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

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## ABSTRACT

Companies not complying with the UK Corporate Governance Code are required to provide explanations for non-compliance. This is the capstone of the 'comply-or-explain' system. There are no regulations about the content of those explanations, leaving shareholders and others to judge their appropriateness. The study develops a typology to assess the quality of corporate governance explanations for non-compliance of UK FTSE 350 companies based on seven quality characteristics. Code breaches generating the non-compliance explanations for analysis are identified for two accounting periods (2004/5 and 2011/12) relating to the 2003 and 2010 Codes (data for 2011/12 in brackets).

There were 204 (125) non-compliant companies, 537 (253) Code breaches and 438 (208) explanations for non-compliance, an average of 2.6 (2.0) Code breaches and 2.2 (1.7) explanations per non-compliant company. Although compliance increased over the period examined, explanations were found to be of variable quality. Results suggest that companies need to improve the quality of their explanations if they are to be useful to users, notably location, complexity and specificity of explanations. There are also important questions raised about the work of auditors and their apparent silence. Companies are being encouraged to move towards compliance. We argue that this is against the 'comply-or-explain' philosophy which accepts that 'one size does not fit all.' Better quality of explanation is more important than compliance and thus companies may be unwittingly heading in the wrong direction.

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## 1. Introduction

The essence of the UK Corporate Governance Code is flexibility, with companies able to choose whether or not to fully comply. Explanations for non-compliance with the Code requirements are the capstone of the 'comply-or-explain' system. However, study of these explanations has been "*largely neglected*" (Solomon, 2010, p. 156). Other authors also raise questions about the validity of a system that is self-regulated (Wymeersch, 2005) and is therefore open to abuse. For that reason alone, it is important to examine the quality of explanations for non-compliance.

In a review of explanations for non-compliance, the Financial Reporting Council (FRC, 2012a) highlights the gradual move towards (apparent) compliance with the Code in recent years and suggests that improving the explanations of the few remaining non-compliant companies might not be worthwhile in terms of the benefits obtained. However, a rather different

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view of significant non-compliance is revealed by Grant Thornton (2011). Chris Hodge, Head of Corporate Governance at the FRC, writing in the Grant Thornton (2011, p. 2) annual review of compliance with the Code admits “(I)t is not enough to simply say non-compliance suits one’s business model: stakeholders deserve to know exactly why this is the case and what arrangements ensure that, despite non-compliance, the business – and their interests – are protected.” Currently, UK companies have free rein over explanations in their annual reports. The Code is entirely silent as to what happens when non-compliance occurs other than to require companies to provide an explanation. The essence of an explanation is that it should be of ‘equal quality’ to full compliance.

The objective of the paper is to develop a typology based on seven quality characteristics from the prior literature and the International Accounting Standards Board’s (IASB) Conceptual Framework (see Fig. 1). A typology is a classification scheme which organises phenomena into groups on the basis of their similarity of key features (Bailey, 1994). Typologies can reduce complexity by highlighting similarities and differences. However, they can also oversimplify complex phenomena and reify theoretical constructs by obscuring that they themselves are social constructs (Bailey, 1994), so they need to be used with care. The seven quality characteristics in our typology are: (i) Location, (ii) Comprehensiveness, (iii) Originality/Mimetic behaviour, (iv) Length, (v) Complexity, (vi) Specificity and (vii) Attestation. This compares with Seidl, Sanderson, and Roberts (2013) quite different 12-component taxonomy of explanations which they empirically generate from their analysis of the discursive legitimacy tactics employed in explanations. Having first revealed the extent of non-compliance with the Code, the study applies the typology to analyse two sets of explanations (646 explanations) for non-compliance relating to years ending in 2004/5 and 2011/12. Our research suggests that companies do not provide high quality explanations. In a multi-theoretic approach, we use institutional theory and resource dependency theory to explore why this might be the case.

