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In Letter but not in Spirit: An Analysis of Corporate Governance in the UK

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Abstract

We examine the effectiveness of the "comply or explain" approach to corporate governance in the UK. Using a unique database of 245 non-financial companies for the period 1998-2004, we perform a detailed analysis of both the degree of compliance with the provisions of the corporate governance code of best practice (Combined Code), and the explanations given in case of non-compliance. We rank the quality of explanations based on their information content. We find an increasing trend of compliance with the provisions of the Combined Code, but also a frequent use of standard and uninformative explanations when departing from best practice, which highlights a common conformity with the letter but not the spirit of the Code.

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Non-Technical Summary

The UK is a pioneer in corporate governance regulation. The UK's approach to governance failures (for e.g. Maxwell, Polly Peck and BCCI) did not assume the prescriptive and legislative tones recently embodied in the Sarbanes-Oxley Act of 2002, but lead the way to a new form of regulation viz. the "comply or explain" approach. The innovative aspect of this reform was the introduction of a voluntary code of best practice characterised by shareholder pressure for adoption and allowing time for implementation. In particular, in their annual reports, companies must mandatorily state whether they comply with the Code and give reasons for any areas of non-compliance. According to Sir Adrian Cadbury, author of the Cadbury Code, the "comply or explain" approach is preferable to statutory measures because it does not imprison companies in a "one size fits all" approach, and it diminishes the risk of complying with the letter, rather than with the spirit, of the provisions.

We perform an empirical investigation aimed at assessing the effectiveness of UK's corporate governance in terms of actual rather than formal implementation of the Code, i.e. have the companies embraced the genuine spirit of the Code or do they simply follow the letter of its recommendations? To answer this question, we analyse 245 non-financial UK companies, listed on the London Stock Exchange and belonging to the FTSE 350 index, from the years 1998 to 2004. The period 1998 to 2004 is chosen because the Combined Code was in force during this time. They then construct a unique dataset by hand-collecting relevant information from the corporate governance and directors' remuneration reports included in the annual reports. Amongst others, the authors collect details of each company's compliance with provisions of the code and the explanation provided in case of non-compliance.

As regards compliance their analysis shows that it is monotonically increasing from a low of 10% in 1998-99 to 56% in 2003-04 but differs significantly among groups of companies. Companies that are widely-held (as opposed to family owned), members of the FTSE100 membership or companies cross-listed in other exchanges (mainly in the US) tend to have a higher percentages of compliance.

The crucial aspect of the "comply or explain" approach is the explanation given for non-compliance. Companies that do not comply with a provision of the code are expected to explain the reasons for not doing so. It was the original intention of the code-setters that the explanation should justify the unique circumstances of a company. It was thus envisaged that investors and shareholders would then use such information to assess the companies' governance practices.

We then investigate the quality of explanations provided by companies. We rank the explanations from the least to the most informative, based on the level of detail given by a company. Our analysis highlights two surprising and unexpected results. Firstly, for an average of 17% of non-compliances over the entire period, no explanations are provided. In such cases, there is neither compliance nor explanation. Since the whole governance system relies on the twin pillars of "comply" and "explain", the simultaneous lack of both is worrying. Secondly, even among those that provide explanations the authors find frequent use of standard and uninformative statements when explaining the departure from best practice. In fact, such explanations account for over half (51%) of the total non-compliances. On the other hand in only 8% of the cases companies provide a genuine and informative description of the their unique circumstances, which shows that most companies do not pay much attention to the quality of the explanations. The widespread propensity to give general explanations is further amplified where agency problems are likely to be more serious viz. family-owned companies; companies are not part of the FTSE100 or those that are not cross-listed.

Finally, using a “transitional matrix” of changes in explanation from one year to the next, we authors find that companies either stick to their original explanations even when it is not informative or comply. The “pressure” to comply is greatest for those where the explanation is missing or where a poor quality explanation is provided.

This evidence confirms a widespread feeling of a mechanical "tick boxes" response, especially among practitioners, to the Combined Code while paying too little attention to the circumstances of the individual company. In conclusion, our analysis shows that the Combined Code and its “comply or explain” approach does not differ much from a prescriptive law. This highlights a common conformity with the letter but not the spirit of the regulation.

"*One can stay within the rules of the game yet play in a particular fashion which is not in the spirit of the game. The same way with legal rules, one can stay within the legal rules and yet not fully comply with the spirit.*"

Charlie McCreevy, European Internal Market Commissioner.

1 Introduction

The United Kingdom is a pioneer in corporate governance regulation. The UK's response to corporate governance failures in the 1980s (like Maxwell Communications, Polly Peck and BCCI) unlike the recent Sarbanes-Oxley Act was not prescriptive and legislative, but led the way to a new form of regulation the "comply or explain" approach[1]. The defining aspect of this approach is a voluntary code of best practice characterised by shareholder pressure for adoption. In particular, it is mandatory for companies to state in their annual reports whether they comply with the code and to identify and give reasons for any areas of non-compliance in light of their own particular circumstances. In short, the approach can be described as voluntary compliance coupled with mandatory disclosure.

The "comply or explain" approach thus provides us with an unique opportunity to assess the voluntary approach to corporate governance in terms of actual rather than formal implementation of the code, i.e. have the companies embraced the genuine spirit of the code or do they simply follow the letter of its recommendations? Secondly, in what respect does this voluntary approach differ from a prescriptive law? Thirdly, does adhering to the code help companies to improve their internal governance? Finally, how has the code impacted on monitoring of governance by shareholders? More generally, the UK approach to corporate governance has been

[1] According to Sir Derek Higgs (the author of the Higgs Report on the role and effectiveness of non-executive directors published in January 2003) "*It (the "comply or explain" approach) offers flexibility and intelligent discretion and allows for valid exception to the sound rule. The brittleness and rigidity of legislation cannot dictate the behaviour, or foster the trust, I believe that is fundamental to the effective unitary board and to superior corporate performance.*" The Higgs report was sought by the UK government in response to the recent corporate governance failures in the US. The above statement is contained in the introductory letter of the Higgs Report to the Chancellor of the exchequer.

adopted as a benchmark by numerous countries[2]. The answers to the above questions will not only suggest improvements to the functioning of the code in the UK, but also highlight to other countries in the process of setting up their governance systems the conditions under which such an approach will function effectively.

To address these questions, we analyse 245 non-financial UK companies, listed on the London Stock Exchange and belonging to the FTSE350 index for the period from 1998 to 2004, where the Combined Code (henceforth, the Code) was in operation. We construct a unique dataset by hand-collecting information from the Corporate Governance statements included in the annual reports. Amongst other things, we collect details of each company's compliance with the provisions of the code and the exact explanations provided in case of non-compliance.

We first analyse the trend of compliance with the various provisions of the Code. The Combined Code fostered widespread adoption of best practice in corporate governance, especially in areas not covered by its forerunner, the Cadbury Code. We observe a monotonic increase in the propensity to comply with the provisions over time. At the end of 2004, more than half of the companies in our sample are fully compliant with the Code, and on average less than 10% of all firms are not complying to a given single provision. However, we do observe significant differences in rates of compliance among groups of companies. In particular, companies that are non-family owned (as opposed to family owned), members of the FTSE100 index, and companies cross-listed in other exchanges (mainly in the US) tend to have higher percentages of compliance.

However, the picture looks less rosy when looking at those firms that did not comply with the provisions of the Code. We find that non compliant firms often do a very poor job explaining the reasons of departure from best practice. Specifically, we rank explanations from the least informative to the most informative, based on the level of detail given by the company. Our analysis highlights two surprising and unexpected results. First, for an average of 17% of non-compliances over the sample period, no explanations are provided. Second, even among those that provide

[2] In particular, the OECD in its 2004 Principles of Corporate Governance, states that countries should follow a flexible regulatory mechanism of corporate governance.

explanations we find frequent use of standard and uninformative statements when explaining their departure from best-practice. The widespread propensity to give general explanations is further amplified where agency problems are likely to be more serious, i.e. in family-owned companies, companies which are not part of the FTSE100 index, or those that are not cross-listed in other exchanges.

We also explore the dynamics of the explanations over time. We find that companies either give the same explanation from one period to the next, or jump straight to compliance. We observe very few cases of changes in explanations. Further, if a company ceases to comply, it does not provide an informative explanation as to why this is the case. This suggests that companies do not use the flexibility of the Code to fine-tune their governance to their changing circumstances. Rather, firms often seem to make a fundamental choice between compliance or non-compliance, while the main strength of the "comply or explain" approach is that it eschews a *one size fits all approach* by allowing flexibility to companies. The wide and common use of uninformative explanations, a tendency which is further amplified in presence for instance in family firms, points at a possible monitoring problem and issues of enforcement.

The paper develops as follows. *Section 2* provides the background about the evolution of the corporate governance in UK . *Section 3* describes the data. *Section 4* analyses trends in compliances and explanations of non compliances. *Section 5* classifies and analyses the quality of explanations. *Section 6* discusses the results of our analysis and some policy issues. Finally, *Section 7* concludes.

2 Background

2.1 *From Robert Maxwell to the Combined Code*

Robert Maxwell's death while cruising off the Canary Islands in 1990 shone a spotlight on his company's affairs. A series of risky acquisitions in the mid-eighties had lead Maxwell Communications into high debts, which was being financed by diverting resources from the pension funds of his companies. After his disappearance, it emerged that the Mirror Group's debts (one of Maxwell's companies) vastly outweighed its

assets, while GBP 440 millions were missing from the company's pension funds. Despite the suspicion of manipulation of the pension schemes, there was a widespread feeling in the City of London that no action was taken by UK or US regulators against the Maxwell Communications Corp. Eventually, in 1992 Maxwell's companies filed for bankruptcy protection in the UK and US. At around the same time the Bank of Credit Commerce International (BCCI) went bust and lost billions of dollars for its depositors, shareholders and employees. Another company, Polly Peck, reported healthy profits one year while declaring bankruptcy the next.

Following the raft of governance failures, Sir Adrian Cadbury chaired a committee whose aims were to investigate the British corporate governance system and to suggest improvements restore investor confidence in the system. The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. The report embodied recommendations based on practical experiences and with an eye on the US experience, further elaborated after a process of consultation and widely accepted. The final report was released in December 1992 and then applied to listed companies reporting their accounts after 30th June 1993.

At the heart of the Committee's recommendations was a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour. The innovative aspect of the reform was the introduction of a voluntary code that, differently from a statutory code, sought to establish best practice, create pressure for adoption from shareholders, and allow an interval of time for its implementation. The choice of a Code of Best Practice was driven by the conviction that *"statutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements"*.[3] In general terms, the Code of Best Practice advocates the principle that *one size does not fit all* in matter of corporate governance. Companies have to choose theory optimal governance structure, in line with their circumstances.[4] Therefore the Code provides guidelines to be

[3] From para 1.10 of the Cadbury Code.

[4] However, some scholars argue that the introduction of a Code is just a way to spread *best* practice, which will become *common* practice after a transitory period, thus forcing companies to adopt a *one size fits all* approach to corporate governance. Further, the introduction of a Code, as its compliance is on voluntary basis, should lead to less controversies and frictions than the imposition

implemented by individuals and companies in the light of their own circumstances. In particular, in their annual reports companies are required to state whether they comply with the Code, identify, and give reasons for any areas of non-compliance. This requirement is mandatory since it is part of the listing agreement with the stock exchange.

The Cadbury committee's major proposals dealt with the structure, role and responsibilities of the board of directors. Among others, its major recommendations suggested:

- the separation of the role of the Chairman from the executive functions of the CEO;
- the creation of three committees, the audit, nomination and remuneration committees, each with a specific function and clearly defined terms of reference;
- the appointment of non-executive directors to the board with a monitoring function.

