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Chapter on Spain

by de las Heras, E., Navallas, B. And Uceda, J.L.

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II. Regulation and scope of Corporate Governance:

In Spain, an European country with a narrow stock market, a strong presence of banking institutions and a high rate of cross shareholdings, and a high ownership concentration, the Olivencia Report was first published in 1998 with similar objectives to the Cadbury Report in 1992. In 1997 the Spanish Government created a special commission with the aim of drafting a report about the role of boards of directors in Spain. Like then, the composition of the committee included representatives from government regulatory agencies and independent experts in different economic areas.

The constitution of this committee was initially referred to a study for an ethical code for companies directors, and consequently did not address questions like the role and responsibilities of auditors, as the Cadbury Report did. As in Britain, Spanish Securities and Stock Exchange Commission (Comisión Nacional del Mercado de Valores –CNMV-) issued its Circular 11/98, recommending listed companies to report the adoption of the Olivencia Report. It was a voluntary disclosure requirement, and the first year for which it applied was 1998. Moreover, the CNMV itself issued a regulated model for listed companies, also based in the Olivencia Report.

On July 19, 2002, the Spanish Government decided to create a new commission that should first study the complying degree, and then establish criteria and guidelines for listed companies in order to increase market transparency. Then, four years after the Olivencia Code was issued, the conclusions and findings of the *Report of the Special Commission for Transparency and Security in the markets and listed companies* - known as the Aldama Report- was released. The reasons for the creation of this new Commission could be found firstly on the scandals that occurred both in Spain (eg: Gestcartera) and abroad (eg: Enron) during those years. Secondly,

because the previous Code considered that companies and the market itself would reward Corporate Governance complying, while what it really happened was that the interest conflict were still standing.

In this report, the Committee members analyzed the level of awareness of the Olivencia Code by more than 800 shareholders and 200 experts, through a survey conducted in 2000, which demonstrates the inadequacy of information provided by the companies, as both shareholders and experts believed transparency was still lacking as no enforcement mechanisms were considered in the Olivencia Report.

In order to increase information transparency, the Aldama Report goes one step further compared to the recommendations made by the Olivencia Code, by recommending the development of an Annual Corporate Governance Report, issued by the Board of Directors of the company, after being studied by the Audit and Control Committee. The Aldama Report sets out the minimum content that must be incorporated in the Annual Report.

In an opposite direction to the voluntary nature of the recommendations by the Olivencia Code, the regulator response decided some of them should be mandatory required by law, as established by Act 44/2002 on Measures to Reform the Financial System (hereafter Financial Act 44/2002), listed companies should have an Audit Committee. Furthermore, some of the recommendations made by the Aldama Report also became mandatory for listed companies under Act 26/2003, on Transparency Measures for Listed Companies (hereafter Transparency Act 26/2003), which requires listed companies to issue an Annual Report on Corporate Governance, as well as the creation of a website. Some authors considered that only mandatory regulation can be effective in Spain (del Brío et al, 2006), as voluntary compliance and auto-regulation which is applicable in most of European countries, will not be effective in our country. Spain is a country with high level of legal regulation due to the Civil Law tradition, with little experience in auto-regulation measures.

As a summary, the Aldama Report follows the line defined by the Olivencia Code, deepening in some areas while maintaining the continuity of its predecessor. But the Aldama Report did not

step into relevant questions like the election of board members, the separation of roles between the president and chief executive; did not propose any anti-takeover measures or enhanced transparency in the remuneration of directors and senior executives.

Additionally, the new requirement to the “Comply or Explain” principle introduced by the Transparency Act 26/2003 added new problems as applying both Olivencia and Aldama Reports imply different recommendations in certain areas –sometimes contradictories-, and Aldama Report did not included a list of recommendations as the previous Code did. Thereby, an answer was necessary in order to achieve a better compliance with the Transparency Act 26/2003, which introduced the “Comply or Explain” principle, as companies should inform in their Annual Corporate Governance Report how far they have adopted Corporate Governance Recommendations, explaining the failure if any.

