or arbitrage. It would be commendable that a comparative analysis is undertaken to determine which subjects can more effectively be laid down in formal regulation – preferably uniform in many jurisdictions- contributing to harmonisation and equal treatment. The higher degree of uniformity of the accounting standards, derived from the International Financial Reporting Standards (IFRS)

can be mentioned as a model contributing to conditions of more effective equal competition on a multinational basis, can be mentioned as a useful reference. It allow accounting statements in many jurisdictions to be considered equalyy reliable.

The Principles of Corporate Governance are among the best known and most useful among the policy statements of the OECD. They are used as a reference for comparison in the rulemaking at national level, and in actual company practice and its supervision. However, in many Member States the familiarity with the OESO Principles could be improved, whether by making copies of the related Principle widely avaliable, or even more effectively by organising business meetings where the principles are exposed, or discussed by people directly involved in their application, both from the company side, and also from other centers of interest (stakeholders as :shareholders, employees, press, academics, etc) . Also a clear distinction is to be made between the OECD corporate governance principles, and its statements in other related fields such as the ones mentioned in the Principles.[1]

A related matter, but of a different nature, concerns the question which topics have to be laid down in formal legal requirements or can further be dealt with in self-regulatory, or voluntary instruments. A significant part of the OECD principles have been transposed in national legal requirements – .eg, structure of the decision making bodies, majority rules - , and references are often made to the Principles. But further advances are possible. This would contribute to higher predictability of the applicable legal regime, more similar translation is several juridictions, and hence facilitate mobility of companies. It would be useful to open a dialogue with the EU Commission on broadening the scope of the governance provisions, especially those which might limit mobility of companies.

A core function of the Principles and other similar instruments consists of creating confidence in the companies' actions. This objective serves the reputation of the companies, strengthens the relations with different classes of stakeholders, mainly the employees and the customers reinforces their link with the company and its products, and generallky stab ilises the economic system . This confidence building is related to the safety of the production or operational procedures, and the absence of unexpected incidents which may undermine the customers' confidence. In some cases, the production chains have had to be stopped due to defects in the products: examples of these have been numerous[2] ; the damage to the reputation may be considerable and the market value of the company seriously affected. Therefore, better surveillance and more active risk management and avoidance of production disturbances may usefully be considered.

[1] The OECD has published positions on several other governance related subjects; See the Guidelines on Multinatioinal Enterprises, the Guidelines on Corporate Governance of State-Owned Enterprises,also :The due diligence standards on responsible business conduct , and the Personal Data Protection rules of the OECD; the OECD Anti-Bribery Convention; further statements on Corporate governance are the FSB Key Standards or the World Bank Roscs;; the ILO Fundamental principles and rights at work.

[2] In the milk industry, the chocolate production, prepared meat products, etc.

Structuring risk management

Underlying to several of the incidents which occurred in large companies and caused great harm, is the absence of advanced quality control processes, initiatied by an adequate follow -up of the applicable standards. More generally, even larger companies do not always have adequate instruments to monitor the production processes, or to surveil these continuously. This can be noticed in th food industry, but also in the production of electrnic devices.This issue can often be analysed as a component of the companies' risk processes.

The need for disposing of efficient risk control processes is officially recognised in some fields of activity, such as banking, where the regulation requires banks to introduce risk procedures, appointing a risk director, reporting to the risk committee, composed on independent directors, and disposing of detailed procedures to follow up on the more risk intense activities, by developing the necessary instruments for an early intervention once a risk event occurs. In the banking field these are regular processes, discussed in the risk committee, a committee of the Board, and a regular follow-up on specific types of incident, money laundering or fraud in particular. This committee reports to the board, while the supervisory authorities are informed. In some cases sanctions are imposed on the bank for deficiencies in its risk policy, e.g. for not having detected in time errors in the processes. Errors in stock exchange transactions have led to major incidents, with loss of confidence and even a market crash.("fat finger cases"). Many companies pay attention to possible risks, but do not have a dedicated structur**e** to follow up on adverse evolutions in the further future, nor the adequate means to intervene once the event occurs. This explains some major incidents, such as the collapse of the Morandi bridge in Genua, which experts could have predicted a long time in advance[3] The risk caused by this incident were considerable, both in human lives and in materal damage. The Principles point to the role of the board in its oversight of risk management in the Principles, in section V D 2. But they do not require the development of adequate risk procedures and structures as a necessary guarantee for the governance of some companies with an higher than standard risk profile.

