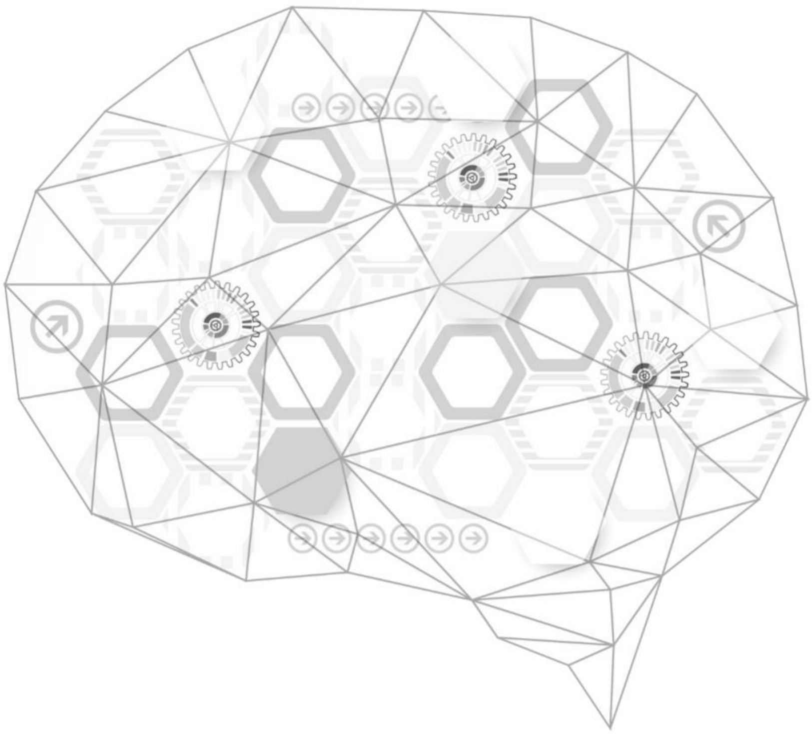
ACCOUNTANCY EUROPE.

10 IDEAS TO MAKE CORPORATE GOVERNANCE A DRIVER OF A SUSTAINABLE ECONOMY

June 2019

COGITO.

Cogito: I think
Accountancy Europe's
thought-leadership series



COGITO

This publication is part of Accountancy Europe’s *Cogito* series. We set up *Cogito (i.e. I think)* to provide new ideas for the European accountancy profession, enhance innovation and contribute more to business and society.

Cogito publications aim to stimulate debate; the views expressed thus do not reflect our official positions or those of any of our 51 member bodies.

This paper is based on the work of an independent task force composed of: Dr. Guler Aras, Anthony Carey, Michele Casò, Paul Druckman, Jens Poll, Eddy Wymeersch and Olivier Boutellis. We are grateful for their involvement, thoughts and outreach to stakeholders. The paper is the product of intense discussions and may not necessarily reflect the views of individual task force members.

HIGHLIGHTS

The climate crisis, declining natural resources, and pollution affect us all. We need to make our economic system sustainable now, to be able to face these imminent threats. Corporate governance is instrumental to change how businesses are run and can be a main driver of a sustainable economy.

Boards and policymakers/regulators are key players to transform the economy. This paper suggests ten actions for them to accelerate this transition. We aim to challenge them and provoke thoughts with ten recommendations that:

- suggest changes in boards' roles and practices
- propose legislative and non-legislative actions by EU and national policymakers and regulators

We want to inspire a debate and welcome your feedback on this paper. Send your thoughts and opinions on how corporate governance needs to evolve to iryna@accountancyeurope.eu by 1 October 2019.

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Our economy brings growing development and wealth but also causes natural resource depletion, pollution, overconsumption and social unrest to a level that is not sustainable anymore. The only way forward is to change how the economy operates. This starts with changing how businesses are run. Corporate governance is therefore instrumental. It is no longer about doing good and making the world a better place: it is about staying in business.

This paper proposes ten ideas to help boards, policymakers and regulators undertake the necessary changes. Sustainability must become the cornerstone of the decisions they make as once ecosystems and societies fail, there is no business and no polity either. Boards have the power to transform their business and can help leverage one the greatest drivers of change: markets. But policymakers and regulators must change too, to support and accelerate systemic transformation. This paper aims to help boards, policymakers and regulators by challenging them and provoking thoughts. We therefore provide ten recommendations that:

- suggest changes in boards' roles and practices
- propose legislative and non-legislative actions by EU and national policymakers and regulators

BOARDS HAVE A PRIME RESPONSIBILITY TO MAKE THE ECONOMY SUSTAINABLE

Markets have proved to be a great transformative force: we need to leverage their power to move towards a sustainable economy. Boards can take the following actions to start business' sustainability transformation:

- recognise their public interest responsibility to make business sustainable
- transform the business model
- make board composition fit for (renewed) purpose
- regularly (re)assess functioning and processes
- think in an integrated way
- transcend the business' boundaries

POLICYMAKERS AND REGULATORS NEED TO BECOME STRATEGIC ENABLERS OF CHANGE

Policymakers and regulators can strategically enable change when they:

- rethink the role of regulators
- move from shareholder protection to stakeholder protection
- create a European regulatory framework for corporate governance in the single market
- ensure consistent and effective enforcement

ACCOUNTANTS ARE CRUCIAL IN THIS JOINT EFFORT

Making our economic system sustainable is a collective responsibility. In their different capacities, professional accountants play a key role at all stages of corporate governance. Good business decisions start with reliable information. As businesses change their benchmarks for success, accountants contribute by: measuring impacts, disclosing information, and adding credibility to what is reported. There is no time to lose, private and public actors need to adopt integrated thinking and must act swiftly and decisively to create a sustainable economy.

CHANGE STARTS TODAY!

This paper aims to inspire a debate, so we welcome your feedback. Send your thoughts and opinions on how corporate governance needs to evolve to iryna@accountancyeurope.eu by 1 October 2019.

QUICK FACTS

In the EU 28, disasters caused by weather and climate-related extremes accounted for **83%** of the monetary losses between 1980-2017 [1]

9 MILLION premature deaths each year due to air pollution [2]

1 BILLION climate refugees by 2050 [3]

2.4 MILLION people displaced due to natural disasters in 2016 [4]

80% of EU businesses acknowledge that climate change is a risk [5]

€4 BILLION is the cost to businesses of water damage in 2018 [6]

All seafood fisheries predicted to collapse by 2050 [7]

240 MILLION people without access to fresh water by 2050 while industry demand growing by 400% [8]

---

[1] https://www.eea.europa.eu/data-and-maps/indicators/direct-losses-from-weather-disasters-3/assessment-2
[2] https://read.oecd-ilibrary.org/environment/the-economic-consequences-of-outdoor-air-pollution_9789264257474-en#page68
[3] http://theowp.org/one-billion-climate-refugees-by-2050/
[4] http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/621893/EPRS_BRI(2018)621893_EN.pdf
[5] https://6fefcbb86e61af1b2fc4-c70d8ead6ced550b4d987d7c03fcdd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/004/069/original/CDP_Europe_report_2018.pdf
[6] Ibid.
[7] https://news.stanford.edu/news/2006/november8/ocean-110806.html
[8] https://www.oecd-ilibrary.org/docserver/env_outlook-2012-sum-en.pdf?expires=1560328356&id=id&accname=guest&checksum=48CF38B51EEF754AA71AE7FC74774CFC

INTRODUCTION

WE FACE A SYSTEMIC CRISIS

Since the industrial revolution, the market economy has propelled prosperity, well-being, life expectancy, cultural creativity and personal fulfilment to unprecedented levels. However, we start realising there was a hidden cost. Our economy is also aggravating natural resources depletion, deadly pollution, overconsumption and growing social concerns ranging from income inequality to climate migration. Warnings about a climate crisis are not new, we have seen increasingly urgent calls to address climate change (see Figure 1)

Different global studies support one of the largest scientific consensuses ever, based on repeated in-depth studies. See the quick facts on the previous page and the examples below:

Climate crisis – the UN Intergovernmental Panel on Climate Change (IPCC) released a landmark report warning against irreversible climate damage in October 2018[9]. The UN Secretary General stated that "if we do not change course by 2020, we risk missing the point where we can avoid runaway climate change, with disastrous consequences for people and all the natural systems that sustain us"[10].

Raw materials' exhaustion – the UN International Resources Panel (IRP) has drawn attention to the vital risks resulting from exhausting critical raw materials in its Global Resources Outlook 2019.[11]

Biodiversity loss - the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES) has outlined the dramatic (economic) impact of the unprecedented loss of biodiversity in its May 2019 global assessment report on biodiversity and ecosystem services[12].

