



ecoDa Corporate Governance Guidance and Principles for Unlisted Companies in Europe

*New Edition
March 2021*



2021 Edition
First edition: March 2010
ecoDa. All rights reserved.

Published by:
ecoDa
42, rue de la Loi
1040 Brussels
Belgium

Tel: +32 2 231 58 11
www.ecoda.org

About ecoDa



The European Confederation of Directors Associations (ecoDa) is a not-for-profit association founded in December 2004 under the laws of Belgium. Through its 21 national institutes of directors (the main national institutes existing in Europe), ecoDa represents approximately 55,000 board directors from across the EU. ecoDa's member organizations represent board directors from the largest public companies to the smallest private firms, both listed and unlisted.

ecoDa's objective is to promote Board members' skills, professionalism, and impact on society. By contributing to a professional framework for both current and future board members, ecoDa hopes to help them develop and add value to their organisations, both in the commercial and non-commercial sectors.

ecoDa proposes solutions to the key corporate governance questions facing Europe today, including the challenge of helping Board members operate effectively across all European Union Member States. ecoDa aims to be an active partner of the European Union and its institutions – especially the European Parliament and the European Commission.

Foreword

In 2010, ecoDa published its first Corporate Governance Guidance for Unlisted Companies in Europe. This publication responded to a concern of the European Commission, which was considering whether its own action in that field would make sense. Eventually, the Commission preferred to rely on voluntary initiatives and, in particular, on the initiative taken by ecoDa.¹

The number of translations into national governance environments and national languages across Europe of these ecoDa recommendations has proven that the interest was there.

In 2021, ecoDa thinks that it is time, 11 years after the initial edition, to revise its content and to adapt it to the emerging challenges that companies are facing.

In contrast to listed companies, where the incentive for governance comes from external pressure, governance in unlisted companies must be stimulated from within and should much more build upon the true value-drivers of governance, such as fostering: 1- continuity (over the generations), 2- growth (opening towards external funding and new shareholders) and 3- professionalism (checks & balances, focus on the interest of the company, etc).

With the Covid crisis, Corporate Governance also appears as a tool for resilience. The need to surround oneself as an executive with the expertise of non-executives is essential in times of crisis to bounce back.

We believe at ecoDa that this Guidance can help entrepreneurs add value to their business with their board.

To support companies in that process, ecoDa has kept a phased approach to governance (rather than one-size-fits-all), tailored to the development phases of the company. We sincerely hope that companies will adapt these recommendations to their needs.

I would like to thank Roger Barker and Juan Alvarez-Vijande who have been instrumental for this project as well as all the members of the dedicated working group who provided them with their expertise.

*Jan Wesseldijk,
Chairman of ecoDa*

This document has been overviewed by ecoDa's board of directors, which is composed of:

- Juan Alvarez-Vijande, *Chief Executive, Spanish Board Directors Association (IC-A)*,
- Rytis Ambrazevičius, *President, Baltic Institute of Corporate Governance*,
- Sorana Baciú, *President, Romanian Independent Directors Association*,
- Gro Braekken, *Secretary General, The Norwegian Institute of Directors*,
- Leda Condoyanni, *President, Hellenic Corporate Governance Council*,
- François Bouvard, *Board Member, French Directors' Association, (IFA)*,
- Svante Forsberg, *Chairman, The Swedish Academy of Board Directors*,
- Sandra Gobert, *Executive Director, GUBERNA (Belgium)*,
- Tom Jacobsgaard, *Executive Director, Board Leadership Society of Denmark*,
- Virginie Lagrange, *Board Member, ILA (Luxembourg)*,
- Leena Linnainmaa, *Secretary General, Directors' Institute Finland*,
- Gorazd Podbevsek, *President, Slovenian Directors' Association*,
- Alessandra Stabilini, *Vice-President, NedCommunity (Italy)*,
- Jan Wesseldijk, *Chair of ecoDa Board*,
- Volker Wiedmeyer, *Vice-Chairman, Vard (Germany)*.



ecoDa Member Institutes



Preface

Corporate governance in recent years has evolved to encompass topics that go beyond notions of agency conflict. Corporate governance has now become a tool for responding to current societal challenges, particularly environmental and social issues.

If in the past, unlisted companies could exempt themselves from the legal rules of governance, it was always recommended to keep them in mind and apply the basic principles. Today, unlisted companies that wish to demonstrate legitimacy have even more need to embrace modern corporate governance, driven by the rapidly changing expectations of wider society. That is why ecoDa has decided that now is an appropriate moment to update its landmark guide to private company governance.

A European Working Group made up of representatives of our national institutes (listed below) was mandated by ecoDa's board to carry out this exercise. The Institute of Directors in the UK played a key role in updating this publication with the collaboration of the Instituto de Consejeros-Administradores in Spain - as in the 2010 version. This updated 2021 edition maintains its non-binding nature as well as a phased approach so that each type of company can tailor the recommendations of the report to its own needs and national circumstances. But it now provides a more modern treatment of the role that ESG issues – particularly climate change - should play in the governance of all kinds of enterprise.

In this new edition a voluntary corporate governance self-evaluation tool is provided in order that users can measure periodically the degree of application of the voluntary corporate governance principles as well as define plans for the future.

Unlisted companies generally do not have a lot of in-house advisors and resources that can help them shape their corporate governance strategy. Nonetheless, they face significant challenges in defining sustainable relationships between the company, shareholders and other stakeholders. This new edition provides companies with the insights that they need in order to define a viable governance framework, both in the present and as they evolve. It should help them ensure that their governance keeps pace with the growth of their underlying business. We are grateful to the members of the Working Group for their contribution, commitment and European focus, as well as to the members of ecoDa's board for their trust and support.

Juan Alvarez-Vijande (ecoDa's Board Member) and Roger Barker (ecoDa's Senior Advisor to the Board), Co-chairs of ecoDa's Working Group on CG for Unlisted Companies

Composition of ecoDa's Working Group on CG for Unlisted Companies:

- Juan Alvarez-Vijande (Chief Executive and Co-founder of the Spanish Board Directors Association /IC-A in Spain), Co-chair;
- Roger Barker (Director of Policy and Corporate Governance at the UK IoD), Co-chair ;
- Rytis Ambrazevičius (President, Baltic Institute of Corporate Governance);
- Roberto Cravero, (Board Director, Nedcommunity in Italy);
- Sorana Baciú, (Chair, AAI in Romania);
- Liesbeth De Ridder (Secretary General, GUBERNA in Belgium)
- Michael Hilb (Titular Professor at the University of Fribourg, Swiss Institute of Directors (SIoD)),
- Leena Linnainmaa (Secretary General, DIF in Finland);
- David Moscato (member of ILA's financial companies committee);
- Irena Prijovic (Executive Director, SDA in Slovenia)
- Béatrice Richez-Baum (Director General, ecoDa)
- Manon Roehrig (Junior Policy Advisor, ecoDa)
- With the special collaboration of Chris Hodge (Corporate Governance Advisor, IoD in the UK) and Carum Basra (Former Policy Advisor, IoD in the UK) and Marcial Campos-Calvo Sotelo (Professional Standards Committee Chair, IC-A in Spain)



Quotes

“In the recent years, sustainability is making echoes on both sides of the Atlantic as an integral part of corporate purpose. We did not need a wake-up call, but the COVID-19 crisis made the alarm sound louder. It exhibited that sustainability has not sufficiently been part of the corporate strategy and decision making as such. I am convinced that the sustainability transition presents opportunities for all companies, regardless of size, sector or type of incorporation. The work of the Commission on the sustainable corporate governance initiative aims to help companies navigate the transition together. Therefore, I welcome the timely ecoDa update of its Guidance on Corporate Governance for Unlisted Companies, which can provide structure and guidance for unlisted companies taking into account their specific needs in this ever-changing environment.”

Didier Reynders, European Commissioner for Justice



Quotes

"This ecoDa update of its Guidance on Corporate Governance for Unlisted Companies comes at a welcome moment, amidst the current COVID-19 pandemic, when we are all reflecting on how our corporate governance practices need to be adapted to reflect current realities. They serve as a useful complement to the G20/OECD Principles of Corporate Governance, which are more focused on listed companies, in order to provide practical guidance on how such principles can be tailored to the particularities of family-owned and privately held companies at different stages of development".

Daniel Blume, Senior Policy Analyst, OECD Corporate Governance and Corporate Finance Division

"Corporate Governance is a crucial discussion within many family businesses, of which the majority are unlisted. In the context of the European Commission's ongoing focus on Corporate Governance, this latest update of ecoDa 'Governance Principles for Unlisted Companies', is a timely reminder that companies are not homogenous; they come in all shapes and sizes. The successful deployment of effective governance principles happens when companies are free to implement a structure that fits their respective values and culture. We welcome this initiative by ecoDa and we suggest to take it as a voluntary tool to improve governance. We hope this report will stimulate open discussions and dialogue within our companies to foster long-term sustainable growth."

Udo Vetter, President, European Family Businesses

"It is never too early to start thinking about corporate governance. Small to medium-size companies can benefit from having a clear corporate purpose, sustainable business practices, and diverse perspectives to support decision-making. Good corporate governance helps companies operate more efficiently, improve access to capital, mitigate risk, and safeguard against mismanagement. It makes companies more accountable and transparent and gives them tools to respond to stakeholder concerns. To survive and grow, all businesses need to be properly governed. I commend ecoDa for providing clear and useful guidance on how unlisted companies, in Europe and beyond, can improve their corporate governance practices."

Martine Valcin, Manager, Global Corporate Governance / ESG Advisory, Knowledge and Learning, IFC

Table of content

Foreword..... 04

Preface..... 07

Quotes..... 09

Executive Summary..... 12

PART I: Guidance on Corporate Governance for Unlisted Companies in Europe.....17

- 1. Why focus on unlisted companies?..... 18
- 2. Why corporate governance matters to unlisted companies?..... 20
- 3. Constructing a governance framework - the key players..... 24
- 4. Foundations of good governance - high level principles..... 26
- 5. The challenge of implementation..... 32

PART II: Principles of Corporate Governance for Unlisted Companies in Europe.....35

- Phase 1 principles - applicable to all unlisted companies..... 38
- Phase 2 principles - applicable to larger and/or more complex unlisted companies; unlisted companies with significant external financing; unlisted companies aspiring to a public listing..... 60

Additional resources.....72

Appendix: corporate governance self-evaluation questionnaire..... 73

Executive Summary

Unlisted companies make a major contribution to economic growth and employment in all EU member states. According to the OECD, improved corporate governance amongst unlisted companies has the potential to significantly boost productivity growth and job creation in both developed and developing economies, as well as benefiting the company itself.

In the eleven years since the first edition of this guidance was published, the scope of corporate governance has widened. It is now often viewed as a component of a company's broader ESG (Environmental, Social, Governance) strategy. Partly as a result, the governance of unlisted companies is now attracting more attention from regulators and stakeholders.

However, it remains the case that there is limited recognition of the need for a distinct corporate governance framework that is appropriate for unlisted companies. In particular, most officially-endorsed corporate governance codes relate to listed rather than unlisted companies, who face different challenges and have different needs.

Most unlisted enterprises are owned and controlled by single individuals or by coalitions of company insiders such as families. In many cases, owners continue to play a significant direct role in management. Good governance in this context is primarily concerned with establishing a framework of company processes and attitudes that add value to the business and help ensure its long-term continuity and success.

Shareholders in unlisted companies are typically restricted in terms of their ability to sell their ownership stakes. This lack of liquidity presents shareholders with a significant investment risk. Investors are forced to commit themselves to the company for the medium to longer term. An effective corporate governance framework provides a way of mitigating this risk.

Furthermore, the voluntary adoption of sound governance practices by unlisted companies themselves may reduce the risk that a 'business-unfriendly' regulatory regime is imposed on them by policy makers in the future.

There is much to be gained from highlighting the specific governance issues of unlisted enterprises and outlining best practice solutions in the form of a set of voluntary corporate governance principles. That is the purpose of this guidance.

This guidance takes unlisted companies through the issues involved in designing their own corporate governance framework. It also presents a set of governance principles that can be followed or not. Determination of the most suitable governance framework for the company should largely be a matter for the shareholders and directors.

The principles are designed to take into account the size, complexity and level of maturity of individual companies, and their objectives concerning their own development. The guidance recognises that a 'one-size-fit-all' approach to governance frameworks at unlisted companies would be unhelpful. Given the diversity amongst unlisted firms, corporate governance principles should be applied in a pragmatic and flexible manner, reflecting the individual circumstances of each company.

A dynamic approach towards governance is essential since governance frameworks must evolve over the life cycle of a business firm. A corporation will generally develop a new governance structure and approach in anticipation of its next major strategic move or phase in development or financing structure.

By distinguishing between principles that are relevant to all companies and those relevant only to larger and more complex companies, or those seeking to grow, the guidance provides a governance roadmap for family owners or founder-entrepreneurs as they plan the development of their companies over the corporate life cycle.

In order to provide further assistance to companies, ecoDa has developed a self-evaluation questionnaire that boards can use to assess the extent to which they are already applying the principles and identify whether there are areas in which they might want to consider taking action to strengthen their governance framework.

This questionnaire can be found [here](#).



Phase I principles:

Corporate governance principles applicable to all unlisted companies

- Principle 1:** Shareholders should establish an appropriate constitutional and governance framework for the company.
- Principle 2:** Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of corporate purpose and strategy. However, an interim step on the road to an effective and independent board may be the creation of an advisory board.
- Principle 3:** The size and composition of the board should reflect the scale and complexity of the company's activities, and take into account an appropriate level of diversity in its composition.
- Principle 4:** The board should meet sufficiently regularly to discharge its duties and be supplied in a timely manner with appropriate information.
- Principle 5:** Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executives board members of the quality required to run the company successfully.
- Principle 6:** The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard the company's assets and the long-term interests of stakeholders.
- Principle 7:** There should be a dialogue between the board, shareholders and other key stakeholders based on a mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders and stakeholders takes place. The board should not forget that all shareholders have to be treated equally, and that each category of relevant stakeholder should be treated appropriately.
- Principle 8:** All board members should receive induction on joining the board and should regularly update and refresh their skills and knowledge.
- Principle 9:** Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationships between family governance and corporate governance.

