TheCityUK

ANALYTICAL CENTER FORUM

UK-RUSSIA CORPORATE GOVERNANCE WORKING GROUP

A collection of monographs on environmental, social and governance, and other contemporary issues

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About TheCityUK

TheCityUK is the industry-led body representing UK-based financial and related professional services. In our 10th anniversary year, we continue to champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK, across Europe and internationally that drive competitiveness, support job creation and ensure long-term economic growth. The industry contributes over 10% of the UK's total economic output and employs 2.3 million people, with two thirds of these jobs outside London. It is the largest tax payer, the biggest exporting industry, generates a trade surplus almost equivalent to all other net exporting industries combined. It also makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business and protect and manage risk.

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About Forum Analytical Centre

Forum Analytical Centre has served as financial markets development RnD hub since 2010.

AC Forum is an integration platform designed to bring together all interested parties: the Bank of Russia as megaregulator, other ministries, licensed market participants and their associations, and the international investment community.

www.ac-forum.ru

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FOREWORD

The UK-Russia Corporate Governance Working Group has met three times since its inception in 2019 to share experience and best practice in corporate governance between the UK and Russia. Its meetings in both Moscow and London provided a forum for the Working Group members to share experiences, views and information in constructive and open discussions. This established a mutual understanding across a range of relevant corporate governance issues.

The scope of the Working Group's deliberations further extended to embrace key aspects of environmental, social and governance (ESG) investment, which has gained irreversible momentum in recent years and increased its importance in influencing the structure and regulation of global capital markets.

During the meetings, the Working Group was mindful of the unique features of Russian capital markets – not least, the significant presence of companies involved in financial services and the extractive industries as well as the important role played by bonds and bond investors, who are becoming a strong force around the world in shaping the evolution of ESG investment and sustainability management.

This report comprises a collection of monographs written by some of the Working Group members which address many of the issues discussed by the Working Group. We hope it will be useful for regulators, investors and companies alike, and that it will be a valuable reference point which will assist in enabling effective corporate governance to contribute to the future success of Russia's economy and capital markets.

We should like to thank all of the Working Group members, especially those who have contributed to this report, for generously giving their time and thoughts and everyone who has directly and indirectly assisted the Working Group.

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INTRODUCTION

ENVIRONMENTAL, SOCIAL AND GOVERNANCE RELATED ISSUES IN RUSSIA

Forum Analytical Centre

Drafting the 2019-2020 agenda for the UK-Russia Corporate Governance Working Group, the Russian side put forward issues that resonate with the agenda of the country's regulators' and industry. We prioritised issues where we felt that industry and regulators could benefit from learning from international experience in order to develop legislative, regulatory and best business practice approaches.

One of the key priorities of the Working Group was ESG, which is perhaps the most rapidly evolving aspect of corporate governance. In recent years, the world has been in the process of rethinking investment approaches and business conduct standards across all levels – civil society, business owners, investors, managers and politicians.

There is hardly any company, state official or expert, who would deny the importance of ESG. In a pivotal statement made in August 2019, the US Business Roundtable said that it would forego the primacy of share profit in favour of stakeholder interests. This is the first time a major US business organisation has adopted such a position.

Adopting ESG standards brings many issues in its wake. The Bank of Russia as a regulator, faces the task of implementing globally accepted ESG approaches without damaging business confidence and continues encouraging companies to adopt modern standards that benefit both business and society at large.

The new 21st century corporate governance paradigm is geared to facilitate the transition from seeing business as being primarily about profit maximisation to seeing business as something that supports the interests of wider society. This emerging paradigm is based on a number of important notions: ESG per se, responsible business conduct (RBC), and sustainable development (SD). These concepts are related to one another and have implications for accounting standards, auditor opinions and agency ratings, depending on the level of a company's compliance with particular requirements. All of these factors in turn affect market valuations of the company by investors.

Another task that the group considered is striking the right balance between market mechanisms and state regulation in ESG promotion and development. Today, we can hardly expect ESG issues to remain with market players alone – this inevitably becomes a matter for national and international regulators. What is the role of regulators in promoting ESG principles? How exactly should regulators interact with the market? By codifying the best existing practices or by proactively pushing companies and investors to boost their ESG focus? In Russia, where business is already under a relatively high regulatory burden and is strongly resistant to additional costly requirements, this issue is especially pressing.

From a commonly shared practical viewpoint, the costs of implementing ESG approaches are evident for issuers and investors alike, both in the short and long term. The benefits, however, at least the ones that are material and measurable, are less obvious, or in any case, delayed.

This naturally poses the question of whether lawmakers, governments and regulators should use incentives to drive ESG-led investment. The Working Group was tasked with exploring international practices in this area. For instance, it examined how often international regulators support (or consider supporting) financial institutions who adopt ESG standards. Do they allow less stringent reserve or capital requirements? Do they consider granting companies tax benefits or additional incentives?

On the other hand, if it is clear that companies with high ESG standards have higher valuations than non ESG-friendly competitors, then it could be argued that there are no additional incentives for adopting ESG standards. However, this proposition cannot simply be accepted on faith, it is important to provide clear evidence that ESG adoption does in fact lead to higher valuations. Therefore, we asked the Working Group to consider quantitative studies that show the correlation between ESG/RBC compliance and share price dynamics, market multipliers (such as P/E), and other efficiency indicators.

In a broader outlook, how does ESG development affect equity and bond issues? It is essential to see the effect of ESG standards and approach development on asset selection and valuation, and on institutional investors' activity in general.

One way in which ESG is advancing is through emerging financial instruments that are eco-related or linked with the sustainable development of the society. These green instruments include green bonds and green loans, social bonds, and sustainable development instruments (SDI). Our working group considered how these instruments relate to the broader ESG movement. It considered how to define and classify these instruments and how to incentivise their use. The group discussed the evidence on whether investors are ready to pay premiums for green instruments, or indeed to settle for lower returns on moral or ethical grounds? What are the criteria involved in making these decisions?

Given the impact that ESG adoption has on company value, it is especially important that the market is able to understand which companies are adopting ESG standards and how well they are doing it. Moreover, are companies who adopt ESG standards actually doing what they say they are doing when it comes to implementing green policies? We asked the Working Group for guidance on how best to verify these matters. Who should verify companies and instruments? How should the verifiers verify? Should consultants, auditors, index and rating agencies (who have positioned themselves as verifiers), have responsibility for this? Or should this be a matter for the state or quasi-public corporations, such as exchanges or SROs to handle? If the state does not verify itself, should it nonetheless regulate those who do and supervise them? Who and how audits ESG reporting, and how are audit standards established in this case?

Another major array of issues concerns optimal ESG disclosure requirements. Russian companies report to national regulators and publicly disclose vast volumes of information. Should there be additional regulatory standards for ESG disclosure? What should be the balance between ESG and general corporate reporting, between ESG and CSR?

Today, there is no fixed international ESG practice in place yet. Standards vary wildly and are in constant flux. All stakeholders are adapting to the ongoing change, contributing to this change in the process.

Many Russian companies operating or listed internationally have already implemented non-financial reporting to international standards, setting their own ESG KPIs and making progress in their investor relations. Sustainable development has become the corporate norm in these companies which have the necessary policies in place, established Board committees and implemented ESG norms at an operational level. The Working Group has studied the practices of Lukoil, Norilsk Nickel and Polyus.

At the same time, the question arises about how other Russian companies who have not listed on international markets should proceed. The Working Group considered the benefits of aligning any new Russian reporting standards with international best practices.

In all of our activities around ESG, we at Analytical Centre Forum seek a nationwide debate around the promotion of sustainable development principles. Our goal is to shape an integrated vision shared by all stakeholders, including local institutional investors.

MONOGRAPH ABSTRACTS

An extract from:

Think Ahead

Environmental, social and governance: global practice and the role of integrated reporting (page 13)

Association of Chartered Certified Accountants (ACCA)

Environmental, social and governance (ESG) is definitely a theme for the 21st century but Russia's demand for ESG products is slightly behind that of the front-runners in Europe. ESG takes the concept of value creation outside the purely business domain and releases it into society. Shareholders are not the only stakeholders that matter anymore.

ESG, 'Responsible Business Conduct' and 'Sustainable Development' are interrelated and complementary concepts but they lack a common reporting framework. For many businesses, the journey of implementing integrated thinking embracing these concepts will be just as important and arduous as the reporting itself, if not more so.

The ACCA encourages companies to tackle a broad range of questions about governance, strategic planning and corporate culture, which will often require opening new channels for dialogue with the board, and new ways of collaborating with others. The benefits make this effort worthwhile.

An extract from:

Update on reporting, disclosure and environmental, social and governance practices in Russia (page 16)

Deloitte

Russia started preliminary discussions about adopting a law on non-financial disclosure in 2017, three years after the EU enacted a directive regarding this issue.

The draft Russian law, which was due to come into force in 2019, initially proposed the development of several key compulsory non-financial indicators for disclosure to be developed, and encouraged independent assurance of all non-financial reporting. However, the enabling Bill in July 2019 encountered resistance due to the potentially higher costs of mandatory non-financial reporting and the proposals are now under review.

An extract from:

Tax as a force for a greener economy (page 17)

ACCA

The UN 'Sustainable Development Goals' provide a way for countries to rebalance their tax systems in order to support a greener and more inclusive economy. The basic principle is simple: 'tax less what you want more of'. In practice, it means a shift from labour taxes towards tax on resource-use, pollution and consumption.

Presently, tax revenue is raised largely on employment. In Economic Cooperation and Development (OECD) countries, labour taxes account for 52.1% of total public revenue raised, while green taxes account for only 5.3%. However, nowadays it is more rational to tax pollution and resource use than it is to tax labour.

Several governments (including China, Germany and France) as well as the EU have adopted the circular economy as a policy goal. This requires governments to implement carbon pricing and by applying internal carbon and water pricing. Over the last few years, the circular economy has gained traction. Reducing labour taxes and increasing green taxes is key to achieving circular economy ambitions.

An extract from:

Green practices: sustainable finance (page 19)

London Stock Exchange Group

London is a global centre for green and sustainable finance and London Stock Exchange is innovating across asset classes to develop the financial instruments needed to help issuers raise the capital they need to support long-term sustainable business models and infrastructure. This includes:

- The Green Economy Mark, which identifies listed companies and funds across all segments of London Stock Exchange's equity markets that generate 50%+ revenues from goods, products and services that contribute to the global green economy.
- A dedicated Sustainable Bond Market that includes a segment for bonds from issuers that generate 90%+ green revenues.
- Providing guidance on green finance tools and ESG disclosure, with an online tool for issuers to calculate their ESG Disclosure Score.

London Stock Exchange Group (LSEG) also regularly convenes conferences on key topics, such as green bonds. In October 2019, the LSEG hosted its first Sustainable Finance & Investment Summit.

