NICG Network for Innovative Corporate Governance

Board Dynamics

Information Management 2019

NICG 2019/1

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Welcome – Acknowledgement

Innovative Corporate Governance.
Action. Creation. Transformation. 2019.

Corporate governance is characterized by practical and scientific stimuli. Its subject area is dynamic and requires continuous adaptation to new social, regulatory and business requirements.

The topic is challenging and demands a lot from all of us. It is hence of utmost importance to identify potential future developments in advance to be the leader and to pursue the guiding principle of «Good Corporate Governance». We believe this is the only way to make an effective contribution to knowledge and to achieve a sustainable competitive advantage in the long run.

This booklet offers a selected overview of innovative corporate governance topics we actively debated within our network in 2019. Be it to broaden your knowledge or to stimulate discussions, we hope you enjoy reading it.

Yours sincerely,

Prof. Dr. oec. Michèle F. Sutter-Rüdisser

RA Dr. iur. Felix Horber

P.S. we are curious , free spirits, and non-profit.
If you feel like being part of our community – we are happy to welcome you anytime.

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Network for Innovative Corporate Governance (NICG)

Conference «Board Dynamics»

The Network for Innovative Corporate Governance (NICG) is a cooperation between the University of St. Gallen and Swiss Re for an in-depth scientific study of the topic. The aim of NICG is to collect existing long-term approaches, to coordinate them and, building upon it, to create new, innovative approaches and solutions in corporate governance. As the name of the network indicates, innovation is a central component of research. The NICG's goal is to collect and discuss scientific research approaches and present the results in a way that is both benefit-oriented and meaningful for society and business.

The network's annual conference «Board Dynamics» intends to provide a platform for the exchange of knowledge, stimulate discussions and communicate possible development potentials. The inaugural conference in 2019 was held in the spirit of board of directors' dynamics with regard to information management. Aim of the conference is to close existing research gaps, to stimulate discussions about new and innovative topics and, from a broad spectrum, to deepen and expand the existing cooperation between academia and practice.

Personalities with various regional, national and international backgrounds took part in the conference program to share their experiences from private as well as listed companies. All this was complemented by presentations from experts in academia, disclosing their knowledge and theoretical points of view in round table discussions and workshops.


NICG
Corporate Governance Keynote

Rethinking Inova©tion:

Why good things are often closer than you (may) think

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The almost inflationary use of the term innovation is increasingly diminishing its meaning. Everyone can (and even must!) be innovative because «it» is crucial for survival. This is especially true for a modern, forward-thinking company. Who can afford to stand still nowadays or even go backwards? Or is that even an option?

The Latin term innovare means to innovate or to renew. The prevailing basic understanding in business literature is often based on the assumption that only a radical renewal is good enough to ensure a long-term competitive advantage. This often results in a flood of «innovation initiatives». These are being fed into the company on different levels and for various processes and contents. Hence, it is hardly surprising that even insiders have difficulties understanding who is doing what, where, why and how.

This is especially true for more complex innovation solutions. It can therefore be beneficial to bundle the initiatives and to coordinate them on a regular and cross-functional basis. One example is the distributed ledger (blockchain technology) and its scope of application in corporate governance processes: A database that is based on cryptography – which validates entries through a peer-to-peer network by means of a consensus algorithm, provides them with a time stamp and stores them in sequential blocks – is truly revolutionary. However, analyzing its actual potential for the respective value chains (still) seems anything but trivial.

Such rapidly developing and widespread technologies make it possible to handle board relevant processes or votes (also on the occasion of general meetings) in the future. Today's information, communication and control processes towards stakeholders will change and – in one way or the other – hopefully be simplified.

With respect to this, the executive management is playing a pivotal role: on the one hand by keeping an eye on the opportunities and challenges for effective innovation performance. Here, the allocation of resources is paramount. A regular examination of various innovation initiatives within the company is not only a question of budget allocation but also concerns the prioritization of entrepreneurial attention and energy. On the other hand, a continuous evaluation of innovation initiatives according to and in accordance with the corporate strategy is imperative for the smart use of finite resources and the ultimate decision whether – and if so, how – to continue and develop the respective initiatives. One should not underestimate the challenge of deciding to end an initiative independently of individuals and as «neutrally» as possible in the company's own best interest.