Company disclosures

Companies report about their activities in their financial statements, which are published every 12 months in the annual report, as approved by the board of directors, prepared by the management and verified by the auditors. This process is of great importance first externally, for presenting the position and the achievements of the company to investors, markets and the outside world.

[3] See G. Pianigiani, *Poor Maintenance and Construction Flaws Are Cited in Italy Bridge Collapse, NY Times Dec 22, 2020; there are many similar incidents, explaining why some companies have their own fire brigade(airportys e.g., petroleum companies)*

Companies should include the corporate governance statement in a specific section of their management report[4]. It shall cointgain at least the information mentioned in artile 20 of the directive at least the information listed in article 20 of that directive. Some of this information will be subject to external review by the auditor

There is also an internal function as the annual accounts document about the efficiency of each of the company's departments, and the achievements of the leadership of these departments, and of the company overall. Weaknesses will raise questions about the future of the department's heads, about their remuneration, their future careers, etc Their identity should be included in the annual statements, along with the aggregate amount of remuneration.

The annual reports will also document on the structure of the group of companies of which the company is part. An analytical corporate governance statement to that effect will be included in the management's report. That statement shall be included as a specific section of the management report and shall contain at least the following information as mentioned in the Principles[5]

In many cases no separate disclosures are mandated for data of controlled entities which are included in the consolidated accounts. Information on intra-group transactions will in these cases not be mentioned separately, a weak requirement when taking into account the frequency and the financial and even structural consequences of these transactions. Shareholders will only be informed as a consequence of the company-law based processes of approval and disclosures, in many cases offering a low degree of protection.

External check on company accounts

The information contained in the company accounts having been prepared by the internal services of the company, an external, independent check is necessary to safeguard their reliability. This check is not limited to the accounts reflecting the internal company data, but extends to the assessment or meaning of these data in the overall functioning of the company. The Principles draw attention to some of these data, which have a separate value from the point of vue of assessing the group's behaviour: the capital and group structures and their control arrangements or their changes, the relative positions in ownership, possibly resulting in preferential agreements with some shareholders, impacting the appointments to board positions,or allowing for related party transactions. In these cases, company information and its disclosure have a definite monitoring influence on the decisions or transactions reported.

The reliability of accounting information is subject to the auditor's assessment and his judgment that the accounts convey a "fair and true" view of the company's position and operations, Confidence in the auditors and their assessments of the data is therefore a prerequisite to confidence in the accounts, and hence in the company. Do these these safeguards offer sufficient protection to third parties dealing with the company, e.g. their present or future creditors? In cases of insolvency, or similar cases of lack of trust, it often appears that the reliability of these data deserves a caveat, which has not been eliminated by

[4] See article 20, accounting directive 2013/34, article 30 e.s. for the publication requirements
[5] Which is also detailed in the directive 2013/34

the auditor's analysis and verifications.Transaction related legal guarantees may reduce these risks, provided they are assessed by the auditor. Further work for strengthening the position of the auditors, but also of the audit framework in general would be welcome.

Position of the auditors

Confidence in the auditors is the result of a partly public sector process: a dedicated education in accounting and auditing, the admission to the profession based on a strict selection test, the supervision by a professional body monitoring the auditor's activities on a regular basis and exercising professional scrutiny. The professional organisation and the market regulators exercise their supervision on the audit work on the basis of a mandate rooted in the public interest. Certain transactions will be more closely verified by the auditor, if there are indications that the transaction may not be objectively justified.