These multiple and intertwined crises threaten the profitability and continuity of businesses. Without access to resources and energy, there is no business. It is no longer about doing good and making the world a better place: it is about staying in business. We are no longer speaking about future generations and long-term value creation: it is about our generation and our choice between short term gain and long-term pain.

BUSINESS IS PART OF THE SOLUTION

As the main producer of goods and services, business has a key responsibility in how these goods and services are produced, from employment conditions to pollution and waste generation. The public now expects business to stop degradations and take up their responsibility to repair and move to a sustainable future. Business has no other option than responding to demand.

Conversely, governmental action has been limited in effect. However, policymakers will also soon have to be seen acting, and regulatory intervention is undoubtedly looming ahead. But to achieve real progress, policymakers and regulators have to change too. The way the economy operates needs to change. This starts with changing how businesses are run. Corporate governance is therefore instrumental.

Regarding the climate crisis alone, the European Commission (EC) estimates that "to achieve the European Union (EU)'s 2030 targets agreed in Paris, including a 40% cut in greenhouse gas emissions, we have to fill an investment gap estimated at 180 billion EUR per year"[13]. Filling this investment gap means decisions that have to be made in boardrooms, thus again, the importance of corporate governance.

---

[9] IPCC, (2018), *Special Report: Global Warming of 1.5 ºC*, see https://www.ipcc.ch/sr15/

[10] Guterres, A., UN Secretary-General's remarks on Climate Change [as delivered], 10 September 2018, see https://www.un.org/sg/en/content/sg/statement/2018-09-10/secretary-generals-remarks-climate-change-delivered

[11] IRP, (2019), *Global Resources Outlook 2019: Natural Resources for the Future We Want*, see http://www.resourcepanel.org/reports/global-resources-outlook

[12] IPBES, (2019), *Summary for policymakers of the global assessment report on biodiversity and ecosystem services*, 6 May 2019, see https://www.ipbes.net/sites/default/files/downloads/spm_unedited_advance_for_posting_htn.pdf.

[13] COM (2018) 97 final - Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions:

This paper also aims to contribute to the EC's goal as stated in its Sustainable Finance Action Plan: to foster sustainable corporate governance and reduce short-termism in capital markets[14].

CORPORATE GOVERNANCE IS ABOUT PURPOSE

Corporate governance is not only about complying with requirements and procedures; it is about the organisation's purpose, which drives its culture. It is primarily concerned with strategy and the business' interactions within its operating context, i.e. its role in society.

However, corporate governance is not a magic bullet; it is one piece within a larger puzzle. Making our economic system sustainable is a collective responsibility for governments, businesses and citizens alike. This paper argues that corporate governance can make an instrumental contribution to transforming our economy. It focuses on the role that boards and regulators should play. However, that is not to exempt other actors, such as investors and their advisors, financial institutions, stock-markets, consumers, civil society organisations – and professional accountants. But those in the boardroom have a particular responsibility when they define a business strategy and oversee its execution.

The UN Sustainable Development Goals (SDGs)[15] (see Text box 1) offer a compass to guide businesses in responsible corporate governance. Meeting the SDGs requires businesses to shift their focus to look beyond value for shareholders. Furthermore, the real challenge will be to reach the SDGs while staying within the limits of the Earth's 'carrying capacity' as defined in 1995[16].

Text box 1: Sustainable Development Goals

The SDGs are 17 global goals set by the UN General Assembly in 2015 for the year 2030. More than 150 governments, including the EU, have signed up to achieve these goals. Over the next ten years countries will mobilise efforts to end all forms of poverty and tackle climate change and other environmental challenges.

Action Plan: Financing Sustainable Growth, see https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

[14] Ibid, see action 10.

[15] The Sustainable Development Goals are 17 global goals set by the United Nations General Assembly in 2015 for the year 2030. See https://www.un.org/sustainabledevelopment/

[16] "The environmental resource base upon which all economic activity ultimately depends includes ecological systems that produce a wide variety of services. This resource base is finite. Furthermore, imprudent use of the environmental resource base may irreversibly reduce the capacity for generating material production in the future. All of this implies that there are limits to the carrying capacity of the planet." See Arrow, K., Bolin, B., Costanza, R., Dasgupta, P., Folke, C., Holling, C. S., et al. (1995). *Economic growth, carrying capacity, and the environment*. Science, 268, p. 520–521.

The SDGs take a holistic perspective, for instance, recognising inequalities' negative impact on economic performance. They also call on all countries (poor, rich and middle-income) to promote prosperity while protecting the planet.

Several corporate boards, Chief Executive Officers (CEOs) and chairpersons have long been leading on the sustainability agenda[17]. They did not wait for legislative requirements or incentives to drive change. Analysing their operational environment, some recognised business opportunities, risks or threats. Others responded to stakeholder activism, market pressure or a moral imperative. More should follow suit.

IMPACT MATTERS MORE THAN SIZE

Corporate governance is sometimes seen as an issue only for larger corporations: it matters for small and medium-sized enterprises (SMEs) too. Not only do SMEs make up the vast majority of European companies and underpin the EU economy, many are also part of a larger business' supply chain. In the end, it is not about the size of a business, but about how much of an impact it makes. For instance, an SME can have a significant impact on the local environment or on the regional job market. Furthermore, SMEs are victims of the environmental crisis just the same (if not more) as large companies: According to Mami Mizutory, UN Assistant Secretary General, 55% of SMEs never recover from major natural disasters and losses from disasters reported by insurers in 2017 amounted to €330 billion[18]. Corporate governance helps them be better prepared.

Corporate governance is equally important in the public sector that represents a significant share of the European economy, amounting to over 50% of Gross Domestic Product (GDP) in several countries. Real change would result if the public sector would put sustainability at the core of its governance, operations and reporting practices. The ideas in this paper should therefore be relevant to most organisations, independent from sector or size.

ACCOUNTANTS SUPPORT CORPORATE GOVERNANCE

In their different capacities, professional accountants make critical contributions to all stages of corporate governance.

In business, accountants are found in various roles that are all key to effective corporate governance: CEOs, Chief Financial Officers (CFOs), non-executive directors, audit committee members, as well as officers in accounting, reporting, internal control or tax functions.

In an advisory capacity, accountants help business to e.g. obtain adequate financing, make strategic investment decisions, enhance business information systems, adapt to their competitive challenges and regulatory environment.

As external auditors, accountants are subject to specific stringent independence requirements. They provide assurance on information reported by business with a high guarantee of independence, objectivity and competence. They can offer an independent expert opinion e.g. on the process used to collect and analyse the data, on the reliability and exhaustivity of the data or on the way it is being interpreted, used and reported. With this information at hand, investors and other stakeholders can gain confidence that businesses make the right decisions to become sustainable.

Good business decisions start with reliable information. The accountancy profession has leveraged its expertise in the field of non-financial information and now has a long-standing experience on how to help companies make the right changes to reduce their environmental footprint – and costs. As businesses change their benchmarks for success, accountants contribute by: measuring impacts, disclosing information, and adding credibility to what is reported. Peter Bakker, the CEO of the World Business Council for Sustainable

[17] For example, see the WBCSD members' page https://www.wbcsd.org/Overview/Our-members
[18] Speaking at the Globe EU High-Level Conference on Sustainable Finance on 20 November 2018

Development (WBCSD), may have sounded optimistic in 2013 when he declared that "accountants will save the world"[19] but they will do their utmost to contribute – they just will not do it alone.