The Greenbury Report on the Executive Remuneration followed in 1995. The Rutteman report on internal control was published in 1994, which was in due course superseded by Turnbull. In 1998 the Hampel Committee released a first revision of the corporate governance system. The remit of the committee was to review the Cadbury code and its implementation to ensure that the original purpose was being achieved. Hampel affirmed that there was no need for a revolution in the UK corporate governance system and he aimed at combining, harmonising and clarifying the recommendations of the Cadbury and Greenbury reports.

These efforts culminated in the Combined Code (1998) - a supercode comprising the recommendations of all three committees, i.e. Cadbury, Greenbury and Hampel. Apart from some minor changes in the minimum number or members – overall and independent - comprising the board and each committees, the main emphasis was on the flow and quality of information the Code should convey, essentially the explanations provided. In the report, Hampel pointed out how the reactions to the Cadbury

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of rigid regulation by law.

and Greenbury codes had been different and sometimes problematic. Companies often believed that the Code was too prescriptive, in the sense that shareholders would be interested only in the comply box -yes or no-, without paying attention to the explanation related to the diversity of circumstances and experience among and within companies. Stating "no" was usually interpreted as a signal of bad corporate governance. In order to overcome the box-ticking approach, the report aimed at securing adequate disclosure such that investors and shareholders were sufficiently informed when assessing the companies' governance practices, including the cases of departure from best practice. The first step to achieve greater disclosure was the promotion of better and wider explanations. In particular, the committee recommended that companies should include in their annual report and accounts a narrative statement of how they apply the relevant principles to their own circumstances. The form or content of this statement was not prescribed. The Combined Code was released in 1998, and it applies to companies with financial year ending on or after 31st December 1998. The principles and provisions of the Combined Code here analysed are described in Appendix 1.

2.2 *From the Combined Code to the Revised Combined Code*

In January 2003, Derek Higgs and Robert Smith published two separate reports, the Review of the role and effectiveness of non-executive directors and of the audit committee, aiming at improving and strengthening the existing Combined Code. There were no important financial scandals in UK, but public shock following the scandals of Enron, WorldCom and Tyco generated the fear of failure of the UK governance system. The US opted for a prescriptive legislation, epitomised by the Sarbanes-Oxley Act. As a consequence, a study of the existing status quo of the UK corporate governance was therefore commissioned to Sir Derek Higgs. Higgs strongly backed the existing non-prescriptive approach to corporate governance: *"The 'comply or explain' concept in the Code, he states, is different from Company Law, which implies 'comply or breach', 'comply or else' or 'comply or be damned'."* However, the Higgs report suggested the introduction of a large number of new code provisions (37), dictat-

ing more stringent criteria for the board composition and evaluation of independent directors in order to remove the discretion in some provisions afforded by the Combined Code.[5] The presence of a higher number and detailed provisions was seen as a movement towards a more prescriptive legislation.

When asked if the Revised Combined Code could prevent dominant situations as in the case of Maxwell Communications Corporation, Higgs affirmed that it would have thrown a bit more light onto the company, because the Code would have required Maxwell to explain how it selected its directors, how the board was evaluated, the number of board meetings and who had attended them. According to Higgs, some City institutions had always refused to deal with Mr. Maxwell, and the information coming out from the annual reports would have encourage more people to make the same judgment. In the intentions of Derek Higgs, in fact, the explanations should be considered as a "*tick in the comply box, as it tells something about the company. It is part of the information flow for their investment decision-making*".

2.3 Literature Review

The empirical literature on corporate governance, especially in the US context, is vast (see Becht, Bolton and Röell (2002) for a detailed survey). In contrast, the academic literature in the UK is limited. To the best of our knowledge, there is no other academic paper that analyses the implementation of the Combined Code in detail. Most of the existing studies deal with the implementation of some of the recommendations of the Cadbury Committee. Our study is the first to comprehensively analysis assessing the working of the "comply or explain" system in the UK over a period of time. In particular, we analyse not only the level of compliance with the individual provisions of the Combined Code of best practice, but also the quality of explanations provided in case of non-compliance.

Dahya, McConnell and Travlos (2002) look at top management turnover and corporate performance for UK companies before and after the Cadbury Code. They

[5] Appendix 2 presents a table comparing the provisions of the Cadbury code, Combined Code and the Revised Combined Code.

find that poorer performance is associated with higher turnover and this relationship is significantly stronger following adoption of the Cadbury Code. They further conclude that this increased sensitivity to performance is mainly due to an increase in non-executive (or outside) directors.

Similarly Dedman (2003) investigates if the Cadbury Code has lead to reduced managerial entrenchment. Based on a sample of UK listed firms between 1990 and 1995, she finds that the Cadbury Code has not reduced the agency problem of managerial entrenchment in large UK firms. However, similar to Dahya et al. (2002) she does find a relationship between company performance and CEO departure.

Conyon and Peck (1998) study the impact of various governance variables and presence of remuneration committees on executive pay. They conclude that executive pay and corporate performance are more aligned in companies having a majority of non-executive directors and remuneration committees.

Furthermore there are studies by accountancy firms and consultancies which look at the degree of compliance with the Combined Code. Grant Thornton (an accountancy firm) produces an annual Corporate Governance Review. The review sets out the compliance of FTSE350 companies with the Combined Code and the explanations provided for the internal control provisions of the code. Similarly, the consulting firm Deloitte has recently produced a report on the effectiveness of the Directors Remuneration Report for the Department of Trade and Industry. However, such studies are narrower in scope and focused only on specific aspects of the Code.

3 Data Description

We analyse 245 non-financial companies, belonging to the FTSE 350 index as of 31st December 2003, for the period from 1st December 1998 to 30th June 2004. We exclude financial companies because the regulatory environment for those companies differs significantly from that of non financial companies. It is felt that those regulations, although not part of the Combined Code, may well interact with its provisions, and have implications for both corporate governance and performance evaluation.

The Combined Code consists of a total of 11 provisions. Out of the 11 provisions,

we analyse the following eight provisions relating to:

1. The separation of Chairman and CEO.
2. The appointment of a Senior Non-executive Director.
3. The total number of Non-executive Directors.
4. The proportion of Independent non-executive directors.
5. The terms of Service contracts.
6. The nomination committee.
7. The remuneration committee.
8. The audit committee.

The remaining three provisions (directors' re-election, pay linked to performance and internal control) are left out for the following reasons. All companies in the sample complied or intended to comply on provision relating to directors' re-election. Judging the effective level of compliance of the provisions pertaining to pay-linked to performance and internal controls required additional information which is not available to us.

For each year, we hand-collected the following information from the corporate governance statements and directors' remuneration reports included in the annual reports of each company:

- The statement of compliance with the eight provisions of the Combined Code, and the exact explanation given in case of non compliance.
- The Board of Directors' composition, with the indication of the total number of executive and non-executive directors, and the total number of independent non-executive directors.
- The composition of the various committees, i.e. the audit, remuneration, and nomination committee,

The annual reports are downloaded from the Mergent Online database. We could not find information for all the companies for all years. This could be due to a new company listing on the stock exchange during the sample period or because annual reports for certain periods not being available on Mergent Online. We collect financial, accounting and cross-listing information from Compustat Global. Information about the membership to the FTSE100 index is obtained from FTSE.

Finally, we collect ownership data for two periods, i.e. 31/12/1998 to 30/06/1999 and 01/07/2003 to 30/06/2004. The ownership data for the first period is obtained from Faccio and Lang's dataset (2002) and pertains to the year 1996 for UK companies. However, they use this data to compare it with the ownership structure of companies in other European countries for the period $1996-99$. Further, they claim in their study that ownership of companies takes a long time to change, and therefore their data are a reasonable approximation of the ownership structure for the period $1998-99$. Data for the last period are gathered from Thomson One Banker Ownership module. Thomson Ownership data are available quarterly, thus we take the quarter ending data which is closest to the year-end of a company.

3.1 *Descriptive Statistics*

Table 1 shows the total number of companies in our sample for each period. As the companies do not have the same financial year ending, we group them in homogeneous periods. Our time periods includes companies having their financial year endings between 1st July and 30th June (inclusive). The first period however is much shorter, since the Combined Code came into effect only from 31st December 1998. We thus have a total of 1287 company year observations divided into six time periods. With the exception of the first two periods, we have at least 200 companies in each period and a maximum of 240 in the $2002-03$ period and 162 companies for the period $1998-99$.

Table 2 shows the industry composition of the total sample. We classify companies in 12 industry groups as in Campbell (1996). The companies in our sample are spread evenly across the 12 industry groups. With the exception of the petroleum group

which consists of a total of 41 observations, most other industry groups consist of 100 or more observations.

Table 3 classifies the observations of our sample according to their FTSE100 membership. The FTSE100 is the index of leading blue chip companies listed on the London Stock Exchange. Companies in the FTSE100 index are typically large companies and are more likely to attract interest from both investors and financial press. Approximately 30% of the observations in our sample are part of the FTSE100 index.

Table 4 presents details of companies cross-listed on US and other stock exchanges. Most of the companies (nearly 73%) are not cross-listed. The majority of the companies (88%) that are cross-listed either on NYSE, NASDAQ or other US exchanges. The remaining are cross listed in Australia, other European countries and South Africa. Further, some companies in our sample are cross-listed on more than one exchange (in fact, 4 are cross-listed on 3 exchanges), which gives a total of 1308 (instead of 1287) observations.

Table 5 reports summary financial statistics for the sample. It is clear that our sample consists of large companies. The median company employs 8336 people has a turnover of GBP 957.07 million and generates operating income of GBP 82 million. The median total assets are GBP1001.20 million while the median market value is GBP 873.74 million.

Finally, Table 6 provides a classification of our sample by Ownership Structure. The ownership structure is calculated at the 10% threshold. A company is said to be owned by a particular type of shareholder if his percentage holding in the company exceeds 10%. We classify ownership into different categories a la Faccio & Lang (2002):

- *Family:* A family (including an individual) or a firm that is unlisted on any stock exchange.

- *Non Family:* A firm which either widely held at the 10% level or whose shareholders are widely held.

- *State:* A national government, local authority or government agency.

- *Miscellaneous:* Charities, voting trusts, employees, cooperatives etc.

The table shows that a majority of firms during both periods have dispersed ownership structures. Companies owned by families form a greater proportion 30% during $1998-99$ as compared to 15% in $2003-04$.

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4 Non-compliances and explanations

This section presents the trends in the degree of compliance with the Code across years, and the cases when no explanation for the non compliances is given.

4.1 *Yearwise*

Table 7 analyses the yearwise number of non-compliances and explanations. It clearly shows that the compliance rate, as well as the explanations provided for non-compliances, are increasing over time. The percentage of companies complying with all the eight provisions analysed monotonically increases from 10% in $1998-99$ to 56% in $2003-04$. The average number of non-compliances per non complying company decreases monotonically from 2.05 in $1998-99$ to 1.57 in $2003-04$. The percentage of non-compliances for which an explanation is provided increases slightly from 81% in $1998-99$ to 87% in $2003-04$. Finally, the gap between average non-compliance and average explanations, which indicates the average number of non compliances per company for which non explanation is provided, halves from 0.40 in $1998-99$ to 0.20 in $2003-04$.

4.2 *Provisionwise*

Table 8 presents the provisionwise analysis of compliances and explanations. The average percentages of compliances are very high (more than 85%) in five out of the eight provisions analysed. The compliance percentage is highest (95.49%) for the provision pertaining to the number of non-executive directors, and lowest (56.73%) for the duration of service contracts.

The percentage of non-compliances for which an explanation is provided is close to or above 70% for all the provisions. Provisions pertaining to audit committee and nomination committee show the highest proportion of cases when an explanation is provided (90%), whereas the remuneration committee is associated with the lowest number of cases when an explanation is present (69%).

