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Applying the 'comply-or-explain' principle:

Conformance with codes of corporate governance

in the UK and Germany

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Applying the 'comply-or-explain' principle: Conformance with codes of corporate governance in the UK and Germany

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Abstract

The comply-or-explain principle is a central element of most codes of corporate governance. Originally put forward by the Cadbury Committee in the UK as a practical means of establishing a code of corporate governance whilst avoiding an inflexible 'one size fits all' approach, it has since been incorporated into code regimes around the world. Despite its wide application very little is known about the ways in which managers apply the principle – in particular, how they make use of the option to 'explain' deviations. To address this we analysed the compliance statements and reports of 257 listed companies in the UK and Germany, producing some 708 records of deviations, which we used to generate our empirically derived taxonomy of forms of 'explanation'. We find these varied forms of 'explanation' are based in part on different logics of argumentation. This leads to a broader use of the option to 'explain' than envisaged by the Cadbury Committee. In addition our country comparison shows significant divergence in compliance patterns in the UK and Germany which may be explained by differences in experience, culture and legal system.
Keywords: Corporate Governance; Corporate Governance Codes; Comply-or-explain; Compliance; Compliance Reporting; Compliance Monitoring

1. Introduction

In the wake of corporate scandals like Polly Peck (UK), BCCI (UK), British & Commonwealth (UK), Maxwell (UK), Mirror Group (UK), Enron (US), World Com (US), Holzmann (Germany), Metallgesellschaft (Germany), Bayerische Hypo- und Vereinsbank (Germany) there have been increasing calls for more effective controls on corporate behaviour in general and the actions of company directors in particular. By way of response many countries have introduced new sets of laws and regulations to protect the interests of shareholders, particularly minority shareholders who have few opportunities to influence the actions of the boards of companies in which they invest. These reforms are considered by many to have been successful in encouraging both domestic and foreign investment (Shleifer and Vishny 1997), especially in common-law countries, but also (to a lesser extent) in German and Scandinavian civil-law countries (see Coffee 1998; La Porta *et al* 1998, 2000).[i]

Irrespective of the form of legal system there has been in recent years a strong trend towards the use of 'soft law' (Mörth, 2004) or 'soft regulation' (Sahlin-Andersson, 2004), in this area, in the form of *codes of corporate governance*. A code of corporate governance can be defined generally as 'a non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations' (Weil *et al*., 2003). The first serious code of this kind arose from the report of the Cadbury Committee in 1992 set up by the London Stock Exchange and the UK Financial Reporting Council.[ii] It contained a set of rules addressed to the boards of directors of all listed companies registered in the UK, many of which are still in force today, for example, 'The roles of chairman and chief executive should not be exercised by the same individual' (Cadbury Committee, 1992: A.2.1). The Cadbury Code as a mode of regulation for the corporate sector was subsequently imitated in more than fifty countries throughout the world (Van den Berghe and De Ridder, 1999; Iskander and Chamlou, 2000; Weil and Manges, 2002; Aguilera and Cuervo-Cazurra, 2004). These codes were variously issued by stock-exchange-related bodies, associations of directors, various types of investor groups, business and industry associations, and governmental commissions (Wymeersch, 2005; Aguilera and Cuervo-Cazurra, 2004). Most of them refer to companies listed on respective national stock exchanges. Apart from these national initiatives there are also some transnational initiatives like the 'OECD Principles of Corporate Governance', which are not so much directed at companies as such, but are primarily meant as 'guidelines for legislative

and regulatory initiatives in both OECD and non OECD countries' (OECD, 2004: 3). Within the EU the use of governance codes as a mode of regulation has been endorsed by The High Level Group of Company Law Experts (2002). Nonetheless, many remain sceptical of the use of codes citing, for example, the economic rationalism that underpins them (Bhimani 2008) and the way that this rationality leads to decisions and justifications of action that are outwith the spirit of the codes (Ahrens 2008).

A central element of most national codes is the "comply-or-explain" principle, which was first put forward in the Cadbury Code as a practical means of establishing a single code of corporate governance whilst avoiding an inflexible 'one size fits all' approach. Cadbury (1992) 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." This approach received support from The High Level Group of Company Law Experts (2002) which compared and evaluated different code regimes throughout Europe and has since been advocated by the Commission (Communication of the Commission 2003) for use by member states. Theoretically the comply-or-explain mechanism provides both flexibility in the application of the code and a means by which to assess compliance: 'While it is expected that listed companies will comply with the Code's provisions most of the time, it is recognized that departure from the provisions of the code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions' (Financial Reporting Council 2006: 5). However, despite its promotion by various national and supranational organizations, very little research has been carried out on the way that the mechanism functions in practice (see Aguilera and Cuervo-Cazurra 2009). There have been numerous surveys on compliance rates (e.g. Von Werder *et al.* 2003; 2004; 2005) and correlations between compliance rates and firm performance (e.g. Gompers et al 2003; Goncharov *et al* 2006; Drobetz *et al.* 2004), but hardly any systematic research has been conducted on the way in which companies make use of the option to "explain". An exception to this is the study by MacNeil and Li (2006) which examined whether share price performance explains compliance rates, in the course of which they analysed somewhat unsystematically the contents of compliance statements concluding they were not suitable vehicles for the provision of reasoned explanations. Yet, a closer look at compliance statements shows that some companies do indeed provide good justifications for deviations. Arcot and Bruno (2006) in their

working paper show there are substantial qualitative differences between 'explanations'. Yet, even their analysis of the different forms of compliance statements is by no means comprehensive. This general deficiency of studies into board members' use of the option to "explain" deviations has also been recognised by the European Corporate Governance Forum (2006):

> *"[I]t seems appropriate to have a closer look at the way in which companies comply with the recommendations of the applicable code. In particular, it does not seem sufficient to rely on simple compliance rates. When applying the principle of 'Comply-or explain' more emphasis needs to be put on the quality of the explanations for deviations from the code as a meaningful explanation can fully justify non-compliance. The potential responsibility inherent to a statement of compliance should also be examined."*

In response to the call for more research on the way the explain option is used in practice we examine in this paper the compliance statements and corporate governance reports of 257 listed companies in the UK and Germany. While explanations for deviating are certainly not restricted to published reports and accounts, (companies can also provide explanations verbally at their AGM or via a press statement or in private meetings with shareholders), the formal statements can nonetheless be considered reasonable indicators of the types of explanation given also elsewhere. Analysing 708 individual cases of deviations from individual code provisions and the respective treatment in the compliance statement we derive a taxonomy of forms of "explanation" It can be shown that different form of "explanation" are based on a different logic of argumentation which is not necessarily in line with the original idea of "comply or explain" as developed by Cadbury. We analyse the distribution of different forms of "explanation" across different companies. Comparing the statements of companies in two countries with different legal cultures, different capital market structures and different experiences of regulatory codes, enables consideration to be given to the extent to which use of the explain option follows a general pattern or is dependent on context.

The rest of this paper is structured into five sections. After this introduction, we will first describe the concept of the 'comply-or-explain' principle in more detail. We will then present our empirical approach to examining the way in which managers apply the "comply-or-explain'

principle. The following two sections will, then, present our analysis of the compliance patterns in UK and Germany respectively. The final section contains a discussion and explanation of these findings together with our conclusion.

2. What is "comply-or-explain"?

The basic idea behind comply-or-explain is to allow for some flexibility in the application of the rules set out in the code. The codes are explicitly meant to be applied flexibly. It is not intended that all companies covered by the code should follow all provisions. Rather, where individual rules do not fit the particular organizational setting, companies are *expected* to deviate. (Baums 2003:7 gives as examples: size; ownership structures, international ownership, and requirements of the capital markets of other countries.) The Combined Code states clearly that: '[D]epartures from the Code should not be automatically treated as breaches' (Financial Reporting Council, 2006: 7), and the official commentary on the German Cromme Code states: 'Flexibility, as [one of the] guiding idea[s] of the code, is meant to prevent companies affected by the code from being corseted into too inflexible regulations. Companies should rather have the possibility of tailoring the modalities of corporate governance to their individual situations and of optimizing them with regard to efficiency criteria' (Ringleb *et al*., 2004: 89; our translation). It is the essential genius of comply-or-explain that companies can be said to be in conformance with the code as a whole whilst deviating from individual rules.

