OECD Principles of Corporate Governance—comments on proposed revisions

Ernst & Young Global Limited, the central coordinating entity of the Ernst & Young organization, welcomes the opportunity to offer its views on the OECD Principles of Corporate Governance—Draft for Public Comment, November 2014 (“Draft for Public Comment”).

Based on our experience with public companies in over 150 countries, we know that effective corporate governance contributes to sound financial reporting and high quality, independent audits, which together create trust and confidence for investors in the capital markets. At the company level, studies have shown a positive correlation between strong corporate governance and shareholder value. Capital markets function more efficiently and attract cross-border investment when jurisdictions set and enforce high expectations for corporate governance.

Since the OECD Corporate Governance Principles (the “Principles”) were first adopted in 1999, they have served as the benchmark for governance frameworks globally. As the OECD notes in Section I of the Draft for Public Comment, there have been many improvements in corporate governance practices in the decade since the Principles were last revised. It is important that the revised Principles take account of these new developments. From our perspective, among the most significant improvements are the widespread acceptance and adoption of independent audit committees and independent audit regulators.

The Draft for Public Comment includes many useful revisions, which we support. We have, however, identified a few areas where we believe the draft could be further improved. In general, we focus on those areas where we have significant direct experience, including audit and financial reporting. Our comments are highlighted below, and the Attachment provides more detail.

Importance of an effective audit committee

Effective audit committees1 help ensure financial reporting integrity by means of their oversight of both management and the auditor (including the internal auditor and systems of internal controls). Effective audit committees communicate candidly with management and the auditor and foster a corporate culture of discipline, transparency and sound risk management. Since 2004, audit committees have become well established and their responsibilities have expanded beyond financial reporting. Audit committees

---

1 We use the term “audit committee” to include those charged with governance of financial reporting, internal controls and the audit, in recognition of diverse language and legal structures around the world. To the extent that some jurisdictions might use a different term to describe bodies that serve the same purpose, the term “audit committee” would apply to those bodies.
are widely seen as contributing to investor confidence, and a number of empirical studies have demonstrated their value.\(^2\)

Investors and other stakeholders can have greater confidence in the relevance and reliability of the company’s financial information and financial reporting when the board has an effective audit committee. We are therefore pleased to see that the Draft for Public Comment endorses independent audit committees as a baseline for “large” listed companies. (Section VI.D.7 and ¶116; Section VI.E.2 and ¶127). However, we believe that investors in all listed companies—not just “large” ones—deserve this benefit because of the important link between effective audit committees, investor confidence and more stable capital markets. We recognize that there may be situations where a company or board’s size or structure might call for an exception, but as Draft for Public Comment recommends (Section I, ¶1), jurisdictions can apply a “comply or explain” approach so that investors understand how listed company boards without audit committees are fulfilling their obligations around oversight of financial reporting and disclosure.

**Strengthening auditor independence frameworks and highlighting the importance of audit quality**

High quality audits conducted by independent auditors provide confidence to investors. External auditors must therefore be independent, both in fact and appearance, from the companies they audit. Independence requirements and governance mechanisms to help ensure auditor independence have evolved significantly since 2004, and we believe that the Principles should be strengthened to reflect these positive developments. The Principles should convey the fundamental importance of auditor independence, and highlight the primary types of threats that exist: self-interest, self-review, advocacy, familiarity and intimidation (as identified by the International Organization of Securities Commissions (IOSCO) in its 2002 auditor independence principles).\(^3\) The Principles should then describe the important roles played by both audit committees and independent audit regulators in helping to oversee the independence of the external auditor.

In our view, the Draft for Public Comment does not sufficiently convey the importance of auditor independence and support best practice. Instead of explaining and reinforcing the fundamental underlying principle, it includes a long list of policy approaches to auditor independence that may exist in some markets but would not be appropriate for others. (See V.C., ¶¶ 93-95.) We believe the Principles should encourage jurisdictions to consider carefully which policy approach to adopt for their particular circumstances. Instead of providing a haphazard list of policy approaches which may or may not work in any given jurisdiction, the OECD should take a more principles-based approach, which would help strengthen auditor independence requirements around the world, by emphasizing the fundamental issues that underlie all independence frameworks, across differing legal and regulatory regimes. Such a principles-based approach also would be more consistent with the approach taken in other sections of the Principles.

