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The Role of Transparency, Capital Allocation & Business Ethics in Effective Corporate Governance

ESG & Sustainability Transformation

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Reporting and Transparency:

Continuing from the previous article, as you may know, the UK has been a model for modern governance for the world. Principle N of the UK Corporate Governance Code, last revised in 2018, states:

"The board should present a fair, balanced and understandable assessment of the company's current position and future prospects." The initial responsibility for oversight of corporate reporting rested with the audit committee, but as Principle N states, this responsibility is shared by the board as a whole. The phrase "fair, balanced and understandable" was introduced after considerable debate and has led many companies to undertake a serious restructuring of their reporting and processes. Reporting and transparency is led first by the management team and then overseen by the audit committee and the board as a whole. The independent challenge then comes from external auditors.

Investors often learn a lot about management from their reports. This is especially true when a company appears to be hiding poor performance. One way this is sometimes done is through alternative performance metrics (APMs). These measures are adjustments to accounting standards-approved performance measures, often referred to as “adjusted” or “underlying.” Their use sometimes indicates a management that wants to flatter performance rather than admit failure to produce better performance, since the omission of factors through these adjustments can be difficult to justify objectively. Investors are especially wary when APM calculations change from one reporting period to the next. Another indicator of an attempt to hide a problem is when the figures in the disclosures section of the annual report do not fully match those disclosed in the financial accounts in the second half of the report.

One area that is particularly at risk of discrepancies between disclosures and financial statements, and is now a major concern for many institutional investors, is climate change, which falls under the ESG pillar E. Often, the fancy language in disclosures under the Task Force on Climate-related Financial Disclosures (TCFD) framework and other reporting standards is not reflected in changes to the relevant financial statements. The International Accounting Standards Board (IASB), which sets International Financial Reporting Standards (IFRS) for most countries around the world, has recently commented that material climate issues should be reflected in financial statements, and the Principles for Responsible Investment (PRI) and others have called on companies and their auditors to ensure that this reporting is provided in practice.

The field of environmental and social reporting is growing rapidly. New Zealand and the UK were the first countries to mandate TCFD reporting for all large public companies, but they will not be the last.

In collaboration with the International Organization of Securities Commissions (IOSCO), the IFRS Foundation announced at COP26 the establishment of a new International Sustainability Standards Board (ISSB). (IOSCO, the international body that brings together the world’s securities regulators, is recognised as the global standard-setter for the

securities industry; COP26, to be held in 2021, is the 26th United Nations global summit to address climate change.)

The ISSB will develop a comprehensive global standard for high-quality sustainability reporting standards to meet the information needs of investors and will merge the Climate Disclosure Standards Board (CDSB, an initiative of CDP) and the Value Reporting Foundation (VRF, which provides the Integrated Reporting Framework and SASB Standards) into the IFRS Foundation.

This new body will have a multi-site structure, bringing together a number of different independent groups that seek to set sustainability reporting standards. It aims to ensure that the different needs of different regions are reflected in the standards being developed.

The creation of the ISSB offers the potential for unprecedented convergence based on a common, consistent standard for high-quality sustainability reporting, assessment and analysis.

A strong audit committee will need to closely monitor the reporting process to ensure fair and balanced reporting, preventing these types of discrepancies from occurring. A strong and challenging auditor, backed by regulation, should also intervene to prevent any opacity or deception. Auditors also have a specific mandate to highlight any apparent inconsistencies between a company’s financial statements and other reporting (such as ESG reporting).

The European Securities and Markets Authority (ESMA) published a set of guidelines on the use of APMs in 2015. These guidelines call for consistency, with APMs not being disclosed more prominently than official measures, and with a full balance between the two. Unfortunately, enforcement of these standards varies.

In a similar vein, in December 2019, the IASB published an Exposure Draft on Primary Financial Statements, which allows management’s preferred performance measure to be disclosed on the income statement side—but only alongside permitted standard measures and with full reconciliation between them. The IASB continues to consider how best to respond to the proposals it has received. It remains to be seen how effectively companies will respond to any new standards.

Financial Integrity and Capital Allocation:

The main concern that activist shareholders often have about corporate strategy is capital allocation (how a company uses its financial resources to create the most value over the long term). Key questions include how much cash flow it allocates to shareholders and how much it reinvests in existing or new businesses. It is rare for a company to have resources large enough to pursue every opportunity it identifies, and therefore capital allocation is as much about what a company will not do as it is about what it will do. These investment decisions are important – whether a company can successfully execute them will determine the returns it receives in the years to come.

Often, capital allocation is partly a function of history: a company retains a legacy business, even a fairly large one, when the opportunities for the entire company have in fact shifted. In this case, shareholders may be clearer than management about how to handle the legacy business or operations. Because they may not fully understand the complexities involved in completely moving away from a legacy operation, nor fully understand the consequences for stakeholders. Even if the issue is not a legacy operation, most companies that have to

make decisions will see their businesses change over time. Multi-business conglomerates are no longer in favor, and most investors prefer to invest in businesses with a specialized focus — with the investors themselves providing diversification in their portfolios. A key decision for the boards of such companies is how to allocate capital across different businesses and make the most of the opportunities they have identified. Even if no activist investors are pushing for a different approach to capital allocation, the board may need to engage in active dialogue with the general meeting of shareholders because different decisions about which business opportunities to pursue will appeal to different investors. In particular, some capital allocation options may require changes to the dividend payout to ensure that more resources can be retained for reinvestment in the business.