Phase 2 principles:

Corporate governance principles applicable to large and/or more complex unlisted companies²

- Principle 10:** There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's business. No one individual should have unrestricted powers of decision.
- Principle 11:** Board structures vary according to national regulatory requirements and business norms. However, all boards should contain members with a sufficient mix of competencies and experiences. No single person or small group of individuals should dominate the board's decision-making.
- Principle 12:** The board should establish appropriate board committees in order to allow a more effective discharge of its duties.
- Principle 13:** The board should undertake a periodic appraisal of its own performance and that of each individual board member.
- Principle 14:** The board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders and establish a suitable programme of stakeholder engagement.

This publication is the latest edition of ecoDa's initiative to define a corporate governance agenda for unlisted companies in Europe. The first edition was published in 2010.

This latest edition provides guidance and a set of **voluntary** "best practice" principles, drawing on both the content of existing national and international corporate governance codes and the experience of good governance in individual unlisted enterprises. The principles provide flexibility for companies to implement them in a way that is appropriate for their size and situation, and to do so in phases as the company develops.

As well as providing direct **guidance** for **shareholders**, **board members** and other **stakeholders**, it is hoped that these ecoDa principles will provide a foundation for the development of more country-specific corporate governance principles at the level of individual European countries.

The **guidance** is contained in **Part I** of the document and is split into five main sections. The first two sections present the rationale for the publication of a set of corporate governance guidance and principles for unlisted companies. Sections 3 and 4 provide a description of the key governance players and high level principles that should be incorporated into a viable corporate governance framework. Section 5 considers some of the challenges involved in the implementation and disclosure of good corporate governance.

The statement of the ecoDa corporate governance **principles** for unlisted companies in Europe is contained in **Part II**. Those readers that are already well versed in corporate governance concepts may wish to turn directly to Part II, in order to focus on the measures that can be directly applied at the level of each company.

The **Appendix** contains a **Corporate Governance self-evaluation questionnaire** that is designed to help boards or companies assess and improve their governance framework.

Across Europe, significant diversity exists in terms of how good governance is structured and practised. Companies are also subject to differing requirements in terms of company law and other regulatory requirements – although EU legislation has played a harmonising role in certain areas.

This Guidance and Principles for Unlisted Companies in Europe is intended to work alongside national and EU regulation in a complementary manner. Ultimately, it is the application of effective governance principles that matters most for business behaviour and performance – rather than the adoption of specific structures or process. The latter should always be determined in the context of the specific business environment in which a company is operating rather than according to a 'one size fits all' approach.



**Part I – Guidance on
corporate governance
for unlisted companies**

The G20/OECD define corporate governance as follows:

“Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”.

The G20/OECD also provides a clear statement of what an effective corporate governance framework is intended to achieve:

“The purpose of corporate governance is to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies.³”

1. Why focus on unlisted companies?

The focus of the guidance and principles is on unlisted companies, i.e. limited companies that are not listed or quoted on public equity markets.⁴ The scope of unlisted companies is wide and encompasses start-ups, single owner-manager companies, family businesses, private equity-owned companies, joint ventures, and subsidiary companies. Moreover, many state-owned enterprises also form part of the unlisted company universe.

Unlisted companies are of particular importance in countries with less developed capital markets, where the vast majority of companies are not listed on a stock exchange or regulated market. But even in economies with more developed markets, most small and medium-sized enterprises are not publicly listed on regulated equity markets **and they represent a major part of employment and contribution to GDP.**

Furthermore, there exist many notable large corporations that have chosen, for a variety of reasons, to forgo or delay a public listing. This trend has been accelerating in recent years, and is also reflected in the fact that the number of companies listed on major markets is significantly lower compared to the situation a decade or so ago.

According to the OECD, improved corporate governance amongst unlisted companies has the potential to significantly boost productivity growth and job creation in both developed and developing economies.⁵

However, despite their large numbers and growing economic importance, the governance of unlisted companies is an often neglected area of corporate governance studies and recommendations.

3. *G20/OECD Principles of Corporate Governance*, 3rd Edition, 2015, p.7 & 9.

4. The key difference between unlisted and listed companies is that unlisted companies do not promote their shares to the general public. Consequently, their shares are not traded on public equity markets. They may also impose restrictions on the transferability of their shares.

5. Vermeulen (2006), p.93.

For example, in recent decades, many countries have adopted corporate governance codes.⁶ However, most of these codes relate to listed companies. In the absence of their own specific reference point, there is a danger that unlisted companies will refrain from developing an appropriate governance framework, with negative implications for their long-term effectiveness and success.

Copying the widely-recognised principles of best practice for listed companies is also not a viable solution, as the corporate governance challenges of listed companies are distinct from those of unlisted companies. The most significant difference is that, in unlisted companies, the same individual may often be a manager, director and shareholder. It is important that companies have a clear understanding of how these roles differ and the relationship between them.

Listed companies often have large numbers of external minority shareholders, and may be run by professional managers without significant ownership stakes. The governance framework of such companies tends to focus on ensuring that external shareholders can exercise effective oversight and control over management and the board of directors. This is often a challenge due to the remoteness of most external shareholders from company decision-making (the so-called “principal-agent” problem), and the difficulties involved in coordinating the actions of a diffuse body of small shareholders vis-à-vis management (the so-called “collective action” problem).

In contrast, most unlisted enterprises are owned and controlled by single individuals or coalitions of company insiders (for example, a family). In many cases, owners continue to play a significant direct role in management. Good governance in this context is not primarily a question of protecting the interests of absentee shareholders. Rather, it is concerned with establishing a framework of company processes and attitudes that add value to the business and help ensure its long-term continuity and success. It is also motivated by a desire to build trust in the enterprise and a status of legitimacy amongst other stakeholders and wider society.

In many respects, unlisted companies face a greater corporate governance challenge than listed companies. Much of the governance framework of listed companies may be externally imposed by various types of regulation and formal listing requirements. Although the number of governance requirements relating to unlisted as well as listed companies has been increasing in recent years, unlisted companies still tend to have greater scope to define (or not define!) their own governance strategy. This means that unlisted companies must themselves reflect on the potential costs and benefits of various governance approaches.

Furthermore, in contrast to larger listed enterprises, smaller unlisted entities may not have access to in-house support (for example, legal advisers or company secretarial resources) to assist them in making important decisions about governance.

6. The first ever corporate governance code was published in 1978 in the United States. By 2008, 64 countries had issued at least one code of governance. At an international level, the *G20/OECD Principles of Corporate Governance* (first published in 1999 and re-issued in 2004 and in 2015) has proved highly influential in shaping national governance agendas. 19

Determination of the governance framework will largely be a matter for the shareholders and directors, who may need to draw on external governance information, relevant reference frameworks as well as tools to assist them in realising the ambition of professional governance.

As a result, ecoDa is convinced that there is much to be gained from highlighting the specific governance issues of unlisted enterprises, and outlining best practice solutions in the form of a set of voluntary corporate governance principles. Furthermore, the voluntary adoption of sound governance practices by unlisted companies themselves may reduce the risk that a ‘non business-friendly’ regulatory regime is imposed on them by policy makers in the future.

2. Why corporate governance matters to unlisted companies ?

Throughout Europe, unlisted enterprises contribute to productivity, generate employment, and provide vital goods and services. Strong, resilient and sustainable unlisted businesses generate value for their stakeholders and wider society. And when run in accordance with a clear purpose and strategy, they are trusted by the communities in which they operate, and have the potential to generate substantial value for their shareholders.

Although unlisted companies benefit from the privilege of limited liability status, they are not subject to the same level of reporting and accountability requirements as listed companies. The traditional rationale for this is that unlisted companies have no reliance on public equity markets to raise capital – hence there is less need for disclosure of company information to the outside world.

Nevertheless, several large-scale failures of unlisted companies have not only drawn public attention to the need for improved transparency and accountability, but also highlighted the risks to wider stakeholders, including the workforce, suppliers and customers, of poor governance amongst these types of companies. Hence, policy makers increasingly advocate that unlisted companies should improve their transparency, accountability and overall standards of governance.

However, the relationships between shareholders, board members, senior management and other stakeholders can vary considerably across the universe of unlisted companies. Unlisted companies are not a homogenous group and are established under a variety of differing ownership and legal structures. Hence a ‘one-size-fit-all’ approach to governance frameworks at unlisted companies is unlikely to be the right answer.

Nonetheless, good governance at unlisted companies is likely to bring clear benefits, including the following:

- Unlisted companies with sound governance will have better access to finance, as they appear more attractive and less risky for investors and banks, and are less risky for investors.
- Unlisted companies with good corporate governance will have better minority shareholder protection.

- Good governance will be a common regulatory pre-requisite for an IPO (initial public offering) or other more significant corporate financing efforts.
- Effective governance policies, structures, and processes can help reduce overreliance on a few “key persons” and professionalise the management of the company.
- Family-run businesses will increase the chances of long-term survival through proactive succession planning and managing the family-versus-business relationship.
- Prudent governance will reduce risks and improves the managing of conflicts among various shareholders and stakeholders.
- Well-structured boards of directors can provide critical stewardship, strategic direction, and business connections for sustainable growth.
- Prudent internal controls will help companies enhance risk management and build greater resistance to fraud, theft, and mismanagement.
- Good governance practices help the founders recover some freedom in their lives.
- Well-governed companies attract and retain higher-quality staff that the founders can rely on.

These benefits of good governance can be unpacked into three broad areas of contribution to the success of an unlisted company:

a. Performance, internal efficiency and resilience

Corporate governance is ultimately concerned with the decision-making processes, procedures, and attitudes that assist the company in achieving its objectives. It is the framework within which decisions are made and power exercised. Consequently, as the firm seeks to improve the professionalism and sustainability of its activities, it needs to give greater thought to issues of governance.

This is a particular need if the firm wishes to shift away from dependence on the unique contribution of the founding entrepreneur. Although the ability and dynamism of one individual may have been instrumental in establishing and scaling the enterprise, this is unlikely to be sustainable in the longer term. As the enterprise grows in size and maturity – or outlives the interest or working life of the founder – governance processes must be established to ensure continuity and success beyond the efforts of one person.

Indeed, the development of effective governance processes may lift a significant burden from the founder, facilitate a swift succession and allow access to a wider pool of expertise and know-how. The result may be improved leadership, decision-making and strategic vision. Improved governance may also make it easier to monitor and manage the various risks to which the company is exposed, particularly as it grows in size and complexity.

Governance will also become an increasing issue for unlisted companies as they develop new sources of finance. Initially, the primary source of funds is likely to be retained earnings or financing from internal networks, for example, families or associated corporate groups. However, unlisted companies may also turn to banks, venture capitalists, and private equity investors in order to finance their expansion and growth.

A greater reliance on such external sources of finance will necessitate the implementation of a more explicit governance framework, as external financiers seek assurance that their investments will be well managed.

In particular, the involvement of additional owners in the company – even if the founder retains a controlling stake – will require governance mechanisms to resolve differences between shareholders with potentially diverging agendas.

A governance structure that sustains the confidence of internal and external sources of finance – such as shareholders, banks and other creditors – will contribute to the long-term success of the firm by securing the commitment of patient capital partners. The reward to the company of such a governance structure will be more stable financing at lower cost than would otherwise be available.

As result a sound governance framework improves company resilience and future sustainability. Good corporate governance contributes to creating value and to strengthening the company.

b. Managing patient capital and illiquidity risk

Shareholders in unlisted companies are typically restricted in terms of their ability to sell their ownership stakes. By definition, the shares of unlisted enterprises are not quoted or traded on public equity markets. Furthermore, in many countries, company law prohibits the sale or marketing of shares in non-listed companies to the general public (or even to any persons without a prior connection with the company or its existing shareholders).

Restrictions on the transfer of shares may also be introduced by the shareholders themselves - through the company's articles of association or shareholder agreements.

As a result, the shareholders of unlisted companies may find themselves in the uneasy position of being “**captive**” owners of a company.

This lack of liquidity presents shareholders with a significant investment risk. Investors are forced to commit themselves to the company for the medium to longer term. In contrast to the owners of listed companies, they do not have the option of easily selling their shares when they are in disagreement with the company's strategy or if they believe the company's activities become too risky.

An effective corporate governance framework provides a way of mitigating this risk. It provides shareholders in unlisted companies with some reassurance that, although there is no easy exit from their ownership stake, their interests will continue to be respected and safeguarded by the board and company management. Moreover the governance framework may also induce reflection on a possible exit strategy for those shareholders that feel the necessity to exit the company's share capital partly or completely.

As a result, shareholders are more likely to invest in the company in the first place. Furthermore, they will be more comfortable in their role as patient capital partners, and be a source of support for the company over the longer term.

c. Winning the trust of wider society

Unlisted companies have to operate within a social context in which there exists growing public scrutiny of corporate behaviour.

The governance of companies is an issue of increasing interest for the media and civil society. Furthermore, the public demand for improved corporate accountability and transparency has grown in the wake of recent corporate scandals involving unlisted companies, the climate change emergency and the Covid-19 pandemic.

Existing corporate governance codes are also raising the profile of corporate governance. Global corporate governance principles (for example, those of the G20/OECD) and national corporate governance codes for listed companies are shaping societal norms of “appropriate” corporate structures, procedures and behaviour. In addition, expectations concerning unlisted company governance have been influenced by the publication of codes of practice for unlisted companies in several European countries.

