

CORPORATE GOVERNANCE DISCLOSURE QUALITY: EXPLORATORY EVIDENCE FROM THE UK

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Abstract

A fundamental aspect of good corporate governance is the protection of shareholders and their investments. These stakeholders are now demanding increasing levels of transparency in all aspects of business with a greater emphasis being placed on non-financial information for investment decision making. While the majority prior research has examined the corporate governance practices of the firm, research investigating the actual disclosure of corporate governance practice is scarce. This study contributes to this debate by providing exploratory evidence on the levels of corporate governance disclosure quality and compliance in a sample of 40 UK listed firms throughout the period 2002 to 2009. Findings report a notable increase in disclosure quality and compliance over this period with the greatest increase occurring from 2002 to 2004/05 and suggest that firms are responding to calls from investors.

Keywords: UK Corporate Governance, Disclosure Quality, Combined Code, Audit Committees

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Introduction

Previous literature illustrates the increasing importance shareholders are now placing on transparency and accountability within firms (Brennan and McDermott 2003). Investors are attracted by relevant and reliable corporate disclosure and are placing more reliance on non-financial disclosure to make investment decisions (Solomon 2013; Orens and Lybaret 2010). Additionally, shareholders have a role to play in monitoring firm disclosures and enforcing high levels of corporate governance (Heneghan 2006). In order to effectively carry out this role shareholders require reliable, quality information

Despite the increase in the value of corporate disclosure and corporate governance, research investigating the disclosure of corporate governance by firms is scarce. Only recently has research broadened to consider the accountability aspects of corporate governance (Solomon 2013). The lack of research in this area highlights the need for greater discussion and consideration of corporate governance disclosure by academics, regulators and shareholders. A particular focus of this study is the Combined Code on Corporate Governance (2003) which introduced many new recommendations including specific corporate governance disclosures by firms in their annual reports. These disclosures remain in the UK Corporate Governance Code (2012) and vary across different areas of corporate governance.

The main purposes of this study are to provide exploratory evidence on how companies listed in the

UK comply with the best practice guidance on corporate governance disclosure, as prescribed in the Combined Code (2003-2008) and to examine how these disclosures have changed over the period 2002 to 2009. Additionally, the study examines whether UK firms have complied with the annual report disclosure recommendations of the Combined Code (1998-2008). This analysis will provide an understanding of what corporate governance disclosure means for governance in general for UK listed firms.

To provide a comprehensive measure of how corporate governance disclosure levels of UK firms have changed from 2002 to 2009, a Corporate Governance Disclosure Score (CGDS) is designed and assigned to each individual firm in each sample period. Using data extracted from the annual reports of a sample of 40 firms, results identify a notable increase in the CGDS throughout the period. Specifically, findings suggest that significant improvements in corporate governance disclosure levels occurred between 2002 and 2009, with the greatest improvement taking place between 2002 and 2004/2005.

This study builds upon prior research by expanding the focus from simply how the corporate governance systems of a firm operate, to examining how they report upon their corporate governance practices in their annual reports as a means of communicating with shareholders. Additionally, this study responds to the call by Holland (1997) for further direct observation research methods to investigate corporate disclosures and disclosure

levels. The findings in this investigation provide a valuable reference point for further research hoping to assess reporting issues in and around corporate governance.

Prior Literature

Transparency in corporate governance is critical. According to Saeed *et al.* (2009) the public expectation of corporate governance is concerned with the transparency of information and the adequate monitoring of information disclosure. Transparency in all business information is becoming increasingly important and demanded by the public in light of recent corporate collapses. Regulation and best practice corporate governance guidance relies on proper disclosure and transparency to operate effectively. UK corporate governance guidance provides flexibility for firms to comply or depart from its provisions as long as any departure is adequately explained in the annual report.

Akerlof (1970) examines how a lack of quality information creates dishonesty within the market and argues that information asymmetry is an inherent risk in the business world which increases agency costs as it is caused by sellers (managers) knowing more information than buyers (investors). The cost of this dishonesty is not just borne by the dishonest company but the entire market, as investors feel uncertain. A lack of valuable, relevant and material disclosure relating to all aspects of companies in the past led to information asymmetry in the market (Moxey and Berendt 2008). Regulation requiring management to fully disclose their private information provides a solution to this problem (Healy and Palepu 2001). Economists often use this theory to justify the existence and need for regulation, as sellers have more information about goods offered than buyers leading to the efficient operation of capital markets which requires the transparency of information to be regulated (Saeed *et al.* 2009). Senior executives publicly disclose information because of external pressures and benchmarks and because they are aware of the benefits in the form of a market response from increased disclosure (Holland 1997). Chung *et al.* (2010) suggest that effective corporate governance can improve stock market liquidity, as it improves financial and operational transparency leading to a decrease in information asymmetries between managers and investors. Further, they report that firms which adopt corporate governance standards that improve transparency and protect shareholder interests may increase the firm value. Increased voluntary disclosure in all aspects of business reduces the information asymmetries between informed and uninformed investors which have been shown to lead to improved stock liquidity and a reduced cost of capital (Healy and Palepu 2001).

The Cadbury Report (1992) argues that the cornerstone of a robust system of corporate

governance system would consist of an effective board which drives the business forward, but within a framework of effective accountability (FRC 2006). This suggests that accountability is at the very foundation of good governance, and better disclosure will encourage greater levels of governance by the entire market.

Levitt (1998, p.1), highlighted the importance of meaningful corporate disclosure when he stated "If a company fails to provide meaningful disclosure to investors about where it has been, where it is, and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested". Prior research suggests that investors perceive a value to corporate disclosure and they are attracted to invest by relevant and reliable disclosure (Solomon 2013). Lang and Lundholm (1996) concluded that by providing more forthcoming disclosures, corporations can attract analysts, improve the accuracy of market expectations, reduce information asymmetry and limit market surprises, which may reduce the cost of capital. Sengupata (2008) similarly found that firms which consistently make timely and informative disclosure are charged a lower risk premium as they are perceived to be less likely of withholding value-relevant unfavourable information. Brennan and McDermott (2003) argue that interest in honesty, transparency and corporate governance rise in proportion to the number of corporate disasters, suggesting that more recently, interest in corporate governance disclosure is increasing.