This is not however a free pass for rule avoidance. Companies are required to declare and, in the original British application of the concept, to provide a public explanation for deviations. In the UK the Combined Code warns that: 'While it is expected that listed companies will comply with the Code's provisions *most of the time*, it is recognised that departure from the provisions of the code may be justified *in particular circumstances*. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions' (Financial Reporting Council, 2006: 5, emphasis added). The flexibility of the code serves as a means of increasing the *responsiveness* of the code to individual circumstances. This means that differences in the circumstances of regulatees do not have to be anticipated by rule-makers and the complexity of the codes is kept to a minimum. Indeed, code issuers employing comply-or-explain are well aware from the outset that some regulatees, companies or groups of companies,

will have difficulties in complying with certain provisions. The Cadbury Committee, for example, recognized that 'smaller listed companies may initially have difficulty in complying with some aspects of the code. […] The boards of smaller listed companies who cannot, for the time being, comply with parts of the Code should note that they may instead give their reasons for non-compliance' (Cadbury, 1992: 3.15). Regulatees should assess their own positions and provide authentic responses - it is not for the code issuer to assess the applicability of the code provisions *on behalf* of affected companies nor to assess their response – the companies themselves are responsible for assessing both applicability and the appropriateness of their response.

The authenticity of such assessments is however for others to monitor and judge. The comply-or-explain principle relies upon third parties to provide such monitoring and thus to enforce conformance with the code (Brunsson, *et al.*, 2000; Kerwer, 2005; Seidl 2007). In this case that third party is, at aggregate level, the capital market, in the form of individual shareholders. The market has two functions in this regard: evaluation of possible deviations and enforcement. It is after all in their direct interest to assess the significance of deviations. Indeed, the code exists primarily to protect their interests.[iii] 'It is for shareholders and others to evaluate the company's statement' (Financial Reporting Council, 2006: 4). Similarly, Baums writes about the German code: 'It is left to the capital market to evaluate the equivalence of any deviations [to the code provisions]' (Baums, 2001: 10). Here too, evaluation by those affected means that no particular institutional arrangements have to be made for this purpose. It thus reduces the complexity of the regulatory design. Additionally, it allows in principle for an authentic evaluation by those affected by the deviations, as opposed to an evaluation carried out by external institutions on behalf of the affected parties. As MacNeil and Li (2006: 488-499) write: "The objective of the 'comply or explain' approach is to allow investors to make an informed assessment of whether non-compliance is justified in the particular circumstances."

An additional function of the integration of the market mechanism is the *enforcement* of code compliance by those affected by potential deviations. Somewhat simplistically, unjustified deviations from the code provisions are expected to be 'sanctioned' through negative share-price reactions (Easterbrook and Fischel 1996). As Schüppen writes: 'The influence of compliance on the share price is the idea behind the [comply-or-explain rule]' (Schüppen, 2002: 1273; our

translation). It is assumed that shareholders will take the level of compliance into consideration when they make a decision to buy, sell, hold, or vote. Accordingly, unjustified deviations from code provisions that appear significant to shareholders are expected to result in lower share prices (Weil and Manges, 2002: 68–69). In this context researchers often cite the study by McKinsey and Company (2002), which found that fund managers stated they were prepared to pay an average premium of 14% for well-governed European and North American companies and even more in emerging markets. Since company directors are interested in delivering shareholder value through higher share prices, this is assumed to work as an enforcement mechanism.[iv] Again, integration of the capital market can be seen to reduce the complexity of the design of the code system, since no separate external enforcement mechanism is required. In Figure 1 we have represented the design of the code regimes graphically.

INSERT FIGURE 1 APPROXIMATELY HERE

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3. Empirical approach

A central component of the comply-or-explain principle is the public declaration concerning compliance or non-compliance together with the explanations provided in respect of deviations. In order to better understand the way the comply-or-explain mechanism is applied by company directors we have examined the compliance statements of companies required to observe national codes of corporate governance. As we were interested in the way that deviations were justified we concentrated on those deviations that were publicly declared in the official statements rather than conducting a survey as e.g. Von Werder et al. (2005) did.[v] We took the position – originally envisioned by the design of the code regime – of the "average" shareholders who try to inform themselves about the level of compliance by studying the official company documents.

As use of the comply-or-explain principle by large companies generally attracts more attention together with comment and controversy we chose to analyse the statements of the 130 largest listed companies listed on the London Stock Exchange and the Frankfurt Stock Exchange respectively (altogether 260 companies). Thus, our data set initially comprised compliance statements of 260 companies in Germany and the UK published in the calendar year 2006,

reporting activities to years ending 31 December 2005, 31 March 2006 or 31 December 2006[vi]. In Germany this includes all companies contained in the Dax30 (30 companies with a market capitalization between €4 bn - €80 bn), the MDax (50 companies with a market capitalization between €0.3 bn and €7 bn) and the SDax (50 companies with a market capitalization of €0.05 bn and €0.5 bn). In the UK this includes all FTSE100 companies and the next largest 30 companies of the FTSE350 – with a market capitalization ranging from £2 bn to £112 bn (€3 bn - €165 bn). From this initial set of 260 companies three were excluded since they did not provide any compliance statements due to their particular legal status during the period in question. Both sets of companies include all types of industries.

The analysis of our data proceeded in four steps. First, we reviewed the literature on code compliance – particularly the practitioner literature (e.g. Baums 2001) for potential types of explanations that one would expect. This was used to sensitize us as authors for the types and forms of explanations that one might find in the compliance statements and company reports. Second, we identified in the compliance statement and company report of each of the 257 companies those passages referring to individual code provisions, which resulted in a set of 708 stated deviations. Third, we conducted a content analysis of the selected passages (Babbie 2003; Krippendorf 2004; Miles and Huberman 1994; Strauss and Corbin 1998; Weber 1990). The coding of the passages involved several iterative steps. Initially, two of the authors of this paper analysed fifty passages independently of each other. This exercise resulted in two sets of preliminary categories of "explanations" for deviations. These sets were then compared and the differences were discussed. Following that an initial set of agreed categories was extracted from the first two sets. Using these categories, a further one hundred passages were analysed independently by the authors. Again, the results were compared and discussed, which led to the addition of some further categories. At the same time it became clear that there was an overlap between some of the initial categories. The overlapping categories were thus replaced by more general categories. The resulting set was then organized into main categories and subcategories. Based on this set of categories we analysed independently of each other the remaining passages. The discussion of the results of this analysis confirmed that the categories we identified were orthogonal and mutually exclusive (Strauss and Corbin 1998). In this way we generated an empirically derived taxonomy of forms of "explanation" for deviations. In a fourth step we examined the distribution of the different types of declaration of levels of compliance (based on

our empirically generated taxonomy) across the different companies. In order to assess the extent to which the use of the explain option follows a general pattern or is dependent on context we compared the distribution of forms of explanation between the two countries. In order to facilitate this comparison we divided the set of companies into similar bands: the German data set was divided along the three main indices – DAX, MDAX and SDAX; the British data was divided into analogous bands – the thirty largest companies, the next fifty largest companies and the fifty smallest companies in the set.

Table 1 presents our empirically derived taxonomy of forms of "explanation" to which we have added two categories – one for full compliance (in order to account also for those companies that do not deviate from code provisions) and one for full non-compliance, which we did not observe in our set, but which has been described in the literature (Von Werder et al. 2005). The taxonomy itself will be explained in more detail in the following sections together with a description of the distribution of the different types of "explanation" across different companies.

TABLE 1 APPROXIMATELY HERE

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4. The comply-or-explain principle in the British Context

4.1 The integration of the comply-or-explain principle in the Combined Code

The relevant version of the Combined Code (Financial Reporting Council 2006) in the UK comprised 48 code provisions while the German Cromme Code (Cromme Commission 2006) comprised 82 code provisions. These are set out in two sections, the first for companies, the second for institutional shareholders, reflecting the nature of the British capital market. There are also three schedules to the Code that provide guidance on aspects such as performance related remuneration, the liability of non-executive directors, and disclosure of corporate governance arrangements. The main focus of our analysis is on the first section which contains subsections on the duties of Directors, Remuneration, Accountability and Audit, and Relations with Shareholders. A number of issues are addressed within each subsection, each containing a statement of the Main Principle involved. This is followed by more detailed Supporting Principles and finally, Code Provisions.

