TO COMPLY OR NOT TO COMPLY: AN EMPIRICAL STUDY OF THE RELATIONSHIP AND IMPACT OF THE COMBINED CODE ON UK FIRMS

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ABSTRACT

Prior studies have shown that the majority of FTSE 350 firms do not fully comply with the Code of Corporate Governance (henceforth known as the Code). This is puzzling since the Financial Reporting Council (FRC) has advocated the benefits of having high corporate governance standards and yet it would seem that not many firms are taking this initiative seriously. Therefore I am motivated to find reasons why most of the firms still decided not to take this kind of opportunity to inform their shareholders that they are working in tandem with the principles of the Code and would rather following their own measures or standards of good governance. In order to address this, I will investigate what makes the firms that fully comply with the Code differ from than those that do not in term of safeguarding the welfare of stakeholders and controlling managers' behaviour, what set of principles within the Code matter most to the shareholders, and what are the potential costs to the firms if they do not fully comply with the Code. I found that firms that claim full compliance with the Code gave higher compensation to CEOs and lesser disclosure on long term compensation plan. I also discover that firms that comply with the important principles in the Code have lower analyst bias and larger analyst following. There is also some evidence that firms are trying to mask their underperformance by claiming full compliance with the Code in their annual report. I also find that firms that have a low compliance rate with the Code will attract higher negative news than firms that fully comply with the Code. This suggests that there is more than merely claiming full compliance with the Code in the annual report and regulators need to rethink their direction in term of formulating more relevant guidance or principles in promoting better governance among firms.

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DECLARATION

I hereby declare that this thesis is my own work and has not been submitted in substantially the same form for the award of a higher degree elsewhere.

CHAPTER ONE:

INTRODUCTION

1.1 Introduction

Prior studies (Padgett & Shabbir, 2005; Grant Thornton, 2006) have shown that the majority of FTSE 350 firms do not fully comply with the Code of Corporate Governance (henceforth known as the Code). This is puzzling since the Financial Reporting Council (FRC) has advocated the benefits of having high corporate governance standards and yet not many firms are taking this initiative seriously. Therefore I am motivated to find reasons why most of the firms still decide not to take this kind of opportunity to inform their shareholders that they are working in tandem with the principles of the Code and would rather follow their own measures or standards of good governance. In order to address this, I will investigate:

1) what makes the firms that fully comply with the Code differs than those that do not in term of safeguarding the welfare of stakeholders and controlling managers' behaviour,
2) what set of principles within the Code matter most to the shareholders, and
3) what are the potential costs to the firms if they do not fully comply with the Code.

My research will be designed to understand whether there are such benefits derived from the decision to fully comply with the Code. If there are indeed positive relationships between compliance to the Code and maintaining the

welfare of stakeholders and controlling the managers' behaviour, then this will raise concerns on why the majority of the firms still do not comply. If the link is in the form of a negative relationship, this will imply that there is no or little incremental benefit associated with full compliance to the Code. This suggests that regulators need to rethink their direction in term of formulating more relevant guidance or principles in promoting good governance among firms. This can be done by identifying which principles within the Code hold greater importance to the shareholders and this is the intention of this study.

I am also motivated to investigate the potential costs to the firm when they decide not to comply with certain principles or requirements of the Code. To measure this potential cost, I will use media criticism (which includes reaction by shareholders, investors, journalists and the general public) to determine the importance or the peril of not complying with certain requirements of the Code.

In recent years, the discussion on corporate governance has become prominent since the occurrence of a series of public scandals involving high profile public companies like Enron and WorldCom among others. There is a perceived need to redefine accounting standards and tighten the existing regulations and acts. The International Accounting Standard Board (IASB) has revised its accounting standards to reflect more accurately the demand for more relevant information by stakeholders of the company[1]. Over the years, regulators in countries have been

[1] In April 2001, the IASB adopted International Accounting Standards (IAS) and developing International Financial Reporting Standards (IFRS) in an effort towards international harmonization.

trying to improve corporate governance through their own regulatory board by producing codes or best practice of corporate governance[2]. A study by Aguilera & Cuervo-Cazurra (2009) has shown that these initiatives have appeared to have generally improved the governance of countries that have adopted those.

One of the earliest forms of a corporate governance code was introduced in the United Kingdom (UK). The Cadbury Code (Financial Aspects of Corporate Governance) was introduced on 1st December 1992 after several high profile scandals such as Polly Peck International in 1990 and the BCCI and Robert Maxwell scandals in 1991. It is mentioned among the reasons for setting up the Cadbury Report (p.11) that:

> 'Companies whose standards of corporate governance are high are the more likely to gain the confidence of investors and support for the development of their businesses'.

This implies that firms that comply with the Cadbury Report and the subsequent Combined Code of Corporate Governance will be favoured by investors and thus could safeguard the interest of the stakeholders. This is especially crucial during the latest UK financial crisis in late 2008 where it is important to have good governance to establish trust and this is echoed by Thyil & Young (2009) study where better disclosure to explain variations to the application of the main principles of the Code is among the main concerns of the shareholders.

[2] Out of 63 countries that already have code or best practises of corporate governance, 15 have revised it in 2006, 12 in 2007, 16 in 2008 and 5 in 2009 (up to September) (http://www.ecgi.org/codes/all_codes.php)

One particularly interesting aspect of the Code in the UK is that it is based on the "comply or explain" principle. Basically, a firm will have to confirm that it complies with the Code's provisions or, where it does not, provide the explanations. The rationale behind this is mentioned in the Cadbury Report (p.10) that:

> "The effectiveness with which boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance."

Even though compliance is not compulsory, firms that do comply with the Code will project an image of being good in governance and its benefits have been extolled by various concerned groups. For example, in 2006, during the launch of "City of London – City of Learning" initiative by the Lord Mayor of London, the FRC published a brief publication explaining the UK approach to corporate governance and what are the advantages and benefits of them. They quoted studies by FTSE ISS Corporate Governance Index, Governance Metrics International and National Association of Pension Funds that confirmed the UK as a leading country in terms of governance standards. Governance Metrics International further argued in their website that:

> "Firms that emphasise corporate governance and transparency will, over time, generate superior returns and economic performance and lower their cost of capital."

Thus, compliance to the Code is seen as a measure of good governance and benefits the firm by higher share returns and financial performance.

However, this is certainly not reflected in the actual rate of compliance to the Code. According to Annual Corporate Governance Review 2004 which is published by Pensions Investment Research Consultants[3], only 34 per cent of FTSE All Share companies are fully compliant with the Code. This is further confirmed by the Grant Thornton FTSE 350 Corporate Governance Review (2006) which suggests that the fully compliant rate is around 34.1 per cent for the FTSE 350 companies[4]. The high rate of non-compliance among the firms begs the question on what are the bases for their decision whether to comply or not with the Code. Prior studies have tried to find explanation or motivation behind this phenomenon and they outlined several reasons.

The first possibility is that firms that do not comply do have fundamental governance weaknesses. It means that compliance can be regarded as a good indicator for good governance, as has been shown by Padgett & Shabbir (2005). Another possibility is that firms are selecting their own set of principles from the Code and, possibly other governance measurements not in the Code. This means that not all principles in the Code are in the same level of priority in determining good governance of the firm because some are nothing more than superficial and

[3] Pensions Investment Research Consultants is a UK-based independent research and advisory consultancy providing services to institutional investors on corporate governance and corporate social responsibility.

[4] In 2004 it managed to achieve 57.8% compliance but halved in 2005 (27.5% compliance) due to the impact of the revised Combined Code of Corporate Governance. FTSE 100 companies tend to have a slightly higher percentage of compliance; 42.9%(2006), 41%(2005), 62.6%(2004).

adherence to them will not necessarily greatly elevate the status of good governance for the firm[5]. Previous studies confirmed that the level of importance of each principle in the Code is different by selecting only a few of them as the proxy for good governance[6].

Even so, firms that do fully comply will usually produce a statement in their annual report to indicate this achievement. For example, AstraZeneca PLC in their 2006 Directors' Report (pg. 75) stated that:

> "The Company is applying all the main and supporting principles of good governance in the Combined Code. The Company is complying with all of the provisions of the Combined Code."

This type of statement should give a strong signal to stakeholders that the firm is doing their best in term of governance compared to other firms that do not fully comply with the Code.

Under agency theory, if managers' objectives are not aligned with the firms, they will find any opportune moment to serve their own interest before the firms and the welfare of the stakeholders. They will indulge in various activities that are detrimental to the firm in the short and long term such as value reducing diversification, rewarding themselves with higher compensation, wasting firm's

[5] For example, Grant Thornton (2006) find that only 55.4% of the FTSE 350 firms disclosed the terms and conditions of appointment of non-executive directors are available for inspection, which forms part of the compliance index, it is doubtful whether it can be interpreted as a reliable measurement for good governance.

[6] MacNeil & Li (2005) have 11 factors in their study whilst Padgett & Shabbir (2005) have 12 factors. Arcot & Bruno (2007) only use 8 factors taken from the Code as indicators for good governance.

resources like cash and manipulate earnings. They will also keep the stakeholders from scrutinizing their action in details by resorting to low quality of disclosure and will make sure they retain their position even if the firm is performing badly.

Prior studies (Denis, Denis & Sarin, 1997; Core, Holthausen & Larcker, 1999; Beekes & Brown, 2006; Core, Guay & Rusticus, 2006) have looked into these issues and link them with one or two measurements of good governance but never in reference to the compliance to the Code in the UK. Other prior studies in the UK have only considered the link between compliance to the Code with firm's performance (Padgett and Shabbir, 2005; MacNeil & Li, 2006; Arcot & Bruno, 2007). Therefore, there is a massive literature gap regarding the need to see the link between firms that comply with the Code and how they are safeguarding the welfare of stakeholders and controlling managers' behaviour.

Prior studies have also examined into the impact of non-compliance on firm performance (Padgett and Shabbir, 2005; MacNeil & Li, 2006; Arcot & Bruno, 2007) but none so far have considered the effect of non-compliance on other factors such as media criticism. Current studies on the effect of media criticism on executive compensation plans (Core, Guay & Larcker, 2008) and board ineffectiveness (Joe, Louis & Robinson, 2007) do not look on the specific requirements of the Code. So there is a knowledge gap in this area of interaction of media with corporate governance.

In this study I extend the earlier works by Denis et al. (1997), Core et al. (1999), Beekes, Pope & Young (2004), Beekes & Brown (2006), Huson, Malatesta & Parrino (2004), Conyon, Mallin & Sadler (2002), Core et al. (2006) and Tetlock (2007) by using alternative measurements of corporate governance, which is the structured compliance rate obtained from Grant Thornton. The study is based on a sample of FTSE 350 firms from 2003 until 2007. I also obtained various financial data from Datastream and FAME, governance and compensation data from Manifest, forecasted EPS from I/B/E/S[7] and share ownership data from the Waterlow Stock Exchange Yearbook[8]. I then tested nine hypotheses and constructed models to represent them which are then analysed by employing ordinary least square, logistic and two-stage least squares regression depending on the type of variables measured.

I found that firms that claim full compliance with the Code gave higher compensation to CEO and lesser disclosure on long term compensation plan. I also discover that firms that comply with the important principles in the Code have lower analyst bias and larger analyst following. There is no evidence of relationship between firms that comply with the Code and level of diversification, timeliness of earnings and CEO turnover. There is also some evidence that firms are trying to mask their underperformance by claiming full compliance with the Code in their annual report. I found that firms that have low compliance rate with

[7] I/B/E/S is the Institutional Brokers' Estimate System database, currently owned by Thomson Reuters

[8] Waterlow Stock Exchange Yearbook is a yearly publication by Caritas.Data and available in most major libraries in the UK

the main principles of the Code will attract higher negative news than firms that fully comply with the Code.

The contributions of this study are as follows. First, the results provide insights on the alternative measurements of corporate governance, which is by looking into the structured compliance rate of the Code provided by an independent body. This fills an existing gap especially in the UK study where prior studies devised their own index of compliance which could hamper comparability. Second, the study sheds light on what benefits and drawbacks associated with firms that claim to fully comply with the Code and firms that actually comply with the important principles within the Code. Third, the study explores the alternative possible ways to look into the potential costs of compliance with the Code through media criticism.

Key limitations of my work are as follows. First, my study uses a sample of FTSE 350 firms from 2003 until 2007. Due to various merging, delisting and takeover activities among others, including the missing data, the final sample can be smaller than expected and might limit the generalisation that I made. Second, various changes based on other prior studies could be incorporated on the models, proxies and indices used in this study. There is still more room for improvement and improvisation by including more alternative research design by other and recent studies. Third, there still exists ambiguity when it comes to defining governance, or in this case, identifying which principles of the Code constitutes good governance. However, the recent availability of compliance data and future

research could help to produce a better governance measures involving the principles of the Code to be used especially in the UK study.

1.2 Thesis Structure

This thesis is organised into six chapters. The next chapter (Chapter Two) describes corporate governance in detail and the development of the Combined Code on Corporate Governance.

Chapter Three reviews the compliance with the Code in the UK and its relationship with various issues related to managerial decision making.

Chapter Four is an empirical study that looks into the relationship between compliance with the Code and several issues related to the welfare of the stakeholders. Chapter Four also studies the interaction between compliance with the Code and firm performance.

Chapter Five investigates the relation between compliance with the Code and media criticism.

Finally, the main conclusions of this thesis are presented in Chapter Six.

CHAPTER TWO:

CORPORATE GOVERNANCE

2.1 Introduction on Corporate Governance in the UK

Corporate governance is the 'system by which companies are directed and controlled' (Cadbury, 1992). Corporate governance also includes relationships between the firm and its stakeholders and also how to achieve a long-term success and build up its reputation by taking into consideration of other factors such as legal, regulatory, institutional environment, macroeconomic policies, degree of competition, environmental and societal interests of the communities (OECD Principles of Corporate Governance, 2004).

Most of the issues on corporate governance gained prominence in the UK after the publication of the Cadbury Report in 1992. After this several other reports were issued through the next decade, such as Greenbury Report (1995), Hampel Report (1998), Turnbull Report (1999) and Higgs Report (2003). In addition, the Combined Code on Corporate Governance was firstly introduced in May 2000 by the Committee on Corporate Governance, which subsequently underwent various improvements in 2003, 2006 and 2008 under the responsibilities of the Financial Reporting Council.

This chapter will examine all of these reports and the Codes to discuss the issues addressed under each publication and therefore the direction and future of corporate governance in the UK.

2.2 Reports on Corporate Governance

2.2.1 CADBURY REPORT

Sir Adrian Cadbury, a former Chairman of Cadbury and Cadbury Schweppes was invited to chair the Committee on the Financial Aspects of Corporate Governance which was formed in 1991. After eighteen months, the Report of the Committee on the Financial Aspects of Corporate Governance (or better known as the Cadbury Report) was produced in December 1992 and was a response to '*continuing concerns about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay, which has kept corporate governance in the public eye* (Preface of the Report)'.

The Report generated lots of interest and discussions among the business community, particularly regarding various recommendations (deemed controversial) during that time. Several of these important recommendations are detailed below:

1) *The CEO and Chairman of companies should be separated*

   The Report is in opinion that given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive (Para. 4.9). Therefore the Report recommended that there should be a division of responsibilities between these two positions, such that no particular individual will have unlimited power to make decisions. However, if the firm decides that the chairman and the CEO will be the same person, the Report urged that there should be a strong and

independent element on the board, although they are silent on how to create that element on the board.

2) *Board of directors should have at least three non-executive directors*

The Report recommended that there was a need to have more non-executive directors on a board to ensure that their views will carry significant weight in the board's decisions (Para 4.11). In addition, the Report suggested that two of the three non-executive directors should have no financial or personal ties to executives.

3) *Audit committee*

The Report recommended that all listed firms should establish an audit committee with a minimum of three members. The committee membership should be confined to the non-executive directors and the majority of these non-executives should be independent (Para 4.35). The committee would be given written terms of reference and must meet at least twice a year, together with the external auditor and the finance director. The committee should also have a discussion with the external auditors without executive board members present, to ensure that there are no unresolved issues of concern.

4) *Directors' responsibilities*

The Report recommended that a brief statement of directors' responsibilities for the accounts should appear in the report and accounts,

as a counterpart to a statement by the auditors about their reporting responsibilities (Para 4.28).

5) *Nomination committee*

The Report suggested that a nomination committee to be set up, consisting of a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director (Para 4.30).

6) *Internal controls*

The Report referred to s.221 of the Companies Act 1985 on the responsibilities of the directors in maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimize the risk of fraud (Para 4.32). Since an effective internal control system is a key aspect of the efficient management of a company, the Report recommend that the directors should make a statement in the report and accounts on the effectiveness of their system of internal control.

7) *Board remuneration*

The Report recommended that in disclosing directors' total emoluments, separate figures should be given for their salary and performance-related elements and that the criteria on which performance is measured should be explained. Relevant information about stock options, stock appreciation rights, and pension contributions should also be given (Para 4.40). In

addition, the Report suggested that directors can only extend their service for more than three years if they receive shareholders' approval.

8) *Remuneration committee*

The Report also recommend that the boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary (Para 4.42). The Report insisted that executive directors should play no part in decisions on their own remuneration and the membership of the remuneration committee should appear in the Directors' Report.

In 1994, the principles recommended under the Cadbury Report were appended to the Listing Rules of the London Stock Exchange. Although it is not necessary for the firms to comply with the principles, they have to explain to the stock market why they did not comply with them.

2.2.2 GREENBURY REPORT

The UK started the privatisation of the public utilities since the early 1980s under the Conservatives government. However, by the early 1990s the public have expressed their anger over spiraling executive pay of the directors of these privatized utilities. Therefore another committee was promptly set up in 1995 and was chaired by Sir Richard Greenbury, a chairman of Marks & Spencer. This

committee was tasked to review the existing principles in the Cadbury Code and to focus specifically on the executive compensation.

The recommendations made by the Greenbury Report was published in July 1995 and focused mainly on the remuneration committee, remuneration disclosure and approval provisions, remuneration policy and service contracts and compensation. Among the salient points are shown below:

1) A remuneration committee must consist exclusively of non-executive directors with no personal financial interest other than as shareholders in the matters to be decided (Para A4).
2) The report by the remuneration committee must include full details of all elements in the remuneration package of each individual director by name, such as basic salary, benefits in kind, annual bonuses and long-term incentive schemes including share options (Para B4).
3) The remuneration committee should judge where to position their firm relative to other firms. They should be aware what other comparable firms are paying and should take account of relative performance (Para C2).
4) The remuneration committees should consider what compensation commitments their directors' contracts of service, if any, would entail in the event of early termination, particularly for unsatisfactory performance (Para D1).

The Report also makes suggestions that all listed firms in the UK should comply with the Code to the fullest extent practicable and to disclose their compliance statement in the annual report. In addition, the Report also requested that the London Stock Exchange should introduce continuing obligations for the listed firms to implement the Code's provisions.

2.2.3 HAMPEL REPORT

Both Cadbury and Greenbury Reports recommended that a new committee should review the implementation of their findings. Therefore another committee was set up in 1998 and it was chaired by a chairman of ICI plc, Sir Ronald Hampel. This committee suggested that a set of principles and code is established, to include all the works that have been done by Cadbury, Greenbury and Hampel Reports. The committee also suggested that the Financial Reporting Council (FRC) should keep under review the possible need in the future for further studies and revisions of the Code on corporate governance.

Among the recommendations produced by the Report are to recommend institutional investors to vote the shares under their control but the voting should not be compulsory, and to continue with the unitary structure of the board, in contrast with a two tier framework currently practice in other European countries like Germany.

2.2.4 TURNBULL REPORT

The following year saw another report produced by the committee chaired by Nigel Turnbull of the Rank Group, plc. This report recommended directors to be responsible for internal financial and auditing controls. It requires directors to exercise judgement in reviewing how the firm has implemented the requirements of the Code relating to internal control and reporting to shareholders thereon.

The Report basically highlighted the importance of internal control and risk management by stressing that a firm's system of internal control has a key role in the management of risks that are significant to the fulfillment of its business objectives (Para 10). Effective financial controls will facilitates the effectiveness and efficiency of operations, help ensure the reliability of internal and external reporting and assists compliance with laws and regulations (Para 11).

2.2.5 HIGGS REPORT

When the Combined Code was due for revisions in 2003, the UK government commissioned Sir Derek Higgs to chair another committee to review the role and effectiveness of non-executive directors. Many of its recommendations for the listed firms have been implemented in the revised Combined Code. Some of the recommendations made under this Report are as below:

1) The Code should provide that at least half of the members of the board, excluding the chairman, should be independent non-executive directors.

2) A chief executive should not become chairman of the same company.
3) A senior independent director should be identified and be available to shareholders, if they have concerns that have not been resolved through the normal channels of contact with the chairman or chief executive.
4) No one non-executive director should sit on all three principal board committees (audit, nomination and remuneration) simultaneously.

2.3 Combined Code on Corporate Governance

Based upon the discussion in the previous section, it can clearly be seen that the Code is essentially a consolidation and refinement of a number of different reports and codes concerning opinions on good corporate governance. Since 2000, there have been four Codes published by the committee on corporate governance and FRC, and they are detailed below.

2.3.1 THE COMBINED CODE: PRINCIPLES OF GOOD GOVERNANCE AND CODE OF BEST PRACTICE (2000)

This Code was derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports. It has two sections; Companies and Institutional Shareholders. Under Companies section, several sub-sections were listed such as Directors, Directors' Remuneration, Relations with Shareholders and Accountability and Audit. The principles outlined in the Code can be seen in Table 2.1. In addition the Code also provides Schedule A which talks about the Provisions on the Design of

Performance Related Remuneration and Schedule B which discusses on the Provisions on what should be included in the Remuneration Report.

2.3.2 THE COMBINED CODE ON CORPORATE GOVERNANCE (2003)

This is the first Code issued by FRC and it supersedes and replaces the Code issued by Hampel Report in 1998. The Code contains main and supporting principles and provisions. At that time, all listed firms are required to make a disclosure statement in two parts in relation to the Code. In the first part of the statement, the firm has to report on how it applies the principles in the Code. In the second part of the statement the firm has either to confirm that it complies with the Code's provisions or where it does not, to provide an explanation.

This Code has similar section arrangement with the previous one but includes additional Schedules to outline the guidance on liability of non-executive directors in term of care, skill and diligence. A second Schedule talks about disclosure of corporate governance arrangements. In addition, this Code includes several other guidance and good practice suggestions from Turnbull, Smith (which focuses on guidance for audit committees) and Higgs Reports.

2.3.3 THE COMBINED CODE ON CORPORATE GOVERNANCE (2006)

This Code has a similar setup with the previous one in term of contents outlay. It supersedes and replaces the previous Code following a review by the FRC of the implementation of the Code in 2005 and subsequent consultations on possible

amendments to the Code. Only several minor changes were made and incorporated into the new Code such as an amendment to the:

1) provision B.2.1, to allow the chairman to sit on the remuneration committee where he or she was considered independent at the time of appointment,
2) section D.2, to provide shareholders voting by proxy with the option of withholding their vote, and to require the publication of details of proxies lodged at the AGM where votes are taken on a show of hands, and
3) for those provisions that require firms to make information available (provisions A.4.1, B.2.1 and C.3.3), to enable the requirement to be met by placing the information on the company's website.

2.3.4 THE COMBINED CODE ON CORPORATE GOVERNANCE (2008)

This Code supersedes the previous Code and by now the structure of the Code has stabilized and remains the same. In this version, several more minor changes were implemented based upon the review and comments from the respondents to the review. Some of the changes include removing the restriction on an individual chairing more than one FTSE 100 firm and for listed firms outside the FTSE 350, the firm chairman is allowed to be a member of, but not chair, the audit committee provided he or she was considered independent on appointment.

2.4 Conclusion

In November 2006, FRC published a document titled 'The UK Approach to Corporate Governance'. Basically, the document emphasises the

> '*need to have good corporate governance to ensure the effective operation of a free market, which enables wealth creation and freedom from poverty* (page. 1)'.

It highlighted the UK approach in regulating business, based upon principles rather than rules based, as it reduces the cost of introducing law and detailed regulations that might constrain business practice and innovation. With its relatively low associated costs, the Code encourages good governance practices, and at the same time allows flexibility to the firms to adopt a different approach if that is more appropriate to their circumstances. In the end, the effectiveness of the firm's governance practices should benefit the shareholders of the firm. That is why under the concept of 'comply or explain', the firm can choose to adopt a different approach if that is more appropriate to their circumstances with explanations to their shareholders, who must then decide whether they are content with the approach that has been taken.

Business environment always changing and the Code will undergo its regular revisions and amendments every few years in order for it to become relevant to the need of the stakeholders of the firms. Even so, no one can deny that the introduction of the Code has influenced not just how the firms are behaving

towards their shareholders in the UK, but the impact has influenced majority of the countries in the world. Every year many countries has adopted a similar guidelines of good practices that mirrors the Code which affirms the effectiveness of principles based over rules based.

TABLE 2.1

PRINCIPLES OF GOOD GOVERNANCE

SECTION 1 COMPANIES

A. DIRECTORS

The Board

1. Every listed company should be headed by an effective board which should lead and control the company.

Chairman and CEO

2. There are two key tasks at the top of every public company - the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

Board Balance

3. The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.

Supply of Information

4. The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

Appointments to the Board

5. There should be a formal and transparent procedure for the appointment of new directors to the board.

Re-election

6. All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

B. DIRECTORS' REMUNERATION

The Level and Make-up of Remuneration

1. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. A proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Procedure

2. Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Disclosure

3. The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

TABLE 2.1 (continued)

C. RELATIONS WITH SHAREHOLDERS

Dialogue with Institutional Shareholders

1. Companies should be ready, where practicable, to enter into a dialogue with institutional shareholders based on the mutual understanding of objectives.

Constructive Use of the AGM

2 Boards should use the AGM to communicate with private investors and encourage their participation.

D. ACCOUNTABILITY AND AUDIT

Financial Reporting

1. The board should present a balanced and understandable assessment of the company's position and prospects.

Internal Control

2. The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

Audit Committee and Auditors

3. The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors

SECTION 2INSTITUTIONAL SHAREHOLDERS.

E. INSTITUTIONAL INVESTORS

Shareholder Voting

1. Institutional shareholders have a responsibility to make considered use of their votes

Dialogue with Companies

2. Institutional shareholders should be ready, where practicable, to enter into a dialogue with companies based on the mutual understanding of objectives.

Evaluation of Governance Disclosures

3. When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

CHAPTER THREE:

COMPLIANCE WITH THE CODE AND ISSUES RELATED TO MANAGERIAL DECISION MAKING

3.1 Introduction

This study investigates the relationship between compliance with the Code and issues related to managerial decision making such as diversification, CEO compensation and accounting quality. Earlier studies have investigated various corporate governance mechanisms affects managerial decision making in various issues such as the effect of ownership structure on the level of diversification (Denis et al., 1997), board structure on CEO compensation (Core et al., 1999) and board composition on earnings management (Peasnell et al., 2000). Denis et al. (1997) finds that larger monitoring role by outside shareholders results in firms having lower level of value-reducing diversification and Core et al. (1999) find that CEO of the firms with greater agency problems receive greater compensation. Peasnell et al. (2000) finds that good governance reduces incidence of earnings management.

While existing studies document links between diversification, CEO compensation and accounting quality with various measurements of corporate governance, none of them has ever attempted to look on these issues and their relationship with the compliance with the Code. Therefore, there is a gap of knowledge in this area, especially in the UK, considering that the Combined Code has been in effect since 2000. Other UK studies that look into compliance with the

Code have only investigated the link with firm performance and the measurements of such compliance was done by self creating an index which could potentially lead to selector bias. This study will not suffer from that as I will be using compliance data provided by Grant Thornton which is obtained through a written agreement with them.

This study is motivated by the theoretical perspective on the link between corporate governance and managerial behaviour which can be explained by the agency cost theory. The separation of corporate managers from outside stakeholders will result in inherent conflict and there is an assumption that managers will act opportunistically to take care of their own interests before the shareholders (Jensen & Meckling, 1976). This is especially true when the managers are given the decision making power and past studies have shown that there are many corporate decisions that can be influenced by the manager action including the four issues discussed in this study. Therefore there is a need for some sort of corporate governance mechanisms by which managers can be disciplined to act in the best interest of the stakeholders and it is the intention of this study to look into the effect on managerial behaviour when the firm is complying with the Code.

This analysis is based on data for FTSE 350 UK firms from 2003 until 2007. I measure compliance with the Code by using compliance index created by Grant Thornton and also a revised index which specifically caters to specific issues addressed. The measurements for diversification, CEO compensation, accounting

quality and excess value of cash holding were based on prior studies that look into their relationship with other corporate governance mechanisms.

I found little evidence to suggest that firms that fully comply with the Code will have a lower degree of diversification. However, I discover a significant positive relationship between the firms who claim full compliance with the Code and the level of CEO compensation, which could complement and provide alternative explanation to the findings by previous study. There could be many possibilities for this reason, among other that firms that claim full compliance with the Code are not willing to reduce CEO compensation especially when the CEO controls high percentage of share ownership. I also found no significant relationship between compliance with the Code and timeliness of earnings which could indicate accounting quality.

The remainder of the chapter is structured as follows. The next section discusses the motivation for the paper, reviews prior studies and formulates my hypotheses. Section 3 then discusses the methodology used, followed by a discussion of the sample and data collection process in Section 4. I present the results of the study in Section 5, and Section 6 concludes.

