Original Article

The comply-or-explain principle: Stakeholders' views on how to improve the 'explain' approach

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ABSTRACT **The comply-or-explain principle is a central element in the EU corporate governance framework that was put in place by Directive 2006/46/EC. While avoiding an inflexible 'one size fits all' approach, the principle has lately been questioned because of the quality of corporate governance reports it has allowed European companies to produce; these companies can either comply with code provisions, or may explain why they do not comply, that is, why they deviate from a provision of the code. Seidl *et al*, in analyzing 257 listed companies that had produced some 715 records of deviations, and their respective 'explanations', found that, in contrast to the original idea of comply-or-explain, which emphasized the possibility of justifying deviations with situation-specific reasons, a significant number of the deviations analyzed were either not justified at all (that is, they were simply disclosed) or were justified on the basis of objections of principle (for example, that the code provisions were inappropriate because they failed to embody best practice). An increasing number of studies provide evidence that corporate governance statements disclosed on European stock markets lack quality, mainly in terms of the explanations they include when the companies do not comply with code provisions. In addressing this issue, the European Commission launched a wide-ranging consultation seeking views on how the 'explain' approach could be improved. From this consultation we analyzed 244 stakeholders' responses, generating an empirically derived taxonomy of responses. First, we examine these by providing a descriptive account of the different ways in which stakeholders agree that the 'explain' option should be used, and what kind of alternative solutions companies should disclose. Second, we discuss the possible implications for code regimes and for management control.**
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INTRODUCTION

When making investment decisions, investors need to have confidence that a company's business is being well managed and will continue

to be well managed in the foreseeable future. To gain this confidence, one of the main things investors look at is the information disclosed by the company's management in reports such as annual reports and corporate governance statements (Mallin, 2010). Corporate governance statements provide information about how a company is governed, and ultimately about how the organization is managed. The information is delivered to investors and other interested stakeholders through reports or statements. However, the information is typically based on a set of non-binding principles that are often known as codes of corporate governance (codes) and are developed by different national and international standard setters such as the European Commission (EC). The common belief is that the application of these codes fosters best practice for the governance of companies.

In Europe the idea of generating best practice codes for companies – typically for listed companies – and their management began in the early 1990s after a series of scandals and related failures of listed companies, particularly in the United Kingdom. A central element of most codes is the comply-or-explain principle that was first put forward in the UK Cadbury Report of 1992. The document required that '[L]isted companies … should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance' (Cadbury Report, 1992, p. 17). This principle became a milestone in the development of the framework for European corporate governance, which guides listed companies toward the adoption of what the leading market participants consider to be best practice (Demirag and Solomon, 2003). Supported by the High Level Group of Company Law Experts, and promoted by the EC for use by Member States, the concept ultimately triggered Directive 2006/46/EC; this Directive made it mandatory for all listed companies to include a corporate governance statement in their annual reports, and for companies to explain if they departed from parts of the corporate governance code and to give the reasons for this departure.

Despite the legal implementation of the principle at an EU level and its wide promotion by various national and international organizations, recent studies (MacNeil and Li, 2006; Akkermans *et al*, 2007; Arcot *et al*, 2010; Hooghiemstra and van Ees, 2011; Seidl *et al*, 2012) highlight the fact that the corporate governance statements disclosed by companies to the European stock markets show a lack of quality, mainly in terms of the explanations the companies provide when not complying. Seidl *et al* (2012) carried out an analysis of 257 listed companies that had produced some 715 records of deviations, and the 'explanations' of these deviations. They found that, in contrast to the original idea of comply-or-explain, which emphasized the possibility of justifying deviations with situation-specific reasons, a significant number of the deviations analyzed were either not justified at all (that is, they were simply disclosed) or were justified on the basis of objections of principle (such as that the code's provisions were inappropriate and failed to embody best practice). The EC, too, has covered the ground in a pan-European study (RiskMetrics Group, 2009). From the assumption that deficiencies in the practical application of the comply-or-explain mechanism might affect its proper functioning (RiskMetrics Group, 2009), the EC launched a wide-ranging consultation, based on a Green Paper, seeking stakeholders' views on the effectiveness of the current corporate governance framework (European Commission, 2011a).

In this article we will examine the result of this consultation, looking, in particular, at the way in which stakeholders express their views on whether companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and to describe the alternative solutions adopted. That is to say, we seek to explore whether, in the stakeholders' view, if the 'explain' option is used, the statement should provide a detailed explanation for

the departure from the code and, in addition, describe the alternative solution adopted. In analyzing the responses on how the 'explain' principle should be applied, we draw in part on Seidl *et al* (2012). We pose the following exploratory research questions:

Research Question 1: To what extent and in what way do stakeholders agree that the 'explain' option should be used to provide a detailed explanation for a departure from the provisions of a code?

Research Question 2: What kind of alternative solutions can be identified in the responses provided?

To address these questions, we analyzed 244 stakeholders' responses, identifying 206 views as 'agree' (that is, agreeing that detailed explanations should be given for deviations) and the remaining 38 responses as 'disagree' (that is, arguing that no additional requirements should be put in place). Our sample included stakeholder views from professional representatives, citizens and public authorities, such as business federations, institutional investors, representatives of the financial services and banking sector, auditors and accountants, public authorities, research institutions and stock exchanges (European Commission, 2011b) from different countries with contrasting legal cultures, capital market structures and experiences of regulatory codes. From the analysis of our data we derived a taxonomy of different views on how to make use of the 'explain' option for deviations; this also illustrates the range of ways the 'explain' option should be used, from the stakeholders' perspectives. In line with the original idea of the comply-or-explain principle, which stresses that deviations should be justified with situation-specific reasons (such as company size or branch), a significant number of the responses that we analyzed were clearly in favor of detailed explanations for deviations and of descriptions of the alternative solutions adopted, or of further amplification being provided. The most obvious response to this result would be to set out provisions requiring deviations to be justified. Such a response is likely to be made by the EC by 'an initiative, possibly in the form of a Recommendation, to improve the quality of corporate governance reports, and in particular the quality of explanations to be provided by companies that depart from the corporate governance codes' (European Commission, 2012, p. 7). Obliging companies to give reasons for any non-compliance, and thus forcing them to explain deviations, may discourage board members and senior management from disregarding their duties or acting in their own self-interest (Dewing and Russell, 2008). In particular, policymakers requiring the comply-or-explain principle to be followed should put forward clear principles on the form of explanation that is required. Our findings suggest that explanations should contain adequate information regarding the areas in which the code has not been implemented, the reasons for the non-compliance and the alternative solution that has been applied, where relevant.

