

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

Philip J. Shrives, Newcastle Business School, Northumbria University
and
Niamh M. Brennan, University College Dublin

Address for correspondence: Dr Philip J. Shrives, Newcastle Business School, City Campus East,
Northumbria University, Newcastle upon Tyne NE1 8ST. Email: Philip.Shrives@unn.ac.uk

Abstract

Companies not complying with the UK Code of Corporate Governance are required by the Code 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. Many previous disclosure studies have mainly focussed entirely or substantially on quantity. The typology is based on seven quality characteristics. Illustrating the typology, this study examines the quality of explanations for non-compliance of UK FTSE 350 companies. The research question addressed is: what is the quality of the explanations provided? The Code violations generating the non-compliance explanations for analysis are identified

There were 204 (75%) non-compliant companies, 537 Code violations and 438 explanations for non-compliance, an average of 2.6 violations and 2.2 explanations per non-compliant company. Explanations were found to be of variable quality. Results indicate the aspects of explanations for non-compliance which companies need to address (notably location of explanations, complexity and specificity of explanations). There are also important questions raised about the work of auditors and their apparent silence. Results suggest that companies need to improve the quality of their explanations if they are to be useful to users. Finally, the paper discusses responses to the Financial Reporting Council's (FRC) Call for comments on the 'comply or explain' system and discusses the FRC's own response to date on questions concerning the quality of the explanations for non-compliance.

Keywords: Comply or explain, non-compliance, explanation, quality of explanations, typology

1. Introduction

Explanations of non-compliance with UK corporate governance requirements are the capstone of the 'comply or explain' system. However, as Solomon (2010) and Sheath and Land (2006) indicate, 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. Much prior research examines disclosures in annual reports using quantification techniques, in the form of counts or indices. This paper examines the quality rather than quantity of explanations for non-compliance by developing a typology based on seven quality characteristics.

A typology is a classification scheme which organises phenomena into groups on the basis of their similarity of particular key features (Bailey, 1994). Bailey lists a number of advantages of typologies and some disadvantages. They can reduce complexity by highlighting similarities and differences and thus can be versatile research tools where comparisons need to be made. However, they can also oversimplify complex phenomena and reify theoretical constructs by obscuring the fact that they themselves are social constructs (Bailey, 1994), so they need to be used with care.

Companies which do not comply with the sections of the UK's Code of Corporate Governance are required to provide an explanation. Who evaluates these explanations (if anyone) is not entirely clear. Does the quality of those explanations really matter? In a review of explanations for non-compliance, the Financial Reporting Council (FRC, 2012a) points out 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. A rather different view is revealed by Grant Thornton (2011):

- Only seven FTSE 350 companies have been fully compliant with corporate governance requirements for the last ten years
- Only half of FTSE 350 companies complied with the Code in 2011 for the whole of the year
- The most commonly disclosed non-compliance relates to board composition and committee membership. These are not minor violations and in fact, are at the centre of good governance. For example, Bujaki and McConomy (2002) find having a majority of non-executive directors is closely associated with more comprehensive implementation of corporate governance guidelines. Thus, robust explanations for non-compliance are essential.

Finally, even Chris Hodge, Head of Corporate Governance at the FRC, writing in the 2011 Grant Thornton annual review admits *“A significant minority of UK listed companies could still improve the quality of their reporting. In ‘explaining’, it 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”* (Grant Thornton, 2011, p. 2). European Union reports issued in 2009 and 2011 also raise important issues about the quality of explanations and the real world working of the ‘comply or explain’ system (Risk Metrics et al., 2009).

1.1 Quality of disclosures

This study examines explanations for non-compliance in UK FTSE 350 company annual reports in order to assess the quality of those explanations. This is important as meaningful explanations are critical to the effectiveness of the ‘comply or explain’ system. Currently, UK companies have free rein over these disclosures in their annual reports. Although the Code specifies what companies should comply with, it is entirely silent as to what happens when non-compliance occurs other than to require companies to provide an explanation. Sometimes questions are raised as to whether these explanations are useful to shareholders. Do companies attach sufficient importance to these explanations? - something raised by Sheath & Land (2006, p. 1):

When there are few questions from investors and the link between governance and investor decisions is not very visible, it’s understandable that some [companies] see little benefit in investing time and effort in moving their reporting forward. But there are benefits and these will increase as investors begin to use governance information more effectively in their assessments of board and management performance.

The implication from this quotation (and a point emphasised in this paper) is that if explanations for non-compliance were more useful, better use would be made of them by investors. Although some authors have suggested that greater focus needs to be placed on stronger enforcement mechanisms (Wymeersch, 2005; FASTERLING, 2006), non-compliance is still left to companies (including preparers and board members), their shareholders and the capital markets.

Having first revealed the extent of non-compliance with the Code, the study analyses 438 explanations for non-compliance. A typology is developed from the prior literature and conceptual framework of IFRSs (see Figure 1, adapted from the ideas of Beattie, McInnes, & Fearnley, 2004) and comprises seven quality characteristics as follows: (i) Location, (ii) Comprehensiveness, (iii)

Originality/Mimetic behaviour, (iv) Length, (v) Complexity, (vi) Specificity and (vii) Attestation. This compares with Seidl, Sanderson & Roberts' (2013) quite different 12-component taxonomy of explanations which they develop based on legitimacy theory.

Each explanation is evaluated against these quality characteristics. Based on each quality characteristic, suggestions are made for improving company practice. This paper does not suggest precisely how explanations for non-compliance should appear in annual reports because that would be inconsistent with the 'comply or explain' philosophy which encourages companies to tailor bespoke explanations for non-compliance according to their own circumstances. The essence of an explanation is that it should be of 'equal quality' to full compliance. It is acknowledged that quality characteristics are context specific (in this case corporate governance). These characteristics can be adapted and used in circumstances where a quality assessment of disclosures is required. Like other papers in the area of corporate disclosure (Beretta & Bozzolan, 2004), this work also acknowledges that many measures of corporate reporting have focussed on quantity of disclosure yet clearly as annual reports have increased in size (Deloitte, 2010) there is a need to affirm the importance of quality. Exploring what we mean by quality can help return the focus to usefulness of reporting.

The paper makes three contributions to the prior literature:

(i) The primary contribution of the paper is the development of a typology for analysing non-compliance explanations. This research develops an array of quality characteristics for assessing disclosure quality in relation to explanations for non-compliance in annual reports. Although some aspects of the quality characteristics have appeared in prior studies, the set of quality characteristics are especially developed for analysing 'explanations'. The qualitative characteristics are more comprehensive than those in previous studies. A particular aspect was the use of the software package 'Turnitin', which was used to monitor the use of mimetic behaviour. Our typology provides an alternative and quite different approach to the taxonomy of Seidl et al. (2013). The empirical analysis serves to illustrate the application of the typology.