Observance of the Combined Code is a compulsory element of the listing rules of the London Stock Exchange but it does not cover private companies and some rules do not apply to smaller companies, those outwith the FTSE 350. Foreign owned companies can either comply with the Combined Code or the code applicable in their country of primary listing but if the latter they must state the extent to which they have complied with that code and outline any significant differences between that code and the Combined Code.
(http://fsahandbook.info/FSA/html/handbook/LR: 9.8.7)

Whilst observance is compulsory the preamble to the Code (2006:2) hints at the high trust basis underpinning the self-regulatory tradition within the City of London, noting that:

> *Whilst recognising that directors are appointed by shareholders who are the owners of companies, it is important that those concerned with the evaluation of governance should do so with common sense in order to promote partnership and trust, based on mutual understanding. They should pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle.*

The successful application of the 'comply-or-explain principle' thus depends on both the company and the investor acting with integrity, applying the code as far as possible but allowing for deviations where sensible and, where necessary, entering into an authentic dialogue to increase each side's understanding of the position of the other. To this end a mere statement of deviation from a code provision is insufficient. Companies are required to explain in all cases. Such explanation is also a requirement set out in the listing rules (Para. 9.8.6) Indeed, Schedule C to the Code (2006:23) stipulates the extent of disclosure required:
Paragraph 9.8.6 of the Listing Rules states that in the case of a listed company incorporated in the United Kingdom, the following items must be included in its annual report and accounts:

- *a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied;*
- *a statement as to whether the listed company has*
    - *complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or*
    - *not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:*

    (i) those provisions, if any, it has not complied with;

    (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and

    (iii) the company's reasons for non-compliance.

Of the 130 UK companies analysed there was just one without valid usable data. Carnival Corporation, formed from a US and a UK company, listed in London under its new identity part way through the relevant year, but its primary listing remained in New York and it did not report on its compliance with the Combined Code for the period we analysed. We thus excluded it and only analysed 129 UK compliance statements. Of the 129 compliance statements analysed 67 companies (51.94%) were fully compliant (see Table 2). The top 30 companies in terms of market capitalization have a slightly higher rate of full compliance than the rest of the sample but in fact there is, perhaps surprisingly, very little difference between the top 30 and the top 80 companies. Full compliance does however fall away towards the bottom of the FTSE 100 and beyond, with the bottom 50 in our sample (those with market capitalization below £4 bn, or €5.92 bn) recording full compliance at just half the rate of the top 80.

TABLE 2 APPROXIMATELY HERE

The average number of deviations per company for the FTSE 1-30 is 0.60, or 1.80 if one excludes companies reporting full compliance (see Table 3). The average rises steadily as market capitalization decreases, from 0.96 cases for the FTSE 31-80 to 1.49 for the FTSE 81-130 although if one excludes full compliers there is little variation by size of company. There is however a steady increase in the maximum number of deviations that companies seem to be

comfortable reporting. (Note that even the smallest company in our sample does not qualify for the dispensations given within the code on grounds of size). This maximum rises from 4 for the top 30 (SABMiller, a holding company with mainly overseas operating subsidiaries) to 7 for the bottom 50 in our sample (Daily Mail & General Trust, essentially still a family controlled firm). But even the least conforming company deviated from less than 15% of the provisions contained in the Code.

TABLE 3 APPROXIMATELY HERE

However, it would appear to be easier to comply with some provisions than others - or companies are less sanguine about being seen to deviate from some provisions. All companies complied with 20 of the code provisions (41.67% of the code) with the top 30 complying fully with 36 provisions (75.00%). Again, as Table 4 shows, frequency of non-compliance increased inversely with size of company.

TABLE 4 APPROXIMATELY HERE

The distribution of the number of deviations varies considerably, both amongst the provisions themselves and between the bands we use in our analysis of the top 130 listed companies. As Table 4 and 5 show, amongst the top 30 non-compliance is fairly low, with provision C.3.1 (composition of the audit committee) attracting the largest number of deviating companies at just 3 (10% of the sample).

TABLE 5 APPROXIMATELY HERE

Table 5 also shows that of the next 50 companies just three provisions, A.3.2 (the requirement for a majority of the board to be independent non-executive directors), B.2.1 (composition of the remuneration committee) and C.3.1 (composition of the audit committee), attracted more than 10% deviations, but for the bottom 50 in the sample the number of deviations per code provision increases, with provisions A.3.2 and B.2.1 attracting more than 20%. Overall, in the entire sample of 129 companies, A.3.2 had the highest rate of deviation at 26 (18,84%), followed by C.3.1 at 19 (13,77%), B.2.1 at 17 (12.32%) and A.4.1 at 10 (7,25%).

High numbers of deviations of code provisions are not necessarily an indication of regulatory failure. As explained previously, a central idea of regulation by codes is the flexibility built into the system, particularly through the comply-or-explain principle. Companies are meant to deviate from individual code provisions in those cases where they seem unsuitable or illogical for their own particular circumstances. Thus instances of deviation, far from illustrating non-compliance, could also be interpreted as indicating that the regulatory regime is working effectively - the flexibility offered by comply-or-explain adding essential lubricants to the system. One way to assess whether the regulatory regime is functioning well is to analyse the compliance statements and the type of explanations given for any deviations, which we will address in the following section.

The explanations provided for the deviations have been coded according to the taxonomy delineating types of explanation shown in Table 1 above. These ranged from complete non-compliance both with and without explanation (neither of which apply to the UK) to various types of partial non-compliance. The latter are shown in Figure 2 below. Company specific reasons (both temporary and non-temporary) account for a high proportion of the explanations given by the reporting companies. Examples include the Burberry Group's demerger from GUS and numerous occasions when directors or even the chairman left, perhaps for health reasons, without completing a full term, causing the board to become imbalanced or requiring the CEO to serve temporarily in a dual capacity as both CEO and chairman.[vii]

FIGURE 2 APPROXIMATELY HERE

The distribution of the different types of explanation between the three segments of the sample is given in Table 6 below.

TABLE 6 APPROXIMATELY HERE

This shows that while temporary company specific reasons other than structure or size were given most often overall (23.91% of all explanations given), these featured more prominently amongst the smaller companies in our sample (32.88%) than amongst the larger ones (11.11%).

Larger companies were more likely than their smaller counterparts to raise principled objections against the content of particular provisions - 5 cases (27.78%) amongst the top 30 companies compared to just 2 cases (2.74%) amongst the bottom 50 companies.

There was little correlation between type of explanation employed and the code provision on which it was employed - with one exception. Some 11 cases (42.30%) of non-compliance with A.3.2 (board independence - a majority of directors should be independent) were explained by 3.3.7.2 (justification on the basis of temporary company specific reasons other than size or structure). This represents 33.33% of all instances of the use of that particular justification in our analysis of UK companies.

5. The comply-or-explain principle in the German Context

5.1 The integration of the comply-or-explain rule in the German Cromme Code

Similar to the British Code, but ten years later, the German Cromme Code was developed by a group consisting (apart from two academics) of practitioners chaired by a well-known corporate figure, in this case, the Chairman and former CEO of ThyssenKrupp Dr. Gerhard Cromme. But, in contrast to Britain the code issuing group was officially set up by the Ministry of Justice as a "Governmental Commission" and the code was also included by the Ministry in the official part of the *Bundesanzeiger*, the gazette where the details of enacted laws are first published. The first version of the Cromme Code was published in February 2002. Since then it has been reviewed and updated on an annual basis, with two major changes in 2005 and in 2007. In this paper we focus on the 2005 edition, the version in force for the year of our analysis.

Although the Cromme Code was to some extent modelled on to the Cadbury Code and the Combined Code it has a slightly different format. First, apart from the code provisions ("recommendations") to which the comply-or-explain principle applies, the code also reiterates various elements of corporate law. It also contains additional "suggestions" from which companies can deviate without disclosure. In this paper we concentrate only on the recommendations, the equivalent of the content of the UK Combined Code. Altogether, there are 82 code provisions, which are grouped around six topics: shareholders and the general meeting, the management board, the supervisory board, cooperation between the two boards,

transparency, and reporting and audit of the annual financial statements. In contrast to the Combined Code the Cromme Code does not distinguish between "principles" and "code provisions" but refers only to "recommendations". These only apply to listed companies *located* in Germany, i.e. not to foreign domiciled companies that choose to list on the German stock exchange.

