



## Corporate Governance

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### Article information:

To cite this document:

Cătălin Nicolae Albu Maria Madalina Girbina, (2015), "Compliance with corporate governance codes in emerging economies. How do Romanian listed companies "comply-or-explain"?", Corporate Governance, Vol. 15 Iss 1 pp. 85 - 107

Permanent link to this document:

<http://dx.doi.org/10.1108/CG-07-2013-0095>

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# Compliance with corporate governance codes in emerging economies. How do Romanian listed companies “comply-or-explain”?

Cătălin Nicolae Albu and Maria Mădălina Gîrbină

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## Abstract

**Purpose** – *The aim of this study is to examine the attitude of Romanian companies listed on the Bucharest Stock Exchange towards the “comply-or-explain” principle, under which they fulfill their corporate governance obligations.*

**Design/methodology/approach** – *We design and use five indexes to investigate the compliance of Romanian listed companies with their corporate governance obligations, and the quality of their explanations in case of non-compliance under the “comply-or-explain” principle. Further, we perform additional analyses by firm characteristics to identify the more compliant companies.*

**Findings** – *Our results point to the difficulties in the application of the “comply-or-explain” principle approach to corporate governance in emerging economies. First, applicable laws and regulations in these countries deter themselves the application of this principle, by the confusions and unclear provisions that they contain. Second, these countries are characterized by low enforcement mechanisms and less demanding users of information. These create an environment where local companies get away with unsanctioned non-compliance instances, and general type of explanations. However, our results suggest that larger, first-tier companies with larger boards have better corporate governance practices.*

**Research limitations/implications** – *The small number of companies listed on the Bucharest Stock Exchange prevented advanced statistical treatment of data.*

**Originality/value** – *We fill a gap in literature by providing, to our knowledge, the first study that addresses the case of corporate governance practices based on the “comply-or-explain” principle in Romania (one of the recent members of the European Union), and one of the few studies addressing the case of Central and Eastern European countries.*

**Keywords** Romania, Corporate governance, Central and Eastern Europe, Emerging economies, Compliance, Comply-or-explain principle

**Paper type** Research paper

## 1. Introduction

The purpose of this paper is to investigate the application of the “comply-or-explain” principle (CEP) by Romanian listed companies. Originating in the UK’s 1992 Cadbury Corporate Governance Code, this principle intends to provide flexibility in the application of the corporate governance codes (CGCs), requiring companies to explain when they depart from the provisions of such codes (see Section 2.1 for details).

The paper is academically motivated by two rationales. The first is the mixed evidence existing at the European level regarding the self-regulatory codes of corporate governance (CG) (Bianchi *et al.*, 2011), with some studies reporting high degrees of compliance and others going in the opposite direction. More specifically, there is evidence to suggest, for example, that explanations on non-compliance seem to be not sufficient in enabling shareholders to evaluate the appropriateness of deviations from the Dutch CGC, and that

Received 22 July 2013  
Revised 16 December 2013  
25 February 2014  
Accepted 27 February 2014

firms having weaker boards and relying more on debt finance tend to provide generic and uninformative explanations (Hooghiemstra, 2012). Research conducted by market regulators reports low quality of explanations in Spain (CNMV, 2011), and positive results generated by enforcement actions in Portugal (CMVM, 2012).

The second rationale is the debate around the applicability of CG principles and related disclosure in emerging markets (exhibiting different characteristics from more developed countries, with Anglo-American backgrounds) (Cankar *et al.*, 2010; Mueller, 2006). Cankar *et al.* (2010), for example, find a low quality of CG in Slovenia, with effective explanations representing only a small minority of disclosures. Lazarides and Drimpetas (2011) report a relatively low level of adoption of international best practices in Greece. Concerns have been expressed (for example, by Peters *et al.*, 2011) regarding the applicability of Organisation for Economic Co-operation and Development's (OECD) best practices in emerging markets, questioning the adoption of Western CG practices in poor CG systems (Cornelius, 2005).

The scant literature on the CEP in Romania is mainly descriptive and does not investigate its application. While the national regulators of several countries (e.g. France, Portugal, Spain and Sweden among others) have published reports on the application of CGC, this has not yet been done by the Romanian bodies. At the same time, Romania has not been considered in much of the literature investigating CG in emerging economies (for example, Cornelius, 2005; Mitton, 2004; Mueller, 2006), despite the inclusion of other Central and Eastern European (CEE) countries such as the Slovak Republic, Bulgaria or Hungary. We contribute, therefore, to literature on the CEP (Arcot *et al.*, 2010; MacNeil and Li, 2006; Salterio *et al.*, 2013) and to literature on CG in emerging economies (Braga-Alves and Morey, 2012; Mueller, 2006), particularly on CEE countries (Campbell *et al.*, 2009; Gołębiewska-Tataj and Klonowski, 2009; Hardi and Buti, 2012). We fill this gap in literature by providing, to our knowledge, the first study that addresses the case of CG practices based on the CEP in Romania, and one of the few studies addressing the case of CEE countries. With Romania becoming a member of the European Union (EU) in 2007 and the first CEE country to adopt a CGC (Przybyłowski *et al.*, 2011), academic research is useful in understanding if and how this principle is applied in this jurisdiction and vis-à-vis the other EU members and the rest of the CEE region. Additionally, the developing Romanian capital market offers an interesting research field because of the heterogeneity of the listed firms, concentration of ownership in the case of some listed companies, preference for rules and statutory requirements and a lower level of transparency as compared to more developed stock markets. Although it experienced increases in trading value, the Romanian capital market still has to catch up with other European countries in the stock exchange's share of the economy. For example, its 2011 Capitalization/gross domestic product index was 15 per cent as compared to EU countries' average of 56 per cent, according to the Eurostat data.

Finally, this is a good opportunity to study the application of a principle-based CGC, especially in the context where many other countries (the UK included) now have many specific rules included in their CGCs (Cankar *et al.*, 2010).

The remainder of this paper is thus organized: in Section 2 we review the relevant literature on the CEP and the application of CG principles in Romania; then, we present the research methodology in Section 3, the main results and findings in Section 4, and we finally conclude in Section 5, and indicate the implications and future research avenues.

## 2. Literature review

### 2.1 The "comply-or-explain" principle

The CEP originated in the UK's 1992 Cadbury code, favoring flexibility in application, where companies are encouraged to adopt the spirit of the code instead of a box-ticking approach. This principle is now a central element in many CGCs around the world,

including emerging countries. In this approach, companies are not expected to follow all the provisions of the CGC; where individual rules do not fit the particular organizational setting, companies are expected to deviate, but they need to explain the reasons for this departure.

Despite a general support for this principle expressed by regulators, companies and investors alike (European Commission, 2009), research revealed important shortcomings in its application. Opponents of the “comply-or-explain” approach argue that it creates the space for companies to escape their CG obligations. Also, the “explain” part would lack substance, as many companies only make superficial disclosures to justify departure from the prescriptions of the code. For example, MacNeil and Li (2006) examined the content of compliance statements in the UK and dismissed them as being unsuitable to provide reasoned explanations. Arcot and Bruno (2006) showed that there are some qualitative differences between the explanations. However, Sanderson *et al.* (2009) found that a positive conformity with the codes depends on factors such as the extent to which regulatees are engaged in the formation and revision of the code, the existence of interested and relevant monitors and the extent to which soft regulation is a traditional means of control in a particular domain. The Spanish market regulator (CNMV, 2011) reported no significant improvement in the quality of explanations, except for the companies included in the IBEX Index. An important part of explanations was considered as redundant or generic. Arcot *et al.* (2010) analyzed the application of CEP for a sample of 245 non-financial companies in the UK between 1998 and 2004, and found an increasing trend of compliance with the Combined Code, but also low-quality explanations. The paper shows that most companies perceive the Code as a mandatory requirement and shareholders have limited monitoring capabilities.