3.2 Motivation, Literature Review and Hypotheses

3.2.1 RESEARCH MOTIVATION

There are many approaches and analytical frameworks that can be used to diagnose and hopefully solve the problems affecting corporate governance especially from the perspectives of the publicly held firms. Keasey, Thomson and Wright (1997) outlined four competing perspectives based on Blair's (1995) taxonomy. The four schools of thought are the principal-agent model, the myopic market model, the abuse of executive power model and the stakeholder model. The first two are also commonly viewed as the shareholder perspective and the latter two as the stakeholder perspective which has been used in the study by O'Sullivan (2000) and Kakabadse and Kakabadse (2001). The shareholder perspective models will be discussed in this chapter and the stakeholder perspective model in the next one.

Both principal-agent and myopic market models agree that the separation of ownership and control may allow manager behavior to be different from shareholders' value of profit maximising. On top of that, principal-agent model believes that the markets for capital, managerial labour and corporate control is the most effective control on managerial discretion and shareholders can strengthen this by using their residual voting rights. The model also suggests solutions to the corporate governance problems in form of removing restrictions on the market, strengthening the incentive system like bonuses and share options and introducing a voluntary code. However, myopic market model argues that the market systematically undervalues certain long-term expenditures, such as capital

investment and R&D spending in favour of short-term market value. Therefore the model suggests that shareholders and managers should be encouraged to share long-term performance horizon such as increasing shareholders' loyalty and trying to keep the other stakeholders such as employees and suppliers in a long-term relationship.

3.2.1.1 Principal-agent model

The principal-agent model stemmed from an assumption that the social purpose of corporations is to maximize shareholders' wealth (Friedman, 1970). It has an origin from the earliest corporate law theory which states that the right to incorporate is inherent in the right to own property and write contracts, and corporations should be regarded as legal extensions of their owners. This theory is further updated with a view that the corporation is the property of the shareholders, and managers and directors are agents of shareholders, who have legal obligations to any other stakeholders (Blair, 1995). The proponents of this model also contend that shareholders' interests are best served by maximising share price in the short run. This is based on their belief of financial economics' theory that the share price today fully reflects the market value of all future profits and growth that will accrue to the company.

There are three aspects that have been mostly outlined by this model; firm as a nexus of contracts (Williamson, 1979), the principal-agent relationship in the corporation (Jensen & Meckling, 1976) and market efficiency and market discipline (Manne, 1965).

When explaining on the agency theory, Jensen & Meckling (1976) describe that contractual relations are the essence of the firm and this also covers employees, suppliers, customers, creditors and other stakeholders. They contend that the firm is not a reality or an individual with motivations and intentions, but a legal fiction created by a 'nexus of contracts' of the principal-agent variety. Therefore, in order to align the interests of the agent with those of the principal requires having a contract that provides safeguards for both of them and this contract must contains specifications of their duties, rewards and the rights of the principal to monitor their performance. The real issue is then to decide on which incentive systems that can effectively align the behaviour of agents with the desires of principals. In general, prior studies have focused the discussion on the efficiency of a behaviour-oriented contract (e.g. salaries, hierarchical governance) over an outcome-oriented contract (e.g. commissions, stock options, transfer of property rights, market governance). Eisenhardt (1989) suggests that it depends on the scenarios presented. If the principal needs to observe the behaviour of the agent, then a behaviour-based contract is optimal because the agent's behaviours are considered as the purchased commodity, provided this is a simple case of complete information. If there is incomplete information, the principal will have to decide whether to motivate the manager to work hard by giving generous incentives or engage the management in risk bearing. In other words, the principal need to find an optimal balance between incentives and transferring risk to the agent.

Agency problem will occur when agent does not share the principal's objectives. This can happens when we hold to the assumption that owners, managers and all the other stakeholders within the firm will always try to maximise their own utility. This become more prevalent when there is a clear separation of ownership and control. When such thing is happening, it will be difficult and even expensive for the principal to verify what the agent is actually doing and whether the agent is behaving appropriately. Another problem is that the principal might have different attitudes towards risk than the agent. These problems will result in principals attempting to ensure that the agents act in principals' interests and this management cost has been defined as 'agency cost' (Jensen & Meckling, 1976). Again, the solution to this problem can be found by producing the most efficient contract governing the principal-agent relationship and an optimal incentive scheme to align the behaviour of the agents with the interest of the principals.

Another characteristic of this principal-agent model is the belief that markets are the most effective disciplines on managerial discretion. Even though the separation of ownership and control may lead the managers to have different objectives from the shareholders, it does not going towards inefficiency because markets for capital, managerial labour and corporate control provide the most effective restraints on managerial discretion. Fama & Jensen (1983) argued that even if an owner sells his equity to outsiders, the benefits of flotation and the gains from the management professionalism are sufficient to outweigh the costs of separation of ownership from control. Therefore, many developments in the managerial labour market such as executive share options, leveraged and

management buyouts are seen as a corporate governance response to institutional deficiencies. Even takeover threat will force the managers to stick to the objective of profit maximisation because shareholders hold the ability to vote on takeover approaches. In this respect, the principal-agent model insists that corporate governance is a market exchange issue and should be allowed to follow its due course without any interference. In consequence, if there is any attempt to introduce some measures to improve governance, it should be based on a voluntary basis such as the Code.

3.2.1.2 Myopic market model

The myopic market model shares a lot of similarities with the principal-agent model but it argues that the model is fundamentally flawed by an over concern with the short-term value of firm's returns and performance, which lead to management suffer from 'competitive myopia' (Hayes & Abernathy, 1980). This in effect will sacrifice long-term value and competitiveness of the firm. On top of that, market pressures will often force the managers to behave in such a way that the maximisation of long-term wealth for the shareholders is more than often ignored (Blair, 1995).

There are many studies that look into the corporate governance system of Anglo-American management. Charkham (1994) argues that British-American corporate governance system suffers from a high tension system where information is unsatisfactory, boards are not sufficiently responsible to shareholders and the firms are rather poor at maintaining standards and securing continuity in the

medium and long terms. The managers also are affected by the market pressure whenever they make decision towards short-term interest, thus jeopardising the development of people with real merit and intrinsic value for long-termism.

Sykes (1994) highlighted four main corporate governance weaknesses related to failure to meet long-term requirements of both shareholders and management. The first weakness is absentee owners. Letza, Hardwick & Ashton (2000) conducted an empirical investigation in the UK listed firms and find that external shareholders have little or no influence on either CEO or executive board turnover, whereas internal shareholdings help to entrench management by significantly reducing the rate of CEO and executive turnover. This confirms Sykes' argument that institutional shareholders would rather not to exercise their influence over the firms because these shareholders had to maintain hundreds of investments in their portfolios, making monitoring difficult and competition between themselves to attract and retain investment funds are judged on short-term performance. The second weakness is perverse fund management contracts. It is common knowledge that investment institutions impose a short period for the fund managers and they were forced to demand firms to provide high dividend payouts and high share price over such period. The third weakness is counter-productive management remuneration and incentives. Studies have shown that in the UK and US, management remuneration is poorly related to medium to longer-term firm profits and share prices and this has resulted in inverse relationship with firm performance. The fourth weakness is excessive reliance on takeover threats. One of the disadvantages of relying on the threat of hostile takeover to hold under-performing management accountable is that sometimes it is too late to

rectify poor performance when the underlying losses has been happening for several years before. Additionally, there is little evidence that takeovers will improve the firm performance in a long run and the transaction costs and disruption caused by it can be significant (Franks & Mayer, 2000). All these weaknesses mentioned above came from promoting short-termism and Sykes argued that in order to create a successful corporate governance system it needs to have active shareholders with long-term wealth maximisation and professional management with the preconditions and incentives for long-term performance and proper accountability to their shareholders.

The myopic market model is similar to the principal-agent view that the intention of firms is to maximise shareholders' wealth. However, the myopic market model believes that corporate governance system should provide an environment in which shareholders and managers are encouraged to share long-term performance horizons. This can be done by implementing several reforms such as locking financial institutions into long-term positions, restrictions on the takeover process and on voting rights for short-term shareholders, and the empowerment of other groups such as employees and suppliers that have long-term relationships with the firm (Keasey et al., 1997).

Both principal-agent and myopic market models deal with the relationship between the principals and their agents, with the focus centred upon short-term and long-term visions of corporate governance system. Under any circumstances, if there is a lack of control by shareholders, managers are more likely to divert firm's resources into non-optimal investments such as value-reducing

diversification, higher managerial compensation, excessive spending on firm's resources like cash and earnings management. Managers can be encouraged to follow shareholders' best interests by stronger governance mechanisms implemented within the firm. Thus in the next chapter, we will be looking into various governance mechanisms that could help in imposing control over managerial behaviour.

3.2.2 THEORETICAL FRAMEWORK AND LITERATURE

One of the activities that can lead to a conflict between shareholders and managers is corporate diversification. The debate whether it brings benefits or costs to the firm are still ongoing but recent studies have indicated that diversification reduces value (Beiner and Schmid, 2005; Jiraporn, Kim & Davidson III, 2007). This does not explain why firms remain diversified and many studies have looked into characteristics of managers of these firms and the effect on diversification level and value. They found that level of diversification is negatively related to managerial equity ownership (Denis et al., 1997) and deeper diversification discount occurs when board members are busy holding more outside board positions (Jiraporn et al., 2007).

Firms that completely comply with the Code will have more independent boards of directors among others and they will have more control over the managers' actions especially if they decide to engage in a value-reducing diversification. Based on this I propose this hypothesis (presented in both null and alternative forms):

$H_0 1$: There is no relationship between full compliance with the Code and the level of diversification

H1: Firms that comply completely with the Code have a lower level of diversification

Literature shows that CEO compensation is important because if it is structured correctly, it will align the interest of managers with shareholders. Therefore, many studies have looked into the relationship between governance mechanisms and CEO compensation. Some have studied the effect of board organisation and composition (Core et al., 1999; Frye, Nelling & Webb, 2006), ownership structure (Firth, Fung & Rui, 2007), CEO characteristics (Rajgopal, Shevlin & Zamora, 2006) and shareholders rights (Jiraporn, Kim & Davidson III, 2005; Davila & Penalva, 2006) on CEO compensation. All these studies found that weaker governance mechanisms will lead to a higher CEO compensation. Based on this I proposed these hypotheses (presented in both null and alternative forms):

$H_0 2$: There is no relationship between firms that comply completely with the Code and CEO compensation

H2: Firms that comply completely with the Code have lower CEO compensation

If interests of managers and shareholders are not aligned, managers will have incentives to manipulate reported earnings especially if their compensation contracts depend on it. Therefore, it is important for the shareholders to ensure that there is a high standard of accounting quality in the financial reporting.

There are many studies that look into how governance mechanisms such as board composition and ownership structure link to various dimensions of accounting quality such as earnings management (Peasnell, Pope & Young, 2000), timeliness (Bushman, Chen, Engel & Smith, 2004; Beekes et al., 2004) and conservatism (Beekes et al., 2004). Their results suggest that these governance mechanisms promote higher accounting quality such as less income-increasing accrual management (Peasnell et al., 2000) and timeliness of earnings (Beekes et al., 2004; Bushman et al., 2004). Based on these findings I proposed these hypotheses (presented in both null and alternative forms):

$H_0$3a: There is no relationship between firms that comply completely with the Code and the reflection of bad news in earnings in a timelier manner

H3a: Firms that comply completely with the Code reflect bad news in earnings in a timelier manner

$H_0$3b: There is no relationship between firms that comply completely with the Code and the reflection of good news in earnings in a timelier manner

H3b: Firms that comply completely with the Code reflect good news in earnings in a timelier manner

3.3 Research Methodology

In this section I present the regression models used in the empirical analysis and discuss how I measure compliance with the Code and managerial behaviour. I then discuss the control variables used in the models.

3.3.1 REGRESSION MODELS

This study employs ordinary least squares (OLS) regression model for each hypothesis presented in the previous section and most of these models are based on the previous works done on the subject issues.

3.3.1.1 Diversification Model

The first diversification model is based on the works by Denis et al. (1997) which look into the relationship between agency problems, equity ownership and corporate diversification. The diversification model for *H1* is specified as below:

$$LevelDiv_{i,t} = \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \qquad (1)$$

where *LevelDiv* is a proxy for the level of diversification, measured using number of segments reported by the management; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the level of diversification; ε is the error term and *i* and *t* are firm and time subscripts respectively.

3.3.1.2 CEO Compensation Models

The CEO compensation model is based on the works by Core et al. (1999) which look into the relationship between corporate governance, CEO compensation and firm performance. The CEO compensation model for *H2* is specified as below:

$$SalaryComp_{i,t} = \beta_0 + \beta_1 COM_{i,t-1} + \beta_2 Controls_{i,t-1} + \varepsilon_{i,t} \qquad (2)$$

$$CashComp_{i,t} = \beta_0 + \beta_1 COM_{i,t-1} + \beta_2 Controls_{i,t-1} + \varepsilon_{i,t} \qquad (3)$$

where *SalaryComp* is a proxy for component of compensation that is fixed at the beginning of the year; *CashComp* is a proxy for the sum of salary and annual bonus; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the CEO compensation: ε is the error term and *i* and *t* are firm and time subscripts respectively.

3.3.1.3 Accounting Quality Model

The accounting quality model is based on the works by Beekes et al. (2004) who look into the link between earnings timeliness, earnings conservatism and board composition. The model for *H3* is specified as below:

$$EPS_{i,t} = \beta_0 + \beta_1 RET_{i,t} + \beta_2 NEG_{i,t} + \beta_3 NEG_{i,t} \cdot RET_{i,t} + \beta_4 COM_{i,t} + \beta_5 NEG_{i,t} \cdot COM_{i,t} + \beta_6 COM_{i,t} \cdot RET_{i,t} + \beta_7 NEG_{i,t} \cdot COM_{i,t} \cdot RET_{i,t} + \beta_8 Controls_{i,t} + \varepsilon_{i,t} \quad (4)$$

where *EPS* is a proxy for earnings per share scaled by prior year-end price[9]; *RET* is a proxy for 12-month raw returns beginning eight months before the fiscal year-end and ending four months after the year-end; *NEG* is a proxy for dummy variable coded 1 if returns are negative, 0 otherwise; *COM* is a proxy for dummy variable coded 1 if firm claims full compliance with the Code, 0 otherwise; *Controls* are additional determinants of the *EPS*; ε is the error term and *i* and *t* are firm and time subscripts respectively. An interaction between *NEG* and *RET* is to proxy for bad news (*H3a*) and the main effect of *RET* is a proxy for good news (*H3b*). I included *COM* into the interaction of these two variables to understand the effect of compliance with the Code under two separate circumstances.

[9] EPS is calculated by dividing net income (minus any dividends on preference shares) with average outstanding shares

Therefore if there is good news and no compliance with the code only the main effect of RET will remains in the model.

Whenever a firm complies with the Code, it will have a greater number of independent directors on its board. They will exercise a greater monitoring role and can improve the timeliness of reporting earnings. Such action will have an immediate impact on managers especially when they are making accounting-based decisions. Therefore the models above are presented without any lagged variables.

3.3.2 COMPLIANCE WITH THE CODE AND ISSUES RELATED TO MANAGERIAL DECISION MAKING

Previously, study on the compliance level of the Code had to rely on self-constructed indices (Padgett & Shabbir, 2005; Arcot & Bruno, 2007) and survey (MacNeil & Li, 2006) since such data were not available publicly in any database or publication. However, since 2002, Grant Thornton UK LLP has started to review and publish annual study on the level of compliance for FTSE 350 firms. Through a series of discussions, they have agreed to provide me with their raw data for the year 2004 until 2007. Grant Thornton have their own compliance index and I have included their index in my study together with the amended index to incorporate stringent requirements to link relationship between compliance with the Code and various issues studied.

I used measurements on various issues such as diversification, CEO compensation and accounting quality based from the past studies in order to provide comparability with them.

3.3.2.1 Measuring Compliance with the Code

In order to measure compliance rate, I will use several levels of measurement starting from a basic measurement to a more refined measurement. The first level is a dummy variable coded 1 if the firm announces in their annual report that they fully comply with the Code, 0 otherwise. The second level is a continuous variable where percentage of compliance to the Code is measured using Grant Thornton questionnaire method (20 questions based on the principles in the Code, see Table 3.1). I decided to refine this index further by introducing third level of measurement because some of the questions posed by Grant Thornton are merely informational in nature and not really promoting the true objectives of the Code[10]. Therefore I created several compliance indexes that consist of requirements that truly promote corporate governance. Each index will be modified to correspond to specific issues because many studies have argued that there is no one 'best' measure of corporate governance since it needs to look into the context of the specific issue and firm's specific circumstances (Arcot & Bruno, 2007; Bhagat, Bolton & Romano, 2007).

[10] For example, one of the questions asked by Grant Thornton is whether the terms and conditions of appointment of non-executive directors are available for inspection.

Therefore, diversification model will use a compliance index based on four questions from Grant Thornton index only. CEO compensation model will have additional two questions on remuneration committee and three questions on audit committee on top of the four questions used in diversification model. Accounting quality will only use the first level of compliance variable due to the need to see its interaction effect with bad news and good news variables. Table 3.2 listed these revised questions.

3.3.2.2 Measuring Issues Related to Managerial Decision Making

To measure the level of diversification I use the number of business segments reported by the management. There are two different measurements of CEO compensation: salary and cash compensation. Salary compensation measures the fixed component compensation at the beginning of the year. Cash compensation is the total of salary and annual bonus. To measure accounting quality, I use earnings per share scaled by prior year-end price as dependent variable to see if compliance with the Code plays any role in influencing the timeliness of earnings.

3.3.3 CONTROL VARIABLES

3.3.3.1 Control Variables for a Diversification Model

In the diversification model, there are six control variables. *OwnBlock* is a proxy for the equity ownership of outside blockholders. Outside blockholders are defined as those holders of at least 5 percent of the firm's shares that are not related to the top management team. This variable is used to control for monitoring role by the significant blockholders over diversification exercises as suggested by agency cost hypothesis (Denis et al., 1997). *OwnDir* is a proxy for the equity ownership of directors. It is suggested that managers with more personal wealth invested in the firm seek to reduce risk through diversifying acquisitions (May, 1995). Sometimes firms have large amounts of firm-specific knowledge that is not transferable to other lines of business and therefore I use *R&Dsales* to proxy for this R&D intensity. *Analyst* is a proxy for the number of analysts following the firm to control for information asymmetries. I also include *Industry* as a proxy for a dummy variable for industry and *Size* as a proxy for firm size which is the natural log of the firm's market capitalisation.

3.3.3.2 Control Variables for CEO Compensation Models

In the CEO compensation model, there are six control variables that could also be determinants for CEO compensation. I use *Sales* (using natural log of sales) for the year prior to the year in which compensation is awarded to proxy for firm size

and complexity. This control variable is important because larger firms with higher complexity will demand more competent managers which will results in higher compensation level (Core et al., 1999). I also include *ROA* (earnings before interest and taxes over total assets for the prior year) and *RET* (percentage share market return for the prior year) as the proxies for firm performance to be consistent with other studies on CEO compensation (Smith & Watts, 1992).

To control for the monitoring role by larger shareholders, I use *OwnCEO* to proxy for percentage of outstanding shares owned by the CEO. I also use *NonCEO5%* to proxy for dummy variable coded 1 if the firm has an internal board member who owns at least 5% of the outstanding shares and 0 otherwise because a similar study by Core et al. (1997) find a negative relationship. Finally, I use *OwnBlock* as a proxy for dummy variable coded 1 if the firm has an external blockholder who own at least 5% of the outstanding shares and 0 otherwise.

3.3.3.3 Control Variables for an Accounting Quality Model

In the accounting quality model, I use four variables to control for other determinants of accounting quality. I use *Size* as a proxy for firm size (in natural log), *Auditor* as a proxy for auditor type and *OwnDir* and *OwnBlock* to proxy for the monitoring role by larger shareholders.

3.4 Sample, Data Collection and Descriptive Statistics

3.4.1 SAMPLE SELECTION

The initial sample of firms used for this study is based on the FTSE 350 UK firms (excluding financial and utility firms) for each year from 2003 until 2007. These firms were selected because they were in the Grant Thornton Annual FTSE 350 Corporate Governance Review (2004 – 2007) to which Grant Thornton UK LLP has agreed to provide their raw data to me to analyse further for the purpose of this study[11].

From the initial set of sample from Grant Thornton, several firms were omitted for the reasons such as firms that have been undergoing acquisition, merger, demerger and being delisted from the stock exchange as their data is no longer available in the database. Table 3.3 shows the final sample for each year from 2003 until 2007 including the compliance rate compiled by Grant Thornton each year. Since the number of firms in the sample has been slightly changed, I have adjusted the compliance rate to the Code which has been reported earlier by Grant Thornton using their original sample.

3.4.2 DATA

Compliance with the Code data is obtained from the Grant Thornton Annual FTSE 350 Corporate Governance Review raw data for each year from 2003 until 2007. This raw data consists of survey information on each individual firm in the

[11] Even though the start date of Review is 2004, most of the annual reports in the 2004 survey are actually for the financial year ending during 2003.

FTSE 350. The survey questions are driven directly from the Code provisions and Turnbull guidance and are created to reflect the 'best practice' as perceived by the Code. The survey is completed by reading the hard copies of each firm's annual report and accounts, focusing on the front half of the report (i.e. not the accounts) including the sections; Business Review, Corporate Responsibility, Corporate Governance and Remuneration Report.

The number of segments reported by the management and all other financial data are obtained from Datastream and FAME database. Number of analysts following the firms is obtained from I/B/E/S database. Shareholders ownership structure is obtained from Waterlow Stock Exchange Yearbook. This data is hand collected from the ownership structure report section of the corresponding firm's published annual report and accounts. CEO compensation and management share ownership data is obtained from Manifest database.

3.4.3 DESCRIPTIVE STATISTICS

Table 3.4 reports descriptive statistics for the variables used in the analysis for *H1* to *H3*. Panel A of Table 3.4 presents the descriptive statistics for sample used in the diversification model. Mean for *LevelDiv* is 3.21 with a standard deviation of 1.6 and skewness of 0.84 which implies normal distribution. This is slightly higher than what Denis et al. (1997) reported in their sample of US firm in 1984 which has a mean of 2.41. Mean for *ClaimFull*[12] is 0.39 with a standard deviation

[12] *ClaimFull* is a dummy variable for firms claiming full compliance with the Code with 1 indicates claim of full compliance and 0 otherwise.

of 0.49 and skewness of 0.47. Mean for *Comp20*[13] is 0.79 with a standard deviation of 0.16. Mean for *Comp4*[14] is 0.74 with a standard deviation of 0.24.

Panel B of Table 3.4 presents the descriptive statistics for sample used in the CEO compensation model. Mean for *SalaryComp* is £504,533 and mean for *CashComp* is £888,546 which indicates that salary in this sample is about 57% from total cash compensation. Conyon, Peck, Read and Sadler (2000) observed salary of 200 large UK firms and found it to be 71% of total cash remuneration, with median total cash pay to be £390,000. This means that bonus cash payment has greater representation in the CEO compensation and CEO are also receiving higher pay in recent years. Mean for *ClaimFull* is 0.39 with a standard deviation of 0.49 and skewness of 0.46. Mean for *Comp20* is 0.79 with a standard deviation of 0.15. Mean for *Comp9*[15] is 0.78 with a standard deviation of 0.18.

Panel C of Table 3.4 presents the descriptive statistics for sample used in the accounting quality model. Mean for *EPS* is 0.08 with a standard deviation of 0.13. This is slightly higher than 0.059 mean for *EPS* reported by Beekes et al. (2004) which uses sample data of firms from 1993 to 1995. This indicates that on average top firms in the UK have been performing better for the past 10 years. The share returns has also improved with mean for *RET* is 0.26 with a standard deviation of 0.4 compared to mean of 0.193 for *RET* in the sample study of Beekes et al.

[13] *Comp20* is a compliance variable for number of criteria fulfilled by the firms out of 20 set of questions set by Grant Thornton to determine full compliance with the Code.
[14] *Comp4* is a compliance variable for number of criteria fulfilled by the firms out of a specific set of 4 questions relating to most basic and important principles in the Code.
[15] *Comp9* is a compliance variable for number of criteria fulfilled by the firms out of a specific set of 4 questions relating to most basic and important principles in the Code and 5 questions relating to audit committee and remuneration committee.

(2004). Mean for *ClaimFull* is 0.39 with a standard deviation of 0.49 and skewness of 0.45.

In addition of looking into the skewness of the data, Q-Q plots have been employed to check the deviations of the data from the normal distribution. Q-Q plots for *H1*, *H2*, *H3a* and *H3b* are presented in the Appendix A, B and C respectively.

3.5 Analysis

This section examines the relation between compliance with the Code and various managerial behaviour measures such as diversification, CEO compensation and accounting quality of FTSE 350 UK firms from 2003 until 2007. I report the main regression results in the next section.

3.5.1 RESULTS

Table 3.5 reports coefficient estimates and model summary statistics for ordinary least square regression estimated using the full sample of 728 for level of diversifications. The adjusted r-squared for models using *ClaimFull*, *Comp20* and *Comp4* as its compliance variables are 0.2249, 0.2249 and 0.2251, indicating that the model explains a reasonable amount of cross-sectional variation in level of diversifications. However results indicate that there is no significant relationship between compliance with the Code and level of diversifications. This continues the argument among previous study whether improving corporate governance will

really effect the level of diversifications undertook by the firms. Nevertheless, one control variable, *OwnDir* (total shares held by executive directors over the total number of shares outstanding) has a significant negative relationship with the level of diversifications. This means that executive directors with high ownership of the firm will prefer to have lower number of diversifications. This is consistent with Denis et al. (1997) which prove that directors believe that diversification will reduce the value of the firm.

Table 3.6 presents regression results for CEO compensation models. The adjusted r-squared for all 9 models are quite high, ranging from 0.2398 up to 0.4880, indicating that the model explains a reasonable amount of cross-sectional variation in CEO compensations. I found a significant positive relationship between total cash compensation and *ClaimFull* variable but could not find any significant relationship between any type of compensation and two other compliance variables (*Comp20* and *Comp9*). This positive relationship can be explained by several significant relationships among the control variables. *Sales* has a significant positive relationship that indicates CEO performance is based on firm performance. This is quite an interesting link because it agrees with the findings of Watson and Wilson (2005) that questioned many previous studies of large firms who are unable to find any significant link between par and performance measurement measures. *OwnCEO* (percentage of outstanding shares owned by the CEO) also has a positive significant relationship with CEO compensation which means that the higher percentage of CEO ownership in the firm, the higher compensation will be given by the firm to the CEO. As discovered by Core et al. (1997) I also found that *NonCEO5%* (dummy variable

coded 1 if the firm has an internal board member who own at least 5% of the outstanding shares and 0 otherwise) has a significant negative relationship with CEO compensation, which indicates that large individual shareholder still have control over the CEO compensation. Overall results suggest firms that claim full compliance with the Code will have higher level of CEO compensation. This notion is further enforced when CEO controls a significant percentage of the share. However, significant shareholders who remain in board of directors will also have an influence on the level of CEO compensation.

A regression result for accounting quality model is presented in Table 3.7. I could not find any significant relationship between timeliness of earnings and compliance with the Code. The model has a very low adjusted r-square even though some of the variables did show some positive relationship like *Size* and *RET*. The positive relationships shown by these two variables were also reported by Beekes et al. (2004) but unlike their study I am unable to find any significant relationship among all those interaction variables. The summary table for outcomes for all hypotheses is presented in Table 3.8.

3.6 Conclusion

This chapter examines the relationship between compliance with the Code and issues related to managerial decision making such as level of diversification, CEO compensation and accounting quality. Whilst previous studies have look into relationship between these issues and various measurements of corporate

governance, none of them has used compliance with the Code as a determinant governance factor. This is crucial because full compliance with the Code has been advocated vigorously by FRS in lieu with recent accounting scandals happening in the UK and all over the worlds. In addition, findings by Grant Thornton which show that less than half of FTSE 350 firms can claim full compliance with the Code is seem perplexing and need further investigation on the usefulness of actual compliance with the Code itself. This chapter adds to current literature by providing a UK perspective on the measurements of corporate governance and what impact it has on various issues on managerial decision making.

Three hypotheses were tested. I find level of CEO compensation to be significantly related to the claim of full compliance by the FTSE 350 firms. However, no significant relationship was found between compliance with the Code and level of diversification and timeliness of earnings.

Limitations of the analysis are as follows. Due to various issues need to be covered in this chapter and the next two chapters, the study only uses one specific model to analyse the relationship between each issue and compliance with the Code. However, past studies have employed various methods and different measurements for each issue, and selecting more than one method could produce better results and understanding on these relationships.

For example, instead of looking into just levels of diversification, I could expand the study to include a model that will explore the relationship between value of diversification using Berger and Ofek (1995) model. I could also improve the CEO compensation model by including valuation of share options, performance plans, phantom and restricted share received by the CEO which was done in a study by Core et al. (1999). Accounting quality model can also be improved by looking into another perspective by analysing abnormal accrual as studied by Peasnell et al. (2000) which look into the association between board composition and earnings management activity using the modified-Jones model. Future research could employ this alternative models and measurements to better capture the relationship between various issues of managerial decision making and compliance with the Code.

