



University of HUDDERSFIELD

University of Huddersfield Repository

Filatotchev, Igor, Jackson, Gregory, Gospel, Howard and Allcock, Deborah

Key drivers of 'good' corporate governance and the appropriateness of UK policy responses : final report

Original Citation

Filatotchev, Igor, Jackson, Gregory, Gospel, Howard and Allcock, Deborah (2007) Key drivers of 'good' corporate governance and the appropriateness of UK policy responses : final report. Project Report. The Department of Trade and Industry and King's College London, London, UK.

This version is available at <http://eprints.hud.ac.uk/id/eprint/473/>

The University Repository is a digital collection of the research output of the University, available on Open Access. Copyright and Moral Rights for the items on this site are retained by the individual author and/or other copyright owners. Users may access full items free of charge; copies of full text items generally can be reproduced, displayed or performed and given to third parties in any format or medium for personal research or study, educational or not-for-profit purposes without prior permission or charge, provided:

- The authors, title and full bibliographic details is credited in any copy;
- A hyperlink and/or URL is included for the original metadata page; and
- The content is not changed in any way.

For more information, including our policy and submission procedure, please contact the Repository Team at: E.mailbox@hud.ac.uk.

<http://eprints.hud.ac.uk/>

KEY DRIVERS OF 'GOOD'
CORPORATE GOVERNANCE AND
THE APPROPRIATENESS OF UK
POLICY RESPONSES

Final Report

Igor Filatotchev, Gregory
Jackson, Howard Gospel,
Deborah Allcock King's
College London, University
of London

JANUARY 2007

About this publication

The project manager for this report was Sheetal Radia, Economic Adviser, Corporate Law and Governance Directorate, Department of Trade and Industry

Published in January 2007 by the Department of Trade and Industry.

URN 07/581

ISBN:

ISBN:

© Crown Copyright 2007

This DTI publication can be downloaded at: www.dti.gov.uk/bbf/corp-gov-research/page15049.html

Postal enquiries should be addressed to:

James Carey

Corporate Law and Governance Directorate

Department of Trade and Industry

1 Victoria Street

London SW1H 0ET

United Kingdom

Email enquiries should be addressed to: james.carey@dti.gsi.gov.uk

The views expressed in this publication do not necessarily reflect those of the Department or the Government. We publish it as a contribution towards open debate about how best we can achieve our objectives.

Acknowledgements

The authors would like to acknowledge the generous support of the Department of Trade and Industry in funding this research. They would like to thank the project steering group members for their help and advice. Furthermore they would also like to thank various members of staff at the Department of Trade and Industry and the participants of a Focus Group for their helpful comments.



University of London

**The Department of Trade and Industry
and King's College London**

“Key Drivers of ‘Good’ Corporate Governance and the
Appropriateness of UK Policy Responses”

Final Report

Igor Filatotchev
Gregory Jackson
Howard Gospel
Deborah Allcock

Executive Summary

The DTI's Corporate Law and Governance strategy aims to promote and deliver an effective framework for corporate governance in the UK, giving confidence to investors, business, and other stakeholders to underpin the relationship between an organisation and those who hold future financial claims against that organisation. However, corporate governance involves various problems of asymmetric information and incomplete contracts that generate a need for public policy responses to mitigate market failures and ensuring that companies moves towards 'good' corporate governance. Since the early 1990s, the UK has been very active in undertaking policy reforms that includes a number of corporate governance codes, expert reports, a high level review of company law, and new regulations and legislation. These policy initiatives need to be monitored and evaluated in terms of their success in influencing the key drivers of 'good' corporate governance.

This Report undertaken for the DTI has several aims: to identify key drivers of good corporate governance based on a review of social science literature; to describe the content of UK regulatory initiatives with regard to those drivers; and to evaluate gaps in the content and implementation of UK policy regarding corporate governance, using those drivers as benchmarks. In addition, some further implications of this study are discussed for future policy and research on UK corporate governance.

The Report identifies key drivers of good corporate governance based on extensive review of the broad social science literature. Good corporate governance is defined here with regard to the rights and responsibilities of company stakeholders, and the wealth-creating and wealth-protecting functions of corporate governance within this context. Based on this definition, a detailed review of the theoretical and empirical social science literature on corporate governance was undertaken across seven broad areas: boards of directors, shareholder activism, information disclosure, auditing and internal controls, executive pay, the market for corporate control, and stakeholders. The result was the identification of 18 key 'drivers' or governance mechanisms, which promote 'good' corporate governance. An internet-based survey of international corporate governance experts was conducted in order to confirm and further specify these drivers in relation to the UK context.

Next, key gaps in the UK regulatory framework are explored with reference to the drivers of good corporate governance. A comprehensive review was undertaken to evaluate corporate governance-related developments in UK regulation since 1990. Policy initiatives were analysed with regard to both their content and effectiveness in promoting each of the identified drivers. Several potential gaps in coverage were identified in the areas of executive pay and employees stakeholders. A number of potential gaps in effectiveness were also identified with regard to other key drivers such as boards, shareholder involvement, information disclosure, auditing, and the market for corporate control. The analysis was supported by feedback from a Focus Group of expert practitioners that took place at the DTI in January 2006.

The Report also emphasises that the effectiveness of corporate governance regulation depends very much on balancing different governance demands and regulatory trade-offs. Corporate governance is shaped by a number of contingencies, complementarities, and costs. Various organisational contingencies may place different demands on corporate governance drivers, and their implementation is also associated with different sorts of costs. Looking more generally, different drivers may act as complements or substitutes for one another. Better appreciation of

such interdependencies is crucial to formulating a coherent regulatory strategy and balancing important regulatory trade-offs between the following - mandatory regulation (uniform requirements) and more flexible forms of soft-law such as codes based on comply-or-explain principles and self-regulatory norms of professional groups.

This analysis suggests a number of areas for future research. Bearing in mind the depth and breadth of the UK regulatory initiatives, it is important to verify whether they were followed by behavioural changes of the participants in corporate governance mechanisms, including unintended consequences such as the development of ‘gaming’ practices. Further research is needed on a potential ‘gatekeeper failure’ in situations where reliance on ‘reputational intermediaries’, such as auditors, securities analysts, attorneys, and other professionals, is not fully justified. Other research recommendations are related to wealth creation and performance trade-offs. It is important to go beyond the question of maximizing shareholder returns and consider to what extent different corporate governance configurations promote long-term, value-creating economic production in a fashion that benefits not only shareholders but also other groups that make specific investments in corporations. Finally, a more holistic approach to the effectiveness of corporate governance drivers requires further research on such aspects as stakeholder involvement, contingencies, complementarities, and cost aspects that may affect the effectiveness of corporate governance mechanisms.

The authors would like to point out that, since the report was written, there have been various developments, not least changes in UK law, which have overtaken some of the details in our analysis. However, the basic review of the evidence basis and the perspectives offered remain very much current.

Table of Contents

1	Introduction	6
1.1	Background.....	6
1.2	The Role of Public Policy.....	7
1.3	Report Objectives	8
1.4	Research Design and Methodology.....	9
1.4.1	Theoretical underpinnings of ‘good’ corporate governance	9
1.4.2	Identifying issues from a social science perspective.....	10
1.4.3	Research Methodology.....	12
2	Review of the Social Science Literature on Corporate Governance	15
2.1	Introduction	15
2.2	The Board of Directors	15
2.2.1	Introduction	15
2.2.2	Board composition and performance	17
2.2.3	Board composition and strategic decisions	19
2.2.4	Board characteristics, business strategy and performance.....	20
2.2.5	Board processes.....	23
2.2.6	Board governance effects: contingency factors	26
2.2.7	Complementarity and substitution between governance channels.....	27
2.3	Share Ownership and Shareholder Activism.....	27
2.3.1	Introduction	27
2.3.2	Large-block shareholders, business strategy and firm performance	28
2.3.3	Governance roles of different types of blockholders	30
2.3.4	Process aspects of shareholder activism	33
2.4	Information and Disclosure	34
2.4.1	Introduction	34
2.4.2	Information disclosure: the firm, its investors, and performance	35
2.4.3	Other types of information disclosure.....	38
2.4.4	Conclusions	39
2.5	Audit and Internal Controls	40
2.5.1	Introduction	40
2.5.2	The governance role of auditors.....	41
2.5.3	The governance role of internal controls	48
2.5.4	Support and protection of ‘whistleblowers’	49
2.5.5	Costs of audits and controls	50
2.5.6	Complementarity and substitution among governance mechanisms	51
2.6	Executive Pay	51
2.6.1	Introduction	51
2.6.2	The governance role of executive pay schemes.....	52
2.6.3	Executive pay tied to performance.....	53
2.6.4	The Remuneration Committee	55
2.6.5	Pay disclosure.....	56
2.6.6	Costs, complementary and substitution among governance mechanisms	56
2.7	The Market for Corporate Control.....	57
2.7.1	Introduction	57
2.7.2	The market for corporate control and financial performance	58
2.7.3	Takeovers in the context of corporate strategy, structure and stakeholders	64
2.7.4	Takeover market: contingency factors.....	67

2.7.5	Costs, complementarity and substitution among governance channels	68
2.8	Stakeholders.....	68
2.8.1	Introduction	68
2.8.2	Stakeholders: identification, contrasting perspectives, and empirical evidence.....	68
2.8.3	Debt holders	72
2.8.4	Employees	74
2.8.5	Costs, complementarities and substitution among governance mechanisms...	77
2.8.6	Conclusions	78
3	Survey of Corporate Governance Experts.....	80
3.1	Methodology.....	80
3.2	Survey Results	80
4	Drivers of ‘Good’ Corporate Governance in the UK Context.....	82
4.1	Introduction	82
4.2	Summary of Good Corporate Governance Drivers	82
4.3	Corporate Boards.....	83
4.3.1	Driver 1: Board independence	83
4.3.2	Driver 2: The diversity, human and social capital within the board	84
4.3.3	Driver 3: High engagement in board processes	84
4.4	Share Ownership and Shareholder Activism.....	85
4.4.1	Driver 4: Presence of large-block shareholders	85
4.4.2	Driver 5: Shareholder activism	86
4.5	Information and Disclosure	87
4.5.1	Driver 6: Breadth and depth of public information disclosure.....	87
4.5.2	Driver 7: Breadth and depth of private information sharing.....	88
4.6	Audit and Internal Controls	88
4.6.1	Driver 8: Independence of the external auditors	88
4.6.2	Driver 9: Competence of the audit committee	89
4.6.3	Driver 10: Presence of internal control systems and support of whistleblowing	89
4.7	Executive Pay	89
4.7.1	Driver 11: Long-term performance-related incentives	90
4.7.2	Driver 12: Transparent and independent control of the remunerations committee.....	90
4.8	Market for Corporate Control.....	91
4.8.1	Driver 13: An active market for corporate control.....	91
4.8.2	Driver 14: Transparency and protection for shareholders and stakeholders during mergers and acquisitions.....	92
4.8.3	Driver 15: Board power regarding takeover bids, subject to shareholder veto.....	92
4.9	Stakeholders.....	93
4.9.1	Driver 16: Stakeholder involvement within corporate governance	93
4.9.2	Driver 17: Voice mechanisms for debt holders.....	94
4.9.3	Driver 18: Employee participation in financial outcomes and collective voice in decision-making	94
4.10	Corporate Governance Drivers: Complementarities, Contingencies and Costs.....	95
4.10.1	Complementarity and substitution among corporate governance drivers.....	95
4.10.2	Contingencies related to ‘good’ corporate governance drivers.....	97
4.10.3	Costs related to ‘good’ corporate governance drivers.....	98
5	Focus Group Analysis	100

5.1	Introduction	100
5.2	Aims and Objectives of the Focus Group.....	100
5.3	Participants and Groupings.....	100
5.4	Focus Group Discussions	101
5.4.1	Focus Group 1. Boards, auditing and internal controls, executive pay.....	101
5.4.2	Focus Group 2. Shareholder activism and the market for corporate control .	103
5.4.3	Focus Group 3. Information disclosure, stakeholders.....	107
5.5	Summary of Focus Group Discussions	109
6	The UK Regulatory Framework: Gap Analyses	110
6.1	Introduction	110
6.2	Background.....	110
6.3	An Analysis of Regulatory Gaps	112
6.3.1	Corporate boards	113
6.3.2	Shareholder engagement	119
6.3.3	Information and disclosure.....	125
6.3.4	Audit and internal controls.....	129
6.3.5	Executive pay	137
6.3.6	Market for corporate control	141
6.3.7	Stakeholders	148
6.4	Conclusions	154
7	Implications for Public Policy and Future Research	156
7.1	Introduction	156
7.2	Potential Regulatory Gaps	157
7.3	Regulatory Trade-offs.....	160
7.4	Balancing Different Corporate Governance Demands	161
7.5	Implications for Specific Areas of Public Policy	163
7.5.1	Corporate boards	163
7.5.2	Shareholder engagement	164
7.5.3	Information and disclosure.....	164
7.5.4	Audit and internal controls.....	165
7.5.5	Executive pay	165
7.5.6	Market for corporate control	166
7.5.7	Stakeholders	166
7.5.8	Summary	166
7.6	Future Social Science Research.....	167
7.6.1	Implications for research on corporate governance	167
7.6.2	Boards	169
7.6.3	Shareholder engagement	169
7.6.4	Information and disclosure.....	170
7.6.5	Audit and internal controls.....	171
7.6.6	Executive pay	171
7.6.7	Market for corporate control	172
7.6.8	Stakeholders	173
7.7	Conclusions	173
8	Conclusion.....	175
	Appendix I: Experts' Survey Questionnaire	178
	Appendix II: Participants in the Focus Group.....	191
	Bibliography	192

1 Introduction

1.1 Background

The scandals at Enron, WorldCom and Parmalat have placed the corporate governance systems of modern corporations under close scrutiny. Lapses in the personal and professional integrity of accounting firms and their corporate clients have led to some undermining of confidence in capital markets and to substantial erosion of trust in institutions of modern capitalism. As a result, investors and regulators are forcing companies to improve disclosure policies, to rethink their relationships with auditors, and to strengthen corporate boards as part of a wide ranging reform of corporate governance. The aim of the corporate governance regulatory initiatives in the UK and elsewhere is to promote and deliver an effective framework for corporate activity, giving confidence to investors, business and other stakeholders. Such a framework encompasses the internal structures of the company that result in more effective management, as well as external relationships between a company and its stakeholders.

Corporate governance regulation is designed to ensure an effective framework exists to underpin the relationship between an organisation and those who hold future financial claims against that organisation. Holders of such claims may include shareholders, commercial lenders and other stakeholders all of whom are important from a public policy perspective. All of these groups (sometimes referred to as principals) rely on the good stewardship of executives and managers (often referred to as agents) in the organisation to meet these claims when they arise. Therefore, it is important that there is a close alignment between managerial objectives and those of principals, and that stakeholders can obtain timely and verifiable information (both financial and non financial) regarding the organisation's past performance and future prospects. Moreover, investors and key stakeholders should be made aware of the potential risks facing the organisation and the policies in place to mitigate them. When these conditions are met capital markets may operate more effectively, scarce human and financial capital may be allocated more efficiently, and company stakeholders are likely to be treated more fairly and equitably, as well as more effectively exercise their responsibilities.

Social scientists have produced a wide body of research that addresses various aspects of corporate governance and their effects on organisational outcomes in individual countries and within an international perspective. This research shows that corporate governance often involves a number of market failures, which can result in a less than optimal outcome for both principals and agents. Information is often asymmetric or imperfect. It is impossible to write contracts accounting for all potential uncertainties and differing incentives can result in the objectives of principals and agents being misaligned. Public policy responses are therefore geared towards mitigating these 'market failures' and ensuring that moves towards 'good' governance are made. These responses, however, need to be informed by well grounded research. This report addresses these issues by considering general social sciences research on the "good" governance principles and how recent policy initiatives correspond to these principles.

1.2 The Role of Public Policy

In order to improve corporate governance practices and the efficiency of corporate governance mechanisms, a number of initiatives have been developed in recent years to enhance the transparency and quality of corporate financial and non-financial disclosure, to increase levels of shareholder engagement, to improve the effectiveness and accountability of boardrooms, and to foster a long-term investment culture.

In the UK, the major policy developments began in the late 1980s and early 1990s as a result of a number of corporate scandals such as Polly Peck and Maxwell. The presence of financial reporting irregularities led to the establishment of the 'Financial Aspects of Corporate Governance Committee' led by Sir Adrian Cadbury. The resulting **Cadbury Report**, published in 1992, developed a set of principles of good corporate governance, which were enshrined in a code of best practice which, in turn, was incorporated into the Listing Rules of the London Stock Exchange.

Since then a number of reports have built on the work of Cadbury and have updated and enhanced the original recommendations. In 1994 the **Rutteman Report** on Internal Control and Financial Reporting was published. The **Greenbury Report** followed in 1995, responding to concerns over directors' pay. In January 1996 the Hampel Committee was established to review the extent to which the objectives of the Cadbury and Greenbury Reports were being achieved. The resulting **Hampel Report** led to the publication, in 1998, of the **Combined Code of Corporate Governance**, which applied to all listed companies. It introduced the principle of 'comply or explain'. Companies had to produce a narrative statement, detailing the extent of their application of the Code, together with an explanation if they had not applied its principles.

Since the publication of the Combined Code, the content and implementation around these codes have been reflected upon, supplemented and revised in a nearly continuous process of review. Regarding internal controls, the **Turnbull Committee** was established in 1998 to develop guidance for companies regarding these provisions and published the **Turnbull Guidance**, 'Internal Control: Guidance for Directors on the Combined Code' in 1999. The Financial Reporting Council undertook a subsequent review of the Turnbull guidance on internal control and published revised guidance in October 2005. Regarding shareholder engagement, in 2001 the **Myners Review** considered the relationship between institutional shareholders and companies and made a number of recommendations concerning communication between the two parties and the role of investors as responsible owners. Regarding boards and directors, in 2002 the **Directors' Remuneration Report Regulations** were introduced following further concerns over the increasing levels of directors' pay. In addition, in 2003, the **Tyson Report** on the recruitment and development of non-executive directors was published. Finally, in December 2004, the DTI launched **Building Better Boards**. This is a set of guiding principles, building on the **Higgs** and **Tyson** reports, designed to assist companies in developing more diverse and effective boardrooms.

In 2002, the DTI and HM Treasury launched a review of the Combined Code. The result was the **Higgs Report** on 'The Role and Effectiveness of Non-Executive Directors', which was published in January 2003. Around the same time, the Financial Reporting Council published the **Smith Report** entitled 'Guidance on Audit Committees'. The recommendations from both of these reports led to amendments to the **Combined Code of Corporate Governance**, which was published in July 2003. Following a review of the implementation of the Combined

Code in 2005, the FRC consulted on a small number of changes to the Code that were incorporated in an updated version of the Code published in June 2006.

Parallel to this rapid development of codes, in March 1998, the DTI launched a long-term fundamental review of core company law. This review, the Company Law Review, was led by an independent Steering Group whose aim was to develop a simple, modern, efficient and cost effective framework for carrying out business activity in Britain for the twenty-first century. The CLR presented its Final Report in July 2001, and a full statement of its proposals in the White Paper of 17 March 2005. The proposed reforms rest on four key objectives:

- Enhancing shareholder engagement and a long-term investment culture;
- Ensuring better regulation and a Think Small First approach;
- Making it easier to set up and run a company; and
- Providing flexibility for the future.

The Bill was introduced in 2005 and at the time of writing is nearing its final stages and about to be passed into law.

There is a clear need to evaluate the effectiveness of these policy initiatives in terms of their success in influencing the key drivers of good corporate governance. The results of the monitoring and evaluation will also inform the development of future policy.

1.3 Report Objectives

This Report reflects an effort to summarise various research advances with regard to corporate governance within a broader social sciences perspective, and create additional understanding around current and future policy options. The report draws upon a broad and integrated perspective of corporate governance issues in order to increase the social science evidence base upon which public policy is made. This evidence base will serve as a benchmark to examine whether and how key drivers of ‘good’ corporate governance are addressed within recent public policy initiatives, as well as evaluate the extent to which those policies successfully support the drivers of good corporate governance. On this basis, the report outlines potential areas where the government may consider whether measures are necessary to close gaps in existing regulation, and better understand the strengths and deficiencies in the implementation and enforcement of existing regulatory frameworks. The focus of these discussions is largely centred on listed UK companies and does not attempt to address other important corporate governance issues specific to non-listed or other types of firms.

Specifically, the objectives of the Report are to undertake a detailed review of the social science literature on corporate governance, to identify key ‘drivers’ or mechanisms that are seen as promoting ‘good’ corporate governance, and to map and evaluate UK policy initiatives with reference to these drivers. The main research questions are as follows:

- To what extent can we usefully talk about *good* corporate governance?
- Does the existing corporate governance literature enable us to determine the key *determinants* or ‘drivers’ of *good* corporate governance?
- How closely have the public policy initiatives in the UK, introduced since the early 1990s, corresponded to these determinants of good corporate governance?

- Are there clear areas where either public policy initiatives, or the manner of their implementation, do not adequately support the drivers of good corporate governance?
- Following on this, is it possible to identify broad areas in which new policy initiatives should be developed or in which alternative methods of implementing existing policies should be considered?

1.4 Research Design and Methodology

1.4.1 Theoretical underpinnings of ‘good’ corporate governance

Understanding the determinants of ‘good’ governance and their implications for regulation in the UK requires an analysis which integrates different aspects of corporate governance into a broader perspective, in turn firmly rooted in the theory and evidence coming from various streams of the social sciences, including economics, finance, law, political science, sociology, and management studies.

Perhaps not surprisingly, no universally accepted consensus exists as to what ‘good’ corporate governance means. The economics and finance literature is focused on the problems of agency relations between shareholders and managers which result from the separation of ownership and control, particularly in large corporations. Grounded in agency theory, the overwhelming emphasis of this research has been on the efficacy of the various mechanisms available to protect shareholders from the self-serving behaviour of executives (Shleifer and Vishny 1997). The stakeholder literature is often set up in terms of differing perspectives. A broad contrast is made between shareholder and stakeholder orientations: the former is said to see the firm in terms of relations between shareholder principals and managerial agents and the maximisation of shareholder value; the latter sees the enterprise in terms of broader relations between all stakeholders with an interest in the firm and a broader set of goals to be maximised or satisfied (Freeman 1984; Donaldson 1989; Donaldson and Preston 1995). Attempting to reconcile the two, Some writers talk about ‘enlightened shareholder value’ or ‘instrumental stakeholder theory’ or ‘strategic corporate social responsibility’ or ‘the good firm’ (Parkinson 1995; Jones 1995; Kay and Silberston 1995).

While this debate between shareholder and stakeholder perspectives cannot be resolved here, both perspectives share some common prescription in promoting basic accountability of executive directors for how they use company assets – in short, the corporate governance problem relates to how to assure that managers remain both honest and dynamic over time (Dore 2005). Consequently, a broad and less normative definition of corporate governance would include “structure of rights and responsibilities among the parties with a stake in the firm” (Aoki 2001a). Any notion of ‘good’ corporate governance certainly implies mechanisms to ensure executives respect the rights and interests of company stakeholders, as well as ensuring that stakeholders act responsibly with regard to the wealth invested in and generated by the enterprise. This definition may also imply significant public interest elements regarding corporate governance that legitimate, but also regulate, the purposes for which managerial power over the corporation may be legitimately exercised (Parkinson 1993).

In this Report, the analysis of ‘good’ corporate governance is undertaken within a broad social sciences perspective. Within this perspective, the notion of ‘good’ corporate governance is seen as involving both the minimisation of downside risks to shareholders or

other stakeholders, as well as enabling management to engage in entrepreneurial activities which may benefit those shareholders or stakeholders through the upside potential of firms' wealth creation (Keasey et al. 1997). This distinction has been referred to as the wealth-creating and wealth-protecting sides of corporate governance (Page 2005; Filatotchev and Wright 2005). Therefore, our research attempts to extend our understanding of 'good' corporate governance issues beyond the narrow confines of an economics and finance perspective, and embraces issues of corporate strategy, knowledge, and innovation.

1.4.2 Identifying issues from a social science perspective

This Report approaches corporate governance in terms of understanding its multiple dimensions, including the economic, strategic, social, and legal factors associated with different mechanisms of corporate governance. While corporate governance operates at the firm-level, its effectiveness also has social prerequisites. The Report therefore draws upon a broad interdisciplinary social science literature in order to identify potential determinants or drivers of 'good' corporate governance that are relevant in the UK setting. This perspective also suggests examining the effectiveness of corporate governance drivers in a holistic fashion that takes account of the costs of corporate governance, the various organizational contingencies in applying corporate governance in different environments, and the complementarities or substitution among different corporate governance drivers. Finally, gaps in public policy may be identified by comparing regulatory initiatives with these key drivers of 'good' corporate governance. Where these drivers are addressed by regulation, the Report evaluates to what extent those initiatives are effective in the light of regulatory trade-offs and the need to balance different corporate governance demands. In sum, the Report focuses on a number of key issues informed by a broad social science perspective.

Concerning potential determinants of 'good' corporate governance:

- *Understanding of the economic and strategic effects of corporate boards.* This includes analysis of monitoring, resource, and strategy roles of independent directors and board committees. From the knowledge-based view of the firm, the cognitive capabilities of boards for the accumulation and processing of relevant information are critically important, especially for the growing number of firms from knowledge-intensive sectors.
- *Understanding key factors underpinning shareholder activism.* With the increasing concentration of ownership among institutional investors, shareholders are becoming more pro-active in terms of their influence upon the strategic decisions that drive the firm's dynamics. However, the current system of voting shares and policies of fund managers suggest continued deficits in terms of fulfilling fiduciary responsibilities and effectively communicating their views to management by recording their policy position. Research also suggests important differences in the role and interests of large block holders and smaller, portfolio-oriented investors. Ownership concentration may be a potential substitute for other governance mechanisms, but, in turn, it raises separate issues of minority shareholder rights, as well as transitions from and to concentrated ownership structures.
- *Analysis of the optimal extent of information disclosure.* Substantial information asymmetries exist between managers and shareholders, executive and non-executive board members, and managers and employees. Bearing this in mind, an efficient system of reporting and disclosure forms a cornerstone of 'good' governance. However,

disclosing too much of proprietary information may harm the firm's competitive advantage and reporting also involves substantial fixed costs. Comprehensive research on effective and efficient disclosure practices is a central task from the policy-making perspective.

- *Discussion of the relationships between the firm and external governance constituencies*, such as the firm's auditors and advisors. An independent auditor that scrutinises financial and strategic information and documents developed by the executive team represents a powerful driver of good corporate governance. A longer-term involvement in non-audit transactions may provide the auditor with in-depth knowledge and information about the firm that may enhance their monitoring capacities. An in-depth analysis of monitoring and strategic roles of the auditor may provide a valuable input into the policy process.
- *Understanding of links between general corporate governance factors and the organisation's control systems*, such as financial controls, risk management, etc. Research shows that 'good' governance is not solely based on board routines and auditor's vigilance. These governance factors need to be integrated with internal organisational rules and procedures, and this "seamless" integration requires an appropriate model of functional links and information flows.
- *Analysis of executive compensation as an incentive mechanism that aligns interests of managers and shareholders*. Performance-related pay should complement monitoring functions of corporate governance, in particular in complex, diversified organisations where information asymmetries and potential for shareholder abuse are at their highest levels. However, executive equity-based compensation schemes can also lead to short-termism and an increase in managerial opportunism. When internal control systems fail to prevent cases of "reward-for-failure", a regulatory approach may need to be informed by evidence from 'good' governance research.
- *Understanding of the market for corporate control*. Takeovers constitute an important mechanism for replacing inefficient management or executing important business restructuring. However, markets for corporate control may also lead to opportunistic behaviour and "breach of trust" through asset stripping and the elimination of healthy competitors. The resource-based view of firm capabilities suggests the importance to balance regulatory "level playing fields" with protection of firm-specific assets.
- *Analysis of how 'good' corporate governance drivers operate within a broader stakeholder framework*. Participation of stakeholders such as employees should complement internal monitoring and control functions in promoting greater managerial accountability, as well as enhance the effective implementation of decisions. Both international and UK evidence suggests that stakeholder participation is particularly salient in promoting organisational effectiveness in the context of firm-specific knowledge and information sharing.

Concerning the effectiveness of 'good' corporate governance drivers:

- *Understand potential costs of corporate governance and their organisational effects*. Corporate governance regulation may lead to an increase in direct and indirect costs of compliance with 'good' governance principles, including the out-of-pocket compliance costs that are reflected in the firm's balance sheet and other accounting documentation (e.g., the audit costs, directors' insurance, etc.) and less explicit opportunity and strategic costs (e.g., directors' time spent on governance issues, costs of strategic disclosure, etc.).

- *Understanding contingency factors that affect benefits and costs of ‘good’ corporate governance drivers.* Agency problems and associated corporate governance remedies may have different characteristics in young and mature companies, in fast growing as opposed to declining organisations, in regulated and competitive industries, etc. ‘good’ corporate governance is an essentially dynamic phenomenon, and it is essential to understand the life cycle of corporate governance when making decisions on the implementation aspects of governance regulation.
- *Identifying possible complementarities/substitution between different corporate governance ‘drivers’.* Since ‘good’ corporate governance comes at a cost, organisations should be able to create an optimal “bundle” of governance drivers that should match organisational resources and its strategic objectives.

Concerning the role of public policy in promoting ‘good’ corporate governance drivers:

- *Understanding regulatory trade-offs.* Public policy faces choices between mandatory regulation (e.g. uniform requirements), enabling regulation (e.g. removing past restrictions, allowing choice of structures), or more flexible forms of soft-law such as codes based on comply-or-explain principles, self-regulatory norms of professional groups and voluntarism. Mandatory regulation can help to overcome market failures and weak diffusion of governance practices, but may be inflexible in addressing the governance needs of different types of firms. Meanwhile, soft-law approaches may be less effective in terms of enforcement.
- *Balancing different governance demands.* Given the affinities between corporate governance, firm’s lifecycles (e.g. start-up promotion, mature firms, and restructuring or wind-up) and important stakeholders, analysis is needed of how these different governance needs can be implemented within the UK regulatory framework.
- *Tensions between national and international regulation.* UK companies and government policy are increasingly affected by regulatory developments outside the UK, such as Sarbanes-Oxley, international accounting standards, or EU directives. While the formulation of common international standards may be important in some regulatory areas, such initiatives need to be integrated into existing national regulatory frameworks in ways that complement existing approaches and incentives. Public policy analysis must therefore not only identify gaps in the UK law, but also understand the extent of overlap with or differences in the approaches taken by various international initiatives.

1.4.3 Research Methodology

The research involved three stages: 1) literature review and the determinants of good corporate governance concepts; 2) analysis of UK public policy measures related to corporate governance; and 3) identification of potential gaps in the content or effective implementation of these policy measures.

The main objectives of the literature review stage were as follows: 1) to review corporate governance literature drawing on a broad range of social sciences; 2) to understand to what extent a ‘good’ corporate governance framework suggested by the literature can be usefully deployed in the UK context; and 3) to identify the main drivers of ‘good’ corporate governance in the UK context and to consider how these can be translated into policy evaluation benchmarks. The review was based on an extensive research of relevant social science literature, including academic journals, books, and web-based sources. On the basis of

this review, it was possible to identify drivers of ‘good’ corporate governance and to develop a number of policy evaluation benchmarks. To verify the appropriateness of these benchmarks, the researchers conducted a web-based survey of leading experts in the corporate governance field. This methodology provided a cost-effective and timely access to a pool of expertise both in the UK and abroad. A special website was created and a web link to a structured questionnaire was sent by e-mail to a network of experts. This allowed the researchers to bring an element of objectivity into the process of identifying corporate governance drivers and associated policy evaluation benchmarks.

The objectives of the public policy analysis was to identify the main components of corporate governance regulation in the UK, with a particular emphasis on the regulatory initiatives that underpinned the amended Combined Code and changes in Company Law with regard to information disclosure and boardroom reforms. The researchers undertook a review of the regulatory initiatives starting from the publication of Cadbury Report in 1992, using diverse sources such as government publications, the DTI website, etc. In addition, a number of EU regulations and the introduction of International Financial Reporting Standards may also have a profound impact on the governance regulation in the UK, and the researchers included relevant EU initiatives into their survey of corporate governance regulation. This stage of the analysis focused on how those policy initiatives relate to the determinants of ‘good’ corporate governance as identified in the earlier stages of the research.

The overarching objective of the final policy evaluation stage was to assess whether corporate governance regulation in the UK fully reflects the determinants of ‘good’ corporate governance suggested by the social science literature. The researchers identified current gaps in the regulation with regard to corporate governance benchmarks, as well as problems with implementation. This stage suggested strategic guidelines for future policy developments as well as outlining possible adjustments to the implementation methods.

The evaluation methodology included a Focus Group that involved representatives of business, the accounting profession, investor communities, and stakeholder groups. The objectives of the discussions were to help the researchers in the following respects: (1) to develop an in-depth understanding of organisational issues related to corporate governance regulatory processes; (2) to obtain feedback on the research framework and benchmarking methods that would allow them to refine research outcomes; and (3) to define more precisely the structure of gap analysis and metrics that were used in the evaluation.

The next step of the evaluation was the development of a gap analysis of regulatory initiatives versus ‘good’ corporate governance benchmarks. This analysis provided a mapping of policy initiatives against the identified drivers of ‘good’ corporate governance and an evaluation of these initiatives along two dimensions:

- Content Gaps: Are there ‘good’ governance drivers that are not adequately covered by the governance regulation?
- Efficiency Gaps: To what extent do outcomes of the regulatory initiatives meet their objectives?

This analysis of regulatory gaps was closely related to the issues around choices of regulation implementation methods. Even when regulatory initiatives reflect ‘good’ governance drivers, specific implementation problems may reduce anticipated outcomes. In this regard, the

researchers focused on efficiency and context aspects of the implementation, with a particular emphasis on the following questions:

- Does a specific policy initiative take into account direct and indirect costs of compliance with ‘good’ governance principles, including the out-of-pocket compliance costs that are reflected in the firm’s balance sheet and other accounting documentation (e.g., audit costs, directors’ insurance, etc.) and less explicit opportunity and strategic costs?
- Does the scope of regulation accommodate various firm- and industry-level contingency factors, such as differences in organisational size and age, resource base, stages in the firm’s life cycle (e.g., fast growth versus maturity and decline), etc?
- To what extent the regulation encourages stakeholders’ involvement that should complement internal monitoring and control functions in promoting greater managerial accountability, as well as enhance the effective implementation of decisions?

The gap and implementation analyses helped to identify areas where additional policy developments may be needed or the methods of implementation may need to be changed.

This Report forms a fact base, which can be use to direct future corporate governance reform. It helps to identify and measure regulatory gaps, in terms of the aims, coverage, and implementation of corporate governance regulation. In particular, the report helps to understand the interrelationships between different elements of corporate governance and their regulation and hopefully offer a useful evaluation of UK corporate governance. The project also helps to identify a series of priority actions required to execute effective and efficient corporate governance regulation strategies.

2 Review of the Social Science Literature on Corporate Governance

2.1 Introduction

This section presents a detailed review of the social science literature on corporate governance. By way of introduction, a preliminary indication of the scope of our review is needed.

Seven key areas or ‘families’ of issues were identified for this review: board of directors, shareholder activism, information and disclosure, auditing and internal controls, executive pay, the market for corporate control, and stakeholder involvement. The review covers a broad base of social science literature drawing heavily on the fields of financial economics, strategy, management, and sociology, as well as law and political science. Our emphasis here is on the review of empirical research results, rather than conceptual and theoretical debates (although these are discussed briefly where appropriate). Furthermore, the review focuses on corporate governance at the level of the company and its direct relationship with key stakeholders. As such, it does not attempt to review the impact of different regulatory regimes and policies in the UK or otherwise.

The review of empirical literature draws heavily on UK studies, where possible. The review also inevitably draws on the large body of empirical research on U.S. corporate governance, but also provides brief comparisons with other European or other countries where these provide useful alternative benchmarks for ‘best practices’. Where possible, we also present the result of ‘meta-analysis’ that undertakes a secondary analysis of statistical data from a large number of studies in order to examine the robustness of research findings across different samples and contexts.

2.2 The Board of Directors

2.2.1 Introduction

Corporate governance research that examines the impact of board composition on critical decisions has predominantly adopted an agency theory rationale. Three fundamental behavioural assumptions about agents and principals underlie agency theory: Both agents and principals are assumed to be (a) rational and (b) self-interested, whereas the agent is assumed to be (c) more risk-averse than the principal (Jensen and Meckling 1976). It is therefore argued that in situations in which there is a conflict of interest between the agents and principals, the former are likely to select self-serving actions at the expense of the latter’s welfare (Fama 1980; Fama and Jensen 1983). This stream of research identifies situations in which shareholders’ and managers’ goals are likely to diverge and examines mechanisms that can mitigate managers’ self-serving behaviour (Shleifer and Vishny 1997).

Board monitoring has been centrally important in corporate governance research, with boards of directors described as “the apex of the internal control system” (Jensen 1993: 862). Boards represent an organisation’s owners and are responsible for ensuring that the organisation is

managed effectively. Thus, the board is responsible for adopting control mechanisms to ensure that management's behaviour and actions are consistent with the interests of the owners. Important control mechanisms are the selection, evaluation and if necessary removal of a poorly performing CEO and top management, the determination of managerial incentives and the monitoring and assessment of organisational performance (Johnson et al. 1993; Mizruchi 1983; Zahra and Pearce 1989). The main driver of these control mechanisms is the board's obligation to ensure that management operates in the interests of the company's shareholders – an obligation that is met by scrutiny, evaluation, and regulations of top management's actions by the board (Hillman and Dalziel 2003).

A review of corporate governance literature reveals that a conflict of goals between a firm's CEO and its shareholders typically revolves around three main underlying issues: CEO compensation, risk to the firm, and corporate control. CEOs have been criticized for benefiting themselves by receiving excessive compensation, which is often unrelated to the performance of the firm (Jensen and Murphy 1990). Furthermore, because risk averse CEOs, unlike shareholders, are unable to diversify their firms' non-systematic risk, they have been criticized for adopting risk-reduction strategies that are not optimal to shareholders (Amihud and Lev 1981). Finally, managers who isolate themselves from the disciplinary force of the market for corporate control and resist being replaced have embodied perhaps the costliest manifestation of self-serving behaviour (Jensen and Ruback 1983; Shleifer and Vishny 1989). Given that a board's governing role is oversight, it follows that board effectiveness will be manifested in the mitigation of self-serving behaviour by managers and improvement in performance.

Management research has suggested that boards can extend their involvement beyond monitoring and controlling top management to the provision of ongoing advice and counsel to executive directors on strategic issues (Johnson et al. 1996; Westphal 1999; Zahra and Pearce 1989). Advice and counsel from non-executive directors can broaden the range of strategic options considered by management and help management to identify new strategic opportunities (Judge and Zeithaml 1992; Pfeffer and Salancik 1978). Strategy researchers indicate that a board of directors may also play an important role in establishing relationships between the organisation and its external environment. Resource dependence theory proposes that organisations are dependent upon resources in the environment for their survival and views directors as instruments, which organisations can use to deal with external dependencies (Dalton et al. 1999; Hillman and Dalziel 2003; Pfeffer and Salancik 1978). Directors, in this view, help to secure valuable information and resources and provide access to key constituents (Hillman et al. 2000). Again, these roles of boards in regarding to service, strategy and resources should lead to an improvement in the firm's competitiveness and performance. Moreover, despite the focus on shareholder interests and the board, outside of the U.S. or UK, it should be noted that board composition often involves a wider spectrum of stakeholders and, more specifically, includes employee representatives in Scandinavian countries, Germany, Austria, and the Netherlands (Jackson 2005a). Here board behaviour may substantially depart from the agency theory perspective to consider the governance of a wider range of managerial objectives.

The review of existing research on the governance roles of the board in the broader social sciences field has focused on three main themes: the effects of board composition and structural parameters on business strategy and performance; relationships between board characteristics, such as diversity, external ties, etc. on the firm's competitiveness and performance; and links between board processes and organisational outcomes.

2.2.2 Board composition and performance

2.2.2.1 Board independence

An important stream of research in the financial economics and management fields is focused on organisational outcomes of board composition and structural characteristics. The extent of board independence is often considered as an important driver of ‘good’ corporate governance. This focus on board independence is grounded in agency theory, which addresses inefficiencies that arise from the separation of ownership and control (Fama 1980; Fama and Jensen 1983; Jensen and Meckling 1976). From the agency theory perspective, boards of directors (and particularly independent or outside members) are put in place to monitor managers on behalf of shareholders (Lynall et al. 2003). The board of directors has the formal authority to ratify management initiatives, to evaluate managerial performance and to allocate rewards and penalties to management on the basis of criteria that reflect shareholders’ interests. Consistent with agency theory, a board comprised of independent directors (e.g., board members who are not dependent on the current CEO or organisation) is more likely to provide an effective oversight of the firm’s CEO and other executive directors. Independent directors are generally believed to be more effective in protecting shareholders’ interests, resulting in higher firm performance (Baysinger and Butler 1985; Baysinger and Hoskisson 1990). In some countries, the distinction between supervisory and managerial roles within the board is formally codified into a two-tier board structure (Donnelly et al. 2000). Similarly, legal scholars emphasize the fiduciary responsibilities of directors to ensure that managers are acting in the interests of shareholders (Bhagat and Black 1999; Mace 1971).

An extensive literature has examined the relationship between the composition of the board of directors and different proxies for corporate performance. Four main approaches to measuring board composition have been identified: inside, outside, affiliated, interdependent/independent directors (Anderseen and Reeb 2004; Daily et al. 1997; Daily et al. 2003; Hermalin and Weisbach 1991; 2003; Lynall et al. 2003). Most of the studies on board composition effects classify directors either as insiders (current and retired firm employees and their family members) and outsiders (non-employees). Outside directors are often further divided into those with existing or potential business ties to the firm (affiliated directors) and those members for whom directorships are their only tie to the firm (independent directors). Daily et al. (2003) makes further differentiation within the independent director group by considering the timing of outside director’s appointment to the board. Directors appointed during the tenure of current CEOs (“interdependent directors”) may feel beholden to them and may be less likely to challenge them. The remaining group (“independent directors”) may be best able to fulfil the control role since they are not encumbered by personal and/or professional relationships with firm management. A number of authors point out that independent directors on a firm’s board are very often executive directors in other companies. There is evidence that better managers are preferred as independent directors because they will be better monitors of managerial discretion (Fama 1980; Fama and Jensen 1983; Mace 1971; Kaplan and Reishus 1990; O’Sullivan 2000).

A substantial number of empirical studies try to verify whether independent directors perform their governance functions effectively by linking board structure with performance. Baysinger and Butler (1985) found that firms with more outside board members realised higher return on equity. Rosenstain and Wyatt (1990) examine a stock price reaction on the day of the announcement that outside director will be added to the board. They find that there is a statistically significant 0.2 percent increase in stock prices in response to the announcement of

these appointments. In their analysis of family controlled firms in the USA, Anderson and Reeb (2004) provide evidence that when the divergence of interests between family- and outside-shareholder interests becomes large and costly, independent directors can intervene to protect the interests of all shareholders. Using a sample of the Standard & Poor's 500 firms they show that the proportion of independent directors on a family-controlled firm's board is positively associated with performance measured by Tobin's Q, whereas the affiliated directors provide a negative impact on performance. Several other researchers have also noted a positive relationship between outside directors' representation and firm performance (Barnhart and Rosenstein 1998; Chaganti et al. 1985; Pearce and Zahra 1991).

However, a number of studies find negative relationship between board independence and firm performance (Baysinger et al. 1991; Davis et al. 1997; Kesner 1987). Some researchers have suggested that the amount and quality of inside directors' information may create benefits associated with the inside directors' majority and may lead to more effective evaluation of top managers (Baysinger and Hoskisson 1990, Hill and Snell 1988, Hoskisson et al. 1994). Finally, Hermalin and Weisbach (1998; 2003) suggest that board composition is an endogenous outcome of the firm's operating and strategic decisions and past performance. Hence, there should not be any causal effect of board composition on performance.

Some authors tried to verify the relationship between board independence and performance using meta-analytical methodology (Dalton et al. 1998; Dalton et al. 1999; Rhoades et al. 2000). Meta-analysis is a statistical research synthesis technique that allows for the aggregation of results across separate studies to obtain an estimate of the relationship between two variables in the population (Hunter and Schmidt 1990). Therefore, these methods can contribute to a broader and more robust understanding of governance effects that is less dependent on the specific data and methods used in individual studies. Dalton et al. (1998), for example, used 54 empirical studies of board composition and financial performance, and did not identify any significant effects of board composition on performance. This conclusion holds across the many ways in which financial performance has been measured in the literature. The results of other meta-analyses (e.g., Dalton et al. 1999; Rhoades et al. 2000) are inconclusive.

2.2.2.2 Separate CEO and Chairman

A number of papers analyse another important proxy for the board power: CEO duality (whether the CEO concurrently serves as board chairperson). Many researchers believe that the dual board leadership structure seriously compromises the independence of the board. The tenets of agency theory would suggest that such centralised leadership authority will lead to management domination of the board and result in poor performance (Fama 1980; Fama and Jensen 1983; Lorsh and MacIver 1989; Molz 1988; Shleifer and Vishny 1997). While there is a relatively small body of empirical research examining board leadership structure, neither the joint nor separate board leadership structures has been strongly supported as enhancing firm financial performance (Daily and Dalton 1992; 1994; Beatty and Zajac 1994; Boyd 1994; Ocasio 1994). In their meta-analysis of 31 studies of links between board leadership and financial performance, Dalton et al. (1998) do not establish any significant causal relationships. Again, their data provide no evidence that the board leadership structure – firm performance relationship is moderated by the nature of the performance indices.

2.2.2.3 Board committees

A relatively small number of academic papers analyse how independent directors can impose structural constraints on managers by limiting their participation in important board subcommittees, such as the audit committee, nominating committee and compensation

committee (Anderson and Reeb 2004; Golden and Zajac 2001; Lorsh and MacIver 1989; Wesphal and Zajac 1995). Daily (1995), Kesner (1987) and Dalton et al. (1998) explain that many of the critical processes and decisions of boards of directors do not derive from the board-at-large, but rather in its subcommittees. Daily (1995) finds that greater proportions of affiliated directors on the audit committee have impact on the structure and length of bankruptcy procedures. Tosi and Gomez-Mejia (1997) report that CEO compensation was related to the composition of the compensation committee. Shivdasani and Yermack (1999) examine the extent to which the CEO is involved in the board selection process. They find that the CEO's involvement in nomination committee decreases the firm's subsequent number of independent directors. Aguilera (2005) suggests that staggered (or classified) boards that make only a fraction of board members eligible for re-election each year reduce accountability of board members to shareholders. However, no empirical research that addresses the relationship between subcommittee composition and its impact on firm financial performance has been identified as conclusive (Dalton et al. 1998).

2.2.3 Board composition and strategic decisions

Another stream of research suggests that, rather than examining a board's monitoring effectiveness by using the firm's financial performance as a proxy, a more accurate evaluation can be gained by examining discrete decisions that involve a potential conflict of interest between management and shareholders (e.g., Deutsch 2005; Mallette and Fowler 1992; Sundaramurthy 1996). Such decisions will be referred to as "critical decisions." The rationale behind this line of inquiry is that whereas board monitoring has a direct effect on firms' critical decisions, it has only an indirect effect on firm performance. Moreover, a company's financial performance is influenced by a multitude of endogenous and exogenous factors beyond the composition of its board (Kosnik 1987; Bhagat and Black 1999).

2.2.3.1 CEO turnover

A central task of effectively functioning boards is the removal of poorly performing executives. Boards with greater structural independence may be more able to remove ineffective executives prior to a crisis reaching the point of corporate bankruptcy. This action may prove critical in reversing a financial decline, since deficiencies within the top management team may be related to firm failure. A substantial number of studies are focused on board structure effects on the probability of the CEO turnover (Alexander et al. 1993; Boeker 1992; Daily 1995; Diacon and O'Sullivan 1995); Fazel and Louie 1990; Judge and Dobbins 1995; Mangel and Singh 1993; Sanders and Carpenter; 1998; Weisbach 1988; Young et al. 2000). In his meta-analysis of board independence effects on strategic decisions, Deutsh (2005) uses 16 different studies to support the assumption that more independent boards are associated with a higher probability of the CEO turnover.

2.2.3.2 Executive compensation

Another stream of research links board structure with executive compensation. Although it is often argued that a high level of total compensation enables firms to attract and retain high-quality CEOs, the elevated levels of remuneration awarded to CEOs of publicly traded corporations is often criticized (Deutsh 2005) suggesting that a number of firms systematically overpay their executives and that these firms could have secured the service of the same CEO at substantially lower costs to shareholders. Because CEOs prefer the highest compensation level possible, vigilant board monitoring is expected to result in lower levels of CEO compensation. A number of authors analyse the effects of board independence on the level of CEOs

compensation (Boyd 1994; Conyon and Peck; 1998; Fazel and Louie 1990; Mangel and Singh 1993; Sanders and Carpenter; 1998). However, no systematic relationship was found between the two variables.

2.2.3.3 Independent directors and strategic restructuring

Prior strategy research has indicated that independent directors are involved in strategic change, restructuring, and corporate entrepreneurship (Johnson et al. 1993; Pearce and Zahra 1992; Hoskisson et al. 2002; Tihanyi et al. 2003). Gibbs (1993) in a study of strategic restructuring in large U.S. firms provides evidence that board independence is positively associated with re-focusing strategies and an increase in financial leverage that reduces the firm's free cash flow. Goodstain and Boeker (1991) in their study of 327 hospitals in the USA provide evidence that independent boards are positively associated with strategic restructuring measured in terms of changes in the breadth of products and services an organisation offers.

However, more recent studies suggest that board structure may have a selective effect on different types of strategies. For example, a number of studies associate board independence with diversification and M&A strategies (Baysinger et al. 1991; Beekun et al. 1998; Hill and Snell 1988; Hoskisson et al. 1994; Johnson et al. 1993; Judge and Zeithaml 1992; Pearce and Zahra; 1992; Sanders and Carpenter 1998; Hoskisson et al. 2002; Tihanyi et al. 2003; Zajac and Westphal 1994). Studies of R&D expenditure suggest that innovation intensity, on the other hand, is positively associated with insider-dominated boards (Barnhart and Rosenstein 1998; Baysinger et al. 1991). Baysinger and Hoskisson (1990) suggest that the superiority and quality of inside directors' information combined with their specific risk preferences may explain these differential effects of board structure on various types of business strategies.

2.2.3.4 Anti-takeover defences

Both financial economists and strategy researchers investigate the effects of board independence on the adoption of the anti-takeover defences. Takeover defences are adopted to deter hostile takeovers. Indeed, Pound (1987) found that takeover defences decrease the likelihood of takeover attempts by 26 percent. Whereas CEOs favour takeover defences because they protect their positions and provide greater freedom from the disciplining influence of the market for corporate control, it has been argued that takeover defences have negative effects on shareholders' wealth (Mallette and Fowler 1992). For example, research indicates that poison pills, a common takeover defence, have a significant negative effect on a firm's stock price.

Furthermore, stock prices typically decline following court decisions that validate poison pills and rise after court decisions that invalidate them. This negative wealth effect may stem from the fact that firms that adopt a poison pill are less likely to be targets of acquisition. Shivdasani (1993) suggest that board independence affects takeover probabilities by influencing both the quality of the company's management and the process of takeover. However, other empirical studies by Buchholtz and Ribbens (1994), Coles and Hesterly (2000) and Mallette and Fowler (1992) provide ambiguous results.

2.2.4 Board characteristics, business strategy and performance

Although agency theorists emphasize the core board's function as a monitoring and control mechanism, there is growing recognition in management research and an upper echelon perspective (e.g., Carpenter and Westphal 2001; Daily and Dalton 1992; Geletkanycz and Hambrick 1997) that board directors also constitute a critical organisational resource. Rooted in

behavioural and socio-economic research, stewardship theory holds a less self-centred view of managerial behaviour than do agency theorists. The stewardship framework suggests that whereas managers are expected to adopt self-serving behaviour as a response to highly threatening situations, they tend to serve the good of the organisation in situations where only relatively minor conflicts of interests exist (Anderson and Reeb 2002; Davis et al. 1997; Deutsch 2005). Acting as stewards, executive directors may collaborate with independent board members who provide industry specific expertise, objective advice and act as advocates for corporate health and viability.

More recent resource-dependence, behavioural and socio-cognitive views on corporate boards have extended agency research by suggesting that pro-active behaviour by non-executive directors depends not only on the extent of board independence, but also on the strategic perspective and base of experience they bring to the organisation (Carpenter 2002; Carpenter and Westphal 2001; Carpenter et al. 2003; Beatty and Zajac 1994; Westphal and Zajac 1995; Westphal 1999; Golden and Zajac 2001). The resource-dependency view emphasizes that, in addition to control functions, the board may also play service and strategic roles in the decision-making process (Pfeffer 1972; Pfeffer and Salancik 1978; Provan 1980), especially at those points in the life cycle of the firm that involve strategic transition (McNulty and Pettigrew 1999). Pye (2001) suggests that in order to 'add value' to the board, non-executive directors are expected to bring a background of executive experience of running other firms. Previous studies identify four types of resources that are provided by boards: (1) advice and counsel; (2) legitimacy; (3) channels for communicating information between the firm and external organisations, and (4) assistance in obtaining resources or commitments from important stakeholders outside the firm (Hillman et al. 2000; Lynall et al. 2003).

Therefore, according to socio-cognitive and resource perspectives, outside board members' experience may not only improve their monitoring efficiency, but also substitute for a relative lack of executives' business experience/contacts (Carpenter et al. 2003; Beatty and Zajac 1994; Shivdasani and Yemack 1999). Within this research, structural board characteristics are not so important compared to factors associated with board's 'human' and 'social' capital, such as board size, demography characteristics and business links outside the focal firm (Carpenter and Westphal 2001). These characteristics underpin service, strategy and resource roles of boards and should lead to an improvement in the firm's competitiveness and performance.

2.2.4.1 Board size

Resource dependence theory has been the primary foundation for the perspective that larger boards will be associated with higher levels of firm performance (Dalton et al. 1999; Pfeffer 1972; Pfeffer and Salancik 1978; Provan 1980). In this view, board size may be a measure of an organisation's ability to form environmental links to secure critical resources. From the monitoring perspective, a number of authors suggest that larger boards are not as susceptible to managerial domination as their smaller counterparts (Zahra and Pearce 1989). Daily et al. (2002), and Daily and Dalton (1992; 1994) find positive effect of board size on financial performance in large samples of firms in the USA. Golden and Zajac (2001) find a non-linear (inverted U-shape) relationship between board size and strategic change. Using 27 board size-related studies in their meta-analysis, Dalton et al. (1999) find significant positive effect of board size on performance.

However, agency researchers are more sceptical about the effects of board size on the monitoring capacity of independent directors (Jensen 1993). When boards become too big, agency problems (such as director free-riding) increase within the board, and it becomes more

symbolic and less part of the management process (Hermalin and Weisbach 2003). Yermack (1996) reports that there is a significant negative relationship between board size and Tobin's Q. Judge and Zeithaml (1992) report that large boards are less likely to be involved in strategic decision, a finding also supported by Goodstain and Boeker (1991). Therefore, the organisational outcomes of board size remain an empirical issue.

2.2.4.2 *Board diversity*

Research on the service/expertise/counsel roles of the board emphasises that directors may provide a quality of support and advice to the CEO otherwise unavailable from other corporate staff (Dalton et al. 1998; 1999; Hillman and Dalziel 2003; Lorsh and MacIver 1989; Zahra and Pearce. 1989). The effectiveness of these support and service roles of the board, in turn, depends on the boards' cumulative human capital that is often linked to various board demography characteristics, such as tenure, professional diversity, etc. Boards that are composed of lawyers, financial representatives, top management of other firms, public affairs specialists, etc. may be more effective in terms of bringing important expertise, experience and skills to facilitate advice and counsel. This research emphasises that board structural characteristics (e.g., the proportion of independent directors, separate CEO and Chairperson) are less relevant compared to the quality of the board's cumulative human capital. A number of studies argue that board diversity in terms of directors' professional experiences should lead to more efficient service/expertise/counsel roles of the board and, as a result, to better performance (Carpenter 2002; Baysinger and Butler 1985; Baysinger and Hoskisson 1990; Kaplan and Reishus 1990; Wagner et al. 1998; Westphal 1999).

Another stream of research links board's human capital with a number of 'demographic' factors, such as directors' age and tenure, although empirical evidence linking these factors with performance outcomes is rather limited. Boeker (1992), Pfeffer (1983) and Finkelstein and Hambrick (1996) argue that greater tenure of board members is associated with greater rigidity, increased commitment to established practices and procedures, and increased insulation towards new ideas. However, Hambrick and Mason (1984) and Hambrick and D'Aveni (1992) suggest that longer tenure provides directors with much more comprehensive access to a richer stock of remembered information, relative to what novice can access. Golden and Zajac (2001) in their study of strategic change in U.S. hospital find a curvilinear relationship between the average tenure and strategic restructuring: as average board member tenure increases, its effect on strategic change is positive for boards with lower levels of tenure, and negative for boards with higher levels of tenure. Similarly, these authors present evidence of non-linear effect of directors' age on strategic change: as the average age of board members increases, its effect on strategic change is positive for younger boards, and negative for older boards. Generally, existing research considers board diversity and limits on board members' tenure and age as 'good' corporate governance drivers.

2.2.4.3 *Interlocking directorships*

A board's social/relational capital is another important factor essential for the provision of resources, advice and counsel. This factor is usually associated with external directorships and other extra-organisational "ties" held by the firm's directors. First, resource based research provides evidence that board interlocks are associated with effective capital acquisition (Filatotchev and Toms 2003; Mizruchi 1996; Mizruchi and Stearns 1994). Second, building cognitive capacity by "importing" knowledge from the outside becomes vital for a long-term survival of the firm (Carpenter 2002). This "import" may be facilitated by appointing non-executive directors who have served on the boards of other, well established firms, or who have important professional and social links that may be used strategically by the firm. The links that

non-executive directors have with the firm's environment can be used to obtain important information and strategic expertise (Golden and Zajac 2001; Pettigrew 1992; Westphal and Fredrickson 2001). Carpenter and Westphal (2001) and Westphal (1999) find that boards consisting of directors having ties to strategically related organisations were able to provide better advice and counsel, which is positively related to firm performance. Third, board social capital has been linked to the provision of firm legitimacy and reputation. Social network theory emphasizes the importance of network formation in terms of reputation, trust and mutual interdependence (Geletkanycz and Hambrick 1997; Lynall et al. 2003). Therefore, having directors with extensive extra-organisational ties may be an important factor associated with resource and service roles of boards.

Some authors, however, are cautious with regard to possible governance implications of board interlocks. A "class hegemony" perspective suggests that by inviting their friends from other companies to sit on the focal firm's board, executives re-enforce their power within the organisation (Mace 1971; Pettigrew and McNulty 1998; Useem 1984; 1993). Hermalin and Weisbach (2003), for example, provide evidence that CEO pay at a given company increases when the given company's board contains directors who are CEOs of firms on whose boards the CEO of the given company sits. In this context, previous research emphasises the importance of both the intensity of non-executive directors' external ties (for example, an average number of board "interlocks" held by a non-executive director) and their diversity, such as directors' membership in social and political elites, professional services organisations, etc., in addition to their board "interlocks" (Carpenter 2002; Daily et al. 1999; Filatotchev and Bishop 2002; Pettigrew 1992; Zahra and Pearce 1989). Certo (2003) and Certo et al. (2001) find that firms with prestigious and diverse boards experience better performance at their initial public offering (IPO). Filatotchev and Bishop (2002) draw similar conclusions in their study of IPOs in the UK. Higgins and Gulati (1999) suggest that board interlocks are particularly important for young, entrepreneurial firms that are in search of resources and legitimacy.

2.2.5 Board processes

Although there seems to be general agreement in the governance literature that boards deal with strategic issues, the extent of the board's involvement in strategic decision-making is disputed. Lorsch and McIver (1989) argued that the board's primary role is in advising and evaluating strategy, rather than in initiating strategy. Demb and Neubauer's (1992) research on boards of directors from a number of European countries found that 'setting strategic direction' was considered an important role of the board. However, overall they found a wide variety of views on how boards should be involved in strategy. At one end of the spectrum, the board was perceived as rather passive and uninvolved while at the other end the board was regarded as initiating, decisive and fully responsible for strategic decision-making.

A growing number of papers move away from research on the organisational outcomes of board structure and demographic characteristics to greater focus on board processes and functions. This research aims to shed light on a number of relatively under-researched issues that Pettigrew (1992, p. 176) raised in his study on managerial elites, such as: Why do boards look the way they do? How do particular constellations of human resource assets on the board occur and build up? How does executives' power affect the control relationships between team members and the board? These questions extend discussion beyond the relatively narrow boundaries of agency theory. Indeed, a growing number of studies suggest that the agency framework should be used in conjunction with complementary theories (Daily et al. 2003;

Pettigrew 1992), including behavioural (e.g., Hambrick and Mason 1984; Sanders and Carpenter 2003) and socio-cognitive research (Carpenter et al. 2003; Carpenter 2002) in examining governance-related issues.

2.2.5.1 Conduct and processes of the board

Board process research is focused on the general conduct of board affairs and how and why board processes impact on empirical patterns of strategy and performance (Pettigrew 1992). These studies move away from the empirical analysis of publicly available data on board structure and characteristics and rely on an in-depth research methodology, such as interviews and case studies (e.g., McNulty and Pettigrew 1999; Pettigrew and McNulty 1995), customized surveys (e.g., Pye 2001; Roberts and Styles 1999), and ethnographic research (e.g., Samra-Fredricks 2000).

Board process researchers emphasize that independent directors have by virtue of their different positional power, knowledge of the business, and information a lesser set of structural sources of power than the CEO and other executive directors. Their prospect of influence depends on their will and skills in mobilizing resources available to them (Pettigrew and McNulty 1998; Lorsh and MacIver 1989; Zajac and Westphal 1996). Whilst board structure conditions board effectiveness, it is the behavioural dynamics of a board and the web of interpersonal and group relationships between executive and independent directors that determine board effectiveness (Roberts et al. 2005). Therefore, ‘good’ corporate governance drivers may also be associated with factors that affect board dynamics and interrelationships, such as the role of a Chairperson, information flows inside and outside the firm, coalition formation, etc.

Bearing in mind power discrepancy between full-time executive directors and non-executive directors, ‘good’ corporate governance drivers may be associated with company actions aimed at reducing this power gap. An unrestricted access to information is generally regarded as a source of directors’ power, as well as directors’ in-depth knowledge of the business (Golden and Zajac 2002; Roberts et al. 2005; Useem 1993; Westphal 1999). The conduct and process of the board may be another potential source of directors’ power and their involvement in strategy. McNulty and Pettigrew (1999), Pye (2001; 2002) draw attention to factors such as the board meeting agenda, the process and conduct of board meetings, strategy “away days”, etc. If accompanied by process of information sharing, challenge and open debate, these activities may increase board effectiveness.

Board process research develops a new perspective on the roles of the Chairperson. Roberts and Styles (1999), Pettigrew and McNulty (1995) and Roberts et al. (2005) argue that a complementary relationship between the CEO and Chairperson is at the heart of effective board relationship. They suggest that the Chairperson’s work in building non-executives’ knowledge through induction and strategy away days, in structuring board agenda and ensuring the quality and timeliness of board information are pivotal in creating the conditions for non-executives to be effective.

Moving away from formal board structures and procedures, other authors emphasize the importance of informal dialogue between board members, between board meetings. Mace (1971), Lorsh and MacIver (1989) and Westphal (1999) suggest that social ties and interactions between the CEO and independent directors may enhance mutual trust, intensify advice-seeking activities of executives, and reduce defensive and political behaviour on board. It is important for directors to build and maintain trust in their relationships with executives, but also to maintain some distance so that effective monitoring can be achieved (Dalton et al. 2003).

Roberts et al. (2005) identify a set of three characteristics critical to independent directors effectively creating accountability in the boardroom: they should be (1) engaged but non-executive; (2) challenging but supportive; (3) independent but involved. This research suggests that “independence of mind” rather than independence of board is the key to effective board behaviour, and, hence, ‘good’ corporate governance.

2.2.5.2 Board evaluation and controls

One of the critical functions of boards is to evaluate performance of executive directors. However, managerial strategies are often evaluated more on financial criteria because rich information is difficult to obtain for non-executive board members. The opportunity costs and time required to evaluate strategic decisions are high for outside directors, and they are likely to use financial controls such as returns on sales and assets, total shareholder return, etc. This may create managerial risk-aversion and focus on strategic decisions that generate immediate financial outcomes rather than long-term returns, such as R&D and innovation (Baysinger and Hoskisson 1990; Hoskisson et al. 2002). Board members may be tempted to step back from the involvement in strategy development process and rely on evaluation of strategic outcomes instead (McNulty and Pettigrew 1999). A number of authors strongly suggest that board members should rely on strategic controls when evaluating performance of the executives, such as the quality of strategic decisions, their justification, short- and long-term objectives, etc. For example, by approving or disapproving capital investment projects, board takes strategic decisions. Independent directors should ensure that executive directors are actively involved in formulating strategy, rather than leaving strategy to emerge in a haphazard fashion. Where a strategy is in place, McNulty and Pettigrew (1999) suggest that independent directors should evaluate its content and impact by asking executives to justify their strategic intentions and questioning their course of actions. Introducing the notion of “honest incompetence” as a more realistic driver of the need for board oversight, Hendry (2002) suggest that the involvement of independent directors does not need to be threatening to executive directors, and board reforms should focus on increasing board competence. In a rare empirical study, Golden and Zajac (2002) provide support of these arguments by studying strategic change in the U.S. hospitals. They find that strategic change is positively associated with (a) board attention to strategic issues, and (b) the comprehensiveness of a board’s evaluation of the CEO.

Board process researchers emphasize that, in terms of ‘good’ corporate governance practice, boards should undertake a formal and rigorous annual evaluation of its performance, as well as performance of individual directors. Board assessment would lead to changes in the composition of boards to make them more effective (Shen 2005). Evaluating the balance of skills, knowledge and experience on the board, in advance of making new appointments, is an important aspect of maintaining board effectiveness. An induction and professional development system should also ensure that directors are, and remain, sufficiently knowledgeable about the company (Roberts et al. 2005).

2.2.5.3 Board incentive systems

Literature review above suggested that outside directors are expected to play the monitoring, resource and service roles inside boards. Yet their incentives are not clear. Fama (1980), Fama and Jensen (1983), and Hermalin and Weisbach (2003) emphasize the fact that they have incentives to build reputations as expert monitors. From the cognitive perspective, it may be vital that non-executive directors are not only vigilant, but that they also have strong incentives to share their valuable knowledge and experience with members of the board.

Extending agency arguments related to the incentive alignment effects of directors' equity, some researchers suggest that non-executive directors will perform their advisory and resource roles better when they have a significant financial stake in the company. The primary hypothesis here is that board equity compensation will be positively associated with firm performance because of improved board functions (Dalton et al. 2003; Hillman and Dalziel 2003; Hoskisson et al. 2002; Kosnik 1990; Shen 2005). Hambrick and Jackson (2000) indicate that non-executive share ownership not only creates financial incentives for non-executives but also increases their identification with the company, making them more willing to use their knowledge and more generous in their time and attention. Hermalin and Weisbach (2003) cite evidence suggesting that the relationship between CEO turnover and firm performance is stronger when boards have incentives. Filatotchev and Bishop (2002) provide evidence that directors' ownership improves performance of IPO firms in the UK. However, while theoretically appealing, this "incentives – performance" hypothesis has not been unambiguously supported in a recent meta-analysis (Dalton et al. 2003).

2.2.6 Board governance effects: contingency factors

A number of authors suggest that the effects of board structure and characteristics on performance may be contingent on various contingent factors such as the firm's size, age, industry, growth/decline phase, etc. In particular, the scale and diversity of large firms may cloud any relationship between board composition and performance. However, in smaller, entrepreneurial firms, boards could more easily meet their resource, counselling and control roles. Boards of smaller, less complex firms would enjoy more discretion with fewer vested interests within the firm (Dalton et al. 1998). Consistent with this perspective, recent meta-analysis has found that the board size/firm performance relationship is stronger for smaller, as compared to larger, firms (Dalton et al. 1999). Daily and Dalton (1992) provide evidence of a positive relationship between both the number and proportion of independent directors and price-earnings ratio in a sample of small firms. IPO research in the USA and UK (Certo 2003; Certo et al. 2001; Filatotchev and Bishop 2002) discover that newly listed companies with more diverse and independent boards have better performance.

Some researchers emphasise that board governance may be particularly important in the environment of organisational decline or bankruptcy (Daily and Dalton 1994; Filatotchev and Toms 2003; Hambrick and D'Aveni 1992). In their study of UK textile companies in the environment of industrial decline, Filatotchev and Toms (2003) show that the "survivors" had relatively larger boards and significantly larger board diversity measured in terms of outside directorships held by individual directors compared to the "early exits". These authors argue that board "interlocks" helped companies to restructure and survive. Daily and Dalton (1994) and Dalton et al. (1999) suggest that board size may play an important role in crisis situations, since, from a resource-dependency view, larger boards may provide more diverse networking links to resource providers. Gilson (1990) and Hermalin and Weisbach (2003) find that following a bankruptcy or private restructuring, debtholders take an active role in the firm's governance, including appointing a number of directors.

Finally, an emerging research on the life cycle of corporate governance (Filatotchev and Wright 2005; Lynall et al. 2003) suggest the notion of a number of firm life cycle stages where different forms of corporate governance may be required. Corporate governance may thus need to be viewed as a dynamic system that may change as firms evolve over these stages. The firm's evolution is accompanied by changes in ownership structure, board composition, the degree of

founder involvement, etc. The balance of the accountability and enterprise roles of the various governance elements may change over this life cycle from establishment, growth, maturity and decline. For example, the knowledge contribution of boards may be more important in growing entrepreneurial firms than in firms facing more mature markets. However, monitoring roles of the board may be particularly important at maturity stage. Therefore, there may be a number of optimal board configurations, depending on a particular stage of the firm's life cycle.

2.2.7 Complementarity and substitution between governance channels

In a vast majority of governance-related papers a particular aspect of corporate control, such as board structure or composition, is related to performance measurements. Some authors have recognized that governance mechanisms operate interdependently, with the overall effectiveness depending on a simultaneous operation of several mechanisms in limiting managerial opportunism (Rediker and Seth 1995; Walsh and Seward 1990). Since alternative control mechanisms exist, greater use of one mechanism need not be positively related to firm performance. Where one specific mechanism is used less, others may be used more, resulting in equally good performance (Agrawal and Knoeber 1996). Different governance mechanisms can substitute or complement each other (Dalton et al. 2003; Hoskisson et al. 2002), and the cost-benefit trade-offs among a variety of governance mechanisms would determine their use.

A limited number of papers explore these substitution/complementarity effects empirically. Deutsch (2005) and Hermalin and Weisbach (1991) find complementarity between board composition and executive pay. Rediker and Seth (1995) in their study of 81 bank holding in the USA find a substitution effect between governance effects of independent boards and large-block investors. They suggest that a combination (or bundles) of governance mechanisms may reduce principal-agent costs and align interests of principals and agents.

2.3 Share Ownership and Shareholder Activism

2.3.1 Introduction

There is a growing body of research in the economics and management literature that links the pattern and amount of stock ownership with managerial behaviour, and, eventually, corporate performance (see Dalton et al. 2003, and Short 1994, for a comprehensive survey). The concentration of ownership may be an effective approach to controlling the agency problems caused by the separation of risk-bearing and decision functions in firms (Alchian and Demsetz 1972; Demsetz 1983; Tihaniy et al. 2003). However, because most of the previous research in the corporate governance area is focused on corporations with diffused ownership within the framework of the conventional U.S./UK model of corporate control, little is known about the behaviour of joint stock firms with concentrated ownership (Holderness and Sheehan 1988). In terms of issues related to ownership structure and identities of the major groups of shareholders, previous research has recognized several possible governance roles for large-block shareholders, some of which are likely to be value-enhancing while others are likely to have negative effects (see Hansmann 1996; Shleifer and Vishny 1997, for an extensive discussion).

