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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. Companies can either comply with code provisions or may explain why they do not comply, i.e., why they deviate from a code provision. Despite its wide application very little is known about the ways in which comply-or-explain is used. In addressing this we employ legitimacy theory by which explanations for deviating can be understood as means of legitimizing the company's actions. We analyzed the compliance statements and reports of 257 listed companies in the UK and Germany, producing some 715 records of deviation. From this we generated an empirically derived taxonomy of the explanations. In a second order analysis we examine the underlying logic and identify various legitimacy tactics. We discuss the consequences of these legitimacy tactics for code regimes and the implications for policy makers.

Keywords Corporate governance · Corporate governance codes · Comply-or-explain · Compliance · Compliance reporting · Compliance monitoring · Legitimacy · Institution

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1 Introduction

Many countries have instated codes of corporate governance over the past two decades (Aguilera and Cuervo-Cazurra 2004; Van den Berghe and DeRidder 1999; Iskander and Chamlou 2000; Weil et al. 2002; Haxhi and Van Ees 2010). Since 1992, when the first comprehensive code of corporate governance was published by the Cadbury Committee in the UK, more than eighty countries have introduced such codes (see http://www.ecgi.org/codes/all_codes). These codes are sets of non-binding rules pertaining to the internal governance of—typically listed—companies, which are issued by a collective body such as a stock exchange, government commission, shareholder or other interest group (Weil et al. 2003).

A central element of most codes is the "comply-or-explain" principle, which was first put forward in the Cadbury Report 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 for use by member states (Communication of the Commission 2003; European Corporate Governance Forum 2006; see also RiskMetrics Group 2009). 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 2006a, b: 5).

Despite its promotion by various national and supranational organizations, very little scholarly research has been carried out on how the comply-or-explain mechanism functions in practice (see Aguilera and Cuervo-Cazurra 2009). There have been numerous surveys on compliance rates (e.g. Von Werder et al. 2005; Von Werder and Talaulicar 2006, 2010; Akkermans et al. 2007) and correlations made between compliance rates and firm performance, size or share prices (e.g. Gompers et al. 2003; Bauer et al. 2004; Goncharov et al. 2006; Drobetz et al. 2004; Fernández-Rodríguez et al. 2004; Alves and Mendes 2004; Andres and Theissen 2008), but hardly any systematic research has been conducted on the different ways in which companies make use of the option to "explain". The limited extent to which comply-or-explain has been researched has not gone unremarked. In a statement endorsing the principle the European Corporate Governance Forum (2006; similarly Von Werder and Talaulicar 2010: 861) stated:

> [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.

To date, only five studies have attempted in a rather general way to address questions relating to the use of comply-or-explain and the overall quality of the explanations: The first is a paper by MacNeil and Li (2006) which provides a cursory review of the contents of compliance statements concluding they were not suitable vehicles for the provision of reasoned explanations. However, their conclusion is questionable as monitors clearly find acceptable many of the explanations provided, as Akkermans et al. (2007) and Arcot et al. (2010) find. While the latter two do examine explanation quality they do not attempt to delineate and classify the explanations. The European Commission too has covered the same ground in a pan-European study (RiskMetrics Group 2009). Here again the analysis lacks depth. Categorisation is fairly basic. Explanations are delineated as "invalid," "general," "limited," "specific," or "transitional" (p. 169). Perhaps the best attempt so far to categorise explanations has been by Hooghiemstra and van Ees (2011) who, drawing in part on Seidl et al. (2009), used nine separate categories in the content analysis element of their examination of firms' trade-offs between flexibility and uncertainty in the use of comply-or-explain. These studies provide a starting point but given the wide diffusion of governance codes and the centrality of the comply-or-explain principle 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, not least to assist policymakers to determine the conditions under which such flexible forms of regulation are likely to be most effective—or indeed, ineffective.

Effectiveness of course requires evaluation. Monitors, particularly in the form of institutional investors or other influential shareholders, determine the quality of the explanation given, and in so doing, can be said to confer legitimacy on the explanation and the underlying action and, hence, on the organization as a whole. Indeed, legitimacy theory (arising from organisational institutionalism and resource dependency theory—see Suchman 1995; Deephouse and Suchman 2008) appears to lend itself particularly well as a theoretical perspective for studying the practical use of the comply-or-explain principle as it addresses the *relational aspect* between organizations and their external audiences. According to legitimacy theory, organizations are generally expected to provide explanations for behaviours that deviate from institutionalised expectations in order to preserve their legitimacy in the eyes of their external audiences. These external audiences observe the organizational activities and structures and accordingly make legitimacy assessments (Ruef and Scott 1998: 880). This resonates well with the idea of "comply or explain".

Two aspects of the "comply-or-explain" principle appear particularly interesting from the perspective of legitimacy theory. First, in contrast to other institutions examined in prior studies (e.g. ISO 9000), comply-or-explain based codes explicitly acknowledge that deviation is legitimate—if justified and such justifications are generally accepted. In other words, 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. Hence, noncompliance can be compliant. Second, these codes put particular emphasis on discursive forms of legitimacy rather than simple compliance. Both compliance with the code and the justifications for deviation are assessed. External audiences read and evaluate company statements on corporate governance. This discursive dimension of legitimacy has been variously stressed in the institutional literature (e.g. Vaara et al. 2006; Phillips et al. 2004; Lounsbury and Glynn 2001).

In this paper we will examine the way in which companies apply the comply-or-explain principle. We posed two exploratory research questions:

(1) To what extent and in what way do companies make use of the "explain" option, i.e., the possibility to deviate from code provisions by stating their reasons for doing so?
(2) What kind of legitimacy tactics can be identified in the "explanations" provided?

To address these questions we analysed the compliance statements and reports of 257 listed companies, producing some 715 records of deviations and respective "explanations". In order to reduce the risk of bias in terms of context specificity, our sample included companies from two different countries (UK and Germany) with contrasting legal cultures, capital market structures and experiences of regulatory codes (La Porta et al. 1998, 2000; Licht et al. 2005; Haxhi 2010).

From the analysis of our data we derived an empirically grounded taxonomy of different forms of "explanation" for deviations which also illustrates the extent of the variety of ways in which the "explain" option is used by companies. In contrast to the original idea of "comply or explain", which emphasised the possibility of justifying deviations with situation-specific reasons (e.g., company size or company structure), a significant number of the deviations analysed were either not justified at all (e.g., deviations are simply disclosed but not justified) or were justified on the basis of principled objections (e.g., inappropriateness of code provisions especially where both companies and monitors consider a provision fails to embody best practice). In a second order analysis we identified different legitimacy tactics underlying the different forms of "explanation" and the associated consequences for governance codes as institutions.

The remainder of the paper is structured in five sections. First, the concept of the "comply-or-explain" principle is explained in more detail and legitimacy theory is introduced as our particular theoretical perspective. Second, the empirical research design and analytical process is explained. Then, we present the empirical findings in two sections: (1) providing a descriptive account of the different ways in which companies make use of the "explain" option and (2) providing an analysis of the different legitimacy tactics that the identified form of compliance statements represent. Finally, we discuss the results and their contributions to the exiting literatures.

2 Theoretical background

From the perspective of legitimacy theory, established governance codes constitute institutionalized expectations regarding the actions or structures of organizations. Companies typically respond to governance codes in order to sustain their legitimacy (Enrione et al. 2006: 968; Hooghiemstra and van Ees 2011); that is to say, to sustain the "generalized perception or assumption that [their] actions […] are desirable, proper, or appropriate" (Suchman 1995: 574). In turn, the legitimacy of codes of governance themselves derives in part from the fact that they embody what is generally considered "best practice"—practices that may be expected to have a positive impact on the management of the company. Of course these practices may be little more than beliefs about, for example, the correlation of good governance with good performance, the evidence for which is debatable—investigators seems to divide fairly equally between those who find the relationship positive and those who do not, much depending on the variables selected and the means by which endogeneity is controlled (Renders et al. 2010; Bianchi et al. 2011). In this sense, governance codes can be seen as constituting "myths of rationality" (Meyer and Rowan 1977), to which companies respond for reasons of legitimacy rather than mere efficiency.