(ii) Explanations for non-compliance with governance codes remain relatively unexplored in the prior literature, with the exception of MacNeill and Li (2006), Pass (2006), Andres & Theissen (2008), Arcot, Bruno & 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 (see, for example, Pass, 2006) or earlier versions of the Code (Arcot et al, 2010).

(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). We discuss how these might suggest companies might behave; and then considers these different theories in the light of the findings. For example, although companies were found not to behave in the way predicted by signalling theory, other theories can help explain company behaviour. Resource dependency theory is useful in understanding the type of explanations companies provide for non-compliance and institutional theory can also help explain company behaviour.

This paper proceeds as follows: the next section examines the background to corporate governance in the UK, then the paper examines theory and accounting concepts in relation to quality of the disclosure. Next a suggested typology is described and the results are discussed. The paper discusses responses to the FRC's Call in relation to 'comply or explain' and its actions as a result of comments made. The paper ends with policy implications, a conclusion and suggestions for further research.

2 Background to the UK Corporate Governance Code

The current (2012) Corporate Governance Code in the UK (and Ireland) has developed over 20 years beginning with the Cadbury Report (Committee on the Financial Aspects of Corporate Governance, 1992) and more recently resulting in the 2012 Code (FRC, 2012b). The essence of the Code is flexibility, with companies able to choose whether or not to fully comply. The Code is often contrasted with the much more restrictive US Sarbanes-Oxley Act 2002 which has to be complied with by US companies and those seeking a listing, for example, on the New York Stock Exchange. The advantages and disadvantages of each system are to some extent debateable in an almost the 'grass is always greener' fashion. Anand (2006), for example, extols the virtues of the UK Code based on the assertion that the costs of compliance are substantially less than in the US. The 'zero tolerance' attitude taken by the Sarbanes-Oxley Act may, however, be welcomed by those who believe that British companies are likely to exploit the flexibility that the UK Code offers. Given that flexibility, then one might expect companies to follow closely the 'comply or explain' requirements in order to stave off possible future Sarbanes-Oxley style legislation in the UK. In contrast, this research suggests that companies do not provide high quality explanations and explores why this might be the case. Possible reasons can be found in disclosure theories and these are now discussed.

Table 1: Prior empirical research on comply-or-explain corporate governance disclosures				
Paper	Theory	Data	Non-compliance disclosure measure	Conclusion
MacNeill & 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 & 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 (1 point); (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 & Roberts (2013)	Legitimacy theory	715 non-compliance explanations of German and UK firms published in 2006	1. Deficient (three categories), 2. Context-specific (five 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

3 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 an 'magpie' like fashion. The same is true of disclosure. Although some studies refer to a 'theory of disclosure' (Leuz & Verrecchia, 2000), many theories are available which can help explain the disclosure practices of companies. Thus, in the area of corporate governance, there is a raft of theories to explain nearly every practice. For example, when examining risk reporting, Abraham and Shrivies (2012) identify ten theories that can be used to explain risk disclosure practices by companies. As different theories can be used to explain different disclosure behaviour, 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. Managers will signal information about corporate governance because it is in their interest to do so (Milne, 2002). Bhat et al. (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.

Companies enjoy the flexible nature of the Code as they can adapt corporate governance practices to fit in with their own circumstances. It is therefore reasonable to expect quality explanations for those circumstances which are at variance with the Code. Research adopting agency and signalling theory explanations for disclosure tends to measure disclosure in a dichotomous manner, as being present or not. This 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; Mizruchi & Fein, 1999), with its focus on conformity which is associated with survival, tends to suggest compliance. First, companies may feel coerced into compliance. This could be on grounds they should follow best practice (for some it may be unthinkable to do otherwise – see Oliver, 1991) or they may be reluctant to craft an explanation for non-compliance. The latter may be the case where no suitable examples as to how construct explanations exist. It may also be that companies experiment with non-compliance to begin with but then reluctantly feel coerced to move towards compliance. DiMaggio and Powell (1983) 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”* (p. 156). 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). There are various ways non-compliance can be concealed but an outright false claim may be quite effective particularly as there are few (if any) inspectors and when the Code itself is complex and subject to interpretation.¹ Second, companies may copy other companies’ non-compliance (termed mimetic behaviour by DiMaggio and Powell, 1983). For example, companies may see a high profile company not complying with certain provisions of the Code and may decide not to comply with the same aspects. They might do this to save costs of compliance, while at the same time claiming legitimacy from the practices of others. When Marks and Spencer combined the posts of chairman and chief executive contrary to the Code’s recommendations², other companies may have believed that they can also behave likewise with little long term damage to their reputation. Third, companies may be tempted to mimic or copy the actual explanations of others particularly where they are unsure themselves how best to disclose the explanation. The Code itself provides no guidance which could be seen 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 to *“maintain legitimacy and increase survival prospects”* (Dillard, Rigsby and Goodman, 2004, p. 510). In this case, legitimacy comes from conforming with or following the practice of other

respected or bellwether organizations. Additionally it provides some evidence that auditors, shareholders or other stakeholders have not visibly questioned an explanation.

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 (ideally) provide bespoke and specific explanations. However, if a manager of a non-compliant company sees another well-respected company's explanation which appears well crafted, and that company's circumstances seem similar, then he or she may decide to copy the explanation it perceives as high quality. Thus, a high quality explanation is perhaps more likely to be copied than one of lower quality. Because readers are unlikely to be able to identify copied explanations, company officials may have an incentive to copy. Copied disclosures cannot be bespoke and, as indicated above, because the circumstances of each company are inevitably different, the explanation is unlikely to be as good as a specially crafted one. Even where managers believe their circumstances are identical, information asymmetry means that they *cannot be sure* of this and so should write their own explanation for non-compliance.

Another but related aspect of institutional theory is decoupling. Decoupling (Meyer & Rowan, 1977; Dillard et al., 2004) refers to corporate practices that are inconsistent with their 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 organizational literature (Zahra & Pearce, 1989), suggests that companies (or their managers) will maximise the resources available to them. Thus, companies will prioritise the need for certain key resources such as a need for banking or legal expertise, over compliance with the Code such as independence of non-executive directors. As such it "*elaborates the virtues of non-compliance... (such as) discretion or autonomy over decision making*" (Oliver, 1991, p. 150). Thus flexibility and the ability to adapt to changing circumstances are factors which indicate that this theory is likely to help explain aspects of non-compliance and is consistent with agency theory. 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 at first sight 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 *importantly*, these issues were detected.

These theories can help with the prediction of the *overall quality* of disclosure and may help identify some of the types of explanations but it is acknowledged that they are unlikely to help with the assessment or identification of the *component parts* of quality disclosure. Therefore, in the next section, in order to consider the components of quality, the work of Botosan (1997) is considered alongside the conceptual framework of International Accounting Standards Board (IASB) (IASB, 2010).