2.3.2 Large-block shareholders, business strategy and firm performance

2.3.2.1 Shareholder activism and firm's performance

Within economics and corporate finance research, the majority of studies were focused on ownership concentration effects in large, publicly traded firms. Jensen and Meckling (1976), for example, explain how the increase in concentration in managers' cash flow rights constrains the consumption of perquisites by managers and thus produces a positive effect on corporate valuation. Further research suggests that large-block outside ownership may also be an effective counter-balance to managerial opportunism. Companies may have large, undiversified shareholders that play a critical leadership and monitoring role. They have both the incentives and the means to restrain self-serving behaviour of managers (Maug 1998; Zeckhauser and Pound 1990). Monks and Minow (2002), Hoskisson et al. (2002) and Tihaniy et al. (2003) provide an extensive survey of literature, which suggests that shareholders with significant ownership positions have both the incentives and to monitor executives and the influence to bring about change they feel will be beneficial. Concentration of voting power in large investors is, therefore, only a partial indicator of ownership influence; some of them use their power through the increased shareholder activism. Increased activism is a preferable *modus operandi* for large shareholders because of their major stakes in corporations. The barriers to these investors' divestments of their holdings are high, and they have few options for alternative (large) investments (Admati et al. 1994; Agrawal and Knoeber 1996).

Therefore, a large number of studies grounded in agency theory suggest that large-block shareholders have both the incentive and influence to assure that managers and directors operate in the interests of shareholders (Daily et al. 2003). Therefore, their presence among the firm's investors provides an important driver of 'good' corporate governance that should lead to efficiency gains and improvement in performance (Alchian and Demsetz 1972; Shleifer and Vishny 1997). This assumption has been subjected to extensive empirical tests. For example, Holderness and Sheehan (1988) analyse performance of large firms with majority shareholders (e.g., owners with equity stakes between 50 and 100 percent). In their study, firms with concentrated shareholders outperformed a control group of diffusely held firms. Wruck (1989) provides empirical evidence that suggests that when managers have an opportunity to conduct a self-serving deal that damages shareholders, the decision to sell a block of securities to non-management investors increase shareholder wealth. Mikkelson and Rubak (1985) also find that firm market value increases when a block purchase is announced. The study by McConnell and Servaes (1990) suggests a positive relationship between institutional share ownership and Tobin's Q. Hill and Snell (1980) find a positive relationship between ownership concentration and productivity for their sample of 122 *Fortune 500* firms. Glassman and Rhoades (1980) report a positive relationship between ownership concentration and profit rate of lead banks in the USA. Finally, Filatotchev and Toms (2003) in their study of UK textile firms suggest that the firm's performance and survival in this declining industry was partially explained by presence of dominant institutional equity-holders.

A number of studies provide empirical evidence on the relationship between corporate ownership patterns and firm's performance around the world (see La Porta et al. 2000b, for a comprehensive survey). In particular, La Porta et al. (2000a), in their study of the largest quoted firms from 27 countries, find that higher cash flow ownership is associated with higher corporate valuation, and that this effect is greater in countries with inferior shareholder protection. Using a data-set of 2,658 listed East Asian corporations, Claessens et al. (1999) document that high cash-flow rights in the hands of large-block holders are positively related

with corporate valuation. However, the concentration of control rights in their study is negatively associated with valuation of corporate assets, pointing to a possibility of an entrenchment effect of concentrated voting control. This evidence is consistent with the assumption that in established publicly traded firm's ownership concentration is a substitute for legal protections in providing the functions of corporate governance (La Porta et al. 1998).

2.3.2.2 *Shareholder activism and strategic decision*

Strategic management provides another important stream of research that links ownership patterns with the firm's strategic decisions. For example, using structural equation modelling, Hoskisson et al. (1994) show that large block shareholders help mitigate against poor strategy, such as diversification, to evolve into poor performance, therefore decreasing the magnitude of restructuring. Hill and Snell (1988) find that ownership concentration is positively correlated with R&D expenditures, specialization and relatedness in a sample of 94 firms in research-intensive industries. According to Black (1992) institutional investors have demonstrated a decided propensity to restrain managerial appetite for value destroying mergers and acquisitions.

2.3.2.3 *Conflicting evidence*

Some researchers have indicated, however, that concentrated shareholding may create a trade-off between incentives and entrenchment (La Porta et al. 2000a; Short 1994). For example, using a variety of linear regressions, Morck et al. (1988) suggest that there is an incentive effect of managerial ownership on performance (measured in terms of Tobin's Q) in the 0 percent to 5 percent ownership range, negative relation in the 5 percent to 25 percent range, and a further positive relation beyond 25 percent. Building on this theoretical framework, the empirical study by McConnell and Servaes (1990) finds a significant curvilinear relation between Tobin's Q and the share of common stock owned by the managers. In addition, there is evidence that concentrated non-managerial ownership can also harm market valuation (Roe 1990).

In particular, lack of diversification and limited liquidity mean that large shareholders are affected adversely by the company's idiosyncratic risk (Maug 1998). To compensate for this risk they may use an opportunity to collude with managers or shift wealth from minority shareholders to themselves. For example, Pound (1988) argues that large institutional investors and unaffiliated blockholders are likely to side with management (the strategic-alignment hypothesis). Likewise, blockholders may be influenced by other existing business relationships with management (the conflict-of-interest hypothesis). Building on this research, some authors point out that ownership concentration *per se* may negatively affect the value of the firm when majority shareholders have a possibility to abuse their position of dominant control at expense of minority shareholders (Bebchuk 1994; Stiglitz 1985). As a result, at some level of ownership concentration the distinction between insiders and outsiders becomes blurred, and blockholders, no matter what their identity is, may have strong incentives to build coalitions with managers and divert resources in ways that make them better off at the expense of other shareholders (Wruck 1989). La Porta et al. (1998) and Modigliani and Perotti (1997) suggest that in this environment firms with concentrated owners would face difficulty raising equity finance, since minority investors fear expropriation by managers and concentrated owners, and, as a result, profitable new ventures will be forsaken.

A number of empirical studies failed to confirm positive links between ownership concentration and performance. For example, Demsetz and Len (1985) find no association between ownership concentration and accounting profit rate in their sample of 511 large U.S. firms. Using a large sample of *Forbes 800* firms and controlling for endogenous nature of large-block shareholding,

Agrawal and Knoeber (1996) do not find any significant effects of ownership concentration and a variety of performance measurements. Bethel and Liebeskind (1993) examine strategic restructuring in a panel of the large U.S. firm and suggest that institutional investors did not serve to discipline managers. They also provide evidence that concentrated shareholders normally support managers in their quest for growth. In addition, Dalton et al. (2003) applied meta-analytical procedure to 229 studies related to equity holdings and firm financial performance. Their tests do not provide support to the hypothesized relationship between share ownership by large blockholders and a number of performance proxies that include Tobin's Q, returns on assets, equity, sales, investment, etc. The authors conclude that, "the results of our meta-analyses do not support agency's theory proposed relationship between ownership and firm performance."

A number of more recent studies tried to find explanations for this inconsistency in theoretical predictions and empirical evidence with regard to the governance roles of concentrated owners. Jensen (1993) has questioned the promise of shareholder activism in general, and institutional investor activism in particular. Their increasing reliance on indexing investment strategies suggests that they believe that, on average, their portfolio of firms will yield returns comparable to those for the market as a whole, regardless of the governance structure of their portfolio firms. Black (1992) documents an increasing importance of "exit" strategies for the fund managers as opposed to shareholder activism. Daily et al. (2003) also suggest that shareholder activism can be much more costly than pure reliance on indexing strategies. Some authors challenge the very foundations of the "blockholders – firm performance" hypothesis. More specifically, previous research treats ownership concentration as exogenous and does not address the issue of what affects ownership concentration for a given firm. A number of authors have suggested that firm characteristics, such as size, investment needs, industry, location, etc., may determine its ownership structure (Demsetz and Lehn 1985; Jensen and Warner 1988). In other words, a firm's ownership structure is an equilibrium response to an individual firm's operating characteristics and its competitive environment (Short 1994), and the direction of causality between ownership concentration and firm characteristics is not entirely resolved by papers using cross-sectional variations in ownership.

Despite these empirical and theoretical arguments against shareholder activism hypotheses, a growing number of studies point out that the answer may be in the types of blockholders and what they actually do in terms of governing the firms in which they invest.

2.3.3 Governance roles of different types of blockholders

Most research on performance effects of large-block share ownership has not differentiated among types of investors. Only recently have studies acknowledged that the identity of such owners has important organisational implications because different owners may have different objectives and decision-making horizons (Hoskisson et al. 2002; Tihanyi et al. 2003; Aguilera and Jackson 2003). For example, banks and investment trusts may behave differently in terms of their strategic preferences (see Chang 2003; and McConnell and Servaes 1990, for a discussion).

2.3.3.1 "Pressure-sensitive" vs. "pressure-resistant" investors

Some authors (e.g., Briceley et al. 1988; David, Kochhar and Levitas 1998; Kochhar and David 1996) differentiate between "pressure-resistant", "pressure-sensitive" and "pressure-indeterminate" institutional investors. Pressure-resistant institutions, such as public pension

funds, mutual funds, foundations and endowments, are unlikely to have strong business links with their investors, and they may have stronger influence on strategy choices and their performance outcomes (Dalton et al. 2003; Hoskisson et al. 2002). Johnson and Greening (1999) also indicate that pension and investment fund managers' objective is a high relative performance of their portfolio firms because of their own reward system. They are the most likely among institutional investors to monitor organisational decision makers and to be labelled "activist institutional investors" (Brickley et al. 1988). On the other hand, "pressure-sensitive" investors such as insurance companies and banks are likely to have business relationships with the firms in which they invest (Kroszner and Strahan 2001). Because they often have an obligation to support the management's agenda, their governance role tends to be more passive compared to "activist" investors (Tihaniy et al. 2003). Corporate pension funds typify the pressure indeterminate institutional investor category. Relationship between the funds and the firms in which they invest may exist, and they are unlikely to actively challenge firm decision makers (Dalton et al. 2003).

Daily et al. (2003) and other authors suggest that only pressure-resistant investors behave in line with the assumptions of agency arguments related to the governance roles of block-holders. Hoskisson et al. (2002), for example, provide empirical evidence, which suggests that managers of public pension funds prefer internal innovation and investment in R&D, whereas professional investment funds' managers prefer external innovations such as M&A. Wahal (1996) finds that pension funds moved away from takeover related proxy proposals in the late 1980s and toward governance related proxy proposals in the 1990s, suggesting that their managers are interested in active voice and less interested in short-term arbitrage. Research by Woidtke (2002) supports this view. Tihaniy et al. (2003) provide evidence of long-term strategic orientation of pension funds compared to other institutional investors.

2.3.3.2 Private equity firms

Another stream of research in economics and finance suggests that private equity firms and venture capitalists may have a particularly strong impact on the process of corporate governance development because of their early involvement in the strategic development of the portfolio firm. They also gain a detailed knowledge and substantial decision-making rights in firms that they finance (Lerner 1995). In particular, private equity firms impose contractual restraints on managerial discretion, including the use of staged investment, an enforceable nexus of security covenants, and the option to replace the entrepreneur as manager unless key investment objectives are met (see Megginson and Weiss 1991, for a discussion). Since these special rights end at the time of an exit, when the need for oversight is particularly great, outside investors may compensate for a relative loss of control by strengthening other governance mechanisms, such as increasing the IPO firm's board independence (Black and Gilson 1998). In addition, they often influence the distribution of the firm's shares in the process of IPO (Brav and Gompers 1997). Therefore, private equity firms represent an ultimate version of "pressure-resistant" investors, although in the UK their investments are mainly confined to entrepreneurial ventures, buy-outs and public-to-private transactions (Manigart et al. 2002).

2.3.3.3 Individual blockholders

A number of studies identify individual or group blockholders as another important type of "pressure-resistant" investors. These investors hold 5 percent or more of a give firm's equity. Demsetz (1983) suggests that the substantial wealth they have at risk implies that benefits of monitoring will outweigh associated costs. Therefore, they have a stronger incentive than even activist institutional investors to engage in control activities (Dalton et al. 2003). Pound (1992) suggests that blockholders demonstrated their ability to effect changes in the composition of

boards and corporate constitutions. Bethel and Liebeskind (1993) provide empirical evidence that blockholders' equity was associated with proactive restructuring strategies in their panel of 388 *Fortune 500* firms. Their evidence is consistent with the argument that large blockholders play a critical role in monitoring and re-directing corporate strategy.

Family owners represent an important subset of individual and group blockholders. A number of researchers express concerns about the problems associated with family control, and the increased likelihood of the abuse of managerial power. Research from North America in particular, (e.g. Morck et al. 1988, Smith and Amoako-Adu 1999) provides evidence of the negative effect of a controlling family on corporate performance. In addition, strategy research identifies family firms to be altruistic in the relationship between parents and their children ((Schulze et al. 2003), which may have an impact on the effective succession process when the founder retires. Moreover, family interest may dominate over the interest of non-family shareholders, since the concentration of personal and family wealth in owner-managed firms normally creates a preference for income and for wealth preservation over other dimensions of firm performance such as maximisation of dividend payments to outside shareholders (Carney and Gedajlovic 2003). Finally, family control tends to shield a firm from the disciplinary pressure of the market for corporate control since concentrated share ownership reduces the probability of a hostile take-over (Gomez-Mejia, et al. 2001; 2003).

However, whether families or professional managers run companies better for society in general is still open to debate. During the current prolonged recession, corporate scandals and the collapse of stock markets have resulted in a return to the kind of values prevalent in family-owned companies. Family businesses that survived their own internal succession dramas have tended to take a longer-term view rather than live and die by stock market evaluation of their performance (Bruton et al. 2003). Because of the extension of altruism from the family system to the firm, owners in the current generation have the tendency and obligation to reserve wealth for the next generation. As a result, family firms often possess longer horizons compared to non-family firms (James 1999). Family firms, therefore, represent a special class of large shareholders that may have a unique incentive structure, a strong voice in the firm, and powerful motivation of managers. Anderson et al. (2003) suggest that these characteristics can alleviate agency conflicts between the firms' debt and equity claimants and reduce the agency costs of debt. In addition, strategy analysis of corporate governance (Filatotchev and Bishop 2002) view family control as less of a problem as it could be a potential provider of more useful resources and a possible enhancement of firm value. Furthermore, through family networks, uncertainties and complexity are reduced because information is shared and circulated among the participants in the network, resulting in better monitoring of activities both within and between firms. A number of more recent empirical studies provide evidence that controlling family ownership is associated with better performance (Chang 2003; Joh 2003; Carney and Gedajlovic 2002).

2.3.3.4 Blockholder coalitions

Finally, some recent studies emphasise that firms may have multiple large shareholders. Some researchers suggest that it may be optimal to have more than one large owner in terms of the effectiveness of corporate governance (Dyck 2000). When control is dissipated among several large investors, a decision to behave opportunistically requires the consent of a coalition of investors, and this coalition might hold enough cash flow rights to choose to limit expropriation of the remaining shareholders and pay the profits as efficient dividends (La Porta et al. 2000b). In this particular case, a relatively low entrenchment effect associated with small shareholdings of the coalition's members may be dominated by the Jensen-Meckling incentives generated by

the combined coalition's share ownership. For example, Bennedsen and Wolfenzon (2000) suggest a theoretical model explaining an alignment effect of a coalition of large shareholders, that is a positive relation between the cash flow stake of the controlling coalition and total firm value.

2.3.4 Process aspects of shareholder activism

A number of recent studies have moved from traditional empirical analysis of links between ownership structure and types of owners outlined in sections above to more qualitative, multi-disciplinary research on actual actions of large-block owners in terms of their involvement in corporate governance. For example, Daily et al. (2003) discusses corporate governance practices of large public pension funds such as CalPERS and TIAA-CREF in the USA. CalPERS, for example, has been active in seeking greater board independence by requesting that firms in which the fund invests (1) compose their boards predominantly of independent directors, (2) identify a lead director to assist the board chair, and (3) impose age limits on directors (Daily et al. 2003: 373). Similarly, TIAA-CREF was very critical of firms that maintain what the fund views as inappropriate corporate governance structures. More specifically, the fund pressured Walt Disney to reconfigure its board and make it more independent from management. Sundaramurthy and Lewis (2003) provide evidence, which suggests that by publicly criticizing board oversight and confronting complacent management, institutional investors destabilize managerial power and pressure strategic changes in line with shareholder demands. Black (1992) notes that institutional investors have the motivation to discourage conglomerate acquisitions that may dilute managerial attention and depress firm value. Aguilera (2005) indicates that companies in the UK and USA are under pressure from institutional investors to appoint a lead (senior) independent director whose responsibility is to serve as a communication channel between shareholders and the board.

Sundaramurthy and Lewis (2003) suggest that external blockholders also act as an agent or catalyst for certain types of change. For example, blockholders may alter the balance of power by influencing board and management turnover (Denis and Sarin 1999) enabling an efficient succession (Boeker and Goodstain 1993). Wahal (1996) suggests that target firms are increasingly adopting proxy proposals regarding changes in corporate governance. Blockholders may initiate revisions in executive compensation (David et al. 1998) and in directors' term of office (Sundaramurthy and Lewis 2003).

Since institutional investors are usually companies with their own ownership and management systems, it is important to monitor their activism. Institutional fund managers are themselves agents, and may not fulfil their duty to influence managers in their portfolio companies (Black 1992). It is important to have transparency of voting by institutional investors and disclosure to clients on how their shares were voted (Woidtke 2002). However, this may increase the costs of compliance burdens with limited benefits in terms of improved corporate governance.

The legal perspective on corporate governance suggests further that to be effective, institutional investors should have a right to sue company directors and auditors for negligence and breach of duty. In the past, the company itself primarily initiated legal actions against directors. Legal scholars suggest that shareholders should have a statutory right to bring an action enforcing the company's rights against directors through so-called derivative claims (Bebchuk 2005). Some researchers document that the increase in shareholder activism has been accompanied by an increase in shareholder lawsuits in recent years (Kesner and Johnson 1990). Langevoort (2001)

suggests that the very threat of lawsuits may provide a powerful governance effect associated with large-block shareholders.

Bebchuk (2005) indicates, however, that only a small fraction of public companies in the USA faced contested board elections that were designed to oust existing directors. One of the barriers to contested board elections is associated with financial and organisational difficulties shareholders face when trying to place their own directors on a company's proxy statement. Bearing this in mind, Bebchuk supports suggestions that companies should be able to choose to provide shareholders with proxy statements via the Internet.

2.4 Information and Disclosure

2.4.1 Introduction

The academic literature suggests that information flows are a fundamental prerequisite, cornerstone, or driver of corporate governance and that in turn the informational environment of the firm affects strategy and performance. The starting point for most analysis is that 'information asymmetry' (Akerlof 1980) or 'information impactedness' (Williamson 1985) is pervasive in firms and has negative effects in terms of uncertainty, adverse selection, moral hazard, and opportunism. In turn, this leads to higher transaction costs, the false pricing of assets, the misallocation of resources, and lower liquidity. Because of market failures and fears of competitive disadvantage, the state has intervened with laws to make firms disclose. However, in addition, firms have an interest in disclosing, above what it legally mandated, in anticipation of benefits, such as the reduction of uncertainty and of the price of capital. Much of the literature then suggests that an optimal disclosure strategy is one where firms supply maximum information, subject to legal, cost, and proprietary constraints (for a broad review of the concepts and the theoretical literature, see Stigler 1961; Jensen and Meckling 1976; Hirschleifer 1973; Grossman and Hart 1980; Grossman 1981; Milgrom 1981; Healy and Palepu 2001; Verecchia 2001).

The literature makes a number of distinctions, which are useful for analysis. As already suggested, information disclosure may be divided into mandatory and voluntary, the latter also encompasses requirements of a 'comply or explain' type. This distinction may also be put in terms of public and private information. There are various kinds of information, for example, financial information (profits, losses etc.), operating information (strategy, performance against objectives etc.), and governance information (board composition, executive remuneration etc.). Information may be backward- or forward-looking, with the latter usually adjudged to have a premium.

There are also various producers, holders, donors or withholders, recipients, and users of information. In other words, there is a stock and a flow. The main producers and holders of information are the top management team. However, within the management hierarchy, there are information flows, vertical and horizontal, which may have implications for corporate governance and business strategy and performance. Hence, managers below the top team may have information which is useful to superiors and which they may or may not convey. In turn, senior managers and executives will have information, which has relevance to the board, including non-executives directors. Finally, senior managers may provide information to fixed claim holders, employees, and other stakeholders. The main body of literature surveyed below

concerns the flow of financial and operating information, both mandatory and voluntary, from the top management team to investors and their advisers.

2.4.2 Information disclosure: the firm, its investors, and performance

Within economics and accounting research, the vast majority of studies have focussed on the provision of strategic financial and operating information by the top management team (senior managers and executive directors) to outside investors, especially shareholders, and those associated with them, such as fund managers and analysts. The literature is mainly concerned with voluntary disclosure and refers to how informative disclosure is in terms of both quantity and quality of information (Healy and Palepu 2001; Core 2001). The underlying notion in the literature is that greater disclosure will allow investors to monitor management better and effectively to exercise their rights. The focus is on both the determinants and effects of discretionary information disclosure.

In terms of determinants, for the U.S., Lang and Lundholm (1993) show that disclosure is greater where firms are larger, perform better, and need to raise capital. Ruland et al. (1990) demonstrate that, as insider ownership increases, firms are less likely to provide certain types of information such as earnings forecasts. By contrast, El-Gazzar (1998) shows that the presence of large institutional owners leads to a higher level of voluntary disclosure. Consistent with other research, Skinner (1994) finds that firms with bad earnings news are more likely to disclose information than firms with good news. Using information on contested takeover bids, Brennan (1999) suggests that targets disclose more information on earnings than a sample of other firms. One interesting study of Singapore listed firms suggests that companies with a higher proportion of independent directors have higher levels of voluntary disclosure (Cheng and Courtenay 2004).

For the UK, Meeks et al. (1995) find disclosure related to firm size, debt-equity ratios, country of incorporation, and international listing. It should be noted that in this and other cross-country studies UK firms rank highly in such exercises in terms of informativeness of disclosure. Again using a sample of UK firms, Mangena and Pike (2004) confirm work which suggested that better information is provided where audit committees are independent and have financial expertise (Beasley 1996; McMullen 1996; Klein 2002; Carcello and Neal 2000 2003). In their own study, the authors find that the quality of disclosure and financial reporting is negatively associated with shareholdings of audit committee members, but positively associated with the presence of financial expertise on the audit committee and external auditor involvement. In their work, no statistically significant relationship was found between the quality of financial reporting and other corporate governance variables (such as audit committee size, directors' shareholdings, and the proportion of non-executive directors). Other UK research suggests that disclosures are not just positively related to firm size, but vary significantly across sectors, and that companies whose future earnings are poor are more likely to make disclosures (Abraham and Tonks 2004). Preliminary research by Hussainey, Schleicher, and Walker (2004) suggests that for the most part loss-making firms tend to decrease disclosure in the year that the loss is reported. However, a significant proportion of loss-making firms respond by temporarily increasing their disclosure. Perhaps not surprisingly, loss-making firms increase the narrative content of the annual report giving more information about projected future earnings. Using case studies, Holland (1997) showed private disclosure was driven by the financial reporting cycle, by the need to build on this with core fund managers, and by *ad hoc* events. In more recent work, Holland (2005) has suggested that disclosure, both public and private, increases

when firms seek additional market-based finance (equity or debt), when performance declines, and during take-over battles.

A recent UK study (Emmanuel and Garrod 2004) of the content of segment reports within annual reports and of operating and financial reviews (OFR) finds that companies, which provide the fullest and most relevant segment reports, provide less voluntary additional disclosure in the OFR than companies providing less extensive disclosure in their segment reports. This consideration of mandatory and at the time voluntary reporting leads the authors to conclude that it is unclear that the introduction of more mandatory disclosure will automatically lead to an increase in useful disclosure.

In terms of outcomes of disclosure, the theoretical literature suggests a negative relationship between disclosure and the cost of capital. Information asymmetries are said to produce a 'lemons' problem, which causes good and bad projects to be valued at the same level and thereby to reduce liquidity in firms' shares (Akerlof 1970; Copeland and Galai 1983; Kyle 1985; Glosten and Milgrom 1985). By contrast, the disclosure of good information reduces asymmetry, lowers the returns which investors demand, and thus lowers the cost of capital to the firm (Diamond and Verrechia 1991).

Empirical research usually valorises disclosure outcomes by looking at the cost of capital. The research has produced mixed findings. For the U.S., Lang and Lundholm (1996) suggested that there is a significant positive relationship between disclosure and analyst following, in the sense that companies' financial affairs are watched closely. The benefits of this are higher liquidity (Roulstone 2002). Such firms also have less dispersion in analysts' reports and less volatility in forecasts. However, Botosan (1997) and Richardson and Welker (2001), using voluntary disclosure in annual reports, found a significant negative relationship between disclosure and the cost of capital, both equity and debt, though this is only for firms with low analyst following. For foreign firms trading in the U.S., Botosan and Frost (1998) found a significant negative relationship between the timeliness, but not the level of disclosure, and liquidity. In a later study, Botosan and Plumlee (2002a) found that more extensive and timely disclosure resulted in lower equity and debt costs. In the case of debt finance, Sengupta (1998) produced similar results, finding that higher levels of disclosure are associated with lower interest rates. He argues that greater disclosure lowers perceived default risk and results in a lower cost of borrowing. Another recent study (Bushee and Leuz 2004) of smaller U.S. firms coming under SEC regulations for the first time suggests that mandatory requirements do lead to more disclosure and for some firms a significant increase in liquidity. Disclosure also had positive externalities for other firms who can be better valued and more easily raise funds. However, for some newly regulated firms, the costs of disclosure, both real and perceived, forced them to go private or into less regulated markets. In an interesting study, Leuz and Verrechia (2000), using a group of German firms, some using less-informative German (IAS) standards and others more-expansive U.S. (GAAP) standards, found that the latter had lower bid-ask spreads and higher share turnover and therefore presumably lower capital costs.

For the UK, Walker and Tsalta (2001), in a study for the Association of Certified Chartered Accountants, found that there is a strong positive relation between the quality of both review material and forward looking information in annual reports and analyst following. In addition, they suggest that improvements in disclosure tend to be driven by higher levels of analyst following. Gietzmann and Ireland (2004), using measures of disclosure, which attempt to capture quantity rather than quality of disclosure, find the expected negative relationship between timely disclosure and the cost of capital. Schleicher and Walker (2002) and Hussainey

et al. (2003) find that improved levels of annual report disclosure lead to higher levels of share price anticipation of earnings and less volatility in shares, especially for loss making firms.

Chahine and Filatotchev (2005) review the literature on information disclosure and IPOs. Using signalling theory, they examine the links between disclosure, corporate governance, and 'underpricing' of IPOs in France. They argue that there is a negative effect of board independence and venture capital ownership on disclosure. However, disclosure mitigates information asymmetry between the IPO firm and investors and has a significant negative effect on underpricing. The results also suggest that other governance characteristics, such as board independence and venture capital ownership, may act as substitutes for disclosure. This supports earlier work by Schrand and Verecchia (2002) for the U.S., which also found that greater disclosure is associated with lower underpricing.

Other research considers different outcomes. Thus, Healy, Hutton, and Palepu (1999) suggest that improved corporate disclosure results in higher levels of institutional ownership and less share volatility. However, related research suggests higher institutional ownership is positively associated with stock market volatility (Sias 1996). Bushee and Noe (2000) qualify this literature and suggest that this higher volatility is the result of 'transient' institutions, which are attracted by 'good news' and increase their holdings subject to disclosure changes.

It has long been argued that in the UK there has always been extensive 'behind closed doors' disclosure by top management to investors and fund managers and that this is both an advantage and disadvantage of the British system (Charkham 1994; Black and Coffee 1994). Private briefings and 'one-to-one' meetings are an important aspect of information disclosure by firms to large investors. In its guidance on the improper use of private information, insider dealing, and market abuse, the Financial Services Authority (FSA) draws attention to the grey area of illegality which exists around such briefings and selective disclosure (FSA 2005). In terms of academic research, much of the UK work in this area is theoretical or legal. It suggest that, on the one hand, activities of this kind can lead to the disclosure of price-sensitive information and give one set of investors, invariably large institutional investors and fund managers, an edge over others. In turn, this can have adverse effects on credibility and market efficiency. On the other hand, if within the law, the disclosure of private information can help in marketing a firm's shares and in setting the right price for them. It can also help smooth the market (Marston 1999). A review of the legal literature suggests that on the whole the advantages of such briefings outweigh the costs and disadvantages and that such behaviour is likely to increase in the future (Hendry et al. 1999; Al-Hawamdeh and Smith 2005; Helbok and Walker 2003). One U.S. study suggests that the provision of good and timely information by firms limits insider's ability to trade profitably on private information. Using the intensity and profitability of insider trades to proxy for information asymmetry, Frankel and Li (2004) find that greater disclosure and increased analyst following is associated with reduced insider purchases and reduced profitability of insider trades. Financial statement informativeness is negatively associated with the frequency of insider purchases.

Finally, we turn to a recent stream of cross-country research, which touches on information disclosure, its determinants and outcomes. Much of this work uses the index developed by the Centre for International Financial Analysis and Research (CIFAR). This represents the average number of 90 items included in the annual reports of a sample of domestic companies from a spread of countries. The index has limitations, in particular it does not include private information and some of the scoring might be questioned. However, the index suggests significant cross-country differences in corporate disclosure regimes and it has been widely

used to measure the quality of accounting information and investor protection in a country. It should be noted that the UK scores high in the index on measures relating to information disclosure and informativeness.

In a much-quoted study, LaPorta et al. (1998) suggest that the CIFAR index is positively correlated with the willingness of investors to finance firms and the resulting costs of capital. The index is also significantly negatively related to concentration of stock ownership, suggesting that where there is less information disclosure and investor protection, there is a substitution towards monitoring by large shareholders, which the authors suggest may be more expensive. However, the possibility that the causality goes in the opposite direction cannot be rejected. Levine, Loayza, and Beck (2000) also find that the CIFAR index explains differences in the level of financial intermediary development – the lower the index in terms of transparency, the higher the level of financial intermediation. In another study, Rajan and Zingales (1998) show a positive correlation between the CIFAR index and external financing and between the index and the growth in the number of new enterprises. Later, Lombardo and Pagano (2000) found a negative correlation between the CIFAR index and IPO underpricing. Also using the same index, Carlin and Mayer (2000) show that the growth in industry GDP and in R&D spending as a share of value added are higher in industries with a high demand for external financing in countries with a high CIFAR index.

The index and the LaPorta type work has been strongly criticised by some commentators (for a useful overview, see Vitols 2005). Others have tried to improve the index. Thus, Bushman, Piotroski, and Smith (2001) provided a framework for measuring corporate transparency across countries, which includes the quality of corporate reporting and public information, measures of private information provision, and measures of the dissemination of information. In part taking up on this, in more recent work, La Porta et al. (2004) use a more specific index of information disclosure (covering prospectus, transactions, shareholders, inside ownership, compensation, and irregular contracts). Again it should be noted that the UK scores high in this. The work shows that higher disclosure is positively correlated with larger stock markets, a larger number of listed firms, and IPO values and that it is negatively correlated with ownership concentration.

2.4.3 Other types of information disclosure

To this point we have discussed mainly (1) the public and private disclosure of financial and operating information by (2) senior managers and executives within the firm to (3) shareholders, fund managers, and analysts. There are, however, other aspects of information disclosure, which have important implications for corporate governance and for firm performance. These are areas, which also start to take us away from a more structural approach based on economics and accounting and into areas of process analysis and areas where multidisciplinary perspectives are more useful. First, there is what might be called governance information viz. information on aspects of corporate governance *per se*, such as board composition, the make-up of committees, executive pay etc. Here there has been little academic research to date on mandatory and voluntary disclosure of such information. The main exception is on executive pay, which has received considerable public and academic attention. This is dealt with in more detail in section 2.6. One useful review of the Australian literature by Collett and Hrasky (2005) suggests that voluntary governance disclosure is positively associated with the intention to raise equity capital, but not with the intention to raise debt capital.

Second, another area very important to corporate governance centres on the flows of information within management itself. Here Williamson's (1985) notion of information 'impactedness' is useful – information may exist within an organisation, but it may be held by certain groups, and there are limits to the extent to which actors are able to understand and process the information (bounded rationality). An important aspect of this is the flow of information to directors, especially non-executive directors. Much thinking on governance is posited on the notion that the board of directors will monitor and check top management. Furthermore it is based on the notion that non-executive or independent directors will play a significantly large part in this. It is then assumed that they will have free access to information required to fulfil their obligations of monitoring and control and that they will have the time and capability to process this (Tricker 1997). One interesting Australian study (Nowak and McCabe 2003), drawing on case studies of a number of companies, suggests that in practice many non-executives believe that it is top management and full-time executives who have power over information and may release it differentially and at times which suit them. There is thus a contradiction between theory and practice. Access to information for monitoring and control therefore depends on the incentives of directors to seek information and on the incentives or 'integrity' (Nowak and McCabe 2005) of top managers to provide it. Some evidence to support the contention of information impactedness is to be found in Gaved (1997). He notes that fund managers consistently express the wish to work only with executive directors. In reality they are doubtful as to the quantity and quality of information, which non-executive directors possess.

Third, there is the provision of information by shareholders, especially large block and institutional shareholders, about their own activities. Clearly in the case of large block holders, institutional investors, and venture capital funds, their actions have a significant effect on corporate governance. Of course, there is law in this area. At certain levels of ownership, large shareholders have to declare their holdings and also to declare their intentions in terms of takeover where this is appropriate under the City Takeover and Merger Code. Also, in so far as institutional investors are themselves firms, they have to make disclosures to their own shareholders. Where they are funds, such as pension funds, they have to make disclosures to their members. There are a number of specialist areas of law here and a number of other academic literatures. One topic area concerns whether shareholders should provide information on how they cast their votes. Thus, in the U.S., from 2003, the SEC has required that mutual funds disclose publicly their proxy voting policies and their voting records. In the UK, the Hampel Committee has made recommendations in this area, and the government has announced that it will reserve rights to make this obligatory. Gaved (1998) has reviewed the limited and mainly normative literature and suggests a code of disclosure for institutional investors. The suggestion is that it is important to have agents watching the agents and to have the latter making disclosures about their activities (Black 1992; Woidtke 2002).

2.4.4 Conclusions

Four conclusions may be drawn on consequences, determinants, and interactions of information disclosure as a mechanism of corporate governance.

First, information disclosure, both public and private, has effects on corporate governance and in turn on business strategy and firm performance. Many of these are beneficial e.g. reduced uncertainty and lower cost of capital.

Second, there are costs for the firm to be offset against any advantages and we have touched on some e.g. the possible attraction of short-term investors and greater share price volatility. There are three other costs: (a) the fixed costs of producing and processing information; (b) the proprietary or indirect costs when competitors, customers, and others use the information to the firm's disadvantage; and (c) the legal and reputational costs which may be incurred when firms get their information practices wrong.

Third, we have mainly been concerned with how information disclosure may drive corporate governance. However, it is also the case that other corporate governance arrangements can shape disclosure practice. The studies cited above are not always able clearly to specify the direction of causal links. The system of corporate governance plays a key role in the improvement of the quality of the financial reporting and information system for several reasons. First, an effective governance system is able to identify the key recipients of information. Second, no one dominant group dictates the disclosure content or timing of disclosure. Third, an effective corporate governance system is able to verify the information and decide on appropriate communication channels and timing (Forker 1992; Melis 2004). One useful Australian study (Beekes and Brown 2005) suggests that better governed firms make more informative disclosures, in particular they make more price-sensitive disclosures, they have a larger analyst following, and price discovery is faster.

Fourth, information acts as a substitute or complement for other forms of corporate governance. Other corporate governance mechanisms may substitute for information disclosure e.g. monitoring by large shareholders. It is more likely that other corporate governance mechanisms complement information disclosure e.g. non-executive directors and independent auditors. There are thus interactions across corporate governance mechanisms, and information provision, though important, is not sufficient to solve all corporate governance problems.

2.5 Audit and Internal Controls

2.5.1 Introduction

Auditing and internal controlling are self-regulatory elements of corporate governance. A well-functioning system of auditing and controls is often seen as central to creating appropriate linkages of information, incentives, and governance between managers and investors. This process involves a wide set of intermediaries, including: various groups of investors; reputational intermediaries that certify the objectivity of information provided to investors, such as financial analysts, ratings agencies, internal and external auditors; and internal governance agents such as corporate boards (Palepu and Healy 2003). Reputational intermediaries play a particularly central role as 'gatekeepers' in giving assurance about the quality of informational flows and compliance with governmental regulation (Grabosky 1995). However, these intermediaries are themselves subject to their own sets of incentive and governance problems, and are therefore regulated by a variety of state agencies and professional bodies charged with certifying and maintaining standards.

The external audit function has long been viewed as a certification mechanism to aid in controlling incentive or contracting problems (Lambert 2001). Financial audit procedures, in particular, are intended to demonstrate the completeness, accuracy and validity of transactions, which make up the financial statements. Auditing and controlling issues were often considered technical and straightforward, and the issue received relatively little attention in the mainstream

of the corporate governance debate compared to topics such as board structure or shareholder activism. This changed dramatically after the collapse of Enron in 2001. The case suggested that the incentive structure that motivates actors in the system generates much less powerful checks against abuse than many observers have believed (Bratton 2002).

While the case of Enron is not, in itself, evidence of a wide failure of corporate governance, many observers note that Enron and UK cases like Maxwell, are symptomatic of a wider set of governance issues related to the extent and quality of auditing. The deeper problems with auditing are indicated by the fact that, between January 1997 and June 2002, approximately 10 percent of all listed companies in the United States announced at least one financial statement restatement and resulted in an average decline of 10 percent of the firms' stock prices (Coffee Jr. 2003). This massive loss in shareholder wealth due to faulty financial statements suggests a more systematic problem.

At the same time as concern grows regarding the quality of financial accounting and auditing, a growing interest in auditing is now arising from the stakeholder perspective (Baker and Owsen 2002). In order to support stakeholder involvement or monitoring in corporate decision-making, a demand has grown for increased disclosure of information on corporate social responsibility or environmental performance. All these aspects of information disclosure have widened the scope of issues in need of auditing or where firms are under pressure to develop systems of internal control. The large economic literature on 'reputational risk' confirms the importance of auditing and control of a wide array of non-financial risks that may threaten the reputation of the firm, and damage intangible assets and consumer goodwill.

A further and somewhat neglected aspect of this literature concerns how information disclosure and auditing relate to the broader firm-internal information flows and participation of stakeholders within the organisation. For example, much of the broader social science literature on auditing has stressed the fact that auditing increasingly means the auditing of internal systems of control (Power 1997). This broader social science perspective focuses not just on the incentives and legal constraints on behaviour, but the question of how corporate governance institutions influence people's tendencies toward cooperative versus uncooperative behaviour (Blair 2002). In particular, where corporate cultures instil large incentives for or acceptance of unethical behaviour, legal controls alone prove insufficient (Dallas 2003). The process of 'distrust' and verification can never give complete assurance, and therefore all governance processes need to carefully balance elements of 'trust' and 'distrust' (Lane and Bachmann 1998; Blair and Stout 2001).

Consequently, growing attention has been placed on the links between external governance through auditors and internal controlling. Controlling is also about assuring information flow to the board and procedures for monitoring compliance throughout the organisation. One emerging issue here is 'whistle blowing' and more generally governance mechanisms to assure that employees are protected when reporting fraud.

2.5.2 The governance role of auditors

2.5.2.1 Introduction

Audits involve verification based on the concept of sufficiency – namely, that the scope and depth of information is sufficient to enable an opinion to be formed. Over time, the depth of

mechanical checking of financial calculations evolved into a 'systems audit' approach, where essentially auditors form an opinion as to whether adequate internal controls are in place so that the accuracy of financial information is assured (Power 1997). The Cadbury Code requires that directors must now maintain effective systems of internal control, and has led to growing reflection of the process of auditing and controlling. Some critics stress that while the public interest objective of audits is to detect fraud, in reality, audits deliver an opinion on the financial statements with reference to notion of fairness or 'true and fair' view (Humphrey and Moizer 1990; Humphrey et al. 1992). Attempts to develop audit guidance along these lines have results in the concept of having systems that yield 'reasonable expectation' of detecting fraud. Within this context, the lack of clear criteria for establishing what audits can and cannot do leads to heated debates over the role of audit failure in corporate fraud. Keasey and Wright note, "audit failures are almost impossible to judge because the activities of accounting and auditing are so vaguely defined" (Keasey and Wright 1993, p.299).

The obscurity about the nature of assurance provided by accounting means that any evaluation ultimately appeals to practitioners' judgement in determining what is reasonable. Given this high level of uncertainty, the audit process is heavily involved in formal procedural knowledge and in the development of professional codes of ethics, rules on independence and the like (Preston et al. 1995). This type of uncertainty about the quality of audits also entails that reputation and image management are essential in the operation of the auditing market (Podolny 2001).

2.5.2.2 Auditor independence

Auditor effectiveness, like board effectiveness, hinges on the ability to act independently as a gatekeeper. However, the auditing industry has evolved to take a rather narrow and mechanical approach to auditing, eschewing issues of business judgement. In the U.S., this approach evolved in response to the growing deregulation of the industry and threat of litigation against auditors in the 1970s. These regulatory changes prompted auditing firms to move toward less variable, more mechanical and standardized auditing procedures (Palepu et al. 2003). The sinking profit margins associated with this approach also prompted greater emphasis on economies of scale and gaining more clients. Some observers note, in particular, that auditing firms became increasingly dependent on recommendations from large clients to generate higher volume business. This dependency of client firms is noted as a factor that helped undermine the independence of U.S. auditing firms (Palepu et al. 2003).

Many U.S. observers note a decline in the quality of auditing and auditor independence during the 1990s, which contributed to scandals such as Enron. Coffee notes two trends (Coffee Jr. 2003) in particular. First, auditors faced reduced legal exposure as the result of legislation and judicial decisions in the 1990's sheltering them from liability. Second, auditors also benefited from the increased potential for consulting income or other benefits from their clients that resulted in their acquiescence as gatekeepers or financial irregularities.

The provision of non-audit services by auditing firms is also considered to have a strong potential to undermine the objectivity and scepticism of the auditors, and consequently the independence of the audit process (Francis 2004). The issue of Arthur Andersen's independence is a case in point, since Andersen served as both Enron's internal and external auditor for two years and ended up auditing the transactions on very same special purposes entities that it had advised to set up (Gillan and Martin 2002).

Econometric evidence on these points is unfortunately scarce, and the results largely unclear. Based on a large sample of NYSE-traded S&P 1500 stocks, Acioğlu et al. (2005) find some weak evidence to support the argument that auditor compensation lowers firm disclosure quality and market liquidity (Ascioglu et al. 2005). Large consulting fees (relative to audit fees) received by auditors from the same client have been shown to influence auditor's independence (Frankel et al. 2002). Another study by Callaway et al. also finds that auditors are less diligent in curbing income-increasing earnings management for client firms from which they receive high proportions of non-audit fees (Callaway Dee et al. 2002). However, other studies find that auditors are more likely to issue going concern opinions to clients paying higher audit fees, suggesting that auditors behave with relatively greater independence towards these clients (DeFond et al. 2002). Similarly, another study by Ashbaugh-Skaife et al. (2003) concluded that auditor fees had no effect on discretionary accruals after controlling for firm performance. These results may suggest that market-based incentives, such as loss of reputation and litigation costs, override the benefits auditors are likely to receive from compromising their independence to retain clients that pay larger fees (Reynolds and Francis 2001). Auditors may therefore be unlikely to risk their reputation on a single client's indiscretions (Coffee Jr. 2003).

One interesting interpretation of this literature suggests the link between auditor fees and independence may depend upon the corporate governance context of the client firms themselves. A large study of over 2,000 U.S. firms showed that while no general relationship existed between auditor fees and accrual behaviour, the provision of non-audit services is potentially problematic for a small subset of firms that appear to be de facto controlled by management (Larcker and Richardson 2003). Firms with lower institutional holdings, higher insider holdings, smaller board of directors (and audit committee), and lower percentage of independent board (and audit committee) members had more discretionary accruals.

Despite the lack of clear empirical evidence, the climate of the late 1990s U.S. led to more fundamental arguments about the very system of auditing. The audit system sets up a fundamental tension for the auditor because the parties to whom he technically owes allegiance are not the party who hires him and pays for his services (O'Connor 2004). If accountants rely on repeat business from management, auditors face a fundamental compromise of their objectivity and independence (O'Connor 2002). The provision of non-audit services by auditors to their audit clients has exacerbated this fundamental tension. The experience of the 1990's U.S. suggests that auditors may act irrationally in acquiescing to managerial fraud, despite the large losses to reputation (Prentice 2000).

This discussion suggests a question of how big the impact of auditor reputations might be, and whether this is effective as a governance mechanism. Econometric analysis of the Arthur Andersen case in the wake of Enron suggest that the clients of Andersen lost only about 4 percent more than the non-Andersen clients in risk-adjusted stock market returns over the events in the four month period (Callen 2002). Likewise, audit fees have increased and concentrate even more on 'Big Four' audit firms following Enron (Asthana et al. 2004). A further study did find a fall in information quality post-Enron across all auditors, and adverse effect on market risk premiums (Dunne et al. 2005). However, the size of these effects seems rather modest and one cannot infer that reputation effects will be self-enforcing as a corporate governance mechanism.

These results are suggestive for the UK, where the situation regarding auditor independence is largely similar. Auditors in the UK are appointed by and report to shareholders. In theory, therefore, the UK system avoids the conflict of interest in the auditor being accountable to two

different constituencies. However, in practice the directors and auditors also have a conflict of interest because directors are required to manage the auditor on behalf of the shareholders (Turnbull 2005). Professional bodies in the UK have recently shifted from a rule-based notion of independence toward a more framework-based approach to independence (Citron 2003). This notion of independence is seen largely as accommodating the interests of the profession (ibid). Other studies document the large concentration and importance of non-audit fees in the UK market (Beattie et al. 2003). The largest four firms received 90 percent of audit fees in 2002, and 96 percent following the demise of Andersen. The average ratio of non-audit fees (paid to auditor) to audit fees was 208 percent.

These arguments have led to proposals about possible 'best practices' for auditors, including:

- The mandatory rotation or state-appointment of the external auditor;
- Placing restrictions on the quantity of 'non-audit' tasks involving external auditors;
- Placing unconstrained legal liability on auditors.

2.5.2.3 *The role of the Audit Committee*

Most public policy around the world has sought to address the issue of auditor independence largely by extending and improving the oversight of external auditors through an active audit committee within the board of directors. The audit committee should assure that the auditors are independent from the CEO, but supervised closely by independent outside directors. Various governmental bodies and researchers have expressed doubts about the effectiveness of audit committees. Again, cases involving fraud, such as Enron, have further vindicated those doubts.

Despite the presence of the audit committee at Enron, serious issues appeared regarding the independence of committee members. The U.S. Senate investigation into the role of the Enron board of directors in the company's collapse highlighted numerous financial ties between Enron and certain directors in three general areas: directors being paid consulting fees in addition to board fees, transactions with entities in which directors played a major role, and donations to groups with which directors were affiliated (Gillan et al. 2002). Such events have accentuated a variety of previous criticisms found in the literature. For example, audit committee members may lack genuine independence, expertise and experience in oversight (Cohen et al. 2002). Moreover, the level of interaction between the audit committee and auditors is highly variable (DeZoort 1998). This raises a large set of research questions about how audit committees actually operate and to what extent they fulfil their responsibilities (Kalbers and Fogarty 1998)

The post-Enron literature explored further the potential weakness of the board's capacity to protect the integrity of financial disclosure, and highlighted problems related to the increasing reliance on stock price performance in measuring and rewarding managerial performance (Gordon 2002). Here the nominal independence of outside directors in the audit committee may be insufficient to assure better selection and monitoring in the audit process, since the those directors have few incentives to more actively intervene in the audit process (Blair 2002). In particular, the dramatic changes in executive compensation toward equity-based compensation such as stock options has arguably given management strong incentives to inflate reported earnings and create short-term price spikes, even if they were unsustainable. Here the use of independent directors does not address the fundamental conflict of interest. In this regard, the Sarbanes-Oxley Act has been argued to further support the problem it was supposed to eliminate. The Act relies on what it defines as independent directors to manage their legally

mandated conflict of interest between shareholders or investors. However, this in turn introduces a conflict of interest between executives and non-executive directors when a check on management is most required (Turnbull 2005).

Despite the huge debate over audit committees, empirical evidence on the role of audit committees is still mixed and inconclusive (Turley and Zaman 2004). A few studies try to draw links between audit committees with outside membership and overall corporate performance (Laing and Weir 1999). Here three more specific aspects of the literature on audit committees are identified and reviewed.

A first set of literature addresses the adoption of the audit committee as a response to agency costs. One systematic review of the empirical literature concludes that, "Overall, the empirical evidence on the formation of, and/or reliance on, audit committees provides very limited support for viewing their effects solely in terms of managing the costs associated with agency related factors" (Turley et al. 2004). While the voluntary adoption of audit committees is positively related to board characteristics such as independence, the actual activity of the committee is mostly affected by firm size (Collier and Gregory 1999). For example, the frequency of meetings has been found to increase with firm size and with increases in the proportion of outsiders on the board (Menon and Williams 1994). Likewise, the number and duration of AC meetings are negatively related to the presence of a dominant chief executive officer (CEO) and positively related to top tier audit firms (Collier et al. 1999).

A second set of literature looks at the impact of audit committees on financial reporting itself, particularly the issue of so-called 'earnings management.' A study of 684 NYSE listed firms shows that having a majority of independent members of the audit committee reduced levels of earnings management (Klein 2000). Similarly, Larcker et al. noted a negative link between board independence and earnings management (Larcker et al. 2003). A positive link has also been demonstrated between audit committee existence and earnings overstatements, as indicated by prior period adjustments to correct errors in previous reports, are less likely among companies that have audit committees (Dechow et al. 2000; DeFond et al. 2002).

Other recent studies stress the importance of director qualifications in promoting audit effectiveness (Xie et al. 2003), finding that board and audit committee members with corporate or financial backgrounds are associated with firms that have smaller discretionary current accruals. Felo et al. also find that the percentage of audit committee members having expertise in accounting or financial management is positively related to financial reporting quality (Felo et al. 2003). The same authors report, however, that audit committee independence is not related to financial reporting quality, even when using several different measures of financial reporting quality. Thus, the empirical literature does provide some support for the view that mandating greater expertise on audit committees may be beneficial to investors.

A final set of literature looks at the impact of audit committees on broader aspects of the audit function. There are several issues here, such as the selection, retention and removal of the auditor or influence the level of audit fees. Given the difficulties of measuring independence, little evidence exists as to whether audit committees actually influence auditor independence (Turley et al. 2004). One study finds no impact of audit committees *per se* on changes in auditors, but a negative relationship between auditor committee independence and irregular changes of auditors (Archambeault and DeZoort 2001). Other literature looks more deeply at the broader social networks of audit committee members. For example, one study of 247 NYSE listed firms concluded that independent directors still displayed important biases in their

selection and retention of audit companies, in that their decisions were often influenced by relationships between the audit firms and the companies of the committee members (Reinstein and Weirich 1996). Turning to audit fees, some evidence supports the idea that the audit committee seeks to enhance audit quality, and may lead to an increase in audit fees (Collier et al. 1999). Meanwhile, little evidence suggests that if the audit committee initiates greater control over the audit process, fees may decrease.

Turning to the UK specifically, empirical studies also suggest rather mixed evidence about the effectiveness of the audit committee. On earning management, one study suggests that the existence of an audit committee is not associated with the extent of changes to financial statements (Beattie et al. 2003). Audit committees did reduce the confrontational intensity of interactions between auditors and management by increasing the level of discussion and reducing the level of negotiation. Another study of audit committee independence and audit reporting has found that the greater the percentage of independent directors on the audit committee, lower the probability that the auditor will issue a going-concern audit qualification (Carcello and Neal 2003). For a sample of 47 UK firms subject to regulatory action by the FRRP, no significant relationship existed between FRRP action and presence of audit committees (Peasnell et al. 2000). However, Windram and Song (2000) found a significant negative relationship between FRRP action and the AC's financial literacy, the frequency of AC meetings and the number of outside directorships held by AC members (Windram and Song 2000).

On the audit process, one study of UK firms found no evidence that the presence of audit committees impact the level of audit fees (Goddard and Masters 2000). However, another study of 402 listed UK firms found that the proportion on non-executive directors did have a positive impact on audit fees, while the proportion of equity owned by executive directors had a negative impact (O'Sullivan 2000). This suggests that non-executive directors may play a beneficial role in raising the intensity of auditing. Consistent with theories stressing auditor reputation, 'Big Six' auditing firms had a positive effect on audit committee activity (Collier et al. 1999).

On the whole, recent literature expresses strong scepticism as to whether the integrity of audits is improved by the appointment of independent directors and auditing committees (Romano 2004). The most robust evidence seems to be that the qualifications of audit committee members have a positive impact on various aspects of the auditing process. Yet, in one recent evaluation of the empirical literature, the authors suggest the following conclusion:

“The fact that corporate failures and irregularities occur in companies with ACs complying with, or even exceeding, recommended best practice illustrates the importance of understanding the process associated with audit committee operations. For example, Enron provides an example which counters the proposition that financial literacy among AC members will lead to effectiveness... While audit committees may be enhanced by certain characteristics (such as independence and expertise), these attributes alone are unlikely to deliver an improvement in financial reporting quality... Policy on audit committees has tended to emphasise characteristics of the committee and its members, but the processes through which the AC's activities are conducted and the impact on other organisational processes and the behaviour of other participants are of at least equal importance. Extant research provides very little understanding of these processes.” (Turley et al. 2004)

Likewise, one of the most in-depth qualitative studies on auditing, based on interviews with members of UK audit committees, suggests their largely ceremonial function in giving mutual assurance and comfort to outsiders, rather than their substantive role in intervention and verification of company information (Spira 1999b; Spira 1999a).

2.5.2.4 The role of shareholders

Scandals such as Enron, Tyco, or Parmalat also demonstrated the interdependence between auditing and disclosure practices and the ‘demand’ for information by investors. These cases provide serious reasons to question the strength of the efficient market hypothesis given that, for example, Enron’s stock price was based on a highly irrational reliance on its auditors’ compromised certification (Gordon 2002).

A central issue is how information links with the incentives of investment fund managers (Coffee Jr. 2003). The ‘herding argument’ suggests that institutional investors may be “uniquely focused on their quarterly performance vis-à-vis their rivals, and have strong incentives to ‘ride the bubble,’ even when they sense danger, because they fear more the mistake of being prematurely prophetic” (Coffee Jr. 2003).

A range of academic research findings have found evidence that sell-side analysts are influenced by their proximity to investment banking. Several U.S. studies show that earnings forecasts and investment recommendations are more optimistic for analysts that work for lead underwriter banks (Lin and McNichols 1998; Michaely and Womack 1999; Dechow et al. 2000). Selective disclosure by companies, together with a desire by analysts to maintain access to management and to attract investment banking business to their employers, is shown to lead to biased earnings forecasts (Hutton 2002). In general, the conflict between research and underwriting may explain a decline in sell recommendations by analysts over time and the poor record of analysts that covered dot-com stocks.

However, some research indicates that blockholders who play a more active monitoring role can make positive contributions to audit quality and lead to lower levels of earnings management. For example, one U.S. study showed that the presence of a blockholder within the audit committee had a large and significant impact in reducing earnings management of listed firms (Klein 2000). One UK study on auditing, however, found no evidence that large blockholders had any significant impact on audit fees (O’Sullivan 2000).

2.5.2.5 Regulation and professional norms

A last important area of research concerns the impact of regulatory intervention itself on the auditing process. Just considering the UK, inquiries by the UK Financial Reporting Review Panel (FRRP) have been shown to have a positive impact on subsequent auditor independence and compliance practices, since personal embarrassment and loss of personal reputation appear highly motivating to board members (Fearnley et al. 2002). In particular, the FRRP helps give auditing firms additional leverage in negotiating with directors and thereby prevent non-compliance. Moreover, the presence of executive directors on the audit committee was found to have a negative impact on audit committee activity (Collier et al. 1999).

Finally, an under explored area of research has been the role of professional bodies themselves. Various scandals such as Enron, Tyco, or Parmalat, have led to international debates about the need to re-examine the incentives inside the audit firms that would be needed to encourage audit professionals to exercise judgment, and walk away from clients that don’t deserve their certification, even when they are large and important clients (Bratton 2002).

2.5.3 The governance role of internal controls

2.5.3.1 Introduction

The Turnbull Guidance (1999 2005) is about the adoption of a risk-based approach to establishing a system of internal control and reviewing its effectiveness and aims to provide a conceptual framework for companies to disclose risk. It makes good business sense to manage risk effectively and to embed internal control in the business processes by which a company pursues its objectives. An internal control system encompasses the policies, processes, tasks, behaviour and other aspects of a company taken together. With Enron and WorldCom, few boards will need to have constant reminders that managing risk is important to the overall well being of the business. The proliferation of risk management systems has become a prevalent feature of contemporary organisations (Power 1997). As noted in the previous sections, a growing aspect of auditing and disclosure relates to using self-regulation within the corporation itself in the form of procedures and standard practices of risk management and control.

2.5.3.2 Risk management systems

The board of directors is directly responsible for a company's risk management and control (Turnbull 1999; Financial Reporting Council 2005). The Combined Code states that it is the responsibility of the audit committee to not only consider the internal financial control but also look at the broader aspect of the internal control and risk management systems. Despite practitioners increasing interest in internal control and corporate risk management there has been little published to conceptualise an adequate system of internal control that promotes good corporate governance (Solomon et al. 2000). Companies are still able to be flexible to individual company needs, which is particularly relevant for grouped companies (Meyrick-Jones 1999). However, systems should still be referenced towards safeguarding shareholder value (Groves 1999; Blackburn 1999). It is important to stress that risk should be managed, not eliminated. Elimination of risk would be contrary to economic principles in that risk is effectively part of the entrepreneurial process and profits are seen to be the reward for risk taking. If then risk is to be managed rather than eliminated, the board of directors must ensure that all types of risk are considered (Informa Group 2003).

If a broader approach to risk is to be taken, the board of directors cannot directly manage risks in such diverse areas. However, they must be satisfied that responsibility for managing appropriate levels of risk has been delegated to individuals at the appropriate levels within the company. This should ensure that risk is fully embedded in the firm's culture. This would include not only legal/regulatory compliance and financial risks, but broader assessment of items that could be strategic, people, market, ethical or operational risk (RSM International 2003). Legal and compliance risk is one of the biggest risks that a company could ignore. There is a vast regulatory environment that the company must comply with, ranging from accounting and finance laws to health and safety. Strategic risk can affect a company in a number of ways, such as failure to have a proactive focused corporate strategy or manage change within the internal environment. Ethical risk to the company would involve items such as the failure to have high ethical standards across the business, and obtain contracts via unethical means (Cooke 1991). This could also then cross over into financial risks and susceptibility to fraud or accounting irregularities.

Competitive risks involve items such as not responding to the developments within the marketplace. This might involve a firm lagging behind its competitors with regards to area such as technological advances within its product range or Internet developments, both internally and externally. After sales services being weak could also provide higher levels or risk in a competitive marketplace, especially if the company is already floundering by not responding to market trends. Internal communication with the company can highlight risks at all levels. Within the board of directors, there is particular reputation risk to the human capital of directors if performance is poor (Cannella Jr et al. 1995). There is also the risk of losing key members from the board of directors. A practitioner survey shows many company boards do have clarity when it comes to identifying the key risks faced by their companies. Robson Rhodes show that 72 percent of respondents in their 2003 survey claimed that key risks have been identified at board level (RSM Robson Rhodes 2003).

All of the various types of risk, and particularly the invention of the catch-all notion of 'operational risk', are recognized as contributing to a broad notion of reputational risk (Power 1997). Although reputation is an intangible asset, a growing literature in economics recognizes the value of reputation. Reputation management is particularly important when firms face crisis situations, and where external stakeholders focus attention on various sorts of mismanagement. The proliferation of risk management also reflects the defensive stance of groups, such as companies or professionals, who used to absorb risk on behalf of the public. The growing salience of reputational risk may help explain the increasing interest in corporate social responsibility (CSR), as well as the diffuse nature of this debate.

A study by the Institute of Chartered Accountants for England and Wales (1997) not only reveals a lack of risk information in the UK but advocates that risk should be incorporated in firms financial statements. There is now even greater concern for advocating financial control following the powers introduced under the Sarbanes-Oxley Act (2002) and the International Financial Reporting Standards (IFRS). The IFRS will increase the risk of compliance for companies and their auditors (The Institute of Chartered Accounts in England & Wales 2004).

2.5.4 Support and protection of 'whistleblowers'

2.5.4.1 Introduction

Jubb (1999) suggests that the term whistleblowing should not be directly interchangeable with 'informing' and insists that "whistleblowing is characterized as a dissenting act of public accusation against an organization which necessitates being disloyal to that organization" (Jubb 1999 p77). Furthermore, whistleblowing is seen as the process whereby employees are able to report any practice or incident where members of the company have been behaving unethically (Lewis 2001).

There are organisational needs for both loyalty and institutionalised whistleblowing (Wim and Commers 2004). Whistleblowers often act because, as professionals, they feel compelled to adhere to certain recognised ethical standards (Brinker et al. 1985). The moral motive for whistleblowing is further discussed by Bowie and Duska (1990) and implied by Chambers (1995). However, the truth is that support for whistleblowers' might not be there. Employees may experience retaliation for doing so (Martin 2000). There might be the threat of job loss, an unexpected department demotion or physical threats. It is no surprise that there has been the public acknowledgement that whistleblowing is relevant to all organisations and systems to

protect whistleblowers should be an everyday function of corporate life (Borrie and Dehn 2001).

The Public Interest Disclosure Act (1998) provides protection for whistleblowers. This implied that employees should be encouraged to 'raise concerns' and hence installing internal company whistleblowing policies was a proactive way to ensure early-warning systems were established in organisations and help maximize long-term owner value from an ethic perspective (Sternberg 1996). This act provided full protection to the whistleblower, who if victimized, could then claim to an employment tribunal.

The Institute of Chartered Accountants in England and Wales (2003) highlighted that responsibility should be with the board of directors who should be more accessible, with an open door policy with regards to whistleblowing. Finally, the new revised Combined Code (2003) clearly shows the responsibility for systems to enable (and protect) whistleblowing lies now with the audit committee: "The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action" (Combined Code 2003 section C 3.4 p17).

The guidance challenges the board to ensure that there are adequate procedures to track any whistleblowing and further follow the actions that have been taken in relation to the concerns raised by the whistleblower. This then ensures that companies complement the Act with their own internal procedures.

Empirical research on the effectiveness of the whistleblowing procedures is difficult to find, presumably due the requests for anonymity. However, Public Concern at Work reported in 2003, that people were twice as likely to blow whistles at work than five years ago (Public Concern at Work 2003). Increasingly there are debates as to good practice within this area which supplement board and company advice contained within the Combined Code (2003) and the Turnbull Guidance (2005). Practitioners and government bodies ensure that this remains within the public eye. The Committee on Standards in Public Life (2005) has only recently endorsed the following four key elements of good practice with regards to whistleblowing: (1) ensuring that staff are aware of and trust the whistleblowing avenues, (2) the provision of realistic advice about what the whistleblowing process means for openness, confidentiality and anonymity, (3) a continual review of how the procedures work in practice, and (4) ensuring regular communication to staff about the avenues open to them.

2.5.5 Costs of audits and controls

Auditing and internal controls impose considerable costs upon firms. The costs of any significant new regulation may outweigh the compliance yield, particularly given the entrepreneurial and risk taking purposes of private corporations. Legal regulation and reputation effects will inevitable prove inadequate as constraints.

Evidence from the U.S. suggests that outright audit failure rates are infrequent, far less than 1 percent annually, and audit fees are quite small, less than 0.1 percent of aggregate client sales (Francis 2004). Francis argues that there may be an acceptable level of audit quality at a relatively low cost. However, the cost of failure in the area of auditing and controls, as well as

the impact of earnings restatements on shareholders may be quite high (Coffee Jr. 2003). The appropriate trade-off between the quality and cost of auditing and control are likely to be affected by a number of important contingencies, such as the involvement of stakeholders, incentives and composition of boards, or different patterns of ownership. Francis concludes, “We do not know from research the optimal level of audit quality and therefore whether we currently have ‘too little’ or ‘too much’ auditing?”

Literature on internal control and risk management has also suggested a number of critical points. In particular, the trend toward defensive reporting and proliferation of internal procedures as part of risk management are all extremely time consuming and may undermine the ethics of communication and cooperation with organisations (Power 1997). These trends undermine the distinction between regulation, auditing and organisation-specific rules, since private actors are likely to consider procedures defensively and demonstrate compliance. The management of risk may effectively undermine professional judgement, as professionals themselves attempt to ‘manage’ risks associated with their own judgements.

2.5.6 Complementarity and substitution among governance mechanisms

The intense focus on auditing reflects the importance of disclosure and quality of public information within Anglo-Saxon corporate governance systems. Here the efficiency of market-based governance mechanisms depends, in strong part, on the transparency of corporate information. This emphasis is therefore rather different than in European or Japanese corporate governance, where private information flows between stakeholders play a greater role. Where stakeholders have their own sources of private information, corporate governance systems may be less vulnerable to gatekeeper failure. Here fewer conflicts of interest may exist between the way executives are paid and the process of the audit. Furthermore, inside stakeholders, such as employees, may bring internal information to bear that is independent from the executive directors, thereby increasing transparency and quality of internal control systems.

In the UK context, auditing independence is closely linked to broader issues of director independence and shareholder involvement. Here it seems unlikely whether auditing and internal controls act as substitutes for these corporate governance devices, but they may prove complementary in the sense that genuine director independence may strengthen the audit process, and quality auditing will strengthen the effectiveness of monitoring by the board or shareholders. However, perhaps more fundamental, are issues of incentives and conflicts of interest that may undermine the quality of firm-internal communication.

2.6 Executive Pay

2.6.1 Introduction

This section is concerned with the impact that corporate governance initiatives have had on the remuneration of UK executives. Over the late 1980’s and early 1990’s, the levels of executive pay were felt by many to increase dramatically and unjustifiably (Smith and Szymanski 1995). Whilst the Cadbury Report (1992) made several recommendations on good practice, the general opinion was that it did not go far enough with regards to executive pay (Association of British Insurers 1994). The Cadbury Report’s prime recommendation connected with pay was the establishment of a Remuneration Committee. This committee was to be more independent,

consisting of wholly (or mainly) non-executive directors; furthermore, the pay setting procedures were to demonstrate greater transparency. Aside from this, the general consensus was that Cadbury did little to address the issue of executive pay in detail. Instead, the main focus was on disclosure and transparency. Some investor groups (such as the National Association of Pension Funds and the Association of British Insurers) were highly disappointed, having hoped that Cadbury would bring about more specific suggestions, such as shorter service contracts for executive directors, improved disclosure of pay levels, and showing the different elements of pay for individual directors.

Greenbury Report (1995) reinforced the Cadbury approach by extending the role and the independence of the remuneration committee, which should be composed entirely of non-executive directors and report directly to shareholders via the annual report and accounts (including the chair of remuneration committees attending the company's AGM). The remuneration committee were to cover all aspects of remuneration including service contracts, severance pay, bonuses, incentive schemes and disclosure of these in the remuneration committee's report.

The early 1990s also saw an increasing academic debate within the UK and elsewhere (Conyon and Leech 1994; Keasey et al. 1993; Hallock and Murphy 1999; Tosi et al. 2000). These studies showed that whilst there had been a rapid growth in the levels of remuneration, there was a suggestion that these increased levels of pay did not promote or reflect increased company performance.

2.6.2 The governance role of executive pay schemes

The implementation of incentive schemes to promote shareholder value is underpinned by agency theory. Classic agency theory shows a relationship where the owners (principals) of companies, namely the shareholders, delegate the management of the company to hired persons (agents) (Jensen and Meckling 1976; Fama 1980). These agents take the form of management and in particular the higher echelons of company management, i.e. the board of directors. The separation of ownership from control leads to information asymmetries, and leaves room for self-serving opportunist behaviour by the agent (Berle and Means 1932). Within the agency theory literature, executive pay is a key mechanism for helping to minimize agency costs in order to align the incentives of managers with the interests of shareholders. (Eisenhardt 1989).

The central prescription of the agency theory literature is to develop outcome based contracts for the executive (Fama and Jensen 1983), and designing these contracts to include an appropriate incentive in terms of a compensation plan (Williamson 1985). Corporate governance issues such as monitoring of verifiable performance targets and incentive alignment should also be an integral part of such contracts. Indeed, "corporations can and should increase their control over top managers by increasing the use of managerial incentives and monitoring by the board of directors" (Zejac and Westphal 1994 p121).

In designing such contracts, Hart (1995) argues that any contract design will not be able to cover all eventualities. In short, all contracts are inherently incomplete because attempting to write a contract that would cover all future eventualities would be insurmountable. Consequently, incentive contracts for executives need to be complemented by other corporate governance mechanisms that support monitoring of management, such as having independent directors in charge of remuneration and nomination of executive directors.

In the absence of a ‘perfect contract’, the interests of the shareholders can be promoted by the remunerations committee issuing a ‘second best’ contract that relates executive reward to the performance of the company (Fama 1980; Fama et al. 1983). Such contracts should incorporate incentive schemes for executive directors as this is deemed to be a key help in overcoming agency problems (Murphy 1985; Beatty and Zajac 1994; Fama 1980; Fama et al. 1983; Dittmann and Maug 2003). Indeed this is supported by the recommendations of the Greenbury Report (1995) and the Combined Code (2003).

In response to this and in order to recruit and retain competent executives, companies within the UK design compensation strategies to incorporate long-term incentives (Conyon et al. 2000b; Conyon 2000). These compensation strategies involve the use of two main types of incentives, namely the executive share option scheme (ESOS) and the long-term incentive plan (LTIP). To assist companies in devising suitable schemes which align the interests of executives and shareholders, the Greenbury Report (1995) and the Association of British Insurers (ABI) have continued to promote ‘best practice’ and over the years since 1995 the ABI have issued various proposed ‘best practice’ guidelines (Association of British Insurers 1996; 1999; 2002; 2004). These guidelines recommend that companies adopt conditional incentive schemes, which incorporate predetermined performance criteria, which must be met before option and LTIP grants can vest to the executive. If performance criteria are not met by the executive then grants should lapse and so the executive gains nothing.

2.6.3 Executive pay tied to performance

The Combined Code (2003, p 12) states that: “A significant proportion of executive directors pay should be structured so as to link rewards to corporate and individual performance”. With this in mind executive pay can be seen to have three distinct elements. Firstly, a ‘base’ pay, which usually includes fees salary and bonus, secondly, additional benefits to the executive, for example perquisites, (annual cash values of company cars, club memberships etc.) and lastly, long term incentives (generally ESOs or LTIPs) (Conyon et al. 2000b). This modern day structure of compensation can be seen to be clearly underpinned by the principal agent problem and with agency theory in mind, does promote executives to act in the shareholders interests (Rosen 1990). Such compensation structures are not however the direct result of the policy developments with the UK. It was clear even prior to Cadbury, that such incentive style pay elements were awarded (Main and Johnston 1993). However, performing detailed empirical research in the UK in the early 1990’s proved to be difficult due to the lack of information disclosure (Gregg et al. 1993).