Spira and Page (2009) recognise disclosure as being beneficial for many reasons including better corporate accountability, securing the exercise of good corporate governance, enabling better investment decisions and achieving the goals of regulators through indirect regulation. Investors are more concerned about quality not quantity and stronger reporting helps the board to consider more carefully about the key corporate governance issues relevant to their firm, thereby making the process of governance less of a compliance issue and more of an integral part of business success (Independent Audit Limited 2006).

The Office for Economic Co-operation and Development (OECD) cites 'Disclosure and Transparency' as one of its main Principles of Corporate Governance (2004). This principle outlines the importance of accurate and timely disclosure of information regarding all material, including governance matters. Such information is required to conform to high quality standards of financial and non-financial disclosure. The OECD Principles of Corporate Governance (2004) emphasise that markets work better when information is freely available and that companies, analysts and rating agencies have a role to play in providing such information. They also

call for an overall increase in independence and transparency (OECD 2011).

The Conceptual Framework for Financial Reporting (2010) identifies relevance and faithful representation as two fundamental characteristics of financial information. Comparability, verifiability, timeliness and understandability are also widely recognised as enhancing qualitative characteristics of financial information. In contrast, characteristics of non-financial information are not as widely considered or defined. However the developments of a knowledge economy, globalisation and new technologies have led to a decrease in the relevance of financial information. Analysts and investors alike increasingly rely on non-financial information to judge firm value and make investment decisions (Orens and Lybaret 2010). Perceived limitations of the annual report by companies include the domination of financial data and variables and the lack of qualitative information on the quality of management (Holland 1997). Thus it seems that these principles and the traditional desire in business to have sound, relevant and reliable financial reporting should also be applied to the increasingly valuable non-financial disclosures.

Corporate governance literature has been dominated by discussions and examinations of the process by which corporate governance operates and is whether or not firms are compliant with regulations/best practice, but there has been little investigation into the application of corporate governance within corporate reporting, and how corporate governance information is reported (Parker, 1997, Saeed *et al.* 2009). Amman *et al.* (2009) found that prior research has focused on examining corporate governance with regard to the board, remuneration and audit committees and the relationship between good corporate governance and firm value. A review by Brennan and Solomon (2008) of previous literature focusing on corporate governance and accountability found the majority of studies were traditionally based on agency theory and were conducted using quantitative methodologies. They also found that previous studies tend to focus on mechanisms of transparency particularly financial reporting and aligning these with corporate governance mechanisms of accountability, including audit committees, internal audit and risk management. They also contend that prior research has focused on the effects of corporate governance procedures and policies on financial reporting. However Brennan and Solomon's (2008) review calls for a consideration of accountability in corporate governance beyond the focus of financial reporting and that more research investigating the levels and quality of non-financial corporate disclosure is needed. Similarly Parker (2007) recognised that governance accountabilities extend beyond financial status and results. Thus a key focus of this study is to expand corporate governance research beyond the traditional mechanisms of

accounting mentioned by Brennan and Solomon (2008) to consider non-financial reporting and disclosure as a mechanism of accountability in corporate governance.

Corporate Governance Disclosure Guidance in the UK

In terms of reporting on the corporate governance mechanisms in place within the firm, UK guidance comes from the Financial Reporting Council (FRC). For a decade the Combined Code (1998-2008) represented the benchmark against which a UK company's standards of corporate governance were judged. Most of these provisions were re-applied in the creation of the current best practice guidance, the UK Corporate Governance Code (2010, 2012). Some of the provisions of the Combined Code (2003, 2006 and 2008) and the UK Corporate Governance Code (2012) require disclosures to be made in the annual report in order to comply with them (FRC 2011). Since data for this study is extracted from the annual reports of the sample firms for the period 2002-2009, the focus of this study will be the disclosure provisions in the Combined Code (2003, 2006 and 2008). No corporate governance disclosure provisions were contained in the first Combined Code (1998).

It has been claimed that regulation of corporate governance in the UK is light touch and is essentially controlled by three main bodies; the FRC, the Financial Services Authority (FSA), and shareholders (AccountancyAge, 2009). The FRC wrote the Combined Code (1998 - 2008), but have no policing or disciplinary role over compliance with it. From 2001 until 2013 when it was dissolved as part of the UK government's restructuring of financial regulation, the FSA held a disciplinary role by enforcing FSA Listing Rules that required companies to explain how they applied the principles of the Combined Code (1998-2008) and whether or not they complied with the provisions of it. However this Listing Rule was regarded by the FSA just as a disclosure obligation and is not statutory. In addition, this requirement is only a small part of the total disclosure requirements set out in the Combined Code (1998-2008). Therefore the remaining disclosure requirements remain to be regulated and enforced only by shareholders. This reflects the argument made by Bolkestein (2003) that the responsibility of the regulator is to set up the framework and to enable the market to play a disciplinary role.

With such an informal system of monitoring compliance with the Combined Code (1998-2008), it is questionable as to how meaningful governance disclosures made by UK firms actually are. This research aims to shed insight into this issue. The level of compliance with the Combined Code (1998-2008) is further questioned by Dewing and Russell's (2008) argument that enforcing compliance with a 'comply or explain' code is problematic, especially if de-

listing from the stock market is the only regulatory sanction available. In contrast, Bolkestein (2003) argues that a self-regulatory market approach combined with disclosure and transparency obligations is the way forward for corporate governance and that transparency and information are powerful tools for shareholders.

Saeed *et al.* (2009) argue that companies will not voluntarily uphold high principles of transparency, meaning that regulation of a firm's corporate disclosure is required. Moreover, Holland (1997) reports there are many perceived costs and benefits to disclosing voluntary information and that the perceived limitations of financial reporting often leads firms to believe that they must release increased voluntary information rather than simply statutory information for financial reporting purposes. Brennan and McDermott (2003, p.12) question the comprehensiveness of information provided in the annual report and suggested that without specific disclosure requirements, 'the annual report may remain an interesting rather than an influential document'. This highlights the importance and relevance of the specific annual report disclosures recommended by the Combined Code (2003-2008) which identifies the key areas where corporate governance disclosures should be provided: the board, board balance and independence, appointments to the board, performance evaluation, financial reporting, internal control, board subcommittees, dialogue with institutional shareholders and overall compliance.

