Looking at yourself from outside: why good corporate governance matters 3/2/23


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The last decade has seen a considerable increase in regulatory requirements in the governance and non-financial reporting space. At the same time, various stakeholders (shareholders, employees, customers etc) are expecting reliable, high-quality and standardised information from companies on their governance practices and non-financial performance. Both of these factors affect companies in Latvia as well.

A corporate governance statement

Under the Public Person's Shares and Companies Governance Act, a public person's companies and publicly private companies whose indicators for the previous financial year meet certain criteria (a net turnover of over EUR 21 million and a balance sheet total of over EUR 4 million) are required to prepare a corporate governance statement. Companies meeting these criteria were to prepare their first statement for the financial year 2021 (the financial year that began on 1 January 2021 or during the calendar year 2021) according to the Cabinet of Ministers' Rule, applying the Latvian Corporate Governance Code, developed by the Corporate Governance Advisory Council set up by the Ministry of Justice, whose principles summarise the best international practice in corporate governance and may be applied to any company.

The Code comprises 17 principles developed to promote a company's long-term value growth, efficient governance, and business transparency. These principles are grouped into ten sections covering corporate governance matters (such as strategy, internal culture and ethics) and company council elections. Each principle has specific criteria for assessing whether the company complies with it.

Companies having their financial instruments listed on the regulated market will prepare and publish their corporate governance statements in line with the Financial Instruments Market Act, yet those companies prepare statements according to the Code as well.

According to the rules, a company's corporate governance statement must give information on whether and how it applies the principles included in the Code. If a company does not apply any principle of good corporate governance, it must give reasons for this behaviour. Companies may include a corporate governance statement in the management report of their financial statements or prepare it as a separate component of their financial statements.

A non-financial statement

In Latvia, large central and local government companies as well as large companies having their financial instruments listed on the regulated market are required not only to apply the principles of good corporate governance but also to develop and publish a non-financial statement. This must give information on the company's development, performance and financial position, as well as on the environmental impact, social and employee aspects, human rights compliance, and anti-corruption and anti-bribery measures.

This statement must also include details of the company's policy on corporate social responsibility, including a description of procedures the company has put in place to pay proper attention to how this policy is implemented, as well as information on key corporate social responsibility risks and their management.

To give information on corporate social responsibility areas, companies may use any of the guidelines or recommendations included in Latvian or EU legislation or in documents issued by the UN, the OECD, the International Labour Organisation, the International Organisation for Standardisation, or another international organisation.

The non-financial statement must specify which guidelines or recommendations the company is using. Published in November 2022, PwC's survey on the quality of information included in the publicly available non-financial statements of Latvian companies and their corporate maturity, which analysed 52 companies in 13 various sectors, found that the Global Reporting Initiative (GRI) standard was used by Latvian companies most frequently for preparing their non-financial statements.

Future requirements for non-financial statements

When it comes to the future of non-financial statements, the European Council and Parliament reached a provisional political agreement on the draft Corporate Sustainability Reporting Directive last year, and the directive was approved by the European Parliament on 10 November 2022. The directive aims to improve the non-financial reporting rules and enhance the quality of available non-financial information in order to help Europe transition to a more sustainable economy.

The Corporate Sustainability Reporting Directive will widen the range of companies that are required to develop and publish a sustainability or non-financial statement together with their financial statements by including a certain amount of information in their management report. The statement will have to be prepared according to Europe's new sustainability standard, covering environmental matters, social responsibility, human rights, and various governance aspects. The European Financial Reporting Advisory Group is currently working on the new sustainability reporting standards.

Under the directive, non-financial statements will be examined and approved by an auditor. The auditor opinion requirement is being introduced to ensure companies adhere to Europe's new sustainability standards.

Tax governance and how this is reflected

Corporate sustainability is unthinkable without transparent and responsible payment of taxes. Yet currently only a very narrow range of companies in Latvia are required to prepare tax risk management documentation (read on to see what companies are covered by this requirement).

The significant sustainability impact of tax governance and tax compliance culture is illustrated by the tax gap. According to the SRS, the tax gap is the ratio of unreported taxes, plus taxes that are reported but remain unpaid, to the potential mass of taxes that would be charged and collected if all taxpayers fully met their tax obligations. According to the SRS, the national social insurance contributions gap in 2020 exceeded EUR 445 million – this amount could increase the state pensions budget by almost 20%. So tax governance, tax transparency and responsible payment of taxes are factors that significantly affect the social space as one of the pillars of the Sustainability (ESG) Framework. Recognising the sustainability impact of tax governance, various stakeholders will expect reliable, high-quality and standardised information on the company's tax governance as well.

In Latvia, only members of the SRS Advanced Cooperation Programme (ACP) are currently required to prepare such standardised information. The operation of the programme is governed by section 7.1 of the Taxes and Duties Act and by the Cabinet of Ministers' Rule No. 748 of 27 November 2018, *Rules for the Operation of the Advanced Cooperation Programme*. These rules require ACP Gold members to adopt and document their tax risk management to a degree of detail enabling a competent person to follow this up to a level where actions pose tax risk (the company has to adopt and periodically carry out control measures, and update its tax risk management documentation).

A new scheme is being developed for rating taxpayers (companies) that may include elements of the existing ACP but it's possible that the tax risk management documentation requirement will be omitted from the new rules. However, it's advisable for companies to adopt tax governance processes, and to prepare and publish information on their high tax compliance culture and tax governance. Such information not only promotes public trust in the company but also helps it attract investors.

Companies may follow the Latvian ACP rules, the OECD guidelines and the GRI standard to prepare information on tax governance aspects and include those in their non-financial statements.