What are the overarching principles of corporate governance?

WHAT WE THINK: A DIALOGUE IN CORPORATE GOVERNANCE

NEW CHALLENGES INITIATIVE

The ICAEW thought leadership initiative *Dialogue in Corporate Governance: New challenges* is considering five questions arising from recent events and seeing how they affect the foundations of existing corporate governance frameworks. We intend to explore these questions in a series of bite-size thought leadership projects.

While accepting that there are no easy solutions, we hope to bring greater clarity to people's thinking through dialogue with a range of interested parties and stakeholders including boards, investors, and academics.

Five questions

1. **What should companies be responsible for?**

2. **What are the overarching principles of corporate governance?**

3. **When is comply or explain the right approach?**

4. **How diverse should boards be?**

5. **Who should be covered by codes?**

A number of major changes have taken place in capital markets over recent years. These include: the growing importance of non-equity financial instruments; new types of equity owners; changes in the services offered by, and the use of, intermediaries; and pressures to harmonise internationally diverse practices in corporate governance.

Furthermore, a number of major business controversies are discussed as corporate governance issues, for example: state bail-outs of failing financial institutions during the economic crisis, public outcry over executive remuneration, and the lack of diversity on boards.

These changes and controversies present significant challenges to existing models of corporate governance built around the agency theory which sees boards of listed companies acting as agents of absent equity owners. Moreover, the changing nature of capital markets tests the validity of existing models of corporate governance.

Rather than treat current controversies as topical and fleeting matters, we intend to explore them as symptoms of misalignment between today's markets and corporate governance frameworks. We invite anyone interested in corporate governance to join our dialogue at Talk Accountancy www.ion.icaew.com/talkaccountancy or email corporategovernance@icaew.com

What are the overarching principles of corporate governance?

Discussion of question 2

One of the strengths of principle-based regulation is that it should be intuitive. Its application should not require reference to too much detail. Yet, do the principles of existing corporate governance codes provide a complete set of necessary high-level principles to guide the behaviour of a company board operating in today's business environment? If not, what should we add or take away?

Our second thought leadership discussion identifies a small number of overarching principles. They should promote good governance practice internationally and facilitate better application of national corporate governance codes.

WHAT SHOULD OVERARCHING PRINCIPLES ACHIEVE?

Our first thought leadership discussion focused on how the following four responsibilities are fundamental to companies operating successfully today.

- Achieving a business purpose
- Behaving in a socially acceptable way
- Meeting legal and regulatory requirements
- Stating how responsibilities are met

Business purpose defines company identity and provides the basis for discharging the three other fundamental responsibilities. Each company should consider the relative importance and relevance of these responsibilities in its own context and make appropriate decisions to facilitate long-term business success. Understanding its responsibilities should therefore help a company develop a sustainable business model. However, these responsibilities are not themselves overarching principles of corporate governance.

Overarching principles of corporate governance should help a board determine how to run a company to achieve its business purpose. These principles should be internationally applicable and sufficiently high level to allow companies to pursue their unique business purpose. They should also be both aspirational and credible and guide the development, where necessary, of more detailed principles, rules and guidance.

Clearly set-out overarching principles encourage companies to think beyond the letter of laws and regulations. This applies also to principles-based standards such as the UK Corporate Governance Code and other codes. Companies need to think through how best to achieve the overarching principles in practice and apply them in their own context.

More detailed principles and provisions in codes may help this process. However, to achieve the overarching principles of effective corporate governance, companies need to go beyond compliance. There may be times when companies need to explain the link between the overarching principles and their actions, notwithstanding their compliance with codes.

OVERARCHING PRINCIPLES

We have identified the following five overarching principles. Though generally derived from the UK Corporate Governance Code, they also underpin other corporate governance codes. Most components of existing codes should relate to one or more of these principles. However, some of the principles go beyond the current scope of codes.

Leadership
An effective board should head each company, steering the company to meet its business purpose in both the short and long term.

Capability
The board should have an appropriate mix of skills, experience and independence to enable its members to discharge their duties and responsibilities effectively.

Accountability
The board should communicate to the company's shareholders and other stakeholders at regular intervals, a fair, balanced and understandable assessment of how the company is achieving its business purpose and meeting its other responsibilities.

Sustainability
The board should guide the business to create value and allocate it fairly and sustainably to reinvestment and distributions to stakeholders, including shareholders, directors, employees and customers.