At the centre of legitimacy theory is the relationship between the organization and its audiences. It is not the structures or actions of a company per se which grant it legitimacy but rather the particular relationship with its audience (Suchman 1995: 594). That is to say, every company will try to ensure that its audiences perceive its actions and structures as desirable, proper or appropriate. Apart from conformance to institutionalized expectations, whether authentic or inauthentic, companies employ a variety of "strategies" or "tactics" to preserve legitimacy (Suchman 1995) such as "promising reform" (Meyer and Rowan 1977) or engaging in dialogue with the relevant audiences in order to convince them about the desirability or moral superiority of an alternative course of action (Oliver 1991; Suchman 1995; Deephouse and Suchman 2008). These legitimacy tactics are essentially discursive (cf. Vaara et al. 2006; Phillips et al. 2004; Lounsbury and Glynn 2001; Elsbach 1994). Legitimacy management, as Suchman stresses, "rests heavily on communication—in this case, communication between the organization and its various audiences" (Suchman 1995: 586). This can be seen in the language employed in the UK and German code documents which speak of "general expectations", "justifications", "considered explanations" etc. (see Weil et al. 2002, 2003; Seidl 2007).

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: 499), and thus whether an illegitimacy discount should be applied (Easterbrook and Fischel 1996; Weil et al. 2002: 68–69). 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*). Even if the capital markets are content, adverse comment in the media on a company's compliance position may impact negatively on the company (Seidl 2007; Dyck and Zingles 2002). While this may be simplistic, many (but not all) companies do report

considerable pressure to provide convincing justifications for any deviations (see Sanderson et al. 2010).

Particularly interesting from a legitimacy perspective is the inherent flexibility of comply-or-explain based codes. The code provisions are explicitly meant to be applied flexibly. Companies are not expected to follow all provisions on a one size fits all basis. Rather, where individual rules are not appropriate for a particular organizational setting, companies are expected, even actively *encouraged,* to deviate. This expectation is made explicit in the preamble to the codes. The Combined Code, for example, states clearly that: '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' (Financial Reporting Council 2006a, b: 7). 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 thus acknowledged that "in particular circumstances" (Financial Reporting Council 2006a, b: 5) deviation from code provisions is legitimate. Indeed, policy makers employing comply-or-explain are well aware from the outset that some 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). Hence, rather than forcing corporations into governance solutions that do not fit their particular circumstances, either because they are "technically" not feasible or because the costs incurred by 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. Non-compliance can be (but is not necessarily) compliant.

In term of legitimacy theory, the comply-or-explain principle can be understood as providing a means of legitimating deviations from individual code provisions. In contrast to most other institutions corporate governance codes acknowledge *from the outset* that deviations can be as legitimate as compliance with the code provisions. In other words, the institution—in the form of the comply-or-explain principle—reflexively regulates the deviations from itself. In that sense, we can also speak of the comply-or-explain principle as a meta-institution; i.e., an institution that regulates when and how deviations from the primary institution (in this case the code provisions) can be seen as legitimate. While in other cases organizations would engage discursively in explanations and justifications particularly when deviating from an institution, here explanation and justification of deviations is part of the institution itself (i.e., the formal comply-or-explain principle). This is an important aspect of great theoretical interest that deserves further empirical investigation, which is the main focus of this study.

3 Methodological approach

3.1 Data collection

To study the discursive legitimacy tactics employed by companies in respect of their relevant code of corporate governance, we analysed their annual compliance statements and governance reports—the documents in which they are expected to declare compliance and justify deviations. Our choice of data was guided by three considerations: Firstly, our focus on legitimacy means we are more concerned with the extent of compliance and quality of any 'explanation' given than most existing studies where the primary focus tends to be on compliance rates (e.g. Von Werder et al. 2005); Secondly, since attitudes towards compliance with code provisions have been shown to vary with relative company size due to differences in capital market attention and media coverage (Akkermans et al. 2007: 1109), we include companies from different size ranges. In line with earlier studies (e.g. Akkermans et al. 2007; Von Werder et al. 2005), we include companies from different stock market indices ranging from the largest, the German DAX30, through the mid-size companies that comprise the MDAX, to the smaller companies in the SDAX; Finally, in order to reduce the risk of bias due to country specificities we include also companies with the same rankings on the London Stock Exchange. The UK has of course a contrasting legal culture, capital market structure and a different tradition and experience of regulatory codes (La Porta et al. 1998; Haxhi 2010) so we would expect therefore to capture a reasonably broad range of explanations.

The UK 'Combined Code' and German 'Cromme Code' are fairly similar in terms of their format and content (Akkermans et al. 2007: 1107). The most noticeable difference is in number of code provisions. For the year analysed the Combined Code (Financial Reporting Council 2006a, b) contains 48 code provisions while the Cromme Code (Cromme Commission 2005) has 82. This is because the rules are aggregated to a greater extent in the UK—hence we generally use percentages rather than absolute numbers. The treatment of comply-or-explain differs slightly also. In the UK the obligation to comply or explain is part of the listing requirements while in Germany it is integrated into statutory law (§ 161 Stock Corporation Act) as an obligation to "disclose" any deviations and, additionally, integrated into the Cromme Code as a "recommendation" to provide explanations for any deviations disclosed (Cromme Code: 3.10)—subsequent to the study the respective law was changed to include the obligation to provide explanations. Despite this formal difference, in both countries there is a strong expectation that deviations are explained (Ringleb et al. 2004).

Our combined data comprises the compliance statements therefore of 260 companies—the largest 130 from each stock exchange. The statements we analyse are those published in the calendar year 2006, reporting their activities to years ending 31 December 2005, 31 March 2006 or 31 December 2006.[1] In Germany this

[1] 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

Table 1 Summary of data set

Index	Size band	Number of compliance statements available	Total number of deviations
Germany			
DAX 30	Band A (30 companies)	30	79
MDAX	Band B (50 companies)	49	210
SDAX	Band C (50 companies)	49	282
UK			
FTSE 1–30	Band A (30 companies)	30	19
FTSE 31–80	Band B (50 companies)	49	47
FTSE 81–130	Band C (50 companies)	50	72
Total	260	257	715

includes all companies contained in the Dax30 (30 companies with a market capitalization between €4 bn and €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 FTSE250—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 (one from the UK and two from Germany) as they were not required to submit statements of compliance—either under the relevant listing rules or because of their legal status during the period in question. This leaves 257 companies and their respective compliance statements and corresponding corporate governance reports.[2] The companies in both our chosen countries cover all the core economic sectors. The combined number of deviations recorded is 715. See Table 1 for a summary of the data set.

3.2 Data analysis

To answer our research questions on the extent to which companies make use of the explain option, and what legitimacy tactics they are using in their explanations, we first identified in the compliance statement and company report of each of the 257 companies those passages referring to individual code provisions. This resulted in a set of 715 stated deviations. Then content analysis of the selected passages was

Footnote 1 continued
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).

[2] Note that in Germany some companies provide the explanations for their deviations in the so-called Corporate Governance Report" rather than the "Compliance Statement" (*Entsprechenserklärung*) as such. When we talk about "compliance statement" here we refer to any section in the company report that provides information on compliance.

carried out (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 considered leading to an initial common set of categories. Using these common categories, a further one hundred passages were analysed independently by the authors. Again, the results were compared and reconciled, which led to the addition of some further categories. At this point it emerged that there was overlap between some of the initial categories so some more general categories were introduced. The resulting set was then organized into main and sub-categories. Based on this set of categories we analysed the remaining passages independently of each other. 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. Finally, in order to ensure inter-coder reliability an independent researcher recoded all the records again and the few discrepancies found were addressed. We then examined the distribution of the different types of declaration of levels of compliance (based on our empirically generated taxonomy) across the different companies, countries and company sizes. This was done in order to assess whether any types of explanations were particular to a specific context. In order to facilitate this analysis 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. Finally, in a second order analysis we analyzed the identified types of explanations to determine the different legitimacy tactics that they represented. The result of this analysis is presented in the second part of this paper.

4 Analysis and findings

4.1 Flexibility granted through the comply-or-explain principle

Examination of the corporate governance reports and compliance statements in our sample shows that companies make considerable use of the flexibility provided by the comply-or-explain principle. While about half of all the British companies declare deviations from some of the code provisions, in Germany this rises to five

Table 2 Number of deviating companies

Companies (size)	UK (%)	Germany (%)
Band A (1–30)	33.3	60.0
Band B (31–80)	38.8	89.2
Band C (81–130)	65.0	98.0
Total	48.0	85.9

Table 3 Number of deviations per company

Companies (size)	Average number of deviations by non-compliers		Maximum number of deviations by company	
	UK (%)	Germany (%)	UK (%)	Germany (%)
Band A (1–30)	3.8	5.4	8.3	24.4
Band B (31–80)	5.2	5.8	12.5	36.6
Band C (81–130)	4.6	7.2	14.6	18.3
Total	4.7	6.3	14.6	36.6

Table 4 Number of code provisions that are not universally applied

Companies (size)	UK (%)	Germany (%)
Band A (1–30)	25.0	37.8
Band B (31–80)	35.4	57.3
Band C (81–130)	43.8	56.1
Total	58.3	78.1

out of six (see Table 2). In both the UK and Germany there is a strong correlation between number of deviations and size, with smaller companies recording considerably more. The maximum number of deviations recorded by any one company is 14.6% of all code provisions in the UK and 36.6% in Germany. The average number of deviations by non-compliers is 4.7% in the UK and 6.3% in Germany (see Table 3). Again, the number of deviations tends to be inversely related to company size. These findings are consistent with earlier studies of compliance rates in the UK, Germany and the Netherlands (Hooghiemstra and van Ees 2011; MacNeil and Li 2006; RiskMetrics Group 2009; Von Werder et al. 2005; Von Werder and Talaulicar 2006).