2. Governance characteristics:

a. Recent regulations

A new Working Group was created in 2005 in order to publish a Harmonized Code. On January 18, 2006 the Draft Recommendations of the Unified Code of Corporate Governance were released, opening a public information period ending February 28. The aim of that project was to update the existing codes, Olivencia and Aldama Codes, and to adapt the new recommendations at the international level, particularly the recent recommendations of the European Union: Recommendation of 14 December 2004 (2004/913/EC) on remuneration of directors of listed companies and the Recommendation of 15 February 2005 (2005/162/EC) on external committees.

Before the final Report was issued, there was a high controversy between listed companies and the Working Group. The Draft Code considered the possibility of increasing mandatory measures, like the presence of women on the Board, and some listed companies complained. Finally, this and other measures were finally included as new corporate recommendations.

Thus, the Unified Code maintained its earlier voluntary approach, with new recommendations that may apply to entities others than listed companies. The main criticisms emerged related to the excessive interference in issues such as the presence of independent directors, as well as the necessary characteristics to be qualified as such.

Finally, a summary of the information is shown in the following table about the existing Corporate Governance regulation in Spain.

Table 1: Corporate Governance regulations in Spain				
1998	Olivencia Report	Voluntary	Listed companies	Recommendations on Corporate Governance
2002	Aldama Report	Voluntary	Listed companies	Recommendations on Corporate Governance
2002	Financial Act	Mandatory	Listed companies	Audit Committee required
				directors requirements about honorability and professional skills are applied to managers
				disclosure of related companies operations
			auditors	new Independence requirements
				audit and non-audit fees disclosure in the Financial statements
2003	Transparency Act	Mandatory	Listed companies	Website required
				Annual Report on Corporate Governance (<i>Comply or Explain</i> principle)
			All companies	Disclosure about directors shares or directors presence on the board of companies with similar objectives,
2003	Orden ECO/3722/2003	Mandatory	Listed companies	CG Annual Report characteristics
2004	CNMV Circular 1/2004	Mandatory	Listed companies	Standard CG Annual Report
2005	CNMV Circular 2/2005	Mandatory	listed saving entities	Websites and CG Annual Report Requirements
2006	Unified Code	Voluntary	Listed companies	Recommendations on Corporate Governance
2007	RD 1362/2007	Mandatory	Listed companies	Disclosure requirements for financial statements, audit report, voting rights etc

b. Auditing

After the deep reform made in the late 1980s, Spain adapted its legal and financial system to the European Union requirements, by the adoption of Audit Law 19/1988, establishing the rules to regulate the audit activity which also included the creation of a new public entity ICAC - Accounting and Auditing Institute- (*Instituto de Contabilidad y Auditoria de Cuentas*), run by the Ministry of Economy and Finance. The ICAC duties are not only focused on Accounting regulation but also on controlling audit activity, “... *proceeding ex officio when in the public interest, via review or verification of some of the auditors’ work, as well as to exercise disciplinary powers in respect of auditors and audit firms ...*” (Audit Law, 19/1988) Thus, auditing in Spain became a private professional activity controlled and ruled by a public entity.

Since then, little changes were taken until recent economic scandals brought new regulation affecting auditing, as those new requirements stated by Financial Act 44/2002 in order to achieve greater transparency and to improve financial statements credibility: a new regulation for auditors. After 2002, all companies –not only listed companies- must disclose audit and non- audit fees paid to their auditors in their Annual Financial Statements, and a more restrictive interpretation of auditor independency meant new circumstances that determined a conflict of interests.

As explained in the Olivencia Report, a large number of the audit report opinions issued by the external auditors contained reservations or qualifications regarding the financial statements (an average of 27% were qualified in the three previous years). The Commission pointed this anomalous situation without parallel in other developed markets.

