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Firm performance and comply or explain disclosure in corporate governance

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A R T I C L E I N F O

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A B S T R A C T

This study investigates the degree of Danish firm adherence to the Danish Code of Corporate Governance and analyzes if a higher degree of comply or explain disclosure is related to firm performance. This article formulates a methodology for quantifying the degree of comply or explain disclosure.

The analysis shows that there is a positive link between ROE/ROA and Danish firm total corporate governance comply or explain disclosure scores. Specifically, this is also the case when this level is increased within the following two categories: board composition and remuneration policy, whereas there is no impact on performance when increasing compliance with the recommendations on risk management and internal controls. This article demonstrates that these three areas are the ones where Danish firms show the lowest degree of comply or explain disclosure, although the overall adherence to the Danish code's many recommendations is relatively high.

This article relates to the burgeoning literature that deals with listed firm compliance with national corporate governance codes and how compliance can be appropriately quantified. It is suggested that compliance is classified into the following four categories: complies, complies poorly, explains and explains poorly. The article demonstrates that measuring the degree of compliance cannot be done in a mechanical way. Instead, it must be customized to the respective national institutional environment, which suggests country comparisons will be difficult to make. The article contributes to the ongoing discussion of whether firms consider soft law to be a “tick the box” exercise or, alternatively, whether firms should work seriously with the recommendations in order to professionalize and increase competences among board members. The article's findings suggest that soft law may be an efficient way of increasing the quality of corporate governance among listed firms. However, in order to strengthen investor confidence, national code authorities/committees should be more active in penalizing poor explanations as well as cases where firms wrongfully state that they comply with a specific recommendation.

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1. Introduction

The “comply or explain” principle is a mandatory legal disclosure rule in all 28 EU member states, from the extra-legal corporate governance code provisions that may be drafted by more or less independent bodies. The comply or explain principle was originally put forward by the Cadbury Committee in the UK as a practical way of establishing good corporate governance while avoiding the inflexible hard law “one size fits all” framework (see Seidl, Sanderson, and Roberts (2013)). Even though national codes build on soft law, it is still debated if the voluntary nature of compliance is sufficient in promoting a higher degree of best practice among listed firms (see e.g. Aguilera and Cuervo-Cazurra (2009) for an overview and argument that the codes' voluntary nature may limit the ability to improve governance practices).

Most countries now have their own codes of corporate governance where various bodies have formulated specific recommendations based on the principle of comply or explain. These codes are issued by various bodies with a greater or lesser degree of state participation. For example, the UK Combined Code is issued by an independent regulator: the Financial Reporting Council (FRC). The French corporate governance codes are drafted by wholly private organizations (e.g. the AFEP-MEDEF code); the German corporate

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governance code is drafted by a government commission, which appoints independent members and the Danish corporate governance code is drafted by an independent body.

Several national codes have been inspired by the work of international organizations such as the OECD and the European Governance Forum. For an overview and discussion of the relevance of disclosure requirements, see Nowak (2008). The OECD first released its recommendations in 1999, which were later revised in 2004. The OECD Principles are one out of twelve key standards utilized to ensure the international financial stability of the Financial Stability Board. The recommendations form the basis for the corporate governance component of the Report on the Observance of Standards and Codes adopted by the World Bank Group. The OECD principles are currently under review in order to ensure the continuing high quality, relevance, and utility of the principles taking into account recent developments in the corporate sector and capital markets.

Corporate governance is essential in cases where there is a separation between ownership and control, especially in firms with dispersed ownership. Due to the free rider problem associated with dispersed ownership, shareholders do not have any incentive to challenge incumbent management, which grants top management a considerable amount of power. Dispersed ownership means that individual shareholders only hold a small ownership stake in a company. Any gains from active ownership must be divided among all other passive shareholders, despite the fact that the active shareholder bears all the costs. Thus, the incentive to challenge the supervisory/executive board may be limited.