Assessing the quality of disclosures is fraught with difficulty. However, that does not mean it should not be attempted. The purpose of this research is to analyse explanations for non-compliance and assess the extent some of these constitute good and bad practices. In the next section seven quality characteristics are identified. Together these components form a typology which can be used to examine the quality of explanations for non-compliance (shown diagrammatically in Figure 1).

4 Quality Characteristics and Research Question

In order to address the research question: what is the quality of explanations provided, a quality typology is derived from the literature comprising seven components (see Figure 1). In the following sections the seven components are discussed including the component research questions.

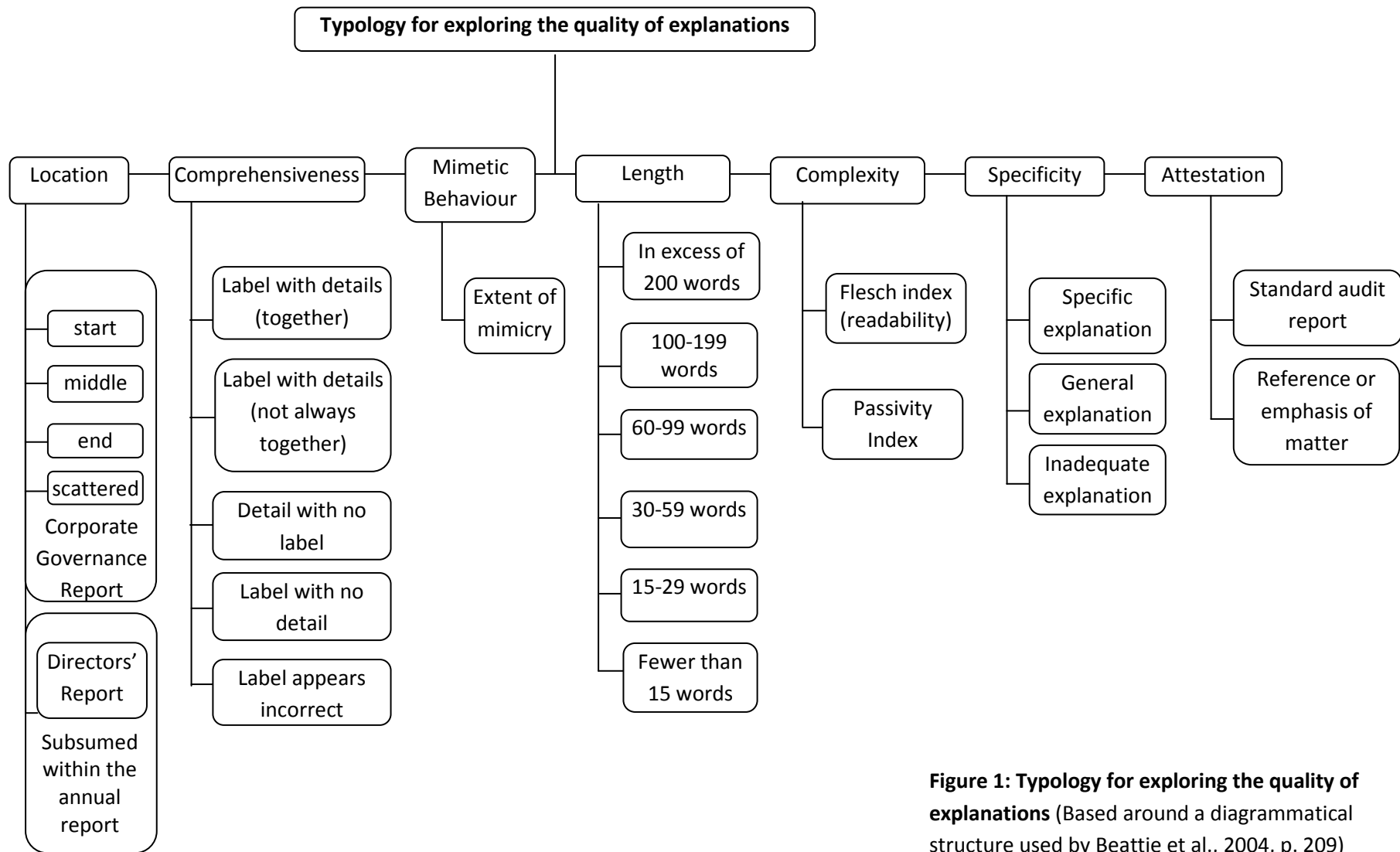


Figure 1: Typology for exploring the quality of explanations (Based around a diagrammatical structure used by Beattie et al., 2004, p. 209)

4.1 Location

Location is the first item that was considered in the typology. Given the length of annual reports (Deloitte, 2010), it is difficult for readers to assimilate all the information. Thus some content is likely to be overlooked. Location is important because readers need to be clear which aspects of the Code are not complied with. Consequently, explanations should be easily accessible and preferably give an 'at a glance' account of the state of compliance (see Sheath & Land, 2006). If companies do not disclose the information in such a way that users can easily access, there is a danger that readers may misunderstand the nature of companies' compliance/non-compliance. Of course, it is quite possible that that is the intention.

A number of disclosure studies have explored location. Solomon et al. (2000) devised a framework for risk disclosure which identified six elements of risk disclosure one of which was concerned with location. Also in the area of risk disclosure, to get an overall picture of risk, Woods and Marginson (2004) found that various sources of information within the annual report had to be linked together and manipulated to make sense of the disclosure. In an environmental reporting study, Warsame, Neu, and Simmons (2002) scored higher environmental disclosures that were more organized and located more conveniently than those that were harder to locate. Kirkman and Hope (1992) identified eight locations for environmental disclosures, the majority of which are relevant to this study. Hirshleifer and Teoh (2003) also discussed the prominence with which information is displayed. They claim that because investors have limited attention spans, different ways of disclosing the same information may have an impact on perception and even market price. These references suggest that location is a factor, especially in the context of non-compliance where directors have an incentive to hide information.

Perceptions of firm performance and prospects can be manipulated by the way information is presented in corporate documents. Ordering or physical location of information is used to direct readers' attention to or away from specific items of information (Staw et al., 1983; Baird & Zelin, 2000; Bowen et al., 2005; Elliott, 2006; Brennan et al., 2009).

In Botosan's (2004) discussion of Beretta and Bozzolan's (2004) paper, she was critical of their view of quality preferring instead to use the concepts from the IASB 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 for the following reasons. 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 or are hidden in any way, understandability is likely to be compromised. Similarly comparability is also assisted by location. If all companies disclosed their explanations in a consistent location, comparability would be enhanced. For this reason, it seems appropriate to include location as a component of quality and the first part of the research question examines this (Research Question 1.1).

