



<b>Title</b>	A typology for exploring the quality of explanations for non-compliance with UK corporate governance regulations
<b>Authors(s)</b>	Shrives, Philip J., Brennan, Niamh
<b>Publication date</b>	2015-03
<b>Publication information</b>	Shrives, Philip J., and Niamh Brennan. "A Typology for Exploring the Quality of Explanations for Non-Compliance with UK Corporate Governance Regulations." Elsevier, March 2015. <a href="https://doi.org/10.1016/j.bar.2014.08.002">https://doi.org/10.1016/j.bar.2014.08.002</a> .
<b>Publisher</b>	Elsevier
<b>Item record/more information</b>	<a href="http://hdl.handle.net/10197/7419">http://hdl.handle.net/10197/7419</a>
<b>Publisher's statement</b>	This is the author's version of a work that was accepted for publication in The British Accounting Review. Changes resulting from the publishing process, such as peer review, editing, corrections, structural formatting, and other quality control mechanisms may not be reflected in this document. Changes may have been made to this work since it was submitted for publication. A definitive version was subsequently published in The British Accounting Review (VOL 47, ISSUE 1, (2015)) DOI: 10.1016/j.bar.2014.08.002.
<b>Publisher's version (DOI)</b>	10.1016/j.bar.2014.08.002

Downloaded 2026-05-02 00:30:04

The UCD community has made this article openly available. Please share how this access benefits you. Your story matters! (@ucd\_oa)



© Some rights reserved. For more information

**A typology for exploring the quality of explanations for non-compliance with UK corporate governance regulations**

Philip J. Shrives<sup>a,\*</sup>, Niamh M. Brennan<sup>b</sup>

<sup>a</sup> *Newcastle Business School, Faculty of Business and Law, Northumbria University, City Campus East, Newcastle upon Tyne NE1 8ST, UK*

<sup>b</sup> *UCD School of Business, University College Dublin, Belfield, Dublin 4, Ireland*

(Published in the *British Accounting Review*, 2015, 47(1): 85-99.

<http://dx.doi.org/10.1016/j.bar.2014.08.002>)

✉ **Acknowledgements:** The authors gratefully acknowledge helpful comments on earlier drafts of the paper from participants at the following conferences/seminars: Asia Pacific Interdisciplinary Perspectives on Accounting (APIRA) Conference, Kobe, 2013, Queensland University of Technology and the University of Sydney. We also thank Mahmud Al Masum from the University of Adelaide for his insights and also Anthony Devine from Northumbria University for his final proofreading. Finally, we thank the reviewers and editors for helping us bring our paper to publication standard.

\* Corresponding author.

*Email address:* Philip.Shrives@northumbria.ac.uk

## **Abstract**

Companies not complying with the UK Corporate Governance Code are required to provide explanations for non-compliance. This is the capstone of the 'comply-or-explain' system. There are no regulations about the content of those explanations, leaving shareholders and others to judge their appropriateness. The study develops a typology to assess the quality of corporate governance explanations for non-compliance of UK FTSE 350 companies based on seven quality characteristics. Code breaches generating the non-compliance explanations for analysis are identified for two accounting periods (2004/5 and 2011/12) relating to the 2003 and 2010 Codes (data for 2011/12 in brackets).

There were 204 (125) non-compliant companies, 537 (253) Code breaches and 438 (208) explanations for non-compliance, an average of 2.6 (2.0) Code breaches and 2.2 (1.7) explanations per non-compliant company. Although compliance increased over the period examined, explanations were found to be of variable quality. Results suggest that companies need to improve the quality of their explanations if they are to be useful to users, notably location, complexity and specificity of explanations. There are also important questions raised about the work of auditors and their apparent silence. Companies are being encouraged to move towards compliance. We argue that this is against the 'comply-or-explain' philosophy which accepts that 'one size does not fit all.' Better quality of explanation is more important than compliance and thus companies may be unwittingly heading in the wrong direction.

*Keywords:* Corporate governance, comply-or-explain, non-compliance, explanation, quality of explanations, typology

## 1. Introduction

The essence of the UK Corporate Governance Code is flexibility, with companies able to choose whether or not to fully comply. Explanations of non-compliance with the Code requirements are the capstone of the 'comply-or-explain' system. However, study of these explanations has been "*largely neglected*" (Solomon, 2010, p. 156). Other authors also raise questions about the validity of a system that is self-regulated (Wymeersch, 2005) and is therefore open to abuse. For that reason alone, it is important to examine the quality of explanations for non-compliance.

In a review of explanations for non-compliance, the Financial Reporting Council (FRC, 2012a) highlights the gradual move towards (apparent) compliance with the Code in recent years and suggests that improving the explanations of the few remaining non-compliant companies might not be worthwhile in terms of the benefits obtained. However, a rather different view of significant non-compliance is revealed by Grant Thornton (2011). Chris Hodge, Head of Corporate Governance at the FRC, writing in the Grant Thornton (2011, p.2) annual review of compliance with the Code admits "*(I)t is not enough to simply say non-compliance suits one's business model: stakeholders deserve to know exactly why this is the case and what arrangements ensure that, despite non-compliance, the business – and their interests – are protected.*" Currently, UK companies have free rein over explanations in their annual reports. The Code is entirely silent as to what happens when non-compliance occurs other than to require companies to provide an explanation. The essence of an explanation is that it should be of 'equal quality' to full compliance.

The objective of the paper is to develop a typology based on seven quality characteristics from the prior literature and the International Accounting Standards Board's (IASB) conceptual framework (see Figure 1). A typology is a classification scheme which organises phenomena into groups on the basis of their similarity of key features (Bailey, 1994). Typologies can reduce complexity by highlighting similarities and differences. However, they can also oversimplify complex phenomena

and reify theoretical constructs by obscuring that they themselves are social constructs (Bailey, 1994), so they need to be used with care. The seven quality characteristics in our typology are: (i) Location, (ii) Comprehensiveness, (iii) Originality/Mimetic behaviour, (iv) Length, (v) Complexity, (vi) Specificity and (vii) Attestation. This compares with Seidl, Sanderson, and Roberts (2013) quite different 12-component taxonomy of explanations which they empirically generate from their analysis of the discursive legitimacy tactics employed in explanations. Having first revealed the extent of non-compliance with the Code, the study applies the typology to analyse two sets of explanations (646 explanations) for non-compliance relating to years ending in 2004/5 and 2011/12. Our research suggests that companies do not provide high quality explanations. In a multi-theoretic approach, we use institutional theory and resource dependency theory to explore why this might be the case.

The paper makes three contributions to the prior literature:

- (i) The primary contribution is the development of a typology of quality characteristics especially developed for analysing non-compliance explanations which are more comprehensive than those in previous studies. Our typology complements the taxonomy of Seidl et al. (2013) by providing an alternative and quite different approach based on quality characteristics derived from the International Accounting Standards Board's (IASB) Conceptual Framework and the prior disclosure quality literature.
- (ii) Explanations for non-compliance with governance codes remain relatively unexplored in the prior literature, with the exception of MacNeil and Li (2006), Pass (2006), Andres and Theissen (2008), Arcot, Bruno and Faure-Grimaud, (2010), Hooghiemstra (2012), and Seidl et al. (2013) whose research is summarised in Table 1. As such, this paper contributes to an understanding of this under-researched area. In addition, a wider range of disclosed non-compliance is analysed with greater depth than some previous studies which have only examined parts of companies' non-compliance or restricted samples from the FTSE 350.

(iii) The study examines different theoretical propositions than the predominantly agency theoretical lens adopted in the prior literature and Seidl et al.'s (2013) legitimacy theory perspective (see Table 1).

**<Insert Table 1 here>**

Section 2 of the paper examines theory and accounting concepts in relation to quality of the explanations. Our typology is described in Section 3 and the results are discussed in Section 4. The paper ends with policy implications, a conclusion and suggestions for further research.

## **2. Theoretical Basis**

A concern with corporate governance (as a subject), is that it has no conceptual framework and borrows from other closely related subjects almost in a 'magpie' like fashion, with a raft of theories to explain nearly every practice. For example, Abraham and Shrivs (2014) refer to in excess of ten theories that can be used to explain risk disclosures. This can result in a 'pick 'n' mix' approach by academics. Despite this caution, it is widely accepted that a multi-theoretical approach to corporate governance is beneficial (Zahra & Pearce, 1989). This paper uses different theories only where they add insights at different stages of the research process.

Agency theory is commonly invoked to explain disclosure, suggesting that company managers will want to provide explanations to suit themselves but will need to demonstrate to shareholders that their corporate governance practices are appropriate. Under signalling theory (Spence, 1973), companies recognise that users of financial reports are relatively uninformed (versus managers) about their governance practices (see Zhang & Wiersema, 2009; Connolly, Certo, Ireland, & Reutzel, 2011). Thus managers should signal that their own non-compliant practices are of equal value to those required by the Code by providing detailed and bespoke explanations. Bhat, Hope, and Kang (2006) adopt both agency and signalling explanations concerning the positive relationship found

between the accuracy of analysts' forecasts and corporate governance disclosure/transparency. Under agency theory, managers' reporting incentives influence financial reporting quality, which in turn is influenced by governance. The credibility of financial disclosures can be inferred from/signalled by governance disclosures. Their results suggest that governance-related disclosure plays a bigger role in improving the information environment when financial disclosures are less transparent.

Research adopting agency and signalling theory explanations for disclosure tends to measure disclosure in a dichotomous manner. Such an approach does not capture the focus of this study – the quality of disclosure. For this reason it makes sense to look elsewhere for useful theories. In particular, institutional and resource dependency theories offer particular insights to “*demonstrate how organizational behaviour may vary from passive conformity to active resistance in response to institutional pressures...*” (Oliver, 1991, p. 146).