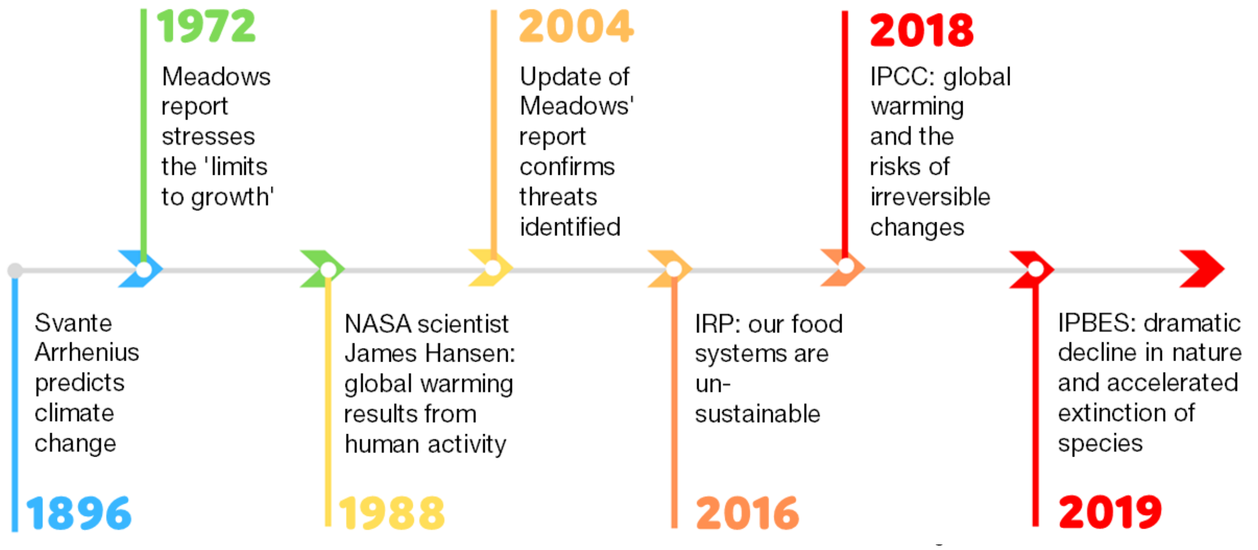
WHAT YOU WILL FIND IN THIS PAPER

Boards have the power to transform their business and can help leveraging one the greatest drivers of change: markets. But policymakers and regulators must change too, to support and accelerate systemic transformation. This paper aims to help boards, policymakers and regulators by challenging them and provoking thoughts. It therefore

- suggests changes in the board's role and practices
- proposes legislative and non-legislative actions by EU and national policymakers and regulators.

In doing so, the paper looks at principles, not detailed technical proposals. It is concerned with facts, opportunities and risk management, value creation and business continuity, and stays away from ideology or beliefs of any kind. As any such change, the proposals in this paper come at a cost. This cost of non-action will inevitably be higher. In light of the accumulated scientific evidence that our economies and civilisations are accelerating toward collapse[20], there is no room for business as usual.

Figure 1: Warnings for the climate crisis



[19] https://hbr.org/2013/03/accountants-will-save-the-world

[20] Servigne, P., Stevens, R., (2015), *Comment tout peut s'effondrer. Petit manuel de collapsologie à l'usage des générations présentes*, Seuil, p. 304.; Diamond, J., (2005), *Collapse: How Societies Choose to Fail or* Succeed, Viking Press, p. 592.

BOARDS HAVE A PRIME RESPONSIBILITY TO MAKE THE ECONOMY SUSTAINABLE

1. RECOGNISE THE PUBLIC INTEREST RESPONSIBILITY TO MAKE BUSINESS SUSTAINABLE

Law-making takes time and is often subject to many constraints, from politics to lobbying. Waiting for the perfect regulatory framework is a luxury we may not have. All boards must take their responsibility and put their businesses on an accelerated path toward sustainability.

From a practical business standpoint, sustainability encompasses many matters that fall directly under the board's strategic responsibility, such as access to raw materials, energy efficiency, supply chain resilience, social license, reputational risk and contingency planning.

At least since the 1972 Meadows' Report[21], we (should) know that there are 'limits to growth'; these limits are now approaching, and the cost is unaffordable. The only realistic option at this stage is to move to a circular economy[22] (see Text box 2). Each citizen and each business must now think in terms of 'sustainable prosperity' as proposed by the former Economics Commissioner on the UK Government Sustainable Development Commission, Tim Jackson[23]. Boards must ensure their business starts the transformation now and navigates related challenges and uncertainty in the most effective way.

Text box 2: Circular economy

A **circular economy** is the alternative to our linear economy – make, use, dispose – in which we keep resources in use for as long as possible, extract the maximum value from them whilst in use, then recover and regenerate products and materials at the end of each service life.

In a circular economy, businesses not only have to create the maximum value with the minimum resources (which enhances business efficiency) but also have to recover and regenerate products and materials.

The European Commission adopted an action plan[24] in 2015 to help accelerate Europe's transition towards a circular economy, boost global competitiveness, promote sustainable economic growth and generate new jobs.

The action plan sets out 54 measures to 'close the loop' of product lifecycles: from production and consumption to waste management and the market for secondary raw materials. It also identifies five priority sectors to speed up the transition along their value chain (plastics, food waste, critical raw materials, construction and demolition, biomass and bio-based materials). It puts a strong emphasis on building strong foundation on which investments and innovation can thrive.

There is no single and universally accepted definition of responsible governance. The SDGs and the the Stockholm Resilience Centre planetary boundaries[25] (see Text box 3) provide boards with an overarching strategic framework for thinking about responsible corporate governance. However, the Stockholm Resilience

---

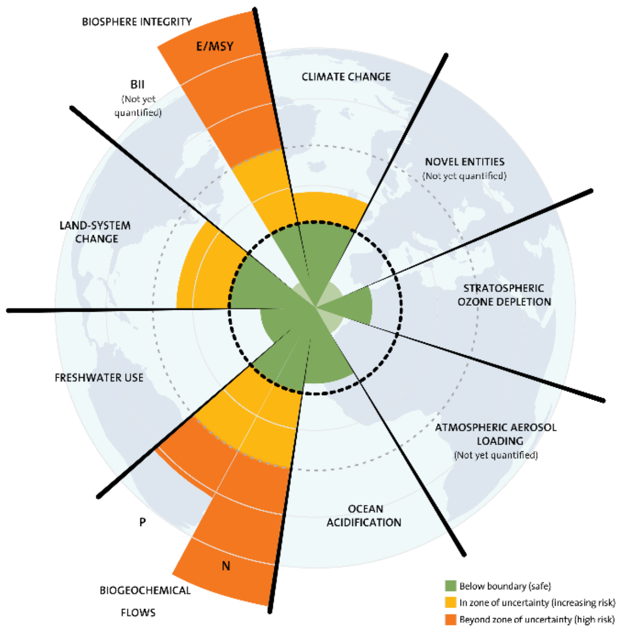
[21] Meadows, Donella H., et al., (1972), *The Limits to Growth: A Report for the Club of Rome's Project on the Predicament of Mankind*. New York: Universe Books, p. 205.
[22] A circular economy maximises the value of products and materials, minimises waste and resources, and recycles products to create further value. See https://ec.europa.eu/commission/priorities/jobs-growth-and-investment/towards-circular-economy_en and
[23] Jackson, T., (2017), *Prosperity without Growth: Foundations for the Economy of Tomorrow.* 2nd ed. Abingdon/New York: Routledge, p. 350. Tim Jackson is now the director of the Centre for the Understanding of Sustainable Prosperity (CUSP, https://www.cusp.ac.uk/)
[24] https://ec.europa.eu/commission/priorities/jobs-growth-and-investment/towards-circular-economy_en. See also https://www.ellenmacarthurfoundation.org/ and https://www.kateraworth.com/doughnut/.
[25] https://www.stockholmresilience.org/research/planetary-boundaries.html and Concept box 2.

Centre has cited serious concerns about whether it is possible to achieve the SDGs within the planetary boundaries i.e. without harming the Earth system[26].

The SDGs pinpoint the environmental and socioeconomic challenges that deserve the board's attention. They map issues that directly affect the business, like access to energy or other resources. They also help to anticipate stakeholder concerns and regulatory change that governments will need to make to address these concerns or fulfil their own commitments.

The planetary boundaries indicate the immutable limits within which human activity, including business, can be conducted. They will therefore shape the way the SDGs can be pursued by governments. The board should investigate how the SDGs and planetary boundaries affect the business and how business is impacted by them. It is a prime board business responsibility – not an altruistic concern.

Text box 3: Planetary Boundaries



The **planetary boundaries** set out the limits of the Earth's carrying capacity. This framework was developed in 2009 by a group of Earth system and environmental scientists to define the series of thresholds that, once crossed, will trigger non-linear, abrupt environmental change within continental-to planetary-scale systems. Once crossed, these will trigger non-linear, abrupt environmental change. As of 2009, two of the boundaries had already been crossed, while others were in imminent danger of being overstepped.