Caution is necessary in considering the early studies of executive pay and how it is linked with performance. Firstly, the measure of compensation used in some early UK studies focussed on the cash elements of compensation i.e. salary and bonus and was generally only the amount attributed to the highest paid director rather than the whole board of directors. There is also no indication as to whether any account was taken for exceptional payments (such as an incentive bonus to join the company), which would temporarily distort the levels of pay (Bruce and Buck 1997).

Secondly, this method only measures actual compensation paid and takes no account of any long-term compensation, such as the estimated value of share options and any other forms of deferred remuneration. Some scholars argue that by excluding an estimation of these additional

components the actual level of pay recorded is underestimated (Murphy 1985). The consequence of this is that any estimated relationship between levels of remuneration and company performance may be biased (Bruce et al. 1997; Conyon et al. 1995). Of particular relevance here is that Murphy (1999) concluded for the U.S. that there is the tendency for the non-cash incentive pay to be greater than the cash element and Conyon and Murphy (2000a) see the UK following in the same direction. So the question about the pay-performance link still remains unanswered. Evidence from the UK is not only conflicting but also limited in exactly what proportions of pay have achieved greater performance outcomes. For example, Gregg et al. (1993) study 288 large UK companies (based on the top 500 Stock Exchange companies). Whilst their study covers a period of 1983-1991 (pre Cadbury), they found that whilst pre 1988, there was a weak pay-performance link, after this the link broke down and was not significant.

One of the first studies to be completed in the UK that incorporated the values of executive option grants was that of Main, Bruce and Buck (1996). Although their sample was comparatively small (only 60 companies), they found evidence of a much stronger link between pay and performance. With a broader approach having been taken towards measuring pay, the strengthening of the pay performance link might be due to the incorporation of performance-based contracts. In support of this, Conyon et al.(2000c) also found a link between pay and performance. This study, however, only covers a period up to 1995, but uses two primary measures of performance: total shareholder return (defined as the return of an investors shareholding reflected in the company's share price, assuming all dividends are reinvested) and earning per share (defined as the total profit after tax divided by the number of ordinary shares). Whilst links were positive with regards to total shareholder return, no link existed between pay and earnings per share. However, it is hard to distinguish in such early studies any impact of the corporate governance reforms, as there is little information whether the companies studied had incorporated suggested reforms into their pay strategies at the time.

Following on from these early studies, Conyon, Peck and Sadler (2005) sample companies in 1997. These companies had the opportunity to incorporate 'best practice' and yet still did not demonstrate the stronger links found by Main et al. (1996). With little evidence in this study to link pay and performance, Conyon et al. propose that pay-performance links vary with the structure of the option contract given to executives. In a further study of 510 CEOs in the fiscal year 1997/1998 Conyon (2001) found evidence of a positive relationship between firm performance and the effective ownership of stock-based compensation by management.

Whilst differences in compensation levels are observed and links to performance in these studies are significant, other scholars offer a word of caution that these may not be due to increased performance but could result from differences in firm size, growth opportunities, firm financial policy, ownership characteristics, and other governance arrangements (Konstantinos et al. 2004).

The focus of these studies was to investigate the links between pay and performance, a parallel stream of research also developed examining the differing types of incentive pay being used. With the public emphasis, via the Combined Code, that incentive should now be linked to performance, it was not surprising to see a growing use of variable pay packages with specific performance targets attached (Câmara 2001; Pass et al. 2000). However, early evidence shows that UK companies post 1995 who have imposed specific performance targets have not necessarily increased performance levels or out performed those with no performance criteria (Pass 2003). Pass (2003) shows that a substantial proportion of the schemes used are 'undemanding', rewarding for average performance rather than exceptional performance.

Indeed, Edelsten (2005) recently encouraged employers to incorporate best practice in incentive design and stated that this would involve clarifying what the concept of ‘good performance’ means. Even with the growth of performance conditions and the use of LTIPs there has still been an increase in average total rewards to executives. Yet there has been an apparent reduction in the performance sensitivity with regard to pay (Buck et al. 2003). This study suggests that the effectiveness of either the incentive mechanism or the performance targets are still not adequate. It is unclear then as to whether the types of incentive grant has any differing effect on performance, however, there has been a growing switch from share options to LTIPs, with only two-thirds of FTSE 100 companies now continuing to grant share options and around 80 percent granting LTIPs (IDS 2005).

2.6.4 The Remuneration Committee

Following the recommendations of the Cadbury, Greenbury and Hampel Reports, and in line with the Combined Code, the remuneration committee is primarily responsible for the setting of executive pay. The theoretical importance of the remuneration committee is clear, as without it, executives have the opportunity to award themselves levels of pay that have no relationship to shareholders interests (Williamson 1985). The remuneration committee of today should comprise “at least three, or in the case of smaller companies two members who should be independent non-executive directors” (Combined Code 2003, Section b.2.1 p 14). The committee must consider when setting compensation that it should attract, retain and motivate high quality directors. In doing so they must compare levels of the pay with the performance of the company and examine pay levels within the given industry. It must also be sensitive to the organisations pay strategy on a wider scale. Further it should ensure that it follows Schedule A within the Combined Code when designing schemes of performance related pay, which should be a significant proportion of the total remuneration package.

Main and Johnson (1993) studied 220 large UK companies in 1990 for evidence of a remunerations committee finding that some 30 percent indeed had them. Where they existed, Main and Johnson found that they were often not composed solely of non-executives, which is now seen as good practice. Furthermore, they found a positive relationship between the highest paid director’s compensation and whether the company revealed the existence of a remunerations committee. This suggests that having a remuneration committee was not an indication of improved corporate governance. Indeed their findings showed that remuneration committees seemed to be associated with higher levels of pay and made no positive impact on the incentive structure of pay. Whilst this study was pre-Cadbury, further support comes from Conyon and Peck (1998), who also reported that higher levels of executive pay were associated with a greater proportion of independent directors on the remuneration committee. Therefore, independence of the remuneration committee may not provide adequate controls over the levels of pay. Daily et al. (1998) found no evidence that remuneration committees with affiliate directors paid the executives higher than independent committees.

This could be indicative of Ezzamel and Watson’s (1998) suggestion that a ‘cosy collusion’ exists between executive directors and non-executive director who happen to sit on each others remuneration committees and thus are able to bid up each others earning. If this is the case then the concept of the remuneration committee is failing and not tough enough (Brett 2003). In the UK, nearly half of company chairmen surveyed in the wake of the Hampel Report thought that bidding up of pay occurred, but as a consequence of increased disclosure rather than the presence of remunerations committees (Clarke et al. 1998).

2.6.5 Pay disclosure

Academics have cited lack of disclosure as a barrier to compensation research (Conyon, 2001; Egginton *et al.*, 1993; Gregg *et al.*, 1993; Main *et al.*, 1996) and bodies such as the Association of British Insurers has called for greater levels of disclosure (Association of British Insurers, 1996). The disclosure of directors' pay has increased over the last 15 years. Pre Cadbury few details were included and certainly not against named board members (unless the CEO or Chairman). The disclosure requirements now provide for greater transparency and are contained within the statutory based Directors' Remuneration Report Regulations (2002). This requires companies to provide information as to names of remuneration committee members (and advisors where used), overall remunerations policy statements, performance conditions for share options and LTIPs, and details of service contracts to name but a few. The regulations provide a comprehensive framework for shareholders to assess how well remuneration is governed. This increased level of disclosure has particularly been welcomed by bodies such as the ABI (Association of British Insurers, 2004) whilst others advocate caution (Conyon, 2001) with the benefits unproven (Conyon *et al.*, 2002). Early research suggests that there is a high level of compliance with the regulations with most of the top 350 FTSE companies disclosing what the regulations require (Deloitte & Touche, 2004). However, meeting the regulations requirements for disclosure still does not mean that the company's remuneration policies and practices will be clearly explained. Deloitte & Touche's research suggests that only half of the FTSE 350 companies use the remuneration report to communicate their remuneration policies in an effective way.

As mentioned above, levels of disclosure might be perceived as a mechanism that increases overall pay levels for executives (Clarke *et al.*, 1998). It is however perhaps too early to say what effect (if any) this has had on levels of executive pay as the regulations only came into force in August 2002. One thing is known, the UK is considered to be well in advance of most other European countries, with possibly the highest levels of disclosure in the world (Sunders, 2005).

2.6.6 Costs, complementary and substitution among governance mechanisms

Practitioners believe the issues of executive compensation is now more complex (Deloitte 2005). There are more 'rules' to follow. Greater transparency means more inspection by shareholders and the general public. Moreover, other company stakeholders are taking a greater interest in executive pay.

The question still remains as to how effective incentive pay mechanisms are in promoting shareholder value. Whilst Murphy (2003) in the USA has found a growing trend towards greater proportions of incentive pay in new economy firms the link to performance is still questionable. This growing trend is replicated in the UK where on average, incentives currently comprise 51.7 percent of FTSE 100 lead executives total earning, whereas one year ago, the proportion was 41 percent (IDS 2005).

Given the weakness of the link between executive pay and performance, improving the effectiveness of incentive contracts needs to be supported by a variety of other complementary corporate governance mechanisms. Conventional wisdom does stress that executive pay must be implemented and monitored by genuinely independent directors within the board. This

section also suggested the importance of shareholder activism in promoting more fair and equitable executive pay schemes, both directly in terms of pressuring companies and indirectly by improving the quality of independent directors. A further argument exists that other stakeholders should be involved in the design of executive pay schemes. The recent experience of Germany suggests that employee representation in the board has important effects on the design of executive stock option plans, leading to adoption of more and qualitatively stricter performance conditions than similar U.S. companies (Buck and Sharhriem 2005). Finally, given the paucity of evidence on the effectiveness of current executive pay schemes, a large debate has emerged over the costs of executive pay and expensing of stock options within company balance sheets.

2.7 The Market for Corporate Control

2.7.1 Introduction

The market for corporate control is one of the most controversial aspects of corporate governance. Many takeovers are motivated by industry-specific factors such as synergy effects (Chatterjee 1986), gaining market access or power (Stigler 1982), diversification (Marris 1964) or restructuring in response to changes in the technological, economic or institutional environment (Pfeffer 1972). Firms may use acquisitions to access new products, research and knowledge (Hitt, et al. 1996). Acquisitions may also provide important exit strategies for investors and entrepreneurs (Thornton 1999). Moreover, waves of acquisitions often occur in response to changes in regulatory environments, such as deregulation of an industry or financial innovations related to financial markets or systems of taxation (Stearns/Allan 1996; Fligstein 1990). A large social science literature has emerged in this regard as to the role of M&A in corporate strategy.

A second broad set of motivations for takeovers relate to corporate governance and the agency costs associated with the separation of ownership and control (Fama 1980; Fama 1983). Here control is seen as a valuable asset where value may be realized by gaining control of poorly performing firms and replacing inefficient management (Shleifer and Summers 1988). Markets for corporate control become salient given a high “separation from ownership and control” (Berle and Means 1932) within large corporations. Where ownership is fragmented, few incentives exist for investors to monitor management because other “free-riding” shareholders may appropriate resources devoted to monitoring. Individuals therefore diversify their portfolios and prefer exit to voice in response to poor performance. Moreover, small shareholders often lack information to monitor management effectively. The literature identifies several mechanisms through which these market failures may be remedied: legal protection of shareholders, incentive contracts for management, the presence of large blockholders, or markets for corporate control (Shleifer and Vishny 1996). In particular, the market for corporate control can be seen as a substitute for corporate governance based on direct monitoring by large blockholders who possess substantial control rights. Consequently, takeovers constitute a key governance mechanism within market-based systems of corporate governance such as the UK or USA. By contrast, in bank-based systems of governance such as Germany and Japan monitoring is undertaken by banks, who are engaged in relationship lending and holding equity within listed firms (Aoki 1988; Aoki and Patrick 1994; Berglöf 1991). This difference in the role of the market for corporate control is a central factor distinguishing diverse national systems of corporate governance (Kester 1990; Baums 1993; Höpner and Jackson 2001).

Henry Manne (1965) first described the governance function of takeover markets: “The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently.” Manne posited a strong relation between share prices and managerial performance. As shareholders exit poorly performing firms, lower share prices create incentives for outsiders to accumulate control rights, replace the management, and restructure the firm. These outsiders can recoup their investment through a share price premium, selling their equity stakes later at a higher price. Moreover, the institutionalisation of an active market for corporate control exerts market discipline on the managers of (potential) target firms. When exposed to the threat of hostile takeover, management must seek to improve returns to capital and not investment in “underperforming” assets, or else managers risk their jobs if shares under-perform. In sum, the market for corporate control is an important driver of market-based corporate governance, which allows investors to retain capital liquidity and diversified portfolios.

The market for corporate control has faced strong critics. Two criticisms, in particular, question whether tender offers, mergers and leveraged buyouts produce net gains to society (Jarrell et al. 1988): first, gains to a given party may be simple re-distributions resulting from losses to someone else; second, M&A may divert energy from more productive endeavours. Many authors note that the transfer of wealth from stakeholders to shareholders accounts for a large proportion of takeover premiums and may lead to net losses of efficiency due to breaches of trust (Shleifer and Summers 1988). Manne (1965) himself anticipated the enormous impact of takeovers on the distribution of wealth: “...we can see how this mechanism for taking control of badly run corporations is one of the most important ‘get-rich-quick’ opportunities in our economy today.”

Several arguments cast empirical doubt on the efficiency of the market for corporate control. First, the stock market may often fail to effectively value corporations (Kraakman 1988). Capital markets often take myopic, short-term views of investments, follow speculative trends that make valuations very volatile, or fail to respond to bad management because shareholders are uninformed (Miles undated). Second, management may react negatively to takeovers through costly defensive strategies such as golden parachutes, poison pills and legal protections (Bittlingmayer 1998). Third, management may adopt short-term strategies to bolster share prices, thereby sacrificing beneficial long-term projects and investments. A large debate has emerged around this issue of managerial short-termism in the UK (Demirag 1998; Cosh 1990). Fourth, bidding firms may themselves pursue selfish managerial interests, as suggested by the so-called hubris theory of M&A (Roll 1986).

Existing research on the governance roles of the market for corporate control has focused on three main themes: the effects of takeovers on the financial performance of target and bidder firms; the relationships between takeovers and other aspects of firm strategy and structure; and the issue of takeover defences and their implications.

2.7.2 The market for corporate control and financial performance

The empirical evidence on performance impact of takeovers is heavily dependent on the country, time period, method, and criteria of performance. Given that the empirical evidence on takeovers is mixed at best, it is useful to review the various meta-analytic analysis of merger and acquisition performance. The first published meta-analysis of takeovers covered

41 published studies and examined the impact of M&A on stock market performance (Datta et al. 1992). Their report suggests that the overall empirical results indicate that while target firms' shareholders gain significantly from mergers and acquisitions, those of the bidding firm do not. They also find lower gains in stock financed acquisitions, as well as in acquisitions involving conglomerate firms. A variety of studies have concluded that the impact on acquiring firm performance remains 'inconclusive' (Haspeslagh and Jemison 1991; Jarrell et al. 1988). Bruner (2002) comes to similar conclusion in his less formal review of 100 scientific studies from 1971 to 2001.

More recently, a meta-analytic study by King et al (2004) analysed the results of 93 empirical studies, largely of US companies. An important feature of their study was to include both stock market and accounting measures of post-merger performance. Their analysis utilizes a combined total of 852 bivariate effects and a total n size of 206,910. Their analysis shows that target firms did gain abnormal share price returns as a result of mergers. In this regard, their results are consistent with past reviews of the empirical literature of M&A (Jensen and Ruback 1983). However, the meta-analysis showed that acquiring firms had no abnormal returns within the first 20 days and even showed significantly negative abnormal returns in periods longer than 20 days. Likewise, acquiring firms had significantly negative ROA in the first year following a merger, but no significant positive or negative effect thereafter. The authors conclude that: "Collectively, these results imply that anticipated acquisition synergies are not realized by acquiring firms. That is, M&A activity does not create superior post-acquisition performance for acquiring firms and is consistent with the non-value-maximizing arguments often advanced to explain M&A activity" (p.192-193).

Given the largely negative results, an important question arises as to whether some sets of mergers characteristics influence the likelihood of positive performance effects. Several potential moderating variables include conglomerate mergers, related acquisitions, method of payment (cash vs. equity) and prior acquisition experience. Among these four variables, conglomerate mergers involving unrelated product-market diversification had significant negative abnormal returns (King, et al. 2004). The remainder of the section presents a more detailed review of the literature focused on the UK or international evidence related to four aspects linking the market for corporate control and company financial performance – target firm characteristics, share price performance, the issue of stock market misvaluation and the method of payment in M&A.

2.7.2.1 Target firm characteristics

A large literature on takeover explores the link between target firm performance and the likelihood of takeover. The agency theory perspective suggests that takeovers play a disciplinary role based on the underperformance hypothesis – namely, poorly performing firms are more likely to be the target of a takeover and particularly a hostile takeover bid. Overall the empirical literature does not provide strong evidence that target firms have underperformed prior to takeover (Agrawal and Jaffe 2003).

Studies in the U.S. find that friendly targets are not poor performers and are motivated by specific synergies desired by the acquirer (North 2001; Powell 1997). Hostile takeovers should be more likely to occur for disciplinary reasons than friendly takeovers (Morck et al. 1988). However, several studies conclude that no evidence of share price underperformance exists among targets of tender offers, which are associated with unsolicited or hostile bids (Martin and McConnell 1991; Dodd and Ruback 1977; Kini et al. 1995). The evidence using Tobin's Q and

operational performance is mixed. Thus, the U.S. literature seems to have largely rejected the underperformance hypothesis (Agrawal 2002).

In the UK, empirical work is more limited. Early UK studies find that target firms displayed lower profitability than non-acquired firms (Singh 1975; Levine and Aaronovitch 1981; Cosh et al. 1984). More recently, Dickerson et al. (2002) (2002) find that a one standard deviation increase in profitability is associated with a fall in the conditional probability of takeover of 25 percent among UK manufacturing firms from 1975-1990. However, the authors note that this effect was weaker during the takeover boom in the later half of the 1980s, as compared to the earlier half. Nuttall (1999b) finds that friendly targets have significantly lower Q values than non-acquired firms. Looking specifically at hostile takeovers in the UK, the evidence for the underperformance hypothesis is again mixed. Franks and Mayer (1996) concluded no evidence existed of negative abnormal returns in firms' targeted in hostile takeovers in 1985 and 1986. However, hostile targets did have significantly lower Q values than non-hostile targets. Several further studies also find that share price underperformance has no significant impact on the likelihood of becoming a hostile takeover target vs. a non-target or friendly target (Sinha 2004; Kennedy/. 1996). Meanwhile, Dahya and Powell (1998) find that hostile targets in the UK have significantly lower profitability, higher debt, lower managerial ownership, and high ownership stake held by external block holders relative to friendly targets. In sum, the UK literature finds some evidence for the underperformance hypothesis but this evidence is positive for operational measures and largely insignificant for stock market measures.

Less literature addresses the question of whether corporate governance characteristics also impact on probability of being acquired. Several US studies report that non-hostile target firms had higher levels of managerial shareholding than non-acquired firms, suggesting that executive pay may influence managerial attitudes toward mergers (North 2001; Morck et al. 1988). However, these results are contradicted by other studies which show no relationship (Song and Walkling 1993). In the UK, Dayha and Powell (1999) find that friendly targets had lower shareholdings by outside directors and higher shareholdings by executive directors than hostile targets. In terms of board structure, Dayha and Powell (1999) find no difference between hostile and non-hostile targets in the separation of the CEO and Chairman role (board duality), nor the percentage of non-executive directors. Both results are contradicted by Weir, who finds that friendly targets had a greater incidence of duality than non-targets and no difference in CEO shareholdings or executive director shareholdings (Weir 1997). Several more recent studies post-Cadbury again produce contradictory results. Comparing hostile vs. non-target firms, Sinha (2004) finds that corporate governance characteristics had no significant impact on becoming a hostile takeover target. Meanwhile, Weir and Laing (2003) show that "firms that were more likely to attract a friendly bid if they had higher institutional shareholdings, higher executive director shareholdings, as well as higher CEO shareholdings and greater non-executive director independence." These findings suggest that director shareholders and independence may align managerial interests with target firm shareholders in accepting friendly bids.

In sum, the literature does suggest some link between poor performance and the likelihood of takeover. However, the strength of this association seems to vary substantially according to the country, industry and time period examined. Perhaps more significantly, the evidence using stock market based performance measures appears largely inconclusive. The important implication here is that the share price mechanism, posited by Manne (1965) as the central driver of the market for corporate control, does not appear to operate efficiently. This finding is quite significant for debates on the appropriate role of the board, shareholders and takeover

defences for increasing the efficiency of the market for corporate control. Nonetheless, the empirical evidence suggests that accounting based measures of operational performance are broadly consistent with the underperformance hypothesis and disciplinary role of takeovers.

Sociological literature has stressed that the characteristics of target firms will differ greatly depending on the historical and institutional context (Thornton 2001). For example, US target firms were very different in the 1960s, during the heyday of the conglomerate firm, than during the 1980s, when the changes toward great institutional investor power led to firms being sanctioned through 'conglomerate discounts' and subsequent takeover (Davis and Stout 1992). Patterns of M&A activity have also been shown to differ according to the educational backgrounds and ideologies of top managers in a given place and time. The rise of executives with backgrounds in finance and decline of executives trained in production and engineering in the United States were significantly associated with shifts in the patterns of M&A activity (Fligstein 1990). Finally, conformity with prevailing strategies and structures, such as relational network forms of organisation, help explain changes in the risk of acquisition (Thornton 2001).

This literature suggests, more broadly, that the effectiveness of the market for corporate control depends strongly on complementarities with a variety of supporting institutions. Institutional differences or shifts in the aggregate composition of ownership, the identities of top managers, or the conformity with prevailing patterns of strategy and structure within an industry all impact upon the likelihood of acquisition and hence the potential efficiency or role of the market for corporate control. In particular, the research on the relationship between governance characteristics and the likelihood of acquisition suggests the potential importance of ownership patterns and boards in shaping takeover activity.

2.7.2.2 Shareholder returns

A broad consensus exists that share price premiums for target firms are large (Bittlingmayer 1998). The order of magnitude often cited within econometric studies of U.S. firms is often for average abnormal returns as high as 20-30 percent (Bruner 2002). Studies of UK firms (Danbolt 2000) and European firms (Goergen and Renneboog 2004) have confirmed similar gains for target firm shareholders.

Meanwhile, the literature largely agrees that for shareholders of acquiring firms returns are either zero or negative. While most of the literature relates to U.S. companies, very similar results are found elsewhere, such as Germany (Gerke et al. 1995) or Europe more generally (Goergen and Renneboog 2004). Several studies that analyse long-term returns to shareholders of UK acquiring firms tend to find significant negative cumulative abnormal returns to acquirers (Gregory and McCorrison 2002; Forsyth and Raj 2002 2003; Sudarsanam et al. 1996). Other studies of UK firms have argued that shareholder returns for acquiring firms are neither negative, nor positive on the whole. For example, Higson and Elliot examine takeovers between 1975 and 1990, and found no evidence of negative abnormal returns over the three years following takeover completion (Higson and Elliot 1998). These authors found that weighted abnormal returns, measured against a benchmark that controls for firm size, are not significantly different from zero. Meanwhile, they find that whereas positive abnormal returns were witnessed during the period 1981-1984, negative returns were found for the periods 1975-1980 and 1985-1990.

Advocates of the market for corporate control stress a bright side interpretation of the M&A literature. Specifically, they interpret the empirical evidence as suggesting that target firm shareholders do benefit, and that bidding firm shareholders do not lose (Jensen et al. 1983).

Jensen and Ruback (1983) argue that, “Since targets gain and bidders do not appear to lose, the evidence suggests that takeovers create value” (p.21).

In particular, the large gains for target firm shareholders are argued to offset the negative or neutral returns for acquiring firm shareholders. Clear knowledge of the *source* of take-over gains is still lacking. The evidence on the net gains of takeover activity is mixed, and most studies report zero or quite small net gains (Mulherin and Boone 2000). Andrade et al. examine mergers between 1973 and 1998 and also find that target firms gains are offset by acquiring firm losses to net a statistically insignificant change in performance (Andrade et al. 2001). Similarly, one UK study reported net abnormal returns of around 2 percent after target firms gains offset bidder firm losses (Sudarsanam et al. 1996), and this is consistent with other studies of UK firms (Draper and Paudyal 1999; Franks and Harris 1989).

2.7.2.3 *Misvaluation*

Most research on M&A assumes that capital markets efficiently value firms. This view, which has been called the Q hypothesis of takeovers, focuses on how takeover can cause target assets to be employed either more or less efficiently (Lang et al. 1989; Servaes 1991; Jovanovic and Rousseau 2002). Efficiency improves after takeovers following elimination of wasteful target behaviour, better bidder investment opportunities, etc. High market value is an indicator that a firm is well governed or has good business opportunities, and that these are reflected in the creation of shareholder value. Takeovers of less efficient target firms by better-managed firms will improve efficiency.

The misvaluation hypothesis holds that bidders try to profit either by buying undervalued targets for cash at a price below fundamental value; or by paying equity for targets that have lower relative valuations than the bidder. Overvaluation of target firms encourages target management to voluntarily accept offers in order to ‘cash out’ before share prices are corrected to lower levels (Shleifer and Vishny 2003). In essence, therefore, misvaluation affects the expropriation opportunities and managerial incentives for conducting M&A. Relative levels of (mis)valuation between targets and acquirers should impact transaction characteristics, including the means of payment (stock versus cash), the form of the offer (merger versus tender offer), the bid premium, hostility of the target to the offer, and event period returns.

Recent empirical work on U.S. takeovers in the period 1978-2000 gives substantial support for the misvaluation hypothesis (Dong et al. 2003). Dong et al. show, in particular, that bidders are overvalued relative to their targets in both cash and equity offers, and in both mergers and tender offers. Overvalued bidders are more likely to use stock and less likely to use cash as consideration, are willing to pay more relative to target market price, are less inclined to use tender offer rather than merger bid. An important consequence is that these deals earn lower announcement period returns. Undervalued targets receive higher premium relative to market price, are more likely to be hostile to the offer, more likely to receive tender offers rather than merger bids, and earn higher announcement period returns.

2.7.2.4 *Method of payment*

Two fundamental methods for acquiring firm to pay for acquisitions are cash and stock shares (equity). Financial economists argue that firms will use cash to finance an acquisition if their firms’ shares are undervalued, but use equity (e.g. share swaps) if their firm’s stock is overvalued (Travlos 1987). Cash offers are further argued to act as an important signal of a high-valuing bidder that is determined to acquire the target firm, thereby discouraging other bids. Some studies find that cash offers are associated with higher long-term post-merger

performance of the acquiring firms, whereas acquisitions for stock had negative performance (Rau and Vermaelen 1998).

More generally, however, the link between type of payment and performance remains unclear empirically (Hayward and Hambrick 1997). In particular, meta-analysis of post-merger performance in 24 different studies shows no demonstrable relationship between payment method and post-acquisition performance (King et al. 2004). Looking at the UK evidence, only a handful of studies look at the method of payment. One study from the UK found that cash financed mergers outperform stock financed mergers (Abhyankar 2005). One study of UK firms in 1995-96 shows that cash bids did deter competing bids, and were associated with higher post-merger performance (Cornu 2000). Finally, Draper and Paudyal suggest that shareholders of UK target firms benefit the most if given to option to receive payment in either cash or shares (Draper and Paudyal 1999).

Despite the ambiguities of the evidence, one possible interpretation is that share based acquisitions are more vulnerable to misvaluation and bidders may suffer from overvaluation relative to targets (Shleifer et al. 2003). The misvaluation hypothesis implies that bidders will tend to be overvalued relative to targets, especially among stock offers, in which it is the bidder's relative overvaluation that enables its expropriation of target assets. In such circumstances, takeovers are not driven by generating value through the elimination of agency costs, but by overvaluation itself. These arguments are consistent with empirical research showing that the payment of high premiums to shareholders of the target firm was associated with lower post-acquisition performance (Travlos 1987).

2.7.2.5 Leveraged buy-outs and public-to-private transactions

A particular category of transactions attracting recent attention in the literature is public-to-private buy-outs. In the UK, during the 1990s, the decline in number of hostile acquisitions coincided with a general increase in share prices and improvements to corporate governance. Meanwhile, the number of public-to-private transactions (PTPs) in the UK grew nearly five-fold. These transactions are characterized not only by de-listing firms after acquisition, but also finance through private equity and a higher proportion of debt than other transactions (Weir et al. 2003). The motivations and governance aspects of PTPs are argued to be distinct. They are neither hostile because the objective is not to replace poorly performing management nor are they synergistic because the outcome does not involve the association of two complementary companies.

Most literature on PTPs stresses not poor performance, but high agency costs due to incentive misalignment as a motivation of PTP. Jensen (1986) argues that firms going private will have substantial free cash flow and that the PTP transaction will return some cash to the shareholders (Jensen 1986). PTPs are usually highly leveraged and thereby commit management to paying out free cash flow to cover the debt repayments rather than spend them on unprofitable investments. Alternatively, various authors stress that undervaluation by the stock market may give equity-holding executives or institutional investors incentives to cash out their shares (North 2001). However, a variety of additional hypotheses exist regarding PTPs, suggesting that managers may use buy-outs as a last resort takeover defence (Lowenstein 1985) or to avoid transaction costs associated with stock exchange listings.

In the UK, Weir et al. have explored the characteristics of PTPs showing that target firms have higher board shareholdings and higher institutional shareholdings, consistent with the financial incentive hypothesis (Weir et al. 2003). However, the authors find no evidence that PTP target

firms have different internal governance structures, have higher free cash flow or spend different amounts on capital projects. It was also found that the premiums received by shareholders in firms going private were lower than those received by shareholders of other acquired firms. Another study of UK PTPs from 1997 to 2003 stresses that target firms were significantly undervalued and undervaluation led subsequent PTPs to have large premiums for shareholders, particularly in the case of management buy-outs (Renneboog et al. 2005). Here inside management could use information asymmetries to exploit undervaluation. By contrast, the authors find no evidence in support of the free cash flow hypothesis.

2.7.3 Takeovers in the context of corporate strategy, structure and stakeholders

While the above literature in finance is focused on the issue of shareholder gains or losses as a result of M&A, another large literature in business strategy and industrial relations explores the effects of the market for corporate control on other aspects of firms' performance, corporate and business strategy, organisational structure, and the wealth of different stakeholders. This literature attempts to address arguments about business synergy and whether M&A lead to improved productivity and operational performance. Another stream of literature addresses issues of distributive outcomes among stakeholders, and whether the shareholder gains noted by financial economists result from transfers of wealth from other stakeholders that potentially destroy value.

2.7.3.1 Operating performance and productivity

Literature in strategy is concerned with the effects of takeovers on operational performance (e.g. accounting based measure of profitability) and, in particular, productivity. In the UK context, particular concern relates to the 'short-termism' argument: the way that the incentives faced by institutional fund managers transmit a short-term focus to management, which means that they discount returns in the distant future too heavily. In particular, the threat of takeover (or consequences of hostile bids) may lead firms to forego long-term investments. This argument is often thought to explain why investment and indeed R&D levels are relatively low in the UK compared to other countries (ESRC 2003). Likewise, the emergence of hostile takeovers in Continental Europe may have a significant impact on the firm-specific investments and competitive advantage of firms in more coordinated market economies such as Germany (Hall and Soskice 2001).

Compared to the large literature in finance on shareholder returns, fewer studies have directly explored the link between takeovers and productivity (Bond et al. 1998). Powell and Stark report that takeovers completed in the UK over the period 1985 to 1993 result in modest improvements in operating performance (Powell and Stark 2004). They report that the median increase in post-takeover performance for acquiring firms ranges from 0.13 percent per annum to a statistically significant 1.78 percent per annum, depending on the definition of operating performance used. Industrial relatedness and the removal of the target CEO have a positive impact on post-takeover performance, but method of payment is found to have an insignificant impact. Another UK study, based on a panel of firms in 1989-1996, finds that the risk of takeover has a positive and significant effect on productivity (Nuttall 1999a).

2.7.3.2 Dividends and investment

Generally, takeovers lead to significantly lower investment and had a positive but insignificant impact on dividends (Nuttall 1999a). Looking at hostile takeovers, in particular, the risk of takeover had a strong and significant negative effect on investment and strongly positive effect

on dividend payout (Nuttall 1999b). These results are partially consistent with both a disciplinary view of takeovers, as well as the short-termism view.

The 'free cash flow' theory suggests that firms without profitable investment opportunities are more likely to be taken over (Jensen et al. 1983). However, these effects can be mitigating by a firms' dividend strategy. Paying higher dividends may act as a signal to shareholders that managers are not wasting valuable resources. Rather, profits that cannot be reinvested within the firm and paid out in the form of dividends and reinvested in other more profitable opportunities. As such, dividend policy is a useful device for encouraging or maintaining shareholder loyalty. Conversely, the presence of an active market for corporate control may encourage firms to raise dividends (Dickerson 1998) and pay-out a higher share of corporate value-added to shareholders (De Jong 1992 1996). Some UK studies have found the raising dividends has a significant, although modest, negative impact on the likelihood of being taken over (Dickerson 1998; 2002). However, the impact of dividends was not greater among firms with poor investment opportunities (defined by low Tobin's-q), as would be expected by the free cash flow hypotheses (ibid).

Takeover may also have an impact on investment patterns. Interestingly, both over and underinvestment might prevail, depending on the relative bargaining powers between the acquiring firm, target firm management and shareholders (Canoy et al. 2001). The reduction of investments and short time horizons of investment in UK firms is strongly associated with debates over managerial short-termism (Barton 1992). Some studies show that high R&D investment does not appear to increase vulnerability to takeover and firms that are acquired do not have higher R&D than those that are not (Jenkinson and Mayer 1994). However, the same studies note strong reductions in levels of investment, which may be consistent with either the disciplinary role of takeovers or short-termism.

2.7.3.3 Business portfolio

A large literature, particularly in institutional theory, has noted the different characteristics of various merger waves in the last century in terms of their business characteristics. During the 1960s, conglomerate mergers involved firms building up diversified groups by moving into unrelated industries (Steiner 1975). These mergers occurred during a period of high stock market valuation and generally were financed through exchange of shares (Shleifer et al. 2003). During the 1980s, diversified firms in the U.S. were undervalued by the stock market – the so-called "conglomerate discount." Changes in anti-trust law and financial innovations around so-called junk bonds contributed to an unprecedented takeover wave (Blair 1993; Bhagat et al. 1990). Diversified firms were taken over at high rates, split into component business, and sold to firms within the same industry (Davis et al. 1994). Takeovers promoted corporate consolidation, since acquiring companies could keep related parts of the target company but recoup the purchase price through selling unrelated business to other buyers in those industries (Bhagat et al. 1990). Others firms proactively divested assets in order to focus on a core competence. In the 1990s, mergers became much less hostile and took place largely in related industries, using stock swaps to consolidate industry structures (Holmstrom and Kaplan 2001).

One study of 178 successful UK bids in 1979-1989 suggested that conglomerate mergers in unrelated areas were actually more successful than mergers between related firms (Holl 1997). The authors also note that managers in related firms were less likely to resist bids. But they noted that financial and managerial synergies were more important in M&A success than operational synergies.

2.7.3.4 Managerial turnover

The impact of an acquisition on executive turnover is well documented. In the U.S., Martin and McConnell (1991) found that 41.9 percent of CEOs left within one year of an acquisition (Martin et al. 1991). UK evidence suggests that hostile takeovers are associated with a greater degree of top executive turnover compared to that of friendly takeovers. Dahya and Powell show that 35.24 percent of top management teams leave in the first year post take-over and 25.80 percent in year 2 (Dahya et al. 1998 1999). Kennedy and Limmack (1996) report that in the first year after acquisition, 40.14 percent of companies changed their CEO in the first year after acquisition and 25.7 percent changed them in the second. Franks and Mayer found that 50 percent of directors of target firms resigned after the bid had been accepted (Franks et al. 1996). The results give further support to the disciplining role of the hostile takeover.

2.7.3.5 Employment

The impact of takeovers on employees is central to the controversy over the market for corporate control. From the agency theory perspective, the disciplinary role of takeovers should reduce excess employment and enhance labour productivity. Takeovers are argued to shift assets to more efficient uses while also enhancing the accountability of managers to shareholders. Alternatively, from the resource-based view of the firm or stakeholder theory, takeovers may diminish firm-specific human capital and knowledge, particularly in the case of hostile takeovers. Here the source of gains in takeovers derives from the ability of managers to breach with impunity the ‘implicit contracts’ of a variety of key stakeholders (Shleifer and Summers 1988). In particular, if employees and other constituencies with asset-specific investments are not adequately protected by law, takeovers will serve to transfer wealth to shareholders at the expense of long-term performance of the enterprise (Deakin et al. 2002). More generally, the threat of hostile takeover may decrease the level of investment in firm-specific assets by managers, employees and other stakeholders, thereby offsetting any gains in the reduction of agency costs (Schnitzer 1995)

The ‘breach of trust’ hypothesis assumes that employees are willing to make firm-specific investments in human capital in return for an implicit promise of job security. Since employees hold assets whose value is ‘locked in’ to the particular firm, they become vulnerable to ex post renegotiation of implicit contract terms by management. In the context of a hostile takeover, downsizing enables management to capture the future ‘rents’ or income streams which would otherwise have accrued to employees, and to convert them into takeover premiums for the shareholders’ benefit. Shleifer and Summers (1988) suggest that, following a successful hostile bid, a new management team comes in and finds itself able to realize short-term gains to meet the costs of the takeover through asset disposals. They argue that, “Hostile takeovers are external means of removing managers who uphold stakeholder claims. Takeovers then allow shareholders to appropriate stakeholders’ ex post rents in the implicit contracts. The gains are split between the shareholders of the acquired and the acquiring firms. At least in part, therefore, the gains are wealth redistributing and not wealth creating”.

A wide range of social science literature supports the ‘breach of trust’ argument in UK firms, and generally suggests casts doubt on the efficiency of the market for corporate control. Conyon et al. (2001; 2002) examined hostile takeovers in the UK between 1987 and 1996, reporting significant falls in both employment and output. While the authors interpret these changes as increased organisational efficiency, they also suggest that the evidence cannot directly measure or test for potential losses in firm-specific assets. Deakin et al. (2002) conducted case studies of 15 UK takeovers in 1993-1996, reporting substantial job losses and

short-term sale of assets (Deakin et al. 2002). Their study gives additional qualitative insights into the marginal role of employment considerations within the decision-making process, and subsequent losses of employee morale. These results are consistent with other UK research in organisational behaviour suggests that, even where merging firms have similar corporate cultures, mergers lead to a substantial decline in the mental health of employees (Cartwright 1993).

Comparative research likewise suggests that the *absence* of takeovers has important distributive consequences. In countries with active markets for corporate control, such as Britain, a lower proportion of corporate wealth goes to employees and reinvestment in corporate growth (De Jong 1992; 1996). Research on the 100 largest German firms show that the threat of takeover is associated with higher dividend pay-outs and a declining labour share of value-added (Beyer and Hassel 2002).

2.7.4 Takeover market: contingency factors

A number of authors suggest that the role played by market for corporate control is contingent upon a variety of firm-internal factors such as the firm's size, age, industry, growth/decline phase, etc. Moreover, environmental factors such as stock market activity, ownership patterns, regulatory institutions, inter-firm networks and managerial conceptions of control impact M&A.

An emerging research on the life cycle of corporate governance (Filatotchev and Wright 2005) suggest that as firms evolve over different stages of development, they face different corporate governance demands. This line of theory suggests that the market for corporate control can be most important in managing difficult 'transitions' between stages, such as when maturing entrepreneurial firms are purchased and integrated with more established firms or when firms in declining industries consolidate.

Industry factors are also important, such as whether competitive advantage is based around incremental innovation or radical innovation (Hall et al. 2001). Industries characterized by incremental innovation tend to require input of firm- or relationship-specific assets, unlike industries undergoing radical innovation where new knowledge and assets need to be combined quickly using the external market.

In this context, the threat of hostile takeover may undermine particular institutional advantages associated with firm-specific investments (Höpner et al. 2001). In order to generate sufficient shareholder returns, firms are constrained from growing beyond a level at which the marginal returns to equity diminish. Without such constraints, firms retain a wider range of strategic options, such as: pursuing higher market share, spending more on capital and R&D investment; specializing on market segments offering lower returns but large size and relatively low risk; and absorbing higher labour costs to avoid layoffs during downturns and protect employee morale and firm-specific human capital. More generally, one might say that the importance of firm-specific or relationship-specific investments by different stakeholder groups for competitive advantage is an important contingency that impacts the wealth creating or destroying effects of the market for corporate control (Deakin et al. 2002).

2.7.5 Costs, complementarity and substitution among governance channels

The literature on the market for corporate control suggests a number of important linkages between governance channels. The literature on misvaluation suggests that effective markets for corporate control presuppose high levels of information disclosure, long-term value-oriented investors and legal regulation of takeover defences. In this sense, the market for corporate control is complementary to a liberal, market-oriented financial regime. The complementarities of takeover markets with employee voice may, however, be negative according to the ‘breach of trust’ hypothesis. These negative influences may, nonetheless, be mediated by greater protection of firm stakeholders during the process of M&A, as suggested by the regulatory experiences in Germany or Japan.

The market for corporate control acts as a substitute for other channels of governance, particularly the mechanisms of monitoring by relationship-oriented banks or direct monitoring by large blockholders. The mixed or weak evidence on the performance aspects of M&A suggest that the market for corporate control is not superior to these other forms of monitoring, but given the particular ownership and financing patterns of firms, the market may be a substitute governance mechanism ‘of last resort’.

2.8 Stakeholders

2.8.1 Introduction

It has been argued that participation by various stakeholders may complement other internal and external monitoring mechanisms and thereby promote greater managerial accountability. In turn, some have argued that this will make for better decisions, the more effective implementation of decisions, and better performance outcomes.

An extensive literature exists on stakeholding in the modern business enterprise. An increasing amount of this literature is set within the framework of corporate governance and draws parallels or contrasts between shareholding and stakeholding. Some of the literature draws on economics and accounting, but much uses political science, legal analysis, and sociological and management literatures. In part because of paucity of empirical data, fewer studies exist of the kind found in the financial literatures on boards or blockholders, which use statistical techniques to test the basic hypotheses found within the stakeholder literature. A large amount of the literature is also of a more normative kind, putting the case for stakeholder voice in the firm and in its governance. The stakeholder literature overlaps with the corporate social responsibility (CSR) and corporate social performance (CSP) literature. These literatures are included in this review where appropriate.

2.8.2 Stakeholders: identification, contrasting perspectives, and empirical evidence

This section discusses the issue of identifying who are stakeholders and discusses the widely contrasting perspectives on stakeholders. Empirical work on the impact of firms adopting a general stakeholder orientation, represented largely through CSR, is reviewed. We then focus on two particular stakeholders – debtholders and employees

2.8.2.1 *Identification*

No firm agreement exists in the literature as to which groups constitute stakeholders. Some of the literature includes creditors and debtholders in the definition – they have real claims on the firm, which are not necessarily the same as those of shareholders. Employees are normally included – they have an economic stake in the firm, have a voice of varying degrees, and their involvement can arguably affect performance. As part of an outer circle of stakeholders, local communities are often included in the definition – they also have a stake in the firm's existence and disregarding the voice of local communities can have negative effects on the firm. The environment is increasingly included in discussions of stakeholding – the firm's activities can affect environmental conditions and the sustainability of company activities. These issues can, in turn, affect the reputation of the firm in the eyes of consumers and investors.

Some would include customers as stakeholders – they clearly have an interest in the firm's activities, though here it might be objected that the relationship between the firm and its customers is primarily a form of market transaction often of a short-term nature, thereby falling outside the internal governance of company decision-making. Some would also include suppliers and subcontractors – they also have an interest in the well being of the firm and relations between them can be long term. On the other hand, again it might be objected that the relationship between the firm and its suppliers is largely of a transactional kind.

Below we focus on two groups: creditors and employees. This is for several reasons. First, they are included in most definitions of stakeholding. Second, they are both relatively distinct groups. Third, there exists an extensive body of empirical literature, both national and international.

2.8.2.2 *Contrasting perspectives*

The stakeholder literature is often framed in terms of differing perspectives. A broad contrast is made between shareholder and stakeholder orientations: the former is said to see the firm in terms of relations between shareholder principals and managerial agents and the maximisation of shareholder value; the latter sees the enterprise in terms of broader relations between all stakeholders with an interest in the firm and a broader set of goals to be maximised or satisfied. Various arguments are made in support of the stakeholder perspective. One argument is moral or political – there is an intrinsic case for the involvement of stakeholders in the firm in terms of democratic rights and voice (Freeman 1984; Donaldson 1989; Donaldson and Preston 1995; Blair 1995; Davis et al. 1997). Another argument is more instrumental or economic – there is an extrinsic case for shareholder participation in terms of team production, commitment, firm-specific investments, and risk sharing (Blair and Stout 1999; Parkinson 2003). This latter perspective might also be termed the enlightened self-interest model.

Arguments against all forms of stakeholding go back at least to Friedman (1962) and Hayek (1969). Apart from basic moral objections linked to the notion of private property, various more practical problems with stakeholding are identified – too many stakeholders, the lack of pledgeable income in the case of some, no clear task or accountability for management, deadlocks in decision making, problems of mechanisms (Sternberg 1997; Tirole 2001).

Some writers see middle courses and talk about 'enlightened shareholder value' or 'instrumental stakeholder theory' or 'strategic corporate social responsibility' or 'the good firm' (Parkinson 1995; Jones 1995; Kay and Silberston 1995; Campbell 1997; Kay 1997; Keasey, Thompson, and Wright 1997; Kelly and Parkinson 1998; Slinger 1999). With some variants,

this basically states that satisfying stakeholders is both morally desirable and makes good business sense; firms which build good relations with stakeholders gain competitive advantage; however, according to this perspective, the primary responsibility for the running of the firm should be vested in managers and their task is to balance or integrate the interests of the different stakeholders (see debates in Vinten 2001; Gamble and Kelly 2001; Letza et al. 2004; O'Sullivan 2000).

2.8.2.3 *Empirical literature on stakeholding and corporate social responsibility*

Here we review the general empirical literature on stakeholding. Some of the literature focuses on determinants, other literature on outcomes of stakeholder participation.

In terms of determinants, McGuire et al. (1988), using *Fortune* ratings of CSR reputations, show that rankings of firms' prior performance, assessed by both stock market returns and accounting measures, are closely related to CSR, more so than subsequent performance. They suggest that firm performance affects CSR rather than the reverse. Various articles by Graves and Waddock (1994) and Waddock and Graves (1997) also report that prior financial performance is positively associated with CSP, suggesting that 'slack resource availability' and CSP are closely aligned. Also, the salience of CSP issues varies by industry in line with the concern of firms in different contexts. However, the same authors also show that CSP is positively related to future financial performance. Luoma and Goodstein (1998) focus on the representation of non-shareholder stakeholders, such as employees, public officials, suppliers and customers, on company boards. Their research finds that stakeholding representation is modest in the U.S. (as it is in the UK) and is more likely to occur where companies are larger or are in industries with a higher degree of regulation. These factors do not influence stakeholder representation on board committees. However, firm size and the legal environment are associated with the adoption of stakeholder-oriented board committees.

In an interesting U.S. study, Johnson and Greening (1999) used the Kinder, Lydenberg, Domini (KLD) index of five broad variables to measure a firm's stakeholder position (employees, product safety / quality, diversity, community, and natural environment). They found that different aspects of governance shaped different social activities. Thus, pension fund equity ownership was associated with certain type of CSP, such as employee relations, women and minorities, and communities, which they described as 'people' issues. It was also associated with quality and environmental aspects of CSP, which they described as 'product' issues. Outside director representation was also positively related to both CSP dimensions. By contrast, mutual fund and investment bank equity exhibited no direct relationship with CSP. Top management equity holdings were positively related to product but unrelated to people dimensions. Finally, organisations, which perform well on the people dimensions of CSP, tend to have higher financial performance as well

For the UK, Cox et al. (2004) use data from a *Management Today* survey compiled over a ten-year period. Matching this with ownership, they find that long-term institutional investment is positively related to CSP. On the lines of Johnson and Greening (1999) above, disaggregation of CSP into its constituent components suggests that pension funds and insurance companies exhibit a positive orientation to employee- rather than community-based CSP. They suggest that this may reflect the positive relationship between employee-based CSP and efficiency and risk reduction. Considering the impact of investment screens on the selection of stocks, they suggest that long-term institutional investors select stock primarily through exclusion, rejecting firms, which have poor CSP.

In terms of outcomes of stakeholder participation, there is considerable case study based research, which suggests a positive relationship between stakeholding and performance (see, for example, the Royal Society of Arts 1995). However, there are obvious problems with the selection of companies and the ability to generalise from such studies. Fortunately, there are also a number of statistical studies and meta-analyses of these.

An early meta-analysis by Ullmann (1985) found no clear relationship between CSP, social reporting, and economic performance of U.S. companies. The author concluded that this was because of different definitions of terms and deficiencies in the various studies. However, he suggested that the more elaborate studies seemed to reject a relationship between social performance and economic success. He concluded that the area was one where poor data was in search of a good theory. In a later meta-analysis of event studies, Frooman (1997) found that irresponsible and illicit behaviour had a negative impact on share price performance. Similarly measures of CSP, including responsibility for the environment and fair treatment of employees, were positively correlated with return measures of financial performance, such as return on assets and stock appreciation (see also Wood and Jones 1995).

In another meta-analysis of 51 studies, Griffin and Mahon (1997) suggest that the majority of these report a positive relationship between CSR and profitability. Similarly, Orlitzky (2000) uses meta-analysis techniques and draws from relevant articles in major world management journals over 20 years. He suggests that CSP and financial performance display a significant positive correlation, but more so with accounting measures than other economic measures. However, environmental aspects of CSP are not as highly correlated with financial outcomes. The main transmission mechanism is argued to relate to reputation, both reducing downside reputational risks and promoting positive corporate image. In a joint article, Orlitzky and Benjamin (2001) use measures of CSP such as disclosure to stakeholders, reputation ratings, social audits, and managerial orientation. They find that the higher a firm's CSP, the lower its financial risk, but more so with market risk than accounting risk. They suggest that there is reciprocal causality: prior CSP is negatively related to subsequent financial risk and prior financial risk is negatively related to subsequent CSP. Of all the CSP measures, reputation for social responsibility is more important in terms of risk implications.

Finally, we cite two useful individual studies. Berman et al. (1999), taking 81 large U.S. firms and using the KLD index, find that only employee and product quality / safety measures directly affected financial performance. They suggest the results confirm the 'strategic stakeholder management model', which says that firms address stakeholder concerns, which they believe will enhance financial performance. Their study suggests that firms are unlikely to voluntarily address stakeholder concerns because of moral commitment to stakeholder groups. For the UK, Greenley and Foxall (1997) take a multiple stakeholder orientation and find in their sample of UK companies that consumers are prioritised as the main stakeholder. The orientation towards multiple stakeholders is positively associated with performance, though the association is contingent on a good external environment and the absence of strong competitive pressures. The limited nature of voluntary efforts may provide rationale for further regulatory intervention.

These studies provide some suggestive findings about the reciprocal links between corporate governance, stakeholder activity, and company strategy. However, they have shortcomings. Some of these problems relate to the small-scale nature of the statistical research in terms of the number of observations, cross sectional data, missing variables, and issues involving the direction of causation (Harrison and Freeman 1999; De Bakker, Groenewegen, and Den Hond

2005). However, research on CSR also suffers from some particular problems. The data is drawn variously from business magazines, consultancy work, content analysis, and event studies; some of the constructs are rather vague; and there is a lack of a common theory to underpin the studies. As one recent overview has suggested ‘empirical tools are only beginning to be developed’ and ‘the stakeholder model remains relatively unsophisticated’ (Harrison and Freeman 1999: 481, 484).

We now turn to two specific groups - debtholders and employees.

2.8.3 Debtholders

Debt and debtholders can play a significant role in corporate governance and in shaping business strategy and performance (Hart 1995, chapter 6; Jensen 1986; Myers 2001). Debt may take the form of long- or short-term loans from a variety of financial intermediaries who are more or less likely to intervene directly in the firm. It may take the form of loan contracts arranged ‘privately’ with banks or ‘publicly’ via bond issues in financial markets. Here we focus mainly on banks because of the availability of literature. In practice, debt is a contractual guarantee to future cash flows, and the expectation is to achieve a level of return specified at the commencement of the debt contract, including repayment of the debt. The contractual claim on future cash flow constrains managerial discretion. Debt-holders may force liquidation and restructuring when firms are in distress. For these reasons, debt has been seen as a critical control on managerial behaviour in the financial economics literature (Modigliani and Miller 1958; Hart 1995). Credit ratings are also important mechanisms of control because they signal the financial health of firms to all investors and affect the cost of capital. The negotiation of the initial debt provides the first potential for influence. Thereafter, monitoring through the stages provides the basis for further interactions between creditors and managers. Where there are repeated interactions and a ‘relationship’ develops, financiers may become directly involved in the governance and management of the firm (Stiglitz 1985). This can lead to interlocking directorships when a senior officer of the bank sits on a customer’s board. Arrangements of this kind have been particularly common in Germany and Japan, where debt is intertwined with equity ownership and where loan providers often have board representation (Jackson 2003).

The literature is concerned with both the positive and negative effects of debt on the governance and performance of the firm

2.8.3.1 Advantages of debtholders for the firm

First, banks and other forms of intermediated finance obviously provide firms with access to funds. Banks may also provide economies of scope in terms of a breadth of other services (deposit, investment, currency, and advisory activities). These roles will be particularly important at certain points in the company’s life cycle, especially during early stages when equity finance is unobtainable or too expensive, during flotation or rapid expansion, and during distress via the revision of contracts or by providing new lending. Banks have access to a wide spread of private information, especially where they also provide other services. They are also likely to have the professional capability and expertise to engage in effective scrutiny. In this way, they can obtain a good picture of the firm’s financial and operational position which helps with monitoring and can provide reliable signals to those outside the firm (Fama 1985; Boot and Thakor 1997a and 1997b; Holland 1994; Myers and Majluf 1984; Mickiewicz and Filatotchev 2005).

Second, bank lending can send positive messages to the market and reduce the cost of capital. Thus, there is evidence that it reduces the underpricing of IPOs and has a positive effect on the share price of the firm. Equally, corporate divestiture can be influenced beneficially: firms with bank debt receive better returns on such divestitures (James 1987; Slovin et al., 1988; Lummer and McConnell 1989; James and Weir 1990; Slovin and Young 1990; Hirshey et al. 1990).

Third, through inside information and monitoring, lenders can prevent borrowers from overextending themselves and making unwise investments (Boot and Thakor 1997a and 1997b). Similarly, bank relationships can enable a firm to obtain finance without disclosing proprietary information and this may encourage investment in R&D or in non-tangible, but high value, assets (Bhattacharya and Chiesa 1995; Yosha 1995). Bank involvement may also offer protection against hostile takeover (van Damme 1994).

Finally, and more generally, banks and other major lenders can provide a set of counterbalances: against self-seeking behaviour by managers; against shareholders who may be more prepared to take on unwise risks; and against both managers and large shareholders who may exploit the firm to the disadvantage of smaller shareholders and other stakeholders (Hart 1995; Jensen 1986). Also where there is equity ownership by banks, the possibility of strategies towards risk, which are too heavily skewed in favour of one type of financier, are reduced. The incentive to take large risks with borrowed money for the benefit of shareholders is reduced if shareholders also are lenders (Stiglitz 1985; Van Damme 1994).

These functions of intermediated finance are classically seen as operating in the Japanese and continental European, especially German, systems (Charkham 1994; Corbett 1994; Berglöf and Perotti 1994; Gilson and Roe 1993; Hoskisson et al. 2004). Franks and Mayer (1997) provide empirical evidence of how these relationships can work. They suggest that banks not only provide funds for company expansion, but can also develop well-informed and positive relations with executives. This may be particularly appropriate where the firm's activities are opaque to outsiders (as proxied by long-term R&D expenditure), or where complex supplier / customer relationships exist, or where other intangibles are concerned (Zeckhauser and Pound 1990; Roe 1997). Edwards and Fischer (1996) and Ongena and Smith (2000) provide an overview of the evidence on the relationship between German and Japanese banks and firms. They suggest that benefits historically outweighed costs, but may have reduced over the long term.

2.8.3.2 Disadvantages of debtholders for the firm

On the negative side, it has been contended that lenders such as banks can have too much influence within the firm and that this can lead to a hold-up problem. Equally, some have argued that there has been a tendency, especially in the 1970s and 1980s, to 'romanticise' the corporate governance role of German 'house' banks and Japanese 'main' banks (Coffee 1991; Edwards and Fischer 1996; Macey and Miller 1997).

First, relationships with banks may paradoxically mean that firms finish up paying above-market interest rates for their borrowing. Macey and Miller (1997) interpret such rates as 'rents' which banks earn on their loans in exchange for insulating incumbent managers from the market for corporate control and accepting less than optimal returns on any equity holdings they may have. In turn, this situation lowers market liquidity and prevents outside shareholders making a credible takeover threat where this might be desirable. In U.S. empirical work, Petersen and Rajan (1994 and 1995) found that the length of relationship between a bank and a firm positively affects the availability of bank credit but had no significant influence on interest

rates. Some European research confirms these U.S. studies with regard to availability and loan rates (Elsas and Krahnert 1998; Harhoff and Körting 1998; Degryse and Van Cayseele 1998; and Angelini et al. 1998). Of course, if banks do gain a monopoly position and firms become locked in, it is to the advantage of the latter to maintain multiple-credit relationships, and indeed these are quite common (Houston and James 1996; Ongena and Smith 1998a; Ongena and Smith 1999).

Second, there is evidence that intermediated forms of finance may distort investment decisions. Thomas and Waring (1999), for example, find that in making investment decisions large bank-controlled firms in Germany and Japan are influenced more by liquidity considerations than by the prospect of long-term returns. In the case of both Japan and South Korea, it has been argued that banks have allowed firms to engage in unwise diversification projects and have been slow to force restructuring and the sale of under-utilised assets (Taniura 1993).

Third, intermediated finance in general and banks in particular may be less efficient in dealing with managerial opportunism and controlling owners. In part, this is because the credibility of bank threats is reduced where the bank is a big lender and where action would hurt the bank and jeopardise the loan. Similarly, where the bank is also a large shareholder this may constrain its disciplinary role (Holland 1994; Andersen et al. 2003).

Fourth, banks may collude with managers to retain profits rather than distribute dividends (Baums 1993). For example, Harris and Raviv (1990) provide evidence that German banks are reluctant to discipline managers in client companies, especially where they are linked to these companies through a system of cross-shareholdings. Thus, banks with board seats and/or shares in a firm have been seen to protect their investments by keeping cash within the firm. 'This amounts to banks forming a coalition with managers to keep down dividends payable to outside shareholders' (Baums 1993). In his study of German banks, Nunnenkamp (1996) has shown that high retention reduces the risk that the company will default on its outstanding debts. Thus, banks may be less than ideal monitors for outside shareholders (Macey and Miller 1997)

Fifth, because of the small numbers involved, it is also possible that large creditors may collude with large shareholders to the disadvantage of small shareholders. Wright et al. (2003) and Mickiewicz and Filatotchev (2005) have suggested that the problems of collusion between banks and incumbent managers at the expense of shareholders and between banks and major shareholders at the expense of minority shareholders may be particularly acute in transition and developing economies.

Finally, lenders may form an implicit coalition with our next stakeholder viz. employees. If both are risk-averse and their claims are a concave function of firm profitability, they have some congruence of interests. This may lead to low risk, but low reward projects (Perotti and van Thadden 2004).

2.8.4 Employees

Employees can be stakeholders in the firm individually or collectively. Individually employees may have a stake through voice mechanisms such as line management meetings, briefing groups, report-back circles etc. They may also be communicated with via various company reports. These mechanisms are often referred to as direct communication and voice. Individuals may also have a stake through financial plans such as individual share ownership.

Collectively employees may express their voice through joint consultation or collective bargaining via trade unions or board level representation. These are usually referred to as indirect or representative employee voice. In addition, there is the important role of employee trustees in pension schemes.

2.8.4.1 Employees as individuals

The relevant literature on individual voice is least extensive. Using the Workforce Employment Relations Survey (WERS), Forth and Millward (2002) suggest that formal mechanisms such as line management meetings, briefing groups, and quality circles have become more common in recent years and that around three quarters of large private sector workplaces have such arrangements. Employees and employers value these arrangements. These voice mechanisms do not seem to have been used to supplant collective representation, for example, via trade unions, but they may be used to exclude such. Little relevant work has been done on the effects of such forms of voice on outcome variables, which relate to governance. However, the literature suggests that they have little effect on matters, which might be deemed to come within the area of corporate governance (Gospel and Willman 2003). One recent study (Peccei et al. 2005a) suggests that such forms of voice are strongly correlated with the provision of information to employees and in turn that this can have a positive effect on employee commitment and ultimately on productivity.

The literature on employee shareholding has been well surveyed (Pendleton 2001). It makes the following points. There are about 2,000 all-employee share plans in operation in the UK and about 3 million private sector employees are members of such schemes (HM Revenue and Customs 2005). Individual employees hold a relatively small proportion of shares, which constitute less than 5 per cent or less of total equity in enterprises with shareholding schemes in total (Pendleton 1997). In terms of determinants, empirical studies suggest that share ownership plans are most likely to occur in large, listed firms, and there is growing evidence of a correlation with high levels of human capital (Robinson and Zhao 2005). In terms of outcomes, the literature finds a positive effect of share ownership plans on productivity, but no link with profitability has been clearly demonstrated. However, this causal link with productivity is debated, as it is unclear whether high productivity may drive employee share ownership or vice-versa (Pendleton 2001; Sesil et al. 2002). Overall, the impact of employee share plans on corporate governance practices appears to be limited. It should be noted that share plans are themselves influenced by corporate governance practices (see the Association of British Insurers' corporate governance guidelines which recommends a limit of 10 per cent of equity being made available to employees).

2.8.4.2 Employees as collectives

The literature on collective voice is more extensive. The stylised facts for the UK are as follows. First, there is no legal right to board representation for employees as in some other European countries. Second, there are, however, now legal rights to voice via various joint consultation arrangements, which have some parallels with works councils in continental European countries. In companies above a certain size and with operations in more than one EU country, there are also rights to establish European works councils. Third, in the private sector, voice via joint consultation is stable, while voice via trade unions and collective bargaining is shrinking (Gospel et al. 2003; Gospel and Willman 2003).

In terms of empirical studies 20 per cent of private sector workplaces in large companies have joint consultation committees and most of these have committees at both workplace and company level. Company size is negatively associated with workplace committees, but

positively associated with higher-level committees or a combination of the two (Cully et al. 1999: 99). Less work has been done on outcomes. However, Peccei et al. (2005a and b) show that employees receive less information and voice through these mechanisms than they do through either direct participation or through trade unions. In recent years, European works councils have been established in a number of British multinationals and other EU multinationals operating in the UK. The initial verdict on these is that to date their coverage has varied between sectors, being strongest in areas of manufacturing, such as motor vehicles, and that some have been able to provide real voice in company activities, especially where they are backed by trade union representation (European Foundation 2004). It is too early yet to comment on legally mandated national works councils in Britain since these only started to come into effect in 2005. Overall, the literature on consultation suggests that it has little effect on matters, which might be deemed to come within the area of corporate governance, but the European, and national works councils have the potential to bring about changes in this area (Gospel and Willman 2003).

The literature on employee voice through trade unions is the most extensive, paradoxically given the decline in union recognition, membership, and coverage in recent years. Theoretically, it is argued that trade unions can monitor management and act as a check on its activities (Freeman and Medoff 1984). Presently in the UK 20 per cent of private sector workers are in trade unions. Unions bargain at various levels, but in particular at the level of the workplace and company level bargaining is relatively limited in the UK. The determinants of trade unions recognition and collective bargaining in the private sector include industry, firm or workplace size, and age of plant. In terms of outcomes, nowadays unions have only a modest effect on pay, productivity, financial performance, investment, and employment growth, compared to the past. However, unions are a force for fairness in the workplace: they narrow pay differentials, improve health and safety, and boost family friendly policies (Cully et al. 1999; Metcalf 2005). The effect that unions in the UK have on corporate governance is limited, in part because they have rarely had much voice at the level of the company.

Finally, in this review of the UK, we refer to employee stakeholding via pensions. Employees, both present and past, have a substantial stake in the firm where there is a company pension scheme. At the present time in the UK, there are around 18,000 private sector defined benefit schemes and 70,000 defined contribution schemes and there are around 9.8 million active members of such schemes (National Statistics 2005). The existence of such plans was historically deemed to have had broadly beneficial effects for firms in terms of recruitment and retention (Hannah 1986). However, in more recent years, the liabilities attaching to pensions funds have come to be seen increasingly as a major cost for the firm and for shareholders and hence the decline in the number of such schemes and in particular of defined benefit schemes. More is said in section 2.3 above on large blockholders. Here, from a stakeholder viewpoint, we would make the following points. Since 1995 employees and retirees get to name at least one third of the trustees on boards running pension schemes. One stated intention of this has been to increase member involvement in pension fund boards, making them more attentive to social responsibilities and more activist in nature. On the other hand, trustees are required to act in the best interests of the schemes' members in a manner consistent with overall liabilities and returns. Furthermore, trustees may lack sufficient knowledge for active involvement. These factors place significant restrictions on the management and investment activities of trustees. However, where there is union involvement and where trustees have the information and motivation, they can have more effect on corporate governance and in companies in which they invest. To date, in the UK, this has not developed to the extent of CALPERS and TIAA-CREF

in the U.S. Thus, large cross-national differences exist in the extent of employee voice in the governance of pension funds (Jackson and Vitols 2001; Kakabadse and Kakabadse 2004).

2.8.4.3 The German case

The case of Germany is often referred to in discussions of employee stakeholding and is briefly summarised here. In Germany, there are two well-developed institutions, which either do not exist or do not exist to the same extent or with the same rights as in the UK. The first is employee representation on the supervisory board; the second is works councils.

In terms of board level representation, arrangements vary with the size of firm, but basically either one third or one half of seats on supervisory boards of large firms go to employee representatives, and these may include trade union officials. Most big firms have such representation, which is highly correlated with size. In terms of effects, there has been considerable debate in recent years. Recent studies by Schmid and Seger (1998) and Gorton and Schmid (2000) present findings that parity codetermination caused a 21-25 per cent decrease in share price relative to companies with one third codetermination. However, the study has been strongly criticised on methodological grounds (Frick et al. 1999). Baums and Frick (1998) find no negative effect on share price following on the introduction of parity codetermination and significant court decisions. Kraft and Stank (2004) and Fitzroy and Kraft (2005) show a small positive effect of codetermination on the innovation and on productivity.

In terms of works council representation in Germany, these operate in most large firms and have extensive information, consultation, and codetermination rights. They can exist at workplace, subsidiary, and company level. The existence of such councils is highly correlated with size. Here, the effects of such representation seem to be clearer. Several recent articles have summarised the literature (Addison et al. 2004; Frege 2002; Frick and Lehmann 2004). These studies suggest that significant productivity advantages accrue to plants with works councils over those without. For a recent overview of the German literature in a comparative perspective, see Vitols (2005).

Many critics of the German system argue that employee codetermination is not compatible with strong capital market pressures, as found in the UK (Pistor 1999; Roe 1999). However, a number of studies now show how employee representatives in Germany are adapting to a growing shareholder-value orientation of German management. These studies suggest the emergence of augmented stakeholder coalitions which now include institutional investors, resulting in a kind of “negotiated shareholder value” in Germany (Vitols 2004; Höpner 2001; Jackson 2005b). For example, performance incentives for employees remain less strong than in the UK, thus perhaps representing a more egalitarian version of Anglo-American practices. Likewise, company case studies in Germany show that employees still maintain an active voice in the decision making process (Jackson 2003).

2.8.5 Costs, complementarities and substitution among governance mechanisms

Stakeholder participation in corporate governance certainly has important costs associated with it. Disclosure of CSR or environmental impacts greatly increases the scope of information to be included in company reporting and raises issues of establishing objective and comparable standards across firms. Likewise, stakeholder voice may also have considerable impact on decision-making processes within the firm. In particular, employee involvement may slow down decision times. However, stakeholder involvement may have offsetting benefits of

speeding up implementation once decisions have been made, since stakeholders will have higher levels of information and greater consensus around those decisions. As such, the net cost impact of stakeholding remains unclear, but is unlikely to be prohibitive for large organisations.

Stakeholding has important complementarities with other elements of corporate governance. For example, the linkages between various dimensions of corporate governance and employee voice have been conceived in different ways in economic theory. First, transaction cost models suggests that commitment by investors to specific firms supports stable long-term employment, investment in worker training and co-operative industrial relations (Hall et al. 2001). These institutional complementarities support dynamic (X-) efficiency in lower-volume, higher-quality product markets requiring high skills (Streeck 1992). Second, agency theory argues that employee rights increase the agency costs to diffuse shareholders (Jensen et al. 1976) and reinforce the advantages of direct control coming from relational finance, which are needed to counter-balance the strength of labour. For example, Roe (1999) argues that, in countries like Germany, ‘diffuse owners may be unable to create a blockholding balance of power that stockholders would prefer as a counterweight to the employee block.’ Third, the economics of information and co-operation stress potential positive-sum aspects. For example, information and disclosure may enhance the prospect of voice for both investors and employees, thereby increasing the accountability of management (Aoki 1988; Hirschman 1972). The presence of stakeholders on boards may provide greater independence from the CEO, and help establish a more effective system of checks and balances within the board (Aguilera et al. 2003).

Different models of complementarities may represent only some aspects of economic exchange that have potential trade-offs. Strong labour participation may increase agency costs but lower transaction costs. Take-overs may lower agency costs, but increase transaction costs. Inferences about the overall complementarity between particular institutions remain challenging. Likewise, we cannot tell a priori which dimension will drive overall performance (Jackson 2005c). Efficiency does not result from a universal “one best way,” but suggests that different patterns of comparative institutional advantages exist for different sorts of strategies (Hall et al. 2001; Aoki 2001b). Importantly, these may imply different salience of firm-specific employee investment and, consequently, different sorts of corporate governance arrangements for protecting stakeholder wealth (Parkinson and Kelly 2001).

Finally, stakeholder involvement may be an important substitute for other corporate governance mechanisms. A large literature suggests that bank-based monitoring is a substitute for an active market for corporate control (Aoki et al. 1994; Baums 1993). Where banks play an active role intervening in the governance of firms during financial distress, in the last resort mechanism of takeover may be unnecessary.

2.8.6 Conclusions

A number of conclusions may be drawn on the nature, determinants, consequences, and interactions of stakeholder involvement in corporate governance.

First, stakeholders are a heterogeneous group and concepts and theories attaching to them are also diverse. Second, the studies suggest that in various ways and to varying degrees stakeholders can be involved in the governance of firms. However, in the UK, the group, which probably has the most influence, are banks and other debt holders, followed by employees. Third, many of the general studies suggest a small positive effect of stakeholding on certain

aspects of company performance. However, this is not confirmed by all studies. In the case, of specific groups such as debtholders and employees, their stakeholding can pose costs on the firm. There are also benefits in terms of information flows and commitment. Fourth, there are some, albeit limited, complementarities within stakeholder groups and between stakeholders and other forms of corporate governance. Hence, employee representation may complement community representation. Similarly, bank voice and shareholder voice may overlap – though equally we have suggested that they may conflict.

3 Survey of Corporate Governance Experts

3.1 Methodology

On the basis of our literature review, the Team members have identified broad “families” of drivers of ‘good’ corporate governance such as: “board independence”, “board diversity”, “disclosure practices”, etc. Each “family” of drivers includes more specific, measurable and observable operationalizations that allow us to develop a number of policy evaluation benchmarks. For example, the “board independence” family includes five specific operationalizations, such as “a high proportion of independent board members”, “separation of the roles of CEO and board Chairman”, etc.

