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CORPORATE GOVERNANCE PRACTICES IN EUROPE: REVISITING THE INDEPENDENCE CRITERIA ON BOARD OF DIRECTORS

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Revisiting the Independence Criteria on Board of Directors

Introduction…………………………………………………………………………........pg.4

1- Theoretical framework

1.1 Corporate governance and the codes of best practice recommendations……………....9

1.2 Agency theory and the role of independent directors ………………………………...11

1.2.1 The agency costs……………………………………………………………...13

1.2.2 Types of agency conflicts…………………………………………………….14

1.2.2.1 The effort problem……………………………………………………15

1.2.2.2 Horizon problem……………………………………………………....16

1.2.2.3 The asset problem…………………………………………………...17

1.2.2.4 Risk sharing……………………………………………………….....18

1.2.3 Mechanisms for controlling the agency problems……………………………19

1.2.3.1 The market for managers……………………………………………20

1.2.3.2 The market for corporate control……………………………………...21

1.2.3.3 Financial policy………………………………………………………..22

1.2.3.4 Investor protection…………………………………………………….23

1.2.3.5 Remuneration ……………………………………………………………24

1.2.3.6 The Board of directors…………………………………………………27

1.2.4 Controlling shareholder companies and agency relationship …………………..31

1.2.4.1 Agency theory for CMS firms………………………………………33

1.3 Harmonization or convergence? ……………………………………………………..34

2. Literature review

2.1 European corporate governance practices…………………………………………….38

2.1.1 Descriptive analyses of best practices in European countries…………………...46

2.2 Studies focusing on the independence criteria………………………………………...55

2.2.1 Independent directors and the agency problem…………………………………..55

2.2.2 Differences in the classification of independent directors………………………62

2.3 Studies analyzing the convergence……………………………………………………63

3. Sample selection and research model

3.1 Data collection and description of the sample……………………………………...…67

3.2 Defining independence………………………………………………………………......69

4. Results

4.1 Descriptive statistic on the proportion of independent members on the Board of Directors and the Audit Committee……………………………………………………….74

4.2 Level of compliance of the companies with the best practices recommendations and the independence criteria developed in this study……………………………..……………80

4.3 Measuring (T-test) how the proportion of independence is affected by the country's legal regime and by the anti-director rights index (LaPorta et al., 1999)…………………85

Conclusions……………………………………………………………………….88

References………………………………...……………………………95

Appendix…………………………………………………………………...104

Introduction

After the corporate scandals affecting listed companies such as Enron, WorldCom or Parmalat improving corporate governance became an important issue and many changes have been in act during the years. The globalization but also the pressures from international organisms are leading towards the development of new principles of corporate governance. The codes of corporate governance are an important factor in governance practices. As Aguilera and Cuervo-Cazurra (2009) document there has been an increasing number of codes in the recent years and they also have improved the corporate governance of the countries that adopted them. Corporate governance codes are a set recommendations for best practices with regard to the structure and the functioning of the board of directors (Aguilera and Cuervo-Cazurra, 2004).

The independence criteria has become a central issue over the last decade and many studies have reported that independent directors constitute an important mechanism of corporate governance (Daily et al., 2003; Gordon, 2007; Kim et al., 2007; Zattoni and Cuomo, 2008). It is a commonly shared idea that increasing the proportion of independent members in the board of directors and its committees improves the corporate governance of the firm.

The role of independent directors became important after the Sarbanes-Oxley act, which enforced the companies to increase the number of independent members in the board. Independence over the years, has also been the object of an increasing number of studies analyzing the role of independent members in mitigating the agency problems in the firm (Klein, 2002; Peasnell et al., 2005; Xie et al.,2003). Empirical findings have shown that independent directors on boards contribute in increasing firm performance (Dahya et al.,

2008). Others documented the proportion of independent members in companies (Crespi and Pascal Fuster, 2013) .

Independent directors are important in mitigating the agency problems arising as a result of the separation of ownership and control (Fama, 1980; Fama and Jensen, 1983). In the European context, where most firms have controlling shareholders, independent directors are important in protecting the minority shareholder from the risk of expropriation (Bebchuk and Hamdani, 2009). Their particular role in mitigating both the agency problems arising in widely held firms but also in the controlling shareholder firms, has been recognized in the European Commission recommendation of 2005[1]. The Commission's report highlights the important role independent directors may play in improving corporate governance.

As a result of the increasing importance of the role of independent directors in improving the quality of corporate governance, in this study we focus our attention in the recommendations of the best practices of the European countries regarding the proportion of independent members on the board of directors and the audit committee. In addition, we also analyze the independence of boards by verifying whether the division of duties between the CEO and Chairman is recommended by the best practices of European countries. The main objective is to analyze how the independence criteria is determined in the countries' best practices. Doing so, we also verify if there are similarities or differences among the European countries in their definition of independence.

We also develop a rigorous new measure of independence according to the recommendations of the SEC rules of corporate governance, the OECD principles of (2004), the EU

[1] Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.

Commission recommendations and the single countries best practices of corporate governance. Using our measure of independence, we gather firm level-statistics on the corporate governance practices on a sample of 463 European listed firms to analyze the degree of independence of the boards and the level of compliance of our sample with their respective country codes.

In this study, we also measure the degree of compliance of our sample firms with the Anglo-Saxon best practices of corporate governance at a country and a firm level. There has been an increasing debate during the years whether corporate governance mechanisms are converging towards the Anglo-Saxon best practices. The diffused idea that managers should act in the shareholders' interests but also the failure of alternative models of corporate governance are some of the reasons that are driving the convergence towards the Anglo-Saxon best practices (Hansmann and Kraakman, 2001). In this study by analyzing the recommendations of the best practices in Europe but also the corporate governance mechanisms of the companies, we want to contribute to the existing debate on convergence by determining the degree of convergence of the European best practices with those of the Anglo-Saxon countries. To determine this, we use our measure of independence and analyze at a firm level, the proportion of independence of the companies' board of directors and audit committee and also the division of duties between the CEO and Chairman. We then measure the level of compliance of the companies of the sample with the Anglo-Saxon best practices of corporate governance

Analyzing the corporate governance codes of 17 European countries, we find differences regarding their recommendations on the proportion of independent members in the board. Most of the countries do not recommend a majority of independent members in the board of directors and the audit committee. The main difference in the recommendation of the best

practices is related to the independence criteria for which most of the definitions used are not similar among the governance codes. Countries use different definitions of independence and the main difference is related to the independence from the major shareholders. For some countries' best practices being a shareholder representative does not influence the independence of a board member. According to the recommendations of the countries' best practices regarding the independence criteria, we ranked the countries from the strongest to the weakest based on the quality of their governance. This allowed us to compare the results with La Porta et al's (1999) ranking and so to validate our independence model.

When analyzing firm-level corporate governance, we find that companies tend to follow their countries best practices regarding the proportion of independent members in the boards. We also observe a high degree of compliance of the companies with our measure of independence. Our findings also suggest that European countries corporate governance practices also comply with the Anglo-Saxon best practices of corporate governance. The result are interesting considering the fact that we use a stricter criteria of independence compared to the one suggested by the countries bests practices. We also find a high degree of companies having a fully independent audit committee.

We also perform mean comparisons on the level of independence of the BOD, the audit committee and the CEO duality according to the legal regime (Common versus Civil law) as well as La Porta et al.,'s (1999) ranking of countries according to high and low anti-director rights.

Finally, with regard to the discussion on convergence, we document a high degree of adoption of Anglo-Saxon principles of corporate governance in a firm-level basis. Our findings suggest

convergence is in act and this is more related to the companies' corporate governance mechanisms than the best practices of the European countries.

This study is structured as follows. In the first section, we discuss the theoretical framework with a particular focus on the role of independent members in improving the corporate governance of a firm and their important role in mitigating the agency problems. Than follows the literature review and the description of the European corporate governance practices. In the third section, we discuss our sample selection and the independence criteria developed in this study. In section 4, we present the findings of our firm-level empirical analysis. We conclude in section 5 with the contributions, the limitations and future research perspectives.

Chapter I

Theoretical framework

1.1 Corporate governance and the codes of best practice recommendations

After the corporate scandals, corporate governance has become an important item for researchers all over the world and the main debate has been how to increase its efficiency. Several reforms have been in act during the years with the main objective to improve the quality of corporate governance. According to Aguilera et al., (2011) the reason of all this important focus on corporate governance mechanisms, is connected to the increasing number of international investors and corporate scandals worldwide. The globalization of capital markets has given the opportunity to international investors to invest in different markets across the world. At this point, investors need an assurance for their investments and corporate governance may be important in providing this (Shleifer and Vishny, 1997). Investing in countries endowed with a weak corporate governance system is risky for the investors and this affects companies whose structures are not in line with the expectations of the international investors. Shleifer and Vishny (1997) suggest that, at the long run and as a result of the globalization, more efficient corporate governance mechanism will prevail, providing more protection for the investors and alleviating costs of external financing.

On the other hand, corporate governance scandals have also affected the credibility of listed firm. Companies that respect the governance rules and apply the required governance mechanisms are also those that will have more opportunities to access different capital markets at lower costs. Because corporate governance is known to be an important factor for

the success of a company over the years, several efforts have been made to increase the efficiency of corporate governance.

