

8th DFI Corporate Governance Group Meeting



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An Interactive Introduction to the EDFI CG Toolkit



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FMO

- **Mandatory requirements**
 - Business integrity assessment focusing on the reputation of board members
 - Structured CG section in final investment proposal (FP stage)
 - Early risk screening (CIP stage)
- **Core competency of investment staff, supported by**
 - Knowledge centers, CG Unit and tools
 - Champions / experienced users
- **Risk-return based pricing incentives**



What do we want to achieve by integrating CG in the investment process

- Increased (but still selective) identification of opportunities in which improved CG could add value to our clients.
- More structured risk analysis on corporate governance in the FP, analyzing
 - the board of directors;
 - the control environment;
 - transparency and disclosure;
 - minority shareholder rights;
 - the overall commitment of the company and issues of family involvement in case of a family-owned business.
- Higher emphasis on the risk related to
 - internal audit, internal controls, MIS, and risk management of a company; and
 - intra-group and related-party transactions.
- The (mostly optional) discussion of CG related risks at CIP stage with the CG Officer. Required only if
 - a direct equity stake is taken that provides FMO with a share of above 15% in the investee client; or
 - if there are at least four high CG risk areas.
- Better differentiation between matters of KYC and CG.
 - No references to KYC and/or corruption at CIP and FP stage.



A set of documents / tools,
representing practices,
developed over time,
to help investment teams,
assess the governance of investees...

...and to work with owners, boards,
management and other shareholders
to improve practices.



“Are these just guidelines, or are they actual new policies?”



FMO's processes and tools

Step	Finance Process Step	Tool	Output
1	Clearance in Principle	CIP Screening Tool	Involvement of CG Officer or decision to conduct CG Review
2	Appraisal / Due diligence	Progression Matrix Questionnaire	
3	Finance Proposal	Result Matrix	Corporate Governance section in FP
4	Documentation		Operational Documents Legal Agreements Corporate Governance Action Plan
5	Portfolio Management	Progression Matrix	SUSTRAK or alternative system



First Impressions (Clearance in Principle)

- Objectives:
 - To form an initial view on whether corporate governance poses a special *risk*
 - To identify: (1) whether a CG Officer should be consulted/involved during due diligence; or (2) whether a CG Review should be drafted for FP by the Investment team?
- Tools: **CIP Screening Tool**; deal experience (nose); and common sense



The rapid risk screening for FOEs - I

Oil Seed Crusher and Trader in Moldova

Corporate Governance (CG) Screening Tool for non-listed or family-owned corporates	Evaluate each category separately: >= four 'true' lead to a '1' two to three 'true' lead to a '2' <= one 'true' leads to a '3' each 'unknown' counts as 'true'.				'1' = high risk '2' = moderate risk '3' = low risk
Topic	UN-KNOWN	TRUE	FALSE	Not applicable	
Commitment to CG					
Information has been provided (by the auditor, the company or a third party) which indicates that the company does not follow legal and regulatory requirements with regards to CG.			x		2
The company has not assigned responsibility for CG internally (e.g., to a corporate secretary).		x			
There is likely resilience towards corporate governance improvement from the majority owners, the (supervisory) board, or senior management.			x		
The company is a family business in its second or in a later generation.			x		
There is employment of family members in senior management and/or other functions and neither family governance bodies such as a family council nor policies on family employment.		x			
Structure and Functioning of the Board of Directors					
The company has a (supervisory) board comprised of senior management only or no board at all.		x			1
There is no audit committee or it is again comprised of senior executives and/or family members.		x			
The (supervisory) board has directors who are owner representatives, family members or close to senior management.		x			
The (supervisory) board's role is not clearly distinct from senior management; or the board does not provide for oversight, strategic input and succession planning.		x			
The (supervisory) board meets less than four times a year; or alternatively, the board meets more than 12 times a year.			x		