The creation of the Audit Committee, which is compulsory after the Transparency Law for listed companies, would help to overcome this problem. In fact, for 2006, the proportion of unqualified audit reports is more that 95%, the highest level since the CNMV was created in 1989 (CNMV Annual Report, 2007).

c. Power and Responsibilities of Top Management

The Spanish corporate governance regulation is focused on promoting the implementation of new committees like the Audit and the Nomination committees. However in Spain, listed companies traditionally had another one known as Executive Committee. This committee is often created to take management decisions and integrates the main responsibilities given to the top management: more than 80% of IBEX companies have an Executive Committee (Spenser Stuart 2008). The risk of having an Executive Committee may come not only from the concentration of responsibilities, but also because its composition may not match Board composition itself. The Unified Report expected a decrease in the relevance of this committee: the recommendations made about smaller boards and more frequently meetings may gradually end with the presence of Executive Committees on Spanish listed companies. Moreover, to reduce the risk, the Code considered that the Executive Committee should have a similar composition than the Board of Directors, with a similar presence of independent directors on it.

With the adoption of the Olivencia Report recommendations, listed companies should create new committees as the Audit and the Nomination committees. The Audit Committee was almost unknown by Spanish companies before the Olivencia Report release. But the creation of an Audit Committee in a context of voluntary compliance made its appearance varies systematically across listed companies, and only a 5% of companies created an Audit Committee under voluntary basis (Ruiz Barbadillo et al, 2007). As mentioned, the creation of an Audit Committee, which should be composed by a majority of independent directors, became mandatory for Spanish listed companies under the Transparency Act 26/2003.

Focusing on directors' responsibilities and duties, little attention was paid to the conflict of interest and directors duties in Spain before Corporate Governance Codes were developed. The Olivencia Code following the stream of Anglo-Saxon countries pointed two rules to reduce conflicts of interests, as directors should avoid to participate in those discussions about facts in

which they have interests, and reducing the number of transactions between the company and himself.

The Aldama Report went again one step ahead, by recommending that some of these matters should be required by law. Latter on, the Transparency Act 26/2003 included some of the Aldama Report recommendations, not only for listed companies but also for small and medium companies, as the obligation to disclose, as a part of the Annual Report, information about the presence of the company's directors on similar or related companies, not only as shareholders but also as a member of the Board of Directors.

d. Conflict of interests and the Agency problem

As mentioned, one of the main characteristics of Spanish Stock Exchange is the high ownership concentration, with an average value of 40% (Gisbert and Navallas, 2009). Due to this circumstance, the agency problem in Spain may be found not only between owners and managers, but also between controlling shareholders and minority shareholders, the so-called horizontal agency costs. Then, this may be an important difference to Corporate Governance results to some other countries like in the Anglo-Saxon countries or Civil Law countries like Germany.

The presence of controlling shareholders on the Board of Directors is consequently higher than in other countries, and represent more than the 40% of the total Board members (Garcia y Gill de Albornoz, 2008). These directors (non-executive, non-independent) are also called institutional or *gray* directors, and can be considered as a control mechanism in reducing the agency cost arised from the separation between ownership and control. Following La Porta et al (1998), large shareholders are usually found in a weak investor protection environment as the one existing in Spain, which is identified by Miguel et al (2005) by a civil Law country characterized by having one of the weakest legal systems. This lack of legal protection explains the higher levels of ownership concentration in Spain.

Following Spencer Stuart Report (2008) the proportion on independent directors on the Board, which is around 53%, is still lower than in some other countries, and far below from Anglo Saxon countries like United Kingdom. But even though listed companies may comply with the presence of independent directors on their Board and Committees, controversy might come from the independence definition, as the 85% of them were proposed by the controlling shareholder or the company president. The Aldama Report had relevant critics because of its *shy* answer to the regulation of the independent definition while the Unified Code rounds out to the Aldama Report, adding the more concise conditions stated by the UE Recommendation in 2005: independent directors should be proposed by the Nomination Committee while allowing directors to be considered so for not more than twelve years service.

e. Evaluating Board Performance

Following the Unified Report, the Board of Directors must at least once a year evaluate its own performance as a collegiate body, in a formal exact manner, with special attention to: (a) the quality and efficiency of Board operations (b) based on a report issued by the Nomination Committee, evaluate the President and Chief Executive performance, and (c) the annual performance of the Committees.

The Board is responsible for the remuneration policy, which practical development might be delegated to the Remuneration Committee. The Code recommends that the Board should submit a detail report about directors' remuneration to the General Shareholders Meeting.