Particular instruments that have an important role in improving the corporate governance are the codes of best practice recommendations. The main objective of the codes is to reduce the differences between the companies adopted corporate governance systems and to harmonize the corporate governance system of all the companies of a particular country. These codes include several recommendations and guidelines on governance mechanisms for a company such as the board of directors and the management, its committees, mechanisms for electing the members of the board, decisions regarding their remuneration, etc. The codes of best practices, with the exception of the United States, are based on the *comply or explain* principle, which enforces the companies that are not complying with the principles to explain the reasons of non-compliance.

Aguilera and Cuervo-Cazurra (2009) suggest that for the year 2008, 64 countries all over the world had issued 196 distinct codes as a result of the importance that different organisms gave to these codes in improving the corporate governance. The codes, according to the authors, are issued as a result of different factors influencing the governance of firms such as the globalization and the integration of the financial markets, the increasing number of international investors and also the financial scandals. Aguilera and Cuervo-Cazurra (2009) suggest that the codes are also released by different issuers such as governments, stock exchanges, investors, associations or other international organisms.

However, differences in the scope and the roles that the codes of best practices have in improving corporate governance mechanisms still exist. Zattoni and Cuomo (2008) investigate

the reasons behind the wide diffusion of the codes by collecting the corporate governance codes worldwide for the year 2005. The authors find several differences in the diffusion, recommendations and the scope of the codes issued in civil and common law countries. Trying to explain the reasons for the adoption of the governance codes, the authors suggest that civil law countries also extend the recommendations of the codes to the non-listed firms. They suggest that civil law countries adopt the codes later and issue new codes to legitimize domestic companies in the global market rather than to improve corporate governance the of their country.

1.2 Agency theory and the role of independent directors

Berle and Means (1932) were the first to raise the question whether managers being independent from shareholders, in the separation of ownership from control, act towards maximizing the value of the firm or pursue their own interests. According to their study, the creation of the quasi-public corporations through their increasing size, creates the separation of ownership and control, and results in a divergence of interests and incentives between the manager and the shareholders.

Under the definition of Jensen and Meckling (1976), the firm is a set of contract with which the conflicts of interest of the two parties (management and shareholders) are brought into equilibrium. However, these contracts could not cover every single action of the different parties in the firm and so there are opportunities for agency problems to arise. They define the agency relationship as a contract in which the principal engages the agent to perform some duties on his behalf. In this sense in widely held companies, the principal is represented by the shareholders who give the decision making power to the manager (the agent) of the company.

According to the authors, if both parties are utility maximizers, the interests of the managers will not always be the same as the interests of the shareholders. This situation applies particularly to widely held companies, where there is a clear separation of ownership and control. Managers usually are more risk averse than the shareholders and also they may decide to expend less effort to the company than it is expected. As the risk and effort aversion of the managers are different from those of the shareholders, the decisions taken by management may not be the ones that maximize firm value, as shareholders expect from them. In this sense the main issue related to the separation of ownership and control, is the manager-shareholders' divergence in interests leading to suboptimal decision making for the firm.

According to Shleifer and Vishny (1997), when there is a separation of ownership and control, the managers end up with control rights on how to allocate the fund of the investors. According to them, even though managers and shareholders can sign different incentive contracts to regulate the behaviors of managers, not all contracts can control the managers' decisions. This is explained by the fact that not all the future eventualities can be foreseen and the contracts are signed in advance. These contracts do not cover all the situations that may arise during the years and the financiers are not qualified or informed enough. In this situation managers have the control rights in advance and the discretion on how to allocate the funds provided by the financiers, thus, more possibilities for opportunism by the managers. Managers can expropriate the funds allocated by the investors by consuming the perquisites of the company. Shleifer and Vishny (1997) argue that the managerial opportunism reduces the amount of resources that investors provide to the company as a result of the agency problems. The authors also point out different ways of expropriation from the managers. One form of expropriation is taking out the cash directly from the company or selling the outputs or the

assets to other companies they own. Managers may also consume perquisites or may focus in increasing the company size beyond the rational by reinvesting the free cash flows (Shleifer and Vishny, 1997). Their interests to increase the firm's size beyond the rational is related to more power and resources under their control (Jensen, 1986).

1.2.1 The agency costs

Jensen and Meckling (1976) suggest that for the shareholders one way to limit the divergences is in engaging in costs that they define as agency costs. The agency costs are the costs that the shareholders bear to limit the risks of managerial opportunism. These costs are mainly the monitoring costs, the bonding expenditures and the residual loss.

The monitoring expenditures are costs related to the control of the activities of managers. These expenditures, according to Jensen and Meckling (1976) may be costs related to auditing, budget restrictions, control systems or establishing new compensation incentive to the managers in order alleviate the divergence of interests between them and the outsiders. The monitoring expenditures are costs that shareholders bear to make sure that the managers will pursue their interests. In this sense, shareholders who invest in monitoring expenditures will expect better returns on their investments as a result of the alignment of interests between the shareholders and the managers. However, the problem of engaging in monitoring activities in widely held firms is that no shareholder has the incentive to invest their own resources in monitoring the activities of the managers (Grossman and Hart, 1980). This can be explained by the fact that the shareholder will not gain all the benefits of investing in monitoring expenditures but will share them with other investors who will benefit from this without having to bear any of the monitoring costs. This phenomenon is called "free-riding" and,

because every shareholder thinks or "assumes" that someone else will be involved in monitoring and they will have the opportunity to "free-ride" at the expense of others, no shareholder will invest in these costs.

The bonding expenditures are related with the guarantees that the managers tend to provide to the shareholders on following actions that are in line with their expectations. The bonding expenditures in this case is a cost that the manager will bear as an assurance to the shareholders that he will not engage in opportunism behaviors. Engaging in bonding costs gives to the agent the possibility to use the resources provided by the principal. Jensen and Meckling (1976) suggest that bonding expenditures may be related to the engagement to audit the financial statements by an external auditor. Other bonding expenditures according to the authors may be the decision of the manager to limit his decision power or a guarantee that he will not be engaged in activities that reduce the outsiders' wealth.

The residual loss is related to the divergences that still exist between the shareholders and the managers and that are not alleviated by the monitoring and the bonding activities. As it is impossible to prevent, ex-ante, all the behaviors of the managers, problems related to the alignment of interests will still persist after the monitoring and the bonding costs.

1.2.2 Types of agency conflicts

In widely held companies, as a result of the separation of the ownership and control, the decisions are made from the managers who are delegated by the shareholders to run the firm. Managers risk and effort aversion is different from the shareholders, hence, the incentives that they have in making decisions may not always be in line with what the shareholders expect. As a result of the diversities of the motivations between the two groups, different agency

conflicts may arise in the firm. The literature have shown that these conflicts of interests may be classified into four different types (Byrd, Parrino, and Pritsch, 1998)

1.2.2.1 The effort problem

The effort problem is related to the dedication that the managers put in the firm to create value for the stakeholders. Managers are the controllers but not the owners of the firm, and in this sense their incentives to work and so to maximize the value of the firm may differ from what the shareholders would expect. This is a moral-hazard problem that refers to the lack of effort that the managers put in the firm to pursue the objectives of the shareholders (Eisenhardt, 1989).

The management incentives to shirk will depend on their ownership on the firm (Jensen and Meckling, 1976). The authors demonstrate that when a firm is wholly owned by the manager, he will have incentives to maximize his utility and in this case these incentives are also related to the firm value maximization. As the ownership of the manager decreases, his incentives to shirk will increase as a result of the agency cost created by the divergence between the interests of the manager and the outside shareholders. Jensen and Meckling (1976) argue that the incentive of the manager to invest in new creative activities will depend on his ownership of the firm, and as this ownership decreases, so does his incentives resulting in a significant reduction of the firm's value.

The findings of Rosenstein and Wyatt (1994) are in line with this theoretical argumentation. The authors analyze the announcements in which one director joins the board of another company and find that the value of the firms declines significantly after the announcement.

These findings suggest that an increase in the duties of the directors may decrease their efforts and devotion in a given firm.

1.2.2.2 Horizon problem

The corporation is expected to have an infinite life and in this perspective, another diversity of interests arises between the shareholders and the managers. Shareholders are concerned on the value of the firm for its entire continuous life which contrasts with the managers who are only concerned on the cash flows during their employment period (Byrd et al., 1998). As a result of this divergence of interest, the projects that the managers will choose for their investments may not be in line with the projects that the shareholders would choose if they were also managers. Because of the horizon problem, managers may be more interested in projects that generate high accounting returns in the short-term instead of choosing long-term investments with a positive Net Present Value (McColgan, 2001). Accordingly, what the managers will only take into consideration the cash flows produced during their period of employment in the firm and not focuses on value-enhancing investments that will generate returns on a long term period after their employment with the firm.

This problem, according to Dechow and Sloan (1991), becomes more relevant when the managers are about to retire or to leave the company. In these situations, managers prefer to invest in short term projects with quick results instead of focusing on long term projects that may generate more profits. The authors found that the R&D expenditures tend to decline as the managers approach their retirement, and they suggest that the reason for this decline is related to the time horizon problem. A firm investing in R&D expenditures may reduce the

manager's compensation in the short term period and so, the managers that are about to retire may be reluctant to these investments before their retirement.