According to the CEP, it is generally incumbent on the markets to determine whether the response of the companies is appropriate and subsequently to take some form of action to enforce conformity with the provisions or disclosure of sufficient explanations of any deviations. Hence, the aim of CEP is to empower shareholders to make an informed evaluation as to whether non-compliance is justified, given the company’s circumstances, which assumes “[. . .] shareholders place value on their right to voice opinions on key decisions at shareholder meetings, and exercise their rights” (European Commission, 2009, p. 15). The market has two functions in this regard: evaluation of possible deviations and enforcement (Seidl *et al.*, 2009). Unjustified deviations from the code’s provisions are expected to be sanctioned by the market, through negative share-price reactions. Hooghiemstra and van Ees (2011) found that non-compliance could also lead to a higher cost of capital for companies.

There are two core elements of the CEP (UNCTAD, 2010):

1. the code is “soft” law (non-binding and voluntarily implemented); and
2. regardless of the implementation approach, companies have to disclose compliance or non-compliance, with additional explanations in latter case (hence, it is voluntary implementation of the code and mandatory disclosure).

In the case of non-compliance, companies should explain the circumstances which make it inappropriate for them to follow the provisions laid down. Where individual rules do not fit the particular organizational setting, companies are expected to deviate. Factors such as firm size, ownership structures, international ownership and requirements of the capital markets of other countries could be used to justify deviations (Baums, 2001 cited by Seidl *et al.*, 2009).

The intent behind the CEP is not to force companies to comply when they have good reasons for not doing so. This places a great deal of importance on the explanations given by companies. However, the quality of such explanations was indicated as problematic in prior studies. Despite the very strong positive attitude in Europe towards the CEP

(77 per cent of the investor respondents indicating their support for the “comply-or-explain” approach in the [European Commission’s \(2009\)](#) study on monitoring and enforcement practices in CG across member states), serious concerns with regard to the quality of the explanations provided were expressed (only 39 per cent of all explanations are classified as sufficiently informative). [Arcot and Bruno \(2006\)](#) found that 17 per cent of non-compliance cases were not explained at all. They also found that only a few companies changed their explanations for non-compliance over time and either maintained the same explanations from one time period to the next or moved directly to compliance. [Seidl et al. \(2009\)](#) found that about 15 per cent of UK companies that they investigated failed to provide explanations for their deviation from the Combined Code.

## 2.2 CG in emerging economies and in Romania

Stronger CG principles are needed in emerging economies to improve their accountability model ([Dyck, 2001](#)) and attract foreign investors. While CG practices in emerging markets tend to be weaker than in developed capital markets, several emerging markets have improved their CG practices substantially ([Cornelius, 2005](#)). Literature to date seems to indicate that, at least in developed countries, more effective CG systems lead to increased attractiveness of the country for local and foreign investors and, hence, promote economic growth ([Aguilera and Cuervo-Cazzura, 2004](#)). Literature also argues for a positive relationship between good CG practices and operational performances ([Bauwhede, 2009](#)). Nonetheless, the implementation process is neither easy nor always successful because of the significant differences between the local environment and incentives existing in emerging countries and those in developed ones (as sources of evolved CGCs). Besides legal institutions, other factors such as politics and cultural and historical roots matter for CG practices as well ([Cornelius, 2005](#)). CG improvements in CEE countries “[. . .] often took a back seat in the race for market share and profit, particularly in the absence of co-ordinated pressure from investors, or any consistent drive by regulators and governments to prioritize this area” ([Allen and Overy, 2010](#), p. 3). The relatively short histories of CEE countries as market economies, the absence of powerful investor groups across the region and the advent of the financial crisis make the CG environment in these countries is very different from that in more developed countries (*idem*).

There has been an increased interest by foreign investors in emerging economies in general in the aftermath of the global economic crisis ([Peters et al., 2011](#)) and in Romania in particular after 2000, based on the country’s economic development and its accession to the EU in January 2007 ([Middleton et al., 2007](#)). Romania ranked 6th with regard to the number of mandatory disclosure requirements against the ISAR Benchmark for CG in UNCTAD’s 2010 investigation of 21 frontier markets ([UNCTAD, 2010](#)). [Gîrbină et al. \(2012\)](#) finds, however, that Romanian managers are more inclined to make mandatory rather than voluntary disclosures, and that the disclosures made are relatively scarce. [Ienciu \(2012\)](#) finds that CG characteristics such as board size, structure and independence influence the level of environmental reporting of Romanian listed entities. However, one noteworthy finding by [Ienciu \(2012\)](#) is that board size is negatively correlated with the level of such reporting, questioning the effectiveness of large boards in improving the level of disclosure in Romanian entities.

The first Romanian CGC was issued in 2001 by the Bucharest Stock Exchange (ro. [Bursa de Valori București \[BVB\], 2008](#)) following recommendations by the OECD, but stringent requirements regarding its application limited its use (companies were required to amend their statutes to include all the provisions of the CGC and exclude any prior conflicting provision). As a consequence, only one Romanian listed company has applied the provisions of the Code. Prior to 2001, CG provisions were included in the Romanian company law, in the accounting and capital market legislation ([Ienciu, 2012](#)). An analysis of Romanian CG practices conducted by [OECD \(2001\)](#) revealed a number of malfunctions

such as: neglecting minority shareholders' rights, a rather formal role of the board and its domination by the majority shareholder.

The 2001 BVB CGC was replaced by a new code in 2008, to be used starting in 2010. Certain CG requirements applicable to listed companies are included in both the CGC and its Implementation Guidance, in the form of recommendations, and in other laws and regulations, either in the form of compulsory requirements or recommendations. This incoherence does not provide a clear reporting framework, is confusing for companies and gives them incentives for non-compliance[1]. For example, according to the Emergency Ordinance no. 90/2008[2], public interest entities are required to form an audit committee. This was also included as a recommendation in the CGC, to be applied on a "comply-or-explain" basis. Consequently, certain entities provided explanations for not complying with this provision of the law. Additionally, according to the Company Law, companies whose financial statements are audited should also organize internal auditing. However, we identified companies admitting in their annual report that they do not have an internal audit. Companies' disclosures additionally reveal confusion on the purpose of internal controls, internal audit and external audit. EU Directives' requirements and recommendations on CG issues were included in the national legislation but low enforcement mechanisms enabled reduced compliance levels in certain cases.

The recommendations of the BVB's CGC address issues related to CG structures, shareholders' rights, the role and structure of the board, the appointment and remuneration of board members, transparency requirements, internal control and risk management, conflicts of interests, the regime of corporate information and the social responsibility of the issuer.

