

# 'COMPLY OR EXPLAIN' IN BELGIUM, GERMANY, ITALY, THE NETHERLANDS AND THE UK: INSUFFICIENT EXPLANATIONS AND AN EMPIRICAL ANALYSIS

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## Abstract

This study analyses the level and quality of the application of the comply or explain principle for listed companies in Belgium, Germany, Italy, the Netherlands and the UK. Although the comply or explain principle has nowadays become a central element in the corporate governance of the EU, a common understanding of the scope and necessary conditions for it to work effectively has not yet been achieved. This study explains the comply or explain principle from the perspective of the economic theory (legitimacy theory and theory on market failure) and is the first study of the application of the principle in which consecutive years are analysed for multiple countries simultaneously with one research method. In previous research the quality of the explanations for the code provisions not complied with and the explanatory factors have often been overlooked, while these are the key elements of the current European debate. In this study 237 annual accounts for the years 2005-2007 are analysed for five countries. The results show that company size and the period of time the comply or explain principle has been applicable in a country predict the level and quality of compliance. Although the level of code compliance is high, the quality of the explanations for code provisions not complied with is insufficient. Further fine-tuning of the comply or explain principle is necessary to achieve the most effective application in order to make the principle work in practice as intended.

**Keywords:** Corporate Governance, Code, Comply or Explain Principle, Compliance, Disclosure

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## 1. Introduction

Through EU Directives 2006/46/EC and 2013/34/EU, the 2011 EU Green Paper on corporate governance and through national corporate governance codes, the comply or explain principle has nowadays become a central element in the corporate governance of the European Union (the EU). Nevertheless, a common understanding of the scope and necessary conditions for it to work effectively has not yet been achieved and is still a relevant and current matter of discussion. The EU Green Paper (EU Green Paper 2011) i.a. states that the explanations of deviations from the code provisions are unsatisfactory. This article reviews the quality of these explanations for the code provisions not complied with in Belgium, Germany, Italy, the Netherlands and the United Kingdom (the UK), as well as the possible explanatory factors. Until now no such study with a research period of more than one year and one research method for different countries simultaneously has existed. Moreover, in scientific literature the comply or explain principle is not or hardly explained from the perspective of the economic theory (legitimacy theory and theory on market failure). Section 2 of this article elucidates the principle from this perspective. Section 3 discusses the legal embedding of the comply or explain

principle, after which section 4 shortly addresses previously performed studies on the comply or explain principle. Section 5 explains the research method and dataset used, after which in section 6 the descriptive, bivariate and multivariate results are presented. Finally, section 7 summarises the results and gives the conclusions.

## 2. The comply or explain principle in theory

From the viewpoint of the agency theory (Jensen & Meckling 1976) the comply or explain principle is theoretically a variation on the disclosure remedy. To minimise the agency problems between agents and principals, a number of solutions (remedies) are developed (e.g. monitoring, commitment and alignment) (Alchian & Demsetz 1972). As such a remedy disclosure hopes to avoid information asymmetry and as a consequence thereof reduces opportunistic behaviour that results in agency costs (Santen 2007). The comply or explain principle is a disclosure as such and influenced by the legitimacy theory and the theory on market failure. Those theories are reviewed below so they can be elaborated further upon when researching the application of the comply or explain principle in practice.

## **2.1 Legitimacy theory**

The legitimacy theory throws light on the reasons why companies want and have to disclose information such as by means of the comply or explain principle. Maurer defines the theory as the process whereby an organisation (a company) justifies to a peer group or superordinate system its rights to exist (Maurer 1971). By searching for legitimacy companies increase their probability of survival which is common organisational behaviour (DiMaggio & Powel 1983) (Hooghiemstra, Van Ees et al. 2008). Today a company cannot afford to ignore society; the continuity of a company is dependable on the perception in society regarding its reputation. A company constantly needs to justify – i.a. by means of transparency - its existence and activities to society (Boot & Soeting 2004). The annual report is considered a very appropriate instrument for disclosing all this information, because of its degree of credibility not associated with other forms of advertising (Neu, Warsame et al. 1998). The development of corporate governance regulations regarding mandatory and voluntary disclosures (e.g. the comply or explain principle) can to a certain extent be clarified by the legitimacy theory. In the direct aftermath of the corporate scandals companies used i.a. the comply or explain principle to regain the trust of the shareholders and to legitimise their existence. By disclosing proper information in their annual accounts companies wanted to assure their stakeholders that their corporate governance structure was back in place, irregularities taken note of in time and scandals prevented. Nowadays companies still disclose based on the comply or explain principle for similar reasons. They want to signal to the market (by showing in annual accounts that the company fully complies with a corporate governance code or gives proper explanations for deviations) that they ‘exceed’ other companies and thus hope to attract additional investors - the signalling theory (Campbell, Shrivies et al. 2001).