External audit and supervision

The Principles call attention to the importance of financial and non-financial disclosures in the functioning of the companies as publicly traded entities. These disclosures are preparaed by the companies' staff, under the direct supervision of the audit committee of the board, and under close oversight of the statutory auditor.The staturory auditor or audit firm shall report to the audit committee on key matters arising from his audit and in particular on material weaknesses in internal controls in relation to the financial reporting process[6]. The national quality assurance system will ensure that auditor**s** report to the board the violations or non-application of the the laws and regulations applicable to the matter[7] Auditors are subject to public oversight, also with respect to weaknesses in their audit work, their lack of independence, possible conflicts of interest, eg for non-audit services[8] The auditor is civilly liable for not applying the audit standards

Sustainability and resilience

The Principles add a new chapter to their previous versions, dealing with sustainability and resilience. This addition is very much in line with the recent recommendations from many national and international authorities and has led to innovative regulations and case law in

[6] See directive 2006/43

[7] See PIOB See Standard 225, applicable to PIEs and relating to cases of violations of law and regulations as "encountered" by the auditor, or when he has been made aware about it. For an analysis, see Wymeersch, NOCLAR or How accountants deal with suspected or occurred breaches of the law, ECGI,

See also ISA 240 on the auditor's responsibilities relating to fraud in an audits of financial statements

[8]

some EU Member States, while two important proposed EU.directives are being discussed and widely commented on.

The principles seem to deal mainly with "climate risk and other sustainability risks", the latter being left undefined, although further referring to " human rights and human capital policies" the latter seeming a narrowing description of human rights. The same remark can be made about the absence of a reference to environmental due diligence, policies and risks, which are equally classified under the wider label of sustainability risks. These different risks are considered mainly from the angle of their impact on the value of the company, and on its shares. Other classes of sustainbility risks remain unmentioned: mentioning **the** different other classes of interests affected, directly or indirectly, eg through the companies'value chain would contribute to clarity. The impact on the subcontractors, or on the value chain might also be included.

The Principles adopt the widely followed approach dealing with sustainability matters by upgrading the disclosure duties to facilitate the comparability across markets (VI.A.7). The disclosure approach is widely followed and accepted in several jurisdictions active in the sustainability field. It consists of a delegated enforcement of the sustainability standards to the markets, to the evaluation by shareholders, and to activist investors. This approach is haphazard and not always effective. One can wonder whether it would not be more effective to declare some of the specific requirements applicable by rule of law, describing the illegal, or unhealthy practices and enforce these in the normal legal way as "hard law rules" . Reliance on the legal system and on the intervention of the judiciary has proved to be equally, if not more effective than for self-regulatory approaches . Another effective approach might be to consider these risks as normal business risks, to be included in the tasks of the risk committee, and subject to the responsibility of the board in terms of restoring the harm, while delegating its verification to the regular auditors.

The addition -in the numbers VI D 5 - mentions several enforcement mechanisms if unethical or illegal conducts have been committed whether by executives or by employees. There is a need for a structured answer to these problems, guaranteeing the company's interest and reputation to be protected, while putting the responsibility for non-taking appropriate action on the executives in charge. In fact one notices that abusive conduct, eg. by major shareholders, or their representatives on the board often remain unchallenged and not sanctioned. These instruments mentioned in the Principles - such as giving access to an independent board member, even reporting to the competent authorities does not always secure an effective remedy or sanction, leaving the whistleblower or the victim of unethical or illegal conduct unprotected. The legal regime for these cases should be strengthened, and adequate disclosure secured, beyond the provisions in the corporate governance code.The division of competence between the professiional or selfregulatory bodies and the state supervisors deserves to be clarified.