The CEP was introduced in Romania via the [Order of the Minister of Public Finances \(OMFP\) no. 2001/2006](#), enacting locally the European Directive 2006/46/EC. According to this regulation, listed companies were required to publish a CG statement which had to include at least a reference to the code that the company may have voluntarily decided to apply and all relevant information about the CG practices applied beyond the requirements under the national law. The requirement, however, produced effects in practice much later (in 2010) when the entities listed on BVB started to apply the 2008 CGC, an Implementation Guidance of the Code and the CES format[3]. The code states companies admitted to trading on the regulated market of the BVB shall adopt and comply with the provisions of the 2008 CGC on a voluntary basis ([BVB, 2008](#)) in a "comply-or-explain" approach. BVB mandated the yearly disclosure of a Statement of CG Compliance (the "comply-or-explain" statement [CES]) explaining the implementation of various provisions of the CGC by the companies, or the reasons for failure to implement. This statement is standardized and includes a list of 51 questions elaborated based on the recommendations of the Code (see [Table VI](#) below) related to the application of its 19 principles and 38 of its 41 recommendations, that companies need to consider when completing the statement. If compliance with the CGC is voluntary, disclosure of CES is compulsory. BVB monitors its availability, but the informative value of such statements is not tested, which is of course one of the critical aspects of the "comply-or-explain" concept. This environment does not trigger the correct application of the CEP, as it is:

[...] an environment where investors or quasi-regulatory bodies are simply telling the companies to comply. The principle requires the commitment of institutional shareholders and, in particular, their compliance officers to devote the time necessary to assess each company's explanation ([KPMG, 2008](#)).

### 3. Research methodology

We analyzed all 67 non-financial companies listed on the BVB in 2010 and 2011 (the first reporting periods for which data are available) in the first and second tiers[4]. Similarly to previous literature ([Arcot et al., 2010](#)), we excluded financial companies due to their regulatory framework differing significantly from that of non-financial companies. We



excluded five other companies because they were not listed in both 2010 and 2011. Of the 62 remaining companies, we were further constrained to narrow down to only the ones that published the CES on their Web site as a separate document or within their annual reports[5]. We thus narrowed our research down to 14 companies in 2010 and 32 companies in 2011. For these companies, we downloaded their CESs for the two years, and used them for the purpose of this paper. While small in size, we collected and analyzed data from all the non-financial companies listed on the BVB in both 2010 and 2011. Considering the number of companies publicly disclosing their CES on their Web site, 2,346 principle-company-year observations were finally available to us.

To better understand the way that the “comply-or-explain” mechanism works in practice in Romania, we examine separately:

- the degree of compliance with the provisions of the BVB’s CGC in the CES prepared by the companies listed on the regulated market of the BVB in 2010 and 2011; and
- the quality of the explanations provided for non-compliance. We also intend to document the extent to which compliance with CGC provisions evolved over time, and to identify the characteristics of the more compliant companies.

Accordingly, to assess the extent to which companies comply or not with the specific CGC principles, we first assigned 1 if companies answered “yes” to each specific question in their CES, and 0 if they answered “no”. We thus calculated a compliance index per question, by dividing the total number of compliant companies with the total number of companies in the sample or subsample (each of the two years), and a compliance index per company by dividing the number of CG principles implemented with the maximum number of questions (51) based on CES.

Then, we classified answers to each question according to a scale developed from the taxonomy suggested by [Arcot et al. \(2010\)](#):

- *No explanation*: If no explanation was provided.
- *General*: A general or non-specific (to the company) explanation was provided. We include in this category explanations that use standard texts and do not provide any specific details.
- *Transitional*: An explanation which points to a transitional situation facing the company due to which it is temporarily not compliant.
- *Specific*: Those that we judged to be in the spirit of the Code, specific to the company and well argued.

For example, we classified an explanation such as “The company did not consider it necessary to establish board committees” as general. Cases where the company declared its intent to implement the principle in the future were classified as transitional (e.g. “We plan the setting up of a nomination committee in 2011”), while an explanation such as “The company adopted a unitary administration system which better corresponds to its actual needs of good administration and governance considering its size and ownership structure. By respecting the principles of clear separation of responsibilities between the board and the executive management, by avoiding the implication of the board in the daily management decisions of the Company, and by counting on a majority of non-executive board members, the governance system of the company fulfills the objectives of good corporate governance and assures an efficient functioning of the Company” was considered specific.

We maintained the “transitional” level in the scale because we anticipated a high frequency of this type of answer (Romanian companies traditionally display a preference for rules) and the fact that we investigated the first years of application of the Code. This category was used before by [Arcot and Bruno \(2006\)](#) and the study developed by the [European Commission \(2009\)](#), which facilitates the comparability of results[6].

Subsequently, we awarded 4 points when companies indicated compliance with a specific CGC provision. To investigate the quality of the explanations provided for non-compliance with the CGC provisions, we also awarded 4 points when the companies offered specific explanations (considering that providing a good explanation is as valuable as complying with the Code), 3 points to transitional explanations, 2 points for general explanations and 1 point when no explanation was given. Using these scores, we determined a “comply-or-explain” index per question calculated as follows:

$$\text{Comply-or-explain index per question} = \frac{\text{CGScoreperquestion}}{\text{MaxCGScoreperquestion}},$$

where:

- CGScoreperquestion is the sum of the scores granted to all the companies in the sample or a subsample for a specific question, or  $\sum_{i=1}^n \text{Score}$ , where  $n$  is the number of companies included in the sample or subsample (i.e. 14 in 2010, 32 in 2011 and 46 overall); and
- MaxCGScoreperquestion is the number of companies  $\times$  the maximum number of points that could have been awarded to each question (for example,  $32 \times 4 = 128$  in 2011).

We also determined a comply-or-explain index per company as:

$$\text{Comply-or-explain index per company} = \frac{\text{CGScorepercompany}}{51},$$

where CGScorepercompany is the sum of scores granted to each company for the answer to all questions, or  $\sum_{i=1}^{51} \text{Score}$  (51 is the total number of questions in the CES).

Further, we developed a quality index per question considering only non-compliance cases. This index was determined as follows:

$$\text{Quality index per question} = \frac{\text{CGScoreperquestion}}{\text{Numberofnoncompliantcompaniesperquestion}}$$

Finally, to identify the characteristics of the most compliant companies, we calculated the Pearson correlation coefficients between the compliance index per question and the comply-or-explain index per company, and firm characteristics (firm size, ownership concentration, listing category, separation of chairman of the board and chief executive officer [CEO] roles, board size and presence of non-executives in the board, return on assets [ROA] and international ownership).

Di Miceli da Silveira *et al.* (2010) identified the size of the firm as a potential determinant of firm-level CG. Firstly, political costs (arising out of the regulatory process) are higher for larger companies (Watts and Zimmerman, 1990). It is expected that bigger companies have better disclosure to increase trust and decrease political costs. Secondly, disclosure is less costly for bigger companies than for smaller companies. We thus expect a correlation between the firm size and the compliance with CG principles. Following Klapper and Love (2004), we measure firm size by the natural log of book value of total assets at year-end to avoid size effects. According to Durnev and Kim (2005), the market value of firms increases with good CG practices. To avoid size effect we correlated the natural log of market capitalization with the CG indexes above-mentioned.

Generally, companies in emerging markets tend to have higher levels of ownership concentration, and agency issues focus on the conflict between the controlling and the minority shareholders. Di Miceli da Silveira *et al.* (2010) find the influence of the concentration of control rights over the presence of good CG practices to be ambiguous, while Chhaochharia and Laeven (2009) show that firms with concentrated ownership are less likely to adopt standard governance practices. We thus tested the correlation between the CG indexes mentioned and ownership concentration, measured by the percentage of capital held by the main shareholder.



We also correlated firm performance with the CG indexes to investigate consequences of CG choices on the efficient use of the company assets (Arcot and Bruno, 2013). We used an accounting measure of profit because prior studies conducted in Romania demonstrated the low level of efficiency of the Romanian capital market (Dragotă *et al.*, 2009). ROA (the ratio of net profit over total assets) has been widely used in prior CG research (Klein, 1998; Vafeas and Theodorou, 1998).