The rapid risk screening for FOEs - II

Topic	UN-KNOWN	TRUE	FALSE	Not applicable	
Control Environment and Processes					
The company's key internal control processes are not documented in writing or have material flaws.		x			1
There is no independent function, such as internal audit, to ensure that key processes are followed.		x			
There is no Management Information System (MIS) in place.		x			
The independence and quality of external audits is insufficient, because it is engaged since many years, provides other services (except for tax advice) or does not issue management letters, etc..			x		
The (supervisory) board's oversight of internal controls, internal audit and risk management is weak.		x			
Transparency and Disclosure					
The financial statements are not audited by a reputable auditor (Big Four or second tier with a solid reputation).			x		3
The audit opinion has been qualified in the past, or there have been material restatements.			x		
The company employs unusual accounting principles or practices or has frequently changes its accounting standards during the last five years.			x		
The company does not appear to be approachable and responsive.			x		
The company does not provide basic forms of disclosure (e.g., through an annual report, quarterly financials, website, etc.).		x			
Rights of Minority Shareholders					
There is no information on the shareholding structure and the ultimate beneficial owners available.			x		2
There are pyramid structures, cross-holdings or other complex shareholding arrangements.	x				
Different share classes exist or differences between cash flow and voting rights exist.			x		
There are other important businesses of the majority owners or members of the (supervisory) board and do these present potential conflicts of interest.		x			
There is no independent approval and disclosure system on intra-group and related party transactions.		x			



FMO CG Review Process – Clearance in Principle stage

1a) Was a CG Officer Consulted on the Potential CG Risks of the Deal?

1b) Is a CG Officer to Be Involved During Due Diligence?

2.) Is CG Review to Be Drafted for FP by Investment team?

CG Sections in CIP		
1a.) Was a CG Officer Consulted on the Potential CG Risks of the Deal?		
	<input type="checkbox"/> YES	<input type="checkbox"/> NO
<p>The consultation needs to take place if</p> <ul style="list-style-type: none"> √ direct equity or mezzanine investment at or above 15% ownership, or √ at least four high risk indications. <p>In all other cases the involvement of a CG Officer at this stage is on a voluntary basis.</p>		
<p>If 'yes' under 1a.) then answer the question below; if 'no' under 1a.) go to 2.) directly:</p>		
1b.) Is a CG Officer to Be Involved During Due Diligence?		
	<input type="checkbox"/> YES	<input type="checkbox"/> NO
<p>Indicate 'yes' if</p> <ul style="list-style-type: none"> √ based on the consultation, the CG Officer decided to be part of the due diligence. <p>Indicate 'no' if</p> <ul style="list-style-type: none"> √ the CG Officer decided not to be part of the due diligence. 		
<p>If 'no' under 1a.) or 1b.) then answer the question below, otherwise no need to answer the below:</p>		
2.) Is a CG Review to Be Drafted for FP by Investment team?		
	<input type="checkbox"/> YES	<input type="checkbox"/> NO
<p>Indicate 'yes' if</p> <ul style="list-style-type: none"> √ direct equity or mezzanine investment, or √ loan amount is above 5% of the balance sheet of the client, or √ at least one high risk indication. <p>Indicate 'no' if</p> <ul style="list-style-type: none"> √ green-field or start-up project, or √ investment in fund, or √ if no 'yes' indication as above. 		

- Let's put the tool to test....



Maderero Sicilia – Governance Challenges for a Growing, Family-Controlled Corporate in Argentina



Corporate governance due diligence

- Objectives:
 - An informed analysis of the client company's governance
 - Component of investment decision (risk/mission/return)
 - Help the company understand strengths and weaknesses of its own governance in a structured way
 - Identify any need for further internal and external resources to help in design and implementation
- Tools: Progression Matrix; CG Questionnaire; internal and external resources



