Digitization and transparency – transforming the future of corporate governance?

Key findings of the 19th European Corporate Governance Conference that took place in Bratislava on 27 October 2016

MINISTRY OF JUSTICE OF THE SLOVAK REPUBLIC

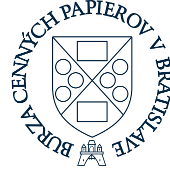
SK EU2016

MINISTRY OF FINANCE OF THE SLOVAK REPUBLIC

EY

Building a better working world

CECGA
CENTRAL EUROPEAN CORPORATE GOVERNANCE ASSOCIATION
STREDOEURÓPSKA ASOCIÁCIA SPRÁVY A RIADENIA SPOLOČNOSTÍ

Kingfisher
executive search

BURZA CENNÝCH PAPIEROV V BRATISLAVE

otpbanka
Dôverujeme si navzájom

SQUIRE
PATTON BOGGS

VÚB BANKA

EuropeanIssuers

BUSINESSEUROPE

British Chamber of Commerce in the Slovak Republic

ecoDa The European Voice of Directors

AmCham Slovakia

CAMERA DI COMMERCIO ITALO - SLOVACCA
TALIANSKO -SLOVENSKÁ OBCHODNÁ KOMORA

Contents

- Introduction 02
- Opening remarks 04
- Corporate governance in a global context 10
- Challenges for the board: remuneration and transparency 14
- The relationship between digital transformation and corporate governance 23
- Audit committees and the new regulatory paradigm 24
- Principal conclusions 00

Introduction

The global business environment may be changing rapidly but the focus on corporate governance remains constant. There are good reasons why, regardless of what is going on in the world — and often *because* of what is going on in the world — policymakers take a keen interest in the subject.

We already knew that well-governed companies attract vital investment that helps economies to expand, leading to greater innovation and job creation. What is now becoming more evident is that well-governed companies can have a very positive social and environmental influence, which matters greatly in an age where organizations are increasingly being held to account for their actions.

For a long time, company boards wrestled with the issue of how they can better deliver value to shareholders and communicate with them more effectively. Of course, this is an issue that they continue to explore, particularly in light of the proposed Shareholder Rights Directive. Now, however, they are also expected to consider the needs of a host of other stakeholders in their decision-making. These stakeholders include customers, employees, the media, regulators, politicians and suppliers.

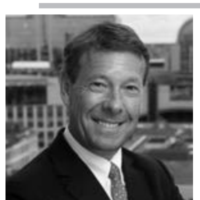
Today's boards need to ensure that their companies have a purpose that extends beyond the sole activity of making profits. They also need to set the right tone at the top so that management decisions are made with both long and short-term outcomes in mind. The scale of the challenge that boards have in this respect should not be underestimated — if they fail in their responsibilities, they run the risk of their company being sanctioned by regulators, falling foul of public opinion and suffering long-term reputational damage.

At the 19th European Corporate Governance Conference in Bratislava, we explored some important issues relating to governance in 2016. These ranged from the changing expectations of capitalism in a global context and the continuing controversy around executive remuneration through to the rise in shareholder activism, the opportunities presented by the digital transformation agenda and the governance landscape of smaller businesses.

As 2016 marked the year that the new EU audit framework took effect, we also devoted an entire panel session to the specific challenges facing audit committees. We heard that audit committees are expected to do more than ever before but sometimes they are doing work that should really fall within the remit of the main board.

We had a diverse range of speakers at the conference, encompassing representatives from academia, business associations, director organizations, regulatory bodies and shareholder groups. Together they offered a broad spectrum of views, reflecting concerns and ideas that are circulating in both the public and the private sectors. Conference attendees were able to ask questions, learn best practice and network with each other at the event. We also polled the audience to get their views on some key topics and we include the results of those polls here.

I hope you find this report interesting and informative and that it provides some useful takeaways for you to take back to your own organization.



Jeremy Jennings

Regulatory & Public Policy Leader, EY, EMEIA

Foreword

Welcome to this report on the findings of the 19th European Corporate Governance Conference, which took place in Bratislava on 27 October 2016 as part of the first-ever Slovakian Presidency of the EU.

The conference, which was supported by EY and took place at the Sheraton Bratislava Hotel, was important to my country for two major reasons. To start with, it was the first time that Slovakia had hosted an international conference on corporate governance. Secondly, it marked the public launch of the updated *Corporate Governance Code for Slovakia*, which is based on the Organization for Economic Co-operation and Development's (OECD's) Principles of Corporate Governance that were endorsed by the G20 leaders in 2015.

Slovakia is one of the smaller markets in the EU, but we have a strong focus on good corporate governance. We recognize that corporate governance plays a crucial role in attracting investment into our economy from both domestic and international investors. Well-governed companies can also have a very positive impact on society and help to strengthen the relationship between the public and the private sectors.

For this reason, we were delighted that over 250 corporate governance professionals, from more than 30 countries, attended our conference. They heard from a succession of expert speakers from across the EU and beyond on some of the most important topics in corporate governance today. These topics included the role of corporate governance in a global context; transparency in board remuneration, the impact of digital transformation on relationships with shareholders and the new regulatory paradigm facing audit committees.

Transparency is a particularly important topic to me so I was pleased that it was a major theme of this conference. It came up not just in the context of directors' remuneration but also in the lively discussion around the new regulatory challenges that face audit committees.

Thank you for taking the time to read this report on the key findings of the conference. I hope you enjoy it.

Lucia Žitňanská

Deputy Prime Minister and Minister of Justice of the Slovak Republic

01 Opening remarks

The conference was opened by Elena Kohútiková, Deputy Chief Executive Officer for Bank of Intesa Sanpaolo Group, and Chairwoman of the Board of the Central European Corporate Governance Association (CECGA).

She explained that the conference was taking place as part of the first-ever Slovakian presidency of the EU and was the first-ever international conference on corporate governance in Slovakia. "This is a unique opportunity to make corporate governance principles more visible in Slovakia as we still face many challenges in this area," she said.

Kohútiková revealed that the updated *Corporate Governance Code for Slovakia*, which was based on the OECD's 2015 Principles of Corporate Governance, was in delegates' information packs and would be seen for the first time by the public on the day of the conference.

She said that the conference would focus on four particular themes: corporate governance in a global context; challenges for the board: remuneration and transparency; digital transformation and corporate governance; and audit committees and the new regulatory paradigm.

Message from the President

Next came a video message of welcome from Andrej Kiska, President of the Slovak Republic. He explained that while Slovakia has a population of just five million people, making it one of the smaller markets in the EU, it has a strong focus on good corporate governance.

"We understand that it plays a crucial role in terms of attracting investment from both domestic and foreign investors," he said. "Well-governed companies attract investment that enables them to innovate, expand and generate wealth and jobs for their economies. That is the reason why this important subject has been important to public representatives since the turn of the millennium."

President Kiska also noted that he was pleased that digitalization and transparency were on the conference agenda because they were among his priorities since being in office. "There is a lot of work ahead of us," he said. "I hope your discussions will contribute to the process of finding long-term, effective solutions."

Emphasis on transparency

After the President's video came Lucia Žitňanská, Deputy Prime Minister and Minister of Justice of the Slovak Republic.

"Well-governed corporations have benefits, not just for shareholders, employees and clients, but for society as a whole," she told the conference. "They participate in the social climate and set relationships in a wider context, not only for the private sector but for the government and public sector as well."

Žitňanská said that transparency was a very important topic to discuss because it is a precondition of every functioning relationship – from relationships between family members through to the relationship between the private sector and the state. Where conflict arises with regard to transparency, it is usually because different stakeholders have different ideas about what it actually means.

Finding common ground on transparency is a process that is "decided by internal relations and expectations and influenced by various global phenomena and challenges", Žitňanská noted.

She added that while the public usually has a justified right to know whom the government is doing deals with, the government cannot always meet this expectation if private companies are involved. For this reason, Slovakia has created a legal regulation to introduce more transparency into the relationship between the state and company actual owners.

Concluding, Žitňanská said: "We all know that to improve the environment, it is not enough to pass legislation. The will and the willingness of key stakeholders to take full responsibility for creating a social climate, and an environment where this legislation can really be implemented, are also important."

Corporate governance in a dynamic business landscape

Speaking on behalf of the Ministry of Finance of the Slovak Republic, State Secretary Dana Meager said the focus on corporate governance has increased since the financial crisis of 2009. It is also the outcome of the dynamic business environment and new trends such as the advance of digitalization.

"The world economy has not yet recovered from the crisis," Meager warned. "Businesses around the globe face immense pressure. They are struggling to survive and they have to change their patterns of doing business." The result is that not all entrepreneurs are using legitimate means to overcome the challenges they face.