International ownership was considered to be a valid justification for non-compliance in prior studies (Baums, 2001 cited by Seidl *et al.*, 2009). We thus correlated international ownership (measured by a variable coded 1 if the main owner is foreign or 0 otherwise) with CG indexes.

Board size is mostly used as an indication of its monitoring role. Larger boards are likely to have more knowledge and skills at their disposal and act more efficiently, consequently improving other CG practices and the quality of disclosure. The total number of board members is used as a measure of board size (Coles *et al.*, 2008). We take the natural log of this variable as a proxy of the board size.

CGCs require a more important presence of non-executives on the board and key committees. From the agency theory perspective, outsiders are more likely to carry out their oversight responsibilities effectively than insiders because their interests will be more closely aligned with those of the corporation's owners (Johnson *et al.*, 1993). They could also stimulate the adoption of higher CG standards and improve disclosure.

The separation of the positions of CEO and chairman of the board has been suggested to be an important requirement for improving the board governance (OECD, 2004), in accordance with the agency theory, suggesting that this separation would better serve the interests of shareholders. We measured this separation with a dummy variable (0 if the CEO and the chairman of the board are different persons and 1 otherwise).

Di Miceli da Silveira *et al.* (2010) show that Brazilian firms that upgrade their listing environment subsequently improve their CG quality. We thus expect first tier companies to have higher CG compliance levels and better disclosure. We measured the listing category by a variable coded 1 for first category companies and 2 for second category companies.

#### 4. Results and discussion

Table I presents descriptive information regarding the publication of the CES by all the companies in our sample.

We note Romanian companies' increasing preoccupation and transparency related to compliance with BVB's CGC in 2011 compared to 2010, as reflected firstly by the increasing percentage of companies disclosing the CES on their Web site. Still, only about one company in two disclosed in 2011 this statement on its Web site, which is well below the EU's average of 86 per cent (European Commission, 2009). A similar situation was reported by the European Commission (EC) study in Bulgaria. With regards to the Romanian setting, this could be explained by the confusion generated by the fact that the OMFP no. 3.055/2009 (implementing the EU Directive 2006/46/EC) requires the publication of the CES within the CG section of the annual report for all listed companies, while BVB's CGC suggests that the application of the Code is voluntary and the statement is required only for the issuers entirely or partly adopting its Code.

<b>Table I</b> Percentage of Romanian non-financial listed companies disclosing the CES on their Web site in 2010 and 2011		
<i>Sub-sample/years</i>	<i>2010</i>	<i>2011</i>
Companies in the first tier	57.14	57.14
Companies in the second tier	12.76	51.0
Total	22.58	51.61

We note from [Table II](#) that the Romanian companies listed on the BVB in 2010 and 2011 declared that they complied with at least 35 per cent of CG principles. Additionally, we observe from the same table that companies in our sample report that they comply with almost two-thirds of the questions in the statement (a mean of 0.701 for the compliance index per company), which largely explains the high values obtained for the comply-or-explain index (mean of 0.888). We consider, however, that care needs to be exercised when interpreting these positive results, as some of the companies might have simply indicated that they comply to avoid giving explanations in case of non-compliance; in this respect, the Romanian environment has already been found to have low enforcement levels ([Gîrbină et al., 2012](#)), similar to other emerging economies.

[Table III](#) gives details regarding the evolution of the compliance and the comply-or-explain indexes per company across the entire sample over the time frame studied.

As we note from [Table III](#), the mean values of both the compliance and the comply-or-explain indexes have marginally decreased in 2011 as compared to 2010. We argue that this is because those companies that began to fill in their CES in 2011 had lower levels of compliance and lower quality of the explanations per principle (for the 18 companies starting to complete the statement in 2011 the mean value of the compliance index is 0.654, and the mean value of the comply-or-explain index is of 0.862). For the companies that continued to complete the statement in 2011, the mean values of the compliance index and the comply-or-explain index recorded small increases (from 0.725 to 0.738 for the compliance index and from 0.899 to 0.909 for the comply-or-explain index). Only one company answered positively in 2011 to all 51 questions.

We further eliminated the cases of compliance for each principle and retained only non-compliance cases for each question. We analyzed the quality of explanations following the taxonomy that we mentioned above (see [Table IV](#)).

As resulting from [Table IV](#), the quality of explanations is significantly lower than the European average (according to the EC's 2009 study, 39 per cent of explanations are

**Table II** Descriptive statistics for the compliance index per company and the comply-or-explain index per company across the entire sample and over the entire period

	<i>Compliance index per company</i>	<i>Comply-or-explain index per company</i>
Minimum	0.353	0.632
Maximum	1	0.990
Mean	0.701	0.888
SD	0.164	0.080
Median	0.725	0.914

**Table III** Dynamics of the compliance and the comply-or-explain indexes per company

	2010		2011	
	<i>Compliance index</i>	<i>Comply or explain index</i>	<i>Compliance index</i>	<i>Comply or explain index</i>
Minimum	0.373	0.676	0.353	0.632
Maximum	0.923	0.980	1	0.990
Mean	0.725	0.899	0.691	0.883

**Table IV** The quality of explanations (mean of occurrence frequency, per type of answer)

<i>No explanation</i>	<i>General</i>	<i>Transitional</i>	<i>Specific</i>
14%	33%	42%	11%

sufficiently informative) and values reported in the UK and Germany by [Seidl et al. \(2009\)](#). However, comparability might be impaired by the limited harmonization between the requirements of different Codes. We observe the relative high level of transitional explanations (cases in which the company affirms that it intends to comply with the Code). In total, 72.5 per cent of companies disclosing the statements in 2010 and 2011 provide transitional explanation in both years, confirming our decision to maintain this category in the scale.

The absence of any explanation is certainly not in spirit of the CGC or of the CEP. However, we found such cases (as reported in [Table V](#)).

The descriptive statistics in [Table V](#) confirm the results of similar studies conducted in other countries ([De Cleyn, 2008](#) for Belgian listed companies, for example). Even though the compliance rates (as measured by the index) are relatively high (with a total average of 70.12 per cent), an average of 3.54 per cent of the firms fail to provide any explanation in the case of non-compliance with a certain principle. General statistics for each question included in the CES are presented in [Table VI](#).

The most frequent non-compliance cases are related to the reluctance of issuers to apply CG standards that are higher than those required by the compulsory requirements of the law. A qualitative analysis of the explanations offered for non-compliance by companies in our sample confirms this assertion. Certain answers reflect misunderstandings, confusions, reluctance to be transparent and an insufficient attention given to CG by companies. We illustrate some of the “explanations” listed in this category:

The internal regulation governing the functioning of each specialized committee is confidential.

The remuneration policy of the board is confidential.

We do not have the approval of board members to publish their Curriculum Vitae on the Web site.

The company doesn't organize meetings with the financial analysts, brokers, rating agencies and other market specialists because the investment decision belongs to the General Meeting of Shareholders (GMS) and to the board.

The annual report does not include a special chapter dedicated to CG events because the Annual report includes only relevant events for the company and, as these events were not so significant till now, the introduction of a separate chapter for them was not considered to be necessary.

Board tasks on financial reporting, internal control and risk management are fulfilled by the internal and the external auditors.