4.3 *Industrywise*

Table 9 presents the industrywise classification of non-compliances and explanations. The percentage of companies complying with all eight provisions is the highest for utilities. It ranges from a maximum of 44% (utilities) to a minimum of 23% (con-

struction). The average number of non compliances per company is highest for capital goods (2.12), and lowest for basic industry (1.60). The percentage of explanations provided is the highest in case of petroleum companies (96%) and the lowest in case of capital goods (69%). The gap is lowest (0.07) for petroleum and highest (0.65) for capital goods.

4.4 *FTSE100 membership*

In Tables 10 and 11, we divide our sample into FTSE100 companies and non-FTSE100. Table 9 shows that FTSE100 members have a higher rate of compliance (37%) and lower average number of non-compliances (1.65), as compared to non-FTSE100 firms (31% and 1.87, respectively). It further shows that FTSE100 members are more likely to provide explanations for non-compliances. The number of non-compliances for which explanations are not provided (gap) is lower at 0.20 for FTSE100 members as against 0.35 for non-members.

In Table 11 we test whether the difference in the average number of non compliances between FTSE100 and non-FTSE100 companies is significant, each year and for the average across all years. We find that the difference across all years is significantly higher (at the 99% level) for FTSE100 companies than non-FTSE100 ones. However, it is not significant in any of the individual periods.

4.5 *Crosslisting in other exchanges*

Companies listed on the London Stock Exchange can also have secondary listings on other exchanges, such as in the US (NYSE, NASDAQ, Amex and others) through their ADRs, in Continental Europe, Australia or South Africa. Table 12 shows the level of compliances of crosslisted and non-crosslisted companies. The percentage of crosslisted companies which are fully compliant with the Code is nearly 58%, against approximately 17% of non-crosslisted companies.

This relative high difference between the two groups could be explained by the bonding hypothesis (Coffee, 2002). Indeed, Coffee argues that firms opt to crosslist in the US not only to obtain access to additional pools of equity, but also to commit

themselves to higher standards of corporate governance. If this is true, we would expect crosslisted companies to perform better than those that are not crosslisted. However Coffee's argument might not necessarily apply to UK companies, since UK is already perceived to have high standards of corporate governance. Besides, companies crosslisted in the US markets do not need to follow the US corporate governance rules, as long as they get themselves certified by a suitable authority that they are satisfying the requirements in their home country. We feel that the willingness to provide a "clean picture" of the corporate governance practices adopted, i.e. fully compliance with the Code, is the driving motive behind the higher degree of compliance among crosslisted companies.

Crosslisted companies which do not comply with the Code have a lower average number of non compliances (1.66), as compared with non-crosslisted (1.86). The t-test difference in means is significant at the 95% level over the all period (Table 13). For crosslisted companies, the percentage of non-compliances for which explanations are provided is higher, while the gap is lower with respect non-crosslisted firms.[6]

Table 14 splits the sample based on a two-way classification depending on both crosslisting, as well as FTSE100 membership. Of the total FTSE100 company year observations, about 60% are also crosslisted in other exchanges. We further find that companies that are both crosslisted and FTSE100 members have the highest percentage compliance (40.89%) and the lowest average non-compliance (1.63).

4.6 *Ownership structure*

Tables 15 and 16 show that non-family companies have on average a higher level of compliance (46%), as compared to family owned companies (20%), difference which is

[6]Given the enormous difference in compliance rates we decided to investigate average non-compliances computed over all companies (rather than only non-compliant companies) yearwise. We find that cross-listed companies have lower average non-compliances as compared to non cross-listed companies in all the periods and that the average difference across all years is highly significant. Furthermore, our yearwise analysis shows that these differences are statistically significant in 4 (out of a total of 6 periods) periods of our sample. This suggests that cross-listed companies have a systematically higher rate of compliance with the combined code (tables are not provided here, but are available from the authors on request).

significant at the 1% level. The average number of non compliances is also significantly higher for family owned companies in both the periods (2.35 versus 1.59). Further, the average number of non compliances in family owned companies increase in $2003-04$ as compared to $1998-99$ (2.26 versus 2.58), whereas it falls for non-family companies (1.87 versus 1.29) (Table 15). In particular, in the period $2003-04$ the average number of non compliances related to family owned companies is two times that of non-family companies (2.58 versus 1.29), and the difference is significant at the 1% level. A similar pattern can be observed in explanations. The average gap between non-compliances and explanations provided is again nearly 2 times higher for family owned companies as compared to non-family companies.

Our data shows that the level of compliance is clearly affected by the ownership structure. Companies with dispersed owners tend to comply more than family owned companies. This result is not surprising though. The Code places a lot of emphasis on board composition and independence. In fact, seven of the eight provisions analysed in our study pertains in some way to this feature. Therefore, as the board of directors of family owned companies comprises a large proportion of directors connected to the family, it is more likely to observe a high level of non compliance related to both the board and the committee composition.

5 Quality of Explanations

Flexibility is the crucial aspect of the "comply or explain" approach to corporate governance. Companies can either comply with the provisions of the code or, they can opt out by providing a suitable explanation. The explanation given when departing from best practice is therefore representative of the companies' flexibility when choosing their optimal governance structure. The Combined Code does not prescribe a format that companies have to follow when giving such an explanation, but simply says that the explanation has to be narrative and refer to the company's unique circumstances:[7]

[7] "*In the first part of the statement, the company will be required to report on how it applies the principles in the Combined Code. We make clear in our report that we do not prescribe the form or*

We however find different degrees of "narration" and "specific circumstances" in the explanations given in the annual reports. In particular, some explanations are more informative and provide more details than others. Consider the following examples of explanations:

- *The Board has not at present formally appointed a senior independent director, other than the Chairman, to whom concerns can be conveyed. Three new non-executive directors have been appointed within the last 12 months, and it is considered that the Board should be given time to settle into its new composition prior to taking such a decision (BBA 1998).*

- *In determining its overall policy in respect of service contracts, the Committee aims to balance the costs associated with any early termination provisions with the need to protect GlaxoSmithKline's intellectual property rights. The Committee maintains a close watch, through its advisors, on trends in contractual terms amongst other companies in the competitor panel and in the wider market place. It is committed to ensuring that, in achieving this balance, its processes are fair, while limiting as far as possible the scope for 'rewarding failure'. The Committee has considered the recent guidance produced by the Association of British Insurers and the National Association of Pension Funds in the UK. It will take this into account, alongside market practice, when reviewing contractual terms. Executive Directors are employed on service contracts under which the employing company is required to give 24 calendar months' notice of termination and the Executive Directors are required to give 12 calendar months' notice.*
  Executive Directors' service contracts contain 'garden leave', non-competition, non-solicitation and confidentiality clauses.

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content of this part of the statement, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. It must be for shareholders and others to evaluate this part of the company's statement. [..] In our report we make clear that companies should be ready to explain their governance policies, including any circumstances justifying departure from best practice; and that those concerned with the evaluation of governance should do so with common sense, and with due regard to companies' individual circumstances." (Points 4 and 6 of the Preamble to the Combined Code)

The Remuneration Committee currently believes that one year contracts would not be in the best interest of GlaxoSmithKline with regard to offering a globally competitive overall remuneration package and securing maximum protection for its intellectual property rights.
The Remuneration Committee believes that the current termination payments due under Executive Director's contracts are justified because they represent fair and reasonable compensation in the event that the contracts are terminated, given market practice and the associated restrictions arising from the need to protect intellectual property. (GlaxoSmithKline, 2002).

The contents of above mentioned explanations are narrative and contain verifiable and specific elements, unique to the company. BBA, for instance, justifies the non appointment of a senior figure in the board with the presence of new board members and the consequent difficulty to appoint a senior figure in such a newly constituted board.

On the contrary, consider the following explanations:

- *The Board has not identified a senior independent non-executive director, as specified by the Code, because it considers such an appointment to be unnecessary at present (Reuters 1999).*

- *The board believes that this arrangements (i.e. service contracts superior to 12 months) are in the best interests of the company (Rentokil Initial 1998).*

- *Although Mr Wilson has the combined role of Group Chairman and Chief Executive, the Board considers that the requirements of the Code are satisfied and that the combination of these roles does not work to the disadvantage of the Company or its shareholders (Wilson Bowden plc 2001).*

- *The company ensures that it recruits to the board only individuals of sufficient calibre, knowledge and experience to fulfil the duties of a director appropriately. The company does not have any non-executive directors on the board (A.2.1,*

A.3.1, A.3.2, A.6.1). The directors are mindful of the provisions of the Combined Code in this regard and regularly review the situation.
The company's nomination committee is made up of the chairman and managing directors. There are no non-executive members on the committee (A.5.1).
The company does not have a formal remuneration committee (B.1.1-3, B.1.9-10, B.2.1-6, C.2.3) but the emoluments of the directors are the subject of appraisal by the chairman and the managing directors taking into account individual performance and market conditions.
The company does not have an audit committee (C.2.3, D.3.1, D.3.2) but the board as a whole regularly monitors internal controls and also ensures that an objective and professional relationship is maintained with the auditors. (W.M. Morrison 2004).

The above explanations clearly fail to identify specific circumstances for departing from best practice. For instance, Reuters justifies the non appointment of a senior figure in the board as simply necessary at the present, without further details. Such explanation is far less informative and detailed than the one provided by BBA. At the extreme, the company W.M. Morrison does not give any explanation as to why there are no executive directors on the board.

We therefore classify the explanations of non-compliances by searching for the presence of *verifiable and specific* elements relating to the company's circumstances in their narrative statements. Such classification requires some subjectivity, which we tried to limit by using an objective criteria of classification based on both verifiability and informativeness. We do not make any judgement as to whether the explanations provided are valid from a business perspective. So, in that respect, our identification can be termed optimistic. Our classification of explanations is simple to implement and easy to replicate, since it classifies explanations from the least to the most informative, after checking for their actual veracity. We use the following classification:

- *No explanation (Type* 0*):* When no explanation is provided.

- *General (Type* 1*):* A general or non-specific (to the company) explanation is provided. In this category we include explanations which use standard phrases and do not provide any specific details. For e.g. explanations asserting that the non-compliance is *"in the best interests of the company"*, *"a market practice"* or simply *"as necessary".*

- *Inline (Type* 2*):* An explanation which is general in nature but repeats words from the combined code provision. For instance, provision $B1.10$ states that "*remuneration committees should, within legal constraints, tailor their approach in individual early termination cases to the wide variety of circumstances*". Some companies justify the rolling service contracts with more than one year notice period for executive directors for *"the mitigation of early termination"*, without giving any further details. Therefore, when a circumstance or words from the combined code provision is repeated in the company's corporate governance statement without any additional information we classify this as an Inline (Type 2) explanation.

- *Limited (Type* 3*):* An explanation which provides more information than *General* or *Inline* but still falls short of being unique to the company's circumstances. For e.g., in case of the non-compliances arising due to rolling service contracts of more than one year, some companies explain that this is place for *"guaranteeing long term projects".* This adds some more information unlike the *General* or *Inline.* However, it still does not relate to the company's circumstances by making available further information about the company's development and projects which would help in clarifying the explanation.

- *Transitional (Type* 4*):* An explanation which points to a transitional situation facing the company due to which it is temporarily not compliant. Examples include *unforeseen resignation of a director* or an *internal restructuring arising due to a merger.*

- *Genuine (Type* 5*):* Explanations are those that we judge "genuine" and in the spirit of the combined code. Such explanations are specific to the company and

motivated in detail and also the information given is verifiable. We actually checked if the information reported was referring to the company's unique circumstances and if it was correct. For instance, the pharmaceutical company *GlaxoSmithKline* justifies the 24 months' notice of termination for its directors *to protect its intellectual property rights.* This company further states that executive directors' service contracts contain "gardening leave", competition and confidentiality clauses which are relevant to its business. The explanation thus provided is specific to the business/industry it is operating in and the justification for non-compliance is directly related to those circumstances. We therefore classify such explanations as *Genuine* and accord it the highest quality in our scheme.