«Life isn't about waiting for the storm to pass; it's about learning how to dance in the rain.»

(anonymous quote, more recently attributed to Vivian Greene)

Furthermore, seemingly simple innovations should be given special heightened attention – for example the prioritization of information quality before information quantity as well as the focus on entrepreneurial core competencies. It is particularly important to keep the focus on the client (less time for inessential things), to promote active entrepreneurship (versus «merely managing») as well as to cultivate a culture of enthusiasm, joy and engagement. Failure needs to be an option and can lead to success. Creating space for creative thinking and reflection periods for the V O I D is also crucial (just abandoning expectations of needing to be present 24/7 can work wonders). And, last but not least, truly critical thinking should be valued – even if this is an inherently unpleasant side effect for the homo sapiens.

With respect to the quote above, there are three indispensable thoughts:

- *Rethinking underlying assumptions:* «Do we even want to dance in the rain?» Every executive management should examine and decide whether they should and can participate in the respective innovation initiatives. Who knows, it may even be beneficial for some companies to avoid dancing in the rain altogether and to «just» sing in the rain, or to enjoy it quietly not doing anything.
- *Carefully observing prevailing conditions:* «What kind of storm is it?» The key is to observe the kind of storm before one starts to dance. Accordingly, fundamental questions should regularly be discussed. This includes: Which industry are we part of today and what will the situation look like tomorrow? How are we positioned geographically and demographically? Are we where we want to be and/or are there other growth opportunities (also of virtual nature)? Could it even be advantageous to shift our markets (in some areas or altogether)? Are today's client needs congruent with tomorrow's, and in which life cycle are we with respect to our products, services and processes? How exactly are we going to identify the consequent opportunities and risks for our business models?
- *Passion for the movement:* «Do we like this dance?» Here, the motto is – not every dance is attractive and suitable for everyone. And this is ok. Be it waltz, tango, salsa, merengue, country and folk or hip hop; without fun and according active engagement, innovation initiatives are mostly just expensive measures with little effect. Innovation culture (individually designed) must not just be an empty phrase. A shared understanding and exemplary behavior determined by the «tone at the top» is the key to success.

To sum it up and associate it with the initial quote, a company should also allow for an innovation initiative to be paused, reconsidered and even suspended. Innovation in small steps or an initiative that even takes (or needs to take) back one step does not necessarily mean for the company to miss the boat (wherever the future lies). However, if the momentum is right and the executive management supports the innovation initiative, the rocket can be launched with more «courage to take risks» without allowing internal political obstacles to extinguish the fire before it has been lit.

Board Dynamics – Information Management

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1. Introduction

Information means power and informational advantage leads to information asymmetry. Information imbalance or lack of information bears the risk of wrong or inappropriate decision-making. Hence, for optimal decision-making there should be information symmetry among the decision-makers. Information management aims at restoring this symmetry by removing information imbalances. At board of directors level information management has different characteristics in each phase of the information cycle: the phase before a board meeting (**Pre-Board Meeting Phase**), the phase during a board meeting (**Board Meeting Phase**) and the phase after a board meeting (**Post-Board Meeting Phase**).

2. Pre-Board Meeting Phase

2.1 Starting Position and Problem Statement

The Pre-Board Meeting Phase is characterized by the following issues:

- Can an individual board member directly approach an executive committee project leader to gain additional insights or information about that specific project?
- Can an individual board member request additional analysis and ask for dissemination of the outcome of the analysis to the full board in advance of a board meeting?
- Can individual board members exchange relevant information among each other and eventually act in concert?
- To what extent do such activities, if they are deemed appropriate at all, require the chairman/chairwoman's attention and do they need to be submitted to the company secretary for the records?
- Do the chairman/chairwoman or company secretary, if they have been notified of such activities, have to share this information with the full board prior to a board meeting or is it sufficient to do so on the day at the beginning of a board meeting?
- Does such information have to be included in the minutes of the respective board meeting?

