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### Behavioral corporate governance

van der Laan, G.

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## 4. Explaining Compliance with Corporate Governance Codes: Towards a Behavioral Compliance Theory<sup>7</sup>

All around the world, codes of corporate governance have flourished in the late 20<sup>th</sup> and early 21<sup>st</sup> centuries, and still are doing so. Whereas the US and the UK were the only countries involved in codifying the shareholder-management relationship in the early 1990s, 24 countries had at least one corporate governance code at the end of that decade (Aguilera and Cuervo-Cazurra, 2004), a number that has increased to more than 50 by the end of 2005. Codes of corporate governance have thus diffused rapidly across the globe, mainly due to the ever-increasing mobility of financial capital and the emergence of headline-hitting corporate scandals.

Not only have codes of corporate governance received ample media attention, scholars are likewise publishing research that aims to improve upon our understanding of the causes and effects of this proliferation of regulation and codification of management practice. Governance codes contain a wide variety of best practice provisions, relating to independence of non-executive directors, the length of the term of the executives, (the reporting upon) executive (and non-executive) remuneration, auditor independence, anti-takeover measures, and the organization of the annual meeting of shareholders, among many other topics. A large number of studies has appeared, detailing compliance with the best practice provisions contained in governance codes (e.g., Akkermans et al., 2007; Conyon and Mallin, 1997; Fernández-Rodríguez, Gómez-Ansón and Cuervo-García, 2004; Von Werder, Talaulicar and Kolat, 2005). Also, the effects of compliance on such corporate outcomes as managerial turnover and share performance have been widely studied (e.g., Alves and Mendez, 2004; Dedman, 2000, 2002).

The number of governance prediction studies that aims to explain *why* firms comply with the governance provisions is, however, fairly small. Institutional theories are invoked to identify macro-level factors that can be considered drivers of diffusion of codes (Aguilera and Cuervo-Cazurra, 2004; Haxhi and Van Ees, 2006; Thomsen, 2006) and several compliance studies report that compliance is higher in large firms, but a behavioral theory of compliance has yet to be developed – let alone tested. Such a theory first of all has to acknowledge the

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<sup>7</sup> This chapter draws heavily on a manuscript with the same title, co-authored with Hans van Ees and Arjen van Witteloostuijn. The paper has been presented at the International Association of Business and Society Conference (Florence, 2007), and the Academy of Management Annual Meeting (Philadelphia, 2007). A previous version appeared in the IABS conference proceedings in 2007 under the title “Adherence to societal norms: The case of the Dutch corporate governance code”.

large variety in scope and content of the corporate governance best practice provisions. Thus, merely making a study of compliance at the aggregate level of the code is allegedly a rather meaningless effort. In this chapter, we develop such a fine-grained compliance theory, identifying managerial incentives to comply or not to do so. Moreover, we present a first empirical test for 130 Dutch stock-listed corporations for the fiscal year 2004. In terms of Figure 1.1, this chapter focuses on the relationship between executives, non-executives, and shareholders (relationships 3, 4, and 5).

In a nutshell, our argument runs as follows. In order to maintain support from key stakeholders – including shareholders and customers – managers want their firm to have a positive reputation, and thus are inclined to comply with corporate governance codes. In doing so, they seek to profile the firm in accordance with a norm, avoiding the negative consequences of not lining up. However, code compliance is a multidimensional concept. Since codes generally contain many best practice provisions, it is possible to comply with one provision, while not complying with another best practice. We argue that managers are inclined to resist the implementation of best practices that restrict their discretion to serve their personal interests the most. We refer to such best practices as managerially contested best practice provisions. We argue that executive compensation is the exemplary area in which such non-compliance will be predominant.

Subsequently, we draw arguments from agency and network theory to hypothesize on forces that counter this drive to serve these personally motivated self-interests. Based on agency theory, we argue that supervisory (non-executive) board power *vis-à-vis* management (executive) board power and the independence of these two boards from each other restrict the possibility of managers to act according to their personal interests. Based on network theory, we argue that if the firm takes a central position in the network of interlocking directorates, it is more likely to be forced to comply. After all, compliance is a societal norm that may be enforced through this intercorporate network to avoid more strict regulations from government or the stock exchange.

This chapter thus contributes to two literatures. First, compliance theories have focused mainly on hard laws, such as tax laws (e.g., Kirchler and Maciejovsky, 2001) or international treaties developed by supranational bodies (e.g., McLaughlin Mitchell and Hensel, 2007). Compliance with the latter is studied at the national level, whereas compliance to corporate governance codes takes place at the firm level. Non-compliance to the former (e.g., taxation laws) would be considered illegal, whereas non-compliance to governance codes is specifically allowed for through the ‘comply or explain’ mechanism, which offers firms the opportunity to legally motivate deviations from best practice provisions. We thus extend compliance theories into the realm of soft laws that apply at the corporate level. Second, governance prediction studies (Black, Jang and Kim, 2006) aim to explain why

companies adopt certain governance practices. For example, research has focused on the effect of a country's economic and financial development (Doidge, Karolyi and Stulz, 2004), a firm's growth opportunities, financing needs, and ownership structure (Durnev and Kim, 2005), and firm size and performance (Lang and Lundholm, 1993) on governance ratings. Also, the adoption of particular provisions such as poison pills or golden parachutes has been studied (Davis and Greve, 1997). We contribute to this literature by developing a behavioral compliance theory. We thus extend previous governance prediction studies by suggesting explanations that go beyond country and firm specific contingencies, such as a country's economic conditions and firm size.