**Supporting board evaluations for all companies**

Effective corporate governance is driven by a board that understands its oversight role and responsibilities in areas including strategic planning and risk management, legal and regulatory compliance, selecting and compensating the senior executives and financial reporting and audit. An effective board helps to ensure that management’s implementation of corporate strategy is focused on

---


\(^3\) IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence (October 2002).
generating sustainable, long-term shareholder value. Evaluations are a useful mechanism to help boards assess their performance and ensure they are functioning effectively. Training and board evaluations can be particularly useful where there may be challenges in finding and cultivating a pool of effective directors with the balance of skills and experience required given the company’s long-term strategy.

We support the OECD’s proposed addition of board evaluations to the Principles. We believe that boards should conduct periodic evaluations to consider how effectively they are carrying out their responsibilities, including whether they continue to have the right diversity of skills and competencies among their directors. Such evaluations should take into consideration the effective functioning of a board’s committees, seeking input beyond the board itself from those who work with the board. For example, auditors could be asked to weigh in on the quality and effectiveness of the audit committee. Due to their ability to enhance board performance and in turn to benefit investors, board evaluations should not be limited to “large” companies. (See VI.E.4, ¶129.)

The importance of board reporting to supplement corporate reporting

Timely and reliable reporting on information material to investors is vital for investor confidence. To this end, we support efforts to promote more comprehensive and comprehensible corporate reporting and recognize there is greater focus today on narrative and non-financial reporting in addition to financial reporting. The growing interest in “integrated reporting” and the innovative work and efforts of the International Integrated Reporting Council are important elements of the debate.

Investors have an increasing interest in how boards execute their responsibilities. We believe that investors benefit when corporate boards and their key committees report periodically on how they have fulfilled their obligations. In particular, to promote investor confidence in auditor independence and objectivity, we believe there should be greater transparency about the audit committee auditor oversight process. We believe the OECD discussion of the role of board in overseeing corporate disclosure should be expanded to include a recommendation for periodic board reporting as well. (See VI.D.8, ¶118.)

* * *

The Attachment includes our suggested edits to reflect our comments above as well as a few additional recommendations, including in particular with respect to the OECD’s proposals on related party transactions. We support the direction of the OECD’s revisions; our edits are intended to clarify the importance of identifying, monitoring and disclosing such transactions, consistent with international accounting and auditing standards.

We would be pleased to discuss our comments with members of the Corporate Governance Committee or the Secretariat. If you wish to do so, please contact Bridget Neill, Director of Regulatory Policy, at bridget.neill@ey.com or +1 (202) 327-6297.

Yours sincerely

Ernst & Young Global Limited

Attachment
Attachment to EY comment letter
OECD Principles of Corporate Governance—proposed revisions

We propose the following line edits to address the concerns highlighted in our comment letter, as well as a few other issues. We would be pleased to discuss these suggestions with members of the Committee or the Secretariat.

In the marked text below, OECD Secretariat proposed changes are marked in brown. EY suggestions are marked in blue.

1. Audit committees (Section VI.D.7, ¶116; Section VI.E.2, ¶127)

   EY comment: We recommend the following edits to Principle VI.D.7 and to ¶127 to clarify language so the focus here remains on the oversight of internal controls and different mechanisms for doing that. The use of “large companies” is misleading even though in some countries these mechanisms need to be scalable.

   VI.D.7. Ensuring the integrity of the corporation’s accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards. Large companies should be encouraged to put in place an internal audit function and an audit committee of the board to Audit committees of the board oversee the internal audit function and management processes to assess the effectiveness and integrity of the internal control system.

   ¶127. Where justified in terms of the size of the company and its board, while the use of committees may improve the work of the board, they may also raise questions about the collective responsibility of the board and of individual board members. In order to evaluate the merits of board committees it is therefore important that the market receives a full and clear picture of their purpose, duties and composition. Such information is particularly important in the increasing number of many jurisdictions where boards have established independent audit committees with powers to oversee the relationship with the external auditor and to act in many cases independently. In large companies, the Audit committee should also often be able to oversee the management processes to assess the effectiveness and integrity of the internal control system. Other such committees include those dealing with nomination, compensation, and risk. The establishment of additional committees can sometimes help avoid audit committee overload and to allow more board time to be dedicated to those issues. Nevertheless, the accountability of the rest of the board and the board as a whole should be clear. Disclosure should not extend to committees set up to deal with, for example, confidential commercial transactions.
2. Strengthening auditor independence frameworks and highlighting the importance of audit quality (Section V.C., ¶¶93-96)

EY comment: In our view, the current draft does not sufficiently convey the importance of auditor independence and support best practice. Instead of providing a haphazard list of policy approaches which may or may not work in any given jurisdiction, the OECD should take a more principles-based approach, which would help strengthen auditor independence requirements around the world, by emphasizing the fundamental issues that underlie all independence frameworks, across differing legal and regulatory regimes. Such a principles-based approach also would be more consistent with the approach taken in other sections of the Principles.