An extract from:

Environmental, social and governance rises to top of the agenda in Moscow (page 21)

Moscow Exchange

Moscow Exchange (MOEX) recognises that business must take up the challenge of integrating sustainability practices into their operations in substantive and measurable ways, and it has taken several steps to promote sustainability principles and best corporate governance practices among Russian issuers and the professional investment community.

A key component of MOEX's strategy is broadening access to investment and savings solutions for a diverse clientele, including private individuals in all regions of the country, thereby enhancing the value that MOEX brings to Russian society.

MOEX has updated its Corporate Governance Code to enshrine sustainability, and has launched its Sustainability Sector and two sustainability indices, which strive to promote and improve ESG transparency.

An extract from:

Sustainability in the Boardroom: PwC Russian Boards Survey (page 22)

PwC

The survey addresses key issues, such as the level of importance that board members attach to the sustainability agenda, the sustainability issues that are gaining traction in the boardroom, the drivers of board commitments to sustainability and the extent to which sustainability is integrated into long-term business strategy. It draws on insights from respondents representing almost 200 Russian joint stock companies across a dozen industries in Russia. Its findings include:

- Thirty-five per cent of board members see the need for environmental or sustainability expertise on their boards. Sustainability is managed in different ways. For example, only 15% of directors claim to have staff dedicated to sustainability matters.
- Despite investors' increasing focus on environmental issues, gender diversity and corporate governance, boards do not believe such issues are critical to their company's development.
- To effectively carry out ESG oversight, boards need continuing education on ESG trends and developments. There is a learning curve involved.

An extract from:

Incentives for driving ESG implementation in business practice (page 25)

EY

EY annually conducts research on investor perspectives of ESG/non-financial reporting and the role it plays in their decision making. The latest edition (2018) covered more than 260 institutional investors from across the globe. The research revealed that:

- Ninety-seven per cent (78% in 2017) say they conduct either an informal (65%) or a structured, methodical evaluation (32%) of a target company's non-financial disclosures.
- Ninety-six per cent (68% in 2017) say that ESG information has occasionally (62%) or frequently (34%) played a pivotal role in investment decision making. Climate change is consistently one of the most material issues.
- For all investment strategies, including green bonds, consideration of ESG aspects yields excess return and lowers risk, and also allows the achievement of important non-financial objectives of a portfolio.

An extract from:

Investors call for proactive effort in building environmental, social and governance practices (page 27)

Prosperity Capital Management

Prerequisites to having an active board that leads the ESG agenda is having truly independent non-executive directors, elected by both a controlling shareholder and minority shareholders.

Investors are now actively monitoring and engaging with companies about social and environmental issues, as well as governance, which has created investor demand for relevant disclosures, research, and ratings. This is starting to be reflected in the corporate reporting of many Russian companies. That said, we believe there should be regulated national ESG reporting standards. ESG integration and disclosures should be honest, ambitious and make a meaningful contribution towards good corporate governance and sustainable development.

An extract from:

Corporate governance in financial and non-financial holding companies (page 28)

Issues of corporate governance in parent companies and subsidiary companies

Ashurst

Typically, directors of a UK parent company will be reluctant to accept responsibility for the affairs of a subsidiary, particularly where that subsidiary is incorporated in a foreign country and subject to that country's laws and principles of good corporate governance. In the Russian, context group subsidiaries are often incorporated in different jurisdictions from the parent.

Group structures can be complex with their legal structure not matching their corporate governance decision making structure. Russian-centred corporate groups may wish to consider creating a single corporate governance function for the group to ensure the development of appropriate corporate governance principles and to achieve their consistent and effective application.

Group governance when the parent and the subsidiary belong to different sectors: a summary of the issues (page 29)

Nestor Advisors

Group governance arrangements within a multi-entity corporate group in which a parent entity controls one or more operating subsidiaries, can be viewed as a continuum. On one end lies the operating holding structure, where often the parent is in the same business as the subsidiary. Typically, these groups would have many of their functions, such as finance, risk and audit fully integrated.

On the other end of the spectrum lies the purely financial holding entity, which is often the case when the parent and subsidiary companies are in different sectors. In such situations, the governance model is likely to be similar to that used by private equity funds. For example, the executives of the parent are likely to play an important role as non-executives on the subsidiary boards.

It is important for regulators and outside investors to be appreciative of the significant differences that can exist along the continuum of group governance arrangements.

Group-wide corporate governance: does it matter? (page 30)

Baker McKenzie

It is imperative that any decision making in any part of the organisation is consistent with the strategy set by the Board, in accordance with group governance policies and that the relevant directors are informed of their legal duties.

Good governance can help to manage risk and improve subsidiary performance. It can also increase the quantity and quality of information flow up to the parent, therefore increasing trust and enabling the parent to make informed strategic decisions and identify and resolve issues at an early stage.

The UK government has introduced a number of new reporting requirements for financial years beginning on or after 1 January 2019. They relate to different types and sizes of companies and cover topics such as a statement regarding engagement with suppliers, customers and others in a business relationship with the company.

An extract from:

Internal control vs compliance (page 34)

ACCA

The primary objective of the internal control system is to help an organisation perform better through the use of its resources, while avoiding serious problems such as overspending, operational failure and violation of laws.

Compliance's objective is fundamentally operational. The compliance function is meant to reasonably ensure that the company is complying with all applicable laws, rules and regulations, set by state, national and international bodies.

Controls and compliance are only two parts of the story; internal audit is the third. Together, they create the three lines of defence model.

The Bank of Russia's 'Russian Financial Market Development Program for 2019-2021' is commended. It is suggested that the two major issues for it to address are issues arising from the proliferation of technology and the critical need to engender a circle of trust between consumers, financial institutions and regulators. Proportionality is also considered important. The Bank is encouraged to increase its internal control oversight in important subsectors, such as pensions, and be transparent about its reasons for doing so.

ENVIRONMENTAL SOCIAL & GOVERNANCE: GLOBAL PRACTICE AND THE ROLE OF INTEGRATED REPORTING

Think Ahead

ACCA

Emergence of environmental, social and governance

ESG is definitely a theme for the 21st century. In the past, the investment climate was almost wholly driven by demand where it was the investors who wanted to see ethical products and investment strategies finding their way to the market. In the 21st century the supply side is finally catching up. Product development, regulation and, what is most significant, infrastructure (such as rating agencies, compliance services, ESG integration, portfolio management, screening and sustainability indices) are finally being made available to the consumer.

Russia's demand for ESG is slightly behind that of the front-runners in Europe and some parts of Asia, where attention to ESG is driven by its role as a risk management framework or even as a regulatory measure. Nevertheless, this will change in due course with the help of success stories from early adopters and educational initiatives both from businesses and regulators.

It is hardly worth considering ESG without a recognition that financial performance remains critical for any business. It may be satisfying to think about it from the philanthropic or an altruistic perspective; but this is far from the reality of today's financial and business environment. Value creation is still the central theme. However, ESG takes this concept of value creation beyond the purely business domain and releases it into society. Shareholders are not the only stakeholders that matter anymore.

There is a large body of academic research that links ESG to stronger financial performance such as lower volatility, greater stability, share price growth and improvements in information symmetry. ESG is definitely a driver of growth but it is also an instrument that can attract fresh talent to the organisation, raise brand awareness, provide a suitable risk matrix for strategic decision making and importantly, create an integrated corporate culture.

The relationship between environmental, social and governance, responsible business conduct and sustainable development

It is evident that ESG has a myriad of advantages that could encourage an organisation to consider its adoption. It is also often considered together with (or as an alternative to) other concepts such as responsible business conduct (RBC) and sustainable development (SD). These ideas are closely related but nevertheless lead to different outcomes and are underpinned by diverse underlying ideas.

ESG is a measure of the sustainable and ethical impact of investment. In an ideal world, social and environmental factors should be embraced by the business model from value proposition (i.e. focus on products and customers), to value creation itself (such as resources, governance and transaction structure, to value capture reflected in the cost structure, revenue formula and profit model), which is geared towards strategic business decisions.

However, ESG, which applies to a wide range of investment categories, including bonds and real estate, is often considered only as an element of the investment process in terms of research, asset valuation and allocation, portfolio management and risk management activities which are geared towards purely investment decisions.

On the other hand, RBC, a related concept developed by the Organisation of Economic Cooperation and Development (OECD) as a framework for investment, is focused on corporate governance and compliance but excludes the reporting, disclosure and accounting perspectives.

Sustainable development provides another angle to these issues: it sets out a long-term perspective which is so broad it is often hard to pinpoint its exact meaning and the potential outcomes. It can be defined as a triad which includes harm-prevention (the regulatory perspective), 'doing good' through innovation (the business opportunity), and governance-responsibility which ties the two concepts together.[1]

[1] Voegtlin, Christian and Scherer, Andreas Georg, 'Responsible Innovation and the Innovation of Responsibility: Governing Sustainable Development in a Globalized World', (January 2016), pp. 227 -243, avilable at: https://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=2716152

Hence ESG, RBC and SD are interrelated strategies and complement each other as each covers a specific area without direct overlap. Implemented together, they create a regulatory infrastructure that allows organisations to identify business opportunities which create value for the stakeholders, both shareholders and a wider society which is managed through robust governance and reporting. The missing piece is the suitable framework that would allow this system to function effectively.

Choosing a suitable framework

Many frameworks have been developed to address the need of businesses to measure and report on their social and environmental responsibilities. However, the implication of many of these frameworks is that financial reporting and ESG reporting exist as separate processes within the organisation.

Often ESG reporting has no strategic or business-model perspective and is only loosely linked to the numbers in the financial statements and is beyond the understanding of an average investor.

The International Integrated Reporting (IR) Framework, issued by the International Integrated Reporting Council (IIRC) embraces the integrated management approach to reporting.[2] It takes into consideration wider drivers of organisational performance in a forward-looking way, providing the instruments to relate financial performance and ESG to strategy and the organisation's business-model, which is often referred to as integrated thinking.

The IR Framework is structured as a matrix of six capitals: financial, human, manufacturing, intellectual, natural and social – the inputs that drive the organisation's operations and create its outputs. Embracing the entire business model, but giving the organisation the flexibility to select only those capitals that are relevant to its operations, the framework is focused on reporting for the providers of financial capital, including bond finance.