Byrd et al., (1998) suggest that the horizon problem may also be relevant in the case where the equity market does not recognize in a short term basis, the true long term value of a new project for the firm. A manager who is worried about these short term market reactions may be more willing to choose investments that produce high cash flows in the short term instead investment with high positive net present values in the long term.

1.2.2.3 The asset problem

Managers may also engage in an inappropriate use of the firm's assets for their personal interests. Because the managers do not bear the entire costs of these expenditures, they may have incentives to misuse the company assets. The agency problem arises because the shareholders are those who bear almost all the costs related to the asset consumption problem which ultimately becomes value destructive destroys value for the firm and for them.

According to Jensen (1986), managers have incentives to push their firms to grow because they benefit from these growth opportunities by increasing their power and the resources under their control. The author also suggest that another reason why managers tend to cause their firm to grow is because the size of the firm has an impact on their remuneration which tend to increase as the firm grows in size (Jensen and Murphy, 1990).

Jensen (1986) suggests that according to the free cash flows of the firm, new divergences of interests between managers and shareholders may arise. In fact, while shareholders prefer to have the free cash flows of a firm distributed to them once all value enhancing investments are made, managers tend to retain the excess cash flows and undertake suboptimal investment

decisions that will result in an increase in firm size and, consequently, increase managers' power of control, prestige, and remuneration.

1.2.2.4 Risk sharing

Another agency problem that arises as a result of the divergence between managers and shareholders is the risk sharing. The risk sharing problem is related to the fact that the two parties have different attitudes towards risk (Eisenhardt, 1989). Shareholders should diversify their firm-specific risk they can do so and also at a low cost. As the shareholder may diversify their specific risk at a low cost, they are less risk averse than the managers who are more risk averse because they have fully invested their human capital in the firm and hence are not diversified. Most of the managers' wealth depends on the success of the firm and its survival. Byrd et al., (1998) argue that when the managerial compensation is composed of a fixed salary and their skills are difficult to transfer from one firm to another, their risk preferences will differ from those of the shareholders. Risk increasing investment decision from the managers may also increase the probabilities of bankruptcy which will increase the risk of the managers' loss of remuneration and reputation. This will make it more difficult for managers to find another job of same remuneration (McColgan, 2001).

The manager's risk preferences will also be reflected in their policies to reduce the risks in which the firm is subjected to. Instead of choosing new products or new technologies, managers may choose a less risky investment such as expanding an existing product, and hence limiting the possibilities of failure (Byrd et al., 1998). From one point of view, this choice reduces the risks for the managers but may also reduce the shareholders' wealth from not investing in more profitable but riskier new projects.

As Jensen (1986) points out, managers' risk aversion may also influence their financial policies. In fact managers who are risk averse will prefer to use debt as little as possible for the financing of their investments because of the high risk of bankruptcy associated with debt. They may also choose to finance their investments by shares with low dividend payouts to avoid debt. However, debt will reduce the agency costs related to the free cash flows available for the managers who will consequently have less discretion for overinvesting and for serving their own interests (Jensen, 1986).

1.2.3 Mechanisms for controlling the agency problems

The main agency issue that arises as a result of the separation of ownership and control is related to the alignment problem. The interest of the shareholders and the managers may not be aligned because of the different incentives of these two parties. To address these problems, widely held firms can rely on various governance mechanisms created to alleviate alignment related agency costs. Accordingly, the main objective of governance mechanisms is to develop new ways to mitigate the agency problems and so to increase the alignment of interests between the shareholders and the managers. The literature categorizes corporate governance mechanisms as external and internal mechanisms depending on the parties that are involved in the monitoring of managers, whether directly from governing directors or indirectly through market forces outside the firm. Hence, external mechanisms may be such as the market for corporate control, market for managers and the financial policy of the firm. Inside mechanisms are related to the mechanisms inside the firm that monitor the managers such as the board of directors and the remuneration policy of the firm.

1.2.3.1 The market for managers

The market for managers may be an important factor in reducing the agency costs related to the alignment issues by encouraging managers to increase their performance and consequently, align their interests with those of the shareholders. Managers tend to have more opportunities if they obtain good results and are effective. According to their performance in creating value for the firm, the market for managers will pressure the firms' compensations policies. This can be a positive incentive for the efficiency of managers because of the potential high remuneration opportunities and possibilities to be hired as board members in alternative firms of larger size. According to Fama (1980), managers 'remuneration will depend on their success or failure to create value for the firm. Based on corporate performance and how well the managers are able to align their interests with those of shareholders, the market for managers will signal the required level of remuneration to offer to managers. In fact he argues that the market for managers puts pressure on the firm's wages to compensate the managers according to their performance. This will also allow the alignment of incentives between managers and shareholders as the managers will be more focused optimizing corporate so to signal the information on their skills and performance be signaled to the markets. Fama (1980) also points out that the firm is more able to evaluate the managers according to their past performances and so, when the firm is searching for a new manager, a good way to determine their abilities is by measuring their performance. This is also helpful for the managers because when their firm compensation system does not correspond to the level the managers deserve, they have the possibility to change firm and so to find a job that pays them the salary they are worth receiving.

In line with Fama's (1980) arguments, Gilson (1989) found that the market for managers uses past information regarding the performance of managers in the firm, when determining the wages and other job opportunities for the managers. . Using a sample of US listed firms, he found that managers who resign from financially distressed firms, are not employed by other listed firms for at least 3 year after their resignation. He also finds that when the managerial costs of financial distress are high, managers tend to limit their default probabilities by choosing less risky investments, less borrowing or more management efficiency.

1.2.3.2 The market for corporate control

Takeovers contribute in mitigating the agency problems when the internal control mechanisms are non efficient (Jensen, 1986). He argues that the market will reflect the agency problems of the firms. Hence, investors will catch these signals and will pay less for the shares of the company which will result in a decrease of the price of shares. Managers are underperforming as a result of the agency problems and they are using the resources under their control for their own interests. In this case, investors who realize that they can do better and increase the performance of the firm and consequently its value, become potential bidders.

Consistent with these arguments are the findings of Healy et al., (1992). These authors analyze the performance of a sample of US firms after their mergers and find that the corporate performance of the firms has increased after the mergers suggesting that takeovers may play an important role in pushing managers to perform better and increase firm value.

Martin and McConnell (1991) suggest that an important role of the takeovers is to discipline the managers of underperforming firms. The authors argue that the takeover may serve as a threat for the actual managers of a firm to perform better and to focus more on value

maximizing activities. In fact, the potential bidders will monitor the performance of the managers of target firms. Hence, the managers being in the risk of losing their position if their firm becomes a potential target, may be more concerned in aligning their interests with those of the shareholders and focusing on maximizing the value of the firm.

1.2.3.3 Financial policy

The agency problems and hence the agency costs may also depend on the financial policy of the firm. How the firms decide their financial policy may contribute to the alignment of interests between the managers and shareholders. The high risk of bankruptcy associated to debt financing may lower the agency problems of the firms. Also the fact that managers are evaluated according to their performance may push them to align their interests with those of the shareholders, to be more focused on firm efficiency and to produce value for the firm. Debt financing is considered a corporate governance mechanism that plays an important part in mitigating the agency problems of a firm. Debt holders monitor managers by setting covenants on required corporate performance and financial situation and also by evaluating the investment activities that they are financing. This monitoring will lead managers to be more concerned in making value-enhancing investment decisions, and therefore limit the agency costs which arise from the non efficient use of the free cash flows. Debt financing limits the opportunity of managers to make misuse of the resources they control.

Jensen (1986) described the important role of debt in reducing the agency costs of the firm and also the benefits of debt in motivating the managers and the organizations to be more efficient. He argues that in firms with substantial free cash flows, managers have the control on how to use these cash flows. The substantial cash flows may be misused by managers in

investing in low return investments or increase the firm size so to increase their power and their remuneration. The agency problem arises as a result of the decision of the manager to use the cash flows for their interests instead of choosing to pay out the cash. Debt financing will limit the resources under the control of managers as creditors will monitor their activities. Creditors will follow the investment opportunities and the company will not invest in low value projects. From the monitoring activity of the debt financing, managers will be enforced to reimburse the free cash flows.

When debt levels are high and profits are low, cash flows will be associated to negative ratings from the rating agencies and this will push the shareholders to substitute the managers for their poor performance (Byrd et al., 1998).

1.2.3.4 Investor protection

Investor protection deals with the mechanisms by which the corporate laws offer a protection to corporate investors. As the investors are investing in the firm, they also need an assurance of obtaining a return on their investments. Without this mechanism of legal investor protection, investors face the risk of expropriation from managers or large blockholders, they may decide not to provide financing for the firm. La Porta et al., (2000) suggest that as investor protection increases, the insiders being themselves either managers or major shareholders, have less opportunities to expropriate the minority shareholders, or so their interests will be aligned. When the investor protection mechanism is strongly enforced, insiders will expropriate less and hence, their private benefits of control will diminish. The authors suggest that a good investor protection is offered by both, legal laws and their enforcement. They suggest that some of the rights of the investors generally protected by laws

or regulation may include the shareholder rights to receive dividends on pro-rata terms, to vote for the directors, to sue directors or major shareholders for suspected expropriation etc. For the creditors, they suggest that these rights deal with bankruptcy and reorganization procedures, and may include mechanisms that enable creditors to repossess collateral or protect their seniority etc.