Meager revealed that the Panama Papers scandal had been the "earthquake" that motivated authorities around the world to tackle the misuse of the financial system and the loopholes in tax framework. The EU, for example, is amending the Fourth Anti-Money Laundering Directive as well as Directive 2011/16/EU as regards access to anti-money-laundering information by tax authorities.

Ultimately, Meager told delegates, corporate governance should not just be about regulators, it should be about businesses and investors. "It is time for the sector to be a role model. Either that or regulators will tell you what to do and, in some cases, it may not be what suits you well. You will have authentic information on what can be improved and how to get things run in a better way."

She added: "If you decide to do this and take the initiative into your own hands and improve the way you work, you will definitely have the support of all of society, including the ministries of finance. Regulators are open to listening. Rather than being enemies, they could be partners in this endeavor."

Digitalization and corporate governance

"The spread of new technologies, with new models of behavior, are having a huge impact on daily life and the economy as a whole," said Věra Jourová, Commissioner for Justice, Consumers and Gender Equality at the European Commission via a video message. "It is shaping the way we communicate and the way firms do business."

A more digitalized economy is also having an impact on corporate governance, she continued. "We should capitalize on digitalization to share information faster, better and safer."

In particular, Jourová emphasized that the proposed Shareholder Rights Directive is an important step towards more digital corporate governance. "It will ensure more efficient communication throughout the investment chain," she explained. "In this way, it will enable listed companies and their shareholders to communicate more efficiently. This, in turn, will encourage more shareholder engagement."

She also highlighted that the directive will be an important step towards increasing accountability regarding directors' pay and fostering a responsible approach to investment. As such, it will contribute to one of the priority areas identified under the recent European Commission communication on Capital Markets Union – sustainable finance. "I am confident that a successful agreement on this proposal can be found under the Slovak Presidency and the Commission stands ready to support the process," Jourová concluded.

Corporate governance in a global context

Our dynamic environment presents both exciting opportunities and complex challenges to businesses. During the opening panel session, panelists discussed the major global issues that impact on corporate governance today.

Moderator: Martin Peter, Head of the Banking Department, Ministry of Finance of the Slovak Republic

Panellists: Colin Mayer, Professor of Management Studies and Former Dean, Oxford University's Saïd Business School

Kerrie Waring, Executive Director, International Corporate Governance Network

Frank M Placenti, Partner and Chair of the US Corporate Governance Practice, Squire Patton Boggs

Marcello Bianchi, Chairman of the Corporate Governance Committee, OECD and Deputy Director General, Assonime

Natacha Dimitrijevic, EU Corporate Governance Expert, Hermes Investment Management

> "Profits are the rightful by-products of purpose, but profits are not the same as purpose."
>
> **Colin Mayer**
> Professor of Management Studies and Former Dean, Oxford University's Saïd Business School

Martin Peter, Head of the Banking Department at the Ministry of Finance of the Slovak Republic, moderated the opening session on corporate governance in a global context. This session explored governance codes, engagement with shareholders and the interaction between businesses and the broader economic, political and social ecosystem, among other topics.

> "Some directors don't spend enough time on strategy and generating value. They spend way too much of their time on compliance and oversight. In other companies, there is too much focus on profits and too little on compliance and oversight."
>
> **Frank M Placenti**
> Partner and Chair of the US Corporate Governance Practice, Squire Patton Boggs

Changing expectations of capitalism

Colin Mayer, Professor of Management Studies and Former Dean at Oxford University's Saïd Business School, explained that the public is increasingly aware "that corporate governance really matters". This is not just in the traditional sense of increasing shareholder value, but also in the sense that it helps to determine the future of our economic and political systems.

The recent political upheaval in the UK demonstrated this all too clearly, Mayer said. "One of the consequences of Brexit has been a complete reversal of view on the merits of the UK's corporate governance system. From being upheld as the finest in the world, it is now perceived to be a source of greed, inequality and profound public disillusionment with the UK corporate sector."

It is widely acknowledged that public trust in the financial sector was destroyed by the financial crisis, he continued. Now there is a view that this breakdown in trust has extended to all business sectors as a result of the existing systems of corporate governance not being tough enough.

For this reason, there are calls for a closer alignment of corporate and shareholder interests through, for example, more accepted powers of shareholders to reject unreasonable remuneration practices. Furthermore, there are demands for

stricter enforcement of rules against bribery, corruption, market manipulation, market abuse and environmental damage.

That said, Mayer revealed an alternative view of the breakdown in public trust that is gaining traction around the world. According to this view, it is not that we are failing to impose the right model of capitalism with significant vigor, rather we have the wrong model of capitalism altogether. He said this was reflected by the rise of "a substantial movement under various banners of responsible, conscious, personal and sustainable business and capitalism".

We need to take a more enlightened view of the role of corporations in societies around the world, suggested Mayer. At the heart of this enlightened outlook is the idea that a business should be driven by purpose and values and not just profits. "Profits are the rightful by-products of purpose but profits are not the same as purpose," he noted. "Purpose should be diverse and reflect the interests of customers as well as the interests of owners."

Corporate governance should be tailored toward helping the company to deliver on its purpose, said Mayer. This means it must be diverse and flexible because it will need to vary according to the company's particular purpose and activities. So policymakers should take this into account. He suggested that it may be necessary to promote the adoption of different business models, such as the public benefit corporation model in the US, where directors have a fiduciary duty to uphold public as well as private interests.

For a balanced form of capitalism to be achieved, companies will need to be accountable and transparent, observed Mayer. They will need to promote long-term as well as short-term value creation, they will need to engage stakeholders and shareholders in delivering a broader purpose, and they will need to embed values, as well as shareholder value, in the corporate culture. "This more diverse, transparent, accountable form of capitalism will be essential if it is to address the malaise that lies at the heart of the public disillusionment," he concluded.

An ambitious and pragmatic approach from the OECD

Marcello Bianchi, Chairman of the Corporate Governance Committee at the Organization for Economic Cooperation and Development (OECD), and Deputy Director General of Italian business association Assonime, talked about the spread of corporate governance principles.

The first example of self-regulation in the field of corporate governance was the UK Corporate Governance Code, which dates back to the publication of the Cadbury report in 1992. This was a response to corporate scandals associated with governance failures. A number of European countries followed the UK's example and created their own corporate governance codes. The US has yet to agree a formal code, however, and Japan didn't have a code until 2015.

In 1999, the OECD released its own Principles of Corporate Governance and these were updated in 2004. A revision of the principles, overseen by Bianchi's committee, was published in November 2015 and adopted by the G20, which made them the model standards in corporate governance.

"With the revision of the principles in 2015, we tried simultaneously to be ambitious and pragmatic and in the same way traditional and innovative," said Bianchi. "We were ambitious because we would like to better understand the framework for corporate governance and we created some new chapters of the principles, such as a chapter on the role of the stock exchange."

He continued: "We were pragmatic because we did not suggest a single specific solution, but provided very general principles and examples. We were traditional because we did not take a strong position on the cultural view of corporate governance. We tried to provide inputs and instruments for everyone. We were an innovator because we tried to talk to policy makers in different areas, which are at different stages of development. We know corporate governance cannot be the same in Bangladesh as in the US."

The rise of investor stewardship

Kerrie Waring, Executive Director of the International Corporate Governance Network (ICGN), explained that her organization was established in 1995 in the wake of the globalization of capital. The majority of ICGN members are asset owners and asset managers who represent combined assets under management in excess of USD $26 trillion.

She reflected on the origins of corporate governance and quoted Scottish philosopher Adam Smith, who made the following observation about joint-stock companies in 1776: "The directors of such companies, however, being the managers of other people's money than their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own… negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." So Waring emphasised that corporate governance is about keeping 'negligence and profusion' in check.

She then referred to the world's first Corporate Governance Code, produced by the Cadbury Committee in 1992, which defined corporate governance as "the system by which companies are directed and controlled". Direction comes from the board, which governs the company and sets its values (a role that is distinct from the management of day-to-day operations by executives). Control comes from the shareholders who are responsible for monitoring and engaging with companies, including exercising their right to vote. This system, embedded within a 'comply or explain' context, is effectively implemented in the UK today. It provides an alternative mechanism to regulation by helping to embed good corporate governance practices. It also provides a tool for engagement between companies and investors alike.

An important trend is the rise of the investor stewardship code movement, which was provoked by the 2008 financial crisis. Waring noted that the ICGN's first statement on institutional investor responsibilities was published in 2003. There are now well over a dozen national codes of stewardship, which articulate a clear set of responsibilities for investors, such as an obligation to monitor the corporate governance of companies in which they are invested, to vote appropriately and to disclose their votes at annual general meetings. Nevertheless, Waring emphasized that the "real elephant

in the room" is the lack of resources that investors allocate to corporate governance.