More broadly, the scope of corporate governance has widened in recent years – as investors and wider society have increasingly linked governance to the fulfilment of social and environmental goals. As a result, corporate governance is nowadays often viewed as a component of a company’s broader ESG (Environmental, Social, Governance) strategy. In this context, good corporate governance is not designed in isolation but through interaction with the achievement of broader societal objectives – such as the net-zero objective of the EU’s Green Deal or the emissions reduction targets set by the 2016 Paris Agreement on Climate Change.

In assessing whether companies are governing themselves appropriately – including the achievement of these wider environmental and social impact goals - public opinion is unlikely to pay much regard to nuances such as whether an enterprise is listed or unlisted. Indeed, unlisted companies may even be viewed with greater suspicion by external observers due to their lower levels of transparency in comparison with publicly-listed entities. These changes of perspective about the purpose of governance are also being reflected in regulatory and disclosure policy, which increasingly applies new requirements to business entities according to their size or economic significance, rather than on the basis of their status as listed or unlisted enterprises.

Good governance can play a crucial role in gaining the respect of key external stakeholders – such as actual and potential financiers, employees, customers, local communities and regulators. It effectively provides a “mandate to operate”, since it offers external stakeholders some assurance that the company is being run in an appropriate and responsible manner, with due regard for the interests of “non-insiders” and wider society.

When company behaviour does not fulfil the expectations of society, the company may suffer significant consequences. Even if the firm is not breaking any formal laws, it may be affected by the negative perception of employees and consumers. The implementation of a robust governance framework is the main means by which such significant reputational risks can be mitigated.

3. Constructing a governance framework – the key players

An effective governance framework establishes stable and accepted relationships between shareholders, the board, management, and other stakeholders. In effect, it defines an agreed distribution of power between the main players involved with the firm. This is an essential pre-requisite for the effective operation of an enterprise.

Some aspects of the governance arrangements may be stipulated in national law, while others will be a matter for individual companies to judge. We consider each of the main governance roles in turn.

a. Shareholders

Notwithstanding differences of emphasis about shareholder primacy, there is wide acceptance across Europe that a company should further the interests of its shareholders. However, from a strictly legal perspective, shareholders do not have direct power over the operation of a company. The power of shareholders primarily arises from their ability to appoint, dismiss, and influence the decision-making of the board of directors, as well as to approve the bylaws, dividends, company restructuring and other matters.

Such powers may be defined both by company law (which establishes a baseline of shareholder rights) and the specific contents of a company's constitutional documents, for example, the articles of association or bylaws.

In addition, shareholders may enter into agreements amongst themselves. These shareholder agreements may further define the rights and responsibilities of shareholders, for example, relating to the transferability of shares or the rights of different categories of shareholding.

Beyond compliance with the law, a governance framework must decide how the shareholder's interaction with the company should be organised. For example:

- How can shareholders call a shareholder meeting?
- How can shareholders table resolutions at a shareholder meeting in order to influence or veto the decision-making of the board, nominate or dismiss individual directors?
- What information should be provided by the company to shareholders?
- How are minority shareholders rights are taken in consideration?
- How should the exit and entry of shareholders into the ownership structure be handled?

In addition, a governance framework may wish to highlight the responsibilities as well as the rights of shareholders. A proactive and constructive relationship between shareholders and the board will increase mutual understanding and commitment, both at times of crisis and during normal business conditions.

One of the difficulties faced by shareholders in asserting their interests is that they are not necessarily a homogeneous group. There may be a variety of competing or conflicting objectives. This may be a particular problem in family companies, where some family members are actively involved in the management of the company and others are not.

In such cases, it is important for a governance framework to define accepted relationships between shareholders. This will include procedures by which conflicts can be anticipated and resolved in an effective manner. Also, effective procedures for family governance can enhance the long-term success of family-owned companies.

b. Board members

One of the main shareholder rights is to nominate the board members and define the powers the board is entrusted with.

As such, the **shareholders ultimately define many of the key features of the governance framework.**

Although differences may exist between jurisdictions as well as between types of registered companies, the board of directors (or supervisory board in two tier board systems) is seen as the primary decision-making body of the company. It is collectively responsible for all or most aspects of the company's activities, even though management is responsible for the daily operations of the company. Notwithstanding the possibility for shareholders to limit its powers, the board's broad responsibilities are:

- to establish and maintain the company's purpose, values and culture.
- to establish its structure, strategy, and risk profile.
- to delegate authority to management, and to monitor and evaluate its implementation of policies, strategies, and operational plans.
- to appoint and dismiss the CEO or managing director
- to account to – and be responsible to – shareholders, other stakeholders and wider society.
- to define its own operation: key functions to be performed, composition, organization, agenda, evaluation and compensation.

A governance framework will formally establish the board's specific responsibilities. It will define the board's structure, size, and composition, and the process by which board members are appointed to the board. It will also seek to embed an optimal degree of diversity in terms of gender and other board member characteristics in order to enhance the robustness of decision-making and avoid group-think.

The organisation and logistics of board meetings are important aspects of the governance framework. Key issues include the functions to be performed by the board members, the role of the board Chair, the frequency of board meetings, the management of the board's agenda, the nature of the information provided to directors, the taking of minutes, the nature and style of boardroom discussions and decision-making, and the role of the board secretary.

The governance framework should also determine whether the board would be able to carry out its responsibilities most effectively by delegating specific functions to committees, for example an audit, nomination or remuneration committee.

People as well as organisational structures are essential to effective governance. Consequently, a governance framework will establish ways of identifying potential management and board-level talent across a diverse range of candidates, and ensure that board members understand their legal and moral responsibilities (including their personal liabilities).

d. Stakeholders

The role and impact of other company stakeholders – such as employees, financiers, suppliers, local communities, and government – vary considerably across companies, sectors, and European nation states.

In some European countries, the rights of stakeholders are enshrined in company law or other related legislation, for example, codetermination, employment protection or health and safety legislation. Companies in certain countries have a tradition of focusing more narrowly on the interests of shareholders – although there is a growing trend towards opening up governance to a wider range of stakeholder voices, both in law and business practice.

However, regardless of legal obligations, the governance framework should take into account the interests of stakeholders if it is to build a sustainable and trusted enterprise. The risks to the firm – reputational and otherwise – of insufficiently incorporating the stakeholder perspective into governance arrangements could be considerable. Consequently, it is important to consider ways of establishing dialogue and constructive engagement with relevant stakeholders – including those located within and outside of the enterprise.

A key board task is to identify those stakeholders that are most relevant for the company and understand the nature of their interdependences with it. It is a permanent task for the board and it forms the basis on which to build a viable ESG strategy.

4. Foundations of good governance – high level principles

The design of a credible framework of governance involves the linkage of the key corporate governance roles with a number of widely-accepted principles of good governance. The way in which such principles are implemented may vary according to the specific jurisdiction and business context – the key point is that they should be incorporated by individual governance frameworks in an appropriate manner.

a. Corporate purpose

A well-developed corporate purpose – above and beyond simply generating profits - helps companies of all sizes articulate their business model and develop their strategy, operating policies and approach to risk. It also helps to motivate staff and business partners around a shared definition of long-term sustainable business success. In defining the corporate purpose, boards will engage closely with key shareholders, the workforce and wider stakeholders. They will also be proactive in ensuring that all aspects of corporate behaviour remain aligned with the company's chosen purpose.

b. Culture and values

Corporate culture is defined as a combination of the values, attitudes and behaviours manifested by a company in its operations and relationships with its stakeholders. A healthy culture is critical to a company's competitive advantage, and vital to the creation and protection of long-term value. The board, shareholders and management should maintain a commitment to embedding the desired culture and values throughout the organisation – including in their own personal conduct.

c. Sustainability

Sustainability is an approach to business decision-making and behaviour which aims to generate long-term value for the company's stakeholders and for the planetary environment in which the company operates, particularly with respect to environmental impact and climate change. Increasingly, sustainability is viewed as a powerful means by which companies can win the trust of stakeholders and wider society in their approach to business.

For smaller companies, notions of purpose, culture and values, and sustainability principles, might appear at first sight to be optional extras. But if a credible governance framework is to be established, these principles must be addressed, albeit proportionately, and made explicit in the company's objectives, its high level policies and even in its bye-laws.

d. Diversity

Diversity is a governance principle which aims to improve decision-making by involving diverse perspectives in leadership, strategy and oversight. Diverse perspectives serve to counter organisational group-think, complacency or lack of connection with wider society. Appropriate levels of diversity across dimensions such as professional skills and experience, gender, nationality, age and ethnic background also help build organisational alignment with wider social trends relating to inclusion and a responsible business environment.

e. Delegation of authority

In any company, a key source of authority is equity ownership. However, the company may soon reach a point in its development where the main shareholder is no longer able to simultaneously fulfil the roles of shareholder, director, and manager. At that point, it becomes necessary to reflect on the most effective way to delegate authority from the main shareholder to the board and the management.

The articles of association (or equivalent constitutional document) and shareholder resolutions exist to formalise the rights of shareholders.

The owner and/or the board should develop a systematic approach towards the delegation of authority and formalise this in writing. A schedule of matters reserved for the board and for executive management should be established, which sets out the parameters of the delegated authority (with attention for any financial thresholds regarding decision-making powers).

Delegated authorities should be reviewed periodically to ensure that they remain appropriate given the structure, size, scope, and complexity of the firm.

It should be emphasised that the execution of some board responsibilities can be delegated but the responsibility itself cannot be delegated. The board in particular remains fully responsible.

f. Checks and balances

A basic principle of good governance is that no one individual should have unfettered power over decision-making. There should exist “checks and balances” that subject the actions of individuals to scrutiny, while the most important decisions should be taken on a collective basis.

Fulfilling this principle is often a challenge for owner-managed companies, which are normally established on the basis of the autocratic control of a single individual (or small group of individuals). However, while such a governance approach may be viable in the early stages of a company’s development, it is not a sustainable model for the longer term.

Building the right checks and balances is therefore a delicate exercise for any developing company and will probably necessitate a **“phased” or step-wise approach** to align governance needs with the founder/owner’s willingness to accept external influence.

Aside from the practical difficulties involved in a single person making all the decisions, a lack of appropriate checks and balances exposes the enterprise to human weakness. Even the most capable of individuals can sometimes make mistakes or lose their ability to analyse issues in an objective manner.

To minimise these risks, it is important to establish governance procedures that subject all decision-making to some kind of third-party scrutiny. There should also be clear lines of accountability with the firm – each corporate actor (whether an employee, manager, or director) should justify their actions to someone else. Corporate transparency is also an effective means of encouraging appropriate behaviour (see below).

Specific examples of checks and balances within the corporate structure include splitting the role of leading executive management (CEO or managing director) from that of Chair of the board, the utilisation of a “four eyes” principle when signing contracts or making important commitments on behalf of the firm, the obligation to have an external auditor, and the involvement of independent directors on the board.

When the company has reached a certain size or stage of development, it could be suitable for independent directors to join the board. If the company has a Chair who also has an executive role, nominating one of the independent directors to act as senior independent director can help to improve checks and balances.

g. Professional decision-making

The focus of collective decision-making in most companies is the board.

However, directing an organisation through a board is more difficult than is commonly supposed. Simply placing competent people of goodwill around a boardroom table will not necessarily result in an effectively functioning board. Building an effective board takes time and patience on the part of board members, and benefits from a professional approach to boardroom procedure.

The Chair has a particular responsibility in welding a group of capable individuals into an effective board team. The Chair has to find a way to reach a consensus between diverse and diverging views on the company and its future. An atmosphere of open discussion should be encouraged. Perspectives and viewpoints should be properly documented in the minutes, allowing dissenting voices to be recorded. There should also be a clear formulation of decisions, so that the decision-making process is followed by decisive action.

It is also important to ensure that due care is taken over the choice of board members, and that board members have the necessary skills and competencies to fulfil their responsibilities.

Board members will need to undertake specialised professional training if they are to effectively make the transition from operational manager (with a focus on one aspect of a firm’s activities) to board member (where they must exercise oversight over the firm as a whole).

h. Accountability

Within a company, there should be a hierarchy of accountability. Each level in the hierarchy is granted defined responsibilities and powers. However, these powers must be associated with meaningful accountability regarding performance and the exercise of powers.

The accountability hierarchy begins at the bottom of the pyramid, with each superior level monitoring and supervising the level below it. Employees are accountable to managers, who themselves report into the board. Finally, the board is accountable to shareholders and other external stakeholders (including government agencies and regulators).

For accountability to exert an effect over behaviour, it is important that each employee, manager, and board member understands expectations about the nature and scope of his or her responsibilities. As the company expands in size and complexity, this will require formalisation in the form of explicit business conduct rules (including ethical principles). At the board level, board members should clarify their responsibilities by defining corporate governance principles for the firm, which should be regularly reviewed and updated.

Once responsibilities have been defined, the efficient functioning of the system depends on proper oversight. However, this will only be possible if there exists relevant information with which to evaluate behaviour and performance.

For this reason, an appropriate framework of reporting and control is an important aspect of good governance. Senior managers, board members, shareholders, and other stakeholders need reliable and understandable information with which to evaluate performance. In most cases, such reporting will be undertaken by both internal departments (for example, management accounting reporting and internal audit) and external intermediaries (for example, the external auditors).

i. Transparency

Transparency regarding the firm's activities can be highly effective in encouraging high standards of behaviour. Board members, managers, and employees are likely to give greater thought to their conduct if they perceive that they are being observed by others. This perspective is summarised by the maxim that "sunlight is the best of all disinfectants".

A certain level of transparency in the firm's activities may be mandated by law and regulation (for example, publication of financial statements). The nature of such statutory transparency for unlisted companies has been growing in recent years. Furthermore, unlisted companies may choose to voluntarily disclose more information than required by law as a means of gaining the confidence and commitment of external stakeholders.

