

# Good Practices in Corporate Governance: One-Size-Fits-All vs. Comply-or-Explain

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## Abstract

There are many studies exploring the effects of hard and soft legislation on good practices. Few studies examine the strengths and weaknesses of particular legislation. These mainly focus on positive results of legislation and justify the application of existing approach for better practices.

The study compares the approaches of hard and soft legislation. It finds that both approaches are suitable for implementation despite of state policy. The analysis is developed by using the practices of several countries for latest 20 years.

This study explored national legislation and its effects on good practices in corporate governance. It revealed that there was no significant difference between state policy and approaches, and between legislation and corporate governance practices.

The objective of the study is to develop deeper insight into pros and cons adoption of approaches. Comparative analysis shows that state policy determines the good practices. Moreover, the conclusion point out that there is a small freedom of action for companies to attract investors.

**Keywords:** good practices, corporate governance

## 1. Introduction

More and more frequently, researchers explain the roots of modern crisis and proposals for recovery. Policy makers search balance among competitive power of national economy and international agreements for economic growth of world economy. Managers fulfil their fiduciary engagements to shareholders taking in mind the social engagements to stakeholders. Investors dispose the capital among companies and judge the quality of corporate governance practices.

Studies to date have analysed the corporate governance practices in their own legal environment only. The state policy defines a frame for good practices and discourages companies for innovative practices. Self-regulated organizations and non-government entities extend horizons by adoption of a new approach.

Present study compares the two most popular approaches for good practices in corporate governance. The pioneer analysis has a target to describe and contradict both approaches than to assess and improve them. In order to understand which approach better meets investor's need, we will use evolutionist and comparative methods.

Good practices in corporate governance are a part of the economic policy for investors attracting. Changes of good practices are an indicator for globalisation and harmonisation reforms. Part of these reforms is becoming of close the different systems of corporate governance.

Discovery of balance between legal and regulation instruments together with codes and initiatives is the base for state policy in corporate governance issues. The modern theory confirms the acceptance of voluntary codes as preferred variant for decrease of regulation costs and increase of market flexibility. The practice for implementation of unified criteria and legal requirements, familiar as one-size-fits-all approach, was replace by a new approach – comply-or-explain.

After a consecution of wrong actions by local companies (BCCI, Maxwell, etc.), in 1992 UK introduced a new practice for corporate governance. By adoption of Cadbury Code was removed the one-size-fits-all approach due to the possibility for fictitiously report on good practices by observation of obligatory rules (Arcot et al., 2005).

The Cadbury Code introduced a new approach, based on voluntary actions for observation or reasons for any areas of non-compliance. The approach indicates the policies of leading companies as a landmark for the rest market participations. Implementation of the approach creates an information flow for good practices and gives opportunity to the market to assess the condition of every company.

## **2. Theoretical and Conceptual Framework**

### *2.1 Evolution of One-Size-Fits-All Approach*

The harmonization wave required a new approach for good practices in corporate governance. National legislations introduced one-size-fits-all approach. The competent authorities unified company's structures and practices for better regulation.

The increasing regulatory requirements additionally brings for dropping out. The one-size-fits-all approach was legally tie after the drop out of restrictions regarding free capital movement in EU and created opportunities for regulatory arbitrage in country with better regulatory legislation (Streeck, 2001). The privatisation wave in 1990's changes the laws to create a mass property and the necessity of ownership protection, requires a new approach.

National and multinational measures to contemporary economic crisis involve one-size-fits-all approach in new light. Regulators' steps for better governance standards has driven important innovation which includes mandatory requirements for all companies in the area of executive remuneration and active voting shareholders (United Nations Conference on Trade and Development, 2010).

### *2.2 Evolution of Comply-or-Explain Approach*

The globalization, modernization and interdependence posed new challenges to corporate governance (Rosenau, 1997). The one-size-fits-all approach was ill suited for enlarge process in EU (Zielonka, 2007). The wrong adoption of one-size-fits-all approach identifies a regulatory gap, which may be filled with appropriate counter measures.