The ICGN and its members strongly support the proposed Shareholder Rights Directive, as well as the work of the OECD. Waring described the OECD's principles as "a wonderful global template of founding governance principles of accountability, transparency, fairness and responsibility for us all to be inspired by". In particular, she referred to the transparency that today calls for companies to take into account integrated reporting, which puts historical performance into context, and portrays the risks, opportunities and prospects for the company in the future. This helps shareholders and stakeholders to understand a company's strategic objectives and its progress towards sustainable value creation over the longer term.

Four foundations of a healthy financial system

Natacha Dimitrijevic, an EU Corporate Governance Expert with Hermes Investment Management, said her organization was a strong backer of stewardship and governance codes because "they help us to ensure our fiduciary duties are carried out properly".

Nevertheless, she observed that the codes must apply the principle of 'comply or explain' to avoid prescriptive governance. Responsibility for this falls equally on the company and its shareholders, who need to be active owners.

According to Dimitrijevic, a healthy financial system is based on the following foundations:

1. Companies should remember that institutional shareholders represent the ultimate beneficiaries – workers and their pensions.
2. No financial performance will compensate for the exploitation of valuable, increasingly diminishing resources.
3. Inappropriate risk-taking, disproportionate remuneration and pay for poor performance will result in social unrest.
4. A resilient and prosperous economy is necessary to meet pension liabilities. Too much focus on short-term financial returns ultimately compromises returns to pension beneficiaries.

A wealth of studies has demonstrated that environmental, social and governance (ESG) factors are material to the financial performances of companies, so it is essential for investment managers to monitor the ESG performance of companies. Dimitrijevic said: "We believe that our fiduciary duties as institutional shareholders should include the monitoring of these issues."

Governance in smaller companies

Frank M Placenti, Partner and Chair of the US Corporate Governance Practice at international law firm Squire Patton Boggs, opened with the wry observation that a director's job used to consist of "showing up, eating the sandwiches and voting 'yes'". Much has changed in the intervening years, he remarked.

Placenti explained that in the US, corporate governance has been shaped by case law – in particular, a 1985 case called Smith v Van Gorkom, which held that directors could be liable for failing to prepare for, and know about, a transaction before they voted to approve it. Corporate governance also gained momentum via a letter from the Department of Labor to a pension fund manager that established the concept that a vote was an asset of the pension fund and that the managers needed to exercise care when casting their votes in order to discharge their fiduciary duties. This gave rise to the proxy advisory firms that have so greatly impacted US corporate governance.

It is easy to focus on large companies when considering corporate governance, noted Placenti, but seven out of every 10 public companies in the US has a market capitalization below $450 million. "The reality is most public companies are not large and most public company failures are not failures of oversight or compliance," he explained. "They are business failures." What's more, many of these companies "couldn't afford a director of sustainability, a director of corporate responsibility or even a director of investor relations". They are focused on real business issues, not the topics that are monopolizing the governance conversation today, he added.

Referring to corporate governance as a "three-sided triangle of oversight, compliance and value generation", Placenti argued that boards often struggle to maintain an equilateral triangle. "Many boards don't spend enough time on strategy and generating value. They spend way too much of their time on compliance and oversight. In other companies, there is too much focus on profits and too little on compliance and oversight."

Policy makers need to understand that smaller public companies do not have the same resources as larger companies in either the management team or the boardroom, emphasized Placenti. "Small-company boards are often not comprised of the same caliber of people who are involved in boards of larger companies," he said. "Smaller company boards are smaller. They have fewer people and fewer resources. And they don't attract the same top-tier management talent or the same top-tier advisers." As a result, it is particularly important that these companies receive information from the governance community that is relevant and helpful to their governance, much of which should focus on director competence.

Placenti concluded with three key messages for smaller public companies:

- Directors need to be competent for the tasks that they are undertaking.
- Pay attention to capital raising – a badly structured capital transaction can destroy value quickly in small public companies.
- Values matter – just because a business is small doesn't mean it has permission to damage the environment or to abuse employees or public officials.

Panel discussion

In a lively panel discussion, moderator Martin Peter asked what the role of governments and policymakers should be in setting corporate governance rules.

Mayer argued that it was the role of government to set the legal framework, in the form of anti-bribery and anti-corruption laws, and to ensure such rules were upheld. Government and society leaders then had the responsibility to establish "the right norms and values" and encourage organizations to adopt the right type of culture.

Dimitrijevic observed that it is hard to achieve the right balance between a legislative regime and self-regulation. Not only is it difficult to regulate company culture, she argued that "when there are specific rules, people find ways around them".

A heavily regulated system leads to nothing more than mere compliance, Placenti said. "We should be trying to achieve more than mere compliance. We should be asking directors to understand that when they are in the boardroom they are proxies for more than just the shareholders." In that situation, we will find directors "who are going to act with greater integrity, greater courage and greater responsibility," he added.

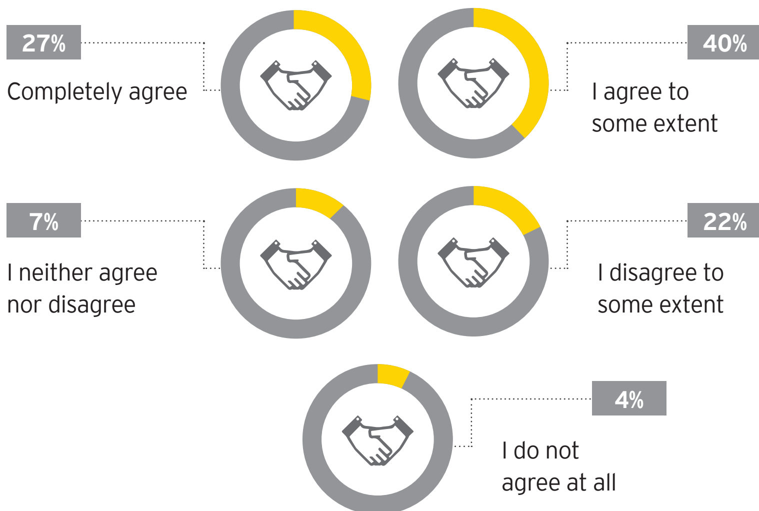
Waring argued that the principle of fairness, or the equitable treatment of shareholders, is "one of the most important pillars of effective corporate governance". The ICGN supports 'one share, one vote' – a stalwart governance principle. It also advocates against the introduction of differential voting rights, which can skew economic interests vis-à-vis voting influence, disenfranchise small investors and entrench management. "The development of stewardship codes is a better way to encourage longer-term thinking and behavior in capital markets," she said.

Mayer pointed out that the evidence of differential voting rights was extremely controversial, however, and emphasized that some of the most successful companies in the US, such as Alphabet and Facebook, have dual-class shares.

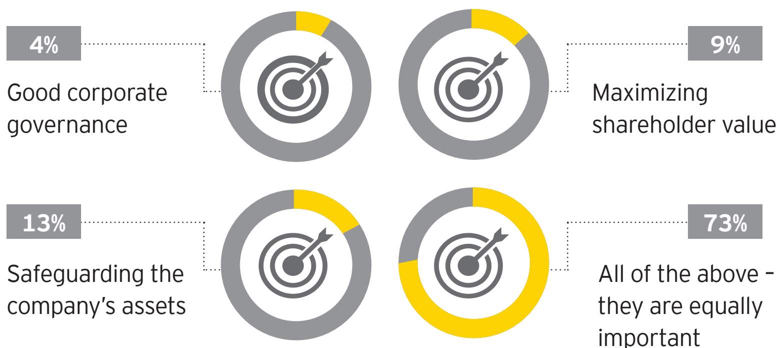
"Corporate governance is real people making real decisions in real time," commented Placenti. "Those stewards who engage with directors need to keep that in mind. The most important thing they can do to bring about change in the corporate governance world is to push to have directors who have courage, integrity and the peripheral vision to see issues in the very broad landscape that is necessary in today's world."

Audience poll*

To what extent do you agree with the general principle of 'one share, one vote'?



What should a board's primary goal be?



03

Challenges for the board: remuneration and transparency

Remuneration is arguably the most controversial aspect of corporate governance, attracting the attention of shareholders, politicians, the media and the wider public. In this session, panelists debated the key issues.