## **2.2 Theory on market failure and information asymmetry**

Next to the legitimacy theory, the theory on market failure explicates the existence of disclosures and more in particular the comply or explain principle. Market failure encompasses a situation where, in any given market, the quantity or quality of a product demanded by consumers does not equate with the quantity or quality supplied by suppliers. This is a direct result of a lack of some ideal economical factors, which prevents a social optimum (Leftwich 1980). For example, the problem of information asymmetry is the lack of an ideal economical factor. No perfect financial market exists in which every agent and principal receive all the information needed (i.e. no information asymmetry) and in which moral

hazard and adverse selection do not occur. Nevertheless, one tries to minimise these problems to come as close as possible to achieving the perfect financial market, for instance by disclosing (mandatorily or voluntarily) the relevant information to prevent market failure (Schön 2006). A shareholder will only make a contribution to the equity of a company when the uncertainties of his investment can be decreased to a minimum: an investor makes an investment when the asymmetric information problem between him as principal and the management as agents is brought to a satisfactory level and compliance with disclosure regulations (among which the comply or explain principle) contributes thereto.

The comply or explain principle as a form of disclosure is theoretically embedded in the legitimacy theory and the theory on market failure. By legitimising their corporate governance to their stakeholders companies try to prevent market failure (agency costs) and gain trust and investments. As an instrument of corporate governance the comply or explain principle tries to make a contribution to the minimising of agency costs/problems and enhance good corporate governance. A change in the quality of information about corporate governance (‘transparency’) could have consequences for corporate governance itself (‘behaviour’) and vice versa, since governance and information about governance are inseparably linked (Hof et al. 2013). The comply or explain principle allows investors to determine to what extent a company has or has not complied, and to assess the company’s stated reasons for non-compliance. Investor pressure would tend to be the most immediate response to non-compliance. Such instances may lead investors, particularly those who can exert significant influence on the company (e.g., due to the size of their shareholding) to seek further information or assurance from the directors (Mallin 2009).

## **3. Judicial embedding of the comply or explain principle**

For the purpose of the interpretation of the results of the empirical research as set out in section 6, this section elaborates further on the legal embedding of the comply or explain principle in the five countries studied.

It was believed in the EU that what constitutes good corporate governance is continually evolving and ‘one size does not fit all’. Soft regulation by means of national corporate governance codes, together with the comply or explain principle, was therefore opted for. In 2006 this approach was confirmed by Directive 2006/46/EC, imposing that a listed company must include a corporate governance statement in its annual report which refers to the corporate governance code the company is subject to and also explains which parts of the code are deviated from and for what reasons. Directive 2013/34/EU - on

the annual (consolidated) financial statements and related reports of certain types of undertakings – furthermore imposes similar obligations on listed firms. The European Commission recently proposed to amend the latter directive in Directive 2014/208/EU, which was accompanied by a Recommendation on the quality of corporate governance reporting ('comply or explain'). Section III of the Recommendation explicitly states what information companies should provide for each departure from an individual recommendation of the code(s) they are subjected to. That information should moreover be sufficiently clear, accurate and comprehensive and refer to the specific characteristics

and situation of the company, such as size, company structure or ownership or any other relevant features. Also, explanations for deviations should be clearly presented in such a way that they are easy to find for shareholders, investors and other stakeholders, according to the Recommendation (Galle 2014).

The EU Member States have implemented Directive 2006/46/EC in different ways which is also reflected in their application of the code (see section 6). A distinction can be made between five defined judicial corporate governance arrangements as derived from Wymeersch and Voogsgeerd (Wymeersch 2005) (Voogsgeerd 2006) (see Table 1).

**Table 1.** Judicial corporate governance arrangements

Serial number	Name	Characteristics	Country
A	Pure self-regulation	<ul style="list-style-type: none"> <li>• Less detailed company law</li> <li>• No overlap between code and law</li> <li>• Code is alternative for legislation</li> </ul>	Belgium until 2010
B	Supported by non-statutory norms	<ul style="list-style-type: none"> <li>• Material norms in codes supported by regulation (e.g. listing rules)</li> <li>• Results: compliance with norms not entirely voluntary</li> </ul>	Italy until 2005 and United Kingdom
c	Facilitation by statutory rules	<ul style="list-style-type: none"> <li>• As B. but code is supported by or has basis in legislation</li> </ul>	The Netherlands. Belgium since 2010 and Italy since 2006
D	Regulation of self-regulation (meta-regulation)	<ul style="list-style-type: none"> <li>• E.g. as a result of non-compliance the legislation has more than a supporting or facilitating role</li> </ul>	Germany
E	Pure regulation	<ul style="list-style-type: none"> <li>• Codes are of no real importance</li> <li>• Accent on detailed national legislation</li> </ul>	

For the UK judicial corporate governance arrangement B applies; the code and the comply or explain principle are embedded in the listing rules; code and principle are supported by non-statutory norms. Judicial corporate governance arrangement C applies for the Netherlands, and nowadays for Belgium and Italy as well: the code and principle are supported by or have a legal basis in legislation. For Germany arrangement D (meta-regulation) applies: although the code has a basis in legislation, the code is not considered very important but rather the detailed national company law (regulation of self-regulation).