It is also fitting to mention the work of the TCFD that is relevant in the context of integrated reporting.[3] This initiative focuses not on the activities the organisation carries out to address climate change but the risks climate change poses to the business. It is a suitable framework for embedding into the risk management and strategic decision making processes as it provides sufficient amount of information to the investor and directly links the risks to the organisation from climate change to the International Financial Reporting Standards (IFRS) framework and the financial statements supporting the same idea of integration across the entire organisations' proposed IR Framework.[4]

Whichever framework is selected, it will have to address several issues:

- It must have international application to ensure transferability across jurisdictions and the opportunity for economies of scale from implementation. A global approach means it must also align to national regulation and listing rules which implies flexibility in implementation. The dark side of flexibility is the diversity in interpretation which puts comparability at risk.
- Each industry has its own KPIs and a set of capitals for one industry will differ from another. The KPIs can also vary year-on-year as businesses and the environment evolve. There is a definite call amongst experts for some standardisation of KPIs to make reporting more comparable. However, standardisation will not allow for the specific circumstances of organisations to be reflected and is likely to lead to much less informative reporting. It is still a question if a framework should allow for such adaptability to individual circumstances.
- Conciseness remains the largest issue today when reporting on social and environmental aspects. An overwhelming number of reports issued are over 150 pages long. Having a large number of parameters to choose to report on makes it difficult for the organisation to prioritise and focus on what is important. A robust framework should not be too limiting in choice but provide the company with a sufficient structure to emphasise the priorities.

[2] Integrated Reporting, 'The international framework', (December 2013), available at: https://www.integratedreporting.org/resource/international-ir-framework/
[3] TCFD, 'Task Force on Climate-related Financial Disclosures', (January 2020), available at: https://www.fsb-tcfd.org
[4] IFRS, 'About us', (January 2020), available at: https://www.ifrs.org

- Both the IR Framework and ESG are about predicting the future and not many executives are willing to take on this responsibility, especially at times of geopolitical instability, rapid innovation and technological disruption. A set of guidelines alone will hardly resolve this fear of the future but suitable disclaimers and willpower will support those making the final call.
- While the IR Framework provides a way to consider the business as a whole, many executives still find it hard to link strategy and performance to capitals and their outcomes. Where a holistic approach is needed there is still much fragmentation but a shift in the status quo requires a shift to integrated thinking mode.

The final choice will lie with a framework that promotes a holistic approach to reporting that is forward thinking and supports value-creation. It would need to be flexible to reflect the organisation-specific activities and processes yet still be comparable across both companies and industries.

Even a framework answering to all of these requirements alone will not bring the benefits expected of it. There must be an adjustment to the organisations' approach to looking at ESG and reporting by embedding an integrated thinking model. For many, the journey of implementing integrated thinking will be just as important and arduous as the reporting itself, if not more so.

Therefore, the ACCA encourages the executives who prepare annual reports and related material to tackle wider questions about governance, strategic planning and corporate culture.

These include:

- **Strategic focus:** defining a consistent mission statement hand-in-hand with the strategy function and the board.
- **Outlook:** challenging the board about how to approach information considered commercially sensitive.
- **Materiality:** considering whether the materiality assessment process could be aligned with the strategic planning cycle.

For many, this will require opening new channels for dialogue with the board, and new ways of collaborating with others but the benefits make this effort worthwhile.

UPDATE ON REPORTING, DISCLOSURE AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE PRACTICES IN RUSSIA

Deloitte

While the EU Directive on non-financial disclosure (95/EU) was adopted in 2014, it was not until 2017 that preliminary discussions about adopting a similar law began in Russia.[5]

The draft law initially proposed that the Russian government develop for mandatory disclosure several key compulsory non-financial indicators and encouraged independent assurance of all non-financial reporting.

The law should have come into force in 2019 and would have applied to a wide range of large enterprises and state-owned entities operating in Russia.

However, proposals on implementing non-financial reporting requirements continued to evolve during 2019, with the Economic Development Ministry submitting a Bill 'On Public Non-Financial Reporting' to the government in July 2019.

In this Bill, the term Public Non-Financial Reporting refers to the disclosure of both general information and indicators that reflect a company's strategy, goals, management approach, stakeholder interaction and "the results of an organisation's social responsibility, sustainable development and anti-corruption activities, including achieved KPIs in economic, social and environmental aspects".

The Bill requires that the following types of entities prepare and disclose non-financial reports:

- state-owned and public companies
- unitary enterprises
- companies with annual revenue or assets of more than 10bn rubles
- listed companies.

Members of the working group for the Public Non-Financial Reporting Concept said that, as of mid-December 2019, various company executives were opposed to the introduction of mandatory non-financial reporting.

The main reasons for this resistance are the potentially higher costs associated with preparing a company's financial reports and obtaining independent verification of non-financial disclosures.

However, it appears likely that globally interest from regulators and various other stakeholders that companies obtain external assurance of ESG data will continue to grow as key groups – such as investors – seek greater confidence from reported data that concerns potential risks and opportunities related to ESG factors. Moreover, a company's management may also acquire greater confidence in the quality of non-financial data for use in decision making.

Russia's Economic Development Ministry is also considering the development of a national plan to implement responsible business standards. The plan under development takes into consideration responsible business conduct standards that were initially developed by the OECD and have been introduced by several EU members. The adoption and implementation of the proposed plan should help Russian companies assure partners of the reliability of their strategies, goals, management approaches and stakeholder interaction processes. The initiative to implement responsible business standards was placed on hold at the end of 2019 due to the detailed discussions about revisions to the proposals on regulations for non-financial reporting, but it is expected to resume in early 2020.

[5] European Commission, 'Non-financial reporting', (October 2014), available at: https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

TAX AS A FORCE FOR A GREENER ECONOMY

ACCA

Think Ahead

The UN Sustainable Development Goals (SDGs) – made up of 17 objectives – provide a way for countries to rebalance their tax systems in order to support a greener and more inclusive economy.[6]

The basic principle to do this is simple: tax less what you want more of. In practice it means a shift from labour taxes towards tax on resource-use, pollution and consumption.

Presently, tax revenue is raised largely on employment. In OECD countries, labour taxes account for 52.1% of total public revenue raised, while green taxes account for only 5.3%. There is some variation across continents: African, Asian, Latin American and Caribbean countries may rely more on taxes on goods and services. Still, labour taxes provide a significant share of revenues in all regions – and substantially more than green taxes.

Nowadays it is more rational to tax pollution and resource use than it is to tax labour. Economic modelling has shown that switching €554bn of taxes from labour to pollution and resource use in the EU could add €842bn in GDP, enable 6.6m more people to be in employment, cut carbon emissions by 8.2% by 2020 and save €27.7bn on the energy import bill over a five-year period.

Lower labour taxes reduce unemployment. High payroll costs encourage employers to gain efficiency by minimising the number of employees. They could also tip the scales towards more precarious ways of working: insecure, temporary or part-time jobs (including in the 'gig economy' or 'platform economy'), and informal employment (where people work without a legal contract). In general, a lower tax burden on labour should benefit all sectors that rely heavily on human resources, from innovative businesses undertaking research and development, to hospitals and universities.

Avoiding a high tax burden on labour, while boosting social protection, is indispensable to fostering inclusive economies. A key option for financing such a strategy is to shift the tax burden towards pollution and resource-use, as these tend to be relatively tax-free, or even subsidised.

The costs of the environmental megatrends such as climate disruption and pollution are becoming ever clearer. The Lancet Commission estimates global welfare losses from pollution at $4.6trn a year, or 6.2% of global economic output.[7,8] The long-term negative impacts on the global economy caused by carbon emissions in 2017 alone were $16trn. Such costs are externalised – meaning that they are passed on to society – individuals and future generations, rather than absorbed by the polluter. While international organisations agree that carbon pricing is key to achieve the goals of the Paris Climate Agreement, at the moment, 46% of carbon emissions are still free of charge. Half of the emissions covered by carbon pricing mechanisms are priced at less than $10 per tonne.

More than a hundred options for green taxes are available to governments for applying the polluter pays principle, including putting a price on air pollution (such as carbon emissions), fossil fuels, waste and water. Green taxes are considered growth-friendly, as they are less distortive to the economy than taxes on labour and income. Currently, however, their use is limited. Over the past 15 years, environmental tax as a share of GDP has declined in 52 out of 79 countries in the OECD database. In addition to relatively low green tax levels, global fossil fuel subsidies amounted to $373bn in 2015.

Despite many barriers (such as short political vision), tax shifts have been implemented in several countries, including the UK (1996), Germany (2007), and Colombia (2012). In the 1990s and early 2000s, seven European countries took steps to shift the tax burden from labour

[6] The UN, 'About the Sustainable Development Goals', (January 2020), available at: https://www.un.org/sustainabledevelopment/sustainable-development-goals/

[7] The Lancet, 'Pollution is the World's Largest Environmental Cause of Disease and Premature Death', (2017), available at: https://www.thelancet.com/pb-assets/Lancet/stories/commissions/pollution-2017/Pollution_and_Health_Infographic.pdf

[8] Global Alliance on Health and Pollution, 'Press Release: The Lancet Commission on Pollution and Health', (October 2017), available at: http://gahp.net/press-release-lancet-commission-pollution-health/

to energy and transportation. In 2008, the Canadian province British Columbia began to tax fossil fuel users while recycling revenue through tax cuts on both labour and capital, and an additional tax credit for low-income households.

A lower tax burden on labour can generally be achieved by using revenues from green taxes towards a reduction of personal income tax, payroll taxes and social security contributions. An often-heard worry is that green taxes could increase income inequality: they hit low-income households more, as they pay higher shares of their incomes towards energy-intensive goods. It is, however possible to prevent taxes from increasing income inequality if the revenues are used to benefit the poorest sections of the population. Compensating retired pensioners for the increase in heating costs, for example. Benefits can also take the form of (means-tested) tax credits, exemptions, allowances or deductions.

Green taxes can also be made more progressive by applying block tariffs (higher rates for higher usage) or a tax-free threshold, e.g. leaving a certain amount of water or energy untaxed.

Depending on the desired outcomes, revenues could also be used for increased social protection (including pensions), education and health care.

Several governments – including China, Germany and France – as well as the EU have adopted the circular economy as a policy goal. This requires governments to implement carbon pricing and by applying internal carbon and water pricing. Over the last few years, the circular economy has gained traction, moving away from today's linear 'take-make-waste' industrial model, to a carbon-neutral and regenerative model in which products are 'made to be made again'. In this way, finite resources and materials are not wasted, and businesses can add value over and over again by applying business models such as repair and maintenance services, recycling, remanufacturing and refurbishment.

When pollution and primary resources are tax-free (or even subsidised) and labour costs are high, businesses face a barrier to scaling up their circular activities.

Reducing labour taxes and increasing green taxes is key to achieving the circular ambitions set by governments and businesses.

GREEN PRACTICES: SUSTAINABLE FINANCE

London Stock Exchange Group

The transition to a low-carbon or net-zero economy is set to become one of the defining issues of the twenty-first century. The scientific community has detailed the risks, and many policymakers, regulators and businesses are now taking action.

An increasing number of companies and institutional investors are recognising the risks posed by climate change with the rationale for strong action clearer than ever. We know that the green economy represents 6% of the market cap of global listed companies, approximately $4trn. With an estimated $30trn in assets under management now implementing sustainable investment strategies, investors around the globe are increasingly focused on sustainability. This figure is set to increase, with investment in ESG based strategies growing by 20% annually. Sitting at the heart of the world's financial markets, London Stock Exchange Group is well positioned to support the global transition to a sustainable low-carbon economy.