Although the absolute number of deviations varies considerably between the two countries, and between size bands within the countries, the sheer number of deviations recorded would seem to suggest that concerns about companies being driven towards full compliance are largely unfounded. It had been argued (see Wymeersch 2005: 418; Seidl 2007) pressure to be classified as fully compliant could force companies into inappropriate or sub-optimal decisions. Even though we cannot rule this out completely almost 60% of firms examined from the UK and almost 80% from Germany deviated from at least one code provision (see Table 4). That is to say, the majority of code provisions are treated as flexible regulations. They are also the code provisions that generate most controversy (Von Werder et al. 2005; MacNeil and Li 2006). The most frequent deviations in the UK concerned (in the order of frequency):

A.3.2. the requirement for a majority of the board to be independent non-executive directors;
C.3.1. the composition of the audit committee
B.2.1. the composition of the remuneration committee, and;
A 4.1. the requirement for the majority of members of the nomination committee to be independent.

In Germany the provision with the highest level of deviation was:

4.2.4S2. requiring the individualized disclosure of the compensation of the Management Board Members, followed by;
3.8. agreeing a suitable deductible for the D&O insurance policy, and;
5.4.7Para3S1. requiring the individual disclosure of the compensation of the Supervisory Board Members

Table 5 presents an overview of the code provisions with the highest number of deviations from both countries.

Table 5 Code provisions with the highest number of deviations

UK	Germany
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 ….	**3.8** If the company takes out a D&O policy for [its] Board[s], a suitable deductible shall be agreed.
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. …	**4.2.4S2** The figures [of the compensation of the members of the Management Board] shall be [reported] individualized [in the Annual Report].
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. …	**5.3.1** […] the Supervisory Board shall form committees with sufficient expertise.
A.3.3 The board should appoint one independent non-executive director to be the senior independent director. The senior independent director should be available to shareholders ….	**5.3.2S1** The Supervisory Board shall set up an Audit Committee […]
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. …	**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.
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. …	**5.4.7Para2S1** Members of the Supervisory Board shall receive fixed as well as performance-related compensation.
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…	**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.
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. …	**7.1.2S3(1.HS)** The Consolidated Financial Statements shall be publicly accessible within 90 days of the end of the financial year;
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. …	**7.1.2S3 (2.HS)** Interim reports shall be publicly accessible within 45 days of the end of the reporting period.

While it can be argued that these figures demonstrate and confirm that comply-or-explain offers regulatees a flexible form of regulation that avoids one size fits all, alone they say nothing about the extent to which the deviations observed are 'justifiable' and consistent with the intentions of the code designers. They may just be an expression of the companies' unwillingness to comply (MacNeil and Li 2006: 488). In order to address this it is not sufficient to merely analyse compliance rates. Rather one needs to examine the contents of the compliance statements, which we turn to in the following section.

4.2 Forms of "explanation"

Our analysis of the different compliance statements and governance reports revealed considerable differences in the types of explanations that companies provide. In addition to a very few cases where the statements were either ambiguous or incomplete we identified three general categories of explanations, each with several subcategories (see Table 6; see also Table 10 in the Appendix for a list of exemplary "explanations" in each sub-category).

4.2.1 Deficient justification

The first category of explanation we term "deficient justification"—where companies confirm they have not complied with a code provision but do not provide reasons for deviating. Such deviations may be either temporary or persist over time. We identify three sub-categories: *(a) pure disclosure, (b) description of alternative practice* and *(c) empty justification*. In the case of *pure disclosure*, companies merely declare that they are deviating from particular code provisions. For example, Grammer AG simply declares: "The Grammer AG has a Directors & Officers Liability Insurance ("D&O Insurance") for the Supervisory Board Members, Executive Board Members and Managing Directors, but the insurance does not contain a deductible [as code provision 3.8 requires]" (our translation). Such pure-disclosure statements may indicate that the failure to comply is temporary. Gerry Weber AG, for example, states: "The consolidated financial report was available within 120 days of the end of the financial year. We are working on meeting the deadline of 90 days [as required by code provision 7.1.2 S3 (1HS)] in the future" (our translation). *Description of alternative practice* refers to statements where the company does not comply with the requirement in the code but has acted in a way that it addresses the underlying principle. While this kind of statement provides more information than pure disclosure no reasons are given for choosing an alternative solution. The codes are, after all, supposed to reflect best practice. Adidas-Salomon AG, for example, states: "The structure and level of the Executive Board compensation is reviewed and determined by the Supervisory Board's General Committee instead of the entire Supervisory Board [as required by code provision 4.2.2 Para 1 (1HS)]. The General Committee informs the Supervisory Board as a whole on the respective results." The final "deficient" subcategory we label *empty justifications,* where the explanation has (almost) no explanatory power. Hornbach Holding AG, for example, writes: "Since we believe that the

Table 6 Taxonomy of explanations

Categories of explanation	Sub-categories of explanation	Definition
Deficient justification Company discloses deviation without providing reasons for the deviation	Pure disclosure (temporary/ persistent)	Company only declares that it deviates from the code provision. No explanation is given. There are two forms of this: (a) the company indicates that the deviation is temporary or (b) it does not.
	Description of alternative practice	Company presents an alternative solution to the governance problem that the code provision addresses but does not provide any justification for having chosen the stated solution. There are two forms of this: (a) the company indicates that the deviation is temporary or (b) it does not.
	Empty justification	Company provides an explanation that seems like a justification for its deviation but which does not possess any explanatory power.
Context-specific justification Company justifies deviation with reference to its specific situation	Size of company or board	Company justifies deviation with regard to the (small) size of the company or its board due to which the application of the code provision appears inappropriate or impossible.
	Company structure (temporary/ persistent)	Company justifies deviation by regarding the code provision as inappropriate or impossible to implement given its specific company structure.
	International context of company	Company justifies deviation with regard to specific aspects of its international operations which mean the code provision is inappropriate or impossible to implement.
	Other company specific reasons (temporary/persistent)	Company justifies deviation with regard to the particular situation of the company, other than its size, structure or in ternational con text which the application of the code provision appears inappropriate or impossible to implement. There are two forms of this: (a) the company indicates that the deviation is temporary or (b) it does not.
	Industry specificities	Company justifies deviation with regard to the specificities of the industry in which it is involved which mean the code provision is inappropriate or impossible to implement.

Table 6 continued

Categories of explanation	Sub-categories of explanation	Definition
	Transitional justification (new code provision or new entrant)	Company justifies deviation with regard to either (a) the novelty of the code provision or (b) the fact that the company is a new entrant to the particular stock exchange, as a consequence of which an application of the code has not been possible, yet.
Principled justification Company justifies deviation with reference to problems with the specific code provision as such	Effectiveness/ efficiency	Company justifies deviation by pointing out that an application of the code provision will be sub-optimal generally—not just for its own operations
	General implementation problems	Company justifies deviation by pointing out some general problems in implementing the code provision.
	Conflicts with laws or societal norms	Company justifies deviation by pointing out that the code provision conflicts with societal norms, values or laws.

compensation of our Management Board is adequate we see no necessity in disclosing the compensation of every individual member [as required by provision 4.2.4 S2]" (our translation). Another example is the statement by Fielmann AG: "The existing structure of compensation for the members of our Supervisory Board is in accordance with their responsibilities and duties, hence we see no need for any performance-related components [as required by provision 5.4.7 Para2 S1]" (our translation). Although such statements may at first glance seem to contain a rudimentary explanation they are in fact merely statements confirming failure to comply and as such provide investors and other audiences with little more information than those purely disclosing noncompliance. In terms of the comply-or-explain principle all three of these sub-categories are problematic in that they do not provide any rational justification for deviating from what is deemed to be "best practice". In the UK such deficient justifications constitute a breach of the Listing Rules of the London Stock Exchange which explicitly require companies to provide explanations for their deviations (see also Akkermans et al. 2007: 1116, endnote 3 on the Dutch case). Yet, beyond such formal concerns deficient justifications undermine the basic idea of comply-or-explain. As MacNeil and Li (2006: 488) write: "without adequate explanation in the event of non-compliance there can be no possibility of the market evaluating whether or not it is justified."