For ¶93, our suggestions address two technical inaccuracies:

- Auditors don’t “certify” but rather “obtain reasonable assurance” that financial statements are fairly presented and are free of material misstatement due to error or fraud, and
- It is an “auditor’s report,” not an “audit statement.”

We also propose language to clarify existing text addressing an internal control assurance role. In addition, due to differences in legal systems around the world, we recommend removing the phrase “accountability to shareholders.” Finally, we suggest adding a clear statement that the external auditor needs to be independent in fact and appearance.

¶93. **External auditors play an essential role in upholding investor confidence in a company’s financial statements.** In addition to certifying that the financial statements represent fairly the financial position of a company, they also include an opinion on the way in which financial statements have been prepared and presented. The objectives of the auditor are to obtain reasonable assurance that the financial statements are fairly presented and are free of material misstatement due to error or fraud and to express an opinion in the auditor’s report. They also include an opinion on the way in which financial statements have been prepared and presented. In addition, in some jurisdictions auditors also express an opinion about whether the company’s financial reporting processes and internal accounting controls are appropriately designed and operating effectively. This should contribute to an improved control environment in the company.

Due to the significance of this role, the external auditor should be required to be independent in both fact and appearance of the company being audited. Investor confidence requires independence requirements that are robust and enforceable. These requirements should address the primary threats to auditor independence. Many countries have introduced measures to improve the independence of auditors and to tighten their accountability to shareholders. A number of countries are tightening audit oversight through an independent entity. Indeed, the *Principles of Auditor Oversight* issued by IOSCO in 2002 states that effective auditor oversight generally includes, *inter alia*, mechanisms: “... to provide that a body, acting in the public interest, provides oversight over the quality and implementation, and ethical standards used in the jurisdiction, as well as audit quality control environments”; and—“... to require auditors to be subject to the discipline of an auditor oversight body that is independent of the audit profession, or, if a professional body acts as the oversight body, is overseen by an independent body.” It is desirable for such an auditor oversight body to operate in the public interest, and have an appropriate membership, an adequate charter of...
responsibilities and powers, and adequate funding that is not under the control of the auditing profession, to carry out those responsibilities.

The designation of an audit regulator independent from the profession, consistent with the Core Principles of the International Forum of Independent Audit Regulators (IFIAR), can be an important factor in improving audit quality.

EY comment: Our suggestions for ¶94 reinforce a principles-based approach, with reference to the key principles on auditor independence identified by IOSCO.

¶94.  It is increasingly common good practice for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly. Moreover, the The IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence states that, “standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation”. Jurisdictions have taken different approaches to address these threats but in all cases auditors should not be permitted to compromise their objectivity or professional integrity.

EY comment: For ¶95, our suggestions emphasize the important oversight role of the audit committee. We recommend deleting the list of practices in various countries to make this annotation consistent with the principles-based approach adopted elsewhere in the revised Principles. As noted in the Preamble of the Draft for Public Comment, “[the] corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country’s specific circumstances, history and tradition.”

¶95.  The audit committee or an equivalent body should provide oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor including the nature of permissible non-audit services provided by the external auditor to the company and oversight of internal audit activities. The audit committee should report to shareholders on its oversight of the external auditor, including the auditor’s independence and effectiveness. Such reports should include its policy on the approval of permissible non-audit services provided by the external auditor and the disclosures of fees paid to external auditors for non-audit services. Provision of non-audit services by the external auditor to a company can significantly impair their independence and might involve them auditing their own work. To deal with the skewed incentives which may arise, a number of countries now call for the disclosure of payments to external auditors for non-audit services should be required. Examples of other provisions to underpin auditor independence include, a total ban or severe limitation on the nature of non-audit work which can be undertaken by an auditor for their audit client, mandatory rotation of auditors (either partners or in some cases the audit partnership), a temporary ban on the employment of an ex-auditor by the audited company and prohibiting auditors or their dependents from having a financial stake or management role in the companies they audit. Some countries take a more direct regulatory approach and limit the percentage of non-audit income that the auditor can receive from a particular client or limit the total percentage of auditor income that can come from one client.
3. Board evaluations (Section VI.E.4)

EY comment: We support the addition of a principle on board evaluations. We recommend the following amendments because all boards can benefit from periodic evaluations, no matter what size the company, and evaluations should consider the performance of committees as well.

VI.E.4. Boards of large companies should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.