2.2 Solution Statement

Information Management ahead of a board meeting should be driven by a spirit of addressing information asymmetries through advance information dissemination in order to achieve an information balance at the time of the board's decision. A company's decision-making process should be structured in a way that a board's decision is based on a maximum of reliable and relevant information, which equally requires transparency, flexibility as well as some pragmatism. Internal rules and regulations should facilitate an ongoing elimination of existing or developing information asymmetries through dissemination of new or additional decision-relevant information to ALL board members, irrespective of who asked for it in the first place. This must be seamlessly documented to make sure that it is clear what information was requested by whom and who that information was shared with at any point in time. This information dissemination process has to be conducted centrally through the chairman/chairwoman. As a prerequisite, all decision-relevant activities in advance of a board meeting must be coordinated with the company secretary. Internal rules and regulations for information exchange prior to a board meeting (for example in the Corporate Bylaws) can provide clear guidance as to what is permissible and what is not. This creates transparency, provides clarity and is the foundation for acceptance of the decision-making process. As part of the board's annual self-assessment process these rules and regulations have to be evaluated for effectiveness and efficiency and revised if needed.

3. Board Meeting Phase

3.1 Starting Position and Problem Statement

The Board Meeting Phase is characterized by the following issues:

- How best to update board members with the latest information at the beginning of a board meeting?
- Which means can be used by individual board members to request additional information during a board meeting? Is there any entitlement to enforce an information request?
- Who is responsible for ensuring that there is a sufficient level of information on agenda items so that the board can make effective decisions?
- What is the chairman/chairwoman's role in general with regard to information management in a board meeting? To what extent is he/she responsible for achieving and maintaining information symmetry in a board meeting?
- How should board committee chairpersons be involved in this context? To what extent do they have to participate in the board's information management?
- Can a board agenda item be removed or postponed if a board member is not satisfied with the answer to his/her information request? Can the removal of an agenda item be enforced or is this subject to the chairman/chairwoman's sphere of competence or should there be a formal request to be decided by a majority vote?
- Can the interruption of a board meeting be ordered to organize additional information or to invite those with sufficient knowledge to join the board meeting? Can the agenda be altered in order to do so?
- To what extent does any of the above have to be minuted?

3.2 Solution Statement

Agenda:

- The agenda defines the meeting structure. From an information management point of view, items addressing developments since the last board meeting should be allocated to the beginning of the meeting, when specifying the sequence of agenda items. Minutes of the last board meeting are always the first agenda item. The resolution of pending issues, as reflected in earlier board minutes, can also be added to this item. The chairman/chairwoman can use this first agenda item to report on developments that happened since the last board meeting or prior to the current meeting.

- The agenda is also a management tool for the chairman/chairwoman. It should enable the board to work in a timely, efficient and productive manner. Accordingly, changes to sequence, removal or postponing of agenda items or interruptions of board meetings should be possible at all times.

Meeting management:
- The chairman/chairwoman plays a crucial role and is responsible for both the efficient process and running the meeting.
- Committee chairpersons should also be actively involved.
- Prior to the formal resolution of an agenda item, a short summary of the major points of view by the chairman can be helpful.
- The chairman/chairwoman is also responsible for concluding a given item.

Board members' obligation to cooperate:
- Passiveness does NOT discharge responsibility. Neither ignorance nor lack of expertise are excuses when it comes to their responsibility in the case of court proceedings.
- Each board member is expected to actively participate and ask questions if there is a lack of clarity with respect to a certain agenda item. This is why Article 715a para 1 in the Swiss Code of Obligations explicitly states that at a board meeting each board member has the right to inquire about any matter of the company.
- In the decision-making process the board has to make sure through active exchange that there is sufficient information flow to allow for a broad-based and well-informed decision.
- All board members have an obligation to efficiently and effectively cooperate, discuss and debate to allow the chairman/chairwoman to bring agenda items to a conclusion.