Panellists: Carmine Di Noia, Commissioner, CONSOB

Turid Elisabeth Solvang, Chair, EcoDa

Joanna Sikora-Wittnebel, Team Leader for Corporate Governance, DG JUSTICE, European Commission

Guylaine Saucier, Board Member and Audit Committee Chair, Wendel

Katarína Kaszasová, Governing Bodies Department, European Investment Bank

Moderator: Leena Linnainmaa, Deputy Chief Executive, Finland Chamber of Commerce

> "If shareholders do not approve of a board decision, executive remuneration included, they have the privilege of being able to dismiss the board. That is their say on pay."
>
> **Turid Elisabeth Solvang**
> Chair, EcoDa

Opening this panel discussion, moderator Leena Linnainmaa, Deputy Chief Executive of the Finland Chamber of Commerce, said: "If you ask the media, remuneration is the most important and the only important thing about corporate governance, but we know better. There are other interesting issues." Nevertheless, she said there are plenty of meaningful areas to explore with regard to remuneration including the appropriateness of taking a one-size-fits all approach, the unintended consequences of too much transparency over executive pay and the link between remuneration and shareholder relations.

> "Transparency is like democracy. It has a lot of downsides and creates a lot of problems, but we haven't found a better solution yet."
>
> **Joanna Sikora-Wittnebel**
> Team Leader for Corporate Governance, DG JUSTICE, European Commission

Remuneration disclosure in Italy

Carmine Di Noia, a Commissioner with CONSOB, the Italian Securities and Exchange Commission, outlined the process for disclosing board remuneration in Italy. He explained that CONSOB has adopted a standardized table format for disclosing the individual remuneration of directors in listed companies' annual reports. This approach aligns with the EU recommendation that director remuneration should be disclosed on an individual basis.

The standardized format consists of two tables. The first table is a compensation overview table. This states the level of fixed compensation that the director received in the financial year, their variable non-equity compensation, the fair value of their equity compensation, bonuses and other incentives, profit sharing, severance pay and compensation from subsidiaries, among other information. The second table is the stock options and variable compensation table. This provides a detailed breakdown of the stock options that the director has received, including what the options were worth when they were assigned and when they were exercised.

Di Noia said it is important to have standards for disclosure of remuneration "or all this transparency is confusing and useless". He continued: "Disclosure is necessary, but disclosure and compensation are technical issues. Standards give a

framework for actual and potential shareholders to evaluate what's going on. Transparency is the best disinfectant."

Overall, Di Noia said there are seven key criteria for boards to consider when it comes to remuneration:

1. *How?* Do we use regulation or self-regulation or both?
2. *To whom?* Members of boards, supervisory boards, other executives?
3. *Which companies?* Listed companies, state-owned entities etc.
4. *What kind of transparency?*
5. *When?* What are the timing criteria for the remuneration policy?
6. *What in?* Cash compensation, equities, fixed, variable?
7. *The means of disclosure.* Do the numbers have any meaning? Is it necessary to use a standard?

Remuneration and trust

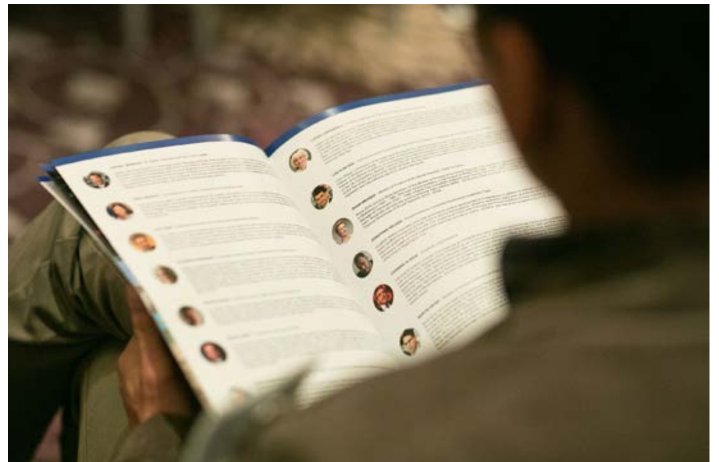
Remuneration and transparency are complex issues that can take many directions, observed Turid Elisabeth Solvang, Chair of EcoDa, the European Confederation of Directors' Associations. This explains why there is currently much focus both on the content of compensation packages and whether disclosure provides all stakeholders with equal access to information about compensation.

Addressing the matter of why there is a major focus on remuneration at both the EU and national level, Solvang said: "What lies at the heart of all businesses, all transactions and all relationships is trust. When trust is compromised, relationships become fragile. Distrust flows in a negative spiral. We all become more cautious, more suspicious. We seek more information and we want to eliminate every opportunity of foul play."

If companies fail to respond to this breakdown in trust, regulation will continue to proliferate, warned Solvang, with the risk that if ultimately regulation fails to deliver the desired results, "the board's stewardship and privileges may be delegated to other bodies".

Solvang highlighted that English MP Chris Philp has already suggested creating special shareholder committees to overlook proportional executive remuneration. These shareholder committees would ratify the pay policies and actual pay packages proposed by the remuneration committee.

So can shareholders be relied on to effectively control executive pay? "Shareholders definitely have a vested interest in ensuring that remuneration corresponds with performance," acknowledged Solvang. "But is it reasonable to expect passive shareholders to evolve into micro managers or will they just hand power to the proxy advisers?"



"It is the task of the board of directors' to consider the company's overall interest," Solvang observed. "For that reason, the independently-minded board is probably best placed to consider the company's interest, including the decision on executive remuneration. Shareholders cast a vote at the general meeting by electing non-executive directors and approving their remuneration. If shareholders do not approve of a board decision, executive remuneration included, they have the privilege of being able to dismiss the board. That is their say on pay."

Ultimately, the board of directors should ensure that remuneration is aligned with the company strategy, explained Solvang. It should tell a story, explain why this level of compensation is right for this company and communicate regularly with shareholders. Also it needs to determine the tone at the top. "The summit of the corporate peak is not executive management but the board of directors," she said. "To rebuild trust, the board needs to set aside short-term profitability and dividends and take responsibility for the company's values and incentives.

The European Commission's say on pay

"Remuneration is the most understandable aspect of corporate governance for the wider public," observed Joanna Sikora-Wittnebel, Team Leader for Corporate Governance, Directorate-General Justice at the European Commission.

Yet the European Commission does not want remuneration to overshadow other important issues, which is why the Shareholder Rights Directive deals with additional topics besides compensation. Its own interest on remuneration focuses on whether short-term incentives are leading directors to take short-term decisions.

In March 2016, the Commission concluded a consultation on long-term sustainable investment, which found that a short-term approach to investment pervades at all levels in the capital markets. The Shareholder Rights Directive, which is currently being negotiated, aims to address this short-termism by requiring companies to prepare and disclose a remuneration policy that describes their approach to remuneration. Both the remuneration policy and the remuneration report are submitted to shareholders in the form of a vote.

Looking beyond remuneration, a much broader challenge is the sustainability of the financial markets in general. Since short-term views are still predominant in the market, the Commission is reflecting on how it can encourage a more sustainable approach to investment. So it is forming a higher-level expert group that will be tasked with thinking about what regulatory and non-regulatory measures can be introduced at EU level to encourage the markets to be more sustainable and look at the long term.

How transparent is too transparent?

Guylaine Saucier, Board Member for French investment company Wendel, explained that in her native Canada companies began disclosing the remuneration of the five top directors 15 years ago. The result was an upwards spiral in pay as people compared themselves to peers in other companies in both Canada and the US. "The net impact is much higher remuneration, no doubt about that," she said.

Since the purpose of transparency is to give shareholders and stakeholders the information they need to make their own decisions, remuneration reports should be clear, complete and pertinent, Saucier noted. "If we need 50 or 60 pages to explain what we are doing, it may be that our system is too complex and we need to simplify it because we are not helping anyone."

Saucier said that she disapproved of the idea that shareholders should have a say on pay "because it is an erosion of the role of the board." Her preferred approach would be a shareholder-approved remuneration policy on the basis that if shareholders approve the policy, they should then accept the result of the policy.

She also argued that when it comes to incentivizing directors, boards could learn from the approach of investor Warren Buffett, who structured the remuneration packages of the companies he bought according to what he wanted to achieve with each company. "This is work we really need to do as a board and I think that this is the most important job of a board," she said.

Transparency is the currency of trust

There is an innate conflict between confidentiality and transparency within the public sector, explained Katarína Kaszasová from the Governing Bodies Department of the European Investment Bank (EIB). As an EU body owned by EU Member States, the EIB is committed to achieving the highest possible level of transparency in all its activities, so it applies compensation disclosure. At the same time, however, it is a bank that follows the best banking practice so it must abide by some restrictions regarding confidential information.

The EIB has four statutory bodies: the board of governors, the board of directors the management committee and the audit committee. There are 54 individuals on the board of directors, which is in distinct contrast to listed boards that normally number between five and 15 board members. It is written in the EIB's statute that members of the board of directors should be responsible only to the bank. Yet they are nominated by member states, usually occupy senior positions in ministries and tend to have very strong public policy backgrounds. "This, of course, embeds a strong conflict of interest for each individual board member," noted Kaszasová.