In the sections below concerning the empirical research, the influence of the method of legal embedding on the extent and quality of code compliance is researched further. It is initially expected that the stricter the comply or explain principles are embedded in a country, the better the code compliance and the quality of the explanations for the deviations will be. On the other hand, matters such as the experience with the comply or explain principle in a specific country and the culture in relation to self-regulation will also play a part.

#### **4. Previous studies on code compliance and the comply or explain principle**

Studies on code compliance - unlike studies on corporate governance characteristics - are quite rare, maybe even in their infancy and (with one exception (RiskMetrics Group 2009)) focus on one country with research methods that change annually. Most studies conducted have diffuse outcomes and only concern the relationship between compliance and performance. This section briefly mentions the main results of studies that do investigate the code compliance more thoroughly.

In 2006 Arcot and Bruno conducted a study of 245 non-financial UK companies for the period 1998-2004 (Arcot & Bruno 2006). They documented the degree of compliance and more importantly the quality of the explanations provided in the case of deviations from the code provisions. Although they conclude - based on their univariate analysis - that the compliance of the companies does increase during the years under review, some drawbacks in the system are highlighted. They find that for an average of 17% of the deviations no explanations are provided.

Moreover, in 51% of the cases the explanations are standard and uninformative and this even worsens for a company in which agency problems are likely to be serious (Arcot & Bruno 2006). Von Werder, Talaulicar and Kolat examine the annual accounts of 408 companies listed at the Frankfurt Stock exchange that have to comply with the German corporate governance code as adopted in 2002 (Von Werder, Talaulicar et al. 2005). They distinguish some neuralgic code provisions of which it is expected that they will not be complied with within the near future by more than 10 per cent of the companies. These provisions concern i.a. personal liability, board compensation and the structure of the supervisory board. Moreover, Von Werder, Talaulicar and Kolat conclude that the acceptance of the code provisions tends to increase with the size of the companies, as will also be researched in the underlying study. Goncharov, Werner and Zimmermann analysed whether there is a pricing effect connected to the declared degree of compliance to the German Corporate Governance Code for 61 (big) publicly traded German companies listed in the DAX 30 and MDAX. They find that the degree of compliance is value-relevant (Goncharov et al. 2006). In their study, Goncharov, Werner and Zimmermann measured hard compliance figures without taking the level of compliance and (the quality) of the specific explanation given by companies into account. Hooghiemstra and Van Ees examined the annual accounts of 126 Dutch companies in 2005 and as a consequence thereof doubt the effectiveness of the comply or explain principle, since the explanations for non-compliance are relatively standard and not built upon firm-specific circumstances. The underlying study uses more or less the same subdivision in reasons for non-compliance as in the study of Hooghiemstra, Van Ees and Van der Laan. Hooghiemstra, Van Ees and Van der Laan conclude that an emerging 'one size fits all' approach is visible which they consider not to be in line with the fundamental logic of the comply or explain principle (Hooghiemstra, Van Ees et al. 2008). Abma & Olaerts analysed the reasons provided by the 100 largest Dutch listed companies in the financial year 2010 for the non-application of four provisions of the Dutch Corporate Governance Code. They conclude that in a large majority of the cases in which a code provision has not been applied, the reasons have been formulated in general terms, a disclaimer has been incorporated, or no reason whatsoever is given (Abma & Olaerts, 2012).

The single international study on code compliance up till now is the "Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States" performed by the RiskMetrics Group in September 2009. They examined the compliance with the applicable codes for 270 listed companies from 18 Member States for the financial year 2008 (15 companies per country). Although no

annual developments in compliance can be reviewed, the study of the RiskMetrics Group showed some interesting results (RiskMetrics Group 2009); 86 per cent of the companies they reviewed provide some kind of comply or explain information regarding a corporate governance code and 23 per cent of those companies state that they comply with all the code provisions. The companies reviewed have an average of approximately three explanations per company. Code provisions concerning the board of directors and concerning remuneration are the provisions explained most often. Other code topics repeatedly explained are shareholder rights and duties, disclosure and audits. The explanations provided for these deviations mainly involve the presence of an important shareholder, the specificity of the companies' activities and contracts set up before the implementation of the code (RiskMetrics Group 2009). The average number of deviations is higher for mid-cap companies than for large-cap companies. In the end the RiskMetrics Group concluded that the comply or explain principle enjoys wide acceptance, although the quality of explanations is mainly considered to be at an unsatisfactory level and should be remedied by strengthening the comply or explain principle itself and by strengthening the role of market-wide monitors and statutory auditors (RiskMetrics Group 2009).

Based on the studies discussed above, it can be concluded that further research should - preferably from an international perspective and covering a period of more than one year - review the different concrete forms of code conformity together with underlying causes (such as the manner in which the code is implemented, the 'one size does not fit all approach', opportunistic behaviour or company's size) for the purpose of studying code compliance and the comply or explain principle more in-depth and, ultimately, to provide sufficient recommendations.