Minuting of board meetings:
- The dynamics of the board's decision-making process have to be reflected in the minutes.
- Changes to sequence, removal or postponing of agenda items also have to be precisely documented in the minutes. The same is true for individual board members' requests for additional information or insights into business documents, to verify who asked whom, when for what and in which form.
- Controversial board discussions should be reflected in the minutes as well, though naming and quoting of involved board members should only happen if explicitly requested.
- Non-unanimous votes should be documented numerically in the minutes.
- Minutes should reflect how the specific discussion- and information-flow has evolved during the board meeting and how the decision-making process ended in the resulting resolution.

4. Post-Board Meeting Phase

4.1 Starting Position and Problem Statement

The Post-Board Meeting Phase is characterized by the following issues:
- Do conversations between individual board members which took place immediately after a board meeting have to be minuted subsequently? What if the chairman/chairwoman participated in these discussions?
- Are informal meetings between individual board members before or after a board meeting admissible?
- Can an individual board member after a board meeting directly approach an executive committee member with an information request to gain additional insights or information about a specific matter which was on the agenda of the preceding board meeting?
- Is there a need to systematically capture and document additional, agenda item-specific information which, in agreement with the chairman/chairwoman, was made available after a board meeting to all board members?
- Who is responsible for capturing pending items and who manages the pending item list? Who is in charge of communicating captured pending items? How can be assured that pending items are added to the agenda of the subsequent board meetings?

4.2 Solution Statement

Documentation versus minuting:
- Board meetings must be minuted. A meeting is defined as a gathering of board members, which is included in the board calendar in advance, and which requires a formal invitation and a meeting agenda. A meeting has a beginning and an end – clearly defining the period which is covered in the minutes.
- Occurrences after a board meeting are thus outside the official meeting and are not subject to minuting. However, it is conceivable that, judging on a case-by-case basis, the chairman/chairwoman instructs the company secretary to prepare a memorandum about a specific incident which occurred after a board meeting.
- It is advisable that the company secretary maintains a log of correspondence with the board between board meetings.

Informal information exchange versus formal meeting:
- Often there is a need for information exchange between board meetings – either between individual board members or between board members and members of the executive committee. It is advisable to establish internal rules to address this informal information exchange.
- To assure an orderly process, board members' information requests related to specific agenda items outside of board meetings should be addressed to the chairman/chairwoman, to make sure he/she also maintains leadership outside of board meetings (see Article 715a para 3 in the Swiss Code of Obligations).

Management tools of the board:
- Management tools that ensure a company has established a decision-making process, which complies with the Business Judgement Rule, are an integral part of a structured information management in the board. They form part of a board's organizational responsibilities and set the boundaries of the company's decision-making processes.
- The board calendar (also referred to as «roadmap») clearly defines the dates in a year, when a company's decision-makers have to address certain topics. The agenda sets out for a specific board meeting date, who has to present what in what form and for what purpose.
- These tools are only fit for purpose if they are updated on an ongoing basis. This means that the board calendar needs to be adjusted after each board meeting to reflect new pending items.
- Guardian of these tools is the company secretary. He/she is responsible for maintaining the pending item list, updating the board calendar and drafting board agendas which are consistent with the board calendar requirements and reflect in a timely manner what items have to be addressed at the next board meetings.
- Board calendar and agendas have to be made available on time and in the appropriate form within a company to allow for sufficient preparation time for the meeting participants. This communication also forms part of the company secretary's job.

5. Conclusion

A board's timely and well-informed decision-making process is crucial to the success of a company especially in today's fast-paced business environment. The decision-making has to follow clearly defined procedural guidelines in order to be compliant with the Business Judgement Rule. Best practice information management is a key enabler to this. Each phase (pre-, during and post-board meetings) has its specific characteristics which need to be addressed differently in the information cycle to assure best possible information symmetry at all times. This paper has identified challenges and possible solutions for each of these phases and outlined how dynamic board information management should be organized.

Blockchain Innovation from a Corporate Governance Perspective

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Blockchain and distributed ledger technology provide vast potential and opportunities. In order to assess the potential and opportunities as well as the risks of blockchain, a company and its directors need a certain level of familiarity with the technological basics. Familiarity thereof requires knowledge about public-private-key-cryptography, hashing algorithms, network architecture and the data processing and storage concept of the most widespread type of blockchain.