Given the fact that unlisted companies are often labelled as "closed" companies, the case for greater external transparency will need to be made to a possibly sceptical company owner/founder. Rather than making sudden changes, an appropriate strategy may involve increasing company transparency via a stepwise approach towards greater openness.

A key stage in opening up the company to external scrutiny is taken by the appointment of independent (non-executive) directors. This signals a firm's willingness to become more open and accountable in respect of its decision-making and performance assessment. Within the management structure, the replacing of the owner-manager or founding entrepreneur by external managers can also be perceived as an important step in this direction.

At some stage, the unlisted company must make choices about the extent of its disclosure to external stakeholders. This is important if the company is seeking external capital or contemplating a future listing. But it may also be crucial for building reputational capital.

Greater transparency is beneficial in establishing the legitimacy of the company as a responsible enterprise in society. Increasingly, civil society views organisations that lack transparency with suspicion. The baseline assumption in the mind of the public is that opaque organisations have something to hide. This is a societal attitude that unlisted companies cannot afford to ignore, even if their regulatory obligations vis-à-vis transparency are still less substantial than those of listed companies.

j. Conflicts of interest

An important principle of company law in most jurisdictions is that board members have a duty to promote the success of the company as a whole.

They are specifically prohibited from directing the activities of the company in favour of themselves or particular shareholders and/or stakeholders.

Even in owner-managed firms, the authority of an individual to manage the firm derives from his or her status as a board member. The company should not be regarded as an extension of the personal property of the owner. Although shareholders have legally-defined economic entitlements (for example, to dividends) and powers vis-à-vis the board (for example, to appoint and remove directors), it is board members – not shareholders – that are charged with directing the affairs of the company. And this must be undertaken in the interests of the company as a whole.

This principle may be difficult for owner-managers or large shareholders of unlisted enterprises to accept or understand. They may view the firm's interests as synonymous with their own. This may lead to a self-interested bias in their decision-making. At worst, it could lead them to seek ways of expropriating the assets of the firm at the expense of minority shareholders or stakeholders. Note that a company's assets also include intangibles such as patents, trademarks and copyrights.

Some examples of where conflict of interest situations may arise include the following:

- The firm undertakes business transactions with enterprises controlled or managed by its shareholders (known as related party transactions), leading to a potential conflict of interest between the firm and its shareholders.
- A manager or board member has a personal interest in the adoption of a particular corporate strategy or policy (for example, his or her own remuneration or the sale of company property to related family shareholders), which leads him or her to be less than objective in decision-making.
- Board members or shareholders encourage the firm to undertake activities that benefit specific shareholders (for example, relating to dividend policy, or requiring a subsidiary company to provide special guarantees or loans to a mother or another group company) or stakeholders with which they have a strong personal association (the promotion of a family employee or decisions on succession planning).

Conflicts of interest have the potential to undermine the governance and reputation of the company. Good governance demands that the company is being steered by the board in an objective manner, and not as a means of promoting specific personal interests or enriching a specific constituency.

Consequently, a robust governance framework needs to define credible mechanisms by which potential conflict of interest issues can be managed or resolved.

Board members should always declare potential conflicts of interest to the rest of the board, abstain from influencing the decision and be prepared to leave the board entirely in cases where such conflicts are structural and could eventually become detrimental to the success of the company.

k. Aligning incentives

Aligning objectives among shareholders, board members and senior management is a critical task.

The incentives of board members and senior managers are primarily (although not entirely) shaped by the firm's remuneration policy. Remuneration is an issue that frequently attracts the attention of the media. Indeed, an impression may be gained from the public discourse that corporate governance is almost entirely about remuneration, which is of course a distortion.

Unlisted companies benefit from the fact that they are not subject to the same degree of public scrutiny and mandatory transparency regarding remuneration as publicly listed companies. However, unlisted companies have an equal need to ensure that remuneration policy is incentivising behaviour from board members, managers and employees in a way that is consistent with the long-term interests of the enterprise.

Furthermore, a credible and transparent remuneration policy can help win the commitment and loyalty of company stakeholders (for example, employees, suppliers, providers of finance, the media, and the local community) to the company's objectives.

Some important issues of remuneration policy include the following:

- What are the relevant benchmarks and performance criteria in the remuneration process?
- Who makes the decisions about remuneration?
- How much information regarding remuneration issues should be disclosed?

5. The challenge of implementation

The implementation of sound corporate governance principles is not necessarily easy.

It may involve a significant change in the way that companies operate and a shift in the distribution of power in relation to corporate decision-making.

For example, the necessary steps may involve the inclusion of external parties in important decisions, establishing meaningful chains of accountability, and the communication and reporting of activities to stakeholders. Such steps may be viewed with suspicion by the original owner-manager or founding-entrepreneur.

Furthermore, improved governance is likely to be associated with the increased formalisation of company processes and procedures. Many small and medium-sized companies may see this as imposing an unnecessary bureaucratic burden on their enterprises.

Consequently, there exist important prerequisites for the implementation of a corporate governance framework:

- The firm's key decision-makers – normally the shareholders or the owner-manager – must themselves be convinced of the need to implement a robust governance framework. The commitment of these parties is essential in order to make governance work.
- Although the governance framework should pay due regard to best practice principles, it should also be implemented in a manner that is both proportionate and realistic. Corporate governance is not an end in itself, but a means of adding value and providing continuity. Given the diversity amongst unlisted firms, corporate governance principles should be applied in a pragmatic and flexible manner, with regard to the individual circumstances of each company.

The implementation of a corporate governance framework should also take account of the firm's objectives concerning its own development. A corporation will generally develop a new governance structure and approach in anticipation of its next major strategic move or phase in development or financing structure (for example, before succession takes place in a family firm, before attracting external capital, etc.). Such a change in governance will indicate its readiness to take the next step in its evolution.

Events in the company's life cycle that may trigger a change in governance approach include the following:

- Changes in the relationship between shareholders, the board and management. This may be triggered by the desire of the founder entrepreneur or family owners to withdraw from the day-to-day management of the company, and hand over executive responsibilities to professional managers. A special trigger of governance change may be the decision to nominate the first independent non-executive director on the board.
- Expansion of the shareholder base by attracting additional internal (family, group) shareholders. This may trigger important challenges for the sole owner (for example, the founder).
- Change in the capital and shareholding structure, due to a desire to attract external financing. This will involve dilution in the ownership concentration of existing owners, and the entry into the company ownership of external shareholders.
- Increasing complexity in the firm's business portfolio, its business environment, and its risk profile.

The ecoDa principles of best practice presented in the next section of this briefing are **voluntary** recommendations, leaving the companies the freedom to decide on the way in which they should be implemented in practice.

Companies have the latitude to decide on the pace and depth of their governance implementation process.

The ecoDa principles do not stipulate any form of obligatory implementation or an application of the comply-or-explain principle.⁷ According to the OECD,⁸ an excessively formal approach in the case of unlisted companies would have adverse implications for costs and flexibility. Consequently the principles should not be viewed as a corporate governance code, but rather as a set of proposals aimed at increasing the professionalism and effectiveness of unlisted companies.

Once a choice is made regarding an appropriate governance framework, it should be implemented with a high level of discipline and consistency. The credibility of the firm in the eyes of its various shareholders and stakeholders (for example, employees, creditors, suppliers, customers) will be affected by the manner of its implementation. Furthermore, good governance requires more than the implementation of formal rules and processes. Equally important is the right governance attitude, which applies the spirit of key governance principles throughout the organisation. If a new corporate governance framework is perceived to be just window dressing, it will deliver few of the potential benefits of good corporate governance.

Although there may not necessarily be a legal obligation to do so, the company should consider how to communicate their governance framework through some kind of corporate governance statement in their annual report or on a website. This will help to build trust and legitimacy amongst stakeholders. Within this statement, boards should aim to explain in their own words how they have implemented the ecoDa Principles in their governance practices.

7. The comply-or-explain principle underpins the application of most European codes of governance for listed companies. According to this principle, a company must either comply with the principles of the code or explain its reason for not complying in its annual report.

8. OECD (2006), p.14.



**Part II - Principles of
corporate governance for
unlisted companies in
Europe**

The ecoDa governance principles – a phased approach

Reflecting the diversity of unlisted companies, fourteen governance principles are presented on the basis of a dynamic stepwise process. This phased **approach** takes into account the specific nature of a company in terms of size, complexity, and maturity. Two categories of corporate governance principles are proposed.

Phase 1 principles (principles 1-9) **apply to all kinds of unlisted companies**, regardless of size or level of complexity. Such principles are viewed as broadly universal in their application, and do not necessarily require the creation of bureaucratic or costly governance procedures. They represent a core framework of basic governance principles that can be implemented in some form by all unlisted companies.

It should be recognised, however, that even the application of the first phase principles will probably necessitate a **stepwise approach**, taking into account the resources available to the company, the stage of its development and the need for owner-managers in particular to be comfortable with the changes being made and convinced that they are in the best long-term interest of the company.

Phase 2 principles (principles 10-14) **are more sophisticated corporate governance measures that are relevant to larger or more complex unlisted companies, or enterprises with significant external financing.**

They should also be considered by unlisted companies that are seeking to prepare themselves for a future public listing.

The most important of the phase 2 principles is the decision to invite **independent directors** onto the board. This is a landmark event in the evolution of an unlisted company. It normally signals an irreversible step towards good governance and is likely to exert an immediate effect over the culture of boardroom behaviour.

The implementation of phase 2 principles is likely to increase the formality of governance arrangements. However, this is invariably a necessary step in larger or more complex enterprises in order to provide the necessary reassurance to owners or external creditors regarding the longer-term sustainability of the enterprise.

In short, the **ecoDa principles offer a phased approach to corporate governance**, both in terms of the way in which individual principles are implemented and in the transition from the phase 1 to the phase 2 principles. This provides a governance roadmap for family owners or founder-entrepreneurs as they plan the development of their companies over the corporate life cycle.

After a statement of each of the governance principles, a number of key points are listed.

The application of these points is likely to underpin the implementation of each governance principle. This is followed by a discussion of the practical issues that are likely to be of interest to unlisted companies of differing sizes and levels of complexity in addressing each of the ecoDa principles.

It must be stressed that the objective of the ecoDa principles is to provide insight for unlisted companies in the design of a governance framework. They are not intended to be a straitjacket. Unlisted companies should exercise common sense in their implementation, and ensure that their response is both proportionate and tailored to the specific needs of their organisation.

In order to provide assist companies, ecoDa developed a Corporate Governance self-evaluation questionnaire that boards or companies can use to assess the extent to which they are already applying the principles and identify whether there are areas in which they might want to consider taking action to strengthen their governance framework. This questionnaire can be found in the Appendix.

Phase I principles – applicable to all unlisted companies

Principle 1: Shareholders should establish an appropriate constitutional and governance framework for the company.

Key Points

- Shareholders should establish a basic framework of corporate governance through the company's constitutional documents (for example, the articles of association or bylaws).
- There should be a formal schedule which states which matters are specifically reserved for the shareholders' decision and which are to be delegated to the board (see principle 2).
- However, shareholders should minimise the extent to which the articles constrain the ability of the board to shape the detailed governance framework.

Practical considerations for unlisted companies

The company's constitutional documents define the “rules of the game” with respect to many aspects of a company's corporate and internal governance. They can be used to establish company rules relating to matters such as the issuance of shares, the different voting and dividend rights attached to different classes of shares, restrictions on the transfer of shares, the powers, role and conduct of board and shareholder meetings, and the appointment and remuneration of directors (see also principle 2).

The articles essentially represent a contract between the company and its shareholders. They bind the way in which directors can subsequently exercise power over the company. A director that ignores the constraints defined by the articles is at risk of acting *ultra vires* (“beyond powers”) and may be subject to legal sanction.

The detailed content of company articles is often given little attention by owner-managers in the early stages of a company. In many instances, company founders rely on so-called “model” or default articles that are made available by public authorities or legal advisers.

However, prior to further development of corporate governance, it is important for shareholders to consider if the existing constitutional framework is in the long-term interests of the company and adapted to its specific needs.

In particular, shareholders should avoid embedding too much detail on governance procedures in the articles of association. The articles are an inflexible means of establishing a governance framework. In many European jurisdictions, they can only be changed via a special resolution of shareholders. Consequently, they impose severe constraints on the ability of the board of directors to tailor the governance framework to the changing needs of the company, and also take account of the interests of other stakeholders.

Shareholders should recognise that the board is the primary decision-making body of the company. This role should not be undermined by an excessively prescriptive approach to governance in the articles of association.

However, in some unlisted companies, there may be governance issues which are of significant personal concern to the founding-entrepreneur or existing shareholders, for example, concerning the transferability of shares or succession issue procedures. A constitutional framework which safeguards the interests of the shareholders in these areas is likely to be an important prerequisite for further development of the governance framework.

Investors in unlisted companies take – in many respects – a bigger investment risk than investors in listed enterprises. The illiquidity of their shareholdings may require them to commit to the company for a relatively long period of time. A constitutional framework that protects their long-term interests is likely to be an important determinant of their willingness to invest in the company.

Shareholders may also wish to ensure that their specific interests are guaranteed in relation to the interests of other shareholders. Equity owners may have diverging aspirations for the company. In a relatively widely-held family company, for example, it is almost inevitable that such differing objectives will come into conflict at some point.

The constitutional framework offers a way of defining relationships and conflict-resolution procedures between shareholders. This will help to ensure stability over the longer term.

In contrast to the articles of association, shareholder agreements are contractual agreements between shareholders of the company. In some jurisdictions, shareholder agreements may be seen as a more flexible and effective means of safeguarding shareholder rights than the company's articles of association. A shareholder agreement may even be used to set expectations about the degree of profit that will be distributed and the amount to be re-invested into the business. In some cases it may specify dispute resolution mechanisms.