## **4.1 Theory development**

### **4.1.1 Corporate Governance Codes**

A central assumption in agency theory is that managers, who own a small fraction of company stock, may behave in a self-serving manner, through diverting attention towards investments that are not in the company's best interest, or through suboptimal managerial investment of effort (Jensen and Meckling, 1976). Several external governance mechanisms, such as the market for corporate control, output markets, and the market for top managers, serve to discipline executives and align their interests with those of the owners of the company (Bhagat and Jefferis Jr., 2002). Internal governance mechanisms, such as monitoring by boards of directors and incentive contracts, serve a similar purpose. Legislation, however, applies a one-size-fits-all approach, by definition, as deviations from hard law are not permitted. In situations where this approach is considered inefficient to prevent managerial opportunistic behavior from occurring, codes are developed as a means to supplement national legislation.

The first corporate governance code was published by the US Business Roundtable in 1978, and concerned the role and composition of boards of directors in public corporations (Aguilera and Cuervo-Cazurra, 2004). In 1992, the British Cadbury committee brought governance codes to Europe (Cadbury committee, 1992), and with the publication of the Bulgarian code in October 2007, each European country has issued at least one code. Virtually all these governance codes aim to regulate the relationship between non-executive directors and executive top managers, on the one hand, ensuring independence, and the relationship between the firm and shareholders, on the other hand, creating accountability through transparency.

A key feature distinguishing corporate governance codes from hard law, for example the US Sarbanes-Oxley Act (SOx), is the so-called comply (or apply)-or-explain principle. Already Cadbury (1992: 16) “[...] recommend[s] that listed companies reporting in respect of years ending after 30 June 1993 should state in the report and accounts whether they comply with the Code and identify and give reasons for any area of non-compliance.” Thus, corporate decision makers face a choice whether or not to live up to the best practice provisions. The Dutch corporate governance code, which is the focus of the empirical test in this chapter, refers to this choice, too: “Listed companies may depart from the best practice provisions. Non-application is not in itself objectionable and indeed may even be justified in certain circumstances.” (Corporate Governance Committee, 2003: 4). Whether the reasons given for non-compliance are accepted, is up to the shareholders and other key stakeholders.

The comply-or-explain mechanism gives rise to a key follow-up question: what factors predict (non-)compliance? Although many studies have been conducted to assess the level of compliance, little is known about the drivers. In the sequel, we discuss several such predictors. The next section introduces reputation and profitability arguments, and also makes a case for observing non-compliance when managerial well-being is restricted the most. These insights may explain the high compliance levels, which are generally found in the literature, but also the lower compliance with a selected set of best practice provisions, which is also found across several European compliance studies. Subsequently, two forces pushing for compliance with best practice provisions, which restrict managerial well-being, are discussed: strong, independent supervisory boards, and pressure emanating from a network of interlocking directorates.

#### **4.1.2 Compliance with Governance Codes**

As several studies into the effects of the Sarbanes-Oxley Act (SOx) on corporate financial performance show, complying with the provisions contained in corporate governance codes is not costless. A survey of twenty of the largest US banks reveals that compliance costs grew with 159 per cent between 2001 and 2006 (Der Hovanesian, 2008). For the average US listed company, as a survey among financial executives demonstrated, audit fees went up \$2.4 million in one year (Economist, 2005). Finally, Zhang (2005) estimates that the total net loss in US market value due to SOx equals \$1.4 trillion. For codes that follow the comply-or-explain mechanism, costs are likely to be lower because managers are able to deviate from provisions that would require unprofitable investments. Still, the question remains that when compliance is costly and voluntary, why are high compliance rates observed? In this section, we develop three arguments that may explain this. We first

discuss two motives, profit and reputation seeking, which both may explain the generally high compliance levels. Subsequently, we qualify the concept of code compliance and present a classification of best practices that may explain the non-compliance that is consistently observed in several areas, notably executive compensation.

***Profit-motivated compliance.*** Firms may benefit economically from compliance. Appointing independent outside directors, assuring auditor independence from management, and increasing the influence of shareholders on strategy, have been said to reduce the extent to which executives may engage in opportunistic behavior. This, in turn, may reduce agency costs and positively affect profitability. An intriguing empirical question arising from this reasoning is whether corporate performance does increase after the introduction of governance codes, *ceteris paribus*, which would imply indirect evidence for the claim that they make agency problems less salient.

Several studies have been conducted to test this hypothesis in a variety of national settings. Fernández-Rodríguez et al. (2004) show that the stock market reacts positively to compliance with Spain's governance code, but they could not nail down the specific recommendations that were the drivers of these wealth effects. Leverage and the relative number of executive directors were found to be important contingencies boosting the returns to compliance. Dedman (2002) reports that, for the UK, sales figures have increased after the implementation of the Cadbury code, and that the relationship between sales and financial performance became stronger in the post-Cadbury period. A positive relationship between compliance and performance has also been documented for the German governance code (Goncharov, Werner and Zimmermann, 2006). Alves and Mendez (2004) consider the Portuguese case, finding alternative results: specific recommendations have significant but not necessarily positive abnormal stock returns, whereas an overall compliance score is unrelated to stock market performance. Also, for The Netherlands, there are no strong performance consequences attached to the 1997 Peters' report (De Jong, DeJong, Mertens and Wasley, 2005). It has also been suggested, although results supporting this thesis have not been found, that from a signaling perspective, a negative relationship between compliance and performance may exist (Goncharov et al., 2006). The argument is that well-structured firms are able to show good performance and do not need to comply to easily applied provisions, whereas badly structured firms would comply to exactly these provisions. Overall, there does not seem to be strong evidence that codes are universally good for corporate performance.