4.2.2 Context-specific justification

In contrast to the previous category this comprises explanations for noncompliance that are fully justified, where compliance is either irrational or impossible. We

found six sub-categories, relating to *(a) company size; (b) company structure; (c) international context; (d) other company specific reasons*; *(e) industry specificities;* and; *(f) transitional issues*. With regards *size,* small companies often have smaller numbers of directors on the boards than their larger counterparts, with obvious implications for the formation of subcommittees. Rational AG, for example, writes: "Since the Supervisory Board of RATIONAL AG consists of only three members the formation of committees for complex issues [as requested by code provisions 5.3.1 und 5.3.2 S1], such as an audit committee, appears inappropriate" (our translation). On *company structure* H&R WASAG AG argued that "Due to the many subsidiaries that have to be included the annual consolidated financial account for the year 2004 was only published at the beginning of May 2005 [cf. code provision 7.1.2 S3 (1HS)]" (our translation). *International context* may be important where, for example, accepted best practice in a company's key overseas market differs from domestic practice as embodied in their national code of governance. Stada AG, for example, states: "The D&O Liability Insurance, which includes both the board members and senior management, does not contain a deductible [as required by code provision 3.8] since this is unusual in other countries" (our translation). In addition to that, there are many *other company-specific reasons*, some completely unavoidable, for example where serving board members become ill or even die, causing the board to become unbalanced in respect of maintaining a majority of independent directors, perhaps requiring the CEO to serve temporarily in a dual capacity as both CEO and chairman. Beyond the reasons to do directly with the company, there are also *industry-specific* reasons. WCM AG, for example, states: "At the moment, we do not plan to change the current compensation system [to comply with code provision 5.4.7Para2 S1], since forms of payment related to company performance are unusual in our particular competitive environment" (our translation). Finally, there are what we have termed *transitional justifications* where companies have not yet been able to comply with a particular code provision because either the provision itself is new or the company (or at least parts of it in the case of mergers and acquisitions) has only recently become subject to the regulations of the particular stock exchange ("new entrant"). An example for the former is the statement by Adidas-Salomon AG which explains that notwithstanding code provision 4.2.3Para2 S4, setting out conditions for stock option plans, "all stock options had already been issued before the code provision was introduced in May 2003" (our translation). These are all formally consistent with the original idea of comply-or-explain—the avoidance of one size fits all. Companies should be allowed to take into account their own individual circumstances in complying with the principles set out in their respective codes, avoiding being "corseted" by the code (Ringleb et al. 2004: 89; Financial Reporting Council 2006a, b: 5). Several of the reasons given above were anticipated when the codes were designed. The Cadbury Committee (Cadbury 1992: 3.15), for example, explicitly mentions size as a potential justification for deviating. Similarly, Baums (2001a, b: 7), chair of the panel that set up the German Code Commission, gives international context as a possible reason.

4.2.3 Principled justification

In contrast to context-specific justifications, explanations that we categorize as *principled* arise when a company contends that a provision does not reflect best practice. There are three sub-categories: *(a) effectiveness/efficiency issues; (b) general implementation issues,* and*; (c) conflicts with other laws/norms*. On *effectiveness/efficiency* Fresenius AG contends that: "Disclosure of individual compensation for each member of the Management Board, required by clause 4.2.4, sentence 2, in our view limits the structuring of compensation in such a way as to distinguish individual performance and responsibility." Another example is the statement of BWH Holding AG: "The Management and Supervisory Board think that a general age limit for members of the supervisory board [as required by code provision 5.4.1 S2] is inappropriate. It limits the shareholders' choice of candidates and does not adequately consider the personal qualification and experience of individual candidates" (our translation). *General implementation issues* are similar but rather than objecting to the principle outlined these explanations stress that the provision to which they refer is difficult to put into practice, for all companies, not just in their case, which we would categorise as company-specific. Deutsche Beteiligungs AG, for example, explains it deviates from the requirement for D&O Liability Insurance to contain a deductible because a "standard regarding amount and composition of a deductible has still not been developed" (our translation). Finally, there are those explanations that justify the deviation by pointing out that the provision in question *conflicts with laws or social norms*. Loewe AG, for example, justifies their departure from certain disclosure requests with concerns about the invasion of personal privacy: "In order to protect their privacy we will not disclose any information on the compensation of the individual members of the executive board [as requested by code provision 4.2.4 S.2]" (our translation). Similarly, EM TV AG EM TV AG refers to legal concerns to justify its deviation: "The introduction of performance related payment for members of the Supervisory Board [as requested by code provision 3.3.10] is put on hold, since there are currently concerns regarding the legality of performance related payments" (our translation). While these forms of explanation may or may not provide acceptable justification for deviating they are not the company-specific reasons envisaged when the codes were originally formulated.

In fact, somewhat to our surprise, analysis of the relative frequency of occurrence of types of explanations (see Table 7) reveals that just under one half of the deviations in the UK, and less than a quarter of deviations in Germany, were explained by context-specific reasons. Of those that are context specific the "other" category was most common in both countries where, for a whole host of reasons, companies find compliance difficult if not impossible as a result of some singular event, characteristic, or condition. This is followed in the UK by "transitional justifications", which relate to mergers, demergers and overseas companies seeking a listing on the LSE for the first time. In Germany "size of company or board" was the second most frequent context-specific reason, almost all of which, as one would expect, are to be found in Band C, i.e., companies in the small cap index. In Britain, by contrast, there was not a single instance of this category, consistent with the

Table 7 Distribution of different types of explanation

Type of explanation	Germany (%)	UK (%)
I. Lack of justification	55.7	41.3
Company discloses deviation without providing reasons for the deviation		
I.1 Pure disclosure (persistent)	28.3	4.3
I.1 Pure disclosure (temporary)	10.3	10.9
I.2 Description of alternative practice (persistent)	8.3	11.6
I.2 Description of alternative practice (temporary)	0.0	5.1
I.3 Empty justification	8.8	9.4
II. Context-specific justification	23.8	52.2
Company justifies deviation with reference to its specific situation		
II.1 Size of company or board	6.0	0.0
II.2 Company structure (persistent)	3.6	3.6
II.2 Company structure (temporary)	0.3	0.0
II.3 International context of company	2.2	1.4
II.4 Other company specific reasons (persistent)	8.3	7.2
II.4 Other company specific reasons (temporary)	1.2	18.3
II.5 Industry specificities	0.5	1.4
II.6 Transitional justification (new code provision)	0.7	1.4
II.6 Transitional justification (new entrant)	0.2	13.0
III. Principled justification	19.7	6.5
Company justifies deviation with reference to problems with the specific code provision as such		
III.1 Ineffectiveness/inefficiency of code provision	12.8	6.5
III.2 General implementation problems	0.5	0.0
III.3 Conflicts with laws or societal norms	6.4	0.0
IV. Ambiguous or incomplete information	0.9	0.0

larger relative market capitalisation of British companies. Industry-specific reasons, which some actors expected to be much in evidence (e.g. Baums 2001a, b), 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.

Strikingly, a very large number of explanations (40% in the UK and well over 50% in Germany) fall into the category of "deficient justification". In both countries, this applies more to the smaller companies surveyed. Pure disclosure, where deviations were simply disclosed without any reason being given, accounts for 15% of deviations in the UK and almost 40% in Germany, although a large part of these were indicated as being of temporary nature. The disparity between the two countries can be explained in part because at the time of the study German companies were not formally obliged to provide explanations—it was merely "recommended". In both the UK and Germany almost 10% of the explanations were what we referred to as "empty", where companies presented explanations which merely appeared to be justifications but which did not possess any substantial

information value beyond indicating areas of deviation, with a further 15% in the UK and 8% in Germany describing alternative practices without justifying why. Whether companies offering such deficient explanations did not have any convincing justification or simply did not consider their external audiences would have any interest, we cannot say.