Another recommendation is made about the remuneration policy: External Directors should not have any variable remuneration related to the company performance, measured by any financial indicators or share performance, in order to avoid any conflict of interests when taking decisions that affects company's earnings.

f. Disclosure on Corporate Governance

Since the enactment of the Transparency Act 26/2003 listed companies must publish an Annual Report on Corporate Governance (ARCG), which has to be approved by the Board of Directors and sent electronically to the *CNMV -Comisión Nacional del Mercado de Valores-* Spanish Securities and Exchange Commission. The CNMV published an ARCG model, which has to be filled in. After the Unified Code was released in 2006, a new ARCG was published to include new disclosures recommended. Companies are obliged to disclose the recommendations applied and the reasons for not applying, under the “comply or explain” principle. The Unified Code pointed that listed companies are free to decide whether or not to comply, but they must disclose and explain their decisions.

The CNMV Corporate Governance Report (2007) shows those disclosure items companies comply more frequently, which are information about ownership structure, Board of Directors size, composition and director categories, board committees, board and senior remuneration or general shareholders meeting. On the opposite side those items for which companies must improve their explanations are conflicts of interest, related-party transactions and risk management system.

3. Evidence of Corporate Governance practices in Spain

As previously explained, disclosing corporate governance practices in Spain is relatively new and it is mainly focused on listed companies. Thereby, in order to identify factors influencing corporate governance disclosure over time a total of 176 and 168 Spanish listed companies for the year 2001 and 2004 have been analyzed respectively. To identify differences between firms disclosing and not disclosing corporate governance practices, we used a parametric (t-test) and a non parametric (Wilcoxon Z-test) univariate test. Results, which are presented in table 2, show that before 2002, only few companies adopted and disclosed voluntarily such practices. Nevertheless, this number increased significantly after the enactment of the Financial Act 44/2002 and the Transparency Act 26/2003, which requires that Spanish listed companies

should adopt and disclose the most relevant corporate governance. However, company' disclosure choices in Spain are not only influenced by the enactment of the Financial Act 44/2002 and Transparency Act 26/2003, but also by firm characteristics as those included in the index IBEX 35 and/or low ownership concentration. Consistent with previous studies related to the voluntary disclosure of Corporate Governance in Spain (Babio and Muino 1998, 2001) it could be argue that these companies may have high incentives to increase information to reduce agency cost.

Table 2: Firm determinants for disclosure on corporate governance practices in Spain

Year =2001										
Variable	Disclosure				Non-Disclosure				Dif	
	obs	mean	median	std	obs	mean	median	std	T-value	Z-Value
IBEX	51	0,37	0	0,49	125	0	0	0	5.45***	7.20***
OWN	42	39,77	34,73	22,22	73	61,48	58,74	27,77	-4.33***	-3.90***
Year =2004										
Variable	Disclosure				Non-Disclosure				Dif	
	obs	mean	median	std	obs	mean	median	std	T-value	Z-Value
IBEX	141	0,26	0	0,44	27	0	0	0	6.93***	2.95***
OWN	112	48,47	51,54	27,24	12	71,68	67,69	22,82	-3.28***	-2.83***

*, **, *** Indicates significance at p_0,1, p _ 0.05 and p _ 0.01 respectively.

Variables

IBEX = Dummy variable that equals one whether the listed company is in the IBEX and cero otherwise

OWN = Dummy variable that equals to one whether ownership concentration, which is measured by the number of closely held shares divided by the common shares outstanding, is higher than the mean of ownership concentration (year=2004) and cero otherwise

As it has been explained in the previous section, the Spanish regulation includes high quality corporate governance practices: the existence of an Audit Committee, the separation of roles between the president and CEO, board size between five and fifteen directors, the proportion of institutional directors plus independent directors should be the majority of the board, the proportion of independent directors should be greater than one third, and that an executive Committee is not recommended but not forbidden.

Beyond these recommendations only the implementation of an Audit Committee became compulsory by law. Then, there are no significant changes in the disclosed corporate governance practices over the last years. Hence, it could be affirmed that variables that represent Spanish corporate governance practices are sticky.

