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Accountability and Coherence in the G (Corporate Governance) Connotation in ESG Analysis

ESG & Sustainability Transformation

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Corporate governance is the structure and process for overseeing the business and management of a company. Derived from the Latin gubernare, meaning to steer a ship, governance combines guidance and control. Corporate governance has become more complex as companies have grown in size and complexity and as ownership has become more dispersed.

As a result, the role of the board has become more important. The board is responsible for representing the owners of the company and ensuring that management teams are accountable for running the business in the interests of the owners. The effectiveness of the board depends on whether good governance practices are in place. The principles that shape these practices have been developed over many years and codified into corporate governance codes. Increasingly, investors expect companies to be transparent about their corporate governance structures and processes so that external investors and other stakeholders can understand where the company stands in terms of good governance.

Increasingly, investors expect companies to be transparent about their corporate governance structures and processes so that outside investors and other stakeholders can understand where the company stands on good governance. The types of issues that investors will address when considering corporate governance include, but are not limited to:

• shareholder rights;

• the likelihood of success of the company’s strategy and the effectiveness of management in implementing that strategy;

• executive compensation;

• audit practices;

• board independence and expertise;

• transparency or accountability;

• related-party transactions; and

• dual-class share structures.

In this article, we will examine the G-consequence of Environmental, Social and Governance (ESG) factors, corporate governance and provide analysts in Vietnam with an insight into the core fundamentals of this concept, its history and development, global practices and how investment professionals use governance analysis to deliver value to clients while minimizing the risk of value destruction.

What is Governance? Why is it Important?

Corporate governance is the process by which a company is managed and supervised. There are different rules around the world — governance develops from the legal system of the country where the company is incorporated — but at its core, governance is about people and processes. Good governance also involves developing the right culture that will reinforce the delivery of strong business performance without taking excessive risks, through the conduct of appropriate business activities. Good corporate governance will lead to strong business performance and long-term prosperity for the benefit of the company’s

shareholders and other stakeholders. The corporate culture needs to support that long-term business success for the benefit of all stakeholders.

Although corporate governance is about people (the individuals on the board and how they interact with outside individuals), board members are supported by processes to carry out their responsibilities effectively. These processes are increasingly burdensome in large, complex companies; in smaller companies, there is more scope for senior individuals with direct knowledge of a business to come forward, but in larger companies this is not possible. Companies will often have policies and codes of conduct, but they will rely on processes to provide confidence that those policies are actually implemented in practice. Investors will judge a company's governance by the quality of its policies and processes and by the diligence and care with which the board of directors oversees their implementation. Ultimately, they will judge governance by the quality and diligence of the board members.

Evaluating the effectiveness of a company's corporate governance systems provides investors with insight into the accountability mechanisms and decision-making processes that support all key decisions that affect the allocation of investor capital and the ability to deliver long-term value. A company with sound governance is better able to address the key risks it faces, including environmental and social issues. Conversely, a company that fails to manage its long-term material risks (including environmental and social issues) may be a fundamental governance failure that inhibits its ability to address them.

In fact, corporate governance has two A's: Accountability and Alignment.

These concepts are reflected in many core elements of corporate governance standards as well as the expectations of investors and other stakeholders.

Accountability:
People need to be:
• empowered and given the responsibility to make decisions; and
• held accountable for the consequences of their decisions and the effectiveness of the work they do.

Accountability and Boards:
People perform best when they feel accountable to someone – typically their manager – in the same way that senior executives need to feel accountable to non-executive directors on their boards. In turn, boards perform best when non-executive directors feel accountable to shareholders for effective performance. Corporate governance therefore places a strong emphasis on board structure and the independence of directors on the board.

The mix of skill sets of directors (board members) is also important, so that discussions and debates can take place in a way that accommodates a diversity of perspectives and avoids the risk of "group think". Increasing diversity and range of perspectives on boards—through gender diversity, but also diversity in background and professional experience—has been shown to result in a more challenging culture and therefore greater accountability that is more likely to enhance long-term value.