In what follows we analyse the quality of explanations given by various companies using different methods of classification.

5.1 *Yearwise and industrywise*

Table 17 presents the yearwise distribution of the quality of explanations according to our classification. Surprisingly, an average 17% of non-compliers (across all years) provide no explanations at all. When an explanation is given, the majority of the times it is either *General (Type* 1*)* (26%) or *Inline (Type* 2*) (*25%*).* In fact, Type 1 and Type 2 explanations together account for more than 50% in most years. Of the remaining explanations, *Transitional (Type* 4*)* accounts for 16% with *Genuine (Type* 5*)* and *Limited (Type* 3*)* bringing up the rear. These statistics highlight the tendency to give explanations with little information when departing from best practice. In fact, the average quality of explanation is constantly between 2 and 3, with a peak of 2.63 in $2003 - 04$ (Graph 1).

We also analyse (table not shown) the percentage distribution of the quality of explanations by industry. Petroleum companies give explanations with an average quality of 3.11, followed by basic industry companies with an average quality 2.98. The high average in both these industries, are in fact driven by a higher frequency of *Genuine (Type* 5*)* explanations. For basic industry companies Type 4 and Type 5

explanations comprise nearly 50% of the total. In contrast, companies in the capital goods industry companies give a high proportion of Types $0, 1$ and 2 explanations (nearly 90% of the total), thus reducing the average quality to 1.46.

5.2 *Provisionwise*

Table 18 shows that explanations for non-compliance with the senior non executive director provision perform the best in the sample. Overall, they have one of the lowest percentage of no explanations (11%), and the highest percentage of Type 5 explanations (18%). The provisions relating to the Audit and Nomination Committee have the lowest percentage of Type 0 explanations (9%). There were no Type 5 explanations for the provisions pertaining to separation of the roles of CEO/Chairman and the recommended number of non executive directors in the board. Explanations related to the Remuneration Committee tend to be general (Type 1, 44%). When we group Type 1, Type 2 and Type 3 explanations, and Type 4 and 5 together, we observe that the majority of companies do not give detailed explanations, especially in case of non compliance with the Nomination Committee (76%). All these results have to be judged, in light of the fact that there are fewer companies which are not compliant with provisions relating to the audit, nomination and remuneration committee as compared to the provisions relating to the senior non executive director or to the length of service contracts.

We believe that an important determinant of the quality of explanations is their diversity. For instance, in the case of the designation of a senior non executive director, companies offer a variety of circumstances to justify non-compliance: some companies point to the risk of division in the board, others to the existence of a strong non-executive presence on the board etc. In contrast, some companies justify the non-compliance with the Remuneration Committee provision as to be "*in the company's best interest*" or because "*the company's interests are aligned with the other shareholders*". Similar explanations are often given when the majority of non executive directors are not independent. For instance, some companies state that the arrangements in place are "*appropriate for the nature and culture of the company*",

or the appointed non-executives have "*deep industry knowledge*". In our view, diversity of explanations are an important factor which make the "comply or explain" approach work.

In summary, when analysing any one of the eight principles we find that out of one hundred company-year observations, roughly ninety comply. Out of the remaining ten cases, two do not provide any explanation and with the exception of the senior non executive director and audit committees, there are then six instances of unconvincing explanations. Pertinently, we identify approximately two cases of genuine explanations. Furthermore there is possibly a positive time trend with regard to the quality of explanations as the percentage of specific explanations improves after 2001, but on diminishing non-compliances.

5.3 *FTSE100 Membership*

FTSE100 companies on average give higher quality explanations than non-FTSE100 companies (Table 19, Panel A). The difference in the average quality between the two groups (FTSE100 and non-FTSE100), based on a T-test, is significant at the 10% level in two out of six periods. In fact, FTSE100 companies tend to give less Type 0, 1, 2 and 4 explanations and more Type 3 and Type 5 explanations (table not shown). All these differences, except Type 3 differences, are significant at the 90% level with the Type 0 and 5 differences being highly significant. The above evidence suggests again that on average FTSE100 companies are more likely to be monitored with respect to both compliance with the Code, as well as the quality of explanation in case of non-compliance.

5.4 *Crosslisting in other exchanges*

Table 19 (Panel B) shows the level of the quality of explanations provided by cross-listed companies, mostly in the US. Crosslisted companies tend to give an average higher quality of explanation (2.50) those not cross-listed (2.08). The average quality of explanations by cross-listed companies is higher across all years, and significantly different at the 1% level one period, 5% level in one period and 10% level in one

period. The higher average quality for cross-listed companies is explained by a higher number of Type 5 explanations, and a lower number of Type 0, 1, and 2 than non cross-listed companies. This suggests further support for the "bonding hypothesis" described in the sections before.

We also report the quality of explanation in Table 20 based on a two-way classification of Crosslisting and FTSE100 which shows that Crosslisted companies which are not FTSE100 members give the highest average quality of explanation (2.58) followed by Crosslisted and FTSE100 members (2.46). As expected companies which are neither crosslisted nor FTSE100 members perform the worst. The analysis suggests that crosslisting is more important for average quality of explanation than FTSE100.

5.5 *Ownership structure*

Table 19 (Panel C) shows the trends in quality of explanations according to the company ownership structure. The average quality of explanation provided by a non-family company is higher (2.56) than that provided by a family owned company (2.18). This difference is significant at the 90% level. In the period $1998-99$, such difference in the quality of explanation is not statistically significant. On the contrary, in the period $2003-04$, the difference becomes significant at the 90% level. In fact, a comparison of the average quality within family owned companies in the two periods, reveals that the average quality goes up by a non-significant 0.06, whereas within non-family companies it increase by a significant (at the 5% level) 0.81.

When investigating which type of explanation most affects such difference between the two groups (family and non-family), we find that non-family companies give more Type 4 explanations as compared to family companies. However, non-familiy companies tend to give on average a slightly lower number of Type 5 explanations. This difference is not statistically significant. (Results not shown here)

6 Discussion

Differently from statutory laws, codes of best practice are based on the principle that one size does not fit all in matters of corporate governance. Companies are heterogeneous entities and, as a consequence, they should adopt different corporate governance structures. Along these lines, the OCED in its Principles of Corporate Governance recognises the existence of heterogeneity also at national level, and advises developed and developing countries to implement flexible regulatory regimes of corporate governance:

"*There is no single model of good corporate governance. [...] The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Their purpose is to serve as a reference point. They can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.*" (OCED Principles of Corporate Governance, 1999)

Even other multilateral agencies, like the World Bank, advocate a *one size does not fit all* approach to corporate governance. The aim being that adherence to the code can help prevent future underperformance and corporate failures. In more general terms, the main objective of codes of corporate governance is to limit agency problems between shareholders and management and amongst shareholders, by recommending the adoption of generally accepted standards of corporate governance. The pioneer of all these codes of best practice (the Cadbury Code) is characterised by voluntary compliance and mandatory disclosure. There is no body or regulator designated to monitor the compliance with the provisions of the Code or the type of explanation given. Shareholder pressure should *per se* secure adherence. Indeed, shareholders should effectively monitor compliance, since it is in their interest to reduce agency costs and limit managerial expropriation of company funds. If shareholders are not satisfied with the company's level of compliance or with the explanation given in case of non-compliance, they would lobby management for a change in the corporate governance policy. As monitoring is entirely left to shareholders, problems could arise

when shareholders do not actively monitor. Such situations could arise for instance in presence of an entrenched board or a concentrated ownership structure with effective control over the company's management, or because of free-rider problems amongst dispersed shareholders bearing high monitoring costs.

In light of the above, we seek answers to the following questions, which in turn would allow us to make inferences about the overall effectiveness of the code: *Does the combined code encourage compliance? Do companies provide adequate explanations? To what extent is the code monitored?*

6.1 *Does the combined code encourage compliance?*

We focus our attention on the "comply" pillar of the "comply or explain" approach. We investigate if the practices recommended in the code are implemented by companies because the Code has established best practice, or whether there are other factors inducing companies to comply. We can test the impact of the Code by looking at past trends of compliance of various provisions. Table 21 shows the compliance percentages of three provisions (separation of CEO/Chairman, service contracts' length and identification of a senior non executive director(SNED)) over time. Our sample period starts in 1998, therefore we can only provide indirect evidence on the preceding periods based on existing academic studies. Any conclusion from our analysis should be regarded with this caveat. In particular, we focus on one provision that was already in place in the Cadbury Code before 1998 (the separation of CEO/Chairman), one provision which was in place in the Cadbury Code, but subsequently modified by the Combined Code (length of service contracts restricted from 3 to 1 year), and one new provision introduced by the Combined Code (the identification of a SNED).

Coynon (1997) shows that between 1991 and 1994, the percentage of companies which had split the CEO/Chairman roles increased from 48% to 64%. Similarly, Dedman (2003) finds that compliance with this provision increases from a median of 70% in 1990 to 83% in 1993. Finally, the study by Dahya et al. (2002) confirms this trend by showing that the separation of the roles increases from an average of 64% in the period $1989-1992$ to 85% in $1993-96$. The compliance figures for our sample

ranges from 86% in $1998-99$ to 92% in $2003-04$. This evidence highlights a higher difference in the compliance rates pre and post-Cadbury rather then pre- and post Combined Code. Thus, it suggests that the Cadbury Code, but not the Combined Code, did make a difference in spreading compliance with this provision

On the other hand, when looking at provisions newly introduced or modified by the Combined Code we see a strongly increasing pattern. The percentage of companies that appointed a senior non-executive director in the board jumps from 57% in $1998-99$ to 92% in $2003-04$. Such pressure towards compliance is further confirmed by the provision related to the duration of service contracts for executive directors, which percentage of compliance jumped from 35% to 80%. Thus, the Combined Code has succeeded in encouraging compliance with its provisions.

6.2 *Do companies provide adequate Explanations?*

We now focus our attention on the "explain" pillar of the "comply or explain" approach. The explanation portion of the code is what differentiates it from a prescriptive law. Non-compliance with any of the Code provisions is not necessarily a signal of poor corporate governance, as long as a valid justification is provided. We have shown in Section 4 before that the majority of companies give uninformative explanations for their non-compliances. More worrying, an average of 17% of non-compliances are not explained at all. In our subsequent study (Arcot and Bruno, 2006), we show that lack of explanations is associated with underperformance. On the contrary, companies providing Type 5 explanations perform exceptionally well.

The Transition Matrix presented in Table 22 shows further patterns in explanations. The matrix traces how an explanation evolves from one type to another (or directly to compliance), from one period to the following one. In all rows (except Type 4) we observe that the diagonal elements have the highest percentage, which indicates the tendency to stick to the same explanation (or no explanation) year after year. Only in case of transitional explanations, a change to compliance dominates. Importantly, the second highest transition for all explanations (except Type 4) is to comply. This clearly shows that companies either stick to the same explanation or

comply. They do not change their explanation in the intermediate, which suggests the existence of four possible scenarios: 1. company's circumstances have not changed over the period; 2.shareholders are satisfied with the explanation provided; 3. shareholders do not give sufficient importance to the explanations; 4. shareholders did not succeed in improving the level of informativeness conveyed through the explanations in the company's statements. The fact that most explanations in the first place given are of a low quality and that the average quality is lower in presence of family firms, suggests that the last two scenarios are more likely to be true.

The following evidence on the behaviour of companies moving from compliance to non-compliance further clarifies and supports this contention. It is not surprising to observe companies ceasing to comply, as their circumstances might have changed. We would be expect such companies to be able to provide a valid explanation of why the circumstances have changed. After all, this flexibility allowed in the code would be most useful in such cases. However, companies that cease to fully comply do not provide good explanations. In the whole sample, there is only one instance of a company which stops to comply and then provides a specific, verifiable explanation that was not purely transitory (e.g. the company does not have a separate CEO and chairman of the board as a result of the CEO's resignation). Table 18 shows that most of the explanations provided by such companies when ceasing to comply are transitional (29%), followed closely by 23% of cases where no explanation is provided, and then 22% where general explanations are provided.