The nine planetary boundaries are:

- stratospheric ozone depletion
- biosphere integrity (critically transgressed)
- chemical pollution
- climate change (transgressed)
- ocean acidification
- freshwater and global hydrological cycle
- land system change (transgressed);
- biochemical flows (critically transgressed)
- atmospheric aerosol loading

2. FIRST TRANSFORM THE BUSINESS MODEL

There is overwhelming evidence that our ecosystems will not be capable of continuing to supply business with raw materials if we carry on business as usual[27]. Similarly, they will not be able to absorb the waste and pollution that our current economic system creates. **At macro level, this means moving to a circular economy. At micro level, it means transforming the business model.**

---

[26] "There are deeper driving forces working against achieving the SDGs within planetary boundaries. These can be found not in least social, institutional and corporate inertia, existing physical infrastructure, vested interests by incumbents, outdated ideas along with short-sightedness in individuals, capitalism and democratic four-year horizons." See https://www.stockholmresilience.org/download/18.51d83659166367a9a16353/1539675518425/Report_Achieving%20the%20Sustainable%20Development%20Goals_WEB.pdf

[27] See the ongoing work carried out by the IRP https://resourcepanel.org/

For instance, increasing sales volume via planned obsolescence, artificial differentiation and versioning, aggressive marketing may be very good for the company's turnover but devastating for everybody else and for the planet. Increasing internal efficiencies, through optimising resource and energy consumption as well as redesigning durable products, is indispensable – but not sufficient. **Creating stakeholders' value will increasingly mean shifting sources of income to repairing, recycling, sharing and servicing**.

The centrality of business model transformation must be reflected on the board's agenda as a number one priority. Monitoring progress on this transformation roadmap should be a standing agenda item.

In addition, **the board will have to broaden its approach to risk management** including, e.g. the impact of stranded assets, environmental litigation and reputational risk. An increasing number of scientists[28] are warning against a possible systemic collapse. As hard as it is to think about rare but catastrophic risks, it seems worthwhile to develop contingency plans to prepare for external shocks such as resource disruptions, energy crises, social unrest or a systemic breakdown.

In the shorter term, **boards also need to anticipate regulatory reforms**. As environmental and social challenges continue becoming more blatant and costlier, public opinion pressure will persistently raise and policymakers will have no choice but to react forcefully and impose drastic changes on business.

Those who will lobby against such changes will face serious reputational damage and will not improve their longer-term position. The board will also need to redefine what business ethics and responsibility mean in such circumstances.

3. MAKE BOARD COMPOSITION FIT FOR (RENEWED) PURPOSE

While each company will have different needs and specificities, the change agenda needs to be owned and forcefully driven forward. **Given the magnitude of the challenges, the people and processes involved in business decision-making will have to change**.

Boards need to assess the skills and characteristics necessary to support their collective functioning and efficiency. They should d**efine the collective profile for the board as well as the profile of individual board members**, reflecting on what makes a 'good board member'. In addition to competences, skills and diversity, the following criteria are critical to board effectiveness: soft skills and emotional intelligence, moral values and psychological traits, such as independence and the ability to question or disagree.

Most boards have been centred around financial performance, controls and risk with the CEO and CFO playing the primary role. **It is in boards' interest to reorganise themselves and review the roles, duties and competences of directors**, without waiting for regulatory prescriptions.

New roles are necessary, and the board has a strategic responsibility to create them **d**. Such new roles could incorporate a Chief Value Officer, since value creation encompasses more than financial gain. For example, Professor Mervyn King[29] has challenged the shareholder-centric governance model by advocating for the accountant as a key changemaker, moving from chief financial officer to chief value officer. The role of this Chief Value Officer would entail a broader perspective on value creation and fully integrate environmental, social and governance (ESG) factors with financial performance. The role would help transform how the business is run and ensure that the business model shifts towards a truly sustainable one. Many qualified accountants, including those currently acting as CFOs and CEOs, have the education and skills to take up such new roles.

A board that functions in a fully collegial manner is essential to developing an integrated approach encompassing both financial and non-financial performance factors, but setting up ad hoc committees may further help, for instance a business model transformation committee, an integrated performance committee or a global ethics committee. Similarly, existing committees will have to be reconfigured, in particular, the

---

[28] For example, see Servigne, P., Stevens, R., (2015), *Comment tout peut s'effondrer. Petit manuel de collapsologie à l'usage des générations présentes*, Seuil, p. 304.; Diamond, J., (2009), *Effondrement: Comment les sociétés décident de leur disparition ou de leur survie*, Folio Essais, p. 873.
[29] King, M., with Atkins, J., (2016), *Chief Value Officer: Accountants Can Save the Planet*, Routledge, p. 138.

remuneration committee, the risk committee and the audit committee will need to review their agendas and enlarge their skill set to deal with the emerging challenges.

A broader and more strategic understanding of board diversity is necessary. In addition to gender and ethnic diversity, **boards should seek to diversify professional competences and ways of thinking**. Deep insights in the business, its sector and its operational context remain necessary, but knowledge of sustainability issues relevant to the business has become critical. The board needs to be fully equipped to assess how the SDGs and planetary boundaries impact the business and vice versa. Most important of all is that the board has members with the capacity to think laterally, challenge and speak-up. To this end, it is useful that different cultures, social backgrounds and generations find their way into the boardroom. Several academic studies explore that board diversity enhances company performance. Diversity makes boards more effective in monitoring the conflicts of interest between stakeholders and managers, hence mitigating agency problems.[30]

4. REGULARLY (RE)ASSESS FUNCTIONING AND PROCESSES

Board efficiency starts with putting effective processes in place to constantly assess the board's functioning. Experience shows that shortcomings in such processes have often played a role in corporate failures. Each board needs to develop:

- objective **directors' selection and recruitment** procedures
- ad hoc **on-boarding and development programmes**
- balanced **reward and retention policies**
- regular individual **performance assessments** and full board assessments

The scope of such processes now has to **cover sustainability expertise, cultural and psychological diversity and ethical behaviour**. They can also be further enhanced by including external feedback, such as stakeholder surveys and employee comments. These processes are only means to an end and therefore need to take a 'substance over form' approach and consider effective outcomes, including the business' impacts and progress toward a sustainable business model. To prevent complacency and groupthink, these processes need to **have the necessary degree of independence and objectivity**. This could be achieved by involving more outsiders and independent professionals. They may also benefit from more monitoring. A review process also needs to be reviewed to remain state of the art.

5. THINK IN AN INTEGRATED WAY

Boards need to consider the full range of factors used in the value creation process in a holistic perspective. As Professor Mervyn King puts it:

> *"Integrated thinking involves the board of directors as a collective understanding, knowing, and then planning how the company will make its money. In other words, it must determine the company's business model, embracing its governance, enterprise risk management, strategy, and internal controls. It also will consider how the company will maintain value creation in the longer term in a sustainable manner. To do this, the board has to determine the inputs into its business activities, the outputs from those business activities, and the effects its outputs have on the resources used by the company, more particularly the effect it has on society and the environment—the social and natural capitals"[31].*

According to the International Integrated Reporting Council's (IIRC) [32], in applying this mindset, the organisation views itself as part of a greater system, one shaped by the quality, availability and cost of resources, as well as

---

[30] For example, for gender and demographic diversity on the boards this is evidenced in the study by Erhardt, L. N. et al., (2003), *Board of Director Diversity and Firm Financial Performance*, Corporate Governance An International Review, 11, p. 102-111.

[31] King, M., (2017), *Integrated Thinking and the Integrated Report*, see https://trainingmag.com/integrated-thinking-and-integrated-report

[32] http://integratedreporting.org/faqs/

evolving regulations, norms and stakeholder expectations. This entails putting in place mechanisms to ensure the business operates in a wholly connected and consistent way. Decisions cannot anymore be based on financial factors only or considered in a timeframe that doesn't match the impacts of the business. Furthermore, connecting information helps making more informed decisions, with improved awareness of externalities. It thus leads to a more efficient and productive allocation of the different capitals needed by business both within an entity and on markets.

Boards need to take a fully integrated approach to strategy, management and reporting:

- **A comprehensive approach to strategic planning including scenario analysis:** boards should ask directors to run different scenario analyses, assessing their respective impacts on the different capitals the business uses, in particular natural and human capital
- **Managing change inclusively and efficiently:** a truly integrated approach and transitioning to sustainable business models will require experimentation, decentralisation and empowerment. While leadership is essential, bottom-up feedback channels can be instrumental to:
    - developing new solutions
    - assessing their feasibility, effectiveness, and acceptability
    - contributing to ongoing progress
    - ensuring better organisational alignment, from staff to management, supported by adapted rewards and risk management systems throughout the business
    - rolling out identified best practices throughout the business and its supply chain and, where appropriate, sharing them with stakeholders
- **Adopting integrated reporting <IR>[33]:** businesses should also report on their performance in an integrated way using the International <IR> Framework[34]. This will help to measure transformative progress and share experience on issues that are of public interest. It may be helpful to also ask businesses to explain the basis on which they make their strategic choices and how they move toward a fully integrated approach. To play their role, such disclosures would need to be verifiable and trustworthy.