TABLE 3.1

Grant Thornton 20 Questions

No.	Questions	Section in the Code
1	Does the report identify the chairman, chief executive, senior independent, members and chairs of the nomination, audit and remuneration committees?	A.1.2
2	Is the number of meetings of the board and overall attendance disclosed?	A.1.2
3	Led by the senior independent, do the non-executive directors meet without the chairman at least annually to appraise the chairman's performance?	A.1.3
4	Are the roles of the chairman and chief executive exercised by the same individual?	A.2
5	Is at least half of the board comprised of independent non-executive directors?	A.3.2
6	Are the terms and conditions of appointment of non-executive directors available for inspection?	A.4.4
7	Is there a description of the work of the nomination committee, including the process it has used in relation to board appointments?	A.4.6
8	Are the majority of nomination committee members NEDs and is the chairman either chairman of the board or a NED?	A.5.1
9	Does the company state the potential maximum remuneration available including performance related elements?	B.1.1
10	Are there at least three remuneration committee members, all of whom are independent NEDs?	B.2.1
11	Is it stated that the board (or shareholders where required) set the remuneration for the non-executive directors?	B.2.3
12	Is there a statement that a review of the effectiveness of the group's internal controls has been undertaken at least annually?	C.2.1
13	Is there a statement that this review covers all material controls including financial, operational and compliance controls, and risk management systems?	C.2.1
14	Are all the audit committee members independent NEDs?	C.3.1

15	Does the audit committee state to have at least one member with recent and relevant financial experience?	C.3.1
16	Does the audit committee monitor and review the effectiveness of internal audit activities?	C.3.2
17	Is there a separate section of the annual report which describes the work of committee?	C.3.3
18	If the auditor provides non-audit services, is there a statement as to how the auditor's objectivity and independence is safeguarded?	C.3.7
19	Are terms and reference available for the audit, remuneration and nomination committees?	N/A
20	Do they have an internal audit function or equivalent?	N/A

TABLE 3.2

Revised Compliance Index

No.	Questions	Categories
1	Led by the senior independent, do the non-executive directors meet without the chairman at least annually to appraise the chairman's performance?	Non-Executive Directors
2	Is at least half of the board comprised of independent non-executive directors?	Non-Executive Directors
3	Are the roles of the chairman and chief executive exercised by the same individual?	Board and Committees
4	Are the majority of nomination committee members NEDs and is the chairman either chairman of the board or a NED?	Nomination Committee
5	Does the company state the potential maximum remuneration available including performance related elements?	Remuneration Committee
6	Are there at least three remuneration committee members, all of whom are independent NEDs?	Remuneration Committee
7	Are all the audit committee members independent NEDs?	Audit Committee
8	Does the audit committee monitor and review the effectiveness of internal audit activities?	Audit Committee
9	Do they have an internal audit function or equivalent?	Audit Committee

TABLE 3.3

Sample Selection Filters

	Year				
	2003	2004	2005	2006	2007
No. of sample from Grant Thornton Review	n/a	315	320	314	306
No. of sample after redistribution according to end of financial year	267	312	306	275	95
less Takover, delisted and others	107	97	74	28	16
Final Sample	160	215	232	247	79
Claim of full compliance rate from Grant Thornton Review	n/a	57.80%	27.60%	34.10%	40.80%
Claim of full compliance rate from Final Sample	53.75%	39.53%	27.59%	43.32%	40.51%

The table presents a breakdown of the sample selection process. The initial sample of firms consisted of firms included in Grant Thornton raw data. Details of reasons for omission are presented, together with the final sample and revised compliance rate.

TABLE 3.4

Descriptive Statistics for Diversification, CEO Compensation and Accounting Quality models

Panel A: Descriptive statistics for Diversification model

	N	min	max	mean	stdev	skew	kurt
LevelDiv	720	1	9	3.21	1.60	0.84	0.97
ClaimFull	720	0	1	0.39	0.49	0.47	-1.79
Comp20	720	0.15	1	0.79	0.16	-1.06	1.14
Comp4	720	0	1	0.74	0.24	-0.67	-0.18
OwnDir	720	0	0.88	0.04	0.12	3.99	16.89
OwnBlock	720	0	1	0.53	0.50	-0.11	-1.99
Size	720	19.04	25.29	21.09	1.19	1.05	1.01
R&Dsales	720	0	0.19	0.00	0.01	8.28	81.17
Analyst	720	1	29	8.32	5.22	0.78	0.33

Panel B: Descriptive statistics for CEO Compensation model

	N	min	max	mean	Stdev	skew	kurt
SalaryComp	485	2692	1551000	504532.98	222356.69	1.11	1.58
CashComp	485	2692	7569000	888545.69	831572.83	3.64	18.25
ClaimFull	485	0	1	0.39	0.49	0.46	-1.79
Comp20	485	0.25	1	0.79	0.15	-1.04	0.97
Comp9	485	0.11	1	0.78	0.18	-1.00	1.11
Sales (£' million)	485	1.84	42,641.00	3330.79	6112.60	3.52	13.86
ROA	485	-0.66	3.99	0.58	0.62	2.03	5.60
RET	485	-0.86	1.83	0.25	0.34	0.68	2.96
OwnCEO	485	0	1	0.06	0.24	3.58	10.84
NonCEO5%	485	0	1	0.08	0.27	3.10	7.61
OwnBlock	485	0	1	0.49	0.50	0.03	-2.01

Panel C: Descriptive statistics for Accounting Quality model

	N	min	max	mean	Stdev	skew	kurt
EPS	650	-0.01	0.30	0.07	0.05	1.07	2.08
Size	650	11.51	25.40	21.22	1.37	0.28	4.37
Auditor	650	0	1	0.99	0.08	-12.66	158.73
OwnDir	650	0	0.88	0.03	0.11	4.74	25.26
OwnBlock	650	0	1	0.49	0.50	0.02	-2.01
RET	650	-0.86	2.48	0.25	0.37	1.27	5.84
NEG	650	0	1	0.16	0.37	1.81	1.29
ClaimFull	650	0	1	0.38	0.49	0.48	-1.78

This table presents the descriptive statistics for Diversification, CEO Compensation and Accounting Quality model in the sample. Panel A presents the statistics for all the variables used in Diversification model, Panel B presents the statistics for all the variables used in CEO Compensation model and Panel C presents the statistics for all the variables used in Accounting Quality model.

TABLE 3.5

OLS Regression Results for H1

Independent	*CompFull*			*Comp20*			*Comp4*		
variables	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	2.110	9.065	0.000	2.092	5.170	0.000	2.173	7.430	0.000
Y2003	0.039	0.225	0.822	0.040	0.210	0.833	0.020	0.113	0.910
Y2004	0.112	0.705	0.481	0.115	0.682	0.495	0.097	0.594	0.553
Y2005	0.066	0.449	0.654	0.069	0.470	0.639	0.061	0.415	0.678
Y2007	0.018	0.088	0.930	0.020	0.095	0.925	0.019	0.091	0.927
Size	0.000	-0.846	0.398	0.000	-0.859	0.391	0.000	-0.841	0.401
OwnDir	-1.214	-2.332	0.020	-1.205	-2.313	0.021	-1.240	-2.361	0.018
OwnBlock	-0.173	-1.491	0.136	-0.171	-1.484	0.138	-0.173	-1.498	0.135
NoAnalysts	0.020	1.467	0.143	0.019	1.438	0.151	0.020	1.500	0.134
R&D/Sales	-3.272	-1.108	0.268	-3.272	-1.108	0.268	-3.328	-1.126	0.261
Compliance variables	-0.014	-0.122	0.903	0.017	0.040	0.968	-0.098	-0.371	0.711
R-Square			0.284			0.284			0.284
Adj. R-Square			0.225			0.225			0.225

TABLE 3.6

OLS Regression Results for H2

Independent variables	*SalaryFull*	*CashFull*	*Salary20*	*Cash20*	*Salary9*	*Cash9*
Intercept	-1792994	-3200288	-1789018	-3255975	-1794720	-3245225
	0.000	*0.000*	*0.000*	*0.000*	*0.000*	*0.000*
Y2003	593	-603948	*-3187*	-556230	-157	-593367
	0.980	*0.000*	*0.904*	*0.000*	*0.995*	*0.000*
Y2004	2560	-489009	-53	-477147	1092	-510573
	0.901	*0.000*	*0.998*	*0.000*	*0.959*	*0.000*
Y2005	-4921	-169467	*-5898*	-190349	-5621	-200692
	0.814	*0.074*	*0.777*	*0.045*	*0.787*	*0.034*
Y2007	-9199	187100	-8844	184893	-9284	186240
	0.748	*0.150*	*0.757*	*0.157*	*0.745*	*0.153*
Sales	110487	204190	*111153*	204706	111052	214894
	0.00	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
ROA	-16829	-2341	-17180	-8297	-17152	-13085
	0.163	*0.966*	*0.154*	*0.880*	*0.155*	*0.812*
RET	-37588	-35680	*-38054*	-27031	-37815	-33604
	0.080	*0.713*	*0.077*	*0.782*	*0.078*	*0.731*
OwnCEO	-38610	471846	-39494	472144	-39068	461859
	0.235	*0.001*	*0.226*	*0.002*	*0.230*	*0.002*
NonCEO5%	-15726	-417692	*-16733*	-412982	-16428	-427454
	0.590	*0.002*	*0.568*	*0.002*	*0.575*	*0.001*
OwnBlock	15966	39571	15927	26203	15893	27196
	0.281	*0.555*	*0.280*	*0.696*	*0.281*	*0.685*
Compliance	1276	142398	*-19454*	128304	-10954	-127002
variables	*0.934*	*0.042*	*0.755*	*0.652*	*0.816*	*0.553*
R-Square	0.4995	0.2633	0.4996	0.2571	0.4996	0.2574
Adj. R-Square	0.4879	0.2462	0.4880	0.2398	0.4880	0.2401

This table presents the OLS regression results for *H2* with its estimated coefficients and its p values beneath in italic. Column *SalaryFull* is for model that uses salary compensation as dependent variable and *ClaimFull* as its governance variable. Column *CashFull* is for model that uses total cash (salary and bonus) compensation as dependent variable and *ClaimFull* as its governance variable. Column *Salary20* is for model that uses salary compensation as dependent variable and *Comp20* as its governance variable. Column *Cash20* is for model that uses total cash (salary and bonus) compensation as dependent variable and *Comp20* as its governance variable. Column *Salary9* is for model that uses salary compensation as dependent variable and *Comp9* as its governance variable. Column *Cash9* is for model that uses total cash (salary and bonus) compensation as dependent variable and *Comp9* as its governance variable.

TABLE 3.7

OLS Regression Results for H3a and H3b

Independent variables	*EPS*	
	est. co-eff.	p-value
Intercept	0.240	0.000
Y2003	0.001	0.909
Y2004	0.011	0.033
Y2006	-0.003	0.493
Y2007	-0.006	0.422
RET	0.023	0.004
NEG	-0.009	0.310
*NEG*RET*	0.042	0.129
COM	0.006	0.292
*NEG*COM*	0.016	0.267
*COM*RET*	0.000	0.979
*NEG*COM*RET*	0.021	0.644
Size	-0.008	0.000
Auditor	-0.007	0.780
OwnDir	-0.016	0.364
OwnBlock	0.000	0.982
R Square		0.1480
Adjusted R Square		0.1279
F value		4.839

TABLE 3.8

Summary of outcomes for all hypotheses

Hypothesis No.	Hypotheses	Outcomes
H1	*Firms that comply completely with the Code have a lower level of diversification*	Fail to reject H_01
H2	*Firms that comply completely with the Code have lower CEO compensation*	Reject H_02, firms that fully comply with the Code have higher CEO compensation
H3a	*Firms that comply completely with the Code reflect bad news in earnings in a timelier manner*	Fail to reject H_03a
H3b	*Firms that comply completely with the Code reflect good news in earnings in a timelier manner*	Fail to reject H_03b

CHAPTER FOUR:

COMPLIANCE WITH THE CODE AND ISSUES RELATED TO THE WELFARE OF SHAREHOLDERS

4.1 Introduction

This study investigates the relationship between compliance with the Code and issues related to the welfare of shareholders such as disclosure quality, CEO turnover, compensation disclosure quality and firm performance. Earlier studies have investigated how various corporate governance mechanisms safeguard the welfare of shareholders in various issues and found that better governed firms make more informative disclosures (Beekes & Brown, 2006) improved performance after CEO turnover (Huson et al., 2004) and have higher compensation disclosure quality (Conyon et al., 2002). There are also many studies that have attempted to look into the relationship between corporate governance and firm performance (Fama & French, 1992; Padgett & Shabbir, 2005; Core et al., 2006)

While existing studies document links between disclosure quality, CEO turnover and compensation disclosure quality with various measurements of corporate governance, none of them has ever attempted to look into these issues and their relationship with the compliance with the Code. There are several UK studies that have looked into relationship between compliance with the Code and firm performance but all of them created their own index which could induce selection bias. Therefore, there is a gap of knowledge in this area especially in the UK

considering that the Combined Code has been in effect since 2000. Other UK studies that look into compliance with the Code have only investigated the link with firm performance and the measurements of such compliance was done by self creating an index which could potentially leads to selection bias. As with Chapter Three, this study will not suffer from that as I will be using compliance data provided by Grant Thornton which is obtained through a written agreement with them.

As mentioned in Chapter Three this study is also motivated by the theoretical perspective on the link between corporate governance and managerial behaviour which can be explained by the agency cost theory. The separation of corporate managers from outside shareholders will result in inherent conflict and there is an assumption that managers will act opportunistically to take care of their own interests before the shareholders (Jensen & Meckling, 1976). This is especially true when the managers are given the decision making power and past studies have shown that there are many corporate decisions that can be influenced by the managers action including the four issues discussed in this study. Therefore there is a need for some sort of corporate governance mechanisms such as the Code by which managers can be disciplined to act in the best interest of the shareholders.

This analysis is based on the data for FTSE 350 UK firms from 2003 until 2007. I measure compliance with the Code by using a compliance index created by Grant Thornton and also a revised index which specifically caters to specific issues addressed. The measurements for disclosure quality, CEO turnover, compensation

disclosure quality and firm performance were based on prior studies that look into their relationship with other corporate governance mechanisms.

I found that firms that comply with the crucial principles in the Code have a lower analyst bias and a larger analyst following. I also found that there is no relationship between compliance with the Code and CEO turnover. There is some evidence that compliance with the Code affects compensation disclosure quality. There is also some evidence that firms are trying to mask their underperformance by claiming full compliance with the Code in their annual report.

The remainder of the chapter is structured as follows. The next section discusses the motivation for the paper, reviews prior studies and formulates my hypotheses. Section 3 then discusses the methodology used, followed by a discussion of the sample and data collection process in Section 4. I present the results of the study in Section 5, and Section 6 concludes.

4.2 Motivation, Literature Review and Hypotheses

4.2.1 RESEARCH MOTIVATION

Firms with strong governance mechanism in place will safeguard the welfare of shareholders in term of maintaining high quality of disclosure and will not hesitant to replace its CEO if they are not performing well.

There are four schools of thought that can best describe problems and solutions affecting corporate governance and they are the principal-agent model, the myopic market model, the abuse of executive power model and the stakeholder model. The first two have been discussed in previous chapter and the stakeholder perspective model will be discussed here.

4.2.1.1 The abuse of executive power model

The abuse of executive power model argues that abuse of executive power is a major problem in the corporation governance structure. Supporters of this view contend that management have been given excessive power to serve their own interest at the expense of shareholders and none of the current institutional restraints such as non-executive directors, the audit process and the threat of takeover can prevent them. The abuse of executive power is usually manifested in the problem of executive overpay. Studies have shown that executive remuneration has risen far faster than average earnings and the link between compensation and management performance has been very weak (Conyon, Gregg & Machin, 1995). Executive pay is bettered by share option schemes and management have been known to write themselves contracts that will benefit them no matter how the firm is performing (Keasey et al., 1997). Even the introduction of independent remuneration committees is not effective because it is still open to abuse by the management.

The supporters of this model also do not believe that the shareholders are capable on monitoring the action of the management and they also do not agree that

managers are the agents of shareholders. Instead, they claim that managers are trustees of the firm and thus there should be different ways to implement corporate governance system inside the firm. Kay & Silberston (1995) explained that the responsibility of the trustees is far wider than the agents. Rather than focusing on serving the financial interest of the firms, the managers also need to consider the skills of employees, the expectations of customers and suppliers, and the firms' reputation in the community. Managers also have to consider the interests of present and future stakeholders and long-term business development of the firm. Therefore, Kyle & Silberston (1995) argued that the appropriate governance reform is more towards statutory changes such as amending the statutory duties of the directors to include promoting the business of the firm and to balance the shareholders' claims. In addition, the appointment of directors and senior managers will be under the responsibilities of independent parties and the appointment of a CEO should be based on a fixed term basis with only one time renewal of the contract if necessary. This in turn will prevent hostile takeover since large ownership of shares no longer has the right to appoint managers at will and this reform will give executive management the freedom to develop the longer term vision of the business and at the same time responsible to various stakeholders of the firm.

4.2.1.2 The stakeholder model

The proponents of the stakeholder model argue that objectives and purpose of the firm should not be limited to the maximisation of shareholder welfare alone. Other groups such as customers, suppliers, employees and managers should also be

recognized. Keasey et al. (1997) suggest that a wider objective function of the firm is not only more equitable but also more socially efficient than one confined to shareholder wealth.

The concept of stakeholder theory was first introduced by Freeman (1984) and he defines a stakeholder as any group or individual who can affect or is affected by the achievement of the firm's objectives. He argued that those groups of stakeholders are vital to the survival and success of the firm and therefore strategic management model should be sensitive to them.

There are two principal ways to demonstrate the efficiency of the stakeholder model and this is explained by Keasey et al. (1997). The first way is to build up a reputation for the ethical treatment of customers, suppliers and employees in order to cement trust relations, which will leads to profitable investments and mutually beneficial exchanges. This is because ethical behaviour can reduce the costs of social association. The second efficiency case is where extensive stakeholder involvement with the firm is pervasive and corporate goals are typically defined more widely than shareholders' profits.

However, one major criticism of this theory is that sometimes it is difficult to give clear guidance to help managers deal with competing social purposes and stakeholders' benefits, and it can be difficult to have an effective mechanism to ensure firms perform their social obligations. In addition, Keasey et al. (1997) suggest that the stakeholder model is not at all in conflict with the principal-agent model. The reason is that if ethical behaviour is the strategy that maximises long-

term profits, shareholders should encourage their managers to practise it. It seems that at least the instrumental aspect of stakeholder theory is compatible with the principal-agent model.

4.2.2 THEORETICAL FRAMEWORK AND LITERATURE

One of the principles in the Code requires that the board should present a balanced and understandable assessment of the firm's position and prospects. Balanced assessment could mean making more informative disclosures regarding both good and bad news. Therefore a firm with a high standard of corporate governance will make more informative disclosures. Some of the advantages of having more informative disclosures are larger analyst following, more accurate analysts' earnings forecasts and timelier price discovery (Beekes & Brown, 2006). Based on this I proposed these hypotheses (presented in both null and alternative forms):

$H_0$4a: There is no relationship between firms that comply completely with the Code and analyst bias

H4a: Firms that comply completely with the Code have lower analyst bias

$H_0$4b: There is no relationship between firms that comply completely with the Code and analyst accuracy

H4b: Firms that comply completely with the Code have higher analyst accuracy

H_0*4c: There is no relationship between firms that comply completely with the Code and analyst disagreement*

H4c: Firms that comply completely with the Code have lower analyst disagreement

H_0*4d: There is no relationship between firms that comply completely with the Code and analyst following*

H4d: Firms that comply completely with the Code have higher analyst following

Various studies have shown that strong boards of directors will monitor firm performance and will not be hesitant to replace the managers if the firm is performing poorly (Weisbach, 1988; Denis & Denis, 1995; Huson et al., 2004). Since firms that comply with the Code will have more independent directors in the board, the chances are that CEO turnover will be high if the firm if performing badly. Based on these findings I proposed this hypothesis (presented in both null and alternative forms):

H_0*5: There is no relationship between firms that comply completely with the Code and CEO turnover during bad performance*

H5: Firms that comply completely with the Code have higher CEO turnover during bad performance

The Code stresses that the firm must state the potential maximum remuneration available to the managers including performance related elements[16]. Information on salary and bonus is usually straight forward but not necessarily for other long term compensation plans especially when it involves share options. Since such information is not legally compulsory, firms have a choice on whether to disclose it or not[17]. However, there is growing evidence that board composition has started to exercise its monitoring function and demanding more information to be disclosed on long term compensation plans. Conyon et al. (2002) indicate that the quality of information disclosed about share options is a positive function of the increased presence of nonexecutive directors. Based on this finding I proposed this hypothesis (presented in both null and alternative forms):

$H_0$6: There is no relationship between firms that comply completely with the Code and quality of information disclosed about long term compensation.

H6: Firms that comply completely with the Code have higher quality of information disclosed about long term compensation.

There are several studies in the UK trying to find whether good governance will leads to better firm performance and the results are generally mixed. Padgett & Shabbir (2005) find that compliance to the Code leads to a better share price return. However, MacNeil & Li (2006) discover that firms that consistently do not comply with the Code tend to perform better in term of share prices but Arcot &

[16] Section B.1.1 and Schedule A of Combined Code of Corporate Governance 2003
[17] However, beginning 1 January 2005 all listed firms had to disclose the accounting treatment for all share-based payments under FRS20.

Bruno (2007) find that only firms which provided detailed explanation for their non-compliance managed to produce abnormal returns.

In general though, most studies tend to focus on finding link between firm performance and specific governance mechanisms or against governance index created by the study itself (Gompers, Ishii & Metrick, 2003; Larcker, Richardson & Tuna, 2007). They find some evidence of the effect of governance mechanisms on firm performance (Gompers et al., 2003; Core et al., 2006; Larcker et al., 2007) but others have found that endogeneity problem could give misleading results (Chidambaran, Palia & Zheng, 2006). Based on these findings I proposed this hypothesis in a null form:

$H_0 7$: *Firms that comply completely with the Code are not associated with firm performance*

4.3 Research Methodology

In this section I present the regression models used in the empirical analysis and discuss how I measure compliance with the Code and issues related to the welfare of shareholders. I then discuss the control variables used in the models.

4.3.1 REGRESSION MODELS

This study employs ordinary least squares (OLS) regression model for each hypothesis presented in the previous section and most of these models are based on the previous works done on the subject issues.

4.3.1.1 Disclosure Quality Models

The disclosure quality models are based on the works by Beekes & Brown (2006) which also look into firm's corporate governance and the informativeness of its disclosures. The model for *H4a* is specified as below:

$$Bias_{i,t} = \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \quad (5)$$

where *Bias* is a proxy for signed Forecast Error (FE), calculated by mean forecast EPS less EPS, deflated by prior share price; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the disclosure quality; ε is the error term and *i* and *t* are firm and time subscripts respectively.

The model for *H4b* is specified as below:

$$Accuracy_{i,t} = \beta_0 + \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \quad (6)$$

where *Accuracy* is a proxy for absolute value of the FE, deflated by prior share price; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the disclosure quality; ε is the error term and *i* and *t* are firm and time subscripts respectively.

The model for *H4c* is specified as below:

$$Disag_{i,t} = \beta_0 + \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \quad (7)$$

where *Disag* is a proxy for level of disagreement, by calculating standard deviation across analysts' forecasts for that firm-month, deflated by share price; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the disclosure quality; ε is the error term and *i* and *t* are firm and time subscripts respectively.

The model for *H4d* is specified as below:

$$Analyst_{i,t} = \beta_0 + \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \quad (8)$$

where *Analyst* is a proxy for number of analysts contributing to the forecast; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the disclosure quality; ε is the error term and *i* and *t* are firm and time subscripts respectively.

Among the reasons for why each firm has a different level of disclosure of its financial report is due to management incentive (Noe, 1999). However, if a firm has strong governance, management will be required to make an optimal disclosure for the benefit of shareholders including the financial analyst. Such high quality of disclosure will therefore attract more analyst following and more accurate forecast on firm's performance. All the models above reflected contemporaneous effect since analysts are taking any changes in firm's policy and governance effort in a very timely manner.

4.3.1.2 CEO Turnover Model

The model for *H5* is specified as below:

$$CEOResign_{i,t} = \beta_0 + \beta_1 \text{NEG}_{i,t-1} + \beta_2 \text{COM}_{i,t-1} + \beta_3 \text{NEG}_{i,t-1} \cdot \text{COM}_{i,t-1} + \beta_4 Controls_{i,t} + \varepsilon_{i,t} \quad (9)$$

where *CEOResign* is a dummy variable coded 1 if CEO resigns and 0 otherwise; *NEG* is a proxy for dummy variable coded 1 if returns are negative and 0 otherwise; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the CEO turnover; ε is the error term and *i* and *t* are firm and time subscripts respectively.

Board of directors have responsibility to monitor and evaluate management. If the management did not perform according to board expectation, the board has a right to replace the management with the new one especially the CEO of the firm. Since

evaluation of the management is usually based on firm prior performance, the model incorporated lagged variables.

4.3.1.3 Compensation Disclosure Quality Model

The compensation disclosure quality model is based on the works by Conyon et al. (2002) which look into disclosures of directors' share option information in UK firms. The model for *H6* is specified as below:

$$CDQ_{i,t} = \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \qquad (10)$$

where *CDQ* is a proxy for compensation disclosure quality, measured by percentage of long term compensation plan disclosed without information on its performance scale and comparator; *COM* is a proxy for compliance with the Code; *Controls* is an additional determinants of the compensation disclosure quality; ε is the error term and *i* and *t* are firm and time subscripts respectively.

One of the positive impacts of having larger number of independent directors is that they will require more information regarding management compensation to be disclosed for the benefits of shareholders. This is hoped will reduce the opportunity by the management to engage in any earnings management especially if their compensations are depending on firm's performance. Therefore, if the board insists on greater transparency management will have to produce all information available regarding disclosure of compensation policy.

4.3.1.4 Firm Performance Model

The firm performance model is based on the works by Core et al. (2006) who investigate whether weak corporate governance causes poor stock returns. The model for H_07 is specified as below:

$$ROA_{i,t} = \beta_0 + \beta_1 COM_{i,t-1} + \beta_2 Controls_{i,t-1} + \varepsilon_{i,t} \quad (11)$$

where *ROA* is a proxy for future operating income over year-end total assets; *COM* is a proxy for compliance with the Code; *Controls* are an additional determinants of the firm performance; ε is the error term and *i* and *t* are firm and time subscripts respectively. Since we are looking into a direct effect of governance towards firm performance, the model is presented using the lagged variables.

As mentioned earlier, there is a potential endogeneity issue in relation to the link between corporate governance and firm performance (Chidambaran et al., 2006). Standard linear regression models assume that errors in the dependent variables are uncorrelated with the independent variables, meaning that relationships between these variables are not bidirectional. However, sometimes this is not the case with governance and firm performance where some studies suggested that performance can have an effect on governance. Therefore in this case, OLS regression can no longer provides optimal model estimates. To address this I will use a two-stage least squares regression method which uses instrumental variables that are uncorrelated with the error terms to compute estimated values of the

problematic variable (the first stage), and then uses those computed values to estimate a linear regression model of the dependent variable (the second stage). Since the computed values are based on variables that are uncorrelated with the errors, the results of the two-stage model are optimal.

4.3.2 MEASUREMENTS OF COMPLIANCE WITH THE CODE

Previously, study on the compliance level of the Code had to rely on self-constructed index (Padgett & Shabbir, 2005; Arcot & Bruno, 2007) and survey (MacNeil & Li, 2006) since such data is not available publicly in any database or publication. However, since 2002, Grant Thornton UK LLP has started to review and publish annual study on the level of compliance for FTSE 350 companies. Through series of discussion, they have agreed to provide me with their raw data for the year 2003 until 2007. Grant Thornton has their own compliance index and I have included their index in my study together with the amended index to incorporate more stringent requirements to link relationship between compliance with the Code and various issues studied.

In order to measure compliance rate, I will follow the same levels of measurement stated in Chapter Four, starting from a basic measurement to a more refined measurement. The first level is a dummy variable coded 1 if the firm announces in their annual report that they fully comply with the Code, 0 otherwise. The second level is a continuous variable where percentage of compliance to the Code is measured using Grant Thornton questionnaire method (20 questions based on the principles in the Code). I decided to refine this index further by introducing third

level of measurement because some of the questions posed by Grant Thornton are merely informational in nature and not really promoting the true objectives of the Code[18]. Therefore I created several compliance indexes that consist of requirements that truly promote corporate governance. Each index will be modified to correspond to specific issues because many studies have argued that there is no one 'best' measure of corporate governance since it needs to look into the context of the specific issue and firm's specific circumstances (Arcot & Bruno, 2007; Bhagat, Bolton & Romano, 2007).

Therefore, CEO turnover model will use a compliance index based on four questions from Grant Thornton index only. Disclosure quality and firm performance models will also use these four questions and three questions on audit committee. Compensation disclosure quality model will have additional two questions on remuneration committee. Table 4.1 listed these revised questions.

4.3.3 CONTROL VARIABLES

4.3.3.1 Control Variables for Disclosure Quality Models

The first two models will use two control variables. The first variable is *Size* as a proxy for firm size, (natural log of the firm's market capitalisation) since large firms are subject to greater public scrutiny and are therefore likely to disclose more frequently. The second variable *Analyst* is a proxy for number of analysts contributing to the forecast.

[18] For example, one of the questions asked by Grant Thornton is whether the terms and conditions of appointment of non-executive directors are available for inspection.

In the third and fourth models, both will be using the same three control variables.; *Size* is a proxy for firm size, calculated as a natural log of the firm's market capitalisation on the forecast cut-off date; *FE* is a proxy for forecast EPS minus actual EPS over the share price, for the same firm and same forecast horizon; *ABSFE* is a proxy for absolute value of FE;

4.3.3.2 Control Variables for CEO Turnover Model

The CEO turnover model will have three control variables: *Size* is a proxy for firm size, measured by natural log of the firm's market capitalisation; *OwnDir* is a proxy for total shares held by executive directors over the total number of shares outstanding and *OwnBlock* is a proxy for dummy variable coded 1 if at least one external shareholders holds more than 10% of outstanding equity and 0 otherwise.