In countries where there is a weak investor protection, the risk of expropriation of the minority shareholders is high. According to La Porta et al ., (1998) (1997), countries with weak investor protection are also those that have more controlling shareholder structures. In response to the weak investor protection concentrated ownership is important to limit the risk of expropriation. On the other hand, widely held companies are more common in countries with strong shareholder protection which can be explained by the fact that strong legal protection mechanisms which limit the risks of expropriation for the minority shareholders are strong in these countries. In fact, Leuz et al., (2003) find that strong and enforced outsider rights limit the insiders' behaviors for private control benefits and so the insiders have less opportunities to manage earnings.

1.2.3.5 Remuneration

Until now, we described the mechanisms that tend to alleviate the agency problems that are related to parties outside the firm. These are mechanisms that align the interests of the outsiders being themselves shareholders or other stakeholders with the managers inside the firm. The remuneration policy is especially important in firms where the managers make decisions that cannot be monitored by the board of directors or the investors (Byrd et al., 1998). The remuneration policy depends on the decision of the parties inside the firm, being

themselves managers or other parties involved in the management of the firm such as the board of directors and its committees, which decide the remuneration for the managers so as to align their interests with those of the shareholders. The remuneration policies may represent a high incentive for the manager of the company to do well. An efficient remuneration policy will provide the necessary incentive for managers to increase their efforts to do well and will therefore mitigate agency problems. Jensen and Meckling (1976) suggest that higher levels of compensation for the managers will lead to higher company performance and consequently to lower levels of agency costs.

The remuneration policy is composed of three components; salary, accounting-based bonuses and executive stock options.

The salary is structured in a way to provide managers the incentives they need to focus on increasing the performance of the firm. Usually the salary is determined by the market for managers and also depends on other factors such as the size of the firm or the duties of the manager. Salary can be used to reward the managers according to their performance and push them to increase their incentives towards maximizing firm value (Byrd et al., 1998).

Baker et al., (1988) suggest that compensation plans based on the performance are effective and able to incentivize employees to do exactly what they are told to do. However, the authors also underline some limits of the performance-based compensation in motivating the employees. They suggest that the monetary awards in some cases may be counterproductive in that they can lower the employee motivation by reducing the intrinsic rewards associated to their performance in the firm. They also argue that the performance-based compensation may

affect the employee morale and productivity because of the different treatment of the employees based on their performance.

The accounting-based compensations are incentive schemes under which the performances of the manager are compensated according to accounting measures and the remuneration of the managers may be in stocks and cash. Accounting-based compensations may play an important role in aligning the shareholders and managers incentives. This assumption is supported by Banker et al., (1996) who find that the implementation of these plans is associated with an increase in sales, which persists over time. The authors analyze 15 retail outlets and find that when managers are compensated according to their performance, the output increases.

Another important aspect of the accounting-based compensation plans is that these plans can also be designed to reward the performance in division levels. Accordingly, these plans can incentivize lower-level managers to increase the value of the firm as well (Byrd et al., 1998).

However, Byrd et al., (1998) suggest that although these plans may help align the interests between the managers and the shareholders, many problems are related to them. The accounting numbers may be subject to manipulation by the managers to increase their performance in order to obtain their bonuses.

Executive stock options are used as market based compensation that also plays an important role in aligning the manager and shareholders' interests. Under the stock option compensation, managers have the rights to buy or receive company stocks as compensation, and so become part owners of the company they manage. This mechanism help mitigate the agency problems because managers having become shareholders have the same incentives as the other shareholders in increasing firm value so also maximizing their wealth as a result of the

increased value of the stocks they own. Stock options may also be long term incentive plans motivating managers to focus on long term value maximization for the firm and not only for the period of their employment. Agrawal and Mandelker (1987) suggest that executive stock options help mitigate agency problems thus align the interests between the managers and shareholders. They also suggest that stock options will push the managers towards choosing the best investments that increases the firm value. Mehran (1995) also found that firm performance is related to the stock options held by managers, discussing the important role that these compensation plans have in mitigating agency problems. He found that these plans are especially used in firms with more outside directors. Firm with large shareholders or insiders owning a large percentage of the shares, tend to use less equity-based compensations. These findings suggest these types of compensations may be effective in limiting the agency costs in widely held companies but not in companies with controlling shareholders who have the right incentives to monitor managers.

1.2.3.6 The board of directors

Another important mechanism in aligning managers' and shareholders' interests is the board of directors. The board of directors is responsible for the governance of the company and its main issue is determining the future strategies of the company. The members of the board of directors are elected by the shareholders and as they are delegated with all the powers to manage the firm, it is expected that they will act in their best interests. The shareholders have the rights to appoint the directors of the company, to choose the auditing company and to approve new stock issues. However, all the other powers such as the management and control functions of the firm are delegated to the board of directors (Fama and Jensen, 1983). The board of directors, on its end, delegates powers to other agents which are under the control of

the board. To increase the efficiency of the board, the board of directors is assisted in its decision making process by other sub-committees such as the nomination, remuneration and audit committees. These committees, being part of the board, have the function to assist the board in the nomination of new board members, in solving issues related to the company finances or in making decisions on the remuneration policies of the company.

The role of the board of directors in mitigating agency problems has been subject of several debates. As the directors are elected by the shareholders, they may not be able to monitor all the activities of the directors. One possible way for the shareholders to oversee the managers is by electing independent directors. Independent directors are seen as an important mechanism in controlling the insiders and protecting the shareholder's interests.

Independent directors

The board of directors is composed by inside and outside directors. Insiders are the people who are linked to the management of the company and in some cases, who also have connections with other shareholders either by being their representatives or being elected by them to oversee the interests of the large shareholders of the company. In this case, agency problems may arise linked to the fact that these insiders have their interests aligned with the managers or the major shareholders. On the other hand, the independent directors being outsiders and being unlinked with other stakeholders of the company, have an important role in controlling the managers and the other executive members.

Fama and Jensen (1983) argue that independent directors are more incentivized to align their interests with those of the shareholders than with the insiders. They point out that outside directors have to keep good reputations for themselves as decision experts because of the

market for independent members. As they may also be members of other corporations, their value will strongly depend on their past performances and their ability to play an important role as referees between the insiders and the shareholders. The motivation of having independent members in the board is the need for greater transparency, accountability and efficiency of the corporate governance mechanisms (Aguilera, 2005).

It is a commonly shared opinion that the independent directors play an important role in effective corporate governance. Usually, their presence in the boards is seen as a good mechanism of governance from the investors, because of the role that independent directors play in controlling the managers. The presence of independent members in the board is seen as a good principle of corporate governance in many studies (Daily et al, 2003; Gordon, 2007; Zattoni and Cuomo, 2008). According to Bebchuk and Hamdani, (2009), independent directors are important in both controlling and non-controlling shareholder companies. The authors point out that the role of independent directors is to protect the interests of shareholders from management opportunism, in the case of non-controlling shareholder companies. For the controlling shareholder firms, the presence of independent directors is important in assuring protection for the minority shareholders' interests. In this case, independent directors may limit the risk of expropriation of the minority shareholders from the major shareholders. Zattoni and Cuomo (2010) analyze the corporate governance codes worldwide and find that the independent non-executive directors' recommendations are commonly shared among all the governance practices. They also find that measures to mitigate the agency problems are also commonly adopted as measure in the codes worldwide.

Different studies document the important role of the independent members in aligning the managers with the shareholders' interests. Studies in the US (Xie., 2003; Klein, 2002;) and

Europe (Benkraiem, 2011; Peasnell et al.,2005) find that the presence of independent directors is negatively related with earnings management, suggesting that independent directors do mitigate the agency problems.

However, in regards to the role of independent directors on firm performance, studies have been controversial and inconclusive. In fact, Bhagat and Black (1999) do not find any relation between the presence of independent members in the board and firm performance.

Finally, there is a clear relation between independent directors and the county's minority shareholder rights. Kim et al., (2007) analyzing a sample of firms for 14 European countries, found that when the minority shareholder's rights are strong, there is a significant presence of independent members in the board suggesting that in these countries, the minority shareholders have more legal power to affect the board of directors and so to nominate more independent members. They suggest that for these countries, the minority shareholder law and board independence are complements for the effective governance of firms.

CEO independence

CEO independence deals with the idea of the CEO also occupying the role of Chairman of the board of directors. It is expected that CEOs that are also Chairmen of the board of directors have more power to control their decisions thus increasing the agency problems in firms. By appointing the board of directors, the shareholders control the activities of the CEO. However, when the CEO has more power on the board, it will be difficult to control him or even substitute him when he underperforms. As a senior manager, the CEO may have different incentives to pursue his or her own incentives instead of focusing on maximizing the firm's value. According to Weisbach (1988), it is difficult to substitute the CEO in case of poor past

performance when the board of directors is composed of a majority of insiders. Instead, the authors suggest that when the board is dominated by outsiders, they observe more CEO turnover as a result of poor past performance. The author suggests that the CEO being also an insider, may have the same interests as those of the other insiders in the board of directors at the expense of the shareholders.