The remainder of the article is divided into five sections. First, the theoretical background is introduced. Second, existing studies on the use of the comply-or-explain principle, and the overall quality of the explanations, are reviewed. Third, the empirical research design and analytical process is explained. Fourth, we present the empirical findings, providing a descriptive account of the different ways in which stakeholders agree that the 'explain' option should be used, and analyzing the arguments against this option. Finally, we discuss the results and their implications for standard setters.

THEORETICAL BACKGROUND

Agency and stakeholder theory

Corporate governance is commonly taken to mean the set of policies, processes and customs by which a company is directed. The pioneering definition in the UK Cadbury Report (1992) states that 'corporate governance can be defined as the system by which companies are

directed and controlled', and the OECD Principles of Corporate Governance 2004 explain that 'corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.' (OECD, 2004, p. 11).

Both definitions express the aim of securing a company's good corporate governance practice by mitigating conflicts of interests, which are commonly referred to as agency problems (such as where a manager as agent acts to the detriment of the shareholders) and which might arise between different groups of stakeholders (Gillan and Starks, 2003). The global business sector is well described in the context of such conflicts of interests by considering the growth of the modern company, financed by its stakeholders such as stockholders, banks and other institutions and scattered in its ownership, which over time has legitimated and incorporated the concept of the separation of ownership and control (Freeman, 2010). This has led to the current *status quo* of a global business sector that is bloated, profitable and prone to break down. The reason for this is that the prevailing approaches failed to identify those who could influence or be influenced by the company, in the sense of not acknowledging a broader dimension of influential forces, namely the stakeholders (Freeman, 2010). That is what the purpose of corporate governance reporting is about. It tries to promote the trust of the company's stakeholders, which by and large comprise international and national investors, customers, employees and the general public.

Cost of capital

The information asymmetries between companies and their users – typically in the Anglo-Saxon tradition we focus on investors as users rather than stakeholders – have over recent decades become more acute in the discussion surrounding the information disclosed in the corporate reports provided by the company's management. As managers are assumed to act in a self-interested way, they create agency costs. They do this by making decisions that transfer wealth from the shareholders, who in turn anticipate such actions and discount the value of the shares (Beatty and Thomson, 2010). Disclosure of information is recognized as one tool that can be used by managers to facilitate monitoring by shareholders, thereby reducing agency costs (Jensen and Meckling, 1976).

As part of this theoretical discourse, there is an ongoing debate about whether companies benefit from improved disclosure of information with a lower cost of capital. At the center of this discussion stands a commonly expressed view that enhanced disclosure lowers the cost of capital. The logic of this view is based on the theory that commitment by a company to increased levels of disclosure lowers the information asymmetry component of its cost of capital (Leuz and Verrecchia, 2000), and thus that policies that reduce information asymmetry will increase the liquidity of the market for the company's shares (Diamond and Verrecchia, 1991). For instance, based on the assumption that an environment of information asymmetry introduces adverse selection into the capital market, Handa and Linn (1993) reason that companies can lower the discount at which their shares are issued by improving their disclosure and so reducing the information asymmetries arising either between the company and outside shareholders or between those buying and selling the company's shares. Similarly, Diamond and Verrecchia (1991) argue that, by improving disclosure, a company enhances the liquidity of its shares, thereby attracting increased demand for them, which in turn increases their price. By the same argument it is acknowledged that when managers provide convincing 'explanations' for departures from code provisions, a commitment to increased levels of disclosure and increased transparency to capital markets is given by the company (see MacNeil and Li, 2006), so the information

disclosed should reduce the company's cost of equity capital by mitigating its agency risks (Habib, 2006).

Empirical research on the relationship between disclosure and cost of capital is, however, inconclusive (Mangena *et al*, 2010). Indeed, many studies have investigated disclosure to provide insights into the relationship between the cost of capital and disclosure, but overall there is still only limited evidence regarding the capital market impact of disseminating information broadly (Bushee *et al*, 2003). For example, while some studies document a positive relationship between the cost of capital and disclosures (Richardson and Welker, 2001; Botosan and Plumlee, 2002), others show a negative relationship (Botosan, 1997; Hail, 2002; Francis *et al* 2005) and/or no relationship at all (Mangena *et al*, 2010). By reviewing these studies, Mangena *et al* (2010) and Botosan (2006) demonstrate that the findings are generally mixed. Botosan (2006) suggests that different types of disclosures may influence the cost of capital in different fashions, and Mangena *et al* (2010) conclude: '[T]here exists no evidence on how the different types of disclosure combine and interact with each other to influence the cost of capital' (p. 6).