However, the literature does not provide a comprehensive assessment of the validity of individual drivers in a systematic way. Nor does it provide ranking of individual drivers in terms of their relevant importance vis-à-vis other drivers in the same “family” of the ‘good’ governance benchmarks.

To verify the appropriateness of the identified ‘good’ governance drivers, the Team conducted a Web-based survey of leading experts in the corporate governance field. This methodology provided a cost-effective and timely access to a pool of expertise both in the UK and abroad. A special Website was created at the Management Department, and a Web link to a structured questionnaire was e-mailed to a network of experts.

The literature review outcomes were used to develop a Survey Questionnaire that included 18 “families” of good corporate governance drivers. Each “family” comprised a number of specific, observable and measurable operationalizations of a particular driver, and the respondents were invited to score each item on a 7-point Likert scale, with 1 = not important and 7 = highly important. Full details of the questionnaire items are provided in Appendix I. This framework allowed the Team to introduce some greater objectivity into the process of identifying drivers of ‘good’ governance and associated policy evaluation benchmarks.

This methodology was aimed at achieving three objectives. First, a relatively high score across the population of respondents would indicate high importance of a particular family of “good” governance drivers. Second, using individual average scores, various drivers within the same family could be ranked in terms of their relative importance vis-à-vis other drivers in the same family. Third, the standard deviations of individual scores could be used as an indication of the extent of experts’ agreement or disagreement with regard to importance of a particular driver. This allows to make various caveats with regard to the expected validity of a particular evaluation benchmark when applied to the UK regulation.

3.2 Survey Results

The Team identified 133 corporate governance experts using various sources of information, such as the literature review, corporate governance-related Websites (e.g., the European Corporate Governance Institute, University of Birmingham Centre for Corporate Governance Research, etc) and personal contacts. Bearing in mind the Project’s objectives, the main focus was on corporate governance experts in the UK. However, the Team also tried to approach a

number of international experts, since their opinion and expertise would contribute to the overall objectivity and reliability of the Survey. In terms of the country-of-residence, the population of experts had the following breakdown:

<u>Country/region</u>	<u>Number of experts</u>
UK	70
North America	28
Other Europe	20
Japan	8
South Korea	3
Australia	2
Israel	1
Russia	1

In terms of their professional background most of the respondents work in academic and research organisations. However, the Team decided to include a control group of 17 corporate governance practitioners from a variety of business and professional organisations such as the ICAEW, Standard Life Investments Ltd, etc. The experts’ professional backgrounds had the following breakdown:

<u>Background/research field</u>	<u>Number of experts</u>
Economics	35
Business, management	28
Finance and accounting	18
Law	17
Sociology	12
Others (political sciences, HRM, etc)	6
Practitioners	17

The Team notified all experts about the Survey on 31 October 2005. The Survey Website was open on 14 November 2005, and all experts were invited to fill in the questionnaire. Subsequently, two further letters were sent to the experts on 21 and 28 November 2005. The Website was closed on 6 December 2005.

The Survey generated 53 useable responses with an above average response rate of 40 percent which indicated that the respondents had found the Survey interesting and important. Relatively low standard deviations and the average scores above 5 for the majority of the drivers indicate high levels of validity and reliability of the Survey results. This also indicates that the experts attached a high level of importance to a substantial number of ‘good’ governance drivers identified during the literature review. These were important findings since they helped to define to what extent we can usefully talk about good corporate governance. The survey also explicitly confirmed that the existing corporate governance literature enables us to determine the key determinants of good corporate governance.

Drivers of ‘Good’ Corporate Governance in the UK Context

4.1 Introduction

The results of the literature review and the experts’ survey form a factual base for identifying ‘good’ corporate governance drivers. The literature review provides empirical and theoretical underpinning for selecting an individual driver using a broad range of social sciences-based research. More specifically, it helps to identify (1) a ‘good’ corporate driver as a broad conceptual construct (e.g., “board independence”; “stakeholder involvement” etc;) and (2) to develop a more detailed set of specific and measurable operationalizations of each driver (e.g., “the proportion of independent directors on board”, “separate Chairperson and CEO”, etc.).

However, the literature review does not necessarily provide a clear validation of the individual drivers and their operationalizations in an integrated, systematic way. Most of the academic publications reviewed above are usually focused on one-two aspects of “good” governance, without providing an overall picture of relative importance of a wider range of drivers. Therefore, to identify the validity and importance of the individual driver operationalizations in a systematic manner we use the results of our expert survey. Corporate governance experts were asked to rate each individual operationalization on a 7-point Likert scale (1 = not important, 7 = high importance). Individual scores allow us to verify the importance of a particular driver operationalization relative to other operationalizations in the same “family”.

Before we report Survey results, a number of important caveats should be introduced. First, the vast majority of our respondents were from the UK/USA. Therefore, their views may be biased towards the Anglo-American model of corporate governance that puts less emphasis on the role of employees and other stakeholders. Second, the average scores should be considered in conjunction with the standard deviations of individual responses in order to explore the extent of disagreement among experts with regard to a particular driver operationalization. For example, although the “Caps on the size of executive pay” driver has received a relatively low score of 3.54, the standard deviation of 1.95 indicates that there is a serious disagreement among experts with regard to the importance of this driver. Finally, although our methodology allows to introduce some elements of hierarchical order into broad families of drivers, it does not provide sufficient scope for a robust econometric analysis of the effectiveness of individual drivers. Indeed, such analysis should be based on large samples of company-level data that links corporate governance factors with business strategy and performance (Filatotchev and Wright, 2005).

4.2 Summary of Good Corporate Governance Drivers

Our analysis suggests the following as ‘drivers’ of good corporate governance in the UK context:

1. Board independence
2. The diversity, human and social capital within the board
3. High engagement in board processes
4. Presence of large-block shareholders
5. Shareholder activism
6. Breadth and depth of public information disclosure

7. Breadth and depth of private information sharing
8. Independence of the external auditors
9. Competence of the audit committee
10. Presence of internal control systems and support of whistleblowing
11. Long-term performance-related incentives
12. Transparent and independent control of the remunerations committee
13. An active market for corporate control
14. Transparency and protection for shareholders and stakeholders during mergers and acquisitions
15. Board power in takeover bids, subject to shareholder veto
16. Stakeholder involvement within corporate governance
17. Voice mechanisms for debt holders
18. Employee participation in financial outcomes and collective voice in decision-making

The next sections review and briefly explain each of these drivers alongside the results from our expert survey.

4.3 Corporate Boards

The literature review has identified three major ‘good’ corporate governance drivers associated with corporate boards:

- Board independence;
- Diversity, human and social capital within the Board;
- High engagement in Board processes.

4.3.1 Driver 1: Board independence

The review of the economics and corporate finance literatures does not provide unambiguous evidence that the extent of board independence has a positive effect on the firm’s efficiency and performance. However, management and business strategy research suggests that this corporate governance parameter has significant effects on “critical” organisational decisions, such as executive turnover, value-enhancing business strategy, and limitations on anti-take-over defences. These “critical” decisions are, in turn, related to efficiency improvement and superior performance. In terms of specific operationalizations of board independence, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Independent nomination, remuneration and audit committees	6.08	1.38
Separation of the roles of CEO and board Chairman	5.74	1.43
A high proportion of independent board members	5.24	1.41
Presence of a senior (lead) independent director	5.12	1.62
Board size	3.98	1.43
Control question: a high proportion of executive directors	3.26	1.49

As this table clearly shows, the following two driver operationalizations have obtained the highest score (in descending order): (1) independent board committees and (2) absence of the

CEO duality. The presence of a senior (lead) independent director and the proportion of independent directors have median importance, whereas the large board size is considered as a relatively less important factor. A control question confirmed that the high proportion of executive directors on board might be detrimental for ‘good’ governance. There is a good deal of agreement among the experts on the individual scores that is confirmed by the standard deviations.

4.3.2 Driver 2: The diversity, human and social capital within the board

Our analysis of the governance roles of boards in the broad social sciences field, including management, sociology and behavioural research has suggested that boards can extend their involvement beyond monitoring and controlling top management to the provision of ongoing advice and counsel to executive directors on strategic issues. Resource dependence theory indicates that a board of directors may also play an important role in establishing relationships between the organisation and its external environment. From the service, strategy and resource roles of boards ‘good’ corporate governance drivers are associated with high levels of board diversity and its human and social capital. In terms of specific operationalizations of board diversity and its human and social capital independence, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Human capital of independent board members (experience, expertise, reputation)	5.92	1.20
Board directors’ heterogeneity in terms of human capital (education, expertise, etc.)	4.85	1.52
Number of network ties to other firms and external constituencies	4.21	1.56
Board directors’ heterogeneity in terms of gender and age	3.87	1.68

The following two driver operationalizations have obtained the highest score (in descending order): (1) human capital of independent board members (experience, expertise, reputation) (2) board directors’ heterogeneity in terms of human capital (education, expertise, etc.). One of the respondents emphasized the importance of international experience among independent directors. The number of network ties to other firms and external constituencies has median importance, whereas board directors’ heterogeneity in terms of gender and age are considered as relatively less important factors.

4.3.3 Driver 3: High engagement in board processes

Our review of the board process research indicated the importance of factors associated with the general conduct of board affairs and how and why board processes impact on empirical patterns of strategy and performance. This research identifies the effective and efficient board processes as ‘good’ governance drivers, including issues around information provisions and communication, incentives, etc. In terms of specific operationalizations of ‘good’ board processes, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
-----------------------------------	-------------------	---------------------------

Extensive and timely provision of information to independent directors	6.17	0.97
Board focus on strategic controls (growth of market share, competitiveness)	5.46	1.24
Regular evaluation of board members	5.35	1.38
Regular meetings of independent directors (separately from board meetings)	5.35	1.44
Bottom-up information flow from functional departments to independent directors	5.35	1.52
Regular communications with major shareholders/investors	5.22	1.34
Frequency and lengths of board meetings	4.91	1.32
Board focus on financial controls (accounting performance, TSR, EPS etc.)	4.87	1.40
Directors' financial incentives, including equity-based incentives	4.52	1.44
Imposing age and term limits for independent directors	4.04	1.67
Using specialist recruitment companies when recruiting new board members	3.92	1.58
Imposing age and term limits for executive directors	3.70	1.72
Independent directors' social ties with CEO/executive directors	3.02	1.74

This table shows that the extensive and timely provision of information to independent directors is widely considered as a ‘good’ governance driver by (the average score is above 6 and standard deviation is below 1). This driver is followed by the “board’s focus on strategic controls (growth of market share, competitiveness)”. Interestingly, board focus on financial controls (accounting performance, TSR, EPS etc) received a relatively low score of 4.8 on average indicating that these financial parameters of the firm’s performance are less important from the ‘good’ governance perspective than longer-term, strategic outcomes.

Information-related drivers of ‘good’ governance, such as regular communications among board members, vertical and horizontal information flows, etc., generally received above the average scores. On the other hand, directors’ financial incentives were not considered as part of the efficient board process, followed by age and term limits on executive and independent directors. Independent directors’ social ties with the CEO are considered as a sign of bad governance.

4.4 Share Ownership and Shareholder Activism

The literature review in Chapter 2 focuses on two major ‘good’ corporate governance drivers associated with shareholder activism:

- The presence of large-block shareholders;
- Shareholder activism

4.4.1 Driver 4: Presence of large-block shareholders

The review of economics, corporate finance and “law and economics” research streams did not provide unambiguous evidence that presence of large-block and institutional investors among the firm’s shareholders may perform monitoring and resource functions of ‘good’ corporate

governance. However, management and business strategy research suggests that this corporate governance parameter has significant effects on “critical” organisational decisions, such as executive turnover, value-enhancing business strategy, and limitations on anti-take-over defences.

The experts’ evaluation of the governance roles of various types of shareholders provided the following pattern:

Driver operationalizations	Mean Score	Standard Deviation
Pension funds, mutual funds, foundations	4.58	1.50
Private equity investors	4.52	1.76
Individual (non-family) blockholders	4.36	1.70
Family blockholders	4.20	1.63
Corporate pension funds	3.85	1.55
Insurance companies	3.69	1.69
Banks	3.31	1.49
Dispersed individual shareholders	2.18	1.41

In line with research on “pressure-resistant” and “pressure-sensitive” institutional investors, the experts assigned the highest scores to the governance roles of pension funds, mutual funds, foundations, and private equity investors. Some respondents also suggested that various associations of institutional investors such as NAPF, ABI, etc., play strong governance roles, as do individual blockholders and family owners. At the other end of the spectrum are dispersed individual shareholders whose governance roles received the lowest score. However, it must be kept in mind that none of the individual scores is above 5 indicating that, on average, our experts were rather sceptical about the effectiveness of large blockholders from the ‘good’ governance perspective.

4.4.2 Driver 5: Shareholder activism

Our review of research on actions of large-block owners suggests that their presence *per se* may be a necessary but not sufficient condition to promote efficient governance in their portfolio companies. Shareholder activism, or direct involvement of shareholders in “critical” decisions, may be another important driver of ‘good’ governance. In terms of the specific operationalizations of this “family” of drivers, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Influencing revisions of executive compensation	5.02	1.35
Influencing board and management turnover	4.98	1.28
Regular discussions with board members of strategy issues (M&A, etc.)	4.87	1.73
Disclosure of voting at shareholder meetings	4.87	1.84
Voting at the AGM	4.63	1.88
Use of lawsuits against managers and auditors for negligence or breaches of duty	4.15	1.88
Use of electronic voting systems	4.12	1.93

Publicly criticizing board members	4.04	1.66
Maintaining stable shareholding	3.53	1.32

Investors' active involvement in revisions of executive compensation and board/management turnover received relatively high ranking by the experts. It is closely followed by the regular discussions with board members of strategy issues and 'good' voting practices. Apart from maintaining stable shareholdings, all aspects of shareholder activism received above average scores.

4.5 Information and Disclosure

The literature review in Chapter 2 focuses on two major 'good' corporate governance drivers associated with information and disclosure:

- Broad and deep public information disclosure
- Private information sharing

4.5.1 Drive 6: Breadth and depth of public information disclosure

The review of the economics, corporate finance, and accounting literature suggested that information disclosure is a significant driver of corporate governance. The literature is mainly focused on flows to shareholders and it suggests a positive effect of such flows. More broadly, information on employment and environmental policies are important prerequisites for promoting corporate social responsibility and socially responsible investment as governance mechanisms. In terms of the operationalization of information disclosure, the survey produced the following results:

Driver operationalizations	Mean Score	Standard Deviation
Annual report and related documents	5.79	1.49
Information specifically on corporate governance (e.g. director's pay)	5.74	1.15
Operating and financial reviews	5.65	1.20
Audit committee's oversight of publicly disclosed information	5.63	1.51
Information on related party transactions	5.62	1.11
Information on employment policies	4.94	1.45
Information on environmental policies	4.72	1.60
Quarterly or monthly reports	4.70	1.79
Information on corporate social responsibility	4.69	1.70

The survey results show that annual reports with general information, as well as particular sorts of information on corporate governance, operating and financial reviews, and related party transactions were important aspects of disclosure. Other sorts of information related to stakeholders were also considered moderately important. It will be noted that public information is generally rated more important as a driver than private information (see below). Overall, there was little variation in the views of our respondents.

4.5.2 Driver 7: Breadth and depth of private information sharing

The literature places considerable emphasis on the flow of private information to large investors, fund managers, and analysts. It is less about flows within the firm vertically or horizontally and here it would seem that more research could be done since there are important processes. In terms of the operationalization of private information sharing, the survey produced the following results:

Driver operationalizations	Mean Score	Standard Deviation
Vertical information flows between the board and function departments	5.12	1.38
Provision of information to employees	4.80	1.55
Horizontal information flows between functional departments	4.62	1.59
Provision of information to other stakeholders	4.62	1.56
Private information to key investors	3.84	1.83
Private information to analysts	3.50	1.78

In terms of private information, it is not the provision of information to fund managers and analysts, which is rated highly, but the provision of internal information to boards themselves. There is substantial agreement between the experts on the individual scores, which is confirmed by the standard deviations.

The results suggest that both public and private information flows are key drivers of good corporate governance and that it complements various other mechanisms.

4.6 Audit and Internal Controls

The literature review in Chapter 2 focuses on three major ‘good’ corporate governance drivers associated with executive pay:

- Independent external auditors
- Highly qualified audit committees within the board
- Support of audit through internal control, risk management and protection of whistle-blowing

4.6.1 Driver 8: Independence of the external auditors

The empirical literature stresses the importance of auditor independence in promoting the quality and integrity of information provision and disclosure. In terms of the specific operationalizations of auditor independence, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Restriction on the quantity of ‘non-audit’ tasks involving external auditors	5.28	1.65
Regular rotation of appointed external auditor	4.87	1.72
Shareholders’ vote on appointment of the external auditor	4.40	1.91

Unconstrained legal liability of auditors	4.26	1.90
---	------	------

The survey results stress the prevention of conflicts of interest by restricting non-audit tasks. Other devices such as rotation of auditors, shareholder involvement or unconstrained legal liability were seen as only moderately important.

4.6.2 Driver 9: Competence of the audit committee

In tandem with auditor independence, the empirical literature suggests that oversight by a professionally qualified audit committee has positive effects on the intensity and quality of the audit process. The literature suggests that nominal independence of audit committee members is insufficient to improve audit quality without sufficient qualification. In terms of the specific operationalizations of auditor committee structure, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Professionally qualified members on the audit committee	5.73	1.37
Reporting from the audit committee to shareholders	5.47	1.60
Board approval of external auditor appointment	5.23	1.71

The results show that professional qualification, reporting of the committee to shareholders and board involvement in the appointment of auditors are all considered highly important.

4.6.3 Driver 10: Presence of internal control systems and support of whistleblowing

Existing literature suggests that having adequate systems of financial controls and risk management are a driver of good corporate governance. It might also be noted that the literature often lacks detailed codification of what constitutes good systems of internal control, as these are often very specific to the firm. However, the literature also stresses that the integrity of such systems may be enhanced by support and protection of ‘whistleblowers’ with inside information to form internal checks and balances, particularly where ethical misconduct or fraud is an issue. In terms of specific aspects of controlling, the survey produced the following results:

Driver operationalizations	Mean Score	Standard Deviation
Financial control and budgeting systems	5.81	1.14
Support and protection of ‘whistleblowers’	5.73	1.27
Risk management systems	5.48	1.36

These results suggest the high importance of internal systems of control as a driver of ‘good’ corporate governance.

4.7 Executive Pay

The literature review in Chapter 2 focuses on three major ‘good’ corporate governance drivers associated with executive pay:

- Provision of long term incentives tied to company performance
- Pay set by an independent remunerations committee
- Disclosure of pay.

4.7.1 Driver 11: Long-term performance-related incentives

Whilst there is still apparent dispute between academic literature as to whether pay and incentives provide stronger links with performance, and thus promote the board of directors acting in line with the wishes of owners, incentive schemes still remain highly acclaimed within the UK in terms of ‘best practice’. In terms of long-term performance pay and its link to performance, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Long term incentive plan	5.00	1.61
Performance-related bonus	4.48	1.67
Share option incentive scheme	4.23	1.69
Non-remuneration based incentives (e.g. firm’s pension contribution)	3.58	1.53

As noted in Chapter 2, UK firms have moved somewhat away from share option schemes in favour of the long-term incentive plan. The survey results show this as the highest scoring corporate governance driver. The expert survey also revealed the performance related bonus scored higher in terms of promoting good corporate governance than the share option scheme. The performance related bonus is generally, in pay structure terms, considered only to be a ‘short-term’ incentive. Executives typically receive an annual cash bonus that is paid on the achievement of company and/or individual performance. It is deemed that this motivates year on year growth, rather than linking to long-term objectives.

4.7.2 Driver 12: Transparent and independent control of the remunerations committee

High levels of disclosure came top in the good corporate governance drivers. This is promoted effectively within the Directors Remuneration Report Regulations (2002) (see Chapter 2 Literature Review and Chapter 4 The Regulatory Framework). Shareholders are now able to see within the remuneration report details of pay for individuals and details of incentives schemes along with performance conditions. This is not just confined to the performance conditions but also the company must provide an analysis of the methods used to assess whether the performance conditions have been met with an explanation of why those methods were chosen.

Driver operationalizations	Mean Score	Standard Deviation
High levels of pay disclosure	5.69	1.35
The costs of issuing share options clearly shown in the annual report and accounts	5.23	1.79
Incentives tied to performance targets	5.00	1.63
Remuneration committee’s access to external profession advice	4.91	1.75

Shareholders to vote on remuneration	4.48	1.84
Issuing ‘out of the money’ options	3.76	1.77
Caps on the size of executive pay	3.54	1.95

When combined with independence within the board committees, pay disclosure acts as a complementary governance aspect to promote objectivity and openness of information. Taking into account the knowledge, in real terms, as to how much such incentives cost the company, the shareholder now has differing methods to overcome previous asymmetries of information. The launch of IFRS2 requires companies to charge share options, which have only previously been disclosed in footnotes, through the income statement so investors can see exactly how much company board members stand to gain from options. Shareholders’ voting on the remuneration of the executives has not been chosen as a prime governance driver. It could be that our experts understand that even if the company’s shareholders do not approve the remuneration report, it does not necessarily mean that past (or future) payments are rendered unlawful. However, few listed companies would want to flout shareholder opinion, and such action would undermine the remuneration committee.

4.8 Market for Corporate Control

The literature review has identified three major ‘good’ governance drivers associated with the market for corporate control:

- An active market for corporate control;
- Transparency and protection of shareholders and stakeholders during the takeover process;
- An active role of the board regarding takeover bids

4.8.1 Driver 13: An active market for corporate control

The role of the market for corporate control has been highly controversial within the corporate governance literature. Empirical research does not provide strong evidence for a positive effect on the long-term shareholder returns. As such, the disciplinary role of takeovers must be considered a governance mechanism ‘of last resort.’ However, management and business strategy research suggests that M&A may play an important role in managing certain organisational transitions as the firm grows, matures and declines. These “critical” decisions are, in turn, related to efficiency improvement and superior performance.

In terms of various sorts of transactions that constitute the market for corporate, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
An active M&A market	4.73	1.48
Management buy-outs (MBO)	4.54	1.54
Public-to-private transactions	4.44	1.72
Leveraged buy-outs (LBO)	4.43	1.73
Hostile takeovers	4.40	1.72

This table shows that an active M&A market was considered important by our survey respondents, but achieved a result near to the overall survey average. The survey gave near equal rating to all the various types of M&A transactions, although greater consensus existed over the importance of management buy-outs (MBO).

4.8.2 Driver 14: Transparency and protection for shareholders and stakeholders during mergers and acquisitions

The literature also suggests a number of procedural aspects of takeovers that are important in the context of good corporate governance. In particular, to function effectively, the market for corporate control must be characterized by high transparency and fair treatment of various shareholders, including protection of minority shareholders. The literature also stresses the protection of employee rights and firm-specific human capital as important in minimizing ‘breaches of trust’ and undermining cooperation and commitments within companies. Finally, empirical research also associated cash payment with higher performance of M&A. In terms of various sorts of procedural aspects of takeovers, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
Transparency of ownership and control (inc. defensive measures)	5.74	1.36
Principle of equal treatment of shareholders	5.50	1.46
One-share / one-vote principle	5.22	1.86
Mandatory bid rule	4.62	1.70
Squeeze out and sell-out rules	4.61	1.55
Protection of employee interests during M&A	4.46	1.64
Establishment of an international ‘level playing field’ that reduces takeover barriers	4.39	1.81
Protection of firm-specific assets during M&A	4.11	1.63
Payment through cash	4.02	1.61
Payment through debt (e.g. LBO)	3.86	1.28
Break-through rules	3.74	1.52
Payment through share swaps	3.71	1.29
Ability to ‘ring fence’ target firms from acquirers in countries with higher takeover barriers	2.85	1.42

The survey results stress the important of transparency and equal treatment of shareholders as being highly important. One-share / one-vote principles also received a high score, but a high standard deviation. The type of payment used during acquisitions was considered as relatively unimportant. Wealth protection functions of guarding employee interests or other firm-specific assets were considered moderately important.

4.8.3 Driver 15: Board power regarding takeover bids, subject to shareholder veto

The literature on takeovers suggests that the board should play a substantial role in the takeover process. Empirical research showed that while some sorts of takeover defences may destroy firm value, the complete neutrality of the board is likely to be unrealistic and undesirable.

Managers should be able to say “no,” but not say “never” regarding takeover bids. In terms of the appropriateness of various sorts of board actions, the survey generated the following results:

Driver operationalizations	Mean Score	Standard Deviation
The board should have substantial decision power regarding takeover bids, subject to shareholder veto	4.74	1.50
White knights or defence through building a constituency of stable long-term shareholders	3.93	1.34
Pre-bid defensive actions	3.70	1.57
The board should be strictly neutral during takeover bids	3.55	1.77
Post-bid defensive actions	3.44	1.30
Anti-takeover devices (e.g. poison pill, golden parachutes, etc.)	3.05	1.38

The survey results suggest that the board should play an active role in takeovers rather than being neutral, but board actions should also be subject to some oversight or final power by the shareholders. Various anti-takeover devices and defensive actions were generally considered as inappropriate.

4.9 Stakeholders

The literature review has identified three major ‘good’ governance drivers associated with the stakeholders:

- Stakeholder involvement within corporate governance
- Voice of debt-holders
- Employee participation in financial outcomes and collective voice in decision-making.

4.9.1 Driver 16: Stakeholder involvement within corporate governance

The review of the economics and corporate finance literature does not assign much role to stakeholders as drivers of corporate governance, with the exception of debtholders. Much of the literature on banks is ambiguous in terms of benefits and costs. The accounting and behavioural literatures does suggest that the involvement of stakeholder in general can have a significant effect on corporate governance and performance outcomes. The literature on employee involvement suggests that in the UK context, employees and their representatives do not play a significant role.

Driver operationalizations	Mean Score	Standard Deviation
Employees	4.65	1.73
Debtholders	4.45	1.53
Customers	3.66	1.86
Suppliers	3.55	1.63
Local communities	3.47	1.62
NGOs	3.19	1.63

Our survey rated employees and debtholders as the two most important drivers of corporate governance among the various stakeholder parties. However, they only just obtained critical importance, e.g., an average score above 4. In addition a relative high standard deviation of responses points to a certain disagreement among experts.

4.9.2 Driver 17: Voice mechanisms for debt holders

Debtholder voice was considered an important driver of ‘good’ corporate governance. The finance literature stresses the potential monitoring role of banks, particularly as a substitute for the market for corporate control. In terms of specific operationalizations, the survey produced the following results:

Driver operationalizations	Mean Score	Standard Deviation
Individual voice through meetings and contacts with managers	4.75	1.49
Use of contractual mechanisms of monitoring (bank covenants, etc.)	4.67	1.65
Inclusion of governance factors in risk evaluation mechanisms	4.45	1.56
Use of delegated monitoring systems	4.18	1.61
Access to private information	3.86	1.53
Board presence	3.45	1.59

Among the mechanisms of debtholder involvement, direct voice based and formal contractual mechanisms were rated high. Private information or board presence was considered as relatively less important.

4.9.3 Driver 18: Employee participation in financial outcomes and collective voice in decision-making

Employee participation is widely considered to be an important driver of ‘good’ corporate governance by supporting firm-specific investment of employees and alignment of incentives with those of shareholders or managers. In terms of specific operationalizations of employee participation, our survey produced the following results:

Driver operationalizations	Mean Score	Standard Deviation
Employee share ownership	4.73	1.64
Employee voice via pension fund	4.49	1.73
Consultative committees such as works councils	4.48	1.82
Individual voice through meetings, employee reports	4.44	1.80
Board-level representation of employees	4.08	1.87
Trade unions	3.69	1.72

Among the mechanisms of employee involvement, share ownership was rated highest. This was followed by voice via pension funds and via consultative committees such as works

councils. Both forms of individual voice, such as employee reports, and trade unions were not seen as important.

4.10 Corporate Governance Drivers: Complementarities, Contingencies and Costs.

Most of the empirical evidence base in corporate governance research reviewed in Chapter 2 has remained focused on isolated sets of corporate governance practices, such as independence of outside directors or shareholder activism. The empirical results of such studies are often ambiguous, since the effects of corporate governance structures or processes remain contingent on the presence or absence of other corporate governance elements. In looking at these corporate governance ‘drivers’ as a benchmark for good corporate governance, some caution must be advised. Rather seeing good corporate governance ‘drivers’ that are universally applicable, best practices or ‘drivers’ may better be understood to be good in particular combinations. Corporate governance systems are often viewed as clustering along two internally consistent types, either a pure market or shareholder type vs. a pure relational or stakeholder type (Aguilera and Jackson 2003; Hall et al. 2001). Here we consider the potential complementarity or substitution among drivers from the perspective of the UK context, taking existing institutional frameworks as given.

In addition, ‘drivers’ of good corporate governance must be seen in light of different organisational contingencies. That is, ‘drivers’ may be effective only in particular contexts that are specific to an industry or the life cycle of the firm. While this makes generalization about best practices more difficult, one potential implication is that public policy should allow firms to adopt a diversity of corporate governance devices in order to best deal with important contingencies. In short, a ‘one size fits all’ approach may be undesirable.

Finally, we consider corporate governance drivers in the context of potential cost implications.

4.10.1 Complementarity and substitution among corporate governance drivers

More recent studies suggest viewing corporate governance as a system of interrelated elements having strategic or institutional complementarities (Aoki 1994; Milgrom and Roberts 1994, 1995). Some authors have recognized that governance mechanisms operate interdependently, with the overall effectiveness depending on a simultaneous operation of several mechanisms in limiting managerial opportunism (Rediker and Seth 1995; Walsh and Seward 1990). For individual firms, corporate governance involves different sets of practices that need to operate as a whole in order to be effective. Since alternative control mechanisms exist, greater use of one mechanism needs not be positively related to firm performance. Where one specific mechanism is used less, others may be used more, resulting in equally good performance (Agrawal and Knoeber 1996). Different governance mechanisms can substitute or complement each other, (Dalton et al. 2003; Hoskisson et al. 2002), and the cost-benefit trade-offs among a variety of governance mechanisms would determine their use. Likewise, national models or regulatory frameworks for corporate governance have interrelated elements that need to perform complementary functions (Aoki 2001b; Aguilera and Jackson 2003; Fiss 2005).

The results of the Experts Survey are consistent with these arguments. We have selected 10 ‘good’ governance drivers that obtained the highest score, and list these drivers and their average scores in descending order:

Survey Item	Average Score (scale of 1-7)
Extensive and timely provision of information to independent directors	6.17
Independent nomination, remuneration and audit committees	6.08
Human capital of independent board members	5.92
Financial control and budgeting systems	5.81
Annual report and related documents	5.79
Transparency of ownership and control (inc. defensive measures)	5.74
Separation of the roles of CEO and board Chairman	5.74
Information specifically on corporate governance	5.74
Support and protection of ‘whistleblowers’	5.73
Professionally qualified members on the audit committee	5.73

These survey results clearly show that drivers belong to different “families” that were identified in the literature review. In other words, there is no one single “family” that was identified as the most efficient driver of ‘good’ corporate governance, and the efficiency of corporate governance in a particular firm depends on a combination of drivers coming from various “families”. These drivers may substitute or complement each other in terms of their effects on organisational outcomes, including business strategy and performance.

Research that explores these substitution or complementarity effects empirically is limited, but existing studies provide important empirical evidence. For example, a number of studies suggest that disclosure may be an important complement to other governance ‘drivers’, such as institutional ownership, board independence, etc. El-Gazzar (1998) showed that large institutional blockholders were associated with higher levels of voluntary information disclosure. Using information on contested takeover bids, Brennan (1999) suggests that targets disclose more information on earnings than a sample of other firms. A recent study of Singapore listed firms indicates that companies with a higher proportion of independent directors have higher levels of voluntary disclosure (Cheng and Courtenay 2004). Similarly, using a sample of UK firms, Mangena and Pike (2004) confirm that better information is provided where audit committees are independent and have financial expertise.

Some authors emphasise that inefficiency of certain types of corporate governance drivers may be compensated by active functioning of alternative governance mechanisms. Jensen (1986; 1993) suggests that when the market for corporate control is less efficient, the governance effects of debt holders may play particularly important role in restraining managerial discretion, especially in companies with a substantial “free” cash flow. In their study of U.S. firms with continued founding-family ownership in the U.S. Andersen and Reeb (2004) provide evidence that independent, non-family directors may substitute for the governance deficiencies associated with family owners.

These findings led Rediker and Seth (1995) to suggest that a combination (or *bundle*) of governance mechanisms is required to reduce principal-agent costs and align interests of principals and agents. Complementarities/substitution imply that reforms made in one element

of corporate governance are mediated by the wider configuration of governance channels and national institutions. Thus, best practice should be understood in terms different combinations of practices, rather than as individual good corporate governance ‘drivers’ that are universally applicable.

4.10.2 Contingencies related to ‘good’ corporate governance drivers

A number of recent review articles on various drivers of good corporate governance suggest that their effectiveness and efficiency depends on a number of important firm- and industry-level contingency factors such as the firm’s size, age, industry regulation, growth/decline phase, etc. (Dalton et al. 1999; 2003; Deutsch 2005; Hermalin and Weisbach 2003). For example, some governance drivers may be more efficient in smaller firms since the scale and diversity of large firms may cloud any relationship between corporate governance and performance. However, a small scale of operations and lack of resources may constrain the firm’s ability to introduce effective governance systems, such as an extensive reporting and diverse and independent board.

A growing amount of research now explores the effects of various governance drivers in different contingencies empirically. For example, Meeks et al. (1995) find disclosure being related to firm size, debt-equity ratios, country of incorporation, and international listing. Other UK research suggests that disclosure is not only positively related to firm size, but varies significantly across sectors, and that companies whose future earnings are poor are more likely to make disclosures (Abraham and Tonks 2004).

Consistent with this perspective, recent meta-analysis has found that the relationship between board size and firm performance relationship is stronger for smaller, as compared to larger firms (Dalton et al. 1999). Daily and Dalton (1992) provide evidence of a positive relationship between both the number and proportion of independent directors and price-earnings ratio in a sample of small firms. IPO research (Certo et al. 2001; Filatotchev and Bishop 2002; Sanders and Boivie 2004) shows that newly listed companies with more diverse and independent boards have better performance. On the other hand, Luoma and Goodstein (1998) focus on the representation of non-shareholder stakeholders, such as employees, public officials, suppliers and customers, on company boards. They find that such stakeholder representation is more likely to occur where companies are larger or are in industries with a higher degree of regulation.

Some researchers emphasise that various corporate governance drivers may be particularly important in the environment of organisational decline or bankruptcy. Holland (2005), for example, has suggested that disclosure, both public and private, increases when performance declines and during take-over battles. Daily and Dalton (1994), Filatotchev and Toms (2003) and Hambrick and D’Aveni (1992) argue that board diversity and external “interlocks” may play an important role in crisis situations, since, from a resource-dependency view, these board configurations may provide more diverse networking links to resource providers.

An emerging body of research on the life cycle of corporate governance (Filatotchev and Wright 2005; Johnson 1997; Lynall et al. 2003; Aoki 2001) suggests the notion of a number of firm life cycle stages where there may need to be different “bundles” of corporate governance characteristics. Corporate governance should thus be viewed as a dynamic system that may change as firms evolve over these stages. The firm’s evolution is accompanied by changes in

ownership structure, board composition, the degree of founder involvement, etc. The balance of the accountability and enterprise roles of the various governance elements may change over this life cycle from establishment, growth, maturity and decline.

In the early stages of the life cycle, the entrepreneurial firm has a narrow resource base. It is, as a rule, owned and controlled by a tightly knit group of founder-managers and/or family investors, and the level of managerial accountability to external shareholders is necessary low. In this context, the knowledge contribution of boards may be more important than in firms facing more mature markets. As the firm grows, it requires access to external resources and expertise that may fuel and support this growth, and it opens up its governance system to external investors, such as “business angels” and venture capital firms. At this stage, the balance between resources and accountability starts to shift towards greater transparency and increasing monitoring and control by external providers of resources.

When the firm has exhausted its growth opportunities in the focal industry and perhaps over-diversified into related and unrelated industries (Hitt et al. 2003), the governance system becomes less transparent. Misalignment of incentives leads to a managerial drive for ever-increasing expansion and diversification producing performance deterioration and loss in shareholder value. Even where there is a substantial inherited resource base, at this stage the existing governance system may be insufficient to prevent managerial opportunism or arrest organisational decline (Filatotchev and Toms 2003). In a turnaround situation, governance itself may turn into a driver of further decline by imposing serious financial constraints that erode the organisation’s resource base.

Bearing in mind these changing strategic and operating conditions of the firm, its dynamics may impose different demands on its governance system. Therefore, there may be a number of optimal configurations and combinations of ‘good’ corporate governance drivers that should perform different monitoring, resource and strategy roles, depending on a particular stage of the firm’s life cycle.

4.10.3 Costs related to ‘good’ corporate governance drivers

Most of the corporate governance-related research is focused on potential benefits of various corporate governance practices. However, drivers of ‘good’ corporate governance may also have associated costs, including the out-of-pocket compliance costs that are reflected in the firm’s balance sheet and other accounting documentation (e.g., the audit costs, directors’ insurance, etc.), less explicit opportunity costs (e.g., directors’ time spent on governance issues instead of business strategy, costs of strategic disclosure, etc.), and the legal and reputational costs which may be incurred when firms get their governance practices wrong.

Direct costs of corporate governance are related to the out-of-pocket expenses that are associated with compliance with the governance rules and regulations. More specifically, these costs include expenditures on recruitment and remuneration of executive and independent directors and costs of setting up and running control and risk-management systems, including board committees, etc. For example, recent changes in corporate governance standards require the auditor to perform a walk-through of major classes of transactions while evaluating management’s assessment of controls, in addition to traditional audit functions. Aguilera (2005) suggests that accounting firms are concerned with being sued, and they have developed a voluntary “enhanced audit” that costs companies more than traditional audit services. In

addition, new corporate governance rules increase litigation risks and associated increase in the firm's expenditures on directors' insurance and indemnity policies. A survey of 224 large public firms in the USA by Financial Executives International with regard to the direct costs of complying with Section 404 of the Sarbanes-Oxley Act finds that the average first-year estimate is almost \$3 million for 26,000 hours of internal work and 5,000 hours of external work, plus additional audit fees of \$823,200, or an increase of 53% (Zhang 2005). Aguilera (2005) reports that AIG is concerned over the new regulatory environment and its \$300m per year expense to fulfil the new requirements.

Similar to the costs of compliance, the board monitoring and control effort is costly, both for the directors and for the firm. Being very busy people, independent board directors necessarily consider their board duties as a part-time job. While they are compensated handsomely for their time, neither their incentive structure nor their time commitment allows them to devote all their energies to monitoring activities (Walsh and Seward 1990). Aguilera (2005) points out that boards can easily become overwhelmed with reporting requirements stemming from new regulation such as the U.S. Sarbanes-Oxley Act, as well as voluntary codes and initiatives from the investor, accounting and legal professions.

Some researchers differentiate between direct compliance costs and less explicit, indirect opportunity costs and strategic costs of competition. Indirect corporate governance costs are associated with the fact that focusing on compliance may divert managers' attention from strategic and operating decisions associated with running the firm. In addition, the litigation risks may change management's risk-taking behaviour, and this, in turn, will likely slow down the growth of the firm. These costs are impossible to quantify on the basis of *ad hoc* assumptions (Zhang 2005).

A number of studies associate disclosure with high opportunity costs relating to the firm's proprietary information (Healey and Palepu 2001; Lang and Lundholm 2000). In environments where information leaks routinely and competitive advantage may evaporate quickly, executive team members may not be willing to share their trade secrets or other proprietary information about the firm's R&D in progress, innovations or recent discoveries (Verrecchia 1983). In addition, an extensive disclosure policy may lead to high costs of possible *ex post* litigation (Beatty and Welch 1996). Voluntary disclosure, therefore, represents an endogenous choice that is an outcome of a trade-off between the reduction of cost of capital resulting from a reduction of asymmetric information and the increase in proprietary and litigation costs (Leone et al. 2003).

Aguilera (2005) suggests that there may be a cost/benefit trade-off associated with 'good' governance drivers. On the one hand, restoring investors' confidence might translate into a higher market capitalization, and, hence, it might pay off in the long-term. On the other hand, potential consequence of over-regulating the corporate governance environment is that it might detract from flexibility and risk-taking, to the point that some of the firms might consider going private, and smaller companies might be deterred from listing because of higher governance demands. The costs of internal monitoring and control can become so high that no effective managerial control exists. In such cases, the value of the company would diminish accordingly (Walsh and Seward 1990).

5 Focus Group Analysis

5.1 Introduction

The review of the literature identified a number of key drivers of corporate governance relevant to the UK context, as previously discussed in Chapter 2. The overarching objective of the next stage of research is to evaluate whether corporate governance regulation in the UK fully reflects the determinants of ‘good’ governance suggested by the social science literature. As part of this stage, the Project Team has organised a one-day Focus Group discussion with an objective to discuss potential gaps in the regulation with regard to the corporate governance benchmarks, as well as problems with the chosen methods of implementation. The concept of ‘families’ of good corporate governance drivers provided a firm foundation for Focus Group discussions, giving a vital qualitative input into the implementation and efficiency of corporate governance regulations and best practice guidelines within the UK. The utilisation of the Focus Group enabled various governance-related aspects to be discussed in a more unstructured way and then further incorporated within the overall view of corporate governance and in particular the gap analysis as presented in Chapter 6.

5.2 Aims and Objectives of the Focus Group

The aims and objectives of the focus group was to provide discussion as to whether the corporate governance regulation in the UK fully reflects the determinants of good corporate governance suggested by academic literature and good corporate governance benchmarks. The focus group is an integral part of this stage, and its objective is to help the DTI and the research team in the following ways:

- (1) To develop an in-depth understanding of what constitutes good corporate governance and what drives it
- (2) To obtain feedback on the gaps which might exist in the content of the present UK regulatory framework
- (3) To generate practical insight about the problems and costs of implementing the current regulation or relevant desirable alternatives.

5.3 Participants and Groupings

The presence of several participants was required in order to provide a representative sample incorporating many sectors with differing requirements and views of corporate governance. Invitations to participants placed an emphasis on their participation in the debate about what constitutes good corporate governance and the practicalities of implementing regulation and best practice guidelines within the UK.

In line with current methodology for focus groups, all participants received a briefing note prior to the session and this was further enhanced by an introductory presentation on the day. Team members acted as facilitators and managers of the discussions in order to encourage involvement by all members of the group and to maintain its intended focus. Appendix II provides a list of participants in the focus group.

Overall, the Focus Group discussions involved thirty participants who were divided into three groups organised around separate ‘families’ of good corporate governance drivers. The groups were carefully selected in order to provide a mix of perspectives, while at the same time bringing together experts with a particular set of interests. The presence of several participants allowed for a variety of points of view to emerge and for the group to respond to and discuss these views. In order to direct the discussions and provide participants with guidance for the day, each group was briefed separately to consider specific corporate governance drivers with regard to the following three aspects:

- (1) To what extent and in what way is each of the items genuinely a ‘driver’ of good corporate governance;
- (2) How adequate is current UK regulation in promoting each driver; and
- (3) What are the problems and costs of implementing the current regulation?

The outcomes of the focus group discussions are reported below.

5.4 Focus Group Discussions

Whilst the remit of each group was to consider the three aspects mentioned above, where additional topics arose during the discussions, these too have been incorporated in the outcomes from the focus groups. The following sections provide a summary of discussions that took place in the three groups.

5.4.1 Focus Group 1. Boards, auditing and internal controls, executive pay

This group was focused on internal corporate governance systems. The discussion topics included the following good corporate governance ‘drivers’:

- The nature and importance of board independence
- The diversity of human and social capital within the board
- Ensuring directors’ engagement in board processes
- The transparency, independence and competence of the audit committee
- The independence of external auditors.
- The presence of internal control systems
- The role of performance incentives for executives

5.4.1.1 Corporate boards

The group wished to emphasise that issues were considered vis-à-vis the ‘enlightened shareholder’ model. With this in mind, the general consensus of the group was that boards should be viewed as a whole and there was a danger of giving too much emphasis to structure rather than the practices of the board. It was not so much a drive towards independent boards that was required, rather a balance. It was not necessarily independence that was an asset to the board, but rather experience. Whilst there should be independence of appointment and behaviour, this should not be viewed as, or lead to, a lack of engagement with company issues. The ‘comply or explain’ was complimented within the UK by a ‘peer regulation’ as board of directors are able to use other boards as comparators to their own environment

although some caution should be shown in that the board should not just look to others but to shareholders.

Within the UK, disclosure and the lack of restrictions enabled an informed debate to take place where companies respect views of their shareholders. This was an advantage of the UK system and should not be regulated away. The UK showed a 'layered' approach and the Combined Code promoted good practice and a checklist rather than a 'one size fits all' approach. This was particularly demonstrated in the success of AIM, where the lack of regulation enabled companies to follow what was appropriate for their needs. This highlighted the need to take into account company contingency factors, such as company size, age etc.

This promoted discussions with regards to the roles of the board and how it functions against the background of shareholders. It was acknowledged that the role of the board was very different to that of executive management. It was felt that boards could not operate on a 'tick box' approach and that efficiency came from clarity of roles within the board. In particular the presence of a senior (lead) independent director provided a safety gap and a starting point for challenging both board roles and decisions, although in practice independent directors were more likely to act collectively.

The overall consensus was that no content gaps existed in the current regulatory environment in the UK with regard to the corporate board roles and functions. However, there is a shift in balance towards more formal approach that is focused on structural parameters. Efficiency gaps came from too much focus on structural issues rather than understand how boards work and the processes used. Caveats should be made to enable contingencies with regards to company size, age and organisational development. For example smaller companies may not a) need more independent directors and b) may not be able to afford them. There may be room here for guidelines and principles but certainly not regulation.

5.4.1.2 Audit and internal controls

The UK does not seem to show the systematic problems seen within the US in terms of failures of the internal control systems and company auditors. Whilst there is still a 'post Enron' sentiment in the USA; the market place within the UK shows no apparent market failure. Some participants expressed concern that there had been considerable reviews and changes, which were still being embedded into practice. The general view was that these were now being consolidated and that more 'process' did not necessarily mean greater quality. More regulation and too much emphasis on independence of auditors do not necessarily lead to a higher quality of auditing. Some participants emphasize that it is important to organize effective and efficient communications around auditing process. The concern was that if regulation transposed advisors into 'gatekeepers' then trust and judgement would be 'regulated out'. As a consequence, auditors would not be able to provide sound advice, and this would make it more difficult for directors to make sound and well-informed decisions.

There had been a drive towards greater communication and transparency although there may still be an expectation gap that when the auditors sign an item off it is 'perfect'. The imposition of further rules would put the profession in danger of spending more time following rules than working actively for the client.

It was felt that audit firms were now driven by ‘reputational risk’, which provided a powerful market force and should not be underestimated. This gave more focus on quality, which went far deeper than legislation. Furthermore, the Combined Code asked for ‘recent and relevant’ experience for Audit Committee members. It should be left for the board to decide how to interpret this; their interpretation could be tougher than a simple academic qualification. More regulation would infer a failure of trust, judgement and purpose. It was felt that internal control systems are one of the hardest items to assess if you are an investor in the company.

As such no content gap was exposed. There was a danger, however, that the rules had created an environment that had become fixated on structure.

5.4.1.3 Executive pay

The focus on levels of pay and performance related incentive reduced this to a purely financial basis. Executives are not just concerned with financial rewards but other aspects such as loss of jobs or negative reputation.

The group felt strongly that pay must not become an issue for regulation. Levels of pay should be left to market forces. In leaving this to companies, specific consideration could be given to size of company, and a balance between short-term v long-term issues. The greater transparency had provided a basis for dialogue, but this must be balanced and an over emphasis on transparency had the danger of driving good talent either into the private sector or abroad.

Guidance for the remuneration committee was well defined within the Combined Code and this should be left alone and trusted to function. It was felt that remuneration committees are now more accountable and must balance this with the need to attract the right calibre of talent to the board. This still means offering competitive levels of pay.

There was no need for regulation in this area, this should be left to the market mechanism and entrusted to the board of directors and shareholders. However, executive remuneration initiatives should be considered in conjunction with other laws and regulations, such as employment law. This law could often be enforced, although designed for another purpose and may result in unintended consequences where directors are protected and thus there is the potential for this to enable rewards, even for failure.

5.4.2 Focus Group 2. Shareholder activism and the market for corporate control

This group was focused on the following aspects of corporate governance:

- The role of large-block shareholders
- The prospects and barriers to shareholder activism
- The role of the market for corporate control in good corporate governance
- Transparency and protection for shareholders and stakeholders during mergers and acquisitions
- Board power in takeover bids

5.4.2.1 Share ownership and shareholder activism

The group made an initial observation on terminology – namely, shareholder ‘activism’ may have negative connotations, and the report would be better served by a term such as shareholder ‘involvement.’

Regarding large-block shareholders, the participants stressed that some concentration of share ownership facilitated greater involvement. However, large shareholders may have both positive and negative impacts. In some cases, dominant shareholders (such as the case of Abbott Group) have a positive effect and supports innovation. Likewise, firms with more dispersed owners may be more likely to engage in ‘aggressive accounting.’ But in other cases, dominant shareholders may aim to entrench certain persons in the firm, as in the case of family ownership. Or dominant shareholders may promote certain interests that differ from other shareholders. Here a stake of 5-10% may be enough for a conflict of interest to arise. Hence, the ability for minorities to have protection is important.

In practical terms, it may be very hard to prove that the actions of a large shareholder led to abuses of other shareholders short of discovering criminal behaviour by the shareholder. Thus, although regulatory protection does exist, it may be worth further consideration of the implementation of minority shareholder protections. However, some participants observed that cases such as the Fox TV case couldn’t happen in the UK, since the rights for shareholders to vote are better protected.

Other interesting cases included corporate pension funds, where large shareholders may have an issue of self-investment. However, most participants thought regulation of this issue was adequate. Private equity funds were also considered to have different interests from other shareholders, since they take an active stance toward management of the firm. However, most participants did not consider this a problem for regulation.

For investment funds, an important prerequisite of effective involvement is the ability of different funds to coordinate their actions. Most participants felt that this was possible in the London market, since the circles of investors were small enough for informal communication. In regulatory terms, this issue is addressed in the City Code. However, a problem regarding coordination concerns the lack of transparency about shareholder involvement. Lots of involvement is ‘behind the scenes’, as funds do not want to be perceived as being interventionist. At the same time, lots of funds are not active.

Participants debated further whether investors really have an interest in good corporate governance itself. Some participants noted that investors are only interested in returns, and corporate governance was only a means to this end. Other participants disagreed and noted that trustees of the pension funds were most likely to write in regarding corporate governance issues. This suggests a large mandate for pension funds to get actively involved in corporate governance. Moreover, many trustees are concerned about corporate social responsibility issues. The example was noted that a racism case might damage the reputation of a firm and therefore shareholder value. At the same time, conflicts may arise since trustees may be employees or stakeholders in the firm and thus face conflicts of interest in being too active.

The group noted that a more serious issue about shareholder involvement regards the resources of shareholders themselves. Pension funds have economies of scale compared to individual investors, but still lack capacity to get too involved. Some participants noted that

fund managers might not understand corporate strategy issues, whereas others noted that short-termism is endemic within the City.

Different strategies of involvement were noted among the group. Some argued that it was driven by the size of the stake, whereas others saw it as a more complex function of a) the absolute exposure in money terms; b) the relevance of the stock within the portfolio; and c) a sense check as to whether one can realistically influence an outcome. Other participants suggested that involvement could alternatively be issue-led – shareholders target particular issues across a wider range of firms.

In terms of regulation, disclosure is centrally important to shareholder involvement. The participants largely agreed that the UK approach was quite good in being flexible about disclosure. No amount of information is ever enough for outside investors to really control the company. But requiring disclosure has a psychological effect on managers in making them consider issues, and consider shareholder interests. Promoting disclosure is not too expensive, and Turnbull guidance is very flexible in this regard.

A long discussion rose around the issue of operating and financial reviews (OFRs). Many participants were concerned that the lack of a clear framework for reporting is a problem and detracts from having a level playing field. Some feared that the situation might revert back to being worse than before the whole issue emerged in the UK. Other participants disagreed and thought that more flexibility is good, since other frameworks do exist and a single, uniform framework would be too heavy handed. In practice, the group agreed that more disclosure of information about the context of the business and potential risks is good as a principle, but the details become very complicated. High standards may evolve in a flexible way, but market participants must first identify the best standard. For example, guidance on reporting about the firm as a “going concern” has evolved nicely, but the quality of evaluation of the board remains poor since no standards have been identified.

The group noted an important contingency in that institutional investors could gain private information about large, FTSE-100 firms based on one-to-one meetings with the directors, but mandatory disclosure is very important for small firms where investor knowledge is much weaker.

Participants lacked clear agreement about the importance of the AGM. Some noted that this was the ‘up most important focus’ for funds, whereas others noted that funds rarely attend AGMs. Funds are reluctant to raise problems at the AGM, since any information enters the public domain and negative information may damage share prices. So at the AGM, the key role is that of individual shareholders, rather than institutions. Institutional investors use their influence largely outside the forum of the AGM. A final issue raised was how to facilitate the participation of foreign shareholders at UK AGMs through more modern technology.

Some noted that the positive effect is largely psychological, since the directors must prepare for any type of question to be asked. Also shareholders can observe the entire board interact, and gain useful clues about the roles of board members. One participant noted, however, that directors are not required by regulation to answer all the questions asked at the AGM.

In terms of shareholder rights, the group agreed that less regulation is good. An important backdrop of shareholder rights exist in the Combined Code and this system was considered to work well ‘most of the time.’ Other recommendations, such as the right to question auditors,

were considered impractical since the process of actually doing so will be too cumbersome. Disclosure of executive remuneration was noted as one recent change in regulation that had a very good effect.

The group stressed the importance of self-regulation in the area of voting. The ABI Guidelines are very important in setting an agenda, and these work well in the context of comply-or-explain principles. Here the focus is on the level of corporate disclosure, rather than the exact content. Some participants felt that voting itself is a rather blunt instrument for corporate governance. Shareholders have diverse views, and managers must make their own judgment about strategy. Important is that that managers clarify ‘why’ shareholders cast no votes.

Some participants thought disclosure of pension fund voting is important for trustees as part of market transparency. However, most participants doubted any effect of having pension funds know how each other voted. ISC Principles govern this issue, but have proven ineffective in getting voluntary compliance. Most participants were opposed to legislation, but suggested trustees should move vocally demand disclosure. Some participants noted that a shareholder lawsuit would prompt greater action by funds. This relates to the broader issues of corporate governance of funds and other gatekeepers themselves.

5.4.2.2 Market for corporate control

The group noted that the UK takeover rules are quite stringent. Many participants cited the flexible nature of the UK code as being beneficial.

The main issue in terms of takeovers was the quality of the acquirer. It was noted that while giving share price premiums to target shareholders, not all takeovers create value for the acquiring company. However, some group members expressed strong scepticism as to whether regulation could possibly address this issue.

In terms of takeover defences, the group discussed the issue of U.S. style poison pills. The group generally viewed these as undesirable, and some even described them as “damaging and undesirable.”

One regulatory gap that emerged in the discussion related to the charging of ‘break fees’ paid to the bidder if negotiations were broken off. Investors felt that these charges were too common and too high, representing a source of major abuse in the UK system. Some group members also noted that the role of advisors in deals were potentially under-regulated.

In sum, the focus group did not unambiguously identify any major content gaps in the regulation of shareholder involvement, nor in the area of takeovers. However, many members of the group considered the abandonment of the OFR to be a gap in the regulation of information disclosure that would have otherwise facilitated greater shareholder involvement. This point was widely debated in the group.

More broadly, other potential market failures were noted regarding shareholder involvement, particularly regarding smaller companies where information provision may be weaker and institutional investors may have fewer resources for active involvement. However, these were not necessarily identified in the focus group as areas that should be subject to regulatory intervention.

In terms of implementing regulation, the focus group often noted that the flexible regulatory approach in the UK as a strong point of the UK market. In this regard, the focus group stressed the need for further development in mechanisms of soft-law and self-regulatory guidelines on voting and disclosure of voting by institutional investors.

5.4.3 Focus Group 3. Information disclosure, stakeholders

This group was focused on the following issues:

- The role of public information disclosure
- Private information sharing as an informal governance mechanism
- The role of stakeholders or more generally, corporate social responsibility, in corporate governance
- The role of debtholder voice within corporate governance
- The role of employee voice in corporate governance
- Appropriate mechanisms for stakeholder involvement

5.4.3.1 Information and disclosure

The group agreed on two initial general statements on information. First, they felt that information disclosure was a ‘lubricant’, which made the whole system of corporate governance work. It is essential to all other structures and processes in governance. Second, they thought that, by most international standards, disclosure in the UK is already high.

On the provision of public information, the group felt that disclosure in annual reports and public documents is a significant driver. It has grown extensively in recent years and is well covered by the regulatory framework. Firms have to and do provide information of this kind. Both, the content gap and implementation gap are therefore small. However, there are costs involved and these have risen, especially for smaller firms.

One of the big developments in terms of public information has been information on corporate governance per se. This often now takes up more space than the financial report. It does act as a real driver, but gaps in the regulatory framework and its implementation are not evident. Indeed, there is over-regulation in some areas, such as details of executive share options, providing information, which is often difficult to interpret.

There was a general feeling that it was desirable to have an OFR and the proposed version of this was acceptable and potentially useful to companies. Many firms have already introduced it and find it beneficial. However, in the absence of a mandatory requirement, not all firms will voluntarily produce an OFR. This will be the case in particular with smaller firms and may well be to the disadvantage of their shareholders. It was noted that there would be an Business Review under the EU Accounts Modernisation Directive. However, this will not require certain types of information especially on corporate social responsibility; it will also not be audited – this will entail certain cost savings, but may also reduce the value of the document.

In other areas, such as the disclosure of related party transactions and the oversight of information provision by audit committees, it was felt that no gaps exist in the UK regulatory

framework as broadly defined in terms either of content or implementation, again with the exception of smaller firms.

On the provision of private information, one area in particular was stressed in terms of a driver of good corporate governance, namely the provision of information to independent directors. The role and demands of these have increased significantly in recent years and, to do their job effectively, they require information. It was felt that both Company Law and the codes are sufficient here and there is little gap in terms of their implementation except for a random mix of firms.

Another area, which the group stressed, was the disclosure of information in private briefings for institutional investors and city analysts. These have become more demanding in terms of information provision and briefings constitute a real monitoring of the firm's top management. However, though investors and analysts gain a feel for the firm and its management, nevertheless companies have to be very careful that they do not disclose privileged information, which is not available to other investors. All information shared with these parties should go on company websites.

5.4.3.2 Stakeholders

There was some debate within the group as to which stakeholders should be included as drivers of good corporate governance. There was some discussion of customers, local communities, NGOs, the state, the press, but these were not emphasised as drivers. Two groupings were, however, discussed further.

In the case of debtholders, it was felt that they were not quite stakeholders in ways that have come to be defined. They do play an important role via meetings and via delegated monitoring. However, the regulatory framework as it stands at the moment in terms of contract law was seen as sufficient.

In the case of employees, there was more debate, but on the whole it was felt that they can be a driver in corporate governance via whistleblowing, via checks on management, and because they are a core resource which needs to be involved in the business so as to get the best out of them. There was felt to be some gap in terms of the content of employee voice mechanisms. One area, which was singled out, was the role of employee trustees in pension funds. The running of and accounting for pension funds is becoming more important and complex and this will increase in the future. Here, there may be something of a gap in the regulation of disclosure. Whilst some regulation had been beneficial, there was also a negative side in that the legislation on pension fund management had forced company directors and other senior managers to resign from managing certain funds, thus leaving the management of those funds in the hands of more junior employees. There is also a gap in implementation in that pension fund trustees do not always have the capability to perform their tasks. More training might be required. Another area, which was stressed, was the usefulness of reporting to employees and reports about employee value. However, consensus was less strong when it came to mechanisms for implementation. No support was expressed for board level representation; however, some support was expressed for employee consultative committees, including trade union back up where appropriate.

Overall, the group favoured an approach based on a set of good corporate governance principles, supported by an underlying framework of minimal regulation and a good whistleblowing process.

5.5 Summary of Focus Group Discussions

The Focus Group did not unambiguously identify any major content gaps in the corporate governance regulation. However, many members of the group considered the abandonment of the OFR to be a gap in the regulation of information disclosure that would have otherwise facilitated greater shareholder involvement. This point was widely debated in the Group.

More broadly, other potential market failures were noted regarding shareholder involvement, particularly regarding smaller companies where information provision may be weaker and institutional investors may have fewer resources for active involvement. However, these were not necessarily identified in the Focus Group as areas that should be subject to regulatory intervention.

In terms of implementing regulation, the Focus Group noted that the flexible regulatory approach in the UK as a strong point of the UK market. In this regard, the focus group stressed the need for further development in mechanisms of soft-law and self-regulatory guidelines on voting and disclosure of voting by institutional investors.

6 The UK Regulatory Framework: Gap Analyses

6.1 Introduction

In this chapter we outline the main elements of the UK regulatory framework and map these against the drivers we have already identified. The approach in UK policy and practice has been to see the company as primarily a private body, albeit subject to public interest concerns and a regulatory framework. The company is a private body in that its members are shareholders and the governance of the firm concerns the relationship between shareholder principals and managerial agents who oversee and run the firm on their behalf. This contrasts with the public view of the company, which has prevailed in much of continental Europe where the constitution and governance of the firm is seen in terms of the insider relationship between various parties, such as shareholders, debt holders, employees, and other stakeholders. A major issue in the UK has been to what extent companies should be regulated by outside bodies, in particular, by the state (Parkinson 1993; Donnelly et al. 2000).

In the following sections, we provide some brief background on the UK regulatory framework, outlining the major bodies of laws, regulations, codes and other forms of professional self-regulation, which bear upon corporate governance. Next, we undertake a detailed analysis of ‘gaps’ in the UK regulatory framework in addressing the various drivers of ‘good’ corporate governance identified in Chapter 4. As will be explained below, the gap analysis examines gaps in the regulatory content (e.g. to what extent a particular driver is addressed) and in the effectiveness of implementation (e.g. whether or not regulation achieves the desired effect). Our view of effectiveness is a broad one that incorporates not just traditional issues of regulatory enforcement, but how regulation relates to various contingencies facing different types of companies, complementarities with other elements of corporate governance, and costs related to compliance. The chapter concludes with some preliminary observations about gaps in the UK regulatory framework.

6.2 Background

There are two main sources of corporate governance regulation in the UK – laws and regulation of various kinds and rules and self-regulatory codes with some legal underpinnings. The latter have already been referred to in other chapters, but here we place them in a broader regulatory context. We proceed here along a spectrum from ‘hard’ to ‘soft’ law. We also include in the analysis the roles played by the relevant bodies such as the Institutional Shareholders Committee. These are clearly influential bodies as shown in our Survey above, but given the concern of this report with public policy, we concentrate on forms of regulation, which have some legal underpinnings.

In the UK, the common law has long played an important part in regulating companies, as in areas such as shareholder rights and directors’ fiduciary duties. From the mid-nineteenth century onwards, there have been various statutory interventions, some of a piecemeal kind, others major initiatives, consolidations, and reforms. In practice, the legislature has tended to intervene periodically when significant problems have been perceived or when there is a felt need for consolidation of existing legislation. The main laws at the present time are the Companies Acts 1985 and 1989 and the Financial Services and Markets Act 2000. In the area

of insolvency and restructuring, there is also the Insolvency Act 1986 dealing with companies in distress and the Enterprise Act 2002 outlining administration procedures.

Reacting to concerns about accounting and auditing, the government introduced the Companies (Audit, Investigations, and Community Enterprise) Act in 2004 to improve the oversight and regulation of the accounting and auditing profession. This increased the powers of oversight and enforcement of the relevant regulator, the Financial Reporting Council (FRC).

Following an extensive review of company law and a white paper (DTI 1998; Company Law Steering Group 2001; DTI 2002), a major revision of corporate law is contained in the present Company Law Reform Bill 2005. The key areas covered are as follows: formation, meetings, and resolutions; capital maintenance; reports and accounts; and directors' duties and responsibilities, including to stakeholder groups. The Bill also includes the following: investors' powers to sue directors for negligence and breach of duty – so-called derivative actions; protection for auditors from catastrophic damage claims, though it will become a criminal offence for an auditor knowingly to produce a misleading audit report; and the government's assumption of reserve powers to require institutional investors to disclose how they vote on company activities. It should be noted that the Government consulted on future narrative reporting requirements between December 2005 and March 2006. In response to the consultation, on 10 May the Government brought forward amendments to the Company Law Reform Bill relating to future narrative reporting requirements. Under the new proposal, all companies, other than small companies, will continue to be required to produce a Business Review, in accordance with the EU Accounts Modernisation Directive. Quoted companies will need to provide certain information over and above that required of unquoted companies. At the time of this Report, the Bill is still going through Parliament. The Bill is taken into account in our analysis and ranking of legislation below with a caveat that its final content is obviously not certain

Other regulations of various kinds can be introduced in so-called secondary, delegated, or subordinate legislation. These enable parliament or a designated body to introduce regulations, statutory instruments, and rules in line with primary legislation. One relevant example of this in recent years is the Directors' Remuneration Report Regulations (2002), which require quoted companies to disclose executive remuneration policies and seek shareholder approval for these.

A further piece of the regulatory framework is the City Code on Takeovers and Mergers (2003-2004). This sets out the principles and rules governing takeovers and mergers of UK companies. It is issued and administered by an independent body, the Takeover Panel. The Code is not legally binding. However, in practice, it is mandatory, since parties failing to comply run the risk that the FSA may take action, which can include unlimited fines and criminal action. With the implementation of the EU Takeover Directive in 2006, the Code will have statutory force. The Code is further supplemented by legal rules on insider dealing through the Criminal Justice Act 1993, part V, which replaced the Company Securities (Insider Dealing) Act 1985.

An important piece of the regulatory jigsaw is the Listing, Prospectus, and Disclosure Rules (2005), issued and administered under the law by the Financial Services Authority (FSA). These revised earlier Stock Exchange Listing Rules in order to take account of the EU Market Abuse Directive, the EU Prospectus Directive, and the introduction of certain International Financial Reporting Standards. The Rules set out a series of principles, which cover the

admission of securities to listing, directors' responsibilities, information disclosure, the use and misuse of insider information, internal controls, and obligations to shareholders.

In recent years, voluntary codes have been developed to regulate wider aspects of corporate governance. A number of factors have driven this development— business scandals and corporate failures in the 1980s and early 1990s, perceived shortcomings in the regulatory framework, and possible legal interventions and EU Directives. The development of such codes is in the British tradition of a preference for voluntarism by the state and self-regulation by companies and the City. The Codes have been referred to in earlier chapters and will only be summarised in brief here. The two initial documents were the Cadbury (1992) and Greenbury (1995) reports. The former of these focused on broad aspects of governance such as director's responsibilities, audit committees, and the relationship between directors, auditors, and shareholders. The latter focused more specifically on directors' pay and remuneration committees. Later, Hampel (1998a and b) reviewed the implementation of the Cadbury and Greenbury codes and the outcome of this report was the Combined Code 1998. There were further reports by Turnbull (1999) on internal controls, Higgs (2003) on the role of non-executive directors, and Smith (2003) on audit committees. In 2003, a new Combined Code was issued. This superseded the earlier Code and drew on the Turnbull, Higgs, and Smith guidelines. A latest revision of the Combined Code took place in June 2006.

The Code is neither law nor regulation, but best practice recommendations for good corporate governance for listed companies (the requirements do not apply to AIM companies). However, the Listing Rules interact with the Code, and listed companies must include a section in their annual report and accounts, which explain how they have complied with the Code or why they have not done so. Since mid 2003, the Combined Code has come within the domain and oversight of the FRC, the statutory body, which regulates accounting and auditing. Subsequent to this change, the Council initiated a review of the original Turnbull report and made a small number of amendments, including a recommendation that boards confirm that they have taken action remedying any significant failings in internal control systems (FRC 2005).

Finally, in this overview of the regulatory context, we briefly refer to Accounting Standards and International Accounting Standards. The 1989 and 2004 Act referred to above give statutory underpinning to the various accounting standards and the Accounting Standards Board (ASB) is recognised as the authorised standard-setting body. In addition, the Financial Reporting Review Panel (FRRP) is similarly recognised as the body authorised to investigate departures from accounting standards and other legal accounting requirements. Both of these bodies are now part of the FRC (Nobes and Parker 2002; Dewing and Russell 2004)

6.3 An Analysis of Regulatory Gaps

Our gap analysis comparing various regulatory initiatives against the benchmarks of 'good' corporate governance drivers is based on information obtained from the review of the social science literature on corporate governance (Chapter 2), survey of corporate governance experts (Chapter 3), the development of 'good' governance drivers (Chapter 4), as well as feedback from the Focus Group (Chapter 5). The analysis maps policy initiatives against the identified drivers of 'good' corporate governance and provides an evaluation of these initiatives along a number of dimensions, which we conceptualise as content and effectiveness gaps. By content gaps, we mean areas where drivers are not adequately covered by the regulatory framework. By effectiveness gaps, we refer to gaps between the aim and actual outcome of regulatory initiatives.

In terms of effectiveness, we consider several aspects. Implementation is explored by examining the type of regulatory instrument used (e.g. law, codes, professional norms) and the degree to which evidence exists regarding effective enforcement or whether potential gaps or market failures can be identified. However, the consideration of effectiveness gaps has broader elements in terms of contingencies, complementarities, and costs. By contingencies we mean that the situation of a particular company may have an impact on the salience of different drivers and the costs of regulation, e.g. differences in the size and age of companies, in their resource base, and in their life cycle. By complementarities, we refer to situations where drivers and regulations in different areas may complement or substitute for one another, e.g. shareholder involvement depends on disclosure or the takeover market may substitute for blockholder involvement. The cost of regulation and drivers must also be taken into account in terms of compliance, opportunity, and strategic costs.

The remainder of the section undertakes gap analyses for each ‘driver’ of corporate governance, which are presented in terms of seven broad ‘families’ of drivers: corporate boards, shareholder involvement, information disclosure, auditing and internal controls, executive pay, the market for corporate control, and stakeholder issues.

6.3.1 Corporate boards

The literature review has identified three major ‘good’ corporate governance drivers associated with corporate boards:

- Board independence;
- Diversity, human and social capital within the board;
- High engagement in board processes.

The governance roles and functions of company boards have received a comprehensive coverage within the regulatory initiatives starting from Cadbury (1992) and Greenbury (1995) reports. In this section, the following regulatory and related documents have been reviewed with respect the above aspects of corporate boards identified as important drivers:

- Company Law (the Companies Acts of 1985 and 1989, the Financial Services and Markets Act 2000, the Insolvency Act 1986, the Enterprise Act 2002, and the Companies (Audit, Investigations, and Community Enterprise) Act 2004).
- Company Law Reform Bill (January 2006)
- Financial Services Authority (2005) “The Listing, Prospectus, and Disclosure Rules”
- The Combined Code on Corporate Governance (2003)
- Higgs Report (January 2003) “Review of the role and effectiveness of non-executive directors”
- Dyson Report (June 2003) “Recruitment and development of non-executive directors”
- Financial Reporting Council (January 2006) “Review of the 2003 Combined Code on Corporate Governance”

6.3.1.1 Content gaps

This section aims at identifying various areas of board-related regulation where drivers are not adequately covered by the regulatory framework. We consider the gaps in the regulatory

framework vis-à-vis the areas which academic research, including our own rankings above, suggest may be areas where government and business may wish to consider further action. We also consider gaps identified by public and private bodies, vis-à-vis statements and research by the major actors as to areas, which they perceive to be gaps.