4.3.3.3 Control Variables for Compensation Disclosure Quality Model

The compensation disclosure quality model has six control variables. *Size* is a proxy for firm size, measured by natural log of the firm's market capitalisation. It is argued that larger firms will be more visible and they will attract greater disclosure costs, thereby reducing its disclosure (Forker, 1992). *OwnDir* is a proxy for total shares held by executive directors over the total number of shares outstanding and *OwnBlock* is a proxy for dummy variable coded 1 if at least one external shareholder holds more than 10% of outstanding equity and 0 otherwise. *ROA* is a proxy for future operating income over year-end total assets. This

control variable is a bit similar to *Size* in a sense that a successful firm will be reluctant to disclose more information on their compensation information as this will give their rivals to emulate their proven rewards structure. *Salary* is a proxy for component of compensation that is fixed at the beginning of the year; *Cash* is a proxy for the sum of salary and annual bonus.

4.3.3.4 Control Variables for Firm Performance Model

The firm performance models will have five control variables: *Size* is a proxy for firm size, measured as natural log of the firm's market capitalisation. Fama & French (1992) found negative relationship between firm size (measured by market equity) and average return which is confirmed again by Weir, Laing & McKnight (2002) even when its proxy is sales. *OwnDir* is a proxy for total shares held by executive directors over total number of shares outstanding and *OwnBlock* is a proxy for dummy variable coded 1 if at least one external stakeholder holds more than 10% of outstanding equity and 0 otherwise. Schleifer and Vishny (1986) and Leech and Leahy (1991) found a positive relationship between external shareholders and firm performance. However, in the current studies, there is little evidence of relationship between block holding and firm performance (Agrawal and Knoeber, 1996; Short and Keasey, 1999; Weir et al., 2002; Gillan, Hartzell and Starks, 2003) with an exception of study by Bohren and Odegaard (2003) on the Norwegian firms.

4.4 Sample, Data Collection and Descriptive Statistics

4.4.1 SAMPLE SELECTION

As with the previous chapter, the initial sample of firms used for this study is based on the FTSE 350 UK firms (excluding financial and utility firms) for each year from 2003 until 2007. These firms were selected because they were in the Grant Thornton Annual FTSE 350 Corporate Governance Review (2004 – 2007) to which Grant Thornton UK LLP has agreed to provide their raw data to me to analyse further for the purpose of this study.

From the initial set of sample from Grant Thornton, several firms were omitted for the reasons such as firms that have been undergoing acquisition, merger, demerger and being delisted from the stock exchange as their data is no longer available in the database. Since the number of firms in the sample has been slightly changed, I have adjusted the compliance rate to the Code which has been reported earlier by Grant Thornton using their original sample. Table 4.2 shows all the changes in Grant Thornton sample.

4.4.2 DATA

As with the previous chapter, compliance with the Code data is obtained from the Grant Thornton Annual FTSE 350 Corporate Governance Review raw data for each year from 2003 until 2007. This raw data consists of survey information on each individual firm in the FTSE 350. The survey questions are driven directly from the Code provisions and Turnbull guidance and are created to reflect the

'best practice' as perceived by the Code. The survey is completed by reading the hard copies of each firm's annual report and accounts, focusing on the front half of the report (i.e. not the accounts) including the sections; Business Review, Corporate Responsibility, Corporate Governance and Remuneration Report.

The financial data are obtained from Worldscope and FAME database. Numbers of analysts following the firms and forecasts for EPS are obtained from I/B/E/S database. Shareholders ownership structure is obtained from Waterlow Stock Exchange Yearbook. This data is hand collected from the ownership structure report section of the corresponding firm's published annual report and accounts. Management compensation, management share ownership data and information on resignation of CEO will be obtained from Manifest database.

4.4.3 DESCRIPTIVE STATISTICS

Table 4.3 reports descriptive statistics for the variables used in the analysis for *H4a* to *H4b*. Panel A of Table 4.3 presents the descriptive statistics for sample used in the *H4a* and *H4b* models. Mean for *Bias* is -0.004 with a standard deviation of 0.013. This is quite low than what has been obtained by Beekes and Brown (2006) where they have a mean of 0.057 and a standard deviation of 0.2. Mean for *Accuracy* is 0.007 with a standard deviation of 0.012. Again this is lower than mean of 0.069 in the sample obtained by Beekes and Brown (2006). Possible reason for lower mean for both *Bias* and *Accuracy* is because my sample focused on top 350 firms in the UK which command high profile and better scrutiny by the analysts compared to Beekes and Brown (2006) study that only

look into 250 Australian firms. Mean for *ClaimFull*[19] is 0.391 with a standard deviation of 0.488 and skewness of 0.447. Mean for *Comp20*[20] is 0.809 with a standard deviation of 0.148. Mean for *Comp7*[21] is 0.775 with a standard deviation of 0.188. Mean for *Analyst* is 9.067 with a standard deviation of 5.312 and this is on par with what Beekes and Brown (2006) have in their sample with a mean of 9.59 for analyst following.

Panel B of Table 4.3 presents the descriptive statistics for sample used in the *H4c* model. Mean for *Disag* is 0.004 with a standard deviation of 0.07. This is slightly lower than with Beekes and Brown (2006) study where they found a mean of 0.01 and a standard deviation of 0.01. Mean for *ClaimFull* is 0.374 with a standard deviation of 0.484 and skewness of 0.523. Mean for *Comp20* is 0.781 with a standard deviation of 0.157. Mean for *Comp7* is 0.757 with a standard deviation of 0.19. Mean for *FEMean* is -0.005 with a standard deviation of 0.015. Mean for *ABSFEMean* is 0.008 with a standard deviation of 0.013. These are slightly lower than what Beekes and Brown (2006) reported in the sample where they obtained a mean of 0.020 and 0.0359 for *FEMean* and *ABSFEMean* respectively. Panel C of Table 4.3 presents the descriptive statistics for sample used in the *H4d* model. Mean for *Analyst* is 8.66 with a standard deviation of 5.44 and a skewness of 0.78. Mean for *ClaimFull* is 0.39 with a standard deviation of 0.49 and skewness of 0.46. Mean for *Comp20* is 0.80 with a standard deviation of 0.15. Mean for *Comp7* is 0.77 with a standard deviation of 0.19.

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[19] *ClaimFull* is a dummy variable for firms claiming full compliance with the Code with 1 indicates claim of full compliance and 0 otherwise.
[20] *Comp20* is a compliance variable for number of criteria fulfilled by the firms out of 20 set of questions set by Grant Thornton to determine full compliance with the Code.
[21] *Comp7* is a compliance variable for number of criteria fulfilled by the firms out of a specific set of 4 questions relating to most basic and important principles in the Code and 3 questions relating to audit committee.

Table 4.4 reports descriptive statistics for the variables used in the analysis for *H5* to H_07. Panel A of Table 4.4 presents the descriptive statistics for sample used in the CEO turnover model. Mean for *CEOTurnover* is 0.14 with a standard deviation of 0.35. This is on par with what Huson et al. (2004) found in their study on 1344 US CEOs from 1971 to 1994. They found a mean of 0.16 for CEO that was forced to resign. Mean for *ClaimFull* is 0.40 with a standard deviation of 0.49 and skewness of 0.47. Mean for *Comp20* is 0.80 with a standard deviation of 0.15. Mean for *Comp4*[22] is 0.76 with a standard deviation of 0.23.

Panel B of Table 4.4 presents the descriptive statistics for sample used in the compensation disclosure quality model. Mean for *CDQ* is 0.87 with a standard deviation of 0.20. Mean for *ClaimFull* is 0.42 with a standard deviation of 0.49 and skewness of 0.35. Mean for *Comp20* is 0.79 with a standard deviation of 0.15. Mean for *Comp9* is 0.78 with a standard deviation of 0.18. Panel C of Table 4.4 presents the descriptive statistics for sample used in the firm performance model. Mean for ROA is 0.47 with a standard deviation of 0.44. Mean for *ClaimFull* is 0.39 with a standard deviation of 0.49 and skewness of 0.45. Mean for *Comp20* is 0.79 with a standard deviation of 0.16. Mean for *Comp7* is 0.75 with a standard deviation of 0.20.

In addition of looking into the skewness of the data, Q-Q plots have been employed to check the deviations of the data from the normal distribution. Q-Q

[22] *Comp4* is a compliance variable for number of criteria fulfilled by the firms out of a specific set of 4 questions relating to most basic and important principles in the Code.

plots for *H4a*, *H4b*, *H4c*, *H4d*, *H5*, *H6* and H_07 are presented in the Appendix D, E, F, G, H, I and J respectively.

4.5 Analysis

This section examines the relation between compliance with the Code and various issues related to the welfare of shareholders such as disclosure quality, CEO turnover, compensation disclosure quality and firm performance of FTSE 350 UK firms from 2003 until 2007. I report the main regression results in the next section.

4.5.1 RESULTS

Table 4.5 reports coefficient estimates and model summary statistics for OLS regression on *H4a* and *H4b*. I could not find any significant relationship between compliance with the Code and analyst bias and accuracy using the *ClaimFull* and *Comp20* compliance variables. However, when using *Comp7* as a compliance variable, I found a significant negative relationship between compliance with the Code and analyst bias. This is consistent with the findings by Beekes and Brown (2006) which also produced a significant negative relationship between analyst bias and corporate governance quality. However, I also found a significant positive relationship between compliance with the Code and analyst accuracy. This is in contrast with earlier findings by Beekes and Brown (2006) and warrants further investigation. The fact that these regression results produce low adjusted r-

square could explain this anomaly and could be better improved by including more related variables.

Panel A of Table 4.6 reports coefficient estimates and model summary statistics for OLS regression on *H4c*. I could not find any significant relationship between compliance with the Code and analyst disagreement. However both *Size* and *ABSMean* are significantly related to analyst disagreement. Never the less under Comp7 compliance variables I found that its p-value is the lowest (0.127) than the other two compliance variables. Panel B of Table 4.6 reports coefficient estimates and model summary statistics for OLS regression on *H4d*. I found a significant positive relationship between compliance with the Code and analyst following. *Size* and *ABSFEMean* also show significant relationships with analyst following. This is consistent with findings by Beekes and Brown (2006) which also found significant positive relationship between corporate governance quality and analyst following. A high adjusted r-square also indicates that this model explains a reasonable amount of cross-sectional variation in analyst following. All models under *H4* are also tested using median instead of mean for measuring *Bias*, *Accuracy* and other control variables and the results still indicate the same outcome.

Table 4.7 reports coefficient estimates and model summary statistics for binary logistic regression on *H5*. I found no significant relationship between compliance with the Code and CEO turnover. This shows that the event where CEO resigns or being forced to resign is not associated with the fact whether the firm is fully in compliance with the Code or not. This is possibly due to a fact that investors

would rather based their decision whether to retain their CEO on the basis of financial perform as being proposed by Huson et al. (2004). The firm's decision to comply or not with the Code seems irrelevant in the eyes of their investors when coming into the arguments on retaining or forcing the resignation of their CEO.

Coefficient estimates and model summary statistics for OLS regression on *H6* is presented in Table 4.8. I found no significant relationship between two compliance variables (*ClaimFull* and *Comp9*) and compensation disclosure quality. However I found a significant negative relationship between compensation disclosure quality and *Comp20*, which is the set of criteria used by Grant Thornton to define full compliance with the Code. At a first glance, this looks odd as influential shareholders might be demanding more information to be disclosed on long term compensation plans. On the other hand though, this looks like they are compensating such deficiency of information on their long term compensation plans by complying fully with the Code, hopefully to pacify the increasing demands and monitoring by their shareholders.

Table 4.9 reports coefficient estimates and model summary statistics for two-stage least squares regression on $H_0 7$. I found some interesting finding on this model. It seems that under *ClaimFull* compliance variables, it shows a significant negative relationship with firm performance. Both *OwnDir* and *OwnBlock* also have significant negative relationship with firm performance. However, no significant relationship was found between the other two compliance variables and firm performance. As we recall, *ClaimFull* variable is a dummy variable with value of 1 if the firm claims in their annual report that they are in full compliance with the

Code and 0 otherwise. However, Grant Thornton argued that only very small percentage of these firms actually fully complied with the principles of the Code. Could this negative relationship between *ClaimFull* and *ROA* simply suggest that the firms are trying to mask their underperformance by making claim that they have done their best efforts which include fully complying with the Code? This result suggests similarity with MacNeil & Li (2006) findings which discover that firms that consistently do not comply with the Code tend to perform better in term of share prices. However, low adjusted r-square warrants caution and further investigation into this result. The summary table for outcomes for all hypotheses is presented in Table 4.10.

4.6 Conclusion

This chapter examines the relationship between compliance with the Code and issues related to the welfare of shareholders such as disclosure quality, CEO turnover, compensation disclosure quality and firm performance. As mentioned in the previous chapter, many studies in the UK and the US have look into relationship between these issues and various measurements of corporate governance but none of them has used compliance with the Code as a determinant governance factor with an exception of looking into a relationship with firm performance. Even then these UK studies found conflicting results and could not reach a consensus whether compliance with the Code will improve firm performance or not. This is crucial because full compliance with the Code has been mentioned by FRS to be helpful for investors in making their decision and can help firms perform better. However, findings by Grant Thornton shows that

less than half of FTSE 350 firms can claim full compliance with the Code and this is in contrast with FRS objective. Therefore this chapter adds to current literature by providing a UK perspective on the measurements of corporate governance and what impact it has on various issues on the welfare of shareholders.

Four issues were examined and seven hypotheses were tested. I find that firms that comply with the crucial principles in the Code have lower analyst bias and increase analyst following. I also find that there is no relationship between compliance with the Code and CEO turnover. There is some evidence of compliance with the Code affects compensation disclosure quality. There is also some evidence that firms are trying to mask their underperformance by claiming full compliance with the Code in their annual report.

Limitations of the analysis are as follows. As with the previous chapter, this chapter only deals with a specific model to analyse the relationship between each issue and compliance with the Code. By including more models and alternatives in measuring the crucial variables, better and comprehensive results could be obtained to better understand these relationships.

For examples, I could introduce another model to analyse the relationship between disclosure quality and compliance with the Code. Beekes and Brown (2006) look into timeliness model where they found that firms with high governance quality will make more balanced and timelier disclosures. I could also look further into reasons why CEOs resign from their position because according to Huson et al. (2004) most of the events surrounding CEO turnover could be divided into two

types; CEO being forced to resign and CEO voluntarily resigns. In term of measuring compensation disclosure quality, I could try to determine whether there is enough information provided by the firms for the investors and shareholders to calculate and estimate the potential payoffs from these long term compensation plan. Results from firm performance model shows some promise and perhaps I could expand it further by including more firm performance measurements and other control variables that can better explain the variations in the model. Future research could employ this alternative models and measurements to better capture the relationship between various issues of welfare of shareholders and compliance with the Code.

TABLE 4.1

Revised Compliance Index

No.	Questions	Issues	Categories
1	Led by the senior independent, do the non-executive directors meet without the chairman at least annually to appraise the chairman's performance?	CEO turnover, disclosure quality, firm performance, compensation disclosure quality	Non-Executive Directors
2	Is at least half of the board comprised of independent non-executive directors?	CEO turnover, disclosure quality, firm performance, compensation disclosure quality	Non-Executive Directors
3	Are the roles of the chairman and chief executive exercised by the same individual?	CEO turnover, disclosure quality, firm performance, compensation disclosure quality	Board and Committees
4	Are the majority of nomination committee members NEDs and is the chairman either chairman of the board or a NED?	CEO turnover, disclosure quality, firm performance, compensation disclosure quality	Nomination Committee
5	Does the company state the potential maximum remuneration available including performance related elements?	Compensation disclosure quality	Remuneration Committee
6	Are there at least three remuneration committee members, all of whom are independent NEDs?	Compensation disclosure quality	Remuneration Committee
7	Are all the audit committee members independent NEDs?	Disclosure quality, firm performance, compensation disclosure quality	Audit Committee
8	Does the audit committee monitor and review the effectiveness of internal audit activities?	Disclosure quality, firm performance, compensation disclosure quality	Audit Committee
9	Do they have an internal audit function or equivalent?	Disclosure quality, firm performance, compensation disclosure quality	Audit Committee

TABLE 4.2

Sample Selection Filters

	Year				
	2003	2004	2005	2006	2007
No. of sample from Grant Thornton Review	n/a	315	320	314	306
No. of sample after redistribution according to end of financial year	267	312	306	275	95
less Takover, delisted and others	107	97	74	28	16
Final Sample	160	215	232	247	79
Claim of full compliance rate from Grant Thornton Review	n/a	57.80%	27.60%	34.10%	40.80%
Claim of full compliance rate from Final Sample	53.75%	39.53%	27.59%	43.32%	40.51%

The table presents a breakdown of the sample selection process. The initial sample of firms consisted of firms included in Grant Thornton raw data. Details of reasons for omission are presented, together with the final sample and revised compliance rate.

Note: Table 4.2 is similar with Table 3.3

TABLE 4.3

Descriptive Statistics for H4

Panel A: Descriptive statistics for *H4a* and *H4b*

	N	min	max	mean	stdev	skew	kurt
Bias	652	-0.091	0.058	-0.004	0.013	-1.498	10.219
Accuracy	652	0.000	0.091	0.007	0.012	3.113	11.426
ClaimFull	652	0	1	0.391	0.488	0.447	-1.805
Comp20	652	0.150	1	0.809	0.148	-1.144	1.488
Comp7	652	0.143	1	0.775	0.188	-0.786	0.289
Size	650	11.513	25.403	21.259	1.352	0.250	4.672
Analyst	652	1	27	9.067	5.312	0.814	0.268

Panel B: Descriptive statistics for *H4c*

	N	min	max	mean	stdev	skew	kurt
Disag	452	0.000	0.050	0.004	0.006	4.022	23.311
ClaimFull	452	0	1	0.374	0.484	0.523	-1.734
Comp20	452	0.150	1	0.781	0.157	-0.995	1.009
Comp7	452	0.143	1	0.757	0.190	-0.742	0.297
Size	452	11.513	25.384	21.244	1.386	0.018	5.765
FEMean	452	-0.091	0.058	-0.005	0.015	-1.107	7.451
ABSFEMean	452	0.000	0.091	0.008	0.013	2.653	8.028
FEMedian	452	-0.093	0.059	-0.005	0.015	-1.204	7.710
ABSFEMedian	452	0.000	0.093	0.008	0.013	2.694	8.374

Panel C: Descriptive statistics for *H4d*

	N	min	max	mean	stdev	skew	kurt
NoAnalysts	683	1	27	8.67	5.46	0.78	0.21
ClaimFull	683	0	1	0.39	0.49	0.47	-1.79
Comp20	683	0.15	1	0.80	0.15	-1.11	1.29
Comp7	683	0	1	0.77	0.19	-0.85	0.53
Size	683	11.51	25.40	21.20	1.35	0.31	4.38

FEMean	683	-0.14	0.06	0.00	0.01	-2.34	18.22
ABSFEMean	683	0.00	0.14	0.01	0.01	3.90	22.86
FEMed	683	-0.13	0.06	0.00	0.01	-2.27	16.71
ABSFEMed	683	0.00	0.13	0.01	0.01	3.76	20.61

This table presents the descriptive statistics for disclosure quality models. Panel A presents the statistics for all the variables used in *H4a* and *H4b* model, Panel B presents the statistics for all the variables used in *H4c* model and Panel C presents the statistics for all the variables used in *H4d* model.

TABLE 4.4

Descriptive Statistics for H5, H6 and H_07

Panel A: Descriptive statistics for *H5*.

	N	min	max	mean	stdev	skew	kurt
CEOTurnover	708	0	1	0.14	0.35	2.03	2.13
ClaimFull	709	0	1	0.40	0.49	0.39	-1.85
Comp20	709	0.15	1	0.80	0.15	-1.13	1.37
Comp4	709	0	1	0.76	0.23	-0.66	-0.30
NEG	709	0	1	0.17	0.37	1.78	1.18
Size	707	11.51	25.40	21.30	1.38	0.21	3.74
OwnDir	709	0	0.88	0.03	0.11	4.54	22.95
OwnBlock	709	0	1	0.48	0.50	0.10	-2.00

Panel B: Descriptive statistics for *H6*.

	N	min	max	mean	stdev	skew	kurt
CDQ	453	0	1	0.87	0.20	-1.79	3.50
ClaimFull	453	0	1	0.42	0.49	0.35	-1.89
Comp20	453	0.15	1	0.79	0.15	-0.87	0.63
Comp9	453	0.11	1	0.78	0.18	-0.92	0.81
Salary	453	11.69	14.16	13.02	0.42	-0.03	-0.21
Cash	453	12.17	15.34	13.40	0.62	0.56	0.16
Size	453	19.04	24.77	21.11	1.18	0.82	0.18
OwnDir	453	0	0.88	0.04	0.12	4.39	21.37
OwnBlock	453	0	1	0.52	0.50	-0.09	-2.00
ROA	453	-1.00	0.98	0.21	0.39	-0.92	0.90

Panel C: Descriptive statistics for H_07.

	N	min	max	mean	stdev	skew	kurt
ROA	611	-1.30	1.98	0.47	0.44	0.73	2.00
ClaimFull	611	0	1	0.39	0.49	0.45	-1.81
Comp20	611	0.15	1	0.79	0.16	-1.13	1.28

Comp7	611	0	1	0.75	0.20	-0.81	0.33
Size	611	11.51	25.53	21.09	1.35	0.28	4.76
OwnDir	611	0.00	0.88	0.04	0.13	3.64	13.68
OwnBlock	611	0	1	0.52	0.50	-0.07	-2.00

This table presents the descriptive statistics for CEO turnover, compensation disclosure quality and firm performance models. Panel A presents the statistics for all the variables used in CEO turnover model, Panel B presents the statistics for all the variables used in compensation disclosure quality model and Panel C presents the statistics for all the variables used in firm performance model.

TABLE 4.5

OLS Regression Results for H4a and *H4b*

Panel A: OLS Regression results for *H4a*

Independent variables	*Bias (mean)*			*Bias (median)*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	-0.067	-0.964	0.335	-0.053	-0.832	0.406
Y2003	-0.008	-0.637	0.525	-0.003	-0.213	0.831
Y2004	-0.032	-2.802	0.005	-0.032	-2.955	0.003
Y2005	-0.009	-0.852	0.394	-0.007	-0.731	0.465
Y2007	0.000	-0.031	0.975	-0.001	-0.067	0.947
Size	0.005	1.375	0.169	0.004	1.215	0.225
Analyst	0.000	-0.165	0.869	0.000	-0.047	0.963
Comp7	-0.045	-1.961	0.050	-0.040	-1.876	0.061
R Square	0.0182			0.0202		
Adjusted R Square	0.0076			0.0096		

Panel B: OLS Regression results for *H4b*

Independent variables	*Accuracy (mean)*			*Accuracy (median)*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	0.076	1.108	0.268	0.061	0.955	0.340
Y2003	0.017	1.363	0.173	0.011	0.961	0.337
Y2004	0.034	2.946	0.003	0.033	3.073	0.002
Y2005	0.009	0.842	0.400	0.007	0.741	0.459
Y2007	0.000	-0.026	0.979	0.000	-0.012	0.991
Size	-0.005	-1.573	0.116	-0.005	-1.389	0.165
Analyst	0.000	0.024	0.981	0.000	-0.087	0.931
Comp7	0.056	2.464	0.014	0.050	2.366	0.018
R Square	0.0225			0.0230		
Adjusted R Square	0.0119			0.0124		

This table presents the OLS regression results with its estimated co-efficients and its p values. Panel A presents the OLS regression results for *H4a* and Panel B presents the OLS regression results for *H4b*.

TABLE 4.6

OLS Regression Results for H4c and *H4d*

Panel A: OLS Regression results for *H4c*

Independent variables	*ClaimFull*			*Comp20*			*Comp7*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	0.009	2.426	0.016	0.010	2.571	0.010	0.010	2.687	0.007
Y2003	0.001	1.049	0.295	0.001	0.823	0.411	0.001	1.159	0.247
Y2004	-0.001	-0.807	0.420	-0.001	-0.839	0.402	0.000	-0.587	0.558
Y2007	0.000	0.096	0.923	0.000	0.045	0.964	0.000	0.028	0.978
Compliance variables	0.000	-0.853	0.394	0.000	0.046	0.963	0.002	1.530	0.127
Size	0.000	-1.666	0.096	0.000	-1.750	0.081	0.000	-2.269	0.024
FEMean	-0.010	-0.503	0.615	-0.009	-0.454	0.650	-0.010	-0.483	0.629
ABSFEMean	0.195	8.510	0.000	0.195	8.480	0.000	0.192	8.371	0.000
R Square	0.2017			0.2004			0.2046		
Adjusted R Square	0.1892			0.1878			0.1921		

Panel B: OLS Regression results for *H4d*

Independent variables	*ClaimFull*			*Comp20*			*Comp7*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	-33.733	-12.537	0.000	-34.551	-12.879	0.000	-33.565	-12.583	0.000
Y2003	-2.270	-4.230	0.000	-1.741	-2.902	0.004	-1.882	-3.483	0.001
Y2004	-2.471	-5.007	0.000	-2.203	-4.197	0.000	-2.146	-4.272	0.000
Y2005	0.042	0.091	0.928	0.031	0.068	0.945	0.029	0.064	0.949
Y2007	1.345	1.999	0.046	1.315	1.955	0.051	1.347	2.014	0.044
Compliance variables	0.598	1.688	0.092	2.273	1.674	0.095	3.097	3.268	0.001
Size	2.040	16.149	0.000	1.997	15.025	0.000	1.925	14.583	0.000
FEMean	6.400	0.429	0.668	6.405	0.430	0.668	5.394	0.364	0.716
ABSFEMean	-34.853	-2.056	0.040	-35.712	-2.104	0.036	-38.330	-2.268	0.024
R Square	0.3653			0.3652			0.3725		
Adjusted R Square	0.3578			0.3577			0.3651		

This table presents the OLS regression results with its estimated co-efficients and its p values. Panel A presents the OLS regression results for *H4c* and Panel B presents the OLS regression results for *H4d.*

TABLE 4.7

Logit Regression Results for H5

Independent variables	*ClaimFull* est. co-eff.	p-value	*Comp20* est. co-eff.	p-value	*Comp4* est. co-eff.	p-value
Intercept	-1.211	0.001	-1.413	0.116	-1.440	0.017
Y2003	-1.034	0.028	-1.088	0.029	-1.164	0.016
Y2004	-0.513	0.198	-0.511	0.214	-0.527	0.200
Y2005	-0.418	0.285	-0.394	0.311	-0.404	0.301
Y2006	-0.527	0.175	-0.569	0.142	-0.560	0.148
Compliance variables	-0.255	0.320	0.117	0.903	0.195	0.736
NEG	0.270	0.425	0.153	0.921	1.520	0.084
Compliance by NEG	-0.544	0.408	-0.039	0.983	-1.894	0.101
Size	0.000	0.678	0.000	0.762	0.000	0.721
OwnDir	-0.768	0.481	-0.623	0.570	-0.837	0.450
OwnBlock	0.035	0.874	0.080	0.716	0.051	0.820
F value	0.9470		0.6700		0.9530	
Cox & Snell R Square	0.0136		0.0097		0.0135	
Nagelkerke R Square	0.0243		0.0172		0.0242	

This table presents the logit regression results with its estimated co-efficients and its p values for *H5*.

TABLE 4.8

OLS Regression Results for H6

	ClaimFull			*Comp20*			*Comp9*		
Independent variables	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	0.558	1.795	0.073	0.481	1.547	0.123	0.432	1.362	0.174
Y2003	-0.005	-0.160	0.873	-0.028	-0.784	0.433	0.002	0.059	0.953
Y2005	-0.014	-0.512	0.609	-0.013	-0.448	0.654	-0.007	-0.269	0.788
Y2006	-0.004	-0.132	0.895	-0.013	-0.487	0.626	0.006	0.202	0.840
Y2007	0.051	1.322	0.187	0.059	1.566	0.118	0.063	1.587	0.113
Salary	0.068	1.869	0.062	0.078	2.152	0.032	0.080	2.183	0.030
Cash	-0.028	-1.116	0.265	-0.030	-1.180	0.238	-0.031	-1.228	0.220
Size	-0.008	-0.671	0.502	-0.004	-0.310	0.757	-0.005	-0.393	0.695
OwnDir	0.021	0.269	0.788	-0.018	-0.219	0.827	-0.010	-0.127	0.899
OwnBlock	-0.042	-2.249	0.025	-0.041	-2.184	0.030	-0.042	-2.240	0.026
ROA	0.013	0.515	0.607	0.013	0.520	0.604	0.014	0.565	0.572
Compliance variables	0.012	0.609	0.543	-0.153	-1.921	0.055	-0.092	-1.551	0.122
R Square	0.0303			0.0375			0.0347		
Adjusted R Square	0.0061			0.0135			0.0107		

This table presents the two-stage least squares regression results with its estimated co-efficients and its p values for *H6*.

TABLE 4.9

Two-stage Least Squares Regression Results for H_07

Independent variables	*ClaimFull*			*Comp20*			*Comp7*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	0.334	1.156	0.248	0.369	1.272	0.204	0.328	1.123	0.262
Compliance variables	-0.063	-1.725	0.085	0.136	1.140	0.255	-0.064	-0.665	0.506
Size	0.010	0.730	0.466	0.002	0.128	0.899	0.011	0.779	0.436
OwnDir	-0.226	-1.668	0.096	-0.187	-1.370	0.171	-0.223	-1.621	0.105
OwnBlock	-0.076	-2.095	0.037	-0.073	-2.031	0.043	-0.073	-2.014	0.044
R Square	0.0169			0.0142			0.0128		
Adjusted R Square	0.0104			0.0076			0.0062		

This table presents the two-stage least squares regression results with its estimated co-efficients and its p values for H_07.