The discussion around the information disclosed in corporate governance statements is commonly based on the comply-or-explain principle, which is seen as a self-enforcing mechanism, in the sense that the capital market monitors compliance with a code and adjusts the share prices because investors estimate the parameters of the return on a company's share according to the available information, based upon perceived risk or moral hazard. It is argued that it is the role of the capital market to assess the adequacy of a company's corporate governance practices (MacNeil and Li, 2006). Since a company may deviate from an individual standard, the regulatory approach of 'comply-or-explain' rejects the view that 'one size fits all'. Instead, where individual rules are not appropriate for a particular organizational setting, companies are expected, even actively encouraged, to deviate (Seidl *et al*, 2012). This expectation is made explicit in the preamble to the codes. Indeed, policymakers employing the comply-or-explain principle are well aware from the outset that certain companies will have difficulties in complying with certain provisions (Seidl *et al*, 2012). A decision not to comply is based on the assumption that the market will either penalize non-compliance through lowering the share price (thus creating a market sanction), or accept (for whatever reason) that non-compliance is justified in the circumstances (MacNeil and Li, 2006). In the first case, it might be expected that a company that does not provide a convincing 'explanation' will face an 'illegitimacy discount' (Zuckerman, 1999) from the market. In the second case, it is argued that 'there is a *prima facie* link between share price performance and investors' tolerance of non-compliance' with code provisions (MacNeil and Li, 2006, p. 486). On the second point, it is worth noting that if such a link does exist then it has been surprisingly hard to demonstrate; 'in any event […] market forces evidently lacked the power to prevent the kind of scandals that has so undermined investor confidence' (Alles *et al*, 2006, p. 86). Thus, if there are grounds that make sanctions unlikely to be imposed (for example, the company is performing well, so investors are unlikely to question governance practices), the risks of market sanctions being imposed on the company 'may be regarded as relatively low, even if non-compliance is a recurring event' (MacNeil and Li, 2006, p. 487). One explanation that can be given for this is that a perquisite for pricing governance is the ability to measure it, but for outside shareholders the correct measurement of a company's internal governance practices is precisely the main hitch, thus short-circuiting the application of market forces (Alles *et al*, 2006). This might explain why empirical evidence on whether disclosure reduces the cost of capital, via a reduction in adverse selection and the estimation risk associated with investors' assessment of the return from a company's shares, is generally mixed

(Mangena *et al*, 2010). Most importantly, shareholders seem to be willing to tolerate non-compliance with corporate governance codes so long as financial performance is deemed to be adequate (MacNeil and Li, 2006; Dewing and Russell, 2008), and they may, in their investment and divestment decision-making process, use a combination of financial and non-financial information. There is support for this from Amir and Lev (1996), who propose that there is a complementarity between financial and non-financial information in explaining share prices. As Mangena *et al* (2010) write, 'the impact of disclosure on the cost of capital may be influenced by the combination and interaction of difference disclosure types' (p. 6). The implication is that investors may, in their investment decision-making processes, use a combination of the information that is disclosed (such as governance structure and financial disclosures) to arrive at an appropriate valuation of the company.

Legitimacy theory

In the eyes of a company's stakeholders there are institutionalized expectations of how the company should behave in order to gain legitimacy. If legitimacy is defined as a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs and definitions (Suchman, 1995), legitimacy theory can be explained in the light of Directive 2006/46/EC. This Directive imposed the comply-or-explain principle on all companies listed on an EU stock market, by mandating the inclusion of a corporate governance statement in their annual reports. Companies must explain any departure from a part of the corporate governance code, and the reasons for this departure. Although the statutory auditor is obliged to check whether a corporate governance statement is produced, he has no obligation to evaluate the quality of the explanation. In terms of legitimacy theory, companies that do not provide convincing 'explanations' for non-compliance are expected to face an 'illegitimacy discount' (Zuckerman, 1999) from the capital markets. It is up to the key audience, in this case primarily investors, 'to make an informed assessment of whether non-compliance is justified in the particular circumstances' (MacNeil and Li, 2006, p. 499), and 'thus whether an illegitimacy discount should be applied' (Seidl *et al*, 2012, p. 795). Even if the capital markets are content, adverse comment in the press on a company's compliance position may have a negative impact on the company (Seidl 2007; Seidl *et al*, 2012).

Particularly interesting from a legitimacy perspective is the inherent flexibility of comply-or-explain based codes (Seidl *et al*, 2012). The code provisions are explicitly meant to be applied flexibly. Behind the comply-or-explain principle lies the argument that companies are not expected to follow all provisions on a 'one size fits all' basis. Instead, since companies differ widely in their businesses and structures, companies should choose the structure that suits them best, and therefore corporate governance structures and rules that suit all companies cannot be laid down (Arcot *et al*, 2010). Where individual rules are not appropriate for a particular organizational setting, companies are expected, even actively encouraged, to deviate. Hence, rather than forcing companies into governance solutions that do not fit their particular circumstances, either because they are 'technically' not feasible or because the costs incurred in meeting these solutions are disproportionate to the benefits, companies can deviate from individual code provisions – as long as they clearly state their reasons. It is the essential genius of comply-or-explain that companies can be said to be in conformance with the code even when deviating from it. In that sense 'a meaningful explanation can fully justify non-compliance' (European Corporate Governance Forum, 2006a, p. 1), so '[n]on-compliance can be (but is not necessarily) compliant' (Seidl *et al*, 2012, p. 796).

The comply-or-explain principle can be understood well in the light of legitimacy

theory, since explanations for deviations from the code can be understood as means of legitimating the company's actions. If the given explanations are satisfactory, the principle confers legitimacy on both the underlying action and the explanation, and hence legitimates the company as a whole (Seidl *et al*, 2012). Thus, compliance statements are a key means by which companies seek approval for their governance arrangements, and hence preserve their overall legitimacy. The explanations provided in the statements can be conceived as legitimacy tactics (Seidl *et al*, 2012).

Further, in contrast to most other regimes, corporate governance codes acknowledge from the outset that deviations can be as legitimate as compliance with the code provisions. The regime – in the form of the comply-or-explain-principle – reflexively regulates deviations from itself. In that sense, the comply-or-explain principle acts as a meta-regime, or a regime that regulates when and how deviations from the primary institution (in this case the code provisions) can be seen as legitimate (Seidl *et al*, 2012). While in other cases organizations would engage discursively in explanations and justifications, particularly when deviating from an institution, here explanation and justification for deviations is part of the institution itself (that is, the formal comply-or-explain principle). This is an important aspect when one is examining the implications of the way the comply-or-explain principle has been used to go beyond the intention of the designers of the codes (which was to avoid an inflexible 'one size fits all' body of rules).