When handling token, important aspects have to be considered, especially in the light of the board's non-assignable and non-deprivable tasks according to art. 716a CO. Aside from their consensus algorithm and whether a specific blockchain has permissionless accessibility respectively public availability, token can be distinguished based on their economic properties and the rights they confer as claims on the counterparty. While Bitcoin does not have an intrinsic value or legally bound counterparties, asset token that represent e.g. a bond can be transparently valued and convey an enforceable claim.

Another factor worth reckoning is the currently dynamic juridical and regulatory environment in which laws and regulation from the pre-crypto age clash with the impact of blockchain technology, where the latter continuously tends to be one step ahead of legislative and regulatory institutions. Additional challenges include a secure private key management, the irreversibility of transactions, valuation risks and several administrative aspects, e.g. in accounting and taxation.

Even though the use of blockchain technology requires certain precautionary measures, it also offers versatile new opportunities, business models and possibilities for more effective and efficient operations throughout the company. On this account a lot of companies explore possible use cases, conduct trials (e.g. logistics tracking or bonds emissions) or already integrated blockchain technology in their regular operations. Important traits of blockchain technology to the participants are, inter alia, its resistance towards manipulation, the absence of a single point of failure by redundancy, real-time verification and reduction of transaction costs. With regard to corporate governance blockchain technology enables facilitating consensus processes among diverse interest groups, reducing opportunism and the need for monitoring, allowing real-time verification of information and providing audit trails back to the first block.

Application areas of blockchain technology within a company's operations and administration are multifarious. A first example specifies commodity deliverance where blockchain impacts several stages, beginning from logistics tracking and payment over to a more comprehensive integration that allows for automatic and reliable payment execution at the point of risk transfer upon previously agreed Incoterms recorded on the blockchain via smart contracts. Further examples are general assemblies, where the assignment of voting rights and their execution can be administered on a blockchain, or specifically insurance companies benefiting from parametric policies, accelerated claim settlement and growth potential in the field of microinsurance.

Blockchain technology also impacts the financial reporting process. Foremost daily accounting routines like record keeping of transactions could be affected by an increasing dissemination of blockchain technology, driving automation and efficiency. This would be accompanied by respective routines of auditors and within the consolidation process. Accounting areas which require judgement, e.g. valuation of investments, impairments and provisions, are less likely to be affected by blockchain technology.

To conclude, blockchain is still juvenile and, as a drawback, misses standardization which currently limits the application for companies. While the operational risks of blockchain technology necessitate an informed decision of its usage, the higher risk probably lies in the non-consideration of this innovation.

Why effective Communication with Internal Audit is invaluable for the Board of Directors

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In May and June 2018, data from 113 Swiss-based internal auditors was collected to investigate on what good communication with the board of directors is, what promotes – or hinders – effective exchange and what would be the benefits for corporate governance on the whole. The survey consisted of a quantitative and a qualitative section.

As it turned out, effective communication is critical not only directly for the involved parties, in this case the board and internal audit, but it also has wider implications for the functioning of the governance, risk management and internal control systems per se that rely on the effective exchange of key information.

The underlying organizational setup making effective communication between the actors charged with governance so crucial is that the span of control becomes too wide at the top tiers – especially for the board members – to oversee and control the organization by themselves. Consequentially, the board must rely on internal audit, amongst others, as an actor to help discharge of its oversight-related responsibilities and to ensure the effectiveness of governance, risk management and internal control.

Conversely, with respect to the value of internal audit, one survey participant concluded that «if communication is not effective and accepted by the various parties, internal audit becomes less useful (for the board) and almost a waste of time», indicating the mutual dependency of the board but also of internal audit on effective exchange. More specifically, the survey participants associated certain – but respectively different – quality criteria with good communication from the board and from internal audit.