Our final core category, "principled justification" accounts for about 6% of UK deviations and almost 20% in Germany, of which the most frequent instances concerned the general effectiveness/efficiency of a code provision. A similar proportion of code provisions were questioned in both countries in this way. In the UK companies objected for reasons of general effectiveness/efficiency, to eight out of the 48 provisions of the Combined Code while in Germany the comparative figure for the Cromme Code was 15 out of 82. In addition to that, some German companies had issues with how practically to implement two particular code provisions. Finally, six per cent of the deviations of our German companies, relating to some 10 provisions, were justified on the basis of potential conflicts with law or social norms (Akkermans et al. (2007) and Hooghiemstra and van Ees (2011) report similar types of principled justifications in their studies of the Dutch code). The difference between the UK and Germany regarding types of principled justifications may be explained partially by the fact that the German code (like the Dutch Code) is still relatively new compared to the UK code. Issues around implementation of individual provisions and their compatibility with statute law or wider societal norms are more likely to arise under these circumstances. The longer a code and its individual code provisions have been in place the more likely it is that that these issues will have been resolved—e.g., through explicit guidance on implementation or through adjustments of the code provisions.

If all the explanations had been context specific, that is to say peculiar to each individual deviating company, there might be little more to say on the matter. However, the way that companies seem to coalesce around a number of common types of justification, (our core categories and sub-categories) suggests there is more to investigate. We consider these, as aspects of companies' legitimacy tactics in the following section where we also examine the implications for comply-or-explain of the way the principle has been used beyond the codes designers' intentions—to avoid an inflexible one-size-fits-all body of rules.

4.3 Second order analysis: "explanations" and their legitimacy tactics

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. Different explanations refer to different points of reference as the basis of justification for the chosen governance arrangements (see Table 8). The most obvious and straightforward form of explanation is a simple declaration of *compliance with a particular code provision*. As such 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;

Table 8 Legitimacy tactics associated with different types of explanation

Type of Explanation	Legitimacy tactic employed	Basis of legitimacy claim
Compliance with provision	Conformance with code provision as primary institution	Code provision (primary institution)
Context-specific justification	Claims exception from code provision consistent with logic of comply-or-explain	Comply-or-explain principle (meta-institution)
Principled justification:		
Effectiveness/efficiency and general implementation problems	Rejection of code provision as conflicting with audiences' interests ("pragmatic legitimacy")	"Self-interest of immediate audience"
Conflict with laws or social norms	Rejection of code provision as conflicting with higher institutions ("moral legitimacy")	Beyond the code (other institution)
Deficient justification:		
Pure disclosure and description of alternative practice—*temporary*	Promises future compliance with code provision	Code provision (primary institution)
Pure disclosure and description of alternative practice—*persistent* and empty justification	Ambiguous	Ambiguous

Suchman 1995). In the case of *context-specific justifications*, legitimacy is conferred by the legitimacy of the comply-or-explain principle itself. Comply-or-explain serves here as a kind of meta-institution that provides a means of claiming "a valid exception to the sound rule" (Higgs 2003: 3). As we have already described, some potential exceptions, such as "size", are even referred to within the codes and/or related guidance. That is to say, companies are conforming to the institutionalized notion at the heart of comply-or-explain—that companies should deviate where a code provision is inappropriate for their particular context. Hence, the basis on which companies seek approval for deviating is nonetheless compliant—noncompliance is, in this case, compliant.

This is very different to the case of a *principled justification*. Principled justifications—rejecting the code—were not envisaged in the original Cadbury Report (1992). This is a rejection of the code or at least of one or more of its provisions, typically on grounds of "general (rather than company specific) effectiveness/efficiency" and/or "general implementation problems." This is consistent with what Suchman (1995) refers to as pragmatic legitimation where legitimacy is preserved by appealing to the "self-interested calculations of an organization's most immediate audiences" (Suchman 1995: 578). The organization calls for approval of their departures from the code with the claim that the code provision conflicts with the audience's self-interest. For example, BHW Holding AG rejected the code provision requiring an age limit to be determined for members of the supervisory board on the basis that this would limit the choice of suitable

candidates for the board and thus be against the interests of shareholders. A somewhat similar legitimacy argument underlies those explanations we describe as "conflicting with societal norms and laws". Like the other two principled forms of justification, this type of explanation also involves rejecting a code provision. However, in this case it is a moral legitimacy argument (Suchman 1995). Legitimacy is not obtained or preserved by consideration of the interests of a key audience but simply by "judgments about whether the activity is the 'right thing to do'" (Suchman 1995: 579). Companies in effect appeal to a higher institution, for example, laws or social norms that would be violated by compliance with the code provision. Companies reject the provision by referring to some "higher" institutions such as laws or other societal norms that seem to be violated by the provision. By way of example, Loewe AG and Celesio AG both rejected the provision requiring the disclosure of individual board member's compensation as this, they argued, would conflict with privacy norms or laws.

Finally, even within the *deficient justification* type of explanation one can find some rudimentary legitimacy arguments employed. Those in the "temporary" sub-categories of pure disclosure and description of alternative practice typically seek approval for their practices by pointing to future compliance with the code provisions. In the words of Suchman (1995: 590), they "promise reform, thereby segregating today's reality from tomorrow's ideal". They are attempting to secure acceptance for deviating from best practice by pointing to a future time when they will be in compliance (Meyer and Rowan 1977; Oliver 1991). The basis for legitimacy here though is not consistent with the original comply-or-explain concept. Although describing an alternative practice they do not disclose any reason why they should be treated exceptionally—merely they hold they should be considered legitimate as they are moving towards compliance. In the case of empty justifications the legitimacy tactic is merely mimetic. Companies deploying this argument purport to be providing the same sort of explanation as those offering context specific or principled reasons yet their explanations contain no real informational value and, at best, constitute a rather rudimentary legitimacy argument. The two remaining "persistent" sub-categories of pure disclosure and description of alternative practice do not contain any explicit legitimacy arguments. They merely disclose the area of deviation and describe the deviating arrangement. No attempt is made at specifying on what grounds the legitimacy of these deviations is to be assessed—all that can be said is that the company is open about its deviating governance arrangement.

5 Discussion

To recap, we set out to investigate the extent to which companies make use of the "explain" option and the bases by which companies claim legitimacy in the explanations they provide for deviating. Our analysis of the compliance statements and governance reports of the 257 companies we examined yielded three principal findings. First, our quantitative analysis of the distribution of deviations across different size bands and national contexts revealed that companies make considerable use of the flexibility offered by the comply-or-explain principle. This is

consistent with earlier studies of compliance rates (e.g. Von Werder et al. 2005; Von Werder and Talaulicar 2006; Akkermans et al. 2007) but at odds with some (e.g. Wymeersch 2005; Seidl 2007) concerned that companies would not be able to resist the pressure to attain full compliance. Our present study differs from all these previous studies in that we are concerned more to understand how companies use the flexibility of comply-or-explain.

Second, our content analysis of the compliance statements led us to develop an empirically derived taxonomy of types of explanation—deficient, context-specific, principled and several important sub-categories—which reveal common ways in which companies use the opportunity to explain deviations from code provisions. We thus build upon and extend earlier work on modes of explanation, particularly Akkermans et al. (2007), Arcot et al. (2010), Hooghiemstra and van Ees (2011), MacNeil and Li (2006), and RiskMetrics Group (2009). While these studies raised awareness of the importance of "explanations" they did not focus specifically on explanation as a practice. MacNeil and Li (2006: 489) distinguish between explanations that record deviations, those that provide proper justifications and those that provide justifications of limited informational value. Arcot et al. (2010) distinguish between disclosure with "no explanation", "general explanations" and "specific explanations" while both Akkermans et al. (2007) and Hooghiemstra and van Ees (2011) report on a variety of different kinds of explanations but do not attempt to organise their categories. In a report to the European Community, RiskMetrics Group (2009) examines frequency of explanations across Europe. Their categories comprise "invalid explanations" (just disclosing deviation), "general explanations", "limited explanations" (just describing the existing governance arrangement), "specific explanations" (explaining deviation on the basis of the situation of the company) and "transitional explanations" (explanations referring to the temporary nature of the deviation)—but our own taxonomy goes beyond this. The methodological and analytical rigour employed in our research design enables us to take a more robust and systematic approach to categorisation than these studies.

Third, in our second order analysis we identified the institutional bases and legitimacy arguments made in respect of each type of explanation (Table 8). The institutional bases were: (1) the code as the primary institution—for compliance and "temporary" deviations; (2) the comply-or-explain principle as a meta-institution—for context-specific justifications, and; (3) external higher order institutions such as laws and societal norms or considerations of the immediate audience's self-interest—for principled justifications. In theoretical respects this differentiation offers important insights. It provides a basis for evaluating the challenges and prospects of different legitimacy claims and for developing an appropriate regulatory response to those legitimacy claims, as we show in the following section.