***Reputation-based compliance.*** Firms need to maintain support from their environment – e.g., investors and customers – for the firm to remain going concern (Pfeffer and Salancik, 1978). According to this logic, therefore, a reputation for protecting investors is a condition that is positively affecting performance. Because stakeholders act upon their

perception of the firm in deciding whether or not to support the organization, the firm's reputation is an important asset to be considered in managerial decision-making. As Fombrun and Shanley (1990: 252) show “[p]ublics appear to construct reputations from a mix of signals derived from accounting and market [performance] information, media reports, and other non-economic cues. Firms’ risk-return profiles, resource allocations, social responsiveness, institutional ownership, media exposure, and corporate diversification postures signal constituents about firms’ prospects and generate reputations.” Since compliance studies on corporate governance codes attract broad media attention and increase transparency about corporate operations, the strategy companies use to reply to the code’s provisions is a factor shareholders may consider in determining the extent to which they will support the corporation. Thus, compliance may establish a reputation of being well-governed, which allows firms to secure stakeholder support. This may explain why high general compliance levels are found. However, this argument cannot explain why specific best practice provisions are not complied with. Evidence has shown that non-compliance is observed for a specific set of best practice provisions in many countries (e.g., Akkermans et al., 2007; Conyon and Mallin, 1997; Fernández-Rodríguez et al., 2004; Von Werder et al., 2005).

***Managerially contested corporate governance provisions.*** In managerial decision-making theory, two basic views of mankind have served as the basic postulate on which theories are built. On the one hand, neo-classical economic theories, and its current offsprings in principal-agency theory and transaction cost economics, assume that individuals maximize their private gains. On the other hand, stewardship theory argues that managers are intrinsically motivated to do good and to be a steward to the company (Davis, Schoorman and Donaldson, 1997). This distinction is in line with Etzioni’s (1988) classification, who distinguishes collective rationality – reasoning aimed at group decision-making – from individual rationality. Etzioni (1988) acknowledges that collective rationality is to be preferred in some situations, whereas individual rationality is more efficient in other circumstances. We combine these two positions by hypothesizing that the extent to which managers act in line with company interest depends on the extent to which the activities they perform affect their private benefits.

Governance codes contain a wide variety of best practice provisions, relating to independence of non-executive directors, the length of the term of the executives, (the reporting upon) executive (and non-executive) remuneration, auditor independence, anti-takeover measures, and the organization of the annual meeting of shareholders, among many other topics. Consequently, it may be expected that compliance with these provisions depends not only on firm-specific contingencies, but also on the topic that is covered by the provision. For instance, some provisions require the installation of a procedure, of which the costs are

relatively fixed. Examples are the recommendation – in the Dutch governance code (Akkermans et al., 2007) – to webcast shareholder meetings, and the installation of board committees, as included in the German governance code (Von Werder et al., 2005). By the nature of the provisions, some firms – here, larger firms – are more likely to comply than others. However, for other provisions, firm-specific contingencies are less likely to explain (non-)compliance, and compliance behavior may be the consequence of general attitudes of decision-makers towards the recommendations.

In order to assess these general attitudes towards compliance with specific best practice provisions, we distinguish three types of best practices (see Table 4.1). This classification is based on the extent to which the recommendation affects the private gains of the executives, and acknowledges that the level of detail of the best practices as well as the variety in content and scope allows for compliance with selected parts of a corporate governance code. First, some governance codes prescribe practices that do not influence managerial discretion or private gains. Such managerially accepted corporate governance provisions may or may not be complied with, but a relationship among managerial discretion and compliance is not to be expected. For example, managers are not likely to have strong preferences over provisions that call upon supervisory boards to regularly evaluate their own performance. Such provisions do not enter the managers' utility function, and managers will not contest compliance with these recommendations.

**TABLE 4.1**  
**Classification of Corporate Governance Provisions**

Type of provision	Examples	Types of behavior
Managerially accepted provisions	Supervisory board self-evaluation; auditor independence	Managers are stewards to the firm
Managerially debated provisions	Dismantling of anti-shareholder mechanisms; director independence	Managers trade-off preferences and pro-organizational behavior
Managerially contested provisions	Disclosure of remuneration; length of TMT contracts	Managers maximize private gains

Second, managerially debated governance provisions enter the utility function of the executive, but only do so indirectly. For example, provisions that relate to the market for corporate control do not directly affect executives' well-being. However, if executive performance is more directly scrutinized by hedge funds and activist shareholders, the probability of job loss after a takeover will increase. The difference with managerially accepted best practice provisions is thus that a self-interest maximizing individual would be



tempted not to comply with managerially debated provisions, if she would operate in a vacuum. However, the manager's "opportunity set is constrained by the perception that the utility gained from pro-organizational behavior is higher than the utility that can be gained from individualistic, self-serving behavior" (Davis et al., 1997: 25). Pro-organizational behavior comprises activities that benefit the organization as a whole. This is not only so because the manager derives utility from acting in line with the demands of other actors, but also because resistance to the implementation may result in arousal among these actors that negatively impacts upon managerial well-being. After all, "boards may be less likely to engage in self-serving behaviors ... if they feel these actions are likely to be observed and discussed publicly" (Pollock, Fischer and Wade, 2002: 1175).