For effective communication from the board, most respondents stated that clarity of communication was the most important feature, whereas for effective communication from internal audit, objectivity was more paramount. As further features of effective communication between internal audit and the board the survey participants identified the following factors: 43% favored communication in small groups and 37.2% preferred individual face-to-face communication over more impersonal exchange via video conference (<5%), telephone conference (<5%) or email (< 10%). 70% also liked pre-planned communication with the board while 8.49% preferred informal communication on an ad hoc basis (approx. 20% indicated no preference).

Meanwhile, mutual trust was identified as the most significant driver of effective communication from internal audit to the board, followed by the independence of the internal audit activity from senior management.

On the flip side, to be able to implement good communication, the following structural and interpersonal barriers should be avoided, minimized or in the very least become aware of:

Structural barriers:

- Communication only via email or telephone conference;
- Geographical distances;
- Insufficient resources;
- Unavailability of the board (schedule);
- Lack of independence of internal audit from senior management.

Interpersonal barriers:

- Lack of confidence in internal auditors' ability to communicate effectively with the board (perceived behavioral control over the communication process);
- Lack of support for internal audit from the board;
- No awareness for the value of internal audit and no optimal use of internal audit in the organization («one of many control functions»);
- Personal career ambitions of internal auditors seeking to connect with management for internal transfers;
- Hubris of internal auditors («best in class»).

The vast majority indicated that effective communication between internal audit and the board increased the effectiveness of corporate governance and the organization as such, stating for example:

- «Effective communication between internal audit and the board optimizes operations and simultaneously reduces risks»;
- «It leads to organizational improvement»;
- «The result is more added value to the firm»;
- «It enables the implementation of concrete actions on how we can make our organization better».

Overall, the qualitative survey results not only clarified the properties, drivers and consequences of good communication but at a closer glance also invite and encourage board members to communicate effectively in order to find out how to deploy internal audit in the most optimal manner and to use it more centrally as a support function for the discharge of its own responsibilities. Internal audit, due to its ideally direct reporting line to the board, enables the board to receive information unfiltered from management and is thus in a unique position to alleviate potentially remaining information asymmetries. Once mutual trust is established and communication (from the board) and objective (from internal audit) are clear, significant benefits for the board, for internal audit and for the organization were shown to manifest.

Litigation IR – Investor Relations in Legal Disputes as a Strategic Management Task

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«Litigation IR – Investor Relations in legal disputes as a strategic management task»: The relevance and necessity of stock-listed companies to proactively communicate with their stake- and shareholders in on-going legal disputes gained a more important role over the course of the last few years, and legal disputes themselves have become an important factor in assessing the financial and non-financial performance of a company. No longer does the dictum «silence is gold» apply; on the contrary, within the framework of Litigation Investor Relations, a transparent and proactive form of communication with the financial markets has to be preferred.

More and more, companies are involved in litigation, be it on the civil side or the criminal side. Yet, those disputes do not only take place in a court room but are also increasingly fought in the public, in the so-called «court of public opinion». Often, the judgement of the court of public opinion and consequently of the financial markets is the more serious verdict for a publicly listed company than the legal ruling itself. Thus, companies become increasingly aware of the fact that strategic communication during litigation must be actively managed as legal disputes have an important impact on the valuation of a company, and an insufficient flow of information during lawsuits only increases the uncertainty of the financial community. Thus, companies must actively address legal issues in their Investor Relations in order to allow investors and analysts to value the potential outcome and financial burden a company could face as the result of a legal dispute.

Yet, Litigation IR is not only a special form of financial communication but also a strategically important management task that creates added business value. With the necessary care and a clear intention, an attempt should be made to minimize the loss of confidence of the interest groups and to reconcile market expectations with the facts of the legal case by means of transparent information. That not only safeguards the reputation of the company on the capital markets but has also the effect of reducing the costs of debt and equity as the markets are able to develop a better understanding of potential costs resulting from a legal dispute a company potentially faces. Thus, a proper Litigation IR enables a more transparent valuation of a company as the markets can better estimate the potential effects of a legal dispute, i.e. how a potential ruling affects the share price.