## 5. Data collection and methodology

This section explains the method of data collection for the underlying research, as well as the research method and variables, after which the research results are presented.

### 5.1 Data collection

A total of 237 annual accounts for the years 2005-2007 are reviewed for the five countries under research (Belgium, Germany, Italy, the Netherlands and the UK) by means of content analysis.<sup>14 15</sup> The annual accounts are reviewed for the application of the comply or explain principle and more specifically

<sup>14</sup> The research method content analysis is to be defined as a systematic, objective, quantitative analysis of message characteristics for making replicable inferences (Neuendorf 2002).

<sup>15</sup> The Cohen's kappa measured has a value between 0.419 and 0.807 and can be considered more than sufficient.

for the quality of the explanations provided. For the purpose of making relevant comparisons within the data collected, the annual accounts analysed concern companies listed for the three consecutive years 2005-2007 on the same stock exchange index within the same market capitalisation compartment (see Table 2). Of the companies remaining in the sample after this selection (For Belgium 56 companies, Germany 78 companies, Italy 227 companies, the Netherlands 37 companies and for the UK 384 companies.), 50 companies are selected per country. In the Netherlands only 37 companies were quoted on the same stock exchange (AEX, AMX or AMS) for three consecutive years and therefore all have been selected. The years under research are 2005, 2006 and 2007, since the comply or explain principle was applied in all the countries under research in these financial years (Not all companies have a financial

year corresponding with the calendar year. However, for the purpose of this study they are grouped in homogenous periods, i.e. 2005, 2006 and 2007 (more specifically 1 January to 31 December 2005, 1 January to 31 December 2006, and 1 January to 31 December 2007) (Arcot & Bruno 2006)) (Belgium since 2005, Germany since 2002, Italy since 2004, the Netherlands since 2004 and the UK since 1993) and during this period Directive 2006/46/EC, making the comply or explain principle mandatory for listed companies, was adopted by the EU Parliament and EU Council. Outdated research data is thus not a direct threat, since other (national) studies on code compliance with more recent data come to similar conclusions, although only based on one country and often one year and with no possibilities of country comparisons. Table 2 shows an overview of the research population.

**Table 2.** Research population

Compartment	Number per country		rr	NL	UK	Total
	BEL	GER				
A	23	35	25	27	25	135
B	17	15	15	10	15	72
C	10	0	10	0	10	30
Total	50	50	50	37	50	237

Compartment A includes companies with a market capitalisation which exceeds 1 billion euros.

Compartment B includes companies with a market capitalisation between 1 billion euros and 150 million euros.

Compartment C includes companies with a market capitalisation lower than 150 million euros.

The aim of the present study is to add to previous research, but its limitations are also acknowledged. The level of compliance of the companies under review is measured by the contents of the corporate governance-related information provided in their annual accounts. Unfortunately, companies may mention in their annual accounts that they comply with the provisions of the applicable code but they may deviate from it in practice. Material compliance with the code is hard to measure and this problem is inherent to the chosen corporate governance model. However, it is not simply the hard compliance figures that are of interest in this study, but rather the trends in the level of compliance and (the quality) of the specific explanations given by the companies. As Durisin and Puzone state regarding corporate governance research: “*There is an empirical gap in cross-national studies in the literature*” (Durisin & Puzone 2009).

## 5.2 Variables

Section 6 presents the most important results of the analyses conducted. A number of variables require some explanation. Firstly, the dependent variables themselves, secondly the level of compliance with the corporate governance codes and thirdly the quality of

the explanations provided for the deviations from the code provisions.

The *level and quality of the compliance* with the applicable corporate governance codes is measured by the contents of the annual accounts based on what the company itself indicates about code compliance. Whenever a company indicates a deviation from a code provision, it is measured as such for the dataset. This variable is named *CodecomplianceI* in this study. Whenever the quality of the explanations of the deviations is taken into account as well, this is measured with the dependent variable *CodecomplianceII*. The explanations are distinguished into six categories of quality as presented in Table 3. These subdivisions are based on previous research (Arcot & Bruno 2007) (Galle 2012). The underlying study considers the type 1, type 2 and type 3 explanations to be insufficient. Although type 4 and type 5 need further improvement, together with type 6 they are considered ‘sufficient’ and thus a correct application of the comply or explain principle (‘*made-to-measure*’ code compliance). Therefore, variable *CodecomplianceII* consists of the number of deviations from code provisions the company gives a sufficient explanation for (types 4, 5 and 6).

**Table 3.** Categories of quality of explanations

Serial Number	Category of explanation
1	No explanation: No explanation is provided by the company.
2	General: A general or non-specific (to the company) explanation is provided. Often standard phrases are used that do not provide any specific details. For example, explanations asserting that the non-compliance is in the best interests of the company, a market practice, or simply necessary.
3	Inline: An explanation which is general in nature but repeats phrases from the provision of the code not complied with.
4	Limited: An explanation which provides more information than General or Inline but still falls short of being unique to the company's characteristics' circumstances.
5	Transitional: An explanation which points to a transitional situation facing the company due to which it is temporarily not compliant.
6	Genuine: Explanations that are judged genuine and in the spirit of the applicable code. Such explanations are specific to the company, motivated in detail and variable.