In the UK, the Financial Conduct Authority (FCA) recently set out proposals designed to improve the climate change disclosures for companies and other issuers, building on the work of the industry-led Taskforce on Climate-related Financial Disclosures (TCFD) and the UK government's streamlined Energy and Carbon Reporting Framework. The Governor of the Bank of England, Mark Carney, said in a speech in October 2019 that "firms that align their business models to the transition to a net-zero world will be rewarded handsomely. Those that fail to adapt will cease to exist". Sustainable business models and investment are now both an environmental and commercial imperative.

London is a global centre for green and sustainable finance and London Stock Exchange is leveraging the collective strength of our markets and the wider London Stock Exchange Group businesses. Together, with the expertise of the City of London, we are working to convene the market to respond to these key issues. By raising awareness and increasing knowledge we can facilitate consistent, investment-grade information flows, showcase best practice and champion issuers in new growth markets.

We're innovating across asset classes to develop the financial instruments needed to help all our issuers raise the capital they need to support long-term sustainable business models and infrastructure.

This includes:

Equities: Green Economy Mark

This is awarded to listed companies and funds across all segments of London Stock Exchange's equity markets that generate 50%+ revenues from environmentally positive goods, products and services. Currently 78 issuers with a combined market capitalisation of more than £67bn have been awarded the Green Economy Mark, with an approximate 50:50 split of Main Market and AIM issuers.

Underpinning the Green Economy Mark is a comprehensive taxonomy of green revenues developed and managed by FTSE Russell for its global investor clients (figure 1). The Green Economy Mark enables investors to easily identify those issuers active in the green economy across all sectors – not only renewable energy but also areas such as chemicals, transport and agriculture that may otherwise be overlooked. It also enables London Stock Exchange to facilitate dialogue and engagement across a broad range of business activities that have a common environmental theme.

Fixed income: Sustainable Bond Market

London Stock Exchange listed the first ever green bond in 2007 from the World Bank, and was the first major exchange to create a dedicated green bond segment in 2015 as that market grew. The latest evolution is the creation of a dedicated Sustainable Bond Market (SBM), comprising of separate segments for certified green, social, sustainability bonds, along with increased oversight of annual reporting. SBM also includes a segment for vanilla bonds from Green Economy issuers (using the taxonomy in figure 1) that generate 90%+ green revenues. There is potential within the structure for additional innovations, such as climate transition bonds, a concept that London Stock Exchange and other market actors are developing to enable heavy emitting sectors to raise capital to support their transition strategies.

Figure 1: Green Economy classification: industry sub-sectors

Source: London Stock Exchange Group

Energy Generation	Energy Equipment	Energy Management	Energy Efficiency
EG Bio Fuels EG Clean Fossil Fuels EG Geothermal EG Hydro EG Integrated Energy Generation EG Ocean and Tidal EG Solar EG Waste to Energy EG Wind	EQ Bio Fuels EQ Clean Fossil Fuels EQ Geothermal EQ Hydro EQ Integrated Energy Equipment EQ Ocean and Tidal EQ Solar EQ Waste to Energy EQ Wind	EM Combined Heat/Power EM Controls EM Fuel Cells EM Integrated Energy Management EM Logistics and Support EM Power Storage EM Smart Grids	EE Advanced Materials EE Buildings and Property EE Industrial Processes EE Integrated Energy Efficiency EE IT Processes EE Lighting EE Video Conferencing
Environmental Infrastructure	**Environmental Resources**	**Modal Shift**	**Operational Shift**
EI Carbon Capture & Storage EI Desalination EI Flood Control & Land Erosion EI Integrated Environmental Infrastructure EI Logistics & Support EI Pollution Management EI Recyclable Products EI Waste Management EI Water Management	ER Agriculture ER Aquaculture ER Integrated Environmental Resources ER Mining ER Minerals and Metals ER Source Water ER Sustainable Forestry	MS Aviation MS Integrated Modal Shift MS Railways MS Road Vehicles MS Shipping	OS Finance/Investment OS Integrated Operational Shift OS Retail/Wholesale OS Property

Issuer support: Guide to green finance ESG Disclosure Score and online tool

To help issuers understand and maximise opportunities, London Stock Exchange develops guidance documents and tools for issuers and the advisory community.

Recognising that different industries are differently exposed to ESG risks, the ESG Disclosure Score is an innovation to help issuers understand what the key metrics for disclosure are in their sector. It provides a percentage score for their disclosure of the key ESG metrics for their industry sector and benchmarking against industry peers. The score is provided to large-cap issuers via the London Stock Exchange Issuer Services platform with industry average comparison. An online tool has been developed to enable all other issuers to calculate their own score, providing specific information on disclosure metrics using internationally recognised standards as well as industry benchmarks.

'Navigating the Green Finance Landscape' is a comprehensive 70-page guide to green finance that provides policy context and investor perspectives on green finance, overviews on all relevant capital raising tools and issuer case studies.

We also regularly convene the market on key topics. Often these may be on specialist areas such as green bonds or with regional focus. In October 2019 London Stock Exchange hosted its first 'Sustainable Finance & Investment Summit', a full-day conference with deep dive workshops held in London to support issuers. It featured panels of issuers, investors, regulators, policymakers and disclosure-standards bodies.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE RISES TO TOP OF THE AGENDA IN MOSCOW

Moscow Exchange

In recent years, Moscow Exchange (MOEX) has paid close attention to the growing importance of sustainability on the global agenda. With topics like climate change, inequality and cybersecurity emerging as key challenges, investors worldwide have little choice but to integrate ESG risks and value drivers into their analysis and investment decision-making processes. The result is that businesses – MOEX included – must take up the challenge of integrating sustainability practices into their operations in substantive and measurable ways.

MOEX has taken several steps to promote sustainability principles and best corporate governance practices among Russian issuers and the professional investment community.

A key component of MOEX's strategy is broadening access to investment and savings solutions for a diverse clientele, including private individuals in all regions of the country. The strategy also aims to expand the product and service offering, while accelerating business and technological innovation and maintaining transparency and trust. All these measures will enhance the value that MOEX brings to Russian society.

MOEX has updated its Corporate Governance Code, which now enshrines sustainability as one of the pillars of the corporate governance system and includes important social and environmental criteria.

MOEX's core business activities directly support sustainability. Helping enterprises access capital is fundamental to promoting innovation, growth and job creation. MOEX's Growth Sector, first launched in 2017, provides small and medium enterprises (SMEs) with attractive listing requirements and financial preferences from government and state development agencies.

In order to help issuers raise funding for environmental and social projects, the Exchange has launched the Sustainability Sector. To date, two green bond issues compliant with the International Capital Market Association Green Bond Principles trade on the sector. MOEX also launched the first two sustainability indices in Russia, with both receiving International Standards of Accounting and Reporting Honours in 2019. By providing these indices we strive to enhance non-financial disclosure and promote greater transparency in relation to ESG.

MOEX continuously promotes the development of financial literacy among citizens and professional communities in Russia. We also participate in International Organization of Securities Commissions' Ring the Bell for Financial Literacy initiative during the annual World Investor Week.

The company's corporate values – responsibility, partnership, transparency and excellence – form the foundation for its engagement with clients and employees.

The Exchange holds an annual Ring the Bell for Gender Equality initiative, bringing together women executives at leading public companies and SMEs, in order to highlight the empowerment of women in Russian business. MOEX's charitable activities support key focus areas, access to formal education and skills, and medical care for disadvantaged social groups.

SUSTAINABILITY IN THE BOARDROOM: RUSSIAN BOARDS SURVEY

PwC

Sustainability, which encompasses ESG issues, has become an important strategic concept for companies across all industries. Investors are increasingly giving high-priority to sustainability issues, reinforcing the notion that sustainability is critical to long-term business success. With greater stakeholder attention to sustainability, there is growing emphasis on the duty of boards of directors to engage in and oversee their companies' long-term strategies. For this reason, PwC chose sustainability as the theme for 2019 Russian Boards Survey.[9]

The survey addresses a number of key issues, including the level of importance that board members attach to sustainability agenda, the sustainability issues that are gaining traction in the boardroom, the drivers of board commitments to sustainability and the extent to which sustainability is integrated into long-term business strategy. The 2019 version draws on insights from respondents representing almost 200 Russian joint stock companies across a dozen industries in Russia.

Sustainability and Boards

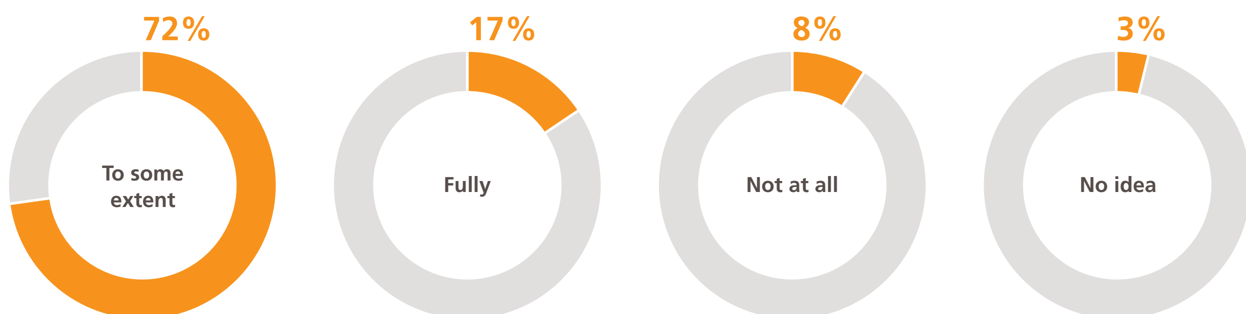
The UN Global Compact's 2018 'Russian Business in the Context of Sustainable Development' report noted that leading Russian companies have started to integrate sustainability into their business strategies, driven mainly by the idea of being a good corporate citizen and stakeholder demand.[10] According to the PwC survey, sustainability matters are at the top of board agendas and are being viewed as a strategic issue, with every ninth respondent saying that sustainability and CSR objectives are reflected in their company's overall strategy. This is a 21-percentage point jump over last year.

Tracey Kerr, Chair of Board Sustainability, Polymetal explained: "The title of our 2018 Sustainability Report was 'Integrating Sustainability Throughout' and I think that sums it up perfectly. Sustainability is not an extra or side issue, but an integral part of everything we do, considered in every decision we take, large or small."

For effective strategy execution and oversight, boards need directors who have the relevant expertise and experience that are critical to the company. In Russia, directors with risk management expertise, industry and international experience are important for most boards. According to PwC's The Board's Role in Strategy Survey from March 2018, with technology being one of the important megatrends, 72% of boards have started to look for directors with IT and digital expertise.[11] This year, 35% of board members see the need for environmental or sustainability expertise on their boards, which would benefit their board and company.