6. TRANSCEND THE BUSINESS' BOUNDARIES

In a context of global systemic threats, externalising costs, risks and responsibilities to other parties such as suppliers, outsourcers or taxpayers, can no longer be a viable strategy. The board needs to comprehend the entire supply chains and ecosystems of the business, at least to manage reputational risk from a narrow self-interested perspective.

Sourcing and procurement strategies cannot only look at the short term: they need to consider availability of and access to decreasing natural resources, substitution strategies and growing environmental constraints (which gradually also become short-term issues). Boards must also look beyond the business' boundaries. They need to set measurable sustainability targets that take a systemic approach and are relevant at all levels. Measuring effective progress requires thorough analysis of the impacts that business activities generate upstream and downstream. **Appropriate due diligence needs to be conducted throughout the entire supply chain. Impacts on markets need to be analysed and measured, including lifecycle assessments of products**.

Business is not conducted in isolation. **Directors need to engage with, and listen to, all stakeholders**. They should draw on feedback from external and internal stakeholders. Employee consultation and full involvement is important, as well as supplier and outsourcer engagement. The most advanced businesses run extensive stakeholder engagement programmes as part of their corporate social responsibility (CSR) policies.

[33] http://integratedreporting.org/the-iirc-2/
[34] http://integratedreporting.org/wp-ontent/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf

However, others continue doing just the opposite and try to blur their impact and responsibilities[35]. These efforts put in fighting change and transparency may work on the short term, but rarely on the longer run. Stakeholder engagement is not only indispensable from a CSR perspective. It also enables a better understanding of market trends and expectations, helps designing socially acceptable products and enhances idea generation and innovation.

Transforming to sustainable models requires continual, complex reassessments that necessitate multidisciplinary expertise leveraging the latest scientific findings. In addition, to access relevant expertise, business needs to engage with, and support, the scientific community without influencing their independence. All these sources are essential for the board to foster business transformation.

[35] For example, see Conway, M. E., Oreskes, N. (2012), *Merchants of Doubt: How a Handful of Scientists Obscured the Truth on Issues from Tobacco Smoke to Global Warming*, Bloomsbury Paperbacks, p. 368

POLICYMAKERS AND REGULATORS NEED TO BECOME STRATEGIC ENABLERS OF CHANGE

7. RETHINK THE ROLE OF REGULATORS

Policymakers and regulators are just like any other party: in a changing world, they have to review their role, priorities and ways of working and adapt. The remarks below only aim to indicate some directions of change. They are particularly important in corporate governance and can be equally relevant at EU and national level. As we kept our comments high level, we opted for the broad terms, policymakers and regulators: we use regulators in a generic way, e.g. to refer to those with a responsibility in a particular field to produce and/or apply rules, supervise or enforce. We only refer specifically to policymakers when we want to designate those with the power to initiate or design public policies or produce legislation.

FOCUS ON STRATEGIES THAT ACHIEVE EFFECTIVE OUTCOMES

Regulators have a tremendous responsibility and have to strike a difficult balance between different objectives. The challenge is to constantly **support the market shift to a sustainable paradigm** and adapt while providing legal certainty and stability.

Regulators need more **focus on outcomes and effective enforcement of better and simpler rules to produce results, not ever more regulation**. Excessive and rigid prescriptive rules that are unrooted in practice tend to fuel rule circumvention. Focusing on formal compliance often only produces mindless compliance and box-ticking.

Rather, regulators should aim at fostering true and lasting behavioural change. In addition to rulemaking, regulators can use different and often complementary approaches, such as research, awareness raising, education, incentives, reporting, benchmarking, labelling, etc. This is not meant to suggest that they should shy away from taking a hard stance when necessary. **Mandatory measures will have to be considered when they are the best way to meet environmental and social objectives in due time**. Imposing mandatory requirements can be in the interest of markets integrity and of market players, insofar as these are effectively and consistently enforced. In any case, regulators and the entire governmental sector must also lead by example.

Deciding a regulatory strategy should be guided by effectiveness considerations and based an objective impact assessment of the different options available. When policy objectives are not met, regulators should consider (further) intervention or corrective action. However, the response to failed regulation is not necessarily 'more of the same'. Existing rules should be regularly assessed and only altered if there is clear evidence that a specific change will help in meeting the objectives.

MAINSTREAM BEST PRACTICES

Thought leaders and innovators play a critically important role in business and society. They are instrumental in initiating change. However, they are often insufficient to create systemic transformation. Systemic transformation calls for rapidly rolling out best practices and changing collective values and behaviours. It appears that solutions are often better developed close to practice, rather than mandated by untested laws produced in offices. It is critical that regulators closely monitor and understand market developments and the emergence of best practices – or lack thereof.

Once best practices have emerged (or if their development is hampered), regulators should intervene. One of their fundamental roles is to rapidly mainstream best practices. The goal is to foster change and to ensure a level playing field so that sustainability frontrunners do not end up facing a competitive disadvantage, compared to those who lag behind. 'Soft law' approaches and non-binding measures are mostly helpful when best practices are still developing. However, in a fast-changing context and considering the magnitude of the transformation needed in the way markets function, regulators need to regularly assess whether the desired outcomes and progress remains on schedule.

Past experience has often fuelled concerns around overregulation. However, this should not bias us: the extent of today's challenges are likely to make drastic regulatory intervention inevitable. Concerns related to the cost of regulation are also often put forward. **Regulatory burdens need to be judged in consideration of the scale of the environmental harm and resulting damage to markets and society** that appear disproportionally higher. This is yet another dilemma of short-term gain versus long-term pain.

SIMPLIFY FOR EFFICIENCY

Simultaneously, regulators need to strive for simplification. To a certain extent, regulatory complexity reflects the intricacies of the economy, although regulators often tend to make complexity more complex. While there is an inevitable degree of complexity, more efforts should be focused on limiting and reducing it. **Complexity has a cost**, e.g. in terms of legal uncertainty, error rate or inconsistencies. Compliance monitoring also becomes more difficult and haphazard as well as costlier. Perhaps less visible but nonetheless relevant, complexity significantly increases resource consumption, which should also be considered.

Most of the time, policymakers and bureaucrats are seen as only paying lip service to simplification. New mechanisms might therefore need to be created. For example, simplification review panels could help by involving a variety of stakeholders, including experts from other fields and non-experts. **Regulators' efforts and results on simplification should be regularly assessed and policymakers and regulators at all levels should be responsible for their results.**

COOPERATE WITH ALL STAKEHOLDERS

Regulators should engage with all stakeholders, including regulated entities. Formal consultations on specific subject matter are useful but not enough: in-depth regular dialogue, both structured and informal, should be fostered. **A culture of dialogue, cooperation and trust will be more beneficial than an antagonistic one**. Business needs to also work collaboratively as without a reciprocal leap of faith, progress will be difficult. Cooperation can be fostered while fully respecting each party's independence. If, in certain sectors, there are risks of conflicts of interest or of undue influence, the answer is to develop proper prevention mechanisms, safeguards and procedures to manage such risks.

Cooperation is equally indispensable between regulators: in the same country, where silo thinking needs to be broken, but also across borders. In the most integrated region of the world, the EU, cooperation amongst regulators helps reduce the risk of divergences, loopholes and regulatory failures. It fosters the dissemination of best practices. Therefore, all Member States should provide the necessary means and resources to their regulators to engage in broad cooperation. As this is in the European collective interest, it would seem justified that the EU plays a monitoring role.

RELY ON ROBUST INDEPENDENT ENVIRONMENTAL AND SOCIAL IMPACT ASSESSMENT

EU policymakers and regulators should base policies on environmental and social impact assessments that are independent and objective. Performing an impact assessment before considering legislative or regulatory action is best practice. Countries that have not yet adopted ex-ante independent impact assessment as a standard practice should be strongly encouraged to do so. The EU and its Member States should be compelled to use a principles-based standard methodology to ensure the quality and independence of impact assessments. In view of the ecological and social challenges we now face, sustainability should be the cornerstone of this methodology.

Existing policies and regulations should also undergo systematic and thorough impact assessments. These policies should then be confirmed, amended or withdrawn based on an objective analysis and measurement of their environmental and social effects. Such assessments should be protected from any political interference and ideological prejudice: they should only provide quantitative and qualitative data to foster an objective debate and support adequate political decision making.