A further interesting point of note is that while UK best practice corporate governance guidance is built on the premise that it principles based and not rules based, a firm *must* disclose its compliance/non-compliance with the Combined Code (2003-2008) in order to be listed on the stock market, meaning that, paradoxically, compliance with best practice guidance is not mandatory, but disclosure of compliance is compulsory. This highlights the level of importance placed upon corporate governance disclosures within the regulatory environment. As MacNeil and Li (2006) note, the operation and effectiveness of corporate governance in a firm is portrayed to and perceived by the shareholders through these disclosures and shareholders and potential investors base decisions on this information and use the disclosures as a mechanism to observe and monitor compliance with the Combined Code (2003-2008). The main corporate governance disclosure provisions of the Combined Code (2003-2008) and their focus are shown in Table 1 which shows that a primary focus of corporate governance disclosures are those relating to the board of directors and the independence of its members, including the chairman. The board of directors is the main internal control device within the corporation which helps to reduce agency costs by monitoring and ratifying management actions on behalf of the shareholders (Overbeek *et al.* 2007). The role of the board is not to engage in daily

management activities, but to delegate these responsibilities and monitor management's performance (Lipman 2007). Brennan and Solomon (2008) report that corporate governance research has been dominated by studies regarding the impact of board effectiveness on profitability and shareholder value, which highlights the importance of the board in corporate governance. However, the Irish Stock Exchange (ISE) and the Irish Association of Investment Managers (IAIM) (2010) contend that unless shareholders are familiar with the board, the only visible evidence of board quality are the disclosures made in the annual report.

Brennan and McDermott (2003) examined the independence of non-executive directors in Irish companies and found that information disclosed in the annual report needs to be more consistent. They found that specific information rather than more information is required on both executive and non-executive directors and that this information should be made explicit to prevent ambiguity. Although the importance of director independence is clear, the concept of independence is difficult to define (Overbeek *et al.* 2007). Non-executive directors are seen as being of societal importance, as they are the link between the company and its shareholders. Recently, it has been suggested that the societal interest in and workload of non-executive directors has intensified and yet society increasingly distrusts both executive and non-executive directors, due to the continuing financial scandals in which they have been complicit (Lückerath-Rovers and De Bos 2011).

Corporate governance guidance and regulation has consistently asserted that the chairman, as the leader of the board, must be independent (Cadbury Report, 1992; Combined Code 1998-2008; the UK Corporate Governance Code 2010, 2012). In the United States the role of chairman and CEO are often combined (Behan 2008). However, the Combined Code (1998-2008) recommends that both roles be separated. There has been notable debate and prior research regarding this issue (Felton and Anderson 2004, Tuggle *et al.* 2008). In the UK it is largely viewed that CEO duality weakens board independence and reduces the board's ability to monitor and control management (Tuggle *et al.* 2008). However research examining the disclosure of this important principle is scarce. This is highlighted by the fact that until 2010, reasons for the appointment of CEO as chairman was not specifically required to be disclosed in the UK.

In terms of performance evaluation, the Combined Code (2003-2008) states that the evaluation be conducted formally and rigorously. Shareholders are now encouraged to demand more informative disclosure with regard to annual board performance evaluation (Aguilar 2013). Disclosures regarding the process itself and resulting outcomes should be more meaningful (FRC 2009). PriceWaterhouseCoopers (2007) reported that less

than 50% of the FTSE 350 disclosed that their boards were operating in an effective manner. In addition, these disclosures were often unhelpful and of a boilerplate nature (Leblanc 2010).

The UK Corporate Governance Code (2010) introduced the requirement that an externally facilitated review is conducted once every three years by FTSE 350 companies. McKenzie (2011) suggests that good external evaluators bring objectivity, insight, challenge and understanding, which may partially explain why the FRC has given these parties a more prominent role. McKenzie (2011) further suggests that despite the numerous debates over the causes of huge corporate collapses in recent years, there are fewer discussions as to whether boards were subjected to effective evaluations, and suggests that perhaps these collapses may not have happened if initial evaluations had been undertaken and monitored correctly. Diereckx (2005) suggests that firms should be committed to their performance evaluation since deriving increased value from the evaluation is more desirable than merely compliance.

In terms of financial reporting disclosures, the going concern basis is fundamental to financial statement preparation, and directors are required to explicitly report whether it is appropriate for the coming year (FRC 2008). The reporting responsibilities of the auditor are presented via the audit report, which often includes a description of the director's responsibilities. The directors have a duty to maintain accounting records and have additional reporting duties depending on the size and status of the company, under the Companies Act 2006 (Institute of Chartered Accountants in England and Wales 2011).

As Table 1 shows, directors must now review and disclose the firm's risk management activities and strategies. Risk management systems, financial, operational, and compliance controls should all be considered in the review, and the annual report must disclose that this has been conducted. The FRC (2009) reports that the financial crisis has led to a greater consideration of the major risks faced by UK firms. Operational risk is considered to be dealt with appropriately whereas further guidance was found to be required for strategic risk. Jones (2010) provides a discussion of how the financial crisis provided the ultimate stress test in risk management and infers that many companies have accordingly reviewed and modified their risk management procedures. Despite these improvements, Jones (2010) calls for more quality disclosures on risk management in the future that provide details of the entire risk management process within the firm. The role of internal control as a corporate governance device has changed from being an integral part of an organisation in achieving goals, to a preventative system designed to minimise obstructions to goal achievement (Spira and Page 2009).

Details regarding the members and work of the audit, nomination and remuneration committees are required to be disclosed under the Combined Code (2003-2008). Board sub-committees are established mechanisms for improving board effectiveness (Brennan and Solomon 2008). The board delegates tasks to these smaller groups which should consist of mainly independent non-executive directors. Audit committees are regarded as a key means of enhancing board accountability (Brennan and Solomon 2008). Indeed past research has found that the mere existence of an audit committee has significant benefits for a company including improvements in the audit process, auditor independence, earnings quality, and reduces the likelihood of manipulation occurring within the firm (Fichtner 2010). The importance of the audit committee is identified by the Sarbanes-Oxley Act (2002), particularly the independence of its members (Overbeek *et al.* 2007). Remuneration committees provide important benefits by facilitating the objective management of executive pay (PriceWaterhouseCoopers 2004). Remuneration has been a recent area of particular focus, largely due to heightened concerns regarding remuneration and remuneration setting in financial institutions FRC (2009). O'Hare (2009) argued the most profound changes from the current crisis will be changes to governance arrangements and in particular in the governance of remuneration. Further, he claims that shareholders are focusing more on the oversight applied by the remuneration committee, and there is a greater demand for transparency and an effective governance framework between shareholders, remuneration committees and management.