Third, managerially contested best practice provisions are those that directly and negatively affect the well-being of the executive. Examples are a requirement to fix the term of the contract with the executive, or the requirement to disclose the executive remuneration policy. Absent any pressure to comply, managers are likely to resist the implementation of these provisions the most. Facing a trade-off between benefits derived from adherence to others' demands, and private interests that go against these demands, managers are likely not to opt for pro-organizational behavior in this context. Overall, our classification approximates a continuum of provisions that trigger pro-organizational behavior based on the extent to which the compliance with the provision would go against the manager's self-interest. This gives

*Hypothesis 4.1: Compliance is lower for managerially contested best practice provisions (relative to managerially accepted and debated provisions).*

We thus have outlined three arguments as to why compliance with specific best practice provisions may be observed. Note that, due to the relevance of such arguments, which depend on differential contingencies, it is not likely that studies trying to find explanations for overall compliance levels will have much predictive power. For any provision, compliance may yield financial benefits to the firm, may generate a reputation for being well-governed or may simply be the consequence of no objection against the implementation (i.e., managerially accepted best practice provisions). A combination of these factors may also be found. Particularly, we suggest that the extent to which managerially debated governance provisions are complied with, depends on the financial and reputation benefits that may be derived from compliance.

Our intent here is, however, not to show which combination of factors establish compliance to specific best practice provisions. Instead, we focus on managerially contested corporate governance provisions, and develop arguments as to why compliance may be observed in spite of the managerial intentions not to comply. The argument again takes a

behavioral lens, and acknowledges that managers do not operate in a social vacuum. The extent to which executives are able to oppose the compliance with managerially contested corporate governance provisions may depend on the power of opposing forces. Below, we discuss two such forces: normative pressure emanating from a network of interlocking directorates, and pressure from independent supervisory boards.

### 4.1.3 Opposing Forces

The extent to which managers are able to resist implementation of specific managerially contested best practice provisions depends on the extent to which other actors are able to strive for their implementation. We suggest two opposing forces that may establish high compliance levels with these provisions, regardless of their effect on managerial discretion and private gains. We do not aim to provide a full overview of all opposing forces that may operate, yet we wish to illustrate some main directions in which the theory can be further developed.

*Normative pressure from other companies.* Codes are generally developed by national bodies, and hence become a societal norm upon their publication. Compliance with best practice provisions is monitored strongly by both governments and stakeholder groups. When non-compliance is observed with a recommendation that is close to the interests of a stakeholder (group), this stakeholder is likely to call for more hard law on the topic. Since codes are self-regulatory devices, there is a need for managers who do not want corporate law to be developed such that the code's provisions become mandatory, to comply with the code to the extent that it at least appeases those parties who could otherwise enforce legislation. Thus, a dilemma emerges: although managers individually wish to resist implementation of certain provisions, collective non-compliance may result in stricter laws that force managers to implement the provisions. Networks of corporate directors have been suggested to serve as carriers of normative pressure (Mariolis, 1975; Mizruchi, 1996), and we suggest that managers who wish to both resist the implementation of a provision and prevent the development of additional legislation, are likely to press directors at other firms to enforce the implication of the provisions in those firms (DiMaggio and Powell, 1983). When a firm is thus central in a network of interlocking directorates (Pennings, 1980), it is more under pressure to comply to managerially contested corporate governance provisions. This suggests

*Hypothesis 4.2: Firm embeddedness in the inter-corporate network is positively related to compliance with managerially contested best practice provisions*

***Pressure from independent supervisory boards.*** Managers are more likely to provide detailed and transparent information supporting the proposals they present to the supervisory board if the latter is independent. An independent supervisory board is less open to deal-making behind closed doors, as it takes its responsibilities *vis-à-vis* the shareholders more seriously than a dependent board that is more willing to take the executive team's side. As Westphal (1998: 512) mentions, "structural board independence increases the board's overall power in its relationship with the CEO." The extent to which the board will allow managers to behave in line with their private interest is determined largely by the power balance between the two bodies. As Walker (1985) shows, less powerful team members are likely to adopt the cognitive perspectives of their more powerful counterparts. Hence, we propose

*Hypothesis 4.3: Supervisory board independence is positively related to compliance with managerially contested best practice provisions*

## **4.2 Data and Method**

To test our theory, we used the database collected by Akkermans et al. (2007), pertaining to compliance with the Dutch corporate governance code in 2004. The Dutch context is particularly suitable for our purpose for at least two reasons. Firstly, code development has been particularly strong in the US and the UK. In these countries, it is difficult to nail down one specific code and study compliance in isolation. The European Corporate Governance Institute, for example, lists more than 20 codes that appeared in the UK since the establishment of the Cadbury code in 1992. In the Netherlands, two main codes were introduced since 1997 (see below). It is thus easier to isolate compliance with the code under study. Secondly, the Dutch corporate governance system is characterized by a two-tier governance system in which the influence of investors on company policy was limited, at least up to 2004. For a first empirical test of our theory, it is helpful that the decision-making at the top of the firms under study involves fewer decision-makers. Also, the two-tier system guarantees a clear division of responsibilities at the top.

The next sub-section provides a brief overview of the empirical context. More extensive reviews are available elsewhere (e.g., De Jong et al., 2005; De Jong, 2001; Poutsma and Braam, 2005; Van Ees and Postma, 2005). Subsequently, the sample and the measurement of the variables is described. Finally, attention is devoted to some estimation issues.