This could lead to two possible interpretations. It could be that those companies are unable to provide good explanations, because they do not have valid reasons to cease compliance. Or, it could be that they do have some, but do not take the step to state them in their annual reports. The first interpretation suggests that there does not seem to be a set a recurrent circumstances under which, in the words of Sir Derek Higgs, "*a valid exception to the sound rule*" is warranted. The second interpretation is that there are some such circumstances, but they can be hardly used in support of the "comply or explain" approach: the outcome would be the same without any regulation. The absence of explanations suggests that shareholders do not pay much attention, so that managers do not feel compelled to justify non-compliance.

Moreover, our investigation of individual provisions (for more details, refer to Appendix 3) reveals that in some cases there is no consistency in the explanations provided from one period to the next. For instance, 42 companies state in a particular period that they are offering service contracts of more than a year because of the "*calibre of their managers*". However in the following period, approximately 50% of companies announce their intention to offer a one year contract to the same manager without justifying why their original circumstances have changed. We also found instances where companies states their intention to comply in the following financial year, but in the end they remain non compliant. In general, the analysed tendency towards compliance rather than better quality explanations provides further evidence that the Code does encourage compliance, but fails in pushing towards informative explanations.

6.3 *To what extent is the code monitored?*

The Cadbury Code as well as the Combined Code envisaged that the monitoring of the code should be done by institutional shareholders[8]. Sir Cadbury, in the introduction to his report, states that the Code of Best Practice is aimed at encouraging pressure from shareholders to hasten its widespread adoption, but also at allowing flexibility in its implementation. Therefore, we would expect shareholder's pressure when dissatisfied with the company's corporate governance practices. The previous two sections raise the question on who actually monitors the degree of compliance and the quality of explanations given in the corporate governance statements. Essentially, the quality of the explanation given in the statement may be considered as a proxy for governance. However, the "explanation" pillar of the approach seems to play a

[8]This is also confirmed by the Financial reporting Council (FRC). The FRC is responsible for monitoring the content of company's annual report. The corporate governance and remuneration statements form part of the annual report. The FRC says that it aims to achieve high standards of governance by:

-*maintaining an effective Combined Code on Corporate Governance and promoting its widespread application;*

-*encouraging constructive interaction between company boards and institutional shareholders.*

marginal role in the companies' governance decision Companies do not seem to make use of the flexibility allowed by the Code.

In particular, the institutional shareholders' attitude to corporate governance encourages a box-ticking approach to corporate governance, which is biased towards unconditional compliance with all the Code provisions: if all the boxes are ticked, in the sense that the company does comply with respect to all provisions of the Code, then the conclusion is that the company is well governed There are innumerable examples and anecdotal evidence of pressure to comply rather than explain in the companies' annual reports, in the press, and in the practitioners' reports (Coombers and Wong, 2004). For instance, Pearson plc states in its 2002 annual report: "*Our second non-compliance with the Combined Code is that we have not named a senior independent director (SID). To date we have been satisfied with the practice that if any shareholder raises a concern or makes a complaint to the chairman, he is obliged to share it with the other directors. Pearson has also for some time been happy for non-executives to meet shareholders. However, recognising the appetite to formalise these processes, we do now intend to appoint a SID.*" The following quote from the Financial Times of 10th March, 2005 further illustrates the point "*Also there is a widespread feeling in the British boardrooms that institutional investors are responding too mechanistically to the 'comply of explain' approach of the Combined Code, paying to little attention to the circumstances of individual businesses and disregarding good explanations of non-compliance.*" However, one of our studies (Arcot and Bruno, 2006) shows that there is no improvement in performance after adopting all the Code provisions.

Moreover, if there is shareholder pressure on corporate governance issues, this usually takes place after periods of bad performance. The case of W.M. Morrison can be used to illustrate this form of shareholder activism. W.M. Morrison has always been not compliant with most (i.e., six out of eight) provisions of the code and either no explanation was offered or a poor quality explanation was provided by the company. Shareholders apparently did not raise this issue as long as the performance of the company was good. In 2004, W.M. Morrison completed the takeover of Safeway, after which (in July), W.M. Morrison announced its first profit warning in its 106 year

history. This was followed by three more warnings in quick succession, which led to shareholder pressure and the appointment of David Jones as its first non-executive director in March 2005. In its annual meeting in May 2005 the company revealed its inability to forecast the financial position for the coming year. Shareholder pressure further intensified which led to the appointment of three more independent non-executive directors in July 2005 and a fourth in September 2005. In the meantime the CEO of the company, Bob Stott resigned and Sir Ken Morrison stepped back from operational responsibilities. It is easy to check that although until July 2004, the stock price performance of Morrison was in line with the market. After that date, Morrison significantly under performed the FTSE100 index to the extent of nearly 40% upto July 2005. We believe that Morrison's case illustrates some features common to many companies. In particular it demonstrates that the intervention by shareholders in matters of corporate governance is usually not preemptive, but typically occurs after bad performance. This highlights a significant cost of the flexibility offered by the Code, in that it does not foster shareholders' incentives to take preemptive actions.

We therefore raise the following question: is there a monitoring failure? Monitoring is not a costless activity, which is borne if its costs outweigh the benefits deriving from it. For instance, in case of highly dispersed ownership, the free-riding problem could prevent shareholders from monitoring. A ticking-box approach is not very costly, as it is relatively simple to check whether all the boxes are ticked. On the contrary, verifying the veracity of an explanation and judging its optimality with respect to the company's governance structure could require more time, business knowledge and interaction with the board members.

In Section 4, we show that family firms tend to have a lower degree of compliance than non family companies. Non compliance is not a signal of bad corporate governance *per se*, as it is allowed by the Code. In particular, a family-owned company has peculiar features which could explain differences in the composition and balance of a board from the ones recommended in the Code. More worrying is the lower quality of explanations provided when justifying such non compliances (Section 5), which points to inadequate information conveyed to minority shareholders. Our analysis

therefore shows how minority shareholders may be vulnerable even in the presence of strong governance protection provided in the UK. Lower degree of compliance and bad quality explanations thus cast doubts on the transferability and implementation of the UK model of corporate governance in countries with concentrated ownership or with no activist shareholders, and no proper enforcement.

An additional analysis of the monitoring aspect is performed on how quickly companies move to compliance as a function of the initial quality of their explanation. Table 23 shows the results. On average, the number of years a company takes to move from a genuine (Type 5) explanation to full compliance (3.70) is higher than the other types of explanations. In particular, explanations classified under Type 0 take an average of 2.55 years before reaching compliance, Type 1 an average of 3.08 years, Type 2 an average of 2.63 years, Type 3 an average of 3.11 years, and Type 4 an average of 1.21 years. Such difference in the average number of years between Type 5 explanations and the others, are significant at the 1% level in case of Type 0 and Type 2, at the 5% level in case of Type 1, and at 10% level in case of Type 3. This table shows that there seems to be a tendency to push companies towards compliance especially if a company does not provide an explanation for its non-compliance. Further, the move to compliance happens in a single stage. This once again suggests that companies are encouraged to comply rather than provide adequate explanations for their non-compliances.

Our analysis therefore highlights how the monitoring function does not work under all circumstances. This is confirmed by the following quote which appeared in an article on 24th May, 2004 in the Financial Times "*The FSA had wanted auditors to consider whether the 'comply or explain' statement was accurate and whether it had been made after due and careful enquiries by the board of directors.*"

7 Conclusion

In this paper we investigate the UK approach to corporate governance, by using a unique database of 245 non-financial UK companies over the period 1998 − 2004. We document the degree of companies's compliance to the Code and the quality of

the explanations provided in case of non-compliance. We also rank the explanations based on their level of informativeness. We find that the Code works effectively in encouraging compliance. Compliance is monotonically increasing from a low of 10% in $1998-99$ to 56% in $2003-04$ but differs significantly among groups of companies. However the analysis of the explanations highlights drawbacks in the system. Firstly, for an average of 17% of non-compliances no explanations are provided. Secondly, we find that in 51% of the cases the explanations are standard and uninformative. Finally, the propensity to give general explanations is further amplified where agency problems are likely to be serious, e.g. in family-owned companies.

The introduction of the Revised Combined Code (2004) with more stringent criteria highlights a tendency towards less discretion in the rules. On the other hand, the introduction of more rigorous criteria is itself a signal of failure of the principles driving a non-prescriptive code of best practice, and a general movement towards a more legislative approach.[9]

Our analysis confirms a widespread feeling of a mechanical "tick boxes" response to the Combined Code, which pays too little attention to the circumstances of the individual companies. Companies on their part also seem to be paying lip-service to the concept of disclosure. Nevertheless, in one of our papers (Arcot and Bruno, 2006) we show that flexibility has a value. Non compliant companies for valid reasons perform exceptionally well, and even outperform the fully compliant ones. The highlighted general conformity with the letter but not the spirit of the regulation thus leaves space for further analysis and, possibly, regulatory intervention.

[9] To quote Arthur Piper (Internal Auditor): *"Many people believe that Higgs in particular introduces so many requirements that it is simply legislation by the back door. This, they complain, will lead to a box-ticking culture that will see companies going through the motions in their annual report and accounts to keep shareholders happy, while ignoring the spirit of good governance because it has become too onerous. What is needed, they conclude, is a light touch to good practice, where those who are remiss are gradually embarrassed into compliance by peer pressure"*

Appendix 1. Provisions of the Combined Code analysed

Chairman and CEO

Principle

There are two key tasks at the top of every public company - the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. (Section 1, A.2.)

Code Provision

A decision to combine the posts of chairman and chief executive officer in one person should be publicly justified. (A.2.1)

Senior Non-executive Director (SNED)

Code Provision

Whether the posts are held by different people or by the same person, there should be a strong and independent non-executive element on the board, with a recognised senior member other than the chairman to whom concerns can be conveyed. The chairman, chief executive and senior independent director should be identified in the annual report. (A.2.1)

Board Composition and Non-Executive directors

Principle

The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking. (A.3)

Code Provisions

- Non-executive directors should comprise not less than one third of the board (A.3.1)

- The majority of non-executive directors should be independent of management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgment. Non-executive directors considered by the board to be independent should be identified in the annual report (A.3.2)

Service Contracts and Compensation

Code Provisions

- There is a strong case for setting notice or contract periods at, or reducing them to, one year or less. Boards should set this as an objective; but they should recognise that it may not be possible to achieve it immediately. (B.1.7)

- If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce after the initial period. (B.1.8)

Nomination Committee

Principle

There should be a formal and transparent procedure for the appointment of new directors to the board.