Roche-Tarry (2009) provides a discussion of how the nomination committee has in the past had a relatively low profile in comparison to the other sub-committees of the board, despite its highly significant corporate governance role. It is noted that the nomination committee essentially determines the leadership of a company and that the board recruitment process has become a more rigorous and professional exercise, with an external advisor often used. Roche-Tarry (2009) suggests that the increased risk of corporate failure seen recently has forced committees to become more accountable and transparent and the nomination committee must appoint board members with the necessary and wide-ranging skills to survive this difficult business environment, which again serves to reinforce the strategic importance of the nomination committee.

In terms of dialogue with institutional shareholders, Davis and Alogna (2008) state that there is little evidence that boards regularly engage with their shareholders on governance matters. However, they identify certain benefits to this dialogue including understanding the shareholder's interests in long term objectives. Millstein (2008) suggests that boards design shareholder communication procedures

tailored to suit the company considering its size, shareholders and past governance issues.

The Combined Code (2003-2008) states that firms should provide a statement in the annual report of how it has applied the main principles of the Combined Code (2003-2008). Firms must state whether they have complied with the provisions throughout the accounting period, and details of non-compliance must be provided including the provision, the period, and the reasons for non-compliance.

The UK Corporate Governance Code (2010) introduced changes to the disclosure requirements in 2003. These additions required firms to disclose reasons for chief executives being appointed as the chairman of the board, explanations of how the directors generate long-term value for shareholders and the strategy for delivering the firm's long-term objectives and a report that the board has conducted a review of the effectiveness of the company's risk management in addition to the internal controls systems. No disclosure requirements were removed with the introduction of the UK Corporate Governance Code (2010).

Methodology

The central aims of this paper are to investigate how corporate governance disclosure levels within UK firms have changed over time and the extent of

compliance with disclosure requirements. This will allow the authors to present exploratory evidence on the implications of disclosure and disclosure compliance for UK corporate governance.

To gauge corporate governance disclosure within UK firms, the Combined Code (2003-2008) was analysed to identify the main areas of corporate governance recommended to be disclosed in the annual report. Changes in these disclosure recommendations between 1998 and 2008 were also identified. Based upon these recommendations, nineteen variables were designed to measure the level of company compliance with the individual disclosure requirements in their annual reports. These variables were applied to the annual reports of a sample of 40 UK listed firms for three periods; 2002, 2004/05 and 2009. These time periods selected as UK corporate governance underwent significant change during this period. Moreover, significant changes in the business and economic environment occurred between each of these three periods including; the Enron collapse, the introduction of the Sarbanes-Oxley Act (2002) which had global governance implications and the global financial crisis. Indeed it has been argued that a failure by firms to adhere to the spirit of good corporate governance was a primary factor in the global credit crunch (Moxey and Berendt, 2008).

Table 1. UK Corporate Governance Disclosure Provisions (Source: Combined Code (2003- 2008))

Corporate Governance Area	Provision
Board Balance and Independence	<ul style="list-style-type: none"> ▪ How the board operates, how decisions are made & how authority is delegated. ▪ The names of the chairman (and changes to his/her commitments), the CEO, the senior independent director, independent non-executive directors (and reasons for independence, where necessary) and the chairman and members of sub-committees of the board. ▪ The number & attendance of board and sub-committee members.
Performance Evaluation	<ul style="list-style-type: none"> ▪ How the annual performance evaluation of the board, its committees and directors has been conducted.
Financial Reporting	<ul style="list-style-type: none"> ▪ An explanation from the directors of their responsibility for preparing accounts. ▪ A statement by the auditors about their reporting responsibilities. ▪ A statement from the directors that the business is/is not a going concern.
Internal Control	<ul style="list-style-type: none"> ▪ A sound system of internal control must be maintained and its effectiveness must be reviewed annually. Risk management systems, financial, operational, and compliance controls should all be considered in the review, and the annual report must disclose that this has been conducted. ▪ The reasons for the absence of an internal audit function if it does not exist. ▪ How the independence and objectivity of the external auditor has been safeguarded in the provision of non-audit services.
Audit Committee	<ul style="list-style-type: none"> ▪ Details regarding members and how the audit committee operates. ▪ The reason(s) why the board does not accept the audit committee recommendation regarding the external auditor, where a disagreement occurs.

Nomination Committee	<ul style="list-style-type: none"> ▪ Details regarding members and how the nominations committee operates.
Remuneration Committee	<ul style="list-style-type: none"> ▪ Details regarding members and how the remuneration committee operates. ▪ Details of earnings received by an executive director where they serve elsewhere as a non-executive director. ▪ Reasons for a failure to use an external search consultancy when appointing a chairman or a non-executive director.
Dialogue with Institutional Shareholders	<ul style="list-style-type: none"> ▪ The steps the board has taken to understand the views of major shareholders.
Overall Compliance	<ul style="list-style-type: none"> ▪ A statement in the firm's annual report of how the main principles of the Combined Code (1998, 2003, 2006 and 2008) have been applied. ▪ A statement in the firm's annual report as to whether the firm has complied with the provisions of the Combined Code (1998, 2003, 2006 and 2008) throughout the accounting period. ▪ In the event of non-compliance, details of non-compliance must be provided including the provision, the period, and the reasons for non-compliance.