### **4.2.1 Dutch corporate governance**

The focal point of the Dutch corporate governance system is a two-tier board structure consisting of a management board in charge of the day-to-day operations of the firm in combination with a separate supervisory board. The supervisory board's scope of influence varies substantially, depending on which institutional governance regime the firm adopts. The so-called 'structural regime' applies to the majority of public limited liability companies listed on Euronext Amsterdam's stock exchange. Two-third of all Dutch firms listed on Euronext Amsterdam are required by law to follow the structural regime, whilst other firms may opt to do so.

The supervisory board has three primary functions: first, to appoint, monitor, suspend and dismiss members of the management board; second, to draft the annual financial statement for presentation at the annual shareholders meeting; and, third, to approve major business decisions proposed by the management board concerning, for example, expansions, acquisitions, restructurings or financing arrangements. Members of the supervisory board are appointed for four-year terms by the annual meeting of shareholders. The mean number of members on the supervisory and management boards is slightly more than 5 and 3, respectively. An individual cannot serve on both boards of the same company. Inside (managerial) ownership of listed firms is unimportant in the Netherlands.

At the annual meeting, the influence of investors is circumscribed under the structural regime in two ways. First, few important issues are brought forward to the annual meeting: the financial statement drafted by the supervisory board is voted on (amendments are not permitted), and nominations for the supervisory board may be proposed and rejected. Large investors can exert influence by refusing to approve the financial statements, however that rarely happens. Second, and more devastating to investors' voting rights, management can make use of several anti-investor devices for diluting voting power and separating control rights from cash flow rights.<sup>8</sup>

In 1997, the Peters committee was the first to explicitly discuss the roles, competences and responsibilities of the management and supervisory boards in the Netherlands. The forty best practice provisions formulated by the committee can be regarded as the first Dutch corporate governance code. De Jong and Roosenboom (2002) evaluated the extent to which Dutch companies complied with the provisions of the Peters report in the period 1997-2002. The results appeared to be disappointing: the information companies provided in their annual reports on compliance with the provisions of the Peters report turned

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<sup>8</sup> Employees are represented by a works council, which exists in virtually all large firms. From October 2004 onwards, the works council has the right to a binding nomination of at most one third of the supervisory board. Since the data collection took place over the financial year 2004, this right does not affect the results of this study.

out to be scant. Moreover, in most cases, companies seemed to comply only formally, without this having any major consequences for corporate activity. These disappointing findings led to the establishment of a new corporate governance committee: the Tabaksblat Committee. The committee, representing the Dutch government, the Dutch shareholder association, the Amsterdam Stock Exchange and the Dutch employers' organizations, was assigned the task to establish a new Dutch corporate governance code. This Tabaksblat code was presented in December 2003.

Based upon 21 principles of good governance, the committee formulated a detailed list of best practice provisions of corporate governance. According to the code, all companies listed on the Dutch stock exchange and foreign companies with a statutory residence in the Netherlands have to comply or explain non-compliance with the best practice provisions of the code. In addition, listed companies are required by law to report on their compliance with the code in their annual report, based upon the comply-or-explain principle. The principles of the code apply to five important aspects of corporate governance. These include: (I) compliance with and enforcement of the code, (II) the management board, (III) the supervisory board, (IV) the shareholders and general meeting of shareholders, and (V) financial reporting. On January 1 2004, the code came into force, implying that companies have to report on compliance from the fiscal year 2004 onwards.

#### **4.2.2 Data**

To test our hypotheses, we use the database that was constructed in the context of the study of compliance with the Dutch corporate governance code performed by Akkermans et al. (2007). This research, commissioned by the Dutch Ministry of Finance, concerns the 150 largest Dutch stock-listed corporations. For the current study, we included all firms from the major stock indices of Euronext Amsterdam in the Netherlands (130 firms, in total). This sample includes such well-known global players as Philips, ING and Unilever, but excludes firms with no business activity in the Netherlands.

To determine whether a company complied with a specific best practice provision, a data collection instrument was developed in which all provisions of the code were split up in single, one-dimensional propositions or statements. This was necessary because many provisions relate to multiple practices. The higher-level provisions were split up in up to 24 lower-level sub-provisions, yielding insights at a level of detail that is, to the best of our knowledge, unique. Subsequently, the company websites and annual reports were accessed to answer the following questions for each and every sub-provision: (i) is this best practice sub-provision relevant for the corporation (e.g., sub-provisions as to share options are only

relevant if the company indeed grants these options?); (ii) if so, does the firm act in line with the sub-provision?; and (iii) if not, does the firm explain its non-compliance?

A pilot study was conducted, and about five meetings were held in which the researchers extensively discussed their experience with the data instrument, leading to iterative updates of both the data collection instrument and the assessment of the corporation's compliance. Another check of the validity of the data was conducted by providing the corporations the opportunity to respond to the assessment by email. The first round, concerning executive and non-executive compensation, yielded a response rate of 41 per cent, whereas a second round on the other provisions of the code resulted in a response rate of 27 per cent. We consider these response rates acceptable, given the difficulty of accessing managerial elites. Also, companies had fewer incentives to reply when they fully agreed with our assessment. The difference between the response rates can, to our opinion, be explained by the fact that executive compensation has received broad attention in the media, also in the Netherlands.