Institutional theory (DiMaggio & Powell, 1983; Mizuchi & Fein, 1999), with its focus on conformity which is associated with survival, tends to suggest compliance. First, companies may feel coerced into compliance either to follow best practice or they may be reluctant to craft an explanation for non-compliance. DiMaggio and Powell (1983, p. 156) state that “*abrupt increases in uncertainty and ambiguity (such as when a new Code is introduced) should, after brief periods of... experimentation lead to rapid isomorphic change.*” This might suggest a long term equilibrium of compliance among companies, something which could undermine the ‘comply-or-explain’ philosophy. This would be the case if companies felt so pressurised into compliance such that their compliance was more apparent than real (Oliver, 1991). Second, companies may copy other companies’ non-compliance (termed mimetic behaviour by DiMaggio and Powell, 1983). Third, companies may be tempted to mimic or copy the actual explanations of others particularly where they are unsure themselves how best to craft the explanation. The Code itself provides no guidance which could be interpreted as indirect

evidence that it favours compliance. As DiMaggio and Powell (1983) state *“Uncertainty is... a powerful force that encourages imitation”* (p. 151). If there are questions about legitimacy regarding non-compliance, managers may copy what might be seen as acceptable practices of respected or bellwether organisations to *“maintain legitimacy and increase survival prospects”* (Dillard, Rigsby, & Goodman, 2004, p. 510).

Mimetic behaviour is inconsistent with ‘comply-or-explain’ as the act of non-compliance implies the company is unlike other ‘typical’ companies. Thus, managers of non-complying companies should provide bespoke and specific explanations. Copied disclosures cannot be bespoke. Because the circumstances of each company are inevitably different, the explanation is unlikely to be as good as a specially crafted one.

Another related aspect of institutional theory is decoupling. Decoupling (Meyer & Rowan, 1977; Dillard et al., 2004) refers to corporate practices that are inconsistent with organisational processes. For example, managers may choose to disclose an explanation from another company’s annual report even though that explanation is unrelated to the company’s own circumstances. Alternatively, managers may construct an explanation which bears no relation to reality or is just partly true. A version of this could also be the circumstance where the company simply fails to give an explanation (i.e. is silent on the reason for non-compliance).

Resource dependency theory, which has its origins in the sociological and organisational literature (Zahra & Pearce, 1989), suggests that companies (or their managers) will maximise the resources available to them. Thus, companies will prioritise certain key resources such as banking or legal expertise over compliance with the Code such as independence of non-executive directors. Agency theory predicts that managers act in a self-serving manner and resource dependency theory predicts that *“companies will view the function of the non-executive director more in terms of usefulness (to*

*the company) than independence”* (as desired by the Code) (Shrives, 2010, pp. 118-119). Convergence exists between resource dependency and institutional theory in that both, like agency theory, predict self-serving behaviour which seeks legitimacy and stability (Oliver, 1991). For resource dependency theory, that manifests itself in non-compliance (in order to secure vital resources), while for institutional theory, that *normally* manifests itself in compliance. Mimetic non-compliance can also be a predicted outcome of institutional theory.

Non-compliance with the Code should not be seen as a legitimacy issue because it is *entirely* legitimate within the ‘comply-or-explain’ framework to provide an explanation for non-compliance. One of the concerns with the operation of the Code, as it now stands, is that interest only in compliance or non-compliance (i.e. rather than the explanation) can drive companies towards compliance where it is inappropriate (e.g. misaligned with company objectives) or simply false. Legitimacy issues would only arise if an explanation was defective or missing, or non-compliance was framed as compliance and subsequently detected.

Resource dependency theory helps researchers understand why certain sections of the Code are not complied with and may predict where non-compliance is most likely. Institutional theory suggests that managers may utilise a number of devices to make the non-compliance less visible particularly in companies which have high public visibility. If legitimacy is seen as a ‘resource’ (DiMaggio & Powell, 1983), then resource dependency theory also helps researchers understand the approaches companies may take to hide non-compliance.

### **3. Research methods: Quality Characteristics, Typology and Sample**

A quality typology comprising seven components (see Figure 1) is applied to address the research question: what is the quality of corporate governance non-compliance explanations? For ease of

exposition of results, sub-questions are identified by reference to the seven elements of our typology.

**<Insert Figure 1 here>**

### *3.1 Location*

Hirshleifer and Teoh (2003) claim that because investors have limited attention spans, different ways of disclosing the same information may impact on perceptions and even market price. The Securities and Exchange Commission (SEC), in its staff reviews of IFRS compliance, also commented that some companies scatter disclosure (SEC, 2007) and this can have an impact on understanding. Perceptions of firm performance and prospects can be manipulated by the way information is presented in corporate documents. Ordering or physical location of information can be used to direct readers' attention to or away from specific items of information (Staw, McKechnie, & Puffer, 1983; Baird & Zelin, 2000; Bowen, Davis, & Matsumoto, 2005; Elliott, 2006; Brennan, Guillamon-Saorin, & Pierce, 2009). Companies may take advantage of the lack of rules on location, placing the explanations where they are less visible.

In Botosan's (2004) discussion of Beretta and Bozzolan (2004), she was critical of their view of quality preferring instead to use the concepts from the IASB's and Financial Accounting Standards Board's generally accepted conceptual frameworks. Botosan (2004) reminds us that quality can be considered a function of understandability, relevance, reliability and comparability. More recently in the IASB's 2010 framework, relevance and reliability were replaced by timeliness and verifiability, understandability and comparability remaining. These four are termed 'enhancing qualitative characteristics' (IASB, 2010, paragraph QC19). Location can help facilitate both understandability and comparability. Quick identification of non-compliance can help with understanding the extent to which a company complies with the Code. If explanations are less easy to find, understandability may be compromised. Similarly comparability is also assisted by location. If all companies disclosed

their explanations in a consistent location, comparability would be enhanced. For these reasons, we include location as a component of quality (Research Question 1.1).

Location is analysed in five categories: (A) Explanations for non-compliance as part of a corporate governance report: (1) At the start; (2) In the middle; (3) At the end; (4) Scattered throughout the corporate governance report; (B) No corporate governance report: Explanations for non-compliance subsumed within another part of the annual report and may therefore be more difficult to locate.

Investors are likely to prefer a separate corporate governance report (A) to no corporate governance report (B). It is debateable the extent different categories are preferred, but arguably either start (A(1)) or end (A(3)) are the best locations. Scattered disclosure is likely to be difficult for readers to comprehend.

### *3.2 Comprehensiveness*

Research Question 1.2 examines the extent to which companies provide comprehensive explanations of their non-compliance. Comprehensiveness is analysed in five categories: (1) Full explanation of non-compliance: Code provision labels (e.g. A.2.1) with customised explanations (best); (2) Explanation and Code provision label disclosed but not always together; (3) Explanation with no Code provision label; (4) Code provision label with no explanation; (5) Code provision labels appear incorrect (worst).

Completeness is consistent with the quality measures discussed by Botosan (2004), facilitating both understandability and comparability. If a Code provision label is supplied there can be no doubt as to which provision of the Code is being referenced. In its absence, even the most articulate description about non-compliance can result in some doubt, particularly when the Code often refers to the same issue in a number of provisions. Code provision labels also help with another of IASB's enhancing

qualitative characteristics – verifiability. However, institutional theory suggests that managers may be reluctant to disclose non-compliant Code details as it draws attention to a lack of compliance and differentiates the company from compliers

### *3.3 Mimetic Behaviour*

Non-compliance by its very nature is different from the ‘norm,’ thus the need for a bespoke, individually crafted explanation. A copied/boilerplate explanation represents someone else’s thinking and may not reflect the individual company circumstances. Thus the disclosure will be symbolic rather than substantive (Day & Woodward, 2004). In addition, copied/boilerplate explanations may violate the fundamental qualitative characteristics of relevance and faithful representation (IASB, 2010). To investigate the extent of copied/boilerplate explanations, one Code Provision – A.2.1 – was selected which requires the roles of chair and chief executive not to be exercised by the same person (duality). This provision was chosen because it is a key Code requirement which researchers have long emphasised as being important (Conyon & Mallin, 1997). Too much power concentrated in one person is often cited as a particular weakness leading to corporate governance failure and is believed to be one of the factors which led to the events at Enron (see, for example, Solomon & Solomon, 2004).

Research Question 1.3 examines the extent to which companies appear to copy other companies’ explanations in relation to duality. A three-stage process was devised. First, companies breaching Provision A.2.1 were identified. Second, explanations were extracted and read through and compared. Any similarities between explanations were noted. Third, explanations in separate files were uploaded to the software plagiarism-detection program ‘Turnitin.’ Holder-Webb and Cohen (2012) examine ethics codes in US companies using similar software. Matches are displayed and colour coded according to the degree of match. Some matches are expected (for example to a

company's own internet site) and these are discarded. No cut off point or percentage of copying is suggested as acceptable.