The broad social sciences research reviewed in section 2.2 of this Report identified a number of functions of ‘good’ governance that ranges from monitoring and control (“wealth-protection”) to promoting managerial entrepreneurship (“wealth generation”) roles. Although the Company Law does not provide statutory statements of directors’ duties, subsequent regulatory documents develop specific definitions of an effective board. The Combined Code suggests that, “the board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risks to be assessed and managed” (p. 4). The FSA’s “Listing, Prospectus, and Disclosure Rules” states that directors must exercise due skill, care and diligence in managing the business of the firm. The Company Law Reform Bill is aimed at embedding in statute the concept of “Enlightened Shareholder Value” by insisting that directors’ duty is to promote the success of the company for the benefit of its members as a whole, and in fulfilling this duty the directors must have regard to the both short- and long-term factors and wider interests including employees, trade partners, etc. (Section 156). This approach is in line with academic research that suggests that a combination of entrepreneurial and monitoring functions of corporate boards is most likely to drive long-term company performance and maximise overall competitiveness, wealth and welfare of all stakeholders.

6.3.1.1.1 Board independence

The review of the economics and corporate finance literatures generally considers the extent of board independence as an important benchmark of good corporate governance. On the other hand, directors dependent on the CEO and other executives, or directors with various conflicts of interest, are considered as unable to perform their monitoring and control functions objectively. Regulatory documents in the UK are specific about preventing possible conflicts of directors’ interests. Part 10 of the Companies Act 1985 contains a large number of provisions designed to deal with situations in which a director may potentially have a conflict of interests. Section 157 of the Company Law Reform Bill states that, “a director of the company must exercise independent judgement.” The Bill is aimed at simplifying these provisions and making them more effective by introducing a number of requirements with regard to the disclosure of directors’ interests and service contracts. Section 9.8.6 of the FSA’s “Listing, Prospectus, and Disclosure Rules” state that, “annual reports and accounts should include a statement setting out all the beneficial and non-beneficial interests of each director of the listed company.” This information should help shareholders to verify if the company’s directors may have conflicting interests that may affect their independent judgement.

The Combined Code on Corporate Governance provides the most comprehensive guidelines on good corporate governance principles associated with structural parameters of board independence. The main principle in Section A.3 suggests that the board should include a balance of executive and non-executive directors (in particular independent non-executive directors). Section A.3.1 provides a detailed account of factors that may affect the extent of non-executive director’s independence, and section A.3.2 suggests that, except for smaller companies, at least half of the board, excluding chairman, should comprise non-executive directors determined by the board to be independent. In addition, the Combined Code states the roles of chairman and chief executive officer should not be exercised by the same individual

(section A.2.1). The Code also suggests that the board should nominate a Senior Independent Director (SID) that should lead meetings of non-executive directors to appraise the chairman's performance without the chairman present. The Code also has provisions with regard to independence of the three main committees of the board. Section A.4.1 stipulates that a majority of members of the nomination committee should be independent non-executive directors. Sections B.2.1 and C.3.1 suggest that all members of a remuneration and audit committees should be independent non-executive directors. The Note to SYSC 2.1.4 R and section 3.2.15 G in the "Listing, Prospectus, and Disclosure Rules" also stipulate that the board of a listed company should establish an audit committee of non-executive directors.

In sum, these regulatory documents combined mention and address the 'good' corporate governance drivers related to board independence identified in sections 2.2.2, 2.2.3 and 4.3.1 of the Report.

6.3.1.1.2 The diversity, human and social capital within the board

Our analysis of the corporate governance roles of boards drawing on a broad social science perspective (including management, sociology and behavioural research) has suggested that boards can extend their involvement beyond monitoring and controlling top management to the provision of ongoing advice and counsel to executive directors on strategic issues. Resource dependence theory indicates that a board of directors may also play an important role in establishing relationships between the organisation and its external environment. From the perspective of the service, strategy and resource roles of boards, 'good' corporate governance drivers are associated with high levels of board diversity and its human and social capital.

Section A.3 of the Combined Code states that the board should have the balance of skills and experience that is appropriate for the requirements of the business. Section A.7, suggest that non-executive directors should be regularly re-elected, and all directors serving longer than two regular terms (e.g., 6 years) should be subjected to a particularly rigorous review.

The Tyson Report (2003) makes a number of further steps and emphasises the importance of diversity in the backgrounds, skills, and experiences of non-executive directors in terms of enhancing board effectiveness by bringing a wider range of perspectives and knowledge to bear on issues of company performance, strategy and risk. In addition, this report suggests fostering greater board diversity in terms of age, gender, ethnicity and nationality of non-executive directors.

The Combined Code and Tyson Report, therefore, provide a number of guidelines that correspond to 'good' governance drivers associated with the Board Diversity family identified in sections 2.2.4 and 4.3.2 of the Report.

6.3.1.1.3 High engagement in board processes

Our review of the board process research indicated the importance of factors associated with the general conduct of board affairs, as well as how and why board processes impact patterns of strategy and performance. This research identifies the effective and efficient board processes as 'good' corporate governance drivers, including issues around information provisions and communication, incentives, etc.

The Combined Code, Higgs Report, and Tyson Report suggest a number of board procedures that should enhance directors' engagement and the effectiveness and efficiency of boards. The Combined Code indicates that independent directors should not have external commitments that prevent them from allocating sufficient time and efforts to their duties. Both the Code and Higgs Review emphasise the roles of the chairman whose main responsibility is to encourage active engagement by all the members of the board. S/he should make sure that non-executive directors receive proper induction and training that should assist with their professional development. The company should ensure that independent directors have access to independent professional advice (Section A.5.2 of the Combined Code). Section A.6 also suggests that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. Higgs Report indicates that board focus should be not only on financial performance but also on strategic matters rather than formulaic approvals of management proposals.

Finally, the Combined Code suggests that the board should be supplied in a timely manner with information in a form and quality appropriate to enable it to discharge its duties. This suggestion is re-enforced by Section 3.2.11 of the FSA's "Listing, Prospectus, and Disclosure Rules" that is focused on reliability, relevance and timeliness of information provided to the board.

These regulatory documents, therefore, provide a number of guidelines that correspond to 'good' governance drivers associated with board processes as identified in sections 2.2.5 and 4.3.3 of the Report.

Our overall conclusion is that with regard to board-related drivers of 'good' corporate governance, no major content gaps exist in the UK regulatory framework. Although some of the specific structures or practices of boards discussed in section 2.2 have received less coverage (for example, external board ties of non-executive directors, non-executive financial incentives, etc.), the results of our Expert Survey in section 3 indicate that these drivers did not receive high scores, and the experts' opinion on their effectiveness was divided. On the other hand, all top scoring drivers are, to various degrees, covered in the UK Regulation.

6.3.1.2 Effectiveness gaps

By effectiveness gaps, we refer to gaps between the aim and outcome of regulatory initiatives. These gaps may include implementation problems associated with a particular element of the regulation, lack of provisions for various firm contingencies, and potential costs of regulation.

6.3.1.2.1 Implementation gap analysis

The FRC's "Review of the 2003 Combined Code" (2006) emphasizes that its provisions are underlined by the principle of "comply or explain" which recognizes that one size does not fit all, and that there may be circumstances where it is in the interests of the company and its owners to adopt practices that differ from those set out in the provisions of the Code" (p. 1). Under section LR 9.8.6 of the FSA's "Listing, Prospectus, and Disclosure Rules" companies should provide in their annual reports a statement of how they have applied the principles set out in Section 1 of the Combined Code. Alternatively, if the company did not comply with these rules, it should explicitly indicate: (i) those provisions it has not complied with; (ii) the period within which it did not comply with some or all of those provisions; and (iii) the company's reasons for non-compliance. It is recognised, therefore, that companies may use

corporate governance practices other than those set out in the Code when they are persuaded that shareholders and their advisors are willing to accept explanations.

The Focus Group participants emphasised that the Combined Code puts heavy emphasis on monitoring and control aspects of the board. However, the test of a company's board efficiency should also consider whether board members help to generate shareholder value through entrepreneurship and improved performance, not just whether they have increased transparency and improved wealth protection aspects of governance. While this is to be achieved through good practices set out in the Code, there is a scope for different approaches to board configurations and functions. For example, the Code's detailed prescriptions with regard to non-executives' tenure, independence etc, should be viewed as principles rather than rules, leaving to the board and investors to judge whether the director has sufficient ability and incentives to perform her duties efficiently.

However, a number of investment institutions, voting and rating agencies apply their own, private criteria that are different to those set out in the code when assessing a company's corporate governance practices (FRC 2006, p. 9). According to the FRC survey, companies indicate that some investors and rating agencies still rely on a 'box-ticking' approach to the Code. As a result, many companies are reluctant to run the perceived risk of explaining and tend to default to compliance regardless of their circumstances.

Finally, although the regulatory documents clearly define a set of principles of good corporate governance practice with regard to corporate boards, the enforcement mechanisms received much less coverage. For example, the main principle in Section A.3 of the Combined Code suggests that the board should include a balance of executive and non-executive directors (in particular independent non-executive directors). Section A.3.1 provides a detailed account of factors that may affect the extent of non-executive director's independence. However, a body of case study evidence suggests that non-executive directors very often are nominated by the CEOs of the company. These independent directors may actively pursue interests similar to executive directors. Existing regulation does not provide enough power to shareholders to put forward their candidates or, indeed, have a significant impact on board diversity.

6.3.1.2.2 Contingency analysis

Our literature review suggested that the effectiveness and efficiency of corporate governance drivers depends on a number of important firm- and industry-level contingency factors such as the firm's size, age, industry regulation, growth/decline phase, etc. The UK regulatory framework seeks to account for these sorts of effects in various ways. The Combined Code, for example, suggests that, when discussing best governance practices, one should "pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces" (p. 2). More specifically, the Tyson Report states that "factors such as company size and age, the makeup of its customer and employee base, the extent of its participation in global markets, its future strategies, and its current board membership are important determinants of NED requirements" (p.1). Section 2.1.2 of the FSA's "Listing, Prospectus, and Disclosure Rules" states that, "the roles undertaken by non-executive directors will vary from one firm to another." Sections 3.1.2 and 3.2.7 stipulate that internal control and compliance systems which a firm needs to maintain depend on a variety of factors including (a) the nature, scale and complexity of its business; (b) the diversity of its operations, including geographical diversity; (c) the volume and size of transactions; (d) the degree of risk associated with each area of its operations.

Despite this recognition of contingencies, the Code provides a limited number of guidelines that address this issue. A number of recommendations related to the board structure and its committees have specific clauses with regard to smaller companies. (Sections A 3.2; B. 2.1; C.3.1). Section E.2 suggests that institutional shareholders, when considering explanations for departure from the Code should bear in mind the size and complexity of the company, as well as company-specific risks.

Smaller companies are able to bypass compliance with the Combined Code by listing on AIM. In doing so, they can avoid enforced practices that are more appropriate to larger companies whilst still gaining the benefits of being listed. However, the Code provisions do not have sufficient flexibility to address issues associated with important contingencies such as growth phase of the company, the nature of competition in its industry (e.g., regulated vs. competitive), knowledge intensity, etc. Even when the Code takes into account the company's size, its prescriptions are mainly focused on structural parameters, such as the proportion of non-executive directors, size of board committees, etc. Because of the investors' approach to the assessment of corporate governance outlined above, smaller companies may be under pressure to adopt practices more appropriate to larger companies in circumstances that can cause them considerable difficulty.

These considerations suggest the importance of complementarities in enforcing corporate governance rules. While the formal rules of the Code allow for a flexible approach in principle, comply-or-explain will only achieve such flexibility when it works in conjunction with investors who have sufficient capacity to actively understand and properly evaluate company explanations.

6.3.1.2.3 Cost analysis

Most of the corporate governance-related research is focused on potential benefits of various corporate governance practices. However, drivers of 'good' corporate governance drivers may also have associated costs, including the out-of-pocket compliance costs that are reflected in the firm's balance sheet and other accounting documentation (e.g., the audit costs, directors' insurance, etc.), less explicit opportunity costs (e.g., directors' time spent on governance issues instead of business strategy, costs of strategic disclosure, etc.), and the legal and reputational costs which may be incurred when firms get their governance practices wrong.

The regulation put an increasing burden of new compliance requirements on listed companies, in particular on smaller companies, which may distract from board's ability to provide entrepreneurial leadership. Too much focus on the compliance issues may reduce the amount of time board members spend on strategy-related matters. Developing sophisticated board processes, such as induction, training and personal development of board members may have serious resource implications, in particular for smaller companies.

Tyson Report (2003) indicates that the growing responsibilities and liabilities facing directors may become a constraint on the ability of companies to find and attract individuals from non-traditional sources who otherwise have time and willingness to accept NED positions. In addition, the increasing complexity and risks of board responsibilities may tempt companies to narrow down the skills and experiences they seek from new directors. As a result, instead of promoting board diversity, the UK regulation may reinforce the traditional emphasis in NED selection on previous board or management experience in the commercial sector.

6.3.2 Shareholder engagement

The literature review has identified two major ‘good’ corporate governance drivers associated with shareholder engagement:

- Presence of large-block shareholders;
- Shareholder activism.

The governance roles and functions of large, concentrated shareholders have received a comprehensive coverage within the regulatory initiatives starting from Cadbury (1992) report which stated that “given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance”.

In this section, the following regulatory and related documents have been reviewed with respect to ‘good’ corporate governance drivers identified in previous sections:

- Company Law (the Companies Acts of 1985 and 1989, the Financial Services and Markets Act 2000, the Insolvency Act 1986, the Enterprise Act 2002, and the Companies (Audit, Investigations, and Community Enterprise) Act 2004).
- Company Law Reform Bill (January 2006)
- Financial Services Authority (2005) “The Listing, Prospectus, and Disclosure Rules”
- The Combined Code on Corporate Governance (2003)
- Myners Report (March 2001) “Institutional investment in the United Kingdom: a review”
- Myners Report (January 2004) “Review of the impediments to voting UK shares”. Report to the Shareholder Voting Working Group.
- Sandler Review (July 2003) “Medium and long-term retail savings in the UK: a review”
- ISC (Institutional Shareholders’ Committee) (2002) “The responsibilities of institutional shareholders and agents – Statement of principles”
- HM Treasury Report (December 2004) “Myners principles for institutional investment decision-making: review of progress”
- Financial Reporting Council (January 2006) “Review of the 2003 Combined Code on Corporate Governance”

6.3.2.1 Content gaps

This section aims at identifying various areas of shareholder-related regulation where drivers are not adequately covered by the regulatory framework. We consider the gaps in the regulatory framework vis-à-vis the areas which academic research, including our own rankings above, suggest may be areas where government and business may wish to consider further action. We also consider gaps as identified by public and private bodies, vis-à-vis statements and research by the major actors as to areas which they perceive to be gaps.

6.3.2.1.1 Presence of large-block shareholders

The review of economics, corporate finance and “law and economics” research streams suggest that presence of large-block and institutional investors among the firm’s shareholders may perform monitoring and resource functions of ‘good’ corporate governance. However, management and business strategy research suggests that the governance roles of block-holders differ depending on their investment strategies and objectives. Some large investors, such as pension funds, individual block-holders, etc., may be better monitors than others (e.g.,

insurance companies and banks), and their presence *per sae* may be considered as a driver of good corporate governance. Therefore, the regulator should encourage their equity involvement in companies.

However, corporate governance regulation in the UK does not differentiate between various types of shareholders. Both Company Law and subsequent Company Law Reform Bill consider a general body of “company members” when referring to shareholder rights. Section 9.3.1 of the FSA’s Listing Rules refers to “all holders of listed equity securities” when introducing a principle of equal treatment of shareholders. The Combined Code in Section D suggests that companies should establish a dialog with institutional shareholders, which are also referred to as “major shareholders” without making a distinction between them. However, the Code also includes in this category investment managers and voting services appointed by institutional investors to act on their behalf. The Institutional Shareholders Committee Principles (2002) suggest that the term “institutional shareholder” include pension funds, insurance companies, and investment trusts and other collective investment vehicles, but it does not identify any differences among them in terms of their governance effects. Finally, Myners Reports (2001; 2004) are focused on pension funds and related financial institutions.

Therefore, the UK regulatory documents do not consider the corporate governance roles of a number of important large investors, in particular, individual block-holders and private equity firms that were discussed in sections 2.3.3 and 4.4.1 of this report. Instead, UK regulation is focused on corporate governance roles of public institutional investors. However, this reflects the general pattern of ownership and control in the UK economy, and therefore, does not relate to any specific regulatory failure.

6.3.2.1.2 Shareholder activism

Our review of research on actions of large-block owners suggests that their presence *per se* may be a necessary but not sufficient condition to promote efficient governance in their portfolio companies. Shareholder activism, or direct involvement of shareholders in “critical” decisions, may be another important driver of ‘good’ governance. Regulatory documents in the UK are particularly specific about promoting shareholder activism and providing channels, which can be used by shareholders to influence the direction of the company.

The major bulk of regulation is focused on “voice”-based channels of shareholder activism, such as participation and voting at company’s meetings. Under Section 372(1) of the Companies Act 1985, any member of a company, the registered or “legal” owner, is entitled to attend and vote at a meeting of the company, and has a statutory right to appoint an agent (“proxy”) to attend and vote on her behalf. The FSA’s Listing Rules, section 9.3.3 states that companies should provide all the necessary facilities and information to enable holders to exercise their rights (1) to attend shareholder meetings; (2) to cast their vote. Section 9.3.6 regulates the procedures related to proxy votes by shareholders.

The proposed Company Law Reform Bill aims at improving the efficiency of shareholder activism by requiring public companies to hold their AGMs within 6 months of the end of the financial year. An amendment to clause 136 proposes that small investors whose shares are held by corporate nominees should be able to receive the same information and exercise the same voting rights that their nominees do. Companies will be required to put on their websites the preliminary announcements of their annual results, accounts and reports. Section 308 of the Bill suggests that companies may use an electronic system of voting and communication with

shareholders, including proxy votes. The Companies Act 1985 (Electronic Communication) Order 2000 has already provided companies and their shareholders with the option to communicate electronically. Companies will be also required to disclose on their websites the results of polls at general meetings (Section 315 of the Bill). In addition, shareholders will have a right to request an independent scrutiny of votes. Section 239 of the Bill is aimed at introducing derivative actions by shareholders as a matter of statute, not common law. Derivative actions are the route by which minority shareholders are able to enforce the company's rights where directors are involved in negligence, default, breach of duty or breach of trust. Unlike class actions in the USA, the shareholder in a derivative action does not seek relief from the directors of the company for herself directly, rather, by statute, on behalf of the company. However, the court must take into account the possibility "that the member could pursue the claim in his own right". The shareholder bringing the action is under the statutory duty to "promote the success of the company" and act "in good faith".

Myners Report (2004) makes a number of suggestions aimed at improving voting procedures, including calling a poll on all resolutions at company meetings; changes from "two way voting" required by the Listing Rules to including a "vote withheld" option; giving more rights to proxies so that they can speak and vote on a show of hands as well as a poll; and allowing multiple corporate representatives at the meeting. More significantly, it states on p. 22 "voting should be fully integrated into the investment process, as it is part of the institution's wider ownership responsibilities, and, indeed, should be recognised, along with other aspects of governance, to be an essential service".

Also being principals with regard to investee companies, institutional investors are, at the same time, agents to their clients, the beneficial owners, and this may create a "second-tier" agency problem that needs to be mitigated by the regulator. The UK, regulatory initiatives emphasise the importance of voting disclosure by institutional investors and their agents. Section E.3 of the Combined Code suggests that institutional investors should make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged. Myners Report (2004) makes a step further and suggests that institutional investors should report to their clients, the beneficial owners, on how they executed their voting responsibilities. Their clients should hold their managers to account for the manner in which the votes have been cast. Finally, clause 866 of the Company Law Reform Bill concerns powers under which ministers could compel institutional shareholders to disclose how they vote.

The Combined Code outlines a number of further guidelines for shareholder activism that go beyond voting at AGMs and legal actions against directors. These guidelines are based on principles of continuous engagement of shareholders, institutional investors in particular, with the company and its board members. Section D of the Code state as a principle that not only the CEO but also the chairman, SID and other directors should maintain sufficient contact with major shareholders to understand their issues and concerns. The chairman should ensure that the views of shareholders are communicated to the board as a whole. FRC Report (2006) "Review of the 2003 Combined Code on Corporate Governance" recommends that institutional investors should identify a lead contact for each of their investee companies. Institutional shareholders should evaluate companies' governance arrangements, and they should consider carefully explanations given for departure from the Combined Code and make reasoned judgements in each case. In terms of voting, institutional investors should take all steps to ensure that their voting intentions are being translated into practice.

The ISC (2002) “Statement of Principles” provides a comprehensive set of guidelines related to shareholder engagement that include a clear policy on: (1) how investee companies will be monitored; (2) requirements with regard to investee company compliance with the Combined Code; (3) meetings with the company’s boards and senior management; (4) the strategy on intervention; (5) the policy on voting; (6) an indication of the type of circumstances when further action will be taken and details of the type of the action. As part of monitoring, institutional investors should endeavour to identify problems at an early stage to minimise any loss to shareholder value. When necessary, they should intervene objectively and in informed way, if necessary, with seeking engagement with other shareholders. The ISC identified a number of areas for intervention when they have concerns about (1) the company’s strategy; (2) the company’s operational performance; (3) independent directors failing to hold executive management properly to account; (4) internal controls failing.

Myners Report (2001) also suggests a number of principles of shareholder engagement including an explicit strategy of fund managers in terms of engagement with their investee companies; circumstances in which they will intervene with the company; the approach they will use in doing so, and how they measure the effectiveness of this strategy.

Therefore, these regulatory documents combined relate to most of ‘good’ corporate governance drivers related to the Shareholder Engagement family identified in sections 2.3 and 4.4.2 of the Report.

6.3.2.2 Effectiveness gaps

By effectiveness gaps, we refer to gaps between the aim and outcome of regulatory initiatives. These gaps may include implementation problems associated with a particular element of the regulation, lack of provisions for various firm contingencies, and potential costs of regulation.

6.3.2.2.1 Implementation gap analysis

The HM Treasury Report (2004) “Myners principles for institutional investment decision-making: review of progress” emphasizes that the shareholder activism guidelines are underlined by the principle of “comply or explain” which recognizes that one size does not fit all. It recommends that compliance with ISC Principles should be voluntary, but that institutional investors, and pension funds in particular, should disclose to their members either their compliance or an explanation of their reasons for departure. It is expected that this would provide an informed commentary, in which trustees explain and justify their approach, and lead over time to the establishment of good practice, and their dissemination across pension funds and other institutional investors.

Therefore, the UK regulatory approach to the shareholder engagement issues is different to that of the USA, where the Labour Department Interpretative Bulletin 94-2 obliges trustees of pension funds and their agents to (1) vote equity shares on issues that may affect the value of the clients’ investment; (2) have a documented policy or guidelines in place for voting on issues; (3) maintain accurate voting records. The US SEC also introduced a new set of rules in relation to “Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies” which require investors to disclose publicly all votes cast in respect of voting shares held within mutual funds (Myners Report 2004). The UK Government has decided not to introduce a mandatory requirement for institutional investors to disclose their compliance with Myners and ISC Principles under the belief that monitoring such a requirement could be costly and time consuming, and might result in uninformative “box ticking” activity (HM

Treasury Report 2004, p.5). Instead, it sees merit in a voluntary, independently compiled report on implementation of principles that may form part of FRAG 21/94 reports on internal control of investments.

Because of the voluntary nature of investors' compliance with Myners and ISC principles, there is evidence that "fund managers appear unnecessarily reluctant to engage with the companies in relation to corporate underperformance (HM Treasury Report 2004, p.8). The lack of engagement activity also reflects in part the conflicts of interest facing fund managers and trustees. For example, the Focus Group participants indicated that conflicts might arise when trustees of the corporate pension fund are employees or stakeholders in the firm and thus face conflicts of interest in being too active. The quality of engagement – as evidenced by the integration of engagement into investment decision-making and asset management process, the quality and quantity of resources committed to it, and the level of disclosure did not reach required levels (Ibid, p. 17). Myners Report (2004) also indicates that investment agents and consultants are mainly focused on economic and financial, rather than governance and voting, issues. Where shareholders have outsourced voting to an agency rather than institutional fund manager, company engagement with voting agencies is even less satisfactory (FRC 2006).

The UK Regulation related to shareholder engagement does not make a full account of institutional features of the UK investment industry. For investment funds, the Focus Group participants suggested that an important prerequisite of effective involvement is the ability of different funds to coordinate their actions. In regulatory terms, this issue is addressed in the City Code. However, a problem regarding coordination concerns the lack of transparency about shareholder involvement. Most of the co-ordination happens 'behind the scenes', as funds do not want to be perceived as being too interventionist.

In addition, when investors, whether major institutional investors or retail investors, buy shares in a listed company they are likely to hold their shares through an intermediary or a chain of intermediaries. Sandler Review (July 2003) and Myners Report (2001) identify at least four parties that are involved between the beneficial owner and the issuer (e.g., a nominee company, custodians, etc), all with distinct and important roles. Shares can also be lent, or used by a third party as collateral. HM Treasury Report (2004, p.7), using a number of previously commissioned research reports, suggests that the investment chain does not work efficiently from the shareholder engagement perspective. This report identifies a number of critical and inter-connected areas where the chain has not been functioning for a number of reasons, including its various principal-agent problems.

The Company Law Reform Bill partially addresses this important issue. The enhanced proxy rights provided in Chapter 3 of Part 13 will enable investors, acting as proxies to a registered member, to exercise all the meeting participation rights that would otherwise rest with the registered member alone. Clause 136 suggests that where companies make provision to extend rights to those holding shares through intermediaries, the provision is legally effective in relation to various statutory requirements. Myners Report (2004), however, suggests that further regulatory initiatives are required to make sure that votes are not "lost", such as registering title in the name of a nominee company with a specific designation; mandatory recall of shares being lent before voting; etc.

6.3.2.2.2 *Contingency analysis*

Our literature review in relation to various drivers of good corporate governance suggest that effectiveness and efficiency depends on a number of important contingency factors such as size, age, etc. With regard to shareholder activism, the UK regulatory initiatives do not provide an explicit account of possible effects of these factors on good corporate governance drivers. The Combined Code suggests that institutional investors should apply the principle of shareholder activism to all firms in their portfolio. Similarly, the ISC Principles do not make any references to the type of investment institution or company.

As a result, there is no sufficient flexibility built into the Code and ISC provisions that addresses issues associated with important contingencies such as growth phase of the investee company, or its size. For example, FRC Review (2006) indicates that, because they invest in a large number of companies, it is not always possible for investors to maintain the level of ongoing dialog they might wish with all investee companies, and in particular smaller listed companies. In addition, the resources required to follow the provisions of the Code and ISC guidelines are proportionately higher, and investors are less likely to keep up an ongoing dialog with companies that are a relatively less significant component of their investment portfolio. Where that is the case, the investors may be reluctant to engage with the companies and instead they may choose a box-ticking approach to their responsibilities.

There is also a substantial heterogeneity within the population of institutional investors in the UK. Different investment institutions have different decision-making horizons, and they use a wide range of investment strategies and management mechanisms. Some of them (e.g., pension funds) may be considered as longer-term investors that may obtain substantial benefits from engaging with companies where they have concerns about a company's governance policies. For other institutional investors (e.g., "index-trackers") shareholder activism can be much more costly than pure reliance on indexing strategies. Sandler Review (2003) documents an increasing importance of "exit" strategies for the fund managers as opposed to shareholder activism. Their increasing reliance on indexing investment strategies suggests that they believe that, on average, their portfolio of firms will yield returns comparable to those for the market as a whole, regardless of the governance structure of their portfolio firms.

Different strategies of involvement are also well documented. Although Myners Report (2004) argues that it is mainly driven by the size of the stake, in practice it may be a more complex function of (1) the absolute exposure in money terms; (2) the relevance of the stock within the portfolio; and (3) a sense check as to whether one can realistically influence an outcome. Shareholders' involvement could also be issue-led – shareholders target particular issues across a wider range of firms.

At present, the UK Regulatory initiatives do not take account of these important differences in investment strategies and mechanisms among UK investment institutions. The Focus Group discussants also indicated that the UK regulatory initiatives do not make a substantial differentiation between the governance roles of majority and minority investors. Dominant shareholders may promote certain interests that are different from other shareholders, and conflicts of interest may arise.

6.3.2.2.3 *Cost analysis*

The costs of implementation of the shareholder activism-related provisions and recommendations set out in the Combined Code, Myners Report (2001) and ISC Principles

are mitigated because they are voluntary best practice codes. The costs of the equivalent prescriptive regulation can be much higher, and some, in particular smaller institutional investors, may find it difficult to allocate internal resources and sufficiently qualified staff to shareholder activism-related systems and procedures, such as direct and regular engagement with companies in their portfolio.

Too much focus on compliance with principles of shareholder activism and excessive disclosure may distract from fund managers' main duty to manage risks and returns from their investment portfolios. In addition, for smaller pension schemes and firms, following Myners principles and ISC recommendations may pose a serious challenge to limited staff and experience of trustees.

From the companies' perspective, the Regulatory requirements related to an increase in shareholder engagement may be potentially associated with substantial costs. Direct costs of corporate governance are related to the out-of-pocket expenses that are associated with compliance with the governance rules and regulations. More specifically, these costs include expenditures on reporting and communications with shareholders, introduction of electronic voting systems including independent assessment of voting procedures, and costs of setting up and running investor relations management systems. More importantly, the companies will incur less explicit, indirect opportunity costs and strategic costs related to shareholder activism. Indirect corporate governance costs are associated with the fact that focusing on engagement with shareholders may divert managers' attention from strategic and operating decisions associated with running the firm. In addition, the litigation risks that are underpinned by the derivative claims provisions in the Company Law reform Bill may change management's risk-taking behaviour, and this, in turn, will likely slow down the growth of the firm. These costs are impossible to quantify on the basis of *ad hoc* assumptions.

6.3.3 Information and disclosure

Two major groups of 'good' corporate governance drivers associated with information and disclosure were identified in our literature review and may be classified under the following broad headings:

- Breadth and depth of public information disclosure;
- Breadth and depth of private information disclosure

Disclosure of information is widely covered both in laws and other regulations, as well as codes and related documents. In this section, the following are considered with respect to 'good' corporate governance drivers identified in previous sections:

- Company Law (the Companies Acts of 1985 and 1989, the Financial Services and Markets Act 2000, the Insolvency Act 1986, the Enterprise Act 2002, and the Companies (Audit, Investigations, and Community Enterprise) Act 2004).
- Company Law Reform Bill (2006)
- Financial Services Authority (2005), The Listing, Prospectus, and Disclosure Rules.
- The Directors' Remuneration Report Regulations (2002)
- The City Code on Takeovers and Mergers (2003-2004)
- The Combined Code on Corporate Governance (2003)
- Financial Reporting Council, various standards.

- Financial Reporting Council (January 2006), Review of the 2003 Combined Code on Corporate Governance.
- Employment Law (the Trade Union and Labour Relations (Consolidation) Act (1992), the Employment Relations Act 1999, and various regulations such as those covering Transfer of Undertakings, European Works Councils, and Information and Consultation.

6.3.3.1 *Content gaps*

The academic literature suggests that information flows are a basic driver of corporate governance and that in turn the informational environment of the firm affects strategy and performance. Informational asymmetry is pervasive in all organisations and may have negative effects in terms of uncertainty, high transaction costs, and the misallocation of resources. Because of market failures and fears of competitive disadvantage, the state has intervened with laws and regulations to make firms disclose. However, in addition, firms may have an interest in disclosing, above what it legally mandated. The academic literature suggests that an optimal disclosure strategy is one where firms supply maximum information, subject to legal, cost, and proprietary constraints.

Company Law (1985; 1989) has long provided a basic floor of information, which needs to be publicly disclosed and also made provision for information, which need not be disclosed. Over time, the courts have interpreted this and brought about some broadening and some narrowing. However, the legislature has progressively broadened the range of information to be disclosed, as seen in the disclosure provisions of the present Company Law Reform Bill. In addition, statutory-based regulations such as the Listing, Prospectus, and Disclosure Rules and the City Code on Takeovers and Mergers have information provision at their core. Similarly, the Combined Code places great emphasis on the flow of useful and timely information within the company and from the company to relevant outsiders. Accounting standards provide the currency; auditing and other ‘gatekeepers’ ensure the value of information.

Two broad areas of information disclosure are seen as important drivers – public information which is provided on a mandatory basis and private information which is voluntarily provided.

6.3.3.1.1 *Breadth and depth of public information disclosure*

In terms of public information provision, our research has suggested that information in annual reports is a major driver. Though obviously much of the annual report is of a standard nature and also often backward looking, it is nevertheless of fundamental importance. This is not least because private disclosure often builds on it. Public disclosure is well covered in UK Company Law. It is underpinned by accounting standards and supported by external auditing. In addition, the Listing Rules and the City Code supplement the requirements for public information disclosure at specific points in companies’ affairs.

In our survey of experts, the provision of information on corporate governance itself was also ranked high. In the UK, a combination of the law, regulations, and listing and takeover rules mean that significant information is provided on the composition of boards, make-up of committees, and executive pay. Here, in particular, the Combined Code and its various additions provide detailed prescriptions in terms of board characteristics and composition.

The provision of information on related party transactions and influence, which other parties might have on the firm, is well spelled out in Company Law, the Listing Rules, and in various accounting standards. For example, the Accounting Standards Board has laid down that “It is necessary to establish standards that apply to all enterprises for disclosure of information about related party transactions and certain control relationships.... The Board believes that an enterprise’s financial statements may not be complete without additional explanations of and information about related party transactions and thus may not be reliable” (FAS, No. 57 1982, p. 6-8). These are outlined, and, over the years, they have been further elaborated. Transgressions in this area may also be the subject of criminal proceedings.

The literature review, expert survey and focus group all gave evidence suggesting the importance of the Operating Financial Review as a central driver of good corporate governance. The Government has been consulting on the full range of options for future narrative reporting requirements.. Whatever the outcome, companies will face a mandatory requirement to produce a Business Review, as required under the European Accounts Modernization Directive. However, this will probably not require as much information on social responsibilities as the OFR was intended to require. It will also not necessarily have to be audited.

It may well be the case that most large firms will produce an OFR or something very like it in the Business Review. However, potential gaps may arise. First, not all large companies will provide a full OFR and many medium size firms will not do so. Second, while audit committee oversight and outside auditing of publicly disclosed information ranked high in our research, these audit requirements are not part of the Business Review. Third, broader information on areas such as employment policies, environmental policies, and social responsibility were also rated as important drivers in our research. However, at the present time, information provision in these areas is relatively limited in both Company and Employment Law.

In sum, UK regulation addresses many of the aspects of information disclosure related to company finance and corporate governance practices discussed in sections 2.4.2 and 4.5.1. However, potential gaps exist in the areas of broader information disclosure discussed in sections 2.4.3 of this report. In particular, one area for consideration is narrative reporting of a forward-looking kind, which would contain operational and strategic information.

6.3.3.1.2 Breadth and depth of private information disclosure

In terms of private information provision, our research suggested several key aspects: the extensive and timely provision of information to independent directors, the need for vertical information flows between the board and functional departments, and the need for good horizontal information flows between functional departments. It will be noted that these are all topics, which relate to internal information and control. These areas are not highly regulated in Company Law, in the Listing and City Codes, or by accounting standards. However, they are extensively covered in the Combined Code and the Higgs Report on the role and effectiveness of non-executive directors, the Turnbull Report on internal controls, and the Smith Report on audit committees.

The provision of private information to key investor groups and to analysts was covered in the academic literature in terms of effects of disclosure on the availability and price of capital. However, it was not emphasised as a driver of good corporate governance nor rated so by our Expert Group or Focus Group. Here one argument is that companies have to be very careful

about the provision of private information to those outside the firm, for fear that this might advantage one group and create possibilities of unlawful share dealing. In terms of the latter, Company Law, the Listing Rules and the City Code, and criminal law provide an extensive regulatory framework in the UK. Finally, it will be recalled that the provision of information to employees and the provision of information to other stakeholders were rated as being of importance in our expert research. As will be discussed in the stakeholder section below, this is an area where both Company Law and Employment Law leave some gaps.

The regulatory provisions, referred to above, provide a number of requirements and guidelines that correspond to ‘good’ corporate governance drivers associated with private information flows identified in sections 2.4.3, and 4.5.2 of the Report.

Our overall conclusion on information is that there are some content gaps in the UK regulatory framework. One possible gap, in terms of public information, is the provision of forward-looking information on operations and strategy. It will be interesting to see to what extent companies voluntarily provide an OFR and to what extent the Business Review will substitute for it. In terms of private information, the provision of information to general stakeholders and mechanisms for providing information for employees constitute a gap. We return to this in the shareholder section below.

6.3.3.2 Effectiveness gaps

In this section we consider the gap between the stated aims and actual outcome of the regulatory framework. These gaps may include implementation issues, the neglect of various contingencies, and the potential costs of regulation.

6.3.3.2.1 Implementation gap analysis

In terms of public information, compliance with information and disclosure rules seems to be relatively high. Disclosure requirements are mainly based on the law, on both Company Law and on relatively hard codes, such as the Listing Rules and City Code. The penalties for non-compliance are heavy.

However, it remains unclear whether the UK financial reporting regime always has the intended effect, as witnessed by the debates over short-termism. For example, the high frequency of reporting with regard to financial information may become self-defeating by focusing managers on short-term time horizons and leading to undue stress on certain reported elements of financial performance, rather than strategic and operational goals that are not reported in a standardized way. In this regard, heavy disclosure may impair managers’ willingness to undertake entrepreneurial risks and lead to managers concerned with ‘gaming’ the system to report ever-higher earnings growth. Recent legal changes have also strengthened supervision as to whether Directors of a company have fulfilled their obligations in preparing accounts. For example, the Financial Reporting Review Panel (FRRP) will now be given statutory powers to require companies to provide information necessary to review the accuracy of the annual accounts, and expand the scope of FRRP supervision to interim reports of listed companies. Also, information sharing between Inland Revenue and the FRRP will be opened to improve the effectiveness of detecting non-compliance with accounting rules.

In the case of private information flows, many of the legal instruments focus largely on the prevention of insider dealing and restricting flows of private information in order to uphold

the principle of equal treatment for shareholders. Meanwhile, the Combined Code covers the internal process of information sharing vertically and horizontally within the company. The Combined Code gives guidance about the structure of boards or the presence of risk management systems. However, it is unclear how these translate into directors' or other relevant groups being adequately supplied with timely flows of information sufficient to make good judgements. Here it would appear that most big firms are complying in the sense that few opt to explain non-compliance. However, the extent to which this really feeds through is an empirical question, which requires further research.

6.3.3.2.2 Contingency analysis

The review of the literature on information suggests that the effectiveness and efficiency of information disclosure and sharing depends on a number of important contingency factors, such as size and industry, and on the context of specific events, such as crisis or takeover.

The law recognises some such contingencies in terms of company size and related requirements. It also recognises event contingencies, as under the Listing Rules and Takeover Code. The Combined Code is also very aware of contingencies. For example, the introduction to the Combined Code spells out that, "smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant to their case." In line with the approach of the Code, it goes on to say that deviations "should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches" (p.2). However, the degree of flexibility is not always clear. The high pressure on UK companies to comply means that companies may not be able to consider whether it would be good in the case of the specific company.

6.3.3.2.3 Cost analysis

Despite the many benefits of information disclosure, associated costs also exist. These potential costs in terms of information disclosure include the following: the fixed costs of producing and processing information; the more indirect opportunity costs (e.g. the time spent on such matters instead of business strategy); the proprietary or indirect costs when competitors, customers, and others use the information to the firm's disadvantage; and the legal and reputational costs which may be incurred when firms get their information practices wrong.

The relative balance between costs and benefits will vary between firms and overtime – depending on size, sector, and specific events. It is therefore an empirical question as to the actual trade-off between costs and benefits. Here the history of the OFR perhaps offers some perspective. The literature review suggested that firms have an interest in disclosing, above what is legally mandated, in anticipation of benefits, such as the reduction of uncertainty. The incentive to disclose is particularly strong when other firms disclose. Initially, there was substantial opposition to the OFR on the part of some companies. However, by the time it was due to be introduced, many companies had become convinced of its benefits and many now voluntarily supply this sort of information.

6.3.4 Audit and internal controls

The literature review has identified three major 'good' corporate governance drivers associated with audit and internal controls:

- Independent external auditors;

- Highly qualified audit committees within the board;
- Support of audit through internal control, risk management and protection of whistleblowing

The corporate governance role and implications of audit and internal control processes has received a growing amount of attention in the last three years. The scandal of Enron in the United States and regulatory response of Sarbanes-Oxley (SOX) has influenced debates world wide. Likewise, cases such as Parmalat and Ahold sparked growing attention to the role of auditors in Europe as well. In the UK, a Co-ordinating Group on Audit and Accounting Issues (CGAA), was created and issued their final report in January 2003. At the European level, the 8th Company Law Directive on statutory audit, which has been called the European “Sarbanes-Oxley” Directive, was adopted in April 2006 and came into force 29 June 2006. While the directive contains a number of very important provisions, these are not considered directly here as they have not yet been transposed in UK law.

In this section, the following regulatory and related documents have been the primary ones reviewed with respect to drivers of ‘good’ corporate governance identified in previous sections:

- Company Law (the Companies Acts of 1985 and 1989)
- Companies (Audit, Investigations, and Community Enterprise) Act 2004.
- Company Law Reform Bill (January 2006)
- Limited Liability Partnerships Act (2000)
- Financial Services Authority (2005) “The Listing, Prospectus, and Disclosure Rules”
- The Combined Code on Corporate Governance (2003)
- Guidance on Audit Committees (The Smith Guidance) (2003)
- Accounting Practices Board, Ethical Standards (2004)
- The Institute of Chartered Accountants in England and Wales Guide to Professional Ethics
- Audit Regulations and Guidance, Institute of Chartered Accountants (2005)
- Public Interest Disclosure Act (1998)

Rules on auditing are related to the duty of directors (Section 221 of the Companies Act 1985) to keep accounting records sufficient to explain the company’s transactions, and for the annual accounts to be approved by the board of directors. The audit process is concerned to establish and confirm confidence in this accounting information. The Companies Act 1985 (Sections 384 to 394A) outlines rules on the appointment, rights, remuneration, removal and resignation of auditors. These rules have been largely upheld in the Company Law Reform Bill (2006), although certain provisions have been tightened regarding disclosure to shareholders. A comprehensive review of legal, soft-law and self-regulatory instruments came in 2003 in the final report of the Co-ordinating Group on Audit and Accounting Issues. Their report was significant, and led to substantial regulatory changes, particularly in the area of independent oversight, monitoring and investigation of the profession.

The fundamental responsibility of auditors is to report to shareholders whether the accounts prepared by the directors present a true and fair view of the company’s affairs. The auditor’s role, as codified by the Auditing Practices Board (APB), is not to detect or prevent fraud, but to qualify the audit opinion if they find evidence of substantial material misstatements. This process is now subjected to greater regulatory supervision through the various boards of the Financial Reporting Council (FRC). For example, the Accountancy Investigation and

Discipline Board (AIDB) have supervisory powers, and may bar auditors from the profession if they detect fraud but fail to report it. The standard of care for auditors has also been sharpened through case law, such that auditors should not rely entirely on honesty of other persons, but undertake checks on at least one or more sample items. Thus, auditing has emerged in the last several years as an area of dynamic development that raises its role and profile as an element of corporate governance.

6.3.4.1 Content gaps

This section aims at identifying various areas regulation related to audit and internal controls where drivers are not adequately covered by the regulatory framework.

6.3.4.1.1 Independent external auditors

The literature review suggested that the independence of external auditors is essential to their effectiveness. An important element stressed by the Accounting Practices Board is that independence does not depend on whether the auditor feels their views are influenced by a particular situation, but whether a reasonable and informed third party would conclude that the auditors' objectivity is or is likely to be impaired. Independence in this context can entail several specific elements, including the restriction of 'non-audit' tasks involving the external auditors, the regular rotation of appointed external auditor, shareholder involvement in the appointment of the external auditor and sufficient legal liability of auditors. Other rules govern the qualifications of auditors, and the eligibility of appointments under certain criteria of independence.

In particular, the Ethical Standards of the ABP and the Audit Regulations and Guidance of the ICAEW outline situations that may threaten an auditor's independence: undue financial dependence on an audit client (or group); significant overdue fees from an audit client; actual or threatened litigation in relation to an audit client; influences from outside the audit practice, including those from associated firms; personal or family relationships; beneficial or other interests in shares or other investments in an audit client; beneficial interests in trusts which have investments in an audit client; involvement as a trustee in an audit client; loans to or from audit clients; receipt of hospitality, goods or services from an audit client for less than full value; provision of other services to audit clients; a principal or senior employee joining an audit client; mutual business interests; participation in the business affairs of an audit client; voting on audit appointments; acting as auditor for a prolonged period of time; and an officer or employee of an audit client, who is related to an employee or principal of the firm. The standards are enforced through the system of professional registration as a qualified auditor (see below). Auditor rotation is also an important requirement bearing upon independence. For example, the Professional Ethics of the ICAEW now follow the European Union recommendation to require auditor rotation every five years (reduced from every seven years).

Independence is also covered by shareholder involvement in the appointment of the external auditor, which is guaranteed under the Companies Act 1985 and requires the general meeting of the shareholders to appoint auditors. If no appointment is made, the DTI must be informed and can make an appointment. In practice, however, shareholders usually delegate this right of appointment to the board of directors. Resignation of an auditor requires a notice containing a statement that no circumstances connected with the resignation should be brought to notice of shareholders, or a statement of such circumstances. This statement may help guard the independence of auditors, even during conflicts with management. The

Company Law Reform Bill (2006) is set to introduce a number of proposals to further improve transparency, and support shareholder involvement to improve audit independence and quality. Specifically, the Bill will require publication of audit engagement letters, give shareholders the right to question audits, require more information disclosure within auditors' resignation letters, and require the lead audit partner to individually sign the audit report.

More broadly, the Combined Code advocates the formation of an audit committee within the board of directors that makes recommendations about the appointment, activities, and remuneration of auditors. The audit committee should also review and monitor the auditor's independence and objectivity in light of existing UK standards and regulatory requirements. Moreover, the audit committee should develop policies regarding non-audit services. In short, the audit committee plays a central role in monitoring the independence of the audit. To this end, an important stipulation in Principle C.3 and related code provisions is that the audit committee should consist of at least three members, who should all be independent non-executive directors. Principle A.3 also states that only the committee chairman and members can attend the audit committee meeting.

The independence of board members involved in the audit committee should add a further layer of independence, and act as a buffer between inside board members and the auditors by having some degree of autonomy from each party. This role of the audit committee remains controversial. Auditors are formally appointed by the shareholders in order to avoid conflicts of interest, such as having the auditor being accountable to two different constituencies. However, in practice the directors are required to manage the auditor on behalf of the shareholders, which may undermine their genuine independence, despite the mediating role of non-executive directors.

Auditors in the UK must hold qualifications from one of several recognized professional bodies, such as the Institutes of Chartered Accountants in England and Wales, Scotland, or Ireland, the Association of Chartered Certified Accountants, Association of International Accountants or Chartered Institute of Public Finance and Accountancy. In order to be eligible to act as auditors, they must also be a member of a Recognised Supervisory Body - Association of Authorised Public Accountants, Association of Chartered Certified Accountants, Institute of Chartered Accountants in England & Wales, Institute of Chartered Accountants in Ireland, Institute of Chartered Accountants in Scotland. The EC Eighth Directive brought the profession under greater statutory control through a registration system. Both Company Law and the Audit Rules of the Institutes of Chartered Accountants stipulate that certain qualified persons may not be appointed as auditors: if they are an officer or employee of the company or related company, as well as any connection or association of the auditor with the firm that might compromise their independence. The Institutes of Chartered Accountants can enforce various professional regulations by inspecting and removing the registration of its members. Since September 2005, the Public Oversight Board for Accountancy (POBA) has a legal responsibility to oversee the regulation of auditors by the recognized professional bodies, as well as monitoring the quality of the auditing function in relation to certain significant economies entities.

Auditors hold a variety of statutory rights and powers that help to assure their independence during the audit. For example, auditors have the right to access company books and account, as well as receive notices related to general meetings. Company officers face criminal chargers for providing knowingly misleading statements to the auditors. These powers have been further expanded in the Companies (Audit, Investigations and Community Enterprise)

Act 2004. Auditors are now entitled to require information from a wider group of people, including company employees, and may require directors to make a statement to the effect that they have not withheld important information regarding the company accounts.

The restriction of non-audit tasks is widely considered important to assure independence and limit conflicts of interest from arising in related to the audit. This concern was highlighted by the case of Enron, and resulting demise of Arthur Andersen, where the audit firm was providing non-audit services. The resulting review by the CGAA rejected a ban on the provision of non-audit services, and supported a “threats and safeguards” approach based around strict disclosure. The Companies (Audit, Investigations and Community Enterprise) Act 2004 now requires companies to publish detailed information on the types and costs of services bought from their auditor or their associates. This replaces the previous requirement to disclose the total amounts spent on audit and non-audit services. The rationale behind these measures is that shareholders will be better able to judge whether conflicts of interest arise. As mentioned above, the Combined Code also suggests that the audit committee develop a clear policy and transparency toward retention of auditors to perform non-audit tasks. The EU 8th Company Law Directive will strengthen independence of audits through future requirements for auditor rotation.

Finally, legal liability of the auditors is often considered a further type of rule in fostering independence of the auditors and vigilance in monitoring managers. Liability may stem from statutory duties, contractual obligations or through tort in cases of negligence where the duty of care is shown to be in breach. In practice, professional standards play a central role here, since auditors following the Auditing Standards and Guidelines, Statements of Standard Accounting Practice and Financial Reporting Standards are unlikely to be found in breach of their duty. However, an important change is being planned in the Company Law Reform Bill (2006) which would allow auditors and companies to agree a limitation of the auditors’ liability subject to an override if the Court finds it less than fair and reasonable. A statutory cap on liability was rejected as inappropriate. The aim of this reform is to better balance the need for liability against the high costs associated with the current rules. The Bill would lower the risks of legal claims and the costs of indemnity insurance, thereby stabilizing the audit market and allowing smaller firms to enter this market. In addition, the Limited Liability Partnerships Act (2000) has made it easier for audit firms to limit their liability in the way that other companies have.

These various regulations exist, which are designed to support auditor independence as a driver of ‘good’ corporate governance, as discussed in sections 2.5.2 and 4.6.1 of this report.

6.3.4.1.2 Highly qualified audit committees within the board

The literature review suggested that the qualification of audit committee members was very important in order to suppose the oversight of the auditing process, and assure the quality of external auditors. The formation of an audit committee is advised on a comply-or-explain basis through the Combined Code. Given the central role of the audit committee for auditor independence (see above), the membership of the committee is extremely important in supporting this role. Following the Smith Guidance (2003) on the role of the audit committee, further detail was adopted into the Combined Code. The general notion is that the structure of the audit committee may depend on the particular circumstances of the firm, and therefore some need exists for a flexible approach. Combined Code suggests ways in which the audit committee should assess the audit process—here the emphasis is not on duplicating or auditing the audit, but on assuring a proper system is in place.

In terms of the composition and qualification of its members, all should be independent non-executive directors. The Smith Guidance states that, “the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience” (Section 2.3). More specifically, the guidance suggests that one board member should “have a professional qualification from one of the professional accounting bodies” (Section 2.17). Other members should have “a degree of financial literacy” appropriate to the circumstances of the company. However, ultimately the board may judge whether then qualifications of the committee are sufficient. The guidance also suggests that companies should provide an “induction programme” for new members, and provide training for committee members regarding understanding financial statements, etc. Despite their nominal independence, non-executive directors may often lack the real expertise and incentives to pro-actively intervene in the audit process. The guidance recommends meetings three times per year. Thus, the level of engagement and factual independence from the information and opinions provided by the external auditors may be highly variable across companies

These recommendations have been adopted into the Combined Code, which now gives substantial guidance with regard to issue of audit committee composition, which was discussed as a driver of ‘good’ corporate governance, as discussed in sections 2.5.2 and 4.6.2 of this report. It may be noted, however, that the provisions are of a rather broad nature and may leave gaps, particularly in terms of implementation.

6.3.4.1.3 Internal control, risk management and protection of whistleblowing

The review of corporate governance literature identified several important aspects of internal company process that complement external supervision by auditors. Specifically, internal control systems are central to monitoring risk and assuring the company meets its objectives. Financial controls are important here, but also a broader evaluation of the types of risks to which companies are exposed. Complementary to this are procedures for whistleblowing that protect company staff and encourage their reporting of misconduct.

The Combined Code states that it is the responsibility of the audit committee to not only consider the internal financial control but also look at the broader aspect of the internal control and risk management systems. Principle C.2 of the Combined Code covers internal control and states that, “the board should maintain a sound system of internal control to safeguard shareholders’ investments and the company’s assets.” Principle C.2.1 charges directors with reviewing the system of internal control and reporting to shareholders that they have done so. The UK Listing Rules (Paragraph 9.8.6) also require disclosure of how companies applied these principles.

The Turnbull Guidance (1999, 2005) outlines important responsibilities and elements of sound internal control systems as required by the Combined Code. The broad approach is to have risk-based internal control systems where the board should consider the nature and extent of risks facing the company, the extent and categories of risk that they company can bear, the likelihood of risks materializing, the company’s ability to reduce those risks, and the costs and benefits of risk management. As such, the guidance aims at providing a flexible, principles-based approach that allows companies to implement internal controls that are appropriate and proportional to the different risk environments in which they operate. Key generic elements, however, constitute good systems of reporting within the company and monitoring of compliance. The guidance also stresses that internal control and risk management should be embedded in the regular operations of the company.

The literature on quality of control and checks upon failures in compliance suggests the importance of ‘bottom-up’ monitoring by employees involved in the implementation of business. To this end, the protection of employee ‘whistle-blowers’ is important to ensure that employees are able to disclose wrong doing, and problems can be identified and quickly resolved. Employees making such disclosures must be protected to that they make qualified disclosures without having fear of retaliation or punishment.

Substantial legal protection for whistleblowers was introduced by the Public Interest Disclosure Act 1998, which outlines the kinds of disclosures that qualify for protection, such as those related to criminal offences, breaches of legal obligations, dangers to health or safety or the environment and so on. Receiving legal protection requires that the disclosure be made in good faith and when it is reasonable to believe that the information is substantially true. The act provides a list of ‘prescribed persons’ to whom such disclosures can be made, which cover a wide gambit of regulatory agencies responsible for different areas. The act offers a broad scope of protection “from being subject to a detriment by their employer.” Detriment goes beyond cases of unfair dismissal and includes denial of promotion, facilities or training which the employer would otherwise have offered.

In addition to whistleblowing to outside regulators, many companies have related procedures as part of their internal control system. The Smith Guidance (Section 4.8) and revised Combined Code suggests that the audit committee review arrangements “by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters.” The audit committee should provide that proportionate and independence investigation and follow-up action occurs when such reports are received.

Overall, the areas of internal controls, risk management and whistleblowing have thus recently become the subject to increasing levels of regulation that address, in broad terms, some aspects of ‘good’ corporate governance practices as discussed in sections 2.5.3, 2.5.4 and 4.6.3 of this report. Therefore, one conclusion may be that the coverage of important audit-related ‘drivers’ has improved substantially in recent years in response to the various scandals and resulting wave of worldwide concern about audit-related issues. This coverage is more comprehensive in terms of structure and disclosure, but leaves substantial flexibility in terms of actual practices and organisational processes. These latter issues will be raised in terms of effectiveness gaps.

6.3.4.2 Effectiveness gaps

In this section we turn to the gap between the stated aim and actual outcome of the regulatory framework with regard to auditors and internal control processes.

6.3.4.2.1 Implementation gap analysis

Recent developments have substantially strengthened the oversight and enforcement of audit rules, particularly in the area of auditor independence. The Companies (Audit, Investigations and Community Enterprise) Bill 2004 gave the FRC greater powers and resources in the area of audit oversight. A Professional Oversight Board of Accounting (POBA) was also created in 2004 to take responsibility for the oversight of audit regulation, as well as setting up an Audit Inspection Unit (AIU) to monitor the quality of audits of economically significant entities. In its first year of operation, POBA found that 80-87% of the registered auditors receiving monitoring visits by professional bodies were compliant with regulations, but some

non-compliance existed and this often led to having registration withdrawn. The AIU also undertook monitoring of major audit firms with regard to their audit process, as well as the audit partners' actual judgments. According to the POBA 2005 Report (p.11), "the AIU inspections identified no systematic weakness in the overall policies, procedures and systems of quality control operated by the firms," but rather focused on areas of more incremental improvements to the implementation of those systems. For example, the AIU noted the lack of written records in some cases, where partners' judgments had to be explained orally. In 2005/6, the AIU will extend its inspections beyond the 'Big 4' to the next tier of audit firms.

In the area of internal controls, the FRC established the Turnbull Review Group in 2004 to consider the impact of the Turnbull Guidance issued in 1999. The 2005 report concluded that internal control in UK companies had substantially improved. The Evidence Paper published in June 2005 provided very positive reports from relevant practitioners about the implementation of Turnbull. However, it seems too early to evaluate the implementation and long-term effects of recent regulation. In particular, the implementation of restrictions of non-audit tasks relies largely on information disclosure and sanctioning by the market. Given the limits and costs of shareholder engagement in the appointment and monitoring of auditors, the effectiveness of such measures must be evaluated and perhaps tightened as common practices become more established. This observation should not detract from the improvements made in recent years, but point to potential effectiveness gaps in a forward-looking manner.

6.3.4.2.2 Contingency analysis

Various aspects of the regulation discussed in this section point out the need to adopt audit and internal control systems that fit the circumstances of individual firms. This approach is particularly clear in the Combined Code and related guidance, and implemented through the comply-or-explain basis. In particular, companies of different sizes or having different levels of complexity can ideally shape their auditing and control process to their own situation. As such, the flexibility of the UK principles-based approach seems to have some advantages in being adaptable to the varying circumstances of firms. Particularly in the area of risk management, it would appear extremely difficult to have clear rules about what such systems should look like that would be universally applicable. The types of risks faced by firms are highly contingent on different national and sectoral operating environments.

6.3.4.2.3 Complementarity and substitution analysis

The audit process is conceived as a complementary institution that should support the quality of information disclosure. Without objectivity and assurance, the value of public information disclosure is highly questionable. Conversely, the quality and independence of auditors relies importantly on other supporting elements of corporate governance such as the independence of the directors who form the audit committee and supervise the audit process. Put rather simply, the quality of independence in the audit depends very much on the quality of independence among directors, and problems in the area of director independence can endanger or even undermine the relationship with auditors.

An important aspect in this regard relates to the incentives and remuneration of the parties involved, and more widely to the scope of non-audit activities. Some analyses of the Enron case suggest the use of high-powered share-based incentives among the directors gave very strong incentives for the persons involved not to report the true and fair view of the company value. This problem even extended to independent directors as well, who face similar types of incentives. Given these dangers, the importance of external oversight and powers of the

auditor vis-à-vis directors and company staff would seem to be an important substitute for trust in the board and audit committee. One potential solution here is the “reputational risk” to auditors, who are exposed as being insufficiently independent and objective. However, it remains an open empirical question as to how well such reputational mechanisms work to protect the independence of various ‘gatekeepers’ such as auditors or other risk management professionals. As mentioned above, the reliance on disclosure and sanctioning by market actors such as institutional investors may be too weak to reinforce regulatory provisions in the audit area.

A further interesting question arises for public policy – when and to what extent can there be a substitute for auditing itself? Some possible alternatives may be improving the selection of staff, increasing the levels of training of those staff, and acculturation into particularly ethical or normative ways of doing things.

6.3.4.2.4 Cost analysis

The improvement of auditing and internal controls surely has associated costs. Still, increased regulation over the audit process in recent years has also improved coverage in terms of ‘good’ corporate governance drivers. A number of potential effectiveness gaps remain, but these must be cautiously evaluated in terms of emerging practices and the costs of potential further regulation. Future comparative study of the U.S. and UK policy would serve as an important benchmark in evaluating the costs and benefits of recent regulation.

6.3.5 Executive pay

The literature review has identified three major ‘good’ corporate governance drivers associated with executive pay:

- Provision of long term incentives tied to company performance;
- Pay set by an independent remunerations committee;
- Disclosure of pay.

The role of executive pay within the corporate governance framework has been highlighted predominately in the Greenbury Report (1995), which has subsequently been incorporated into the Combined Code on Corporate Governance (2003). Executive pay has also been subject to greater disclosure following the implementation of The Directors’ Remuneration Report Regulations (2002). In this section the following regulatory and ‘best practice’ documents have been reviewed with respect to ‘good’ corporate governance drivers identified in the previous section.

- Company Law (the Companies Acts of 1985 and 1989)
- The Combined Code on Corporate Governance (2003).
- The Greenbury Report (1995)
- Financial Services Authority (2005) “The Listing, Prospectus, and Disclosure Rules”
- The Directors’ Remuneration Report Regulations (2002).
- Company Law Reform Bill (January 2006)
- Financial Reporting Council (January 2006) “Review of the 2003 Combined Code on Corporate Governance”
- Association of British Insurers, various guidelines.

6.3.5.1 Content gaps

This section aims at identifying areas of regulation and best practice, where the regulatory framework may not adequately cover drivers of ‘good’ corporate governance.

6.3.5.1.1 Long-term performance related incentives

The Combined Code on Corporate Governance (2003) has incorporated many of the good practice guidelines with regards to executive pay initiated within the Greenbury Report (1995). The Remuneration Section within the Combined Code can be found in section B. Section B1 states within the main principle that, “A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.” The responsibility for incorporating this within any proposal (and implementation) of pay policies lies with the company’s remuneration committee and as such, this statement leaves members of the remunerations committee with two clear challenges. Firstly, they must address the level chosen to define ‘significant’, which would rely on internal interpretation, and secondly, measuring performance. When measuring performance there is the question of whether you are measuring an individual, a team or the whole corporation’s performance. Neither the Combined Code nor Greenbury give guidance on either of these two specific issues. This is in line with a principles-based approach used in the UK, but allows rather considerable discretion on behalf of the companies with regards to their rewards.

Thus, the design of performance related remuneration schemes are clearly identified within Greenbury (1995) and the Combined Code (2003), and guidance is given here on a ‘comply or explain’ basis. The implementation of incentive schemes is then entrusted to the mechanisms of shareholder approval. UK regulation takes a rather broad and principled-based approach to the corporate governance drivers discussed in sections 2.6.3 and 4.7.1 of the report.

6.3.5.1.2 Transparent and independent control of the remunerations committee

The separate report by the remunerations committee within the annual report and accounts provides the shareholder with vital information with regards to pay issues. The UK Listing Rules (LR 9.8.8) provided requirements as to what should be in the directors’ remuneration report; these have now been put on formal footing with The Directors’ Remuneration Report Regulations (2002). The remunerations report must provide detailed information regarding the actual amounts received in the financial year by way of salary and fees, bonuses, expenses and other non-cash benefits. It further must state any compensation for loss of office or other termination payment; information on each director’s share options and interests under long term incentive schemes, and information on each director’s entitlements under pension schemes. All these items are subject to audit verification (LR 9.8.11).

The Combined Code attaches great significance to the role of the independent non-executive director. At present the company chairman is not seen as an independent director in terms of serving on the Remuneration Committee. The revised Combined Code (2003) became more prescriptive with regards to the composition of the Remuneration Committee, whilst the 1998 version (Section B2.1) stresses independence of the committee; the revised section within the 2003 version states at least three independent directors should be on this committee (for FTSE 350 companies and 2 for smaller companies). However the composition of this committee is subject to proposals for change within the FRC’s Review of the 2003 Combined Code (2006). The proposals from this review (if accepted) will allow the company chairman to be an additional member of the remuneration committee, subject to them being considered

independent at appointment. This will give additional insight into the verification that performance incentives and other element of executive pay are correctly aligned with the strategic objectives of the company. Additionally the Chairman may provide a key in role with good knowledge of the company and be responsive to the requirements of shareholders.

For these reasons the Directors' Remuneration Report Regulations (2002) and the Combined Code provide significant guidelines that correspond to the 'good' corporate governance drivers identified in sections 2.6.4, 2.6.5 and 4.7.2 of the report. The underling conclusion is that with regards to the executive pay related drivers; there are deemed to be no content gaps within the UK regulatory/policy framework. The question with regards to executive pay seems to be one of effectiveness rather than gaps.

6.3.5.2 Effectiveness gaps

In this section we turn to the gap between the stated aim and actual outcome of the best practice and regulatory framework. These 'efficiency' gaps may involve implementation problems, a failure to take into account various contingencies, and the potential costs of regulation.

6.3.5.2.1 Implementation gap analysis

The issuing of share options is intended to motivate executives, relieve agency problems and thus ensure managers perform in line with shareholder interests. The practice of using such incentive mechanisms is common. The standard UK executive share option provides the executive with the right (but no the obligation) to purchase shares at a fixed, predetermined price (exercise or strike price) following some specified period of time. Consideration must be given to the fact that share price is not just a matter of company performance; it can also be heavily subject to market sentiment. For example, if a company is suddenly subject to bid speculation and has a premium added to the share price, executives might simply gain rewards for circumstances beyond their control. This is similarly true of the long-term incentive plans or LTIPs awards, which grant of shares (at zero cost) that vest upon the attainment of pre-determined performance criteria, as opposed to share options.

The Focus Group participants emphasised that executive directors are also employees and as such have certain levels of protection under Employment Law. Whilst this is not particularly a governance issue, vast sums of money as payoffs for employment contracts can often be perceived as being rewarded for dismissal or failure. In truth such payoffs are encompassed as part of the directors' service contracts.) Whilst both law and policy advise on service contract issues there is still the balancing act of getting it right for all parties.

There is also a further controversial area of executives being 'rewarded' for failure. The existing regulation with regard to executive pay does not provide extensive safeguards which guarantee that incentive schemes actually reward for performance. The design of these schemes is often criticised as being lax and favourable to the executives in ways that create unintended effects. The decisions about executive remuneration are left to a board remuneration committee (subject to the approval by shareholders), but some committee members may have vested interests in approving inefficient compensation schemes by simply imitating decisions of other peer companies.

6.3.5.2.2 Contingency analysis

One could argue that there is a greater burden placed on companies following the 2002 Remuneration Report regulations. Whilst the Combined Code is limited to those on the official list and is a 'comply or explain' scenario, this is not so with regulation. The Code provides for company specific flexibility, and companies are able to negate responsibilities for areas that might provide burdens due to contingency factors such as company size, age, industry variants and company life cycle, providing they explain the reasons why. With enforced regulation there is no room for such flexibility. All aspects of legal regulation must be complied with; regardless of any additional responsibility this may place on the board of directors. As such legal regulation may place a particularly heavy burden on smaller companies where resources and finances are often limited. Smaller companies are able to bypass compliance with the Combined Code by listing on AIM, in doing so they can avoid enforced practices that are more appropriate to larger companies whilst still gaining the benefits of being listed. This may be particularly pertinent, as AIM has seen considerable growth over recent years. However, there is no bypass of the Regulation embedded within the Companies Acts and the costs associated with compliance of disclosure for smaller companies might negate any perceived benefits of implementing incentive schemes for directors.

6.3.5.2.3 Cost analysis

This use of long-term incentive plans and share option schemes as a way of promoting good corporate governance has an associated cost. Previously the associated cost with such schemes was hidden to the shareholders in the footnotes of the accounts. These are now to be incorporated within the accounts following the implementation of IFRS2. Added to the Directors' Remuneration Report Regulation (2002), a further burden of time is placed on the members of the remunerations committee in ensuring the necessary information for compliance is easily accessible in order to write the remuneration report for the annual report and accounts. Detailed analysis must be undertaken with regards to the company's share option schemes and long-term incentive plans. This requires not just a description of the performance conditions themselves but also an analysis of the methods that are used to assess whether the performance conditions are met. In addition, an explanation of why methods were chosen must also be given, thus the non executive director must be provided with this information or seek it out themselves.

The greater burden from regulation here might not be immediately apparent in terms of financial costs; however there is an opportunity cost implication of the greater accountability. Directors may have to sacrifice time otherwise spent on strategic actions and in particular for non-executive monitoring, in order to ensure accountability for disclosure is fully discharged.

In terms of the costs related to executive pay, IFRS2 (the international accounting standard for share-based payments) will have a dramatic impact on companies. For reporting periods following 1 January 2005, listed companies within the UK will be subject IFRS2. The new accounting standard requires companies to charge share options through their profit and loss accounts so investors can see exactly how much company board members stand to gain. Unlike the past rules, the implementation of IFRS2 will highlight that share options are not 'free' and do have a considerable effect on the profit and loss account. An added dimension to this costing method will be the affect on smaller companies, which have relied on share options as an easy (cheap) way of enhancing executive pay packages in order to attract good talent. In doing so the options appeared not to cost anything initially, but were able to reward executives after the vesting period as share prices appreciated.

It is too early to categorically state whether this will have a dramatic effect on the structure of compensation packages however, this costing will do little to promote the use of share options which are currently considered a way to enhance corporate governance. Companies will seriously have to consider how ‘charitable’ they wish to be with options when they are shown against the bottom line of profit. Further to this, is the added benefit to investors who will be provided with an easier way to challenge any actions, which do not match up to shareholders’ interests.

6.3.6 Market for corporate control

The literature review has identified three major ‘good’ corporate governance drivers associated with the market for corporate control:

- An active market for corporate control;
- Transparency and protection for shareholders and stakeholders during mergers and acquisitions;
- Board power in takeover bids, subject to shareholder veto.

The corporate governance role and implications of the takeover market have received a detailed attention within the UK. The rules concerning takeover bids of UK firms are set out in the City Code on Takeovers and Mergers (the City Code). In this section, the following regulatory and related documents have been the primary ones reviewed with respect to ‘good’ governance drivers identified in previous sections:

- City Code on Takeovers and Mergers (the City Code)
- Substantial Acquisition Rules
- European Takeover Directive (May 2004)
- Company Law Reform Bill (January 2006)
- Financial Services and Markets Act (2000)
- Financial Services Authority (2005) “The Listing, Prospectus, and Disclosure Rules”

Established in 1968, the City Code is the main feature of takeover regulation. It does not have the force of law, but is a framework based on soft-law or self-regulation accepted by market participants as being appropriate for UK companies. As such, “The Code represents the *collective opinion* of those *professionally involved* in the field of takeovers as to *business standards* and as to how *fairness to shareholders* can be achieved” (Section 1A, emphasis added). The City Code contains 10 General Principles and 38 Rules to provide standards of good standards of commercial behaviour and protect the interest of shareholders.

A European Takeover Directive came into force in May 2004 and must be implemented in each member state by May 20 2006. The Directive is structured around general principles inspired largely through the UK Takeover Code, and will replace the existing City Code General Principles. The Takeover Directive lays out minimum requirements concerning the takeover of firms whose shares are traded on a regulated market, such as the requirement for a person who acquires a controlling stake in the target company to make an offer to all other shareholders at the equitable price (mandatory bids), the requirement that offer documents contain certain specified information, the length of the offer period, minority squeeze-out provisions, and disclosure of poison pill provisions. Some provisions new to the UK are “breakthrough” clauses and disclosure of control structures, which are being implemented

through the Company Law reform. On the whole, the Takeover Directive will bring relatively minor changes to the content of existing UK takeover rules. Given the large number of contentious points, the Directive will only partially create a ‘level playing field’ for takeovers within Europe, since it continues to allow countries to opt-out on some provisions, particularly with regard to takeover defences. The government also wishes to “opt in” to the frustrating action article of the Directive (Article 9), by modifying the existing provisions of Rule 21, which address frustrating actions.

