



## International Federation of Accountants

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July 22, 2011

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Dear Sir/Madam,

### **Re: Green Paper - The EU Corporate Governance Framework**

The International Federation of Accountants (IFAC) values the opportunity to comment on the Green Paper examining the EU Corporate Governance Framework. Through its membership, currently 164 professional accountancy bodies in 125 countries, IFAC represents approximately 2.5 million accountants in public practice, industry and commerce, government and education.

Professional accountants play important roles in enabling and ensuring that organizations of all sizes and types have appropriate and effective corporate governance arrangements in place; arrangements that are regularly monitored for performance, and continually improved and enhanced. In recent years, IFAC has developed a range of material addressing corporate governance matters (e.g., an International Good Practice Guidance on Evaluating and Improving Governance in Organizations, to help professional accountants in business implement best practices for corporate governance within their organizations), and has been involved in conferences, workshops, and other activities to support the improvement of governance practices. Details of IFAC's work in this area can be found on the IFAC website: [www.ifac.org](http://www.ifac.org).

### **General Comments on Corporate Governance**

The global financial crisis has highlighted a number of corporate governance issues that IFAC believes need to be resolved to ensure that organizations and markets achieve sustainable performance. A focus on a wider range of stakeholder issues, application of the governance principles in spirit rather than in name, and reporting that embraces a broader, integrated reporting approach, are important aspects of effective corporate governance that are currently at the forefront of international discussions.<sup>1</sup> Examples of good practice in corporate governance

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<sup>1</sup> Refer King III, *King Code and Report on Governance for South Africa*, September 1, 2009

are emerging in various jurisdictions, with several national corporate governance reform efforts using the language of sustainability and stakeholder governance, and encouraging governing boards to take a longer-term view of performance.<sup>2</sup> Also, the global financial crisis has demonstrated the inter-connectedness of the global economy, highlighting the need for international convergence on key regulatory and reporting issues. The area of corporate governance is no exception. Therefore, it is important that corporate governance reforms proposed in Europe are considered in light of what is occurring internationally.<sup>3</sup>

An important aspect of corporate governance that is not considered in this Green Paper relates to the role of an audit committee, and in particular, the relationship between it (and therefore, the Board) and external auditors. Also, the Green Paper does not pose questions pertaining to the important matter of internal control, and the role played by an internal audit function in promoting good corporate governance practice. IFAC encourages the Commission to consider these issues in its review of the EU Corporate Governance Framework.

When considering regulatory reforms, policy makers should be cognizant of differences between the operations, structures, ownership arrangements, number and type of stakeholders, and objectives of small- and medium- entities (SMEs) vis-à-vis public interest entities.<sup>4</sup> That is, SMEs often have negligible public interest concerns in respect of their operations; however, a vibrant SME sector is essential for the economy.

Comments on the specific questions outlined in the Green Paper follow. We have responded only to those questions for which IFAC believes the expertise of the accounting profession is relevant, and so no answers have been provided to Questions 13–23 (inclusive), which come under the heading of “Shareholders.”

## **Questions**

### ***General Questions***

**Question 1** **Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.**

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<sup>2</sup> For example, the philosophy of the stakeholder-inclusive *King Code on Corporate Governance for South Africa* revolves around leadership, sustainability, and corporate citizenship. Similarly, the latest version of the UK’s *Corporate Governance Code* also includes sustainable success of an entity over the longer term as a key component of effective board practice.

<sup>3</sup> In its submissions to the G-20, IFAC has urged that the *OECD Principles of Corporate Governance (2004)* be adopted and implemented (in letter and spirit) in all nations and jurisdictions.

<sup>4</sup> IFAC believes that references in the Green Paper relating to “Listed Entities” should be changed to “Public Interest Entities,” which are defined in the IESBA *Code of Ethics for Professional Accountants*, paragraph 290.25.

IFAC believes that EU corporate governance measures should take into account the size of companies. Measures should be at a sufficiently high, principles-based level so that they can be readily applied to entities of all sizes. Rather than having a differentiated and proportionate regime for SMEs, the use of a principles-based approach allows for specific requirements to be added for public interest entities, or for differences in the application of certain principles to be recognized.

One important area of differentiation between SMEs and larger companies commonly relates to the composition and structure of boards. Indeed, SMEs often do not operate via a company structure with a board. While underlying principles of governance are the same, IFAC highlights the need to recognize that SMEs have some key differences, including: (i) SMEs are frequently family-run; (ii) authority and power is normally held by one individual: the majority shareholder; (iii) those charged with governance and management are often the same; and (iv) there is often limited in-house accounting and financial expertise, and hence there is often a reliance on external professional accountants.<sup>5</sup>

**Question 2 Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?**

On the basis that unlisted companies include some public sector entities and large private companies that may be considered public interest entities, IFAC agrees that corporate governance measures should be taken for such companies. The recent sovereign debt crisis has highlighted the importance of robust and transparent financial reporting and governance arrangements for the public sector. IFAC considers strong corporate governance arrangements to be important for all organizations; they can assist in improving performance, achieving better outcomes, providing oversight and accountability, and increasing stakeholder value. Therefore, we support the promotion of the development and application of voluntary codes for organizations other than public interest entities, and note that organizations will be assisted in developing voluntary codes if appropriate guidance (e.g., a list and discussion of key principles) is provided.