### 3.4 Length

Research Question 1.4 examines the length of explanations. In a paper that seeks to make a distinction between quality and quantity of disclosure, it may appear somewhat strange that length is suggested as a component of quality. First, Beretta and Bozzolan (2004) have also claimed that quality comprises different components of which one is quantity. Second, the pilot study of the explanations of 20 companies preceding this research indicated that explanations for non-compliance tend to be extremely brief. Other research supports that conclusion (MacNeil & Li, 2006; Pass, 2006). Third, directors and managers have an incentive to keep explanations as short as possible in order not to draw attention to non-compliance. For this reason, they may not be as forthcoming as they otherwise might be. Thus, for this *particular* area of disclosure, length is to be welcomed. Finally, longer explanations require considerable effort to craft and are indicative (although not conclusive) of the amount of effort expended by the company or its managers. Thus, in this particular context, short explanations are likely, other things being equal, to be of lower quality than longer explanations. However, over-long explanations may be viewed as convoluted and hence may not be read by users. For this reason, six length categories are adopted: (1) 100-199 words (this is arguably the 'best' category with a full and detailed explanation); (2) In excess of 200 words (over-long and therefore not ideal); (3) 60-99 words; (4) 30-59 words; (5) 15-29 words (too brief); (6) Fewer than 15 words (very brief). The pilot study showed that it was not possible to provide an explanation adequately describing the circumstances of non-compliance in fewer than 30 words. We acknowledge that the choice of these length categories is somewhat arbitrary and our interpretation of them is somewhat subjective.

### 3.5 Complexity

If disclosures are unclear or complex then understandability is likely to be compromised (Rutherford, 2003). The wording of the Code is often quite ambiguous. It can be difficult to resolve whether a company is describing compliance or explaining non-compliance. This sort of concealment (Oliver, 1991) is also predicted by institutional theory. Company managers may feel it is in their interest to be opaque. Understandability is an enhancing qualitative characteristic of the IASB conceptual framework (IASB, 2010). Lang and Lundholm (1993) state that clarity of writing could be seen as a component of quality. For the purposes of Research Question 1.5, complexity is divided into two sub-components: (1) readability and (2) use of the passive voice ('passivity').

The majority of readability studies use the Flesch scores (13 out of 15 studies examined in Brennan et al., 2009, pp. 792-793). This demonstrates that, while the Flesch index should be used with caution, it can be helpful as part of an overall quality measure. By way of comparison, Curtis (2004) found scores in Hong Kong annual reports to be around the mid-30s (difficult to read).

The use of the passive voice as an element of complexity is particularly relevant to company explanations for non-compliance because it enables the writer to be separated from the message (Thomas, 1997). By separating the subject(s) from the verb, the passive voice can make the explanation seem more objective. Put simply, the directors or managers may be more likely to write *"The Code has not been complied with in the following respects..."* rather than *"The directors decided not to comply with the following Code provisions."* This illustrates the danger that the non-compliance is attributed to no-one in particular and thus readers are unlikely to know anything about the processes which led to the non-compliance. One of the advantages with passivity is that it can be electronically calculated at the same time as a word count. However, it is necessary to perform checks and recalculate passivity as the software is not always totally consistent.

### 3.6 Specificity

A number of authors also emphasise the need for specificity and incorporate it in their assessment of disclosure (Sydserff & Weetman 1999; Warsame, Neu, & Simmons, 2002; Beretta & Bozzolan, 2004). Day and Woodward (2004) distinguish between substantive and symbolic disclosure, finding the majority to be merely symbolic. Akkermans et al. (2007, p. 1113) report that many companies only provide “*generally applicable arguments.*” In contrast, Sheath and Land (2006, p. 4) state that “*Investors want a company to use its report to reflect its specific approach to governance.*” An explanation which is of equal value to compliance has to be bespoke and specific. Research Question 1.6 examines the specificity of explanations by reference to three categories: (1) Specific explanation: One which provides details of the non-compliance, giving reasons for it which are relevant to a particular company’s special circumstances, for example, referring to directors’ names, the number of years of service. A specific explanation is best because it is most closely tailored to the company; (2) General explanation: One which could apply to a number of companies and does not attempt to address the specific circumstances relevant to the company in question. This type of explanation is likely to be more symbolic than substantive (Day & Woodward, 2004); (3) Inadequate explanation: One where the part of the Code not complied with is identified but does not detail exactly why the non-compliance occurred. Explanations which are missing are also coded to the category. Company managers who are trying to conceal non-compliance are more likely to provide no explanation or provide a general explanation in line with institutional theory (Oliver, 1991). Specificity is an important component of quality, is indirectly relevant to comparability and is also related to comprehensiveness.

### 3.7 Attestation

Hammond and Miles (2004) surveyed executives and found that “*Verification was generally considered as a stamp of quality*” (p. 69). The IASB lists verifiability as an enhancing characteristic. This suggests that attestation can improve the quality of corporate governance statements. If any of

the nine provisions on which auditors have to report are not adequately disclosed, auditors are required to include an 'emphasis-of-matter' paragraph in their audit report. Although there is no strict requirement for auditors to *audit* corporate governance disclosures, guidance on the review work required is issued by the UK Auditing Practices Board (APB, 2004). In the pilot study of 20 companies, all the audit firms used the suggested form of words in the APB bulletin:

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 FRC Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to...form an opinion on the effectiveness of the [company's] [group's] corporate governance procedures... (APB, 2004, Appendix 2).

Research Question 1.7 examines the extent to which auditors either (i) issue a fully clean report or (ii) include an emphasis-of-matter paragraph. Institutional theory would suggest that auditors are likely to engage in standard ritualistic behaviour so it would seem unlikely that they would use an emphasis-of-matter paragraph in expressing concerns about non-compliance or explanations. Thus, the most likely outcome is an unmodified audit report regardless of non-compliance.

### *3.8 Sample*

Explanations were analysed for two periods: (1) the first year of compliance with the Code (Financial Reporting Council, 2003) when it was substantially changed in 2003 was examined. The 2003 changes were some of the most significant and therefore would provide a variety of explanations to test the quality typology. (2) For comparative purposes, the 2010 version of the Code (Financial Reporting Council, 2010) was also examined. Comparisons are also made between the FTSE 100 and FTSE 250 sectors. Results are based on three levels of analysis: (i) Companies, (ii) Code breaches and (iii) Explanations for non-compliance. Code breaches and explanations for non-compliance were obtained from annual reports. All companies that claimed compliance with the Code were excluded from the sample, as were investment trusts. The sample is shown in Table 2. Code breaches and explanations were identified by searching for the words 'compliance,' 'non-compliance,' 'Combined

Code,' 'Code,' or 'corporate governance' within annual reports until the relevant section was found and then repeatedly until the researcher was sure all relevant items were located.

< Insert Table 2 here >

#### 4. Results

As shown in Table 2, during 2004/5 (the first year of compliance with the 2003 Code), 75% of FTSE 350 companies did not comply with at least one Code provision. This contrasts with 2011/12 (the first year of compliance with the 2010 Code) where the equivalent figure is 47%. In 2004/5, 67% of FTSE 100 companies did not comply with at least one item of Code compared with 79% of FTSE 250 companies which is a significant difference at the 5% level ( $p = 0.03$ ). By 2010/11, non-compliance had fallen to 45% and 47% respectively (with no significant difference). The average number of non-compliances fell from 2.63 to 2.02 across the FTSE 350 (see Table 3). Using chi-square<sup>1</sup> tests, significant differences appear between compliance with the 2003 and 2010 Codes for FTSE 350 (1% level), FSE 250 (10% level) and FTSE 100 companies (5% level). This suggests that companies are being encouraged to comply, although it is not totally clear where that pressure is coming from. This would fit with the behaviour described by DiMaggio and Powell (1983) in that, after a brief period of experimentation (non-compliance), companies rapidly fall into compliance (or maybe merely claim to do so). There is a danger companies may comply in a box-ticking/boilerplate manner as the simplest way of avoiding the need to craft explanations and face increased scrutiny. A wholesale move towards compliance may mean that companies are reluctant not to comply even where they feel justified in not complying. It may well be that companies view the 'explain' option as having been constructively removed because they perceive that the UK context does not consider it to be a legitimate action, notwithstanding it being an acceptable course of action under the Code. If compliance were to become the norm, companies may even feel that the option of non-compliance ceases to exist. Claiming compliance when the company has not complied is a particularly *unsatisfactory* outcome. In short, non-compliance should be welcomed where company directors

have made a clear and conscious decision and it should only be questioned where the explanation is of low quality. Discussion of the quality components of explanations can help to highlight good disclosure practice.

**< Insert Table 3 here >**

The most common Code breaches are summarised in Table 4. Although there are some differences between FTSE 100 and FTSE 250 companies and over time, the rankings are quite similar. Thus while Table 3 has shown the total non-compliance picture has changed, the proportions of what is not being complied with are quite similar. The key areas of non-compliance represent the proportion of the board comprising independent non-executives, followed by the constitution of the various board committees. It is surprising how many large companies do not comply with what are arguably key aspects of corporate governance. It may be that mimetic behaviour can explain this unexpected level of non-compliance. It is reasonable to suggest that managers of companies may feel that as other large companies do not comply, then there are fewer pressures on them to do so. Thus, there may be factors related to institutional theory at work here. In comparison, resource dependency theory would also suggest that once companies feel confident with non-executives, they wish to retain them and benefit from the expertise they have developed. Thus, companies and their managers may be willing to breach the Code (in particular the rules on independence and the related committees) in order to keep those resources (people) who are most useful to them. Thus, resource dependency theory can explain the lack of compliance in these key areas.

**< Insert Table 4 here >**

The next sections examine the seven components of quality disclosures in turn.

#### 4.1 Location

The majority (54% for 2004/5 and 63% for 2011/12) of FTSE 350 companies opted for the optimal location for explanations, i.e. the start of the corporate governance report. The end of the report was selected by 19% of companies (or 15% in the most recent iteration of the Code – see Table 5). Thus, considering both time frames, 70-80% of companies selected what might be seen as a good location for their explanations. For the remaining companies (20-30% depending on time frame), some had no corporate governance report (8% or 3%), while others disclosed the information in the middle of the report (9% or 11%) or worse adopted a scattered approach to disclosure (10% or 8%). Further research is needed to ascertain why companies (or their managers) choose to disclose in this particular way. There is no *significant* difference between FTSE 100 and FTSE 250 companies (using chi square tests  $p > 0.10$  for both years). The need to conceal or hide non-compliance appears consistent with both resource dependency theory and institutional theory.