Analysing the structure of the various legitimacy claims provides us with conceptual tools with which to evaluate the efficacy of different explanations. For instance, claims that are based directly on the code provisions such as straightforward compliance are very likely to be accepted by an external audience—irrespective of their real value—due to the *institutionalized* belief about the provisions constituting "best practice" (Meyer and Rowan 1977; Deephouse and Suchman 2008; Enrione et al. 2006; Hooghiemstra and van Ees 2011). Of course this presupposes the external

audience believes there to be equivalence between the statement of compliance and the actual governance arrangement. Where the legitimacy claim rests on the comply-or-explain principle (particularly in the case of context-specific justifications), the challenge to get approval is somewhat greater, since the audience needs to be convinced that the specific context is indeed a reason for deviating. This can prove challenging as the company and its audience may evaluate the context differently (MacNeil and Li 2006: 487; Seidl 2007). While the audience in principle is likely to approve exceptions to the provisions—to the extent that comply-or-explain is institutionalized—the question is whether the specified context is seen as constituting a valid exception. Where the legitimacy claim implies a rejection of code provisions (i.e., principled justifications) the challenge to get approval is even higher as this constitutes an attempt to modify prevailing cognitive frames about "best practice" (Oliver 1991; Suchman 1995) and the basis for legitimation is external to the code. To succeed, external bases for legitimacy need to be very convincing, by pointing perhaps to significant conflicts with the audience's self-interests or to other institutions, such as law. Gaining approval becomes increasingly doubtful as one moves from compliance on the one hand, to deficient explanations on the other. In line with this, Hooghiemstra and van Ees (2011) in their study on the Dutch code argue that this uncertainty about the stakeholders' approval for deviations leads companies to imitate each others' compliance behaviours, in the sense that they tend to deviate in similar areas and with similar forms of explanation.

Given these challenges one might expect companies would choose only those legitimacy tactics likely to lead to success. Accordingly, one might expect to find almost no deficient justifications, a few rather obvious context-specific justifications, and one or two principled justifications where a strong argument can be made about conflicting imperatives. Yet, this argument is neither in line with the empirical figures presented here and elsewhere (MacNeil and Li 2006; Akkermans et al. 2007; RiskMetrics Group 2009; Hooghiemstra and van Ees 2011) nor with legitimacy theory as it overestimates the importance of gaining approval for a company's governance arrangements. As legitimacy theory emphasizes, the legitimacy of an organization does not rest on approval of a single act but on an overall assessment of its operations and structure. As Suchman (1995: 574) points out, legitimacy represents an "umbrella evaluation that, to some extent, transcends specific adverse acts or occurrences; […] An organization may occasionally depart from societal norms yet retain legitimacy because departures are dismissed as unique." Hence, to the extent that an organization is otherwise largely in conformance with institutionalized expectations, approval for individual governance arrangements is not crucial. Again, this is consistent with findings by MacNeil and Li (2006) that compliance with the code tends to rise in those cases where overall approval of the company's actions is in danger of being withdrawn.

Clearly, if the institutional basis of legitimacy has implications for managing the process of legitimation it also has implications for managing the entire regime. In the original self-regulatory design of the code regime emphasis is placed on the interaction between companies and their immediate audience, the shareholders: Companies provide their explanations which are used as the basis for approval or disapproval of the company's governance practices by key audiences and, where necessary, sanctions are applied (Seidl 2007). However, the legitimacy arguments

deployed and institutional bases we identify point to several limitations, both conceptual and practical, of this basic self-regulatory model. The original model was conceived with two forms of compliance in mind: compliance and context-specific exceptions. Both of these are self-referential. They refer back on the code itself as legitimising organizational action.

Principled justifications have very different implications for code regimes compared to context-specific deviations or compliance. The former constitute rejection of the code provision itself. They do this by seeking legitimacy with reference to external institutions such as norms and laws or to the audience's self-interest—which are beyond the code. Principled justifications, by questioning best practice assumptions, will, if successful, lead to the deinstitutionalization of the respective provision, weaken the regulatory power of the provision and perhaps the entire code. So while "compliance" and "context-specific justifications" uphold the code regime, principled justifications have the capacity to undermine it. Consequently, when faced with large numbers of principled justifications to a code provision the regulator has to act—one way or another. Von Werder, one of the architects of the German Cromme Code acknowledges that larger numbers of principled objections should lead those responsible for the code to "review whether the respective provisions make sense." (Von Werder and Talaulicar 2006: 861, our translation). This is especially likely to be the case in countries where codes or sets of provisions are relatively new but even in the UK the Financial Reporting Council regularly reviews the UK Corporate Governance Code (formerly the Combined Code), in part to assess and act on principled objections to code provisions. Such reviews lead ultimately to one of three regulatory responses: (1) amend the code provision; (2) improve enforcement, or; (3) provide guidance on implementation. In cases based on "general effectiveness/efficiency" or "conflict with laws or social norms" regulators can, if they accept the criticism, either amend the code provision to accommodate concerns or if not improve enforcement by either focusing regulatory resources on the problem using existing sanctions or by escalating up the enforcement pyramid, for example, by moving from "enforced self-regulation"—voluntaristic code—to "command regulation with non/discretionary punishment"—statute law (Ayres and Braithwaite 1992: 38–39). Both responses could also be observed subsequent to the observation period of our study. For example, the UK Financial Reporting Council's review of the code provisions in force for the year we analysed for this study identified "potential changes for which there would appear to be substantial support: [incl.] amending the existing provision relating to the composition of remuneration committees to enable the chairman to sit on the committee where he or she was considered independent on appointment" (Financial Reporting Council 2006a, b). In Germany we could observe the second type of response—escalation—when several code provisions were subsequently enshrined in law (for an overview see Von Werder and Talaulicar 2010: 861). This included the controversial provision requiring disclosure of individual compensation of board members. In the case of "general implementation problems," of which there have been only a few examples, the response has been to provide additional guidance on implementation of the sort provided in the official commentary on the Cromme code [*Kodex-Kommentar*] (Ringleb et al. 2007).

Finally, deficient justifications can also provoke a regulatory response as they undermine the core principle of comply-or-explain, to "allow investors to make an informed assessment of whether non-compliance is unjustified in the particular situation" (MacNeil and Li 2006: 489). To the extent that information is not provided or is inappropriate the organization's immediate audience cannot fulfil their monitoring function. Thus, deficient justifications undermine the functioning of the self-regulatory code regime and will eventually require action by the regulator. The most obvious response in this case would be to increase the level of enforcement regarding the provision of information. Such a response occurred in the period immediately following our study, when the German law (§161 stock corporation act) requiring disclosure of deviations was amended to require additionally that explanations be provided—a requirement that previously had been part of the code, but not enshrined in law. In Table 9 we have summarized the different regulatory responses to principled and deficient justifications.

6 Conclusion

This article has attempted to generate some new insights concerning the way that the comply-or-explain principle, a central element of most corporate governance code regimes, is being used by managers. With our empirically derived taxonomy of "explanations" and the description of the different discursive legitimacy tactics deployed, we offer conceptual tools to aid understanding of the critical role of comply-or-explain in corporate governance regimes. As we discuss, analysing legitimacy tactics on the one hand provides a means for assessing the particular challenges that companies face in securing approval for their activities while on the other it helps identify the consequences of different forms of explanation for the regulatory regime. As such our results have practical implications both for managers—the use of explanations as legitimacy tactics—and regulators—by addressing the implications for regulatory regimes of different types of explanation.

Table 9 Regulatory responses to forms of compliance statement

Type of explanation	Response by regulator
Compliance with provision	No action required (unless in doubt about the equivalence between the statement of compliance and actual governance arrangements)
Context-specific justification	No action required
Principled justification	
General effectiveness/efficiency and conflict with laws and norms	Alternative responses: Change of code provision or increasing level of enforcement
General implementation problems	Provision of additional guidance
Deficient justification	Increasing level of enforcement regarding practice of explanation

We also contribute to three literatures. First, within the corporate governance literature we build upon earlier studies of corporate governance codes. In particular we add to that literature an empirically robust taxonomy of the types of explanation found in corporate governance compliance statements and provide new insights into the way these affect the corporate governance regime. Second, we contribute to the literature on soft regulation and self-regulation by providing new insights into the dynamics of code regimes as a particular type of enforced self-regulatory regime. Finally, with our analysis of the discursive legitimacy tactics deployed in compliance statements we contribute to legitimacy theory by adding to those studies that have analyzed legitimacy tactics in other contexts (e.g. Vaara et al. 2006; Elsbach 1994).