Questionnaire for FOEs I

CG Attributes / Risks	Questions to Ask	Source	
Commitment to CG <i>Key Risks:</i> - The company and its shareholders have not demonstrated a commitment to implementing good CG policies and practices. - Family governance is weak.	· Does the company comply with the (minimum) local legal and regulatory requirements?	<ul style="list-style-type: none"> Local CG country code Interviews: Corporate Secretary 	
	· Is there a charter or articles of incorporation? Do they provide stipulations on the protection of shareholder rights and the equitable treatment of shareholders; the distribution of authority between the annual general meeting of shareholders, the (supervisory) board of directors and executive bodies; and information of the company's activities?	<ul style="list-style-type: none"> Articles of Association Interviews: Corporate Secretary 	
	· Does the company have a corporate governance code or policies? What are the procedures for monitoring compliance with these? Who does the monitoring?	<ul style="list-style-type: none"> CG Code Company Code; ToR for Corporate Secretary Interviews: Corporate Secretary 	
	· Does the company have a corporate secretary? If not, who organizes board meetings?	<ul style="list-style-type: none"> CG section of the annual report Interviews: Board Chair/Member 	
	· Is there an annual calendar of corporate events?	<ul style="list-style-type: none"> CG section of the annual report/web-site Interviews: Corporate Secretary 	
	· Are the board and senior management familiar with the CG regulations of the local authority relevant for their business activities; do they know the (voluntary) code of corporate governance for their country? To what extent does the company comply with this code?	<ul style="list-style-type: none"> CG section of the annual report Interviews: Executive Mgmt.; Board Chair/Member; Corporate Secretary 	
	Additional on family-owned companies:		
	· Does the company have procedures or policies concerning succession at ownership, board and management level, as well as family employment?	<ul style="list-style-type: none"> Succession plan; board minutes Interviews: Board Chair; CEO; CFO 	
	· Does the company have a family governance structure including a family assembly and/or a family council?	<ul style="list-style-type: none"> Family constitution/protocol Interviews: Board Chair/Members; Senior Managers from the Family 	
	Structure and Functioning of the Board of Directors <i>Key Risks:</i> - The (supervisory) board of directors is controlled by the managers or major shareholders. -The board is not up to the task of overseeing the strategy, management and performance of the company. - The board's meeting frequency and working procedures are not adequate.	· How is the composition of the board determined?	<ul style="list-style-type: none"> Directors' Profiles; CG section of the annual report Interviews: Corporate Secretary; Board Chair; Head of Nominations Committee
· Are there any shareholder agreements, provisions of the company's charter, or informal understandings that specify which shareholders appoint directors?		<ul style="list-style-type: none"> Articles of Association Interviews: Corporate Secretary 	
· Are there any non-executive, independent directors? How were they selected? How, if at all, does the company define "independent" director vis-a-vis non-executive and executive directors?		<ul style="list-style-type: none"> CG section of the annual report; Board Charter Interviews: Corporate Secretary; Board Chair/Member 	
· What compensation do independent (and other) directors receive for their services?		<ul style="list-style-type: none"> CG section of the annual report Interviews: Corporate Secretary; Board Chair/Member 	
· Does the company have board committees? If so, how are they established, who sits on them, and how do they function?		<ul style="list-style-type: none"> CG section of the annual report; Board Charter Interviews: Corporate Secretary; Board Chair/Member 	
· Is an agenda prepared and distributed in advance of board meetings? Are minutes prepared and approved after board meetings? How often does the board meet? Who organizes board meetings?		<ul style="list-style-type: none"> Board Charter Interviews: Corporate Secretary; Board Chair/Member 	
· What is understood as the role of the board vis-à-vis management, particularly with respect to the following? (1) Setting strategy and vision of the company; (2) Selection and compensation of CEO and senior management; (3) Risk Management, oversight of internal controls, external audit and preparation of financial statements; (4) Major capital expenditures and large-value transactions.		<ul style="list-style-type: none"> Board Minutes Interviews: Board Chair/Member 	
· How does the current mix of skills/experience on the board serve the company's interests?		<ul style="list-style-type: none"> Directors' Profiles Interviews: Board Chair/Member 	
· Does the board conduct self-evaluations or other reviews of its effectiveness? How and when are the reviews conducted and with whom are the results shared?		<ul style="list-style-type: none"> CG section of the annual report; Board Charter Interviews: Board Chair/Member 	
· Does the company have a formal or informal succession plan for its current CEO? How much longer does the current CEO intend to remain in this position?		<ul style="list-style-type: none"> Succession plan Interviews: Board Chair; CEO; CFO 	