An analysis of annual report disclosures on corporate governance in these three periods will provide valuable insights into the changes, if any, occurring in the level of corporate governance disclosures made by firms. UK Best practice corporate governance guidance was updated by the Higgs Report (2003) which focused on the role and effectiveness of non-executive directors, and the Smith Report (2003) which focused the effective role that the audit committee can play in governance. The recommendations made by both reports, while initially negatively received, were endorsed and incorporated into the Combined Code (1998). Indeed, Tassell (2003, p.1) refers to these revisions as "the biggest shake up of the boardroom in more than a decade". In terms of data extracted from the annual reports of the sample firms for 2002, it should be noted that the Combined Code (1998) was the appropriate benchmark to judge standards of corporate governance in the sample firms at this stage and did not contain any specific disclosure recommendations for UK firms. Thus, 2002 may be regarded as the 'Pre' event phase of the analysis when UK guidance had yet to be changed in light of the Higgs Report (2003) and the Smith Report (2003). The variables used to measure corporate governance disclosure designed and applied to the data are based on the recommendations of the Combined Code (2003) and are applied retrospectively to the 2002 data to provide insight into the levels of corporate governance disclosure quality in the sample firms already in existence before such notable changes were made. This may also provide some insight into the affect these specific requirements had on the disclosure of corporate governance.

As mentioned, The Combined Code (1998) was revised in 2003, and introduced many changes, including the introduction of recommended specific corporate governance disclosures in the annual reports of firms. Thus 2004/05 may be regarded in this study as the 'Event phase' when the effects of the major changes made to UK corporate governance in 2003 were first felt. The Combined Code (2003) was

subsequently revised in 2006 and 2008 but no changes have been made to the disclosure recommendations of the Combined Code (2003) since their introduction. Hence, the disclosure recommendations of the Combined Code (2003, 2006, and 2008) are identical, meaning that the 2009 period included in the sample may be regarded as the 'Post Event' phase of the study.

Measuring corporate governance disclosure

Table 2 presents the variables applied to the data to assess the level of firms' corporate governance disclosures in the annual report over time. Variables denoted with '*' in Table 2 were not used in the analysis of the 2002 annual report disclosures as the main principles/part of the main principles to which these variables relate were not contained in the Combined Code (1998). These variables were used in the analysis of the 2004/2005 and 2009 annual reports only.

Rating Corporate Governance Disclosure

In recent years corporate governance has become increasingly important and is no longer a compliance exercise but an investment discipline (Sherman 2008). Corporate governance rating agencies are becoming increasingly widespread. For example Governance Metrics International has established itself as a global corporate governance rating agency. Moreover, the Stewardship Code (2012) has called for a stronger link to be created between governance and the investment process. Accordingly a Corporate Governance Disclosure Score (CGDS) was devised and applied to the sample firms. This measure will allow multiple facets of corporate governance disclosure to be aggregated into a single measure for a more concise understanding of corporate governance disclosure and how it has potentially changed over the sample period.

Table 2. Corporate Governance Disclosure Variables

Corporate Governance Area	Variable Definition
Board Balance and Independence	<ul style="list-style-type: none"> ▪ OP = '1' if the firm provides a statement of how the board operates; '0' if otherwise ▪ NAM = '1' if the firm discloses the names of the significant members of the board and its committees; '0' if otherwise. ▪ NED = '1' if the firm discloses the names of the independent non-executive directors (with reasons where necessary); '0' if otherwise. ▪ CHA = '1' if the firm discloses any other commitments of the chairman and changes to them during the year; '0' if otherwise. ▪ ATT = '1' if the firm discloses the director attendance and number of board and committee meetings; '0' if otherwise.
Performance Evaluation	<ul style="list-style-type: none"> ▪ PERF* = '1' if the firm discloses how performance evaluation of the board, its committees and directors has been conducted; '0' if otherwise.
Financial Reporting	<ul style="list-style-type: none"> ▪ 'RES = '1' If the directors and auditors provide a statement of their responsibility for preparing the accounts; '0' if otherwise. ▪ CON = '1' if the directors provide a statement that the business is a going concern; '0' if otherwise.
Internal Control	<ul style="list-style-type: none"> ▪ IC = '1' if the firm provides a report that the board has conducted a review of the effectiveness of the group's system of internal controls; '0' if otherwise. ▪ INTA = '1' if the firm has no internal audit function and provides an explanation for the absence of such; '0' if the firm has no internal audit function and fails to provide an explanation for the absence of such; 'N/A' if the firm has an internal audit function and therefore no explanation is required. ▪ NAS = '1' if the firm discloses how the objectivity and independence of the auditor is safeguarded in the provision of non-audit services; '0' if otherwise.
Audit Committee	<ul style="list-style-type: none"> ▪ AUD = '1' if the firm provides a description of the work of the audit committee; '0' if otherwise. ▪ REC = '1' if the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, and a statement from the audit committee is provided explaining the recommendation and the reasons why the board has taken a different decision; '0' if the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, and no statement of explanation is provided; 'N/A' if the board accepts the audit committee's recommendation and therefore no explanation is required.
Nomination Committee	<ul style="list-style-type: none"> ▪ NOM = '1' if the firm provides a description of the work of the nomination committee; '0' if otherwise.
Remuneration Committee	<ul style="list-style-type: none"> ▪ REM = '1' if the firm provides a description of the work of the remuneration committee; '0' if otherwise.
Dialogue with Institutional Shareholders	<ul style="list-style-type: none"> ▪ SHAR* = '1' if the firm discloses the steps taken by the board to ensure board members understand the views of major shareholders; '0' if otherwise.
Overall Compliance	<ul style="list-style-type: none"> ▪ STMT = '1' if the firm provides a statement of how the Main Principles of Section One of the Combined Code (1998, 2003, 2006 and 2008) have been applied; '0' if otherwise. ▪ COMP = '1' if the firm provides a statement as to whether it has complied or not complied throughout the period with all relevant provisions of Section One of the Combined Code (1998, 2003, 2006 and 2008); '0' if otherwise. ▪ NONC = '1' if the firm has not complied with all of the provisions set out in Section One of the Combined Code (1998, 2003, 2006 and 2008) and has disclosed the provision, period and reason for non-compliance; '0' if the firm has not complied with all of the provisions set out in Section One of the Combined Code (1998, 2003, 2006 and 2008) and has not disclosed the provision, period or reason for non-compliance; 'N/A' if the firm has complied with all of the provisions set out in Section One of the Combined Code (1998, 2003, 2006 and 2008).