However, unlike the articles – which are publicly accessible documents – shareholder agreements lack transparency (they are confidential agreements between private parties), and there may exist uncertainty over their enforceability. Consequently, over time, shareholders should seek to move away from shareholder agreements as a means of safeguarding their essential interests.

When undertaking changes to articles of association or shareholder agreements, shareholders should seek the guidance of qualified legal counsel in order to ensure that any proposed changes are in accordance with locally-applicable company law.

Principle 2: Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of corporate purpose and strategy. However, an interim step on the road to an effective and independent board may be the creation of an advisory board.

Key Points

- The board's role is to take legal responsibility for the company, and ensure its effective leadership.
- As an intermediate step on the road to an effective main board, small unlisted companies may consider the establishment of an advisory board, without formal decision-making responsibilities or liabilities.
- All board members must take decisions objectively in the interest of the company, and also with regard to their impact on wider society. As the company develops, inviting an independent director onto the board can help in focusing the board on the corporate interest and on the wider social impact.
- The board should appoint a Chair. The Chair is responsible for coordinating the activities of the board, ensuring its effectiveness on all aspects of its role and setting its agenda.
- The board should appoint a CEO or managing director to lead the management team, and exercise executive authority over the operation of the company.
- The board should set the company's purpose and strategic objectives, and ensure that the necessary financial and human resources are in place for the company to meet its objectives on a sustainable basis.
- The board should be involved in the strategic development process and – as a minimum – approve the strategy, and ensure that it lies within the framework of shareholders' and stakeholders' expectations.
- The board is responsible for monitoring and evaluating management performance.
- The board should set the company's values and culture, and ensure that its obligations to its shareholders, other stakeholders and wider society are understood and met. An ongoing "dialogue" with shareholders and stakeholders should be established.
- The board should report to shareholders periodically and at least annually. It is also recommended that the company should report on how it has fulfilled stakeholders' expectations and interests.

- It is the responsibility of the board to ensure that the company complies with its articles of association as well as relevant legal, regulatory, and governance requirements.
- There should be a formal schedule of matters which states which matters are specifically reserved for the board's decision and which are to be delegated to management.
- Where board members have concerns which cannot be resolved about the running of the company or a proposed board decision, they should ensure that their concerns are recorded in the board minutes.

Practical considerations for unlisted companies

In many smaller unlisted companies, the distinction between the members of the governance tripod of board, management, and shareholders is often unclear. An owner-manager may fulfil all or several of these roles simultaneously.

Nonetheless, it is important to recognise the unique role that the board plays in the leadership of the company. It has overall responsibility for the company's activities.

At an early stage of a company's development, it may be appropriate to operate many aspects of the board's activities in a relatively informal and non-bureaucratic manner.

An interim step on the road to a more independent board could be the creation of an advisory board. In contrast to the main board, such a body would lie outside the formal governance structure of the firm. As a result, the decision-making powers and liabilities of the owner-manager or controlling family on the main board remain undiluted. This option is particularly useful if the owner is not yet willing to cede power or if the relationship between shareholders is fragile.

Advisory boards can be useful, for example by enabling the company to benefit from its members expertise and business contacts (see principle 3). They can also be a way to assess a potential director's performance before inviting them to join the board.

However, they have some shortcomings. Advisory boards cannot exercise proper monitoring and oversight over the company and have no right to obtain information and cannot exercise significant influence over company strategy. In addition, advisory board members cannot be held legally liable for the firm's activities (except in those cases in which it can be proved to be acting as a "shadow director" of the company). In the long run, having both a board and an advisory board is usually not a stable solution.

Consequently, the formalisation of board and governance processes should increase in tandem with the size and complexity of the company, and the extent of its reliance on external sources of finance.

As the company develops further, external and independent directors can play a crucial role on the route to a professional governance framework.

Introducing independent directors is a key step in the development of unlisted company governance (see also principle 11). The decision to invite external independent directors onto the board forms part of a professionalisation process. Its potential effect on boardroom behaviour and culture should not be underestimated.

At a relatively early stage, written statements should be developed to help the board clarify the company's purpose and strategy, and ensure that all concerned parties understand what is expected of them.

A statement of the company's purpose and strategy – supported by a business plan prepared by the management and approved by the board – is a basic necessity. Over time, the board should also seek to develop a company manual that documents all company policies and procedures, for example, in relation to health and safety policy, legal and regulatory obligations, staff and procurement policies, etc.

Board statements should define the board's responsibilities, reserved matters and delegated authorities. However, given its positioning as an intermediate corporate organ between shareholders and management, the decisions reserved for the board are often defined in a "residual" manner, i.e. the boards reserved powers exclude all rights and duties reserved to the shareholders (meeting) or delegated to management.

Within the framework set by the shareholders, the board defines its own areas of decision-making responsibility, and the decision-making responsibilities it wants to delegate to management. Although the detailed definition of those specific authorities will differ substantially between national jurisdictions and individual companies, some general frameworks can be depicted throughout Europe.

A schedule of matters reserved for shareholders (possibly at a shareholders' meeting), would typically include the following:

- Approval of the annual accounts;
- Deciding on the dividend;
- Approval of particularly significant sale/purchase transactions;
- Approval of changes to the articles of association/bylaws and/or changes to capital structure;
- Appointment, remuneration, and dismissal of board members;
- If there is an audit requirement, decisions relating to the external auditor appointment.

A schedule of matters potentially reserved for the board would typically include the following:

- Definition of corporate purpose, strategy, culture, values and structure;
- Responding to shareholders and key stakeholders;
- Supervising and controlling company progress;
- Supervising the CEO or managing director;
- Approval of corporate plans;
- Approval of operating and capital budgets;

- Approval of major corporate actions (for example, acquisitions, disposals, commencing or terminating of business activities);
- Approval of financial statements;
- Approval of borrowings or creditor guarantees (possibly above a certain amount);
- Policy on external communications, for example, with regulators, shareholders, or the media;
- Definition of authorities delegated to management;
- Nomination and dismissal of the CEO or managing director, and decisions relating to his/her remuneration (possibly also of other top management, in consultation with the CEO or managing director).

A schedule of powers delegated to the CEO or managing director and management is likely to cover the following areas:

- Preparing strategic proposals, corporate plans, and budgets;
- Executing the strategy agreed upon by the board of directors;
- Delivering the culture and values determined by the board;
- Executing on transactions in relation to board decisions on investments, mergers, and acquisitions, etc;
- Opening bank accounts and authorising financial payments;
- Signing of contracts;
- Signing of regulatory documents;
- Powers of attorney;
- External communication;
- Staff recruitment and remuneration;
- Establishing a system of internal control and risk management;
- Health and safety operations.

It is best practice to summarise such a schedule of delegation in a delegation policy document, a Board Charter, or an internal governance code, specifying the limits for each of the delegated matters.

The balance between matters reserved for the board and matters delegated to management should be kept under regular review, particularly in a rapidly growing or troubled company.

Owner-managers need to work at developing an effective approach to delegation, and learn to spread decision-making powers to other directors and managers.

Boards should maintain a compliance schedule, which shows when various financial, legal, and regulatory requirements must be completed, and who is responsible for dealing with each item. Such a schedule is likely to include:

- Obligations relating to the preparation and filing of financial statements;
- Tax compliance;
- Banking facilities and covenants;
- Health and safety compliance;
- Insurance;
- Anti-bribery and anti-money laundering compliance

Small unlisted companies may wish to appoint an external party, for example, a lawyer, accountant, or provider of company secretarial services, to ensure that the board fulfils its statutory obligations. In addition, it may be prudent to grant power of attorney to an external adviser to act when directors are unavailable or in an emergency.

As the company expands, it may be appropriate to appoint an in-house board secretary to fulfil these requirements.

As unlisted companies grow, their boards could consider the need to set up **board committees**. We recommend in phase II (principle 12) potential committees that can be set up.

It should always be remembered, however, that the ultimate responsibility for fulfilling the company's regulatory obligations lies with the board as a whole. Board Committees exist to advise not to decide.

A key responsibility of the board is to promote high standards of professional and ethical conduct amongst employees.

As the number of employees expands, the standards expected should be summarised in a code of business conduct. This should be discussed with employees during induction and training periods. It also acts as a benchmark for evaluation during disciplinary proceedings.

The internal code could state the company's expectations with respect to:

- Compliance with laws and regulations;
- Standards of customer service;
- Processes to manage conflicts of interest and related party transactions;
- Gifts or preferential treatment in respect of suppliers, customers, etc;
- The need for integrity and ethical business practice;
- Company obligations to the general well-being of the community;
- Support for employee personal development;
- Diversity targets and expectations
- Sustainability of company activities.

Principle 3: The size and composition of the board should reflect the scale and complexity of the company's activities, and take into account an appropriate level of diversity in its composition

Key Points

- The board should not be so large as to be unwieldy. The balance of skills and experience should be appropriate for the requirements of the business. Changes to the board's composition should be manageable without undue disruption.
- There should be an explicit procedure for the appointment of new board members to the board. Appointments to the board should be made after a board evaluation and careful examination against professional objective criteria – including the need for the board to achieve sufficient skills and diversity.
- The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management. The aim is to maintain an appropriate balance of skills and experience within the company and on the board, and also to make full use of the talent available amongst candidates from diverse and under-represented backgrounds.
- The period of appointment of directors should be carefully considered. The board should balance the flexibility of open-ended appointments against the need to ensure planned and progressive refreshing of the board.

Practical considerations for unlisted companies

During the early years of the company's existence, owner-managers may be uncomfortable about inviting outsiders onto the board. They may not yet be ready to share sensitive company information and decision-making powers with external persons. Hence the board often consists of owner-managers' colleagues, family members, or close friends.

As the company grows, more focus will be placed on the board, which is the key decision-making body of the company. As the success of the company will depend more and more on the board, it is in the owner-manager's interest to get the best possible people onto the board.

It should also be remembered that board structures of companies differ in Europe. Although shareholders typically have the right to nominate persons to the firm's governing body, that body has different names according to the type of board structure in place.

In a **one-tier board structure, there is only one board**, which is referred to as the board of directors. Such boards have non-executive directors (some of which may be independent), and may also include one or more (and in some countries even a majority of) executive directors who also have management responsibilities.

In a **two-tier structure, there are two boards**. The upper decision-making body is only composed of non-executive directors and is referred to as the supervisory board.

This oversees the management board, which is composed only of executives with management responsibilities.

Whichever structure is used, board composition is vitally important and should be addressed seriously. The company's future may require a variety of expertise on the board including marketing, sustainability, technology, finance, production, legal, human resources, international trade, mergers & acquisitions, etc.

Regardless of nationally-defined structures, the ability of any form of committee to make decisions and exercise proper scrutiny becomes increasingly difficult at sizes in excess of 10-12 members.

A smaller board size will improve the quality of communication and is likely to result in more focused discussions. They will also make board meetings easier to organise.

During the early years of the company's existence, owner-managers may be uncomfortable about inviting outsiders onto the board. They may not yet be ready to share sensitive company information and decision-making powers with external persons.

However, this may result in the board lacking expertise and diversity in a number of key strategic areas. As a result, it may make sense to create an additional advisory board, which can fill the expertise gaps in these areas (see principle 2).

However, an advisory board should only be regarded as an **interim step**. Over time, non-executives should be added to the main board. Providers of external finance are also likely to insist on non-executive directors joining the board (see principle 12).

In an owner-managed company, it is likely that a single person will initially fulfil the roles of both Chair and CEO or managing director. A separate independent Chair may not be commercially justifiable. However, the person holding both roles should remember that the responsibilities of Chair and CEO or managing director are distinct, and should be viewed separately.

Succession planning is a particularly important issue in owner-managed companies. The owner needs to consider if the ultimate objective is to pass on the business to younger family members or to seek an exit from the business through a public listing or trade sale. Answers to these questions will influence decisions regarding the appropriate composition of the board.

Boards should comprise people with different perspectives, backgrounds, and experience. External stakeholders are likely to pay particular attention to the gender diversity and, increasingly, the ethnic diversity of Boards as an observable indicator of underlying governance orientation. Board renewal is important to ensure a flow of new ideas.

Service on too many boards can interfere with the performance of board members. Companies should consider whether multiple board memberships by the same person are compatible with effective board performance.

It is important that members of the board enjoy legitimacy and confidence in the eyes of shareholders and stakeholders. Extra services to the company, undertaken on behalf of the board – and the associated remuneration – should be disclosed and justified to both of these groups.

Principle 4: The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information.

Key Points

- Consideration should be given to the appropriate organisation of board meetings – including its location and the appropriate use of technology.
- The Chair is responsible for ensuring that board members receive accurate, timely, and clear information.
- Management has an obligation to provide such information. However, board members should seek clarification or amplification from management where necessary. The board should establish explicit procedures which allow the board to approach management and, where appropriate, external expertise for further information.
- The board should ensure that board members – especially non-executive board members – have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as board members.

Practical considerations for unlisted companies

Given the specific leadership role of the board, it is important to distinguish board meetings from management meetings, even in owner-managed enterprises.

Too many board meetings may result in the board becoming too operational. On the other hand, too few meetings may pose problems for the fulfilment of the board's duties. Therefore sufficient attention should be given to the appropriate number of board meetings.

Companies will typically have four to eight board meetings per annum, possibly including a full-day strategic board meeting. However, the exact number of meetings required by the board to fulfil its responsibilities will depend on the specific needs of the company.

Many boards make use of video-conferencing platforms for at least some of their board meetings. Boards should evaluate the appropriate balance between physical and virtual meetings, and how this affects the frequency, format and quality of board discussions.

Board meeting dates should be “fixed in stone” as far as possible.

