

Rules-based approach - definition

- In a **rules-based approach** to corporate governance, provisions are made in law and a breach of any applicable provision is therefore a **legal offence**.
- This means that companies become **legally accountable for compliance** and are **liable for prosecution in law** for failing to comply with the detail of a corporate governance code or other provision.
- Examples: USA– Sarbanes-Oxley Act 2002(SOx)

Principles-based approach - Definition

- A principles-based approach works by (usually) a stock market making compliance with a detailed code a condition of listing. Shareholders are then **encouraged** to insist on a high level of compliance in the belief that higher compliance is more robust than lower compliance.
- When, for whatever reason, a company is **unable to comply** in detail with every provision of a code, the listing rules state that the company must **explain**, usually in its annual report, exactly **where it fails to comply** and **the reason why it is unable to comply**. The **shareholders**, and **not the law**, then **judge** for themselves the **seriousness of the breach**.
- Examples: UK-combined code 2006 (CC06)

Characteristics of a principles-based approach

- **(a) Focus on aims**
- The approach focuses on **objectives** (for example the objective that shareholders holding a minority of shares in a company should be treated fairly) rather than **the mechanisms by which these objectives will be achieved.** Possibly therefore principles are easier to integrate into strategic planning.

Characteristics of a principles-based approach

- **(b) Flexibility**
- A principles-based approach can lay stress on those elements of corporate governance to which rules cannot easily be applied. These include overall areas such as the requirement to maintain sound systems of internal control, and **'softer' areas such as organisational culture** and maintaining **good relationships** with shareholders and other stakeholders.

Characteristics of a principles-based approach

- **(c) Breadth of application**
- Principles-based approaches can be applied across **different legal jurisdictions** rather than being founded in the legal regulations of one country.
- **(d) Comply or explain**
- Where principles-based approaches have been established in **the form of corporate governance codes**, the **specific recommendations** that the codes make have been enforced on a comply or explain basis.

Characteristics of a rules-based approach

- **(a) Emphasis on achievements**
- Rules-based systems place **more emphasis on definite achievements** rather than underlying factors. The EMAS environmental management system (discussed later) is a good example of a system based on rules, with requirements for targets to be set and disclosure requirements of whether or not targets have been achieved.

Characteristics of a rules-based approach

- **(b) Compulsory compliance**
- Rules-based approaches **allow no leeway**. The key issue is whether or not you have complied with the rules. There is *no flexibility* for different circumstances, for organisations of varying size or in different stages of development.

Characteristics of a rules-based approach

- **(c) Visibility of compliance**
- It should in theory **be *easy to see* whether there has been compliance with the rules**. Comparison between companies should be straightforward. **However that depends on whether the rules are *unambiguous*, and the clarity of evidence of compliance or non-compliance**.
- **(d) Limitations of rules**
- Enforcers of a rules-based approach (regulators, auditors) may find ***it difficult to deal with questionable situations that are not covered sufficiently in the rulebook***.

Principles or rules? - Characteristics

| Principles | rules |
|-------------------------------|---------------------------------|
| Focus on aims | Emphasis on achievements |
| Comply or explain | Compulsory compliance |
| Flexibility | |
| | Visibility of compliance |
| Breadth of application | |
| | Limitations of rules |



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