The CGDS was calculated by combining the total values for all variables defined in Table 2 for each sample firm, dividing by the maximum score attainable and multiplying by 100. CGDS therefore

provides an indication of company's overall corporate governance disclosure compliance in each of the three periods. CGDS was analysed to identify the overall corporate governance disclosure trend over time between 2002 and 2009 in UK firms. It should be noted that the maximum score is determined for each period by totalling the maximum values available from each of the variables applicable to that period. A higher CGDS is argued to provide better governance and accountability for investors. Therefore, variables

which increase due to poorer corporate governance in Table 2 require certain adjustments which are explained in Table 3 below.

As well as examining how the CGDS of the sample firms changes over time, this investigation will employ non-parametric analysis to assess if there have been any statistically significant differences in CGDS between each of the sample periods of focus in the study.

Table 3. Variable Corporate Governance Disclosure Variables adjusted for Computation of CGDS

Corporate Governance Area	Variable Definition
Internal Control	▪ INTA = '1' if the firm has an internal audit function and therefore no explanation is required; '0' if the firm has no internal audit function and provides an explanation for the absence of such; '-1' if otherwise.
Audit Committee	▪ REC = '1' if the board accepts the audit committee's recommendation and therefore no explanation is required; '0' if the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, and a statement from the audit committee is provided explaining the recommendation and the reasons why the board has taken a different decision; '-1' if otherwise.
Overall Compliance	▪ NONC = '1' if the firm has complied with all of the provisions set out in Section One of the Combined Code (1998, 2003, 2006 and 2008); '0' if the firm has not complied with all of the provisions set out in Section One of the Combined Code (1998, 2003, 2006 and 2008) and has disclosed the provision, period and reason for non-compliance; '-1' if otherwise.

Analysis

Table 4 presents the descriptive statistics for the variables defined in Tables 2 and 3 for the sample firms for each time period. As all variables used in the study to measure corporate governance disclosure are dichotomous, the McNemar test is applied to the data to test for statistically significant differences in the data between the three time periods included in the study. Findings from this analysis are presented in Table 5.

As the results in Tables 4 and 5 show, there are notable differences in certain aspects of corporate governance disclosure between the periods investigated. When examining 2002 governance disclosures compared to those in 2004/05, tests reveal

evidence of a statistically significant difference in levels of disclosure regarding of the names of the significant members of the board and its committees (NAM); the names of the independent non-executive directors with reasons where necessary (NED); other commitments of the chairman (CHA); director attendance and number of board and committee meetings (ATT); a description of the work of the nomination committee (NOM); a description of the work of the remuneration committee (REM); and how the objectivity and independence of the auditor is safeguarded in the provision of non-audit services (NAS). As Tables 4 and 5 report, all of these variables increased significantly from 2002 to 2004/05.

Table 4. Descriptive Statistics: Corporate Governance Disclosure Variables

	2002			2004/05			2009		
	% yes	% no	% N/A	% yes	% no	% N/A	% yes	% no	% N/A
OP	60	40	-	75	25	-	90	10	-
NAM	75	25	-	92.5	7.5	-	95	5	-
NED	70	30	-	97.5	2.5	-	97.5	2.5	-
CHA	77.5	22.5	-	95	5	-	100	-	-
ATT	2.5	97.5	-	90	10	-	97.5	2.5	-
PERF	N/A	N/A	N/A	85	15	-	87.5	12.5	-
RES	100	-	-	100	-	-	100	-	-
CON	97.5	2.5	-	100	-	-	100	-	-
IC	100	-	-	100	-	-	100	-	-
INTA	2.5	12.5	85	7.5	2.5	90	2.5	5	92.5
NAS	67.5	32.5	-	100	-	-	100	-	-
AUD	100	-	-	100	-	-	100	-	-
REC	2.5	-	97.5	2.5	-	97.5	-	-	100
NOM	30	70	-	87.5	12.5	-	87.5	12.5	-
REM	5	95	-	70	30	-	82.5	17.5	-
SHAR	N/A	N/A	N/A	80	20	-	92.5	7.5	-
STMT	100	-	-	100	-	-	100	-	-
COMP	100	-	-	100	-	-	100	-	-
NONC	15	50	35	22.5	47.5	30	25	15	60

When comparing corporate governance disclosures between 2004/05 and 2009, the reported differences are considerably less pronounced. Tables 4 and 5 report a statistically significant difference between the number of firms that provided a statement of how the board operates (OP) between 2004/05 and 2009. In terms of comparisons in corporate governance disclosures between 2002 and 2009, there is a statistically significant increase in disclosures on how the board operates (OP); the names of the significant members of the board and its committees (NAM); any other commitments of the chairman (CHA); the director attendance and number

of board and committee meetings (ATT); the names of the independent non- executive directors with reasons where necessary (NED); a description of the work of the nomination committee (NOM); a description of the work of the remuneration committee (REM); and how the objectivity and independence of the auditor is safeguarded in the provision of non-audit services (NAS).

Presented below are the results of the McNemar test for statistical differences in the variables used to measure Corporate Governance Disclosure when compared between each time period.

Table 5. Tests of Statistical Difference

	2002 vs 2004/05	2004/05 vs 2009	2002 vs 2009
	P-value	P-value	P-value
OP	0.180	0.031**	0.000***
NAM	0.039**	1.000	0.008*
NED	0.001***	1.000	0.001***
CHA	0.016**	0.500	0.004**
ATT	0.000***	0.375	0.000***
PERF	N/A	1.000	N/A
RES	1.000	1.000	1.000
CON	1.000	1.000	1.000
IC	1.000	1.000	1.000
INTA	1.000	1.000	1.000
NAS	0.000***	1.000	0.000***
AUD	1.000	1.000	1.000
REC	1.000	N/A	N/A
NOM	0.000***	1.000	0.000***
REM	0.000***	0.227	0.000***
SHAR	N/A	0.125	N/A
STMT	1.000	1.000	1.000
COMP	1.000	1.000	1.000
NONC	1.000	0.219	0.125

‘***’ denotes significance at the 1% level,

‘**’ denotes significance at the 5% level and

‘*’ denotes significance at the 10% level.

Table 6 presents the descriptive statistics for the (CGDS₂₀₀₂), 2004/05 (CGDS_{2004/05}) and 2009 (CGDS₂₀₀₉).