[Table VI](#) recapitulates the evolution of the compliance and comply-or-explain indexes for each CES question over the two years. On a general level, we note that both indexes decreased in 2011 when certain companies listed on the second tier disclosed their CES for the first time, while having lower CG standards. Questions with lower compliance rates are those related to the committees assisting the board (for example, Q33 regarding the nomination committee) and the disclosure of more information. This could be explained by the small size of the board in the case of certain companies, and by the fact that entities seem to perceive the benefits of establishing board committees as low. [OECD \(2011\)](#)

**Table V** Percentage of non-compliance cases without any explanation across the entire sample

Minimum	0.00
Maximum	13.04
Mean	3.54

**Table VI** Compliance and comply-or-explain indexes and percentage of non-compliance cases not explained, by question (in %)

Question	Compliance index		Comply-or-explain index		Overall % of non-compliance cases not explained
	2010	2011	2010	2011	
Q1. Is the Issuer managed in a two-tier system?	7.14	21.88	76.79	74.22	4.35
Q2. Has the Issuer drawn up a Statute/Corporate Governance Regulation which describes the main aspects of the corporate governance?	64.29	56.25	89.29	86.72	6.52
Q3. Is the Statute/Corporate Governance Regulation (mentioning the date of its last update) posted on the Web site of the Issuer?	57.14	46.88	85.71	82.81	6.52
Q4. In the Statute/Corporate Governance Regulation, are there defined corporate governance structures, positions, competencies and responsibilities of the Supervisory Board and of the Executive Board?	64.29	56.25	89.29	86.72	6.67
Q5. Has the Annual Report of the Issuer a chapter referring to corporate governance which describes all the relevant events related to the corporate governance registered in the previous financial year?	71.43	59.38	87.50	85.16	6.52
Q6. Does the Issuer disclose on its Web site:	64.29	56.25	85.71	84.38	6.52
a) a description of Issuer's corporate governance structures?					
Q7. b) the updated Articles of Association?	78.57	62.5	92.86	85.94	4.35
Q8. c) the internal regulation governing the functioning/its essential aspects for each special commission/specialized committee?	28.57	34.38	76.79	78.13	8.7
Q9. d) the "Comply or Explain" Statement?	100.00	100.00	100.00	100.00	0
Q10. e) the list of the (Supervisory) Board members specifying which members are independent, of the Executive Board and of the special commissions/committees?	92.86	78.13	98.21	89.06	6.52
Q11. f) a brief version of the CV of each (Supervisory) Board and Executive Board member?	78.57	65.63	89.29	83.59	2.17
Q12. Does the Issuer respect the rights of the holders of the financial instruments issued by the Issuer, ensuring equal treatment for them while also submitting any change of the granted rights for approval by the special meetings of such holders?	100.00	100.00	100.00	100.00	0
Q13. Does the Issuer publish in a special section of its Web site the details of the holding of the General Meetings of Shareholders ("GMS"):	100.00	100.00	100.00	100.00	0
a) The GMS convening notice?					
Q14. b) the materials/ documents relating to the items on the agenda, as well as any other information about the items on the agenda?	100.00	100.00	100.00	100.00	0
Q15. c) the templates of the special power of attorney?	100.00	100.00	100.00	100.00	0
Q16. Has the Issuer drawn up and submitted for the GMS's approval procedures for an efficient and methodical holding of the GMS according to procedure, however without prejudice to the right of any shareholder to express freely their opinion	64.29	75.00	83.93	88.28	0
Q17. Does the issuer disclose in a special section of its Web site the shareholders' rights as well as the rules and procedures for the attendance at GMS?	100.00	90.63	100.00	96.09	0
Q18. Does the Issuer provide information in due time (immediately after the GMS) to all shareholders through the special section on the Issuer's Web site:	100.00	100.00	100.00	100.00	0
a) the resolutions passed by the GMS?					
Q19. b) the detailed results of the voting?	100.00	93.75	100.00	98.44	0

(continued)

Table VI

Question	Compliance index		Comply-or-explain index		Overall % of non-compliance cases not explained
	2010	2011	2010	2011	
Q20. Does the Issuer disseminate through the special section of the Issuer's Web site, which is easily identifiable and accessible: a) ad-hoc reports/official statements?	100.00	100.00	100.00	100.00	0
Q21. b) the financial calendar, the annual, quarter and half year reports?	100.00	100.00	100.00	100.00	0
Q22. Has the Issuer set-up a special department or has appointed a person dedicated to the relation with the investors?	100.00	93.75	100.00	95.31	4.35
Q23. Does the (Supervisory) Board meet at least once a quarter for supervising the activity of the Issuer?	100.00	100.00	100.00	100.00	0
Q24. Has the Issuer a set of rules referring to the conduct and the reporting obligations relating to the trading of the shares or of the other financial instruments issued by the Issuer ("Issuer securities") made on their account by the members of the Executive?	57.14	53.13	80.36	77.34	8.7
Q25. Are the trades with the Issuer's securities made by the members of Supervisory Board, Executive Board or any other insiders on their own account disclosed via the Issuer's Web site, according to the applicable rules?	64.29	65.63	85.71	82.81	8.70
Q26. Does the structure of the Issuer ensure a balance between the executive and non-executive members (and especially independent nonexecutive members) so that the decision-making is not to be dominated by a single person or a group of persons?	85.71	84.38	96.43	93.75	0
Q27. Does the structure of the Supervisory Board provide a sufficient number of independent members?	85.71	75.00	96.43	89.06	0
Q28. In the course of its activity, is the (Supervisory) Board supported by any consultative commissions/ committees nominated by the (Supervisory) Board, which deal with the analysis of some specific subjects in order to counsel the (Supervisory) Board on such topics?	64.29	62.50	87.50	87.50	0
Q29. Do the consultative commissions/ committees submit activity reports to the Supervisory Board on the specific subjects assigned to them?	64.29	62.50	83.93	87.50	4.35
Q30. For the assessment of the independence of their members, does the Supervisory Board use the assessment criteria listed in Recommendation 16?	92.86	65.63	98.21	84.38	2.17
Q31. Do Executive Board members permanently improve their knowledge through training/ information in the corporate governance field?	78.57	87.50	92.86	96.88	2.17
Q32. Is the appointment of the (Supervisory) Board members based on a transparent procedure (objective criteria regarding personal/professional qualifications etc.)?	100.00	93.75	100.00	96.88	0
Q33. Is a Nomination Committee set-up by the Issuer?	21.43	15.63	69.64	71.09	4.35
Q34. Does the Supervisory Board assess the necessity to have a Remuneration Committee/ remuneration policy for the Supervisory Board and Executive Board members at least once a year?	50.00	53.13	89.29	90.63	0
Q35. Is the remuneration policy approved by the GMS?	71.43	84.38	85.71	93.75	0
Q36. Is there a Remuneration Committee made exclusively of nonexecutive members of the Supervisory Board?	50.00	31.25	80.36	78.13	6.52
Q37. Is the remuneration policy of the Issuer mentioned in the Statute/Corporate Governance Regulation?	42.86	25.00	80.36	75.00	8.70
Q38. Does the Issuer disclose the information subject of the reporting requirements in English: a) periodical information (regularly providing information)?	42.86	40.63	75.00	72.66	8.70

(continued)