Dechow et al.,(1996) found that firms manipulating earnings are more likely to have the CEO serving also as Chairman of the board. They suggest that the CEO may use his power on the board of directors, for his own interests, thus increasing his wealth at the shareholder's expense.

1.2.4 Controlling shareholder companies and agency relationship

To this point, we only described one type of agency problem arising between shareholders and managers in the case of the separation of ownership and control. Villalonga and Amit (2006) name this as agency problem as being of Type 1. The agency relationship that we described above arises in firms where there is no controlling shareholder. In these firms, the agency relationship is between the managers and the shareholders that cannot control the management opportunistic behaviors. However, the literature has shown that with the exception of the United States and the UK, most other countries have a prevalence of controlling shareholders firms (Enriques and Volpin, 2007; La Porta et al., 1999; Faccio and Lang, 2002; Claessens et al., 2000).

Shleifer and Vishny (1997) argue that in countries where the legal protection of the minority investors is weak, one way for the minority shareholders to limit the agency problems is to become large enough in order to get more effective control of the company and protect their

interests. They suggest that becoming a large shareholder gives the investor more incentives to control the manager and also to collect the information needed for this control. In the case of a widely held company, the shareholders will face the free-rider problem. The shareholders will not have the incentives to control the manager thinking that someone else will do the monitoring. This will give the managers enough power to exproriate the shareholders and pursue their own interests. In firms with a large shareholder, this will occur less because the benefits that the large shareholder will gain from the monitoring activity exceed its costs (Shleifer and Vishny, 1986). From one point of view, the controlling shareholders, as a consequence of their important investment in the firm, have both the power and also the incentives to control management opportunism and to make sure that there is an alignment of interest between the two categories (R. Gilson, 2006). Large shareholders have the incentives to maximize the value of the firm, which corresponds to the expectations of all other groups of stakeholders in the firm. They also have the possibility to force the managers to behave according to their expectations or change them through proxy fights or after a takeover (Claessens et al., 2002). In this case, the controlling shareholders will contribute in mitigating the agency costs that arise between the different incentives of managers and shareholders.

However, not all the interests of the large shareholders may be in line with those of minority shareholders (Enriques and Volpin, 2007; Shleifer and Vishny, 1986). The opportunism of the large shareholders may push them to act in a way that is contrary to the expectations of the minority shareholders. Villalonga and Amit (2006) mane this agency problem as Type 2 where the main agency issue is related to the entrenchment of large shareholders. Although the large shareholders help mitigate the Type 1 agency problem, the new agency problem is related to

the unlimited power the controlling shareholders have and the possibility to expropriate private benefits of control from the minority shareholders (Claessens et al., 2002; Shleifer & Vishny, 1997). Large shareholders may have the power and the incentives to control the managers and to limit the agency costs of managerial opportunisms, but on the other hand, they may be large enough to expropriate the minority shareholders. Shleifer and Vishny (1997) indicate different ways in which the large shareholders may expropriate the minority shareholders. Thus, if their control rights are in excess of their cash flow rights, they may try to treat themselves in a preferential way at the expense of other investors. Thus, they point out that when shareholders have control rights in excess of voting rights, they may choose not to pay out cash flows to the other investors but rather pay themselves only. Another opportunistic behavior from the large shareholders is the possibility to transfer wealth to other companies controlled by them or to undertake projects that do not maximize the value of minority shareholders. In the case of pyramid controlling minority structures, the dominant shareholders may also choose projects that do not maximize the value of the firm. Finally, large shareholders also have the possibility to nominate insiders that will protect their interests and may act differently than from what the minority shareholders expect.

1.2.4.1 Agency theory for CMS firms

Bebchuk et al., (2000) describe other agency costs that may arise in companies where there is a difference between the level of voting and the cash flow rights held by a controlling shareholder. The authors call these structures “controlling minority structures” (CMS) because they describe common arrangements that enable the controlling shareholders to maintain the control of the company without necessary holding a majority of cash flow rights. This separation of voting rights from the cash flow rights occurs in three ways; by the creation of

dual class voting rights, by stock pyramids and by cross ownership. Using these mechanisms to control the company by retaining only a small fraction of cash flow rights, the controlling minority shareholders have different ways to expropriate wealth form the company related to the investment project they choose, the scope of the firm and the transfer of control. They show that as the amount of cash flow rights held by the controlling minority shareholder declines, the agency costs of these firms increase at a very progressive rate. The authors argue that these agency costs may be limited by two factors that serve as constraints to the controlling minority shareholder: the bad reputation of a controlling minority structure and the legal protections to the minority shareholders. The authors also suggest that the controlling minority structures are common in countries outside the US. According to them, countries with weak shareholder protection where the legal rules are lax and the private benefits of control are large, are those that have more controlling minority structures.

1.3 Harmonization or convergence?

In the recent years much attention is focused on improving the corporate governance mechanisms in Europe. International organisms but also the European commission are pushing towards the harmonization of corporate governance mechanisms with the main objective to mitigate the agency problems. The creation of a unique capital market in Europe brings the need to harmonize the corporate governance mechanisms for all the countries. This in turn will make ensure that corporate governance best practices are comparable and accepted worldwide to mitigate the agency problems.

The convergence of the corporate governance has gained particular attention from the scholars during the years. The integration of capital markets, the product markets but also the

increasing number of new codes of governance are some of the factors driving the convergence of corporate governance (Yoshikawa and Rasheed, 2009). The authors suggest that competitiveness, the increasing number of cross-country listed firms as well as international investors are reasons for convergence.

Convergence of corporate governance across countries has been subject of several debates and research questions during the years. Hansmann and Kraakman (2001) predict that the convergence of the corporate governance mechanisms of the countries worldwide will lead towards a more shareholder oriented mechanism such as that of Anglo-Saxon countries. According to the authors, the failure of the other existing models and the wide consensus that managers should act towards maximizing the shareholders' interests will increase the convergence of the corporate governance worldwide.

However, Yoshikawa and Rasheed (2009) suggest that despite the different studies proposing convergence of the governance mechanisms among different countries, there is still limited evidence that such convergence is actually occurring.

Of particular interest for some studies is to determine what actually means convergence. Gilson (2001) makes a distinction between convergence in form and convergence in function. According to him convergence in form is related to increasing the similarities in the national laws and institutions among countries and allowing for different countries to adopt the same legal framework. Convergence in function means that different countries may use different legal frameworks or institutions but may still perform well in the same way with other countries having different legal frameworks.

Khanna et al., (2006) distinguish between de jure and de facto convergence. According to the authors de jure convergence is when different countries adopt similar corporate governance laws and on the other side if these actual practices are converging we have a de facto convergence. To simplify, countries may adopt same rules of governance from other countries and this is de jure convergence but how these practices are actually enforced or implemented in the principles of the national codes of the different countries is related to the de facto convergence.

However, different studies point out the difficulties in increasing the convergence of governance practices among countries (Bebchuk and Roe, 1999; Coffee, 1999; Gilson, 2001). For different reasons related to the ownership structure of the firms, countries' national laws, countries' culture and also the costs that request the several improvements or changes in corporate governance, it is difficult to predict the convergence of the national governance mechanisms (Bebchuk and Roe, 1999).

In this study we analyze the European best practices guidelines to measure the level of harmonization of the best practices and also if there is any tendency of convergence. The main objective is to measure the impact of the recommendations of the European commission, international organisms and the new codes of best practices issued in Europe on the harmonization of European corporate governance practices. We do this by analyzing the corporate governance best practices of 17 European countries and in particular their recommendations regarding the independence criteria. We then analyze firm level corporate governance for a sample of 463 European listed companies to see how the companies comply with their respective country codes and how these codes are actually enforced by these firms. Using a definition of independence developed in this study we also measure the level of

convergence of the European best practices with the Anglo-Saxon principles of corporate governance. We measure the convergence with the Anglo-Saxon best practices by analyzing the level of compliance for the companies of the sample with the Anglo-Saxon best practices.