The Takeover Directive will bring important changes to supervision of takeovers, giving the Takeover Code and Takeover Panel a new statutory underpinning (DTI 2006). Under the European Takeover Directive, each member state must now designate a competent authority to supervise takeovers. The Panel is to get be delegated authority to act as a competent authority supervising bids, and receive some new statutory powers, such as rights to information and powers to order compensation to affected parties. As such, the legislative approach has focused on preserving some perceived benefits of the UK Takeover Panel, such as its flexibility, independence, technical expertise, and focus on principles-based regulation.

6.3.6.1 Content gap analysis

This section aims at identifying various areas of takeover regulation where drivers are not adequately covered by the regulatory framework. Takeover regulation has a variety of functions, such as promoting efficient corporate restructuring and mitigating conflicts of interests between diverse company constituencies such as management, shareholders, and stakeholders (Goergen et al. 2005). Hence, takeover regulation has a wide impact on agency problems between management and shareholders, minority and majority investors, and other stakeholders. Common regulatory devices available to achieve these two aims include: (i) mandatory bid rule, (ii) the principle of equal treatment of shareholders, (iii) ownership and transparency of control, (iv) squeeze-out and sell-out rules, and (v) board neutrality with respect to anti-takeover measures.

6.3.6.1.1 An active market for corporate control

The review of the social science literature suggested that an active market for corporate control make important contributions to corporate restructuring. In particular, transfers of control can help firms overcome important life-cycle issues by supporting external growth, consolidation, or shift toward more entrepreneurial activity through focused control or synergistic recombination. While hostile takeover bids also impose high costs, friendly takeovers and private equity deals also constitute elements of the market for corporate control. Hence, an active market for corporate control is important in bringing about the transfer of control towards more productive owners and management. One role of takeover regulation is to minimize the costs and inefficiencies associated with the takeover mechanism. In the UK, an active takeover market is supported by several key elements of regulation such as information disclosure, a squeeze-out rule, and limitations to the use of takeover defence measures.

Regulations over information disclosure are important for fostering greater market activity through the provision of adequate and timely advice and information. According to the City Code, information contained in an offer must be adequately and fairly presented (rule 19.1). The directors of the relevant companies are also responsible for ensuring the accuracy of such documents (rule 19.2), which carries implications for director liability. Rule 3 of the City Code requires independent advice to be provided about the feasibility of the takeover and accuracy of the bid documents as part of the bidding procedure. More generally, bids are

subject to an array of mandatory disclosure that increases the predictability of M&A transactions for investors. Rules 24 and 25 of the City Code spell out detailed contents of the documents provided during the bid. Rules 28 and 29 regulate the use of forecasts and valuations in these documents and rules 30-34 stipulate time limits governing the overall period of an offer and the different stages within it, which must be incorporated into the contractual terms of the offer document. An important aspect of these rules concerns competing bids. Here the original offeror's timetable will cease to apply in the case of a competitive offer, and both parties will work to the new timetable (rule 31.6).

A key provision of the City Code regards board neutrality. In keeping with the principle of fair treatment for shareholders, the board of the offeree has an obligation not to take any action, which could frustrate the offer (rule 21). Likewise, the general principle state that board of the offeree must not take any action which may deprive its shareholders of the ability to decide on the merits of the offer, unless its shareholders approve otherwise in general meeting. Examples of 'frustrating action' are set out in rule 21 and include: issuing new shares, granting options over unissued shares, creating securities carrying rights to convert into (or subscribe for) target shares, selling (or acquiring) assets of a material amount, and entering into contracts otherwise than in the ordinary course of business. The proposed Company Law Reform Bill (2006, p.90) reaffirms the principle of board neutrality, for example, by requiring that any payments made to directors, in relation to transfers of control, should be approved directly by the shareholders of the target firm. It should be noted that the "duty of neutrality" imposes rules in the UK that are far stricter than the U.S. statute under which a board of directors is allowed to take various defence measures, particular poison pills, as a defensive tactic. According to calculations from Thomson Deals database, between 1990 and 2004, UK companies were involved in 215 hostile bids, of which 106 succeeded. The comparable figure for the USA is 402 hostile bids, of which only 104 succeeded (own calculations).

Overall, the UK regulatory framework covers a large number of key drivers of 'good' corporate governance needed to support an active market for corporate control, as discussed in sections 2.7.2, 2.7.3 and 4.8.1 of this report.

6.3.6.1.2 Transparency and protection for shareholders and stakeholders during mergers and acquisitions

The Principle of Equal Treatment is outlined as General Principle 1 of the City Code, which stipulates similar treatment for shareholders. This principle requires controlling shareholders, the management, and other constituencies to treat all shareholders within each individual class of shares equally. Specifically, an acquirer must offer minority shareholders the chance to exit on terms that are no less favourable than those offered to shareholders who sell a controlling block. Rule 16 requires that no special deals be undertaken, whereas rules 6 and 11 regulate the type of consideration. Equal treatment is also enshrined the rules on mandatory offers, described below. Hence, the principle aims at protecting minority shareholders.

Mandatory bid requirements are an extremely important element of protection minority shareholders against expropriation by major shareholders, including the bidder itself. Mandatory bid rules provide shareholders with an opportunity to exit and receive a fair price for their shares. Under Rule 9 of the City Code, an acquirer must make a tender offer to all the shareholders once a threshold of 30 percent of the shares has been acquired. This rule similarly applies to people acting in concert who hold not less than 30 percent but not more

than 50 percent of the voting rights of a company if there is any increase at all in the percentage level of that holding. The rule requires that if shares are acquired by the offeror (or any persons acting in concert with it) which result in a holding of 30 per cent or more of the voting rights of a company, the offeror is required to make a cash offer for the target at the highest price paid by the offeror (or any person acting in concert with it) for any target shares in the previous 12 months. The bidder is required to announce its offer, and provide certain information, which includes confirmation by a financial advisor that resources are available to carry out the offer under the stated terms. While the price of the bid may be raised or parties to the takeover may purchase shares at a price higher than the initial bid (subject to disclosure), rule 6.2 provides that the bidder shall increase its offer to not less than the highest price paid for the securities so acquired. An important element complementing mandatory bids is the mandatory disclosure of ownership stakes. Disclosure makes it harder for bidders to discretely build up large toeholds of control before making a mandatory bid (or paying higher premiums as other shareholders begin to anticipate a bid). However, disclosure may also make bidders more certain about the ownership of target firms and greater certainty about the prospects of white knights or other large blockholders who may become unwilling to sell, particularly in hostile cases.

The effect of mandatory bid rules is to restrict partial acquisitions (acquisitions of controlling stakes, but without making an offer for all shares) except where explicitly allowed by the Panel. In lieu of a mandatory bid, purchasers acquiring a stake greater than 15 percent, but less than the 30 percent are subject to Substantial Acquisition Rules (SAR) enforced by the Takeover Panel. Importantly, these rules discourage two-tier takeover attempts and “greenmail” practices, where bidders might use control of an initial stake to gain concessions from other shareholders in gaining further control of the target company. In terms of disclosure, the UK has one of the lowest thresholds for disclosure of ownership stakes of 3 percent or more. Such information about share blocks allows minority shareholders and regulators to monitor the impact of large blockholders on the company, and therefore supports minority shareholder protection.

Company law in the UK also provides for “squeeze-out” and “sell-out”, which are designed to address the problems related to residual minority shareholders following a successful takeover bid. Squeeze-out rights enable a successful bidder to compulsorily purchase the shares of remaining minority shareholders who have not accepted the bid. Sell-out rights enable minority shareholders, in the wake of such a bid, to require the majority shareholder to purchase their shares. Since these rules involve compulsory purchase or acquisition of shares, high thresholds apply to the exercising of such rights and there are protective rules on the price that must be paid for the shares concerned. The recent Company Law Reform Bill (January 2006) applies a dual threshold of the bidder acquiring both 90% of the shares to which the offer relates, and 90% of the voting rights carried by those shares. Likewise, the requirement of cash consideration is also important protections for to allow the easy exit of target firm shareholders.

While protections for shareholders are well covered by regulation, stakeholder interests are addressed less thoroughly. The general principles of the City Code stipulates that the “shareholders’ interests taken as a whole, together with those of employees and creditors, which should be considered when the directors are giving advice to shareholders.” Perhaps more substantially, rule 24.1 provides for disclosure of important strategic and employment implications within the bid document. The bidder is expected to issue statements on its intentions regarding the continuation of the target firm business, any major changes or

redeployment of fixed assets, the long-term commercial rationale for the deal, and “its intentions with regard to the continued employment of the employees of the offeree company and of its subsidiaries” (rule 24.1). Similar disclosure requirements in the offer document and target response documents are required under the Takeover Directive. Unlike in countries such as Germany, no provisions are provided giving rights on stakeholders, such as employees, to any information, consultation or co-decision rights with regard to M&A transactions. Nor do the disclosure requirements stipulate any detailed specifics regarding employment-related information. Therefore, while the board may consider employee interests under the City Code, these interests are largely outside the corporate governance system in the sense of mutual rights and obligations.

In sum, the UK takeover rules seem to cover very well the requirements of transparency and fairness for shareholders discussed as a driver of ‘good’ corporate governance in sections 2.7.2, 2.7.3 and 4.8.2 of this report. However, coverage of stakeholder protection and involvement during the takeover process is less developed.

6.3.6.1.3 Board power in takeover bids, subject to shareholder veto

The literature review found that involvement of target firm boards during takeover bids is important to assure that the valuation of the bid is favourable. Target managers may possess informational advantages that help to understand “hidden value” in the firm, and active involvement in negotiations may help to assure a better price.

As discussed above, the City Code demands very high standards of board neutrality during takeover bids. As such, the Board does not possess any power to directly veto or reject bids. Rather, the Board is responsible to give advice to shareholders regarding the bid. Rule 25 of the City Code requires the disclosure of views on the offer, and disclosure any alternative offers. In particular, where the board is divided in its opinion, a minority view of the board can also be expressed. Where relevant, the board must also share its views regarding the offeror’s plans for the company and its employees. Rules 22-27 spell out in further details the disclosure rules related to various potential conflicts of interest of the target’s board members.

Yet an interesting phenomenon in the UK is the high number of management buy-out transactions where the target firm management is involved in the bid –these account for 10 percent of UK deals (2000-5) compared to just 3 percent in Germany or 4 percent in France (own calculations, Thomson Deals). Here the City Code provides various guidance in its rules about disclosure and board views, which that stress the role of non-executive directors in these cases. It remains an open empirical question as to how adequately these rules govern potential conflicts of interests or transfers of wealth in such transactions.

UK regulations address the role of the board by stressing their duty to shareholders, and in certain respects restricting an active role of the board, particularly in pursuing defensive actions. In this regard, some gaps may exist in promoting a more active role for corporate boards, as discussed in sections 2.7.2, 2.7.3 and 4.8.3 of this report, that enhance the quality of takeover bids without utilizing wealth-destroying forms of takeover defences.

6.3.6.2 Effectiveness gaps

In this section we turn to the gap between the stated aim and actual outcome of the regulatory framework. These gaps in effectiveness involve implementation problems, a failure to take

into account various contingencies, lack of support from complementary institutions (or unintended consequences related other drivers), and the potential costs of regulation.

6.3.6.2.1 Implementation gap analysis

The City Code is issued and reviewed by the Panel on Takeovers and Mergers (the Panel), which is made up of various representatives of firms within the industry. The Panel deals with enforcement by giving rulings on any uncertain courses of action. For this purpose, the Panel can utilize a variety of sanctions, which range from private censure to public censure to certain cold-shouldering options obtained through the endorsement of the Code by the Financial Services Authority. The Directive also clarifies and tightens rules of international jurisdiction by stating that a target company will be subject to regulation in the member state in which it has its registered office. The Panel plans to retain a wider view of its jurisdiction to cover any offer for a company that has its registered office in the UK and has securities admitted to trading on a UK regulated market.

In practice, the City Code applies to deals where at least one of the firms involved in the acquisition is a listed UK company, as well as private firms some in more limited circumstances. The Takeover Directive lays down further jurisdictional rules, including situations where companies are registered in one EU Member States and their shares are traded on the regulated market of another country. Overall, the high degree of compliance among listed firms is based on the fact that every company listed on the stock exchange must enter into a 'listing agreement' with the UK Listing Authority (an arm of the FSA), which binds the company to the rules. The ultimate sanction for non-compliance is delisting from the stock market. Moreover, since the Panel involved individuals from various key associations representing major financial service providers, non-compliance with the City Code may lead to other informal sanctions including private censure, public censure, the reporting of conduct to other professional bodies and cold-shouldering. Following the Company Law Reform (2006), the Panel will have statutory powers to impose fines or order restitution if certain rules are breached, as well as require parties to act in a certain way or restrain them from taking a certain course of action. Compensation orders are only likely in respect of breaches of Rule 16 (special or favourable deals) and Rule 9 (mandatory bids).

Some critics of the UK approach have questioned whether a non-statutory body, such as the Takeover Panel, should be allowed to make and enforce rules that are, in effect, very close to law. The counter argument, which is widely supported, is that the relative informality and flexibility of the City Code has facilitated an efficient and responsive takeover regime represents an advantage of the UK system that has been borne out in practice. The Focus Group expressed being satisfied with the existing self-regulatory approach to takeover regulation. The Takeover Directive will strike a middle group, by giving the existing Panel a statutory basis. In sum, the City Code is well implemented and further tightening under the EU Directive will further support this role.

6.3.6.2.2 Contingency analysis

The literature review suggested that the role played by market for control is contingent upon a variety of firm-internal factors such as the firm's size, age, industry, growth/decline phase, etc. Moreover, environmental factors such as stock market activity, ownership patterns, regulatory institutions, inter-firm networks and managerial conceptions of control impact M&A. The UK regulatory framework facilitates M&A activity, and delegates a high level of influence to target shareholders in deciding the outcome, particularly of contested bids. The potential downside of this approach is the failure to address certain contingencies.

In particular, companies where firm-specific or relationship-specific investments by different stakeholder groups are central for competitive advantage may need greater protections for stakeholders or greater scope to implement takeover defences in order to avoid destroying effects of the market for corporate control. Likewise, start-up and entrepreneurial firms depend highly on private benefits of control of company founders, but may have low market valuations during early stages of the company life cycle. Here again, greater scope to implement defensive measures may preserve company assets. Although hostile bids constitute a very small percentage of overall takeover activity, UK firms are highly exposed to the market for corporate control in terms of both levels of hostility and the success of hostile bids.

The UK notably has no restrictions on how companies structure their voting rights and permits deviations from one-share-one-vote principles. This deviation might, in theory, allow companies to adopt allocations of voting rights that would effectively act as barriers to takeover bids, and particularly hostile bids. In practice, 88% of UK firms within the FTSE Eurofirst 300 index follow a one-share-one-vote principle (Deminor Rating 2005). Non-voting preference shares are used at some companies (e.g. Daily Mail and General Trust), whereas multiple voting rates are quite rare. Other deviations are non-voting shares without preference, ownership caps, and priority shares. The UK retains so-called 'golden shares' in privatised companies where a strong public interest rationale persists. However, state influence on privatised companies has been progressively abandoned over recent years at companies like BAA, Cable & Wireless, BT Group, National Grid Transco, Scottish Power and Scottish & Southern Energy. This approach would seem positive in terms of allowing companies to tailor their voting arrangements to take account of firm-specific contingencies, while achieving a generally high level of compliance with one-share-one-vote principles.

6.3.6.2.3 Complementarity and substitution analysis

Takeover rules display a number of complementarities with other aspects of corporate governance drivers and related regulation. Efficient markets for corporate control rely strongly on disclosure and information rules, as well as effective auditing processes. In particular, however, a regulatory framework supporting an active takeover market and investor protection is particularly important in situations where ownership is dispersed and shareholders face high agency costs in monitoring management.

However, here takeover rules imply important tradeoffs. Takeover rules aimed at facilitating the exit of minority shareholders of target firms, such as mandatory bids, are likely to discourage the monitoring of managers by large blockholders by limiting the private benefits of such monitoring. For example, mandatory bid rules may discourage the holding of large blocks by requiring bids for complete control of the firm. Consequently, the UK takeover rules may have a strong effect on reinforcing the highly dispersed patterns of ownership and unintentionally lead to lower levels of shareholder involvement by discouraging the holding on large blocks. While more empirical research is needed on this point, takeovers in the UK result in very high percentages of shares being owned by the bidder after the transaction and only a small proportion of transactions involve transfer of large blocks.

Rules supporting high levels of takeover activity and low involvement of target firm boards may also impair the effective involvement of stakeholders within corporate governance, particularly employees as suggested by the 'breach of trust' hypothesis. Examples from other countries such as Germany and Japan suggest that these costs may be offset by specific

legislation that regulates information and involvement of stakeholders during the process of M&A.

6.3.6.2.4 Cost analysis

The costs related to compliance with UK takeover rules are moderate, and reflected in the detailed procedures and supporting independent advice taken by parties during a takeover. For example, the total fees paid to M&A consultants and brokers as a percentage of deal value is quite high in the UK, totalled 1.5 percent of deal value on average in the UK (2000-2005). High costs may restrict levels of M&A activity. For example, mandatory bid rules may make transactions more expensive by requiring companies to offer bids to all shareholders, and thereby discourages bidders from making a bid in the first place. This predictability may have a positive impact on takeover activity. Likewise, the requirements to offer an option of cash payment to shareholders lead may lead to higher out of pocket costs than pure share exchanges. A further point concerns the restrictions on takeover defences, which is often seen as a cost saving element of the UK approach relative to U.S. takeover laws. Clear rules and timetables can help avoid costly battles for control during the bid, and placing shareholder decisions in the foreground. Given the high level of M&A transactions in the UK compared to other OECD countries, it does not appear that mandatory bids or disclosure rules have excessively discouraged M&A transactions. It may be noted that some regulation that raises the cost of transactions may have positive effects of filtering out some bids that are less likely to create value.

In sum, the UK has a well established and relatively comprehensive regulatory framework regarding takeovers. Nonetheless, the social science literature suggests that various trade-offs apply. The UK approach stresses minority shareholder protection through mandatory bids, but more open takeover markets impose potential costs on other stakeholders. Likewise, the UK regulatory regime stresses shareholder rights and sustaining the market through predictable takeover procedures, but at some expense to substantial rights for stakeholders and ability of managers to deflect potentially value-destroying hostile bids.

6.3.7 Stakeholders

Three major groupings of ‘good’ corporate governance drivers associated with stakeholders were identified in the literature review:

- Broad stakeholder involvement in corporate governance;
- Voice mechanisms for debt holders;
- Employee participation in financial outcomes and collective voice in decision making

The role of various stakeholders is covered both in the legal framework and other regulations, codes, and reports. In this section, the following laws, regulations, and related documents are considered with respect to the ‘good’ governance drivers identified in previous sections:

- Company Law (the Companies Acts of 1985 and 1989, the Insolvency Act 1986, and the Enterprise Act 2002).
- Company Law Reform Bill (2006)
- Employment Law (the Trade Union and Labour Relations (Consolidation) Act (1992), the Employment Relations Act 1999, and various regulations such as those covering Transfer of Undertakings

- Transnational Information and Consultation of Employees Regulations (1999)
- Information and Consultation of Employees Regulations 2004
- Public Interest Disclosure Act 1998 on whistleblowing
- Pensions Act 2004
- Financial Services Authority (2005) “The Listing, Prospectus, and Disclosure Rules”
- The City Code on Takeovers and Mergers (2003-2004)
- The Combined Code on Corporate Governance (2003)
- Financial Reporting Council, various standards.

6.3.7.1 *Content gaps*

As with similar sections above, the aim here is to identify areas of possible regulation where drivers may not be adequately covered by the present regulatory framework. Here we consider specifically regulations that affect the involvement of three groups of stakeholders: general stakeholders, debtholders, and employees.

6.3.7.1.1 *General stakeholder involvement within corporate governance*

In terms of general stakeholder involvement, vis-à-vis customers, suppliers, the wider community, and environmental issues, the review of the academic literature has suggested that consideration of these wider stakeholders can act as drivers of ‘good’ corporate governance in certain circumstances. Their involvement in corporate governance can also have a positive effect on performance. However, the discussion of stakeholders is often diffuse and touches on a large number of distinct issues and areas of regulation. Perhaps for this reason, the importance of stakeholders was not echoed strongly by our expert survey and focus group meeting.

In Chapter 2 above, we discussed the “enlightened shareholder value” model. This view states that satisfying stakeholders is both desirable from a democratic voice point of view and also makes good sense from a business performance point of view. Firms, which build good relations with stakeholders, gain competitive advantage and are better able both to protect and generate wealth within the company. This has been a position, which UK Company Law and judicial decisions have moved slowly towards over a long period of time. The present Company Law Reform Bill explicitly states that it is the directors’ duty to promote the success of the company for the benefit of its members as a whole, and in fulfilling this duty the directors must have regard to both short- and long-term factors and wider interests including employees, trade partners, etc (Section 156). This approach is broadly consistent with our review of the academic literature, which suggests that stakeholder involvement is likely to influence long-term company performance and maximise overall wealth protection and wealth creation for all stakeholders.

The relevant sections of the Company Law Reform Bill will take some time to bed down and will undoubtedly be subject to interpretation by the courts. The view that stakeholders other than shareholders have an interest in corporate governance is given some limited support in other laws, codes, and documents. In the case of employee stakeholders, it is supported by certain aspects of Employment Law, which give employees the right to information and the right to consultation.

While Company Law allows managers to give due consideration to stakeholder interests, the regulation of specific rights for stakeholders or obligations is relatively dispersed and

somewhat limited. Besides the new developments in Company Law, in other areas such as Listing Rules, the City Code, the Combined Code, and in professional standards, one can find little systematic notion of broader stakeholder interests. However, this is not to say that there are no other forms of regulation, which play some part here, such as regulation of particular sectors, such as utilities and food, which go some way to fill any gap on a sectoral needs basis.

Though the paucity of regulation cannot be taken as proof of the limited need for regulation, our overall conclusion is that regulation on stakeholders in general, as discussed in sections 2.8.2 and 4.9.1 of this report, does not present significant content gaps in the UK regulatory framework commensurate with the effect of general stakeholders on corporate governance. As noted above, the general issues are covered by the new broader definition of directors' duties. Given their broad and diverse nature, regulation to establish a general framework for stakeholders may be problematic in the UK setting beyond the current rules. Further involvement did not receive unambiguous support our experts or focus group participants, whose opinions were also divided on this matter. However, other more specific stakeholder drivers to which we refer below did receive more support.

6.3.7.1.2 Voice mechanisms for debt holders

The review of the academic literature cited a large number of studies on debtholder involvement. While much evidence exists supporting the idea of debtholder involvement as a driver of 'good' corporate governance, the results of this literature are varied and depend very much on the context being studied. Our experts ranked voice for debtholders medium to high. Our Focus Group felt that debt holders and related 'gatekeepers', such as rating agencies, were influential, but had sufficient support in law and had sufficient leverage to exert appropriate pressure on company management. It is interesting that the highest driver identified in our expert survey was individual voice through meetings and contacts with managers. Voice through delegated monitoring systems was also rated high. These are not necessarily mechanisms best promoted by an extension of the regulatory framework.

Along with these mechanisms, the use of contractual arrangements for monitoring (such as bank covenants, debt contracts) was ranked high. These are widely covered by Contract Law, Company Law, and Insolvency Law. Both access to private information and board presence were not rated. Of course, the former of these is permitted under the law, so long as it does not lead to market abuse and unfair trading. The latter is also permitted under UK law and is sometimes taken up by major lenders. However, bank presence on company boards is obviously not a major feature of the UK system.

Our overall conclusion is that the involvement of debtholders, as discussed in sections 2.8.3 and 4.9.2 in this report, does not have any major content gaps in the UK regulatory framework. On the whole, the aspects of debtholder involvement, which were rated highly by our experts, are well covered.

6.3.7.1.3 Employee participation in financial outcomes and collective voice in decision making

The review of the academic literature pointed to employee involvement as a significant driver of 'good' corporate governance. Here the evidence is less well developed, and much of the literature on collective forms of employee voice draws from other countries with very different institutions than the UK. So, while it is more difficult to draw firm conclusions, the literature surveyed in Chapter 2 gives employee involvement a positive role in governance

and in performance. Our Expert Group also ranked employee involvement as an important driver of good corporate governance. Our Focus Group discussion was more ambivalent on this, but, nevertheless, did agree on the importance of some forms of financial participation and collective voice as drivers of 'good' corporate governance.

In practice, this issue very much revolves around the question of mechanisms. In the UK context, the mechanisms, which were seen as drivers were rated as follows and in this rank order – employee share ownership, employee voice via pension funds, collective voice via consultative committees, and individual voice through meeting and employee reports. We comment on each of these and their regulatory context.

Employee share ownership is covered by existing law and regulations related to share issues and taxation thereof, although employees have no special obligations or rights as shareowners. Little attention is paid to employee share ownership in the rest of the UK regulatory framework. However, as we saw in Chapter 2, the coverage of employee share ownership is relatively small and there is a problem of how employee-owners mobilise their voice actually to effect corporate governance. This is not to say that it should not be encouraged; but nor is it to say that there should be further regulatory intervention.

In the case of employee voice via pension funds, this only covers employees who are members of company-based schemes. The area is well regulated by pension law and by broader fiduciary duties under the law. It is little touched on by other aspects of the UK regulatory framework such as the Combined Code. Of course, it has been affected by new accounting standards, which have brought the question of pension liabilities to the fore and made such liabilities *per se* a significant factor in company decision-making. Here, in particular, FRS17 has had a major effect on reporting about, and the operation of, pension funds.

Employee voice via pension funds, however, runs up against severe limitations – such funds are confined in coverage and shrinking, they are limited in action they can take within their own companies, and they are limited by fiduciary duties and capabilities as to their ability to intervene in other firms. The mixed interests and motivations here limit the extent to which regulation can promote pension funds as a direct vehicle for corporate governance.

In the case of collective employee voice via consultative committees such as works councils, historically there has been no legally based system of collective employee voice in the UK, along the lines of works councils or board-level representation found in various other EU countries. Trade unions are the primary vehicle for employee consultation, and thus indirect involvement in corporate governance. However, 'joint consultative committees' (JCCs) are sometimes created on the basis of collective agreements or voluntarily, although they only cover some 25 percent of UK establishments and usually only relate to the immediate workplace, rather than high-level corporate decision-making.

This situation changed through the implementation of the EC Directive on Informing and Consulting Employees, resulting in the Information and Consultation of Employees Regulations 2004. Under these rules, under certain circumstances, employees in establishments with over 50 employees will have a right to be informed and consulted on a regular basis about issues relating to the company. While the framework binds employers to this process, the form and scope of consultation are largely left to company-specific negotiation. In this regard, these provisions are again rather different than most European

works councils. However, where no agreement is reached, some standard provisions apply as a fallback requiring the employer to inform employee representatives about the company's activities and economic situation, and consult them on employment issues and major changes in work organisation or employees' contractual relations. Disputes emerging in the consultation process are referred to the Central Arbitration Committee (CAC). The CAC will decide the matter, and if necessary, order the employer to take steps to rectify the situation. If the CAC upholds a complaint against an employer, the complainant can then apply to the Employment Appeal Tribunal for a financial penalty to be imposed on the employer.

Other regulations require information disclosure to trade unions, where they are recognised. For example, the Trade Union and Labour Relations (Consolidation) Act 1992 provide a general duty to disclose to recognised unions information for collective bargaining purposes. The Social Security Pensions Act 1975 requires employers to consult with recognised trade unions over contracting-out of the state earnings-related pensions scheme. However, these developments are taking place in the context of shrinking voice via trade unions and the absence of board level representation of employees in the UK.

Other regulations do exist that provide for consultation of employees over certain issues. For example, the relevant EU Directives led to consultation rights applied with respect of collective redundancies and transfers of undertakings. Section 188(2) of the Trade Union and Labour Relations (Consolidation) Act states that redundancy consultation should be genuine and meaningful and include ways of avoiding, reducing and mitigating the consequences of dismissals. Employers are required to disclose information on the reasons, numbers affected, methods of selection and compensation. A recent amendment in 1999 also required employers to consult through a trade union where there was union recognition, or in the absence of a recognised trade union through an existing consultative committee or specially elected employee representatives. Similar issue-specific forms of consultation apply to safety issues under the Safety Representatives and Safety Committees Regulations 1977 and the Health and Safety (Consultation with Employees) Regulations 1996. Likewise, the Working Time Regulations 1998 provide for the conclusion of 'workforce agreements' with elected employee representatives.

Finally, in order to implement the EU European Works Councils Directive (94/45/EC), the UK introduced the Transnational Information and Consultation of Employees Regulations in 1999. These regulations offer a range of statutory information and consultation rights concerning transnational issues in multinational companies, and provided for the first time in the UK for the creation of a standing works council-type body. The requirements are for informing and consulting employees at the European level, in undertakings or groups with at least 1000 employees across the member states and at least 150 employees in each of two or more of those member states. The rules set out detailed provisions about how employees in different EU states are to be represented within the European body and also enumerate topics on which the European Works Council has the right to be informed and consulted (e.g. the economic and financial situation of the business, its likely development, probable employment trends; the introduction of new working methods; and substantial organisational changes).

As to individual voice through meetings, employee reports, etc., this was identified in the literature as important and also seen as important by our Expert Group and Focus Group. Here UK law is limited. There is implied and underlying support for this in the Company Law Reform Bill, but there is no further support in company law or in the various rules and

codes. There is some small support for this in Employment Law, where companies have long had to state in their company accounts what they do by way of employee involvement. However, this is an obligation to report and not to actually operate specific employee involvement processes.

In sum, the regulatory framework contains a number of provisions that correspond to drivers of ‘good’ corporate drivers associated with the stakeholder family identified in sections 2.8, 4.9.1, 4.9.2, and 4.9.3 of the Report. Some areas are well covered by law and regulations of various kinds, including employee share ownership and pension funds. However, though extensively regulated, there must be some question mark as to whether they are regulated in such a way as to promote these mechanisms as significant drivers. The area of collective employee voice is extensively regulated, with some new developments in terms of information and consultation. It will be necessary to see how these arrangements develop, especially in certain specific circumstances. Further, most of the regulation to which we have referred relates to collective employee voice. One area where there seems to be insufficient regulatory coverage would seem to be in the area of individual voice and reporting to individual employees within the firm.

Our overall conclusion on stakeholding is that there are a few significant content gaps in the UK regulatory framework, affecting general stakeholders, debt holders, and employees. Some identified drivers have received less coverage, such as individual employee voice mechanisms, and some drivers, though well covered e.g. pension funds, are not covered in such a way as to promote these arrangements as drivers of good corporate governance. There may be some issue-specific situations where employee voice might be greater, as in the case of takeovers and mergers. Moreover, the UK is weak compared to other countries in terms of the very different ways of involving employees as stakeholders in corporate governance, such as via board level representation (e.g. which exists in Germany and Scandinavia) or via strong trade unions.

6.3.7.2 Effectiveness gaps

In this section we turn to the gap between the stated aim and actual outcome of the regulatory framework. These ‘effectiveness’ gaps may involve implementation problems, a failure to take into account various contingencies, and the potential costs of regulation.

6.3.7.2.1 Implementation gap analysis

The regulatory framework in this area is diverse and covered less by mechanisms such as Listing Rules, City Codes, and Combined Codes. It is more an area of Company and Employment Law. In the case of general stakeholders, it remains to be seen as to how new regulations on directors’ duties will be applied in practice and whether these regulations give more latitude to stakeholder or enlightened shareholder value thinking. In the case of debt holders, significant players who can influence corporate governance enforce insolvency and contract laws.

In the case of employee involvement, the implementation of existing rules is potentially uneven. The law and regulation on pension fund operations are extensive and enforced by their Regulator. However, the regulatory contexts of both pension fund and employee share ownership have various objectives and are not geared towards the promotion of good corporate governance *per se*. In the important area of collective and individual employee rights to information and consultation, these provisions may not always feed through in practice. Here the law is largely permissive and, for it to be triggered, other bodies, such as

trade unions or works councils, may be needed to activate it. Importantly, recent law on consultation remains very broad and leaves much to be negotiated between companies and employees. Thus, practice is likely to be highly variable and employee voice may often be limited to the establishment level, rather than fostering participation at higher levels of the organisation in the case of large firms. It remains to be seen whether these broad frameworks will be sufficient to support effective employee involvement that can act as a driver of ‘good’ corporate governance. Moreover, effectiveness gaps may exist especially in certain situations, such as mergers and takeovers, and that this event-specific intervention could be covered more adequately in other forms such as the City Code and Combined Code (see previous discussion).

6.3.7.2.2 Contingency gap analysis

The literature review of drivers of ‘good’ corporate governance suggests that their effectiveness and efficiency may depend on factors such as the firm’s size, age, industry characteristics etc. Thus, in the case of debtholder influence, this will vary with the size of the debt and may be greater in smaller firms. In the case of employee influence, this may also vary with size or with the extent to which a company is unionised or not. Overall, although these areas are regulated more by law than by codes, the regulatory framework does make some provision for the possible effect of these contingencies. In some cases, triggers for numbers of pension fund trustees or for works council representation depend on the size of the company. Moreover, the framework for negotiation over information and consultation rights leaves large latitude for firm-specific solutions that can take account of individual circumstances and contingencies. As noted above, such flexibility may come at some trade-off to the level of enforcement of legal rights and lead to lower provision.

6.3.7.2.3 Cost analysis

Corporate governance research has tended to focus on the potential benefits of various governance practices. However, drivers of ‘good’ corporate governance may also have associated costs. These potential costs include the following: out-of-pocket compliance costs; more indirect opportunity costs (e.g. the time spent on governance issues instead of business strategy and operations). In addition, there are legal and reputational costs, which may be incurred when firms get their governance practices wrong.

Stakeholder participation in corporate governance may have costs associated with it. Thus, disclosure of information to employees or others increases the amount of information to be collected and processed and raises issues of confidentiality. Likewise, stakeholder voice may also have an impact on decision-making processes within the firm, for example, it may slow down decision times and stakeholder may extract rents from the firm. However, stakeholder involvement may have offsetting benefits of speeding up implementation once decisions have been made, since stakeholders will have higher levels of information and greater consensus around those decisions. As such, the net cost impact of stakeholding remains unclear, but our review of the literature suggests either real benefits or zero net costs.

6.4 Conclusions

This chapter has reviewed various elements of the UK regulatory framework, and explored to what extent they address and support the drivers of ‘good’ corporate governance identified by our review of a broad social science literature. We presented this analysis in terms of ‘gaps’ in the content of regulation, and the effectiveness of regulation, including issues of

implementation, dealing with firm-specific contingencies, and complementarities with other governance mechanisms and costs of regulation.

This review has shown that the UK has a very broad and ambitious regulatory framework. Regulation exists that relates to all of our identified drivers of 'good' corporate governance, albeit with different depth and scope of content and greater or lesser effectiveness of implementation. In recent years, much work has been done to close regulatory gaps and develop a more comprehensive set of rules and guidelines for best practice. In part, these developments have been driven by EU Directives (such as in the areas of employee involvement). Other developments have been driven by scandals of large international companies, such as the case of Enron, Shell or Parmalat, which have had repercussions for debates in the UK. As such, it is clear that corporate governance is increasingly an international policy field. These interdependencies have led the UK to not only rest on its traditional strengths in some aspects of corporate governance, but also gradually develop a broader and more comprehensive view of corporate governance as it is reflected in various regulations.

In order to guide further developments, our analysis suggests several areas of continued gaps in the UK regulatory framework. First, larger gaps were identified in areas such as executive pay and employee involvement. Gaps in these areas relate to the broad nature of regulation, and large scope for private negotiation often fail to give clear guidelines and thereby support best practices in light of 'good' corporate governance. Second, smaller gaps were identified with regard to information disclosure, boards, shareholder activism, auditors, internal control, and the market for corporate control. These areas are often well covered by regulation, but may have problems of effectiveness. Such problems may relate to implementation and enforcement, particularly where these are left to market-based mechanisms supported by disclosure and comply-or-explain rules.

While this distinctive UK approach intends to leave greater scope for flexibility that should help take account of important contingencies in individual firms, the effect may often lead to either conformity and box ticking, or lack of enforcement. Where these market-based notions of enforcement are weak, this is often due to the lack of complementary supporting institutions in other areas of corporate governance. In particular, shareholder involvement is often necessary as a complementary support to various important corporate governance processes, such as auditing and board independence. However, the expectations placed on shareholder involvement often do not seem to be upheld in practice. And the effectiveness of shareholder involvement is often quite variable across different types of firms.

7 Implications for Public Policy and Future Research

7.1 Introduction

This chapter sets out considerations for future strategies for public policy in relation to corporate governance, and considers how future social science research may better contribute to this process. The review of ‘good’ corporate governance drivers and analysis of regulatory gaps from the previous chapters suggest a number of general points that may usefully inform discussion of UK public policy:

- *Potential Regulatory Gaps.* The UK regulatory framework has become increasingly comprehensive in recent years, and now constitutes a very broad and complex set of regulations. Nonetheless, several potential gaps in coverage exist that are related to executive pay, employees, and stakeholders in general. Our analysis has also identified a number of potential gaps in effectiveness that affect key drivers such as boards, shareholder involvement, information disclosure, auditing, and the market for corporate control.
- *Regulatory trade-offs.* The UK regulatory framework embodies an innovative combination of mandatory regulation (uniform requirements), enabling or facilitative regulation (removing restrictions, allowing choice of structures), and flexible forms of soft-law such as codes based on comply-or-explain principles and self-regulatory norms of professional groups. These different regulatory approaches have important trade-offs. On the one hand, mandatory regulation can help to overcome market failures and weak diffusion of governance practices, but it may be inflexible in addressing the governance needs of different types of firms and different contexts. It may also impose significant costs. On the other hand, soft-law approaches provide more flexibility and may elicit more commitment from companies and the City, but may be less effective in terms of coverage and enforcement.
- *Balancing different corporate governance demands.* Corporate governance is shaped by a number of contingencies, complementarities, and costs. These factors bear strongly upon the effectiveness of key drivers in actually promoting ‘good’ corporate governance. Consequently, improving the effectiveness of the UK regulation requires a more holistic approach as to how various corporate governance drivers interact, and are affected by contingencies and costs. These issues may fall in between different specific bodies of regulation, or regulation may build upon presumed support of market mechanisms in areas where these are, in fact, weak and lead to poor implementation. Central issues in this regard concern firm’s lifecycles (e.g. start-up stage, mature firms, and restructuring or wind-up), and the active involvement of shareholders and key stakeholders in supporting other aspects of corporate governance.
- *Future social science research.* Public policy in the area of corporate governance needs to be well grounded on a solid basis of social scientific evidence. Much past research has failed to address corporate governance from a holistic perspective that examines the contingencies, complementarities and costs in a broader sense. An important element of this approach involves better understanding of how corporate governance relates to different elements of company performance, going beyond financial performance to issues of productivity, innovation and social inequality.

The remainder of the chapter turns to a detailed analysis of these regulatory implications with regard to the individual drivers of ‘good’ corporate governance identified in the Report. Finally, we outline considerations for further research, which would widen the evidence base for future public policy development.

7.2 Potential Regulatory Gaps

Table 1 summarizes how the various families of drivers of ‘good’ corporate identified in Chapter 4 relate to different elements of UK regulation outlined in Chapter 6. Regulation ranges from ‘harder’ legal forms of regulation and move toward ‘softer’ forms of voluntary self-regulatory mechanisms. The cells summarize the degree to which the laws, regulations, and codes cover or effectively support each driver using a three-point scale of high, medium, and low. Our assessment considers gaps in the content of the regulation (e.g. quantity and coverage) and effectiveness (e.g. implementation) in promoting each driver. This form of tabular summary necessarily entails simplification and should be read alongside the specific analysis of the preceding chapter. It must be stressed that the table is not intended to be merely descriptive rather than normative—a low score does not imply that more regulation is required; nor does a high score imply that there is over-regulation in a particular area. Fuller conclusions can only be drawn in the context of the empirical evidence regarding a particular driver (e.g. market failures), on one hand, and the potential for different types of regulation to affect those drivers given issues of contingencies, complementarities, and costs surrounding ‘good’ corporate governance, on the other.

Analysis of Table 1 suggests that gaps in the UK regulatory content are relatively small in many areas, including boards, shareholder activism, information and disclosure, auditors and internal control, and the market for corporate control. Most are covered by detailed rules within at least one body of regulation. In some areas this coverage has been longstanding, such as takeover rules, whereas elsewhere regulations have only been recently implemented. The UK regulatory framework has become increasingly comprehensive in the last several years as a result. Nonetheless, important observations can be made regarding potential regulatory gaps.

In terms of content gaps, the main areas where content is less covered are stakeholders (generally), employees, executive remuneration, and information disclosure. Stakeholders are mentioned in the Company Law Bill (2006) in relation to directors’ duties, but questions remain with regard to establishing a framework for stakeholder participation. Employees are likewise covered by new legislation related to joint consultation committees, but these rules are not comprehensive in coverage. Executive pay is also addressed in the Combined Code and through remuneration committees, but these cover the procedure for setting pay rather than the substantive content of remuneration. Information disclosure is also covered extensively in relation to financial disclosure, but some more forward-looking and strategic elements of reporting remain unregulated, although rules on the Business Review may or may not close this gap. Overall, these areas have received less detailed coverage, and often outline only general principles and frameworks. Much more latitude to private contracting and potential for market failures is higher. Here regulation generally lacks supporting standards that would help to differentiate between good and bad practices, or set sufficiently clear standards for implementation.

In terms of effectiveness gaps, the main areas where “good” governance principles are less well implemented concerns shareholder engagement and board independence. The importance of shareholder engagement is stressed throughout the UK regulatory framework. However, since their involvement remains voluntary, some groups of shareholders may fail to be actively engaged in corporate governance. Board independence is also a central driver, but the implementation of current rules may still fail to prevent the ‘capture’ of non-executive directors by the CEO and assure outside directors are themselves accountable and have proper incentives to be critically engaged within the board. Overall, even where regulatory content may be strong, gaps in effectiveness may affect almost all drivers of good corporate governance to different degrees. Issues of effectiveness often stem from the fact that higher coverage regulatory content is often associated with ‘softer’ forms of regulation, such as codes rather than law. This consideration raises further issues related effectiveness, such as how to balance different corporate governance demands, as well as cope with regulatory trade-offs between greater flexibility and standardised enforcement.

**Table 1 Summary of Potential Regulatory Gaps:
A Mapping of Corporate Governance Drivers and UK Regulation**

Regulation	Company Law and related regulations	Employment Law and related regulations	Listing, Prospectus, Disclosure Rules	City Takeover Merger Code	Combined Codes and related documents	Professional standards and self regulation
Drivers						
Boards	Medium	Not covered	Medium	Medium	High	Medium
Shareholder activism	Medium	Not covered	Medium	Medium	High	High
Executive pay	Low	Not covered	Not covered	Low	Medium	Not covered
Information disclosure	Medium	Low	High	High	Medium	High
Auditors and advisers	Medium	Not covered	Low	Medium	High	High
Internal control	Low	Medium	Medium	Not covered	High	High
Market for corporate control	Low	Low	Not covered	High	Not covered	Low
Debtholders	Medium	Not covered	Not covered	Low	Low	Low
Employees	Low	Medium	Not covered	Low	Low	Not covered
Stakeholders in general	Low	Low	Not covered	Low	Low	Not covered

Notes: Company Law includes the Companies Acts of 1985 and 1989, the Financial Services and Markets Act 2000, the Insolvency Act 1986, the Enterprise Act 2002, and the Companies (Audit, Investigations, and Community Enterprise) Act 2004. It also includes EU Directives, which have been transposed into UK law. It includes various Regulations such as the Directors' Remuneration Report Regulations 2002. It does not include the European Company Statute. Employment Law includes the Trade Union and Labour Relations (Consolidation) Act (1992), the Employment Relations Act 1999, and various regulations such as European Works Councils and Information & Consultation, which have been transposed from EU Directives into UK law. It also includes law on pensions such as the Pensions Act 2004 and on whistleblowing rights for employees under the Public Interest Disclosure Act 1998. The Listing Rules are The Listing, Prospectus, and Disclosure Rules (2005) and the City Code is The City Code on Takeovers and Mergers (2003-2004). The Combined Codes (2003) includes the following: Cadbury, Hampel, Turnbull, Higgs, Smith, and Tyson Reports. The column professional standards and self-regulation refers to the activities of the FRC, ISC, accounting standards, etc.

7.3 Regulatory Trade-offs

Gaps relate to a number of important trade-offs exist regarding the mechanisms, coverage, and implementation of the governance-related regulation in the UK. While some drivers are covered extensively by regulation, this coverage is often mainly by ‘softer’ mechanisms, as in the case of shareholder activism or boards. One trade-off that arises is between greater enforcement of legal regulation and greater flexibility of Codes. Likewise, law may be effective at ensuring minimum standards for all, whereas codes may support richer sets of ‘best practices’ in particular contexts.

In terms of balancing enforcement and flexibility, much of the ‘soft’ regulation reviewed in this Report is built around a principle of ‘comply or explain.’ This approach allows for a high degree of flexibility in implementation according to the different situations of firms and their constituent stakeholders. However, the very nature of this approach reduces the scope for effective enforcement of corporate governance principles, since enforcement is a prerogative of the market participants themselves. In some areas, such as shareholder activism, behavioural changes in response to good corporate governance principles have been rather slow. For example, information disclosure may not lead to changes in corporate governance unless investors or other interested parties effectively use that information to actively engage with companies. In such areas, improving the enforcement of Codes and principles-based regulation depends on greater support of complementary market incentives for participation, as well as support of legally-based mechanisms that support participation and effective representation of investor and stakeholder interests within corporate governance. Conversely, legal approaches may be made more flexible by providing company ‘choice’ among alternative sets of legally based structures, such as corporate boards in France or Japan. A limited number of parallel legal regimes may likewise combine benefits of flexibility and greater enforcement.

In addition, this regulatory trade-off creates different sets of unintended consequences related to various forms of ‘gaming’. For example, softer enforcement may allow market participants to engage in box ticking exercises without facing much sanction from the market. Alternatively, harder regulation may lead market participants to take advantage of ‘over-regulation’ by developing various consultancy and advisory services focused solely on costly compliance issues. Likewise, companies may respond to legal regulation by defensive compliance that aims solely at limiting the legal liabilities of individuals or the company, but may not be in the spirit of good corporate governance principles.

In terms trade-offs between minimum standards and best practices, ‘harder’ legal regulation may have advantages in terms of wide coverage and specific enforceable standards. For example, legal intervention can require that all companies of a certain size must follow certain governance practices. But breadth of coverage may make it difficult, even through secondary regulations, to specify detailed structures or give guidance about best practices in any great detail. By contrast, the ‘softer’ approach may not have the same breadth coverage and enforcement, but can give richer support regarding specific arrangements, and turning guiding principles into interpretable norms. The UK approach does, in fact, combine these two approaches to often favour a floor of statutory obligations and rights, backed up by codes and voluntary standards. Courts may also play an important role to interpret legal rules and further develop good practice. Further intervention by the legislature may then fill gaps or consolidate good practice, as and when necessary.

From a more holistic perspective on ‘good’ corporate governance, these considerations on regulatory trade-offs suggest that not all gaps can be effectively filled by greater legal regulation. Rather, corporate governance must be addressed by a balance between self-regulation and state regulation. Each has advantages and disadvantages, but they may also interact in ways that complement and support one another (see Kirkbride and Letza 2004, Deakin and Cook 2000). For example, market mechanisms require support from information disclosure and comply-or-explain rules. Self-regulation may be a first step, often “in the shadow” of further government intervention. However, continued market failure (as might have been the case with some issues surrounding accounting information and the role of auditors) creates a continued role for statutory interventions. On the whole, these processes are not antithetical. Rather, state and self-regulation should work together to make each one work more effectively, thereby promoting both well-run organisations and the maintenance and generation of wealth by encouraging entrepreneurship and innovation.

7.4 Balancing Different Corporate Governance Demands

Strategies for public policy must not only be aware of the regulatory trade-offs mentioned above, but also how these related to contextual factors that surround various corporate governance drivers—specifically, the complementarities among drivers, contingencies related to firm-specific and industry-specific factors, and the non-trivial costs associated with different corporate governance arrangements.

Complementarities. Various drivers of ‘good’ corporate governance may complement or substitute for one another in various ways. Many of the UK regulatory initiatives have been focused on separate elements ‘good’ corporate governance. Still, important inter-dependencies exist among these drivers that need more systematic consideration. This holistic approach suggests viewing corporate governance as a system of interrelated elements with strategic or institutional complementarities. Corporate governance mechanisms operate interdependently, with the overall effectiveness depending on the simultaneous operation of several mechanisms in limiting managerial opportunism. For individual firms, corporate governance involves different sets of practices that need to operate as a whole in order to be effective. Likewise, regulatory frameworks have interrelated elements that need to perform complementary functions.

In the UK, our analysis pointed to a number of areas where the enforcement of ‘good’ corporate governance principles depends upon market-mechanisms. Here, a number of improvements can be made to strengthen the support from complementary practices where they are currently lacking. For example, the independence of board members from the executive directors may be undermined by the use of high-powered incentives schemes or the lack of serious shareholder engagement in matters of nomination. Shareholder involvement also remains a crucial area where the existing corporate governance framework supports many prerequisites for shareholder involvement, such as information disclosure, but lack sufficient complementary mechanisms in the governance of institutional investors to assure that they are engaged and take responsibility in corporate governance matters. Likewise, overriding concern for shareholder interests may undermine the desired consideration for stakeholder interests and greater participation. Thus, future regulatory strategy should consider how regulatory gaps result from the particular combinations of practices, which may be important good corporate governance ‘drivers’ on their own but not cohere together in terms of a complementary system of elements.

Contingencies. Our report cited the need to consider various contingencies related to a company's size, age or industry. Existing regulations do often take into account some firm-specific contingencies, such as size, market of listing, etc. However, less consideration has been made of factors such as the firm's strategic dynamics, growth phase, and innovation characteristics. An emerging body of research on the life cycle of corporate governance suggests the notion of a number of dynamic stages where different bundles of corporate governance characteristics are needed. For example, a firm's evolution is accompanied by changes in ownership structure, board composition, the degree of founder involvement, etc. The balance between greater external accountability and fostering of entrepreneurship and risk taking may change over this life cycle from establishment, growth, maturity and decline. Specifically, the corporate governance roles of boards, shareholders or executive pay schemes may change substantially.

A potential strength of the UK regulatory framework is the flexibility of implementing corporate governance rules through a comply-or-explain approach that should, in principle, be well suited to accommodate different contingencies by letting firms adopt the practices that best suit their situation. Most discussion of UK corporate governance is centred on a single set of standards that is not necessarily well tailored to the needs of smaller firms and new ventures. For example, the concept of shareholder rights and engagement may be very different given the different ownership patterns of new start-up ventures. Likewise, the role of the board may be more strategic and entrepreneurial rather than monitoring for the sake of the financial interests of distant institutional investors. While being flexible in terms of compliance, it may be difficult for firms to 'explain' their use of alternative corporate governance templates and may thus find it easier to comply in a box ticking-like fashion.

The UK guidance, particularly in terms of the Combined Code, does not yet fully consider these 'dynamic' issues of corporate governance. One consequence may be to unintentionally promote 'inertia' of corporate governance practices that fail to suppose dynamic transitions in the company lifecycle. For example, UK regulation on boards outlines a number of key elements such as independence or diversity, but does not consider that the relative importance of these may change over time. In younger, venture-type business, boards may play a more strategic and involved role, and where ownership by founders and inventors is a key element of providing entrepreneurial incentives for innovation. Future regulatory initiatives may take into account these contingency factors by developing a number of guidelines for 'families' of firms with similar strategic characteristics, in addition to their size and listing parameters. The UK regulation may provide a greater set of clearly structured alternatives corporate governance templates for firms to choose among.

Costs of corporate governance. Most regulatory efforts are underpinned by potential benefits of 'good' corporate governance. However, drivers of 'good' corporate governance may also have associated costs of several types. Direct costs related to compliance with rules that result in out-of-pocket expenditures that are reflected in the firm's balance sheet and other accounting documentation (e.g., the audit costs, investment in internal risk management and control systems, etc.). Less explicit costs include opportunity costs, such as directors' time spent on governance issues instead of business strategy or when strategic information is disclosed. Legal and reputational costs may also be incurred when firms get their governance practices wrong. In particular, the risk of litigation may change management's risk-taking behaviour, which is likely to affect the growth or strategy of the firm. These costs are impossible to quantify on the basis of *ad hoc* assumptions. But future cost-benefit analyses of regulatory initiatives should also consider these broader notions of costs in addition to benefits of correcting market failure.

The Combined Code and other recent regulatory initiatives have introduced some concern about the framework of prudent and effective controls. Any rebalancing from a sole focus on governance compliance towards the broad focus on the performance and strategic development of the business should make sure that governance does not become an alternative agenda to a company's successful growth and development. 'Good' corporate governance should be considered as a means towards various ends and not as a stand-alone system of checks and controls, which is discussed and enforced outside the context of company's wealth-protection and wealth-creation strategies.

7.5 Implications for Specific Areas of Public Policy

This section briefly sets out some more specific considerations in developing strategies for public policy. Public policy can usefully be guided by the analysis of regulatory gaps in relation to key drivers of 'good' corporate governance. The gaps identified in previous sections suggest areas where future regulatory initiatives may be considered. However, as already explained, simply because a gap is identified does not imply that further legal regulation is necessary or effective. Nor does law necessarily achieve the desired result. This Report has suggested that better regulation will result from stronger linkages between hard state- and self-regulation with an eye toward how different drivers of corporate governance interrelate in complementary ways or how those drivers are affected by contingencies and costs.

The remainder of this section briefly considers selected public policy issues related to the various families of corporate governance drivers. Our intention here is not to recommend or advocate specific policies, but outline some potential issues for consideration in light of the gap analysis.

7.5.1 Corporate boards

Company Law and the Combined Code provide a comprehensive set of principles that are closely related to major 'drivers' of good corporate governance. Further regulation in this area may be in danger of becoming over-prescriptive and supportive of formal 'box-ticking'. However, important issues remain in relation to enforcement and support from complementary governance mechanisms. For example, the link between the board and shareholder engagement needs to be examined more closely. One area concerns helping companies establish dialogue with institutional investors and various 'gatekeepers' (e.g. voting and rating agencies) concerning corporate governance arrangements that deviate from the Code's prescriptions. Various regulatory investment institutions, rating agencies and corporate governance activists also apply their own, private criteria that differ from those in the Code. The use of divergent standards and potentially uneven reporting with regard to different issues may interfere with or complicate compliance. Similarly, board independence and diversity is outlined as a main principle of good corporate governance in the Code, but the selection of independent and diverse boards may only be weakly linked to participation of minority shareholders, institutional investors or other stakeholders to influence directly directors' nomination and selection.

7.5.2 Shareholder engagement

The area of shareholder engagement and activism has received considerable attention from both the regulatory authorities and the investment industry. The Combined Code, Company Law and various government-commissioned reports provide shareholders with various legal rights and mechanisms that can be used for an effective monitoring and control of managerial decisions. However, the hope that institutional investors might voluntarily comply with the Myners and ISC recommendations have not been followed by a significant increase in shareholder activism or changes in institutional investor behaviour. The possible benefits of introducing mandatory requirements might be explored with regard to investors' responsibilities (1) to vote equity shares on issues that may affect the value of the clients' investment; (2) to have a documented policy or guidelines in place for voting on issues; (3) to maintain accurate voting records and disclose them to the general public.

The Government and investment industry need to ensure that the ISC Principles have been integrated into investment decision-making and asset management processes, and that the quantity and quality of resources and people committed to engagement, and the level of reporting provided by fund managers, are appropriate from the good corporate governance perspective. However, 'hard' regulation, such as mandatory requirements for voting disclosure, may have unintended consequences such as 'outsourcing' of voting decisions and execution to outside agencies, politicisation of voting process by various pressure groups, etc. A robust impact assessment should accompany regulatory initiatives in this area.

7.5.3 Information and disclosure

Information and disclosure are traditionally seen as crucial areas in driving 'good' corporate governance and they have been the subject of continuing regulatory initiatives over many years. These have led to an increase in information flows within the firm and to those outside the firm. All in all, UK regulation has been effective and has served as something of a model for other countries. However, there would seem to be much to commend by the inclusion of a narrative report which relates to a companies present operations and future strategy. The Business Review may well meet this requirement, but the breadth of topics covered and demands for forward-looking information are lower than originally suggested with regard to OFRs. Of course, this discussion must weight the costs of preparation and other costs such as proprietary costs.

Some concerns are expressed with regard to the absence of US-style 'safe harbour' provisions to exempts reporting companies, their auditors, etc. in certain areas where companies may be open to legal actions over forward-looking reporting. As a result, some companies may not try to reduce the costs of capital through better disclosure, but will take advice from lawyers in order to reduce the liability risk. However, any regulation to deal with this potential 'market failure' has to take into account possible implications in other areas of law affecting directors, auditors, and shareholders.

Another gap identified in the Report suggests that more information should be provided to other stakeholders, especially to employees at a collective and individual level. In addition, more information might be provided about company policy and outcomes with regard to investment in human capital and more broadly to notions of 'corporate social responsibility.' Here a more comprehensive, objective and comparable set of standards would help market participants more accurately take account of long-term or intangible factors in making investment decisions. Likewise, the area of pension provision and the impact of pensions

arrangements are also of considerable importance, where new standards and new disclosures have been introduced.

7.5.4 Audit and internal controls

Audit and internal control has been the subject of many very recent regulatory initiatives. Given that these reforms have led to a substantial tightening of rules, audit and internal controls would not seem to be a major policy priority in terms of closing regulatory 'gaps'. Substantial debates remain about the levels of stringency on various issues, such as restrictions on non-audit work, definitions of independence and qualification of audit committee members, or the actual powers of auditors. Here it remains to be seen whether market mechanisms based around increased disclosure will be sufficient to assure best practice. The impact of recent regulation must be monitored closely in order to generate further incremental improvement in these areas.

More broadly, concerns are often expressed about the creeping scope of auditing and the long-term impact it may have on corporate cultures and decision-making. One direct concern in this area is cost. Likewise, particularly in smaller and younger entrepreneurial firms, the demand for transparency and auditing may not be as high as in firms that have more remote institutional investors. Perhaps more serious in the long term is that, as external pressures for more auditing and greater compliance rise, other unintended consequences arise. For example, in order to comply with auditing rules, the design of organisational processes may become overly bureaucratic and cumbersome for the sake of making them 'auditable'. The sociology of organizations clearly suggests that not every decision or process within an organisation can be audited, as it would require each process to be documented in ways that would consume the organisation in box ticking exercises and bureaucratic routines. The broader issue is whether an increasing scope of auditing or internal controls that make processes auditable is to be equated with good corporate governance, or whether too much auditing may itself undermine levels of trust and lead to excessive gaming of targets, rather than entrepreneurial wealth creation.

7.5.5 Executive pay

Executive pay is an area where a voluntary approach was tried, but later followed by government intervention in the form of the Directors' Remuneration Report Regulations (2002). This provides a consistent format for disclosure, and ensures investors can gain knowledge of pay issues within companies. More detailed disclosure with regard to executive compensation should investors understand the actuarial value of pension rights, fair or market valuation of stock options granted, bonuses and payments-in-kind, and so on. Meanwhile, actual levels of pay are set by remunerations committees within the board. Given the importance of executive's skills and individual human capital for firms, little precedent exists of legal intervention in the setting of pay in the labour market for executive talent. In important respects, regulatory initiatives cannot effectively substitute market-based setting of executive compensation.

However, likewise, the reliance of private enforcement even based on greater levels of information disclosure may have rather limited results. Most regulation in the area either covers the procedures for setting pay, or gives guidance through soft-law regarding best practices in terms of incentive schemes. It remains an open question as to how much impact greater disclosure may have on these market processes and whether the quality of executive

pay schemes will increase as a result. A missing link may relate to giving stakeholders greater input into actual decision making, or assuring the genuine independence of outside board members who will be active in shaping pay schemes.

7.5.6 Market for corporate control

The City Code and other regulatory initiatives have been widely accepted and serve as a standard of best practice for many other countries around the world. The regulatory framework is very focused on a particular set of goals related to minority shareholder protection, and implements these goals quite effectively. However, takeover rules may lack a particular balance with regard to the protection of stakeholder wealth or the capacity for wealth-creation in entrepreneurial ventures. Regulatory gaps exist in relation to the rights of stakeholders, such as employees. Likewise, a further issue is whether the limited scope of defensive measures allowed under the UK rules is genuinely desirable. Particularly given firm-specific contingency factors, it may be worth considering greater flexibility or innovative and creative measures regarding these issues. One interesting avenue for discussion is the rights or involvement of bidding firm shareholders in the takeover process and whether, for large or hostile transactions, some form of involvement or consent might be considered.

7.5.7 Stakeholders

The Company Law Reform Bill has stated that it is the directors' duty to promote the success of the company for the benefit of its members as a whole and, in fulfilling this duty, that directors must have regard to both short- and long-term factors and wider interests including various stakeholders. Future development of this regulation would require the relevant parties to think about how stakeholders are to be engaged in corporate governance and incorporate those understandings with soft or hard regulatory frameworks. In other words, while consensus around this principle is emerging and is certainly well established in many other European countries, the UK regulatory framework must more specifically develop relevant mechanisms.

These considerations are particularly relevant in the case of employees, both collectively and individually. In the case of employees, recent regulatory measures have led to an extension of rights to information and consultation. Some of these measures are general, and establish on-going mechanisms for limited participation. Other regulations are issue specific, and require particular events as triggers, as in the case of redundancies and transfer of undertakings. There is a question as to in what other specific events, such as mergers and takeovers and pension, should employees have rights to further information and consultation.

7.5.8 Summary

In sum, UK regulation has increased in its scope and depth in recent years. Likewise, UK policy initiatives have been innovative in terms of the use of both legal regulation and particularly extensive use of soft-law mechanisms, such as Codes. Still, some potential gaps in the regulatory framework exist. This section has outlined how those gaps often result from lack of complementary relationships between corporate governance drivers, or the need to balance hard and soft-law approaches. One important implication is that regulatory gaps cannot simply be solved by more legal regulation. Further legal regulation of corporate governance may be crucial in some areas, but public policy should be guided by looking more

holistically in terms of understanding the interactions among different aspects of corporate governance, as well as the potential complementarities between hard and soft forms of regulation.

7.6 Future Social Science Research

This report has identified a number of important drivers of ‘good’ corporate governance, and used these as benchmarks to evaluate potential gaps in the UK regulatory framework that might inform future strategies for public policy. However, the social science evidence base for evaluating policy or developing new policy initiatives remains limited. This section explores the gaps in policy-oriented academic research and identifies some specific areas where further research may be particularly important for public policy.

7.6.1 Implications for research on corporate governance

The comprehensive review of academic literature undertaken for this Report suggests several somewhat broad considerations for information future research strategies in the field of corporate governance: the need for greater dialogue of research and public policy, the importance of moving toward a more holistic view of corporate governance, and better understanding of the behavioural impact of regulation. Each of these is discussed in turn.

Greater dialogue of research and public policy. The literature review in section 2 shows the need for a stronger dialogue between empirical research by academics and issues of implementation of public policy. Many of the studies on corporate governance reviewed for this report utilize US data, and a stronger body of empirical research is needed with regard to UK companies, which is also informed by factors and practices specific to the UK. Moreover, the UK regulatory framework has developed rapidly in the past five years and many new initiatives have only recently been put into place. Some key examples here are provisions about auditors and audit committees, proposals for forward looking operational and strategic information disclosure, and new employee rights for information and consultation. It is important to investigate whether these regulatory initiatives were followed by behavioural changes among various governance participants.

Holistic View of Corporate Governance.. Most academic studies and policy initiatives have tended to focus on particular aspects of corporate governance in isolation. This report has argued that it is necessary to look at corporate governance holistically as a system of interdependent elements. At the level of companies, a better understanding is needed as to how drivers of ‘good’ corporate governance are supported (or potentially undermined) by other complementary practices (or lack thereof) (Aoki 2001; Milgrom and Roberts 1990; Milgrom and Roberts 1995). Here new innovations in social science, such as fuzzy-set methods, may help to understand and evaluate how corporate governance factors act in configurations to produce different outcomes (Fiss 2005; Jackson 2005a 2005b). At the level of regulation, the interdependencies and complementary nature of hard and soft forms of regulation must also be more systematically understood (Kirkbride and Letza 2004).

A holistic approach also implies reconsidering the link between corporate performance and research methodology. Much of the literature on corporate governance uses published data from company accounts, or relies on surveys of companies or investors. Much of this research attempts to link the presence of particular corporate governance practices (e.g. board committees) with the economic performance of companies (e.g. share price performance or

profitability). While such research has produced important results, the link between ‘good’ corporate governance and performance is not always straightforward. There is a dearth of research on governance processes that may be intermediating, transmission mechanisms between corporate governance drivers and organisational outcomes, including business strategy and performance. Moreover, performance itself has many dimensions and may be difficult to summarize in a single measure (Dechow and Schrand 2004; Stout 2005), such as shareholder returns, growth, employment, sustainability and quality of earnings, risk parameters, etc. The appropriateness of different measures may differ across firms (e.g. according to sector or life-cycle factors) and corporate governance drivers (e.g. internal controls may reduce risks, but also reduce profits). Corporate governance often affects other important parameters that are proximate but independent from performance outcomes, such as the strategies, resource capabilities and innovation. Here a more holistic view of corporate governance is important to better understand the trade-offs involved in corporate governance drivers as they impact different elements of strategy, resources and, ultimately, different aspects of corporate performance.

On a somewhat different level, a holistic understanding of corporate governance may be furthered by more comparative research on UK companies in the European context. The diversity of corporate governance in Europe and salience of EU-related developments for public policy mean that future development of UK corporate governance will increasingly involve interaction with European practices. While the UK is often considered a leader its approach to corporate governance, European countries have recently adopted a wide range of changes to their corporate governance systems. Moreover, countries such as Germany are developing alternative ‘hybrid’ approaches to enlightened shareholder value that may incorporate a more balanced view of stakeholder involvement and shareholder rights (Aoki 2006; Höpner 2001). These developments should not be complacently overlooked, and benchmarking the practices of top UK companies with their European counterparts will become of increasing importance in coming years. In particular, while UK corporate governance seems well tailored to the needs of investors, a broader evaluation is needed as to how corporate governance may help foster productivity and innovation in a European context.

Behavioural impact of regulation. Finally, more research is needed on how regulations and corporate governance structures impact the processes of corporate governance itself, as well as behaviour of various participants in the governance mechanism. Put another way, much corporate governance research looks at the relationship between easily observable organizational structures and measurable performance outcomes, but often give little direct evidence or explanation about how the two are linked by behaviour. By looking at behavioural processes, research may incorporate a more qualitative understanding of how corporate governance elements interact and influence investors, managers, creditors, employees, and other ‘gatekeepers’ involved in mediating market processes. An important correlate is the necessity to collect and triangulate data from a variety of sources – such as combining statistical studies based on surveys and published information with follow-up of semi-structured interviewing about processes and case studies that look at how these processes interact. This more behavioural approach would help understand issues of compliance or regulatory effectiveness, by conceiving of these not just in terms of adopting particular structures of corporate governance but how stakeholders use them to achieve different ends. A large number of issues raised in this report hinge on better understanding in these areas, such as ‘gaming’, defensive compliance, participation, independence and incentives. For example, corporate governance may suffer from problems of ‘gatekeeper failure’ in situations when reliance on ‘reputational intermediaries’, such as auditors,

securities analysts, attorneys, and other professionals. These groups pledge their reputational capital to vouch for information that investors cannot easily verify, but trust in them may not always be justified (Coffee 2002).

In the next sections, we turn to considerations about specific issues around each family of corporate governance drivers, and identify areas for further research, which seem important in relation to policy gaps in the UK context.

7.6.2 Boards

In terms of board structures, compliance with the Combined Code is generally considered as being relatively high. However, little evidence exists as to whether explanations of non-compliance with the Combined Code are being accepted by shareholders and what impact non-compliance has on those companies. Investors and other ‘gatekeepers’, such as rating agencies, often apply their own private criteria that are different to those set out in the code when assessing a company’s corporate governance practices. The use of different criteria may create a problem with company’s compliance with the Code. Some investment institutions have thus discontinued their separate corporate governance guidelines and would henceforth assess companies against the provisions of the Combined Code. This issue seems of fundamental important to understanding how comply-or-explain works in practice, and whether the intended flexibility is being achieved in practice.

In terms of board process, future research is needed to better understand how boards operate and the issue of how independent directors are fulfilling their roles. The role of independent non-executive directors is at the core of UK corporate governance, and the quality of many other key drivers relate to the presumed independence and quality of NEDs—for example, the role of audit committees, the quality of executive compensation schemes, and so on. However, the evidence base needs to be furthered as to whether NEDs have the necessary information, time, training, and independence to perform these roles. Future research should address the roles of contingency factors (e.g., size, age, complexity, etc.) in defining the optimal board configurations, both in terms its value-protecting and value-creating roles. It should also evaluate potential costs of implementation for different group of companies, in particular, for smaller firms.

7.6.3 Shareholder engagement

Shareholder engagement is also a crucial element of corporate governance, and many processes surrounding comply-or-explain rules rely, ultimately, on the evaluations and engagement of shareholders. While much research has looked at how ownership structure (e.g. concentration or dispersion) affects corporate governance, more research is needed on the processes underlying shareholder engagement. That is, in what ways do shareholders get involved in corporate governance, and what determines the level of shareholder involvement? For example, currently no research has assessed the impact of the ISC Principles on the behaviour of institutional investors. It is unclear to what extent engagement has been integrated into investment decision-making and asset management process, as well as the resources and people committed to it and the level of reporting provided by fund managers to their ultimate clients. Bearing in mind that shareholder activism has substantial cost implications, future research should identify the extent of direct and indirect costs associated with shareholder engagement mechanisms.

When investors, whether major institutional investors or retail investors, buy shares in a listed company they are likely to hold their shares through an intermediary or a chain of intermediaries. The Sandler Review (July 2003) and Myners Report (2001) identify at least four parties that are involved between the beneficial owner and the issuer (e.g., a nominee company, custodians, etc), all with distinct and important roles. Shares can also be lent, or used by a third party as collateral. An HM Treasury Report (2004, p.7) reviewed a number of previously commissioned research reports, and suggested that the investment chain does not work efficiently from the shareholder engagement perspective. Likewise, this report identifies a number of critical and inter-connected areas where the chain has not been functioning. Further research is needed to explore multiple principal-agent problems within the investment chain in the UK, and their possible impacts on the effectiveness of shareholder activism. More generally, these issues surround the question of ‘who monitors the monitors’ and the effectiveness of various ‘gatekeepers’, which act as intermediaries between ultimate beneficial owners and companies. Here much theoretical literature has stressed the importance of reputational mechanisms in promoting best practices, but this area needs further substantiation and empirical investigation.

7.6.4 Information and disclosure

In the area of public information disclosure, future research will be needed on the extent to which UK companies have introduced something like the OFR and the extent to which this will continue in the future. Conversely, it will be important to see how investors evaluate the quality of such information, and how they use this information in making their investment decisions and in setting their agendas for corporate governance. Future research is also needed on the provision of information relevant to stakeholders in general and to employees in particular. A growing debate over stakeholders, corporate social responsibility and socially responsible investment raises issues as to how market participants might better evaluate the social and environmental performance of companies, in order that investors or stakeholders can better judge the sustainability of company strategies and long-term costs of company operations.

In the area of private information flow within companies, the extent, costs and benefits of compliance with the Combined Code requires further research. Very little is known about the quality of internal information flows within companies, and the extent of oversight and involvement of the board in various other processes of the organisation. It is interesting that information flows to boards and in particular to independent directors are seen as a major driver of ‘good’ corporate governance by our expert survey. The validity of this would also seem to be an interesting area for further research.