**Table VI**

Question	Compliance index		Comply-or-explain index		Overall % of non-compliance cases not explained
	2010	2011	2010	2011	
Q39. b) permanent information (continuously providing information)?	35.71	37.50	73.21	69.53	13.04
Q40. Does the Issuer prepare and make public the financial report according to IFRS standards?	50.00	53.13	71.43	78.13	13.04
Q41. Does the Issuer organize, at least once a year, meetings with the financial analysts, brokers, rating agencies and other market specialists with the view to presenting the financial elements relevant for the investment decision?	71.43	53.13	89.29	89.84	6.52
Q42. Is there an Audit Committee within the Issuer?	64.29	62.50	87.50	83.59	2.17
Q43. Does the Supervisory Board or the Audit Committee, as the case may be, assess on a regular basis the efficiency of financial reporting, internal control and the risk management system implemented by the Issuer?	78.57	78.13	92.86	89.84	2.17
Q44. Is the Audit Committee comprised exclusively of non-executive members of the Supervisory Board and is it comprised of a sufficient number of independent members of the Supervisory Board?	57.14	59.38	89.29	82.81	2.17
Q45. Does the Audit Committee meet at least twice a year, with the view to draw up and disclose to the shareholders half year and annual financial statements?	64.29	53.13	89.29	80.47	4.35
Q46. Does the Audit Committee make proposals to the (Supervisory) Board regarding the selection, the appointment, the re-appointment and the replacement of the financial auditor, as well as the terms and conditions of its remuneration?	64.29	59.38	91.07	82.81	2.17
Q47. Has the Issuer approved a procedure with the view to identify and to settle any conflicts of interest?	50.00	62.50	80.36	85.94	2.17
Q48. Do the members of the Supervisory Board inform the Supervisory Board on the conflicts of interests as they occur and do they refrain from the debates and the vote on such matters, according to the relevant legal provisions?	100.00	100.00	100.00	100.00	0
Q49. Has the Issuer approved the specific procedures in order to provide the procedural compliance (criteria to identify the significant impact transactions, of transparency, impartiality, noncompetition etc.) with the view to identify the transactions between related parties?	57.14	50.00	83.93	81.25	6.52
Q50. Has the Issuer approved a procedure regarding the internal flow and the disclosure to third parties of the documents and information referring to the Issuer, considering especially the inside information?	71.43	68.75	89.29	88.28	4.35
Q51. Does the Issuer carry on activities regarding the Issuer's social and environmental responsibility?	92.86	93.75	94.64	96.88	4.35

**Note:** The 51 questions listed are comprised in the BVB's suggested model of CES, which Romanian listed companies applying its Code need to consider when completing their CES

reports a similar low use of non-mandatory committees in other countries (Brazil, Chile, Colombia and Mexico). Explanations given for not establishing a nomination committee reveal a nomination process which is rather informal and dominated by the controlling shareholder.

The examination of the other information provided on companies' Web sites reflects little evidence on the level of activity by these committees. This absence of information points to the possibility that these committee structures do not operate in practice. Independent non-executive directors are viewed as critical actors in the CG agenda, specifically in their roles as members of the audit, remuneration and CG committees. We observe a decreasing level of compliance regarding the presence of independent board members. The reduced size of the



board and the insufficient number of independent members precluded the creation of committees in certain companies.

An important function of the board is to manage potential conflicts of interest involving management, directors and shareholders, including misuse of corporate assets and abusive related party transactions. These functions are sometimes assigned to the internal auditor, who should have direct access to the board (OECD, 2011). A low level of compliance was observed for procedures related to conflicts of interest or for the identification of the transactions between related parties. Research is needed to investigate consequences of non-compliance, as the appropriation of minority shareholder funds by controlling shareholders is as much of a CG problem in Romania as it is in other emerging countries (La Porta *et al.*, 2000).

We noticed, however, a different evolution for other CG aspects we studied. The most notable one is the increase of CG knowledge by board members through training (Q31 in Table VI), which we interpret as an increased awareness of CG issues and the importance of board members to be familiar with such issues by management of Romanian listed companies.

According to the Romanian Company Law, upon shareholders' vote, joint stock companies may be managed in a "unitary" (one-tier) or in a "dualist" (two-tier) system. Under the "unitary" (one-tier) system, the company is managed by one or more administrators (always in an odd number) and eventually by executive managers, while under the "dualist" (two-tier) system, the company is managed by an executive and a supervisory board. The choice of a particular board structure depends on a range of factors such as the business culture, the total board size and the ratio of executive to non-executive directors. The biggest advantages of the unitary model are the increased possibility of dialogue and better communication between executives and non-executives, and access to corporate data and information by non-executive directors. The downside of the unitary system relates to the very powerful position of the CEO. The dualist system encompasses a clearer, formal separation between the supervisory body and the executive board. The major weakness of the dual model lies in a limited access to corporate data and information which has to be delivered by the management board. The dualist system is also often criticized for its higher costs of functioning and the lack of direct contact between executives and outside directors.

Only 21.88 per cent of companies in our sample used the dualist management system in 2011. Reasons for not switching to the dualist system presented by the Companies in their CES include that this is the governance system prescribed by their statute or by their constitutive act and they do not intend to change it; that the decision to use the unitary system was made by the shareholders or by their main shareholder; that the dualist system is not justified considering their company's size or that they ensure the balance between executives and non-executives on the board, with a majority of non-executives. We note, however, that the compliance index for this question increases significantly in 2011 as compared to 2010, while the comply-or-explain index decreases. This means that firms pass directly to compliance but the quality of the explanations decreases. One-tier board structure is predominant, similar to the majority of EU member states. This structure ensures a balance between the executive and non-executive members (and especially independent non-executive members) so that the decision-making is not to be dominated by a single person or a group of persons in around 85 per cent of the cases.

To analyze the quality of explanations in cases of non-compliance, we determined the frequency of each score type and the quality index for non-complying companies as explained above. Table VII reports the frequency of explanation types, the CG score and the quality index (considering only non-compliance cases).

The quality index ranges from 1 to 4, with an average value of 2.43. We note that issuers provided less informative explanations for the questions related to the appointment of

**Table VII** Frequency of explanation types, the CG score and the quality index per question (considering only non-compliance cases)

	<i>No explanation (percentage of non-compliance cases) (%)</i>	<i>General (%)</i>	<i>Transitional (%)</i>	<i>Specific (%)</i>	<i>CG score</i>	<i>Quality index per question</i>
Q1	2.63	5.26	0.00	50.00	81	2.13
Q2	15.70	5.30	63.20	15.80	53	2.79
Q3	13.00	8.70	73.90	4.40	62	2.7
Q4	15.70	5.30	63.20	15.80	53	2.79
Q5	17.60	29.40	41.20	11.80	42	2.47
Q6	15.80	15.80	68.40	0.00	48	2.53
Q7	13.30	20.00	66.70	0.00	38	2.53
Q8	12.90	22.60	48.40	16.10	83	2.68
Q10	37.50	12.50	50.00	0.00	17	2.13
Q11	28.60	35.70	28.60	7.10	30	2.14
Q16	0.00	84.60	15.40	0.00	28	2.15
Q17	0.00	66.70	33.30	0.00	7	2.33
Q19	0.00	0.00	0.00	100.00	4	4
Q22	100.00	0.00	0.00	0.00	1	1
Q24	19.00	52.40	28.60	0.00	44	2.1
Q25	25.00	37.50	37.50	0.00	34	2.13
Q26	0.00	42.90	57.10	0.00	18	2.57
Q27	0.00	60.00	40.00	0.00	24	2.4
Q28	0.00	41.20	52.90	5.90	45	2.65
Q29	11.80	35.20	41.20	11.80	43	2.53
Q30	8.30	58.40	33.30	0.00	27	2.25
Q31	14.30	0.00	71.40	14.30	20	2.86
Q32	0.00	100.00	0.00	0.00	4	2
Q33	5.30	36.80	52.60	5.30	98	2.58
Q34	9.10	9.10	36.40	45.40	70	3.18
Q35	0.00	77.70	22.30	0.00	20	2.22
Q36	10.40	37.90	27.60	24.10	77	2.65
Q37	12.50	25.00	46.90	15.60	85	2.66
Q38	14.80	51.90	33.30	0.00	59	2.19
Q39	20.70	44.80	34.50	0.00	62	2.14
Q40	22.70	54.60	22.70	0.00	44	2
Q41	30.00	0.00	40.00	30.00	27	2.7
Q42	11.10	44.40	44.50	0.00	21	2.33
Q43	12.50	37.50	50.00	0.00	19	2.38
Q44	10.00	40.00	50.00	0.00	24	2.4
Q45	10.00	40.00	40.00	10.00	25	2.5
Q46	10.00	30.00	50.00	10.00	26	2.6
Q47	12.50	12.50	75.00	0.00	21	2.63
Q49	23.10	7.70	69.20	0.00	32	2.46
Q50	22.20	0.00	77.80	0.00	23	2.56
Q51	66.70	0.00	33.30	0.00	5	1.67