In 1990's the countries began to accept a national codes of corporate governance based on new approach – comply-or-explain. The national codes content non-obligatory rules to which local companies must comply or explain the diversion of good practices (RiskMetrics Group, 2009). The implementation of new approach was happening gradually with giving an account to specific features of every country: ownership structure and corporate governance traditions. The new approach was adopted firstly in countries with concentrated ownership and long traditions, mutually prepared by national regulatory authority and private entities. In other countries, the adoption of national codes was doing by stock exchange and without participation of the state. Regardless of introducing time, the modern laws regulate similar elements of corporate governance: board organisation, presence of audit committees, obligatory external audit and shareholders rights. The modern national codes treated similar issues of corporate governance, related to independence of board members, presence of remuneration committee and nomination committee, internal control and risk management.

The base of comply-or-explain approach is voluntary applying of good practices in corporate governance consistent with national codes but with mandatory disclosure. Conditionally, but believable, the approach is named „a uniquely cost-effective framework of quasi-legal controls” (Moore, 2009). Using of the approach creates an ex post standard for fiduciary engagements of agents by means of board structure and procedures (MacNeil and Li, 2006).

Before law harmonisation on European level, the approach was implementing in more countries. The wide implementation of the approach was explained by opportunity for every company to adapt her targets in different legislations. The developed „code culture” was transform to „culture of compliance” (Sanderson et al., 2010).

In 2006, the Directive 2006/46/EC introduces comply-or-explain approach on pan-European level by requirement for separate report by directors about complying of good practices in corporate governance. The certification role for complying is delegate to external auditors. The good practices of corporate governance are choice between law and codes for every Member State. The practices depend on legal tradition and ownership structures (RiskMetrics Group, 2009).

In 2007, the financial crisis was closely associated with the insufficient implementation of corporate governance codes while current corporate governance frameworks are not wrong in general (Sun and Stewart, 2011). The main

errors are in four areas of corporate governance: remuneration systems, risk management practices, the performance of boards, and the exercise of shareholder rights (OECD, 2010).

The European Commission defines comply-or-explain approach as core measure to economic crises (European Commission, 2011). The new moment is implementation of the approach as regulation instead of soft-law, based on principles and flexible.

### 2.3 Strengths of Approaches

#### 2.3.1 One-Size-Fits-All Approach

State authorities for better regulation prefer the one-size-fits-all approach. Due to close companies' structure and practices, the monitoring process is **shortest and cost attractive**. The state policy "top-down" for mandatory implementation of corporate governance practices is recommended for better client protection and conducting of government reconstruction plans. The companies' structure and practices are mirrored to competent authority's structure and practices.

The approach is recommended for **integration process of developing countries**. State "red tapes" are checks and balances for establishing of good management practices (Pitcher Partners Consulting, 2012). Adoption of the approach may be regarded as knowledge inflow and sustainable growth. The EU Program for promotion of good practices in neighbour countries is based on one-size-fits-all approach (Börzel et al., 2008). Since 2004 EU foreign policy to Caucasus region uses the approach for right pursue of privatization process and for decreasing of corruption.

The approach is suitable for **adaptation of state policy for client protection**. Society interests require adaptation of transparency and accountability by companies. For example, the lack of one-size-fits-all approach leads to combined Chairman and Chief Executive Officer's role (Ernst & Young, 2013).

#### 2.3.2 Comply-or-Explain Approach

The comply-or-explain approach is better instrument in modern period of economic recovery due to his **flexibility** (Financial Reporting Council, 2011). It allows companies to adapt their corporate governance practices to their specific situation taking into consideration their size, ownership structure and sectorial specificities (European Commission, 2013). The companies have broad tools for investor attracting and ownership protection. The flexibility involves biggest competition both at company and at national level.

The next advantage of the comply-or-explain approach is the highest level of **market sensibility**. Companies benefit from complied strongest corporate governance practices by attracting more investors, and so reducing the cost of capital for all (Gibson-Smith, 2012).

Third advantage of the approach is his **self-regulation principle**. The implementation of comply-or-explain approach led to focus both on shareholders and on public interests. The companies are better run, more competitive and stable to future crisis (European Commission, 2011).

The comply-or-explain approach gives opportunities both for companies and for regulators for more **efficiency** (European Commission, 2006). The approach forces the regulators to change their structure and to allocate responsibilities between separate national and sector regulatory authorities like a mirror to the market ("bottom-up" policy).

### 2.4 Weaknesses

#### 2.4.1 One-Size-Fits-All Approach

First negative aspect of one-size-fits-all approach is **inflexibility**. By complying of regulatory requirements at national level, no company takes into account local considerations (Eurobarometer, 2011). The fact that requirements are often too detailed and the policy making process takes too long period and is unable to respond quickly enough to local needs.