One may define corporate governance as the ways and mechanisms, in which agency costs are minimized so that the interests amongst members of the supervisory/executive board and the shareholders are aligned, see Shleifer and Vishny (1997). Tirole (2001) argues for a broader definition that includes a wider range of stakeholders such as employees, creditors, customers, the local community etc. However, if agency costs are to be reduced, it is essential that investors are in a position to evaluate whether the board of directors follows acceptable corporate governance policies.

Corporate governance codes consist of recommendations that reflect best conduct practice and serve as national guidelines for publicly listed companies, highlighting transparency as a key corporate governance issue. However, as argued by Mintz (2005), such recommendations may be rendered meaningless unless internal controls are strengthened by senior management and accompanied by the adoption of an ethical tone by the board of directors.

The long-term performance effects of adhering to the recommendations may be difficult to isolate and quantify. However, it may still be relevant for managers and investors to assess whether there is a positive financial impact associated with the corporate governance recommendations; even if it is in the short-term.

Most Scandinavian corporate governance codes deal with issues such as board composition, transparency and remuneration. They may vary in size and structure, but they all focus on these important areas. To illustrate, the Finnish code is quite short and concise whereas the Swedish code is rather long and comprehensive. The Danish code seems to fit in somewhere in-between these examples.

Good corporate governance demands that investors and shareholders are confident that top management is serving the best interests of the company. This confidence lowers the agency premium, which may reduce the firm's cost of capital. Reporting on the corporate governance code serves transparency, but those standards may be specific to the viewpoint of a company.

One may argue that a firm should not be punished if it offers an explanation why it has decided not to follow a specific recommendation. Yet, ultimately, it is up to the stock market to determine if the explanation is sufficient. This facilities a high degree of flexibility instead of excessively rigid hard law rules, which is highlighted e.g. in the UK Corporate Governance Code, see "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. "

The Danish management system consists of a supervisory board (bestyrelse) as well as an executive board (direktion). The supervisory board is responsible for controlling the executive board. The supervisory board must approve all decisions of significant importance. In addition, the Danish supervisory board is in charge of formulating the firm's strategy. The first Danish Corporate Governance code was issued in 2001 and it has undergone a number of revisions since. It builds on the "comply or explain principle", which means that a company must comply with a certain recommendation; otherwise the company must explain why it has decided not to follow what is considered "best practice."

This article presents a methodology for quantifying the degree of listed firms' corporate governance compliance. As recognized by Seidl et al. (2013), despite the wide application of the "comply or explain" principle, very little is known about the ways in which the principle is adopted by firms.

The value of good corporate governance rests on the presumption that "best practice" is not well defined or, in fact, is public knowledge. The development of the Danish corporate governance code is assigned to a special committee that consists of experienced board members and advisors. This implies that the code is revised on a continuing basis in order to ensure that the recommendations are regarded as best practice. This means that the committee consults academia and also analyzes what is considered to be best practice in other countries. The crucial question is whether corporate governance is able to facilitate a change in the mindsets of board members to the point where each board member feels a genuine alignment of interests with the firm's owners.

Best practice is not considered to be a universal tool that can bring a quick fix to a company's corporate governance structure. To illustrate, independent board members are vital in effectively monitoring executive management. Having the right mix between dependent and independent board members where the board works as a team with different competences is what matters if the board is expected to impact firm value.

This article is organized as follows. In the next section, the relevant literature is outlined and discussed. Section three contains a motivation for a number of hypotheses that link corporate governance comply or explain disclosure to firm performance as well as a brief description of the Danish corporate governance system. The methodology for assessing the degree of compliance is presented in section four.

The degree of comply or explain disclosure to the Danish code is presented in detail in section five which is followed by section six with a regression analysis of the relationship between comply or explain disclosure and firm performance. The article ends in section seven with a combined discussion and conclusion.

2. Literature

The majority of the literature focuses on compliance. However, it should be noted that compliance is more than disclosure. Companies may disclose that they comply or not. The most precarious situation is when companies do not disclose that they do not comply. As a consequence, the following literature section is divided into the following subsections: 2.1. Compliance studies, 2.2 Disclosure studies and 2.3. Other contributions.

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