TABLE 4.10

Summary of outcomes for all hypotheses

Hypothesis No.	Hypotheses	Outcomes
H4a	*Firms that comply completely with the Code have lower analyst bias*	Partly fail to reject H_04a, there is a significant negative relationship between compliance with major principles of the Code and analyst bias
H4b	*Firms that comply completely with the Code have higher analyst accuracy*	Partly fail to reject H_04b, there is a significant positive relationship between compliance with major principles of the Code and analyst bias
H4c	*Firms that comply completely with the Code have lower analyst disagreement*	Fail to reject H_04c
H4d	*Firms that comply completely with the Code have higher analyst following*	Reject H_04d, there is a significant positive relationship between compliance and analyst following
H5	*Firms that comply completely with the Code have higher CEO turnover during bad performance*	Fail to reject H_05
H6	*Firms that comply completely with the Code have higher quality of information disclosed about long term compensation*	Partly fail to reject H_06, there is a significant negative relationship between compliance with majority principles of the Code and disclosure of long term compensation
H_07	*Firms that comply completely with the Code are not associated with firm performance*	Reject H_07, there is a significant negative relationship between compliance and firm performance

CHAPTER FIVE:

COMPLIANCE WITH THE CODE AND MEDIA CRITICISM

5.1 Introduction

This study investigates the relationship between compliance with the Code and media criticism. Earlier studies have investigated media criticism relation with firm performance and various governance mechanisms but none has so far tried to look into the link with compliance with the Code. My analysis is motivated by the theoretical perspective such as political cost theory where firms with high political visibility will usually attract the attention of external parties such as media.

This analysis is based on data for FTSE 350 UK firms from 2003 until 2007. I measure compliance with the Code by using compliance index created by Grant Thornton and also a revised index which specifically caters to specific issues addressed. The measurements for media criticism were based on prior studies that look into their relationship with other corporate governance mechanisms.

For the first hypothesis, I could not find any significant relationship between compliance with the Code and number of news report using both levels of compliance variables. However, I do found a significant positive relationship between number of news reported and firm size under both high rate of compliance with the Code models and a significant negative relationship between number of news reported and firm performance under high rate of compliance with the main principles of the Code model. Under second hypothesis, I found a

significant relationship between compliance with the Code and negative news reported over the media. Firms that have low compliance with the Code tend to attract higher negative news than firms that fully comply with the Code.

The remainder of the chapter is structured as follows. The next section discusses the motivation for the paper, reviews prior studies and formulates my hypotheses. Section 3 then discusses the methodology used, followed by a discussion of the sample and data collection process in Section 4. I present the results of the study in Section 5, and Section 6 concludes.

5.2 Motivation, Literature Review and Hypotheses

5.2.1 RESEARCH MOTIVATION

There are many studies that look into the role of media criticism on influencing the market and firm's behaviour. This is because media is seen as one important stakeholder, representing the public and potential investors to the firm and they can act as a monitor or 'watchdog'. Miller (2006) finds that the media fulfils this role by rebroadcasting information from other information intermediaries (analysts, auditors and lawsuits) and by undertaking original investigation and analysis. In general, he finds that the media covers firms and frauds that will be of interest to a broad set of readers and situations that are of low cost to identify and investigate.

Such coverage by the media will have an impact on share prices and the firm has to take notice of the publicity given to them and take corrective action if necessary. Tetlock (2007) quantitatively measures the interaction between the media comments and firms' share price and finds that high media pessimism predicts downward pressure on market prices followed by a reversion to fundamentals, and unusually high or low pessimism predicts high market trading volume. This finding is further confirmed by Tetlock, Saar-Tsechansky & Macskassy (2008) who again use a quantitative measure of language for media content and suggest that it can capture otherwise hard-to-quantify aspects of firms' fundamentals, which investors quickly incorporate into stock prices. In particular they find that negative words used in the media can forecast low firm earnings.

When such findings are taken into the context of non-compliance with the Code, any act of non-compliance which is in conflict with the general perception of appropriateness will be interpreted as having poor governance. Therefore media criticism on such issues can be considered as potential costs for non-compliance and we need to have more understanding of this relationship by looking into what prior studies have done.

Whenever a firm decides to comply or not to comply with certain principles of the Code, there will be benefits and costs associated with it. As only 34% of the firms in FTSE350 in the UK fully comply with the Code, an interesting question is what are the potential costs for the majority of firms that do not comply with the Code? There are many studies that have used firm performance as a proxy for this cost

(Core, Guay & Rusticus, 2006; Larcker, Richardson & Tuna, 2007) but there are also some problems highlighted in prior studies such as endogeneity issue (Chidambaran, Palia & Zheng, 2006) and mixed results which has been highlighted in my previous chapter and other prior studies (Padgett & Shabbir, 2005; MacNeil & Li, 2006). Therefore, the next best indirect approach to proxy for the potential cost would be media criticism. This is because the media is the only entity that can cater to various levels of interested parties and act as an important informational role between the firms and its shareholders (Miller, 2006). Media is also sought after by various parties since it can play a substantial role in reducing the costs for collecting and evaluating information and in shaping the reputation of the firms (Core et al., 2008). With its position as intermediaries between the firm and its shareholders, the media can therefore fulfil the demand for the investigative and analytical role (Miller, 2006).

Through media criticism the firms will know whether their act of non-compliance will receive an approval or rejection of their policy. Severe repercussion can also happen if the media criticism is intense in its negativity. Kothari, Li & Short (2008) analyse disclosure reports by management, analysts and news reporters and discover that when content analysis indicates negative disclosures, it results in firm's increased cost of capital and return volatility. They have also found that favourable reports reduce the cost of capital and return volatility of the firm. Nevertheless, there is still a huge knowledge gap in understanding the relationship between non-compliance with the Code with media criticism as its potential costs as none of the studies in the UK have so far looked into such an effect.

Media criticism can become an important medium with regard to the firm's act of complying or not with the Code. The media can channel the voice of all shareholders and firms might have to take notice and respond in an appropriate manner in order not to cause undue concern to its potential investors and other interested parties. When the Combined Code on Corporate Governance 2003 was introduced, several big firms decided not to comply with some of its recommendations. Barclays was the first FTSE100 firm that did not comply with the Section A.2.2[23] of the Code when they decided to appoint outgoing CEO, Matt Barrett as their new chairman in 2003 and there are many articles[24] covering this issue and all expressed concern and criticism regarding such appointment. Hosking (2003) stated that:

> '...the bank risked provoking a storm of protest by announcing plans to promote the current chief Matt Barrett to the chairman's job in breach of best-practice rules for the boardroom...Promotions from chief executive to chairman are frowned upon under the Combined Code on Corporate Governance'

This article shows that a succession from CEO to chairman is seen as a major factor in hampering a firm's good governance. The potential cost to the business is realised afterwards when Moore (2003) voiced concern by shareholders by reporting that:

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[23] Section A.2.2 stipulates that a chief executive should not go on to be core chairman of the same company.

[24] There are 27 news articles from LexisNexis database covering the issue from October 9, 2003 until February 19, 2004 which is the day after Barclays AGM

'A leading investor group yesterday attacked the planned promotion to chairman of Barclays chief executive Matt Barrett - a day after he provoked a storm by calling the bank's credit cards too expensive to borrow on...The Association of British Insurers (ABI) has written to incumbent chairman Sir Peter Middleton demanding a "full and public explanation as to why it is considered appropriate to deviate from best practice" by promoting Mr Barrett.'

This article shows that a group of investors[25] of the firm immediately required explanation from the firm once they decided not to comply with an important principle in the Code. The firm will then have to explain their decision to the shareholders. Wachman (2003) reported the ongoing negotiation between the firm and its shareholder:

'A fresh row has erupted over the proposed promotion of chief executive Matt Barrett to chairman of Barclays, contravening the Higgs code on corporate governance...Leading shareholders have told Barclays non-executive directors they are not satisfied by a letter sent to them that attempts to explain the decision. The letter was signed by Sir Peter Middleton, current chairman, who intends to hand over to Barrett next year...Said one investor: 'We have to get things right with Barclays, as it is the first company that has decided to ignore Higgs on this issue. If we don't, other firms may be encouraged to break with Higgs for flimsy reasons.'

[25] ABI's investment committee includes several of Barclays' biggest shareholders.

These articles have managed to show that an attempt by a firm to breach an important principle of the Code was resisted by its shareholders. Since then, there are some more cases of CEO duality (Wood Group in 2005), CEO succeeding to become a chairman (HSBC in 2005 and Close Brothers in 2006) and the number of non-executive directors (Aggreko in 2006).

In the case of the Wood Group, Sir Ian Wood's role as a chairman and CEO has been defended by its board of directors because:

> '...as a result of his substantial shareholdings in the company, Sir Ian Wood's interests are very closely aligned with those of the company's other shareholders, and that his continuing to hold the combined role is in the best interests of the company.' (McConnell, 2005)

This shows that the board of directors are willing to support the case of CEO duality if they are convinced it is in the best interests of the company. In some cases the shareholders themselves will give support to the act of non-compliance with the Code if it is in the best interests of the firm, as happened to Aggreko who have insufficient numbers of non-executive directors to comply with the requirements of the Code (Smith, 2006)[26].

Investors raised concerns over HSBC's and Close Brothers' decisions to promote their CEO to become chairman and subsequently sent out a signal to others that they should question executives very closely before sanctioning a move by the

[26] It is worth noting that even when Aggreko received the majority of support, 22% of the shareholders still registered protest votes

chief executive to the top job (Hargreaves, 2006). HSBC acknowledged that the appointment is against the recommendations of the Code but insisted that it is 'in the best interests of all shareholders' (Goodway, 2005).

In recent years media coverage has become more intensive as shown by the example of Marks & Spencers (M&S) in 2008. When its CEO, Sir Stuart Rose took on the position of chairman in March 2008, there were over 78 articles[27] covering the issue which is three times the coverage that Barclays record in 2003 and the reaction from the shareholders were similar in the sense that they demanded explanation on the breach of the Code and the firm had to resort to negotiation with them. For example, Hawkes (2008) recorded a negative reaction from the shareholders following the announcement by M&S:

> 'However, leading institutions said that the move was a clear breach of corporate governance best practice. The Association of British Insurers (ABI) demanded an explanation, and Legal & General, one of Marks & Spencer's biggest shareholders, rounded on the board...Mark Burgess, the head of equities for Legal & General, said: "As set out in the Combined Code we believe strongly in the separation of the roles of chairman and chief executive, believing this allows a much needed balance in the boardroom and prevents the potentially damaging concentration of power. As such, we believe today's announcement from M&S is unwelcome.'

The shareholders had serious concerns over this breach and eventually the firm

[27] These articles are from the LexisNexis database.

had to compromise as described by Fletcher (2008):

> 'Marks & Spencer's beleaguered board has been forced to make a series of concessions in an attempt to pacify shareholders angered by the elevation of Sir Stuart Rose to executive chairman. Following a bitter two-week row between M&S and its institutional investors, the retailer spelt out a series of measures it hopes will win over investors. In a letter to the Association of British Insurers, M&S is understood to have said that it will:
>
> * put Sir Stuart up for re-election every year - a move which will allow shareholders to vote on his appointment later this year at the group's AGM;
>
> * look to appoint a new heavyweight non-executive who will eventually succeed Sir David Michaels as senior independent director; and
>
> * vow not to give Sir Stuart a pay rise, although outgoing chairman Lord Burns is still expected to pick up a pounds 450,000 pay-off.'

Certainly, firms realise that any breach of a major principle in the Code will have serious costs to their business and yet some of them are quite determined and willing to make some other concessions to their shareholders in order to stick with their original decision. This is certainly the case with M&S when Sir Stuart Rose still won a shareholder vote in the July 2008 AGM to reappoint him, albeit with 22% objecting, after reminding their shareholders that

> '...appointing a new chief executive in 2008 or 2009 to replace Sir Stuart "was likely to be a damaging and unwelcome distraction at precisely the time that the business needed clear leadership to sustain its recovery and transformation' (BBC, 2008).

All the above articles discussed the case when the firms are breaching some of the most important principles of the Code. However, when there is non-compliance on other less popular requirements, the media has been silent about it. For example, one of the requirements in the Code is for the firm to provide terms and conditions of appointment of non-executive directors available for inspection (A.4.4). In 2006, there are 140 firms that do not comply with this requirement (45% of the sample) and a sample of one year period of top 10 from these firms (based on market capitalisation) did not yield any media reaction at all[28]. Similarly there are 65 firms (21% of the sample) in 2006 that do not comply with the requirement C.3.1 (Does the audit committee state to have at least one member with recent and relevant financial experience?) but another sample of 10 firms also did not produce any media criticism[29]. Other prior studies have also focused on non-compliance that dealt with mostly main issues such as board independence, setting up of audit, nomination and remuneration committees and the role of chairman and chief executive (Padgett & Shabbir, 2005; MacNeil & Li, 2006).

5.2.2 THEORETICAL FRAMEWORK AND LITERATURE

Based on various articles mentioned above, it is therefore important to investigate the potential costs of non-compliance using media criticisms as the benchmark. Understanding them will help the firm correctly to make a decision regarding

[28] Using Lexis-Nexis database, the number of articles related to 'corporate governance' and firm's name as follow: GlaxoSmithKline (6), HBOS (35), Rio Tinto (8), National Grid Transco (9), Unilever (11), Xstrata (5), Reckitt Benckiser (0), Imperial Tobacco (4), M&S (34), Scottish Power (9).

[29] Using Lexis-Nexis database with the keywords of 'audit committee' and firm's name over one year period starting from the date of annual report.

compliance with the Code and avoid potential backlash by the shareholders. So far none of the studies has attempted to see whether such criticisms are directed towards any kind of non-compliance or just a specific one. Thus, based on the number of newspaper articles and prior studies that I reviewed and lack of findings from prior studies, I propose my first hypothesis in null form as below:

$H_0$8: Non-compliance with the Code is not perceived as having poor governance, as reflected in indifferent media reaction to the incidence of non-compliance.

If the media does react when a firm does not comply with the Code, the next step is to identify which principles of the Code attract greater negative reaction. Within the Code, there are many requirements that can be considered not as important or more informative in nature[30]. Some of the firms decide to comply with all these requirements and some will only focus on the main principles of the Code. Based on Barclays and M&S cases and a sample of firms that do not comply with the less important requirements of the Code, media criticisms seem to focus on non-compliance of main principles of the Code and less exposure is given to non-compliance on less important requirements of the Code. However, there is no prior study to actually look into which principles of the Code receive greater media attention. Therefore, I propose the following hypothesis as below (presented in both null and alternative forms):

[30] For example, some of the requirements asked whether the annual report identifies main employees of the firm (A.1.2) and whether the number of meetings and attendance of the directors are disclosed (A.1.2)

$H_0$9: There is no relationship between compliance with the main or other principles of the Code and the number of negative media criticisms.

H9: Firms that do not comply with main principles of the Code will receive more negative media criticisms than those that do not comply with other principles of the Code.

5.3 Research Methodology

In this section I present the regression models used in the empirical analysis and discuss how I measure compliance with the Code and media criticism. I then discuss the control variables used in the models.

5.3.1 REGRESSION MODELS

The first model will look into the relationship between compliance with the Code and the number of media criticism. The model for $H_0 8$ is specified as below:

$$News_{i,t} = \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \qquad (12)$$

where *News* is a proxy for the number of media criticisms, measured using number of news articles; *COM* is a proxy for compliance with the Code; *Controls* is an additional determinants of the number of media criticisms; ε is the error term and *i* and *t* are firm and time subscripts respectively.

The second model will look into the relationship between compliance with the Code and the number of negative media criticism. The model for *H9* is specified as below:

$$NegNews_{i,t} = \beta_0 + \beta_1 COM_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t} \qquad (13)$$

where *NegNews* is a proxy for the number of negative media criticisms, measured using fraction of negative words over total number of words; *COM* is a proxy for compliance with the Code; *Controls* is an additional determinants of the number of negative media criticisms; ε is the error term and *i* and *t* are firm and time subscripts respectively.

5.3.2 COMPLIANCE WITH THE CODE AND MEDIA CRITICISM

As mentioned in the previous chapter, most of the previous studies rely on self-constructed index to measure governance (Padgett & Shabbir, 2005; Arcot & Bruno, 2007). I have been fortunate to receive assistance from Grant Thornton who agreed to share their database on trends of compliance with the Code among FTSE 350 firms from 2003 until 2007. Therefore my measurement of compliance with the Code will not suffer heavily from selection bias and will also differentiate it from previous studies. I used measurements on media criticism based from past studies in order to provide comparability with them.

5.3.2.1 Measuring Compliance with the Code

Previously, study on the compliance level of the Code had to rely on self-constructed index (Padgett & Shabbir, 2005; Arcot & Bruno, 2007) and survey (MacNeil & Li, 2006) since such data is not available publicly in any database or publication. However, since 2002, Grant Thornton UK LLP has started to review and publish annual study on the level of compliance for FTSE 350 companies. Through series of discussion, they have agreed to provide me with their raw data for the year 2003 until 2007. Grant Thornton has their own compliance index and I have included their index in my study together with the amended index to incorporate more stringent requirements to link relationship between compliance with the Code and various issues studied.

In order to measure compliance rate, I will use two levels of measurements. The first level is a continuous variable where percentage of compliance to the Code is measured using Grant Thornton questionnaire method (20 questions based on the principles in the Code, see Table 3.1 in Chapter Three). I decided to refine this index further by introducing second level of measurement because some of them questions posed by Grant Thornton are merely informational in nature and not really promoting the true objectives of the Code[31]. Therefore I created another compliance index that consists of requirements that truly promote corporate governance. This index has only four questions from the original twenty questions from Grant Thornton index.

[31] For example, one of the questions asked by Grant Thornton is whether the terms and conditions of appointment of non-executive directors are available for inspection.

5.3.2.2 Measuring Media Criticism

Since the GT index already identifies the number of firms that fully or partially in compliance with the Code, the next step is to concentrate on the firms that do not comply with the main principles of the Code and to search in the LexisNexis databases if there is any incidence of media criticism. This scope will be in all UK news with a one year period starting with the date of their annual report using multiple variation of firm's name (for example, Barclays Bank PLC and M&S for Marks & Spencer). Several keywords related to compliance or non-compliance with the Code will be included in the search[32]. The first level of measurement which will be used in $H_0 8$ is to count the number of articles that cover any issues related to the firm compliance with the Code and corporate governance. The second level of measurement, which will be explained in detail in the next paragraph, is to count the number of negative and positive words in each of the articles and present them in terms of percentage of total words. This second level of measurement will then be used to test *H9*.

In order to determine whether any article is deemed negative or positive, I will use General Inquirer, a content analysis program with H4-4 tag categories[33]. This program among its other functions can determine and calculate the number of negative and positive words in an article. There are many other content analysis programs like CATPAC, Concordance and Diction but General Inquirer is more commonly used when analysing accounting and financial information (Tetlock,

[32] Keywords that will be used in the search will be general terms like 'code' and 'governance'.
[33] For further information, please go to http://www.webuse.umd.edu:9090/ where the program is free to use. The current system identifies about 13,000 word roots and utilizes 6,336 disambiguation rules.

2007; Tetlock et al., 2008). General Inquirer also has very large categories for positive words (1,915 words of positive outlook) and negative words (2,291 words of negative outlook). However, I decided to focus primarily on the negative words because negative words are argued to have more impact and are more thoroughly processed than positive words across a wide range of contexts (Rozin & Royzman, 2001). Positive words are also found to produce weaker results, and negative words have stronger correlation when looking into a relationship with share returns (Tetlock, 2007). In addition, since I am looking into firm's non-compliance with the Code, which is generally viewed as having poor governance[34], it is reasonable to think that negative words are more suitable subject to look for in the articles.

Thus, for each article, I will use General Inquirer to calculate the number of negative words and then divided them over total words for that article. I will then calculate the aggregate percentage of negative words per article that correspond to a specific firm's non-compliance with the principles of the Code. The same method was also used in Tetlock et al. (2008) study when they were looking into media coverage surrounding earnings announcement.

5.3.3 CONTROL VARIABLES FOR THE MODELS

Both models mentioned above will be using four control variables. There is a possibility that only firms with certain characteristics are receiving greater attention from the media. Greater coverage has been made over the M&S and

[34] Among the reasons why the Code was introduced is mentioned in the Cadbury Report (1992: p11): 'Companies whose standards of corporate governance are high are the more likely to gain the confidence of investors and support for the development of their businesses'

Barclays, two of the most well-known brands in the UK and yet when Wood Group and Close Brothers decided to breach the main principle of the Code, the media reaction is not as hostile as those more prominent firms even when the shareholders do not agree with the firm's decision[35]. In terms of market capitalisation in 2006, Barclays and M&S were £38.8 billion and £9.4 billion respectively compared to Wood Group and Close Brothers who were only £1.2 billion and £1.3 billion respectively.

Political cost theory can perhaps explain this where firms with high political visibility (usually measured based on the firm size) will usually attract the attention of external parties like the government, regulators and other shareholders because they are deemed to be key and important contributors to the market and the general public. Therefore, larger firms will employ various devices to reduce this political cost by being more transparent through voluntary disclosure (Deegan & Gordon, 1996) and resorting to stricter governance rules (Klapper & Love, 2004). Subsequently, any breach of important governance guidance by large firms will be quickly highlighted by the media as we have seen in Barclays and M&S cases. However, even though there are many studies that looked into the relationship between firm size and other good governance measurements (Laing & Weir, 1999; Gompers, Ishii & Metrick, 2003) none of the studies have so far investigated whether firm size might influence the decision by the media to criticise their breaching of the principles in the Code. Therefore my first control variable will be *Size* which is a proxy for firm size, measured by natural log of the firm's market capitalisation.

[35] There are only two media articles regarding CEO duality issue in Wood Group in 2005 even when one of the articles mentioned a potential shareholder rebellion in the upcoming AGM. Close Brothers only warranted three articles covering its CEO succession to become a chairman.

A study on a link between good governance and firm performance has been a major focus in many studies but produced a variety of results and discussion including the causality issue. Nevertheless, most of the studies agree that good governance is usually associated with good performance and vice versa (Vafeas & Theodorou, 1998; Klapper & Love, 2004; Padgett & Shabbir, 2005; Black, Jang & Kim, 2006) although there are other studies that look into signalling theory where poor performance firm would enhance their governance to make them in similar appearance with the well performed firm if the cost of improving the governance is minimal (Cho & Kim, 2003).

There are several studies that look into the relationship betwen firm's performance and media criticism (Kothari et al., 2008; Tetlock et al., 2008) but none so far has attempted to link poorly governed (as implied by non-compliance with the Code) firm's profitability with the media criticism. Although MacNeil & Li (2006) hinted that there is a link between share price performance and investors' tolerance of non-compliance with the Code in the sense that if the firm is performing better, an incidence of non-compliance might be tolerated by its shareholders, their focus is more on share price performance rather than media criticism as a proxy for potential cost. Thus, my second control variable is firm profitability and measured using ROA (earnings before interest and taxes over average total assets). ROA is the preferred measure for firm profitability because it is not affected by leverage, extraordinary items, and other discretionary items (Barber & Lyon, 1996). It also has more desirable distributional properties than

ROE (net income over common equity) because total assets are strictly positive, but equity can be zero or negative (Core et al., 2006).

The other two control variables are *OwnDir* and *OwnBlock*. *OwnDir* is a proxy for total shares held by executive directors over the total number of shares outstanding and *OwnBlock* is a proxy for dummy variable coded 1 if at least one external shareholder holds more than 10% of outstanding equity and 0 otherwise. These two variables are usually used by prior studies as alternative measurements of corporate governance.

5.4 Sample, Data Collection and Descriptive Statistics

5.4.1 SAMPLE SELECTION

The initial sample of firms used for this study is based on the FTSE 350 UK firms (excluding financial and utility firms) for each year from 2003 until 2007. These firms were selected because they were in the Grant Thornton Annual FTSE 350 Corporate Governance Review (2004 – 2007) to which Grant Thornton UK LLP has agreed to provide their raw data to me to analyse further for the purpose of this study.

From the initial set of sample from Grant Thornton, several firms were omitted for the reasons such as firms that have been undergoing acquisition, merger, demerger and being delisted from the stock exchange as their data is no longer available in the database. Since the number of firms in the sample has been slightly changed, I

have adjusted the compliance rate to the Code which has been reported earlier by Grant Thornton using their original sample.

Then, for each corresponding year (2003 to 2007), I choose 20 firms that have the highest rate and 20 firms that have the lowest rate of compliance according to the measurements of both levels of compliance. I can only choose 20 firms for each set of sample because the original sample only has 79 firms up to 247 for each year (Please refer to Table 3.3 in Chapter Three). Therefore the final sample for each model will be 100 firms each[36].

5.4.2 DATA

Compliance with the Code data is obtained from the Grant Thornton Annual FTSE 350 Corporate Governance Review raw data for each year from 2003 until 2007. This raw data consists of survey information on each individual firm in the FTSE 350. The survey questions are driven directly from the Code provisions and Turnbull guidance and are created to reflect the 'best practice' as perceived by the Code. The survey is completed by reading the hard copies of each firm's annual report and accounts, focusing on the front half of the report (i.e. not the accounts) including the sections; Business Review, Corporate Responsibility, Corporate Governance and Remuneration Report.

The number of news item related to FTSE 350 firms are obtained from LexisNexis database. All other financial data are obtained from Datastream and

[36] For example, 20 firms for five years for high compliance rate model.

FAME database. Shareholders ownership structure is obtained from Waterlow Stock Exchange Yearbook. This data is hand collected from the ownership structure report section of the corresponding firm's published annual report and accounts. Management share ownership data is obtained from Manifest database.

5.4.3 DESCRIPTIVE STATISTICS

Table 5.1 reports descriptive statistics for the variables used in the analysis for $H_0 8$. Panel A of Table 5.1 presents the descriptive statistics for sample used under high rate of first level of compliance model. Mean for *News* is 0.94 with a standard deviation of 1.74. Mean for *Comp20* is 0.93 with a standard deviation of 0.07. Panel B of Table 5.1 presents the descriptive statistics for sample used under high rate of second level of compliance model. Mean for *News* is 0.92 with a standard deviation of 1.76. Mean for *Comp4* is 0.98 with a standard deviation of 0.07. Panel C of Table 5.1 presents the descriptive statistics for sample used under low rate of first level of compliance model. Mean for *News* is 0.71 with a standard deviation of 1.42. Mean for *Comp20* is 0.59 with a standard deviation of 0.17. Panel D of Table 5.1 presents the descriptive statistics for sample used under high rate of second level of compliance model. Mean for *News* is 0.61 with a standard deviation of 1.45. Mean for *Comp4* is 0.42 with a standard deviation of 0.20. It seems that there is less news coverage for firms that do not comply with the Code than firms that do comply with the Code. This could mean that firms that fully comply with the Code took extra efforts in promoting and announcing to the potential stakeholders that they are at least doing something to improve

governance within the firm. The final sample is less than 100 each because I had to remove one, two or three firms from each of the models due to extreme outliers.

Table 5.2 reports descriptive statistics for the variables used in the analysis for *H9*. Panel A of Table 5.2 presents the descriptive statistics for sample used under high rate of first level of compliance model. Mean for *NegNews* is 0.41 with a standard deviation of 0.97. Mean for *Comp20* is 0.93 with a standard deviation of 0.07. Panel B of Table 5.2 presents the descriptive statistics for sample used under high rate of second level of compliance model. Mean for *NegNews* is 0.38 with a standard deviation of 0.98. Mean for *Comp4* is 0.98 with a standard deviation of 0.07. Panel C of Table 5.2 presents the descriptive statistics for sample used under low rate of first level of compliance model. Mean for *NegNews* is 0.53 with a standard deviation of 1.18. Mean for *Comp20* is 0.59 with a standard deviation of 0.17. Panel D of Table 5.2 presents the descriptive statistics for sample used under high rate of second level of compliance model. Mean for *NegNews* is 0.36 with a standard deviation of 1.10. Mean for *Comp4* is 0.42 with a standard deviation of 0.20.

In addition of looking into the skewness of the data, Q-Q plots have been employed to check the deviations of the data from the normal distribution. Q-Q plots for *$H_0$8 and H9* are presented in the Appendix K and L respectively.

5.5 Analysis

This section examines the relation between compliance with the Code and media criticism. I report the main results in the next section.

5.5.1 RESULTS

Table 5.3 reports coefficient estimates and model summary statistics for OLS regression on $H_0 8$. I could not find any significant relationship between compliance with the Code and number of news item reported using both the *Comp20* and *Comp4* compliance variables and under both set of compliance rate. However, all four models show significant positive relationship between number of news item reported and firm size. This conforms to the political cost theory that firms with high political visibility (in this case based on its size) will attracts more attention by the media when dealing with transparency and governance. I also discover a significant negative relationship between the number of news item reported and firm performance under both high and low rate of compliance with the main principles (*Comp4*) of the Code model. It seems that it does not matter if the firm is complying with the main principles within the Code or not, the media will still respond with higher interest to any events related to the underperforming of the firm. Another finding is a significant positive relationship between the number of news reported and *OwnDir* variable under low rate of compliance with the *Comp20* as its governance variable.

Coefficient estimates and model summary statistics for OLS regression on H9 are presented in Table 5.4. Under the sample of firms with high compliance rate, I could not find any significant relationship between negative news and firms that fully comply with the Code. However, under the sample of firms with low compliance rate, I found a significant negative relationship between negative news and compliance with the Code. This means that firms that do not comply with the Code will attract higher negative media reaction than firms that fully comply with the Code. Firms size also play significant role in generating number of negative news. Basically, the bigger the firm is, the higher negative news it will attract if it does not fully comply with the Code. The summary table for outcomes for all hypotheses is presented in Table 5.5.