Code Provision

Unless the board is small, a nomination committee should be established to make recommendations to the board on all new board appointments. A majority of the members of this committee should be non-executive directors, and the chairman should be either the chairman of the board or a non executive director. The chairman and members of the nomination committee should be identified in the annual report (A.5.1)

Remuneration Committee

Principle

Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. (B.1)

Code Provisions

Remuneration committees should consist exclusively of non-executive directors who are independent of management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgment. (B.2.2)

Audit Committee

Principle

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. (D.3)

Code Provision

The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non executive directors, should be named in the report and accounts. (D.3.1)

Appendix 2. Evolution of the UK Code over time

	Cadbury Report December 1992	Combined Code June 1998		Revised Combined Code July 2003	
In force for companies with year-end on or after	30/06/1993	31/12/1998		31/10/2004	
Principle	Comply or Explain	Comply or Explain		Comply or Explain	
Provision	**Recommendation**	**Recommendation**	**No of Prov.**	**Recommendation**	**No of Prov.**
Chairman/CEO	Separation	Separation	1	Separation	1
Role of the Chairman	Running the board	Running the board	1	Clear functions enumerated	1
Independence of the Chairman	Not specified	Not specified	0	Stringent criteria (8)	2
Role of senior non-executive dir (SNED)	Not present	Senior member other than the chairman to whom concerns can be conveyed	1	Available to shareholders if they concerns cannot be solved through normal channels	1
Non-Executive Directors (NEDs)	$\geqq 3$	$\geqq \frac{1}{3}$ of the board	1	$\geqq \frac{1}{2}$ of the board	1
Independent NEDs	Not specified	Majority	1	Majority excluding the chairman	1+1 principle
Criteria of independence	Not specified	Not specified	0	Stringent criteria (7)	
Nomination Committe	Majority NEDs	Majority NEDs	1	Majority NEDs	1
Criteria	Not stated	Not stated		Stringent criteria	5
Audit Committee	$\geqq 3$ NEDs	$\geqq 3$ majority independent	2	$\geqq 3$ independent NEDs	7
Remuneration Committee	$\geqq 3$ NEDs	only INEDs	6	$\geqq 3$ independent NEDs	4+1 principle
Service Contracts' duration	3 years	$\leqq 1$ year	2	$\leqq 1$ year	2

Appendix 3. Detailed provisionwise analysis

In what follows, we will provide a detailed analysis of the compliances and the explanations related to each provision of the Code. In particular, we will discuss the trend in compliance, the quality and the most used explanations.

- *Chairman/CEO* (A.2.1)

  The general *principle* indicates the division between who is in charge of running the board and who has executive powers as best practice. The specific *code provision* specifies the figures of who should run the board (the chairman) and who should run the company's business (the chief executive office, CEO), claiming that these two roles should not be combined. The provision however does not explicity take into account the figure of the "executive chairman". There are some cases where the executive chairman is formally separated from the CEO, but with some executive powers of decision. This generates a unequal interpretation of the principle. In fact, in presence of an executive chairman separated from the CEO, some companies claim to be fully compliant, while some others state the non compliance in the matter and provide a justification.

  The different interpretation of the provision appears in our data. We find 40 companies with an executive chairman that do not consider it a point of not compliance, and 6 companies recognizing the executive role of the chairman and providing an explanation. In both circumstances, a decreasing trend in the percentage of non compliance appears. Clearly, the magnitude of the non compliance differs: when the presence of an executive chairman is considered a matter of not compliance, the percentage of not-compliant companies is about 10% more than the case when only what it is stated in the corporate governance statement is considered (20%).

- *Senior Non-Executive Director* (A.2.1)

The Combined Code states that, irrespective of whether the roles of chairman and CEO are combined, board members should address any concerns about the combined role of Chairman/CEO or the Chairman's acts to a senior non-executive director (SNED).The provision aim at limiting the likelihood that the power is too heavily concentrated in the hands of an executive director and a chairman. The creation of this "trinity" at the top of a company (Chairman, CEO, SNED) has attracted criticism of possible divisions on the board.

The absence of a SNED is one of the most occurrent non-compliance items, together with the service contracts' length. The overall trend shows a constant decreasing number of the non-compliances, from about 43% in the first period to below the 10% in the last period, when only one company refrains from providing any sort of explanation. We found a great variety in the explanations provided, which we carefully analysed. Of the all provisions analysed, the absence of a SNED has the highest number of Type 5 explanations (18%). Explanations falling in the Type 3 and Type 4 taxonomy are the most commonly used (25%).

We further check the inter-temporal consistency of the explanations. We find that all the companies initially stating that the SNED "is not necessary" or "the chairman is enough, hence it is not appropriate to nominate a SNED", end up in changing their prospective and complying. A similar trend is found in the explanations justifying the absence of a SNED because of the chairman's independency or the strong NEDs' presence and calibre. Furthermore, the only company not appointing a SNED because it feels it is not "appropriate for the nature and culture of the company", eventually complies.

Finally, we examine the likelihood of not appointing a SNED and combining the CEO/Chairman roles. Roughly 1 out of 4 companies with an executive chairman in every period does not opt for nominating a SNED. The same choice is made in a lower percentage by the companies with combined role CEO/Chairman. Both decisions are quite debatable in the light of the SNED function. Indeed, the SNED should limit potential pitfalls connected with the chairman's conduction in the board, even more when there is not a complete separation of executive

powers and *"a clear division of responsibilities at the head of the company".*

- *Non-executives representation* (A.3.1)

  The Combined Code does not assess neither the definition of a non-executive director or his role. Only recently, the revised Combined Code contains, for the first time, a formal description of a non- executive director's role and increases the non executive representation in the board from one third to one half.

  In matter of non compliance, we find very few companies with a total number of non-executive directors comprising less than one third of the board since the beginning of our sample. The percentage of not compliances is constantly decreasing and well below the 10% across all the periods analysed. In the last period, only 1.7% of the companies do not comply. However, non compliant companies with this provision either do not provide any justification or give a general explanation.

- *Independent non-executive directors* (A.3.2)

  This is perhaps one of the most indeterminate and vague provision of the Combined Code, because a definition of "independence" is not given. The assessment of independency is indeed left to the board's judgment, which may be biased towards "too wide" and general views of managerial freedom from any business interference. This lack has been recently filled by the Revised Combined Code, where there is a more comprehensive definition of independence.

  In line with the general pattern, there is a monotonically increase in the compliance rate, up to 95% in the last period. In the earlier periods, we can observe few cases where the non executives' independence is not stated, a tendency that disappears in the years. Other more common explanations justify departure from best practice with the experience and independent view of the managers.

- *Service Contracts and Compensation* (B.1.7, B.1.8)

  The innovative aspect introduced by the Combined Code is that all executive directors must have rolling service contracts with the company terminable on

one year notice. This should limit the due compensation to be paid in case of early termination and incentive the CEO dismissal in case of poor performance of the company. The non compliance in respect with the service contracts' provision is the most common matter of violation of the Combined Code, although strongly decreasing across years. It falls from 66% in the first period to 20% in the last period, with an average 10% drop between two consecutive periods.

The Combined Code partially works with regard to the quality of the explanations. In the last period, there are no Type 1 explanations, and no companies declare that "*there are no plans to amend the service contracts*", "*the existing service contracts need to guarantee long-term projects*" or that "*non compliance is in the company's interest*". Very few companies still argue that the non-compliance with the provision helps in retaining and attracting managers of sufficient calibre or expertise, or simply assert that it is "*a common market practice*". It is however surprising to observe a non-decrease in the lack of any justification. Further, it is quite controversial and only slightly decreasing over periods, the fact that some companies do not explicitly highlight the presence of contracts with notice of more than one year in the corporate governance statement as a matter of non compliance. The above companies might have misinterpreted the code provisions, since a justification regarding the executives with a pre-Combined Code service contract of more than 1 year should be present. More serious is the case of the companies neither making a non-compliance statement nor providing a justification.

Finally, we analyse the intertemporal consistency of the explanations. The companies asserting the necessity of having contracts with more than one year notice in order to "*retain or attract high calibre managers*", easily change their explanation. In particular, of the total 42 companies claiming the need of contracts with more than 1 year's notice periods, only 3 companies remain consistent with this explanation. On the contrary, 22 companies opt for compliance, 9 companies declare that the new hired executive directors will be compliant with the code provision and 8 companies modify the existing explanation; of these 8 com-

panies, 5 eventually move towards compliance. A similar pattern appears also in the justifications related to the "*nature of the industry*" or to "*a common widespread market practice*", or when it is stated to be "*in the company's best interest*". Of the 6 companies asserting their unconditional willingness of not modifying the existing contracts, 6 end up in complying with no motivations underlying their change in intentions, while 3 opt for other kinds of explanation.

- *Remuneration Committee* (B.2.2)

  Despite not very high the percentage of non compliances, the code provision related to the existence and composition of a remuneration committee is very interesting. This is the only case, among all analysed provisions, where the percentage of non-compliances is not decreasing across years, and always above the average 10%. To this percentage of non-compliant companies, we might add some "suspicious" cases of asserted independence. In fact, some companies state the independence of their non-executives despite an existing long tenure or the existence of business relations. The companies believe that the independence view of the non-executives is not affected by the above situations. However, these justifications may be quite controversial in the light of the effective independence.

  The most common explanation provided is related to the firm's belief that the Chairman (when not considered independent) or the CEO "*should serve on the remuneration committee*", with no further clarifications though. The quality of the explanations, when any, is standard. Overall, Type 0 and Type 1 explanations are far commonly used by the largest majority of companies. It is surprising to observe the relative high number of companies providing no explanations in case of not compliance: only in the period 2002/03, the lack of explanations amounts to 31% of the companies.

  We however observe an inconsistency in our data. We indeed check whether the total number of members constituting the remuneration committee is greater than the total number of declared independent non executive directors. Quite unexpectedly, we found some cases where the above inequality is holding. In

order to rule out any possible inaccuracy, we analysed again the annual reports in question. Again quite surprising, we had the confirmation of the accuracy in our data, together with a sort of inconsistency in the contents of the annual reports. The companies at hand assess in the *Board of directors*'s section the non independence of some of the non-executive directors, who are on the contrary considered independent when part of the remuneration committee. We report an example of the apparent existing inconsistency provided by British American Tobacco (2000):

Directors. The board of the Company currently has 7 non executive Directors. The majority of the non-executive Directors are independent as set out in the Code. In this context, two of the non-executive Directors are not considered to be independent *for all purposes* because of the shareholders they represent

The Remuneration Committee. The Committee comprises all the no-executive Directors. The Board continues to consider that all non-executive Directors on the Remuneration Committee are independent *for these purposes*"

Therefore, the level of independence of non-executives constituting the board of directors is differently judged when the same are members of the remuneration committee.

- *Audit Committee* (D.3.1)

  The percentage of non compliant companies is below 13% each period and does not follow a specific pattern. Non compliance with this provision is related to 3 aspects: when there is not a majority of independent non-executive directors, or the committee is not exclusively made of non-executives directors, or the number of its members is inferior to 3. In the majority of the non compliant cases, the committee consists of a number of members less to 3. It is also interesting to observe that almost half of the compliant companies have an overall number in the audit committee not exceeding the 3 members, the minimum required by the Combined Code. Apart from the transitional explanations, the most frequent used explanations concern the size of the board and the assertion of

the manager's experience. It is always surprising to observe some companies not providing any explanation (on average 10%).

- *Appointments to the Board* (A.5.1)

  Differently from the remuneration and audit committees' provisions, independency of non executives is not required for the composition of the nomination committee. A majority of non-executive members should comprise the committee, which may not be constituted if the board is small. The Code Provision however does not define specific circumstances or examples under which a board is considered to be small. Of the total 54 non compliant companies, on average they have a smaller number of members in the board as compared with the entire sample, particularly in the non-executive component. In line with the general trend, we observe a strong decrease in the non compliances related to the existence and the composition of a nomination committee: this percentage goes from 21% to 4.3% in the last period.

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Table 1

Yearwise Distribution

The table shows the total number of companies analysed across periods.

Period	Number of Companies
31/12/1998 to 30/06/1999	162
01/07/1999 to 30/06/2000	200
01/07/2000 to 30/06/2001	222
01/07/2001 to 30/06/2002	232
01/07/2002 to 30/06/2003	240
01/07/2003 to 30/06/2004	231
Total Observations	*1287*

Table 2

Industrywise Distribution

The table classifies the total company year observations based on their industry group, as in Campbell (1996).

Industry	Company year observations
Petroleum	41
Consumer Durables	178
Basic Industry	200
Food & Tobacco	222
Construction	232
Capital Goods	240
Transportation	231
Utilities	118
Textiles and Trade	90
Services	176
Leisure	137
Total Observations	*1287*

Table 3

FTSE100 Membership

The table classifies the total company year observations based on whether they are members of the FTSE100 index.