(Arcot & Bruno 2007) (Galle 2012)

It is expected that, due to the fact that companies need *Time* to adapt to the rules as laid down in the code and time to get used to the comply or explain principle itself, the level and quality of compliance increase during the years in which the comply or explain principle is applicable. Previous research on this matter shows various outcomes: claiming that time does or does not have an effect, or sometimes a (temporary) small decrease or a point of saturation has been reached (Shabbir 2008) (Weir & Laing 2000) (Arcot & Bruno 2006). Hence, the number of years the comply or explain principle has been applicable in a country (varying from 1 to 15 years) is the variable *Time* in the analyses presented below. Moreover it is of interest to review whether the *Judicial corporate governance arrangement* as elaborated upon in section 3 is of influence on the application of the principle. It is expected that the stronger a comply or explain principle is embedded in a country the higher the level of compliance and/or quality of explanations will be, since a strong embedding (e.g. the comply or explain principle is laid down in statutory norms) possibly shows faith in and consensus about the principle and, as a consequence, more compliance. Finally, the *Firm size* (presented in three market capitalisation compartments and the country's three main stock exchange indices) is an important variable. As a result of relatively lower compliance costs and greater

visibility (Pollock, Fischer et al. 2002) larger firms are expected to have a higher level of code compliance than smaller companies (Talauciar & Von Werder 2008) (Hooghiemstra, Van Ees & Van der Laan 2008).

## 6. Results

### 6.1 Descriptive results

Table 4 shows per year and per country the level of compliance measured by the number of code provisions the company claims to comply with (*CodecomplianceI*). Code compliance can be expressed as a percentage or the number of deviations. The number of deviations in itself does not provide any substantial information since the number of code provisions per country vary considerably (from 36 provisions for Italy in 2005 to 128 provisions for the Netherlands to which the comply or explain principle is applicable). Per company an average of 2.5 code provisions not complied with were deduced. The percentages in themselves are rather high, but the manner the comply or explain principle is actually applied is not taken into account. Possibly no explanation is provided for a deviation from a code provision or only a very general explanation is provided.

**Table 4.** Compliance rates *CodecomplianceI* (code provisions complied with)

Country	Percentages code compliance 2005	Percentages code compliance 2006	Percentages code compliance 2007	Percentages code compliance 2005-2007	Number of deviations 2005-2007	Average number of deviations per company
BEL	96.53	96.60	96.50	96.54	397	3.01
GER	92.70	94.00	94.29	93.67	383	2.55
IT	95.83	97.65	98.11	97.48	234	1.56
NL (selected)	94.99	95.35	95.17	95.17	573	5.46
UK	96.75	97.33	97.63	97.24	199	1.33
Average for countries	95.50	96.32	96.43	96.11	1786	2.51

Table 5 provides a more informative overview since the quality of the explanations is taken into account as well (*CodecomplianceII*). Table 5 shows per year and per country the level of compliance expressed in percentages consisting of the code provisions complied with together with the deviations with a sufficient explanation (thus the highest three categories of quality of explanation, being (4) an explanation which provides more than only general

information but still falls short of being unique to the company's characteristics/circumstances, (5) an explanation which points to a transitional situation facing the company due to which it is temporarily not compliant or (6) an explanation specific to the company, motivated in detail and variable). Furthermore table 5 presents the average number of insufficient explanations per company.

**Table 5.** Compliance rates CodecomplianceII (code provisions complied with and sufficiently explained deviations)

Country	Percentages code compliance 2005	Percentages code compliance 2006	Percentages code compliance 2007	Percentages code compliance 2005-2007	Average number of insufficient explanations per company
BEL	98.26	98.41	98.08	98.25	1.52
GER	95.90	96.50	96.83	96.41	1.45
IT	97.61	98.69	99.15	98.67	0.83
NX	99.19	99.37	98.79	99.12	1.00
UK	98.71	99.00	99.00	98.90	0.53
Average for countries	98.18	98.56	98.48	98.42	1.02

Especially the last few per cent up to one hundred per cent matter, since in these cases the comply or explain principle is not applied sufficiently: or in other words the 'explain' in the comply or

explain principle fails. Table 6 presents per country the six distinguished categories of quality of explanations of code provisions not complied with expressed in percentages.