### **4.2.3 Variables**

The dependent variable in all our hypotheses is overall compliance with a specific set of code provisions. We took the average of the compliance scores for all statements in a best practice recommendation to calculate compliance with that recommendation. Next, we averaged out – again, unweighted – the compliance rates at the recommendation level to the topics inside the code. We used this measurement method because the structure of the code implies a ranking of importance of specific topics: a subject is obviously more important if it is dealt with in a separate chapter of the code.

Next to a score for two topical areas, we computed overall compliance scores. The topical areas reflect managerially contested corporate governance provisions, namely disclosure of and accounting for executive compensation (the Appendix provides an overview of the provisions that are included in each variable). Following upon our argument, executive compensation is closely associated with the executive's private interests. To test the first hypothesis, overall compliance levels were also computed for other topics in the code (see below).

The independent variables are network centrality, board power and board independence. The websites of the corporations were used to determine who sits on the management and supervisory boards of the 130 corporations by the 1<sup>st</sup> of July 2004. A network centrality measure is computed from this network, where we weigh the interlocks by the compliance rate. Thus, in the models where we explain firms' overall compliance, we include the network centrality variable in which the number of interlocks is weighed by the

relevant compliance rate of the firms in the network. We measure board power as the number of directors serving on the management board over the total number of directors. In the Dutch two-tier system, management and supervision are separated into two distinct bodies. We argue – in line with previous studies – that if one board outnumbers the other strongly, the former’s views on compliance will be more prominently represented in the firms’ strategic choices. The variable board independence is based on information from the compliance study as well (Akkermans et al., 2007). Board independence is a composite measure of various statements referring to this concept (see the Appendix).

Next to industry dummies, three control variables are included, all of which are derived from Thomson Financial’s database Datastream. First, in line with many findings that larger firms comply more, we include firm size in the regressions. Second, we add performance (in terms of profitability), as low performance may be an indicator of firms being scrutinized more by investors. Third, we introduce leverage, as this may proxy for the extent to which managers adhere to the best practices, which are usually designed with the investor’s perspective in mind. Firm size is operationalized as the natural logarithm of the total value of the assets, performance as return on assets in the year prior to our compliance study, and leverage as the debt-to-equity ratio, taking the market value of equity and the book value of debt. Finally, we control for industry effects in compliance by distinguishing between three broad sectors: financial, service, and industrial corporations. The industry classification is the Dutch so-called BIK system, which is based upon the United Nations’ ISIC classification, and which was developed by the Dutch chambers of commerce. We considered controlling for the index in which the corporation is listed as well, but this categorization turned out to be highly correlated with the size measure.

#### **4.2.4 Method**

Because the compliance rates are bounded to the unit interval by definition, we not only entered the rates as the dependent variable, but we also ran analyses with the log odds of the rates as the dependent. After all, applying OLS to range-limited dependent variables may result in predictions that lie outside the unit interval. However, we found that the results do not change substantively, indicating that predictions larger than one or smaller than zero do not occur. Because the coefficient estimates in the models with untransformed compliance rates can be interpreted as the marginal effect of a focal exogenous variable on compliance at any level of the other exogenous variables, and because using the log odds solves for a potential statistical problem we consider not being present, we use the untransformed compliance rates in our regression models below. We have computed predicted compliance

scores and report upon the number of predictions that fall outside the unit interval. We do acknowledge, though, that the variance of an exogenous variable does not need to be constant at all values of the endogenous variables by calculating White's heteroskedasticity-consistent standard errors.

### 4.3 Results

We first test Hypothesis 4.1 by comparing the level of compliance for best practices relating to executive compensation to compliance with other best practice provisions. Subsequently, a test of the other hypotheses is conducted through regression analyses. A difficulty in testing Hypothesis 4.1 is that it presumes a clear division of best practice provisions over the three categories – managerially accepted, debated, and contested provisions, as distinguished in Table 4.1. Such a distinction does not yet exist, and we have chosen to compare the compliance level of one set of provisions – i.e., those concerning executive remuneration – to all other provisions. Since compliance with one provision may depend on compliance with other provisions, future research could verify our approach, and develop more rigid tests of the empirical validity of the classification of provisions our theory suggests. For the purpose of our study, it is sufficient to assume that the dependent variable that has been selected – compliance with executive remuneration provisions – directly affects the utility of the executive. The approach that we take here is in a sense more strict than one that compares the three classes of provisions directly: the other provisions to which we compare the executive compensation best practices contain contested provisions as well, and thus it will be more difficult to find a difference between compliance rates of remuneration vis-à-vis other recommendations.

The Tabaksblat code contains five chapters, which are subdivided into a total of 17 sections. The study by Akkermans et al. (2007) demonstrated four stylized facts: (i) taking all firms into account, section II.2 (on executive remuneration) was complied to by 59 per cent of the companies, which is the lowest percentage for all sections (the second-lowest is 69 per cent); (ii) focusing on the largest firms (those contained in the large-cap AEX index), the compliance rate for executive remuneration provisions is 75 per cent, while most other scores are above 90 per cent; (iii) although provisions relating to director independence were also not-complied to by AEX-listed firms, non-compliance was frequently explained here, whereas this was not the case for remuneration provisions; and (iv), finally, even the smallest companies, where complex compensation packages are usually not in place and directors are paid based on a fixed fee and a cash bonus, compliance with remuneration provisions was at a low 50 per cent, whereas compliance rates for other best practices are mostly between 65 and



85 per cent for these firms. The above percentages clearly show that compliance with this selected set of managerially contested corporate governance provisions is lower than compliance with other provisions. This evidence thus provides tentative support for Hypothesis 4.1.