An important distinction between Germany and the UK concerns the way the comply-or-explain principle is integrated into the code. There are three main differences. First, the comply-or-explain principle has been incorporated into the German Stock Corporation Act (*Aktiengesetz*). § 161 states: "The Management and Executive Boards of the listed company declare every year that they have complied and will comply with the recommendations of the 'Governmental Commission German Corporate Governance Code' […] or declare which recommendations they have not or will not comply with. This declaration must be made available to the shareholders on a permanent basis." (§ 161 AktG, our translation). Second, as the formulation of § 161 makes clear, companies are only required to *disclose* their deviations from the code provisions, they do not have to give any reasons for the deviation. In this sense the German comply-or-explain principle is sometimes also referred to as "comply-or-disclose". Yet, the code itself contains a provision requiring "explanations" for deviations: "The Management Board and Supervisory Board shall report each year on the enterprise's Corporate Governance in the Annual Report (Corporate Governance Report). This includes *the explanation of possible deviations from the recommendations of this Code*." (Cromme Code: 3.10; our emphasis). It is also often assumed that companies will provide explanations out of self-interest (Ringleb et al., 2004). Third, in contrast to their British counterparts German companies are required to publish a separate statement ("Compliance Statement") in which they declare their deviations from the code, apart from an additional Corporate Governance Report in the annual report, in which they can provide further information on their corporate governance. Some authors (e.g. Ringleb et al., 2004) even argue that the Compliance Statement itself should only contain the declaration of compliance or deviations while any explanations for the deviations should go exclusively into the Corporate Governance Report, to enable a fast and easy assessment of levels of compliance.

5.2 Analysis of the compliance statements of companies listed on the Frankfurt Stock Exchange

Altogether we analysed the websites and annual reports of all Dax 30 (30 companies), MDax (50 companies) and SDax companies (50 companies) with regard to their Compliance Statements and Corporate Governance Reports. Apart from two companies valid data on all other companies was found (see Table 7). The two companies that did not publish compliance statements, Highlight Communications AG and EADS, did not do so since being a foreign company they did not fall under the German Stock Corporation Act in which the comply-or-explain principle was contained. In our sample there are however also other foreign companies, e.g. Depfa Bank AG, which did publish compliance statements.

TABLE 7 APPROXIMATELY HERE

Of all the 128 companies 18 declared full compliance (14.06 %). Yet, the number of fully complying companies differs considerably between the different bands (Dax, MDax and SDax). While 40.00 % of companies of the Dax 30 are fully compliant with the code the number is much smaller for the other two indices, at 10.20% and 2.04 % respectively (see Table 8). Amongst the companies included in the study not one deviated from all code provisions. (Interestingly some 5 to 10 small listed companies did declare full non-compliance for the year of analysis, as they are allowed to do under the German system, but they were too small to be included in the three indices analysed here.)

TABLE 8 APPROXIMATELY HERE

The average number of deviations per company is 4.40 (or 5.16 if one excludes those companies declaring full compliance), shown in Table 9 below. Again, there is a considerable difference between the different indices, with an average number of deviations amongst the Dax 30 companies of 2.63 (resp. 4.31), amongst MDax companies of 4.31 (4.41 resp.) and among SDax companies of 5.88 (resp. 5.78). Amongst the Dax 30 companies Henkel AG has the maximum number of declared deviations with 20 deviations - most of them due to their specific legal form. Amongst the MDax companies Depfa Bank AG has declared the most deviations with 30 deviations and, finally amongst the SDax companies Indus Hodling AG has declared the maximum number of 15 deviations.

TABLE 9 APPROXIMATELY HERE

Table 10 below shows that, out of all 82 code provisions, 18 (21.95%) were complied with fully by all the companies in our dataset but there was quite a degree of variation between the three indices. Amongst the DAX 30 companies the number is 51 (62.20%) and for the MDax and SDax 35 (42.68 %) and 36 (43.90 %) respectively.

TABLE 10 APPROXIMATELY HERE

There are however some provisions that have quite low levels of compliance. For example, more than 50 % of all companies in our dataset deviate from code provision 4.2.4S2, which requires the compensation of the Management Board to be disclosed individually. This figure is even higher when only SDax companies are considered, with almost two-third declaring a deviation. Other examples are code provision 3.8, requiring a suitable deductible for the D & O insurance policy to be agreed, and code provision 5.4.7Para3S1, requiring the individual disclosure of the compensation of the Supervisory Board Members - with more than 40 % of all companies deviating from the former requirement (amongst the SDax the figure is nearly 60%) and more 36% of all companies deviating from the latter (42% for SDax companies).[viii] See Table 11 for an overview of the code provisions complied with least.

TABLE 11 APPROXIMATELY HERE

Table 12 provides an overview of the different "explanations" provided for the deviations. The figures in the four rows represent the frequency (in percent) that a particular type of explanation was used. The number of explanations given is slightly higher than the number of deviations observed as some companies gave multiple justifications for a single deviation. For example, several companies justified their deviation from Code Provision 3.8, which requires a deductible for the D & O insurance policy, by arguing against the code provision as counter productive (justification 3.3.2) and by pointing out that it conflicted with international practice (3.3.8).

TABLE 12 APPROXIMATELY HERE

Table 12 provides an overview of the use of different types of explanations for deviations. Interestingly, nearly 30% of all deviations, whether non-temporary (28.32% - 3.1.1) or temporary (1.21% - 3.1.2), are disclosed without any kind of explanation. This is possible in Germany, since the law just requires disclosure, not necessarily justification. Yet, as explained above, it is often assumed that companies will provide justifications, and is indeed recommended in one of the code provisions. In addition to the unjustified disclosures there are a number of what we refer to as "empty" justifications (8.81%). These were presented by companies as explanations but in fact contained no explanatory content. For example, CeWe Color Holding AG 'explained' that they deviated from a code provision "since corporate practice as hitherto […] is to be maintained.". When combined, pure disclosure and empty justifications constitute almost half the deviations analysed here (see Figure 3).

FIGURE 3 APPROXIMATELY HERE

In contrast to pure disclosure and empty justifications, principled justifications against the content of a particular provision (3.3.2) constitute just 19.17% of all deviations. By way of example, Fresenius AG states:

> "Disclosure of individual compensation for each member of the Management Board, according to clause 4.2.4, sentence 2, in our view limits the structuring of compensation so that it is differentiated by individual performance and responsibility." (Fresenius AG)

Over half of all cases of principled justification (53.56%) relate to just three types of code provision: Provisions No 7 (requiring a deductible in case of the D & O insurance policy), Provision No 25 (requiring individual disclosure of the management compensation) and Provision No 41 (requiring an age limit for members of the Supervisory Board), suggesting a feeling that these provisions are not deemed by board members to represent best practice.

In comparison very few companies gave industry-specific reasons (3.3.4.1 and 3.3.4.2) for deviating. Company size or board size (3.3.5), which Cadbury suggested might be a reason for deviating, is given however by just under 10% of the smaller companies in our analysis. Almost all relate to Code Provisions No 36 and No 37, which recommend establishing specialist

committees within the Supervisory Board. In their compliance statements smaller companies frequently justify their deviation on the grounds that their Supervisory Boards are simply too small – in many cases they have just three members – so it makes no sense to set up subsidiary committees. In a few cases this explanation is also used (less convincingly) to justify deviations from Code Provisions No 72 and 73 requiring annual and quarterly reports to be made accessible within 90 and 45 days respectively.

Justifications on the basis of company structure (3.3.6.1 and 3.3.6.2) played a significant role in the case of just one single company, Henkel AG, where the particular legal form of the company requires it to have a different board structure. This was given as justification for 15 deviations. In a few other cases companies referred to their complex international structure to justify a delay in the publication of their annual and quarterly report (Provisions No 72 and 73). "Other company-specific reasons" (3.3.7.1 and 3.3.7.2) played only a minor role. "Conflict with international practice (3.3.8) was invoked several times, but almost exclusively with regard to Code Provision 3.8 requiring a deductible in the D & O insurance policy. Transitional explanations due to the novelty of a code provision (3.3.9.1) or being a new entrant (3.3.9.2) played almost no role. In a very few cases companies also referred to potential conflicts between code provisions and the law (3.3.10). EM TV AG, for example, writes:

> "The introduction of performance related payment for members of the Supervisory Board is put on hold, since there are currently concerns regarding the legitimacy of performance related payment." (EM TV AG; our translation)

Finally, in a few cases, the information provided in the compliance statements and/or Corporate Governance Report was unclear, and categorization impossible (category 4 - ambiguous or incomplete information).