Chapter II

Literature review

2.1 European corporate governance practices

According to Aguilera and Cuervo-Cazurra (2009), in the recent years the number of new codes issued by countries all over the world has increased significantly. They also suggest that the country level adoption of these best practices has improved corporate governance. International organisms such as World Bank and the Organization for Economic Co-operation and Development (OECD) play an important role on the development of new practices of corporate governance. The OECD principles of corporate governance (1999) served as guidelines for the OECD and non-OECD countries in the development of new codes. Taking into account the corporate scandals that followed, the OECD (2004) published the revised version of these principles with the main objective "to strengthen the fabric of corporate governance around the world in the years ahead". These developments also affected the European countries. As a response to the globalization, the integration of capital markets and the increasing competitiveness of businesses, the EU Commission developed new principles in line with the best practices commonly accepted all over the world. The Action Plan was a first move on modernizing the corporate governance practices for European companies (EU, 2003). The main objective of the plan was to encourage the member countries to adopt the best practices suggested by the Commission when issuing new governance codes. These best practices are related to the enhancement of the governance disclosure requirements, the strengthening of shareholder's rights and the protection of the creditors, increasing the role of independent non-executive directors. The Commission suggests that promoting a unique corporate governance code for all the countries of the union is not necessary and there is no

need to do so. Instead, reducing the barriers that determine divergences of corporate governance practices among the European countries allows companies to operate cross-border and integrate in the European market. In the Action Plan there is a commonly shared idea that the comply or explain principle of the United Kingdom's Cadbury Report (MacNeil and Li, 2006) is better than the enforced law of the Sarbanes-Oxley act. Another important priority that was set, was the creation of the European Corporate Governance Forum with the main objective to promote the co-ordination and convergence of the national codes. However, as suggested in the Global Corporate Governance Forum report of (2008), the actual work of the forum is on promoting and developing new best practices on corporate governance that take into account the differences in the laws, culture and market structure among the European countries. Hermes et al.,(2006) analyze the degree of adoption of the European recommendations (EU, 2003) using the corporate governance codes of the European countries. The authors did not find any convergence of the national codes with the EU recommendations. Moreover, they found that the codes of best practices for the European countries are not in full accordance with the priorities set by the EU Commission. They suggest that the codes of best practices are not driven only by external forces but also by domestic forces, which makes the full adoption of the EU recommendations difficult.

It seems that there is a global trend in improving corporate governance, especially after the Sarbanes-Oxley act and the debate among the scholars on whether or not the new governance practices in Europe are pushing towards the Anglo-Saxon best practices of corporate governance. Aguilera and Cuervo-Cazurra (2004) suggest that there is some convergence towards the Anglo-Saxon model of corporate governance while Bauer et al. (2008) observe that large European listed firms are moving towards more shareholder - oriented practices.

According to them, these standards are to be found in the United States (US) and the United Kingdom (UK) models of corporate governance. In fact, the adoption of these practices comes as a need in response to increasing governance quality when cross-listed in international exchanges or the need to adopt practices that are widely accepted by the international investors. Also, the actions taken by the Commission to strengthen the internal corporate governance mechanisms such as the recommendation (2005/162/EC) and the directive (2006/43/EC) seem a progress towards adopting Anglo-Saxon best practices.

However, many problems affect the corporate governance mechanisms in the European countries. As Enriques and Volpin (2007) point out, the ownership structure of the European companies is different from that of united states and the UK. They find that in Europe only a few companies are widely held as opposed to the Anglo-Saxon countries. According to their study, the conflict of interests in the European companies is between the large shareholders and the minority shareholders with the risk for the minority shareholders to be expropriated by the major shareholders.

In this study, we analyze the European corporate governance code recommendations related to the structure of the board of directors and the audit committee. As noted by Zattoni and Cuomo (2010), the corporate governance codes are a set of best practice recommendations related to the structure and the functioning of governance mechanisms. For Europe, the best practices are not rigid rules and are based on the *comply or explain* principle by which the companies that do not comply with the recommendations of the code should explain the reasons of non-compliance. For reasons related to the diversities that still exist between the European countries, the choice of the regulators is not to enforce the companies in adopting the best practices. However the market pressure for compliance and the fact that these best

practices are also recommended by the listing rules, increases the degree of adoption from the companies (Aguilera and Cuervo-Cazurra 2004).

Best practices in Europe differ among countries in their recommendations. Of particular interest are the differences related to the board of director's structure and composition. Countries such as Germany, Austria or Netherland have the two-tier model predominant for their board structure which is different from the unitary model that derives from the Anglo-Saxon model of corporate governance and is adopted widely all over the world. In the two-tier model the supervisory board is responsible for the supervision while the management board is responsible for the management of the company. In the two-tier model of corporate governance both members of the management but also of the supervisory board are elected from the shareholders. The supervisory board in the two-tier model, according to the German best practices (2010), has its main responsibilities to advise and supervise the members of the board of Management. The Supervisory board is also involved in the most important decisions of the company. The Management board, on the other hand, is composed exclusively by executive members or insiders as opposed to the supervisory board which is composed of inside and outside directors and in most of the cases, also by employee representatives. These employee representatives who are included in the supervisory board, have a main objective to supervise the interests of the employees of the company. According to Gregory and Simmelkjaer II (2002) the supervisory board and the board of directors in the unitary model, have the same functions in the corporate governance mechanisms of a company as their members are elected by the shareholders in both board models. The authors also suggest that the supervisory board in the two-tier model and the board of directors in the unitary board are

responsible for electing the members of the management board and they are also involved in matters regarding the financial reporting and control of the company.

However, in countries where a two-tier structure is predominant in the codes of best practices recommendations and also in the structure of the board adopted by the companies, these best practices allow companies to adopt a unitary model if it were more efficient for them. If we look at the case of Italy, in particular, three different structures for the board of directors are recommended for Italian listed companies. For The Italian Code of corporate governance of 2006, the main structure is the traditional model of corporate governance which is composed by the board of directors and its committees as well as the board of Statutory auditors. The board of directors has the same functions as the unitary or the supervisory board while the members of the board of Statutory auditors have duties such as to oversee the functioning of the board of directors, control the financial reporting system of the company and elect its external. According to the Italian law, members of the board of Statutory auditors are independent from the company and elected by the shareholders. They are supposed to act independently in all the situations where a conflict of interest may arise between the management and the shareholders. According to the Italian Code of best practices (2006), as the other two models are only recently introduced, their application by Italian firms should be very limited compared to the traditional model. However, at the time speaking, as a result of the legitimation suggested by Zattoni and Cuomo, (2008) we predict that the number of Italian listed companies adopting the unitary model of corporate governance has increased.

Another important difference in the corporate governance codes of European countries is related to the presence of employee representatives in the board of directors. For countries such as Austria, Germany, Denmark, Luxembourg and Sweden, companies of a certain size

must include employee representatives in their board of directors or supervisory board. In these countries, the members elected by the employees have the same rights in the board as the other members elected from the shareholders. In Germany companies with more than 2000 employees are obliged to have a board of directors in which half of the members are employee representatives. In these companies, the Chairman of the supervisory board is always elected by the shareholders and is not an employee representative. In cases where half of the supervisory board is composed by employee representatives, for all purposes, it is the Chairman of the board who has the casting vote which gives a majority to the supervisory board members who are elected by the shareholders.

In France, the employees have the right to hold shares of the company. In the case where employee shareholdings exceed 3% of the total outstanding shares of the company, those employees have the right to appoint members in the board of directors. These elected members have the same rights as the directors elected by the shareholders, just like in the other countries mentioned above.

Gregory and Simmelkjaer II (2002) make a comparative analysis on the corporate governance recommendations of fifteen EU member states to understand differences and similarities among the countries of the union. According to them, the European countries present important similarities with regards to the best practices of corporate governance. They suggest that the differences found between the recommendations are due to different company laws and securities regulations rather than in the best practices recommendations. The roles of board of directors in the unitary system and those of the supervisory board in the two-tier are very similar, because of the important influence from the international corporate governance best practices.

Differences in the structure and the composition also exist among the committees that assist the board of directors or the supervisory board during their normal activities. The audit committee is the committee that is responsible for the financial reporting system of the company, the internal control, internal audit functions and has also the possibility to choose the external auditing firm of the company. However, the recommendations regarding the main functions of the audit committee and also its composition are not the same for all the countries of our study. In the case of German listed companies, the audit committee will include employee representatives who will be of the same number as the members elected by the shareholders, excluding the Chairman of the committee who is always elected by the shareholders.

The Italian audit committee is also different in the functions and structure compared to the audit committee of most of the European countries. It seems that the duties regarding the audit committee of the Anglo-Saxon model of corporate governance are divided between the Internal control committee and the board of Statutory auditors. According to Melis (2004), some of the responsibilities of the Internal control committee, include the monitoring of the internal auditing staff, the reporting of its activities to the board of directors and also the cooperating with the external auditing company. These responsibilities are in line with the functions of audit committees under the Anglo-Saxon model. Other functions, such as controlling the financial reporting system of the company, are responsibility of the board of Statutory auditors and they are also pertinent to the Anglo-Saxon audit committee model. According to Melis (2004) as the members of the board of Statutory auditors are elected by the shareholders, and because their main responsibility is to monitor the board of director's

activities, in Italy the Internal risk and control committee resembles the audit committee recommended by the Anglo-Saxon best practices.

With the 8th EU Company Law Directive on Statutory Audit (2006), the EU recommended that all the required entities establish an audit committee. In countries such as Austria and Spain the constitution of an audit committee is mandatory by law. Böhm et al. (2013) indicate that audit committees have evolved becoming a mandatory element for the governance system in Europe and the main concern, according to them, is how to design an audit committee rather than establishing one. However, they find that differences still exist in the recommendations of the codes related to the responsibilities of the audit committee, the competencies of its members, and the proportion of independent members in the committee.