5.6 Conclusion

This chapter examines the relationship between compliance with the Code and media criticism. Earlier studies have investigated media criticism relation with firm performance and various governance mechanisms but none has so far tried to look into the link with compliance with the Code. My analysis is motivated by the theoretical perspective such as political cost theory where firms with high political visibility will usually attract the attention of external parties such as media. As such, any act of non-compliance with the Code will be interpreted as having poor governance. Therefore media criticism on such issues can be considered as potential costs for non-compliance and we need to have more understanding of this relationship by looking into different levels of compliance with the Code and media criticism. In that sense this chapter adds to current literature by providing a

UK perspective on the measurements of corporate governance and its relationship with media criticism.

Two hypotheses and eight related models were tested. I could not find any significant relationship between compliance with the Code and number of news reported using both levels of compliance variables and level of compliance rate. However, I do found a significant positive relationship between number of news item reported and firm size under both high and low rate of compliance with the Code models. I also found a significant negative relationship between number of news item reported and firm performance under high rate of compliance with the main principles of the Code model. I found a significant negative relationship between negative news and compliance with the Code. Firms that have low compliance rate with the Code attract higher negative news than firms that fully comply with the Code. Firm size also have a significant positive relationship with negative news.

Limitations of the analysis are as follows. Since this could be the first attempt for the UK study to look into the relationship between compliance with the Code and media criticism, I might have overlooked a better measurements and more accurate models to capture the underlying link between governance and media. By including more alternative measurements and models I could get better and more comprehensive results which could explain in greater clarity of such relationship. For examples, I could introduce more keywords criteria to define governance or issues related to it such as 'CEO Duality' or 'board independence' but having a small set of firm sample prevent me from doing that. Thus the next step might be

to include more firms into the sample and not just FTSE 350 firms. Future research could employ this alternative models and measurements to better capture the relationship between media criticism and compliance with the Code.

TABLE 5.1

Descriptive Statistics for H_08

Panel A: Descriptive statistics for high rate of compliance and *Comp20* model

	N	min	max	mean	stdev	skew	kurt
News	99	0	9	0.94	1.74	2.78	8.37
Comp20	99	0.75	1	0.93	0.07	-1.33	1.19
Size	99	19.36	23.77	21.31	1.11	0.40	-0.44
OwnDir	99	0	0.56	0.02	0.10	4.59	20.17
OwnBlock	99	0	1	0.51	0.50	-0.02	-2.04
ROA	99	-0.99	1.32	0.21	0.44	-0.19	0.67

Panel B: Descriptive statistics for high rate of compliance and *Comp4* model

	N	min	max	mean	stdev	skew	kurt
News	99	0	9	0.92	1.76	2.75	8.02
Comp4	99	0.75	1	0.98	0.07	-3.12	7.92
Size	99	19.36	23.77	21.30	1.11	0.40	-0.58
OwnDir	99	0	0.56	0.02	0.09	4.67	22.47
OwnBlock	99	0	1	0.55	0.50	-0.19	-2.01
ROA	99	-0.83	1.32	0.23	0.37	0.02	0.57

Panel C: Descriptive statistics for low rate of compliance and *Comp20* model

	N	min	max	mean	stdev	skew	kurt
News	97	0	9	0.71	1.42	3.31	13.72
Comp20	97	0.15	0.90	0.59	0.17	-0.31	-0.48
Size	97	19.46	22.60	20.49	0.81	0.90	-0.12
OwnDir	97	0	0.88	0.09	0.19	2.55	6.14
OwnBlock	97	0	1	0.59	0.49	-0.36	-1.91
ROA	97	-0.89	1.23	0.28	0.43	-0.32	0.78

Panel D: Descriptive statistics for low rate of compliance and *Comp4* model

	N	min	max	mean	stdev	skew	kurt
News	98	0	9	0.61	1.45	3.48	14.10
Comp4	98	0	0.75	0.42	0.20	0.09	-0.57
Size	98	19.04	23.56	20.45	0.87	1.29	1.60
OwnDir	98	0	0.80	0.09	0.19	2.22	3.93
OwnBlock	98	0	1	0.51	0.50	-0.04	-2.04
ROA	98	-0.89	1.89	0.37	0.45	0.02	1.48

This table presents the descriptive statistics for $H_0 8$ models. Panel A presents the statistics for all the variables used in high rate of compliance and *Comp20* model, Panel B presents the statistics for all the variables used in high rate of compliance and *Comp4* model, Panel C presents the statistics for all the variables used in low rate of compliance and *Comp20* model and Panel D presents the statistics for all the variables used in low rate of compliance and *Comp4* model.

TABLE 5.2

Descriptive Statistics for H9

Panel A: Descriptive statistics for high rate of compliance and *Comp20* model

	N	min	max	mean	stdev	skew	kurt
NegNews	99	0	4.41	0.41	0.97	2.43	5.36
Comp20	99	0.75	1	0.93	0.07	-1.33	1.19
Size	99	19.36	23.77	21.31	1.11	0.40	-0.44
OwnDir	99	0	0.56	0.02	0.10	4.59	20.17
OwnBlock	99	0	1	0.51	0.50	-0.02	-2.04
ROA	99	-0.99	1.32	0.21	0.44	-0.19	0.67

Panel B: Descriptive statistics for low rate of compliance and *Comp4* model

	N	min	max	mean	stdev	skew	kurt
NegNews	99	0	4.41	0.38	0.98	2.56	5.75
Comp4	99	0.75	1	0.98	0.07	-3.12	7.92
Size	99	19.36	23.77	21.30	1.11	0.40	-0.58
OwnDir	99	0	0.56	0.02	0.09	4.67	22.47
OwnBlock	99	0	1	0.55	0.50	-0.19	-2.01
ROA	99	-0.83	1.32	0.23	0.37	0.02	0.57

Panel C: Descriptive statistics for high rate of compliance and *Comp20* model

	N	min	max	mean	stdev	skew	kurt
NegNews	97	0	4.03	0.53	1.18	2.02	2.63
Comp20	97	0.15	0.9	0.59	0.17	-0.31	-0.48
Size	97	19.46	22.60	20.49	0.81	0.90	-0.12
OwnDir	97	0	0.88	0.09	0.19	2.55	6.14
OwnBlock	97	0	1	0.59	0.49	-0.36	-1.91
ROA	97	-0.89	1.23	0.28	0.43	-0.32	0.78

Panel D: Descriptive statistics for low rate of compliance and *Comp4* model

	N	min	max	mean	stdev	Skew	kurt
NegNews	98	0	4.60	0.36	1.10	2.86	6.69
Comp4	98	0	0.75	0.42	0.20	0.09	-0.57
Size	98	19.04	23.56	20.45	0.87	1.29	1.60
OwnDir	98	0	0.80	0.09	0.19	2.22	3.93
OwnBlock	98	0	1	0.51	0.50	-0.04	-2.04
ROA	98	-0.89	1.89	0.37	0.45	0.02	1.48

This table presents the descriptive statistics for *H9* models. Panel A presents the statistics for all the variables used in high rate of compliance and *Comp20* model, Panel B presents the statistics for all the variables used in high rate of compliance and *Comp4* model, Panel C presents the statistics for all the variables used in low rate of compliance and *Comp20* model and Panel D presents the statistics for all the variables used in low rate of compliance and *Comp4* model.

TABLE 5.3

OLS Regression Results for H_08

Independent variables	*HighComp20*			*HighComp4*			*LowComp20*			*LowComp4*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	-13.080	-2.820	0.006	-4.631	-1.106	0.272	-7.942	-2.097	0.039	-5.750	-1.531	0.129
Y2003	0.615	0.805	0.423				0.406	0.586	0.560	-0.355	-.606	0.546
Y2004	-0.508	-0.925	0.358	-0.283	-0.447	0.656	-0.383	-0.484	0.629	-0.564	-.845	0.401
Y2005	-0.399	-0.771	0.443	-0.076	-0.120	0.905	-0.253	-0.508	0.613	0.424	.827	0.410
Y2006				0.354	0.572	0.569	0.372	0.805	0.423	0.285	.583	0.561
Y2007	-1.286	-2.458	0.016	-0.299	-0.449	0.654						
Size	0.454	2.865	0.005	0.404	2.390	0.019	0.461	2.660	0.009	0.365	1.986	0.050
OwnDir	-1.245	-0.731	0.467	-1.846	-0.896	0.373	1.810	2.392	0.019	0.331	0.391	0.697
OwnBlock	-0.604	-1.755	0.083	-0.482	-1.332	0.186	-0.118	-0.420	0.675	-0.100	-0.329	0.743

ROA	-0.459	-1.191	0.237	-0.951	-1.939	0.056	-0.448	-1.345	0.182	-0.947	-2.787	0.007
Compliance variables	5.431	1.402	0.165	-2.514	-0.799	0.426	-1.340	-0.834	0.407	-1.644	-1.389	0.168
R Square	0.2303			0.1663			0.2416			0.1699		
Adjusted R Square	0.1525			0.0820			0.1632			0.0850		

This table presents the OLS regression results for *H8* with its estimated co-efficients and its p values. Column *HighComp20* is for model that uses a sample of high compliance rate firms and *Comp20* as its governance variable. Column *HighComp4* is for model that uses a sample of high compliance rate firms and *Comp4* as its governance variable. Column *LowComp20* is for model that uses a sample of low compliance rate firms and *Comp20* as its governance variable. Column *LowComp4* is for model that uses a sample of low compliance rate firms and *Comp4* as its governance variable.

TABLE 5.4

OLS Regression Results for H9

Independent variables	*HighComp20*			*HighComp4*			*LowComp20*			*LowComp4*		
	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value	est. co-eff.	F-value	p-value
Intercept	-4.785	-1.772	0.080	-0.079	-0.032	0.974	-3.766	-1.132	0.261	-3.168	-1.162	0.248
Y2003	-0.280	-0.630	0.530				-0.604	-0.992	0.324	-1.128	-2.647	0.010
Y2004	-0.517	-1.617	0.109	0.036	0.098	0.922	-1.059	-1.523	0.131	-1.119	-2.306	0.023
Y2005	-0.430	-1.426	0.157	0.006	0.016	0.988	-0.510	-1.166	0.247	-0.513	-1.376	0.172
Y2006				0.572	1.590	0.115	-0.056	-0.137	0.892	0.124	0.349	0.728
Y2007	-0.744	-2.444	0.017	-0.010	-0.025	0.980						
Size	0.230	2.488	0.015	0.079	0.807	0.422	0.317	2.079	0.041	0.246	1.841	0.069
OwnDir	-1.054	-1.063	0.291	-0.442	-0.369	0.713	0.571	0.859	0.393	0.213	0.346	0.731
OwnBlock	-0.234	-1.165	0.247	-0.233	-1.111	0.270	0.160	0.644	0.521	0.294	1.339	0.184

ROA	-0.128	-0.571	0.569	-0.263	-0.922	0.359	-0.125	-0.428	0.670	-0.301	-1.220	0.226
Compliance variables	0.925	0.410	0.683	-1.169	-0.640	0.524	-3.153	-2.232	0.028	-2.456	-2.858	0.005
R Square	0.1682			0.0926			0.1431			0.2321		
Adjusted R Square	0.0840			0.0008			0.0544			0.1536		

This table presents the OLS regression results for *H9* with its estimated co-efficients and its p values. Column *HighComp20* is for model that uses a sample of high compliance rate firms and *Comp20* as its governance variable. Column *HighComp4* is for model that uses a sample of high compliance rate firms and *Comp4* as its governance variable. Column *LowComp20* is for model that uses a sample of low compliance rate firms and *Comp20* as its governance variable. Column *LowComp4* is for model that uses a sample of low compliance rate firms and *Comp4* as its governance variable.

TABLE 5.5

Summary of outcomes for all hypotheses

Hypothesis No.	Hypotheses	Outcomes
$H_0 8$	*Non-compliance with the Code is not perceived as having poor governance, as reflected in indifferent media reaction to the incidence of non-compliance.*	Fail to reject $H_0 8$
H9	*Firms that do not comply with main principles of the Code will receive more negative media criticisms than those that do not comply with other principles of the Code.*	Partly fail to reject $H_0 9$, firms with low compliance receive more negative media criticisms

CHAPTER SIX:

CONCLUSION

6.1 Summary

Several prior independent studies have found that less than half of FTSE 350 firms do not fully comply with the Code. This is in contrast with the desire of the FRC to see all the firms having high governance standards due to strings of financial scandals in the UK and the rest of the world. The fact that by having good governance practise will improve the firm's relationship with its investors and shareholders make it more puzzling on why firms are reluctant to fully comply with the Code.

In term of studying the Code itself, none of the prior studies, especially in the UK, have looked beyond its relationship with firm performance. There are lots of studies in the US and the UK that have looked into various measurements of governance like board structure, shareholders ownership and CEO ownership among others, even constructing their own governance index, to find their effects on various managerial and shareholders issues but none has so far tried to use the principles of the Code as their main focal point.

Therefore this study intends to investigate what makes the firms that fully comply with the Code differ from those that do not in term of safeguarding the welfare of

stakeholders and controlling managers' behaviour, what set of principles within the Code matter most to the shareholders, and what are the potential costs to the firms if they do not fully comply with the Code.

The aim of this study as identified in Chapter Three is to look into relationships between compliance with the Code and issues related to managerial decision making such as diversification, CEO compensation and accounting quality. With the available data of FTSE 350 firms between 2003 and 2007 provided by Grant Thornton, I present a descriptive analysis of the relationship between compliance with the Code and those issues. I observe a significant positive relationship between the firms who claim full compliance with the Code and the level of CEO compensation, which offers alternative explanation to findings by previous studies. I also found no evidence to suggest any relationship between firms that fully comply with the Code and level of diversification and timeliness of earnings.

My second study, presented in Chapter Four examines relationships between compliance with the Code and issues related to welfare of shareholders such as disclosure quality, CEO turnover, compensation disclosure quality and firm performance. I found that firms that comply with the crucial principles in the Code have lower analyst bias and larger analyst following. I also found that there is no relationship between compliance with the Code and CEO turnover. There is some evidence of compliance with the Code which affects compensation disclosure quality. There is also some evidence that firms are trying to mask their

underperformance by claiming full compliance with the Code in their annual report.

Chapter Five presents my third study which examines media criticism as a potential cost for firms that decide not to fully comply with the Code. I do not find any relationship between compliance rate of the Code and number of news related to it. However I found that firms that have low rate of compliance with the Code will attract higher negative news than firms that fully comply with the Code. Firms' size also plays important factor in attracting news coverage on the firms.

Results of this study have multiple implications. As suggested by findings from Chapter Three to Five, there are several characteristic differences between firms that fully comply with the Code and firms that do not comply. The next step is to determine whether such differences really influence potential investors on the decision whether to invest in these firms or not. Is it enough for firms that have lower analyst bias and higher analyst following to generate interest from the potential investors? Will higher CEO compensation have any effect on the shareholders assessment on the firms or firm performance is the only thing worth to worry about? Will negative news on firm's non compliance with the main principles of the Code be enough to persuade the firms to increase their governance? Answers to these questions will shed light on why the majority of the firms are still not fully compliant with the Code. Therein lays a need for regulatory boards to continuously assess and update the principles embedded in

the Code so as to remain relevant and important in improving governance for UK firms.

6.2 Contributions and Limitations

My thesis contributes to the existing literature in the following ways. First, I extend existing research on corporate governance by looking into the importance of complying with the Code for UK firms. This is crucial because unlike in the US where firms are regulated by Sarbanes-Oxley Act of 2002, firms in the UK have an option whether to voluntarily comply with the Code or not. Therefore if the majority of firms decided not to comply with the Code, this will paint a picture that firms are not really learning from various financial scandals happening all over the world or they understand that investors and shareholders are looking far beyond following several recommendations outlined by the regulatory board.

Second, through my analysis in Chapter Three until Chapter Five, I provide additional and more recent evidence on the relationship between compliance with the Code and various issues related to managerial decision making, welfare of shareholders and media criticism. My study also contributes in term of providing several alternatives for measurements of corporate governance based on the set of principles outlined in the Code. None of the prior studies that used their own index of governance based their measurements on entire principles of the Code. Grant Thornton did focus their measurements entirely on the principles of the

Code but they suffer from including governance criteria that might not be so important and crucial to investors and shareholders. My study refined these governance measurements further by only including the most important and relevant principles and constructing them based on issues studied. For example, if I want to look into CEO compensation, I would include principles that dealt with Remuneration Committee and will not include those principles in the governance measurements if I want to analyse diversification issue. The use of refined measurements as provided by Grant Thornton and my own adjusted index result in more significant evidence in some of the results on issues like disclosure quality, CEO compensation, compensation disclosure quality and media criticism.

Key limitations of my work are as follows. First, my study uses a sample of FTSE 350 firms from 2003 until 2007. Due to various merging, delisting and takeover activities among others, including the missing data, the final sample can be smaller than expected and might limit the generalisation that I made. Future research could expand this sample by expanding the list of firms to include more than 350 firms for each year. Second, various changes based on other prior studies could be incorporated on the models, proxies and indices used in this study. There is still more room for improvement and improvisation by including more alternative research design by other and recent studies. In addition I have not tested for a possible heteroscedasticity problem where the assumption that the error term has a constant variance is not properly tested. There are several tests that can be conducted to test the presence of heteroscedasticity, such as White test

and Breusch-Pagan test. Also a residual plot can be used to visualise a possible occurrence. Nevertheless, unequal error variance is only worth correcting when the problem is severe (Fox, 1997) and heteroscedasticity has never been a reason to throw out an otherwise good model (Mankiw, 1990). Third, there still exists ambiguity when it comes to defining governance, or in this case, identifying which principles of the Code constitutes good governance. It was concluded that studying each and every one of the principles in the Code and incorporating them into the governance measurements will give a better and more refined analysis on the issues of corporate governance. Also, greater understanding will be achieved by customising the measurements according to the specific area studied and not standardising the measurements across various accounting and finance issues. However, more works needs to be done here and future research could help to produce a better governance measures involving the principles of the Code to be used especially in the UK study.

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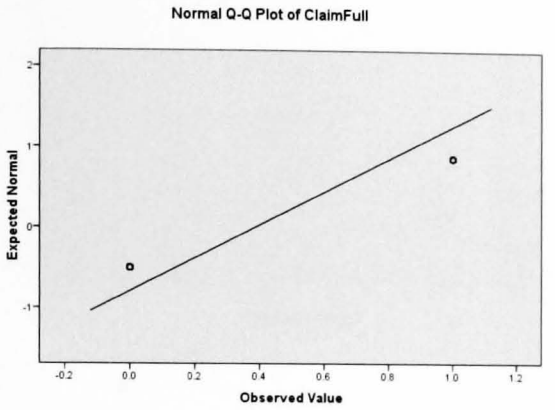
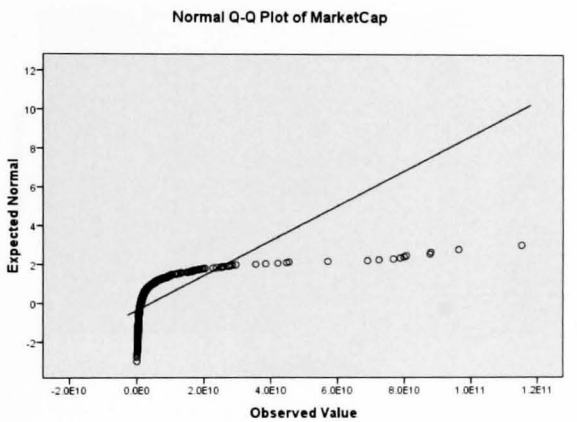
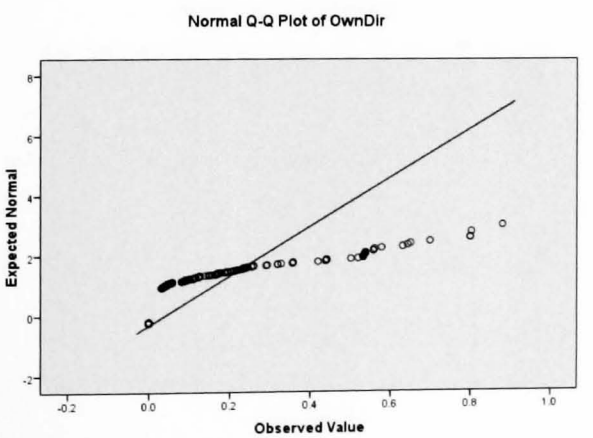
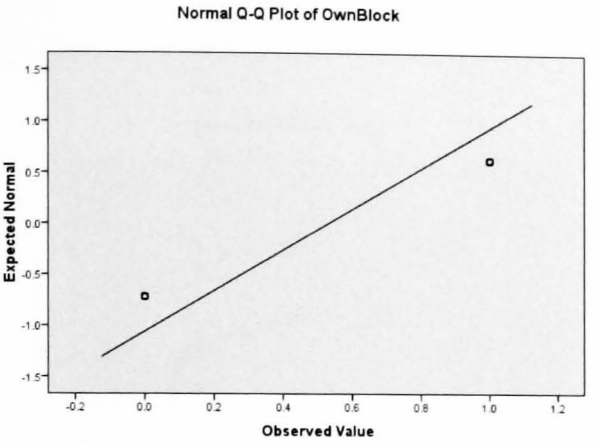
APPENDIX A

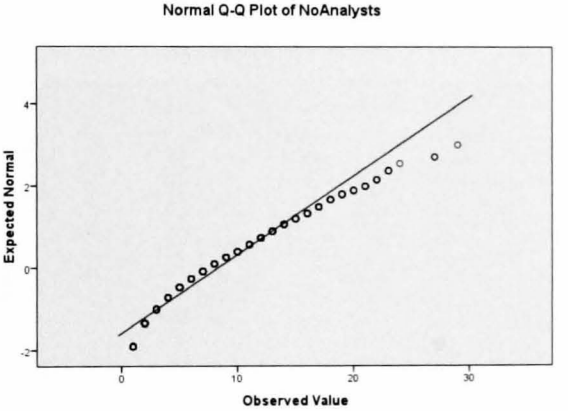
Q-Q plots for H1

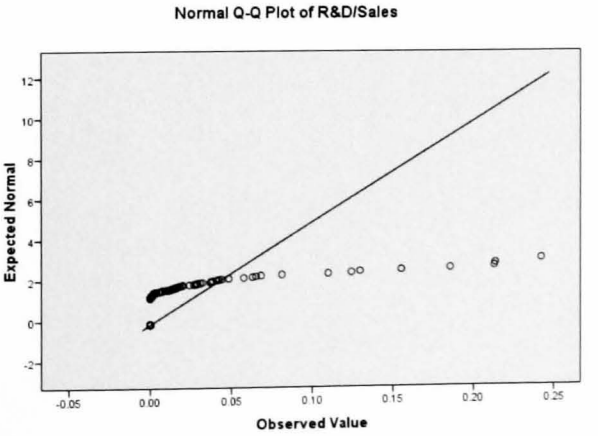






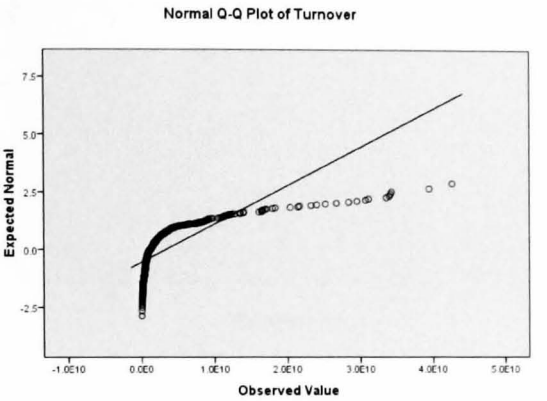

Normal Q-Q Plot of OwnBlock
Expected Normal
Observed Value
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2

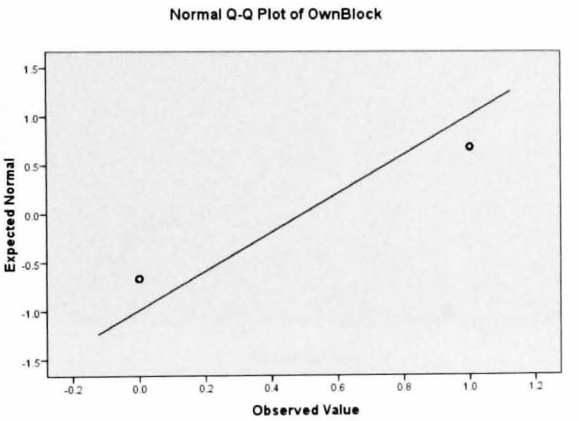

Normal Q-Q Plot of NoAnalysts
Expected Normal
Observed Value
4
2
0
-2
0
10
20
30

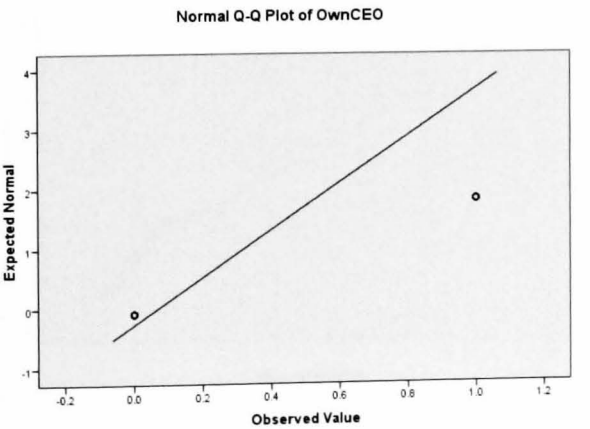

Normal Q-Q Plot of R&D/Sales
Expected Normal
Observed Value
12
10
8
6
4
2
0
-2
-0.05
0.00
0.05
0.10
0.15
0.20
0.25

APPENDIX B

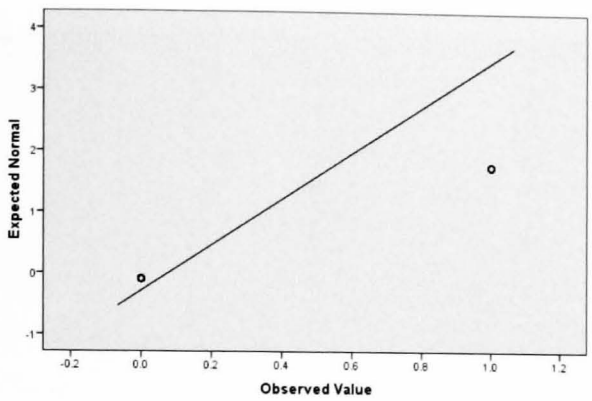
Q-Q plots for H2



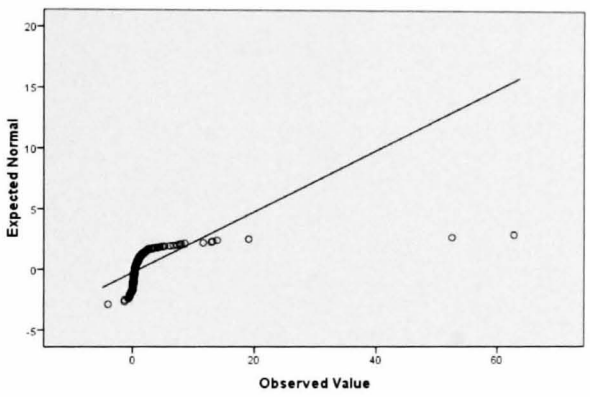




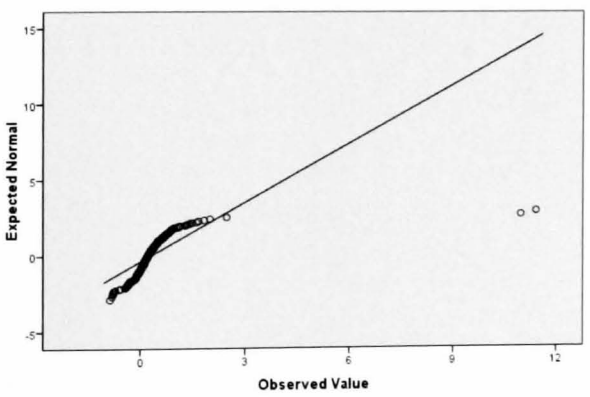
Normal Q-Q Plot of NonCEO5%

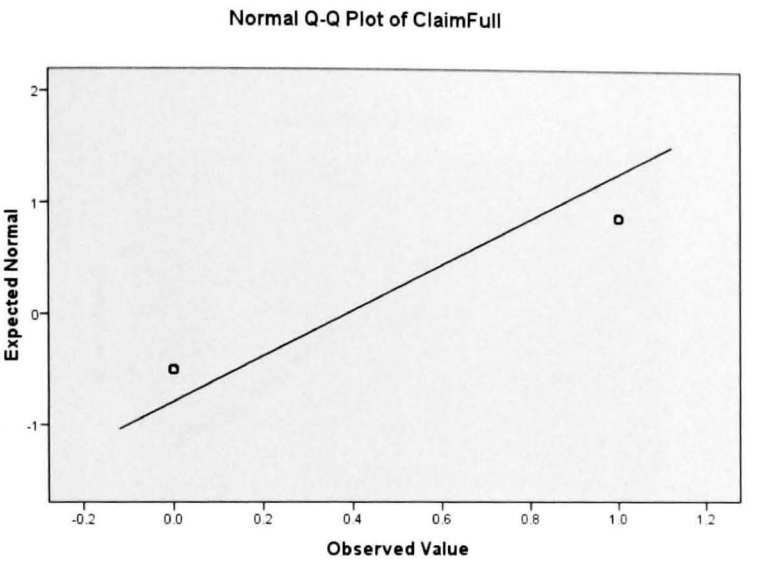


Normal Q-Q Plot of ROA



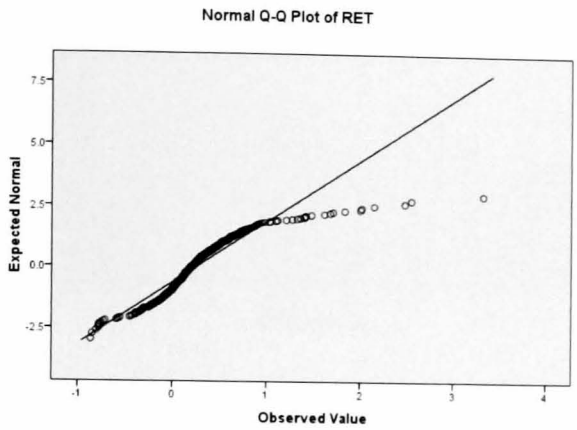
Normal Q-Q Plot of RET

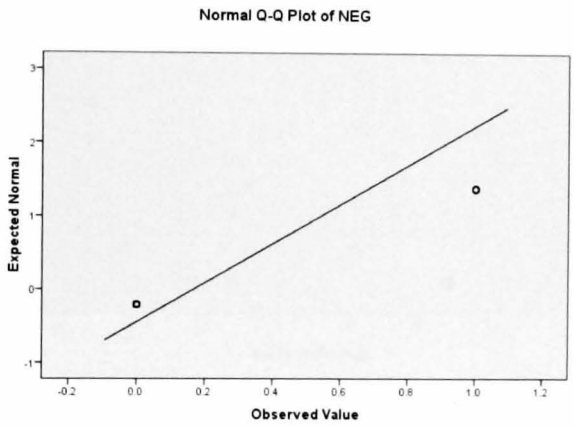


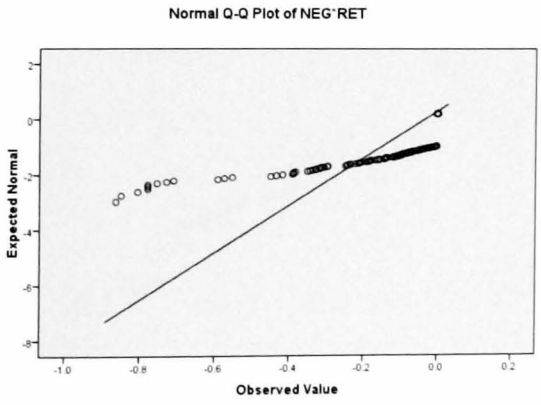

Normal Q-Q Plot of ClaimFull
Expected Normal
2
1
0
-1
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2
Observed Value