However, it can be asked why disclosure – in the form of the comply-or-explain principle – should be regarded as the best way to minimize principal–agent conflicts, particularly when the comply-or-explain principle itself leaves open exactly what form of explanation is required. In juxtaposition, there exists a well-developed body of company law (in the form of the laws relating to directors' fiduciary duty) 'that has as one of its primary objectives controlling the (inevitable) "principal-agent" conflicts that arise in companies' (MacNeil and Li, 2006, p. 487). In other words, as Alles (2010) points out, 'market forces may discipline boards of directors and managers, but that is a diffuse and hence expensive and wasteful policing device compared to other more direct governance mechanisms'(p. 5). Direct governance mechanisms such as, for example, those provided in company law call into question the operation of the comply-or-explain principle, and lead one to ask why a code could not be integrated into company law as a set of default rules that would be open to disapplication through a resolution adopted at a shareholders' meeting (MacNeil and Li, 2006). In the light of the discussion about the link between the comply-or-explain principle and its self-regulatory status, the work by MacNeil and Li (2006) is worth highlighting. The benefits of flexibility that are claimed to result from the comply-or-explain principle and are generally associated with the self-regulatory status of the code seem to be overstated in the argument about why a code could not be integrated into company law. These authors conclude that the comply-or-explain principle 'does not appear to deliver a role for the market that is in principle different from that which would result from the code being a default rule in company law' (MacNeil and Li, 2006, p. 493).

RECENT STUDIES

To date in the European setting, only a few studies have attempted to address questions relating to the use of the comply-or-explain principle and the overall quality of the explanations given. MacNeil and Li (2006) reviewed UK companies and their statements of compliance with the UK code. Their findings were that disclosure of non-compliance provides no foundation to enable investors to make a proper evaluation (MacNeil and Li, 2006), which means that the disclosures were not suitable vehicles for the provision of reasoned explanations. However, their conclusion is questionable, as Akkermans *et al* (2007) and Arcot *et al* (2010) found that monitors clearly decide that

many of the explanations provided are acceptable. Arcot *et al* (2010) examined the effectiveness of the comply-or-explain approach in the United Kingdom for the period 1998–2004. They showed that those UK companies that did not comply also failed to provide appropriate explanations for their deviations, and frequently used generic explanations in cases of non-compliance. In consequence, they concluded that compliance has been adopted by the UK market as a rule, but that companies' reporting practices are evidence that companies have used subjective interpretations of what compliance means. Terming the comply-or-explain approach as 'apply-or-explain' would be a much more accurate definition of the concept. Arcot *et al* (2010) concluded that this small but significant reformulation might help to encourage investors to pay greater attention to explanations. Akkermans *et al* (2007) found similar outcomes when reviewing the implementation of the Dutch corporate governance code. Their findings indicate a high level of compliance with the code, but the conclusion they drew is that the explanations for non-compliance were, in nature and content, quite similar for all companies (Akkermans *et al*, 2007). In contrast to the original idea of comply-or-explain, which emphasized the possibility of justifying deviations with situation-specific reasons, all three studies highlight the fact that companies' corporate governance statements disclosed on European stock markets showed a lack of quality in terms of the explanations they provided for not complying. Deviations are, for example, either not justified at all or are justified on the basis of objections of principle. The EC has also covered this ground in a pan-European study (RiskMetrics Group, 2009). Companies in countries where the recommended method is to disclose the comply-or-explain information on a provision-by-provision basis more often present explanations of a lower quality than companies in countries where only general information needs to be disclosed. The general conclusion one might draw is that there is very likely to be a box-ticking exercise effect, because the comply-or-explain mechanism becomes a box-ticking exercise when disclosure is made on a provision-by-provision basis. In countries where it is only necessary to provide explanations when deviating from a provision, on the other hand, companies give more in-depth and informative explanations (RiskMetrics Group, 2009).

While all four studies examine the quality of the explanations, RiskMetrics Group (2009) further attempts to categorize the explanations, by defining categories, in particular of 'invalid explanations' (when just the fact of the deviation is disclosed), 'general explanations', 'limited explanations' (when just the existing governance arrangement is disclosed), 'specific explanations' (when deviation is explained on the basis of the situation of the company) and 'transitional explanations' (when the explanation refers to the temporary nature of the deviation) (RiskMetrics Group, 2009, p. 169). This report concludes, by using this classification, that the level of information in explanations given in corporate governance reports is insufficient (RiskMetrics Group, 2009). However, as Seidl *et al* (2012) note, 'these studies provide a starting point [relating to the use of comply-or-explain and the overall quality of explanations] but given the wide diffusion of governance codes and the centrality of the comply-or-explain approach within them, there appears to be a particular need for a more detailed, nuanced, exploration of the way in which the principle is put into practice […]' (p. 793). A more in-depth way to categorize explanations has been employed by Hooghiemstra and van Ees (2011). They used nine separate categories in the content analysis element of their examination of the trade-offs for firms between flexibility and uncertainty in the use of comply-or-explain. Perhaps the best attempt so far to categorize explanations has been made by Seidl *et al* (2012), who developed an empirically derived taxonomy of types of explanation – deficient, context-specific, principled – and several important sub-categories, which reveal the common ways in which

companies use the opportunity to explain deviations. The methodological and analytical rigor employed in their research design took a more robust and systematic approach to categorization than earlier studies. Seidl *et al* (2012) found that a significant number of the deviations analyzed were either not justified at all (that is, they were simply disclosed) or were justified on the basis of objections of principle (such as that the code provisions were inappropriate because they failed to embody best practice).

Hooghiemstra (2012) was the first to identify the gap in academic research and the particular need for a more detailed exploration of the way in which the 'explain' approach is put into practice. In his study, Hooghiemstra examined the association between the characteristics of the firm and the level of information in its explanations for deviations. He examined companies in the Netherlands in the time period 2005–2009, concluding that '… not all firms properly explain deviations from the Dutch corporate governance code, and […] certain firm characteristics relating to board strength, ownership concentration, analyst following and leverage are associated with a firm's decision to provide either generic, but uninformative explanations, or more firm-specific explanations' (Hooghiemstra, 2012, p. 20).