EQUIP REGULATORS WITH APPROPRIATE (HUMAN AND FINANCIAL) RESOURCES

High quality regulation is in the collective interest of all market players as well as society, but it has a cost. It cannot be developed without relevant, multidisciplinary and up-to-date expertise, deep knowledge of the subject matter to be regulated, ongoing engagement with stakeholders, practical experience and a strong sense of integrity and social responsibility. In fact, **knowledgeable, well-resourced, and powerful regulators are more beneficial to business than the opposite**. Policymakers have the power and responsibility to provide regulators with the right level of resources.

Regulators need resources to develop their human and intellectual capital. Regulators must offer attractive and competitive careers as well as robust continuous professional development programmes. Investing in technology is also indispensable to improve regulatory and supervisory activities but also to keep pace with the evolution of the supervised markets and entities. Investing in technology means also investing in training.

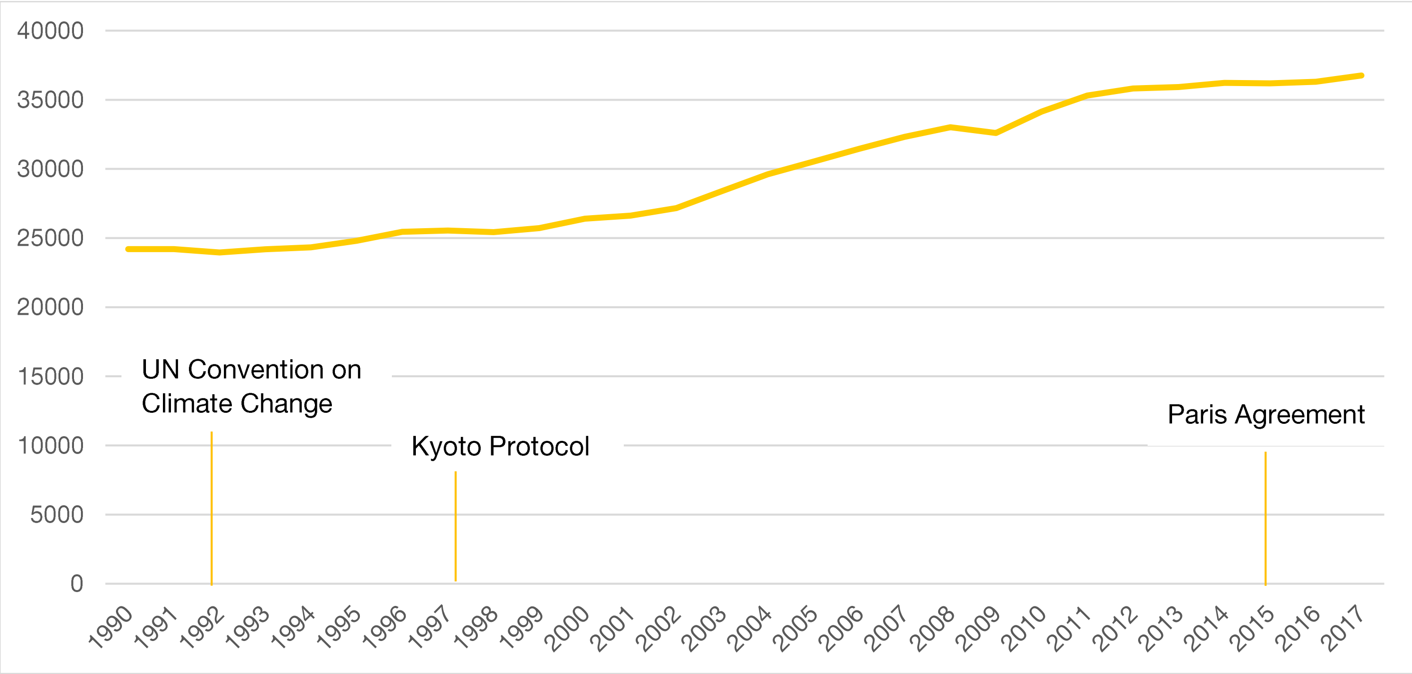
With resources comes accountability. With accountability come legitimacy and efficiency. Regulators should report objectively on their activities, their human and intellectual capital, and more importantly on qualitative outcomes. **Policymakers and regulators should do the same as boards. Namely, be clear on their purpose and performance and integrate ESG factors into their strategy, management, operations and reporting**. Policymakers, regulators and agencies with delegated powers need to communicate their objectives, policies and enforcement priorities. Beyond a signalling effect, each piece of regulation should have a clearly expressed purpose so that it is made easier to comprehend for stakeholders and so that its effect can be assessed.

The benefits of holding regulators responsible for meeting their objectives should be assessed independently. Such good practices are unevenly developed across the EU and the EC has a role to play to foster their general adoption. The public should be informed where regulators are deprived from appropriate resources and the consequences it has.

8. MOVE FROM SHAREHOLDER PROTECTION TO STAKEHOLDER PROTECTION

Governments have been adopting a series of grand commitments, from the SDGs to the Paris Agreement, but it is not always obvious to see how this translates in public policy – and in results. Despite numerous global climate accords, carbon dioxide emissions continue to grow (see Figure 2). In business, advanced leaders are changing their focus from shareholder value to stakeholder value and long-term value creation.

Figure 2: [36]



Corporate governance is about setting a business' purpose and strategy and overseeing delivery. It is a prime tool to leverage the power of markets to achieve sustainability. The regulatory framework should also pursue this objective. Policymakers' and regulators' culture needs to evolve at the same pace as business. However, many regulators continue to prioritise financial markets and shareholders. This mismatch is counterproductive: all regulators need to fully and rapidly integrate the new context of resource constraints, excessive waste and harmful pollution, technology disruptions, plummeting trust and social unrest in which markets operate today and that impact financial performance.

Like business, financial regulation needs to integrate sustainability performance at its heart and all regulators need to think in an integrated way. Regulators need to evolve in full mindfulness of the context, if not lead by example. Regarding financial markets, they should now shift their focus on the protection of broader stakeholders' interests and not only of the financial interest of investors.

9. CREATE A EUROPEAN REGULATORY FRAMEWORK FOR CORPORATE GOVERNANCE IN THE SINGLE MARKET

While markets are increasingly integrated, there is no European corporate governance code and the monitoring of corporate governance statements varies widely across countries. In its 2011 Green Paper on the EU corporate governance framework[37], the EC states that the overall quality of explanations given in corporate governance statements by European companies is unsatisfactory. Against this backdrop, Accountancy Europe's discussion paper *Auditor's role regarding providing assurance on corporate governance statements* (2009)[38] showed that

[36] http://www.globalcarbonatlas.org/en/CO2-emissions

[37] See COM (2011) 164 final – European Commission Green Paper *The EU corporate governance framework*, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011DC0164&from=EN refers to *the Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States* which found that over 60% of companies do not provide sufficient explanations when they choose not to comply, p. 18.

[38] Accountancy Europe was previously the Federation of European Accountants (FEE), see: https://www.accountancyeurope.eu/wp-content/uploads/DP_Assurance_on_Corporate_Governance_Statements_0911_Colour20112009541533.pdf

auditors can add value by providing assurance on corporate governance, internal controls, and sustainability reporting, although, this would require further work, for instance developing specific criteria.

An EU corporate governance code would better match the reality of a single market and bring consistency, coherence, legal certainty and, if done well, simplification. For investors, their advisors and other stakeholders, who give growing consideration to corporate governance, an EU corporate governance code would be easier to comprehend. It would also increase the level playing field amongst companies.

One of the main purposes of a corporate governance code should be to enhance business' contribution to responsibility and sustainability and accelerate the necessary transformation at company level. An EU-wide corporate governance code would first need to be high-level and principles-based. It should also provide the necessary flexibility to accommodate different corporate governance models (e.g. one-tier vs two-tier), company types and ownership structures. It would ideally be based on a building block approach with a set of basic rules that all companies should apply, and a set of additional rules to be followed on a comply or explain basis. To ensure proportionality and that the most demanding rules are only applied where they are fully justified, a bottom-up 'think-small-first' approach should ideally be pursued, even if this often appears difficult in practice.

An EU code would need a strong supervision framework; someone needs to be in charge. This could be the responsibility of either dedicated independent bodies, national regulators or, more logically, of a single European body.

If different national organisations would be involved, they should be closely connected, for instance in a European network (on the model of competition authorities). A European body should be responsible for ensuring coordination and implementation. This would help fostering consistency, trust and cooperation between national entities that is essential to the single market's proper functioning.