Future research should address the roles of contingency factors (e.g., size, age, industry, etc.) in defining the optimal breadth and depth of information disclosure, both in terms its value-protecting and value-creating roles. It should also evaluate potential costs of implementation for different group of companies, in particular, for smaller firms. This issue relates closely to the costs and benefits of information provision by firms and the extent to which greater information provision, of which kinds and to whom, leads to greater wealth protection and generation.

7.6.5 Audit and internal controls

The numerous new policy measures introduced in the very recent past raise obvious questions about how market players will utilize and respond to new rules and regulatory oversight. For example, a key empirical question will be whether disclosure and transparency will have any effect on the level and scope of non-audit services provided. It also remains to be seen whether shareholders will actually become more active toward the audit process, and make use of the right to question auditors. In this sense, future evaluation of the toughness and costs vs. benefits of the various new rules will be needed.

In particular, this consideration suggests more detailed research on how auditors relate to other elements of the corporate governance system, such as shareholder involvement, board independence, and stakeholder involvement. The empirical literature remains very sceptical about the overall impact of structural measures, such as the presence of audit committees or auditor independence, on the quality of audit. Stronger evidence was found related to process factors, including qualification and involvement, which are both harder to measure and harder to regulate. Better understanding of how boards, audit committees, shareholders, stakeholders, regulators, and auditors interact is needed to target further improvements to policy. In particular, it remains unclear whether having independent *structures* is sufficient to provide auditors with real *incentives* to act as effective checks on management behaviour. However, the improvement of external oversight of auditors has seemingly given them greater leverage to require compliance from companies.

A more specific issue concerns how auditing relates to disclosure of information relevant from the perspective of stakeholders and concerns around corporate social responsibility (CSR). While companies have sought to improve their reputation by voluntarily disclosing information under the rubric of CSR, it is nearly impossible for various stakeholder groups to verify this information or objectively compare the CSR strategy of different companies within a common framework.

7.6.6 Executive pay

Within existing literature, considerable debate remains about the effectiveness of incentive schemes designed to give pay rewards based on performance. Here new research has been limited by the exclusive focus on using financial rewards to improve motivation that has not been sufficiently balanced by considerations from other areas of social science. In particular, resource-based approaches to corporate governance (Pfeffer and Salancik 1978) provide an alternative to managers being motivated singularly by financial rewards. In short, financial incentives must be understood within a broader exploration of the formal and informal factors that affect the motivation of executives, such as power, careers, and stakeholder relationships. A related issue is whether certain types of incentives, such as share options, bias decision making in favour of certain financial targets and unintentionally lead to too much focus on the short-term. Further research in these areas could usefully draw from behavioural economics, sociology and social psychology.

Perhaps more narrowly, no empirical evidence can be cited that measures true incentive effects of LTIP. For example, just because a share option or LTIP has been granted, it will not automatically vest. Future research should address the notion of ‘potential’ rewards versus the ‘actual’ ones received, as well as the upside versus downside risks involved in pay for performance schemes. This would further give valuable insight into the motivational issues surrounding the grants of share options, and provide additional insight into the true

costs, which could then be measured against an increase in shareholder value. Related to this, the definitions and criteria for performance criteria attached to share option schemes would provide an area for fruitful further research. The Combine Code only provides details that schemes should be subject to “challenging performance criteria reflecting the company’s objectives” (Combined Code 2003 p21.) These performance criteria could be plotted against actual performance in order to provide an insight as to how demanding such targets are. Some comparative research suggests that the performance criteria set by UK companies are less stringent than, for example, similar schemes used by German companies (Buck et al. 2003; Buck and Sharhriem 2005).

7.6.7 Market for corporate control

Research of mergers and acquisitions is an area where the empirical results remain particularly ambiguous. While takeovers are obviously important for corporate restructuring, the positive and negative effects on performance are often unclear. Future research should address the roles of contingency factors (e.g., size, age, complexity, etc.) in the role of takeover markets, both in terms its value-protecting and value-creating roles. The mix of positive or negative results regarding the market for corporate control reflects the fact that both ‘good’ and ‘bad’ deals exist. While UK regulation stresses the rights of target firm shareholders, the empirical literature suggests that disappointing or negative effects of ‘bad’ deals are born out by bidding firm shareholders, who often have little say in the takeover process. Future research might focus on how investors of bidding firms approach the takeover process, and to what extent those investors are protected (Stout 2006).

The governance functions of a market for corporate control is likewise based on a fundamental assumption of the capital market efficiency. However, the institutional underpinnings of financial market efficiency have been recently challenged by behavioural approaches, which suggest that the level of market efficiency depends on the importance of several market distinct mechanisms - universally informed trading, professionally informed trading, derivatively informed trading, and uninformed trading operates to reflect that fact in market price. A new framework for evaluating the efficiency of the stock market, called "behavioural finance," and a growing number of empirical studies pose a serious challenge to the efficient markets hypothesis (Gilson and Kraakman 2004), and further research that brings together corporate governance and behaviour finance may help to shed light on the efficiency of market for corporate control.

Future research should also take note of the growing international dimension to the market for corporate control. There is currently no data available on the extent of non-compliance with the City Code, and particularly regarding the behaviour of UK companies acting in foreign markets. Around 40 percent of UK mergers and acquisitions are cross-border, and it should be investigated as to whether the lower barriers to hostile deals in the UK relative to other countries puts UK firms at any competitive disadvantages. Given the diversity of takeover rules in Europe, the United States and Japan, an interesting question remains as to what rules are best in terms of their wealth-creating and wealth-protecting effects (e.g. in light of breach of trust issues or bidding firm shareholders). Here comparative research with regard to multiple dimensions of firm performance would seem highly desirable.

7.6.8 Stakeholders

Existing research on stakeholders has been relatively underdeveloped in the UK. In part, this reflects the lack of practical development, since stakeholders have played a rather marginal role in UK corporate governance. More recently, a literature has emerged on corporate social responsibility (CSR) and socially responsible investment (SRI) from a general stakeholder perspective. Much of this literature has remained rather normative (e.g. arguments for and against) and the empirical work in the UK has often been rather exploratory and descriptive (e.g. describing what individual companies are doing voluntarily). This is despite the fact that some research, albeit mainly US, suggests that broader stakeholder involvement can have an effect on governance and on performance. Future research is also needed that sees CSR and SRI from a governance perspective, which explores the processes whereby stakeholders such as SRI funds, NGOs, communities, etc. use information provided by companies to actually affect corporate governance.

In terms of debt holders, further research is needed to complement work on shareholder engagement. The goal would be a more comprehensive picture of the investment chain, and a mapping of the key ‘gatekeepers’ involved in various aspects of the investment process. Here the role of investment analysis and ratings agencies is particularly important, since previous research identifies a number of potential conflicts of interests the ‘gatekeepers’ may have when dealing with individual companies and their investors (Chan et al. 2003).

In terms of employees, three areas of future research are important on understanding the mechanisms of employee involvement. One is on the role of pension funds and how and whether they can give employees a voice in governance. A second is on collective forms of involvement – what makes works councils and information sharing with employees effective and what positive outcomes it has. A third area would be to investigate the mechanisms and effectiveness of more individual forms of employee voice via employee reports, briefing meetings etc. Here recent policy developments in the area of information and consultation rules will need monitoring in terms of how these are implemented in the UK, and whether they sufficiently support a positive role of employment involvement in corporate governance.

Future research should address the roles of contingency factors (e.g., size, age, complexity, sector) in operationalising the role of stakeholder involvement, both in terms its value-protection and value-creation. It should also evaluate potential costs of implementation for different group of companies, in particular, for smaller firms.

7.7 Conclusions

In sum, this section has identified a number of both content gaps and effectiveness gaps in the UK regulatory framework in relation to ‘good’ corporate governance drivers identified in academic research. Content gaps are biggest in relation to executive pay, employees, and stakeholders in general. These gaps are smaller in areas such as information disclosure, boards, shareholder activism, auditors, internal control, and the market for corporate control. Gaps in effectiveness influences almost all drivers of good corporate governance, but to different degrees. Even if regulatory content is strong, the implementation may be potentially weak, especially when enforcement of codes is relying on self-regulatory guidelines. For example, ISC Principles encourage shareholder engagement, but supporting frameworks may not lead to sufficient implementation. In this regard, regulation may also involve unintended

outcomes, which include behavioural aspects (e.g., box-ticking; “gaming”, etc); and defensive compliance to limit legal liabilities.

However, our analysis suggests that more regulation is not always the answer. There are various trade-offs associated with the implementation of corporate governance principles that may influence the effectiveness of individual drivers. For example, greater enforcement of legal regulation should be considered in comparison with greater flexibility of Codes based on comply-or-explain principles. However, Codes and principles may be well enforced if supported by market incentives, and this still remains an empirical question. Similarly, law ensures “minimum standards” for all, whereas codes support “best practices” in certain contexts. Some countries, however, offer “choice” of different legally based structures. An explicit recognition of these interdependencies and trade-offs may inform future regulatory initiatives. Likewise, regulation should strive to balance the different governance demands by taking into account governance-related factors such as complementarities between various governance drivers, firm-level contingencies that may affect the effectiveness of particular governance drivers, and potential costs associated with compliance with good corporate governance principles. For example, key aspects in the UK are shareholder engagement and board independence, which need to support other drivers.

Finally, the social science evidence base for evaluating past policies or developing new policy initiatives remains limited. More evidence-based, policy-oriented academic research in a number of specific areas may help to further inform public policy. First, a more holistic approach to the effectiveness of corporate governance drivers requires further research on such aspects as stakeholder involvement, contingencies, complementarities and cost aspects that may affect the effectiveness of corporate governance mechanisms. One aspect of this is to analyse wealth creation and performance trade-offs. More specifically, it is important to look not only at shareholder returns, but also whether different corporate governance configurations promote long-term, value-creating economic production in a fashion that benefits not only shareholders but also other groups that make specific investments in corporations (Blair and Stout 2006). Second, it is important to verify whether recent regulatory initiatives are followed by the desired behavioural changes, including unintended consequences such as the development of ‘gaming’ practices. This suggests a change of emphasis from corporate governance structures to understanding the processes actual process that underlie corporate governance and how they are shaped by networks of actors inside and outside the company.

8 Conclusion

Corporate governance has become a major topic of debate and policy development in the worlds of business, politics, and academia, in the UK and throughout the world. These debates and policy outcomes have important implications not only for business, but the wider economy and society.

This Report results from a DTI sponsored project on “Identifying the Key Drivers of ‘Good’ Corporate Governance and the Appropriateness of Policy Responses.” The research was carried out in a number of stages. Initially, we reviewed the existing research literature to identify what have been seen as the main ‘drivers’ of corporate governance and in particular ‘good’ corporate governance. ‘Good’ corporate governance is defined here with regard to the rights and responsibilities of company stakeholders, and the wealth-creating and wealth-protecting functions of corporate governance within this context. Based on this definition, a detailed review of the theoretical and empirical social science literature on corporate governance was undertaken, drawing on the fields of economics, finance, management, sociology, law, and political science. The review covered seven broad areas: board of directors, shareholder activism, information disclosure, auditing and internal controls, executive pay, the market for corporate control, and stakeholders. The result was the identification of 18 key ‘drivers’ or governance mechanisms, which promote ‘good’ corporate governance. An internet-based survey of international corporate governance experts was conducted in order to verify and further specify how these drivers operate in relation to the UK context.

The second stage of the project reviewed the existing regulatory framework of corporate governance in the UK, covering a spectrum from ‘hard’ law and regulations to ‘soft’ codes and standards. Policy initiatives were analysed with regard to both their content and effectiveness in promoting each of the identified drivers. A Focus Group discussion was also held at the DTI with practitioners from a wide range of backgrounds. On the basis of our analysis and the feedback from the Focus Group, a number of potential gaps were identified, both in terms of content and implementation of the present UK system. These gaps also suggested a number of areas in which further research is desirable in order to improve the evidence-based relevant for UK public policy.

A number of important conclusions of this Report may be summarised as follows.

First, various perspectives exist with regard to what constitutes corporate governance and especially ‘good’ corporate governance. Our approach focussed on a set of institutions and processes, inside and outside the company, and on a wide range of wealth-protecting and wealth-creating functions, which are often overlooked in traditional corporate governance literatures. In addition, ‘good’ corporate governance involves fairness and transparency with regard to both rights and responsibilities of shareholders and other key stakeholders.

Second, the Report identifies key drivers of ‘good’ corporate governance practices. Our review focused on seven areas: boards of directors, shareholder activism, information disclosure, auditing and internal controls, executive pay, the market for corporate control, and the role of stakeholders. Based on the review of the social science literature within these broad ‘families,’ 18 specific drivers or mechanisms were identified which promote ‘good’ corporate governance. Existing empirical research and our survey of international experts

both show important areas of consensus with regard to some drivers. However, some areas exist where more diverse opinions persist as to the relative salience of different drivers. In particular, strong areas of agreement centred on the structure and composition of boards, as well as information disclosure and the audit process. More contentious issues were related to executive pay and the market for corporate control. Stakeholder involvement was generally viewed as important, although in the UK context stakeholders are often seen as a complementary corporate governance device within a broader ‘enlightened’ shareholder-oriented framework.

Third, our analysis of policy initiatives with reference to drivers of ‘good’ corporate governance suggests a number of potential gaps in the UK regulation. Overall, the UK regulatory framework was deemed to be both extensive and effective, when viewed in international perspective. Nonetheless, several potential gaps in coverage were identified in the areas of executive pay, employees, and stakeholders more generally. A number of potential gaps in effectiveness were also identified with regard to other key drivers such as boards, shareholder involvement, information disclosure, auditing, and the market for corporate control. In particular, many of these key drivers are covered extensively, but by relatively ‘soft’ self-regulatory mechanisms, which rely ultimately on market-driven processes to sanction and enforce ‘good’ corporate governance practices. For example, deficits in shareholder engagement may translate into weaknesses in the effectiveness of other corporate governance mechanisms, such as the board or market for corporate control, since these latter drivers may be missing complementary support from other institutions.

Fourth, the Report stresses the importance of contexts, complementarities, and costs associated with development and implementation of good corporate governance. The context in which the firm operates, its size, industry, age, shapes aspects of governance and needs to be taken into account in terms of regulatory initiatives. In addition, complementarity and substitution effects need to be taken into account, since some corporate governance drivers or regulation may substitute for others and or work to support others. A key issue in this regard concerns supporting greater shareholder and stakeholder engagement with regard to key corporate governance processes. The costs of regulation must also be considered not only in terms of the out-of-pocket compliance costs that are reflected in the firm’s balance sheet and other accounting documentation (e.g., the audit costs, directors’ insurance, etc.), but also the less explicit opportunity costs (e.g., directors’ time spent on governance issues instead of business strategy, costs of strategic disclosure, etc.), and the legal and reputational costs which may be incurred when firms get their governance practices wrong. Future regulatory initiatives should also include a thorough discussion of regulatory trade-offs between mandatory regulation (uniform requirements), and more flexible forms of soft-law such as codes based on comply-or-explain principles and self-regulatory norms of professional groups.

The Report identifies a number of areas where further research may help improve the fact base for new policy initiatives related to corporate governance. A more holistic approach to the effectiveness of corporate governance drivers requires further research on such aspects as stakeholder involvement, contingencies, complementarities and cost aspects that may affect the effectiveness of corporate governance mechanisms. One aspect of this is to analyse wealth creation and performance trade-offs in terms of wider aspects of performance such as productivity, innovation and social inequality. Moreover, it is important to verify whether recent regulatory initiatives are followed by the desired behavioural changes, including unintended consequences such as the development of ‘gaming’ practices. This suggests a

change of emphasis from corporate governance structures to understanding the processes actual process that underlie corporate governance and the creation of wealth.

Appendix I: Experts' Survey Questionnaire

“Identifying the Key Drivers of ‘Good’ Corporate Governance and the Appropriateness of Policy Responses” Project

Name
Affiliation
E-mail

I. Board of Directors

Question 1

How important are the following aspects of board structure in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

board size	1	2	3	4	5	6	7
a high proportion of independent board members	1	2	3	4	5	6	7
a high proportion of executive directors	1	2	3	4	5	6	7
separation of the roles of CEO and board Chairman	1	2	3	4	5	6	7
independent nomination, remuneration and audit committees	1	2	3	4	5	6	7
presence of a senior (lead) independent director	1	2	3	4	5	6	7

Please indicate any other aspects of board structure that you consider important for “good corporate governance.”

Question 2

How important are the following board characteristics in promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

number of network ties to other firms and external constituencies	1	2	3	4	5	6	7
human capital of independent board members (experience, expertise, reputation)	1	2	3	4	5	6	7

board directors' heterogeneity in terms of human capital (education, expertise, etc)	1	2	3	4	5	6	7
--	---	---	---	---	---	---	---

board directors' heterogeneity in terms of gender and age	1	2	3	4	5	6	7
--	---	---	---	---	---	---	---

Please indicate any other board characteristics that you consider important for “good corporate governance”.

Question 3

How important are the following board processes in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

regular evaluation of board members	1	2	3	4	5	6	7
--	---	---	---	---	---	---	---

frequency and lengths of board meetings	1	2	3	4	5	6	7
--	---	---	---	---	---	---	---

regular meetings of independent directors (separately from board meetings)	1	2	3	4	5	6	7
--	---	---	---	---	---	---	---

regular communications with major shareholders/investors	1	2	3	4	5	6	7
---	---	---	---	---	---	---	---

board focus on financial controls (accounting performance, TSR, EPS etc)	1	2	3	4	5	6	7
--	---	---	---	---	---	---	---

board focus on strategic controls (growth of market share, competitiveness)	1	2	3	4	5	6	7
---	---	---	---	---	---	---	---

directors' financial incentives, including equity-based incentives	1	2	3	4	5	6	7
---	---	---	---	---	---	---	---

imposing age and term limits for independent directors	1	2	3	4	5	6	7
---	---	---	---	---	---	---	---

imposing age and term limits for executive directors	1	2	3	4	5	6	7
---	---	---	---	---	---	---	---

extensive and timely provision of information to independent directors	1	2	3	4	5	6	7
---	---	---	---	---	---	---	---

bottom-up information flow from

functional departments to independent directors	1	2	3	4	5	6	7
using specialist recruitment companies when recruiting new board members	1	2	3	4	5	6	7
independent directors' social ties with CEO/executive directors	1	2	3	4	5	6	7

Please indicate any other factors related to board processes that you consider important for “good corporate governance”.

Question 4

In your opinion, which of the “good corporate governance” drivers listed in Questions 1 to 3 may have firm-level costs of execution (including financial, opportunity costs, etc.) that outweigh the benefits of execution?

II. Shareholder Activism

Question 1.

How effective are the following types of shareholders in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

pension funds, mutual funds, foundations	1	2	3	4	5	6	7
corporate pension funds	1	2	3	4	5	6	7
banks	1	2	3	4	5	6	7
insurance companies	1	2	3	4	5	6	7
private equity investors	1	2	3	4	5	6	7
individual (non-family) blockholders	1	2	3	4	5	6	7
family blockholders	1	2	3	4	5	6	7
dispersed individual shareholders	1	2	3	4	5	6	7

Please indicate any other types of shareholders that you consider important in promoting “good corporate governance.”

Question 2.

How important are the following aspects of shareholder activism in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

publicly criticizing board members	1	2	3	4	5	6	7
influencing board and management turnover	1	2	3	4	5	6	7
influencing revisions of executive compensation	1	2	3	4	5	6	7
regular discussions with board members of strategy issues (M&A, etc.)	1	2	3	4	5	6	7
maintaining stable shareholding	1	2	3	4	5	6	7
voting at the AGM	1	2	3	4	5	6	7
use of electronic voting systems	1	2	3	4	5	6	7
disclosure of voting at shareholder meetings	1	2	3	4	5	6	7
use of lawsuits against managers and auditors for negligence or breaches of duty	1	2	3	4	5	6	7

Please indicate any other aspects of shareholder activism that you consider important in terms of promoting “good corporate governance.”

Question 3

Of the “good corporate governance” drivers listed in Question 2 which, in your opinion, may have firm-level costs of execution (including financial, opportunity costs, etc.) that outweigh the benefits of execution?

III. Executive Pay

Question 1

How important are the following executive pay related items in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

performance-related bonus	1	2	3	4	5	6	7
share option incentive scheme	1	2	3	4	5	6	7
long term incentive plan	1	2	3	4	5	6	7
non-remuneration based incentives (e.g. firm’s pension contribution)	1	2	3	4	5	6	7

Please indicate any other executive pay related items that you consider important in promoting “good corporate governance.”

Question 2

How important are the following executive pay processes in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

caps on the size of executive pay	1	2	3	4	5	6	7
shareholders to vote on remuneration	1	2	3	4	5	6	7
incentives tied to performance targets	1	2	3	4	5	6	7
issuing ‘out of the money’ options	1	2	3	4	5	6	7
high levels of pay disclosure	1	2	3	4	5	6	7
remuneration committee’s access to external profession advice	1	2	3	4	5	6	7
the costs of issuing share options clearly shown in the annual report and accounts	1	2	3	4	5	6	7

Please indicate any other pay processes that you consider important in promoting “good corporate governance.”

Question 3

Of the “good corporate governance” drivers listed in Questions 1 to 2 which, in your opinion, may have firm-level costs of execution (including financial, opportunity costs, etc.) that outweigh the benefits of execution?

IV. Information and Disclosure

Question 1

How important are the following forms of public disclosure of information in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

annual report and related documents	1	2	3	4	5	6	7
quarterly or monthly reports	1	2	3	4	5	6	7
operating and financial reviews	1	2	3	4	5	6	7
information specifically on corporate governance (eg director’s pay)	1	2	3	4	5	6	7
information on related party transactions	1	2	3	4	5	6	7
information on corporate social responsibility	1	2	3	4	5	6	7
information on employment policies	1	2	3	4	5	6	7
information on environmental policies	1	2	3	4	5	6	7
audit committee’s oversight of publicly disclosed information	1	2	3	4	5	6	7

Please indicate any other aspects of public information disclosure that you consider important in promoting “good corporate governance.”

Question 2

How important are the following forms of private information provision in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

private information to key investors	1	2	3	4	5	6	7
private information to analysts	1	2	3	4	5	6	7
vertical information flows between the board and function departments	1	2	3	4	5	6	7
horizontal information flows between functional departments	1	2	3	4	5	6	7
provision of information to employees	1	2	3	4	5	6	7
provision of information to other stakeholders	1	2	3	4	5	6	7

Please indicate any other aspects of private information disclosure that you consider important in promoting “good corporate governance.”

Question 3

Of the “good corporate governance” drivers listed in Questions 1 and 2, which, in your opinion, may have firm-level costs (including financial, opportunity costs, etc.) which outweigh the benefits?

V. Audit and Internal Controls

Question 1

How important are the following audit related items in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

board approval of external auditor appointment	1	2	3	4	5	6	7
shareholders’ vote on appointment of the external auditor	1	2	3	4	5	6	7
regular rotation of appointed external auditor	1	2	3	4	5	6	7
professionally qualified members on the audit committee	1	2	3	4	5	6	7
reporting from the audit committee to shareholders	1	2	3	4	5	6	7
restriction on the quantity of ‘non-audit’ tasks involving external auditors	1	2	3	4	5	6	7
unconstrained legal liability of auditors	1	2	3	4	5	6	7

Please indicate any other audit related items that you consider important in promoting “good corporate governance”.

Question 2

How important are the following mechanisms of internal control in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

risk management systems	1	2	3	4	5	6	7
financial control and budgeting systems	1	2	3	4	5	6	7
support and protection of ‘whistleblowers’	1	2	3	4	5	6	7

Please indicate any other aspects of internal controls that you consider important in promoting “good corporate governance”.

Question 3

Of the “good corporate governance” drivers listed in Questions 1 and 2, which, in your opinion, may have firm-level costs (including financial, opportunity costs, etc.) which outweigh the benefits?

VI. Market for Corporate Control

Question 1

Leaving aside potential issues of anti-trust and competition policy, how important are the following aspects of the market for corporate control in promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

an active M&A market	1	2	3	4	5	6	7
hostile takeovers	1	2	3	4	5	6	7
leveraged buy-outs (LBO)	1	2	3	4	5	6	7
management buy-outs (MBO)	1	2	3	4	5	6	7
public-to-private transactions	1	2	3	4	5	6	7

Please indicate any other aspects of the market for corporate control that you important in promoting “good corporate governance.”

Question 2

How important are the following in promoting an effective market for corporate control (score each factor as follows: 1 = not important, 7 = high importance):

mandatory bid rule	1	2	3	4	5	6	7
principle of equal treatment of shareholders	1	2	3	4	5	6	7
transparency of ownership and control (inc. defensive measures)	1	2	3	4	5	6	7
squeeze out and sell-out rules	1	2	3	4	5	6	7
one-share / one-vote principle	1	2	3	4	5	6	7
break-through rules	1	2	3	4	5	6	7

payment through cash	1	2	3	4	5	6	7
payment through share swaps	1	2	3	4	5	6	7
payment through debt (e.g. LBO)	1	2	3	4	5	6	7
protection of firm-specific assets during M&A	1	2	3	4	5	6	7
protection of employee interests during M&A	1	2	3	4	5	6	7
establishment of an international 'level playing field' that reduces takeover barriers	1	2	3	4	5	6	7
ability to 'ring fence' target firms from acquirers in countries with higher takeover barriers	1	2	3	4	5	6	7

Please suggest other aspects that you consider important in promoting an effective market for corporate control

Question 3

How appropriate do you consider the following aspects of takeover defenses in the context of "good corporate governance" (score each factor as follows: 1 = not appropriate, 7 = highly appropriate):

the board should be strictly neutral during takeover bids	1	2	3	4	5	6	7
the board should have substantial decision power regarding takeover bids, subject to shareholder veto	1	2	3	4	5	6	7
pre-bid defensive actions	1	2	3	4	5	6	7
post-bid defensive actions	1	2	3	4	5	6	7
anti-takeover devices (e.g. poison pill, golden parachutes, etc.)	1	2	3	4	5	6	7
white knights or defense through building a constituency of stable long-term shareholders	1	2	3	4	5	6	7

Please indicate any other aspects of takeover defenses that you consider important for "good corporate governance".

VII. Stakeholders

Question 1.

How important is the involvement in company decision-making process of the following stakeholders in terms of promoting “good corporate governance” (score each factor as follows: 1 = not important, 7 = high importance):

debtholders	1	2	3	4	5	6	7
employees	1	2	3	4	5	6	7
customers	1	2	3	4	5	6	7
suppliers	1	2	3	4	5	6	7
local communities	1	2	3	4	5	6	7
NGOs	1	2	3	4	5	6	7
the State	1	2	3	4	5	6	7

Please suggest other stakeholders who are important for promoting “good corporate governance.”

Question 2.

In the case of employees, which of the following mechanisms do you think is important in terms of promoting “good corporate governance”(score each factor as follows: 1 = not important, 7 = high importance):

individual voice through meetings, employee reports	1	2	3	4	5	6	7
employee share ownership	1	2	3	4	5	6	7
consultative committees such as works councils	1	2	3	4	5	6	7
board-level representation of employees	1	2	3	4	5	6	7
employee voice via pension fund	1	2	3	4	5	6	7
trade unions	1	2	3	4	5	6	7

Please suggest other important mechanisms of employee voice that you consider important in promoting “good corporate governance.”

Question 3.

In the case of debt holders, which of the following mechanisms do you think is important in terms of promoting “good corporate governance”(score each as driver as: 1 = not important, 7 = high importance):

individual voice through meetings and contacts with managers	1	2	3	4	5	6	7
use of delegated monitoring systems	1	2	3	4	5	6	7
access to private information	1	2	3	4	5	6	7
board presence	1	2	3	4	5	6	7
use of contractual mechanisms of monitoring (bank covenants, etc)	1	2	3	4	5	6	7
inclusion of governance factors in risk evaluation mechanisms	1	2	3	4	5	6	7

Please suggest other important aspects of debt holder involvement that you consider important in promoting “good corporate governance.”

VIII. Evaluation of UK Corporate Governance Regulation

Question 1

How do regard current UK regulation regarding corporate governance in the following areas (score each factor as follows: 1 = highly unsatisfactory, 7 = highly satisfactory. If unsatisfactory, please provide a brief comment):

protection of minority shareholder interests	1	2	3	4	5	6	7	Don't know
facilitating shareholder activism	1	2	3	4	5	6	7	Don't know
increasing information disclosure	1	2	3	4	5	6	7	Don't know

raising effectiveness of the
Board of Directors

1 2 3 4 5 6 7 Don't know

promoting appropriate incentives
in executive pay

1 2 3 4 5 6 7 Don't know

raising effectiveness of auditors

1 2 3 4 5 6 7 Don't know

improving internal control systems

1 2 3 4 5 6 7 Don't know

regulating the market for corporate control

1 2 3 4 5 6 7 Don't know

promoting corporate social responsibility

1 2 3 4 5 6 7 Don't know

Please, provide comments here if you want to clarify your views.

Thank you for your time and help with this research!

Appendix II: Participants in the Focus Group

Group 1: Boards, auditing and internal controls, executive pay.

Charlotte Barbour	Institute of Chartered Accountants of Scotland
William Claxton Smith	Insight Investment
Tim Copnell	KPMG
Hans Hirt	Hermes
Chris Hodge	Financial Reporting Council
Martyn Jones	Deloitte
Judy Lowe	Bovis Lend Lease, Europe; Wrekin Construction plc.
Giles Peel	Institute of Chartered Secretaries and Administrators
Gerald Russell	Ernst & Young
David Jackson	BP
Chris Yates	Quoted Companies Alliance

Group 2: Shareholder activism and the market for corporate control

Robert Blanks	Institute of Chartered Secretaries and Administrators
Anthony Carey	Robson Rhodes
Frank Curtis	RailPen Investments
Alison Kennedy	Standard Life Investments
Manfred Lam	SEI Investments
Geoff Lindey	NAPF
Michael McKersie	ABI
Ian Richards	Morley
Daniel Summerfield	USS

Group 3: Information disclosure, stakeholders

Patricia Constant	Central Lobby
George Dallas	S&P
Jonathan Hunt	ICAEW
Finn Jackson	Tomorrow's Company
Toby Kent	Corporate Citizenship
Lord Newby	All Party Parliamentary Group on Corporate Responsibility
Sir Geoffrey Owen	LSE
Tom Powdrill	TUC
Andrew Shrager	Renaissance Capital
Alan Thompson	Institute of Chartered Accountants of Scotland

Bibliography

- Abhyankar, A., Ho, Keng-Yu and Zhao, Huainan. 2005. Long-run Post Merger Stock Performance of UK Acquiring Firms: A Stochastic Dominance Perspective. Working Paper Series.
- Abraham, S. and Tonks, I. 2004. Voluntary corporate disclosure by UK companies': mimeo Exeter.
- Addison, J. T., Schnabel, K., and Wagner, J. 2004. The course of research into the economic consequences of German works councils. British Journal of Industrial Relations, 42(2): 255-281.
- Admati, A., Pfleiderer, P., and Zechner, J. 1994. Large shareholder activism, risk sharing, and financial market equilibrium. Journal of Political Economy, 102: 1097-1130.
- Agrawal, A. and Knoeber, C. 1996. Firm performance and mechanisms to control agency problems between managers and shareholders. Journal of Financial and Quantitative Analysis, 31: 377-395.
- Agrawal, A. and J., Jeffrey F. 2002. Do Takeover Targets Under-perform? Evidence from Operating and Stock Returns. Working Paper Series.
- Agrawal, A. and Jaffe, J. F. 2003. The Disciplinary Motive for Takeovers: A Review of the Empirical Evidence. Journal of Financial and Quantitative Analysis, 31: 213-234.
- Aguilera, R. V. and Jackson, G. 2003. The Cross-National Diversity of Corporate Governance: Dimensions and Determinants. Academy of Management Review, XII(3, July): 1-19.
- Aguilera, R. 2005. Corporate governance and director accountability: an institutional comparative perspective. British Journal of Management, 16(S39-S53.).
- Akerlof, G. 1980. The market for "lemons": qualitative uncertainty and the market mechanism. Quarterly Journal of Economics, 84(3): 488-500.
- Alchian, A. A. and Demsetz, H. 1972. Production, information costs, and economic organization. American Economic Review, 62: 777-795.
- Alexander, J. A., Fennell, M. L., and Halpern, M. T. 1993. Leadership instability in hospitals: The influence of board-CEO relations and organizational growth and decline. Administrative Science Quarterly, 38: 74-99.
- Al-Hawamdeh, A. and Snaith, I. 2005. Is "private briefing" illegal in the United Kingdom? Corporate Governance: An International Review, 13(4): 489-504.
- Anderson, R., Mansi, S., and Reeb, D. 2003. Founding family ownership and the agency costs of debt. Journal of Financial Economics, 68: 263-285.
- Andrade, G., Mitchell, M., and Stafford, E. 2001. New Evidence and Perspectives on Mergers? Journal of Economic Perspectives: 103-120.
- Ang, J., Cole, R., and Lin, J. 2000. Agency costs and ownership structure. Journal of Finance, 55: 81-106.
- Angelini, P., Di Salvo, R., and Ferri, G. 1998. Availability and cost of credit for small businesses. Journal of Banking & Finance, 22: 925-954.
- Aoki, M. 1988. Information, incentives, and bargaining in the Japanese economy. Cambridge: Cambridge University Press.
- Aoki, M. 1994. The Japanese Firm as a System of Attributes. In M. Aoki & R. Dore (Eds.), The Japanese Firm: Sources of Competitive Strength: 11-40. Oxford: Oxford University Press.

- Aoki, M. 2006. Whither Japan's Corporate Governance? Toward External Monitoring of Internal Linkage. In M. Aoki & G. Jackson & H. Miyajima (Eds.), Corporate Governance in Japan: Organizational Diversity and Institutional Change. Oxford: Oxford University Press.
- Aoki, M. and Patrick, H. (Eds.). 1994. The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies. Oxford: Oxford University Press.
- Aoki, M. 2001. Information, Corporate Governance, and Institutional Diversity. Oxford: Oxford University Press.
- Aoki, M. 2001. Toward a Comparative Institutional Analysis. Cambridge, MA: MIT Press.
- Archambeault, D. and DeZoort, T. 2001. Auditor Opinion Shopping and the Audit Committee: An Analysis of Suspicious Auditor Switches. International Journal of Auditing, 5: 33-52.
- Arthur, N. 2001. Board Composition as the Outcome of an Internal Bargaining Process: Empirical Evidence. Journal of Corporate Finance, 7: 307-340.
- Ascioglu, A., Hegde, S. P., and McDermott, J. B. 2005. Auditor compensation, disclosure quality, and market liquidity: Evidence from the stock market. Journal of Accounting and Public Policy, 24(4): 325-354.
- Ashbaugh-Skaife, H., LaFond, R., and Mayhew, B. W. 2003. Do Non-Audit Services Compromise Auditor Independence? Further Evidence. University of Wisconsin Working paper.
- Association of British Insurers. 1994. Long-term remuneration for senior executives. London: ABI.
- Association of British Insurers. 1996. Long term incentive schemes - Notes of emerging good practice. London: ABI.
- Association of British Insurers. 1999. Share incentives: A statement of principles. London: ABI.
- Association of British Insurers. 2002. Executive compensation and share based remuneration: Guidelines for share incentive schemes. London: ABI.
- Association of British Insurers. 2004. Principles and Guidelines on Remuneration. London: ABI.
- Asthana, S., Balsam, S., and Kim, S. 2004. The Effect of Enron, Andersen, and Sarbanes-Oxley on the Market for Audit Services. Mimeo
- Baker, R. C. and Owsen, D. M. 2002. Increasing the role of auditing in corporate governance. Critical Perspectives on Accounting, 13(5-6): 783-795.
- Barnes, P. 1999. Predicting UK Takeover Targets: Some Methodological Issues and an Empirical Study. Review of Quantitative Finance and Accounting, 12(3): 283.
- Barnhart, S. W. and Rosenstein, S. 1998. Board composition, managerial ownership, and firm performance: An empirical analysis. The Financial Review, 33: 1-16.
- Barton, H. 1992. Does top management add value to investment decisions. Long Range Planning, 25(5): 43-58.
- Bathala, C. T. and Rao, R. P. 1995. The determinants of board composition: An agency theory perspective. Managerial and Decision Economics, 16: 59-69.
- Baums, T. 1993. Takeovers versus institutions in corporate governance in Germany. In D. D. Prentice & P. R. J. Holland (Eds.), Contemporary Issues in Corporate Governance: 151-183. Oxford: Clarendon Press.
- Baums, T. and Frick, B. 1998. Codetermination in Germany: the impact of court decisions on the market value of the firm. Economic Analysis, 1,2: 143-161.
- Baysinger, B. D. and Butler, H. 1985. Corporate governance and the board of directors: Performance effects of changes in board composition. Journal of Law,

- Economics, & Organization, 1: 101-134.
- Baysinger, B. D. and Hoskisson, R. E. 1990. The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy. Academy of Management Review, 15: 72-87.
- Baysinger, B. D., Kosnik, D. R., and Turk, T. A. 1991. Effects of board and ownership structure on corporate R&D strategy. Academy of Management Journal, 34: 205-214.
- Bazerman, M. and Schoorman, F. 1983. A limited rationality model of interlocking directorates. Academy of Management Review, 8: 206-217.
- Beasley, M. 1996. An empirical analysis of the relation between the board of director composition and financial statement fraud. The Accounting Review, 71: 443-465.
- Beattie, V. A., Goodacre, A., and Fearnley, S. 2003. And Then There Were Four: A Study of UK Audit Market Concentration - Causes, Consequences and the Scope for Market Adjustment. University of Stirling Discussion Paper, No. 03/03.
- Beatty, R. P. and Zajac, E. J. 1994. Managerial incentives, monitoring and risk bearing: a study of executive compensation, ownership, and board structure in initial public offerings. Administrative Science Quarterly, 39(2): 313-335.
- Beatty, R. and Welch, I. 1996. Issuer expenses and legal liability in initial public offerings. Journal of Law and Economics, 39: 545-602.
- Bebchuk, L. 1994. Efficient and inefficient sales of corporate control. . Quarterly Journal of Economics 109: 957-994.
- Bebchuk, L. 1999. A rent-protection theory of corporate ownership and control: National Bureau of Economic Research Working Paper 7203, Cambridge (MA).
- Bebchuk, L., Kraakman, R., and Triantis, G. 1999. Stock pyramids, cross-ownership, and dual class equity: The creation and agency costs of separating control from cash flow rights. : National Bureau of Economic Research Working Paper 6951, Cambridge (MA).
- Bebchuk, L. A. and Roe, M. J. 1999. A Theory of Path Dependence in Corporate Governance and Ownership. Columbia Law School, Center for Law and Economic Studies, Working Papers, No. 131.
- Beekes, W. and Brown, P. 2005. Do better governed Australian firms make more information disclosures? Mimeo, Lancaster.
- Beekun, R. I., Stedham, Y., and Young, G. J. 1998. Board characteristics, managerial controls and corporate strategy: A study of U.S. hospitals. Journal of Management, 24: 3-19.
- Bennedsen, M. and Wolfenzon, D. 2000. The balance of power in closely held corporations. Journal of Financial Economics, 58: 113-139.
- Berglöf, E. 1990. Capital structure as a mechanism of control: A comparison of financial systems. In B. Gustafsson & O. Williamson (Eds.), The Firm as a Nexus of Treaties: 237-262. Cambridge MA: MIT Press.
- Berglöf, E. 1991. Corporate control and capital structure : essays on property rights and financial contracts. Stockholm School of Economics : Distributed by IIB Institute of International Business, Stockholm.
- Berglöf, E. and Perotti, E. 1994. The governance structure of Japanese keiretsu. Journal of Financial Economics, 35: 45-57.
- Berle, A. A. and Means, G. C. 1932. The Modern Corporation and Private Property. New York: Macmillan.
- Berman, S., Wicks, A., Kotha, S., and Jones, T. M. 1999. 'Does stakeholder orientation

- matter? The relationship between stakeholder management models and firm financial performance'. Academy of Management Journal, 42(5): 488-505.
- Bethel, J. E. and Liebeskind, J. 1993. The Effects of Ownership Structure on Corporate Restructuring. Strategic Management Journal, 14 (special issue): 5-31.
- Beyer, J. and Hassel, A. 2002. The Effects of Convergence: Internationalisation and the Changing Distribution of Net Value Added in Large German Firms. Economy and Society, 31(3): 309-332.
- Bhagat, S., Shleifer, A., and Vishney, R. W. 1990. Hostile Takeovers in the 1980s: The Return to Corporate Specialization. In M. N. Baily & C. Winston (Eds.), Brookings Papers on Economic Activity: Microeconomics: 1-84. Washington DC: Brookings Institution.
- Bhagat, S. and Black, B. 1999. The uncertain relationship between board composition and firm performance. Business Lawyer, 54: 921-963.
- Bhattacharya, S. and Chiesa, G. 1995. Proprietary information, financial intermediation, and research incentives. Journal of Financial Intermediation, 4: 328-357.
- Bittlingmayer, G. 1998. The Market for Corporate Control (Including Takeovers). In B. Bouckaert & G. D. Geest (Eds.), Encyclopedia of Law and Economics: Edward Elgar.
- Black, B. S. 1992. Agents watching agents: the promise of institutional investor voice. UCLA Law Review, 39: 811-839.
- Black, B. and Coffee, J. 1994. Hail Britannia: institutional investor behaviour under limited regulation Michigan Law Review, 92: 1997-2087.
- Black, B. S. and Gilson, R. J. 1998. Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets. Journal of Financial Economics, 47: 243-277.
- Blackburn, S. 1999. Managing risk and achieving Turnbull compliance. Accountants' Digest, 417: 1-51.
- Blair, M. M. 1993. The Deal decade : what takeovers and leveraged buyouts mean for corporate governance. Washington, D.C.: Brookings Institution.
- Blair, M. 1995. Ownership and control: rethinking corporate governance for the twenty-first century. Washington.D.C: Brookings Institute.
- Blair, M. and Stout, L. A. 1999. A team production theory of corporate law. Virginia Law Review, 85: 247-328.
- Blair, M. M. and Stout, L. A. 2001. Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law. University of Pennsylvania Law Review, 149(June): 1735-1810.
- Blair, M. M. and Stout, L. A. 2006. Specific Investment and Corporate Law. European Business Organization Law Review.
- Blair, M. M. 2002. Post-Enron Reflections on Comparative Corporate Governance. Georgetown Law and Economics Research Paper, No. 316663.
- Boeker, W. 1992. Power and managerial dismissal: Scapegoating at the top. Administrative Science Quarterly, 37: 400-421.
- Boeker, W. and Goodstain, J. 1993. Performance and successor choice: the moderating effects of governance and ownership. Academy of Management Journal, 36: 172-186.
- Bond, S., Meghir, C., and Windmeijer, F. 1998. Productivity, Investment and the Threat of Takeover. Mimeo, Institute for Fiscal Studies, London.
- Boot, A. and Thakor, A. 1997a. Financial system architecture. Review of Financial Studies, 10: 693-733.

- Boot, A. and Thakor, A. 1997b. Banking scope and financial innovation. Review of Financial Studies, 10: 1099-1131.
- Borrie, G. and Dehn, G. 2001. Whistleblowing the new perspective [online] www.pcaw.co.uk/policy%5Fpub/newperspective.html [accessed 05/12/05.]
- Botosan, C. A. 1997. Disclosure level and the cost of equity capital The Accounting Review, 72(3): 3243-3349.
- Botosan, C. A. and Frost, C. 1998. Regulation, disclosure, and market liquidity. Mimeo, Washington University and Dartmouth College.
- Botosan, C. A. and Plumlee, L. A. 2002. A re-examination of disclosure level and the expected cost of equity capital. Journal of Accounting Research, 41(1): 21-40.
- Bowie, N. and Duska, R. 1990. Business Ethics. New Jersey: Prentice Hall.
- Boyd, B. K. 1994. Board control and CEO compensation. Strategic Management Journal, 15: 335-344. .
- Brady, G. F. and Helmich, D. L. 1984. Executive succession. Englewood Cliffs, NJ: Prentice Hall.
- Bratton, W. W. 2002. Enron and the Dark Side of Shareholder Value. Tulane Law Review, May: Forthcoming.
- Brav, A. and Gompers, P. A. 1997. Myth or reality? The long-run underperformance of initial public offerings: Evidence from venture and nonventure capital-backed companies. Journal of Finance, 52(5): 1791-1821.
- Brennan, N. 1999. Voluntary disclosure of profit forecasts by target companies in takeover bids. Journal of Business Finance and Accounting, 26: 883-918.
- Brett, M. 2003. Company owners need more say in pay. Estates gazette(322): 40.
- Brickley, J., Lease, R., and Smith, C. 1988. Ownership structure and voting on anti takeover amendments', Journal of Financial Economics. Journal of Financial Economics 20: 267-291.
- Brickley, J. A., Coles, J. L., and Terry, R. L. 1994. Outside directors and the adoption of poison pills. Journal of Financial Economics, 35: 371-390.
- Brinker Dozier, J. and Miceli, M. P. 1985. Potential predictors of whistle-blowing: A prosocial behavior perspective. Academy of Management Review, 10(4): 823-836.
- Bruce, A. and Buck, T. 1997. Executive reward and corporate governance. In K. Keasey & S. Thompson & M. Wright (Eds.), Corporate governance: Economic, management and financial issues. Oxford: Oxford University Press.
- Bruner, R. 2002. Does M&A Pay? A Survey of Evidence for the Decision-Maker. Journal of Applied Finance, 57: 1731-1761.
- Bruton, G., Ahlstrom, D., and Wan, J. 2003. Turnaround in East Asian firms: evidence from ethnic overseas Chinese communities. Strategic Management Journal, 24: 519-540.
- Buchholtz, A. K. and Ribbens, B. A. 1994. Role of chief executive officers in takeover resistance: Effects of CEO incentives and individual characteristics. Academy of Management Journal, 37: 554-579.
- Buck, T., Bruce, A., Main, B. G. M., and Udueni, H. 2003. Long term incentive plans, executive pay and UK company performance. Journal of Management Studies, 40(7): 1703-1721.
- Buck, T. and Sharhram, A. 2005. The Translation of Corporate Governance Changes Across National Cultures: The Case of Germany. Journal of International Business Studies, 36: 42-61.
- Bushee, B. J. and Noe, C. F. 2000. Disclosure quality, institutional investors, and stock return volatility. Journal of Accounting Research, 38 (Supplement): 171-202.

- Bushee, B. J. and Leuz, C. 2004. Economic consequences of SEC regulation: evidence from the OTC bulletin board. Mimeo, Wharton School.
- Bushman, R., Piotroski, J., and Smith, A. 2001. What determines corporate transparency? Mimeo, University of Chicago.
- Bushman, R., Piotroski, J., and Smith A. 2004. What determines corporate transparency? Journal of Accounting Research, 42(2): 207-252.
- Cadbury, A. 1992. Report of the committee on financial aspects of corporate governance (Cadbury Committee Report). London: Gee Publishing.
- Callaway Dee, C., Lulseged, A. A., and Nowlin, T. S. 2002. Earnings Quality and Auditor Independence: An Examination Using Non-audit Fee Data. Mimeo.
- Callen, J. L. a. M., Mindy. 2002. The Enron-Andersen Debacle: Do Equity Markets React to Auditor Reputation? EFMA 2003 Helsinki Meetings.
- Câmara, A. 2001. The pricing of relative performance based incentives for executive compensation. Journal of Business Finance and Accounting, 28(9/10): 1115.
- Campbell, A. 1997. Stakeholders: the case in favour. Long Range Planning, 30: 446-449.
- Cannella Jr, A. A., Frasier, D. R., and Lee, S. 1995. Firm failure and managerial labor markets: Evidence from Texas banking. Journal of Financial Economics, 38(2): 185-210.
- Canoy, M., Riyanto, Y. E., and Van Cayseele, P. 2001. Corporate takeovers, bargaining and managers' incentives to invest. Managerial and Decision Economics, 21(1): pg. 1.
- Carcello, J. V. and Neal, T. L. 2003. Audit committee independence and disclosure: choice for financially distressed firms. Corporate Governance: An International Review, 11(4): 289-299.
- Carlin, W. and Mayer, C. 2000. Finance, investment, and growth. Mimeo, Oxford.
- Carney, M. and Gedajlovic, E. 2002. The coupling of ownership control and the allocation of financial resources: evidence from Hong Kong. Journal of Management Studies, 39(1): 123-146.
- Carpenter, M. A. and Westphal, J. D. 2001. The Strategic Context of External Network Ties: Examining the Impact of Director Appointments on Board Involvement in Strategic Decision-making. Academy of Management Journal, 44: 639-660.
- Carpenter, M. A. 2002. The Implications of Strategy and Social Context for the Relationship Between Top Management Team Heterogeneity and Firm Performance. Strategic Management Journal, 23: 275-284.
- Carpenter, M. A., Pollock, T. G., and Leary, M. M. 2003. Testing a Model of Reasoned Risk-taking: Governance, the Experience of Principals and Agents, and Global Strategy in High-technology IPO Firms. Strategic Management Journal, 24: 803-820.
- Cartwright, S. C., Cary L. 1993. The Psychological Impact of Merger and Acquisition on the Individual: A Study of Building Society Managers. Human Relations, 46(3): 327-347.
- Certo, T., Daily, C., and Dalton, D. 2001. Wealth and the Effects of Founder Management Among IPO-Stage New Ventures. Strategic Management Journal, 22: 641-658. .
- Certo, T. S. 2003. Influencing initial public offering investors with prestige: signaling with board structures. Academy of Management Journal, 28(3): 432-446.
- Chaganti, R., Mahajan, S., and Sharma, S. 1985. Corporate Board Size, Composition and Corporate Failures in Retailing Industry. Journal of Management, 22: 400-417.

- Chahine, S. and Filatotchev, I. 2005. Signalling the firm's value: information disclosure, corporate governance, and performance of IPOs. Mimeo, King's College London.
- Chambers, A. 1995. Whistleblowing and the Internal Auditor. Business Ethics: A European Review, 4(4): 192-198.
- Chan, LKC, Kareceski, J and Lakonishok, J. (2003) Analysis' conflict of interest and biases in earnings forecasts. NBER Working paper 9544.
- Chang, S. and Hong, J. 2000. Economic performance of group-affiliated companies in Korea: Intragroup resource sharing and internal business transactions. Academy of Management Journal, 43: 429-448.
- Chang, S. 2003. Ownership structure, expropriation, and performance of group-affiliated companies in Korea. Academy of Management Journal, 46: 238-254. .
- Charkham, J. 1994. Keeping good company: a study of corporate governance in five countries. Oxford: Oxford University Press.
- Chatterjee, S. 1986. Types of Synergy and Economic Value: The Impact of Acquisitions on Merging and Rival Firms. Strategic Management Journal, 7: 119-139.
- Cheng, E. and Courtenay, S. 2004. Board composition, regulatory regime, and voluntary disclosure. Mimeo, Nanyang Business School, Singapore.
- Cho, M.-H. 1998. Ownership structure, investment, and the corporate value: an empirical analysis. Journal of Financial Economics, 47: 103-121.
- Chrisman, J. J. and Leslie, J. 1989. Strategic, administrative, and operative problems: The impact of outsiders on small firm performance. Entrepreneurship Theory and Practice, 4(2): 37-51.
- Citron, D., B. . 2003. The UK's framework approach to auditor independence and the commercialization of the accounting profession. Accounting, Auditing & Accountability Journal, 16(2): 244-274.
- City Code on Takeovers and Mergers. 2003-2004.
- Claessens, S., Djankov, S., and Lang, L. 2000. The separation of ownership and control in East Asian corporations. Journal of Financial Economics, 58: 81-112.
- Clarke, R. N., Conyon, M. J., and Peck, S. I. 1998. Corporate Governance and Directors' Remuneration: Views from the Top. Business Strategy Review, 9(4): 21-30.
- Cochran, P. L., Wood, R. A., and Jones, T. B. 1985. The composition of boards of directors and the incidence of golden parachutes. Academy of Management Journal, 28: 664-671.
- Coffee, J. 1991. Liquidity versus control: The institutional investor as corporate monitor. Columbia Law Review, 91: 1277-1368.
- Coffee Jr., J. C. 2003. "What Caused Enron?: A Capsule Social and Economic History of the 1990's. Columbia Law and Economics Working Paper No. 214.
- Coffee Jr., J. C. 2002. Understanding Enron: It's About the Gatekeepers, Stupid. Columbia Law & Economics Working Paper No.207.
- Cohen, J., Krishnamoorthy, G., and Wright, A. M. 2002. Corporate Governance and the Audit Process. Contemporary Accounting Research 19(4): 573-594.
- Coles, J. W. and Hesterly, W. S. 2000. Independence of the chairman and board composition: Firm choices and share-holder value. Journal of Management, 26: 195-214.
- Collett, P. and Hrasky, S. 2005. Voluntary disclosure of corporate governance practices by listed Australian companies. Corporate Governance: An International Review, 13(2): 188-196.

- Collier, P. and Gregory, A. 1999. Audit committee activity and agency costs. Journal of Accounting and Public Policy, 18(4-5): 311-332.
- Committee on Standards in Public Life. 2005. Getting the balance right. Implementing standards of conduct in public life.
- Companies Act (The). 1985.
- Companies Act (The). 1989.
- Companies (Audit, Investigations, and Community Enterprise) Act (The). 2004.
- Company Law Reform Bill. 2006.
- Company Law Reform. 2005. London: TSO.
- Company Law Steering Group. 2001. Modern Company Law for a Competitive Economy: Final Reports, Vols I and II. London: DTI.
- Company Securities (Insider Dealing) Act (The). 1985.
- Conyon, M. and Leech, D. 1994. Top pay, company performance, and corporate governance. Oxford bulletin of Economics and Statistics, 56(3): 229-247.
- Conyon, M. J. and Gregg, P. 1994. Pay at the top: A study of the sensitivity of top director remuneration to company specific shocks. National Institute Economic Review(149): 83.
- Conyon, M., Gregg, P., and Machin, S. 1995. Taking care of business: executive compensation in the United Kingdom. The Economic Journal, 105(430): 704-714.
- Conyon, M. J. 1997. Corporate governance and executive compensation. International Journal of Industrial Organization, 15(4): 493-509.
- Conyon, M. J. 1997. Institutional arrangements for setting directors' compensation in UK companies. In K. Keasey & S. Thompson & M. Wright (Eds.), Corporate Governance: Economic, Management and Financial Issues: 103-121. Oxford: Oxford University Press.
- Conyon, M. J. and Nicolitsas, D. 1998. Does the market for top executives work? CEO pay and turnover in small U.K. companies. Small Business Economics, 11(2): 145.
- Conyon, M. J. and Peck, S. I. 1998. Board control, remuneration committees and top management compensation. Academy of Management Journal, 41: 146-157.
- Conyon, M. J. 2000. Directors pay in UK Plc's. A guide to executive pay determination. London: Chartered Institute of Personnel and Development.
- Conyon, M. J. and Murphy, K. J. 2000. The prince and the pauper? CEO pay in the US and the UK. Economic Journal, 110: 640-671.
- Conyon, M. J., Peck, S. I., Read, L., and Sadler, G. V. 2000. The structure of executive compensation contracts: UK evidence. Long Range Planning, 33(4): 478-503.
- Conyon, M. J., Peck, S. I., and Sadler, G. 2000. Econometric modelling of UK executive compensation. Managerial Finance, 26(9): 3-20.
- Conyon, M. J. and Schwalbach, J. 2000. Executive Compensation: Evidence from the UK and Germany. Long Range Planning, 33(4): 504-526.
- Conyon, M., Peck, S., and Read, L. 2001. Performance pay and corporate structure in UK firms. European Management Journal 19(1): 73-82.
- Conyon, M. J. 2001. The Disclosure of UK Boardroom Pay: the March 2001 DTI proposals. Corporate Governance: An International Review, 9(4): 276-285.
- Conyon, M. J., Girma, S., Thompson, S., and Wright, P. 2001. Do hostile mergers destroy jobs? Journal of Economic Behavior & Organization, 45(4): pg. 427.
- Conyon, M. J., Peck, S. I., and Sadler, G. V. 2001. Corporate tournaments and executive compensation: Evidence from the U.K. Strategic Management Journal, 22(8): 805.

- Conyon, M. J. and Sadler, G. V. 2001. CEO compensation, option incentives, and information disclosure. Review of Financial Economics, 10(3): 251-277.
- Conyon, M. J. and Sadler, G. V. 2001. Executive pay, tournaments and corporate performance in UK firms. International Journal of Management Reviews, 3(2): 141.
- Conyon, M., J. , Mallin, C., and Sadler, G. 2002. The disclosure of directors' share option information in UK companies. Applied Financial Economics, 12(2): 95-103.
- Conyon, M. J., Girma, S., Thompson, S., and Wright, P. 2002. The Impact of Mergers and Acquisitions on Company Employment in the United Kingdom. European Economic Review, 46: 31-49.
- Conyon, M. and Lerong, H. 2004. Compensation committees and CEO compensation incentives in US entrepreneurial firms. Mimeo.
- Cooke, R. 1991. Danger signs of unethical behavior: How to determine if your firm is at ethical risk. Journal of Business Ethics, 41(4): 249.
- Copeland, T. and Galai, D. 1983. Information effects on a bid-ask spread. Journal of Finance, 38(5): 1457-1469.
- Corbett, J. 1994. An overview of the Japanese financial system. In J. Dimsdale & M. Prevezer (Eds.).
- Core, J. E. 2001. A review of the empirical disclosure literature: discussion. Journal of Accounting and Economics, 31 (1-3): 441-456.
- Cornu, P. I., Dusan. 2000. The Detering Role of the Medium of Payment in Takeover Contests: Theory and Evidence from the UK. European Financial Management, 6(4).
- Cosh, A., Hughes, A., and Singh, A. 1984. The Causes and Effects of Takeovers in the UK: An Empirical Investigation for the late 1960s at the Macroeconomic Level. University of Cambridge, Department of Applied Economics, Economic Reprint(87).
- Cosh, A. 1990. Takeovers and short-termism in the UK. London: Institute for Public Policy Research.
- Cox, P., Brammer, S., and Millington, A. 2004. An empirical examination of institutional investor preferences for corporate social performance. Journal of Business Ethics, 52(1): 27-43.
- Cranston, R. M. 2005. Whistleblowing [online] www.parliament.the-stationery-office.co.uk/pa/cm200405/cmhansrd/cm050405/halltext/50405h05.htm#50405h05_head0 [accessed 02/12/05].
- Criminal Justice Act (The). 1993.
- Cully, M., Woodland, S., O'Reilly, A., and Dix, G. 1999. Britain at Work. London.: Routledge.
- D'Aveni, R. 1990. Top Managerial Prestige and Organizational Bankruptcy. Organization Science, 1: 121-142.
- D'Aveni, R. A. and Kesner, I. F. 1993. Top Managerial Prestige, Power and Tender Offer Response: A Study of Elite Social Networks and Target Firm Cooperation During Takeovers. Organization Science, 4: 123-151.
- Dahya, J. and Powell, R. 1998. Ownership structure, managerial turnover and takeovers: Further U.K. evidence on the market for corporate control. Multinational Finance Journal, 2(1): pg. 63, 23 pgs.
- Dahya, J. and Powell, R. 1999. Top Management Changes Following Hostile and Friendly Take-overs. ACCA Research Report No. 61, London.
- Daily, C. M. and Dalton , D. R. 1992. The relationship between governance structure

- and corporate performance in entrepreneurial firms. Journal of Business Venturing, 7(5): 375-386.
- Daily, C. M. and Dalton, D. R. 1994. Bankruptcy and Corporate Governance: The Impact of Board Composition and Structure. Academy of Management Journal, 37: 1603-1617.
- Daily, C. M. 1995. The relationship between board composition and leadership structure and bankruptcy reorganization outcomes. Journal of Management, 21: 1041-1056.
- Daily, C. M. and Schwenk, C. 1996. Chief executive officers, top management teams, and board of directors: Congruent or countervailing forces? Journal of Management, 22: 185-208.
- Daily, C. M., Johnson, J. L., Ellstrand, A. E., and Dalton, D. R. 1998. Compensation committee composition as a determinant of CEO compensation. Academy of Management Journal, 41(2): 209-220.
- Daily, C. M., Johnson, J. L., and Dalton, D. R. 1999. On the Measurements of Board Composition: Poor Consistency and a Serious Mismatch of Theory and Operationalization. Decision Sciences, 30: 83-106.
- Daily, C., McDougall, P., Covin, J., and Dalton, D. 2002. Governance and strategic leadership in entrepreneurial firms. Journal of Management, 28(3): 387-412.
- Daily, C., Dalton, D., and Rajagopalan, N. 2003. Governance through ownership: centuries of practice, decades of research. Academy of Management Journal, 46: 115-158.
- Daily, C. M., Dalton, D. R., and Canella, A. A. 2003. Corporate Governance: Decades of Dialog and data. . Academy of Management Review, 28(3): 371-398.
- Dallas, L. 2003. A Preliminary Inquiry into the Responsibility of Corporations and Their Directors and Officers for Corporate Climate: The Psychology of Enron's Demise. Rutgers Law Journal, 35.
- Dalton, D. R., Daily, C. M., Ellstrand, A. E., and Johnson, J. L. 1998. Meta-analytic review of board composition, leadership structure, and financial performance. Strategic Management Journal 19: 269-290.
- Dalton, D. R., Daily, C. M., Johnson, J., and Ellstrand, A. 1999. Number of Directors and Financial Performance: A Meta-Analysis. Academy of Management Journal, 42: 674-686.
- Dalton, D., Daily, C., Certo, S., and Roengpitya, R. 2003. Meta-analysis of financial performance and equity: fusion or confusion? Academy of Management Journal, 46: 13-26.
- Danbolt, J. 2000. Cross-Border Acquisitions into the UK - An Analysis of Target Company returns. University of Glasgow, Working Paper.
- Datta, D., Pinches, G., and Narayanan, V. 1992. Factors Influencing Wealth Creation from Mergers and Acquisitions: A Meta-Analysis. Strategic Management Journal, 13(1): 67-84.
- David, P., Kochhar R., and Levitas, E. 1998. The effects of institutional investors on level and mix of CEO compensation. Academy of Management Journal, 41: 200-208.
- Davis, G. F. and Stout, S. K. 1992. Organization Theory and the Market for Corporate Control: a Dynamic Analysis of the Characteristics of Large Takeover Targets 1980-1990. Administrative Science Quarterly, 37: 605-633.
- Davis, G. F., Diekmann, K. A., and Tinsley, C. H. 1994. The Decline and Fall of the Conglomerate Firm in the 1980s: The De-institutionalization of an Organizational Form. American Sociological Review, 59: 547-570.

- Davis, J. H., Schoorman, F. D., and Donaldson, L. 1997. Towards a stewardship theory of management. Academy of Management Review, 22: 20-47.
- De Bakker, F., Groenewegen, P., and Den Hond, F. 2005. A bibliometric analysis of 30 years of research and theory on corporate social responsibility and corporate social performance. Business and Society, 44(3): 283-317.
- De Jong, H. W. 1992. Der Markt für Unternehmenskontrolle. Eine historische, theoretische und empirische Betrachtung. In H. Gröner (Ed.), Der Markt für Unternehmenskontrollen: 141-159. Berlin: Duncker & Humblot.
- De Jong, H. W. 1996. European Capitalism Between Freedom and Social Justice. In W. Bratton & J. McCahery & S. Picciotto & C. Scott (Eds.), International Regulatory Competition and Coordination: Perspectives on Economic Regulation in Europe and the United States: 185-206. Oxford: Clarendon Press.
- Deakin, S. and Cook. J. 2000. Economic Effects of Criminal and Civil Sactions in the Context of Company Law. (www.dti.gov.uk/cld/review.htm)
- Deakin, S., Hobbs, R., Nash, D., and Slinger, G. 2002. Implicit contracts, takeovers and corporate governance: in the shadow of the city code. ESRC Centre for Business Research - Working Papers., wp254.
- Dechow, P., Hutton, A., and Sloan, R. 2000. The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings. Contemporary Accounting Research, 17(Spring): 1-32.
- Dechow, P. M., and Schrand, C. M. 2004. Earnings Quality, CFA Publications. <http://www.cfapubs.org/rf/issues/v2004n3/toc.html>
- DeFond, M. L., Raghunandan, K., and Subramanyam, K. R. 2002. Do Non-audit Service Fees Impair Auditor Independence? Evidence from Going-concern Audit Opinions. USC Leventhal School of Accounting.
- Degryse, H. and Van Cayseele, P. 1998. Relationship lending with a bank-based system', mimeo, Tilburg.
- Deloitte. 2005. Options take a hit but what will take their place? The 2005 Deloitte stock compensation survey: Deloitte Development LLC.
- Deloitte & Touche. 2004. Report on the impact of the Directors' Remuneration Report Regulations. A report for the Department of Trade and Industry. London: Deloitte & Touche LLP.
- Demb, A. and Neubauer, F. 1992. The Corporate Board. Confronting the Paradoxes. . New York: Oxford University Press.
- Deminor Ratings. 2005. Application of the one share - one vote principle in Europe. Brussels. [online] http://www.abi.org.uk/BookShop/ResearchReports/DEMINOR_REPORT.pdf
- Demirag, I. 1998. Board of Directors' Short-term Perceptions and Evidence of Managerial Short-termism in the UK. The European Journal of Finance, 4(3): 195-211.
- Demsetz, H. 1983. The structure of ownership and the theory of the firm. Journal of Law and Economics, 26: 375-390.
- Demsetz, H. and Lehn, K. 1985. The structure of corporate ownership: Causes and consequences. Journal of Political Economy, 93: 1155-1177.
- Denis, D. and Sarin, A. 1999. Ownership and board structures in publicly traded corporations. Journal of Financial Economics, 52: 187-223.
- Deutsch, Y. 2005. The impact of board composition on firm's critical decisions: a meta-analytic review. Journal of Management, 31(3): 424-444.
- Dewatripont, M. and Tirole, J. 1994. A theory of debt and equity. Diversity of securities and management-shareholders congruence. Quarterly Journal of

- Economics, 109: 1027-1054.
- Dewing, P. and Russell, P. O. 2004. Regulation of UK corporate governance: lessons from accounting, audit and financial services. Corporate Governance, 12(1): 107-115.
- DeZoort, F. T. 1998. An Analysis of Experience Effects on Audit Committee Members' Oversight Judgments. Accounting, Organizations and Society, 23(1): 1-21.
- Diacon, S. R. and O'Sullivan, N. 1995. Does corporate governance influence performance? Some evidence from U.K. insurance companies. International Review of Law and Economics, 15: 405-424.
- Diamond, D. and Verrechia, R. 1991. Disclosure, liquidity, and the cost of equity capital. Journal of Finance, 46(4): 1325-1360.
- Dickerson, A. P. G., Heather D.; Tsakalotos, Euclid. 1998. Takeover Risk and Dividend Strategy: A Study of UK Firms. The Journal of Industrial Economics, XLVI(3).
- Dickerson, A. P., Gibson, Heather D, Tsakalotos, Euclid. 2002. Takeover risk and the market for corporate control: The experience of British firms in the 1970s and 1980s. International Journal of Industrial Organization 20(8): pg. 1167.
- Dittmann, I. and Maug, E. 2003. Lower salaries and no options? On the optimal structure of executive pay: ECGI Finance Working Paper No. 032/2003.
- Dodd, P. and Ruback, R. 1977. Tender Offers and Stockholder Returns: An Empirical Analysis. Journal of Financial Economics, 5: 351-374.
- Donaldson, T. 1989. The Ethics of International Business. Oxford: Oxford University Press.
- Donaldson, T. and Preston, L. 1995. The stakeholder theory of the corporation: concepts, evidence, and implications. Academy of Management Review 20: 65-91.
- Dong, M., Hirshleifer, D. A., Richardson, S. A., and Teoh, S. H. 2003. Does Investor Misvaluation Drive the Takeover Market? EFA 2003 Annual Conference Paper, No. 652.
- Donnelly, S., Gamble, A., Jackson, G., and Parkinson, J. 2000. The Public Interest and the Company in Germany and Britain. London: Anglo-German Foundation.
- Dore, R. 2005. Deviant or Different? Corporate Governance in Japan and Germany. Corporate Governance: An International Review, 13(3): 437-446.
- Draper, P. and Paudyal, K. 1999. Corporate takeovers: Mode of payment, returns and trading activity. Journal of Business Finance & Accounting, 26(5/6): 521-538.
- DTI. 1998. Modern Company Law for a Competitive Economy. London: DTI.
- DTI. 2002. Modernising Company Law. London: DTI.
- DTI. 2004. Information and Consultation of Employees Regulations. London: DTI.
- DTI. 2006. Implementation of the EU Directive of Takeover Bids. Guidance on changes to the rules on company takeovers. London: DTI.
- Dunne, P. G., Falk, H., Forker, J., and Powell, R. 2005. Information Quality, Auditor Reputation and Capitalization Effects: The Legacy of Enron.
- Dyck, I. 2000. Ownership structure, legal protection and corporate governance: Mimeo, Harvard Business School.
- Dyson Report. 2003. Recruitment and Development of Non-executive Directors.
- Edelsten, M. 2005. Manage reward or reward new management. Executive Compensation Review, 297(November 2005): 21-23.
- Edwards, J. and Fischer, K. 1996. Banks, Finance, and Investment in Germany. Cambridge: Cambridge University Press.

- Egginton, D., Forker, J., and Grout, P. 1993. Executive and employee share options: Taxation, dilution and disclosure. Accounting & Business Research, 23(91A): 363-372.
- Eisenhardt, K. M. 1989. Agency theory: an assessment and review. Academy of Management Review, 14(1): 57-74.
- El-Gazzar, S. M. 1998. Predisclosure information and institutional ownership: A cross-sectional examination of market revaluations during earnings announcement periods. The Accounting Review, 73: 119-129.
- Elsas, R. and Krahnert, J. P. 1998. Is relationship lending special? Evidence from credit file data in Germany. Journal of Banking & Finance, 22: 1283-1316.
- Emmanuel, C. and Garrod, N. 2004. Rules- versus judgement-based accounting in the UK'. Journal of Accounting and Public Policy, 23(6): 441-455.
- Employment Relations Act (The). 1999.
- Ensley, M. D., Pearson, A. W., and Amason, A. C. 2002. Understanding the Dynamics of New Venture Top Management Teams: Cohesion, Conflict, and New Venture Performance. Journal of Business Venturing, 17(4): 365-386.
- Enterprise Act (The). 2002.
- ESRC. 2003. The UK's Productivity Gap: What Research Tells Us and What We Need to Find Out. London: London School of Economics.
- European Foundation. 2004. European works councils in practice. Dublin: European Foundation for the Improvement of Living and Working Conditions.
- European Takeover Directive. 2004. 25/EC
- Ezzamel, M. and Watson, R. 1998. Market comparison earnings and the bidding up of executive cash compensations: evidence from the United Kingdom. The Academy of Management Journal, 41(2): 221-231.
- Faccio, M. and Lasfer, M. 2000. Do occupational pension funds monitor companies in which they hold large stakes? Journal of Corporate Finance, 6: 71-110.
- Fama, E. F. 1980. Agency problems and the theory of the firm. Journal of Political Economy, 88(8): 288-307.
- Fama, E. F. and Jensen, M. C. 1983. Separation of ownership and control. Journal of Law and Economics, 26: 301-325.
- Fama, E. F. 1985. What's different about banks? Journal of Monetary Economics, 15: 5-29.
- Fearnley, S., Hines, T., McBride, K., and Brandt, R. 2002. The impact of the financial reporting review panel on aspects of the independence of auditors and their attitudes to compliance in the UK. The British Accounting Review, 34(2): 109-139.
- Felo, A. J., Krishnamurthy, S., and Solieri, S. A. 2003. Audit Committee Characteristics and the Perceived Quality of Financial Reporting: An Empirical Analysis. Mimeo.
- Filatotchev, I. and Bishop, K. 2002. Board Composition, Share Ownership and Underpricing' of UK IPO Firms. Strategic Management Journal, 23: 941-955.
- Filatotchev, I. and Toms, S. 2003. Corporate Governance, Strategy and Survival in a Declining Industry: A study of UK Cotton Textile Companies. Journal of Management Studies, 40(4): 895-920.
- Filatotchev, I. and Wright, M. (Eds.). 2005. Corporate Governance Life-Cycle. London: Edward Elgar.
- Financial Accounting Standards Board. 1982. Statement of Financial Accounting Standards No. 57. (Related Party Disclosures). Connecticut: Financial Accounting Standards Board.