In this article we will examine the way in which stakeholders express their views about whether companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and to describe the alternative solutions adopted.

METHODOLOGICAL APPROACH

Data collection

This study focuses on the analysis of secondary data that we have collected from responses to the public consultation held by the EC from 5 April 2011 to 22 July 2011 in which the Commission sought views on possible ways forward to improve existing corporate governance mechanisms. The consultation comprised 25 questions concerning three important corporate governance mechanisms – the board, the shareholders and the comply-or-explain principle – which the Green Paper 'On Corporate Governance in Europe' (European Commission, 2011a) formulated for this purpose. The comply-or-explain principle found its way into question 24 with the formulation, 'Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?'

We analyzed the stakeholders' views on how the 'explain' approach should be used, by looking at the answers to this question that were given by professional representatives, citizens and public authorities such as business federations, institutional investors, representatives of the financial services and banking sector, auditors and accountants, public authorities, research institutions and stock exchanges (European Commission, 2011b). The data we collected comprised the responses of 244 interested parties. To arrive at this number, all publicly available answers were downloaded from the EC website, (ec.europa.eu/internal_market/consultations/2011/corporate-governance-framework/index_en.htm) resulting in a population of 408 respondents.[1] Next, all responses were scrutinized. We first excluded 90 records as they were given in a language other than English, Swedish or Danish, leading to a sample of 318 respondents. Out of this sample, 74 did not provide a response to the relevant question we analyze as to why this stakeholder group had additional to be excluded. This leaves 244 answers as the final sample for analysis (see Table A1 in the Appendix for a list of sources of the responses).

Data analysis

To answer our research question on how many stakeholders are of the opinion that companies

departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and to describe the alternative solutions adopted, we first identified those respondents who were clearly in favor of this requirement. Content analysis of the 244 selected responses was carried out (Babbie, 2003; Krippendorf, 2004). The coding of the answers involved several iterative steps. Initially, two of the authors of this article, working independently from each other, analyzed the 244 answers. This exercise resulted in two sets of preliminary categories of 'agree' (which was defined to mean that the respondent said that deviations should result in detailed explanations) and 'disagree' (which was defined to mean that the respondent thought that no additional requirements should be put in place). These sets were then compared, and the differences considered, leading to an initial common set of categories. Each resulting set was then organized into two final main categories, 'agree' and 'disagree', and sub-categories. On the basis of this set of main categories, two authors independently analyzed the sub-categories again. The results were compared and reconciled, which led to the categories described below.

We identify for the first main category 206 answers as 'agree' (see Table 1); these respondents agree that companies departing from the recommendations of corporate governance codes should be required to provide explanations for such departures. These respondents are classified into the following sub-categories (in order of frequency): (i) *consent with no further remarks* and (ii) *consent with further remarks*.

Table 1: Main categories

	Replies	
	In numbers	*In percentage*
Group of 'agree'	206	84
Group of 'disagree'	38	16
Total sample	244	100

The latter sub-category comprises the following possible views: (i) *the UK and Swedish (SE) Codes are the best practice model*; (ii) *companies should disclose the reason for deviations*; (iii) *companies should briefly explain*; (iv) *companies should comply and explain*; and (v) *companies should disclose their alternative solution*. In the second main category, 38 answers were classified as 'disagree' responses, for those respondents who 'did not agree' (see Table 1). Within this 'disagree' category, six sub-categories grounded in different arguments were identified and classified as respondents who (in order of frequency): (i) *request no more requirements*; (ii) *highlight that the matter should be left to shareholders/the market*; (iii) *declare that the codes and directives are sufficient*; (iv) *see the problem as being the lack of a common set of principles*; (v) *think there will not necessarily be enhanced quality through detailed explanations*; and (vi) *are of the opinion that the full effect of Directive 78/660/EC should be awaited*. The result of this analysis is presented in the section 'Analysis and Findings' of this article.

ANALYSIS AND FINDINGS

Consent with no further remarks

An examination of the responses from the sample shows that a total of 84 per cent of respondents were clearly in favor of requiring companies to provide detailed explanations if they departed from the code. This highlights the fact that the stakeholders who expressed their views in the consultation are in agreement with the original idea of comply-or-explain, an idea that emphasizes the possibility of justifying deviations with situation-specific reasons. Such justifications are generally accepted, as 'we are dealing here with an institution (the provisions of the code) and a meta-institution (the comply-or-explain principle) that together confer legitimacy on what would otherwise be considered illegitimate – noncompliance with rules' (Seidl *et al*, 2012, p. 794). Although an absolute percentage of 84 per cent is of this opinion, 62 per cent of these gave no further

Table 2: Group of 'agree' and sub-categories

	Group of 'agree' replies in	
	Numbers	*Percentage*
(a) Consent with no further remarks	152	62
(b) Consent with further remarks	54	22
	Sub-categories replies in	
	Numbers	*Percentage*
(a) The UK and SE Codes as best practice model	26	11
(b) Disclose reason for deviation	15	6
(c) Briefly explain	6	2
(d) Comply and explain	5	2
(e) Disclose alternative solution	2	1
Total sample of 'agree'	206	84

amplification of their view (see Table 2). Thus, even if the vast majority, an absolute percentage of 84 per cent, is in favor of requiring more detailed explanations to justify deviations, only 22 per cent of them provide additional comments and remarks about this. However, the ideas expressed about the effect of implementing the proposal – that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and to describe the alternative solutions adopted – differ, giving us evidence that the existing comply-or-explain mechanism as a self-regulatory system leaves open the question of what form of explanation is required. We will turn to this in the following section.