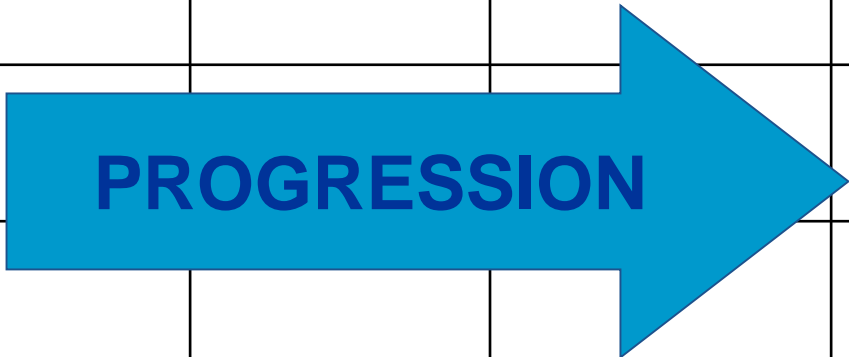
Questionnaire for FOEs II

CG Attributes / Risks	Questions to Ask	Source
Control Environment and Processes <i>Key Risks:</i> - The board's oversight of internal audit, risk and control is weak. - The company's internal audit and control structures and systems are insufficient and/or weak. - The independence and quality of external audits is insufficient to rely on their audit opinions.	<ul style="list-style-type: none"> Does the company have an audit committee? What is the role of the audit committee and the board in ensuring that proper internal controls are maintained, risks are managed and that the company is in compliance with all relevant laws and regulations? 	<ul style="list-style-type: none"> Board Charter Interviews: Corporate Secretary; Board Chair/Member
	<ul style="list-style-type: none"> Does the company have an IA unit? Does the IA unit have a charter that is approved by the audit committee or board? Does the IA unit have full access to records, property and personnel relevant to their audit? To whom does the internal audit (IA) unit report? Is the IA chief independently hired and dismissed with the consent of the board? 	<ul style="list-style-type: none"> Internal Control/Audit and Risk Management Policies Interviews: Head of Audit Committee; Head of Internal Audit/Risk Mgmt.; External Auditor
	<ul style="list-style-type: none"> Are the IA work plans reviewed by the audit committee or the board? 	<ul style="list-style-type: none"> Audit Committee Charter; Internal Control/Audit and Risk Management Policies Interviews: Head of Audit Committee; Head of Internal Audit/Risk Mgmt.
	<ul style="list-style-type: none"> Does the board monitor management's response to deficiencies and weaknesses identified by the IA function and/or external auditors? 	<ul style="list-style-type: none"> Management letters Interviews: Board Chair/Member; Head of Audit Committee; Head of Internal Audit/Risk Mgmt.; External Auditor
	<ul style="list-style-type: none"> Describe the company's internal controls and MIS? Are they properly documented and periodically reviewed? 	<ul style="list-style-type: none"> Interviews: Head of Audit Committee; CFO; Head of Internal Audit/Risk Mgmt.; Chief Risk Officer
	<ul style="list-style-type: none"> Were there any significant problems reported in internal controls, audit and compliance in the past 5 years? 	<ul style="list-style-type: none"> Interviews: Board Chair/Member; Head of Audit Committee; Head of Internal Audit/Risk Mgmt.; Chief Risk / Compliance Officer; External Auditor
	<ul style="list-style-type: none"> Is the company's external audit in line with International Standards on Auditing (ISA)? 	<ul style="list-style-type: none"> Interviews: Head of Audit Committee; External Auditor
	<ul style="list-style-type: none"> Who, formally and in practice, selects the external auditors and to whom are they accountable? Is there a policy to rotate the external auditors or the lead audit partners? 	<ul style="list-style-type: none"> Interviews: Head of Audit Committee; External Auditor
	<ul style="list-style-type: none"> Have the company's accounts ever been qualified? Why? 	<ul style="list-style-type: none"> Interviews: Head of Audit Committee; CFO; External Auditor
	Transparency and Disclosure <i>Key Risk:</i> - There is no confidence in the reliability of the financial statements either because of the lack of proper audit, because of poor quality preparation or other reasons.	<ul style="list-style-type: none"> Are the financial statements prepared in keeping with local or with internationally recognized accounting standards (e.g., IFRS)?
<ul style="list-style-type: none"> Were there any material re-statements of the company's financial statements in the past 5 years? Please specify. 		<ul style="list-style-type: none"> Interviews: Head of Audit Committee; CFO; External Auditor
<ul style="list-style-type: none"> Does the board/audit committee review key elements of the company's financial statements? How often? 		<ul style="list-style-type: none"> Interviews: Head of Audit Committee; External Auditor
Shareholder Rights <i>Key Risks:</i> - The company's minority shareholders' rights are inadequate or abused. - There is a weak disclosure or approval system on intra-group or related party transactions or other potential conflicts of interest.	<ul style="list-style-type: none"> Does the board review material transactions that involve conflicts of interest and related parties? Are they disclosed to all shareholders and how? Is the audit committee involved in approving some of these transactions? 	<ul style="list-style-type: none"> Interviews: Head of Audit Committee; CFO; External Auditor
	<ul style="list-style-type: none"> Are there differences between the voting rights and cash flow rights of the company's various classes of equity and quasi-equity securities (as different from the "one share, one vote" principle)? 	<ul style="list-style-type: none"> Articles of Association; dividend policy Interviews: Board Chair/Member; Controlling Shareholder
	<ul style="list-style-type: none"> Is ultimate beneficial ownership of shares disclosed by controlling shareholders and management? 	<ul style="list-style-type: none"> Annual Report; Articles of Association
	<ul style="list-style-type: none"> Are there any minority shareholders protection mechanisms in place? 	<ul style="list-style-type: none"> Articles of Association Interviews: Board Chair/Member; Corporate Secretary
	<ul style="list-style-type: none"> How will minority shareholders be treated in the event of a change of control of the company (e.g., tag-along rights)? 	<ul style="list-style-type: none"> Articles of Association Interviews: Board Chair/Member; Corporate Secretary
	<ul style="list-style-type: none"> Does the preparation and calling of shareholders meetings enable the participation of all shareholders (notice; agenda and supporting materials; proposing agenda items; participation personally or through proxy; the right to ask questions; dissemination of the results of the meeting)? 	<ul style="list-style-type: none"> Articles of Association; by-laws on shareholder meetings Interviews: Board Chair/Member; Corporate Secretary
	<ul style="list-style-type: none"> Has the company ever been subject to investigation into its treatment of shareholders? How have shareholder disputes been resolved? 	<ul style="list-style-type: none"> Interviews: Board Chair/Member; Corporate Secretary; Minority Shareholder