Second, the approach is **proportional**. The state policy for separation and grouping of companies leads to involuntary implementation of corporate practices. Introducing of criteria and restructuring by regulatory authorities create a company's structure and organisation without taking into account the ownership point of view and discouraging of investors. The companies are demotivated for innovations.

Third, the one-size-fits-all approach creates an undue burden for **smaller companies** (Federal Deposit Insurance Corporation, 2012). Equal requirements to all companies posed a question to the right balance between costs and benefits. The high compliance costs are unsuitable for SMEs. Approach would disadvantage SMEs, whose business

model is focus on meeting the unique needs of local consumers. The costs for regulation of complying with mandatory norms in one-size-fits-all approach are highest to disclosure costs in comply-or-explain approach (European Commission, 2006).

Differences in national legislations make difficulties for companies to establish overseas business (Baker & McKenzie, 2012). The application of one-size-fits-all approach is unduly restrictive on businesses and makes every country **a less attractive place** of business for foreign companies (PricewaterhouseCoopers, 2012).

The one-size-fits-all approach was adopted in USA by Dodd-Frank Act in 2010 for empowerment of shareholders. The reform does not take under consideration the shareholders' interests concerning transborder voting and asset classes (Rose, 2010).

Last, but not least, the approach leads to **formal reporting of compliance**. The "ticking the box" is a company practice to declare fulfilment of regulators' requirements without any real actions from her part. The approach is based on compliance system and the management treats his responsibility as a 'box ticking' exercise (Young, 2005). The contemporary authors describe tick-the-box as a feature of economic boom over the past decade (Watson, 2012) or as a feature of modern practices of cross-border voting (OECD, 2011).

#### 2.4.2 Comply-or-Explain Approach

The comply-or-explain approach is adopted **for listed companies** only. National codes and legislations have not requirements for adaptation of comply-or-explain approach for non-listed, state owned and family owned companies. In practice, more of the overseas subsidiaries are non-listed companies and may raise spillover risk effect to parent company.

The benefits of implementing the corporate governance code exceed the costs (RiskMetrics Group, 2009). Regardless of advantages of the comply-or-explain approach, the implementation costs of the corporate governance recommendations remain **too high for SMEs**.

#### 2.5 Modern Implementation of Approaches

In 2012 Financial Reporting Council, the UK authority who accepted the comply-or-explain approach in 1992, reconsiders his suitability (Treanor, 2012). Frequently reported diversions in corporate governance practices are result from path dependence, i.e. from shareholders structure.

Regardless of comply-or-explain approach advantages, only 51% of 30th biggest UK companies and 40% of 30th biggest Germany companies fully complied with national codes (Seidl, 2009). The economic recession and bank scandals show the necessity of mandatory codes that guarantee for high standards of corporate governance (Ahern, 2010). The OECD experts consider the politicians must to take a decision for legal requirements for corporate governance instead of flexible instruments, based on principles code (Financial Reporting Council (UK), 2010).

The contemporary practice uses both approaches. The traditional approaches are modernized and adopted by new measurements:

##### 2.5.1 Every-Country-a-Different-Strategy Approach

The one-size-fits-all approach is **fit for some areas**. Multinational companies change their strategies in response to the government recovery plans (Lucea and Doh, 2012). The new strategies are flexible despite of host requirements. For example, the country-specific differences in risk potential propose a new strategy to comply with related regulatory model (Eling and Marek, 2009).

##### 2.5.2 Size-Is Not Fit-but Suitable-for Every Company Approach

Some authors propose a new variant of one-size-fits-all approach – the size is not fit but suitable for every company (Dittmeier, 2012). The variant considers the approach as a **combination of four elements** of corporate governance: board responsibilities, board competences, risk management and internal audit.

##### 2.5.3 Comply-or-Else Approach

The standard-based approach comply-or-explain is modified to rule-based approach – comply-or-else. The modified approach differs from the original approach by his **mandatory obligation to comply** with corporate governance standards. The corporate standards are legally binded and failure to obey these standards will result into sanctions. This approach is adopted in USA by Sarbanes-Oxley Act in 2002 and in South Africa by King Committee on Corporate Governance III in 2009 (Institute of Directors in Southern Africa, 2009). The new approach requires higher cost of compliance and focus on compliance at the expense of enterprise by the board and management.