Consent with further remarks

The UK and SE Code as best practice model

We term our first sub-category of 'agree', in the category of 'consent with further remarks', 'the UK and SE Code as best practice model'. These respondents highlight in some way that they are in favor of requiring companies to give a more detailed explanation of deviations, mentioning explicitly either the Swedish (SE) corporate governance code and or in some other cases the UK corporate governance code, as a best practice example. This is in large part the result of the emphasis in the Green Paper on the Swedish corporate governance code as an excellent example of exact requirements for how companies are to act when they deviate from the code (European Commission, 2011a). The Swedish code contains the following stipulations (the bold text is highlighted by the authors):

> The Code acts as a complement to legislation and other regulations by specifying a norm for good corporate governance at a higher level of ambition than the statutory regulation. However, this norm is not mandatory. Companies **may deviate from individual rules**, providing they **report each deviation, describe their own solution and explain why**. In this way, the actors in the market can form their own opinions on the solution the company has chosen.(Swedish Code of Corporate Governance, 2010, p. 3)

The explicit reference made by 11 per cent of respondents to the Swedish corporate

governance code (see Table 2) may very well indicate that this group is making a fairly concrete request that there should be a clarification of corporate governance codes, for which the Swedish code could serve as a best practice model. The Federation of European Accountants (FEE, 2011), for example, states:

> The clarification of the principle could be with regard to the content of the explanations. The explanation should contain adequate information regarding the areas where the corporate governance code has not been implemented, the reasons for the non-compliance and what alternative solution has been applied instead, where relevant. This is similar to the approach taken in the Swedish corporate governance code, as referred to in the Green Paper, and appears to be a measure that could facilitate a more consistent application with more informative explanations of non-compliance. Such clearer principles for the explanations could also to some extent mitigate the risks of explanations being articulated in generic boilerplate disclosures as they would be more company specific.(p. 14)

In other words, if the comply-or-explain principle is to work effectively, then the provisions of the code ought to contain clear principles for explanations. That is to say, informative explanations of non-compliance given by companies on an individual basis could facilitate a more consistent application of the code. This might, in consequence, alter companies' actions without the companies being 'corseted' by the principles to be followed for explanations. On the contrary, if companies take into account their own individual circumstances in complying with principles for explanations set out in their respective codes this will, to some extent, mitigate the risks of explanations being articulated in generic boilerplate disclosures and thus be consistent with the original idea of comply-or-explain – the avoidance of a 'one size fits all' set of rules.

Disclose reason for deviation

The respondents in our second sub-category under 'agree', in the group of 'consent with further remarks', reacted to the formulation of question number 24 of the consultation and the proposal therein on the subject of '… describe the alternative solutions adopted' by proposing that companies should only 'disclose the reason for deviation'. In contrast to the proposed requirement in the Green Paper, and to the views in the previous sub-category that indirectly, by referring to the Swedish code, highlighted a requirement to disclose the alternative solution, the views in this sub-category (into which 6 per cent of the stakeholders' views were found to fall) put an emphasis on a clear and informative explanation of the reason why the company did not comply with the provision or recommendation, rather than on the company being forced to disclose the alternative solution. These stakeholders noted that companies are sometimes unable to comply with a provision, and that there might not be an alternative solution. In that respect the statement drawn up by the BT (2011) Group Plc might be worth quoting:

> In respect of the description of alternative solutions, in some cases there is not a "solution" to a departure from a code provision, the description of the code departure should provide all the information investors require to formulate an opinion. The concept of "alternative solutions" is not therefore a necessary addition. (p. 8)

Briefly explain

The analysis of the empirical findings brought to light the fact that 22 per cent of the stakeholders (whose views are grouped in the category 'agree' and then in the sub-category 'consent with further remarks') agreed in principle with the requirements suggested, but made additional remarks. For the third subcategory we used the term 'briefly explain' to

describe the view of six respondents that it is enough for a company to give a brief explanation. One reason for this view might simply be that answers classified in this category (based on the responses to the survey question) depend on the company's own frame of reference. Another explanation of this opinion might be practical concerns about business secrets. It might be a competitive disadvantage for a company to disclose why it did not follow a suggested provision, and this would equally apply to having to disclose the alternative solution. However, even if an explanation is brief a company can be said to conform to the code even when deviating from it, if the explanation is meaningful. That is, 'a meaningful explanation can fully justify non-compliance' (European Corporate Governance Forum, 2006a, p. 1).

Comply and explain

The fourth sub-category of 'agree' that we could identify in the sub-category of 'consent with further remarks' is that in which respondents highlighted that they preferred a 'comply and explain' model to disclose meaningful information, even when complying would make the company more open and transparent in its communication with its stakeholders. For example, JRBH (2011) Strategy & Management declared:

> In our experience, the "comply or explain" provision is most effective where companies are open and transparent in their communications. Consequently, JRBH would advocate that companies provide more meaningful disclosure, even where they have complied with regulatory measures. (p. 4)

In consequence, by implementing the principle in this way, companies would have to legitimate their compliance as well. The suggestion is in line with a proposal made by Arcot *et al* (2010). By using the term 'apply or explain' instead of 'comply and explain', Arcot *et al* (2010) stressed that explaining a deviation is also a way of complying with the code. They considered that such a reformulation would be more accurate, and would likely encourage shareholders to pay greater attention to the explanations given.

Disclose alternative solutions

The fifth and last sub-category of 'agree' that we could identify in the sub-category of 'consent with further remarks' is 'disclose alternative solutions'. Here respondents expressed the view that it was enough just to disclose the alternative solution, without disclosing the reason for the deviation. When considered with the second sub-category 'disclose reasons only', this group contradicts the view discussed above.

Arguments in the 'disagree' category

A small number of views (16 per cent – see Table 1) fall into the category we classified as 'disagree'. Among these 'disagree' responses, six sub-categories were identified and classified: (i) *respondents who request no more requirements*; (ii) *respondents who highlight that the matter should be left to the shareholders/the market*; (iii) *respondents who declare that the codes and directives are sufficient*; (iv) *respondents who see the problem as being the lack of a common set of principles*; (v) *respondents who think that there will not necessarily be enhanced quality through detailed explanations*; and (vi) *respondents who await the full effect of Directive 78/660/EC* (see Table 3).