In this sense, Litigation IR is the strategic financial communication before, during and after legal disputes of a company and its representatives in order to give the financial markets and its participants a transparent and preferably complete summary of the legal dispute, contingent damages as well as the potential outcome. Thereby, the objective of Litigation IR is to align the expectations of the financial markets with the actual and potential development of a company's legal dispute. While investor relations and litigation public relations concentrate on specific target groups, litigation IR pursues a holistic communication model.

Non-GAAP Reporting – Information Content and Intransparency

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Non-GAAP measures or Alternative Performance Measures (APMs) are financial metrics that are not defined in the applicable recognized accounting standards. Non-GAAP figures such as «Adjusted Profit», «Core EPS» or «Underlying net profit» have become an integral part of the reporting of many companies, also in the Swiss market. In fact, two thirds of all companies listed in the SLI use at least one, and on average even three non-GAAP earnings measures.
The companies emphasize that non-GAAP figures increase the information content and are a way of eliminating one-off costs, circumventing inflexible accounting standards and presenting the company's situation more truthfully. On the other hand, scientific evidence shows that non-GAAP figures are also used to embellish performance and (consciously) create intransparency. The fact that every third non-GAAP earnings measure influences the remuneration of the SLI management further aggravates the situation.

After the SEC, IOSCO and ESMA, the SIX has now also taken action: On 1 January 2019, it has put a binding guideline on non-GAAP reporting into force.

In a joint study with KPMG, the Chair of Accounting and Auditing at the University of St. Gallen examined the current status of non-GAAP reporting in the Swiss market. In doing so, we examined non-GAAP earnings measures «in a narrow sense» (i.e., excluding EBT, EBIT, etc.) of the 30 SLI companies for 2016 and 2017 with regard to their compliance with the SIX Directive, which was still a draft at that time. The aim was to show the status quo of non-GAAP reporting as well as possible fields of action and recommendations for the Swiss market.

In fact, the findings of other studies have also proved to be true for the Swiss market: More than 85% of all non-GAAP earnings measures are adjusted upwards, and on average, the absolute non-GAAP ratio is 67.5% higher than the GAAP ratio. This corresponds to an average increase in return on sales of 4.9%.

The transparency of non-GAAP reporting is not always given. For 53% of all non-GAAP earnings measures a definition was not available, in another 20% it was only indicated indirectly or insufficiently. The reconciliation, which is very important for investors and analysts, was missing for almost half of the non-GAAP figures. In addition, 62.5% of all non-GAAP figures examined were presented with more prominence than GAAP figures, which is likely to particularly deceive inexperienced investors.

Overall, there is still much to be done, and some multinationals such as Novartis or Roche already present their non-GAAP figures in a very transparent and comparable manner. Here, non-GAAP reporting can contribute to an increased information content.

The study shows that there is still considerable room for improvement in the use of non-GAAP reporting in the Swiss market. According to Art. 716a of the Swiss Code of Obligations, members of the Board of Directors are responsible for a company's reporting. It is therefore their task to ensure transparency and comparability of the financial data used and to avoid breaches of rules and loss of reputation. Specifically, it is recommended to design the process as follows:

- Analysis of existing reporting with regard to external requirements, best practices in the industry and alignment with the business model

→ Selecting few but appropriate non-GAAP figures.

- Design the non-GAAP reporting, including internal guidelines, adequate governance processes and structures as well as variable compensation

→ Take responsibility.

- The final non-GAAP reporting should be consistent, clear and transparent.

→ Strive for continuity.

As this article showed, non-GAAP reporting itself can be a valuable additional information source as long as it is carefully analyzed, guided and implemented.