**< Insert Table 5 here >**

#### 4.2 Comprehensiveness

Table 6 shows that for the 2003 Code fewer than 40% of companies provided comprehensive disclosures, with 60% producing information which is inadequate in varying degrees. For the disclosure in 2011/12 (the 2010 Code), the position has improved significantly (using chi-square tests at the 5% level for both sectors and at the 1% level overall) for FTSE 100 and FTSE 250 companies with around 60% providing the 'best' disclosure. However, despite that improvement, 40% of companies still do not provide the Code provisions (e.g. A.2.1) – something that might be seen as basic information. Disguising non-conformity would again be consistent with institutional and resource dependency theories (Oliver, 1991). By appearing to be more akin to a complying company, managers may feel organisational legitimacy is enhanced (DiMaggio & Powell, 1983). Although company managers may feel that their legitimacy is improved by hiding information, it is likely to lead to confusion on the part of readers (which may be the manager's intention). It would be helpful

if the FRC introduced guidance on comprehensiveness in ensuring that disclosures were fully comparable and thus were consistent with IASB's enhancing qualitative characteristics. This would still give companies flexibility as to the specific content of their explanations and thus be consistent with the flexibility offered by the 'comply-or-explain' system.

< Insert Table 6 here >

#### 4.3 Mimetic Behaviour

This part of the study examined one section of the Code (A.2.1) to see the extent companies used the same explanation. Thirty two companies within the sample provided single provision (i.e. not combined with another Code provision) explanations for violation of the Code concerning duality. The anti-plagiarism software, 'Turnitin,' found matches (which are not mutually exclusive):

- To the company's own accounts for either the year in question or for subsequent years. For over two thirds of companies (as expected) there was a 100% match.
- To 11 explanations which partly matched the wording of comment in either academic journals (in the areas of accounting, management or linguistics) or to professional papers (such as *Pensions Week*) or to circulars or other internet sources. Just over a third of explanations matched student essays from various UK universities (including Warwick, Leeds, Bradford and Edinburgh) suggesting that students had referred to explanations relating to this Code item as part of their assignments.
- To 12 company explanations which partly matched other companies' explanations in the UK and overseas. These were found to be matched with the Code itself rather than to other companies' specific explanations. Unsurprisingly, companies tend to use similar words to the Code when describing how the provision should be complied with rather than the 'pure' explanation part for non-compliance.

One company's explanation matched directly to an FRC report (FRC, 2012c). Similar to this study, the FRC also examined Code provision A.2.1. The FRC admitted the standard of explanations was variable (p.16). It was disappointing to see the FRC describing what we believe to be a limited and general explanation as "succinct" (p.18). It is difficult to conclude from these limited results. More work is needed to establish the extent to which companies either copy from the Code (some evidence here) or from each other. There is also some evidence that companies maintain the same explanation from year to year, which does not necessarily indicate a problem but may be worthy of further investigation.

#### *4.4 Length*

There is no ideal length for an explanation. The average length in 2004/5 was 74 words and this increased to 87 words in 2011/12 (see Table 7). For the FTSE 100, the average length has increased from 80 to 97 words (not quite significant using a t-test,  $p = 0.119$ ) and for the FTSE 250 it has increased from 71 to 83 words (significant at the 5% level,  $p = 0.027$ ). This suggests companies are providing more detailed explanations or, at the very least, explanations made up of more words. This is consistent with institutional theory in that managers are encouraged to produce more detailed explanations. A key concern which still remains is that 14% in 2004/5 and 12% in 2011/12 of FTSE 350 companies provided explanations of fewer than 30 words which is unlikely to be adequate to provide enough detail if users are going to understand *both* the nature of and reasons for non-compliance. It may be that by providing fewer words managers feel that they can disguise or avoid drawing attention to non-conformity something which is again consistent with both resource dependency and institutional theories (Oliver, 1991). Although excessive length ( $> 200$  words) was identified as a possible problem, it only applied to 3-4% of disclosures.

**< Insert Table 7 here >**

#### 4.5 Complexity

Complexity of language is measured in two ways: Flesch scores and passivity. Previous research has suggested that financial statements are complex to read so it is no surprise to find that explanations for non-compliance are particularly so. Flesch scores indicate (Table 8) that for the most part explanations are *very* difficult to read with very few explanations (1% or 2%) fitting the *fairly* difficult category in either time period. The scores do not differ significantly between the two periods or the two FTSE sectors. This suggests that Flesch scores are not improving and readability remains a concern with nearly all explanations being difficult or very difficult to read. Of course it may relate to the nature of explanations and the wording used in the Code.

For FTSE 100 companies, the mean passivity scores (Table 9) have fallen from 31% in 2004/5 to 19% in 2011/12 (which is significant at the 1% level,  $p = 0.007$ ). Interestingly for FTSE 250 companies, the average scores have risen from 27% to 31% but not significantly so ( $p > 0.1$ ). Thus, while 2004/5 scores were not significantly different between FTSE sectors, in 2011/12 they were significantly different ( $p = 0.004$ ). This would suggest that FTSE 100 companies are taking greater care over their explanations and using the passive voice less, which improvement has yet to impact on FTSE 250 companies who are not so visible (see explanation for specificity below).

< Insert Table 8 here >

< Insert Table 9 here >

#### 4.6 Specificity

The picture on specificity is complex and differs between FTSE 100 and FTSE 250 companies. Taken as a whole (FTSE 350), many companies do not provide specific explanations (55% in 2004/5 and 60% in 2011/12) (Table 10). A quarter of companies provided a general explanation in 2004/5 but this increased to a third in 2011/12. FTSE 100 companies provided more specific explanations and were not significantly different when comparing the two periods. However, FTSE 250 companies

provided fewer specific explanations between the two time periods (significant at the 1% level using a chi-square test). As FTSE 100 companies have improved, and FTSE 250 appear to have got worse, it is not surprising that in 2011/12 there was a significant difference between FTSE 100 and FTSE 250 companies (at the 5% level). FTSE 100 companies are perhaps more in the 'limelight' and their managers may have been persuaded to make more effort (following institutional theory) to improve disclosures.

For both FTSE sectors, the percentage of no or inadequate explanations was still around a quarter. A typical but sub-optimal approach taken by some companies is where non-compliance is fixed by the end of the year but no explanation is provided. Companies (or their managers) who have fixed their non-compliance by the end of the year may wish to be viewed from an institutional theory perspective as part of the 'compliers' rather than 'non-compliers' group. Since the Code applies for the whole year, this is misleading. Readers are entitled to a full explanation as to why non-compliance occurred in the first instance.

**< Insert Table 10 here >**

#### *4.7 Attestation*

In the study, as expected from a consideration of institutional theory, no auditors of the companies examined raised any issues in relation to company compliance for the periods examined. Auditors are only required to review compliance with nine provisions. One of these provisions (C.3.1 – audit committee constitution) was the second most commonly breached, with 81 and 34 incidences in 2004/05 and 2011/12 respectively. Auditors are not expected to review the explanations, just the disclosure of non-compliance. As might be expected, all auditors used limited but almost identical wording in their reports when referring to corporate governance compliance based on the APB bulletin recommendations. The only exceptions to this were mistakes that some auditors appeared to make. Some mistakes were trivial (e.g. minor errors or omissions in reports) but the majority of

these mistakes (in 2004/5 this related to six companies) involved referring to the seven provisions on which auditors were required to comment in the audit report under the previous 1998 version of the Code, as opposed to nine which is the number under more the recent 2003 to 2010 versions. In one of these cases, the company also made a mistake in its governance report by referring to provision D.3.1 which relates to the previous version of the Code. This provision was replaced by C.3.1 and C.3.2 which auditors are required to review under the APB bulletin and hence *should* have been correctly identified by the auditor. In the 2011/12 corporate governance reports, there were fewer mistakes (for example one FTSE 250 company referred to the wrong Code) but there were still five incidences where auditors wrongly referred to the 2008 Code in their report. At times, it seems as if both auditor and company were still working from the previous Code.

It appears that auditors are reluctant to question either compliance under the Code or the adequacy of explanations. In one sense this is perfectly understandable. In another sense it is quite disappointing that, despite the poor quality of the disclosure, auditors chose not to intervene. Auditor silence may illustrate the provision of standard advice by mainly Big 4 auditors and this is another example of isomorphism and institutional theory in practice (Oliver, 1991). The review carried out by auditors seems solely to be a symbolic ceremonial exercise with seemingly little value (Carruthers, 1995; Fogarty & Rogers, 2005). No 'emphasis-of-matter' paragraphs were found in audit reports. Instead, the standard isomorphic wording dominates.

## **5. Discussion and Policy Implications**

Applying the quality typology in this study has shown that there have been some serious quality issues with explanations for non-compliance which remain unresolved. If self-regulation is to operate effectively then companies need to work towards providing detailed and bespoke explanations for non-compliance. Although some improvements have been identified over time, it is worth considering why managers of companies are continuing to provide poor explanations. One

reason is possibly because they believe that regulators, investors and other parties are looking for compliance and are thus not interested in explanations. Because of the term ‘comply-or-explain,’ explanations may not be seen as part of compliance. Thus, although explanations are an integral part of the ‘system,’ they may be seen as second to compliance. This is problematic because a key aspect of corporate governance is flexibility with the fundamental idea that one approach to governance is not necessarily suitable for all companies at all times.