Figure 2: Does your company's overall strategy reflect its long-term objectives on corporate social responsibility and sustainable development?

Source: PwC



[9] PwC, 'Sustainability in the Boardroom Russian Boards Survey 2019', (October 2019), available at: https://www.pwc.ru/ru/materials/pwc-board-survey-2019-english.pdf

[10] UN Global Compact Russia, 'Global Compact Network Russia 2018', (January 2020), available at: http://www.globalcompact.ru/en/

[11] PwC, 'Governance Insights Center 2018', (January 2020), available at: https://www.pwc.com/us/en/services/governance-insights-center.html

Issues in focus

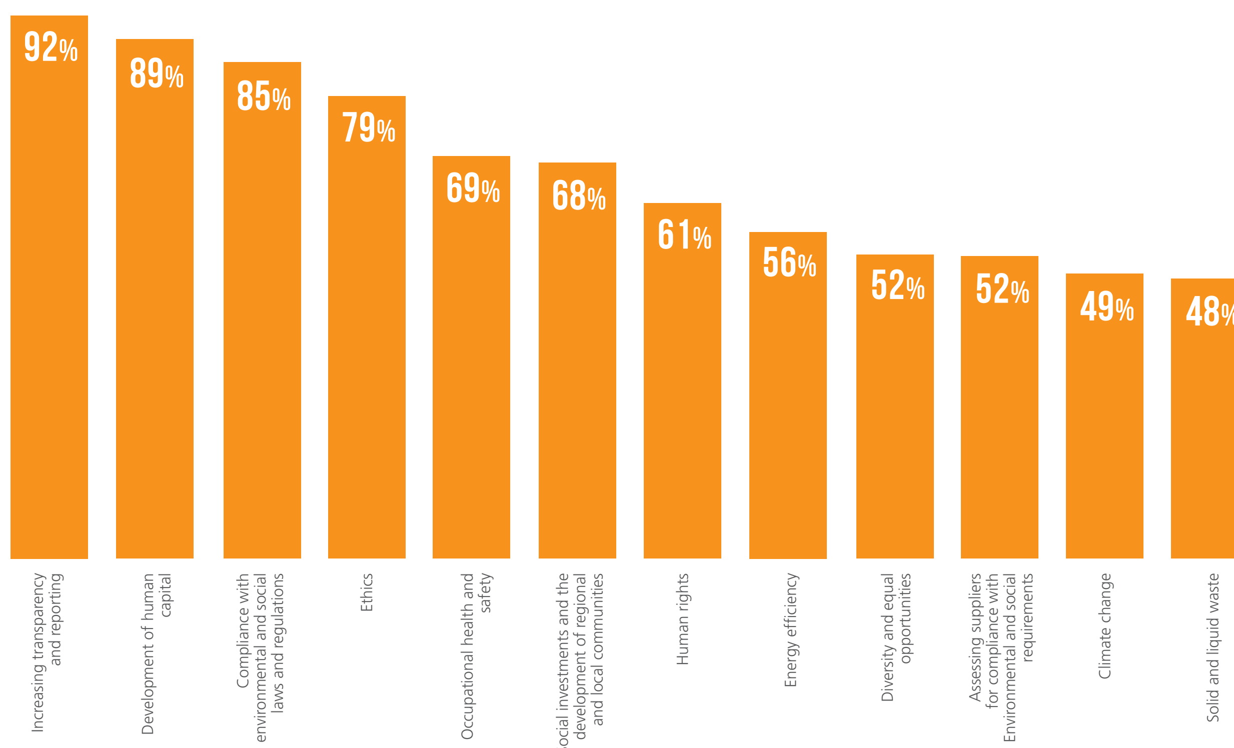
Board members are increasingly engaging directly with investors. The survey finds that more than half of respondents say that a member of their board engaged directly with investors in the past year. Investors have been pushing boards to prioritise environmental and social issues, and it is evident that these conversations filter in through to the boardroom. More than half of respondents are devoting more time in board meetings to sustainable development.

When it comes to sustainability issues that boards believe are vital to the development of their company, the top issues reported by respondents were related to corporate governance.

Perhaps reflecting the focus that institutional investors have placed on corporate governance, increased transparency and reporting and compliance with environmental and social laws and regulations are viewed as very and rather important issues. Based on the survey findings, there appears to be a disconnect between how boards and investors see these issues. Despite investors' increasing focus on environmental issues, gender diversity and corporate governance boards do not believe such issues are critical to their company's development. For example, half of directors claim that climate change and solid and liquid waste are 'rather unimportant' and 'not important at all'.

Figure 3: 'Very' and 'rather' important topics to the development of the company

Source: PwC Russian Boards Survey 2019



Boards taking actions

Sustainability is managed in different ways. There is no one-size-fits-all approach that boards can use. Only 15% of directors claim to have staff dedicated to sustainability matters. When asked if they have a sustainability champion in the company, the largest share (37%) reported that they do not. PwC assume that sustainability may be built into executive job descriptions, as some 26% have a sustainability champion at the executive level. Only 17% have sustainability champions on the board level.

In addition, respondents say that they disclose certain non-financial information on how they manage social and environmental challenges in Russia. Overall, non-financial disclosure, which includes ESG factors, is growing globally, with 56% companies reporting on environmental and sustainability issues in some form.[12] The reporting allows companies to improve their risk management, long-term performance and competitiveness. According to the study, one out of nine respondents believes that transparent and regularly published non-financial data improves investment attractiveness. From ESG-related disclosures, investors can gain insights into the business risks they face when making investment decisions. When asked if listing a company in ESG indices improves a company's investment attractiveness, 23% of respondents think that it 'definitely' does, while 40% claim that it 'most likely' does.

Boards also have appetite for embracing the UN's Sustainable Development Goals (SDGs). A significant percentage of directors believe that the SDGs can be aligned with their company's overall strategy. The survey does not identify which SDGs have been prioritised by business, but it has identified the top three SDGs that directors consider to be important to their strategies. This could be a sign that awareness of and alignment to the SDGs is on the rise. Meanwhile, the survey also identified a negligible percentage (11%) of directors with limited awareness of the SDGs.

Figure 4: Top three 'very important' and 'rather important' Sustainable Development Goals

Source: PwC Russian Boards Survey 2019

Note: Participants were asked to choose which of the SDGs they consider as the most important to their strategy.

What boards need to understand about environmental, social and governance

The focus on ESG has never been sharper and boards are now under the spotlight for their adherence to the principles of ESG. And certainly, boards have a key role in setting the tone for ESG within companies. For ESG and sustainability to be part of the culture, setting 'tone at the top' is crucial. With this step, boards signal their commitment to ESG internally and externally to stakeholders. It is also important for boards to ensure that management includes ESG-related risks in overall risk management processes and ESG-related risks are integrated into corporate strategy. Finally, leading boards understand that there is a learning curve involved. To effectively carry out ESG oversight, boards need continuing education on ESG trends and developments. Awareness of ESG-related trends could help drive long-term performance and mitigate risk. This, too, could accelerate the transition to a sustainable future.[13,14]

[12] Diligent Institute 2019, 'Winds of Change: Environmental Sustainability Rises to the Board Level', (February 2019), available at: https://www.diligentinstitute.com/wp-content/uploads/2019/02/Environmental_Sustainability_Report_DIL-1.pdf

[13] PwC Governance Insights Centre, 'The board's role in strategy: getting the process right', (March 2019), available at: https://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-the-boards-role-in-strategy-getting-the-process-right.pdf

[14] Diligent Institute 2019, 'Winds of Change: Environmental Sustainability Rises to the Board Level', (February 2019), available at: https://www.diligentinstitute.com/wp-content/uploads/2019/02/Environmental_Sustainability_Report_DIL-1.pdf

INCENTIVES FOR DRIVING ENVIRONMENTAL, SOCIAL AND GOVERNANCE IMPLEMENTATION IN BUSINESS PRACTICE

EY

Over the last few years, most publicly traded companies, and also private limited companies working on international financial markets, have faced rapidly growing interest in their non-financial information, including environmental and social policies and performance, and broad range of corporate governance issues from minority shareholders, analyst agencies, investors, credit banks, insurers and other financial institutions. The rise of attention to these factors, nicknamed ESG, is apparent – and evidenced by data.

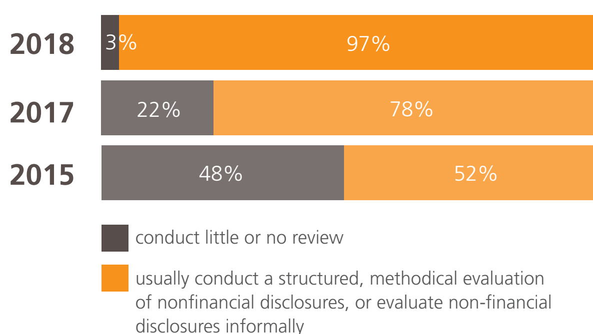
The Global Sustainable Investment Alliance reports that by the end of 2018 total assets under management (AUM), that formally include ESG criteria of any kind, have grown to $41.6trn.[15] This constitutes almost 50% of all AUM in Europe, over 50% in Canada and Australia, and raising rapidly in Japan (15 percentage points growth since 2016) and most importantly, USA where it already exceeded 25% of all AUM.

Formal ESG criteria, however, do not tell the complete picture. EY annually conducts research on investor perspectives of ESG/non-financial reporting and the role it plays in their decision making. The latest, fourth edition covered more than 260 institutional investors from across the globe and of all scale – from less than $1bn to the world's largest funds with over $50bn under management.[16]

After several years of growing evidence of the impact of commerce on climate change, scandals tied to poor corporate governance and a new appreciation for the social impact of business, institutional investors are increasingly likely to use non-financial performance information as an essential component in investment decision making. Nearly all investors who responded to this survey (97%) say they conduct either an informal (65%) or a structured, methodical evaluation (32%) of a target company's non-financial disclosures. This represents a rise of nearly 20 percentage points since the 2017 EY investor survey where 78% of respondents said they conducted either an informal or structured evaluation.

Figure 5: Investors' review of nonfinancial disclosures

Source: EY



In 2018, only 3% of respondents said they conduct little or no review of non-financial disclosures, compared to 22% in 2017 and 48% in 2015. This means that despite formal criteria, virtually every investor now considers ESG issues.

Moreover, ESG information plays an increasingly important role in the investment decision making process, and respondents believe that ESG factors can help mitigate downside risk. Nearly all respondents (96%) say that such information has occasionally (62%) or frequently (34%) played a pivotal role in decision making. Again, this is a dramatic rise from the 2017 survey results, where 68% of investors said they used ESG information frequently or occasionally. Investors say they are more likely to consider non-financial information occasionally or frequently when adjusting valuation for risk (70%), examining industry dynamics and regulation (63%) and when reviewing investment results (61%).