The Three Lines of Control – An Adaptation for Financial Services

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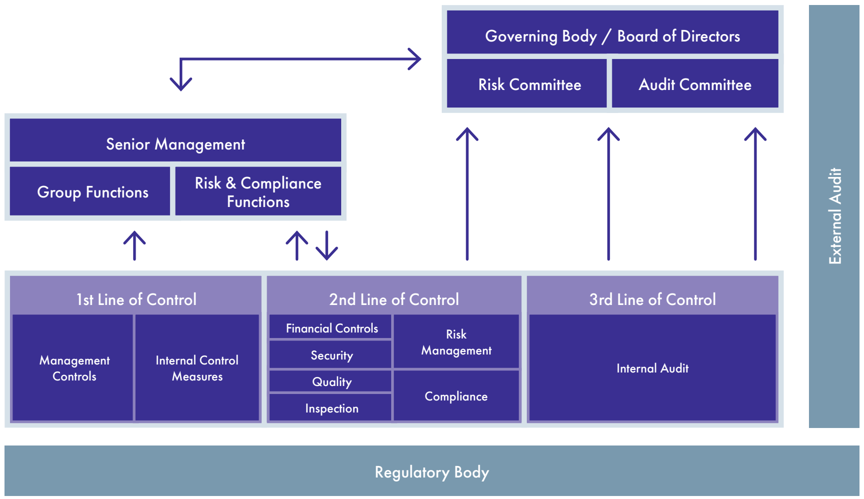
The board of directors of financial service providers is exposed to its regulatory environment with a number of control and compliance processes, requiring follow-up activities on an operational and formal level. The Three Lines of Defense Model (TLDM), introduced by the Institute of Internal Auditors (IIA) in 2013, has become a role model for mapping and organizing control and supervisory functions – inside and outside the organization. However, the model is not without criticism. Science and practice jointly demand a revised model that reflects (economically) new, up-to-date theories. Only then, practical and meaningful benefits are created in order to fulfil the inalienable duties according to art. 716a CO. More precisely, it appears that the TLDM fails to reflect prescribed laws, guidelines and certain dynamics in practice. The application of the model in different industries and areas and the corresponding general, simple character of the design are probably the most obvious reasons (Leech & Hanlon, 2016, p. 335). As risk, compliance and internal audit issues have become the core of control and performance, it is time to take account of these factors by a revised version (as outlined below): **The Three Lines of Control Model (TLCM)**.



The Three Lines of Control Model (Germann & Sutter-Rüdisser, 2019)

The TLCM sets new guidelines and aligns with recognized hard and soft law standards. In detail, the authors consider three corporate governance implications that need to be extended:

1. **Regulator:** The regulator takes a central role in defining the organization, particularly with regard to the organizational structure and its corresponding risk assessment. Financial service regulations have a direct impact on the company structure and the way they are conducting their business. It is therefore time to assign the regulatory experts a more central and fundamental role and to embed the authorities more effectively into the corporate setting. Seeing the state as a supporting entity may also change the perception of how to define the role of the government; changing from an outsider to a sparring partner.

2. **Resource Deployment of Risk Management, Compliance and ICS:** Based on the comprehensive regulatory apparatus (e.g. Basel III), risk management, compliance and ICS play an overriding role and require greater attention to ensure the effectiveness and efficiency of the necessary control measures. It is the exclusive responsibility of the board of directors/ the committees to provide – the earlier the better – the three functions with appropriate (human) resources and competencies (indicated by the size of the boxes). All three are effective and not to be underestimated instruments for determining and monitoring risk appetite.

3. **Risk and Audit Committee Separation and Reporting Lines:** The TLCM proposes a formal separation of the risk and audit committee with individual reporting lines to the management and to the business functions. The purpose first, is to make room for an appropriate partner in complex business environments and, second, to provide formal reporting lines for activities requiring ad-hoc decision-making or of such materiality that board involvement becomes necessary. Likewise, such a structure promotes the collaboration and exchange of information between the business areas and the committees or the board of directors, respectively. However, communication shall not be randomly assessed but should follow formal, purposeful internal guidelines.

Last but not least, the model follows a more agile and active approach, proposed by the change of name from defense to control. Control is more proactive, promoting the positive attitude of communication and personal interaction between different levels of the entity. A framework that aims at initiating measures in advance.

Adapting to new and constantly changing requirements can be unsettling but is a must in order to be best in class within the field of corporate governance. The TCLM provides a framework for identifying areas that need special attention in advance (on a vertical and hierarchical level).

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Prof. Dr. oec. Michèle F. Sutter-Rüdisser
Academic Director NICG
University of St. Gallen

RA Dr. iur. Felix Horber
Group Company Secretary
Swiss Re

Save the Date

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