***Boards of Directors***

**Question 3 Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?**

In order to strengthen the structural checks and balances within an organization, we believe it is good practice for the functions of the chairperson of the board of directors and the chief executive officer to be clearly divided for public interest entities. The clear division of responsibilities is important if the board is to effectively perform its oversight and/or monitoring

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<sup>5</sup> Refer Presentation by Giancarlo Attolini, Deputy Chair, SMPC, *Corporate Governance: SME/SMP Perspectives*, at FCM Annual Conference, Marseille, France, December 2, 2011

role, if conflicts of interest are to be minimized, and if appropriate measures are to be employed to prevent one individual from exerting inappropriate influence over the operations of the company. However, we recognize that the division of the duties of the chairperson of the board of directors and chief executive officer is something that cannot always be easily achieved for SMEs.

**Question 4 Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?**

IFAC believes that organizations should have specific recruitment policies, and transparent nominations and recruitment processes (e.g., an independent nominations committee), to ensure that the board includes the right skills and is suitably diverse. Industry knowledge is especially important in the case of companies that operate in specialized industries, such as banking, insurance, extractive and pharma/biotech. However, the establishment and enforcement of arrangements in this area will need to be cognizant of cultural differences between various jurisdictions that may impact the manner in which policies and processes are implemented.

**Question 5 Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?**

Among other things, a public interest entity should be required to disclose whether it has a diversity policy, including details about its objectives and contents, and changes made to the policy throughout the reporting period. Regular reporting on the progress of the policy would appear to be good practice; however, it is not clear that there should be an expectation of more frequent reporting than yearly, to coincide with annual reporting requirements.

IFAC is of the view that consideration should be given to disclosure and reporting on matters other than just an organization's diversity policy. For example, the Global Reporting Initiative (GRI) reporting guidelines highlight a range of reporting areas that link with social and sustainable performance, such as human rights and local community initiatives. The EU may wish to monitor the output of the International Integrated Reporting Committee (IIRC)<sup>6</sup> to determine further potential areas of disclosure and reporting.

**Question 6 Should listed companies be required to ensure a better gender balance on boards? If so, how?**

To the extent that cultural differences between different jurisdictions are considered, IFAC believes that public interest entities should be required to consider ways to achieve a better gender balance on boards. However, IFAC recognizes that the ultimate goal for board appointments should be to appoint the best possible people available for the positions. The

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<sup>6</sup> Refer [www.theiirc.org](http://www.theiirc.org)

setting of quotas can have a negative effect on those persons appointed, and on the operation and efficiency of the board. Appointing the best people to board positions requires organizations to closely examine, and revise where necessary, their recruitment practices (e.g., criteria, selection, review, work practices/arrangements and culture).

**Question 7** Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

IFAC does not support the introduction of a measure at EU level limiting the number of mandates a non-executive director may hold. While guidelines and the discussion of principles underlying the guidelines may be developed, we believe that ultimately individuals should be able to exercise their professional judgment in determining the appropriate number of mandates to hold.

Furthermore, organizations, through their nominations committees, should take into account the number of mandates a candidate holds when appointing, or re-appointing, non-executive directors. Re-appointments should also take into account the performance of non-executive directors, identifying where holding too many mandates may be impacting director performance.

**Question 8** Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

IFAC supports the need for robust evaluations of performance, on a regular basis, for public interest entities. However, we are unable to support the view that these evaluations be conducted as external evaluations, without having further information on what this entails. There are many important questions to consider when discussing the potential for external evaluations. For example:

- Who would undertake such evaluations?
- What is the role of the external facilitator vis-à-vis other key board personnel—e.g., the chairperson of the board, the nominations committee, and the company secretary?
- What persons/groups would be included as external facilitators?
- Would this be a role expected of external auditors? If so, will external evaluations be assurance engagements, conducted against a defined framework?
- Would the evaluation process need to be disclosed?
- Would the results of evaluations be expected to be made public? What happens if there is a negative evaluation?
- What areas would be covered by the review? Should it focus primarily on issues pertaining to conflicts of interest?
- Is it possible that introducing external evaluations may complicate corporate governance arrangements, and in some circumstances unnecessarily duplicate controls in this area?

