



When is comply or explain the right approach?

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

When is comply or explain the right approach?

Discussion of question 3

Corporate governance codes in the EU are applied on a comply-or-explain basis. However, in other areas of business regulation, we rarely observe this approach in practice. So, under what conditions is comply or explain appropriate? And, what do these conditions mean for its application in different countries?

This paper is about promoting good corporate governance and the role of comply or explain as a means to that end.

WHAT IS COMPLY OR EXPLAIN?

The UK Corporate Governance Code has evolved from the original Cadbury Code of 1992 which is widely seen as the first comply-or-explain governance code. There are now many examples around the world.

Comply or explain is an approach that covers much of the content of the UK Code. Today, the Code contains over 50 'provisions' which set out over 110 instances of what companies, boards, directors and others 'should' do. And yet there is no requirement to comply with these provisions and companies can decide not to do so provided they give an explanation of any non-compliance.

Provisions applied on a comply-or-explain basis set out central features of UK corporate governance. For example: the roles of the chairman and chief executive should not be exercised by the same individual; the board should appoint a senior independent director; at least half the board, excluding the chairman, should comprise independent non-executive directors; there should be nomination, audit and remuneration committees and separate sections of the annual report to describe the work of the nomination and audit committees; and directors should have access to independent professional advice and the services of the company secretary.

Comply or explain is not simply about having no requirements. It is an approach that positively recognises that an alternative to a provision is justified if it achieves good governance and companies are prepared to be transparent. Departures from a code provision are not presumed to be breaches because accompanying explanations should provide insight into how companies think about improving their corporate governance.

Moreover, comply or explain is always used along with other approaches. It coexists with code principles that need to be applied in all circumstances. Company law also contains requirements concerning many aspects of corporate governance. The answer to the question 'When is comply or explain appropriate?' will never be 'Always.'

BENEFITS OF COMPLY OR EXPLAIN

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.

The purpose of all corporate governance codes, whether or not they use comply or explain, is to promote good governance. The same is true for all corporate governance legislation and regulation. That is why it is not enough for supporters of comply or explain simply to argue that the benefits of comply or explain lie in its promotion of good governance.

To support comply or explain, we need to identify specific advantages that it has over alternatives that require straightforward compliance. In our view, comply or explain promotes innovation, proportionality, substance over form and long-term learning.

Comply-or-explain provisions promote innovation because they can accommodate new ideas. Those who are not convinced that new ideas will improve governance or who see them as aspirational have less cause to argue word by word against their introduction into a code if they can explain why they are not complying. This also allows companies time to introduce new ideas at a pace that is realistic in their circumstances and to learn from the experience of others.

Proportionality means not imposing requirements that are excessively burdensome and costly, particularly for smaller businesses. Comply or explain allows companies to accept the principle behind certain provisions while arguing that in their case implementing them does not justify the costs involved. In short, comply or explain does not impose 'one-size-fits-all' solutions. In addition, it encourages the introduction of provisions that apply only to the largest companies where it is clear that general application would lead to widespread explanations of non-compliance by smaller companies.

Substance over form refers to the idea that companies complying with new provisions only do so in the belief that it will make a real difference and lead to better governance in substance. This is because comply or explain gives companies the opportunity to decide not to comply with a new provision. This decision making should encourage companies to think about the purpose of the provision rather than just making sure that they can 'tick the box.'

Comply or explain also provides long-term learning within companies. Regularly thinking through how best to address the purpose and principles of corporate governance by way of different options helps companies internalise those principles as their own norms. This is particularly important in a complex area like corporate governance: it is about human behaviour, interaction and decision making which are most effective when companies act out of their own will, rather than being forced to change through structures and procedures.

WHAT MAKES COMPLY OR EXPLAIN WORK?

If comply or explain is to work, people need to trust companies to demonstrate genuine commitment to good governance and companies need to trust that their explanations will be given proper consideration. Where this mutual trust exists, comply or explain can be seen as providing market-based solutions that are worked out between companies and their shareholders without the need for regulatory intervention. Success depends on two conditions: shared beliefs and institutional arrangements. Both are important in establishing the mutual trust which is essential.

Shared beliefs about what constitutes good governance are needed if an explanation is to be a meaningful alternative to compliance. For example, a company that does not comply with a provision should explain how its actual practices are consistent with the relevant principle and contribute to good governance and the achievement of business objectives. Our previous paper identifying five overarching principles of corporate governance could help people focus on shared beliefs that will make comply or explain effective.

Institutional arrangements need to ensure that explanations are a credible alternative to regulatory and legal enforcement of compliance. These arrangements relate to stock markets, patterns of ownership, the role of intermediaries, shareholder rights and engagement, and legal and regulatory traditions, and the incentives that all these arrangements create. Institutional arrangements will determine whether shareholders will play the

stewardship role expected of them in a comply-or-explain regime. They are expected to challenge companies' explanations and engage with boards if they are unconvincing but pay due regard to companies' individual circumstances.

CHALLENGES TO THE APPLICATION OF COMPLY OR EXPLAIN

Doubts about comply or explain arise mainly where it does not seem to deliver innovation, proportionality, substance over form or long-term learning. We need to address or at least better understand these concerns when thinking about how widely the concept of comply or explain can be applied.

Investors often say that explanations are perfunctory and do not do a good enough job of explaining how a company's alternative arrangements support the relevant principle. Also some companies claim that non-compliance affects market perception negatively and outweighs the benefits of pursuing an alternative that delivers good governance and better serves their business purpose.

Some measures have been discussed to address such issues and improve the performance of comply or explain. Disclosure principles and guidance could help improve the quality of explanations. The UK Stewardship Code encourages investors to be accountable in discharging their responsibilities and these include engaging with companies on their governance.

However, in taking such initiatives it is important not to lose sight of the fundamental causes of the problems that we are observing. Comply or explain will not work as intended if there is a lack of shared beliefs about what constitutes good governance and its value, and if institutional arrangements do not provide adequate incentives for companies and shareholders.

Where such issues arise, it is important to focus on how best to promote good corporate governance and what would achieve this objective effectively. If comply or explain fails to work as intended, mitigating measures may be needed while shared values and institutional arrangements take root. For a period of time this might mean regulatory intervention. It should also be recognised that in a compliance regime, regulators can achieve the benefits of comply or explain by allowing long transitional arrangements and exemptions.

SUMMARY

This paper is about promoting good corporate governance and the role of comply or explain as a means to that end. It can bind companies to the purpose and principles of a corporate governance code while allowing them to depart from specific provisions. It promotes innovation, proportionality, substance over form and long-term learning. However, it depends on shared values of good governance and supportive institutional arrangements. When these are lacking and comply or explain does not work as intended, the situation may call for alternatives, including regulatory intervention.

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