Another important difference of the board of directors composition is related to the members elected by the major shareholders of the company. In some countries the best practices recommend that some of the board members be representatives of the major shareholders. A major shareholder is a shareholder who owns a significant percentage of the outstanding shares of the company. Corporate governance codes of countries such as Germany, France and Sweden suggest that major shareholders owning a certain amount of shares, have the possibility to nominate members that will act in their interests on the board.

After having documented the literature and reviewed the evolution of corporate governance codes, in the next section, we present an in depth descriptive analyses of the best practices guidelines regarding the independence of boards, audit committees and the CEO duality for the 17 countries we examine in this study.

2.1.1 Descriptive analyses of best practices in European countries

Table 1 describes the best practices for European countries on the composition of board of directors, audit committees and the separation of duties between the CEO and Chairman. We focus on the recommendations of the degree of independent members on the board of directors and the audit committee. To analyze the recommendations of the best practices, we took the most recent corporate governance codes with which the companies of our sample are complying. To identify the codes that our sample firms comply with, we analyze the corporate governance reports of these firms. We do not take into consideration what the laws of the European countries suggest in matters regarding the composition of the board of directors, audit committee or the division of duties between the CEO/ Chairman. Most of the codes examined in this study are released from the stock exchanges in which the companies are listed. Other issuers of governance codes are either the government or other associations. The main source used in this study to find the corporate governance codes of the European countries, is the European Corporate Governance Institute (ecgi)[2].

After analyzing the recommendations, we observe that they are different from one European country to another. Each of the countries covered in our study differ in its requirements regarding the proportion of independent members on the board of directors. Only three countries out of sixteen recommend a majority of board of directors' members to be independent. Uk corporate governance code of 2010 recommends that at least half of the board members excluding the chairman should be independent. As the chairman of the board of directors, according to the UK Corporate Governance Code (2010), is independent on the

[2] We made a search in the website of the ecgi (http://www.ecgi.org/codes/) and found that all the codes object of our study where available in the website.

appointment as chairman this brings that the majority of the board of directors be independent. Netherlands corporate governance guidelines are stricter suggesting that only one member of the board of directors be dependent while all the other be independent. In most of the cases, the dependent member is the CEO of the company. Denmark's best practices recommend that the majority of the members elected by the shareholders be independent. However, in most of the cases, this majority does not represent the majority of all the members of the board of directors because in the board composition of Danish firms, the employee representatives who are not qualified as independent members are also taken in consideration. In France, there is a clear distinction between widely held and controlled firms. According to the French Corporate Governance code, only the widely held companies[3] are recommended to have a majority of independent members in the board of directors.

As we mentioned above, only a small number of countries recommend the majority of the board of directors' independence while most of the countries recommend only a minimum number of independent directors. Spain and Greece recommend one third of the board to be independent while Belgium, Finland, Sweden and Norway require that a fixed number of directors be independent. For Austria and France, the recommendations depend on the ownership structure of the firm. However in Austria, as opposed to France, the proportion of recommended independent members is lower. We note that almost all the best practices recommend a minimal number of independent members except for Portugal, Luxembourg and Germany, in which the presence of independent members in the board is only mentioned without indications nor specifications about their required proportions. Italy and Switzerland

[3] The French corporate governance code of 2010 indicates as widely held those companies in which no shareholder owns more than 20% of the shares of the companies.

have no recommendations whatsoever on the required proportion of independent members in the board.

We observe more similarities in the recommendations of the best practices regarding the audit committee independence. For most of the countries the best practices recommend that the majority of the members of the audit committee be independent. However, countries such as Netherlands, Norway and Switzerland do not mention a clear proportion of required independent members in the audit committee. In Norway, it is suggested that the majority of the members of the audit committee should be independent from the company. Because in our, we posit that that a member should also be independent from the company and the major shareholders to be qualified as independent, we can not consider the Norwegian code of corporate governance's independence criteria. Hence, according to this study's definition, Norway does not recommend a proportion of independence for the audit committee. France is the country that recommends the largest proportion of independence in the audit committee while countries such as Spain, Uk, Finland, Sweden and Germany recommend only a minimum number of independent members in the audit committee.

We also analyze the recommendations regarding the presence of the Chairman of the board of directors in the audit committee. Results are very different and most of the countries do not have specific recommendations regarding the presence of the Chairman in the audit committee. For countries such as the UK, Denmark, Finland or Germany, it is specified in the best practices that the Chairman should not be member of the audit committee. As for the Netherlands, the Chairman may assist the audit committee but not as a Chairman of the committee. In Austria, the Chairman should not be or have been member of the management

in the past three years. In Portugal, the Chairman of the board of directors is allowed to be a member of the audit committee only if he is qualified as independent.

Nevertheless, differences in the recommendations and the composition of audit committees still exist. This is in line with Collier and Zaman (2005) who suggest that, although the audit committee is adopted in all the European best practices, the recommendations in the structure and composition of these committees are different among the countries. Comparing our findings for the audit committee recommendations with those from the Sarbanes-Oxley act and the SEC rules for listed companies, we notice that none of the countries in our study recommend a fully independent audit committee. Even the UK which is an Anglo-Saxon country does not recommend a fully independent audit committee but a minimum number of three independent members. We suggest that this principle is related to the fact that the audit committees in UK firms are composed of a small number of members, who in most of the cases, are all independent non-executive members.

Our findings related to the separation of duties between the CEO and Chairman are more consistent throughout our sample of European firms. We identify that many of the best practices recommend the division of roles of the CEO and Chairman of the Board. However, not all the countries recommend the division of duties between the two roles. In the guidelines for best practices in countries such as France, Spain, Greece, Switzerland and Italy, the CEO is also allowed to be Chairman of the audit committee. In the case of Denmark, there are no recommendations for the separation of duties.

In Table 1, we classify our sample countries, in the order of the strongest to the weakest governance practices. According to the results of other studies (Klein, 2002; Xie et al., 2003;

Peasnell et al., 2005; Ramzi Benkraiem, 2011) we define as strong governance practices, those best practices that recommend a majority of independent members on the board of directors as well as on the audit committee and the separation of duties between CEO/ Chairman (Dechow et al, 1996; Jensen, 1993). These practices are closely related to the Anglo-Saxon best practices, also defined as the global best practices (Hansmann and Kraakman, 2001). For the audit committee, we choose the majority instead of the fully independence because, in the UK the best practices recommend that the audit committee be composed of at least three independent members. In the studies above-mentioned the results for the audit committee composition do not change whether the committee is mostly or fully independent.

The classification in Table 1 is made as follows. We begin by the analysis by identifying the countries that recommend the majority of the board of directors be composed of independent members. Next, for we identify the countries that recommend a majority of independent members in the audit committee. Finally, we classify the countries according to the corporate governance guidelines requiring the separation of duties between the CEO and Chairman. Hence to classify countries according to their governance best practice guidelines from the strictest to the weakest, in the case that more than one country recommends the majority of independence, we control for the audit committee independence and then for the separation of duties between the CEO and Chairman.

Table 1

Corporate governance recommendations for the Board of directors and Audit committee by country

Country	% of independence		Audit committee		Chairman presence	CEO/ Chairman	Size
UK	at least half of the board excluding the chairman	50+1	at least three independent non-executive directors	3	not member	no	mentioned but with no specifications
Denmark	at least half of the members elected by the shareholders	50+1	majority	50+1	not member	not mentioned	mentioned but with no specifications
Netherland	all except one	all - 1	mentioned but with no specifications	0	not chairman of the audit	no	mentioned but with no specifications
France	in widely-held=half of the members; controlled companies=at least a third	50+1= widely held; one third= controlled	at least equal to two thirds	2/3	no indications	allowed	no indications
Greece	at least one third	1/3	majority	50+1	no indications	allowed	more than 7 and less than 15
Spain	at least one third	1/3	The committee should be formed exclusively of external directors and have a minimum of three members. Should be chaired by an independent director	1	no indications	allowed	5-15
Belgium	at least 3 independent non-executive members	3	majority	50+1	not member	no	mentioned but with no specifications

Table 1

Corporate governance recommendations for the Board of directors and Audit committee by country

Country	Board independence		Audit committee independence		Chairman presence	CEO/ Chairman	Size
Finland	at least two	2	at least one member	1	not member	no	mentioned but with no specifications
Sweden	at least two	2	at least one member	1	no indications	no	no indications
Norway	at least two	2	majority should be independent of the company	0	no indications	no	mentioned but with no specifications
Austria	free float more than 20%= at least one independent; free float more than 50%= at least two	free float >20%=1; free float >50%=2	majority	50+1	not member of the management in the past three years	no	not more than 10 without the employees
Portugal	adequate number of independent members	0	majority by law	50+1	allowed if independent	no	mentioned but with no specifications
Luxembourg	mentioned but with no specifications	0	majority	50+1	not member	no	max 16
Germany	mentioned but with no specifications	0	the chairman should be independent and not be a member of the Management Board of the company whose appointment ended less than two years ago.	1	not member	no	no indications
Swiss	majority non-executive members	0	the committee should consist of non-executive members preferably independent	0	allowed	allowed	mentioned but with no specifications
Italy	no indications	0	majority	50+1	no indications	allowed	no indications

According to our results, UK has the strongest corporate governance practices followed by Denmark, Netherlands and so on. Uk has the strongest corporate governance mechanisms because according to our definition of strong governance it recommends that half of the members of the board of directors to be independent with the chairman being independent on appointment. For the Uk, the audit committee is also supposed to be independent as the best practices recommend at least three members be independent. As the Anglo-Saxon audit committees are composed on average of four people the Uk audit committees are independent according to our definition of independence. These results are in line with La Porta et al. (1999), who suggest that common law countries have stronger corporate governance compared to the civil law countries. Denmark is second because, although it recommends a majority of board members to be independent, only those elected by the shareholders may be qualified as independent and so, the degree of independence is compromised. However, corporate governance in Denmark is stronger than the Dutch best practices because, although Netherlands recommend that all the members of the board of directors except one should be independent, they don't specify the degree of independence for the members of the audit committee. For our study and our definition of independence, exceeding the majority level of independent members on a board doesn't necessarily improve the quality of governance. Accordingly, studies suggest that dependent inside directors on the board may contribute in improving the governance of a firm because of their knowledgeable insights on a firm's activities and board composed exclusively of outsiders are not recommended (Fama and Jensen, 1983; Weisbach, 1988).