**Table 6.** Categories of quality of explanations expressed in percentages

Country	Percentage per category			Subtotal insufficient	Limited	Transitional	Genuine	Subtotal sufficient
	No explanation	General	Inline					
BEL	18.62	29.08	2.55	50.26	27.55	6.38	15.82	49.74
GER	23.58	17.01	16.72	57.31	21.19	6.27	15.22	42.69
IT	14.21	36.04	0.00	50.25	38.07	2.54	9.14	49.75
NL	7.79	7.79	334	18.92	48.42	13.54	19.11	81.08
UK	13.44	25.27	0.54	39.25	3236	23.66	4.84	60.75
Average	14.98	20.07	5.15	40.21	34.87	10.19	14.74	59.79

Sufficient explanations for non-compliance are too often absent (40.2 per cent of the explanations are insufficient). Per company an average of 2.5 deviations was deduced, of which on average 1 deviation was insufficient. The underlying study does not argue for 100% application of the code provisions, but for 'applied and explained sufficiently' (apply the code provisions and, for the deviations, provide a sufficient explanation), as in that case the 'one size does not fit all' and 'made to measure' approach are taken into account, whilst the comply or explain principle is applied as intended.

## 6.2 Bivariate results (correlations)

### 6.2.1 Variable Time

As already indicated above, in this study it is expected that the level and quality of compliance are positively related to the time the comply or explain principle has been applicable in a country. Since companies need time to adapt to the rules as laid down in the code and time to get used to the comply or explain principle itself, the level and quality of compliance increase during the years in which the comply or explain principle has been applicable. Table 7 shows negative significant (at the 0.01 level) relationships: the longer the comply or explain principle has been applicable, the lower the number of deviations (with insufficient explanations).

**Table 7.** Correlation analysis (Pearson) between Codecompliance I and Codecompliance II and time

	CodecomplianceI	CodecomplianceII	Time
CodecomplianceI	1		
CodecomplianceII	.590(**)	1	
Time	-.226(**)	-.156(**)	1

\*\* =  $p < 0.01$ ; \* =  $p < 0.05$ ;  $n = 711$

The co-relation coefficient is Pearson's correlation since ratio variables are used (Van Datten 2002)

CodecomplianceI: Number of deviations

CodecomplianceII: Number of deviations with an insufficient explanation (categories 1, 2, 3)

Time: The period of time the principle has been applicable (varying from 1 to 15 years)

### 6.2.2 Variable Judicial corporate governance arrangement

In Table 1 the five possible ways of legal embedding of the comply or explain principle have already been presented (being pure self-regulation, supported by non-statutory norms, facilitation by statutory rules, regulation of self-regulation and pure regulation). It is expected that the stronger a comply or explain principle is legally embedded in a country the higher the level of compliance and/or quality of explanations

is. For the regulation of self-regulation (meta-regulation) the best scores are expected compared to the other ways of legal embedding. Since the variable *Judicial corporate governance arrangement* is a nominal variable, an ANOVA-test is performed and for the purpose of better understanding, only the significant details are summarised in Table 8 (Van Dalen & De Leede 2002) (The ANOVA has a significance of 0.001 or lower and the F-value is between 5.831 and 21.707, implying that the overall ANOVA-test is significant (Field 2005)).

**Table 8.** Analysis (ANOVA-test) between CodecomplianceI and CodecomplianceII and the Judicial corporate governance arrangement

	Judicial arrangement I	Judicial arrangement II	Difference between I and II	Conclusion results
CodecomplianceI	Pure self-regulation (mean 2.6467)	<b>Non-statutory norms (mean 1.37 = lowest)</b>	1.27667(*)	Pure self-regulation significant lower compliance than non-statutory norms
	Pure self-regulation (mean 2.6467)	<b>Statutory rules (mean 3.4692 = highest)</b>	-.82253(*)	Statutory rules significant lower compliance than self-regulation
	<b>Non-statutory norms (mean 1.37 = lowest)</b>	Statutory rules (mean 3.4692 = highest)	-2.09919(*)	Statutory rules significant lower compliance than non-statutory norms
	<b>Non-statutory norms (mean 1.37 = lowest)</b>	Meta-regulation (mean 2.5533)	-1.18333(*)	Meta-regulation significant lower compliance than non-statutory norms
Statutory rules (mean 3.4692 = highest)	Meta-regulation (mean 2.5533)	.91586(*)	Statutory rules significant lower compliance than meta-regulation	
CodecomplianceII	Pure self-regulation (mean 1.34)	<b>Non-statutory norms (mean 0.61 = lowest)</b>	.73000(*)	Pure self-regulation significant lower compliance than non-statutory norms
	Pure self-regulation (mean 1.34)	Statutory rules (0.8815)	.45848(*)	Self-regulation significant lower compliance than statutory rules
	<b>Non-statutory norms (mean 0.61 = lowest)</b>	Meta-regulation (mean 1.4467 = highest)	-.83667(*)	Meta-regulation significant lower compliance than non-statutory norms
	Statutory rules (0.8815)	Meta-regulation (mean 1.4467 = highest)	-.56515(*)	Meta-regulation significant lower compliance than statutory rules

\*. The mean difference is significant at the .05 level.