The exact way location is analysed varies from study to study. In relation to corporate governance explanations for non-compliance, location can be analysed as follows:

(A) Explanations for non-compliance as part of a corporate governance report

(B) No corporate governance report as such: Explanations for non-compliance subsumed within another part of the annual report and may be therefore more difficult to locate.

Investors are likely to prefer (A) to (B). This is because proponents of (B) are likely to take the view that corporate governance is not important enough to warrant a separate section (and hence heading) within the annual report. In turn (A) can be analysed into various sub-sections as follows:

1. At the start of the corporate governance report
2. In the middle of the corporate governance report
3. At the end of the corporate governance report
4. Scattered throughout the corporate governance report

It is debateable the extent different categories are preferred to each other, but arguably either start or end (1 or 3) are the best locations. Certainly the last location (scattered) is likely to be difficult for readers to comprehend and assimilate the compliance/non-compliance situation. The middle of the report is also going to be difficult to locate but is probably better than a scattered approach.

Regarding the start/end categories, there are various merits and demerits of these. Some users of annual reports may prefer the information to be disclosed at the start of the report on the basis that that is easily accessible (Bowen, Davis, & Matsumoto, 2005). However, with that position, there is a danger that the rest of the report may go unread and users may neglect other important disclosures. This could also happen with the end of the report where users go straight to the end without reading the detailed content. To some extent, the compliance/non-compliance situation is an outcome and

therefore is properly positioned at the end of the report on the basis that users can read the report and then see the summary of disclosure at the end. This research does not suggest which locations are preferred other than to say a separate corporate governance report is preferred and that explanations at the start or end are preferred to the middle, which is, in turn, preferred to explanations scattered throughout the annual report.

4.2 Comprehensiveness

For readers to understand an explanation it should be as complete as possible. Research Question 1.2 examines the extent to which companies provide comprehensive explanations of their non-compliance. Once again the concept of completeness will vary from context to context. In their work on risk reporting, Beretta and Bozzolan (2004) refer to the depth and the detail of the disclosure. Comprehensiveness or “*completeness is a recognised attribute of quality*” (Hammond & Miles, 2004, p. 67). Disclosure of certain items such as health and safety expenditure will only be complete if a bespoke description is accompanied by quantitative aspects and possibly comparative figures. In the case of non-compliance disclosures, quantitative information will not be applicable but a full explanation of non-compliance will contain the relevant Code provision number (or label). The most comprehensive disclosure will contain the necessary detailed customised description together with the relevant Code provision number. Five other possibilities are suggested below including just the description (item 3) or possibly the wrong or outdated Code reference (item 5):

1. Code provision labels (e.g. A.2.1) with detail / explanations (best).
2. Detail/Explanations and Code provision labels but not always together
3. Detail/Explanation with no Code provision label.
4. Code provision label with no detail/explanation.
5. Code provision labels appear incorrect (worst).

Again, it is relatively easy to see how completeness is consistent with the quality measures discussed by Botosan (2004). Completeness of information must surely help with both the facilitation of understandability and comparability. If a Code provision label is supplied there can be no doubt as to which provision of the Code is being referred to. Where this is not in evidence, 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 different provisions. Thus Code provision labels are particularly helpful in ascertaining which Code provision has not been complied with and this also helps with another of IASB’s enhancing qualitative characteristics – verifiability.

4.3 Mimetic Behaviour

If a disclosure is not tailored specially for a company, there is a risk that the information does not encapsulate the full nature of the non-compliance. Non-compliance by its very nature is different to the 'norm' which is likely to be seen as compliance, thus the need for a bespoke explanation. Even if companies choose not to comply with the same Code provision, the precise reasons – often which might relate to a particular director or their service – are likely to vary. The essence of non-compliance is that something is different about the company. Therefore the explanation should be individually crafted. A copied/boilerplate explanation may appear on the surface to be entirely suitable. But it represents someone else's thinking and may not reflect the individual company circumstances and does not therefore constitute specifically tailored thinking. The Davies report (Davies, 2011) when looking at the constitution of boards, warns against homogeneity of boards and 'group-think'. It is for this reason that copied/boilerplate explanations are unlikely to be as good quality as bespoke explanations. 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 states that the roles of chair and chief executive should not be exercised by the same person (duality). This provision of the Code was chosen because:

- It is a key section of the Code which researchers have long emphasised as being important (Conyon & Mallin, 1997).
- It was formally referred to in the Cadbury Report (Committee on the Financial Aspects of Corporate Governance 1992) and it was subsequently strengthened in the Higgs Report (2003) and then incorporated into the subsequent Code.
- 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).
- When Marks and Spencer plc decided to breach this Provision of the Code with the appointment of Sir Stuart Rose as Chairman and Chief executive it caused a significant furore within the business community (see *The Times* March 29, 2008). This demonstrates that it is viewed as important in practice by institutional shareholders.
- It was not a new provision of the Code so companies had an opportunity to read explanations that other companies had previously provided.

Research Question 1.3 examines the extent to which companies appear to copy other companies' explanations in relation to duality. In order to assess the extent to which companies copied, a three

stage process was devised. First, companies violating Provision A2.1 were identified. Second, explanations were extracted and read through and compared. Any similarities between explanations were noted. Third, explanations were copied into separate files and uploaded to the software plagiarism detection program 'Turnitin'. Typically 'Turnitin' is used in academic institutions to compare students' work with information on the internet to identify plagiarism. In this instance, explanations were in effect treated as if each one was a different student assignment. Once the explanations are uploaded, matches are displayed and colour coded according to the degree of 'match'. Notes are made of all matches. 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. Although the authors have used this technique in other research, the only other researcher to do so of which the authors are aware of is Holder-Webb & Cohen (2012) who examined ethics codes in US companies using a similar type of software.

4.4 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. There are a number of justifications for this. First, Beretta and Bozzolan (2004) have also claimed that quality comprises different components of which one is quantity. Second, and more importantly, quality has to be context specific. 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 in this area 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 are likely not to 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 spent 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, length categories are adopted as follows:

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).

Of particular concern would be the last two categories. Although the categories are subjective they are based on experience of working with explanations. In particular, experience (gained during the pilot study) showed that it was not possible to provide an adequate explanation which adequately described the circumstances of non-compliance in fewer than 30 words.

4.5 Complexity

If disclosures are unclear or complex then understandability is likely to be compromised. 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. Writing which is unclear or over complex can detract from its quality, affecting communication of the information. For the purposes of this study, complexity is divided into two sub-components: (i) readability and (ii) use of the passive voice ('passivity'). Research Question 1.5 measures the extent of these variables.