6. Discussion and Conclusion

In this last section we discuss our main findings in the two different domains (the UK and Germany) highlighting similarities and differences. A first issue of interest when examining the effectiveness of governance codes as a means of regulation is whether the rules have any effect on the practices of the companies to which they apply. In this respect the declared level of compliance is an important indicator - although the declared practices and structures need not

necessarily correspond to actual practices (Meyer and Rowan 1977; Seidl 2007). The declared compliance rates in our study differ considerably. While over 50% of the UK companies analyzed were fully compliant, the respective number in Germany was less than 15%. In both countries compliance levels dropped as company size decreased but there were significant differences. For example, while almost 30% of the smallest 30 companies in the UK top 130 were fully compliant, less than 2% of similar companies in Germany complied fully. Similarly, the average number of deviations of all companies analyzed was about 2 in the UK compared to about 5 in Germany. A similar difference is evident in the number of code provisions from which no deviations were found - more than half in the UK but less than a quarter in Germany, although some of this difference may be accounted for by the different number of provisions in their respective codes (48 in Germany compared to 82 in Germany). In addition, most code provisions in the UK have been in place for more than a decade while the Cromme code only became effective in 2002. Thus, German companies might still be in a process of adapting to a relatively new regulatory regime. Certainly compliance levels have been rising steadily in Germany since inception (see von Werder et al. 2003; 2004; 2005). Size difference might also be relevant: the top 130 companies in the UK were capitalized at between €3 bn and €165 bn while their German equivalents ranged from €0.05 bn to €80 bn.

Of course, analysis of compliance levels provides only a partial insight into the effectiveness of governance codes. As we have emphasized, deviations from code provisions are not, as some corporate governance rating agencies would have it, evidence of regulatory or compliance failure (see Koehn and Ueng, 2005). On the contrary, a high number of deviations may be nothing more than evidence that comply-or-explain is working as intended - providing essential flexibility within a single universal set of rules. On the other hand it could be evidence of boards pursuing their own interests at the expense of their shareholders. In this respect analysis of the provided "explanations" constitutes a good indicator - bearing in mind, of course, that the stated reasons may or may not correspond to the "real" reasons for deviation (Seidl 2007).

Consistent with the logic underpinning comply-or-explain one would expect to find explanations are primarily situation specific (justification types 3.3.4 to 3.3.9 in Table 1), i.e. industry specificities, company size, company structure, new entrant etc., but this is not the case. In the UK they account for around 50% of declared deviations but only around 20% in

Germany. Amongst such explanations "company-specific justifications other than structure and size" (justification 3.3.7.1 and 3.3.7.2) featured most prominently in both countries. In the UK transitional justifications from new entrants to the London Stock Exchange were also fairly frequent, reflecting the relative importance of the exchange - it is the third largest in the world, and around twice the size of its counterpart in Frankfurt. This, combined with the longstanding importance of the UK as a financial centre, makes it an attractive place for companies from outside the UK to obtain a primary listing. In Germany, by contrast, the most common situation specific explanation given was company and board size (although in our classification there were actually more companies in the catch-all 'other' category). This may also be because the average size of German company is smaller. Unsurprisingly size was more often offered as an explanation for deviation by the smallest 30 companies than the largest. But perhaps of greater interest, industry-specific reasons, which some writers expected to be much in evidence (e.g. Baums, 2001), were only rarely cited. A few companies did refer to the specific characteristics of their industry as a reason for deviating but such deviations were relatively unimportant. The small number of explicit justifications drawing on industry specificities also indicates that in this respect one size can indeed fit all.

Most strikingly though, a large number of explanations were clearly not consistent with the principles underpinning comply-or-explain. (Again, in both countries, this applies more to the smaller companies surveyed.) Firstly, there were what we have referred to as pure disclosures (explanation 3.1.1 to 3.1.3, see Table 1) where deviations were simply disclosed without any reason being given. While these amounted to just below 15% of deviations in the UK the respective figure for Germany was almost 40% (or about 30% if we exclude those cases where companies indicated they would comply in future.) The difference between the UK and German figures might partly be explained by the fact that German companies are not formally obliged to provide explanations. Secondly, both in the UK and Germany almost 10% of the explanations were what we referred to as "empty" (explanation type 3.3.1) - varying slightly across the different size bands. Taken together almost 25% of UK deviations, and almost 50% of German deviations were not properly justified. The number is even higher if we add those deviations where companies simply described without explanation their alternative practice (although one might argue that such descriptions implicitly constitute a form of justification.) This undermines one of the central ideas of the code regulation regime, i.e. that companies only deviate where

they can provide convincing justifications to those monitoring code compliance, their shareholders. Whether such companies did not have any convincing justifications for nonconformance or whether they did not wish to publish their justifications we cannot say but the first would suggest such companies do not perceive their external audience - defined broadly as the capital market and more narrowly as their shareholders - to be effective or relevant code monitors while the second implies they do not consider the compliance statement and/or Corporate Governance Report to be important forms of communication - they may for instance have communicated their justifications in other ways, for example in private meetings with their major institutional and/or family shareholders.

A further interesting finding concerns what we referred to as a "principled justification" against the content of a particular code provision. Although this might at first appear very similar to situational explanations in that a "real" reason for the deviation is given, it is clearly not in line with the original idea of the comply-or-explain principle to provide essential flexibility in situations in which specific code provisions simply do not fit. This has also been pointed out by Baums (2001), one of the architects of the German Cromme Code. A principled justification is an implicit criticism of the code drafters. For example, in Germany a number of companies justified their deviation from the code provision requiring a deductible for D&O insurance as a matter of principle, not least because the Cromme commission demanded a 'reasonable' deductible be made without specifying what they consider 'reasonable' - although presumably there is also a degree of self-interest in managers not paying personally the excess on negligence insurance policies that cover their activities. Both in the UK and Germany this type of explanation was used widely (but for different sorts of deviation). Indeed, it was the most common type of explanation amongst the largest 30 companies, accounting for more than a third of their total deviations. To the extent that these "principled" explanations provide general reflections on individual code provisions they can play another important role in the code regulation regime. They can, together with the justification we refer to as "general problems with the implementation/potential conflict with law" (explanation type 3.3.10), provide feedback to the code issuers about problems with individual code provisions. After all, one important characteristic of soft law codes (cf. hard statute law) is that the former can be more readily changed when required (see Baums 2001; Seidl 2006). In the UK there was a sustained refusal to comply with the rule that denied chairmen the option to sit on their company’s remuneration

committee. After consideration it was accepted that this was indeed a proper role for them and the code was amended accordingly.

In general, there appeared to be significant differences in explanations amongst the different indices or size bands (top 30 companies, middle 50 and bottom 50). While this was evident in both countries these differences were more prominent in Germany. To some extent, this has to do directly with size. Smaller companies have less resources than their larger counterparts and some of the code provisions are of less relevance to them. Yet this cannot explain all the differences observed. For a later phase of our research we undertook interviews on code compliance which leads us to speculate that these differences may also be related to levels of exposure, peer pressure and ownership structure (see Sanderson et al 2009). Larger companies (particularly the Dax 30 companies) are more exposed to public scrutiny than their smaller counterparts (in the MDax or SDax). Moreover, companies seem to compare themselves with their own peer group (similar sized companies or companies within the same index.) Thus, in their decisions on compliance, and in their formulation of compliance statements, they tend to refer to precedents set by their peers. Lastly, many companies in the MDax and SDax have a dominant, private shareholder. Many are "family firms," less dependent on the capital market than their larger counterparts, with a dominant shareholder who may well value privacy over transparency and disclosure.