Table 6. Descriptive statistics for the Corporate Governance Disclosure Score (CGDS)

	CGDS₀₀₂	CGDS_{2004/05}	CGDS₂₀₀₉
Minimum	0.429	0.563	0.750
Maximum	0.929	1.000	1.000
Mean	0.663	0.890	0.944
Std. Deviation	0.103	0.102	0.063
Variance	0.010	0.010	0.004

Overall, the trends show an improvement in the CGDS achieved by UK firms from 2002 to 2004/2005, with the average CGDS improving in each period from 66.3% (2002), to 89% (2004/2005) and greater still in 2009 (94.4%). A Wilcoxon signed rank test was used to measure the statistical significance of the changes in the CGDSs between each of the three periods. The untabulated results from these tests reveal evidence of statistically significant difference (at 1%) between each of the three time periods. Further analysis of these changes

finds that the CGDS of 37 of the 40 firms increased from the 2002 to the 2004/2005 period, while the CGDS of 19 firms increased from the 2004/2005 to the 2009. Finally, all firms report an increase in their CGDS from 2002 to 2009. Applying a McNemar test to the data to analyse these changes (untabulated) indicates a statistically significant higher difference between the CGDS for the sample that increased between the 2002 to 2004/2005 period compared to the number of individual firm scores that increased between the 2004/2005 to 2009 period.

Discussion of Findings

Together these findings yield evidence to suggest that, while certain areas of corporate governance disclosure require improvement, significant improvements have occurred in UK firms between 2002 and 2009 and that a more pronounced improvement occurred from 2002 to 2004/2005 compared to 2004/2005 to 2009.

It may be inferred that firms are responding to the demand for increased transparency and accountability in corporate governance. Results suggest that certain areas of corporate governance are better disclosed than others, particularly in relation to sub-committees of the board. Findings show that five disclosure recommendations have been fully disclosed by firms throughout the 2002 to 2009 period. UK firms are evidently aware of the importance of disclosures relating to the audit committee, as they have maintained full disclosure regarding its operations since 2002. This makes sense as the importance of the audit committee in improving board effectiveness and accountability has been extensively researched and established in the literature (Weidenbaum, 2003; Lumsden, 2004; Brennan and Solomon 2008; Laux and Laux, 2009), and was a main focus of the Sarbanes-Oxley Act (2002). Internal control and risk management have become an area of focus for firms since the financial crisis (FRC 2009). Consistently, results show that the effectiveness of internal control has been an area of full disclosure by UK firms since 2002. Most recently in 2009, firms fully disclosed any other commitments of the chairman and changes to them, a statement that the business is a going concern and how the independence and objectivity of the auditors had been safeguarded in the provision of non-audit services. In 2009 a total of eight variables were fully disclosed by all firms examined, which yields strong evidence of the commitment by these firms to providing more meaningful non-financial disclosure in their annual reports.

However, the results also show that full compliance with all the disclosure requirements of the Combined Code (2003-2008) was still not present in 2009. Despite recent increased focus by the business community on the corporate governance scandals where the primary issue is executive remuneration (ISE and IAIM 2010), 17.5% of the sample firms failed to fully disclose a description of the work of the remuneration committee (Spira and Bender 2004). O'Hare (2009) asserts that here will be a greater need for clarity in remuneration disclosures, the avoidance of remuneration jargon by firms after the financial crisis and that the focus should be on transparency rather than volumes of information. Findings in this study support this argument as it was found that many of the firms examined disclosed an extensive remuneration report, but the specific items recommended to be disclosed on the remuneration committee by the Combined Code (2003-2008) were

not included in their entirety. In addition, 12.5% of firms failed to provide a full description of the work of the nomination committee. The nomination committee has been recognised in prior literature as maintaining a lower profile than the other two subcommittees and yet it has a role which equally as important as it ultimately has a notable say in the future leadership of the firm (Roche-Tarry 2009). Overall, these results suggest that the nomination committee is overlooked in terms of corporate governance disclosures. Although describing the work of the remuneration and nomination committees were two areas where lower levels of compliance were observed, the study still reports that significant improvements have occurred in the number of firms complying with these two disclosures between 2002 and 2009, indicating that some efforts are being made to improve these important aspects of corporate governance.

Disclosure quality concerning performance evaluation of the board appears to be of some concern in the sample. McKenzie (2011) suggested that despite the debates over the causes of huge corporate collapses in recent years, there is little discussion as to whether boards had undergone effective evaluations and suggests that such collapses may not have occurred if director evaluations had been monitored. Results of this study suggest the undertaking of evaluations may not have been monitored, as the related disclosures in the annual reports did not exist for a notable 12.5% of firms in 2009. Previous research reports that more meaningful and informative disclosure regarding board performance is being called for by shareholders (FRC 2009). Findings in this study show that not all firms are disclosing the minimum requirements of the Combined Code (2003-2008) regarding board performance, supporting the argument that more disclosure and transparency.

The results of this research are consistent with those of the ISE and IAIM (2010) who examined Irish listed companies' annual report disclosures with the Combined Code (2006). The study found scope for improvement in the disclosures on the workings of key committees of the board, particularly specific aspects of the work of the nomination committee. It was also noted that the disclosure on the process of performance evaluation of the board was poor across the companies assessed. While this study examined data from the UK and the above report from Ireland, the similarity of findings is striking and may suggest that the reoccurring issues reflect the ineffectiveness of the Combined Code (2003-2008) disclosure requirements in certain areas, the arguably light touch regulation of the Combined Code (2003-2008) or the Anglo-Irish attitudes of firms towards corporate governance disclosure. This is an area of potential for future research.