In order to identify factors influencing corporate governance practices over time a total of 36 and 48 Spanish listed companies for the year 2001 and 2004 respectively were analyzed. We used a parametric (t-test) and non parametric (Wilcoxon Z-test) univariate tests. The results, presented in table 3, show that compliance with corporate governance recommendations in Spain is influenced by Ibex-index-companies and low ownership concentration companies, which have higher incentives to reduce agency cost. ¿se puede aclarar que el hecho de pertenecer al IBEX35 y/o tener una baja concentración predispone a que la entidad cumpla más o mejor (o lo que sea) con las recomendaciones de GC? Our results are consistent with the findings obtained by Garcia and Suarez (2003).

Table 3: Firm determinants for corporate governance practices quality in Spain**Panel A: IBEX**

Year =2001	IBEX				Non-IBEX				R	Dif	
Variable	nobs	mean	median	std	nobs	mean	Median	std		T-value	Z-Value
Audit_board	19	1,00	1	0,00	32	0,72	1	0,46	1	3.48***	2.50
Year =2004	IBEX				Non-IBEX				R	Dif	
Variable	nobs	mean	median	std	nobs	mean	Median	std		T-value	Z-Value
Audit_board	36	1	1	0	105	1	1	0	1	-	-
Exe_board	36	0,83	1	0,38	105	0,30	0	0,46	1	6.18***	5.49***
CEO_own	36	0,64	0	0,49	105	0,46	1	0,50	1	1.89**	1.87**
NºDirectors	36	14,64	14	3,92	105	8,73	9	3,51	5<x<15	8.44***	6.63***
Board_Size	36	0,39	1	0,49	105	0,13	0	0,34	1	2.88**	3.30***
Perc_gray	36	0,39	0,41	0,22	105	0,41	0,38	0,27	0,33	-0.40	-0.30
Perc_Indep	36	0,39	0,37	0,17	105	0,29	0,27	0,24	0,33	2.34**	2.49**
Perc_ext	36	0,79	0,79	0,12	105	0,71	0,75	0,22	0,75	2.68***	1.62

Panel B: OWNERSHIP

Year =2004	OWN Dispersion				OWN Concentration				R	Dif	
Variable	nobs	mean	median	std	nobs	mean	Median	std		T-value	Z-Value
Audit_board	48	1	1	0	64	1	1	0	1	-	-
Exe_board	48	0,63	1	0,49	64	0,39	0	0,49	1	2.50**	2.44**
CEO_own	48	0,63	1	0,51	64	0,42	0,00	0,50	1	2.26**	2.11**
NºDirectors	48	12,06	11,00	4,11	64	10,14	9,50	4,40	5<x<15	2.35**	2.30**
Board_Size	48	0,21	0	0,41	64	0,19	0	0,39	1	0.27	0.26
Perc_gray	48	0,34	0,33	0,19	64	0,50	0,50	0,26	0,33	-3.42***	-3.14***
Perc_Indep	48	0,42	0,44	0,20	64	0,25	0,25	0,20	0,33	4.45***	4.16***
Perc_ext	48	0,76	0,78	0,15	64	0,75	0,80	0,19	0,66	0.49	0.01

*, **, *** Indicates significance at p_0,1, p_0.05 and p_0.01 respectively.

The number of observation study for the level of ownership concentration is lower due to missing values.

Variables

IBEX = Dummy variable that equals one whether the listed company is in the IBEX and zero otherwise

OWNERSHIP_Concentration = Dummy variable that equals to one whether ownership concentration, which is measured by the number of closely held shares divided by the common shares outstanding, is higher than the mean of ownership concentration (year=2004) and zero otherwise

Audit_board = Dummy variable that equals one whether the listed company has an executive board and zero otherwise

Exe_board = Dummy variable that equals one whether the listed company has an executive board and zero otherwise

CEO_own = Dummy variable that equals zero whether the chairman office executive is the same person than the owner and one otherwise

Nº Directors= Board size is the number of board members

Board_Size = Dummy variable that equals one whether the number of directors is more than five and less than 15. The dummy equals zero otherwise