**Question 9 Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?**

IFAC supports the mandatory disclosure of remuneration policy, the annual remuneration report, and individual remuneration of executive and non-executive directors for public interest entities. This enhances the transparency and accountability arrangements for organizations. Consideration may also be given to: (i) extending the requirement to all key management personnel; and (ii) requiring the external auditor to express an opinion on the remuneration report, as is the case, for example, in Australia<sup>7</sup>.

**Question 10 Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?**

IFAC cannot support the proposal that it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders, without having further information about what a mandatory vote entails.

IFAC considers that there are many difficulties associated with such a proposal. It is not clear what is meant by “putting the remuneration policy and remuneration report to a vote,” and the implications of doing so. It is not clear whether the proposal is that a mandatory vote would be binding. That is, would a vote by shareholders rejecting the policy and report mean that remuneration specified in the report would then not be paid to directors? Would the remuneration policy then need to be revised? Does it have implications for directors in terms of their positions on the board?

Furthermore, careful consideration would need to be given to the voting arrangements in such circumstances, in respect of the majority required to reject the policy and report (e.g., a “simple” majority, or a “two-thirds” majority), and whether proxy voting would be treated in the same manner as for any other resolution at general meetings.

**Question 11 Do you agree that the board should approve and take responsibility for the company’s ‘risk appetite’ and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?**

IFAC agrees that the board should approve and take responsibility for the company’s risk appetite and report it meaningfully to shareholders. This is consistent with the notion of establishing “the tone at the top.” Taking responsibility for the risk appetite includes overseeing the risk management process. It is important for the board to report to shareholders (and more broadly, to potential investors and the public) as part of its discharging of accountability.

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<sup>7</sup> Refer Australian Auditing Standard (ASA) 700 and Section 300A of the *Corporations Act 2001*

In terms of what should be included in risk disclosures, IFAC believes that disclosures of relevant key societal and environmental risks, alongside economic risks, should be made. These are an important part of providing meaningful integrated reporting and sustainability, and support the need for organizations to take an integrated approach to governance (integrating societal, environmental, and economic aspects in their strategy, risk management, and operations).

**Question 12 Do you agree that the board should ensure that the company’s risk management arrangements are effective and commensurate with the company’s risk profile?**

As noted in the answer to the previous questions, IFAC believes that the board has an important role in overseeing the risk management process of the organization, and ensuring that risk management arrangements are effective and commensurate with the organization’s risk profile. In fulfilling its oversight/monitoring role, the board should ensure that executive management has put in place adequate systems and controls, and that it receives reports/feedback (generally through executive management and internal audit) that appropriate systems and controls are in place and operating effectively.

Establishing the appropriate “tone at the top” assists in promoting the notion that adequate risk management goes beyond just the board, executive management, and those staff working in the “risk function” (as worded in the Green Paper); it is something in which all (operational) staff should be engaged in their fields of work and areas of responsibility.

### *Shareholders*

**Questions 13 to 23 (inclusive)**

*IFAC has not responded to these questions.*

### *Monitoring and Implementation of Corporate Governance Codes*

**Question 24 Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?**

While we agree that companies departing from recommendations of corporate governance codes should be required to provide explanations for such departures, we recognize that it is important that recommendations are written at a sufficiently high, principles-based level to ensure that they are applicable and adaptable for companies of all sizes and complexities. Furthermore, the basis for the recommendations should be clearly enunciated to ensure that companies are aware of what it is that they are expected to apply. That is, if it is not clear what issues the recommendations are attempting to address, it is difficult for companies to ensure that alternative arrangements are appropriate. For example, a recommendation that the roles of the chairperson

of the board of directors and CEO be split should be accompanied by discussion about the need to minimize conflicts of interest, the monitoring/oversight role of the board, ensuring individual power and influence has checks and controls, etc., to allow those who choose not to apply the recommendation to be clear on matters that alternative arrangements need to address.

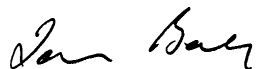
Furthermore, it is debatable whether use of the word “solutions” is appropriate in respect to alternatives that companies may see fit to apply. Solutions suggest responses to questions and problems. Perhaps alternative “arrangements” may be more appropriate wording?

**Question 25 Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?**

IFAC believes consideration should be given to providing bodies such as securities regulators and stock exchanges (where appropriate) with the authority to review the informative quality of explanations in corporate governance statements and seek more information from companies as necessary. This comment is predicated on the view that the requirements for completing corporate governance statements are clearly defined and enunciated (refer answer to Question 24 above). We imagine that the role played by these monitoring bodies would be similar to that employed in respect to other disclosure requirements, such as continuous disclosure regimes.

Please do not hesitate to contact me should you wish to discuss any of the matters raised in this submission.

Sincerely,



Ian Ball  
Chief Executive Officer