Frequent date changes can lead to poor attendance by non-executive directors. In addition to the regular cycle of board meetings, meetings can be organised at short notice if required by company circumstances.

The Chair should ensure that board meetings are run efficiently and should consider developing board guidelines with respect to meeting procedures and agenda-setting – both with regard to physical and virtual board meetings. A typical structure for board meetings is as follows:

- An agenda should be prepared under the leadership of the Chair, following discussions with the CEO or managing director and other board members.
- The agenda and supporting papers (if any) should be circulated in advance of the meeting, allowing directors sufficient time to prepare. Some form of online board portal could be used as a secure platform through which to provide board members with digital access to company and board information.
- Written minutes of board meetings should be taken. All decisions should be recorded (including dissenting opinions) and justified, along with assigned tasks and timescales. The minutes should also give an overview of the main topics discussed at the meeting.
- Board meetings should monitor progress against approved corporate purpose, strategic plans and budgets, and ensure full coverage of matters reserved for the board.
- An annual board task mapping can help to focus board time on main board functions across the year.

As well as promoting better decision-making, a track record of properly documented board meetings is an important indicator of professionalism. Furthermore it is an important legal safeguard for board members, and may assist smaller companies in obtaining external financing at a later stage.

Board members require relevant information on a timely basis in order to support their decision-making. However, a principal concern of many boards is not to increase the quantity of the information that they receive. Rather, it is to increase the quality. Information needs to be summarised and formatted in a manner that makes it accessible and useful for board members.

It is the board's responsibility to decide what information it wants.

However, an informational tool that is widely used by boards is the “balanced scorecard”.

This goes beyond financial measures of performance, and also tracks success according to a range of quantitative and qualitative criteria. It may include measures of customer satisfaction, indicators of training and professional development amongst employees, and qualitative indicators of progress on business processes, for example, major projects, compliance with health and safety standards or achievement of sustainability goals.

Board members may wish to supplement the information they receive from management with information from other channels, such as departmental visits, with or without the CEO or managing director present, and reports prepared by external think-tanks, academics, or regulatory bodies. However, the search for additional information should be undertaken after consultation with the Chair and the CEO or managing director

Principle 5: Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executive board members of the quality required to run the company successfully.

Key Points

- A clear distinction must be made between the remuneration of executives and non-executive board members (where relevant). The former are full-time employees of the company, and are responsible for its operational activities. In contrast, non-executives are “office holders” rather than company employees, and dedicate their time to the company on a part-time basis. Remuneration structure should reflect these differing roles.
- Members of the board are typically accountable to shareholders for their remuneration. However, they may also find it prudent to be able to justify their compensation to other stakeholders, for example, employees and the media. In practice, many boards will themselves define and propose to the shareholders’ meeting any change in their annual remuneration.
- Levels of remuneration for non-executive board members should reflect the time commitment and responsibilities of the role.
- Caution should be exercised when linking non-executive remuneration to company performance. Indeed, in certain European jurisdictions, this may be ruled out by regulatory requirements.
- The board should develop a formal executive remuneration policy and a transparent procedure for implementing the policy, for example, in terms of fixing the remuneration packages of individual executives.
- No one should be involved in deciding on his or her own remuneration.
- Boards should compare the remuneration of their executives and non-executives with that of other relevant companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.
- Boards should be sensitive to pay and employment conditions elsewhere in the company, especially when determining annual salary increases. They should also monitor and avoid any pay discrepancies between board members of differing gender, age, or ethnic backgrounds or for any reasons other than their responsibilities and performance.
- A significant proportion of executive remuneration should be structured so as to link rewards to corporate and individual performance. They should be designed to align their interests with those of shareholders, other key stakeholders and wider society (including achieving corporate goals with respect to key societal issues such as climate change), and give these executives incentives to perform at the highest levels towards the goal of sustainable business success.

- The board should consider the financial implications of early termination of executives' terms of office. In addition, careful thought should be given to notice or contract periods. The aim should be to avoid rewarding poor performance.

Practical considerations for unlisted companies

Although board remuneration is ultimately a matter for shareholders, initial responsibility over this area is often delegated to the board (through the firm's articles of association, although board decisions may still require approval from shareholders).

In contrast to executives, non-executives are normally remunerated on a fixed-fee basis. This is to ensure that non-executives retain an objective and independent perspective on the activities of the company. For this reason, share options would not normally form part of a non-executive's remuneration framework. Indeed, in some European jurisdictions, any form of performance-related pay for non-executives is prohibited by regulation.

Shareholders and boards may consider the rewarding of non-executives through stock. However, although stock ownership may increase the alignment of board members' interests with those of shareholders, the board should be aware that equity holdings may affect external perceptions of independence (see principle 11). The compatibility of stock-based remuneration with non-executive duties is ultimately a matter for shareholders.

Although care should be exercised in linking non-executive remuneration to performance, there should exist a relationship between compensation and the attention and effort required of the individual board members. Board members should receive higher remuneration for a greater time commitment, for example, arising from participation on board committees.

The board should ensure that executive remuneration (particularly that of the CEO or managing director) is reasonable and aligned with the performance of the company. The performance of the company should be measured not only in terms of the achievement of short-term financial targets, but also on the basis of a qualitative assessment of the extent to which a company is fulfilling its longer-term objectives and in terms of its impact on wider society.

In an increasing number of companies, boards develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include criteria that emphasise the longer-run interests of the organisation over short-term considerations.

For unlisted companies this external transparency may initially be a bridge too far, but open governance information can be a step on the road to a higher degree of professionalism and transparency (certainly for Phase II companies).

Good practice in executive remuneration is likely to consider the following elements in its design:

- A balance between fixed and variable pay, and the linkage of variable pay to pre-determined performance criteria (including financial and non-financial elements);

- Alignment of variable pay performance criteria with both shareholder and stakeholder interests;
- Deferral of some proportion of variable pay;
- In cases where shares are granted, a minimum vesting period. A requirement to retain some proportion of those shares until the conclusion of employment;
- The reclaim of variable pay paid on the basis of data which subsequently proves to be manifestly misstated (“clawback”);
- Any share ownership requirements or restrictions;
- A limit on severance pay, and non-payment of severance pay in case of poor performance.

It is important that both executive and non-executive compensation is as transparent and straightforward as possible. It is helpful to canvas what other similar companies pay to ensure that compensation is not out of line, and many boards turn to external experts for this information.

However, boards should exercise caution in their use of remuneration consultants or head-hunters in defining pay levels. In particular, they should pay attention to consultants’ potential conflicts of interest (for example, in advising both executives and non-executives from the same company). The board needs to develop its own pay philosophy, and should avoid just going along with the crowd.

Principle 6: The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard the company's assets and the long-term interests of stakeholders.

Key Points

- The board should attempt to identify the main risks facing the company. It should satisfy itself that all material risks are being appropriately managed.
- The board should establish formal and transparent arrangements for applying financial reporting and internal control principles, and for maintaining an appropriate relationship with the company's auditors.
- The board should periodically assess the need to establish a formal internal control and risk management function. Moreover, a periodic check on the effectiveness of the company's approach towards internal control is necessary. Such review should cover all material controls, including financial, operational and compliance controls, and risk-management systems.

Practical considerations for unlisted companies

Risk is an inherent part of being in business.

The elimination of risk is neither a realistic nor a desirable aim. However, risk needs to be managed. The company should not expose itself to risks that it does not understand or which are not relevant to the success of its business.

Although many risks can be anticipated and managed, material risks that are outside the company's control may arise suddenly and may not be planned for to any significant extent. In order to ensure that sufficient resilience exists to meet these challenges, it is important to maintain appropriate financial reserves and a prudently managed balance sheet.

In an owner-managed business, risk issues are likely to be addressed by the owner in a relatively informal manner. However, it is helpful to document potential risks where possible, for example, using a straightforward SWOT (strengths, weaknesses, opportunities, threats) framework or through risk mapping. This will help to focus decision-making and demonstrate that board members have approached risk management with the necessary care and diligence. Not only financial risks have to be taken into account but also operational, strategic and reputational risks.

It is useful for companies to develop a basic risk register, which is reviewed by the board on a regular basis. This will contain the following categories of information:

- A description of the main risks facing the company;
- The impact should this event actually occur;

- The probability of its occurrence;
- A summary of the planned response should the event occur;
- A summary of risk mitigation (the actions that can be taken in advance to reduce the probability and/or impact of the event).

Board members of smaller unlisted companies should approach professional advisers to gain input on how to establish appropriate internal control processes. As the company grows in size and complexity, it will be necessary to move towards a more professional system of internal control. Strong financial controls will become a significant requirement if the company wishes to obtain external sources of finance.

Notwithstanding the development of more sophisticated internal controls, the CEO or managing director should always view him/herself as the de facto chief risk officer, and seek to encourage an appropriate sense of risk consciousness at all levels of the company.

In larger companies, risk management may become a particular focus of a boardroom audit committee or an internal audit department. However, even when many aspects of risk management are delegated to specific individuals or corporate bodies, it is important that the board as a whole retains ownership of risk supervision.

All members of the board should have a feeling for the main business risks. Furthermore, the board should establish ways of monitoring the development of these risks and seek reassurance that such risks are being managed in an appropriate manner by the management team.

A company manual should be available to all employees, and should outline policies and procedures relating to the specific risks to which the company is exposed. For example, policies should be developed with regard to:

- Anti-fraud;
- Anti money-laundering;
- Cash management;
- Cyber-security;
- Data protection;
- Monitoring of banking covenants;
- Business continuity;
- Data security and reliability;
- Regulatory compliance;
- Health and safety compliance.

Procedures which are likely to support an effective internal control environment are likely to include:

- Authorisation limits;
- Segregation of duties;
- Accounting reconciliations and monitoring of cash flow;
- Suitable qualifications and training;
- Regular testing and patching of IT protection systems;
- Budgetary controls;

- Controls over funds, expenditure, and access to bank accounts;
- Security of premises and control over assets.

In fulfilling its control and oversight responsibilities, it is important for the board to encourage the reporting of unethical/unlawful behaviour by employees. The existence of a company code of ethics should aid this process and should be underpinned by legal protection for the individuals concerned.

Principle 7: There should be a dialogue between the board, shareholders and other key stakeholders based on a mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders and stakeholders takes place. The board should not forget that all shareholders have to be treated equally, and that each category of relevant stakeholders should be treated appropriately.

Key Points

- The board should keep in touch with shareholder and stakeholder opinion in whatever ways are most practical and efficient.
- The Chair has particular responsibility for the effectiveness of communication between shareholders, stakeholders and the board, and should discuss corporate governance and strategy with shareholders and with key stakeholder groups.
- The Chair is the primary means of ensuring that the views of shareholders and stakeholders are communicated to the board as a whole. However, other board members should also be offered the opportunity of attending meetings with shareholders and stakeholders.
- A key role of the Chair is to set the agenda of the Annual (and extraordinary) Meetings.
- The relationship with shareholders and stakeholders should be viewed as a continuous process and not limited to an annual formal meeting.

Practical considerations for unlisted companies

Shareholders of unlisted companies may particularly value a close dialogue with boards due to the illiquidity of their shareholdings.

In contrast to listed companies, they are less able to express their views on a company's strategy and risk profile through the buying and selling of their shares.

Engagement and communication with boards allows them to ensure that the company is moving in a direction that is consistent with their interests (particularly with regard to the risk/reward profile of the company's strategy). It is, therefore, a key way in which they may seek to manage the higher liquidity risk of their equity ownership stakes.

In contrast to listed companies, some national legal frameworks may not require unlisted companies to hold an Annual General Meeting (AGM).

Nonetheless, companies may find that an AGM is a useful way to structure a dialogue with shareholders that are not involved in the management of the company.

It is also likely to be a useful means of developing board-shareholder dialogue in cases where the shareholders are a relatively large and heterogeneous group.

An AGM provides a well-established mechanism in which to review the activities and performance of the past year, and to discuss the future prospects of the company.

However, in certain cases, shareholders may require a much more frequent and ongoing dialogue with the board. Alternatively, the main shareholders may still be actively involved in the company as managers and/or directors.

Ultimately, board-shareholder dialogue and engagement should be structured to suit the particular circumstances of each company.

Boards should give particular thought to how they communicate the company's strategy and risk profile to shareholders. This should be done in a way that is both understandable and meaningful.

Furthermore, it should be undertaken in a spirit that recognises that a key duty of the board is to ensure that the activities of the company remain fully aligned with the interests of shareholders.

Boards should recognise the importance of mapping the importance of other stakeholder groups, and establishing an appropriate engagement strategy for each of them. Developing an understanding of stakeholders' opinions, concerns and perspectives can help the board to arrive at a more comprehensive understanding of its activities.

Board members should monitor on an ongoing basis how this stakeholder engagement strategy is being implemented. They should also seek to establish direct lines of communication with relevant stakeholders so as to better understand their perspectives.

Principle 8: All board members should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

Key Points

- The rigour and formality of the induction should reflect the size and complexity of the enterprise.
- The Chair should ensure that board members continually update their skills, and obtain the knowledge and familiarity with the company required to fulfil their role.
- The Chair should encourage board members to engage in professional training or a board member certification process that specifically enhances their functioning as board members. In certain European countries, there may exist Chartered or certified director qualifications or diplomas that are relevant to this process.

Practical considerations for unlisted companies

Board member orientation is an essential means of providing non-executives with the informational building blocks they need to effectively engage in strategic reflection and oversight. It is also important for senior executives, who may come from a functional background and may not yet be used to exercising oversight across the company as a whole.

New board members may wish to request the opportunity to meet fellow board members in advance of the first board meeting. A request for orientation by a new board member sends a strong signal that he or she is serious about their role on the board.