**Note:** The 51 questions listed are comprised in the BVB's suggested model of CES that Romanian listed companies applying its Code need to consider when filling in their CES

board members based on a transparent procedure, the establishment of an audit committee, lack of transparency (publication of information in the English language or financial statements based on International Financial Reporting Standards [IFRS], disclosure of trades made by the board members or other insiders on the Web site of the company), the existence of a special department dedicated to relations with investors, approval of remuneration policy by the GMS, assessment of board members' independence using the Recommendation 16 of the CGC and establishment of internal rules referring to the conduct and the reporting obligations related to the trading of the shares issued by the company made on their account by the members of the executive. Reduced transparency on board members' nomination was reported in other studies (OECD, 2011) as an indication of a less formal appointment process largely dominated by the controlling shareholder. The low quality of explanations is due in certain cases to confusion and misunderstanding related to the application of the CEP (non-compliance

with a principle is justified by it not being required by the law), to the role of certain CG structures (such as the audit committee), to the importance of having independent or non-executive members within the board or by the reluctance to be transparent.

Regarding the characteristics of firms displaying higher compliance rates, we note from [Table VIII](#) that larger companies (with size being measured by the natural log of total assets and the natural log of market capitalization) and first-tier listed companies comply more with the prescriptions of the code and have a higher comply-or-explain index. The lower level of compliance for smaller firms could be explained by the fact that CG could be too costly for them. Lately, we observe in certain countries (e.g. France) an interest in adapting governance codes to firm size. The authors of the MiddleNext Code in France justify the need for different recommendations for small listed companies by the fact that there are issues that are less relevant for small publicly traded companies in which the director is a significant or major shareholder, such as those related to committees or remuneration. For smaller issuers, there are more relevant issues such as guaranteeing the succession of the leader or the protection of minority shareholders' interests. A study conducted by the French Institute of Corporate Governance (IFGE, 2012) on companies applying the MiddleNext Code in 2011 reveals that some characteristics of these companies explain their CG choices: their capital structure is characterized by concentrated ownership largely dominated by family or individual ownership and they generally have a reduced unitary board and a smaller presence of independent members, a greater concentration of power and fewer committees.

The relationship between the listing tier and the compliance level or the comply-or-explain index is confirmed by the Spearman coefficient of correlation ( $-0.63$  or  $-0.64$  with  $p < 0.05$  or  $p < 0.01$ , respectively). We note that better CG disclosure does not seem to be correlated with firm performance. Finally, we observe that companies with larger boards comply more with the CGC, but do not necessarily explain better departures from its provisions. No significant relationship was identified between international ownership and the compliance level.

## 5. Conclusions

The purpose of this paper was to investigate the application of the CEP by Romanian listed companies. To that end, we collected and analyzed relevant information for all non-financial companies listed on the Bucharest Stock Exchange in 2010 and 2011. We analyzed the companies' CESs where available, and we constructed five indexes to analyze the compliance with CGC recommendations, and the quality of the explanations provided in case of non-compliance. Our study thus contributes to the CEP application literature by analyzing the compliance practices of Romanian listed entities, which is useful in understanding the CG practices in emerging economies in general, and in CEE countries in particular. Additionally, we analyzed the quality of explanations offered in case of non-compliance by companies listed in an emerging economy which is situated in CEE and recently joined the EU. Our findings are thus relevant for the CEE region and potentially for other emerging economies undergoing transformations of their CG practices.

First, we found that there is a modest (although increasing) percentage of Romanian listed companies that disclose their CES on their Web sites. The less powerful enforcement mechanisms which predictably exist in emerging economies, particularly in Romania, as reported in prior literature, and the confusion generated by contradictory requirements in different regulations, explain this finding at least partly. Changes proposed by the new Directive on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC related to the increase of the responsibilities of the board on CG statement and a more significant involvement of the auditor, could improve disclosure in the future. We also analyzed auditors' reports for the two years investigated, and no qualified opinion

**Table VIII** Pearson correlation matrix (N = 46)

	Compliance index per company	Comply or explain index per company	Ownership concentration	Listing category	Separation CEO/chairman	Non-executive members (%)	In (total assets)	In (market capitalization)	In (no. of board members)	ROA	International ownership
Compliance index per company	1										
Comply or explain index per company	<b>0.796978</b> ***	1									
Ownership concentration	0.004528	0.125212	1								
Listing category	<b>-0.58774</b> ***	<b>-0.56822</b> ***	0.043402	1							
Separation CEO/chairman	0.107634	0.210998	-0.0733564	<b>-0.40534</b> ***	1						
Non-executive members (%)	0.177681	0.189981	0.017096	<b>-0.44603</b> ***	-0.21656	1					
In (total assets)	<b>0.452789</b> ***	<b>0.566336</b> ***	0.212873	<b>-0.5623</b> ***	0.059336	<b>0.439478</b> ***	1				
In (market capitalization)	<b>0.522836</b> ***	<b>0.592721</b> ***	0.163032	<b>-0.62713</b> ***	0.209502	<b>0.380576</b> ***	<b>0.760675</b> ***	1			
In (no. of board members)	<b>0.29101</b> **	0.127639	0.083839	<b>-0.45503</b> ***	0.131783	<b>0.510512</b> ***	<b>0.536593</b> ***	<b>0.577764</b> ***	1		
ROA	0.137178	0.220208	-0.07331	-0.08788	0.074636	0.06915	0.131453	<b>0.404662</b> ***	0.192794	1	
International ownership	-0.12035	-0.19888	0.108306	<b>0.249726</b> *	<b>-0.29704</b> **	-0.1073	0.051046	-0.07697	-0.04795	-0.14137	1

Notes: \*, \*\*, \*\*\*Values in bold are significant at the 0.10, 0.05 and 0.01 levels (2-tailed) respectively

mentioned noncompliance cases related to CG. However, this is hopefully improving in the future. Recently, BVB has approached the Legal Transition Team of the European Bank for Reconstruction and Development to assist in its initiative to strengthen the implementation of the CGC, enhance BVB's monitoring and revise the CGC. BVB also wishes to create a BVB Corporate Governance Index in an effort to highlight those companies which demonstrate high CG standards and stimulate other listed companies to improve their practices, similar to other case worldwide (e.g. Turkey, China, Brazil, Mexico and Peru).

Second, we found that the companies in our sample report that they comply with almost two-thirds of the questions in the CES. This can be explained either by an increased awareness of the positive consequences of complying with most of the recommendations in the CGC in terms of profitability and legitimacy, or by the preference of Romanian listed companies to indicate compliance where it is not the case in practice, as there are no formal enforcement mechanisms (BVB does not verify the information included in the CES). The compliance indexes should, therefore, be interpreted with caution, as they were determined without an insider's accessibility to information. We also find cases of non-compliance without any explanations provided (3.54 per cent of our sample companies), which may have similar causes. Additionally, an analysis of the explanations provided outlines several cases of misunderstandings, confusions and an insufficient attention given to CG by some of the studied companies.