Investors believe that ESG factors can provide downside risk protection – 89% say that ESG information is somewhat more valuable (80%) or much more valuable (9%) in investment decision making in a market downturn.

Investors in this year's study report that the main ESG factors in investment decision making have to do with risks related to governance, supply chain, human rights and climate change.

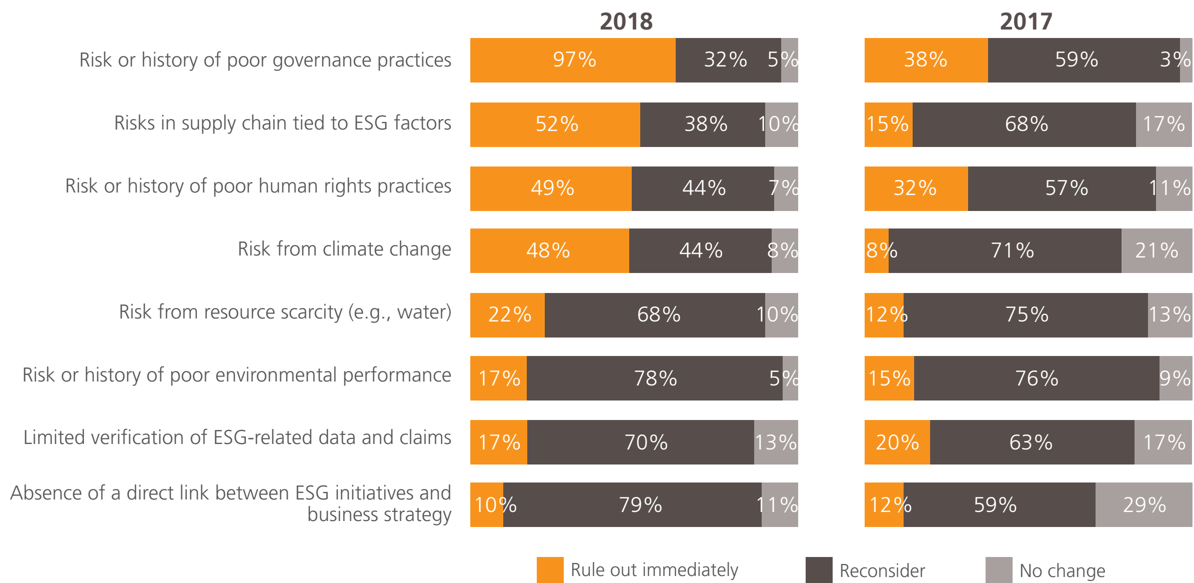
[15] Global Sustainable Investment Alliance, 'Global Sustainable Investment Review 2018', (March 2019), available at: http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf

[16] EY, 'Does your non-financial reporting tell your value creation story', (November 2018), available at: https://www.ey.com/en_gl/assurance/does-nonfinancial-reporting-tell-value-creation-story

Figure 6: Priority environmental, social and governance factors affecting investment decisions

Source: EY

How would the following disclosures about a prospective investment affect your investment decision?



The risk or history of poor governance practices would cause 63% to rule out an investment immediately. Similarly, supply chain risks tied to ESG (52%), risk or history of poor human rights practices (49%), and risk from climate change (48%) are also triggers to avoid an investment. Growth in importance of these factors since 2017 survey was also very significant.

Investors continue to tell us that climate change is consistently one of the most material issues identified by reporters. They are more concerned about the physical implications of climate change risk than the transitional risks such as those tied to adapting to new regulations, practices and processes. Seventy per cent say that, over the next two years, they will pay a fair amount or a great deal of time and attention to physical risks. Forty-eight percent say the same of transition risk.

Investors responding to the survey also emphasised that for all strategies, be it a negative or positive screening, portfolio tilts or specific instruments such as green or social bonds, consideration of ESG aspects yields excess return and lowers risk, and also allows the achievement of important non-financial objectives of a portfolio.

This is increasingly important as the UN estimates the gap in financing to achieve the SDGs at $2.5trn per year in developing countries alone, and approximately half of this gap can only be covered by private money.[17] Current investment remains well short of the needs.[18] This is why governments, including UK, EU, and Russia, are actively considering support instruments to stimulate sustainable/ESG investment.

[17] UNCTAD, '2014 World Investment Report', (May 2014), available at: https://unctad.org/en/PublicationsLibrary/wir2014_en.pdf
[18] UNCTAD, 'SDGs Investment trends monitor', (April 2019), available at: https://unctad.org/en/PublicationsLibrary/diaemisc2019d4_en.pdf

INVESTORS CALL FOR PROACTIVE EFFORT IN BUILDING ENVIRONMENTAL, SOCIAL AND GOVERNANCE PRACTICES

PROSPERITY CAPITAL MANAGEMENT

Prosperity Capital Management

Investors ESG demand

Active and real-functioning Board

First, we believe that an active and real-functioning Board is crucial in terms of corporate governance and further ESG promotion. In order to establish such a Board, a controlling shareholder shall elect to the Board those of its representatives who are qualified and empowered to take decisions in relation to that company and real independent directors supported by the market and the company's minority shareholders. Minority shareholders shall also be able to elect several independent directors. These are the prerequisites to have a Board that leads the ESG agenda.

The Russian market has shown us cases where such Boards drive governance improvements and pursue a broader ESG agenda.

'Environmental' and 'social' disclosure

Today, in addition to the more traditional 'governance' aspect, investors also actively monitor and engage with companies over different 'environmental' and 'social' issues (like greenhouse gas emissions, energy consumption, fuel consumption, water use management, waste management, environmental fines, employee turnover, workforce accidents, lost time incident rate, community spending etc.). This creates investor demand for 'environmental' and 'social' disclosure and reports, research, ratings and databases.

In response to the market ESG drive, most of the largest and mid-size public companies in Russia have already incorporated 'environmental' and 'social' in their corporate reporting.

Still, it is our view that national reporting standards are necessary, and that they shall be mandatory for local companies with a significant environmental footprint and/or influence on social factors. At the same time, we believe that national reporting standards should provide a relevant reporting framework only for those local companies which do not report on ESG in compliance with any internationally recognised standards; national standards should not be applicable to companies that provide such reporting.

Also, state regulators should control 'environmental' and 'social' compliance and disclosure at a basic regulatory level and promote 'environmental' and 'social' performance.

We tend to agree that it should be mandatory for the largest companies with maximum 'environmental' and 'social' impact to have their ESG reports confirmed by auditors or globally recognised ESG bodies. For mid-sized companies, this procedure may be not necessary.

'Environmental' and 'social' goals

Disclosure by itself is not enough. It is our strong view that every company must define its 'environmental' and 'social' factor-related goals, set them in such a way as to improve the company's environmental footprint and social practices, disclose such goals to investors and public at large and report the respective progress.

There is an overarching demand that all these ESG steps and developments should not be mere formalities to combine the environmental, social and governance factors into a high grade 'ESG derivative' for investors and the general public, that would not impress anyone once each factor is broken down and analysed separately. ESG integration and development should be honest, ambitious and make a sizeable contribution towards good corporate governance and sustainable development.

CORPORATE GOVERNANCE IN FINANCIAL AND NON-FINANCIAL HOLDING COMPANIES

ISSUES OF CORPORATE GOVERNANCE IN PARENT COMPANIES AND SUBSIDIARY COMPANIES

Ashurst

From the UK legal perspective, there is no mention of a subsidiary in the 2018 'UK Corporate Governance Code' other than a single brief reference: "For parent companies with a premium listing, the board should ensure that there is adequate cooperation within the group to enable it to discharge its governance responsibilities under the Code effectively. This includes the communication of the parent company's purpose, values and strategy." Therefore, in the UK, focus remains firmly on the corporate governance of the UK listed parent company, not foreign subsidiaries.

Typically, directors of a UK parent company will be reluctant to accept responsibility for the affairs of a subsidiary, particularly where that subsidiary is incorporated in a foreign country and subject to that country's laws and principles of good corporate governance. Also, from the UK's financial services perspective where a parent company is incorporated abroad, the UK FCA will expect UK subsidiaries who offer financial services in the UK to have a robust UK corporate governance independently and separately from their foreign-registered parent company.

In the Russian/Commonwealth of Independent States (CIS) context, group companies are often incorporated in different jurisdictions. From a technical legal perspective each ought to comply with the laws, regulations and best practice corporate governance applicable to it in its place of registration. In the UK, at a parent company, directors' duties are owed to their own company (i.e. a parent company (PC)) not a subsidiary company (SC). UK directors and the parent company will wish to avoid or limit any potential liability and conflict of interest which may arise if they are seen as being 'shadow directors' (or actual directors) of a SC. They must also consider the level of control and involvement the PC has in the SC. Different approaches may be appropriate where there is a wholly owned SC as opposed to a situation where ownership/control arises due to the PC holding shareholding in the SC of 50%+1 share.

One practical recommendation for Russian-centred corporate groups may be to consider which source of the UK corporate governance rules (or a combination) to use in considering a group-wide set of corporate governance principles. In this regard, the UK market has developed two new sources of Corporate Governance rules in the last 12 months (from December, 2018).

There are now rules in the UK (from 1 January 2019) which require more disclosure of the UK companies' internal corporate governance (Companies (Miscellaneous) Reporting Regulations 2018). Disclosure must be made in the annual report. However, a Russian SC will not be within the scope. Large UK unlisted companies (in addition to listed companies which are governed by a separate disclosure regime) will need to produce a Corporate Governance Statement. Another source may be the UK Quoted Companies Alliance Code (QCA Code), developed for AIM market.

From December 2018 there is yet another source of corporate governance principles in the UK called the 'Wates Corporate Governance Principles for Large Private Companies'. It is more flexible and more user friendly for the use by a private group and for the PC/SC corporate governance relationship.

Russian corporate groups may use this opportunity to draft their own corporate governance 'code' rather than complying with or explaining non-compliance with the existing UK Codes.

Corporate groups can be complex with their legal structure not matching corporate governance decision making. Some commentators have suggested aligning the legal structure with corporate governance decision making or, alternatively, SCs delegating corporate governance functions within the group. There are advantages and disadvantages in each approach. Russian-centred corporate groups may consider creating a single corporate governance function for the group to ensure the development of appropriate corporate governance principles as well as consistency and effective application and 'hard-wiring' of such principles throughout the group through policies and management/employment contracts adapted for local requirements.