The respondents identified in the sub-category of *no more requirements* were of the opinion that if the comply-or-explain mechanism were to maintain its flexibility, no more detailed and obligatory requirements should be imposed. Thus, those respondents in the *no more requirements* sub-category, who indicated that their opinion was that the flexibility of comply-or-explain should be maintained, might have excluded the consideration that corporate governance codes are soft law, under which it is not

Table 3: Group of 'disagree' and sub-categories

	Replies in	
	Numbers	*Percentage*
(a) No more requirements	16	7
(b) Up to shareholders/the market	10	4
(c) Codes and directives are sufficient	5	2
(d) Lack of a common set of principles	3	1
(e) Not necessarily enhanced quality	2	1
(f) Wait full effect of Directive 78/660/EC	2	1
Total sample of 'disagree'	38	16

possible to take legal action and which are therefore not considered legally binding. This makes it difficult to require a more detailed explanation of possible deviations from the code and to make sure that the requirement is being followed, as the code provisions are explicitly meant to be applied flexibly. This is particularly interesting from the legitimacy perspective, as explanations provided in the corporate governance statements can be conceived as legitimacy tactics (Seidl *et al*, 2012). Different explanations refer to different points of reference as the basis for a justification of the chosen governance arrangements. In the case of context-specific justifications, legitimacy is conferred by the legitimacy of the comply-or-explain principle itself. That is to say, companies are confirming to the institutionalized notion at the heart of comply-or-explain – that they should deviate where a code provision is inappropriate for their particular context. Hence, the basis on which companies seek approval for deviating is nonetheless compliance – non-compliance is, in this case, compliance (Seidl *et al*, 2012).

This leads us to the type of respondents who suggest that the subject should be *left up to the shareholders/the market*. The most obvious and straightforward form of explanation is a simple declaration of compliance with a particular code provision (Seidl *et al*, 2012). As such a provision is, by definition, held to represent best practice, legitimation is normally assured – provided the code itself is deemed by wider audiences to be legitimate. This is the most elementary legitimacy tactic – seeking approval by conforming to an institution (Oliver 1991; Suchman, 1995). This approval should be given by shareholders or the market once they have decided whether they feel that the explanation is adequate. PKPP Lewiatan (2011), for example, stated [sic]: 'It is our belief, that shareholders are capable to ensure and protect their and their companies interest sufficiently. Therefore, explanations duties in regards actions which don't comply with C.G. regulation should be addressed to shareholders or creditors and not as suggested to "monitoring bodies"' (p. 6). The Budapest Stock Exchange (2011) stated [sic]: 'The rules of corporate governance belong to soft law, so primarily the investors should judge the quality and the quantity of the answers, how important the information are for them. However, we consider advisable to indicate the best market practice regarding the quality of the answers' (p. 7). The Budapest Stock Exchange has further signaled, with this response, that the costs of compliance must be weighed against the benefits of disclosure. It should be up to the investors to accept or reject the quality and level of the information contained in explanations for deviations from the code. In this sense the investors will ultimately have to assess whether or not an explanation is adequate, a view that is explicitly stated by the European Corporate Governance Forum for regulatory authorities: they 'should not try and second-guess the judgment of the board(s) or the value of its/their explanations. This is a matter for the company's shareholders' (European Corporate Governance Forum, 2006b, p. 2). The company's shareholders by making this assessment will finally judge on whether the total scope of explanations provided by the company comes at the cost of an increase in the risk of corporate governance failures. Shareholders seem willing

to tolerate non-compliance with corporate governance codes so long as financial performance is deemed to be adequate (MacNeil and Li, 2006; Dewing and Russell, 2008). However, a reduced share price is a possible punishment for companies offering explanations that are not sufficiently well grounded (Seidl *et al*, 2012). This leads on to the group of respondents *who declare that the codes and directives are sufficient*. In the words of Svenska Cellulosa Aktiebolaget (SCA) (2011) '[a]gainst this background [referring to the argument that the Swedish Corporate Governance Code is sufficiently detailed; authors' comment], SCA believes that more EU rules, with requirements for detailed reporting and monitoring are not necessary. Self-regulation in the form of codes has, in fact, broad support and the development is moving in the right direction' (p. 13).

This is very different to the argument that there is *an absence of a common set of principles*, which was raised by some of the stakeholders, who say that inadequate explanations are caused by this absence. That is to say, '… an important element lacking however is a common set of principles encapsulating all elements that are considered good governance for listed companies …', which is how the European Securities and Market Authority (ESMA) (2011) put it (p. 13). A common set of principles would contribute to a more even standard when comparisons are being made between countries. It would be easier to benchmark the quality of the explanations if there were some common guidelines in the EU as a whole. This would, most likely, also enhance the quality of the explanations. Thus, making it mandatory to provide detailed explanations does not necessarily improve the quality of the information given. For example, PwC (2011) network of member firms states, 'The quality of an explanation is not necessarily enhanced by excessive detail which can obscure key messages. We consider that specific content requirements for explanations are best dealt with at a national level' (p. 18). This is why the respondents holding this opinion are grouped in the sub-category whose title refers to *not necessarily enhanced quality*. The remaining answers fall into the category *await full effect of Directive 78/660/EC*; these respondents highlight the fact that the full effect of Article 46a of the latest Directive 78/660/EC has not yet been seen.

Discussion

To recap, we set out to investigate stakeholders' views on how the quality of corporate governance reports of companies making use of the 'explain' option for deviating can be improved. In particular, we asked both 'Should the "explain" approach provide detailed explanations in the case of a departure?', and 'Should, in addition, the alternative solutions adopted be described in the corporate governance statement?' Our analysis of 244 responses to the consultation launched by the EC in 2011 yielded two principal findings.

First, our analysis across different stakeholder responses and national contexts revealed that the majority are clearly in favor of requiring companies to provide detailed explanations of why they do not comply, that is, why they deviate from a code provision. Given the attention paid by stakeholders to the form and content of disclosed explanations, it is perhaps counter-intuitive to suggest that it is the fact of having to disclose explanations, rather than the form or content of those explanations, that may have more impact. Our findings suggest that policymakers imposing the comply-or-explain principle should include clear principles for explanations within the code. The explanations should contain adequate information regarding the areas in which the corporate governance code has not been implemented, the reasons for the non-compliance and, where relevant, the alternative solution that has been applied.