In a similar way, a company's capital structure is an important area of debate between boards and shareholders. Companies without debt on their balance sheets are often perceived as inefficient and not delivering the full returns they could - not maximizing their return on equity. However, the 2008 financial crisis - and the more recent challenges to business resilience arising from the COVID-19 pandemic - remind all investors that there is a significant risk in trying to force companies to take on excess debt to generate greater returns on equity. That risk is the risk of insolvency if interest rates rise and/or if there is a downturn in business.

A clear example in Vietnam is the case of some corporations that have abused excessive borrowing in the bond and bank credit markets, such as Hoang Anh Gia Lai, which took a decade to correct its mistakes, or recently Novaland and Phat Dat, which have been in a debt spiral and have had to undergo extensive and painful restructuring.

Having a sustainable capital structure means having some compromise between the extremes of maximizing short-term return on equity and ensuring the company is fully resilient to downturns. Unless the company is operating in a highly volatile industry, the board should seek to optimize the capital structure with some debt.

A key question about financial resilience that boards will need to answer is how they strike the right balance between ensuring adequate resilience and maximising short-term returns. Many shareholders will be willing to sacrifice some short-term returns to ensure that the business is strong enough to survive a downturn. The experience of the COVID-19 pandemic has reminded investors and corporate boards that having such a buffer is a sign of good long-term corporate governance. But the prudent balance is delicate: most shareholders will not want businesses to be so financially secure that they can weather any financial crisis. Many corporate fundraisings during the pandemic have demonstrated this point in practice: good businesses that are struggling but have long-term futures have been recapitalised.

Decisions regarding share repurchases and issuance of shares are key elements of these overall capital structure decisions and should be carefully considered by both the board and shareholders. Similarly, considerations regarding the payment of dividends to shareholders should include decisions about the level of capital that is sustainable to ensure the continued success of the business. Paying dividends in excess of cash flows from the business is clearly unsustainable and is likely to raise significant questions among shareholders, although early cash dividend payments may be welcomed. But the opposite situation – a low dividend payout ratio – is also likely to raise concerns, particularly if the company is sitting on a significant amount of cash on its balance sheet. This latter situation has proven to be at the heart of disagreements between shareholders and Techcombank in

Vietnam and between a number of Japanese companies and their shareholders in recent years.

Business Ethics:

A company must comply with the laws of its home country (known as its country of incorporation), and a multinational corporation must act according to the laws of any country in which it operates. In some respects, such as bribery and corruption, many jurisdictions impose extraterritorial jurisdiction, meaning that a company can be convicted even if corrupt activity occurs anywhere in the world. For example, both the US Foreign Corrupt Practices Act and the UK Bribery Act have extraterritorial effect; the latter also explicitly requires every company to maintain policies to ensure that no bribery is committed by its agents or others on its behalf. Many companies tend to believe that complying with the law is enough.

However, many investors expect more, and companies that aspire to be responsible global citizens and benefit from public markets will need to go further. Companies need to operate with a sense of business ethics and a broader responsibility to their stakeholders and communities. By doing so, they are more likely to thrive in the long term, not least because failure to meet these ethical goals can lead to a breakdown in relationships with one or more key stakeholders. At the extreme, an ethical failure can lead to the loss of the right to operate in a market or even the collapse of the business. An ethical approach to business will include issues such as:

- Have a corporate culture and a set of expected standards of behaviour for all employees, with zero tolerance for inappropriate behaviour;
- Treat employees fairly by maintaining high standards of health and safety, human rights and avoiding modern slavery;
- Provide value to customers and avoid discriminatory or other exploitative behaviour, including avoiding collusion with competitors or other anti-competitive practices;
- Avoid bribery, corruption and fraudulent practices;
- Pay suppliers appropriately and promptly, and do not seek unfair advantage from any dominant negotiating position;
- Develop appropriate relationships with local communities close to relevant business operations and be prepared to engage in dialogue on any key concerns they may have;
- Approach any political or legislative lobbying activity honestly (including ensuring that lobbying does not conflict with the Company’s publicly stated approach to particular issues) and does not seek unfair advantage;
- Seek to pay a fair and appropriate rate of tax by taking a tax compliance approach and recognising that tax avoidance, not just tax evasion, may be inappropriate; and
- Recognise that the company’s reputation is a valuable asset that can be damaged by unethical or inappropriate behaviour by the business or its employees.

Typically, the audit committee is required to oversee business ethics as part of a broader risk management framework, but different companies address these issues through different structures. A company with a strong ethics and culture approach will have robust whistleblowing procedures that are publicly available and accessible to all employees (and others, such as contractors and suppliers). These mechanisms will allow any interested

party to raise issues with independent leadership and at the appropriate level, so that any apparent breaches of ethical standards can be identified and addressed promptly.

Typically, these whistleblowing procedures will be overseen by the audit committee (and sometimes by the risk committee or other appropriate board-level group), so that non-executive directors can ensure the independence of the process and have confidence that the company is operating to the standards expected by the board.

In practice, the approach to business ethics within a company, like its corporate culture, is often difficult to discern for outsiders, and it will always be a challenge for both non-executive directors and shareholders to understand and gain real insight into the issue.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!