There is some dispute in the literature about how to measure readability and in particular the use of the Flesch score. There are a number of problems with using the Flesch index, some of which concern its origins as a means of measuring reading age for children's literature. It was decided to use the Flesch tool for two reasons. First, Curtis (1998 & 2004) makes the important point that just as ratio analysis has some defects, it is still a useful tool. It is objective, reliable, comparable and easily replicable. Second, research carried out by Brennan, Guillamon-Saorin, and Pierce, (2009) shows that the majority of studies which examine readability, used the Flesch scores (13 out of 15 studies examined).³ On balance this demonstrates that while the Flesch index should be used with caution, it can be helpful as part of an overall quality measure. Table 2 shows the interpretations of Flesch scores. By way of comparison Curtis (2004), a key researcher in this field, found scores in Hong Kong annual reports to be around the mid 30s (difficult to read).

The second component of complexity is the use of the passive voice. This element of complexity (and hence quality) is particularly relevant to company explanations for non-compliance because it enables the writer to be separated from the message. Thomas (1997) examined the financial statements of the US company Cross and Tracker. She found that as the financial situation worsened the company made greater use of the passive voice in sentences. She observed that use of the passive voice was apposite when *"the writer finds it advantageous to distance himself or herself from*

the message” (Thomas, 1997, p. 53). The other aspect of the passive voice is that by separating the subject(s) from the verb it 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 the reader is 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 software is not always totally consistent. Table 2 also shows scoring categories for passivity. These scores were tested for validity in a pilot study.

Table 2: interpreting Flesch scores and passivity scores			
Flesch score	Interpretation of Flesch score (see for example Courtis, 2004)	Passivity scores	Interpretation of Passivity score
60 and above (best)	Standard English as used in a quality newspaper or straightforward novel	Zero (best)	No use of the passive voice.
50-59	More difficult English as in a classical novel	1-25%	↓Increasing use of the passive voice
30-49	Difficult, such as the standard of a text book	26-50%	
21-29	More difficult	51-75%	
6-20	Very difficult	In excess of 75% (worst)	Substantial use of the passive voice.
5 or lower (worst)	Extremely difficult, perhaps a scientific paper or complex legal document.		

4.6 Specificity

The pilot study suggests that explanations are quite general and could apply to any company. Sydserff and Weetman (1999) recommended exploring specificity in disclosures having developed the idea from Roseberry (1995) and de Beaugrande and Dressler (1981). A number of authors working in the areas of environmental reporting or risk also emphasise the need for specificity in disclosure and incorporate it in their assessment of disclosure (Warsame et al., 2002; Lajili & Zéghal,

2005; Beretta & Bozzolan, 2004 and Aerts, Cormier, & Magnan, 2008). In addition, a Dutch study of corporate governance reports that many companies only provide “*generally applicable arguments*” (Akkermans et al., 2007, p. 1113). Sheath and Land (2006) state that “*Investors want a company to use its report to reflect its specific approach to governance.*” (p. 4). An explanation which is of equal value to compliance has to be bespoke and specific. Research Question 1.6 examines the extent to which explanations are specific. Accordingly, explanations were divided into three categories:

1. **Specific explanation.** This is an explanation which provides details of the non-compliance, giving reasons for it which are relevant to a particular company’s special circumstances. Specific explanations are likely to refer to directors’ names, the number of years of service and reasons that are relevant to that particular situation. This explanation is best because it is most closely tailored to the company.
2. **General explanation.** This is an explanation which could apply to a number of different companies and does not attempt to address the specific circumstances relevant to the company in question.
3. **Inadequate explanation.** This is where an explanation states the part of the Code not complied with but does not detail exactly why the non-compliance occurred. This could be where a company says it did not comply for part of a year. Even though the company managers may feel the issue is resolved (where the company complies by the end of the year), the reality is no proper explanation for the non-compliance has been provided. Explanations which are missing are also coded to the category.

Specificity is not a particular characteristic identified by the IASB. Nevertheless, it is indirectly relevant to comparability. Users need to assess disclosures. Providing company specific explanations enables them to do that. In a sense, specificity is also related to comprehensiveness and for that reason appears justified as an important component of quality.

4.7 Attestation

When considering explanations for non-compliance some consideration should be made of the role of external audit. A number of environmental reporting studies have suggested that some form of assurance can improve the credibility of the information disclosed (see for example, Epstein & Freedman, 1994; Neu, Warsame, & Pedwell, 1998; Warsame et al., 2002). In addition, Hammond and Miles (2004) surveyed executives and found that “*Verification was generally considered as a stamp of quality*” (p. 69). Similarly, the IASB lists verifiability as an enhancing characteristic. All this suggests that attestation can improve the quality of corporate governance statements.

Although there is no strict requirement for auditors to *audit* corporate governance disclosures guidance is issued by the UK Auditing Practices Board in APB Bulletin 3 (APB, 2004) which represents best practice. 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)

In the event that auditors feel the nine provisions on which they have to report are not adequately disclosed, the Bulletin requires auditors to include an ‘emphasis of matter’ paragraph in their audit report. Auditors are not required to actively search for omissions and inconsistencies. This study examines the extent of any variations identifiable in auditor reports. It is acknowledged that auditor reviews provide limited assurance in that just nine provisions of the Code are covered by these reviews and auditor reviews do not examine any explanations. While the amount of assurance given by auditors in their reviews is very limited, nevertheless some form of attestation does seem to be better than none and for this reason it is counted as a subcomponent of quality. Research Question 1.7 examines the extent to which auditors either issue a fully clean report or include an emphasis of matter paragraph. A qualification would not normally be possible unless a disclosure seriously compromised the financial statements in some way. Thus the two possible outcomes are: (i) A clean audit report (best), (ii) an emphasis of matter paragraph.

5. Sample

In order to produce a good range, explanations were analysed from the first year of compliance with the Code when it was substantially changed in 2003. Although the Code has gone through other incarnations, the 2003 changes were most significant and thus it was felt they would provide a variety of explanations to test the quality typology. Results are based on three levels of analysis: (I) companies, (II) Code breaches and (iii) explanations for non-compliance. The company sample was made up of FTSE 350 companies (extracted from Datastream) whose annual reports relate to the first time compliance with the 2003 Code (typically year ends 2004 or 2005). In order to maximise the number of possible explanations, the year after the 2003 Code (which contained the most Code changes) was selected. Code breaches and explanations for non-compliance were obtained from annual reports. Annual reports were obtained from company websites (preferred) or from websites that provide access to company reports. Where these sources failed to produce results, hard copies were obtained from the company, libraries or other sources. All companies that claimed compliance with the Code were excluded from the sample. Investment trusts were also excluded. This is because some have no employees and directors thereby making some sections of the Code meaningless (Deloitte, 2010) and besides, they have a separate Code (Grant Thornton, 2011). As shown in Table 3, the company sample comprises 204 non-compliant companies. There were 537 Code violations and 438 explanations for non-compliance (sometimes a single explanation related to more than one violation). Code violations 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. Occasionally, explanations were in different places to violations so repeated searching helped identified them.