Matrix: A Self-Assessment and Client Orientation Tool

	Factual / Initial	Emerging	Advanced	Developed
Commitment to Corporate Governance				
Structure and Functioning of the Board of Directors				
Control Environment and Process				
Transparency and Disclosure				
Rights of Minority Shareholders				





- Objectives:
 - Provide written analysis for moderate and high risks
 - Explain why certain risks are higher/lower than in rapid risk screening and how the 'Unknowns' played out
 - Potentially identify areas where the EDFI can help
- Tools: **Result Matrix**; Sample CG Improvement Programs; internal / external resources; carrots and sticks

FMO CG Review Process – Finance Proposal stage

Oil Seed Crusher and Trader in Moldova		
CG Attributes	Risk Level	Explanation of Risk Evaluation (2-3 sentences each)
1 Structure and Functioning of the Board of Directors	1	The board is a pure executive board that is comprised of the main Sponsor and executive directors. There is no oversight role that the board currently plays. The composition would need to be changed, including in the future, independent directors who would eventually form an audit committee.
2 Control Environment and Processes	1	The Client is at very early stages and hasn't documented its internal control processes as of yet. There is also no internal audit function, albeit given the early stages of the company, no immediate action is needed here. The client has no risk management function.
3 Rights of Minority Shareholders	2	There are no pyramid structures or cross-holdings. Due to other businesses of the main sponsor there are related party transactions and potential other conflicts of interest. Yet, the related-party transactions are currently at a very low level, not exceeding ...% of the Client's revenue.
4 Transparency and Disclosure	3	No risks identified. For a non-listed company, current disclosure levels are adequate.
5 Commitment to Corporate Governance / Family Governance	2	The Sponsor is committed to improving CG as the company grows. They have retained IFC's advisory services to provide them with a CG Improvement Plan. During the due diligence, it became clear that the Sponsor does not consider his family members to have an automatic right to work in the company. Since this is a first generation business, succession planning is not an immediate must.
Risk Conclusion / Opportunity to engage further (willingness of client, possible action plan on improvement)	1.8	A CG action plan has been made part of the investment transaction with IFC. This plan contains 27 time-bound action items on the subjects mentioned above with a focus on the board structure involving two more non-executive directors out of which one should be independent directors until June 2014. The plan also foresees the documentation of the internal control process already until December 2012 and the development of a related-party transaction policy until June 2013. No additional steps from FMO are currently necessary.

END



Questions?