	Company year observations
FTSE100 Members	377
Others	910
Total Observations	*1287*

Table 4

Crosslisting in other exchanges

The table classifies the total company year observations based on whether they are crosslisted in other exchanges. The total number of observations 1308 exceeds the number 1287, because some companies are cross-listed in more than one exchanges.

	Company year observations
NYSE/NASDAQ/AMEX etc.	317
European	23
Others (Australian, S. African)	21
Non-crosslisted	947
Total Observations	*1308*

Table 5
Financial Information

The table summarises the main financial information and number of employees for all companies in the sample across all the periods.

	Mean	**Median**	**Std. Dev**	**Year Obs**
Market Value (GBP mill.)	3743.05	873.74	12728.82	1169
Turnover (GBP mill.)	2700.56	957.07	7890.91	1212
PBIT (GBP mill)	224.00	82.00	791.56	1212
Total Assets (GBP mill)	3634.39	1001.20	12415.18	1212
Employees	19607	8336	32.28	1159

Table 6
Ownership Structure

The table shows the ownership structure of companies in the first (1998-99) and last period (2003-04). Ownership is calculated at the 10% threshold. The ownership data for the period 1998-99 is imputed from the Faccio & Lang (2002), available on the Journal of Financial Economics website. Data for the period 2003-04 is from Thomson Ownership.

	1998-99	**2003-04**
Non-family Companies	80	174
Family Companies	57	32
State Companies	1	0
Miscellaneous	9	5
Total number of companies	*147*	*211*

Table 7
Yearwise Non-Compliances and Explanations

The table shows the yearwise non-compliances and explanations. *% Compl* indicates the percentage of companies compliant with all eight provisions analysed. *Average NC* is the average number of provisions on which companies are not compliant. *Average Expln* is the average number of non-compliances for which explanations are provided. *Gap* is the difference between *Average NC* and *Average Expln*, and it indicates the average number of non-compliances for which no explanations are provided.

Period	**% Compl**	**Average NC**	**Average Expln**	**Gap**
1998-99	9.88%	2.05	1.66	0.40
1999-00	19.00%	1.98	1.62	0.36
2000-01	24.77%	1.86	1.54	0.31
2001-02	34.05%	1.72	1.43	0.29
2002-03	42.08%	1.58	1.32	0.26
2003-04	56.28%	1.57	1.38	0.20
All periods	*32.56%*	*1.81*	*1.50*	*0.31*

Table 8
Provisionwise Non-Compliances and Explanations

The table shows the provisionwise distribution of non-compliances and explanations. *% Compl* indicates the percentage of companies compliant with the provision analysed across all the periods. *% Expln* is the percentage of non-compliances for which explanations are provided across all periods.

Industry	**% Compl**	**% Expln**
CEO/Chairman	89.90%	86.15%
SNED	76.46%	89.07%
Number of NEDs	95.49%	74.14%
Independent NEDs	92.13%	72.28%
Service Contracts	56.73%	85.53%
Remuneration. Committee	86.63%	69.41%
Audit Committee	91.72%	90.57%
Nomination Committee	88.23%	90.73%
All provisions	*32.56%*	*82.95%*

Table 9

Industrywise Non-Compliances and Explanations

The table shows the industrywise distribution of non-compliances and explanations. *% Compl* indicates the percentage of companies compliant with all eight provisions analysed. *Average NC* is the average number of provisions on which companies are not compliant. *Average Expln* is the average number of non-compliances for which explanations are provided. *Gap* is the difference between *Average NC* and *Average Expln*, and it indicates the average number of non-compliances for which no explanations are provided.

Industry	**% Compl**	**Average NC**	**Average Expln**	**Gap**
Petroleum	31.71%	1.93	1.86	0.07
Consumer Durables	26.40%	1.69	1.39	0.31
Basic Industry	30.40%	1.60	1.41	0.18
Food & Tobacco	40.00%	1.93	1.63	0.30
Construction	23.13%	1.62	1.35	0.27
Capital Goods	34.67%	2.12	1.47	0.65
Transportation	39.00%	1.62	1.36	0.26
Utilities	44.07%	1.88	1.52	0.36
Textiles and Trade	30.00%	1.79	1.59	0.21
Services	36.93%	1.97	1.49	0.49
Leisure	27.74%	2.01	1.79	0.22
Tot. observations	*32.56%*	*1.81*	*1.50*	*0.31*

Table 10
FTSE100 Non-Compliances and Explanations

The table shows the trend in non-compliances and explanations based on the FTSE100 membership. *Fully Comp* indicates the total number of company year observation which are fully compliant, *Non- Comp* which are not. *% Compl* indicates the percentage of companies compliant with all eight provisions analysed. *Average NC* is the average number of provisions on which companies are not compliant. *Average Expln* is the average number of non-compliances for which explanations are provided. *Gap* is the difference between *Average NC* and *Average Expln*, and it indicates the average number of non-compliances for which no explanations are provided.

Type	**Fully Comp**	**Non-Comp**	**Total**	**% Compl**	**Average NC**	**Average Expln**	**Gap**
FTSE100	140	237	*377*	37.14%	1.65	1.45	0.20
Non-FTSE100	279	631	*910*	30.66%	1.87	1.52	0.35
Tot. observations	*419*	*868*	*1287*	*32.56%*	*1.81*	*1.50*	*0.31*

Table 11
FTSE100 Companies Yearwise

The table shows the yearwise average number of non-compliances (*Average NC*) for FTSE100 and non-FTSE100 companies. The difference between average non-compliances of the FTSE100 and non-FTSE100 companies is shown in the difference (*Diff*) column. *,**, and *** indicate significance at the 10%, 5%, and 1% level respectively.

Period	**FTSE100**	**Average NC**	**Non FTSE100**	**Average NC**	**Diff**
1998-99	36	1.78	110	2.15	-0.37
1999-00	48	1.79	114	2.05	-0.26
2000-01	47	1.70	120	1.92	-0.22
2001-02	43	1.65	110	1.75	-0.10
2002-03	36	1.36	103	1.66	-0.30
2003-04	27	1.48	74	1.61	-0.13
Total obs	*237*	*1.65*	*631*	*1.87*	**-0.22***

Table 12
Crosslisting Non-Compliances and Explanations

The table shows the trend in non-compliances and explanations of crosslisted and non-crosslisted companies. *Fully Comp* indicates the total number of company year observation which are fully compliant, *Non- Comp* which are not. *% Compl* indicates the percentage of companies compliant with all eight provisions analysed. *Average NC* is the average number of provisions on which companies are not compliant. *Average Expln* is the average number of non-compliances for which explanations are provided. *Gap* is the difference between *Average NC* and *Average Expln*, and it indicates the average number of non-compliances for which no explanations are provided.

Type	**Fully Comp**	**Non-Comp**	**Total**	**% Compl**	**Average NC**	**Average Expln**	**Gap**
Crosslisted	289	210	*499*	57.92%	1.66	1.37	0.29
Others	130	658	*788*	16.50%	1.86	1.54	0.32
Tot observations	*419*	*868*	*1287*	*32.56%*	*1.81*	*1.50*	*0.31*

Table 13
Crosslisted Companies Yearwise

The table shows the yearwise average number of non-compliances (*Average NC*) of Crosslisted and non-Crosslisted companies. The difference between average non-compliances of the Crosslisted and non-Crosslisted companies is shown in the difference (Diff) column. *,**, and *** indicate significance at the 10%, 5%, and 1% level respectively.

Period	**Cross Listed**	**Average NC**	**Non Cross Listed**	**Average NC**	**Diff**
1998-99	33	2.00	113	2.07	-0.07
1999-00	43	1.79	119	2.04	-0.25
2000-01	41	1.66	126	1.92	-0.26
2001-02	37	1.62	116	1.75	-0.13
2002-03	34	1.38	105	1.65	-0.26
2003-04	22	1.36	79	1.63	0.27
Total obs.	*210*	*1.66*	*658*	*1.86*	**-0.22****

Table 14
FTSE100 and Crosslisting Non-Compliances and Explanations

This table shows the non-compliances and explanations distribution of companies which are both FTSE100 members and crosslisted in other exchanges. *Fully Comp* indicates the total number of company year observation which are fully compliant, *Non- Comp* which are not. *% Compl* indicates the percentage of companies compliant with all eight provisions analysed. *Average NC* is the average number of provisions on which companies are not compliant. *Average Expln* is the average number of non-compliances for which explanations are provided. *Gap* is the difference between *Average NC* and *Average Expln*, and it indicates the average number of non-compliances for which no explanations are provided.

Type	**Fully Comp**	**Non-Comp**	**Total**	**% Compl**	**Average NC**	**Average Expln**	**Gap**
FTSE100 and Crosslisted	92	133	*225*	40.89%	1.63	1.39	0.24
FTSE100 not Crosslisted	48	104	*152*	31.58%	1.66	1.52	0.14
Crosslisted non-FTSE100	38	77	115	33.04%	1.70	1.38	0.32
Neither Crosslisted nor FTSE100	241	554	795	30.31%	1.90	1.54	0.35
Total observations	*419*	*868*	*1287*	*32.56%*	*1.81*	*1.50*	*0.31*

Table 15

Ownership Structure Non-compliances and Explanations

The table shows the non-compliances and explanations distribution according to the company's ownership structure. *Fully Comp* indicates the total number of company year observation which are fully compliant, *Non- Comp* which are not. *% Compl* indicates the percentage of companies compliant with all eight provisions analysed. *Average NC* is the average number of provisions on which companies are not compliant. *Average Expln* is the average number of non-compliances for which explanations are provided. *Gap* is the difference between *Average NC* and *Average Expln*, and it indicates the average number of non-compliances for which no explanations are provided.

Type	**Fully Comp**	**Non-Comp**	**Total**	**% Compl**	**Average NC**	**Average Expln**	**Gap**
Non-family Companies	117	137	*254*	46.06%	1.59	1.36	0.23
Family Companies	18	71	*89*	20.22%	2.35	1.92	0.44
State Companies	0	1	*1*	0.00%	3.00	2.00	1.00
Miscellaneous	1	13	*14*	7.14%	2.15	1.31	0.85
Total observations	*136*	*222*	*358*	*37.99%*	*1.87*	*1.54*	*0.33*

Table 16
Ownership Structure Periodwise

The table shows the yearwise average number of non-compliances (*Average NC*) of family and non-family companies. Non-family (resp. Family) indicates the total number of companies which are classified as non-familiy firms (resp. family firms). The difference between average non-compliances of family and non-family companies is shown in the difference (Diff) column. *,**, and *** indicate significance at the 10%, 5%, and 1% level respectively.

Period	**Non Family**	**Average NC**	**Family**	**Average NC**	**Diff**
1998-99	71	1.87	52	2.26	**-0.41***
2003-04	66	1.29	19	2.58	**-1.29*****
Diff		**-0.59*****		-0.31	
Total obs	*137*	*1.59*	*71*	*2.35*	**-0.76*****

Table 17
Yearwise Quality of Explanations

The table shows the percentage of Type 0, 1, 2, 3, 4 and 5 explanations for each period. *Type 0* indicates absence of explanation; *Type 1* indicates a general explanation provided; *Type 2* is an explanation Inline with the Code; *Type 3* is a Limited explanation; *Type 4* indicates Transitional circumstances; *Type 5* is a genuine explanation. The quality of explanation provided as per the above classification is increasing from 0 to 5 (see Section 5 in the paper for a complete description). *Wt. Avg.* is the mean of the weighted average quality of explanation of each company during the year, calculated by weighting all the explanations given by a company with its respective type.