We further designed two indexes to assess compliance with the recommendations of the CGC and the application of the CEP to compliance, and the quality of explanations provided for non-compliance, respectively. So third, we generally observe the decrease of the two indexes we have constructed over the time frame studied, due to the entrance in the sample of certain companies that have lower levels of CG principles. However, we appreciate the increase of board members' knowledge of CG principles over time, as reported in the companies' CES, an evolution which we hope will be maintained over the years to come.

Fourth, we found a low compliance of Romanian listed companies with their obligation to create board committees. The examination of the other information provided on companies' Web sites reflects little evidence on the level of activity by these committees. This absence of information raises the possibility that these committee structures do not operate efficiently (if at all). Low level of compliance is observed for procedures related to conflicts of interest or for the identification of the transactions between related parties.

Fifth, we found that the issues for which companies do not provide any explanations in case of non-compliance to the highest extent are related to the continuous provision of information subject to the reporting requirements in the English language, and the drawing up and disclosure of their IFRS financial reports on the company's Web site. Other areas where limited explanations are provided are linked, for example, to the disclosure on the company's Web site of transactions made by the members of the Supervisory Board, Executive Board or other insiders on their own account, and the inclusion of the company's remuneration policy in its Statute or other CG regulation. These issues still seem sensitive for Romanian companies, even for the listed ones, and they seem reluctant to offer too much explanation for non-compliance. These findings confirm concerns expressed by [Sørensen \(2009\)](#) regarding the difficulties in the application of comparable CGCs based on the CEP within the EU, and concerns expressed by [Peters et al. \(2011\)](#) regarding the applicability of OECD-prescribed best governance practices, as applicable to emerging markets.

Lastly, our results suggest that larger companies, first-tier listed companies, and companies with larger boards, comply more with the principles of the CGC and have higher comply-or-explain indexes. It would be interesting to investigate any industry effect; however, the small number of companies in our sample prevented a more meaningful analysis. Further research should also investigate the attitude of Romanian listed

companies towards the CEP as the availability of such reports increases, particularly in a more qualitative approach (content analysis). Cross-country (CEE but not only) comparisons with other emerging countries might provide other insights regarding the factors influencing their CG practices. Finally, future research could study the extent to which companies that have low-quality CG practices might be penalized even in emerging economies, for example, by abnormal returns volatility, decreasing importance of investor ownership or decreasing share prices or transactions volume[7].

We finally conclude with the potential for development that the Romanian environment has in terms of the CEP application. A more sustained and research-driven attitude from the national regulators and from the professional bodies, and a stronger presence of powerful investor groups might encourage Romanian companies to further improve their CG practices.

This research is subject to a number of limitations. The most important one relates to the small number of the companies that were available for our investigation. However, we have used data for all the non-financial companies listed on the BVB in both 2010 and 2011, which is significant as it represents the entire population of such companies. The small number of companies disclosing their CES on their Web site (i.e. 14 companies in 2010 and 32 companies in 2011) prevented us from applying more advanced statistical treatments. Other limitations pertain to the evaluation approach of the compliance level (we have only checked the level of compliance indicated by the companies, and did not investigate in practice the extent to which they actually comply) and the subjectivity involved in assessing the quality of the explanations in case of non-compliance. However, we have used a methodology that has been used in prior literature, which increases the significance of our results.

## 6. Acknowledgement

This work has been supported by CNCSIS-UEFISCSU, project number PN II-RU TE 337/2010 entitled "A model of the factors influencing the professional profile of the Romanian accountants in business. A study on the profession's adaptation to the current business environment and a forecast". The authors wish to thank the reviewers and participants at the 8th edition of the Accounting and Management Information Systems international conference co-organized by the Bucharest University of Economic Studies, Romania and the International Association for Accounting Education and Research (IAAER), on June 12-13, 2013, at the premises of the former; participants at the research seminar organized by the Center for Research in Accounting and Management Information Systems of the Bucharest University of Economic Studies, Faculty of Accounting and Management Information Systems, on November 13, 2013; and the reviewers, discussant and participants at the 20th Annual Midyear Meeting of the International Accounting Section of the American Accounting Association, jointly organized with IAAER, held in San Antonio, Texas, during February 20-22, 2014. We also wish to extend our sincerest thanks to the editors and the two anonymous reviewers of the Journal for their sustained and significant support and insightful suggestions for improvement of the paper.

## Notes

1. UNCTAD's 2010 report (p. 16) on the implementation status of corporate governance disclosures in 21 frontier markets already underlined this case as a major challenge in the application of CEP in these economies.
2. Implementing Article 41 of the Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts.
3. A study conducted by the Canadian Business Association (2009) revealed that in 2008, only two issuers mentioned in their annual report that they intend to fill a "comply-or-explain" statement starting the following year.



4. According to BVB's Rulebook, the corporate sector of the BVB is organized into four tiers, namely, the first tier ("blue chip" tier), the second tier ("base tier"), the third tier ("new technology" tier) and the International tier. Shares are admitted to the first tier if the issuer has at least 2,000 shareholders registered. Simultaneously, the issuer's last financial year value of owners' equity or the early capitalization of the date of the request for admission to trade need to exceed the equivalent in lei of 30 million euros (1 euro is about 4.5 lei as of January 31, 2014) and show a positive net profit value over the past 2 years of conducting business. Companies in the second tier must have a capital value or market capitalization in excess of 2 million euros accumulated since the registration date of the application form for the admission to trade on the BVB. Companies listed in the third tier must target the development of new technology applicable to a wide range of fields, such as medicine, biotechnology, agro-technology, telecommunication, etc. (only one company was listed, and it did not publish its CES). The fourth tier comprises only one financial institution. We, therefore, focused our analysis on the first and second tier companies.
5. Although the CES is mandatory according to BVB's CGC, the remaining companies do not disclose it on their Web site, preventing us from accessing it.
6. We acknowledge the subjectivity involved by an extended scale, but we consider that it is more relevant for an analysis of companies' behavior when providing explanations. Arcot and Bruno (2013) used a more reliable three-category scale (i.e. complying, explaining and non-explaining companies), but we considered it less useful for the purpose of this study. We determined a reliable compliance index and including the explaining category does not add too much informative value to this index (companies could provide any kind of information including low quality). We identified also companies which do not provide an explanation for non-compliance.
7. We thank a participant in the AAA IAS meeting for pointing this out to us.

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\*\*\* Means that they do not have an identified authors, since they are issued by a Ministry (part of Government).

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## Appendix

**Table A1** Glossary of abbreviations

Abbreviation	Romanian wording (where applicable)*	English wording
BVB	Bursa de Valori București	Bucharest Stock Exchange
CEE	–	Central and Eastern Europe
CEO	–	Chief Executive Officer
CEP	–	"Comply-or-explain" principle
CES	–	"Comply-or-explain" statement
CG	–	Corporate Governance
CGC	–	Corporate Governance Code
EC	–	European Commission
EU	–	European Union
GMS	–	General Meeting of Shareholders
IFRS	–	International Financial Reporting Standards
ISAR	–	Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting
OECD	–	Organisation for Economic Co-operation and Development
OMFP	Ordinul Ministrului Finanțelor Publice	Order of the Minister of Public Finances
RON	Leu românesc	Romanian New Leu**
UK	–	Great Britain and Northern Ireland
UNCTAD	–	United Nations Conference and Trade and Development

**Notes:** \*Whenever applicable, the abbreviation is based on the Romanian wording;; \*\*1 EUR is about 4.5 RON

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