At least for capital markets, a single European capital market supervisor should be considered, especially with the Capital Markets Union in mind. But a supervisor can only fulfil its role if it is properly equipped and empowered.

The political mood seems rather far from agreeing to an EU corporate governance code and supervision. However, beyond ideology, a lack of vision or simple reluctance to change, markets continue integrating. The fragmentation of regulatory frameworks appears to limit efficiency and be a source of additional costs, inconsistencies and legal uncertainties.

In most instances, EU legislation is dependent on proper transposition (and enforcement) by Member States whose responsibility is paramount. 'Gold-plating' often generates inconsistencies and burdens that undermine the effectiveness of European public policies. The EC should work with Member States to identify where the use of Regulations instead of Directives brings benefits in terms of legal certainty and additional coherence. The EC should focus its infringement policy on the effective attainment of the objectives. This becomes even more important when matters such as the use of resources and the preservation of a liveable environment.

ADAPT COMPANY LAW TO SUPPORT THE TRANSITION

The traditional narrow focus on shareholder value is increasingly seen as having negative consequences on long term value creation as well as on the environment and society. In practice, company by-laws often have boilerplate corporate purposes formulated with a view to ensure maximum flexibility and minimum constraints, risks and commitments. However certain companies have adapted their corporate purpose with the aim of reflecting their commitments to social responsibility. Certain governments are modifying their legislation so that companies' corporate purpose look beyond the primacy of shareholders' interest.

Accountancy Europe also sparked a public debate on developments in audit, assurance and related services. See *Opening a discussion: The Future of Audit and Assurance* https://www.accountancyeurope.eu/wp-content/uploads/Future_of_Audit_and_Assurance_Discussion_Paper_1402.pdf (2014) and *Pursuing a strategic debate: The future of audit and assurance* https://www.accountancyeurope.eu/wp-content/uploads/1601_Future_of_audit_and_assurance.pdf (2016)

A next step is providing new legal forms of companies that expressly pursue specific environmental and/or social purpose(s)[39]. Dedicated incentives[40] could be considered for businesses that adopt such corporate forms and undertake a public interest role, since they are partly making up for the damage that other types of business may be generating. An 'EU label' would recognise such efforts. Companies that fulfil this label's conditions could benefit from becoming more visible towards investors and increase their reputational capital and brand awareness. **Many national company laws still indicate explicitly, or signpost implicitly, a company model that is centred around the shareholder financial interest. This is outdated and needs to be adapted**.

Companies need to be specific on their corporate purposes, in particular on how it balances including different interests, its key stakeholders and its mission. Company law should also require that business include in their by-laws:

- how they consider their environmental and social responsibilities and objectives
- how these relate to their corporate purpose

MAINSTREAM BEST PRACTICES IN DIRECTOR REMUNERATION

Reward systems support strategic alignment within an organisation and are critical to its success. It is not new to include non-financial performance, such as client satisfaction, in corporate incentives and remuneration policies. There is already robust experience here. Today, the most advanced businesses start **developing reward and incentives systems that consider ESG performance**. The SDGs and planetary boundaries could also provide a sense of direction.

Regulators can help mainstream best practise in director remuneration. At a minimum, **remuneration policies and their sustainability impact should be disclosed on a 'comply or explain' basis**. Regarding listed companies, the EC should consider adapting the relevant provisions of the Shareholder Rights Directive[41] in line with best practices.

REVIEW THE EU REPORTING FRAMEWORK

Corporate reporting critically supports corporate governance by enabling companies to make better decisions. Accountants play a crucial role in companies' ability to report meaningful and reliable information. Accountancy Europe has started the debate on the future of corporate reporting in 2015. Since then we have lead developments on non-financial reporting and assurance, and we proposed the Core & More concept to improve how corporate reports are presented (see an interactive overview[42] connecting all our related work).

The EU corporate reporting framework suffers from a piecemeal approach with several legal texts dealing with different reporting obligations (e.g. Accounting Directive[43], IFRS Regulation[44], Non-Financial Reporting Directive[45] with non-binding guidelines, Transparency Directive[46]) There is also pending legislation, for instance, on tax disclosures[47]. The interaction between these texts is complex. Their scope is not always consistent. They use different thresholds. They do not offer a coherent framework, for instance, the Member States were not

[39] https://ssir.org/articles/entry/french_law_revisits_corporate_purpose
[40] For example: 1) simplified administrative requirements, 2) easier access to finance including EU funding and 3) eligibility for inclusion in a sustainability stock index.
[41] Directive 2017/828/ EU of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, see https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN
[42] https://www.accountancyeurope.eu/about-us/the-future-of-corporate-reporting/
[43] Directive 2013/34/EU, see https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0034&from=EN
[44] Regulation (EC) No 1606/2002 see https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32002R1606
[45] Directive 2014/95/EU, see https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN
[46] Directive 2004/109/EC, see https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32004L0109&from=EN, Directive 2013/50/EU, see https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0050&from=EN
[47] COM(2016) 198 - Proposal for a Directive Income tax information by certain undertakings and branches, see https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0198&from=EN

even able to agree on a set of general principles in the Accounting Directive [48]. This approach creates unnecessary complexity and costs. Moreover, it inhibits business compliance and progress.

The EU Institutions and the Member States should carefully consider the opportunity to bring the pieces of the reporting puzzle together. If institutional agreement seems out-of-reach, or hostage to political tinkering, the EU should show the same leadership and wisdom as they did when adopting the International Financial Reporting Standards (IFRS): externalising the standard setting. This approach may be a useful way of accelerating progress, ensuring expert quality and limiting undue influence on standard setting that needs a strong degree of independence.

Reporting is another field where further opportunities for simplification may be found. For instance, the EC should carry out and independent impact assessment to apply disclosure requirements at the group level (rather than at individual company level). Technology can foster simplification, although it is not a panacea: it will not resolve poor, inconsistent or overly complex legislation. Similarly, uncoordinated and fragmented use of technology by the Member States would be detrimental to business and harmful to the single market.

In the field of non-financial reporting, the new Directive should keep pace with best practices. A review of the Directive should be the opportunity to gradually diminish the threshold to progressively mainstream non-financial reporting and make more comprehensive information available to investors, policymakers and other stakeholders. When updating the EC's non-financial reporting guidelines, care must be taken that these non-binding measures do not end up disrupting the level playing field between companies that already do well (and do not need additional encouragement) and those that lag behind (and who will not be incentivised by non-binding measures). This would, in effect, put the former at a competitive disadvantage compared to the latter and, paradoxically, disincentivise good practices.

There is much progress in the area of non-financial reporting, but there is also proliferation of standards and frameworks. **The time has come for consolidation**: this would increase consistency, transparency and comparability as Accountancy Europe stated in its *Call for Action: Enhance the Coordination of the Non-Financial Information Initiatives and Frameworks* (2017).[49] Furthermore, the impact of non-financial reporting is limited if it is not connected to financial reporting. Financial performance results from performance in e.g. strategic planning, resource utilisation and business processes. Performance needs to be judged holistically. Therefore, **the use of integrated reporting should be supported**.

10. ENSURE CONSISTENT AND EFFECTIVE ENFORCEMENT

Change rarely occurs by decree. The effectiveness of any law depends on effective enforcement mechanisms. Inconsistent and uneven enforcement disrupts the market and slows down progress.

Transparency facilitates effective enforcement and creates incentives to conform. As a principle, businesses should be required to analyse and mitigate the impact of their strategy and operations on the environment and society and to be fully transparent about the outcome of their efforts. But the benefits of transparency may have limits too. Public disclosures may not always be the most appropriate way to deal with sensitive matters such as the outcome of board evaluations or certain risks management plans. From this perspective, the benefits of private reporting to a well-equipped regulator deserve further consideration. It would imply a culture of dialogue where both the supervisor and the supervisee share the objective to systemically improve and cooperate. External auditors are also be in the position to contribute to such a dialogue.

ENHANCE THE 'COMPLY OR EXPLAIN' PRINCIPLE

The 'comply or explain' principle provides a good model for enforcement, while also providing flexibility to businesses. It continues to be useful in the field of corporate governance. However, it needs to be strengthened. This principle is only effective insofar compliance is strongly monitored. In a 'comply or explain' context, the

[48] https://www.accountancyeurope.eu/wp-content/uploads/FEE_Position_on_EC_CP_Review_of_Accounting_Directives_090421234200939130.pdf
[49] https://www.accountancyeurope.eu/wp-content/uploads/170918-Call-for-action-letter.pdf

quality, specificity and acceptability of the explanations provided in case of non-compliance need to be properly evaluated. Overseeing the UK Corporate Governance Code (since 1992), the Financial Reporting Council (FRC) is one of the most experienced regulators on the 'comply or explain' approach in corporate governance. They admitted in 2017 that 'comply or explain' needs more teeth to restore public trust in business[50].