Like all such studies our work also has limitations which can serve as an agenda for future research. First, given the exploratory nature of our research questions, we limited our study to two countries (albeit countries with contrasting capital market structures, legal cultures and different experiences of governance codes). So while we are confident of the robustness of our taxonomy in respect of Germany and the UK we cannot say for sure there are no further forms of compliance or explanation to be found in other national contexts. In particular further research in developing countries could prove to be of interest. Second, we focussed on generating our taxonomy of explanations and analysing the discursive legitimacy tactics deployed. Quantitative analysis of the distribution of different types of explanations by sector, size and domain was used only as a means of corroborating our taxonomy. Future studies could examine in more detail the reasons for differences in frequency of the types of explanation we educed. For example, drawing on Hooghiemstra and van Ees (2011) one would expect that the "visibility" of the company has an influence on the choice of explanations and the respective legitimacy strategies. Third, our study was cross-sectional—a snapshot based on a single period of compliance statements—even though to an extent we took account of subsequent regulatory reactions. In order to gain a deeper understanding of the dynamics of the wider self-regulatory code regime we would encourage longitudinal studies to be carried out to capture the responses of regulators and companies to the actions of each over time. Finally, our study focussed on compliance statements and the respective legitimacy tactics they represent. Further studies could look into the correspondence between compliance statements and actual governance arrangements within corporations. If such studies find that compliance statements are decoupled from actual governance arrangements (cf. Akkermans et al. 2007: 1115) there may be a need for additional governance mechanisms to be developed and deployed.

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Appendix

Table 10 Examples of each category of explanation

Categories of explanation	Sub-categories of explanation	Examples
Lack of justification—Company discloses deviation without providing reasons for the deviation	Pure disclosure—temporary (t); persistent (p)	(t) Since the last declaration of conformity in December 2004, the Aareal Bank AG complied with the recommendations, except for the recommendation for individualized disclosure of the executive officer's and the supervisory board's compensation. These recommendations were first implemented for the 2005 annual report. (Aareal Bank AG, referring to Section 2.3.4 Sentence 2 and 5.4.7 paragraph 3 sentence 1 of the code; our translation)
		(t) The consolidated financial report was available within 120 days of the end of the financial year. We are working on meeting the deadline of 90 days in the future. (Gerry Weber AG, referring to code provision 7.1.2 S3(1HS); our translation)
		(t) There was no insurance cover in place in respect of legal action against the Company's directors until 9 June 2005. (Alliance Trust, refering to Code A.1.5.)
		(p) The individualized disclosure recommended by the German corporate governance code did not take place. Furthermore, the executive officer's compensation for the 2005 fiscal year will be reported in detail for the executive board, however, they will not be disclosed to the public. (Münchner Rück AG, referring to Section 4.2.4 sentence 2 of the code; our translation)
		(p) The Grammer AG has Directors & Officers Liability Insurance ("D&O Insurance") for the Supervisory Board Members, Executive Board Members and Managing Directors, but the insurance does not contain a deductible. (GRAMMER AG, referring to Section 3.8 of the code; our translation)
	Description of alternative practice—temporary (t); persistent (p)	(t) [T]he Company has complied in full with the requirements of the Code with the exception that the Chairman has not formally held meetings with the Non-Executive Directors collectively in the absence of the Executive Directors, although one informal meeting of the Non-Executive Directors, without the Chairman, has been held. However, in addition to the usual opportunities that the Chairman and the Non-Executive Directors have for contact and discussion, the Board has decided to hold such meetings at least annually in future. (Kingfisher plc. Code A.1.3)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		(p) The structure and level of the Executive Board compensation is reviewed and determined by the Supervisory Board's General Committee instead of the entire Supervisory Board [as required by code provision 4.2.2Para1(1HS)]. The General Committee informs the Supervisory Board as a whole on the respective results. (Adidas-Salomon, 4.2.2Para1(1HS)
		(p) During the year under review, the majority of the Company's Non-executive Directors have not attended formal meetings with major shareholders. The Remuneration Committee Chairman communicated with the Company's 20 largest shareholders during the early part of the financial year in order to discuss proposed changes to the Company's remuneration policy (which were passed at the 2005 AGM in July). In addition, the Company's Chairman held meetings with a number of the Company's major shareholders to discuss and explain the new Group structure following the announcement on 31 January 2006. (Cable & Wireless, Code D.1.1.)
		(p) The stock option program requires a result oriented, absolute increase of the stock market price. The design was chosen to create an incentive for an absolute, as opposed to a relative increase. (CENTROTEC, Section 4.2.3 paragraph 2 sentence 2 of code; our translation)
	Empty justification	We believe that due to the successful work of the supervisory board and its committees in the past, an additional compensation for the members of the committee is not necessary. (Adidas-Salomon AG, Section 5.4.7 paragraph 2 of the code)
		Responsible action is an obvious duty for all Board members and therefore no deductible is required for this. (HVB; Kodex 3.8)
		Since we believe that the compensation of our Management Board is adequate we see no necessity in disclosing the compensation of every individual member [as required by provision 4.2.4 S2]." (Hornbach Holding AG, 4.2.4 S2; our translation)
		The existing structure of compensation for the members of our Supervisory Board is in accordance with their responsibilities and duties, hence we see no need for any performance-related components [as required by provision 5.4.7 Para2 S1]. (Fielmann AG, Section 5.4.7 paragraph 2 sentence 1 of the code; our translation)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		[T]he Company believes it complied with all principles and provisions of the Code to the extent that they applied to Legal & General Group Plc, except for the publication of proxy votes at the Annual General Meeting (AGM). In order that shareholders present were aware of other shareholders' voting intentions, the details of proxy votes were distributed immediately prior to the AGM. (Legal & General, Code D.2.1)
		Aside from the personnel committee, no further committees are being formed, because the current practice of the supervisory board dealing with the whole range of topics is to be maintained. (CeWeColor Holding AG, Section 5.3.2 Sentence 1 of code; our translation)
Context-specific justification—Company justifies deviation with reference to its specific situation	Size of company or board	In light of the fact that the current supervisory committee of Vossloh AG is comprised of only three members, an individualized disclosure of compensation would not create further transparence. (Vossloh AG, Section 4.2.4 sentence 2 of code; our translation)
		Since the Supervisory Board of RATIONAL AG consists of only three members the formation of committees for complex issues [as requested by code provisions 5.3.1 und 5.3.2 S1], such as an audit committee, appears inappropriate. (Rational AG, Section 5.3.1 and 5.3.2 sentence 1 of code; our translation)
		According to section 5.1.2 of the code, the supervisory board and the executive officers are responsible for a long-term succession plan. However, due to the size of the company, a long-term succession plan is not indicated. (FLUXX AG, Section 5.1.2 paragraph 1 sentence 2 of code; our translation)
	Company structure—temporary (t); persistent (p)	(t) Due to the many subsidiaries that have to be included, the annual consolidated financial account for the year 2004 was only published at the beginning of May 2005 [cf. code provision 7.1.2 S3 (1HS)]. (H&R WASAG AG, Section 7.1.2 sentence 3 (1HS) of code; our translation)
		(p) In view of its particular legal form, specifically, the lack of human resource competences of the supervisory board of a KGaA and the formation of a shareholder's committee according to its statutes, the supervisory board of Henkel KGaA did not form any additional committees… (Henkel KGaA, referring to Section 5.3.1 and 5.3.2 of code; our translation)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		(p) [T]he Executive Chairman, Mr Anil Agarwal, did not, on appointment, meet the independence criteria because he was previously the Chief Executive of the Company and, through Volcan Investments Ltd, he and his family have a controlling interest in Vedanta. Mr Agarwal, founder of Vedanta, has built the Group from its inception in 1976. The Board believes that his knowledge, experience and energy are invaluable to the Executive Chairman's role of setting a vision for the Group, creating business opportunities and providing leadership. Furthermore, Mr Agarwal's appointment in March 2005 as Executive Chairman, allowed him to step back from operational management and focus on turning new opportunities into value-creating projects, thereby further extending the Group's exceptional growth pipeline into the future. (Vedanta Resources, Code A.2.2 and A.3.1)
		(p) The deadline [for publication of the consolidated financial accounts] was missed by a few days because several Australian investment companies with a different fiscal year had to be accounted for in the interim report. (Hochtief AG, Section 7.1.2 sentence 2(2HS) of code; our translation)
	International context of company	The goal could be compromised if the supervisory board members of DaimlerChrysler AG would have to face liability risks in the area (or domain) of negligence. This is particularly true because a deductible abroad is unusual. (DaimlerChrysler AG, Section 3.8 paragraph 2 of code; our translation)
		The D&O Liability Insurance, which includes both the board members and senior management, does not contain a deductible [as required by code provision 3.8] since this is unusual in other countries. (Stada Arneimittel AG, Section 3.8 of code; our translation)
		At least half the board, excluding the Chairman, were not independent for the purposes of the Combined Code. With effect from the retirement of Mr Ning Gaoning at the Annual General Meeting in July 2005, the board satisfied the independence requirements of the Combined Code, but ceased to do so with effect from 9 November 2005, with the appointment to the board of Mr Santo Domingo Dávila and Mr Pérez Dávila as non-executive directors who, as nominees of the Santo Domingo Group, are not independent for the purposes of the Combined Code. (SABMiller, Code A.3.2.)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		[Our D&O Liability Insurance] is a group insurance for a variety of employees at home and abroad. Abroad it is unusual to have a substantial deductible; thus, a differentiation between board members and employees is inappropriate. (Balda AG, Section 3.8 of code; our translation)
	Other company specific reasons—temporary (t); persistent (p)	(t) Subsection 4.2.3 of the German Corporate Governance Code on variable components of Management Board remuneration contains the recommendation to make stock options and similar instruments dependent on ambitious, relevant benchmarks. A retroactive adjustment of benchmarks is supposed to be precluded. A retroactive adjustment became necessary in the case of the stock bonus program for members of the Management Board of METRO AG. The size of the bonuses payable under this program depends on, among other things, the performance of the Metro stock compared to the median performance of a German and a European stock market index. However, the European sectoral index that had previously served as the benchmark for the stock bonus program was closed. The Metro stock was overweighted in the German benchmark index. In addition, this index did not reflect the current perception of the capital markets, which regard the METRO Group largely as an international trade and retail group. It is for this reason that the Presidential Committee and the Personnel and Nominations Committee of the Supervisory Board of METRO AG identified appropriate new benchmark indices for the Management Board's stock bonus program. (Metro AG, referrng to Section 4.2.3 of the code)
		(t) The Company did not have a Senior Independent Non-Executive Director for the entire year. Following the resignation of the previous Senior Independent Non-Executive Director, Tony Illsley, on 30 September 2005, the Board conducted a search for a suitable replacement culminating in the appointment of Sir David Michels as Senior Independent Non-Executive Director on 6 March 2006. (easyjet, Code A.3.3.)
		(p) Because the corporation has only one shareholder, the mandatory disclosure of the report and documentation for the shareholder meeting as well as the invitation to the meeting on the homepage, can be omitted. (DEPFA Deutsche Pfandbriefbank AG, Section 2.3.1 and 2.3.2 of code)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		(p) The Combined Code provides that the terms and conditions of appointment of non-executive directors should be made available for inspection. For Galen Weston the board has not considered it appropriate to enter into a formal letter of appointment. This is due to his relationship with the ultimate holding company of Associated British Foods plc, Wittington Investments Limited. Galen Weston receives no fees for performing his role as a non-executive director and Associated British Foods plc does not reimburse him for any expenses incurred by him in that role. (Associated British Foods, Code A.4.4.)
		(p) Hawesko Holding AG's consolidated financial statement will be disclosed within 120 days as opposed to 90 days after the end of their fiscal year. This extended timeframe is necessary in order to combine the disclosure of the annual report with the first quarter report of the current fiscal year. (Hawesko Holding AG, Section 7.1.2 Sentence 3 (1HS) of code; our translation)
	Industry specificities	At the moment, we do not plan to change the current compensation system [to comply with code provision 5.4.7Para2 S1], since forms of payment related to company performance are unusual in our particular competitive environment. (WCM AG, Section 5.4.7 paragraph 2 Sentence 1 of code; our translation)
		The Remuneration Committee is chaired by Willy Strothotte. As Chairman of the Company and Chairman of Glencore, he is not considered to be an independent director. The Board regards Willy Strothotte's membership as critical to the work of the Committee due to his extensive knowledge and experience of the global mining resources sector. (Xstrata, Code B.2.1.)
		It was intentionally avoided to use additional comparative parameters because of the peculiarities of the German television advertisement market and because of a lack of comparable corporations at home or abroad. (ProSieben Sat.1 Media AG, Section 4.2.3 paragraph 2 Sentence 2 of code; our translation)
	Transitional justification new code provision (c); new entrant (e)	(c) The share option plans of 1996 and 1999 […] contain no cap for extraordinary and unforeseeable events. Since these plans have already been exercised, is does not make sense to introduce such caps retrospectively. (Continental AG, referring to Section 4.3.4 paragraph 2 Sentence 4 of code; our translation)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		(c) In the stock option plan (MSOP) distributed to the board, there is no cap for extraordinary, unforeseen developments, due to the fact that all stock options had already been issued before the code provision was introduced in May 2003. (Adidas-Salomon AG, Section 4.2.3 paragraph 2 Sentence 4 of code)
		(e) Prior to Admission to the Official List of the UK Listing Authority, the Group granted share options without performance criteria attached to them. The majority of these options have now been exercised. Options granted since December 2000 have had performance conditions attached. The Group does not intend to grant further share options to employees without attaching performance conditions to their exercise. (easyjet, Code B.1.1.)
Principled justification—Company justifies deviation with reference to problems with the specific code provision as such	Ineffectiveness/inefficiency of code provision	The recommendation that the corporation implements a performance related compensation to the supervisory board members was not followed. The independence and neutrality as a function of the monitoring tasks of the supervisory board, to uphold the best interests of the corporation, is most ensured by a fixed compensation of the supervisory board members. (Hypo Real Estate Holding AG, Section 5.4.7 paragraph 2 of code; our translation)
		Disclosure of individual compensation for each member of the Management Board, required by clause 4.2.4, sentence 2, in our view limits the structuring of compensation in such a way as to distinguish individual performance and responsibility. (Fresenius AG, code provision 4.2.4 S2; our translation)
		The Board as a whole reserves the authority to make the final determination of the remuneration of directors as it considers that this two stage process allows greater consideration and evaluation and is consistent with the unitary nature of the Board. No director is involved in decisions regarding his or her own remuneration. (Royal Bank of Scotland, Code B.2.2.)
		The Management and Supervisory Board think that a general age limit for members of the supervisory board [as required by code provision 5.4.1 S2] is inappropriate. It limits the shareholders' choice of candidates and does not adequately consider the personal qualification and experience of individual candidates. (BHW Holding AG, Section 5.4.1 Sentence 2 of code; our translation)
	General implementation problems	As long as the development of appropriate criteria for success are connected to legal uncertainty, a definite performance based compensation plan will not come into effect. (DaimlerChrysler AG, Section 5.4.7 paragraph 2 of code; our translation)

