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Understanding corporate governance

1 Corporate governance is understood differently across the public sector. This chapter sets out the Audit Commission's definition of corporate governance and introduces some of the associated key themes that we explore further throughout the report.

2 The development of a common understanding of corporate governance is generally agreed to have started with the Cadbury report **(Ref. 2)**, which identified the principles of good governance as integrity, openness and accountability. The report was the first of several on corporate governance in the private sector, the most recent contributions being the Higgs report on non-executive directors **(Ref. 3)** and the Smith report on audit committees **(Ref. 4)**. In the public sector, the Nolan Report **(Ref. 5)** was particularly important in setting out the principles of public life.[I] Appendix 2 contains a list of relevant reports on corporate governance.

3 The Audit Commission has developed its understanding and in this report defines corporate governance as:

The framework of accountability to users, stakeholders and the wider community, within which organisations take decisions, and lead and control their functions, to achieve their objectives.

4 Good corporate governance combines the 'hard' factors – robust systems and processes – with the 'softer' characteristics of effective leadership and high standards of behaviour. It incorporates both strong internal characteristics and the ability to scan and work effectively in the external environment. The internal combination of 'hard' and 'soft' characteristics involves:

- **leadership** that establishes a vision for organisations, generates clarity about strategy and objectives, roles and responsibilities, and fosters professional relationships;
- **culture** based on openness and honesty, in which decisions and behaviours can be challenged and accountability is clear;
- supporting accountability through **systems and processes**, such as risk management, financial management, performance management and internal controls. They must be robust and produce reliable information to enable better decisions to be reached about what needs to be done in order to achieve objectives; and
- **external focus** on the needs of service users and the public, reflecting diverse views in decision making, producing greater ownership among stakeholders and maintaining clarity of purpose.

I Selflessness, integrity, objectivity, accountability, openess, honesty, leadership.

5 Externally, an effective and **strategic regulatory regime** can promote better corporate governance, with appropriate targets and freedoms and flexibilities for organisations based on comprehensive information about their performance and capacity.

6 How well the internal characteristics are *balanced* is important: public sector organisations operate in complex legislative, political and local contexts, in which they have to make difficult decisions. Well-governed organisations balance their different responsibilities and use information to decide where to allocate effort and resources to meet competing demands. Good governance supports **effective decision making**; poor governance is often seen (in hindsight) as creating the climate, structures and processes that lead to poor decisions.

7 Decision making always involves risk, but this risk is reduced when an open culture exists in which challenge is accepted and supported. This challenge and openness must be underpinned by robust performance, financial and information management systems, the effective use of risk management and an accountability framework that is based on a clear communication and understanding across the organisation of roles and responsibilities.

8 The importance of effective leadership in ensuring good governance is clear from inspection reports and from other reports generated across the public sector. Ultimately, leaders are responsible for achieving the right balance of hard and soft factors and are accountable for the decisions they take, or fail to take. They set the strategy for organisations and give it a sense of direction and purpose. The relationships between those carrying out executive and non-executive roles are fundamental to setting the tone for the cultural aspects of organisations that can never be codified or set out in detailed guidance, but which are immediately recognisable to those who work in or deal with them **(Exhibit 1, overleaf)**.

9 The Audit Commission, in conjunction with the Improvement and Development Agency (IDeA) is currently investigating the topic of leadership and will report later in 2003.