Table 3: Population and sample						
Panel A: Unit of analysis: Companies	FTSE 100		FTSE 250		Total	
	No.	%	No.	%	No.	%
FTSE 350 companies	100		250		350	
<i>Less Excluded from sample</i>	*5		**72		77	
Total sample	95	100%	178	100%	273	100%
<i>Less Claim full compliance</i>	31	33%	37	21%	68	25%
<i>Less Provide ambiguous disclosures</i>	1	0%			1	0%
Companies disclosing non-compliance	63	67%	141	79%	204	75%
Panel B: Unit of analysis: Explanations						
Total explanations of non-compliance	146	100%	292	100%	438	100%
Average per non-compliant company	2.3		2.1		2.2	
Notes:						
* Either taken over or overseas companies following other Codes.						
**Of which 34 were investment trusts and 19 were taken over by other companies. The remainder were de-listed before the relevant annual reports were produced, or identified themselves as being smaller companies. List of companies obtained from Datastream as at December 31, 2004.						

6. Results

As shown in Table 4, three quarters of all FTSE 350 companies did not comply with at least one item. On average, non-complying companies within the FTSE 350 did not comply with 2.6 items of the Code (there was no significant difference between FTSE 100 and FTSE 250 companies). A third of FTSE 350 non-compliers did not comply with one item, a quarter did not comply with two items, a fifth did not comply with three items with the remaining fifth not complying with four or five items or more items. The highest number was 12 items for a FTSE 100 company and eight items for a FTSE 250 company.

No. of Items	FTSE 100 No. of companies	%	FTSE 250 No. of companies	%	Total No. of companies	Total %
1	21	32%	47	33%	68	33%
2	16	26%	36	25%	52	26%
3	15	24%	25	18%	40	20%
4	6	10%	17	12%	23	11%
5	0	0%	8	6%	8	4%
6 or more	5	8%	8	6%	13	6%
Total	63	100%	141	100%	204	100%

The most common Code violations are summarised in Table 5. 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. From a different perspective it is not surprising that managers do not comply with these areas. Resource dependency theory would 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 violate 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.

Table 5: Ranking of Code violations by FTSE 350 companies			
Code Provision	Summarised Code details	Non-compliance No.	Ranking of Code violations
A.3.2	Percentage of the board to comprise independent non-executive directors	101	1
C.3.1	Audit committee constitution	81	2
B.2.1	Remuneration committee constitution	79	3
A.4.1	Nomination committee constitution	43	4
A.6.1	Performance evaluation of the board	33	5
B.1.6	Service contract notice periods	26	6
A.2.1	Duality principle	22	7
D.1.1	Meetings with shareholders	21	8
A.3.1	Independence of non-executive directors	20	9
A.2.2	Appointment criteria for chair	18	=10
A.3.3	Rules re senior independent director	18	=10
	Other	75	
	Total Code provisions not complied with	537*	
<p>*Note: This number is not the same as the 438 explanations given in Table 1 for two reasons. On occasion non-compliance with one Code item means that another closely related Code item is also not complied with. For the purpose of this study this is only treated as one violation. Second, some companies provide one explanation for multiple violations.</p>			

More recent statistics indicate there does seem to be a move towards compliance in the UK (Grant Thornton, 2009, 2010, 2011). 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. There is a danger companies may comply in a box ticking/boilerplate manner as that is seen to be 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. If compliance were to become the norm, companies may even feel that the option of non-compliance is effectively removed from them. 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 following quality components can help to highlight good disclosure practice.

6.1 Location

Even though location is a judgemental characteristic, it is interesting to note that the majority (54%) of companies opted for what was believed to be an optimal location for explanations i.e. the start of the report. The end of the report was selected by 19% of companies (see Table 6). Thus, just less than three quarters of companies selected what might be seen as a good location for their explanations. The remaining companies (just over a quarter) selected a disclosure strategy that was felt to be somewhat unhelpful to readers. Some had no corporate governance report at all (8%) while others disclosed the information in the middle of the report (9%) or adopted a scattered approach to disclosure (10%). A recent survey (Deloitte, 2010) also showed some issues with location. The Deloitte survey examined 130 companies selected from the FTSE 350 firms and using reports from August 2009 until July 2010. It showed that 31% of companies provided their compliance statement in the first paragraph of the corporate governance report, 66% elsewhere in the corporate governance report and 3% in the directors' report. This supports the issues found in this research and confirms that more recent practice continues to raise location issues. Further research is needed in order to ascertain why companies (or their managers) chose to disclose in this particular way. The need to conceal or hide non-compliance appears consistent with resource dependency theory and institutional theory. Oliver (1991), referring to such authors as Meyer and Rowan (1977) and Pfeffer and Salancik (1978), claims that *"several institutional and resource dependence theorists have acknowledged the importance of avoidance as a response to institutional pressures"* (p. 154).⁵

Table 6: Quality criterion 1: Location by companies of their explanations of non-compliance (RQ 1.1)		
Location	FTSE 350 No.	%
Separate corporate governance report (explanation at the start)	110	54%
Separate corporate governance report (explanation at the end)	38	19%
Separate corporate governance report (explanation in the middle)	18	9%
No separate report e.g. explanations in directors' report	17	8%
Scattered approach to disclosure of explanations within any report	21	10%
Total number of companies providing explanations	204	100%

6.2 Comprehensiveness

To understand explanations for non-compliance, details disclosed need to be comprehensive. Table 7 shows that only around 40% of companies provided comprehensive disclosures with 60% producing information which is inadequate in varying degrees. The reasons for substandard disclosure are unclear and more research is necessary. However, it may be that managers feel they are drawing attention to their non-compliance by giving complete information. Disguising non-conformity would be consistent with institutional and resource dependency theories (Oliver, 1991). Providing an explanation *without* detailing the precise Code provision is likely to lead to confusion on the part of the reader and may also indicate confusion on the part of the company. Board members themselves may even be unclear as to the extent of non-compliance. If the FRC introduced guidance on comprehensiveness, this would be helpful in ensuring that disclosures were fully comparable and thus were consistent with the 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.

Table 7: Quality criterion 2: Comprehensiveness by companies of their explanations of non-compliance (RQ 1.2)		
Level of Comprehensiveness	FTSE 350 No.	%
Provision labels (e.g. A.2.1) with description of non-compliance*	73.5	36%
Labels and description of non-compliance but not always together	8.0	4%
Description of non-compliance without any labels	118.5	58%
Code labels only	0.0	0%
Labels appear incorrect	4.0	2%
Total number of companies examined	204.0	100%
*Note: 0.5 is recorded where a company with more than one violation provides provision labels for one violation but does not provide a label for another.		

6.3 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. Twenty companies within the sample provided explanations for violation of the Code concerning duality. ‘Turnitin’ matches (which are not mutually exclusive) were found:

- To the company's own accounts for either the year in question or for subsequent years. For three quarters of companies (as expected) there was a 100% match.
- To seven explanations partly matched the wording of explanations 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. A quarter 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 four of the 20 company explanations which matched other companies' explanations. These matches, which are the focus of the study, were found to be matched with the Code itself rather than other companies' specific explanations. Unsurprisingly, companies tend to use the same words as the Code rather than copying from each other.