A 'comply or explain' approach requires time, resources and moreover competence to carry out monitoring, careful assessment and judgement. A forceful redress mechanism is needed to impose corrective action where necessary. Dissuasive sanctions must be applied in case of repeated or ill-intended failure to provide a valid explanation or of inappropriate or misleading explanation. **'Comply or explain' works insofar as it is properly monitored and enforced.**

CLARIFY DIRECTOR LIABILITY

We are certainly not calling for more litigation, but judiciary action is one of the tools that civil society is increasingly using to create change, sometimes because policymakers are perceived as not keeping pace with needs and expectations[51].

Directors and management have to act in the interest of the company having due care for their stakeholders. The magnitude of business impact entails a particular responsibility. Logically, directors should bear the full consequences of their actions, omissions, negligence or wrongdoing. They should be responsible for preventing and mitigating negative environmental and societal impacts. It should be kept in mind that corporations are legal constructs, but they are run by human beings, and benefit human beings. When considering liability, the balance is always delicate to strike[52]: too heavy responsibilities and excessive liability risk will drive directors away; conversely over-protecting them will reduce their sense of responsibility and may hamper the public interest.

Liability regimes differ widely in the EU: this reduces the level playing field between companies and undermines corporate governance' potential to shift markets. Harmonising directors' liability regimes would probably meet serious political and lobbying resistance. However, the EU should explore providing a European framework to mitigate the negative impact of the diverging liability regimes and enforcement. A European collective redress scheme could also support more accessible and consistent environmental justice.

RETHINK SANCTIONS

New thinking about sanctions is necessary. Rules that are not applied or unevenly enforced are not only inefficient, they are counterproductive. Sanctions are not (only) aimed at dissuading or punishing: they are primarily aimed at protecting legitimate businesses and ensuring that there is a level playing field. Sanctions also contribute to a regulatory system's credibility. If non-compliance does not meet systematic proportionate sanctions, the entire system is at risk.

When sanctions appear necessary, they must be proportionate to the extent of the offense, its consequences, notably on the environment, and to the perpetrator's size and means. Applying the same sanctions for SMEs and large companies is not proportionate, nor fair, nor effective. Sanctions must also be proportionate to the damage the company inflicted to market functioning, other stakeholders, as well as the environment or society. Any business weighing cost/benefits in their approach to compliance, should have no doubt that complying is the better option.

Once rules are in place, enforcement is largely a matter for Member States. Therefore, the EC should step up its oversight of Member State' enforcement policies and make this an important element of its infringement

---

[50] The FRC found too many explanations for non-compliance the Corporate Governance Code were of poor quality, see FRC, (2017). *Developments in Corporate Governance and Stewardship 2016*.

[51] See examples of the growing number of lawsuits against corporations and governments across the world addressing their actions or inactions in relation to climate change: 1) http://www.lse.ac.uk/GranthamInstitute/publication/global-trends-in-climate-change-legislation-and-litigation-2018-snapshot/, 2) http://climatecasechart.com/, 3) https://www.bloomberg.com/graphics/2018-climate-change-lawsuits/

[52] An example of good balance seems to be the French Corporate Duty Of Vigilance Law, see https://www.business-humanrights.org/sites/default/files/documents/French%20Corporate%20Duty%20of%20Vigilance%20Law%20FAQ.pdf

policy. This would prevent local political interference and safeguard independence, objectivity and a level playing field amongst European business.

CONCLUDING REMARKS

COOPERATE TOWARD INTEGRATED THINKING

Environmental and social objectives are not separate from the economy and business. Given the degree to which our economy is impacting the planet, it can be argued that financial schizophrenia has proved to be seriously harmful. We can no longer afford to manage any business on the sole basis of financial performance. **Corporate governance needs to take a holistic approach and consider all aspects of doing business and prioritise the transition to a circular economy as this growingly appears as the only option in a finite world**.

We need to think and act in an integrated way. This means not only taking into account financial capital but also the other capitals used in the value creation / destruction process e.g.: natural, human, intellectual and social. To create and preserve sustainable value, the focus cannot be solely on shareholders, all the relevant stakeholders of a business need to be considered. Furthermore, without integrated thinking, risk and opportunities will be missed; long term value creation and resilience cannot be assured.

As much as corporate governance can be a key driver of sustainability, it does not operate in isolation. Corporate governance is part of a broader economic, legal and cultural ecosystem: its efficiency depends on all actors playing their part and cooperating. **The private and public sector need to work together more, at local, national and European levels**. The EU is best placed to set up and support European multi-stakeholder platforms. In addition, decentralised platforms across the EU are also essential to channel bottom-up input and feedback and foster adoption of new solutions.

The proper functioning of markets is disrupted by negative externalities with environmental and social costs shifted to taxpayers, the ecosystem or future generation. Markets on their own cannot redress that, nor can corporate governance. Therefore, **policymakers must play the lead role in internalising negative externalities into the price system.** Corporate disclosure requirements do inform markets and stakeholders but their impact on negative externalities is limited and policymakers need to use the instruments that make an effective difference even if they are not the most popular, such as taxation[53].

Despite ongoing difficulties and challenges, it is too often forgotten that, in many places around the world, the EU is seen as a role model of consensual policymaking and international cooperation, in particular regarding the imperative shift to a sustainable economy. **We encourage the EU to continue showing leadership, including in multilateral forums, and taking decisive action even if others hesitate. Competitiveness is very important, but without a viable planet it doesn't matter anymore**.

There is no business once ecosystems and societies fail – there is no polity either: therefore business, citizens, as well as governments, policymakers, regulators and enforcement agencies must have the transformation to a sustainable economy as their top priority. **The accountancy profession provides its contribution to the policy debate but more importantly on the ground helping business adapt and transform to a sustainable model**.

ACT SWIFTLY AND DECISIVELY

Better policies will help redressing the functioning of markets and unleash their transformational power. This means carefully but rapidly rethinking virtually all public policies, making sustainability their cornerstone and eliminating inconsistencies. Then systemic change may become possible. Nevertheless, integrating sustainability in all EU public policies will not be sufficient: the main responsibility for the implementation of EU policies lies with Member states. As guardian of the European public interest, **the EC should make sure that Member States are equally mobilised and effectively delivering on the sustainability and social agenda.**

---

[53] For example, the Ex-Tax project sets out that "High taxes on labour encourage businesses to minimize their number of employees. Resources, however, remain untaxed; they are used unrestrained. This system causes unemployment, overconsumption and pollution." See http://www.ex-tax.com/. See also the Association of Chartered Certified Accountants (ACCA), (2018), *Discussion Paper: Tax as a force for good Rebalancing our tax systems to support a global economy fit for the future* https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Tax-as-force-for-good/pi-environmental-tax.pdf

Some readers will find that many of the suggestions in this paper are too costly or too big of an ask. We invite them to objectively research the consequences of further delaying action and change: the costs will be much greater and the impact potentially dramatic.

Amongst those who would be willing to act, many will be concerned about the impact on their competitive position. They fear that adopting ‘costly’ sustainability practices may put them at a competitive disadvantage. Although understandable and legitimate, such fears create a systemic deadlock. It prevents necessary cooperation, the emergence of solutions and their roll-out. This deadlock will not be broken by waiting. The time may have come to question certain aspects of competition, but **it is even more urgent for each of us to take responsibility and act in all our respective roles**.

In closing, we turn to you. We have put forward ten proposals and invite your critical feedback on what more could be done: What is missing? Where should we be more ambitious? And moreover: what will *you* do to contribute to systemic change? Send your thoughts and opinions to iryna@accountancyeurope.eu by 1 October 2019.

Avenue d'Auderghem 22-28, 1040 Brussels

+32(0)2 893 33 60

www.accountancyeurope.eu

@AccountancyEU

Accountancy Europe

ABOUT ACCOUNTANCY EUROPE

Accountancy Europe unites 51 professional organisations from 36 countries that represent close to **1 million** professional accountants, auditors and advisors. They make numbers work for people. Accountancy Europe translates their daily experience to inform the public policy debate in Europe and beyond.

Accountancy Europe is in the EU Transparency Register (No 4713568401-18).