Our analysis shows that a significant number of companies in both the UK and Germany are not providing full and proper justifications for deviating from code provisions. However, there are marked differences between the two countries. Levels of both full compliance and fully justified nonconformance are considerably higher in the UK than in Germany. (This is not to say that *individual* companies in the UK and in Germany might not be very similar in terms of board members' attitudes to comply-or-explain.) There are several potential explanations for this difference. Firstly, board members in the two countries have different experiences of the use of regulatory codes and self-regulation in general. The UK (Cadbury) Code of Best Practice was established as far back as 1992, and was predicated on a traditional reliance on self-regulation and the importance of reputation, particularly in the City of London, in which *'chaps would be trusted to behave under the watchful eye of benign authorities … the old world of small, well-defined, interconnecting circles where everyone knew everyone else and deals were done face-*

to-face' (Augar 2000:46). For their German counterparts used to "hard" regulation, the Cromme code, which had only been in place for very few years, has been more or less their first serious exposure to self-regulation. Board members, especially from smaller domestically oriented companies, may well need time to adjust to the idea of "soft" regulation and its associated obligations. Secondly, behavioural differences may also be explained by differences in the capital market structures in the two countries. In designing the original code the Cadbury Committee took into account UK corporate practice and the structure of the UK capital market where, although share ownership is dispersed, large outsider financial institutions exercise considerable influence on boards. These institutions have both the interest and the resources to monitor and enforce the code provisions. This contrasts sharply with the German context where companies are more likely to be controlled by insider blockholders with networks of cross-shareholdings. There is therefore less pressure to justify publicly deviations from the Cromme Code. It is of no little significance that comply-or-explain has not been adopted as a regulatory mechanism in other economic and social sectors. To be effective it requires powerful external monitors. While the differences in structure and legal tradition in the UK and Germany, and thus differences in their approaches to comply-or-explain may diminish over time - there is the possibility they may not - in which case the Cromme Code will need considerable revision in form if not content. As Cadbury (2002:28) wisely remarked, *"Both statutory and self-regulation have their part to play in corporate governance. The issue is the balance between them and the aspects of governance for which each is appropriate."*

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FIGURES AND TABLES

Figure 1: The design of the code regime

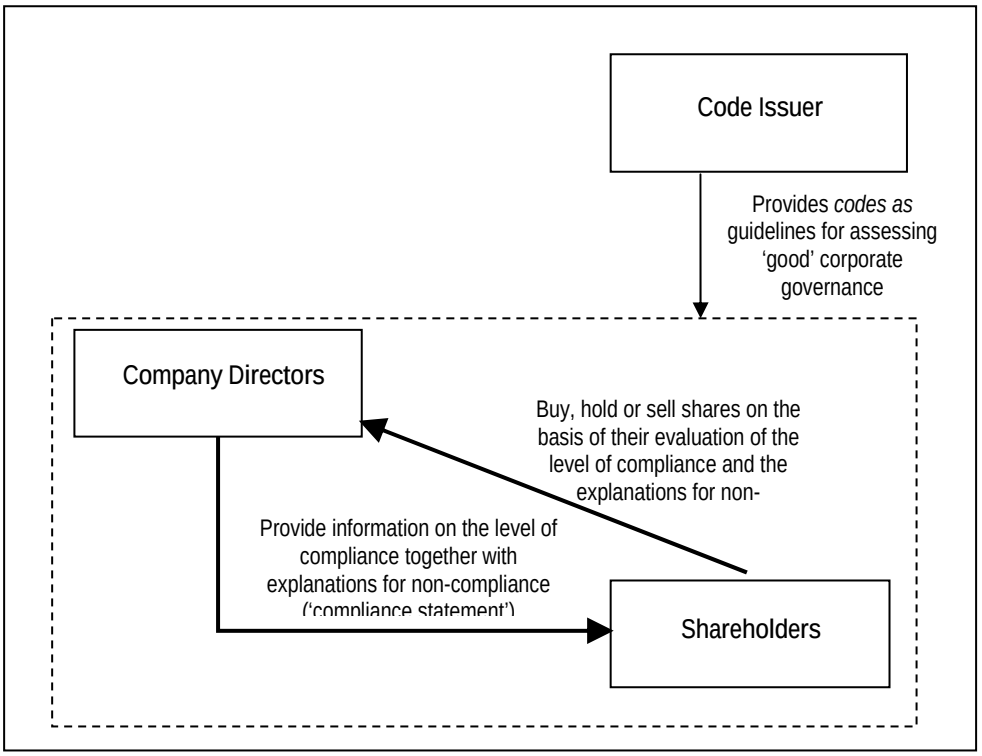

Figure 2. Frequency of type of explanation for non-compliance in the UK

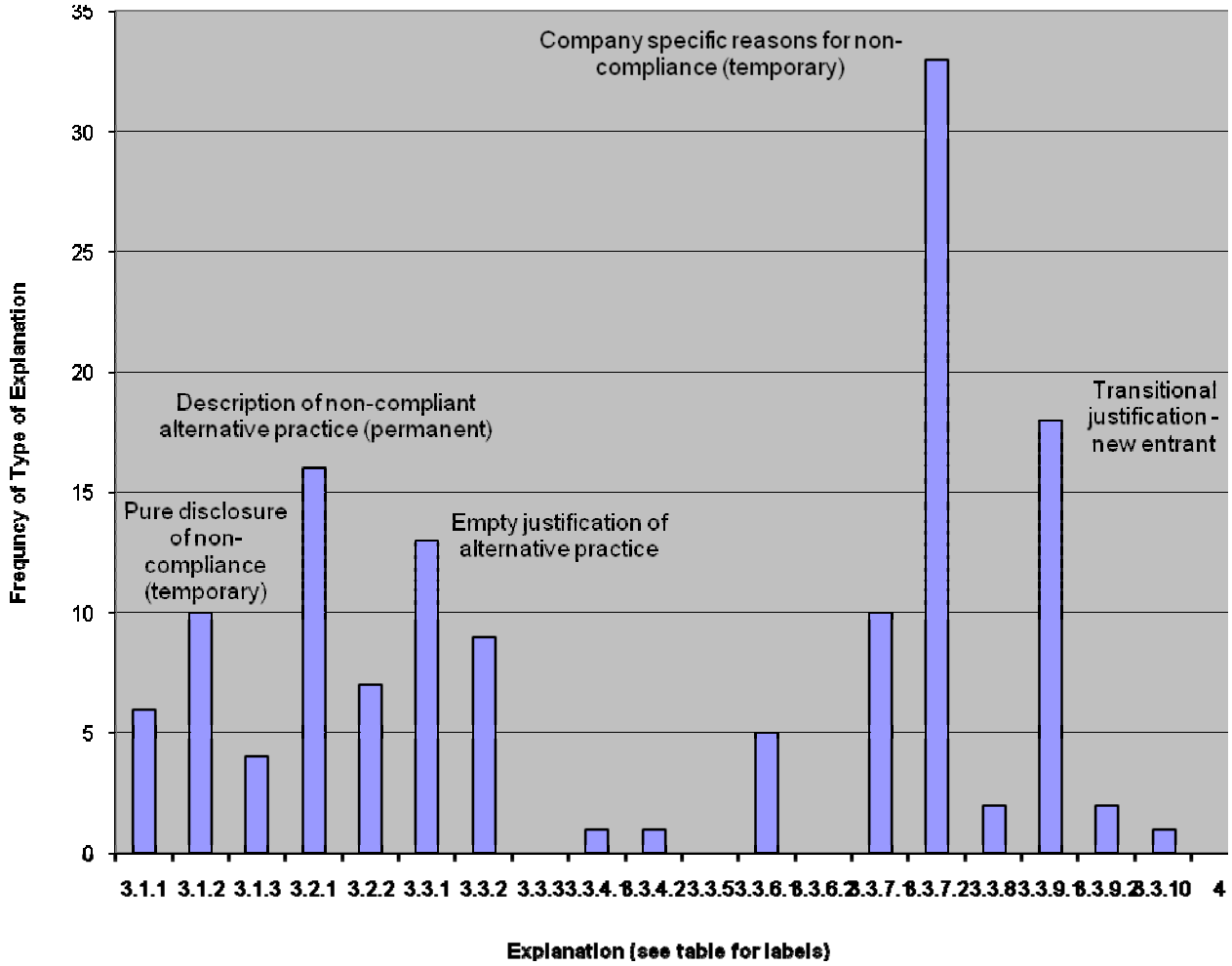

Figure 3. Frequency of type of explanation for non-conformance (130 largest German companies)