APPENDIX C

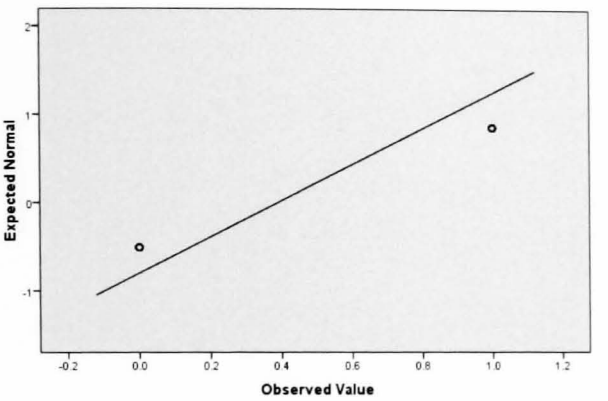
Q-Q plots for H3a and H3b



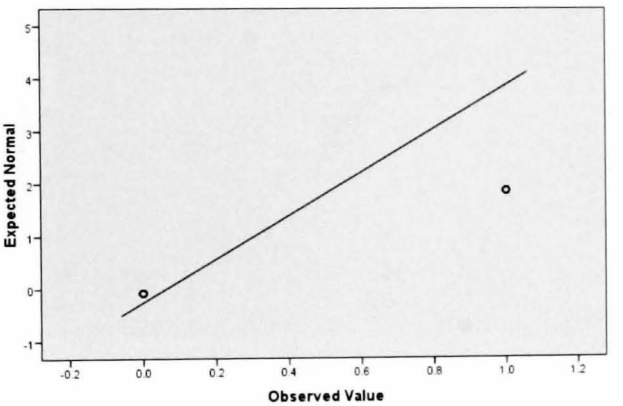




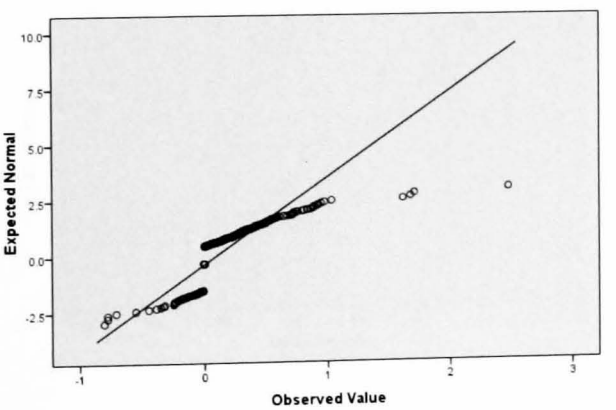
Normal Q-Q Plot of ClaimFull



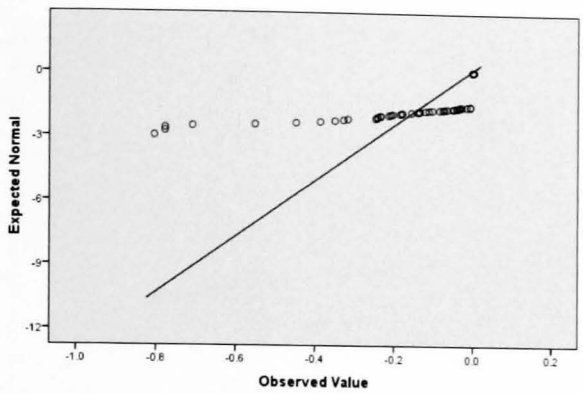
Normal Q-Q Plot of NEG*COM



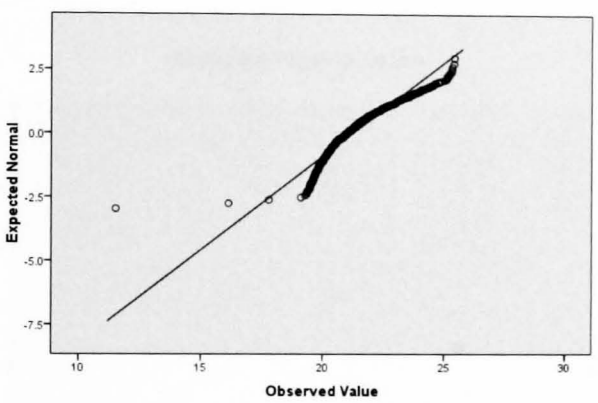
Normal Q-Q Plot of COM*RET



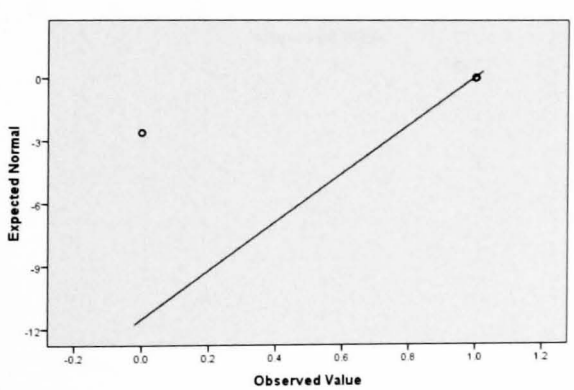
Normal Q-Q Plot of NEG*COM*RET

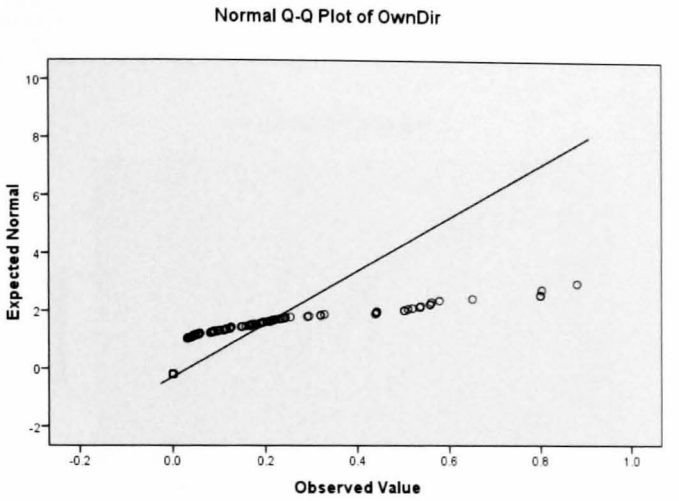


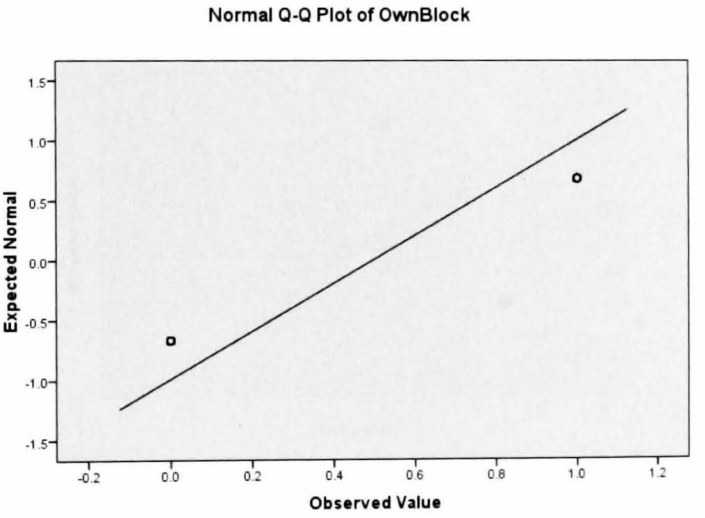
Normal Q-Q Plot of Size(ln)



Normal Q-Q Plot of AuditorBigFour

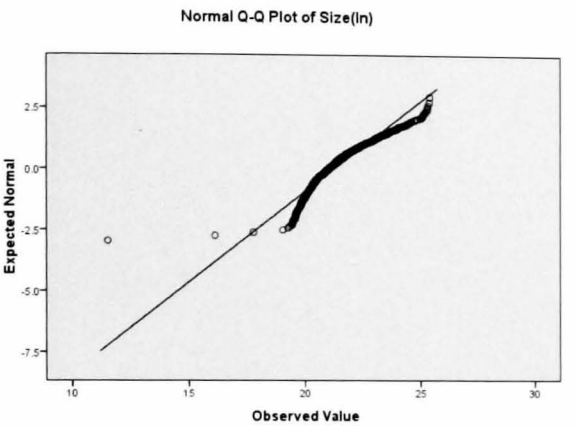


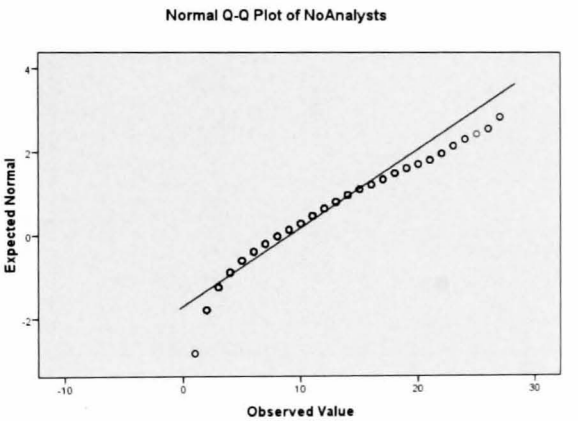

Normal Q-Q Plot of OwnDir
Expected Normal
Observed Value
10
8
6
4
2
0
-2
-0.2
0.0
0.2
0.4
0.6
0.8
1.0

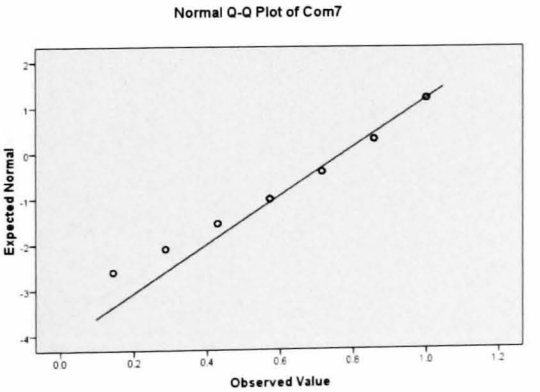

Normal Q-Q Plot of OwnBlock
Expected Normal
Observed Value
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2

APPENDIX D

Q-Q plots for H4a

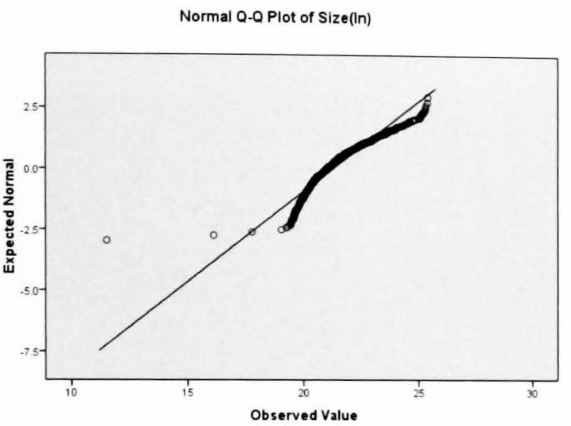


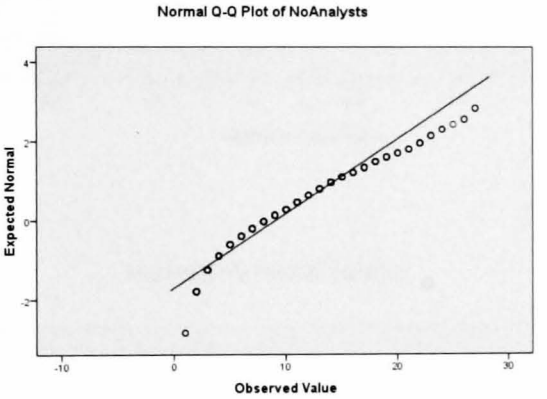


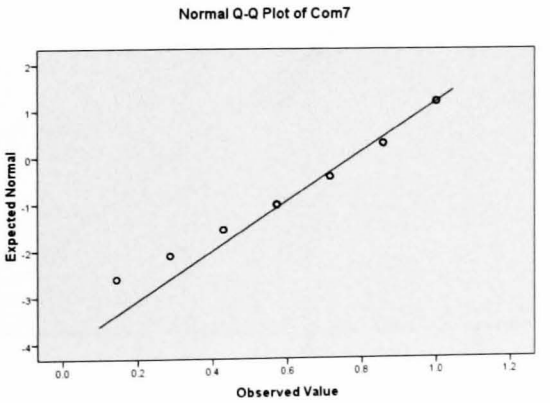


APPENDIX E

Q-Q plots for H4b

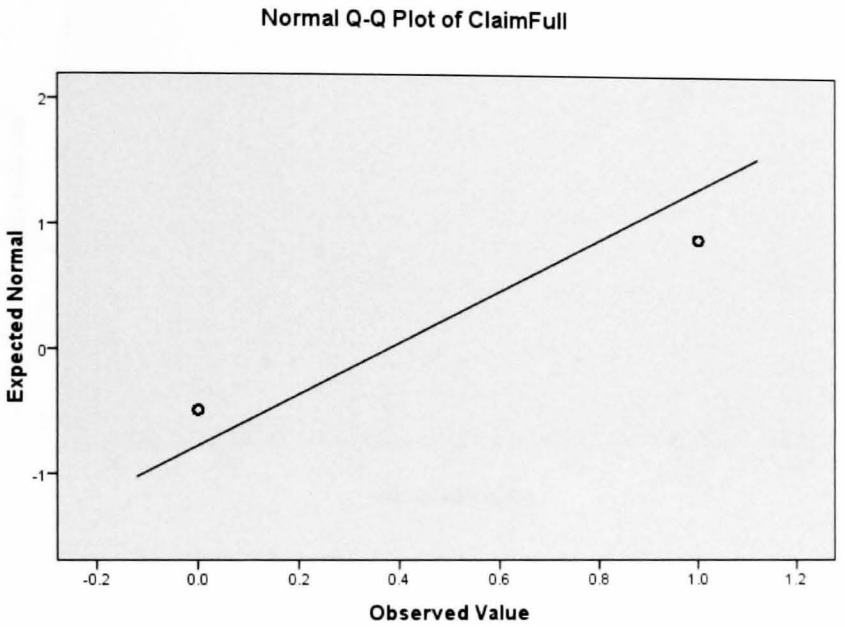


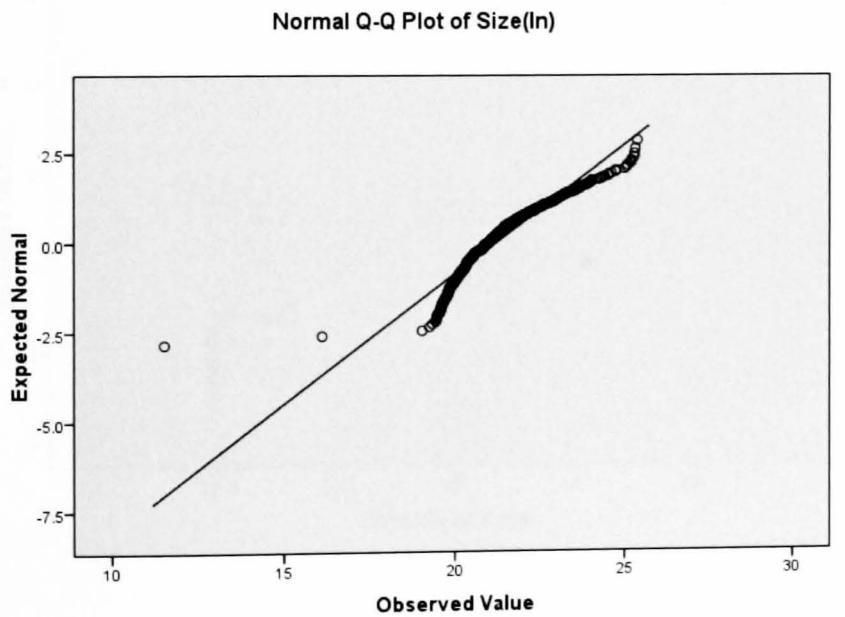


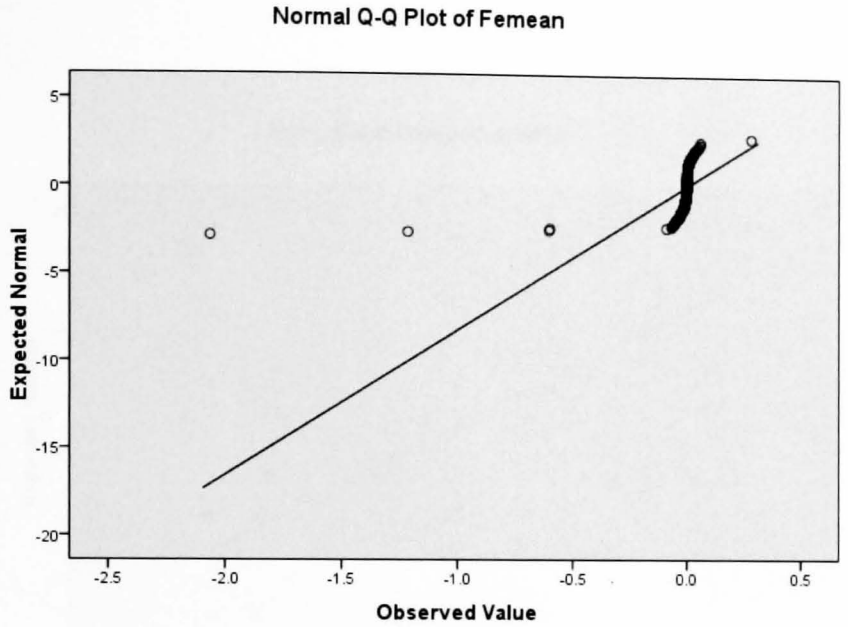


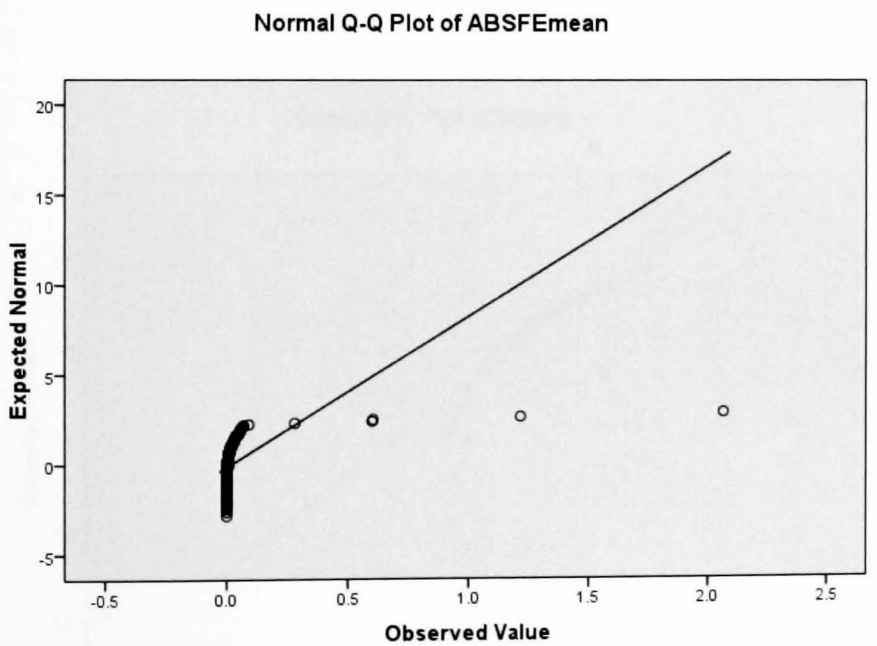
APPENDIX F

Q-Q plots for H4c



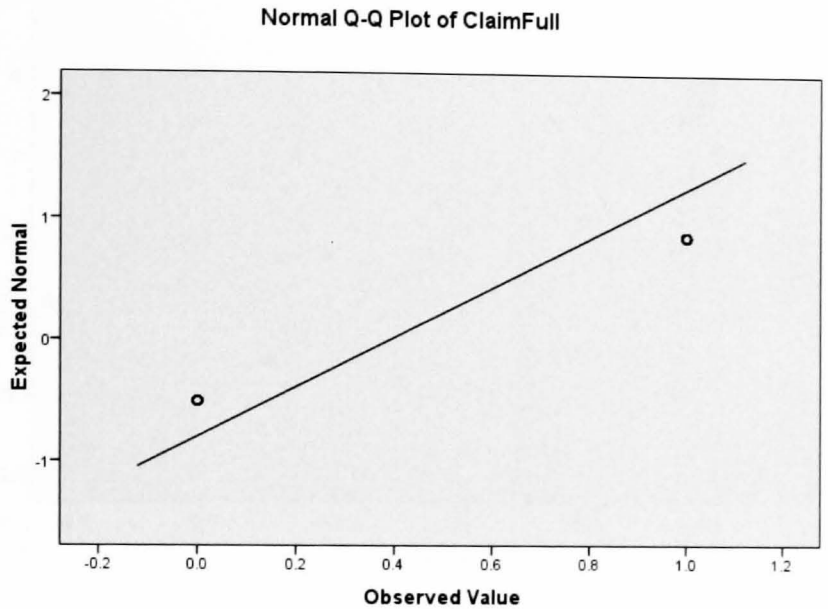


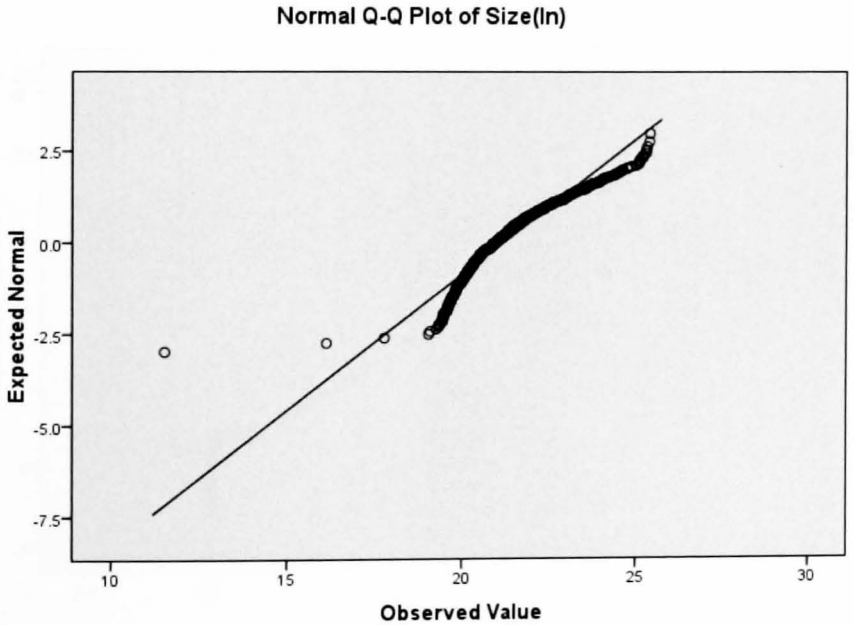

Normal Q-Q Plot of Femean
Expected Normal
5
0
-5
-10
-15
-20
-2.5
-2.0
-1.5
-1.0
-0.5
0.0
0.5
Observed Value

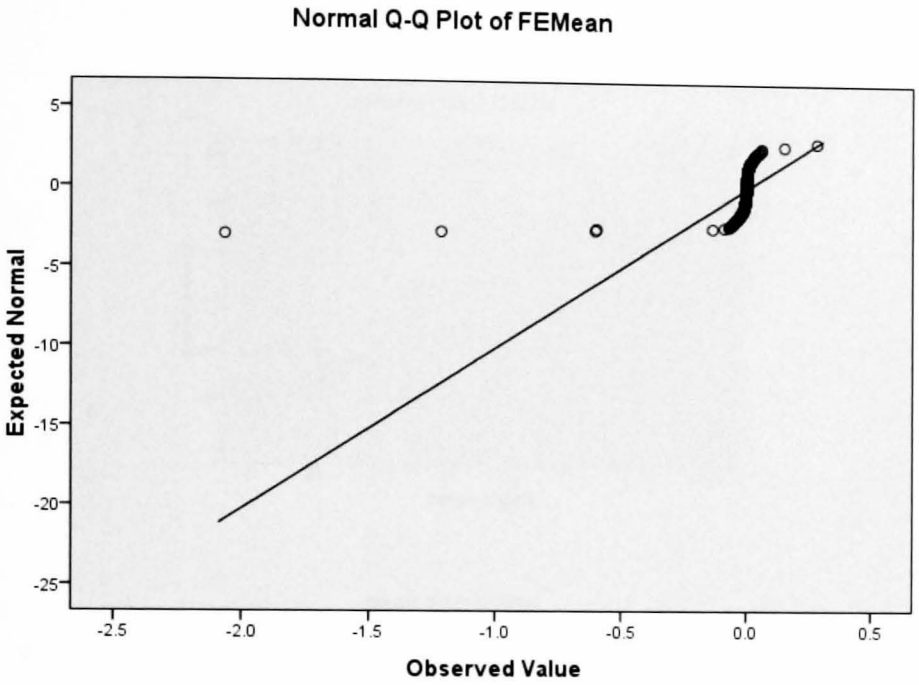

Normal Q-Q Plot of ABSFEmean
Expected Normal
20
15
10
5
0
-5
-0.5
0.0
0.5
1.0
1.5
2.0
2.5
Observed Value

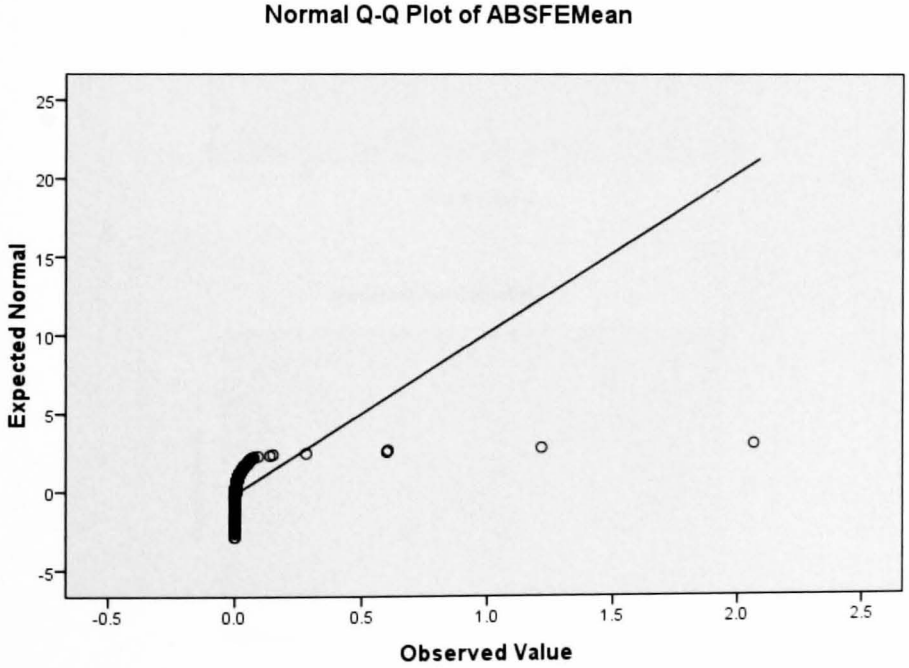
APPENDIX G

Q-Q plots for H4d



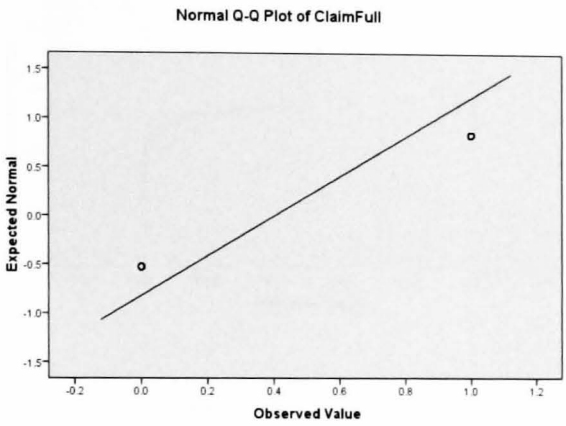


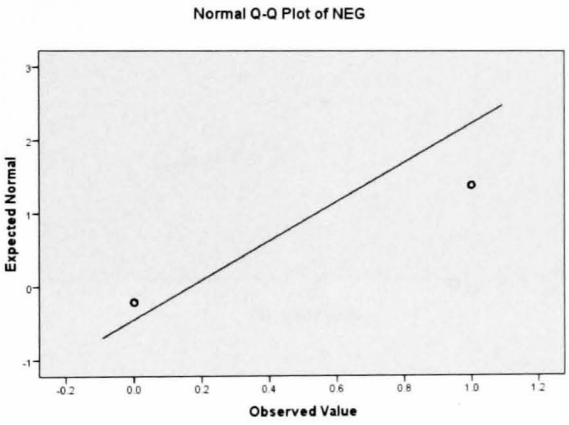

Normal Q-Q Plot of FEMean
Expected Normal
5
0
-5
-10
-15
-20
-25
-2.5
-2.0
-1.5
-1.0
-0.5
0.0
0.5
Observed Value