Second, our content analysis of the consultation responses led us to develop an empirically derived taxonomy of types of stakeholder views, categorized as 'agree' and 'disagree', with several important sub-categories, all of which reveal common ways in which companies use

the opportunity to explain deviations. The result of our analysis is that stakeholders would ideally prefer more substantive information but are reasonably happy with the current mechanism in place. Yet, forcing companies to explain deviations may discourage directors from disregarding their duties and acting in their own self-interest. Disclosures also facilitate shareholders' appraisal of directors' conduct (Dewing and Russell, 2008).

Our present study differs from previous ones in that we are more concerned with understanding how, in the view of stakeholders, the 'explain' option should be used. With our empirically developed taxonomy covering how companies make use of the 'explain' option, and the description of the different stakeholders' views about alternative solutions to deviations, we offer conceptual insights to aid the understanding of the critical role played by the comply-or-explain principle in corporate governance regimes, and how this is viewed. In our analysis of the responses about how the 'explain' approach should be applied, we draw in part on Seidl *et al* (2012) in discussing the consequences in terms of legitimacy tactics. In a nutshell, 'we are dealing here with an institution (the provisions of the code) and a meta-institution (the comply-or-explain principle) that together confer legitimacy on what would otherwise be considered illegitimate – noncompliance with rules' (Seidl *et al*, 2012, p. 793).

CONCLUSION

This article has attempted to generate some new insights into the way in which the comply-or-explain principle, a central element of most corporate governance regimes, is viewed by its stakeholders, and, in particular, how the 'explain' approach (which leaves open exactly what form of explanation is required) should be used. We provide an empirical investigation of the extent to which stakeholders agree that the 'explain' option should be used to provide a detailed explanation for a departure from the provisions of a code, and of the range of their views. The article sheds light on the operation of the 'explain' approach to corporate governance. In particular, justifications for deviations from code provisions, and what kind of alternative solutions stakeholders think should be assessed, are described. We highlight, as suggestions for improving the level and quality of compliance, the requirements that explanations should contain adequate information regarding the areas in which the corporate governance code has not been implemented, the reasons for the non-compliance and the alternative solution that has been applied, where relevant.

Our findings contribute to practical activities for international standard setters such as the EC, by addressing the implications for regulatory regimes of different types of explanation. The Commission has responded to this in its Action Plan 2012 (European Commission, 2012) to improve the quality of corporate governance statements, possibly in the form of a recommendation. The most obvious and straightforward recommendation would be that provided by the Commission, in particular when referring to the Swedish code, where it stated 'in its corporate governance report, the company is to state clearly which Code rules it has not complied with, explain the reasons for each case of non-compliance and describe the solution it has adopted instead' (European Commission, 2011a). When adopting such a formulation in a recommendation at an EU level, companies would have to provide more detailed explanations and, furthermore, the explanations provided in the statements could be conceived as legitimacy tactics. That is to say, different explanations would refer to different points of reference as the basis of justification for the chosen governance arrangements (Seidl *et al*, 2012).

We also contribute to the literature in two areas. First, within the corporate governance literature we build upon earlier studies of corporate governance codes (for example, Von Werder *et al*, 2005; Akkermans *et al*, 2007; Seidl, 2007; MacNeil and Li, 2006; Seidl *et al*, 2012). In particular, we add to that literature a

taxonomy of types of explanation listed by stakeholders, and provide new insights into the way the 'explain' principle can be improved. While it is commonly accepted that ultimate responsibility for assessing the value of non-compliance explanations lies with shareholders, there is no reason why the EC, as an international standard setter, could not assist them in this task by ensuring that the principles in the code are as clear as possible. This study proposes that policymakers imposing the comply-or-explain principle should include in the code clear principles to be followed when companies set out their explanations.

Second, we contribute to the literature on soft law regulation and self-regulation, by providing new insights into the dynamics of code provisions and, in particular, into how the comply-or-explain approach is viewed by stakeholders. We highlight the tendency of most stakeholders to agree with the original idea of comply-or-explain, which emphasizes the possibility of justifying deviations with situation-specific reasons. By this contribution we seek to contribute to society, by offering regulators and the general public an in-depth analysis of the opinions of a wide range of stakeholders about how the quality of corporate governance statements might be improved.

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NOTE

1 The European Commission Feedback Statement (European Commission, 2011b) includes 409 views that were received on the questions raised. However, when we downloaded all individual answers from the European Commissions' website the number of answers counted comprised 408 respondents. The reason for this is that one answer was counted twice by the Commission.

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APPENDIX

Table A1: Sources of the responses

Countries included in the sample	*Responses in numbers*	*Responses made in English*	*Danish*
Australia	2	2	—
Austria	1	1	—
Belgium	23	23	—
Bulgaria	2	2	—
Canada	1	1	—
Cyprus	1	1	—
Czech Republic	4	4	—
Denmark	11	9	2
Europe	17	17	—
Finland	10	10	—
Finland/Norway	1	1	—
France	12	12	—
Germany	12	12	—
Greece	1	1	—
Hong Kong	1	1	—
Hungary	3	3	—
Ireland	3	3	—
Italy	8	8	—
Latvia	1	1	—
Lithuania	1	1	—
Luxemburg	1	1	—
Malta	2	2	—
The Netherlands	12	12	—
Norway	5	5	—
Poland	3	3	—
Portugal	1	1	—
Romania	2	2	—
Slovakia	1	1	—
Slovenia	1	1	—
South Africa	2	2	—
Spain	4	4	—
Sweden	23	23	—
Switzerland	1	1	—
The United Kingdom	64	64	—
The United Kingdom/The United States	1	1	—
The United States	5	5	—
International NGO	1	1	—
Total sample of responses in numbers	244	—	—
Thereof responses made in English	242	—	—
Thereof responses made in Danish	2	—	—