CodecomplianceI: Number of deviations

CodecomplianceII: Number of deviations with an insufficient explanation (categories 1, 2, 3)



The results in Table 8 show the differences in the level of compliance between two different ways of legal embedding: hence the manner of embedding is of influence on the level of compliance. Both for *CodecomplianceI* as *CodecomplianceII* (that takes the quality of the explanations into account), the companies for which the comply or explain principle has been laid down in non-statutory norms score best (lowest means (1.37 and 0.61) thus fewest deviations); they have the highest compliance rate compared to the other corporate governance arrangements. Meta-regulation or statutory rules alternately score lowest for the different levels of code compliance (highest means thus most deviations). It was expected that the stronger a comply or explain principle is embedded in a country the higher the level of compliance and/or quality of explanations will be, since a strong embedding shows faith in and consensus about the principle and likely more compliance. Therefore, one would expect the corporate governance arrangement of meta-regulation and the comply or explain principle laid down in statutory rules to achieve the highest compliance

rates. Apparently the comply or explain principle laid down in non-statutory norms (e.g. listing rules) suffices for the highest compliance rates. Possibly this is concluded too easily and therefore the other variables are also included in the multivariate analyses. Of further interest are variables such as the time the principle has been applicable. For example, in the UK the judicial corporate governance arrangement involves a national corporate governance code and a comply or explain principle supported by non-statutory norms, but it also has a long period of application of the principle.

### 6.2.3 Variable Firm size

Firm size is considered a common predictor for code compliance; as a result of relatively lower compliance costs (Dedman 2000) and greater visibility (Pollock, Fischer et al. 2002) larger firms are expected to have a higher level of code compliance than smaller companies (Talaucar & Von Werder 2008) (Hooghiemstra, Van Ees & Van der Laan 2008).

**Tables 9a/b.** Correlation analysis (Spearman's rho) between number *CodecomplianceI* and *CodecomplianceII* and *Firm size*

	CodecomplianceI	CodecomplianceII	Compartment
CodecomplianceI	1		
CodecomplianceII	.653(**)	1	
Compartment	0.024	.114(**)	1

\*\* = p < 0.01; \* = p < 0.05; n = 711

The correlation coefficient is Spearman's correlation since ordinal and ratio variables are used (Van Dalen 2002) (Field 2005)

CodecomplianceI Number of deviations

CodecomplianceII Number of deviations with an insufficient explanation (categories 1, 2, 3)

Compartment The compartment the company is subject to (large caps, midcaps and small caps measured by market capitalisation)

	CodecomplianceI	CodecomplianceII	Indextype
CodecomplianceI	1		
CodecomplianceII	.653(**)	1	
Indextype	.101(**)	.093(**)	1

\*\* = p < 0.01; \* = p < 0.05; n = 711

The correlation coefficient is Spearman's correlation since ordinal and ratio variables are used (Van Dalen 2002) (Field 2005)

CodecomplianceI Number of deviations

CodecomplianceII Number of deviations with an insufficient explanation (categories 1, 2, 3)

Indextype The index type the company is listed on (a country's three main stock exchange indexes)

Tables 9a and 9b show no significant relationship between market capitalisation (*Compartment*) and *CodecomplianceI* (the number of deviations indicated by the companies). However, when the quality of the explanations for the deviations is taken into account a significant positive relationship is visible; hence, the smaller the company (the lower the market capitalisation), the lower the level of compliance (the more deviations with an insufficient explanation). Next to market capitalisation the stock exchange index is also a commonly used variable in the size hypotheses (Andres & Theissen 2008) (Von

Werder, Talaucar et al. 2005). Since per country the indices and their admission criteria differ, a country's main stock exchange index is coded as 1, first to main stock exchange as 2 and second to main stock exchange as 3 (*Indextype*). For both levels of compliance, a positive relationship (at 0.01 level) with the *Indextype* can be seen, hence implying that the smaller the company (the higher the code for the stock exchange), the lower the code compliance (the more deviations) and thus confirming the stock exchange index hypothesis.

### 6.3 Multivariate results

This section presents the results of the regression analyses. The results of the analyses for the variables *CodecomplianceI* and *CodecomplianceII* (now expressed in percentages) with the time the comply or explain principle has been applicable in a country (varying from 1 to 15 years), the *Judicial corporate governance arrangement* and the *Firm size* (expressed in market capitalisation compartment and the three main stock exchange indices) (The meta-regulation, small caps and second to main index dummies are excluded from the models for several reasons: (i) one less dummy than the recoded groups is necessary for a linear regression model with dummies, (ii) based on

the bivariate results these dummies are excluded from the models since they are considered to be of less interest, and (iii) in testing different models the current model shows most significance). Table 10 below shows the results of the linear regression (The  $R^2$  varies from 0.156 for model *CodecomplianceI* and 0.157 for model *CodecomplianceII* stating that 16% of the total variance in the level of compliance is explained by the independent variables, i.e. the model. The F-ratio is 16.257 for *CodecomplianceI* and 16.368 for *CodecomplianceII* implying that the level of compliance can significantly be explained and predicted by the models).