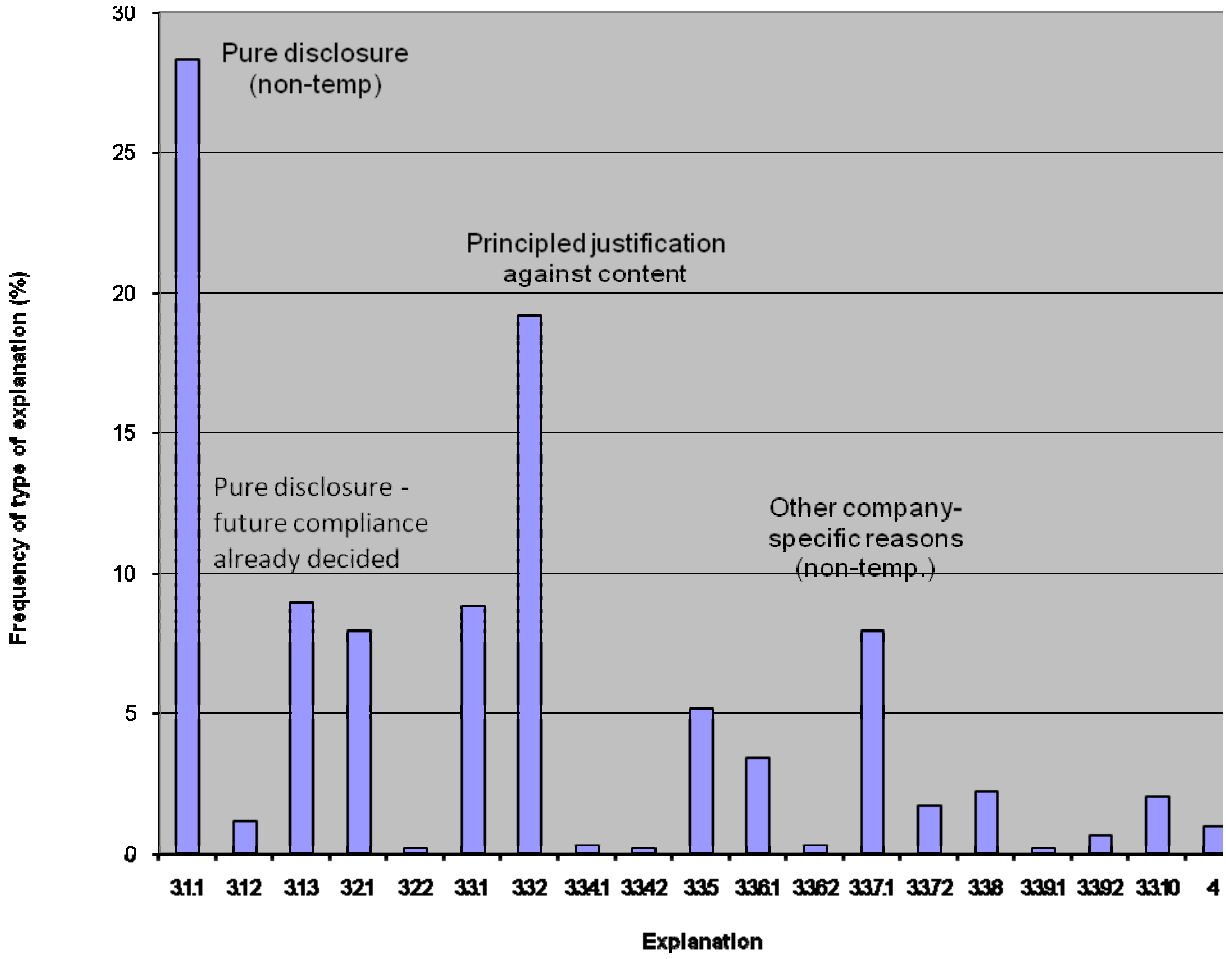

Table 1: Empirically derived taxonomy of compliance

1. Full compliance

2. Full non-compliance

3. Partial non-compliance
   - 3.1 Pure disclosure (indication of areas of non-compliance without descriptions of alternative practice or any justification)
     - 3.1.1 non-temporary deviation
     - 3.1.2 temporary deviation
     - 3.1.3 pure indication that future compliance already explicitly decided
   - 3.2 Disclosure and description of alternative solution without justification
     - 3.2.1 Non-temporary
     - 3.2.2 temporary
   - 3.3 Disclosure with justification
     - 3.3.1 empty justification
     - 3.3.2 principled justification against content of particular code provision
     - 3.3.3 principled justification against code regulation (in contrast e.g. to laws) with regard to a particular provision
     - 3.3.4 justification on the basis of industry specificities
       - 3.3.4.1 non-temporary
       - 3.3.4.2 temporary
     - 3.3.5 justification on the basis of company size or board size
     - 3.3.6 justification on the basis of company structure
       - 3.3.6.1 non-temporary
       - 3.3.6.2 temporary
     - 3.3.7 other company-specific reasons
       - 3.3.7.1 Non-temporary
       - 3.3.7.2 temporary
     - 3.3.8 justification on the basis of international practice
     - 3.3.9 Transitional justification
       - 3.3.9.1 new entrant to the particular stock market
       - 3.3.9.2 new code provision
     - 3.3.10 General (not company-specific or industry-specific) problems with implementation or conflict with legal regulation

4. Ambiguous or incomplete information

Table 2: Number of fully compliant companies in the UK

Companies	Companies analysed	Fully compliant	% of full compliance
FTSE 1-30	30	20	66.67 %
FTSE 31-80	49	30	61.22 %
FTSE 81-130	50	17	34.69%
Total	129	67	51.94%

Table 3: Number of deviations per company in the UK

Companies	Average number of deviations	Median number of deviations	Average number of deviations by non-compliers only	Maximum number of deviations by company
FTSE 1-30	0.60	0	1.80	4
FTSE 31-80	0.96	0	2.47	6
FTSE 81-130	1.49	1	2.21	7
Total	1.07	0	2.23	7

Table 4: Number of code provisions with which all companies comply

Companies	No of provisions with which all companies comply	% of code provisions with which all companies comply
FTSE 1-30	36	75.00 %
FTSE 31-80	31	64.58 %
FTSE 81-130	27	56.25 %
All	20	41.67 %

Table 5: List of code provisions of the UK Combined Code with the lowest compliance figures

Code Provision *(n = no. of deviations)*	**FTSE 1-30**		**FTSE 31-80**		**FTSE 81-130**		**ALL**	
	n	**%**	**n**	**%**	**n**	**%**	**N**	**%**
A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clear ….	0	0.00	2	4.08	4	8.16	6	4.69
A.2.2 The chairman should on appointment meet the independence criteria set in the Code. A chief executive should not go on to be chairman of the same company. …	1	3.33	4	8.16	3	6.12	8	6.25
A.3.2 Except for smaller companies, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. …	2	6.67	7	14.29	17	34.69	26	20.31
A.3.3 The board should appoint one independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders ….	0	0.00	3	6.12	3	6.12	6	4.69
A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority … should be independent. …	1	3.33	3	6.12	6	12.24	10	7.81
A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. …	0	0.00	4	8.16	3	6.12	7	5.47
B.2.1 The board should establish a remuneration committee of at least three … independent non-executive directors. In addition the company chairman may also be a member, but not chair ...	2	6.67	5	10.12	10	20.41	17	13.28
C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. …	3	10.00	8	16.32	8	16.33	19	14.84
D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. …	1	3.33	4	8.16	2	4.08	7	5.46

Table 6: Distribution of different types of explanation in the case of partial non-compliance - UK.