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 and this is also worthy of further investigation.

6.4 Length

There is no ideal length for an explanation. The majority of explanations were above 60 words which is to be expected given that an explanation should contain details of the non-compliance as well as the reasons (in practice it is difficult to disentangle the non-compliance from the reasons). The average length was 74 words (see Table 8). The main concern is that 14% of companies provided explanations of fewer than thirty 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% of disclosures.

Table 8: Quality criterion 4: Length of explanations for non-compliance (RQ 1.4)		
Unit of analysis: explanations adjusted for number of Code violations (except where provisions were closely related)		
Length in words	FTSE 350	%
200 or more words	18	3%
100 to 199 words	94	18%
60 to 99 words	160	31%
30 to 59 words	176	34%
15 to 29 words	66	13%
Fewer than 15 words	7	1%
Total number of explanations including combinations	521*	100%
Mean length (words)	74.4	
Maximum length	519	
Minimum length	8	
*Note: There were 438 explanations (see Table 2) but 83 related to more than one Code violation.		

6.5 Complexity

Complexity of language is divided into two areas: 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 9) that for the most part explanations are *very* difficult to read with only 2% of explanations fitting the *fairly* difficult category. Nearly 40% of companies avoided the use of the passive voice (Table 10) and the more extreme categories had relatively low numbers so passivity does not seem to be a particular problem. Thus the real problem seems to be readability. This again may be a way of disguising non-compliance in line with theories discussed above. However readability and comprehensiveness could be overcome by encouraging companies to adopt a tabular approach (see Section 7 for specific policy implications). It would also help to address the problem identified with location as tables are visible and quickly identified in comparison to text.

Table 9: Quality criterion 5: Complexity of language 1 – Flesch scores measuring readability of explanations (RQ 1.5)			
Score	Interpretation of score*	FTSE 350	%
60 or more	Standard English	2	0%
50 to 59.9	Fairly Difficult	8	2%
30 to 49.9	Difficult	111	25%
21 to 29.9	Very Difficult	122	28%
6 to 20.9	Very Difficult	143	33%
Lower than 6	Very Difficult	52	12%
Total number of explanations		438	100%
Mean score		22.7	
Maximum Score		65.5	
Minimum Score		0	
*Note: See Table 2 for interpretation of scores			

Table 10: Quality criterion 5: Complexity of language 2 – Passivity (RQ 1.5)		
Level of passivity	FTSE 350 No. Explanations	%
Zero passivity	170	39%
1-25%	68	15%
26-50%	140	32%
51-75%	21	5%
Higher than 75%	39	9%
Total number of explanations	438	100%
Mean passivity (%)	28.6	
Maximum passivity (%)	100	
Minimum Passivity (%)	0	
Note: See Table 2 for interpretation of passivity		

6.6 Specificity

A quarter of companies provided a general explanation and 30% provided no explanation (Table 11). In the later case, they either only described the non-compliance or implied that because the problem was now resolved, no justification for non-compliance was necessary. Again this could be resolved with a tabular approach (see Section 7 for discussion) because it would force companies to provide an explanation. Although a tabular approach would not resolve the general/specific issue, that in turn could be resolved by some system of oversight. General explanations which could apply to any company may indicate a degree of mimetic behaviour and thus appear to be consistent with institutional theory. By giving a general explanation, the managers are perhaps indicating a general industry wide issue rather than drawing attention to something specifically affecting their company. Thus, this may also indicate a type of avoidance (Oliver, 1991). If shareholders are unwilling to challenge general explanations and auditors are not prepared to review explanations, then the FRC has to be willing to make companies aware that boilerplate explanations are inadequate.

Table 11: Quality criterion 6: Specificity of explanations (RQ 1.6)		
Level of specificity	FTSE 350 No. Explanations	%
'Specific explanation'	194	45%
'General explanation'	111	25%
'No/inadequate explanation'	133	30%
Total number of explanations	438	100%
Note: See Section 4.6 for interpretation of specificity		

6.7 Attestation

In the study, no auditors of the companies examined raised any issues in relation to company compliance. This has to be considered in the light of the very limited work which is required by the APB bulletin. Auditors are only required to review compliance with nine provisions. One of these provisions (C.3.1) was the second most commonly violated with 81 incidences but auditors were not expected to review the explanations just the disclosure of non-compliance. As might be expected, all auditors used very limited but almost identical wording in their reports (when referring to corporate governance) based on what the APB bulletin recommends. 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 (six out of 204 companies examined) 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 are selected for review by the APB bulletin and hence *should* have been identified by the auditor. 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 given the tone of the APB bulletin, the limited review work involved and the possibility that companies are perhaps likely to rectify any issues that auditors wished to refer to in their reports. 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 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) yet this research calls for a review of compliance and explanations. The author has not been able to locate the use of any 'emphasis of matter' paragraphs which relate to corporate governance in UK company audit reports. Instead, the standard isomorphic wording dominates reports.⁶

Although the research relates to just after the 2003 Code was introduced, a check was performed to ensure that the issues raised were still current. For this purpose, non-compliant FTSE 100 annual reports were analysed in 2010. Although there is undeniably a strong movement towards compliance with 59% claiming full compliance in 2010 versus 33% earlier (which in itself may have undesirable consequences), the issues raised about quality remain at the time of writing. While only 63 infringements were noted in 2010 (versus 168 infringements and 146 explanations in this research – see Table 3), 71% of explanations were general or inadequate (61% earlier), 42% did not provide the section codes and thus were incomplete (albeit an improvement from 59%) and only 45% (of non-compliers) disclosed their compliance statement at the start of the corporate governance report (43% earlier) with 37% either scattering the disclosures or placing them in the middle of the report (the same percentage as earlier). Thus there is no evidence to suggest the explanation quality issues have changed since this research was conducted.

7. 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 have not been resolved over time. If self-regulation is to operate effectively then companies need to work towards providing detailed and bespoke explanations for non-compliance. It is worth considering why managers of companies may be 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 are not seen as part of compliance and thus although explanations are an integral part of the 'system' they are seen as second to compliance. This is problematic because a key aspect of corporate governance is flexibility and the fundamental idea that one approach to governance is not necessarily suitable for all companies at all times. Another reason may be a bandwagon or mimetic effect 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 and not always be ready to appoint replacements. 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.