We applied two theoretical perspectives in the research, finding support for both. Institutional theory supports the bandwagon or mimetic effect found where companies see others as not complying and/or not giving a high quality explanation seemingly with no consequences and then choose to do the same. This would also fit in with companies wishing to retain existing non-executive directors. Resource dependency theory indicates that the value of non-executive directors may not be in terms of Code compliance but rather in terms of providing useful services to the board and company. These findings would suggest that the mainly agency theory focus of prior research provides an incomplete explanation for non-compliance explanations.

Our study extends prior research by analysing the quality of non-compliance explanations with greater depth beyond the two- and three-category scoring systems applied heretofore (see Table 1). Our research complements Seidl et al.’s (2013) more detailed 12-category empirically generated approach based on the discursive legitimacy tactics employed in explanations, by demonstrating that institutional theory and resource dependency theory also explain practice. We would argue that non-compliance is not a legitimacy issue because it is *entirely* legitimate within the ‘comply-or-explain’ framework to explain non-compliance.

Out of over a hundred responses to the FRC’s (2009) ‘Call for Evidence,’ 16 (approximately 15%) *explicitly* referred to issues concerning explanation quality. More recently, the FRC (2012a) published

a report on explanations for non-compliance following two private discussion meetings with senior investors and companies. Relevant points about quality in the FRC (2012a) report include:

- (1) Explanations should be substantive, pointing out that a “*substantial minority are not*” (FRC, 2012a, p.4).
- (2) The FRC rejects the idea that regulators should be responsible for checking explanations, preferring instead to rely on shareholders.
- (3) The EU Green Paper on Corporate Governance (European Commission, 2011) refers to the Swedish Code which requires (in respect of non-compliance) disclosure of: (i) the Code rules not complied with, (ii) the reasons for each case of non-compliance and (iii) the solution adopted instead. The EU questions whether this three-point approach could be a model for the EU as a whole. The FRC maintains that “*Arguably, however, the UK Code already goes further than this...*” (FRC, 2012a, p.3). Based on our research, the FRC’s response seems questionable. UK companies often only provide *one* of these three items (the Code rules not complied with), often explanations are perfunctory, and they *rarely* discuss the solution they have adopted instead.
- (4) A useful part of the FRC (2012a) Report discusses the elements of a meaningful explanation. These comprised context and background, a rationale for the action taken and mitigating action as a result of any additional risk and whether the deviation was limited in time and *when* the company intended to return to conformity. The FRC’s use of the word ‘when’ seems surprising. Non-compliance does not have to lead to compliance if the reason for it is justifiable and unlikely to change. Participants (speaking at the FRC’s 2012 meeting) said explanations should be “*relevant, specific and sufficiently informative*” (FRC, 2012a, p. 6) which is consistent with the recommendations in our paper. Another participant raised the idea that an explanation should not require any follow-up action. Again this is consistent with the idea of a fulsome, complete and bespoke explanation.

(5) Some of the points in the FRC (2012a) Report appear anecdotal and readers are left to wonder whether the FRC uses them to confirm its particular worldview. For example, a corporate participant is quoted as saying “*there were few blatant abusers and explanations had been improving in recent years*” (p. 7). This sort of comment does not sit well with the evidence and one wonders on what it is based. It is hard to disagree with many of the points made by the FRC including the benefits of ‘comply-or-explain’ when used properly. The only issue is: to what extent is it ‘used properly’? If it is not used properly then, as one of the respondents to the FRC’s 2009 Call claims, “... *it is a dangerous charade*” (Boatman, 2009, p. 1).

A key issue is whether the Code can be improved to make it work better. The first step in that evolution is realising that it needs to work better, if it is to work at all. A move towards compliance as the only outcome will result in other problems and cannot be seen as a solution when flexibility is seen as essential. More direction is likely to help. It could be as simple as requiring companies which do not comply to, say, construct a table listing in columns:

- The provision not complied with (e.g. A.3.1).
- A brief summary of that provision.
- A detailed, but clearly written explanation which is bespoke to the company stating the reason for non-compliance.
- How the approach taken still ensures good governance.
- An indication as to whether or not it is intended that the section would be complied with at some time in the future.

The table would be disclosed at the start of the corporate governance report or, failing that, in a prominent position with a cross-reference in the annual report or website contents. By adopting a tabular approach, readability and comprehensiveness could be overcome as would the problem with

location because tables are visible and quickly identified in comparison to text. A tabular approach would also solve specificity problems because it would force companies to provide an explanation.

It does not seem unreasonable to ask for some sort of basic review of explanations by either the auditors or the FRC. This would not have to be too onerous (perhaps just ensuring that all suggested components identified above were present). Companies would then be aware that some checks are being undertaken. The purpose of this would be to improve the quality of disclosure without being overly prescriptive and continue to allow a high degree of flexibility which is within the spirit of the UK Corporate Governance Code.

As a result of the findings of the initial stages of this research, five recommendations were made in response to the FRC's (2009) Call for Evidence:

- Recommendation 1 – Positioning of compliance statements: Compliance statements should be clearly identifiable; ideally, located at the start of the Corporate Governance report listing any non-compliant items.
- Recommendation 2 – Details provided in compliance statements: Compliance statements should contain details of non-compliance, the relevant Code provision together with an explanation.
- Recommendation 3 – Length and readability of explanations: Explanations should be adequately detailed so that shareholders can make proper judgements as to their appropriateness. They should be written in simple language to make it easy to understand the reasons for non-compliance. They should also avoid the use of manipulative language designed to underplay non-compliance.
- Recommendation 4 – Specificity of explanations: Explanations should be specific ensuring that the reasons for non-compliance are pertinent and adequate.
- Recommendation 5 – Review of compliance statements and explanations: The FRC should consider the need to instigate some sort of oversight for 'comply-or-explain' disclosures. We believe that some kind of supervised self-regulation is likely to lead to higher quality compliance statements and explanations for non-compliance.

Recently the 2012 Code has been issued (FRC, 2012b) with small amendments pertaining to the detail of explanations compared with the previous Code (FRC, 2010). This is a step in the right direction but it will be interesting to examine the extent to which managers take note of these changes.

## 6. Limitations, Further Research and Conclusions

This research has examined explanations for non-compliance using a quality typology. We find that while compliance levels improved from 2004/05 to 2011/12, the areas of non-compliance remain proportionately similar, with some key provisions of the Code not being complied with. Although the quality dimensions suggested here are subjective, context specific and may be incomplete, they reflect the prior literature and form a basis for future discussion and work. Our working typology and theoretical framework provides a base upon which others can apply a consistent qualitative assessment of corporate governance non-compliance explanations over time. The typology may also be of use to other researchers working in the wider area of voluntary disclosure. Our quality typology can be adapted to other areas of narrative reporting such as environmental or risk reporting. Quality is likely to be context specific so the components can be adapted in order to measure different aspects of reporting and how that reporting changes over time.<sup>2</sup>

Quality of reporting is difficult to determine but that does not undermine its importance. An examination of comments relating to the FRC's report on 'cutting clutter' (FRC, 2011) suggests that without doubt the majority of stakeholders would prefer to see the quality of reporting improved rather than the quantity of reporting increasing (Linsley & Shrives, in press). Similarly, Sheath and Land (2006) also emphasise that investors unanimously want, *inter alia*, fewer boilerplate disclosures and a focus on quality of reporting (see also Solomon, 2010).

This paper has made suggestions as to how corporate governance reports can be improved specifically with reference to explanations for non-compliance. A move towards compliance may be seen as a solution by some. However, further research is needed to establish whether companies claiming compliance are actually doing so because theory suggests that managers have both incentives and means to hide non-compliance (Oliver, 1991). To encourage a move towards compliance simply because it solves the problem of badly crafted explanations is likely to result in

unforeseen consequences and may permanently damage the system of which the UK is seemingly proud and which the rest of the world is keen to emulate.

**Notes**

1. Chi-square tests were used where results were categorical (e.g. specificity). Where results were numerical (or scale) then t-tests were used instead. Significance was measured in the normal way.

2. A longitudinal study which examines company characteristics (e.g. measures of size) and quality of disclosure would be a subject for further research. That approach would complement existing studies which have confirmed a relationship between quantity of disclosure and size. The authors are most grateful to an anonymous referee for this suggestion.

## References

- Abraham, S., Shrivess, P.J. (2014). Improving the relevance of risk factor disclosure in corporate annual reports, *The British Accounting Review*, 46(1), 91-107.
- Akkermans, D., van Ees, H., Hermes, N., Hooghiemstra, R., van der Laan, G., Postma, T., van Witteloostuijn, A. (2007). Corporate governance in the Netherlands: An overview of the application of the Tabaksblat Code in 2004. *Corporate Governance: An International Review*, 15(6), 1106-1118.
- Andres, C., Theissen, E. (2008). Setting a fox to keep the geese – does comply-or-explain principle work? *Journal of Corporate Finance*, 14(3), 289-301.
- Arcot, S., Bruno, V., Faure-Grimaud, A. (2010). Corporate governance in the UK: Is the comply or explain approach working? *International Review of Law and Economics*, 30(2), 193-201.
- Auditing Practices Board (APB) (2004). The Combined Code on Corporate Governance: Requirements of Auditors under the Listing Rules of the Financial Services Authority (Bulletin 3), London, Auditing Practices Board. Available at <https://www.frc.org.uk/Our-Work/Publications/APB/Bulletin-2006-5-The-Combined-Code-on-Corporate-Gov.pdf>. Accessed 20.06.14.
- Bailey, K.D. (1994). *Typologies and Taxonomies – An Introduction to Classification Techniques*. Thousand Oaks, CA: Sage Publications.
- Baird, J.E., Zelin, R.C. (2000). The effects of information ordering on investor perceptions: An experiment utilizing presidents' letters. *Journal of Financial and Strategic Decisions*, 13(3), 71-81.
- Beattie, V., McInnes, W., Fearnley, S. (2004). A methodology for analysing and evaluating narratives in annual reports: A comprehensive descriptive profile and metrics for disclosure quality attributes. *Accounting Forum*, 28(3), 205-236.
- Beretta, S., Bozzolan, S. (2004). A framework for the analysis of firm risk communication. *The International Journal of Accounting*, 39(3), 265-288.