Type of Explanation		FTSE 1-30 %	FTSE 31-80 %	FTSE 81-130 %	All %
3.1.1	Pure disclosure (non-temp.)	0,00	10.64	1.37	4.53
3.1.2	Pure disclosure (temp.)	5.56	4.26	9.59	7.25
3.1.3	Pure disclosure - future compliance already decided	0,00	8.51	0,00	2.90
3.2.1	Disclosure and description of alternative practice (non-temp)	11.11	10.64	12.33	11.59
3.2.2	Disclosure and description of alternative practice (temp.)	0,00	4.26	6.85	5.07
3.3.1	Empty justification	16.67	10.64	6.85	9.42
3.3.2	Principled justification against content	27.78	4.26	2.74	6.52
3.3.3	Principled justification against code as from of regulation	0,00	0,00	0,00	0,00
3.3.4.1	Justification on the basis of industry specificities (non-temp.)	5.56	0,00	0,00	0.72
3.3.4.2	Justification on the basis of industry specificities (temp.)	0,00	0,00	1.37	0.72
3.3.5	Justification on basis of company size or board size	0,00	0,00	0,00	0,00
3.3.6.1	Justification on basis of company structure (non-temp.)	5.56	8.51	0,00	3.62
3.3.6.2	Justification on basis of company structure (temp.)	0,00	0,00	0,00	0,00
3.3.7.1	Other company-specific reasons (non-temp.)	5.56	8.51	6.85	7.25
3.3.7.2	Other company-specific reasons (temp.)	11.11	14.89	32.88	23.91
3.3.8	Justification - international practice	11.11	0,00	0,00	1.45
3.3.9.1	Transitional justification - new entrant	0,00	12.77	16.44	13.04
3.3.9.2	Transitional justification - new provision	0,00	2.13	1.37	1.45
3.3.10	General problems with the implementation / potential conflict with law	0,00	0,00	1.37	0.72
4	Ambiguous or missing information	0,00	0,00	0,00	0,00

Table 7: Data set on German companies

Companies	No of companies	No of compliance statements
Dax 30	30	30
MDax	50	49
SDax	50	49
Total	130	128

Table 8: Number of fully compliant companies in Germany

Companies	Fully compliant	% of full compliance
Dax 30	12	40.00 %
MDax	5	10.20 %
SDax	1	2.04 %
Total	18	14.06 %

Table 9: Average number of deviations per company

Companies	Average number of deviations	Median number of deviations	Average number of deviations by non-compliers only	Maximum number of deviations by company
Dax 30	2.63	1	4.39	20
MDax	4.31	4	4.41	30
SDax	5.88	6	5.78	15
Total	4.40	4	5.16	30

Table 10: Number of code provisions all companies are in compliance with

Companies	**No of provisions all companies are compliant with**	**% of code provisions all companies are compliant with**
Dax 30	51	62.20%
MDax	35	42.68%
SDax	36	43.90 %
All	**18**	**21.95 %**

Table 11: List of code provisions of the German Cromme Code with the lowest compliance figures

Code Provision *(n = no. of deviations)*	**DAX 30**		**MDAX**		**SDAX**		**ALL**	
	n	**%**	**n**	**%**	**N**	**%**	**N**	**%**
3.8 If the company takes out a D&O policy for [its] Board[s], a suitable deductible shall be agreed.	6	20,00	20	40,82	29	59,18	56	42,97
4.2.2 Para.1(1HS) At the proposal of the committee dealing with Management Board contracts, the full Supervisory Board shall discuss the structure of the Management Board compensation system	6	20,00	2	4,08	4	8,16	12	9,38
4.2.2Para1(2HS) The full Supervisory Board shall regularly review the structure of the Management Board compensation system	6	20,00	3	6,12	3	8,16	12	10,16
4.2.4S2 The figures [of the compensation of the members of the Management Borad] shall be [reported] individualized [in the Annual Report].	10	33,33	25	57,14	31	65,31	66	54,69
5.3.1 [...] the Supervisory Board shall form committees with sufficient expertise.	1	3,33	1	2,04	13	26,53	15	11,72
5.3.2S1 The Supervisory Board shall set up an Audit Committee [...]	2	6,67	6	12,24	21	42,86	29	22,66
5.4.1S2 The international activities of the enterprise, potential conflicts of interest and an age limit to be specified for the members of the Supervisory Board shall be taken into account.	3	10,00	10	20,41	12	24,49	25	19,53
5.4.7Para2S1 Members of the Supervisory Board shall receive fixed as well as performance-related compensation.	4	13,33	13	24,49	19	36,73	36	26,56
5.4.7Para3S1 The compensation of the members of the Supervisory Board shall be reported individually in the Corporate Governance Report, subdivided according to components.	6	20,00	19	40,82	20	42,86	45	36,72
7.1.2S3(1HS) The Consolidated Financial Statements shall be publicly accessible within 90 days of the end of the financial year;	0	0,00	9	18,37	18	36,73	27	21,09
7.1.2S3(2HS) interim reports shall be publicly accessible within 45 days of the end of the reporting period.	0	0,00	6	12,24	12	24,49	18	14,06

Table 12: Distribution of different types of "explanation" in the German context

Type of „explanation“		Dax 30 %	MDax %	SDax %	All %
3.1.1	Pure disclosure (non-temp.)	8.75	30.92	33.21	28.32
3.1.2	Pure disclosure (temp.)	0.00	0.00	2.50	1.21
3.1.3	Pure disclosure - future compliance already decided	2.50	10.14	10.36	8.98
3.2.1	Disclosure and description of alternative practice (non-temp)	13.75	6.76	7.50	7.94
3.2.2	Disclosure and description of alternative practice (temp.)	1.25	0.00	0.00	0.17
3.3.1	Empty justification	10.00	13.53	5.36	8.81
3.3.2	Principled justification against content	26.25	21.74	11.79	19.17
3.3.3	Principled justification against code as form of regulation	0,00	0,00	0,00	0,00
3.3.4.1	Justification on basis of industry specificities (non-temp.)	0.00	0.00	0.71	0.35
3.3.4.2	Justification on basis of industry specificities (temp.)	0.00	0.48	0.00	0.17
3.3.5	Justification on basis of company or board size	0.00	1.45	9.64	5.18
3.3.6.1	Justification on basis of company structure (non-temp.)	18.75	0.48	1.43	3.45
3.3.6.2	Justification on basis of company structure (temp.)	0.00	0.00	0.71	0.35
3.3.7.1	Other company-specific reasons (non-temp.)	1.25	7.73	10.36	7.94
3.3.7.2	Other company-specific reasons (temp.)	1.25	1.45	2.14	1.73
3.3.8	Justification on basis of international practice	6.25	2.42	1.07	2.25
3.3.9.1	Transitional justification - new entrant	0.00	0.48	0.00	0.17
3.3.9.2	Transitional justification - new provision	5.00	0.00	0.00	0.69
3.3.10	General problems with the implementation / potential conflict with law	3.75	2.42	1.43	2.07
4	Ambiguous or missing information	1.25	0.00	1.79	1.04

Endnotes

[i] The extent to which this leads to 'convergence' as countries seek to emulate the Anglo-Saxon world is a matter of some debate, with prominent critics arguing that traditional ownership structures are of more importance. See, for example, Bebchuk and Roe (1999) on 'path dependence.'

[ii] In the USA and Hong Kong there were two precursors to this code in 1978 and 1989 respectively. However, those codes were relatively general and did not receive much attention.

[iii] While the various codes mostly mention also other actors beyond the shareholders, the code regime is ultimately focused on the shareholder. This can be seen from the way the codes are set up – including the composition of many code committees.

[iv] On the other hand de Jong et al (2005) found no correlation between firm value before and after instatement of corporate governance reforms in the Netherlands.

[v] Other than Von Werder et al (2005) we also did not follow up on potential undeclared consecutive deviations as this was of no immediate interest to our study.

[vi] There were minor changes made to the UK Combined Code published in June 2006 for use in reporting years commencing after 01 November 2006. However, depending on their reporting period, some British companies used the 2003 version, some, particularly those that conformed fully (without deviation), used the 2006 version in anticipation, some used one but referred in explanation to the other. For consistency we illustrate the latest 2006 version but in our analysis employed whichever version the reporting company used. It is after all the explanation and use of comply-or-explain with which we are concerned here – not the specific rules themselves. But in fact most changes were minor in the sense that they slightly amended existing provisions rather than making wholesale deletions and insertions, e.g. the restriction on the company Chairman serving on the remuneration committee was removed to enable him or her to do so where considered independent on appointment as Chairman (although it is still recommended that he or she should not also chair the committee).

[vii] Moore (2008) provides a fascinating analysis of CEO-chairman duality in the case of Marks and Spencer

[viii] Andres and Theissen (2008) provide evidence that compliance on this issue is correlated with firm size, levels of remuneration and ownership concentration.