GROUP GOVERNANCE WHEN THE PARENT AND THE SUBSIDIARY BELONG TO DIFFERENT SECTORS: A SUMMARY OF THE ISSUES

Nestor Advisors

Group governance, i.e. the governance arrangements within a multi-entity corporate group in which a parent entity controls one or more operating subsidiaries, can be viewed as a continuum. On one end lies the operating holding structure: the parent is in the same business as the subsidiary which exists because of regulatory or funding reasons but could have very well been an operating division of the parent without legal personality – think of a banking subsidiary of a banking parent. Typically, these groups would have many of their functions, such as finance, risk and audit fully integrated throughout the group while their businesses (in our banking example, the retail bank, the private bank, the wholesale bank etc.) would also see a degree of integration, or at a minimum some coordination.

On the other side of the spectrum lies the purely financial holding company or similar entity – say, a private equity fund. In this case the parent is there to direct business or consolidate controls. Theirs is a pure stewardship role. They are there to see that the business, through its board and CEO, has developed and implemented a strong business case and that its execution is bounded by an effective system of controls.

When the parent and the subsidiary belong to different sectors (a 'conglomerate' holding) it is more likely that the governance blueprint lies closer to the private equity end of the spectrum. Thus, it will be unusual to see business-level, horizontal reporting across the parent subsidiary-divide. The business heads of the parent are unlikely to be the bosses of the business heads of subsidiaries, whose CEOs' authority and power will therefore be much more substantial. Instead of being hard wired to a group performance plan, the incentives of the CEO will be almost totally subsidiary focused. These incentive plans will usually be a very important focus of the parent's stewardship approach.

The second area of parental focus in conglomerate holdings is the robustness of the controls. While centralised arrangements will be quite rare, a close but informal oversight relationship and some coordination and best practice advice/exchange by the parent to the subsidiary will not be uncommon in some of the second and third line of defence functions: risk, financial control and, most importantly, audit. Certain control policies (codes of conduct, conflict of interest, etc) might also be shared across the group in certain cases – but not always. Finally, many conglomerate groups will not only appoint the CEO as a member of the board but also 'own' the appointment of the subsidiary CFO, who might actually have a more solid line to the group finance function than anyone else among their colleagues.

In many conglomerate groups the parent's interest (and residual shareholder risk) will be primarily dealt via subsidiary board participation, which constitutes the main governance conveyor belt between the entities. While operating holdings use subsidiary boards as "secondary" control hubs in the best of cases, and as a legal formality in the worst, conglomerate holdings vest them with significant organisational meaning. In fact, the parent will often expand significant effort – as well as financial and other resources – in finding and appointing the right board members. Some of them will be independent of the parent with skills in the industry of the subsidiary. The audit committee membership of the subsidiary board will be a focal point of the parent's interest and will likely be led by a person that inspires great trust. Increasingly, independent rather than group/parent representatives are also chosen for this role in order to ensure a perspective that is not captured by subsidiary management but is also independent from owner of financial reporting and risk management policies in the group.

Having said this, the executives of the parent are sure to play an important role as non-executive directors. This includes the subsidiary audit committee, even if led by an independent. Through our work at Nestor Advisors, we have found that private equity and conglomerate groups place significant importance on the leadership role of the committee as regards controls, using it as an important additional line of defence, even when they control the finance function as per above.

In closing, it is important for regulators but also outside investors in conglomerate groups to appreciate the significant differences between operating and conglomerate (or financial) holdings. If the subsidiary is listed, there is less of a case for forbearance towards conglomerate groups as regards the norms of board governance and independence. Because the parent-subsidiary relationship is at arm's length, the board in this context is as important as in any listed business with dispersed shareholdings. Conversely, if the subsidiary is fully controlled but the parent is listed, greater visibility at parent level for subsidiary arrangements should be required – but there should also be greater tolerance for governance blueprints other than the main reference, i.e. the listed company model.

GROUP-WIDE CORPORATE GOVERNANCE: DOES IT MATTER?

Baker McKenzie

Baker McKenzie.

The concept of corporate governance is not new.[19] However, we have seen from recent corporate scandals that it is often not a decision at holding company (topco) Board level but a decision at subsidiary company level that can result in huge reputational damage or financial loss to a company. The company policies, legal framework and regulatory environment for decision making at the PLC/ topco Board level are generally clear and understood – but is the Board comfortable with the decision making process down the organisation? Is the Board aware of legal constraints faced by directors on the boards of its subsidiaries across the globe? Given that it is the role of any Board to assist management in creating value, it is imperative that any decision making in any part of the organisation is consistent with the strategy set by the Board, in accordance with group governance policies and that the relevant directors are informed of their legal duties. Given that strong governance underpins a healthy culture, it is imperative that boards demonstrate good practice in the boardroom and promote good governance throughout the business.

What should topco Boards be asking?

From our experience of dealing with situations where things go wrong, we would encourage topco Boards to be satisfied about the following:

- **Global governance policies:** are these followed across the group, as a minimum in key operating subsidiaries? For example, as to Board composition – are subsidiary boards diverse and independent or are they all comprised of two or three head office individuals whose role is reduced to acting as mere signatories?
- **Strategy and communication:** how is group strategy and information communicated to subsidiary boards, and what guidance and expectations exist around implementation and action?
- **Decision making process:** do subsidiary Boards have regular meetings, with clear agendas, papers and discussion? Or do they simply implement the parent's decisions? Often parent instructions are implemented on the basis that what is in the interests of the group is in the interests of its subsidiaries. However, parent instructions should always be tested at subsidiary level through the lens of the subsidiary's interests and local legal requirements.
- **Local legal requirements:** do directors of subsidiary companies understand their legal duties and who they owe their duties to? Are they aware of their exposure should they fall short in meeting such legal requirements? These vary from country to country and it would be good practice for training to be available to directors as they are appointed.[20]
- **Limits of authority:** is there a limits of authority policy in place across the group? If so, are subsidiary directors aware that they are still ultimately responsible for looking after subsidiaries' affairs? And are those named in the limits of authority policy aware that they still need the board's authorisation to enter into decisions or documentation?

Topco Boards may face resistance when raising these questions, as they can seem to run counter to the implementation of a top down one organisation strategy.

[19] Some 30 years ago, the Cadbury Committee Report in the UK stated: "Governance is the system of rules, procedures and processes by which a company is directed and controlled."

[20] See Figure 7 for the position in the UK.

However, good governance can help to manage risk and improve subsidiary performance. It can also increase the quantity and quality of information flow up to the parent, therefore increasing trust and enabling the parent to make informed strategic decisions and identify and resolve issues at an early stage.

And the benefits of good governance may not become apparent until things go wrong. Group governance may be scrutinised in cases of poor financial results, insolvency, bribery, fraud, negative press coverage, for example, around data protection, employees and corporate social responsibility.

In these and other cases, individual directors may have exposure. In some cases, directors' and officers' insurance or qualifying third party indemnities can mitigate this exposure, although this will not alleviate any reputational damage.

The best protection is to proactively seek healthy group corporate governance practices. Improved governance and engagement with subsidiary boards will protect and benefit the parent, its subsidiaries and the group as a whole in good times and bad.

Figure 7: Summary of UK Directors' duties

UK Directors Duties

In most jurisdictions (including the UK), directors owe their duties to the company on whose board they sit, not to a group parent or employer company.

In the UK, generally directors must:

- act within powers
- promote the success of the company
- exercise independent judgment (and not fetter their discretion – although a director who delegates authority in accordance with the company's constitution will not be considered to have breached this duty by doing so)
- exercise reasonable care, skill and diligence
- avoid conflicts of interest
- not accept benefits from third parties
- declare their interest in a proposed transaction or arrangement
- keep company information confidential
- act in good faith.

There are additional specific obligations on directors, including in cases where the company is insolvent or at risk of being insolvent.

UK Penalties/Exposure for Breach of Directors' Duties

Directors may face:

- derivative claims by shareholders against directors of a company on behalf of that company
- damages in respect of failure to exercise reasonable care, skill and diligence
- liability to:
  - repay, restore or account for misapplied money or property
  - pay compensation
- court orders to contribute to the company's assets in certain cases
- disqualification
- criminal liability for breaches by the director or the company of certain legislation (e.g. environmental, bribery, data protection, corporate, fraud and/or market abuse).

New UK corporate governance reporting regime for private companies: what is required?

The UK government has introduced a number of new reporting requirements for financial years beginning on or after 1 January 2019, including a requirement for:

- Very large UK-incorporated private companies to make a corporate governance statement in the Directors' Report (**a corporate governance statement**), and to make that statement available on a website that is maintained by or on behalf of the company and which identifies the company.
- Large UK-incorporated companies to make a statement in the strategic report on compliance by the directors with the Section 172 Duty, and to make that statement available on a website that is maintained by or on behalf of the company and which identifies the company (Section 172 Duty Statement Companies Act 2006).[21]
- Large UK-incorporated companies to make a statement regarding engagement with suppliers, customers and others in a business relationship with the company in the Directors' Report (**a stakeholder engagement statement**).
- UK-incorporated companies with more than 250 UK employees to make an employee engagement statement in the Directors' Report (**an employee engagement statement**).

The UK government has also recently introduced new energy and carbon reporting requirements for large UK-incorporated private companies, which require qualifying companies to include energy and carbon metrics in the Directors' Report for financial years beginning on or after 1 April 2019.

Recognising that existing corporate governance codes (for example, the UK Corporate Governance Code and the QCA Code) would not be appropriate for most private companies to adopt, the UK Government commissioned the Financial Reporting Council to work with a number of other bodies to develop a voluntary set of corporate governance principles for large private companies under the chairmanship of James Wates CBE. Those principles were published on 10 December 2018 and are known as the Wates Corporate Governance Principles for Large Private Companies, or the Wates Principles.

[21] Legislation.gov.uk, 'Companies Act 2006', (2006), available at: http://www.legislation.gov.uk/ukpga/2006/46/section/172

Who must comply?

The new requirement to prepare a Corporate Governance Statement applies to 'very large companies'. A very large company is defined as one incorporated in the UK that satisfies either or both of the qualifying requirements on a standalone basis ((i.e. not based on group accounts):

- it has more than 2,000 employees globally, and/or:
  - a global turnover of more than £200m
  - a global balance sheet total (i.e. the aggregate of the amounts shown as assets in the company's balance sheet, not netted against liabilities) of more than £2bn.

The new requirements do not apply to UK-incorporated companies that are already required to make a corporate governance statement i.e. companies with equity securities admitted to trading on AIM or on the Main Market of the London Stock Exchange.

The new requirement to make a Section 172 Duty Statement applies to large companies. Generally, this includes all UK PLCs and all UK companies meeting two or more of the following thresholds in a financial year (but need not satisfy the same two conditions in consecutive years):

- a turnover of more than £36m
- a balance sheet total (i.e. the aggregate of the amounts shown as assets in the company's balance sheet, not netted against liabilities) of more than £18m
- more than 250 employees.