Integrity
The board should lead the company to conduct its business in a fair and transparent manner that can withstand scrutiny by stakeholders.

CHARACTERISTICS OF OVERARCHING PRINCIPLES

The proposed overarching principles should help companies to achieve their unique business purpose responsibly, yet with freedom to determine how. We want overarching principles to be:

Linked to business purpose
Overarching principles should relate to the overall purpose of the company. The Cadbury Report, which instigated the development of the UK Corporate Governance Code, referred to boards being 'free to drive their companies forward, but exercise that freedom within a framework of effective accountability'. This point remains relevant to any company today. Overarching principles should contribute to, though not guarantee, the achievement of a company's business purpose.

Related to outcomes
Overarching principles should state intended outcomes or effects which compliance with specific governance practices and procedures aims to achieve. Scope details, examples and explanations of how principles apply to specific areas may be useful, but they are application guidance. By contrast, overarching principles should describe a mind-set that drives board members' behaviour and the corporate culture.

Focused on what is most important
Overarching principles should be distinct and relevant to the most important outcomes only.

Clear and concise
Overarching principles should be easy for boards and stakeholders to understand. This should open board decisions and behaviour to challenge and help win internal and external support.

Durable
Overarching principles should be robust to withstand the test of time. This does not preclude the principles and their application adapting to change through consultation with stakeholders.

Widely accepted
Overarching principles should be aspirational and command acceptance among the company and its stakeholders. Even though achieving them might be difficult and take time, such acceptance among stakeholders enhances trust in the overarching principles and the company that seeks to apply them.

BENEFITS OF SETTING OUT OVERARCHING PRINCIPLES

Adhering to overarching principles can guide companies on issues that have threatened public confidence and trust in business in the wake of the global financial crisis.

They can also provide broad guidelines for dealing with contentious governance issues such as board composition, diversity, executive remuneration and corporate taxation. Even where issues will result in new regulations or law in due course, overarching principles can function as interim measures. The scope of the proposed overarching principles is wider than the UK Corporate Governance Code. This reflects what is expected of companies in the context of the financial crisis and changes in capital markets.

Overarching principles can contribute to open and dynamic board processes. The board can focus on how to best apply them in running the business and achieving their business purpose. This requires a different approach to compliance with laws and regulations. Overarching principles can also help board members examine their decision making critically and challenge whether they remain focused on the business purpose and other responsibilities. This should facilitate better understanding of corporate governance, more rigorous internal processes and more effective engagement with stakeholders.

Overarching principles of corporate governance are implicit and hard to identify in existing codes. These codes tend to become longer and more complex over time. For example, the UK Corporate Governance Code is still relatively short but it contains 18 main and 28 supporting principles. This is too detailed for most people to remember. It would be helpful to have overarching principles to which detailed principles and provisions are attached. We believe that all the main and supporting principles of the UK Corporate Governance Code fit under at least one of the proposed overarching principles.

CHALLENGES TO OVERARCHING PRINCIPLES

While people may generally accept the overarching principles as important, some might challenge them because they contain subjective concepts. Terms such as 'effective', 'appropriate', 'fair, balanced and understandable' and 'fairly and sustainably' may require further clarification. We accept that these terms may mean different things depending on the situation. However, we believe that boards need to use judgement to apply the overarching principles appropriately in each individual situation. In turn, boards will need to consider whether they should explain why their judgement is appropriate.

The overarching principles are also aspirational rather than definitive or prescriptive. Overarching principles should encourage companies to continue improving governance in their own context with their stakeholders in mind. This should consequently promote a robust corporate culture.

Encouragingly, leading board members and renowned thought leaders in corporate governance often share their own rules of thumb for effective boards. While they are useful, formal interaction is rare between these personal insights and the development of corporate governance codes. Our effort to set out overarching principles of corporate governance may prompt greater sharing and discussion of individuals' ideas. The outcome of such exchanges could be best practice ideas based on practical experience. Together with aspirational objectives, such ideas could contribute to the improvement of related standards and codes as a whole.

SUMMARY

We have considered the question of what the overarching principles of corporate governance are in the light of the fundamental responsibilities of companies considered in our first paper. The proposed overarching principles of leadership, capability, accountability, sustainability and integrity are deliberately short, purposeful and aspirational and should apply to any company. They should remind boards and their stakeholders what corporate governance should look like if a company is to achieve its business purpose and other fundamental responsibilities. The overarching principles should also help companies and regulators respond to new challenges and maintain stakeholder confidence in business.

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