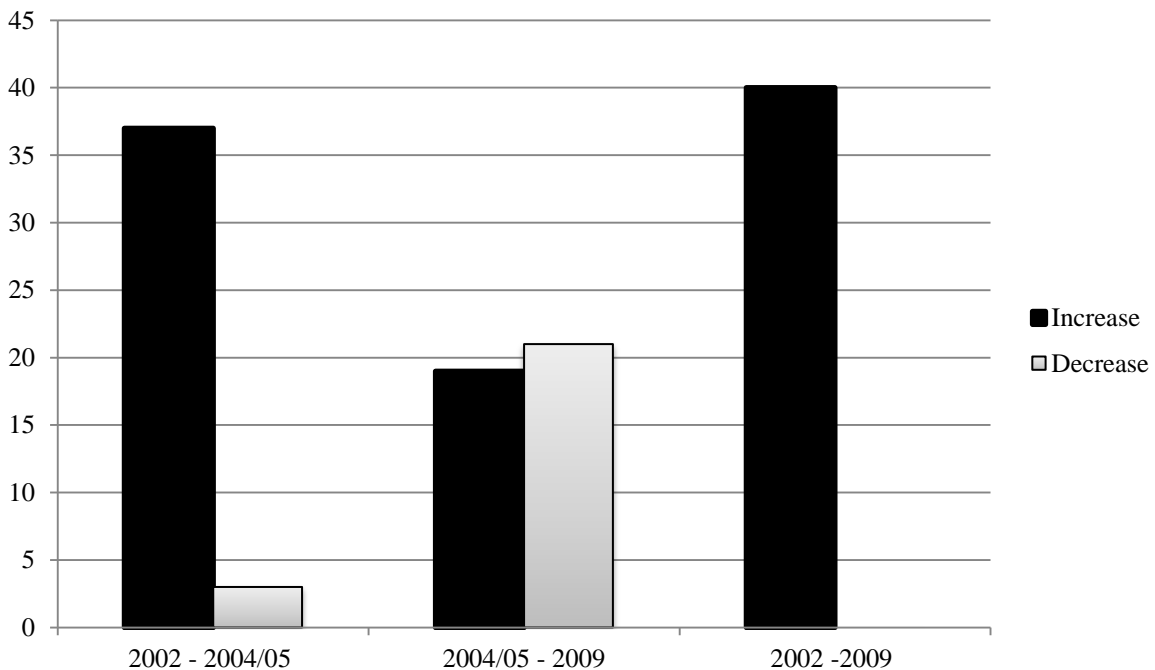
In terms of corporate governance compliance, the study reports that all 40 firms fully disclosed a statement of how the principles of the Combined

Code (2003-2008) had been applied and whether or not they had been fully compliant throughout the period. However, where divergence from specific provisions occurred, complete disclosure was not provided. In 2002, 77% of firms that did not fully comply with all provisions of the Combined Code (1998) failed to provide complete disclosure of the non-compliance. In the 2004/2005 period this decreased 68%, and in 2009 it further decreased to 38%. Although this is a decreasing trend, the overall level of firms failing to comply with this important requirement of the Combined Code (2003-2008) and appropriate listing rules is considerable, particularly in the 2002 and 2004/2005 periods. Compliance with this disclosure requirement should be monitored and enforced and yet it appears that full disclosure by all firms does not exist. This may reflect the inadequacy of the light touch regulatory approach, and the difficulty in enforcing a 'comply or explain' code if the only regulatory sanction is de-listing from the stock market, as suggested by Dewing and Russell (2008). These findings also support the ISE and IAIM (2010) study, which asserts that in circumstances of non-compliance with specific Combined Code (2003-2008) requirements, more meaningful explanation should be provided.

The application of the Corporate Governance Disclosure Score (CGDS) yields interesting insight into the sample. Overall the CGDS shows an increasing trend from one period to the next and that there was a significant increase in the CGDS between each of the three periods, suggesting that overall corporate governance disclosure by UK firms has been increasing significantly from 2002 to 2009 and that firms are accounting more fully for their corporate governance practices. The 2009 average CGDS of 94% suggests that recent corporate governance disclosure is strong.

The authors further analysed the CGDSs by examining the trends of individual firm scores between each period. Findings from this analysis are illustrated in Figure 1 and show that between 2002 and 2009 all of the sample firms' individual CGDSs increased. Between 2002 and 2004/2005 37 of 40 firms (92.5%) experienced an increase in their CGDS. However, between 2004/2005 and 2009, 21 firms (52.5%) experienced a decrease in their CGDS. The below chart depicts the change in the sample firm's Corporate Governance Disclosure Score (CGDS) across the three sample periods. The Y-axis measures the number of firms in the sample. The X-axis measures time changes.

Figure 1. Individual Firm CGDS Trends



This presents a more concerning suggestion, that although corporate governance disclosure has increased significantly since 2002, most of this change occurred between 2002 and 2004/2005. In addition, the decreasing CGDS in a large number of firms between 2004/2005 and 2009 may suggest that firm interest and concern for corporate governance disclosure is decreasing. The dramatic increase in disclosure compliance from 2002-2004/2005 may be

due to the major revisions made the Combined Code (1998) following the publication of the Higgs Report (2003) and the Smith Report (2003).

Brennan and McDermott (2003) emphasise the importance of specific disclosure requirements arguing that the annual report requires them in order to become an influential document. This may suggest that specific disclosure recommendations, even if voluntary, are effective. Saeed *et al.* (2009) argues

that firms will not voluntarily provide high levels of transparency without regulation. Thus the findings of this investigation may indicate that transparency in corporate governance dramatically increased with greater regulation in the form of the revised Combined Code (2003) and that specific disclosure requirements introduced in 2003 led to significantly greater disclosure in the firm's annual reports.

The significant positive change in corporate governance disclosure between 2002 and 2004/05 may also have been the response of firms to the huge corporate collapses that occurred around this time such as Enron and Worldcom. Brennan and McDermott (2003) suggest that interest in honesty, transparency and corporate governance rises in proportion to the number of corporate disasters which certainly was the case in between 2002 and 2004/2005. This may have put pressure on firms to significantly increase their transparency surrounding corporate governance matters and practices.

Conclusion

The purpose of this paper is to provide exploratory evidence on the quality of corporate governance disclosure. The results suggest that corporate governance disclosure by UK firms is significantly increasing. A failure by UK firms to adhere to the principles of good corporate governance has been blamed as part of the problem in recent corporate collapses and the global financial crisis (Moxey and Berendt, 2003) and some even argue that corporate governance is broken (AccountancyAge 2009). This study suggests that not all aspects of corporate governance are broken and while there are always methods of improving corporate governance, this paper provides exploratory evidence to suggest that corporate governance disclosure is strong and has improved significantly over an extremely financially turbulent period and that a focus by firms and emphasis by regulatory bodies on the importance of corporate governance disclosure must continue.

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