In some European countries, it is possible for board members to increase their professionalism through the undertaking of Chartered or certified director programmes or diplomas. Such professional qualifications provide a framework within which to undertake continuing professional development. They also establish an ethical and conduct framework within which to hold board members to account.

In many countries the **Institute of Directors** can assist directors with their professional development and keeping their skills and knowledge refreshed and up to date.

In countries where such training is not readily available, business circles may promote alternative ways of developing the director-specific skills and expertise of their boards, for example, through collaboration between professional advisers, educational providers, board members and/or business associations.

Principle 9: Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationships between family governance and corporate governance.

Key Points

- The choice of family governance processes will depend on the size of the business, the number of family members, and the degree of involvement of family members in the business.
- A family constitution or protocol should outline the vision and objectives of the family for the business. It should define the roles of family governance bodies, and their relationship with the board of directors. It should also state key family policies, e.g. relating to family members' employment, transfer of shares, and CEO or managing director succession.
- Family governance bodies – such as a family assembly and a family council – provide family members with a forum in which to discuss the affairs of the family and the family business, and assist the development of a coordinated family approach.
- A clear distinction in governance status must be made between family institutions and the formal governance structures of the company. The role of the board, shareholder meetings, etc, must be fully understood by family members.

Practical considerations for unlisted companies

Most family companies are unlisted enterprises. However, research shows that family businesses have a short lifespan beyond the generation of the founding-entrepreneur. Very few survive into the third generation of ownership. Family businesses can improve their odds of survival by setting the right governance structures in place and by starting the educational process of the subsequent generations as soon as possible.

Many founding-entrepreneurs or chairs of family companies find it difficult to differentiate their decision-making between family matters (continuity, valuation, liquidity, transmission, dividends, etc) and corporate matters (operation-related decisions).

When the company is still under the control of the founding entrepreneur, few family governance issues may be apparent. However, over time and several generations, the family is likely to increase in size and complexity.

Family members may develop different preferences for the business. For example, a decision to reinvest profits in the company instead of distributing them as dividends may be supported by an owner-manager but opposed by a retired family member who relies on dividends as a main source of income. There are a number of reasons why a corporation may choose to pass some of its earnings on as dividends, and several other reasons why it might prefer to reinvest all of its earnings back into the company.

A further problem for larger families is that members who work in the business have greater access to information than those not directly involved in the business.

In such circumstances, it becomes desirable to establish family governance structures that establish a level playing field for company information, promote discipline among family members, prevent potential conflicts, and ensure the continuity of the business.

Once such structures are created, it must be clear that **family governance should be distinct from business governance**, with each institution having its specific composition, duties, and matters to discuss and decide upon.

A family constitution outlines how this family governance structure should work. It clarifies the family's approach with respect to the following:

- The family's values, mission statement, and vision;
- The role of family institutions, such as the family assembly and the family council.
- The role of the board of directors, and its relationship to the family institutions.
- Policies regarding important family issues, such as employment policies with respect to family members, restrictions on transfers of shares, and succession policy with respect to the CEO or managing director.
- The nomination of the family members of the board.

A family assembly may meet once or twice per year, and brings together all members of the family. It allows family members to stay informed about the business and furnishes them with the opportunity to voice their opinions. It helps avoid potential conflicts that might arise due to an unequal access to information and other resources.

A family council is a small group of family members or family representatives that acts as the primary decision-making body of the family vis-à-vis the company. It is also the main communication link between the family and the company and has a crucial role in conveying the expectations of the family owners to the board. It is normally elected by the family assembly.

Family institutions can play a useful role in coordinating and unifying the interests of extended families. However, the most important step for ensuring the long-term survival of a family company is the establishment of a strong board with independent non-executive board members⁹(see principle 11).

Phase 2 principles – applicable to:

- Larger and/or more complex unlisted companies;
- Unlisted companies with significant external financing;
- Unlisted companies aspiring to a public listing.

Principle 10: There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's business. No one individual should have unrestricted powers of decision.

Key Points

- In larger companies with unitary boards, the roles of Chair and CEO or managing director should not be exercised by the same individual. The division of responsibilities between the Chair and CEO or managing director should be clearly established, set out in writing, and agreed by the board.
- Over time, companies should strive to nominate an independent Chair. However, as an interim measure, appointment of the exiting CEO or managing director (for example, the founding entrepreneur or pater familias) as Chair may be the most viable option.

Practical considerations for unlisted companies

Smaller unlisted companies may not have the resources to appoint a separate board Chair. However, the roles of Chair and CEO or managing director are fundamentally different. Consequently, once a company expands beyond a certain size and level of complexity, the board should give thought to splitting the two roles.

The Chair is pivotal to the operation of the board. He or she must coordinate the contributions of the non-executive directors to ensure that the executive team is subject to a sufficient degree of oversight. There is a danger that the fulfilment of this role will be compromised if the CEO or managing director is also fulfilling the role of chair.

It is sensible to explicitly clarify the Chair's role vis-à-vis the role of the CEO or managing director through a formal statement of responsibilities. This document should define what matters are reserved for the board and what matters are reserved for management.

As a general rule, the CEO or managing director leads the management team and runs the company while the Chair leads the board.

The statement of responsibilities should be reviewed periodically. Developing such a statement is a useful way of ensuring that everyone understands their role and is not stepping on anyone's toes, and that there are no surprises.

Once appointed, the Chair is required to walk a narrow line. He or she must be sufficiently informed, engaged, and able to intervene when required, but must avoid becoming too involved with the day-to-day business of the company. Board dysfunction is likely to result when the distinct roles of the CEO or managing director and Chair are not properly understood or respected.

Principle 11: Board structures vary according to national regulatory requirements and business norms. However, all boards should contain members with a sufficient mix of competencies and experiences. No single person or small group of individuals should dominate the board's decision-making.

Key Points

- Although there may be difference depending on the country, the board of larger companies should include a sufficient number of non-executive and independent board members.
- The largest unlisted enterprises – or unlisted enterprises working towards a public listing on a regulated market – should aim to add non-executives and preferably independent board members to boards until they represent a significant proportion of board seats (although the exact proportion will be a matter for the judgement of individual boards and shareholders).
- Care should be taken to ensure that non-executive or independent appointees have enough time available to devote to the job. This is particularly important in the case of Chairs. The letter of appointment should set out the expected time commitment. Non-executive or independent board members should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment and the board should be informed of subsequent changes.
- The Chair should facilitate the effective contribution of non-executive and independent board members and ensure “**constructive relations**” across the entire board.
- Non-executive and independent board members should constructively challenge and help develop proposals on strategy.
- Non-executives and independent board members should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
- Non-executive and independent board members should satisfy themselves on the integrity of financial information and make sure that financial controls and systems of risk management are robust and defensible (although their approval remains a collective responsibility).
- Non-executives and independent board members should assume primary responsibility for determining appropriate levels of remuneration of management, including senior managers. They should also play a leading role in appointing, and where necessary removing, executives, and in succession planning.
- The Chair may decide to hold meetings with the non-executives without the senior executives present.

- Non-executives or independent board members may be appointed for a specified term (for example, an initial mandate for three years, possibly renewable a couple of times). Decisions to extend terms of service should balance the need for company-specific experience (which may take time to acquire) and the benefits of a progressive refreshing of the board. It should also be recognised that serving for many years on a board may affect external perceptions of a non-executive director's independence.
- On resignation, a non-executive board member should provide a written statement to the Chair, for circulation to the board, if they have significant concerns about the running of the company.

Practical considerations for unlisted companies

Once a company reaches a certain size and level of complexity, an independent board, i.e. a board containing independent non-executive board members and not entirely composed of company or family insiders, becomes essential to the long-term success and survival of the company.

In countries with unitary board structures, the mix of executives and non-executives on the board will be a matter of judgement for the board. However, in a number of European jurisdictions, non-executive involvement on the main board – or on a supervisory board – will be determined by regulation or prevailing business norms.

Even for Phase I companies, the introduction of external board members who are not connected to the owners or management onto the board is a key event in the corporate governance development of an unlisted company.

However, once such companies become larger or have more complex shareholding structures, they should progressively rely more on non-executive and independent board members (eventually up to a majority of board seats for those interested in listing on the stock exchange). More diverse board composition – including with regard to gender and other personal characteristics - generates a significant impetus towards better governance and is likely to have significant impact on the culture of boardroom decision-making.

The key benefits of including independent non-executives on the board include the following:

- Bringing an outside perspective on strategy and control;
- Adding new skills and knowledge that may not be available within the firm;
- Bringing an independent and objective view from that of the owner;
- Making hiring and promotion decisions independent of family ties;
- Bringing an independent view whenever there may be conflicts of interest within the board;
- Acting as a balancing element between the different shareholders (for example, members of the family) and, in some cases, serving as objective judges of disagreement amongst family members or managers. Acting as a balancing element is particularly important when not all shareholders are represented at board level.

Board member independence is not a concept that can be precisely defined. However, factors which may be of relevance in establishing the perceived independence of a non-executive include the following:

- Has proven in character and judgement his/her independence in past business activities;
- Has not in recent years been an employee of the company;
- Has not a material business relationship with the company;
- Does not receive (additional) remuneration from the company during the period of appointment (apart from the director's fee);
- Does not have close family ties with any of the company's advisers, directors, or senior employees;
- Does not hold cross-directorships or have significant links with other directors through involvement in other companies or bodies;
- Does not represent a significant shareholder;
- Has not served on the board for an extended period.

However, these are only guidelines. Ultimately, it is a matter for the board to determine if the board member is independent in character and judgement, and whether there are relationships or circumstances which are likely to affect, or could appear to affect, his/her judgement.

For example, extended service on a board is sometimes thought to negatively impact board member independence. However, this will depend on the individual. A person who serves on a board for an extended period should still be considered independent if that board member possesses strength of character and is willing and able to challenge management, while providing value added on the base of in-depth knowledge of the company and its strategic challenges.

Non-executive board members may not typically have the same access to information as executives or the owner-manager. The contributions of non-executive board members can be enhanced by providing them with access to managers within the company - although such contacts should be coordinated with management, and non-executives should take care not to undermine the authority of the management.

In certain circumstances, non-executives may also be assisted by offering access to independent external advice at the expense of the company, although this generally is undertaken with the knowledge of the board as a whole, in order to avoid creating a confrontational atmosphere between executives and non-executive board members.

In smaller unlisted companies it may be tempting to seek the assistance of independent non-executives in undertaking management or staff functions. However, independent board members should not generally be involved in operational functions or take on a considerable consultancy role.

Independent board members need to retain a degree of distance from operational activities. Their specific role is to ensure that the management team is taking the correct steps and is using available resources in the most efficient manner. If independent board members do assume an additional consultancy role, it should receive explicit approval from the board.

The board should consider appointing a board secretary who reports to the Chair (via a joint report to the CEO or managing director) to ensure that board members receive information in a timely way without excessive reliance on management (even if this is not a formal legal requirement). A board with its own secretariat will generally be in a stronger position to demand information than a board whose secretary reports solely to the CEO or managing director.

However, such designated administrative support for non-executives is only likely to be commercially viable in relatively large unlisted companies.

Principle 12: The board should establish appropriate board committees in order to allow a more effective discharge of its duties.

Key Points

- A company's committee structure should be proportionate to the needs of the company. However, most large unlisted enterprises are likely to require a nomination committee, remuneration committee, and audit committee. Other committees may be established if required in particular circumstances.
- The board should define in writing the terms of reference of the various committees, explaining their role and the advisory authority delegated to them by the board. These terms of reference should be reviewed by the board on a periodic basis.
- Committees should be provided with sufficient resources to undertake their duties.
- Independent non-executives board members should play a significant role in boardroom committees.

Practical considerations for unlisted companies

A **nomination committee** can be established to lead the process for board appointments and make recommendations to the board. The role of the **nomination committee** is to evaluate the balance of skills, knowledge, experience and diversity on the **board**, as well as amongst **top management**.

In the light of this evaluation, it will prepare a description of the role and capabilities required for a particular board appointment, and propose a management succession plan.

A **remuneration committee** is granted delegated responsibility for proposing the remuneration of all executives, including pension rights. The committee should also define and monitor the level and structure of remuneration for senior management.

It may make sense initially to combine the responsibilities of the nomination and the remuneration committee into a single committee. Members of these committees should be non-executives.

The **audit committee** plays a particularly important role in the monitoring and oversight of larger companies. The main responsibilities of the audit committee include the following:

- To monitor the integrity of the financial statements of the company;
- To review the company's internal controls and risk management systems;
- To monitor and review the effectiveness of the company's internal audit function;

- To make recommendations to the board in relation to the appointment or removal of the external auditor;
- To approve the remuneration and terms of engagement of the external auditor;
- To review and monitor the external auditor's independence and effectiveness;
- To develop and implement policy on the engagement of the external auditor to supply non-audit services;
- To review the risk situation, and to monitor risk-management processes.

Given the relatively technical nature of the audit committee's activities, the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

In practice, this is likely to mean that this individual has an accountancy qualification, and has gained relevant financial experience, for example while working as an auditor or financial manager. The members of the audit committee should be non-executive, and preferably independent board members

Where there is no internal audit function, the audit committee should consider whether there is a need for an internal audit function and make recommendations to the board.

The audit committee should also review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters ("whistleblowing").

No one other than the committee Chair and members should be entitled to be present at a meeting of boardroom committees. However, others may regularly attend at the invitation of the committees.

Principle 13: The board should undertake a periodic appraisal of its own performance and that of each individual board member.

Key Points

- The rigour and formality of the appraisal techniques utilised by the board should reflect the size and complexity of the enterprise. Once again, a stepwise or phased approach is the best route ahead for smaller companies.
- The Chair should use the appraisal process to obtain feedback on the effectiveness of his or her management of the board.
- Group appraisal should examine how the board operates as a collective decision-making body.
- Individual appraisal should aim to show whether each board member continues to contribute effectively and to demonstrate commitment to the role (including commitment of time).
- The Chair should act on the results of the appraisal by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of board members.
- Special attention should also be paid to the assessment of the collaboration with the (executive) management.