#### 2.5.4 Comply-and-Explain Approach

The effects of economic crisis put reconsideration of comply-or-explain approach. The practice reports large diversions in implementing of recommendations by national codes. Some authors propose a new variant for the comply-or-explain approach – comply-and-explain (Nedelchev, 2010). The variant foresees **mandatory implementation** of national code and **mandatory disclosure** for manners of implementation.

#### 2.5.5 Comply-or-Disclose Approach

The German legislation implements the comply-or-explain approach by **requirements for disclosure of deviations** from the code provisions without any reasons for the deviation. In this sense, the modified approach is sometimes also referred to as comply-or-disclose (Seidl and Sanderson, 2007).

Since 2009, the New York Stock Exchange amends its listing standard, which requires disclosure about director independence. In addition, the changes would permit companies to make disclosures about certain matters on their websites instead of in their proxy statements.

#### 2.5.6 Apply-or-Explain Approach

In the Netherlands, the comply-or-explain approach was modified to a new approach – apply-or-explain (Institute of Directors in Southern Africa, 2009). The national code considers how the principles and recommendations **can be applied**. The modified approach contains recommendations on principles and practices rather than strict rules, those companies are advised to act accordingly. The companies are allowed to use own discretion on whether to apply to the recommended principles and practices however it is expected of each company to explain why it chose not to comply in for example annual reports. The adaptation of the approach requires regular reports to stakeholders for critically scrutinize. Whilst Dutch code requires from listed companies to provide an explanations for deviations, some other countries merely require a statement for disclosing of non-conformance (Roberts and Sanderson, 2009).

### 3. Conclusions

Corporate governance practices as a part of state policy for investors attracting use two main approaches. Discovery of balance between legal and regulation instruments together with codes and initiatives is the base for corporate governance state policy. The modern theory confirms the acceptance of voluntary codes as preferred variant for decrease of regulation costs and increase of market flexibility. The practice for implementation of unified criteria and legal requirements, familiar as one-size-fits-all approach, was replace by new approach – comply-or-explain.

The one-size-fits-all approach has limited application in modern practices. The obligatory nature of the approach is consistent with requirements of a specific country and is unsuited for global implementation due to impossibility of convergence of main corporate governance details like shareholders protection, independent directors and committee presence (Davies and Schlitzer, 2008).

The comply-or-explain approach has three reasons for fitting compare to one-size-fits-all approach. First, the approach gives decision for manager responsibilities and shareholders taken in account long-term interests of the company. Second, the approach stimulates companies to follow good practices, which are fit to her corporate culture, without taken in account factors like company size, ownership structure and complexity of business actions. Third, the approach reduces the participation of regulatory authorities to imposition of minimum standards.

The modern practices in corporate governance are implementation of hybrid between comply-or-explain approach and mandatory regulation. Implementation of both approaches marks high dynamic and puts a number of questions for good practices in corporate governance. The answer for preference of every one approach is the balance between “hard” and “soft” legislation.

The corporate governance framework in the European Union is a combination of legislation (“hard law”) and recommendations and corporate governance codes (“soft law”). There are corporate governance codes at national level and at the EU level (Directive 2006/46/EC) which require referring in corporate governance statement to a code and that listed companies report on their application of that code on a comply-or-explain base (European Commission, 2011). The proportionate approach is preferred for credit institutions combining both targeted principle-based regulations and flexible comply-or-explain codes of best practice and complemented by regular external evaluation and appropriate regulatory oversight (European Parliament, 2011).

At the heart of good practices in corporate governance is the comply-or-explain approach. The contemporary crisis reveals that the informative quality of explanations departing from the corporate governance code’s recommendation and for many Member States there is insufficient monitoring of the application of the codes.

The evolution of the corporate governance practices depends on the context and circumstances and consequently they need to be tailored to meet the specific needs (Benea, 2012). The solution to economic turmoil is usually a one size fits all alternative, which is often inefficient in avoiding future unforeseen problems.

During the crisis, the comply-or-explain approach is preferred (RiskMetrics Group, 2009). Investor perspectives are an acceptable balance between legislation and comply-or-explain-based codes. The all-important issues relating to corporate governance are a combination of law and codes.

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