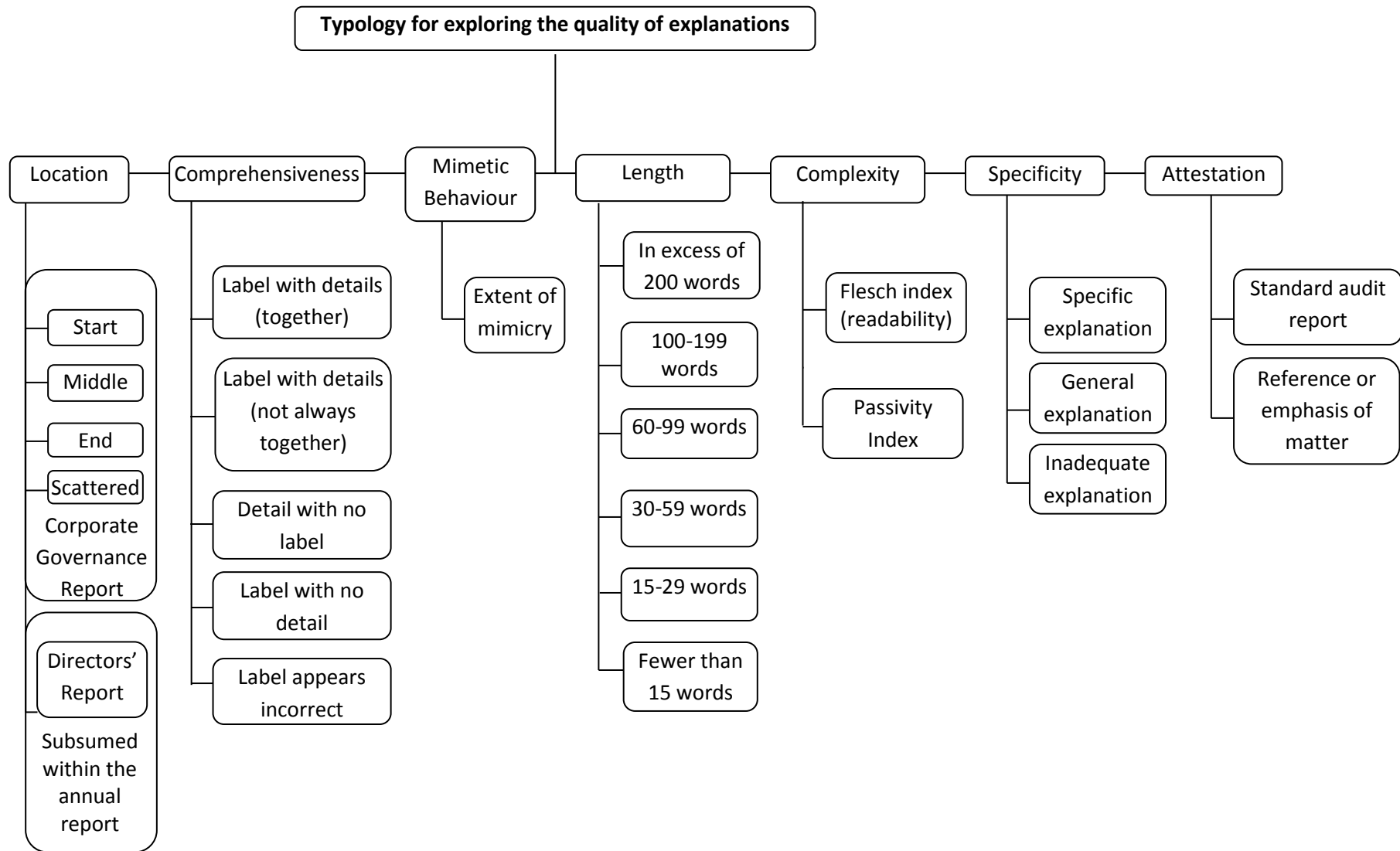
- Bhat, G., Hope, O-K, Kang, T. (2006). Does corporate governance transparency affect the accuracy of analyst forecasts? *Accounting and Finance*, 46(5), 715-732.
- Boatman, T. (2009). Review of the effectiveness of the Combined Code: Letter to Chris Hodge, 28 May 2009. Available at <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Review-of-the-effectiveness-of-the-Combined-Code-C/Responses-to-March-consultation-on-the-2009-Review/Boatman,-Timothy.aspx>. Accessed 20.06.14.
- Botosan, C.A. (2004). Discussion of a framework for the analysis of firm risk communication. *The International Journal of Accounting*, 39(3), 289-295.
- Bowen, R., Davis, A., Matsumoto, D. (2005). Emphasis on pro forma versus GAAP earnings in quarterly press releases: Determinants, SEC intervention, and market reactions. *The Accounting Review*, 80(4), 1011-1038.
- Brennan, N.M., Guillamon-Saorin, E., Pierce, A. (2009). Methodological Insights: Impression management: Developing and illustrating a scheme of analysis for narrative disclosures – a methodological note. *Accounting, Auditing and Accountability Journal*, 22(5), 789-832.
- Carruthers, B. (1995). Accounting, ambiguity and the new institutionalism. *Accounting, Organizations and Society*, 20(4), 313-328.
- Connolly, B.L., Certo, S.T., Ireland R.D., Reutzel, C.R. (2011). Signalling theory: a review and assessment. *Journal of Management*, 37(1), 39-67.
- Canyon, M., Mallin, C. (1997). A review of compliance with Cadbury. *Journal of General Management*, 2(3), 24-37.
- Courtis, J.K. (2004). Corporate report obfuscation: Artefact or phenomenon. *The British Accounting Review*, 36(3), 291-312.
- Day, R., Woodward, T. (2004). Disclosure of information about employees in the directors' report of UK published financial statements: substantive or symbolic? *Accounting Forum*, 28(1), 43-59.
- Dillard, J.F., Rigsby, J.T., Goodman, C. (2004). The making and remaking of organizational context. *Accounting, Auditing and Accountability Journal*, 17(4), 506-542.

- DiMaggio, P., Powell, W. (1983). The iron cage revisited: Institutional isomorphism and collective rationality in organizational fields. *American Sociological Review*, 48(2), 147-160.
- Elliott, W.B. (2006). Are investors influenced by pro forma emphasis and reconciliations in earnings announcements? *The Accounting Review*, 81(1), 113-133.
- European Commission (2011). The EU Corporate Governance Framework. Brussels: European Commission. Available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf). Accessed 20.06.2014.
- Fogarty, T.J., Rogers, R.K. (2005). Financial analysts' reports: an extended institutional theory evaluation. *Accounting, Organizations and Society*, 30(4), 331-356.
- (The) Financial Reporting Council (FRC) (2003). *The Combined Code on Corporate Governance*. London: FRC. Available at [http://www.ecgi.org/codes/documents/combined\\_code\\_final.pdf](http://www.ecgi.org/codes/documents/combined_code_final.pdf). Accessed 20.06.14.
- (The) Financial Reporting Council (FRC) (2009). *Review of the effectiveness of the Combined Code: Call for Evidence*. London: FRC. Available at <https://frc.org.uk/Our-Work/Publications/FRC-Board/Review-of-the-effectiveness-of-the-Combined-Code-C.aspx>. Accessed 20.06.14.
- (The) Financial Reporting Council (FRC) (2010). *The UK Corporate Governance Code*. London: FRC. Available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Corporate-Governance-Code.pdf>. Accessed 20.06.14.
- (The) Financial Reporting Council (FRC) (2011). *Cutting Clutter. Combatting Clutter in Annual Reports*. London: FRC. Available at <https://www.frc.org.uk/getattachment/8eabd1e6-d892-4be5-b261-b30cece894cc/Cutting-Clutter-Combating-clutter-in-annual-reports.aspx>. Accessed 20.06.14.
- (The) Financial Reporting Council (FRC) (2012a). *What Constitutes an Explanation under Comply-or-Explain? Report of Discussions between Companies and Investors*. London: FRC. Available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/What-constitutes-an-explanation-under-comply-or-ex.pdf>. Accessed 20.06.14.

- (The) Financial Reporting Council (FRC) (2012b). *The UK Corporate Governance Code*. London: FRC. Available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf>. Accessed 20.06.14.
- (The) Financial Reporting Council (FRC) (2012c). *Developments in Corporate Governance 2012*. London: FRC. Available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-in-2012.pdf>. Accessed 20.06.14.
- Grant Thornton (2011). *Corporate Governance Review (A Changing Climate Fresh Challenges Ahead)*. London: Grant Thornton Risk Management Services. Available at: [www.grant-thornton.co.uk/pdf/corporate\\_governance.pdf](http://www.grant-thornton.co.uk/pdf/corporate_governance.pdf). Accessed 20.06.14.
- Hammond, K., Miles, S. (2004) Assessing quality assessments of corporate social reporting: UK perspectives. *Accounting Forum*, 28(1), 61-79.
- Hirshleifer, D., Teoh, S.H. (2003). Limited attention, information disclosure and financial reporting. *Journal of Accounting and Economics*, 36(1-3), 337-386.
- Holder-Webb, L., Cohen, J. (2012). The cut and paste society: isomorphism in codes of ethics. *Journal of Business Ethics*, 107(4), 485-509.
- Hooghiemstra, R. (2012). What determines the informativeness of firms' explanations for deviations from the Dutch corporate governance code? *Accounting and Business Research*, 42(1), 1-27.
- International Accounting Standards Board (IASB) (2010). *Conceptual Framework for Financial Reporting*. London: IASB.
- Lang, M., Lundholm, R. (1993). Cross-sectional determinants of analyst ratings of corporate disclosures. *Journal of Accounting Research*, 31(2), 246-271.
- Linsley, P.M., Shrides, P.J. (in press). Douglasian cultural dialogues as an alternative to Hofstede in accounting research. *Critical Perspectives on Accounting* (forthcoming, article in press).
- MacNeil, I., Li, X. (2006). "Comply or explain": market discipline and non-compliance with the Combined Code. *Corporate Governance: An International Review*, 14(5), 486-496.