**Table. 10** Results of linear regression

Variable	Model	
	CodecomplianceI	CodecomplianceII
Variable Intercept	91.541	94.773
Time	146.9413**	215.805**
Pure self-regulation dummy	4.130	2.689
Non-statutory norms dummy	8.835**	8.162**
Statutory rules dummy	1.981	1.552
Large caps dummy	3.857**	4.289**
Midcaps dummy	2.978	2.83
Main index dummy	7.2286**	9.746**
First to main index dummy	-1.263	0.412
$\sigma^2$	(2.1769)*	1,008
$R^2$	-0.725	0.024
Adjusted R2	-1.507	0.071
F-statistic	2.770	0.854
	4.676**	2.046*
	2.442	0.803
	5.367**	2.503*
	13.900	6,907
	0.156	0.157
	0.147	0.148
	16.257**	16.368**

\*\* =  $p < 0.01$ ; \* =  $p < 0.05$ ;  $n = 711$

For both models the variable *Time* shows a positive significant correlation ( $p < 0.01$ ) with the level and quality of compliance, therewith predicting that the longer the comply or explain principle has been applicable, the higher the level of compliance (0.227% for *CodecomplianceI* and 0.136% for *CodecomplianceII*). With respect to the *Judicial corporate governance arrangement* both models analysed are significant ( $p < 0.01$ ). In model *CodecomplianceI*, self-regulation scores best (4.130). But when taking the quality of the explanations into account (model *CodecomplianceII*) the stricter

corporate governance arrangement with statutory rules predicts the highest level of compliance (2.830). The explanatory variables of the market capitalisation show almost no significance, hence *Firm size* does not seem to matter. However, the stock exchange index dummies show the contrary. For both the models *CodecomplianceI* and *CodecomplianceII* it is predicted that, taking all the variables into account, the more important the index the company is listed on (in practice the larger the company), the higher the predicted increase in the level and quality of compliance.

## 7. Summary and conclusions

Recent study shows that the explanations for deviations from code provisions are often unsatisfactory. Often a non-company specific and uniform explanation is provided for a deviation from a provision of the national corporate governance code. The EU asks for further attention to achieve actual improvement in the application in practice. The second section of this article explains that the comply or explain principle is influenced by the legitimacy theory and the theory on market failure and information asymmetry. By applying the comply or explain principle in their annual accounts, companies want to legitimatise their corporate governance structure and attempt to minimise the information asymmetry and therewith hopefully attract investors. Section 3 discusses further that the comply or explain principle and the national corporate governance codes can be legally embedded in different ways in the national judicial systems. Nowadays the comply or explain principle is legally embedded in legislation or listing rules; which of these two possibilities depends on matters such as the experience with the comply or explain principle in a country, and culture in relation to self-regulation. Section 4 briefly describes previously conducted research of the comply or explain principle.

In this study 237 annual reports are analysed by their contents for the years 2005-2007 for the countries Belgium, Germany, Italy, the Netherlands and the United Kingdom. The level and quality of code compliance was researched further. The level of the compliance with the applicable corporate governance codes is measured by the contents of the annual accounts based on what the company itself indicates about code compliance. Whenever a company indicates a deviation from a code provision, it is measured as such for the dataset. Whenever the quality of the explanations of the deviations is taken into account as well, then the explanations are distinguished into six categories of quality of which the highest three categories are regarded as 'sufficient' explanations and therewith as a correct application of the comply or explain principle. The descriptives show that the level of code compliance in the period analysed in itself is high (from 92.70% to 98.11%) and that per company an average of 2.5 code provisions are not complied with. However, when the quality of the explanations is taken into account, it is clear that a substantial part of the code provisions not complied with is explained insufficiently (40.2%).

This study believes in the 'one size does not fit all' approach and therefore does not argue for 100% compliance. However, the explanations for the code provisions not complied with need to be sufficient. The analyses show that the period of time the comply or explain principle has been applicable in a country predicts the level and quality of compliance. The same applies for company size: the bigger the

company, the higher the level and quality of compliance. Regarding the legal embedding of the comply or explain principle in a country, legal embedding in non-statutory norms (listing rules) seems most sufficient, although the legal system and cultural characteristics are not taken into account whilst probably significant. According to the EU Commission this is indeed a topic requiring further research, since improvements in the application of the comply or explain principle are deemed necessary. Recently published guidelines of the corporate governance monitoring committees in the Netherlands and the UK on how to explain non-compliance with code provisions are certainly a step forward (Monitoring Committee 2012), but further fine-tuning remains necessary to achieve a common understanding of the principle's scope and most effective form in order to make the principle work in practice as intended: enhancing the corporate governance within companies whilst making 'made to measure' compliance possible. Although a central element of EU corporate governance, the comply or explain principle is surprisingly not often a topic of research, let alone internationally researched, covering a period of more than one year. As acknowledged by the EU Commission, improvements in the application of the principle are deemed necessary; therefore further research is of interest. The users of the annual accounts are best served by understandable, company-specific and transparent statements. However, it must be kept in mind that the comply or explain principle is not a panacea and has its weaknesses. As far as self-regulation is concerned, success is only within reach when enough awareness and support exist. To end with the beginning of this article: as it is a central element of EU corporate governance, constant care is required to keep the comply or explain principle in top form.

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