As a result of the findings of this research, five recommendations were made to the FRC⁷:

- **Recommendation 1:** Positioning of compliance statements: Compliance statements should be clearly identifiable. Ideally, they should be located at the start of the Corporate Governance report. The company should clearly list any non-compliant items.
- **Recommendation 2:** Details provided in compliance statements: Compliance statements should contain details of non-compliance, the relevant Code section and an explanation.
- **Recommendation 3:** Length and readability of explanations: Explanations should be adequately detailed so that shareholders can make a proper judgement as to their appropriateness. They should be written in simple language so that shareholders and others can easily 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 Financial Reporting Council should consider the need to instigate some sort of oversight for 'comply or explain' disclosures. It is believed that some kind of supervised self-regulation is likely to lead to higher quality compliance statements and explanations for non-compliance.

Out of over a hundred responses to the FRC's March 2009 'Call for Evidence', FRC (2009) 16 *explicitly* referred to issues concerning explanation quality (approximately 15%).⁸ Other respondents also allude to issues with explanations although are less explicit. This affirms that issues with explanations are pertinent. Most recently, the FRC (2012) published a report on explanations for non-compliance following two private discussion meetings were held with senior investors and companies at London Business School.⁹ Although much of the discussion is quite general, relevant points about quality in the FRC (2012a) report included:

- 1) The document emphasises that the Listing Rules and Code requires that 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. The document states that regulators *may* have a role in supporting shareholders although it is difficult to whether this would work and the FRC does not elucidate. If shareholders complained to the FRC about a company explanation

would the FRC be willing to act on their behalf or would it still claim that it is the responsibility of shareholders?

- 3) The EU Green Paper on Corporate Governance refers to the Swedish Code which requires (in respect of non-compliance): (i) the Code rules not complied with, (ii) the reasons for each case of non-compliance and (iii) the solution they have 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 this 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. This seems appropriate although 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 this 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. A final idea was that examples of what was a good or bad explanation could be provided. The FRC backed away from taking up this initiative with the suggestion that it should come from the market – something unlikely to lead to concrete actions. Institutional theory would indicate that providing good examples could possibly lead to mimicry so it is acknowledged that there are issues with that approach. Companies need to be encouraged to craft their own bespoke explanations.
- 5) The report also discussed obstacles to greater disclosure (although better disclosure is what is asked for) including litigation. It is hard to think how better disclosure in this field would lead to litigation but it is possible longer or more detailed explanations could result in more media attention. In reality, the reverse should be true. A full and valid explanation is unlikely to lead to difficulty. Another participant referred to engagement and trust being key and when these were present an explanation was “*more likely to be accepted*” (FRC, 2012a, p. 6).

6) 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 on page 7 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 and 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 reference in the annual report or website contents. Under institutional theory it is hoped that good practice would soon spread to other companies.

It does not seem unreasonable to ask for some sort of basic review of explanations by either the auditors or the Financial Reporting Council. This would not have to be too onerous (perhaps just ensuring that all suggested components identified above were present) and 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.

Recently the 2012 Code has been issued (FRC, 2012b) and there are small amendments pertaining to the detail of explanations compared with the previous Code (FRC, 2010). These are provided in paragraph 3 of the 'Comply or Explain' section (FRC, 2012b, p.4). It is a step in the right direction but it will be interesting to examine the extent to which managers take note of these changes.

8 Limitations, Further Research and Conclusions

This work has examined explanations which related to a major revision to the Code in 2003. This work has used a quality typology to assess explanations and has reviewed actions taken by the FRC subsequently. It is accepted that the quality dimensions suggested here are subjective, context specific and are unlikely to be complete. However, they are based in the literature and form a basis for future discussion and work. They may also be of use to other researchers working in the area of voluntary disclosure.

The empirical data on which this study is based is somewhat out of date. By way of mitigation, a study of the quality of corporate governance comply-or-explain disclosures undertaken by the Irish Stock Exchange (2010) following the 2008 financial crisis suggests that corporate governance disclosure practices had changed little since 2004, the period of our research.

It is acknowledged that 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 'reducing 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, 2012). Similarly, a report by Independent Audit and ACCA (Sheath and Land, 2006) also emphasises that investors unanimously want, *inter alia*, fewer boilerplate disclosures and a focus on quality of reporting (see also Solomon, 2010).

This research offers a quality typology which 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. Measuring changes in quality can help facilitate improvements in reporting. A longitudinal analysis of the extent and quality of non-compliance explanations, with multi-period data, could reveal trends (convergence or divergence) in non-compliance and the quality of the explanations, thereby providing a more convincing story informed by institutional theory.

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. Use of the word 'effective' here may raise some questions. Effective for whom? Although problematic for readers (and hence not effective), for a company which does not want to put resources into compliance, draw attention to non-compliance or put effort into devising a bespoke explanation, such an approach may be seen as efficient use of resources. If undetected, it may also be seen as effective. However, such an approach only serves to undermine the 'comply or explain' system.
2. Evidence that investors may not be happy with explanations is illustrated by (for example) the institutional investor Legal and General's comment following Sir Stuart Rose being made executive chair at Marks and Spencer plc: "*L and G said yesterday it simply did not accept the explanation for why Sir Stuart is getting the dual role*" (*The Times*, March 27, 2008). Although Marks and Spencer's non-compliance may have caused some furore, other companies may have been tempted to mimic the company (in line with institutional theory) after the initial fuss subsided.
3. As with other measures, there are some issues for which the index makes no allowance, such as any technical terms with which the reader may be familiar or indeed the motivation of the reader (Beattie et al., 2004) and inevitably these will have some impact on readability and reader comprehension.
4. Seventy seven companies were excluded from the sample because they were either investment trusts (and subject to different compliance rules), overseas companies, taken over by other companies, delisted or identified themselves as smaller companies (having been in the FTSE 350 for less than one year). One company's disclosures were such that there was ambiguity as to whether they were claiming compliance or not.
5. Other cases of concealment are discussed in the paper. The most serious of all though (claiming compliance when not complying) is outside the scope of this study but could be the subject of

further research. Other impression management strategies are part of separate research in order to control the length of the article (see Shrives, 2010).

6. It is possible that auditors carry out other work even advising their clients on compliance. It was acknowledged by one large firm to the author that guidance was provided to clients on explanations. Again this would lead to isomorphic behaviour. This is a topic for further research.

7. The FRC issued a 'Call for Evidence' in Spring 2009 which was a pivotal moment in corporate governance because up to that point the assumption was made that the 'comply or explain' system worked well. In responding to the call for evidence, the author made these five suggestions to improve company explanations for non-compliance.

8. A detailed table is available from the author which catalogues these comments (not included due to the need for brevity). Concerns about the quality of explanations were made by (inter alia) Grant Thornton, Hermes, the Investment Management Association, the Institute of Chartered Secretaries, Mazars, National Association of Pension Funds, Railpen Investments, SAB Miller plc and Spencer Stuart. Concerns about the lack of oversight were articulated by the Association of Certified Accountants, the Association of Corporate Treasurers and Grant Thornton.

9. From the FRC's document it is not clear exactly who was invited to these two meetings.

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