Members of the board of directors receive a €600 daily fee for attending the board meeting and a €200 daily allowance for expenses if they have to stay overnight. They are reimbursed travel expenses, but they do not receive a bonus or any other reward. "In comparison to the fees paid to directors of listed companies, it is clear the directors of the bank are just paid an honorarial fee for their services," explained Kaszasová. "If they are government officials – and most of them are – they have to transfer this compensation to their ministry in accordance with national rules." Detailed information on the remuneration scheme for members of EIB statutory bodies, including the board of directors, is disclosed in the annual corporate governance report that is available on the EIB web site.

Combining her knowledge of the EIB with her experience of the Slovak Ministry of Finance, where she was Director General, Kaszasová said there were many issues to consider with regard to board members for state-owned companies. She highlighted three in particular:

1. Should the remuneration schemes of board members with roles in both private and state-owned companies be made more transparent by both sets of companies?
2. Should the remuneration of board members, who are also political nominees, contain long-term motivating factors or should they be based only on short-term cash bonuses? (Political nominees on boards are usually victims of the election cycle, which does not promote long-term thinking.)
3. Should nominees who are civil servants or employees of the state administration be remunerated in the same way as their colleagues on the board who are from the private sector? If not, how do we motivate talented civil servants to become board directors?

Commenting on Kaszasová's remarks, Saucier said that in Canada, it is accepted that sitting on a board is part of a civil servant's day job if he or she is mandated to do so by a minister.

Solvang revealed that Norway has solved the problem by not having governmental representatives on boards. "We do have nomination committees where bureaucrats are represented and the election of board members would be on the recommendation of the nomination committee." She added: "The board is a team with the same responsibilities, the same duties. If some people are not remunerated at the same level as other people, you have a problem."

Panel discussion

In the panel discussion, Linnainmaa queried whether company compensation schemes had become so complex, with unclear long-term incentives, that directors no longer found them motivating.

Sikora-Wittnebel pointed out that research suggests that the way share-based remuneration is used, in particular, can be quite counter-productive. "Its aim is to incentivize long-term behaviors but sometimes it has the contrary effect," she said.

An audience member concurred with this view, pointing out that it could be risky to tie up too much of the directors' wealth in stock since these individuals are also expected to communicate honestly with the market about their company's fortunes.

With respect to whether remuneration statements should be standardized, Di Noia confirmed that he agreed with the results of the audience poll – they should be partially standardized but leaving some flexibility. The UK is already looking at this and has formed a working group, which has developed some guidelines to assist companies' remuneration committees.

Summing up, Sikora-Wittnebel said poignantly: "Transparency is like democracy. It has a lot of downsides and creates a lot of problems, but we haven't found a better solution yet."

Audience poll*

How should government appointees on the board of a state-owned enterprise be remunerated?

12%

They should just receive basic government salary

45%

They should receive their basic salary plus an extra amount reflecting their increased responsibility

43%

They should receive the same as any other board director

To what extent should remuneration statements be standardized?

8%

Completely

69%

Partially, but leaving some flexibility

23%

Not at all. Let companies decide

04

The relationship between digital transformation and corporate governance

Digitalization is transforming the global economy. In this session, panelists debated whether the existing company law and corporate governance frameworks are fit to embrace the digital age

Panellists: Jérôme P. Chauvin, Deputy Director General, BusinessEurope

Markus Kaum, Head of the Legal Department, Munich Re

Miroslav Trnka, Co-founder and Co-owner, ESET

Ann LaFrance, Partner and Co-leader, Data Privacy & Cybersecurity Practice, Squire Patton Boggs

Jonathan Nelson, Corporate Governance Leadership Team, Sustainalytics

Moderator: Florence Bindelle, Secretary General, EuropeanIssuers

"Digital, if well implemented in the life of the company, can help the company to move faster in what is already a highly competitive and globalized environment."

Jérôme P. Chauvin
Deputy Director General
BusinessEurope

"System infiltrations raise very serious governance concerns. Cyber attacks can harm an organization's operations and lead to the theft of its intellectual property. In the absence of appropriate security, cyber attackers could also easily manipulate the results of voting on the digital platforms and proprietary systems used in shareholder annual general meetings."

Ann LaFrance
Partner and Co-leader
Data Privacy & Cybersecurity Practice,
Squire Patton Boggs

In 2014, EU President Jean-Claude Juncker identified the creation of a digital single market as one of the priorities of the European Commission. So where are we today? This was the question posed by panel moderator Florence Bindelle, Secretary General of EuropeanIssuers, an organization representing quoted companies across Europe to the EU institutions.

Opportunities and challenges

Digitalization has changed the way that companies operate and create value, said Jérôme P. Chauvin, Deputy Director General of BusinessEurope, which represents national business associations in EU member states. It has also changed the way in which they relate to their customers, investors, market authorities, shareholders, stakeholders and workers.

The benefits of digitalization include cost savings, efficiency gains and the ability to conduct business quicker and in more markets of the world. "Digital, if well implemented in the life of the company, can help the company to move faster in what is already a highly competitive and globalized environment," noted Chauvin.

Nevertheless, despite the obvious value of digitization, Chauvin highlighted that its potential to improve corporate governance had been overlooked by companies and policymakers, particularly at EU level. "In the US, it is common practice to have shareholder meetings with e-facilities, webcasts and electronic votes," he said. "This is the case in some EU member states, such as Denmark, but it is far from being the common practice."

BusinessEurope reflected with its member associations to identify the main challenges associated with the digitalization of corporate governance and company law and to make recommendations to address those challenges. It published its findings in a paper entitled **EU company law going digital.**

According to the paper, the main challenges are as follows:

1. Finding the right balance between regulation, self-regulation and market development. Legislation will not force companies to go digital: there needs to be a balance between the legal framework and market development.
2. Establishing a technologically neutral, future-proof approach that encompasses several different solutions. It is counterproductive to rely on one solution alone.
3. Determining what aspects of digitalization should be left to member states and what to leave to the EU with regard to subsidiaries.
4. Safety is the biggest obstacle to the digitalization of company law and corporate governance. When it comes to cybersecurity, the strength of the whole system will always be measured against its weakest link.
5. Identifying the added value of going digital – there is no point going digital just for the sake of it. Every company must see how and why digitalization can improve its corporate governance.

The paper recommended that there should not be a one-size-fits-all approach to digitalization. "Diversity and flexibility are very important when going digital for company law and corporate governance," said Chauvin.

He added: "We would like to see a gradual parity between physical publications and digital publications and we need more work done on the set-up of e-identification. We should aim for a correct and swift implementation of the eIDAS Regulation (on electronic identification and trust services for electronic transactions) and the directive setting up the interconnection of EU business registers. Finally, we need a more harmonized approach to security, with more coordination and cooperation between national authorities."

Other initiatives have an important role to play, Chauvin said. These include the Shareholder Rights Directive and the EU's single-member company project, which both endorse digital. BusinessEurope believes that national corporate governance codes should promote more digitalization at a general assembly and vote level. It is also necessary to address the digital skills gap and ensure that more people in companies are equipped with digital skills.

Digitalization in practice

"To me the essence of corporate governance is about how to run a better company in the long term and how to create value for its owners in the long term," said Markus Kaum, Head of the Legal Department at German reinsurer Munich Re. "Corporate governance differentiates between the role of managing a company, the role of controlling management and the owner's role in exercising their rights over management. For that, you need a dialogue that allows the possibility for owners to exercise their rights and for owners and companies to have mutual knowledge."

Digitalization plays a crucial role in enabling owners to exercise their rights, particularly in the case of large multinational businesses that will typically have large numbers of overseas shareholders. "You have to think about how you enable owners outside your home country to exercise their shareholders' rights," said Kaum.

Giving the example of Munich Re, Kaum explained that the company has around 210,000 shareholders on its issuer register. Of those, 95.6% are private shareholders in Germany. Nevertheless nearly half (48%) of Munich Re's share capital is held by institutional shareholders abroad. The company sends out invitations to annual general meetings, where shareholders can exercise their voting rights, via post and email. It allows registrations via post and email and has noticed an increasing tendency towards digitalization in registrations. Online is also gaining influence in postal voting. Shareholders are reluctant to participate in annual general meetings using digital technology, however. In 2016, just 156 shareholders participated in Munich Re's AGM online, compared with 2,795 who participated in person.

The challenge, said Kaum, is ensuring that shareholders based outside Germany have sufficient opportunities to exercise the voting rights they acquired when they bought a share. This is a particular problem for retail investors, but even large institutional investors that use intermediaries can struggle to exercise their voting rights. There are many examples of intermediaries not properly following the voting instructions given to them by investors.