Having provided some anecdotal evidence for the first hypothesis, we proceed by testing the effects of opposing forces. Table 4.2 presents summary statistics and correlation coefficients for all the variables in this study. Note that since network centrality is weighed by compliance, there actually are two centrality measures.

The results in Table 4.2 show, first, that it is meaningful to calculate different compliance rates for compensation versus disclosure practices. The correlation coefficient among the two dependent variables in this study is a mere 0.47. This distinction is not apparent in the networks in which firms are embedded: if a network of firms that disclose pay practices would exist relatively unattached to a network of firms that account for pay practices, the two network variables should be empirically distinct, which they are not. Since both variables are not entered into the same regression models, this observation does not warrant statistical concern. We do observe that larger firms tend to have larger networks, although the correlation coefficient is only larger relative to other coefficients, and not so much in absolute terms.

**TABLE 4.2**  
**Descriptive Statistics and Correlation Coefficients**

		Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11
1	Disclosure compliance	0.60	0.15	1.00										
2	Accountability compliance	0.60	0.31	0.47	1.00									
3	Firm size (log of assets)	5.68	1.11	0.36	0.39	1.00								
4	Leverage	0.60	1.20	-0.15	-0.01	0.34	1.00							
5	Performance	-0.01	0.14	0.24	0.10	0.29	0.02	1.00						
6	Board power	0.37	0.16	-0.18	0.07	-0.13	-0.02	-0.28	1.00					
7	Board independence	0.75	0.27	0.29	0.19	0.17	0.09	0.15	0.01	1.00				
8	Network centrality (disclosure)	0.84	0.33	0.74	0.47	0.48	-0.08	0.26	-0.19	0.20	1.00			
9	Network centrality (accountability)	0.84	0.33	0.74	0.47	0.48	-0.08	0.26	-0.19	0.20	1.00	1.00		
10	Industrials (industry dummy)	0.45		0.04	0.08	0.03	-0.19	-0.02	-0.09	-0.17	0.06	0.06	1.00	
11	Financials (industry dummy)	0.35		-0.05	-0.02	-0.08	0.21	0.02	0.08	0.13	-0.12	-0.12	-0.66	1.00
12	Services (industry dummy)	0.20		0.02	-0.08	0.06	-0.02	-0.00	0.03	0.07	0.07	0.07	-0.46	-0.36

Table 4.3 displays the results of the regression analyses. In the first and the third columns of this table, the benchmark models are depicted, whereas the second and fourth columns show the results of the full models. Note, first, that the application of OLS to this dataset indeed turns out to be unproblematic since only one predicted value of the dependent variable in one of the models lies (somewhat) outside the unit interval.

**TABLE 4.3**  
**Regression Analyses**

	Disclosure of pay				Accountability of pay			
Constant	0.27	**	0.24	**	-0.17		-0.47	**
Network centrality			0.32	**			0.37	**
Board power			-0.07				0.29	
Board independence			0.09	*			0.16	+
Firm size	0.06	**	0.01		0.13	**	0.08	**
Leverage	-0.04	**	-0.02	+	-0.04		-0.02	
Performance	0.13	+	0.01		0.02		-0.05	
Financials	0.01		0.02		0.06		0.07	
Industrials	-0.00		0.01		0.06		0.10	+
N	129		127		119		117	
F-test	7.34	**	22.27	**	5.04	**	7.39	**
Incremental F-test			38.71	**			9.53	**
Adjusted R <sup>2</sup>	0.20		0.58		0.15		0.31	
# predictions outside unit interval	0		0		0		1	

White heteroskedasticity-consistent standard errors and covariance; Incremental F is the F-test for the explanatory power of the model *vis-à-vis* a model with the control variables only; \*\*  $p < 0.01$ ; \*  $p < 0.05$ ; and +  $p < 0.10$ .

All models reach statistical significance. The two benchmark cases show that, indeed, larger firms tend to comply more, even to managerially contested corporate governance provisions. This is in line with previous findings in compliance studies (e.g., Alves and Mendez, 2004; Fernández-Rodríguez et al., 2004; Von Werder et al., 2005). For best practices that refer to the disclosure of executive compensation, we also find that leverage contributes negatively to compliance and that past performance exerts a positive influence on compliance. The first is in line with our expectation that firms which are heavily indebted tend to comply more with creditor's best practices that may not necessarily be reflected in shareholder-oriented governance codes. The effect of performance runs counter to our expectations, though. One explanation may be that the effects of firm size, leverage, and performance

together somehow proxy for a firm's reputation. Large firms, with no financing needs (i.e., potentially large free cash flows) and good past performance may be the stars in our sample, which are seen as examples in the press for good governance. In this case, the reputation argument would predict that these firms wish to maintain their status, and consequently comply more to even those provisions to which managers oppose the most.

The independent variables are added in the second and fourth columns of Table 4.3. We clearly find support for both Hypotheses 4.2 and 4.3. The incremental F-test shows that adding board independence, board power and network centrality variables adds significantly to the explanatory power of the models. Previous studies thus omit relevant variables in predicting compliance. Specifically, the effect of firm size that is found in almost all compliance studies may actually proxy for other salient characteristics on which large firms are different from their smaller counterparts. Thus, not only are relevant variables excluded, but also other variables that are included in earlier work may suggest an effect that is in fact due to the covariation of these variables with the omitted measures.