The paper makes three contributions to the prior literature:

- (i) The primary contribution is the development of a typology of quality characteristics especially developed for analysing non-compliance explanations which is more comprehensive than those in previous studies. Our typology complements the taxonomy of Seidl et al. (2013) by providing an alternative and quite different approach based on quality characteristics derived from the International Accounting Standards Board’s (IASB) Conceptual Framework and the prior disclosure-quality literature.
- (ii) Explanations for non-compliance with governance codes remain relatively unexplored in the prior literature, with the exception of MacNeil and Li (2006), Pass (2006), Andres and Theissen (2008), Arcot, Bruno, and Faure-Grimaud (2010), Hooghiemstra (2012), and Seidl et al. (2013) whose research is summarised in Table 1. As such, this paper contributes to an understanding of this under-researched area. In addition, a wider range of disclosed non-compliance is analysed

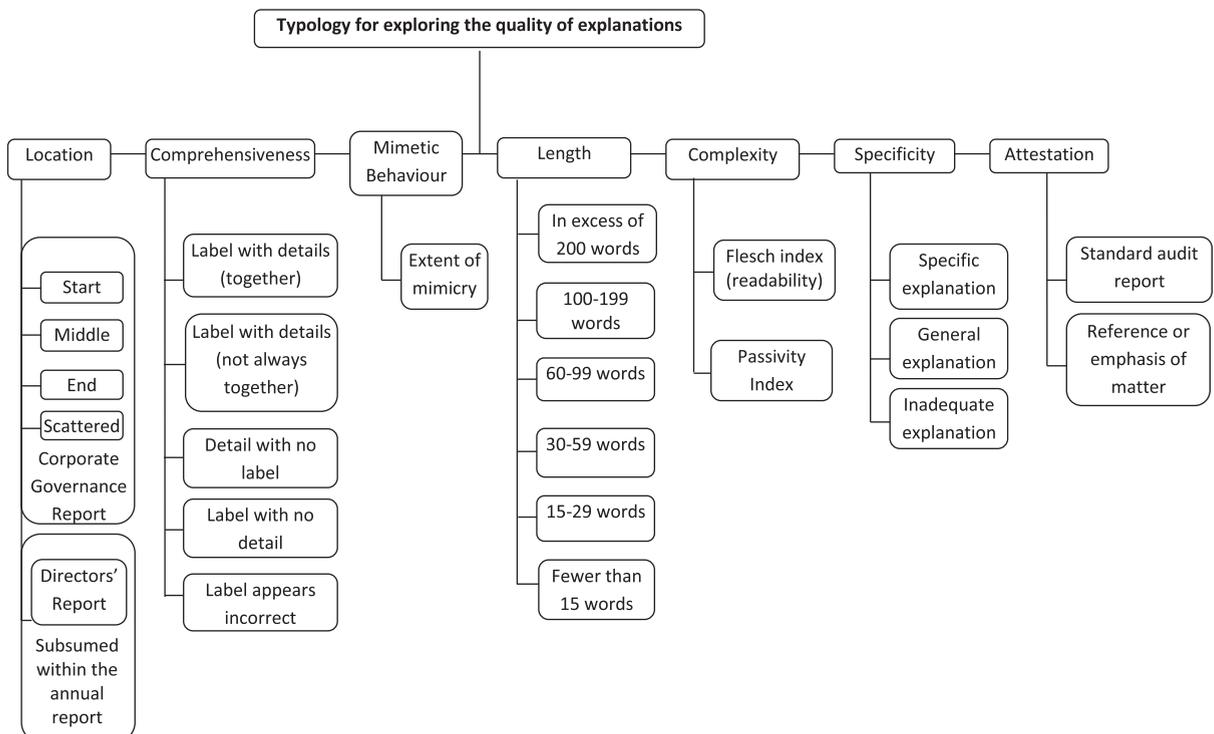


Fig. 1. Typology for exploring the quality of explanations (Based around a diagrammatical structure used by Beattie, McInnes, & Fearnley, 2004, p. 209).

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