Ultimately companies need to know more about their shareholders if they are to use technology to encourage greater participation. "Technology can be used to enable investors to exercise their rights," Kaum explained. "But you need to know data about your shareholders to be able to offer them the right to use digital means for participating in the meeting, be it electronic voting or electronic participation. You need to follow the data from the intermediary to their client to enable shareholders to exercise their rights."

Kaum believes that while privacy is an issue with digitalization, there should be no question of privacy when it comes to a company knowing who its owners are. "There needs to be mutual knowledge between the company and its owners," he said but acknowledged that shareholder data needs to be protected from cybercriminals or analysts who might want to use it to sell their services.

Munich Re uses digitalization for a wide range of activities including digital meetings, virtual conference and virtual project rooms. "All our analyst conferences and all our digital presentations are put on the web at the moment they are happening in the room," said Kaum. "Every shareholder at Munich Re can participate in all our analyst conferences. Worldwide, wherever they are, they can hear what our CFO is telling the representatives of Prudential and BlackRock at the time he is saying it."

The cyber threat

Moving on to the topic of cybersecurity, Miroslav Trnka, Co-founder and Co-owner of Slovakian IT security company ESET said: "We have to protect the digital environment because it brings value to us. In our company, we record around 300,000 new malware every day. Meanwhile, perhaps 70% or 80% of all internet traffic consists of spam and viruses. So if we are talking about digitalization, we also have to seriously think about security."

Ann LaFrance, Partner and Co-leader of the Data Privacy & Cybersecurity Practice at international law firm Squire Patton Boggs, confirmed that cybersecurity is a critical issue for boards at present – along with data protection and privacy.

"For consumer-based companies, monetizing the use of personal data has become the gold rush of the 21st century," she said. "But even if you are a business-to-business company, you are still processing personal data because you have employees."

LaFrance explained that many technology companies understand the importance of using data responsibly because it affects their brand value and reputation. Nevertheless, some companies may not yet fully appreciate that having control of extensive amounts of personal data could mean they will be subject to greater regulation over time under the competition rules or new regulatory frameworks aimed at digital platforms.

In May 2018, the new General Data Protection Regulation (GDPR) comes into effect. Intended to strengthen and unify data protection for individuals within the EU, it includes an accountability principle that gives corporate boards responsibility for ensuring that their companies protect the data they hold and use it responsibly. Where companies fail to comply with the GDPR, they could face penalties of 4% of global turnover or €20 million, whichever is higher. "These are very similar to the penalties for violation of competition rules," noted LaFrance. "They are meant to get the attention of corporate boards."

Cybersecurity relates to the protection of personal data as well as the protection of operating systems, corporate records and intellectual property. To emphasize the importance of cybersecurity, the EU has adopted the Network and Information Services Directive, which will require those involved in the ownership and operation of critical infrastructure to abide by cybersecurity laws.

It is not just about infrastructure; people also have a big role to play in cybersecurity. "The majority of problems arise though the actions of employees," explained LaFrance. "Usually this happens unintentionally, but sometimes not. Employees can fall victim to phishing exercises where they unwittingly give out their data, then hackers infiltrate the system by impersonating those employees. "System infiltrations raise very serious governance concerns. Cyber attacks can harm an organization's operations and lead to the theft of its intellectual property. In the absence of appropriate security, cyber attackers could also easily manipulate the results of voting on the digital platforms and proprietary systems used in shareholder annual general meetings."

She continued: "We need to spend time, money and effort, not only on systems, but also on training employees and making sure they understand what phishing is so that they can avoid getting caught up in the net cast by would-be hackers and help ensure that the company doesn't suffer as a result."

Under both the GDPR and the Network and Information Services Directive, European companies will have new obligations to notify both the supervisory authorities and the data subjects of data breaches. In the case of the GDPR, this is no more than 72 hours after the company became aware of the breach unless that is not feasible. "If you haven't got your corporate governance ducks in a row regarding data protection and cyber security preparedness, and if you haven't followed the accountability assessment process, I can tell you – having assisted many clients with data breaches already – there's no way you can meet the 72-hour deadline," LaFrance said.

At present, shareholder voting in the US is under scrutiny over concerns that a cyberattack could influence a vote and the company might not even know it. Furthermore, the US Securities and Exchange Commission believes that boards have a crucial role to play with regard to the oversight of cyber risk management. Hence it requires publicly traded companies to include in their disclosure statements the extent to which they believe their systems may not be up to standard. "This is an area where corporate governance is merging with the external regulatory obligations that are requiring companies to spend quite large amounts of time and money to resolve the problem of security in a digitalized world," observed LaFrance.

Communication with shareholders

Jonathan Nelson, a Member of the Corporate Governance Leadership Team at analytics provider Sustainalytics, outlined the three main areas where digitalization is impacting businesses:

1. Regulatory and listing requirements – including digitalization of annual general meeting notices and annual disclosure documents.
2. Administrative functions – including filing the initial documents to become a public company and functions such as HR, payroll and systems.
3. Business operations – for example, the process of moving from being a bricks and mortar store to becoming an online store only.

The first and second areas are most relevant to corporate governance. Nelson explained that the digitalization of regulatory and listing requirements "opens up the channel for international capital to flow into regional, smaller markets that did not previously have access". This does present some challenges for companies, however – in particular, whether they will be able to handle a tide of incoming enquiries from shareholders and stakeholders as a result of the increased disclosures they make.

Sustainalytics conducted research of the largest companies in Europe by market capitalization. It found that just 45% of these companies have specific shareholder engagement policies that explain how shareholders can make enquiries and who they should make them to.

"That means that 55% of large companies in Europe currently do not have that capacity," observed Nelson. "They either just provide an email address, which may or may not be responded to, or a contact form that just goes into the ether and may be responded to or not."

Turning to cyber risk, Nelson revealed that the Sustainalytics research had also found that over half (i.e. 56%) of large companies do not have risk management policies that enable shareholders to evaluate the systems that companies have put in place and understand who they can contact when something does go wrong.

He also noted that while boards are responsible for monitoring cyber risk, it is not clear that directors are capable of evaluating the risk reports that they receive. A recent report by NASDAQ, in association with a cyber security risk education provider, found that 60% of boards do not view cyber risk as their purview. The same research highlighted that the level of financial literacy among non-executive directors in companies in the UK and Germany was between 49% and 65%, rising to between 65% and 70% for executives.

"Non-executives are important because in a debate they are supposed to provide a robust counterpoint to management's agenda," noted Nelson. "So if you have such a high gap in financial literacy and cyber risk literacy between execs and non-execs, how do we know the cyber risk policies that the executives are putting in place are actually capable of performing the function they are supposed to do?"

He emphasized that smaller-cap companies have limited capacity to manage these risks and are even less equipped than their larger peers to handle the influx of shareholder communication that will follow initial digitalization.

Nelson finished by pointing out that companies should be mindful of how they communicate with their owners since shareholder activism is on the rise in Europe. In 2014, there were 51 cases of targeted shareholder activism. In 2015, there were 67. Yet, in the first six months of 2016 alone, incidents of shareholder activism had risen to 64.

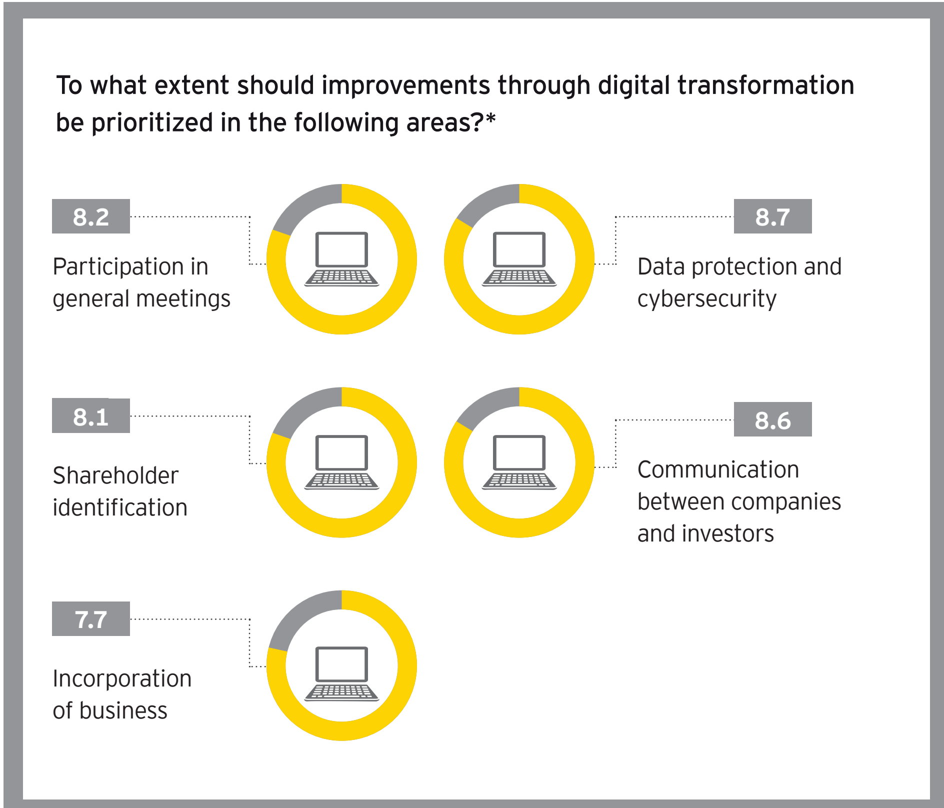
Panel discussion

Trust is an important issue with respect to digitalization, panelists agreed in the Q&A. "We need trust in the system but it's two-way – not just from shareholders, but also from companies," said Chauvin. "If there is a technological problem in the system that prevents a shareholder from being able to vote online, that shareholder might be able to challenge the decision of the general assembly in some countries. As a result, companies are thinking twice before going digital unless they have real trust in the system."