Table 10 continued

Categories of explanation	Sub-categories of explanation	Examples
		Despite the recommendations of the German corporate governance code, there has no standard has evolved as to the structure of the deductible. (Thiel Logistik AG, Section 3.8 of code; our translation)
		A standard regarding amount and composition of a deductible has still not been developed. As soon as we notice a corresponding trend, we will re-address this question. (Deutsche Beteiligungs AG, Section 3.8 of code; our translation)
	Conflicts with laws or societal norms	In order to protect their privacy we will not disclose any information on the compensation of the individual members of the executive board [as requested by code provision 4.2.4 S.2]. (Loewe AG, Section 4.2.4 sentence 2; our translation)
		As long as the shareholder has no significant benefit by publishing individually, the tax confidentiality and privacy safeguards apply for the executive and supervisory board as well as all other Celesio employees. (Celesio AG, Section 5.4.7 paragraph 3 sentence 1 and 4.2.4 sentence 2 of code; our translation)
		The introduction of performance related payment for members of the Supervisory Board [as requested by code provision 3.3.10] is put on hold, since there are currently concerns regarding the legality of performance related payments. (EM TV AG, code provision 3.3.10; our translation)
		The German Securities Trading Act prescribes certain announcements and publications in the event that voting rights in the Company exceed or fall below certain levels and in the event that certain financial instruments are held that could lead to a change in the distribution of voting rights. The same applies to the acquisition or sale of shares or related acquisition or sale rights on the part of members of the Managing or Supervisory Boards of the Company. Legislators have just recently reformed these standards to include additional thresholds, for example. In doing so, the interests of capital markets were weighed against those relating to data protection rights. Section 6.6, Paragraph 2, Sentence 1 of the Code conflicts with this legislation. It is the opinion of the Managing and the Supervisory Boards that the legislative requirements pertaining to disclosure, together with the information under Section 6.6, Paragraph 2, Sentence 2 of the Code, are sufficient. (Hugo Boss AG, Kodex Ziffer, 6.6 Abs2 S.1)

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Author Biographies

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