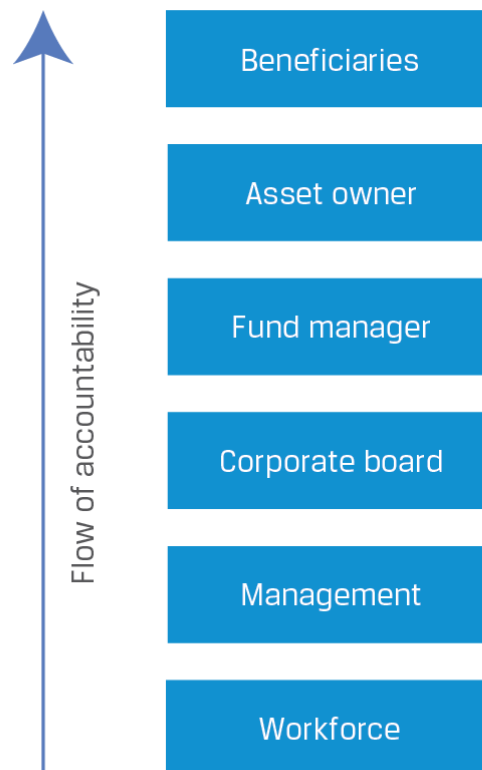
The role of the board chair is critical in facilitating balanced debate in the boardroom. As a result, many investors prefer that the chair be an independent non-executive director. If the chair is not independent, and particularly if that individual combines the role of chair with that of CEO, this situation can lead to an undue concentration of power and impede the board's ability to:
• exercise oversight responsibilities;
• challenge and debate performance and strategic planning;

- set the agenda, both for board meetings and for the company as a whole;
- influence succession planning; and
- debate executive compensation.

The figure illustrates the flow of accountability through the corporate structure and investment chain.

Chain of accountability and circle of responsibility

Source: Paul Lee (2020).



Accountability and Accounts:

Accurate accounts are essential for accountability. A company's annual accounts formally represent the process by which directors hold themselves accountable to shareholders for the financial and wider business performance, which is why the first item of business at many annual general meetings (AGMs) is the adoption of the Report and Accounts, which are usually passed in a formal vote. Hence the central importance of transparent and honest accounting by companies, and the independence of the auditors who audit those accounts. Again, it is no coincidence that auditors formally report to shareholders each year and are reappointed annually at AGMs in most countries. The integrity of the numbers that investors look at when assessing business performance is central to the ability of management and their boards to retain control. Votes to "fire" directors – members of the board of directors in some countries (such as Germany) often depend on annual reports providing full and honest information about the activities during the year and the situation at the end of the year.

Alignment and the Agency Problem:

Alignment raises the challenge of the agency problem. Since the publication of Adolf Berle and Gardiner Means' The Modern Corporation and Private Property in 1932 (widely considered the starting point for the modern understanding of corporate governance), the

agency problem has been identified as an inevitable consequence of the separation of ownership and control. The agency problem arises because the interests of professional managers – the fiduciaries – may not always be fully aligned with those of the owners of the business, and therefore the company may not be run in the way the owners would like. This challenge is magnified in larger corporations, especially public companies, where ownership is fragmented among many investors who own small portions of the company.

Any discussion of the fiduciary issue needs to acknowledge that the issues it raises are not so simple as to be resolved by management and boards simply doing what they are told to do by shareholders. First, it is often difficult to discern a single message from the majority of shareholders of most companies, which includes many investors. Even if there is a single shareholder or a clear message from shareholders, the directors' duty under the company law of most countries is to look after the success of the company, not that of the shareholders directly.

There is also a risk that directors will fail in their duty if they simply abandon their responsibilities and react rashly to requests from shareholders. Promoting short-term share price increases is not the same as promoting the long-term success of the business. Furthermore, there may be fiduciary issues within the investment chain itself, as a disconnect may develop between the interests of fund management companies and portfolio managers and their clients and/or ultimate beneficiaries.

However, the challenge of fiduciary issues is the risk of divergence between the interests of shareholders on the one hand, and the interests of directors and management of the company on the other. Corporate governance seeks to ensure that there is greater alignment between the interests of the trustee and the interests of the owners, through both incentives and appropriate chains of accountability, to mitigate the potential negative consequences of fiduciary issues.

Alignment and Executive Pay

Regarding alignment, the primary focus of executive pay has always been to address the fiduciary issue and help ensure that executives are not subject to incentives to perform in their own interests and at odds with those of the owners. Therefore, executive pay structures aim to align the interests of management with those of the owners, typically by creating a balanced compensation package that includes performance-related remuneration based on long-term targets and paid over the long term. Ideally, targets include a combination of key performance indicators (KPIs) related to business performance and share price. Many incentives often come with some form of equity alignment – which can sometimes make risk management tasks more focused on share price than on the performance of the business itself.

Accountability: Board Committees

Three key board committees, typically required by corporate governance legislation, are established to address each of the key challenges discussed above (accountability and the board, accountability and accounts, and executive compensation and alignment). These committees are:

The Nomination Committee (in some markets this is called the Corporate Governance Committee or some combination of these terms) aims to ensure that the overall board is balanced and effective, ensuring that management is accountable.

The Audit Committee oversees financial reporting and auditing, providing accountability in the accounts. The Audit Committee also oversees internal audit (where applicable) and is responsible for risk monitoring, unless there is a separate risk committee. The

Remuneration Committee (in some markets this is called the Compensation Committee) seeks to deliver appropriate alignment of interests through executive pay.

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