Practical considerations for unlisted companies

The Chair is responsible for working with the board to ensure that it is a high-performing team composed of the right people. He or she occupies a crucial position with respect to board functioning. Board dysfunction will result if the Chair is not sufficiently focused on board dynamics and behaviour.

Chairs cannot improve their effectiveness without honest and constructive feedback. They must be open to input from the rest of the board in order to improve their performance.

There are many ways to undertake board appraisal, including self-evaluations, third-party facilitations, and peer reviews prior to re-election to the board. Board appraisal conducted by independent external assessors is likely to be more objective in its rigour than self-assessment, and should be favoured as the firm grows in size and complexity.

Board appraisals should be designed to elicit an honest discussion about what is going right and what is going wrong on the board. Some of the key questions that an appraisal should address include the following:

- Is the distribution of power in the boardroom appropriate?
- Is there sufficient challenge of executive management in board meetings?
- Does the board have the right levels of expertise and independence?

- Does the board correctly perform its duties? For example, are board members setting a clear purpose for the company, challenging and advising on strategy, and monitoring the company and its management?
- Do board members devote sufficient time and effort to the company and their boardroom role?
- Do board members have adequate access to information and advice?
- Does the board engage sufficiently with shareholders and key stakeholders?
- Are there personal factors that might inhibit individual board members from fulfilling their duties in an independent and objective manner?

There may be some resistance among board members to undertaking a formal evaluation. If that is the case, it might be appropriate for the first evaluation to focus mainly on board processes and support, such as the frequency and agenda of meetings and the quality of information and advice. Paying attention to these aspects can often result in major improvements and can also help to make board members more comfortable with the idea of evaluation before addressing more sensitive issues.

Evaluating individual board members is a very sensitive issue, given the fact that the board is a collegial body, composed of peers. Therefore caution will be necessary in order to avoid possible conflicts and frustrations. Here again, the Chair or an external adviser can be instrumental in bridging the gap between individual and confidential evaluations and a more global discussion of the board's effectiveness, remuneration, and composition.

Feedback to the board as a whole can be provided by the Chair or external facilitator. The Chair should also be able to provide individual directors with feedback as needed so as to encourage self-improvement. The Chair should coach individual directors by providing continuous feedback and assigning them to work with others to improve board dynamics and teamwork.

The board should also be responsible for evaluating the CEO or managing director. The Chair should drive the process. One approach for the Chair is to gather a self-assessment from the CEO or managing director and compare it with the confidential information gathered from the other directors and use this information in appraisal discussions with the CEO or managing director. It is important to integrate into such an appraisal a mutual evaluation of the collaboration between the board and the management.

A strong-minded independent Chair is in a good position to assess the performance of individual directors and that of the executive director or top manager.

However, a Chair that is too close to management will lack objectivity and credibility in fulfilling the assessment of management. This also holds for evaluating the performance of the role of Chair versus that of CEO or managing director. This highlights the need for the Chair to retain an independent profile relative to the CEO or managing director or otherwise appoint a senior independent director and/or involve an external facilitator to undertake such assessment.

Although a formal or externally administered boardroom appraisal process may only make sense for larger unlisted companies, all companies should recognise the importance of periodically evaluating the effectiveness of the board as a decision-making unit.

Principle 14: The board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders, and establish a suitable programme of stakeholder engagement.

Key Points

- The board should publish an annual report that is tailored to the needs of its shareholders and its other key stakeholders.

Practical considerations for unlisted companies

A strong disclosure regime that promotes transparency will be a pivotal feature of a company's relationship with stakeholders. Disclosure improves public understanding of the structure and activities of the company, its policies with respect to environmental and ethical standards, and its relationship with the communities in which it operates.

The annual report is an important means of communicating with stakeholders (as well as shareholders). Apart from the traditional financial reporting, which is mandatory for most companies in most jurisdictions, annual reports can include more information on the following corporate issues:

- A statement of the company's purpose and values.
- An outline of the company's business strategy and the likely risks associated with that strategy.
- A review of the company's activities and performance, and a forward-looking assessment of its business environment.
- A statement of its corporate governance principles and the extent to which it has complied with a specific corporate governance code, with additional governance information, such as:
 - a statement of how the board operates, including a high-level statement of which types of decisions are to be taken by the board and which are to be delegated to management;
 - the names of all the board members, including the Chair, the CEO or managing director, and the chairs and members of the nomination, audit and remuneration committees (if relevant);
 - the names of the non-executive board members whom the board determines to be independent, with reasons for that assessment where necessary;
 - details of how any appraisal of the board, its committees, and individual board members has been conducted.
- A summary of activities and projects of special relevance to stakeholders.

The content of the annual report will become more important as the company develops. It could be the case that, reaching a certain company size, more detailed reporting on **financial information** and **non-financial information** might be required.

Environmental and **climate** related topics and **Corporate Social Responsibility** and social impact projects can act as a major point of engagement with **stakeholders**. They should be integrated into the company's activities and included in management's list of strategic goals.

Direct communication between board members and employees can be an effective way of driving a message home across an organisation. They help to ensure that everyone is "singing from the same hymn book". In cases where such communication takes place on the initiative of individual board members, such contacts should be in line with a general "internal governance" policy developed by the board. If such policy is not yet developed, it is good practice to inform the Chair and CEO or managing director before taking any such steps.

However, in all such direct meetings with employees, the directors should emphasise that the CEO or managing director is ultimately in charge of the management of the company. Board members should ensure that they communicate confidence in the management team, and avoid discussing detailed management issues with employees to minimise the risk of mixed messages.

The board can facilitate communications by providing a contact person with whom stakeholders may discuss any issues. During times of change, it may be useful for the board to communicate regularly with stakeholders to explain what is happening at the company. For example, stakeholders of a company contemplating a major expansion or retrenchment – or merger with another company – may wish to meet with the board to discuss the proposed strategy for the new organisation.

Stakeholders – including individual employees and their representative bodies – should be able to freely communicate their concerns about illegal or unethical practices to the board.

Their rights should not be compromised for doing this. Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company in terms of reputation effects with an increasing risk of future financial liabilities. It is therefore to the advantage of the company to establish procedures and safe harbours for complaints by stakeholders.



Additional Resources

The Corporate Governance Code for Unlisted Companies (Slovenia). The Chamber of Commerce and Industry of Slovenia, The Ministry of Economic Development and Technology, The Slovenian Directors' Association, Ljubljana, May 2016.

Agenda for Improving the Corporate Governance of Unlisted Companies (Finland). Chamber of Commerce. April 2016.

The Swiss Guidelines on Corporate Governance for SMEs (Switzerland). Swiss IoD.

Code Buysse (Belgium).

SME Governance Guidebook. International Finance Corporation. 2019.

The Wates Corporate Governance Principles for Large Private Companies (UK). Financial Reporting Council, December 2018.

Principles of Good Corporate Governance for Unlisted Companies (Spain). Instituto de Consejeros-Administradores, July 2008.




APPENDIX: Corporate Governance self-evaluation questionnaire




ecoDa's Corporate Governance self-evaluation questionnaire for unlisted companies in Europe




- ecoDa's **Corporate Governance self-evaluation questionnaire** is a voluntary tool with which you can periodically measure your Corporate Governance performance.
- It is recommended that you utilize this tool at least once per year, ideally before the Annual General Meeting.
- It is recommended that, once completed, you agree the action points for the coming year.
- Even though it is a **voluntary exercise**, external perceptions of your governance will benefit if you share a summary of the results with shareholders and third parties/stakeholders.
- This self-evaluation questionnaire is a **tool** to help you periodically assess your governance level in relation to ecoDa's Corporate Governance Principles for unlisted companies in Europe.






ecoDa Corporate Governance self-evaluation questionnaire for unlisted companies in Europe		Achieved	Not achieved	Room for improvement/ Additional actions required
		✓	✓	✓
Phase 1 principles – applicable to ALL unlisted companies				
Principle 1	Shareholders should establish an appropriate constitutional and governance framework for the company.			
	Bylaws or similar documents are updated.			
	Matters reserved to shareholders decisions, and matters and fundamental responsibilities delegated to the board, are well defined.			
Principle 2	Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of corporate purpose and strategy. However, an interim step on the road to an effective and independent board may be the creation of an advisory board.			
	An effective board or advisory board has been set up.			
	The members of this board/advisory board understand their duties and responsibilities, including definition of corporate purpose and strategy, among others. Fundamental board responsibilities are clearly established: 1) Strategy definition and strategic decision-making; 2) Accountability to shareholders and stakeholders; 3) Supervision of risks performance, and sustainability; 4) Supervision of senior executives 5) Board management.			

ecoDa Corporate Governance self-evaluation questionnaire for unlisted companies in Europe		Achieved	Not achieved	Room for improvement/ Additional actions required
				
Principle 3	The size and composition of the board should reflect the scale and complexity of the company's activities, and take into account an appropriate level of diversity in its composition.			
	The board(s) reviews periodically their required diversity and composition according to the complexity of companies' activities and has assigned specific responsibilities to board members to support key tasks: Audit and Control, Nominations and Compensation.			
	An orderly succession plan for board members and senior managers is set up and regularly reviewed.			
Principle 4	The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information.			
	To review board matters, (not shareholders meetings or management meeting topics), board meeting dates are set up before new year's entrance, and the annual agenda of the board covers all key areas of board responsibility.			
	Chair and members of the board understand the need for an agenda, information and written minutes to monitor progress against strategy and plans. Budgets are set up regularly.			
Principle 5	Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executive board members of the quality required to run the company successfully.			
	Shareholders approve board member's remuneration and board approves senior executive's remuneration.			
	No one is involved in deciding his/her remuneration and executive remuneration levels have the composition and conditions to reward individual performance. Remuneration is based on previous evaluation.			
Principle 6	The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard the company's assets and the long-term interests of stakeholders.			
	The board understands and reviews periodically main risks and plans to mitigate them.			
	The board should maintain a system of internal control to safeguard company sustainability.			

ecoDa Corporate Governance self-evaluation questionnaire for unlisted companies in Europe		Achieved	Not achieved	Room for improvement/ Additional actions required
				
Principle 7	There should be a dialogue between the board, shareholders and other key stakeholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders and stakeholders takes place. The board should not forget that all shareholders have to be treated equally, and that each category of relevant stakeholders should be treated appropriately.			
	The board knows shareholders and stakeholders main objectives and a periodic dialogue is set up for mutual benefit. This dialogue is viewed as a continuous process.			
	The board understands its obligations to be accountable to shareholders and stakeholders and has established the appropriate communication procedures.			
Principle 8	All board members should receive induction on joining the board and should regularly update and refresh their skills and knowledge.			
	Board members regularly updated and refresh their skills and knowledge to meet their duties.			
	All board members received induction on joining the board.			
Principle 9	Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationships between family governance and corporate governance.			
	Company corporate governance should be based on professionalism and merit.			
	Family governance mechanisms should be set up to coordinate family interests and corporate governance.			
Phase 1 Summary	An executive self-questionnaire summary report is prepared for shareholders and stakeholders.			
	An action plan with responsibilities has been agreed to improve current corporate governance performance in phase I			

ecoDa Corporate Governance self-evaluation questionnaire for unlisted companies in Europe		Achieved	Not achieved	Room for improvement/ Additional actions required
				
Phase 2 principles – applicable to:				
* Larger and/or more complex unlisted companies				
* Unlisted companies with significant external financing				
* Unlisted companies aspiring to a public listing				
Principle 10	There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company’s business. No one individual should have unrestricted powers of decision.			
	Running the board and running the company operations are undertaken by different meetings with different persons. No one has all powers.			
	In large/complex companies the Chair of the board and the CEO or managing director should not be exercised by the same individual.			
Principle 11	Board structures vary according to national regulatory requirements and business norms. However, all boards should contain members with a sufficient mix of competencies and experiences. No single person or small group of individuals should dominate the board’s decision-making.			
	A board is a mix of skills and knowledge with a collective responsibility. This mix is evaluated when successions and appointments are undertaken.			
	Independent criteria, constructive relations and no group/individual domination are the key considerations in board decision making.			
Principle 12	The board should establish appropriate board committees in order to allow a more effective discharge of its duties.			
	The board has evaluated better ways to discharge its duties assigning functions to board individuals or board groups/committees.			
	Board groups/committees are made by non-executive board directors.			
Principle 13	The board should undertake a periodic appraisal of its own performance and that of each individual board member.			
	Periodic board evaluation of the board as a whole is done.			
	In addition, individual board member evaluation is planned or has been done.			

ecoDa Corporate Governance self-evaluation questionnaire for unlisted companies in Europe		Achieved	Not achieved	Room for improvement/ Additional actions required
				
Principle 14	The board should present a balanced and understandable assessment of the company's position and prospects for external stakeholders, and establish a suitable programme of stakeholder engagement.			
	Board presents an accuracy and understanding assessment of company performance, plans and activities for shareholders and stakeholders.			
	A suitable programme of stakeholder engagement is prepared.			
Phase 2 Summary	An executive self-questionnaire summary report is prepared for shareholders and stakeholders.			
	An action plan with responsibilities has been agreed to improve current corporate governance performance in phase I and II.			

More information

2010 Version

ecoDa's Corporate Governance self-evaluation
questionnaire for unlisted companies in Europe

Short version

Contacts

**ecoDa, The European Confederation of
Directors' Association**

Béatrice Richez-Baum,
Director General,
contact@ecoda.org,
Tel: 003222315811

Manon Roehrig
Junior Policy Advisor,
policy@ecoda.org
Tel: 0032493399370

Avenue des Arts 41
1040 Brussels

www.ecoda.org