Similar qualifying thresholds (turnover, balance sheet and number of employees) apply for both the new requirement to prepare a Stakeholder Engagement Statement and the new energy and carbon reporting requirements. However, the qualifying thresholds for these requirements are set out in Schedule 7 of the 'Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008' (SI 2008/410) (as amended) and, in each case, they are not exactly the same as the s172 Duty Statement thresholds, for example, they do not automatically apply to PLCs, certain regulated companies or members of an ineligible group which exceed the small company thresholds.

The new requirement to make an Employee Engagement Statement applies to UK-incorporated companies with more than 250 UK employees. For these purposes, persons employed to work wholly or mainly outside the UK are disregarded. If a parent company, look at the number of UK employees in the group.

When does it apply?

All of the new reporting requirements described above apply for financial years beginning on or after 1 January 2019, save for the new energy and carbon reporting requirements which apply for financial years beginning on or after 1 April 2019.

INTERNAL CONTROL VS COMPLIANCE

ACCA

The role of the regulator

Traditionally internal controls have been the responsibility of senior management, with an implicit expectation – but previously with little intervention – from regulators that organisations would have robust processes in place.

However, internal control and compliance activities have been under greater scrutiny across financial institutions in recent years as a result of the increase in regulatory pressure. Several regulations of decisive importance for the finance industry came into force in 2018 within Europe, including the new European Payment Services Directive (PSD2), the Markets in Financial Instruments Directive (MiFID II), the General Data Protection Regulation (GDPR) and the new IFRS 9 accounting standard.

There is no single answer to how involved the regulator should be with internal controls, nor of course where internal controls end and compliance begins. Before deciding, the Bank of Russia will need to understand that the optimal approach is very much dependent on the areas/risks/protections it deems to be of greatest importance to the Russian financial system (integrity, consumer protection, financial crime), but there is also a fine balance between market protection and over-intervention.

Purpose of Internal Control

The primary objective of the internal control system is to help an organisation perform better through the use of its resources, while avoiding serious problems such as overspending, operational failure and violation of laws. Through an internal control system an organisation identifies its weaknesses and takes appropriate measures to address them. The main objectives of internal control are:

- efficiency and effectiveness of activities
- reliability, completeness and timelines of financial reporting and management information
- compliance with applicable laws and regulations
- accountability to the Board.

Purpose of Compliance

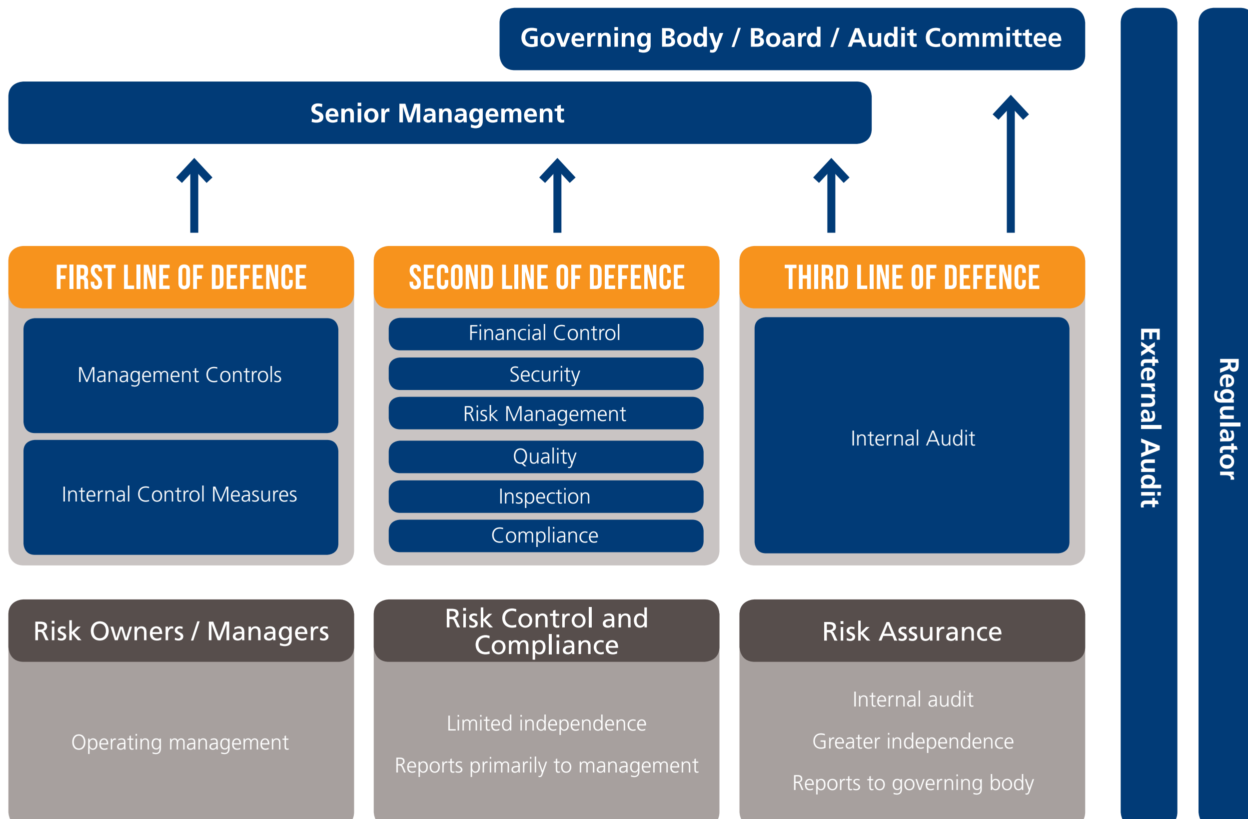
Compliance's objective is fundamentally operational. The compliance function is meant to reasonably ensure that the company is complying with all applicable laws, rules and regulations, set by state, national and international bodies. More often than not, these external legally enforceable rules are designed to offer a layer of protection to an organisation's stakeholders such as the consumer, the workforce, the public, and even the integrity of the system itself. Compliance and regulation sets the bare minimum of expectation and protection. Organisations can of course choose to exceed these standards, and often do. Overregulation will however hinder innovation, competition, viability and sometimes consumer choice.

Three Lines of Defence

Clearly the two functions are intertwined. Compliance will often ensure adherence to internal codes of conduct, policies and procedures as part of a holistic risk and assurance framework, in the same way internal controls seek to address laws and regulations. However, controls and compliance are only two parts of the story; internal audit is the third. Together, they create three lines of defence as demonstrated in the image below.

Figure 8: The Three Lines of Defence Model

Source: ACCA



The use of the three lines of defence model to understand the system of internal control and risk management should not be regarded as an automatic guarantee of success. All three lines need to work effectively with each other and with the audit committee in order to create the right conditions. The 'three lines of defence' model is principles based, and as such does not provide a one-size-fits-all solution. As previously discussed, the lines are not distinct. In some organisations the role of internal audit is combined with elements from the first two lines of defence. For example, some internal audit functions are asked to play a part in facilitating risk management or managing the internal whistleblowing arrangements. It should also not be considered static, such that organisations evolve/grow/diversify and so their requirements will change accordingly. Regulators need to recognise this too.

The challenge for the regulator

The Bank of Russia's 'Russian Financial Market Development Program for 2019-2021' has to be commended for its awareness, honesty and ambition. It acknowledges the challenges it faces, ones it can influence (training, communication), and ones it can't (political risk, societal trends). As we see it, there are two major issues to address: technology, and trust.

The proliferation of technology is changing everything we do, both as an enabler and an end product. It comes with benefits and opportunities, and risks and costs. The Bank of Russia needs to ensure it fully understands these implications and how to respond.

Underpinning regulation, compliance and internal controls is trust. Trust is critical, between all participants. Consumers need to trust financial institutions to manage their money; financial institutions need to trust that regulators will seek to encourage fair competition and innovation; consumers need to trust regulators to take action when necessary.

Proportionality is also important, for the reasons mentioned above. Regulators need to give freedoms to consumers and businesses, while protecting them from absolute catastrophe. A lot of this comes from education and understanding, two-way communication and building meaningful and open relationships.

The securities market has rightly been identified for the improvement and supervision of internal controls to prevent misconduct and financial crime. However, as consumer awareness, trust and engagement is currently low, it may well be worth the Bank of Russia increasing oversight of internal controls in subsectors such as the pension industry, and being very transparent about why it would do so.

The case study below outlines the UK's Pensions Regulator approach to internal controls. Given the importance of pensions to financial security, and some very recent collapses in the UK, it is understandable that the regulator would take a more explicit approach. This might be something the Bank of Russia, as single regulator, would look to emulate for its own pensions industry.

Case study:
The Pensions Regulator Code 09

The regulator's statutory objectives are to protect the benefits of pension scheme members, to reduce the risk of calls on the Pension Protection Fund, and to promote the good administration of work-based pension schemes.

The regulator has a number of regulatory tools, including issuing codes of practice, to enable it to meet its statutory objectives. The regulator will target its resources on those areas where members' benefits are at greatest risk.

Codes of practice provide practical guidelines on the requirements of pensions legislation and set out the standards of conduct and practice expected of those who must meet these requirements.

Codes of practice are not statements of the law and there is no penalty for failing to comply with them. It is not necessary for all the provisions of a code of practice to be followed in every circumstance.

There is no explicit legislative requirement to report a lack of adequate internal controls. However, persistent failure to put in place adequate internal controls may, for example, be a contributory cause of an administrative breach or, in more extreme cases, result in the reduction or loss of scheme assets.

Where the effect and wider implication of not having in place adequate internal controls are likely to be materially significant, the regulator would expect to receive a report, commonly referred to as a 'whistleblowing' report, outlining relevant information in relation to the breach.

Case study:
Internal controls in a digital age

Technology can make internal controls even more effective, efficient and pervasive. Even basic automation can improve internal controls by instilling discipline in organising and standardising processes. However, a process and its controls must be designed appropriately before automation is considered. Automating a poor process is counter-productive and may increase risk. Technology can also give rise to new risks that may not be adequately addressed by current internal control systems.

Many organisations are already deploying or exploring emerging technologies for control tasks or processes, for example, AI for anomaly detection, or drone technology for inspections and aerial surveillance. In the future, we expect these technologies to be used more widely for control purposes. When supply chains are connected to blockchain and the Internet of Things, controls span across an entire ecosystem of companies and individuals interacting through technology. The boundary between internal and external controls will be blurred.

As a result, the concept of internal controls may have to be rethought and revised accordingly. In the digital age, data governance and control culture will become more important as more controls become embedded in automated systems.

Internal controls will impact multiple stakeholders. Technology will impact how management and other lines of defence operate. Audit committees have a role to play in defining expectations, tone and control culture. External bodies, such as auditors or regulators, will change the way supervisory activities are performed. This creates an opportunity to collaborate effectively, harmonise and align assurance efforts among stakeholders. Beyond this, a level of professional scepticism must remain to challenge the systems and be able to identify when the system could be wrong.

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