Period	**Type 0**	**Type 1**	**Type 2**	**Type 3**	**Type 4**	**Type 5**	*Wt. Avg.*
1998-99	19.33%	24.67%	21.33%	6.67%	20.67%	7.33%	*2.18*
1999-00	18.13%	26.88%	26.25%	8.44%	10.94%	9.38%	*2.07*
2000-01	16.77%	30.32%	24.52%	10.00%	9.03%	9.35%	*2.04*
2001-02	16.73%	27.00%	27.76%	7.22%	12.17%	9.13%	*2.15*
2002-03	16.36%	23.18%	25.91%	7.73%	19.55%	7.27%	*2.23*
2003-04	12.58%	20.75%	23.27%	5.66%	30.19%	7.55%	*2.63*
All periods	*17.05%*	*26.02%*	*24.87%*	*7.82%*	*15.78%*	*8.46%*	*2.19*

Table 18

Provisionwise Quality of Explanations

The table shows the percentage of Type 0, 1, 2, 3, 4 and 5 explanations of each provision. *Type 0* indicates absence of explanation; *Type 1* indicates a general explanation provided; *Type 2* is an explanation Inline with the Code; *Type 3* is a Limited explanation; *Type 4* indicates Transitional circumstances; *Type 5* is a genuine explanation. The quality of explanation provided as per the above classification is increasing from 0 to 5 (see Section 5 in the paper for a complete description). *Wt. Avg.* is the mean of the weighted average quality of explanation of each company during the year, calculated by weighting all the explanations given by a company with its respective type.

Provision	**Type 0**	**Type 1**	**Type 2**	**Type 3**	**Type 4**	**Type 5**
CEO/Chairman	13.85%	19.23%	11.54%	32.31%	22.31%	0.00%
SNED	10.93%	19.87%	0.00%	25.50%	25.83%	17.88%
Number of NEDs	25.86%	36.21%	15.52%	0.00%	22.41%	0.00%
Independent NEDs	27.72%	41.58%	11.88%	0.00%	11.88%	6.93%
Service Contracts	17.72%	22.24%	39.24%	3.44%	8.86%	8.68%
Remuneration Committee	30.59%	44.12%	4.71%	0.59%	14.71%	5.88%
Audit Committee	9.43%	20.75%	35.85%	0.94%	25.47%	7.55%
Nomination Committee	9.27%	15.89%	60.26%	0.00%	9.93%	3.97%
All Provisions	*17.05%*	*26.02%*	*24.87%*	*7.82%*	*15.78%*	*8.46%*

Table 19

Quality of Explanations according to FTSE100 membership, Crosslisting in other exchanges, and Ownership Structure

The table shows the average quality of explanations of FTSE100, non-FTSE100, Crosslisted, non-Crosslisted, Family and non-Family companies in each period. The weighted average quality of explanation for each company is first calculated by weighting each explanation given by its respective type, which is then used to calculate the mean for all comapnies in that group. The difference between average quality of the two respective categories is shown in the difference column (Diff). *,**, and *** indicate significance at the 10%, 5%, and 1% level respectively.

	Panel A			*Panel B*			*Panel C*		
Period	**FTSE100**	**Non FTSE100**	**Diff**	**Cross listed**	**Non Cross listed**	**Diff**	**Non Family**	**Family**	**Diff.**
1998-99	2.22	2.16	0.06	2.32	2.13	0.18	2.17	2.16	0.01
1999-00	2.34	1.96	**0.38***	2.47	1.93	**0.56***			
2000-01	2.37	1.91	**0.46**	2.53	1.88	**0.66***			
2001-02	2.36	2.06	0.30	2.52	2.03	**0.49**			
2002-03	2.42	2.17	0.25	2.49	2.15	0.34			
2003-04	3.01	2.49	**0.53**	2.80	2.58	0.22	2.98	2.21	**0.76**
All periods	*2.42*	*2.10*	**0.32***	*2.50*	*2.08*	**0.42***	*2.56*	*2.18*	**0.38**

Table 20

Quality of Explanations of both FTSE100 and Crosslisted companies

The table shows the percentage of Type 0, 1, 2, 3, 4 and 5 explanations of companies which are both members of the FTSE100 index and are crosslisted in other exchanges. *Type 0* indicates absence of explanation; *Type 1* indicates a general explanation provided; *Type 2* is an explanation Inline with the Code; *Type 3* is a Limited explanation; *Type 4* indicates Transitional circumstances; *Type 5* is a genuine explanation. The quality of explanation provided as per the above classification is increasing from 0 to 5 (see Section 5 in the paper for a complete description). *Wt. Avg.* is the mean of the weighted average quality of explanation of each company during the year, calculated by weighting all the explanations given by a company with its respective type.

	Type 0	**Type 1**	**Type 2**	**Type 3**	**Type 4**	**Type 5**	*Wt. Avg.*
FTSE100 and Crosslisted	14.75%	18.89%	25.81%	11.52%	14.75%	14.29%	*2.46*
FTSE100 and non-Crosslisted	8.67%	32.95%	23.12%	7.51%	13.87%	13.87%	*2.37*
Crosslisted but non-FTSE100	19.08%	14.50%	18.32%	6.87%	23.66%	17.56%	*2.58*
Neither Crosslisted nor FTSE100	18.65%	27.78%	25.78%	7.23%	15.32%	5.23%	*2.03*
All observations	*17.05%*	*26.02%*	*24.87%*	*7.82%*	*15.78%*	*8.46%*	2.19

Table 21
Trends in Compliance

The table shows the compliance percentages of three provisions (separation of CEO/Chairman, service contracts' length and identification of a senior non executive director(SNED)) over time. Our sample period starts in 1998, therefore we can only provide indirect evidence on the preceding periods based on existing academic studies: Coynon (1997), Dahya at al. (2002), and Dedman (2003).

Study	Reference Period	Chair./ CEO	Service Cont.	SNED Ident.
Dedman (2003)	1990	*70.39%*		
Conyon (1997)	1991	*48.00%*		
Dahya et al. (2002)	1989-92	*63.50%*		
Dedman (2003)	1993	*83.48%*		
Conyon (1997)	1994	*64.00%*		
Dahya et al. (2002)	1993-96	*84.60%*		
Arcot and Bruno (2006)	1998-99	**86.42%**	**35.19%**	**56.79%**
	1999-00	**90.00%**	**41.50%**	**67.00%**
	2000-01	**88.29%**	**50.00%**	**72.52%**
	2001-02	**90.52%**	**58.19%**	**79.31%**
	2002-03	**90.83%**	**67.92%**	**84.17%**
	2003-04	**92.21%**	**80.09%**	**91.77%**
	All periods	*89.89%*	*55.46%*	*74.14%*

Table 22
Transition Matrix

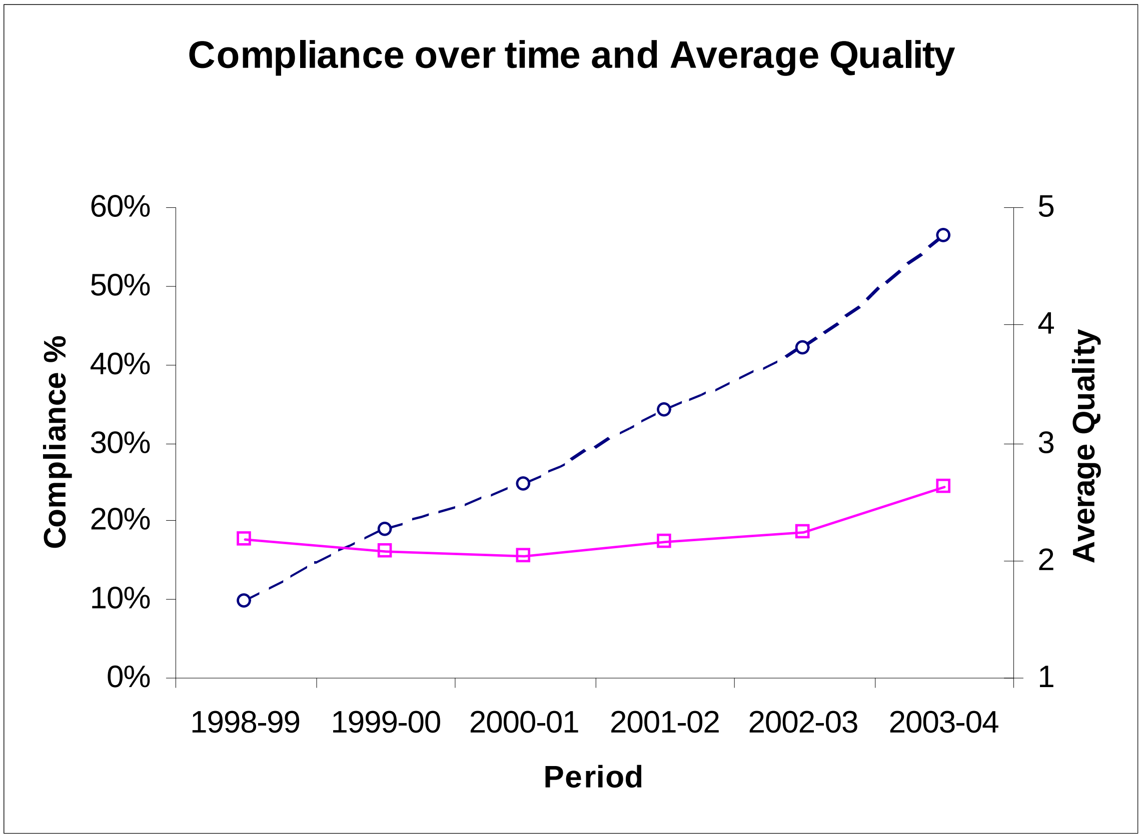
The table shows the evolution of the quality of explanations given by a company from one period to the next. *Type 0* indicates absence of explanation; *Type 1* indicates a general explanation provided; *Type 2* is an explanation Inline with the Code; *Type 3* is a Limited explanation; *Type 4* indicates Transitional circumstances; *Type 5* is a genuine explanation. The figures are in percentages and have to be read row-wise, e.g the figures in the column Type 0 indicate the total percentage of explanations (across all periods) that either remained Type 0 (52.23% of the cases) or moved to Type 1 (6.07%), Type 2 (4.86%), Type 3 (2.43%), Type 4 (8.50%), Type 5 (0.40%) or Compliance (25.51% of the cases) in the next period.

		TO						
		Type 0	**Type 1**	**Type 2**	**Type 3**	**Type 4**	**Type 5**	**Compliance**
FROM	**Type 0**	**52.23**	6.07	4.86	2.43	8.50	0.40	*25.51*
	Type 1	2.67	**70.05**	6.68	1.07	8.56	0.8	*10.16*
	Type 2	4.37	0.87	**65.60**	0.00	8.45	1.17	*19.53*
	Type 3	0.92	1.83	5.50	**66.97**	11.93	0.92	*11.93*
	Type 4	1.52	1.52	1.52	0.51	*10.66*	0.51	**83.76**
	Type 5	1.67	0.83	1.67	0.83	8.33	**74.17**	*12.50*
	Compliance	0.39	0.27	0.37	0.13	*0.49*	0.01	**98.33**

Table 23
Speed of Compliance

The table shows the average number of years and average number of stages for a company giving a particular type of explanation to move to compliance. The difference in means of the average time to compliance is computed between the Type 5 explanations and the other Types. *,**, and *** indicate significance at the 10%, 5%, and 1% level respectively.

From Explanation	Obs	Average Number of Years	Average Number of Stages
Type 0	79	**2.55*****	1.47
Type 1	63	**3.08****	1.54
Type 2	75	**2.63*****	1.33
Type 3	25	**3.11***	1.76
Type 4	101	1.21	1.08
Type 5	20	3.70	1.45
All Types	*363*	*2.39*	*1.36*



Graph 1

This graph plots both the percentage of companies compliant on all the provisions and the average quality on the Y-axis and the various periods on the X-axis.