- Meyer, J.W., Rowan, B. (1977). Institutional organizations: Formal structure as myth and ceremony. *American Journal of Sociology*, 83(2), 340-363.
- Mizruchi, M., Fein, L. (1999). The social construction of organizational knowledge: A study of the uses of coercive, mimetic and normative isomorphism. *Administrative Science Quarterly*, 44(4), 653-683.
- Oliver, C. (1991). Strategic responses to institutional processes, *Academy of Management Review*. 16(1), 145-179.
- Pass, C. (2006). The revised Combined Code and corporate governance: An empirical sample of 50 large UK companies. *Managerial Law*, 48(5), 467-478.
- Rutherford, B. (2003). Obfuscation, textual complexity and the role of regulated narrative accounting disclosure in corporate governance. *Journal of Management and Governance*, 7(2), 187-210.
- Securities and Exchange Commission (SEC) (2007). *Staff Observations in the Review of IFRS Financial Statements*. New York, NY: Securities and Exchange Commission. Available at [http://www.sec.gov/divisions/corpfin/ifrs\\_staffobservations.htm](http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm) (Accessed 20.06.14).
- Seidl, D., Sanderson, P., Roberts, J. (2013). Applying the 'comply-or-explain' principle: discursive legitimacy tactics with regard to codes of corporate governance, *Journal of Management and Governance*, 17(3), 791-826.
- Sheath, R., Land. J. (2006). *Better Governance Reporting: A Practical Framework*. London: Independent Audit/Chartered Association of Certified Accountants (ACCA).
- Shrives, P.J. (2010). *Disclosure in Disarray: Assessing corporate governance explanations of non-compliance*. Doctoral dissertation, University College Dublin.
- Solomon, J.F. (2010). *Corporate Governance and Accountability*, 3rd edition. London: John Wiley and Sons.
- Solomon, J.F., Solomon, A. (2004). *Corporate Governance and Accountability*. Chichester: John Wiley and Sons.
- Spence, M. (1973). Job market signalling. *Quarterly Journal of Economics*, 87(8), 355-374.

- Staw, B.M., McKechnie P.I., Puffer, S.M. (1983). The justification of organizational performance. *Administrative Science Quarterly*, 28(4), 582-600.
- Sydserrff, R., Weetman, P. (1999). A texture index for evaluating accounting narratives: An alternative to readability formulas. *Accounting, Auditing and Accountability Journal*, 12(4), 459-488.
- Thomas, J. (1997). Discourse in the marketplace: The making of meaning in annual reports. *Journal of Business Communication*, 34(1), 47-66.
- Warsame, H., Neu, D., Simmons, C. (2002). Responding to "discrediting" events: Annual report disclosure responses to environmental fines. *Accounting and the Public Interest*, 2(1), 22-40.
- Wymeersch, E. (2005). Implementation of the corporate governance codes. In Hopt, K., Wymeersch, E., Kanda, K., Baum, H. (Eds.) *Reforming Company and Takeover Law in Europe* (pp. 403-419). Oxford: Oxford University Press.
- Zahra, S.A., Pearce, J.A. (1989). Boards of directors and corporate financial performance: A review and integrative model. *Journal of Management*, 15(2), 291-334.
- Zhang, Y., Wiersema, M.F. (2009). Stock market reaction to CEO certification: The signalling role of CEO background. *Strategic Management Journal*, 30(7), 693-710.



**Figure 1. Typology for exploring the quality of explanations** (Based around a diagrammatical structure used by Beattie et al., 2004, p. 209)

**Table 1**

Prior empirical research on comply-or-explain corporate governance disclosures.

<b>Paper</b>	<b>Theory</b>	<b>Data</b>	<b>Non-compliance disclosure measure</b>	<b>Conclusion</b>
MacNeil and Li (2006)	Agency theory	18 FTSE 100 serial non-compliers in 2004	Analysis of non-compliance explanations not systematic	Investors evaluate non-compliance by reference to a proxy in the form of share price performance.
Pass (2006)	Agency theory	70 non-compliance explanations of 50 FTSE 250 companies in 2005	Acceptable/unacceptable explanations	There were 11 companies in breach of the Code not providing acceptable explanations.
Andres and Theissen (2008)	Agency theory (implicit): managers may wish to escape stringent monitoring	150 German listed firms 2002-2003	Disclosure/non-disclosure of executive compensation by individual executive	Firms that paid higher than average remuneration to executive directors were less likely to comply with comply-or-explain executive compensation disclosure requirements.
Arcot, Bruno, and Faure-Grimaud (2010)	None explicitly identified	Longitudinal study of 1,286 FTSE 350 firm years 1998-2004, with 1,576 instances of non-compliance	(i) No explanation; (ii) General explanation; (iii) Specific explanation	Frequent use of standard rather than specific explanations found. A large number of companies provide no explanation for non-compliance.
Hooghiemstra (2012)	Agency theory	Longitudinal study of 331 firm-year observations of Dutch listed firms 2005-2009	Score based on (i) No explanation (1 point); (ii) Generic explanation (2 points); (iii) Firm-specific explanation (4 points)	Firms with weaker boards, followed by fewer analysts, with more dispersed ownership, with greater leverage provide less-informative explanations.
Seidl, Sanderson, and Roberts (2013)	Legitimacy theory	715 non-compliance explanations of German and UK firms published in 2006	1. Deficient (three categories), 2. Context-specific (six categories), 3. Principled justifications (three categories)	Analysis of different discursive legitimacy tactics deployed help to understand the role of comply-or-explain in corporate governance regimes.

**Table 2**  
Population and sample.

	FTSE 100				FTSE 250 (i.e. next 250)				FTSE 350			
	2003 Code		2010 Code		2003 Code		2010 Code		2003 Code		2010 Code	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
<b>Panel A: Unit of analysis: Companies</b>												
FTSE companies	100		100		250		250		350		350	
Less Excluded from sample	<sup>a</sup> (5)		<sup>a</sup> (5)		<sup>b</sup> (72)		<sup>b</sup> (76)		(77)		(81)	
Total sample	95	100%	95	100%	178	100%	174	100%	273	100%	269	100%
Less Claim full compliance	(31)	(33%)	(52)	(55%)	(37)	(21%)	(91)	(53%)	(68)	(25%)	(143)	(53%)
Less Provide ambiguous disclosures	(1)	(0%)	(0)	(0%)	(0)	(0%)	(1)	(0%)	(1)	(0%)	(1)	(0%)
<b>Companies disclosing non-compliance</b>	<b>63</b>	<b>67%</b>	<b>43</b>	<b>45%</b>	<b>141</b>	<b>79%</b>	<b>82</b>	<b>47%</b>	<b>204</b>	<b>75%</b>	<b>125</b>	<b>47%</b>
<b>Panel B: Unit of analysis: Explanations</b>												
Total explanations of non-compliance <sup>c</sup>	146	100%	71	100%	292	100%	137	100%	438	100%	208	100%
Average per non-compliant company	2.32		1.65		2.07		1.67		2.15		1.66	

Notes:

<sup>a</sup> Either taken over or overseas companies following other Codes.

<sup>b</sup> The majority of these (in both years) were investment trusts. A small number were taken over by other companies or de-listed before the relevant annual reports were produced, or identified themselves as being smaller companies.

<sup>c</sup> This is not the same as the number of Code items breached (as shown in Table 4) because some Code items are combined into one explanation.

**Table 3**

Extent of non-compliance.

No. Items non- compliance	FTSE 100				FTSE 250				FTSE 350			
	2003 Code Companies		2010 Code Companies		2003 Code Companies		2010 Code Companies		2003 Code Companies		2010 Code Companies	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1	21	33%	25	58%	47	33%	41	50%	68	33%	66	53%
2	16	25%	10	23%	36	25%	22	27%	52	26%	32	26%
3	15	24%	2	5%	25	18%	8	10%	40	20%	10	8%
4	6	10%	4	9%	17	12%	4	5%	23	11%	8	6%
5	0	0%	2	5%	8	6%	2	2%	8	4%	4	3%
6 or more	5	8%	0	0%	8	6%	5	6%	13	6%	5	4%
<b>Total</b>	<b>63</b>	<b>100%</b>	<b>43</b>	<b>100%</b>	<b>141</b>	<b>100%</b>	<b>82</b>	<b>100%</b>	<b>204</b>	<b>100%</b>	<b>125</b>	<b>100%</b>
Average no. of Code breaches	2.67		1.80		2.62		2.15		2.63		2.02	

**Table 4**

Code breaches by FTSE 350 companies (ordered by 2003 Code FTSE 350 Total).