Perc_gray = Percentage of the firm's directors that are institutional directors

Perc_Indep = Percentage of the firm's directors that are independent directors

Perc_ext = The sum of the percentage of institutional and independent directors

R: Some of the recommendations on corporate governance practices included in Olivencia (1998) and Aldama (2002) reports. The main recommendations on the Olivencia and Aldama Reports include that high quality corporate governance practices imply: the existence of an audit and executive Committee (Audit_board = 1 and Exe_board =1), the separation of roles between the president and CEO (CEO_own=1), the number of directors should be between five and fifteen (5<Board_Size <15), the proportion of institutional directors plus independent directors should be the majority of the board (Perc_ext > 0,66) and the proportion of independent directors should be greater than one third (Perc_Indep > 33), hence, the proportion of gray directors should be also greater than one third (Perc_gray> 0,33).

Listed companies included in the IBEX or/and with lower ownership concentration have higher probability of having an Audit Committee and an Executive Committee, the separation of roles between the president and chief executive and more independent boards. Otherwise, only listed companies included in the IBEX have adequate boards size with a higher the proportion of independent directors. Moreover, the inexistent (negative) correlation between the proportion of gray directors and IBEX-index-companies (low ownership concentration companies) does not mean low quality corporate governance practices. It could be argued that in Spain gray directors, which are designated by institutional directors, do not mitigate the agency problem due to high alignment between institutional investors and managers interests. Previous studies found a positive relationship between the presence of gray directors and the reduction of Earnings Managements manipulations (García and Gill de Albornoz, 2008), while no empirical evidence was found on the relationship between gray directors and voluntary disclosure (Gisbert and Navallas, 2009).

Additionally, it is also important to consider that the CNMV studies about the degree of compliance with corporate governance regulation identified low levels of compliance because companies do not seem to be aware of governance practices. The conclusions obtained are described as very disappointing, with a high inconsistency level on the answers received from listed companies, which explains the decision of redrafting of certain recommendations.

Finally, it is also considered important to evaluate the influence of the corporate governance practices on the quality of the financial information. By doing so, we have examined the

corporate governance practices of companies that present low quality financial reporting which are identified as those that had to restate their accounts over the same period.¹

Results, which are presented in table 3 show that there is low percentage of companies with low quality financial reporting that are adopting the main Aldama and Olivencia recommendations. These companies present lower board independence, probability of having an executive committee, and separation of roles between the president and CEO. Moreover, although these companies present considerable amount of gray directors, those could not mitigate agency problems in Spain (García Osma and Gill de Albornoz 2007). However, considering the small number of our sample these affirmations should be taken in caution.

Table 3: Firm characteristics of companies with low accounting quality

			<u>obs</u>
<u>Number of companies with Accounting irregularities:</u>			24
<u>Number of companies that disclose corporate governance practices:</u>			19
Number of companies that disclosure and compliance with the following recommendations:	R	CG	
	1	Audit_board	16
	1	Exe_board	7
	1	CEO_own	8
	5<x<15	Board_Size	14
	0,33	Perc_gray	11
	0,33	Perc_Indep	7
	0,66	Perc_ext	13

Companies with low accounting quality have been indentify as those that have restate their accounts between years 2002-2007

CG: Variable that indicate high quality corporate governance practices

R: Some of the recomendations on corporate governance practices included in Olivencia (1998) and Aldama (2002) reports. The main recommendations on the Olivencia and Aldama Reports include that high quality corporate governance practices imply: the existence of an audit and executive Committee (Audit_board = 1 and Exe_board =1), the separation of roles between the president and CEO (CEO_own=1), the number of directors should be between five and fifteen (5<Board_Size <15), the proportion of institutional directors plus independent directors should be the majority of the board (Perc_ext > 0,66) and the proportion of independent directors should be greater than one third (Perc_Indep > 33), hence, the proportion of gray directors should be also greater than one third (Perc_gray> 0,33).

¹ The corporate Governance Practices subject to study are those disclosed by the Spanish listed companies in the year 2004. We justify this choice as representative of the general company Corporate Governance performance because the behaviour of these variables is very sticky.

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