

Comply or Explain: The Flexibility of Corporate Governance Codes in Theory and in Practice

David Seidl
Institute of Strategic Management
University of Munich
Ludwigstr. 28
80539 Munich
seidl@bwl.uni-muenchen.de

Paul Sanderson
Centre for Business Research
University of Cambridge
Trumpington Street
Cambridge CB2 1AG
p.sanderson@cbr.cam.ac.uk

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Abstract

The “Comply or Explain” principle is a central element of most codes of corporate governance. Originally put forward by the Cadbury Committee as a practical means of establishing a code of corporate governance whilst avoiding an inflexible ‘one size fits all’ approach, it has since been incorporated into code regimes around the world. In theory the comply-or-explain mechanism provides both flexibility in the application of the code and a means by which to assess compliance. Thus non-compliance (or perhaps better, non-application of the relevant rule) can still be said to be consistent with the spirit of the code. Judgments on matters such as the extent to which deviations are indeed justified are to be monitored by shareholders. Deviations considered unjustified may provoke a reaction ranging from a discreet intervention at board level through to, at the other extreme, disposal of the company’s stock, with possible implications for the share price. However, despite its promotion by various national and supranational organizations, very little is known about the way that the mechanism functions in practice. In response to calls for more research on the way the explain option is used in practice we analyse in this paper the compliance statements and corporate governance reports of listed companies in the UK and Germany. While explanations for deviating are certainly not restricted to published reports and accounts, (companies can also provide explanations verbally at their AGM or via a press statement or in private meetings with shareholders), the formal statements can nonetheless be considered reasonable indicators of the types of explanation given.