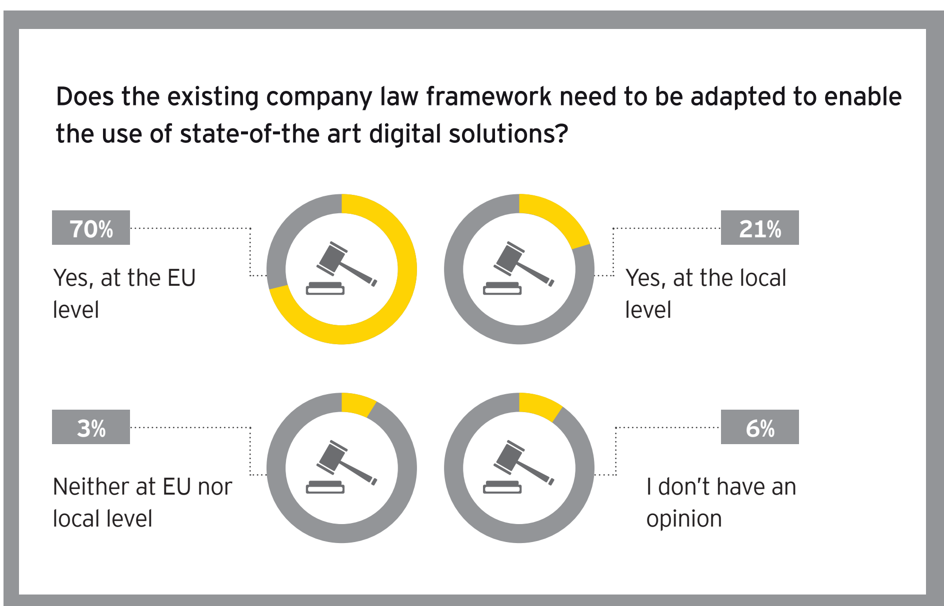
Responding to criticism that the current system for shareholder voting is not working, Kaum acknowledged that there were issues with it but he predicted that technology could help to improve it, particularly if data formats and data fields were standardized and use was made of legal entity identifiers.

Summing up, Chauvin said: "We don't have a silver bullet. Digitalization is not just one proposal. It's a series of proposals that will gradually make digital more used in company law and corporate governance."

Audience poll*



*Polling was done on a scale of 1-10



05

Audit Committees and the new regulatory paradigm

The theme of the final panel discussion was how the role of the audit committee is evolving in response to new audit legislation and the changing expectations of investors, regulators and society at large.

Panellists: **Auke de Bos**, Professor at Erasmus University and Professional Practice Director for the assurance practice, EY Netherlands

David Devlin, Chairman of the European Corporate Governance Institute

Guylaine Saucier, Board Member and Audit Committee Chair of Wendel

Guy Jubb, Independent Governance Advisor and Member of the Standing Advisory Group of the Public Company Accounting Oversight Board

Moderator: **Jeremy Jennings**, Regulatory & Public Policy Leader, EY EMEIA

"I don't know how we are going to manage mandatory auditor rotation if one country is on 10 years and another country is on eight years. In France, we have two auditors. We will need a program to manage it. It is going to be an awful job and totally inefficient."

Guylaine Saucier
Board Member and Audit Committee Chair of Wendel

European audit committee members have more responsibilities and face more challenges than ever before, particularly in light of EU audit legislation that took effect in June 2016. The closing panel session, moderated by Jeremy Jennings, Regulatory & Public Policy Leader, EY EMEIA, explored the new regulatory paradigm and its practical implications for audit committee members.

New EU audit legislation

David Devlin, Chairman of the European Corporate Governance Institute, opened the discussion with an overview of the new EU regulatory framework on statutory audit, which includes an amended directive and a regulation.

He explained that both the directive and the regulation contained ambiguities.

"Enhanced auditor reporting enables investors to unlock what I call 'the black box' of auditing."

Guy Jubb
Independent Governance Advisor and Member of the Standing Advisory Group of the Public Company Accounting Oversight Board

At the same time, member states were given numerous different options under the legislation, which will mean there is a "patchwork" of different audit regimes across Europe – minimum harmonization, in other words.

Under the new legislation, companies that are defined as public interest entities (PIEs) must either rotate their auditor or put their audit out to tender after a maximum of 10 years. Member states have the option to adopt a shorter time frame for rotation, allow public interest entities to keep their current auditor for a maximum of 10 additional years provided a public tender has taken place, or extend the time frame by a further four years if they use joint auditors. Broadly speaking, PIEs are considered to be listed companies as well as all credit institutions and insurance businesses, whether they are publicly or privately owned. There are approximately 37,000 PIEs in the EU.

The new legislation also introduces stricter independence requirements for auditors. It is prohibited for auditors to provide a number of basic services to the PIEs that they audit – including payroll services and certain consulting and tax advice. Assurance due diligence is allowed, but only within the boundaries of the new fee cap. The principle of the fee cap is that over three or more years, the average fees that an auditor earns from permitted non-audit services cannot exceed 70% of the audit fee.

These independence requirements, together with mandatory auditor rotation, will make life challenging for the audit committees of PIEs – particularly where a group has operating subsidiaries in member states that have adopted different time frames for auditor rotation. "You need someone to do audit and some basic non-audit services, you need someone else doing prohibited services only and someone else lined up to stay clean and become your next auditor in due course," Devlin explained.

Audit committees must meet some specific requirements under the new framework. Firstly, it is necessary for most PIEs to have an audit committee, which must be composed of non-executives, or people from the supervisory board in Germany, or elected by the general assembly. One member must have competence in accounting or auditing and the audit committee as a whole must have competence relevance to the sector.

The audit committee's tasks include overseeing the auditor tendering process, recommending a list of at least two potential auditors to the board after conducting a tender, monitoring the independence of the auditor and overseeing the integrity of the financial reporting process, including internal audit, internal controls and risk management systems.

Devlin warned that this puts "audit committee members right in the center if anything goes wrong with financial reporting, or if an auditor turns out not to be independent".

Finally, audit oversight authorities will be given wide powers to conduct inspections and publish audit market monitoring reports that comment on audit quality and the performance of audit committees, among other topics. Sanctions will be imposed on both companies and individual directors that fall short.

The audit committee chair's perspective

Guylaine Saucier, a Canadian non-executive director who is audit committee chair for French investment company Wendel, confirmed that the new audit legislation is creating a lot of work for audit committees.

Although she approved of auditor rotation as a principle, she raised concerns over the requirement to rotate at a specific time. "When you have a set time, you might be in the middle of a merger, you might be in the middle of a restructuring, or your CFO could have had an accident," she said. "This is not a good time to change your auditor, but you don't have a choice. I think audit committees should be given some latitude."

The different rotation options available to member states are also an issue, Saucier observed. "I don't know how we are going to manage if one country is on 10 years and another country is on eight years. In France, we have two auditors. We will need a program to manage it. It is going to be an awful job and totally inefficient."

Regarding the requirement for audit oversight bodies to report on the performance of audit committees, Saucier commented: "Our work is based on our relationship with management – the transparency and trust of this relationship. If they decide to send an observer, I would strictly oppose that. It would probably diminish the transparency between the audit committee and management that is essential for us to do a good job."

Turning to the evolving role of the audit committee, Saucier said that the responsibilities of audit committees had expanded significantly over the three decades that she had sat on them. "At the very beginning, our role was to review financial statements and recommend their approval by board," she recalled. "We probably had an hour-long meeting four times a year."

Now audit committees tend to oversee the efficiency of their company's controls and risk management systems alongside monitoring the financial reporting process. "Most risks are under the oversight of audit committees and I'm not sure that we have all the expertise to do it properly," noted Saucier. "This does not only apply to Europe; it is my experience on both sides of the Atlantic."