- Financial Director. 2006. The Annual Audit Fees Survey [online]
http://images.vnunet.com/v7_images/pdf/aa/fd-audit-fees-2005.pdf
- Financial Reporting Council. 2005. Internal control: Revised guidance for directors on the combined code (Turnbull Guidance). London: The Financial Reporting Council.
- Financial Reporting Council. 2006. Review of the 2003 combined Code on corporate Governance. London: The Financial Reporting Council.
- Financial Services and Markets Act (The). 2000.
- Financial Services Authority. 2003. The Combined Code on Corporate Governance. London: Financial Services Authority.
- Financial Services Authority. 2005. Listing, Prospectus and Disclosure Rules. London: FSA.
- Finkelstein, S. and Hambrick, D. C. 1996. Strategic Leaderships: Top Executives and their Organizations. Minneapolis.: West Educational Publishing.
- Finkelstein, S. and Boyd, B. 1998. How much does the CEO matter? The role of managerial discretion in the setting of CEO compensation. Academy of Management Journal, 41: 179-199.
- Fiss, P. C. 2005. A Set-Theoretic Approach to Organizational Configurations. Academy of Management Review.
- Fitzroy, F. R. and Kraft, K. 2005. Codetermination, efficiency, and productivity. British Journal of Industrial Relations, 43(2): 233-247.
- Fizel, J. L. and Louie, K. K. T. 1990. CEO retention, firm performance, and corporate governance. Managerial and Decision Economics, 11: 167-176.
- Fligstein, N. 1990. The Transformation of Corporate Control. Cambridge, MA: Harvard University Press.
- Forker, J. 1992. Corporate governance and disclosure quality. Accounting and Business Research, 22(86): 111-124.
- Forsyth, M. and Raj, M. 2002. Hostile bidders, long-term performance, and restructuring methods: Evidence from the UK. American Business Review 20(1): pg. 71, 11 pgs.
- Forsyth, M. and Raj, M. 2003. Hubris amongst UK Bidders and Losses to Shareholders. International Journal of Business, 8(1): 1-16.
- Forth, J. and Millward, N. 2002. The Growth of Direct Communication. London.: CIPD.
- Foster, M. and Meinhard, A. 2002. Corporate social responsibility in the Canadian context: the new role of the corporation in community involvement and social issues. Mimeo, Ryerson University.
- Francis, J. R. 2004. What do we know about audit quality? The British Accounting Review, 36(4): 345-368.
- Frankel, R. M., Johnson, M. F., and Nelson, K. K. 2002. The relation between auditors' fees for non-audit services and earnings quality. MIT Sloan School of Management, Working Paper, No. 4330-02.
- Frankel, R. M. and Li, X. 2004. Characteristics of a firm's information environment and the information asymmetry between insiders and outsiders. Journal of Accounting and Economics, 37(2): 229-259.
- Franks, J. R. and Harris, R. 1989. Wealth effects of take-overs in the UK. Journal of Financial Economics: p.225-241.
- Franks, J. and Mayer, C. 1996. Hostile Takeovers in the UK and the Correction of Managerial Failure. Journal of Financial Economics, 40: 163-181.
- Franks, J. and Mayer, C. 1997. Corporate ownership and control in the UK, Germany,

- and France. Journal of Applied Corporate Finance, 9: 30-45.
- Fredrickson, J. W., Hambrick, D. C., and Baumrin, S. 1988. A model of CEO dismissal. Academy of Management Journal, 13: 255-271.
- Freeman, R. and Medoff, J. 1984. What do unions do? New York: Basic Books.
- Freeman, R. E. 1984. Strategic Management: A Stakeholder Approach. Boston.: Pitman.
- Frege, C. 2002. Theoretical and Empirical Research on German Works Councils: A Critical Assessment. British Journal of Industrial Relations, 40(2): 221-248.
- Frick, B., Speckbacher, G., and Wentges, P. 1999. Arbeitnehmerbestimmung und moderne Theorie der Unternehmung. Zeitschrift für Betriebswirtschaft, 69(7): 745-763.
- Frick, B. and Lehmann, E. 2004. Corporate governance in Germany: ownership, codetermination, and firm performance in a stakeholder economy. In H. Gospel & A. Pendleton (Eds.), Corporate Governance and Labour Management. Oxford: Oxford University Press.
- Friedman, M. 1962. Capitalism and Freedom. Chicago: Chicago University Press.
- Frooman, J. 1997. Socially irresponsible and illegal behavior and shareholder wealth: a meta analysis of event studies. Business and Society, 36: 221-249.
- Gamble, A. and Kelly, G. 2001. Shareholder value and the stakeholder debate in the UK. Corporate Governance: An International Review, 9(2): 110-117.
- Gaved, M. 1997. Closing the Gap: Disclosure and Institutional Shareholders. London: ICAEW.
- Gaved, M. 1998. Institutional Investors and Corporate Governance. London: Foundation for Business Responsibility.
- Geletkanysz, M. and Hambrick, D. 1997. The External Ties of Top Executives: Implications for Strategic Choice and Performance. Administrative Science Quarterly, 42: 654-681.
- Gerke, W., Garz, H., and Oerke, M. 1995. Die Bewertung von Unternehmensübernahmen auf dem deutschen Aktienmarkt. Zeitschrift für betriebswirtschaftliche Forschung, 47: 805-820.
- Gibbs, P. 1993. Determinants of Corporate Restructuring: The Relative Importance of Corporate Governance, Takeover Threat, and Free Cash Flow. Strategic Management Journal, 14: 51-68.
- Gietzmann, M. and Ireland, J. 2004. Cost of capital, strategic disclosures, and Accounting Choice. Mimeo, London School of Economics.
- Gillan, S. L. and Martin, J. D. 2002. Financial Engineering, Corporate Governance, and the Collapse of Enron. U of Delaware Coll. of Bus. and Econ. Ctr. for Corp. Governance, Working Paper No. 2002-001.
- Gilson, S. C. 1989. Management turnover and financial distress. Journal of Financial Economics, 25: 241-262. .
- Gilson, S. C. 1990. Bankruptcy, boards, banks and blockholders. Journal of Financial Economics, 27: 355-387.
- Gilson, R. and Roe, M. 1993. Understanding the Japanese Keiretsu: Overlaps between corporate governance and industrial organization. Yale Law Journal, 102: 871-906.
- Gilson, Ronald J. and Kraakman, Reinier H.,2004 "MOME in Hindsight" . Regulation, Vol. 27, No. 4, pp. 64-72
- Glassman, C. A. and Rhoades, S. A. 1980. Owner vs manager control effects on bank performance. Review of Economics and Statistics, 62: 263-270.
- Glosten, L. and Milgrom, P. 1985. Bid, Ask, and Transaction Prices in a specialist

- market with heterogeneously informed traders. Journal of Financial Economics, 14(1): 71-100.
- Goddard, A. R. and Masters, C. 2000. Audit committees, Cadbury Code and audit fees: an empirical analysis of UK companies. Managerial Auditing Journal, 15(7): 358-371.
- Goergen, M. and Renneboog, L. 2004. Shareholder wealth effects of European domestic and crossborder takeover bids. European Financial Management, 10: 9-45.
- Goergen, M., Renneboog, L., and Martynova, M. 2005. Corporate Governance Convergence: Evidence From Takeover Regulation Reforms in Europe. Oxford Review of Economic Policy, 21 (2), 243-268.
- Golden, B. R. and Zajac, E. J. 2001. When Will Boards Influence Strategy? Inclination x Power = Strategic Change. Strategic Management Journal, 22: 1087-1111.
- Gomes-Mejia, L., Nunez-Nickel, M., and Guttierrez, I. 2001. The role of family ties in agency contracts. Academy of Management Journal, 44: 81-95.
- Gomes-Mejia, L., Larraza-Kintana, M., and Makri, M. 2003. The determinants of executive compensation in family-controlled public corporations. Academy of Management Journal, 46: 226-237.
- Goodstain J and W., B. 1991. Turbulence at the Top: A New Perspective on Governance Structure Changes and Strategic Change. Academy of Management Journal, 34: 306-330.
- Gordon, J. N. 2002. What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections. University of Chicago Law Review, Summer.
- Gorton, G. and Schmid, F. 2000. Class struggle inside the firm: a study of German codetermination, Federal Reserve Bank of St Louis, Working Paper 2000-25.
- Gospel, H., Lockwood, G., and Willman, P. 2003. A British Dilemma: Disclosure of Information for Collective Bargaining and Joint Consultation. Comparative Labor Law and Policy Journal, 22(2): 101-123.
- Gospel, H. and Willman, P. 2003. Dilemmas in Worker Representation – Information, Consultation, and Negotiation. In H. Gospel & S. Wood (Eds.), Representing Workers: Trade Union Recognition and Membership in Britain: 144-165. London: Routledge.
- Gospel, H. and Pendleton, A. (Eds.). 2004. Corporate Governance and Labour Management. Oxford: Oxford University Press.
- Grabosky, P. N. 1995. Using Non-Governmental Resources to Foster Regulatory Compliance. Governance: An International Journal of Policy and Administration, 8(4): 527-550.
- Graves, S. and Waddock, S. 1994. Institutional owners and corporate social performance. Academy of Management Journal, 37(4): 1035-1046.
- Greenbury, S. R. 1995. Director's remuneration report of a study group chaired by Sir Richard Greenbury (Greenbury Report). London: Gee Publishing Ltd.
- Greenley, G. and Foxall, G. R. 1997. Multiple stakeholder orientation in UK companies and the implications for company performance. Journal of Management Studies, 34(2): 259-284.
- Gregg, P., Machin, S., and Symanski, S. 1993. The disappearing relationship between directors pay and corporate performance. British Journal of Industrial Relations, 31(1): 1-9.
- Gregory, A. and McCorriston, S. 2002. Foreign acquisitions by UK limited companies: long-run performance in the US, Continental Europe and the rest of the world.

- Working Paper, Financial Markets Research Centre, University of Exeter.
- Griffin, J. J. and Mahon, J. F. 1997. The corporate social performance and corporate financial performance debate: 25 years of incomparable research. Business and Society, 36(1): 5-31.
- Grossman, S. and Hart, O. 1980. Disclosure laws and takeover bids. Journal of Finance, 35: 323-334.
- Grossman, S. 1981. The informational role of warranties and private disclosure about product quality Journal of Law and Economics, 24: 461-483.
- Grossman, S. J. and Hart, O. D. 1988. One share-one vote and the market for corporate control. Journal of Financial Economics 20: 175-202.
- Groves, J. 1999. Identifying, developing and effectively implementing a risk management methodology which suits your company's operating strategy and corporate culture. Paper presented at the Proactively Managing Business Risk and Ensuring Effective Internal Control in the Light of the Combined Code and the New Turnbull Committee Report, London.
- Gulati, R. and Westphal, J. 1999. Cooperative or Controlling? The Effects of CEO-Board Relations and the Content of Interlocks on the Formation of Joint Ventures. Administrative Science Quarterly, 44: 473-506.
- Hall, P. A. and Soskice, D. 2001. Varieties of Capitalism: The Institutional Foundations of Comparative Advantage. Oxford: Oxford University Press.
- Hall, P. A. and Gingerich, D. W. 2003. Varieties of Capitalism and Institutional Complementarities in the Macroeconomy: An Empirical Analysis. Max-Planck-Institut für Gesellschaftsforschung, Discussion Paper.
- Hallock, K. and Murphy, K. 1999. The Economics of Executive Compensation: Edward Elgar Publishing Ltd.
- Hambrick, D. and Mason, P. 1984. Upper Echelons: The Organization as a Reflection of its Top Managers. Academy of Management Journal, 9: 193-206.
- Hambrick, D. C. and D'Aveni, R. A. 1992. Top team deterioration as part of the downward spiral of large corporate bankruptcies. Management Science, 38: 1445-1466.
- Hambrick, D. and Jackson, E. 2000. Outside Directors with Stake: The Linchpin in Improving Governance. California Management Review, 42: 108-127.
- Hampel, R. 1998. Committee on corporate governance: final report (Hampel Committee Report). London: Gee Publishing.
- Hampel, R. 1998. Committee on corporate governance: the combined code. London: Gee Publishing.
- Hannah, L. 1986. Inventing Retirement. Cambridge: Cambridge University Press.
- Hansmann, H. 1996. The ownership of enterprise. Cambridge: Harvard University Press.
- Harhoff, D. and Körting, T. 1998. Lending relationships in Germany. Journal of Banking & Finance, 22: 1317-1353.
- Harris, M. and Raviv, A. 1988. Corporate governance. Voting rights and majority rules. Journal of Financial Economics 20: 203-235.
- Harris, M. and Raviv, A. 1990. Capital structure and the information role of debt. Journal of Finance, 45: 321-350.
- Harrison, J. S. and Freeman, R. E. 1999. Stakeholders, social responsibility, and performance: empirical evidence and theoretical perspectives. Academy of Management Journal, 42: 479-487.
- Hart, O. 1995. Corporate governance some theory and implications. Economic Journal, 105(430): 678-689.

- Hart, O. 1995. Firms, Contracts and Financial Structure. Oxford: Oxford University Press.
- Hart, O. 2001. Financial contracting. Journal of Economic Literature, 39: 1079-1100.
- Haspeslagh, P. and Jemison, D. 1991. Managing Acquisitions: Creating Value Through Corporate Renewal. New York: Free Press.
- Hayek, F. 1969. The corporation in a democratic society: in whose interests ought it and will it be run. In H. Ansoff (Ed.), Business Strategy. Harmondsworth: Penguin.
- Hayward, M. and Hambrick, D. 1997. Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubbris. Administrative Science Quarterly, 42: 103-127.
- Health and Safety (Consultation with Employees) Regulations. 1996.
- Healy, P., Hutton, A., and Palepu, K. G. 1999. Stock performance and intermediation changes surrounding sustained increases in disclosure Contemporary Accounting Research, Fall 1999: 485-520.
- Healy, P. and Palepu, K. G. 2001. Information asymmetry, corporate disclosure, and the capital market: A review of the empirical disclosure literature. Journal of Accounting and Economics, 31(1-3): 405-440.
- Helbok, G. and Walker, M. 2003. On the willingness of UK companies to issue profit warnings. Mimeo, Manchester.
- Hempel, P. and Fay, C. 1994. Outside director compensation and firm performance. Human Resource Management, 33: 111-133.
- Hendry, C., Woodward, S., Harvey-Cook, J., and Gaved, M. 1999. Investors' views of people management. Corporate Governance: An International Review, 7(4): 324.
- Hendry, J. 2002. The Principal's Other Problems: Honest Incompetence and the Specification of Objectives. Academy of Management Review, 27: 98-113.
- Hermalin, B. E. and Weisbach, M. S. 1991. The effects of board composition and direct incentives on firm performance. Financial Management 20: 101-112.
- Hermalin, B. and Weisbach, M. 1998. Endogenously Chosen Boards of Directors and Their Monitoring of the CEO. American Economic Review 88: 96-118.
- Hermalin, B. and Weisbach, M. 2003. Boards of directors as an Endogenously determined institution: a survey of the economics literature. Economic Policy Review, 9: 7-26.
- Higgins, M. and Gulati, R. 1999. Getting off to a Start: The Effects of Upper Echelon Affiliations on Prestige of Investment Bank and IPO Success: Working Paper, Harvard Business School.
- Higgs, D. 2003. Review of the role and effectiveness of non-executive directors. London: HMSO.
- Higson, C. and Elliot, J. 1998. Post-takeover Returns: The UK Evidence. Journal of Empirical Finance, 5: 27-46.
- Hill, C. W. L. and Snell, S. A. 1988. External control, corporate strategy, and firm performance in research-intensive industries. Strategic Management Journal, 9: 577-590.
- Hill, S. 1995. The social organization of boards of directors. The British Journal of Sociology, 46: 245-278.
- Hillman, A., Cannella Jr, A. A., and Paetzold, R. L. 2000. The resource dependence role of corporate directors: Strategic adaptation of board composition in response to environmental change. Journal of Management Studies, 37: 235-255.

- Hillman, A. J. and Dalziel, T. 2003. Boards of directors and firm performance: Integrating agency and resource dependence perspectives. Academy of Management Review, 28(3): 383-396.
- Himmelberg, C., Hubbard, R., and Palia, D. 1999. Understanding the determinants of managerial ownership and the link between ownership and performance. Journal of Financial Economics, 53: 353-384.
- Hirschleifer, J. 1973. Where are we in the theory of information? American Economic Review, 63(2): 31-39.
- Hirschman, A. O. 1972. Exit, Voice, and Loyalty. Responses to Decline in Firms, Organizations, and States. Cambridge, MA: Harvard University Press.
- Hirshy, M., Slovin, M. B., and Zaima, J. K. 1990. Bank debt, insider trading, and the return to corporate sell-offs. Journal of Banking & Finance, 14: 85-98.
- Hitt, M. A., Hoskisson, R. E., Johnson, D., and Moesel, D. 1996. The Market for Corporate Control and Firm Innovation. Academy of management Journal, 39(5): 1084-1119.
- HM Revenue and Customs. 2005. Annual Statistics.
- HM Treasury. 2004. Myners principles for institutional investment decision-making: review progress. London: HMSO
- Holderness, C. and Sheehan, D. 1988. The role of majority shareholders in publicly held corporations. Journal of Financial Economics 20: 317-346.
- Holl, P. K., Dimitris. 1997. Wealth Creation and Bid Resistance in U.K. Takeover Bids. Strategic Management Journal, 18(6): 483-498.
- Holland, J. 1994. Bank lending relationships and the complex nature of bank-corporate relations. Journal of Business Finance & Accounting, 21: 367-393.
- Holland, J. 1997. Corporate communications to institutional shareholders. Edinburgh: Institute of Chartered Accountants of Scotland.
- Holland, J. 2005. A grounded theory of corporate disclosure: mimeo, Glasgow University.
- Holmstrom, B. and Kaplan, S. 2001. Corporate Governance and Merger Activity in the US: Making Sense of the 80's and 90's. Journal of Economic Perspectives: 121-144.
- Höpner, M. 2001. Corporate Governance in Transition: Ten Empirical Findings on Shareholder Value and Industrial Relations in Germany. MPIfG Discussion Paper 01 / 5, Köln: Max-Planck-Institut für Gesellschaftsforschung.
- Höpner, M. and Jackson, G. 2001. An Emerging Market for Corporate Control? The Case of Mannesmann and German Corporate Governance. MPIfG Discussion Paper 01 / 4, Köln: Max-Planck-Institut für Gesellschaftsforschung.
- Hoskisson, R. E., Johnson, R. A., and Moesel, D. D. 1994. Corporate divestiture intensity in restructuring firms: Effects of governance, strategy and performance. Academy of Management Journal, 37: 1207-1251.
- Hoskisson, R. E., Hitt, M. A., Johnson, R. A., and Grossman, W. 2002. Conflicting voices: The effects of institutional ownership heterogeneity and internal governance on corporate innovation strategies. Academy of Management Journal, 45: 697-716.
- Hoskisson, R., Cannella, A., Tihanyi, L., and Faraci, R. 2004. Asset restructuring and business group affiliation in French civil law countries. Strategic Management Journal, 25: 525-539.
- Humphrey, C. and Moizer, P. 1990. From Techniques to Ideologies: An Alternative Perspective on the Audit Function. Critical Perspectives on Accounting, 1(3): 217-238.

- Humphrey, C., Moizer, P., and Turley, S. 1992. *The Audit Expectations Gap in the United Kingdom*. London: Institute of Chartered Accountants in England and Wales.
- Hunter, J. and Schmidt, F. 1990. Methods of Meta-Analysis: Correcting Error and Bias in Research Findings. Beverly Hills, CA: Sage.
- Hussainey, K., Schleicher, T., and Walker, M. 2003. Undertaking large-scale disclosure studies when AIMR-FAF ratings are not available: the case of prices leading earnings. Accounting and Business Research, 33(4): 275-294.
- Hussainey, K., Schleicher, T., and Walker, M. 2004. The information content of the annual report narratives of loss making firms: preliminary evidence: mimeo, Manchester University.
- Hutton, W. 1997. Stakeholding and its critics. London: London.
- Hutton, A. 2002. The Role of Sell-Side Analysts in the Enron Debacle. Working Paper, Harvard Business School.
- IDS. 2005. Incentive schemes boost FTSE 100 directors' earnings. Executive Compensation Review, 297 (November 2005): 4-7.
- IFRS2. 2005. The International Accounting Standard for Share-based Payments.
- Informa Group. 2003. The Review: Corporate Governance Handbook. London: Informa Group.
- Information and Consultation of Employees Regulations. 2004.
- Insolvency Act (The). 1986.
- IRS Employment Review. 2000. Growing use of variable pay packages for UK executives. IRS Employment Review (696): 8.
- ISC. 2002. The responsibilities of institutional shareholders and agents – Statement of principles. London: Institutional Shareholders' Committee.
- Jackson, G. and Vitols, S. 2001. Between Financial Commitment, Market Liquidity and Corporate Governance: Occupational Pensions in Britain, Germany, Japan and the USA. In B. Ebbinghaus & P. Manow (Eds.), Comparing Welfare Capitalism. Social Policy and Political Economy in Europe, Japan and the USA: 171-189. London: Routledge.
- Jackson, G. 2003. Corporate Governance in Germany and Japan: Liberalization Pressures and Responses. In K. Yamamura & W. Streeck (Eds.), The End of Diversity? Prospects for German and Japanese Capitalism: 261-305. Ithaca, NY: Cornell University Press.
- Jackson, G. 2005a. Employee Representation in the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism, and Political Institutions Industrielle Beziehungen, 12(3): 1-28.
- Jackson, G. 2005b. Stakeholders under Pressure: Corporate Governance and Labour Management in Germany and Japan. Corporate Governance: An International Review, 13(3): 419-428.
- Jackson, G. 2006. Modeling Complementarity: Multiple Functions and Different Levels. Socio-Economic Review, forthcoming.
- James, C. 1987. Some evidence of the uniqueness of bank loans. Journal of Financial Economics 19: 217-235.
- James, C. and Weir, P. 1990. Borrowing relationships, intermediation, and the cost of issuing public securities. Journal of Financial Economics, 28: 149-171.
- James, H. 1999. Owner as manager, extended horizons and the family firm. International Journal of the Economics of Business, 6(1): 41-55.
- Jarrell, G., Brickley, J., and Netter, J. 1988. The Market for Corporate Control: The Empirical Evidence since 1980. Journal of Economic Perspectives, 2(1): 49-68.

- Jenkinson, T. and Mayer, C. 1994. Hostile Takeovers. London: McGraw-Hill.
- Jensen, M. C. and Meckling, W. H. 1976. Theory of the firm: Managerial behavior, agency costs, and ownership structure. Journal of Financial Economics, 3: 305-360.
- Jensen, M. C. and Ruback, R. 1983. The Market for Corporate Control: The Scientific Evidence. Journal of Financial Economics, 11: 5-50.
- Jensen, M. C. 1986. Agency costs of free cash flow, corporate finance, and takeovers. American Economic Review, 76: 323-329.
- Jensen, M. C. and Warner, J. B. 1988. The distribution of power among corporate managers, shareholders, and directors. . Journal of Financial Economics 20: 3-24.
- Jensen, M. 1993. The modern industrial revolution, exit, and the failure of internal control systems. Journal of Finance, 48: 831-880.
- Johnson, R. A., Hoskisson, R. E., and Hitt, M. A. 1993. Board of director involvement in restructuring: The effects of board versus managerial controls and characteristics. Strategic Management Journal, 14: 33-50.
- Johnson, J. L., Daily, C. M., and Ellstrand, E. 1996. Board of directors: A review and research agenda. Journal of Management, 22: 409-438.
- Johnson, R. B. 1997. The board of directors over time: Composition and the organizational life cycle. International Journal of Management, 14: 339-344.
- Johnson, R. and Greening, D. 1999. The effects of corporate governance and institutional ownership types on corporate social responsibility. Academy of Management Journal, 42(5): 564-576.
- Jones, T. M. 1995. Instrumental stakeholder theory: a synthesis of ethics and economics. Academy of Management Review 20: 305-360.
- Jovanovic, B. and Rousseau, P. L. 2002. The Q-theory of mergers. American Economic Review, 92: 198-204.
- Jubb, P. 1999. Whistleblowing: A Restrictive Definition and Interpretation. Journal of Business Ethics, 21(1): 77-94.
- Judge, W. Q. and Dobbins, G. H. 1995. Antecedents and effects of outside directors' awareness of CEO decision style. Journal of Management, 21: 43-64.
- Judge Jr, W. Q. and Zeithaml, C. P. 1992. Institutional and strategic choice perspectives on board involvement in the strategic decision process. Academy of Management Journal, 35: 766-794.
- Kakabadse, N. and Kakabadse, A. 2004. Pension fund governance: an overview of the role of trustees. International Journal of Business, Governance and Ethics, 1(1): 3-26.
- Kalbers, L. P. and Fogarty, T. J. 1998. Organizational and Economic Explanations of Audit Committee Oversight. Journal of Managerial Issues, 10(2): 129-151.
- Kaplan, S. and Reishus, D. 1990. Outside directors and corporate performance. Journal of Financial Economics, 27: 389-410.
- Kay, J. The Foundations of Corporate Success. Oxford: Oxford University Press.
- Kay, J. and Silberston, A. 1995. Corporate governance. National Institute for Economic and Social Research, 84: 84-97.
- Kay, J. 1997. The stakeholder corporation. In G. Kelly, et al. (Ed.), Stakeholder capitalism, Macmillan, London. London: Macmillan.
- Keasey, K. and Wright, M. 1993. Issues in Corporate Accountability and Governance: An Editorial. Accounting and Business Research, 23: 291-303.
- Keasey, K., Thompson, S., and Wright, M. 1997. Introduction: the corporate governance problem – competing diagnoses and solutions. In K. Keasey & S.

- Thompson & M. Wright (Eds.), Corporate governance: economic, management, and financial issues. Oxford: Oxford University Press.
- Kelly, G. and Parkinson, J. 1998. The conceptual foundations of the corporation: a pluralist approach. Corporation, Financial, and Insolvency Law Review, 2: 174-197.
- Kennedy, R. J. and Limmack, V. A.. 1996. Take-over Activity, CEO Turnover and the Market for Corporate Control. Journal of Business Finance & Accounting, 23: 267-285.
- Kerr, J. and Bettis, R. A. 1987. Boards of directors, top management compensation, and shareholders returns. Academy of Management Journal, 30: 645-664.
- Kesner, I. 1987. Directors' Characteristics and Committee Membership: An Investigation of Type, Occupation, Tenure and Gender. Academy of Management Journal, 31: 66-84.
- Kesner, J. L. and Johnson, R. B. 1990. An investigation of the relationship between board composition and stockholder suits. Strategic Management Journal, 11: 327-226.
- Kester, W. C. 1990. Japanese takeovers : the global contest for corporate control. Boston, Mass.: Harvard Business School Press.
- Kester, W. C. 1996. American and Japanese Corporate Governance: Convergence to Best Practice? In S. Berger & R. Dore (Eds.), National Diversity and Global Capitalism: 107. Ithaca, NY: Cornell University Press.
- King, D. R., Dalton, D. R., Daily, C. M., and Covin, J. G. 2004. Meta-Analysis of Post-Acquisitions Performance: Indications of Unidentified Moderators. Strategic Management Journal, 25: 187-200.
- Kini, O., Kracaw, W., and Mian, S. 1995. Corporate Takeovers, Firm Performance and Board Composition. Journal of Finance, 1: 383-412.
- Kirkbride, J. and Letza, S. 2004. Regulation, Governance and Regulatory Collibration: achieving an "holistic" approach. Corporate Governance, Vol. 12, No.1, p.85-92.
- Klein, A. 2000. Audit Committee, Board of Director Characteristics, and Earnings Management.
- Klein, A. 2002. Audit committee, board of directors' characteristics, and earnings management. Journal of Accounting and Economics, 33(3): 375-400.
- Kochar, R. and David, P. 1996. Institutional investors and firm innovation: a test of conflicting hypotheses. Strategic Management Journal, 17: 73-84.
- Konstantinos, S., Espenlaub, S., and Walker, M. 2004. U.K. Executive Compensation Practices: New Economy versus Old Economy. Journal of Management Accounting Research, 16: 57-92.
- Kosnik, D. R. 1987. Greenmail: A study in board performance in corporate governance. Administrative Science Quarterly, 32: 163-185.
- Kraakman, R. 1988. Taking Discounts Seriously: The Implications of Discounted Shares Prices as an Acquisition Motive. Columbia Law Review, 88: 891-941.
- Kraft, K. and Stank, J. 2004. Die Auswirkungen der gesetzlichen Mitbestimmung auf die Innovationsaktivitäten deutscher Unternehmen. Schmollers Jahrbuch, 124: 421-449.
- Kyle, A. 1985. Continuous auctions and insider trade. Econometrica, 53(6): 1315-1335.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R. 1998. Law and finance. Journal of Political Economy, 106: 1113-1155.
- La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. 1999. Corporate ownership around the world. Journal of Finance, 54: 471-517.

- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R. 2000. Investor protection and corporate valuation. Mimeo, Harvard University.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R. 2000. Investor protection and corporate governance. Journal of Financial Economics, 58: 3-27.
- Laing, D. and Weir, C., M. . 1999. Governance structures, size and corporate performance in UK firms. Management Decision, 37(5): 457-464.
- Lambert, R. A. 2001. Contracting theory and accounting. Journal of Accounting and Economics, 32(1): 3-87.
- Lane, C. and Bachmann, R. 1998. Trust Within and Between Organizations. Oxford: Oxford University Press.
- Lang, L. H. P., R. Stulz, and Walkling, R. A. 1989. Managerial performance, Tobin's q, and the gains from successful tender offers. Journal of Financial Economics, 24: 137-154.
- Lang, M. and Lundholm, R. 1993. Cross sectional determinants of analysts rating of corporate disclosure. Journal of Accounting Research, 31 246-271.
- Lang, M. and Lundholm, R. 1996. Corporate disclosure policy and analyst behavior. Accounting Review, 71: 467-492.
- Lang, M. and Lundholm, R. 2000. Voluntary disclosure during equity offerings: reducing information asymmetry or hyping the stock? Contemporary Accounting Research, 17(4): 623-663.
- Langevoort, D. C. 2001. The human nature of corporate boards: laws, norms, and the unintended consequences of independence and accountability. Georgetown Law Journal, 89: 797-832.
- LaPorta, R., Lopez-de-Silanes, F., Shleifer, A., and Vishny, R. 1998. Corporate ownership around the world. Journal of Finance, 54: 471-518.
- LaPorta, R., Lopez-de-Silanes, F., and Shleifer, A. 2004. What works in securities laws? Journal of Finance, forthcoming.
- Larcker, D. F. and Richardson, S. A. 2003. Corporate Governance, Fees for Non-audit Services and Accrual Choices.
- Larcker, D. S., Richardson, S., and Tuna, A. 2005. How important is corporate governance? , <http://ssrn.com/abstract=595821>.
- Laverty, K. J. 1996. Economic "short-termism": The debate, the unresolved issues, and the implications for management practice and research. Academy of Management Review, 21: 825-860.
- Leech, D. and Leahy, J. 1991. Ownership structure, control type classifications and the performance of large British companies. Economic Journal, 101: 1418-1437.
- Leone, A., Rock, S., and Willenborg, M. 2003. Disclosure of intended use of proceeds and underpricing in initial public offerings: Working Paper, University of Connecticut.
- Lepsius, M. R. 1990. Interessen, Ideen und Institutionen. Opladen: Westdeutsche Verlag.
- Lerner, J. 1995. Venture Capitalists and the Oversight of Private Firms. Journal of Finance, 50: 301-318.
- Letza, S., Sun, X., and Kirkbride, J. 2004. Shareholding versus stakeholding: a critical review of corporate governance. Corporate Governance: An International Review, 12(3): 242-262.
- Leuz, C. and Verrechia, R. E. 2000. The economic consequences of increased disclosure. Journal of Accounting Research, 38: 91-124.
- Levine, P. and Aaronovitch, S. 1981. The Financial Characteristics of Firms and Theories of Merger Activity. Journal of Industrial Economics, XXX: 149-172.

- Levine, R., Loayza, N., and Beck, T. 2000. Financial intermediation and growth: causality and causes. Journal of Monetary Economics, 46: 31-77.
- Lewis, D. 2001. Whistleblowing at Work. London: Continuum.
- Limited Liability Partnerships Act (The). 2004.
- Lin, H. and McNichols, M. 1998. Underwriting Relationships and Analysts' Forecasts and Investment Recommendations. Journal of Accounting and Economics, 25: 101-127.
- Lombardo, D. and Pagano, M. 2000. Legal determinants of the return on equity: CEPR Discussion Paper, London.
- Lorsch, J. W. and MacIver, E. 1989. Pawns or Potentates. The Reality of America's Corporate Boards. Boston, MA: Harvard Business School.
- Lowenstein, L. 1985. Management Buyouts. Columbia Law Review, 85: 730-784.
- Lummer, S. L. and McConnell, J. 1989. Further evidence on the bank lending process and the capital market response to bank loan agreements. Journal of Financial Economics, 25: 99-122.
- Luoma, P. and Goodstein, J. 1998. Stakeholders and corporate boards: institutional influences on board composition and structure. Academy of Management Journal, 42(5): 553-563.
- Lynall, M. D., Goden, B. R., and Hillman, A. J. 2003. Board composition from adolescence to maturity: a multitheoretic view. Academy of Management Review, 28(3): 416-431.
- Mace, M. 1971. Directors: Myth and reality. Boston: Harvard Business School Press.
- Macey, J. and Miller, G. 1997. Universal banks are not the answer to America's corporate governance "problem": a look at Germany, Japan and the US. Journal of Applied Corporate Finance, 9: 57-73.
- Main, B. G. M. and Johnston, J. 1993. Remuneration committees and corporate governance. Accounting & Business Research, 23(91A): 351-362.
- Main, B. G. M., Bruce, A., and Buck, T. 1996. Total board remuneration and company performance. The Economic Journal, 106(439): 1627-1644.
- Mak, Y. and Li, Y. 2001. Determinants of Corporate Ownership and Board Structure: Evidence from Singapore. Journal of Corporate Finance, 7: 235-256.
- Mallette, P. and Fowler, K. L. 1992. Effects of board composition and stock ownership on the adoption of poison pills. Academy of Management Journal, 35: 1010-1035.
- Mangel, R. and Singh, H. 1993. Ownership structure, board relationship and CEO compensation in large U.S. corporations. Accounting & Business Research, 23: 339-350.
- Mangena, M. and Pike, R. 2004. Shareholding of audit committee members, audit committee size and expertise, and the quality of interim financial reporting. Mimeo, Bradford.
- Manigart, S., DeWaele, K., Wright, M., Robbie, K., Desbrières, P., Sapienza, H., and Beekman, A. 2002. Determinants of Required Return in Venture Capital Investments: A Five-country Study. Journal of Business Venturing, 17: 291-312.
- Manne, H. 1965. Mergers and the Market for Corporate Control. Journal of Political Economy, 73(2): 110-120.
- Marris, R. 1964. The Economic Theory of Managerial Capitalism. New York: The Free Press.
- Marston, C. 1999. Investor relations meetings: views of companies, institutional investors, and analysts. Edinburgh: Institute of Chartered Accountants of

- Scotland.
- Martin, K. J. and McConnell, J. J. 1991. Corporate Performance, Corporate Takeovers, and Management Turnover. Journal of Finance, 46: 671-688.
- Martin, B. 2000. The Whistleblower's Handbook: How to Be an Effective Resister Oxford: Jon Carpenter Publishing.
- Maug, E. 1998. Large shareholders as monitors: Is there a trade-off between liquidity and control? Journal of Finance, 53: 65-92.
- McConaughy, D., Matthews, C., and Fialko, A. 2001. Founding family controlled firms: Performance, risk and value. Journal of Small Business Management, 39: 31-49.
- McConnell, J. and Servaes, H. 1990. Additional evidence on equity ownership and corporate value. Journal of Financial Economics, 27: 595-612.
- McGuire, J. B., Sundgren, A., and Schneeweis, T. 1988. Corporate social responsibility and firm financial performance. Academy of Management Journal, 31(4): 854-872.
- McMillan, I. C., Kulow, D. M., and Khoynian, R. 1988. Venture capitalists' involvement in their investments: Extent and performance. Journal of Business Venturing, 4: 27-47.
- McMullen, D. A. 1996. Audit committee performance: an investigation of the consequences associated with audit committees. Auditing, 15(1): 87-103.
- McNulty, T. and Pettigrew, A. 1999. Strategists on the board. Organization Science 20: 47-74.
- Meeks, G. K., Roberts, C. B., and Gray, S. J. 1995. Factors influencing voluntary annual report disclosures by US, UK, and continental European multinational corporations. Journal of International Business Studies, 26: 555-573. .
- Meggison, W. L. and Weiss, K. A. 1991. Venture Capitalist Certification in Initial Public Offerings. Journal of Finance, 96: 879-903.
- Melis, A. 2004. Financial reporting, corporate communication, and governance. Corporate Ownership and Control, 1(2): 31-31.
- Menon, K. and Williams, J. D. 1994. The Use of Audit Committees for Monitoring. Journal of Accounting and Public Policy, 13: 121-139.
- Metcalf, D. 2005. Trade unions: resurgence or perdition? In S. Fernie & D. Metcalf (Eds.), Trade unions: resurgence or demise. London.: Routledge.
- Meyrick-Jones, J. 1999. Effective strategies to ensure you overcome the barrier of corporate culture when adopting a proactive risk management approach. Paper presented at the Proactively Managing Business Risk and Ensuring Effective Internal Control in the Light of the Combined Code and the New Turnbull Committee Report, London.
- Michaely, R. and Womack, K. L. 1999. Conflicts of Interest and the Credibility of Underwriter Analyst Recommendations. Review of Accounting Studies, 12(4): 653-686.
- Mickiewicz, T. and Filatotchev, I. 2005. Private Benefits of Control and Debt Financing. Mimeo, King's College London.
- Mikkelson, W. H. and Rubak, R. S. 1985. An empirical analysis of the interfirm equity investment process. Journal of Financial Economics, 14: 523-553.
- Miles, D. undated. Testing for short-termism in the UK stock market. Bank of England, Working papers, 4.
- Milgrom, P. 1981. Good news and bad news. Econometrica, 12(2): 380-391.
- Milgrom, P. R. and Roberts, J. 1990. Rationalizability, Learning, and Equilibrium in Games with Strategic Complementarities. Econometrica, 59(1255-1277).

- Milgrom, P. R. and Roberts, J. 1994. Complementarities and systems: Understanding Japanese economic organization. Estudios Economicos, 9(1): 3-42.
- Milgrom, P. R. and Roberts, J. 1995. Complementarities, industrial strategy, structure, and change in manufacturing. Journal of Accounting and Economics 19: 179-208.
- Mizruchi, M. 1983. Who controls whom? An examination of the relationship between management and boards of directors in large American corporations. Academy of Management Review, 8: 426-435.
- Mizruchi, M. S. and Stearns, L. B. 1994. A longitudinal study of borrowing by large American corporations. Administrative Science Quarterly, 39(1): 11-19.
- Mizruchi, M. 1996. What do interlocks do? An analysis, critique, and assessment of research on interlocking directorates. Annual Review of Sociology, 22: 271-298.
- Modigliani, F. and Miller, M. H. 1958. The cost of capital, corporate finance, and the theory of investment. American Economic Review, 48(4): 261-297.
- Modigliani, F. and Perotti, E. 1997. Protection of minority interest and the development of security markets. Managerial and Decision Economics, 18: 519-528.
- Molz, R. 1988. Managerial domination of boards of directors and financial performance. Journal of Business Research, 16: 235-249.
- Morck, R., Shleifer, A., and Vishny, R. 1988. Management ownership and market valuation: An empirical analysis. Journal of Financial Economics 20: 293-316.
- Morck, R., Shleifer, A., and Vishny, R. W. 1988. Characteristics of Targets of Hostile and Friendly Takeovers. In A. J. Auerbach (Ed.), Corporate Takeovers: Causes and Consequences: 101-129. Chicago, IL: University of Chicago Press.
- Morck, R., Strangeland, D., and Yeung, B. 1998. Inherited wealth, corporate control and economic growth: The Canadian disease?: National Bureau of Economic Research Working Paper 6814, Cambridge (MA).
- Morris, R. 1995. Cracking the Cadbury code. Management Today, April 1995: 48-51.
- Mulherin, J. H. and Boone, A. L. 2000. Comparing acquisitions and divestitures. Journal of Corporate Finance, 6: 117-139.
- Murphy, K. 1985. Corporate performance and managerial remuneration: An empirical study. Journal of Accounting and Economics, 7(1-3): 11-42.
- Murphy, K. 1999. Executive compensation. In O. Ashenfelter & D. Card (Eds.), Handbook of Labour Economics Vol 3A. Amsterdam: North Holland.
- Murphy, K. J. 2003. Stock-based pay in new economy firms. Journal of Accounting and Economics, 34(1-3): 129-147.
- Myers, S. C. Capital structure. Journal of Economic Perspectives, 15(2): 81-102.
- Myers, C. A. 1983. Top management featherbedding? . Sloan Management Review, 24(4): 55-58. .
- Myers, S. C. and Majluf, N. S. 1984. Corporate financing and investment decisions when firms have information that investors do not have. Journal of Financial Economics 20: 187-221.
- Myners, P. 2001. Institutional investment in the United Kingdom: A Review (Myners Review).
- Myners Report. 2004. Review of the impediments to voting UK shares". Report to the Shareholder Voting Working Group.
- National Statistics. 2005. Private Pension Scheme Membership. London: Office of National Statistics.
- Nobes, C. W. and Parker, R. 2002. Comparative International Accounting. London: Pearson Education.

- North, D. 2001. The Role of Managerial Incentives in Corporate Acquisitions: the 1990s Evidence. Journal of Corporate Finance, 7: 125-149.
- Nowak, M. J. and McCabe, M. 2003. Information costs and the role of the independent corporate director. Corporate Governance: An International Review, 11(4): 300-307.
- Nunnenkamp, P. 1996. The German model of corporate governance, basic features, critical issues and applicability to transition economies: Working Paper 713. Kiel Institute of World Economics.
- Nuttall, R. 1999a. Takeover Likelihood Models for UK Quoted Companies. Nuffield College, University of Oxford, Working Paper(No. 6).
- Nuttall, R. 1999b. An Empirical Analysis of the Effects of the Threat of Takeover on UK Company Performance. Nuffield College, University of Oxford, Working Paper (5).
- O'Connor, S. M. 2002. The inevitability of Enron and the impossibility of "auditor independence" under the current audit system. University of Pittsburgh School of Law, Unpublished paper.
- O'Connor, S. M. 2004. Be Careful What You wish For: How Accountants and Congress Created the Problem of Auditor Independence. British Columbia Law Review.
- O'Sullivan, M. 2000. Contests for Corporate Control. Oxford: Oxford University Press.
- O'Sullivan, N. 2000a. Managers as Monitors: An Analysis of the Non-Executive Role of Senior Executives in UK Companies. British Journal of Management, 10: 17-29.
- O'Sullivan, N. 2000b. The impact of board composition and ownership on audit quality: evidence from large UK companies. The British Accounting Review, 32(4): 397-414.
- Ocasio, W. 1994. Political dynamics and the circulation of power: CEO succession in U.S. industrial corporations 1960-1990. Administrative Science Quarterly, 39: 285-312.
- Ongena, S. and Smith, D. C. 1998. The duration of bank relationships: mimeo, University of Florida.
- Ongena, S. and Smith, D. 2000. Bank relationships: a review. In P. Harker & S. A. Zenios (Eds.), The performance of financial institutions. Cambridge: Cambridge University Press.
- Orlitzky, M. 2000. Corporate social performance: developing effective strategies: mimeo, Australian Graduate School of Management, Sydney.
- Oswald, S. and Jahera, J. 1991. The influence of ownership on performance: An empirical study. Strategic Management Journal, 12: 321-326.
- Pagano, M. and Röell, A. 1998. The choice of stock ownership structure: Agency costs, monitoring, and the decision to go public. Quarterly Journal of Economics, 113: 187-225.
- Page, J.P. 2005. Corporate Governance and Value Creation. Charlottesville, VA: Research Foundation of the CFA Institute.
- Palepu, K. and Healy, P. M. 2003. The Fall of Enron. Journal of Economic Perspectives, 17(2): 3-26.
- Parkinson, J. 1993. Corporate Power and Responsibility. Issues in the Theory of Company Law. Oxford: Oxford University Press.
- Parkinson, J. 1995. The role of exit and voice in Corporate Governance. In S. Sheikh & W. Rees (Eds.), Corporate governance and corporate control. London.: Cavendish.

- Parkinson, J. and Kelly, G. 2001. The Conceptual Foundations of the Firm. In J. Parkinson & A. Gamble & G. Kelly (Eds.), The Political Economy of the Company: 113-140. Oxford, UK: Hart Publishing.
- Parkinson, J. 2003. Models of the Company and the Employment Relationship. British Journal of Industrial Relations, 41(September): 481-509.
- Pass, C. L., Robinson, A., and Ward, D. 2000. Performance criteria of corporate option and long term incentive plans: a survey of 150 companies 1994-1998. Management Decision, 38(2): 130-137.
- Pass, C. L. 2003. Long-term incentive schemes, executive remuneration and corporate performance: An empirical study. Corporate Governance, 3(4): 18-27.
- Pearce, J. and Zahra, S. 1991. The Relative Power of CEOs and Boards of Directors: Associations with Corporate Performance. Strategic Management Journal, 12: 135-153.
- Peasnell, K. V., Pope, P., and Young, S. 2000. Accrual Management to Meet Earnings Targets: UK Evidence Pre- and Post Cadbury. British Accounting Review, 32(December). 415-445.
- Peccei, R., Bewley, H., Gospel, H., and Willman, P. 2005a. 'Is it Good to Talk? Information Disclosure and Organizational Performance in the UK. British Journal of Industrial Relations, 43(1): 11-37.
- Peccei, R., Bewley, H., Gospel, H., and Willman, P. 2005b. Look who's talking: sources of variation in information disclosure in the UK: mimeo, King's College London.
- Pensions Act. 2004.
- Pendleton, A. 1997. Employees as shareholders. In A. Gamble et al. (Ed.), Stakeholder Capitalism. London: Macmillan.
- Pendleton, A. 2001. Employee Ownership, Participation and Governance. London.: Routledge.
- Perotti, E. and Van Thadden, E. 2004. The political economy of bank and market dominance: mimeo, Tinbergen.
- Petersen, M. A. and Rajan, R. G. 1994. The benefits of lending relationships: evidence from small business data. Journal of Finance, 49: 3-37.
- Petersen, M. A. and Rajan, R. G. 1995. The effects of credit market competition on lending relationships. Quarterly Journal of Economics, 110: 406-443.
- Pettigrew, A. M. 1992. On Studying Managerial Elites. Strategic Management Journal, 13: 163-182.
- Pettigrew, A. and McNulty, T. 1995. Power and Influence in and Around the Boardroom. Human Relations, 48: 845- 873.
- Pettigrew, A. M. and McNulty, T. 1998. Sources and uses of power in the boardroom. European Journal of Work and Organizational Psychology, 7(2): 197-214.
- Pettigrew, A. M. and McNulty, T. 1998. Control and creativity in the boardroom. In D. C. Hambrick & Nadler, D. A & M. L. Tushman (Eds.), Navigating Change: How CEOs, Top Teams and Boards Steer Transformation: 226-255. Boston, MA: Harvard Business School Press.
- Pfeffer, J. 1972. Size and Composition of Corporate Boards of Directors: The Organization and Its Environment. Administrative Science Quarterly, 17: 218-222.
- Pfeffer, J. 1972. Mergers as a Response to Organizational Interdependence. Administrative Science Quarterly, 17(3): 382-394.
- Pfeffer, J. and Salancik. 1978. The external control of organizations: A resource dependence perspective. New York: Harper & Row.

- Pieterse, J. N. 1994. Globalization as Hybridization. International Sociology, 9(2): 161-184.
- Pistor, K. 1999. Codetermination: A Sociopolitical Model with Governance Externalities. In M. M. Blair & M. J. Roe (Eds.), Employees and Corporate Governance: 163-193. Washington, DC: Brookings Institution.
- Plender, J. 1997. A stake in the future: the stakeholder solution. London: Nicholas Brealey.
- Podolny, J. M. 2001. Networks As the Pipes and Prisms of the Market. American Journal of Sociology, 107(1): 33-60.
- Pound, J. 1988. Proxy contests and the efficiency of shareholder oversight. Journal of Financial Economics 20: 237-265.
- Powell, R. 1997. Modelling take-over likelihood. Journal of Business Finance & Accounting, 24: 1009-1030.
- Powell, R. and Stark, A. W. 2004. Does Operating Performance Increase Post-takeover for UK Takeovers? A Comparison of Performance Measures and Benchmarks. Journal of Corporate Finance, Forthcoming.
- Power, M. 1997. The Audit Society. Rituals of Verification. Oxford: Oxford University Press.
- Prentice, R. A. 2000. The case of the irrational auditor: A behavioral insight into securities fraud litigation. Nw. U. L. Rev., 95: 1333.
- Preston, A. M., Cooper, D. J., and Scarborough, P. 1995. Transformations in the Code of Ethics of the US Accounting Profession 1917 and 1988: Changing Narratives of Legitimation. Accounting, Organizations and Society 20(6): 507-546.
- Provan, K. 1980. Board Power and Organizational Efficiency Among Human Service Agencies. Academy of Management Journal, 23: 221-236.
- Public Concern at Work. 2003. Workplace whistleblowing doubles [online] www.whistleblowing.org.uk/news/press_28.html, [accessed 02/12/05].
- Pye, A. 2001. A Study in Studying Corporate Boards Over Time: Looking Backwards to Move Forwards. British Journal of Management, 12: 33-45.
- Pye, A. 2002. Corporate directing: Governing, strategising and leading in action. Corporate Governance, 10: 153-162.
- Pye, A. and Pettigrew, A. 2005. Studying board context, process and dynamics: Some challenges for the future. British Journal of Management, 16: S27-S38.
- Rajan, R. and Zingales, L. 1998. Financial dependence and growth. American Economic Review, 88(3): 559-586.
- Rau, R. and Vermaelen, T. 1998. Glamour, Value, and the Post-Acquisition Performance of Acquiring Firms. Journal of Financial Economics, 49: 223-254.
- Rediker, K. J. and Seth, A. 1995. Boards of Directors and Substitution Effects of Alternative Governance Mechanisms. Strategic Management Journal, 16: 85-99.
- Reinstein, A. and Weirich, T., R. . 1996. Testing for bias in the audit committee. Managerial Auditing Journal, 11(2): 28-35.
- Renneboog, L., Simons, T., and Wright, M. 2005. Leveraged Public to Private Transactions in the UK. ECGI - Finance Working Paper, No. 78.
- Reynolds, K. and Francis, J. 2001. Does size matter? The influence of large clients on office-level auditor reporting decisions. . Journal of Accounting and Economics, 30: 375-400.
- Rhoades, D. L., Rechner, P. L., and Sundaramurthy, C. 2000. Board composition and financial performance: A meta-analysis of the influence of outside directors. Journal of Managerial Issues, 12: 76-91.

- Richardson, A. J. and Welker, M. 2001. Social disclosure, financial disclosure, and the cost of equity capital. Accounting, Organisations, and Society, 26: 597-616.
- Roberts, J. and Styles, P. 1999. The Relationship Between Chairmen and Chief Executives: Competitive or Complementary Roles? Long Range Planning, 32: 36-48.
- Roberts, J., McNulty, T., and Styles, P. 2005. Beyond agency conceptions of the work of the non-executive directors: creating accountability in the boardroom. British Journal of Management, 16: 5-26.
- Robinson, A. and Zhang, H. 2005. Employee share ownership: safeguarding investments in human capital. British Journal of Industrial Relations, 43(3): 469-488.
- Roe, M. J. 1990. Political and legal restraints on ownership and control of public companies. Journal of Financial Economics, 27: 7-42.
- Roe, M. J. 1999. Codetermination and German Securities Markets. In M. M. Blair & M. J. Roe (Eds.), Employees and Corporate Governance: 194-205. Washington, DC: Brookings Institution.
- Roll, R. 1986. The Hubris Hypothesis of Corporate Takeovers. Journal of Business, 59: 197-216.
- Romano, R. 2004. The Sarbanes-Oxley Act and the Making of Quack Corporate Governance. Yale ICF Working Paper, No. 04-37.
- Rosen, S. 1990. Contracts and the markets for executives. In e. b. L. W. a. H. Wijkander (Ed.). Oxford: NBER Working Paper, No. W3542.
- Rosenstein, J. 1988. The board and strategy: Venture capital and high technology. Journal of Business Venturing, 3: 159-170.
- Rosenstein, S. and Wyatt, J. 1990. Outside directors, board independence, and shareholder Wealth. Journal of Financial Economics, 26: 175-184.
- Rosenstein, J., Bruno, A., Bygrave, W. D., and Taylor, N. T. 1993. The CEO, venture capitalists, and the board. Journal of British Venturing, 8: 99-113.
- Roulstone, D. 2002. Analyst following and market liquidity: mimeo, University of Chicago.
- Royal Society of Arts. 1995. Tomorrow's Company. London.: RSA.
- RSM International. 2003. Building World-Class Boards - A Director's Guide. London: RSM International.
- RSM Robson Rhodes. 2003. Board Effectiveness Survey. London: RSM International.
- Ruland, W., Tung, S., and George, N. 1990. Factors associated with the disclosure of managers' forecasts. The Accounting Review, 65(3): 710-721.
- Safety Representatives and Safety Committees Regulations. 1997.
- Samra-Fredricks, D. 2000. Doing 'Boards-in Action' Research – An Ethnographic Approach for the Capture and Analysis of Directors' and Senior Managers' Interactive Routines. Corporate Governance: An International Review, 8: 244-257.
- Sanders, G. W. and Carpenter, M. A. 2003. Strategic Satisficing? A Behavioral – Agency Theory Perspective on Stock Repurchase Program Announcements. Academy of Management Journal, 46: 160-178.
- Sanders, G. W. and Boivie, S. 2004. Sorting Things Out: Valuation of New Firms in Uncertain Markets. Strategic Management Journal, 25: 167-186.
- Sandler Review. 2003. Medium and long-term retail savings in the UK: a review.
- Sarbanes-Oxley. 2002.
- Schleicher, T. and Walker, M. 1999. Share price anticipation of earnings and management's discussion of operations and financing. Accounting and Business

- Research, 29(4): 321-335.
- Schmid, F. A. and Seger, F. 1998. Arbeitnehmerbestimmung, Allokation von Entscheidungsrechten, und Shareholder Value. Zeitschrift für Betriebswirtschaft, 69(5): 453-473.
- Schnitzer, M. 1995. "Breach of Trust" in Takeovers and the Optimal Corporate Charter. The Journal of Industrial Economics, 43(3): 29-259.
- Schrand, C. and Verecchia, R. E. 2002. Disclosure choice and the cost of capital: evidence from underpricing of initial public offerings: mimeo, Wharton School.
- Schulze, W., Lubatkin, M., and Dino, R. 2003. Exploring the agency consequences of ownership dispersion among the directors of private family firms. Academy of Management Journal, 46: 217-229.
- Scott, W. R. and Meyer, J. W. (Eds.). 1994. Institutional Environments and Organizations: Structural Complexity and Individualism. Thousand Oaks, CA: Sage.
- Sengupta, P. 1998. Corporate disclosure quality and the cost of debt. The Accounting Review, 73(4): 459-474.
- Servaes, H. 1991. Tobin's Q and the gains from takeovers. Journal of Finance, 46: 409-419.
- Sesil, J., Kroumova, M., Blasi, J., and Kruse, D. 2002. Broad-based employee stock options in US new economy firms. British Journal of Industrial Relations, 40(2): 273-294.
- Shen, W. 2005. Improve board effectiveness: the need for incentives. . British Journal of Management, 16(1): S81-S89.
- Shivdasani, A. 1993. Board Composition, Ownership Structure, and Hostile Takeovers. Journal of Accounting and Economics, 16: 167-198.
- Shivdasani, A. and Yermack, D. 1999. CEO Involvement in the Selection of New Board Members: An Empirical Analysis. Journal of Finance, 54: 1829-1853.
- Shleifer, A. and Summers, L. H. 1988. Breach of Trust in Hostile Takeovers. In A. J. Auerbach (Ed.), Corporate Takeovers: Causes and Consequences: 33-68. Chicago, IL: The University of Chicago Press.
- Shleifer, A. and Vishny, R. W. 1988. Value Maximization and the Acquisition Process. Journal of Economic Perspectives, 2(1): 7-20.
- Shleifer, A. and Vishny, R. 1989. Management entrenchment: The case of manager-specific investment. Journal of Financial Economics, 25(1): 123-140.
- Shleifer, A. and Vishny, R. W. 1996. A survey of corporate governance, NBER working paper series; Working Paper No. 5554. Cambridge, MA: National Bureau of Economic Research.
- Shleifer, A. and Vishny, R. 1997. A survey of corporate governance. Journal of Finance, 52(5): 737-783.
- Shleifer, A. and Vishny, R. W. 2003. Stock market driven acquisitions. Journal of Financial Economics.
- Short, H. 1994. Ownership, control, financial structure and the performance of firms. Journal of Economic Surveys, 8: 203-249.
- Sias, R. W. 1996. Volatility and the institutional investor. Financial Analysts Journal, 52(2): 13-20.
- Singh, A. 1975. Takeovers, Economic Natural Selection and the Theory of the Firm: Evidence from the Post-War UK Experience. Economic Journal, 85: 497-515.
- Singh, M. and Davidson III, W. 2002. Agency costs, ownership structure and corporate governance mechanisms. Journal of Banking & Finance.
- Sinha, R. 2004. The role of hostile takeovers in corporate governance. Applied

- Financial Economics, 14(18): pg. 1291.
- Skinner, D. 1994. Why firms voluntarily disclose bad news. Journal of Accounting Research, 32: 38-60.
- Slinger, G. 1999. Spanning the gap – the theoretical principles that connect stakeholder policies to business performance. Corporate Governance, 7(2): 136-150.
- Slovin, M. B., Sushka, M. E., and Hudson, C. D. 1988. Corporate commercial paper, note issuance facilities, and shareholder wealth. Journal of International Money and Finance, 7: 289-302.
- Slovin, M. B. and Young, J. E. 1990. Bank lending and initial public offerings. Journal of Banking & Finance, 14: 729-740.
- Smith, R. and Szymanski, S. 1995. Executive pay and performance: The empirical importance of the participation constraint. International Journal of the Economics of Business, 2(3): 485.
- Smith, B. and Amoako-Adu, B. 1999. Management succession and financial performance of family controlled firms. Journal of Corporate Finance, 5: 341-368.
- Smith, R. 2003. Audit Committees Combined Code Guidance (Smith Report). London: Financial Reporting Council.
- Solomon, J. F., Solomon, A., Norton, S. D., and Joseph, N. L. 2000. A conceptual framework for corporate risk disclosure emerging from the agenda for corporate governance reform. The British Accounting Review, 32(4): 447-478.
- Song, M. H. and Walkling, R. A. 1993. The Impact of Managerial Ownership on Acquisition Attempts and the Market for Corporate Control. Journal of Financial and Quantitative Analysis, 28: 439-457.
- Spira, L., F. . 1999a. Ceremonies of Governance: Perspectives on the Role of the Audit Committee. Journal of Management and Governance, 3(3): 231-260.
- Spira, L. 1999b. Independence in Corporate Governance: the Audit Committee Role. Business Ethics: A European Review, 8(4): 262-273.
- Stark, D. 2001. Ambiguous Assets for Uncertain Environments: Heterarchy in Postsocialist Firms. In P. DiMaggio (Ed.), The Twenty-First-Century Firm. Changing Economic Organization in International Perspective: 69-104. Princeton, NJ: Princeton University Press.
- Stearns, L. and Allan, K. 1996. Economic Behavior in an Institutional Setting: The Merger Wave of the 1980s. American Sociological Review, 61(4): 699-714.
- Steiner, P. 1975. Mergers: Motives, Effects, Policies. Ann Arbor, MI: University of Michigan Press.
- Sternberg, E. 1996. A Vindication of Whistleblowing in Business. In: Four Windows on Whistleblowing: 24-39. London: Public Concern at Work.
- Sternberg, E. 1997. The defects of stakeholder theory. Corporate Governance, 5(1): 3-10.
- Stigler, G. 1961. The economics of information. Journal of Political Economy, 69: 213-225.
- Stigler, G. J. 1982. The Economists and the Problem of Monopoly. American Economic Review: 1-11.
- Stiglitz, J. E. 1985. Credit markets and the control of capital. Journal of Money, Credit and Banking, 17: 133-152.
- Stiles, P. and Taylor, B. 2001. Boards at Work. How Directors View their Roles and Responsibilities. Oxford.: Oxford University Press.

- Stout, L. A. 2005. Share Price as a Poor Criterion for Good Corporate Law. UCLA School of Law, Law-Econ Research Paper No. 05-7. <http://ssrn.com/abstract=660622>
- Stout, L. A. 2006. Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem. *Stanford Law Review*, Forthcoming <http://ssrn.com/abstract=338601>
- Streeck, W. 1992. Social Institutions and Economic Performance: Studies of Industrial Relations in Advanced Capitalist economies. London ; Newbury Park, Calif.: SAGE Publications.
- Streeck, W. 1996. Lean Production in the German Automobile Industry: A Test Case for Convergence Theory. In S. Berger & R. Dore (Eds.), National Diversity and Global Capitalism: 138-170. Ithaca, NY: Cornell University Press.
- Sudarsanam, S., Holl, P., and Salami, A. 1996. Shareholder Wealth Gains in Mergers: Effect of Synergy and Ownership Structure. Journal of Business Finance & Accounting, 23(5): 673-698.
- Sundaramurthy, C. 1996. Corporate governance within the context of antitakeover provisions. Strategic Management Journal, 17: 377-394.
- Sundaramurthy, C. and Lewis, M. 2003. Control and collaboration: paradoxes of governance. Academy of Management Review, 28(3): 397-415.
- Sunders, A. 2005. Who's top of the pay pile. Management Today, Sept 2005: 42-47.
- Taniura, T. 1993. The Lucky Goldstar group in the Republic of Korea. Developing Economies, 31: 465-484.
- The Directors' Remuneration Report Regulations. 2002, SI 2002/1986: 1-27. London: HMSO.
- The Institute of Chartered Accounts in England & Wales. 2004. Auditing Implications of IFRS Transition. London: ICAEW.
- The Institute of Chartered Accounts in England & Wales. 2003. Guidance for Audit Committees: Whistleblowing Arrangements. London: ICAEW.
- The Institute of Chartered Accountants for England and Wales. 1997. Financial reporting of risk. Proposals for a statement of business risk. UK: ICAEW.
- The Public Interest Disclosure Act. 1998.
- Thomas, L. G. and Waring, G. 1999. Competing capitalisms: capital investments in American, German and Japanese firms. Strategic Management Journal 20: 729-748.
- Thompson, S. 1997. Takeover Activity Among Financial Mutuals: An Analysis of Target Characteristics. Journal of Banking & Finance, 21: 37-53.
- Thomsen, S. and Pedersen, T. 2000. Ownership structure and economic performance in the largest European companies. Strategic Management Journal, 21: 689-705.
- Thornton, P. H. 1999. The Sociology of Entrepreneurship. Annual Review of Sociology, 25: 19-46.
- Thornton, P. H. 2001. Personal Versus Market Logics of Control: A Historically Contingent Theory of the Risk of Acquisition. Organizational Science, 12(3): 294-311.
- Tihanyi, L., Johnson, R., Hoskisson, R., and Hitt, M. 2003. Institutional ownership differences and international diversification: the effects of boards of directors and technological opportunity. 46: 195-211.
- Tirole, J. 2001. Corporate governance. Econometrica, 69(1): 1-35.
- Tosi, H., Katz, J., and Gomez-Mejia, L. 1997. Disaggregating the Agency Contract: The Effects of Monitoring, Incentive Alignment, and Term in Office on Agent Decision Making. Academy of Management Journal, 40: 584-602.

- Tosi, H. L., Werner, S., Katz, J. P., and Gomez-Mejia, L. R. 2000. How much does performance matter? A meta-analysis of CEO pay studies. Journal of Management, 26(2): 301-339.
- Trade Union and Labour Relations (Consolidation) Act (The). 1992.
- Transnational Information and Consultation of Employee Regulations. 1999.
- Travlos, N. 1987. Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns. Journal of Finance, 42: 943-963.
- Tricker, B. 1997. What information do directors really need? Corporate Governance: An International Review, 5(3): 109-111.
- Turley, S. and Zaman, M. 2004. The Corporate Governance Effects of Audit Committees. Journal of Management and Governance, 8(3): 305-332.
- Turnbull, N. 1999. Internal control: Guidance for directors on the combined code (The Turnbull Guidance). London: The Institute of Chartered Accountants in England and Wales.
- Turnbull, N. 2005. Internal control: Revised guidance for directors on the combined code (Turnbull Guidance). London: The Financial Reporting Council.
- Turnbull, S. 2005. How US and UK Auditing Practices Became Muddled to Muddle Corporate Governance Principles.
- Ullmann, A. 1985. Data in search of a theory: a critical examination of the relationship among social performance, social disclosure, and economic performance of US firms. Academy of Management Review, 10(3): 540-557.
- Useem, M. 1984. The Inner Circle. Large Corporations and the Rise of Business Political Activity in the U.S. and U.K. New York.: Oxford University Press.
- Useem, M. 1993. Executive Defence. Shareholder Power and Corporate Reorganization. Cambridge, MA: Harvard University Press.
- Van Damme, E. 194. Banking: a survey of recent microeconomic theory. Oxford Review of Economic Policy, 10: 14-33.
- Verecchia, R. E. 2001. Essays on disclosure. Journal of Accounting and Economics, 32(1-3): 97-180.
- Verrecchia, R. 1983. Discretionary disclosure. Journal of Accounting and Economics, 12: 179-194.
- Vinten, G. 2001. Shareholder versus stakeholder – is there a governance dilemma? Corporate Governance, 91: 36-47.
- Vitols, S. 2004. Negotiated Shareholder Value: The German Version of an Anglo-American Practice". Competition and Change, 8(4): 1-18.
- Vitols, S. 2005. Prospects for trade unions in the evolving European system of corporate governance. Brussels: ETUI-REHS.
- Waddock, S. and Graves, S. 1997. The corporate social performance – financial performance link. Strategic Management Journal, 18(4): 303-319.
- Wagner, W., Pfeffer, J., and O'Reilly, C. 1984. Organizational demography and turnover in top management groups. Administrative Science Quarterly, 29: 74-92.
- Wagner, J., Stimpert, J., and Fubara, E. I. 1998. Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects. Journal of Management Studies, 35: 655-677.
- Wahal, S. 1996. Pension fund activism and firm performance. Journal of Financial and Quantitative Analysis, 31: 1-23.
- Walker, M. and Tsalta, A. 2001. Corporate financial disclosure and analyst forecasting activity. London: ACCA.
- Wallace, N. D., Worrell, D. L., and Cheng, L. 1990. Key executive succession and

- stockholder wealth: The influence of successor's origin. Journal of Management, 16: 647-664.
- Walsh, J. P. and Seward, J. K. 1990. On the efficiency of internal and external corporate control mechanisms. Academy of Management Review, 15: 421-458.
- Weir, C. 1997. Corporate governance, performance and take-overs: An empirical analysis of UK mergers. Applied Economics, 29(11): pg. 1465.
- Weir, C. and Laing, D. 2003. Ownership structure, board composition and non-hostile take-overs in the UK: an empirical analysis. Aberdeen Business School, mimeo.
- Weir, C., Laing, D., and Wright, M. 2003. Public to Private Takeovers and the Market for Corporate Control. Mimeo.
- Weisbach, M. S. 1988. Outside directors and CEO turnover. Journal of Financial Economics 20: 431-460.
- Westphal, J. D. and Zajac, E. J. 1995. Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection. Administrative Science Quarterly, 40: 60-83.
- Westphal, J. D. 1998. Board Games: How CEOs Adapt to Increases in Structural Board Independence From Management. Administrative Science Quarterly, 43: 511-537.
- Westphal, J. D. 1999. Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties. Academy of Management Journal, 42: 7-24.
- Westphal, J. D. and Fredrickson, J. W. 2001. Who Directs Strategic Change? Director Experience, the Selection of New CEOs, and Change in Corporate Strategy. Strategic Management Journal, 22: 1113-1137.
- Williamson, O. 1985. The economic institutions of capitalism. New York: Free Press.
- Wim, V. and Commers, M. S. R. 2004. Whistle Blowing and Rational Loyalty. Journal of Business Ethics, 53(1-2): 225.
- Windram, B. and Song, J. 2000. The Effectiveness of Audit Committees: Evidence from UK Companies in the Post-Cadbury Period. Paper presented at the British Accounting Association Annual Conference, University of Exeter.
- Woidtke, T. 2002. Agents watching agents?: evidence from pension fund ownership and firm value. Journal of Financial Economics, 63: 99-131.
- Wood, D. J. and Jones, R. E. 1995. Stakeholder mismatching: a theoretical problem in empirical research on corporate social performance. International Journal of Organization Analysis, 3: 229-267.
- Working Time Regulations. 1998.
- Wright, M., Buck, T., and Filatotchev, I. 2003. Is stakeholder corporate governance appropriate in Russia? Journal of Management and Governance, 7: 263-290.
- Wruck, K. H. 1989. Equity ownership concentration and firm value. Evidence from private equity financing. Journal of Financial Economics, 23: 3-28.
- Xie, B., Davidson, W., N., and DaDalt, P., J. . 2003. Earnings management and corporate governance: the role of the board and the audit committee. Journal of Corporate Finance, 9(3): 295-316.
- Yermack, D. 1996. Higher Market Valuation of Companies with a Smaller Board of Directors. Journal of Financial Economics, 40: 185-211.
- Yosha, O. 1995. Information disclosure costs and the choice of financial source. Journal of Financial Intermediation, 4: 3-20.
- Young, G. J., Stedham, Y., and Beekun, R. I. 2000. Boards of directors and the adoption of a CEO performance evaluation process: Agency and institutional theory perspectives. Journal of Management Studies, 37: 277-295.

- Zahra, S. A. and Pearce, J. A. 1989. Boards of Directors and Corporate Financial Performance: A Review and Integrative Model. Journal of Management, 15: 291-334.
- Zahra, S. A. 1996. Governance, ownership, and corporate entrepreneurship: The moderating impact of industry technological opportunities. Academy of Management Journal, 39: 1713-1735.
- Zajac, E. and Westphal, J. 1994. The costs and benefits of incentives and monitoring in the largest US corporations: when is more not better? Strategic Management Journal, 15(Winter Special Issue): 121-142.
- Zajac, E. J. and Westphal, J. D. 1996. Director Reputation, CEO-Board Power, and the Dynamics of Board Interlocks. Administrative Science Quarterly, 41: 507-529.
- Zeckhauser, R. J. and Pound, J. 1990. Are large shareholders effective monitors? An investigation of share ownership and corporate performance. In R. G. Hubbard (Ed.), Asymmetric Information, Corporate Finance and Investment: 149-180. Chicago & London: The University of Chicago Press.
- Zhang, I. 2005. Economic consequences of the Sarbanes-Oxley Act of 2002: Working Paper, University of Rochester.