¶129. In order to improve board practices and the performance of its members and committees, an increasing number of jurisdictions now encourage companies to engage in board training and voluntary board evaluation that meet the needs of the individual company, sometimes with the help of external facilitators to increase objectivity…

4. Board and committee reporting (Section VI.D.8, ¶118)

EY comment: For the benefit of shareholders, boards and key committees should provide regular reports on how they have fulfilled their obligations. We recommend clarifying the reference to the role responsible for disclosure and communications to reflect current practice in most jurisdictions.

¶118. The functions and responsibilities of the board and management with respect to disclosure and communication need to be clearly established by the board. In some companies jurisdictions, and for certain listed companies, it is considered good practice to appoint there is now an appointment of an investment relations officer, an individual(s) responsible for corporate disclosure and communication with investors who reports directly to the board. is considered good practice for large listed companies. Boards and their key committees should report periodically to shareholders on how they have fulfilled their obligations. Such reports ought to clearly distinguish board responsibilities from management’s, and describe their respective roles.

5. Auditor’s duty of care (Section V.D., ¶97)

EY comment: Whether an auditor owes a duty of due care to shareholders is a matter of local law. We recommend reverting to the language of the 2004 version of the Principles.

V.D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

¶97. The practice that external auditors are recommended by an independent audit committee of the board or an equivalent body and that external auditors are appointed either by that committee/body or by the shareholders’ meeting directly can be regarded as good practice since it clarifies that the external auditor should be accountable to the shareholders. It also underlines that the external auditor owes a duty of due professional care to the company and its shareholders, rather than any individual or group of corporate managers that they may interact with for the purpose of their work.
6. References to the board’s responsibilities for tax strategies (Section VI.A., ¶104; VI.C, ¶106)

EY comment: Boards must do more than recognize where an enterprise falls on the tax risk tolerance continuum. They need to understand how the company is preparing, adapting and responding to a rapidly changing tax environment that is being fueled by unprecedented reputational risk, increased scrutiny and unpredictable legislative and regulatory change. However, evaluating tax strategies is only one of the many areas that require board attention. The Principles need to remain flexible and broad enough to address the issues of the future as well as the present. Therefore, we believe that Section VI.A. should focus on the board’s obligation to consider all of the company’s long-term interests when making decisions, without singling out tax strategies. For ¶104, we recommend reverting to the language of the 2004 Principles. For ¶106, we suggest clarifying language.

¶104. This principle states the two key elements of the fiduciary duty of board members: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions there is a standard of reference which is the behaviour that a reasonably prudent person would exercise in similar circumstances. In nearly all jurisdictions, the duty of care does not extend to errors of business judgement so long as board members are not grossly negligent and a decision is made with due diligence etc. or to an obligation to pursue aggressive tax avoidance. The principle calls for board members to act on a fully informed basis. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board advocated by the Principles. In many jurisdictions this meaning is already considered an element of the duty of care, while in others it is required by securities regulation, accounting standards etc. The duty of loyalty is of central importance, since it underpins effective implementation of other principles in this document relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group.

¶106. The board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop company codes of conduct based on, inter alia, professional standards and sometimes broader codes of behaviour. The latter might include a voluntary A good practice is the commitment by the company (including its subsidiaries) to comply with the OECD Guidelines for Multinational Enterprises which reflect, inter alia, all four principles contained in the ILO Declaration on Fundamental Labour Rights. Similarly, many jurisdictions now expect and are increasingly demanding that boards to oversee the tax planning strategies management adopts is allowed to conduct, providing clear guidance and thus discouraging practices that do not contribute to the long term interests of the company and its shareholders, and can cause undue legal and reputational risks.
7. Related party transactions (Section II.F., ¶¶34-36; Section V.A.6, ¶¶ 83-86)

EY comment: We support the direction of the OECD’s proposals on related party transactions. Our suggested edits are intended to clarify the importance of identifying, monitoring and disclosing related party transactions, consistent with international accounting and auditing standards (specifically IAS 24 and related guidance is ISA 550).

II.F. Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders.

1. Conflicts of interest inherent in related-party transactions should be addressed.

¶34. The potential abuse of related party transactions is an important policy issue in all markets, but particularly in those where corporate ownership is concentrated and corporate groups prevail. Banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure. This is all the more important where significant portions of income and/or costs arise from transactions with related parties.