Code area	2003 Code	2010 Code	2003 Code result						2010 Code result					
			FTSE 100	%	FTSE 250	%	FTSE 350	%	FTSE 100	%	FTSE 250	%	FTSE 350	%
Percentage of the board being NEDs	A.3.2	B.1.2	23	14%	78	21%	101	19%	14	18%	35	20%	49	19%
Audit committee constitution	C.3.1	C.3.1	30	18%	51	14%	81	15%	10	13%	24	14%	34	13%
Remuneration committee	B.2.1	D.2.1	22	13%	57	15%	79	15%	12	16%	17	10%	29	12%
Nomination committee constitution	A.4.1	B.2.1	14	8%	29	8%	43	8%	4	5%	13	7%	17	7%
Performance evaluation of board	A.6.1	B.6.1	8	5%	25	7%	33	6%	1	1%	3	2%	4	2%
Service contract notice periods	B.1.6	D.1.5	7	4%	19	5%	26	5%	1	1%	5	3%	6	2%
Duality principle	A.2.1	A.2.1	9	5%	13	4%	22	4%	3	4%	12	7%	15	6%
Meetings with shareholders	D.1.1	E.1.1	7	4%	14	4%	21	4%	2	3%	4	2%	6	2%
Independence of non-executive directors	A.3.1	B.1.1	7	4%	13	4%	20	4%	1	1%	6	3%	7	3%
Appointment criteria for chair	A.2.2	A.3.1	4	2%	14	4%	18	3%	5	7%	13	7%	18	7%
Rules re senior independent director	A.3.3	A.4.1	6	4%	12	3%	18	3%	5	7%	3	2%	8	3%
Performance-related remuneration	B.1.1	D.1.1	5	3%	9	2%	14	3%	1	1%	6	3%	7	3%
Chair meeting with non-executive directors	A.1.3	A.4.2	3	2%	8	2%	11	2%	1	1%	2	1%	3	1%
New: Annual election of directors	N/A	B.7.1							2	3%	11	6%	13	5%
Other categories	Various sections		23	14%	27	7%	50	9%	15	19%	22	13%	37	15%
<b>Total</b>			<b>168</b>	<b>100%</b>	<b>369</b>	<b>100%</b>	<b>537</b>	<b>100%</b>	<b>77</b>	<b>100%</b>	<b>176</b>	<b>100%</b>	<b>253</b>	<b>100%</b>

NEDs: Non-executive directors

N/A: Not applicable

**Table 5**

Quality criterion 1: Location by companies of their explanations of non-compliance (RQ 1.1).

Location	FTSE 100				FTSE 250				FTSE 350			
	2003 Code		2010 Code		2003 Code		2010 Code		2003 Code		2010 Code	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Separate corporate governance report (explanation at the start)	27	43%	24	56%	83	59%	55	67%	110	54%	79	63%
Separate corporate governance report (explanation at the end)	13	20%	7	16%	25	18%	12	15%	38	19%	19	15%
Separate corporate governance report (explanation in the middle)	9	14%	9	21%	9	6%	4	5%	18	9%	13	11%
No separate report e.g. explanations in directors' report	8	13%	1	2%	9	6%	3	3%	17	8%	4	3%
Scattered approach to disclosure of explanations within any report	6	10%	2	5%	15	11%	8	10%	21	10%	10	8%
<b>Total number of companies providing explanations</b>	<b>63</b>	<b>100%</b>	<b>43</b>	<b>100%</b>	<b>141</b>	<b>100%</b>	<b>82</b>	<b>100%</b>	<b>204</b>	<b>100%</b>	<b>125</b>	<b>100%</b>

**Table 6**

Quality criterion 2: Comprehensiveness by companies of their explanations of non-compliance (RQ 1.2).

Level of Comprehensiveness	FTSE 100				FTSE 250				FTSE 350			
	2003 Code		2010 Code		2003 Code		2010 Code		2003 Code		2010 Code	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Provision labels (e.g. A.2.1) with description of non-compliance	21	33%	26	61%	53	38%	47	57%	74	36%	73	58%
Labels and description of non-compliance but not always together	4	6%	1	2%	4	3%	4	5%	8	4%	5	4%
Description of non-compliance without any labels	37	59%	16	37%	81	57%	31	38%	118	58%	47	38%
Only Code labels provided	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
Labels appear incorrect	1	2%	0	0%	3	2%	0	0%	4	2%	0	0%
<b>Total number of companies examined</b>	<b>63</b>	<b>100%</b>	<b>43</b>	<b>100%</b>	<b>141</b>	<b>100%</b>	<b>82</b>	<b>100%</b>	<b>204</b>	<b>100%</b>	<b>125</b>	<b>100%</b>

**Table 7**

Quality criterion 4: Length of explanations\* for non-compliance (RQ 1.4).

Length in words	FTSE 100				FTSE 250				FTSE 350			
	2003 code		2010 code		2003 code		2010 code		2003 code		2010 code	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
200 or more words	8	5%	4	5%	10	3%	7	4%	18	3%	11	4%
100 to 199 words	35	21%	22	29%	59	17%	42	24%	94	18%	64	25%
60 to 99 words	54	32%	25	32%	106	30%	45	26%	160	31%	70	28%
30 to 59 words	43	26%	22	29%	132	37%	55	32%	175	34%	77	31%
15 to 29 words	23	14%	3	4%	44	12%	25	14%	67	13%	28	11%
Fewer than 15 words	3	2%	1	1%	4	1%	1	0%	7	1%	2	1%
<b>Total number of explanations including combinations**</b>	<b>166</b>	<b>100%</b>	<b>77</b>	<b>100%</b>	<b>355</b>	<b>100%</b>	<b>175</b>	<b>100%</b>	<b>521</b>	<b>100%</b>	<b>252</b>	<b>100%</b>
Mean length (words)	80		97		71		83		74		87	
Maximum length (words)	519		661		345		587		519		661	
Minimum length (words)	13		12		8		12		8		12	

Notes:

\* Unit of analysis: explanations adjusted for number of Code breaches.

\*\* Some explanations are combined and relate to more than one Code breach. For this reason, the number of explanations in Table 2 does not agree with the totals in this table. In addition, there are minor discrepancies between the total number of Code breaches in Table 4 and the total number of explanations in this table. Where explanations are combined, the length is divided by the number of breaches.

**Table 8**

Quality criterion 5: Complexity of language 1 – Flesch scores measuring readability of explanations (RQ 1.5).

Score	Interpretation of score	FTSE 100				FTSE 250				FTSE 350			
		2003 Code		2010 Code		2003 Code		2010 Code		2003 Code		2010 Code	
		No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
60 or more	Standard English	1	1%	0	0%	1	0%	1	1%	2	0%	1	0%
50 to 59.9	Fairly difficult	0	0%	1	1%	8	3%	2	1%	8	2%	3	1%
30 to 49.9	Difficult	34	23%	20	28%	77	26%	46	34%	111	25%	66	32%
21 to 29.9	More difficult	45	31%	19	27%	77	26%	33	24%	122	28%	52	25%
6 to 20.9	Very difficult	44	30%	17	24%	99	35%	44	32%	143	33%	61	30%
Lower than 6	Extremely difficult	22	15%	14	20%	30	10%	11	8%	52	12%	25	12%
<b>Total number of explanations</b>		<b>146</b>	<b>100%</b>	<b>71</b>	<b>100%</b>	<b>292</b>	<b>100%</b>	<b>137</b>	<b>100%</b>	<b>438</b>	<b>100%</b>	<b>208</b>	<b>100%</b>
Mean score		21.9		21.7		23.1		24.2		22.7		23.3	
Maximum score		60.1		53.2		65.5		60.1		65.5		60.1	
Minimum score		0		0		0		0		0		0	

**Table 9**

Quality criterion 5: Complexity of language 2 – Passivity (RQ 1.5).

Level of passivity	FTSE 100				FTSE 250				FTSE 350			
	2003 Code		2010 Code		2003 Code		2010 Code		2003 Code		2010 Code	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Zero passivity	51	35%	34	48%	119	40%	49	36%	170	39%	83	40%
1-25%	25	17%	15	21%	43	15%	23	17%	68	15%	38	18%
26-50%	47	32%	18	26%	93	32%	37	27%	140	32%	55	27%
51-75%	7	5%	3	4%	14	5%	18	13%	21	5%	21	10%
Higher than 75%	16	11%	1	1%	23	8%	10	7%	39	9%	11	5%
<b>Total number of explanations</b>	<b>146</b>	<b>100%</b>	<b>71</b>	<b>100%</b>	<b>292</b>	<b>100%</b>	<b>137</b>	<b>100%</b>	<b>438</b>	<b>100%</b>	<b>208</b>	<b>100%</b>
Mean passivity (%)	31%		19%		27%		31%		29%		27%	
Maximum passivity (%)	100%		100%		100%		100%		100%		100%	
Minimum Passivity (%)	0%		0%		0%		0%		0%		0%	

**Table 10**

Quality criterion 6: Specificity of explanations (RQ 1.6).

Level of specificity	FTSE 100				FTSE 250				FTSE 350			
	2003 Code		2010 Code		2003 Code		2010 Code		2003 Code		2010 Code	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
'Specific explanation'	57	39%	36	51%	137	47%	48	35%	194	45%	84	40%
'General explanation'	42	29%	16	22%	69	24%	52	38%	111	25%	68	33%
'No/inadequate explanation'	47	32%	19	27%	86	29%	37	27%	133	30%	56	27%
<b>Total number of explanations</b>	<b>146</b>	<b>100%</b>	<b>71</b>	<b>100%</b>	<b>292</b>	<b>100%</b>	<b>137</b>	<b>100%</b>	<b>438</b>	<b>100%</b>	<b>208</b>	<b>100%</b>

Note:

See Section 4.6 of the paper for the interpretation of specificity.