Hypothesis 4.2 suggests that embeddedness of a firm in a network of director interlocks creates normative pressure on managers to comply, which would be an indication of self-regulating director networks. After all, at the country level, compliance is desirable to avoid stricter regulations, and since managers wish not to comply themselves, they may use influencing tactics to convince others in related firms to adopt the provision. The results in Table 4.3 clearly show that network embeddedness has an important effect on compliance. Substantively, if a firm has one link with another firm, and this other firm complies fully with all best practice provisions relating to disclosing of or accounting for executive compensation, the focal firm has a compliance rate that is 32 to 37 per cent higher than when such a link would not exist. We thus find clear support for Hypothesis 4.2.

Hypothesis 4.3 predicts that independent boards are less inclined to allow managers not to comply with contested governance provisions. Our results also provide support for this hypothesis. Although the effects are less significant than those found for network centrality, still compliance rates are 9 up to 16 per cent higher for firms with fully independent boards, as compared to firms with fully dependent boards. We thus find clear support for Hypothesis 4.3.

## 4.4 Conclusion and discussion

In this chapter, we developed what is, to our best knowledge, the first theory of compliance with corporate governance codes. In contrast to previous studies, in which no distinction among provisions was made, we introduce a classification of best practices according to the extent to which they influence the private interests of executives. At one extreme, we argue that if private interests are not affected by the practice on which a recommendation is developed, managers are more likely to engage in pro-organizational behavior. Managerially accepted best practice provisions refer to such cases. At the other extreme, managers are likely to resist implementation of those best practices that directly target their private interest. In our theory, such provisions, of which executive remuneration is a prominent example, are managerially contested corporate governance provisions. Managerially debated corporate governance provisions are between these extremes, and refer to practices that indirectly affect managerial well-being – for example, through an increased probability of job loss in case of the dismantling of anti-investor constructions. We study the extent to which executive remuneration practices are lived up to, and indeed find that this managerially contested corporate governance provision is significantly less complied with than other provisions. Thus, we find tentative evidence in support of our classification. Human choices are thus incorporated, as we show that abstract firm contingencies actually proxy for social relationships.

We proceed by theorizing that non-compliance with provisions does not take place in a vacuum. We argue that good governance codes become a societal norm upon their introduction, and interested parties will either push for compliance or for additional regulations in case non-compliance is frequently observed. Thus, in order to avoid stricter regulation, managers who wish to resist compliance with contested governance provisions, would also strive for compliance with these provisions at other firms. We thus contend that embeddedness of a firm in a network of interlocking directorships will place the managers of this firm under institutional pressure to comply. We indeed find that for our selected contested governance provision, executive remuneration, centrality in such a network positively impacts upon the compliance score. Additionally, we argue that board independence will also imply a counterforce against managerial motives not to comply, and find evidence for this claim. Thus, context matters to explain compliance, albeit not necessarily the local context.

This chapter thus adds to the governance literature by showing that conformity to corporate norms and relational perspectives may well add to the understanding of compliance with specific best practice provisions. Several areas of future research remain. First, a full test of the distinction between accepted, debated and contested governance provisions would

allow to assess the extent to which the theoretical classification has empirical validity. We are not able to test directly whether compliance levels for either of the categories is significantly different from any of the other categories. Such an endeavor would require an understanding of what constitutes managerial interests and which practices directly or indirectly affect these interests, or leave them unaffected. Second, a full test of the model would show whether the opposing forces we have identified – centrality in a network of director interlocks and board independence – are only important for contested provisions, or whether they also help to strike a balance in deciding whether or not to comply to debated provisions. More broadly, the forces that lead to the acceptance of managerially debated governance practices deserve further attention, where the application of a relational lens is probably useful since a bargaining situation exists almost by definition for these provisions. Third, our study deserves to be replicated in environments where investors have a stronger say in corporate practice, and in environments where a one-tier governance structure is in place. Particularly, the role of other outsiders – such as consultants or accountants – on the decision whether or not to comply to a best-practice provision seems a fruitful follow-up to our reasoning.

## **Appendix: Best practice provisions used for variable construction**

This appendix provides an overview of the best practice recommendations in the code that are considered in each of the topical areas. We briefly summarize the content of a provision. The full text is available in Committee Corporate Governance (2003). The variables on executive compensation include a selection of provisions from section II.2 of the code, leaving out questions referring to non-compensation issues. It is clear from the wording of the provisions, which best practices refer to disclosing pay arrangements, and which refer to accounting for (motivating) these policies. Specifically, the following sub-provisions are included: II.2.1 (conditional stock options), II.2.2 (unconditional stock options), II.2.3 (shares), II.2.4 (exercise price of stock options), II.2.5 (terms of stock options contract), II.2.9 (remuneration report), II.2.10 (content of remuneration report), II.2.12 (special remuneration), and II.2.14 (value of stock options). The independent variable ‘board independence’ draws on the sections III.2 and III.5 of the code. It includes the sub-provisions III.2.1 (supervisory board members shall be independent), III.2.3 (declaration of independence), III.5.1 (drawing of regulations of board committees), III.5.2 (composition of board committees), III.5.3 (report from board committees), III.5.6 (chair of the audit committee), III.5.7 (financial expert in the audit committee), III.5.11 (chair of the remuneration committee), and III.5.12 (no managers in the remuneration committee).