¶35. Most jurisdictions have put in place requirements for identification, monitoring and disclosure of related party relationships and related rules for clearly flagging these transactions. They include broad definitions of what is understood to be a related party as well as rules to disregard some of these transactions when they are not material because they do not exceed ex ante thresholds, can be regarded as recurrent and taking place at verifiable market terms or taking place with subsidiaries where no specific interest of a related party is present. Once the related party transactions have been identified, jurisdictions set procedures for approving them in a manner that minimises their negative potential ensures they are appropriate. In most jurisdictions, great emphasis is placed on board approval, often with a prominent role for independent board members, or a requirement for the board to justify the interest of the transaction for the company. Shareholders may also be given a say in approving certain transactions, with interested shareholders excluded.

3.2. Abusive self-dealing should be prohibited

Abusive self-dealing occurs when persons having close relationships to the company, including controlling shareholders, exploit those relationships to the detriment of the company and investors. As insider trading entails manipulation of the capital markets, it is prohibited by securities regulations, company law and/or criminal law in most OECD countries. However, not all jurisdictions prohibit such practices, and in some cases enforcement is not vigorous. These practices can be seen as constituting a breach of good corporate governance inasmuch as they violate the principle of equitable treatment of shareholders.

Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.
¶36. Members of the board and, key executives and, where applicable, controlling shareholders with a controlling interest or the ability to exercise joint control or significant influence over the entity, have an obligation to inform the board where they have a business, family or other special relationship outside of the company that could affect their judgement with respect to a particular transaction or matter affecting the company. Such special relationships include situations where executives and board members have a relationship with the company via their association with a shareholder who is in a position to exercise control. Where a material interest has been declared, it is good practice for that person not to be involved in any decision involving the transaction or matter and for the decision of the board to be specifically motivated against the presence of such interests and/or to justify the interest of the transaction for the company, notably by mentioning the business rationale for, and terms and conditions of, the transaction.

V.A.6. Related party transactions.

¶83. It is important for the market to know whether the company is being run with due regard to the interests of all its investors. To this end, it is essential for the company to fully disclose the nature of related party relationships and information about all material related party transactions, and including the terms and conditions of such transactions, to the market, either individually, or on a grouped basis, including whether they have been executed at arms-length and on normal market terms individually. For transactions of a similar nature, it is important to consider whether disclosing them on a grouped basis is appropriate, or whether such transactions should be disclosed individually in order to effectively describe their effects on the company. In many jurisdictions this is indeed already a legal requirement. Related parties should at least include entities that: control, jointly control, have significant influence over or are under common control with the company, significant shareholders including members of their families and key management personnel. Related parties should also include those entities over which the company has control, joint control or significant influence, and any material transactions with such related parties should be disclosed, including those with consolidated subsidiaries or other entities in which the company may have a material interest. While the definition of related parties in internationally accepted accounting standards provides a useful reference, the corporate governance framework should ensure that all related parties are properly identified and that in cases where specific interests of related parties are present, material transactions with subsidiaries that are consolidated are also disclosed.

¶84. Transactions involving the major shareholders (or their close family, relations etc.), either directly or indirectly, are potentially the most difficult type of transactions. In some jurisdictions, shareholders above a limit as low as 5 per cent shareholding are obliged to report transactions. Disclosure requirements include the nature of the relationship where control exists and the nature and amount of transactions with related parties, grouped as appropriate. Given the inherent opaqueness of many transactions, the obligation may need to be placed on the beneficiary to inform the board about the transaction, which in turn should make a disclosure to the market. This should not absolve the firm from maintaining its own monitoring, which is an important task for the board.

¶85. To make disclosure more informative, some jurisdictions distinguish related party transactions according to their materiality and conditions. Ongoing disclosure of material transactions is required, with a possible exception for recurrent transactions on “market terms”, which can be disclosed only in periodic reports. To be effective, materiality thresholds may need to be based mainly on quantitative and qualitative criteria, taking into account the nature
of the related party transactions and the importance of the related disclosures to the market, but avoidance of disclosure through splitting of transactions with the same related party should not be permitted.

8. Supporting high quality standards

EY comment: For ¶92, “is expected to” unnecessarily hedges the benefits of high quality standards for any disclosure regime.

¶92. The application of high quality standards is expected to significantly improve the ability of investors to monitor the company by providing increased relevance, reliability and comparability of reporting, and improved insight into company performance. The quality of information substantially depends on the standards under which it is compiled and disclosed. The Principles support the development of high quality standards for financial reporting, which can serve to improve transparency and the comparability of financial statements and other financial reporting between countries. Such standards should be developed through open, independent, and public processes involving the private sector and other interested parties such as professional associations and independent experts. High quality domestic standards can be achieved by making them consistent with one of the internationally recognised accounting standards. In many countries, listed companies are required to use these standards.