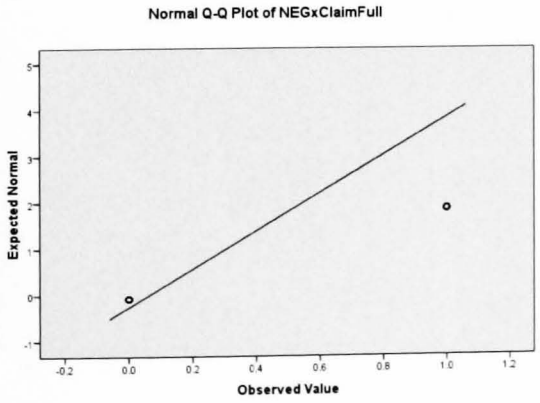

Normal Q-Q Plot of ABSFEMean
Expected Normal
25
20
15
10
5
0
-5
-0.5
0.0
0.5
1.0
1.5
2.0
2.5
Observed Value

APPENDIX H

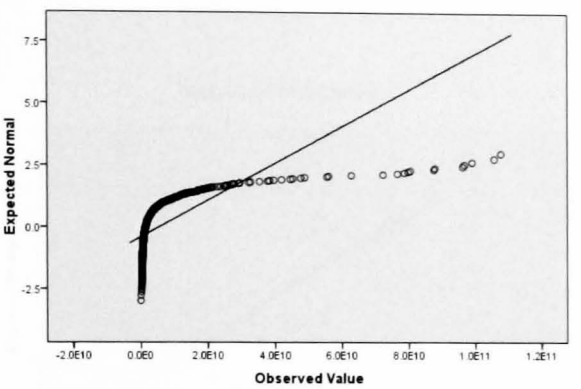
Q-Q plots for H5



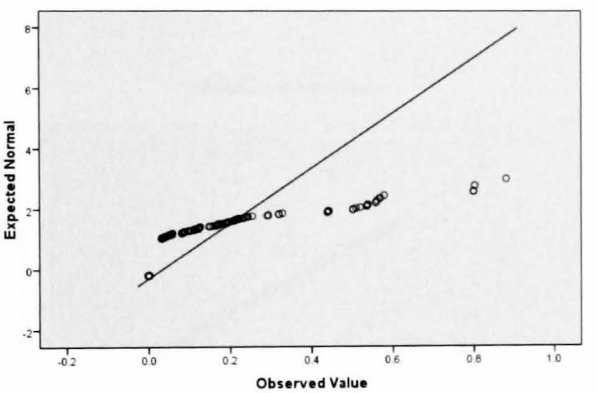




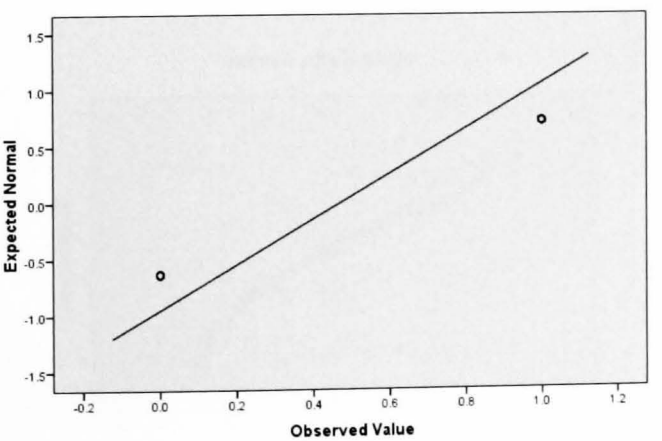
Normal Q-Q Plot of MarketCap



Normal Q-Q Plot of OwnDir

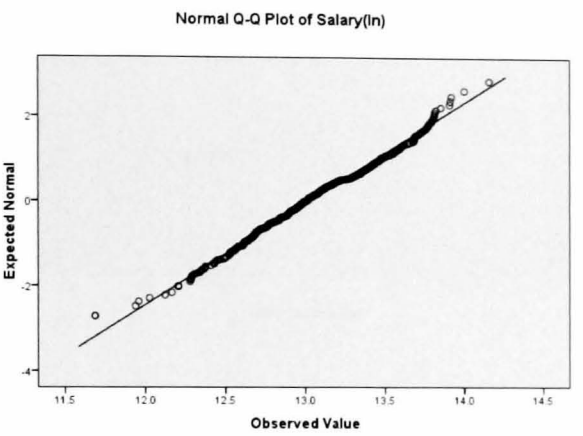


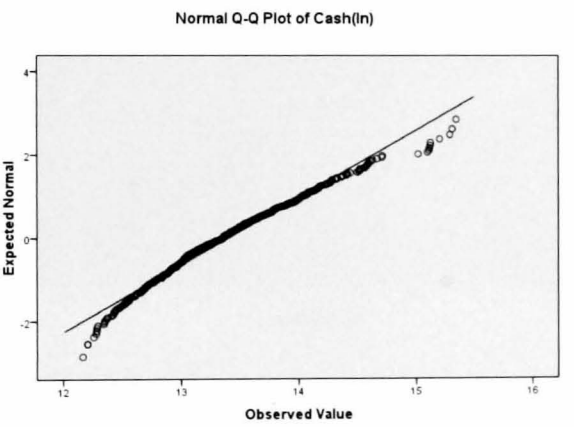
Normal Q-Q Plot of OwnBlock

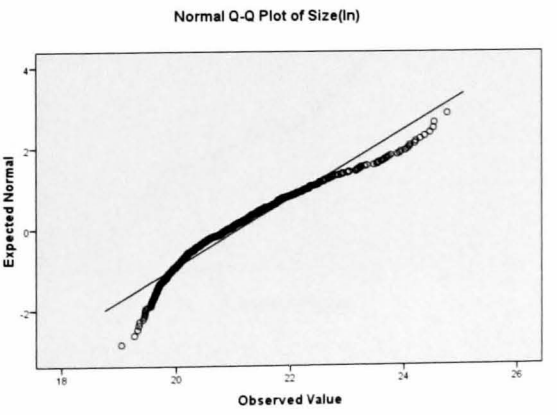


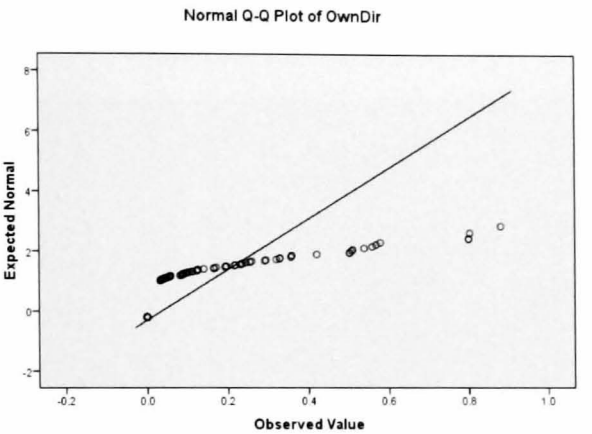
APPENDIX I

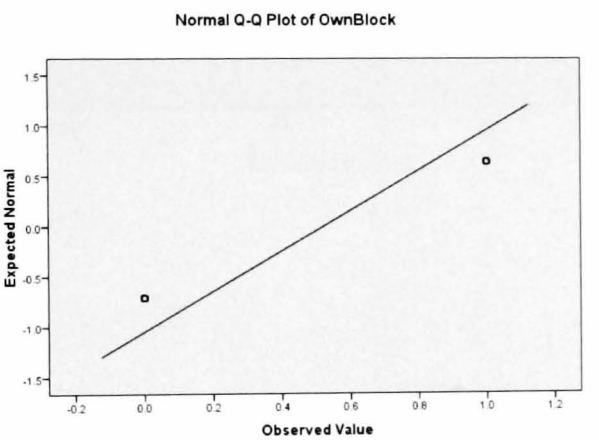
Q-Q plots for H6

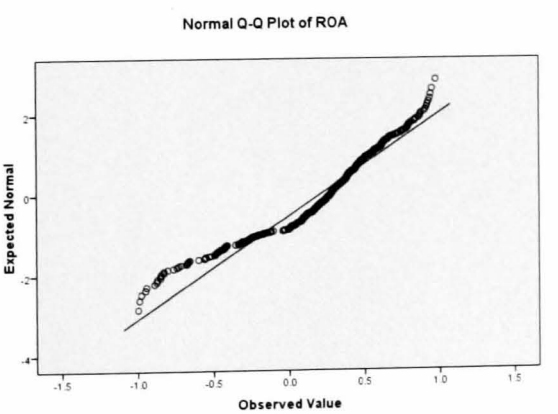


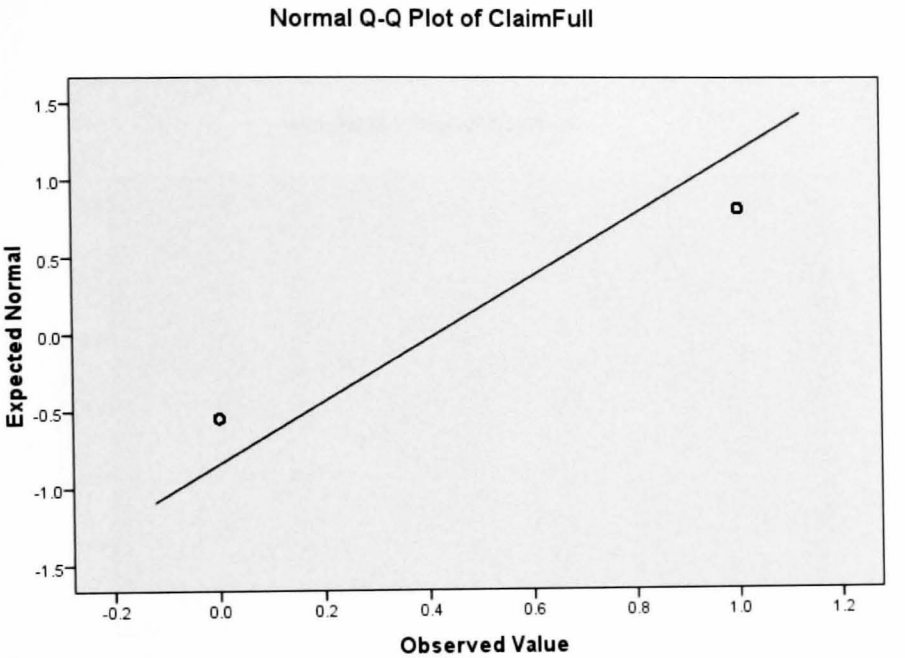





Normal Q-Q Plot of OwnDir
Expected Normal
Observed Value
8
6
4
2
0
-2
-0.2
0.0
0.2
0.4
0.6
0.8
1.0

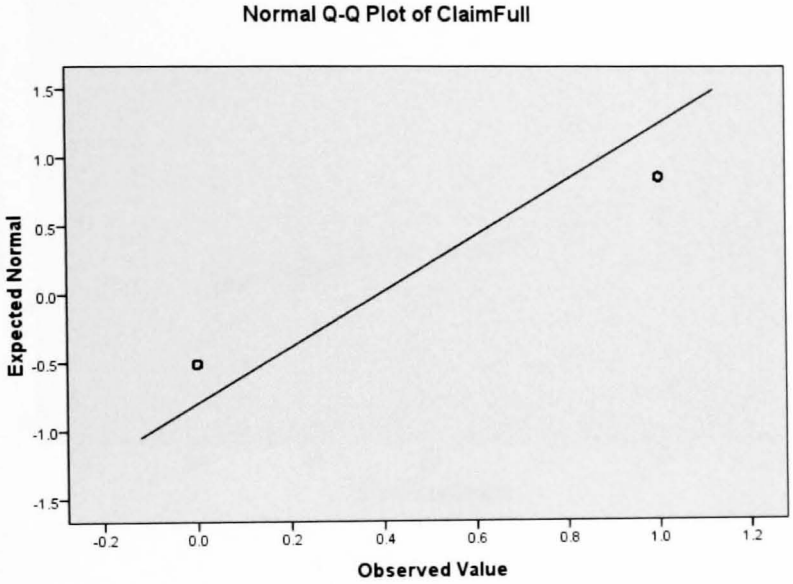

Normal Q-Q Plot of OwnBlock
Expected Normal
Observed Value
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2

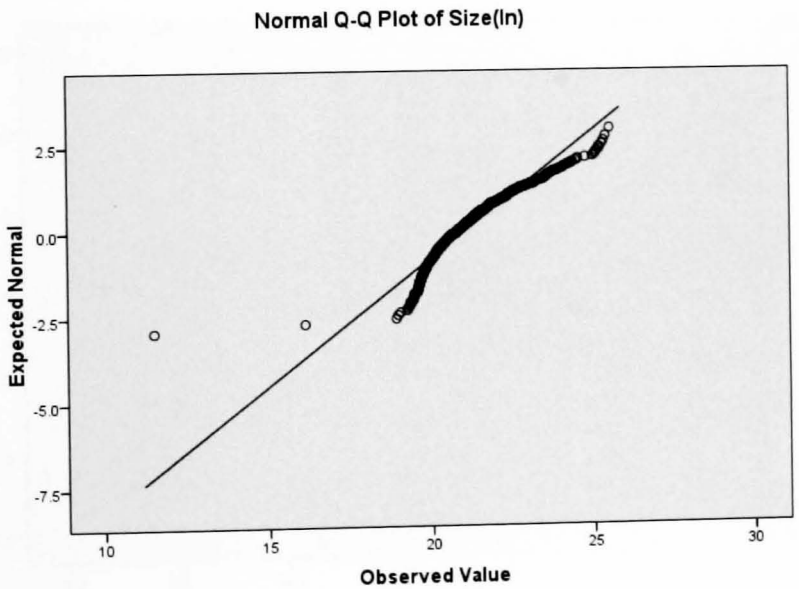

Normal Q-Q Plot of ROA
Expected Normal
Observed Value
2
0
-2
-4
-1.5
-1.0
-0.5
0.0
0.5
1.0
1.5

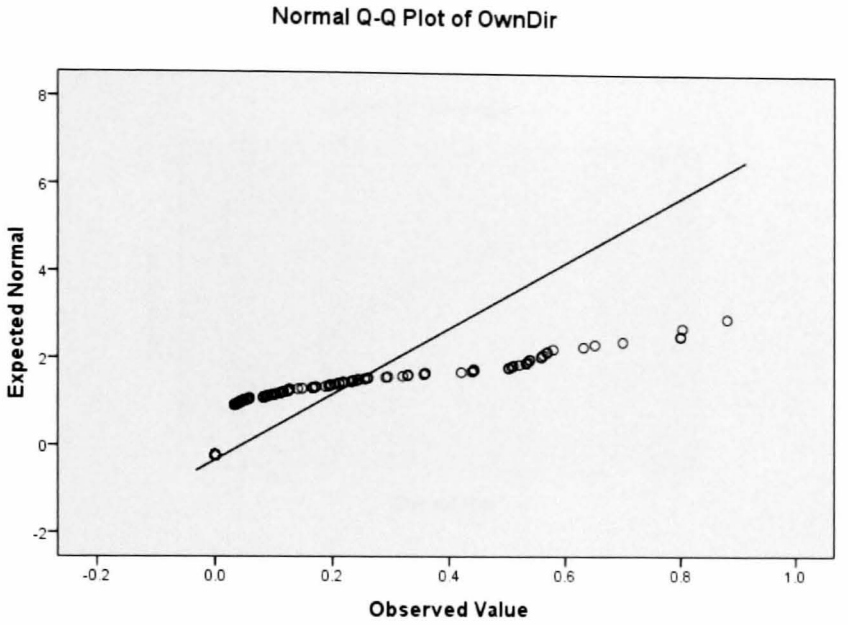

Normal Q-Q Plot of ClaimFull
Expected Normal
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2
Observed Value

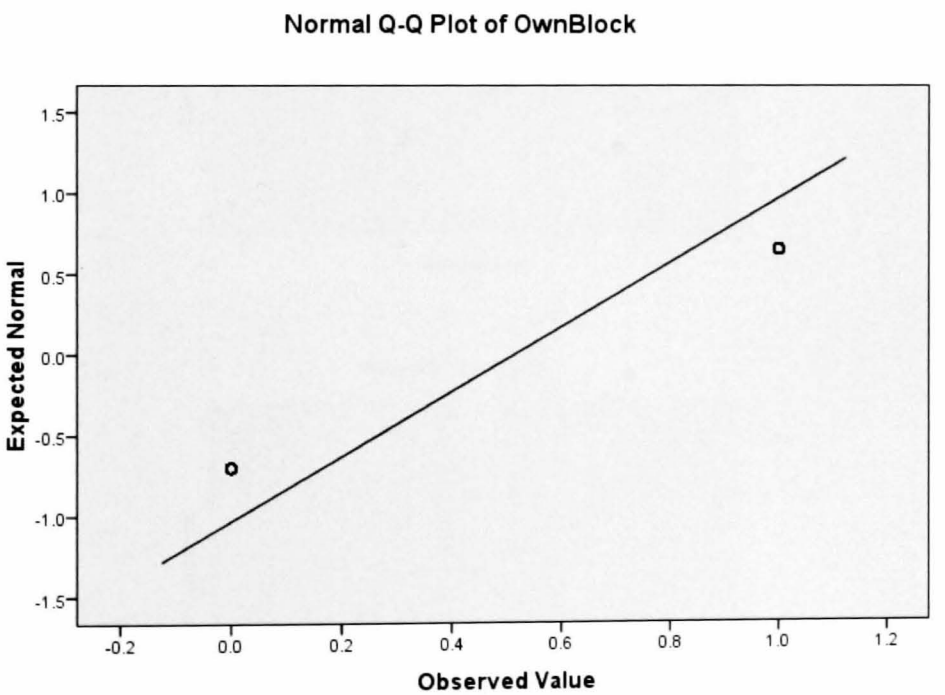
APPENDIX J

Q-Q plots for $H_0 7$



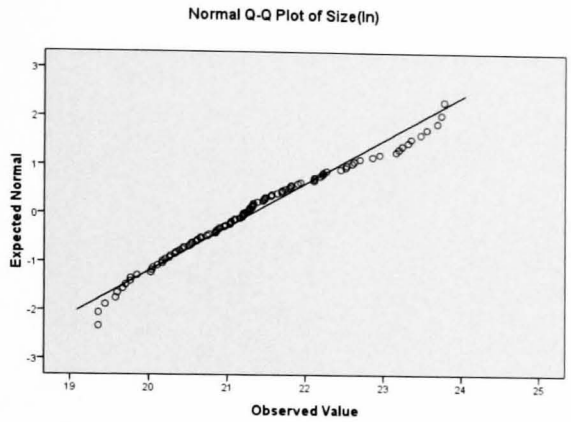


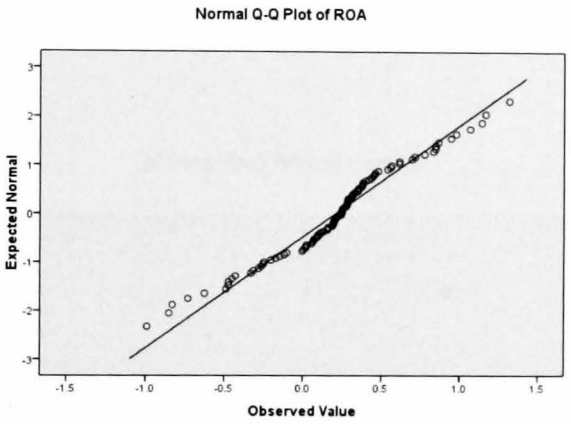

Normal Q-Q Plot of OwnDir
Expected Normal
Observed Value
8
6
4
2
0
-2
-0.2
0.0
0.2
0.4
0.6
0.8
1.0

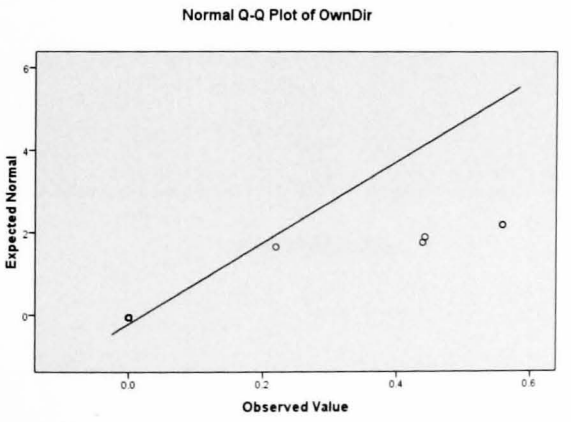

Normal Q-Q Plot of OwnBlock
Expected Normal
Observed Value
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2

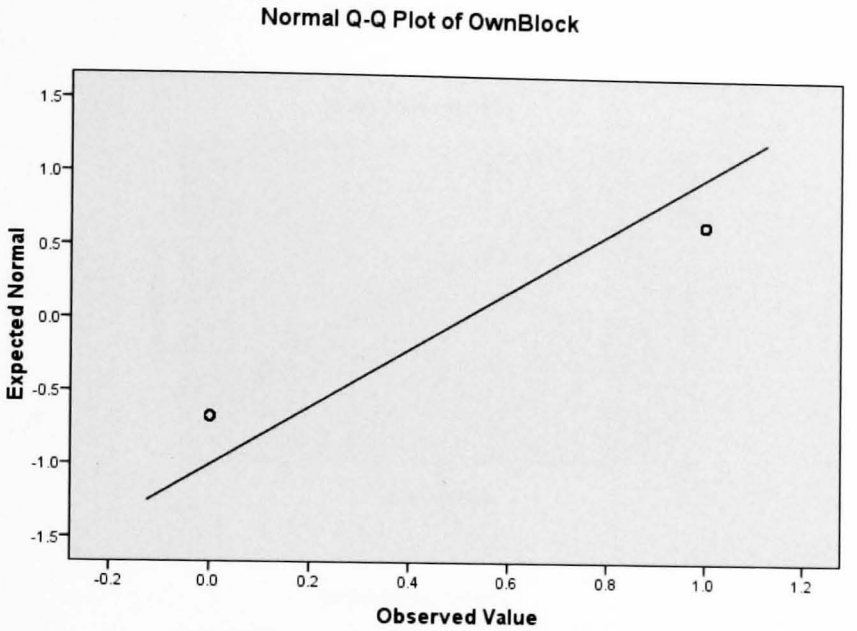
APPENDIX K

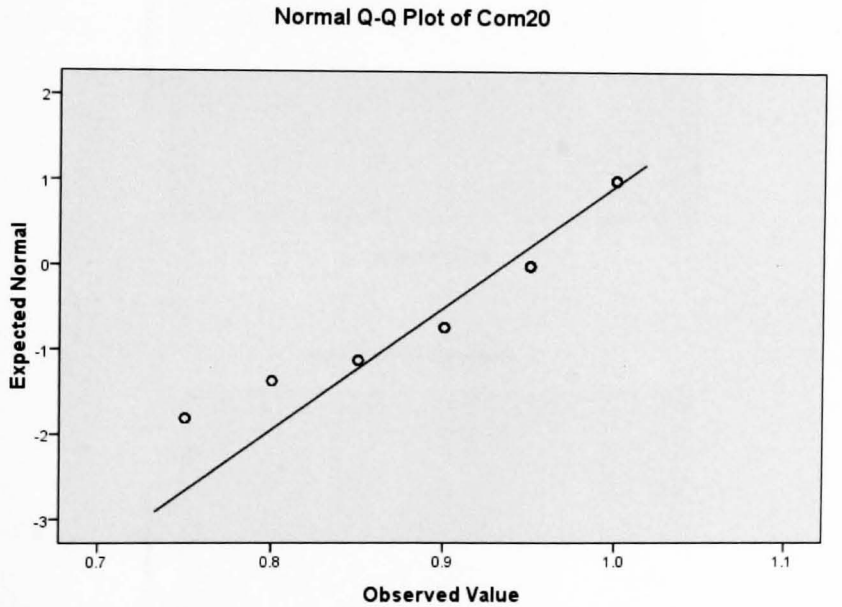
Q-Q plots for $H_0 8$





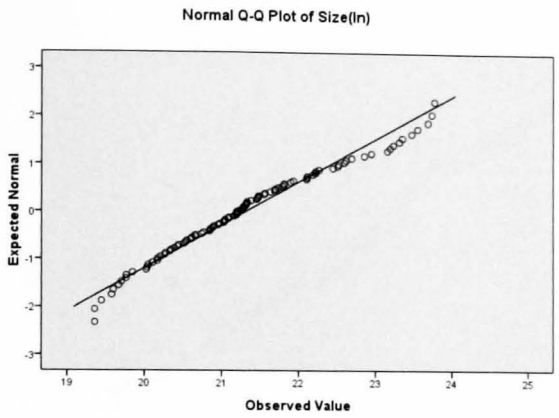


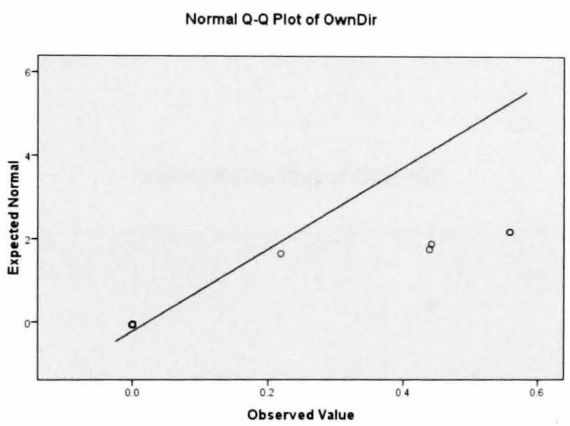

Normal Q-Q Plot of OwnBlock
Expected Normal
Observed Value
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.2
0.0
0.2
0.4
0.6
0.8
1.0
1.2

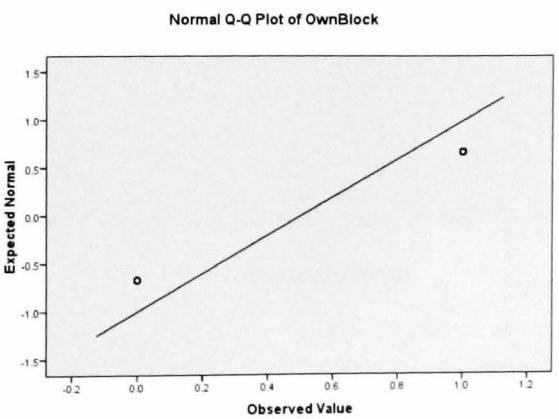

Normal Q-Q Plot of Com20
Expected Normal
Observed Value
2
1
0
-1
-2
-3
0.7
0.8
0.9
1.0
1.1

APPENDIX L

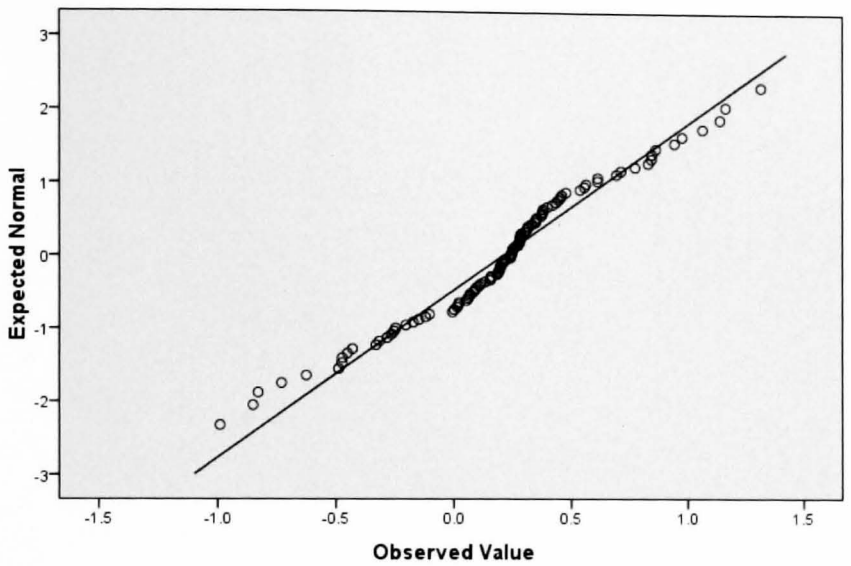
Q-Q plots for H9







Normal Q-Q Plot of ROA



Normal Q-Q Plot of Comp20