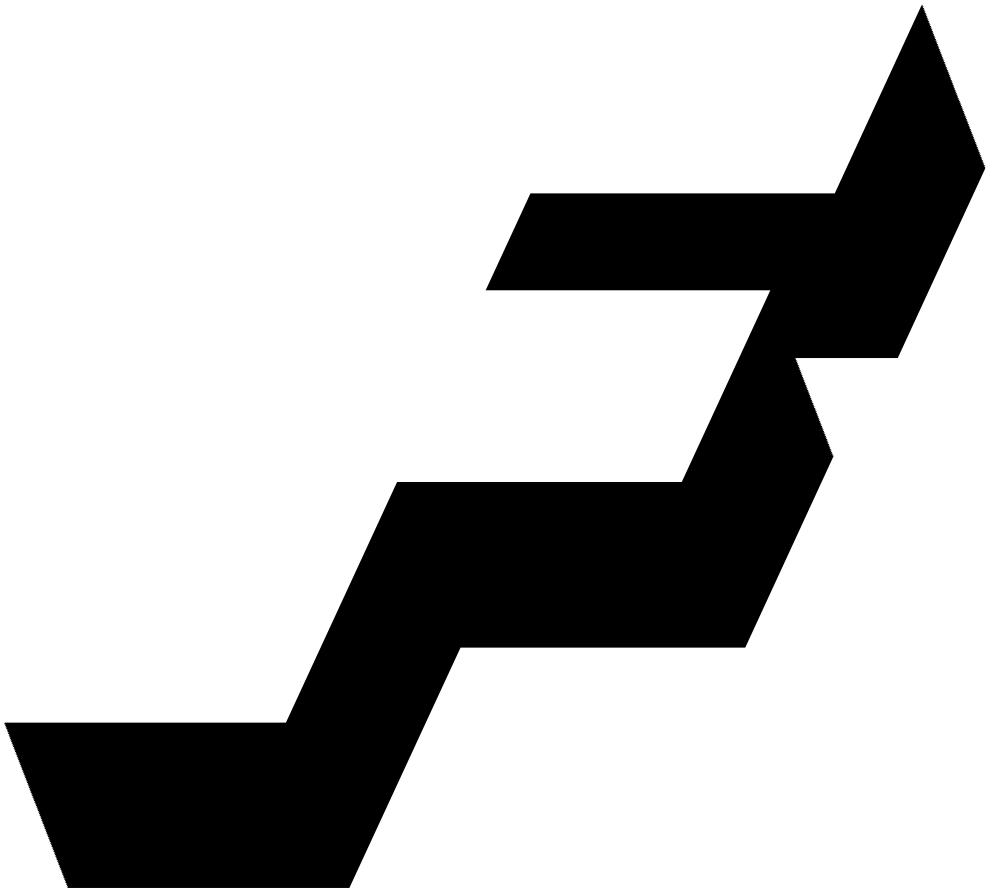
The proposed principles for the corporate governance code are useful instruments for improving management of larger companies and ensure a more reliable but also confident relationship between the different levels of decision-making in these companies. Whether this can be achieved by a voluntary legal instrument, without strict legal backing in certain fields remains to be discussed. Liability may offer some leverage, but is too unsure and haphazard to be used for enforcement.

Conclusion

The OECD consultation on corporate governannce deals with numerous significant issues relating to the mangement of companies. The publication of this overview and the suggestion for improvements are very welcome.

The proposed principles for the corporate governance code are useful instruments for improving management of larger companies and ensure a more reliable but also confident relationship between the different levels of decision-making in these companies. Whether this can be achieved by a voluntary legal instrument, without strict legal backing in certain fields remains to be discussed. Liability may offer some leverage, but is too unsure and haphazard to be used for enforcement.

The work is not finished: corporate governance is a continuously developing discipline evolving with the size, the business type of companies and the expansion of companies over the world. In several fields standards relating to the way coma0nies should be managed have been adopted and are applied., The OECD standard is one of these. National legislators and regulators will find inspirations in many of its proposals



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