Long-term value creation and corporate culture

Two important new developments in corporate governance will have an impact on the future functioning of boards and audit committees, said Auke de Bos, professor at Erasmus University and professional practice director for the assurance practice, EY Netherlands. These two developments are a greater focus on long-term value creation within companies and an emphasis on a healthy corporate culture.

De Bos revealed that the Dutch Corporate Governance Committee is revising the *Dutch Corporate Governance Code* to include the concepts of long-term value creation and culture. The committee believes that listed companies – which tend to place a strong value on short-term profits – can learn from family-owned businesses, which more typically have a long-term perspective.

After noticing that most of the companies with poor management were too focused on the short term, the Dutch Corporate Governance Committee gave supervisory boards and audit committees responsibility for creating a culture aimed at long-term value creation. "To make this work, it is important that the company has common values, that the values are embedded in a code of conduct and that the board sets the right tone at the top," explained De Bos.

The committee's thinking in this respect had been influenced by a report from the UK Financial Reporting Council entitled *Corporate*

Culture and the Role of Boards. According to the report, a healthy culture both protects and generates company values.

Commenting on the future regulatory paradigms for boards and audit committees, De Bos said: "High-quality corporate governance will help companies and capital markets to achieve good long-term performance, which will probably stimulate foreign direct investment."

When it comes to assessing audit quality, De Bos's advice to audit committees was this: "You need a relationship with your auditor that is based on trust. Research in the field of what is important when selecting an auditor shows that it starts with the individual in question. Has the auditor got boardroom presence? What's his or her experience in the sector? Is he or she someone I can trust? Is he or she someone who can challenge me?"

Governance and investors

Former institutional investor Guy Jubb spoke in his capacity as an Independent Governance Advisor, rather than as a Member of the Public Company Accounting Oversight Board's Standing Advisory Group.

He identified three areas where investors have encouraged recent changes in corporate governance. These are the increased integration of corporate governance and audit matters into investors' long-term decision making, investors' changing expectations of auditors and audit committees, and investors' growing engagement with audit and accounting matters.

The integration movement is gaining momentum throughout the global investment market because fund managers want to have a better understanding of the risks associated with the companies they invest in, explained Jubb. "More and more fund managers, responding not just to their increasing client demands but also to changing societal and regulatory requirements, are recognizing the importance of environmental, social and governance issues in terms of how they apply their capital."

With regard to culture, Jubb said that experienced investors who ask the right sorts of questions could learn a lot about the board's approach to culture. "How the chair, CEO and CFO answer questions on culture tells professional investors a huge amount."

Investors are also increasingly focused on accounting policies and companies' adjusted earnings. "In the UK we've had two years of enhanced auditor reporting and it's coming to the rest of Europe," Jubb explained. "This enables investors to unlock what I call 'the black box' of auditing. Until we had transparency in this area, investors struggled to find any hooks with which to engage and have discussions with companies. The information provided on the planning of the audit, the key audit risks, and so on, have enabled conversations to take place, which did not take place before."

Jubb revealed that investors want to explore how audit committees exercise their challenge to management in relation to assumptions and judgments about loan impairment and whole host of other issues. "Investors regard audit committees as the first line of defense," he said. "So they are looking to audit committees to demonstrate that they have challenged assumptions, satisfied themselves that those assumptions are appropriate and robust, and have done so with an independent mind."

He confirmed that investors are increasingly looking to the audit committee to scrutinize not just financial risks, but cultural risks, environmental risks and regulatory risks. Furthermore investors expect the audit committee to play a role in ensuring that internal systems are "delivering the right information to the right people at the right time". They also want the audit committee to ensure that disclosures are fair, balanced and understandable.

Jubb concluded that change was "definitely taking place" with respect to investors integrating corporate governance and other environmental, social and governance factors into their long-term decision making.

"In five years' time, we may have auditors doing audits of culture and diversity, moving beyond financial statements," he predicted. "But we have to be very careful from a public interest point of view that the board does not delegate too much to the audit committee and you have almost a reversal of roles taking place."

Panel discussion

A poll of the audience revealed that most delegates at the conference had never read an audit committee report. Moderator Jeremy Jennings queried why this would be when they are part of the 'black box' of auditing. Saucier suggested the reports are "not the most exciting reading".

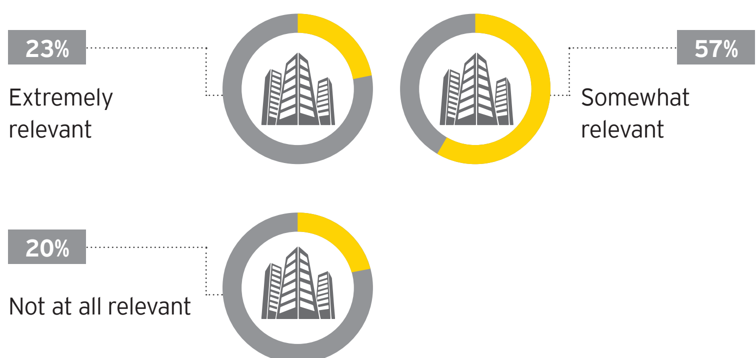
Nevertheless, Devlin emphasized that audit committee reports are critical business documents. "The preparation of the audit committee report, even if it's complicated, will focus attention on whether the job is being done correctly within the company," he said. "I don't think audit committee reports will ever be bedtime reading but I do think that they will be studied with minute care when something goes wrong. So it is worth taking trouble over them."

Audit committee reports can be invaluable to investors, noted Jubb. "I find audit reports and audit committee reports full of useful information that is helpful in understanding the quality of the financial reporting process. But I believe very few people read audit committee reports from cover to cover. Professional investors need to look at themselves hard in the mirror over this." Overall, he said, investors need to raise their level of competence in financial reporting.

Audience poll*

How often have you read an audit committee report over the past year?

How relevant is corporate governance in your domestic environment?



Principal conclusions

The conference reached a number of conclusions that can help to improve corporate governance within the EU. These, therefore, merit the consideration of policymakers:

Corporate governance in a global context

- Corporate governance should be tailored toward helping a company to deliver on its purpose. As such, corporate governance frameworks should be diverse and flexible so that they can be adapted to a company's particular purpose and activities.
- It may be necessary to promote the adoption of different business models, such as the public benefit corporation model that is seen in the US.
- Corporate governance will only be effective if there is a yin to a yang. So where companies abide by a code, they should also have the opportunity to 'comply or explain'. In other words, if there is a recommendation that is not appropriate for the company, it would engage with shareholders to explain why it is deviating from the code.
- Smaller public companies do not have the same resources as larger companies in either the management team or the boardroom. So they need to receive governance information that is relevant and helpful, both to them and their investors.

Challenges for the board: remuneration and transparency

- Shareholders have a vested interest in ensuring that executive remuneration corresponds with performance, but it is debatable whether they should be expected to ratify both pay policies and the actual pay packages proposed by the remuneration committee.
- Transparency around executive pay tends to lead to an increase in compensation as directors compare themselves with peers in other businesses.
- Remuneration packages should be structured with a company's specific aims and objectives in mind.
- There are risks associated with giving equity-based compensation to directors since the markets rely on these individuals to be transparent about their company's fortunes.

The relationship between digital transformation and corporate governance

- There should be not be a one-size-fits-all approach to digitalization – it is important that diversity and flexibility are maintained.
- Digitalization is critical to enabling owners to exercise their rights, particularly in the case of large multinational businesses that typically have large numbers of overseas shareholders.
- Cybersecurity is not just about infrastructure. Employees need training so that they avoid unwittingly giving out their personal data and enabling hackers to infiltrate company systems.
- The digitalization of regulatory and listing requirements presents challenges for companies that are not prepared to handle a tide of incoming enquiries from shareholders and stakeholders.

New EU audit legislation

- The new requirement to rotate auditors, together with stricter independence requirements, will make life challenging for audit committees of PIEs – particularly where a group has operating subsidiaries in member states that have adopted different time frames for auditor rotation.
- Certain responsibilities are being handed over to the audit committee, when they should fall within the domain of the main board. Many audit committees have oversight of risks in areas where they lack the necessary expertise.
- The relationship between the audit committee and the auditor is primarily based on trust.
- Investors see audit committees as the first line of defense when it comes to the integrity of the financial reporting process. They do not always devote as much time as they should to reading audit committee reports, however.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2016 EYGM Limited.
All Rights Reserved.

EYG no. FH0117

ED None

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax- or other professional advice. Please refer to your advisors for specific advice.

ey.com

The views of third parties set out in this publication are not necessarily the views of the global EY organization or its member firms. Moreover, they should be seen in the context of the time they were made.