In France, corporate governance guidelines of best practices are better than in Greece because, the guidelines in France differ according to the corporate ownership structure. As such, the French widely held firms are recommended to have a board composed of a majority of independent members. On the other hand, French controlled firms are

recommended to have independent members that count for at least one third of their board composition. This latter recommendation is similar to the general guidelines for board independence of Spanish firms, regardless of their ownership structure. France also recommends more than a majority of the audit committee members be independent.

In our study, we observe many similarities in the best practices for the three Scandinavian countries, Finland, Sweden and Norway, suggesting the same quality of governance between these countries. The recommendations regarding the board composition and independence are the same for all three countries. Moreover, Finland and Sweden have the same recommendations regarding the independence of audit committees while for Norway no clear indications are specified in this regard. These three countries also require the division of duties between the CEO and Chairman.

The countries that have weakest corporate governance according to our study are Portugal, Luxembourg, Germany, Switzerland and Italy. These countries do not recommend any proportion of independent members in the board of directors and the main differences are related to the composition of their audit committee. Although, Italy recommends majority of independent director in the audit committee, according to our analysis, it is the country that has the weakest corporate governance guidelines, because there are no indication regarding the presence of independent members on the board of directors, nor is there a required division of duties between the CEO and Chairman.

Our classification is in line with La Porta et al.'s (1999) study that classifies countries according to their strong or weak corporate governance. The only exemptions are Spain and Norway which according to our classification they recommend only a minimum proportion of independence in the board of directors and can not be classified as having strong corporate governance contrary to La Porta et al.'s (1999) study.

2.2 Studies focusing on the independence criteria

The important role that independent directors have in improving the corporate governance has been widely studied by scholars. There is a common idea that increasing independent directors in the boards increases also the corporate governance quality of a firm. This is also shared by international organisms who demand more independent directors in the boards of the companies, specifically where the agency problems may arise. However, due to the differences in the culture, capital markets or ownership structure of the firms among countries it is not always possible to measure the impact that independent directors have in improving the corporate governance quality of the firms. For some firms due to the differences in the countries corporate law or corporate governance recommendations it is difficult and costly to adopt more independent mechanisms of corporate governance.

2.2.1 Independent directors and the agency problem

The literature is dominated by studies addressing the role of corporate governance in mitigating the agency problems. These studies analyzing different mechanisms of governance for the firms measure the role that these governance mechanisms have in limiting the risk of expropriation of the shareholders from the managers. The idea is that stronger corporate governance mechanisms would help reducing the agency problems and thus increase the shareholder's wealth. The main differences in the studies analyzing the role of corporate governance in mitigating the agency are related to the governance mechanisms they use to analyze. According to Brown et al., 2011 most of the studies focus on one particular component of governance when analyzing the corporate governance.

A wide part of the scholars when analyzing the corporate governance use indices developed by professional agencies (Bhagat and Bolton, 2008; Doidge et al., 2007; Khanna et al., 2006; Wojcik, 2006). These indices develop a corporate governance score that takes

into account different governance elements and higher the score higher will be also the governance quality of the firm. The score is the result of the different qualities of the governance of the firms taken together. Bhagat and Bolton (2008) for example, document a positive correlation between good corporate governance as measured by the index they use in their study and the firm's performance. Doidge et al., (2007) using different governance ratings explain how country chrateristics such as investor protection or the economic development influence firms improvements of corporate governance mechanisms. For a sample of European companies, Renders and Vandenbogaerde (2004), find that better corporate governance is associated with less earning management suggesting the impact of the governance in improving the accounting quality. The authors use a rating developed from a professional rating agency in order to measure the corporate governance, the Deminor Rating. This rating is an aggregate rating of different governance elements for a firm and Deminor Rating analyses the corporate governance of the companies belonging to the FTSEurofirst 300[4]. Renders et al., (2010) using the corporate governance ratings developed by a professional rating agency, find a correlation between the corporate governance ratings and the firms performance suggesting that improvements in the governance ratings are accompanied by improvements in the performance of the firms.

However, as suggested by Bebchuk and Hamdani (2009), researchers should abandon using the governance scores as they do not take into consideration the different agency problems that arise in the case of companies with different ownership structure. They suggest that because the problems for widely held and controlled companies differ from each other a score that does take into consideration the different agency problems arising in these companies will not be able to measure the corporate governance of the company. As a result of the different problems and limits that the professional governance ratings

[4] This index represents the 300 major companies in listed in European markets ranked by the market capitalization.

present, most of the literature focuses only in particular elements of governance when measuring the effects of good corporate governance in relation to the agency problems.

It is not clear yet if corporate governance improves firm's performances. Brown et al., (2011) suggest that studies are controversial and yet there is not a clear idea on the role of corporate governance mechanisms on the firm's performance. While Renders et al., (2010) finds evidence of firm performance using governance ratings other studies, mainly in US, measuring the role of insider ownership on firm performance do not find any significant relation suggesting that not all the governance characteristics play the same role in increasing the firm performances (Coles et al., 2012; McConnell et al., 2008).

Corporate governance affects the cost of equity capital (Chen et al., 2011) and also the cost of debt financing (Anderson et al., 2004). Analyzing a sample of 2161 firms from the G-index Chen et al., (2008) find that strong shareholder rights are associated with lower cost of equity. Anderson et al., (2004) taking into account the board independence and size find that these governance variables are associated with lower cost of debt financing for a sample of S&P 500 firms.

Corporate governance is also related to the financial reporting quality. Insiders may use the financial reporting system for reasons that benefit their interests instead of protecting the shareholders' interests. In fact if the agency problems do not exist insiders do not have any reason to hide the information and so the accounting quality it is supposed to be higher. According to Bushman and Smith (2001) corporate governance exists to ensure that the minority shareholders receive reliable information on the value of the firm and to protect the minority shareholders' interests form the opportunisms of the managers and large shareholders. They point out that corporate governance is also important in forcing managers to maximize the value of the firm. Even in the absence of the agency costs the authors suggest that corporate governance is useful in providing better information on

managers in evaluating the value of the investments. Further they argue that improved governance makes possible the reducing costs of monitoring of the managerial opportunism by the shareholders and also limits the private benefits that the managers can extract form the company.

Sloan (2001) points out that there is a clear link between the corporate governance mechanisms and the financial accounting of a company. The accounting information is relevant to determine the performances of the managers and also to determine the payoffs of the stakeholders. He suggests that the financial accounting system is the only way the outsiders have to be in possess of the information they need about the risk and allocation related to their investments. According to his study also the inverse correlation is important. Accounting information is also important in providing the necessary information to the corporate governance mechanisms to operate efficiently.

Of particular interest for the researchers and also object of several debates has been one particular characteristic of the board of directors which is the presence of independent members or outside directors in the board of directors and audit committee. There are a large number of studies analyzing the different roles that the independent directors have in mitigating the agency problems.

Studies in US (Xie et al., 2003; Klein, 2002;) document that the presence of independent directors is associated with less earning management suggesting that outside directors play an important role in mitigating the agency problems and so improving the financial reporting quality. Klein, (2002) using a sample from S&P 500 for the years 1992-1993finds a negative relation between board independence and earnings management as measured by the abnormal accruals. She also suggests that these results are more pronounced when there is not a majority of independent members in the board of directors or the audit committee. According to her study, when the number of independent directors

diminishes the level of abnormal accruals increases for the companies of the sample. Conflicting results are found from Xie et al., (2003) analyzing the same sample of companies as Klein, (2002). They suggest that only when both independent directors and directors with corporate experience are included in the board earnings management is less likely to occur.

However, regarding the proportion of independent directors on the board no study finds significant results between a board comprised exclusively of independent directors and their role in improving the corporate governance quality. Fama and Jensen (1983) suggest that it is not recommended a board comprised exclusively of outside directors. Insiders usually are those who are also financial experts and have specific information and expertise which provides them with more knowledge to manage the firm. In fact studies focusing on the independence criteria suggest that there is no significant relation between a fully independent board of directors or audit committee and the firm's agency conflicts (Klein, 2002).

The role of independent directors and their importance as potential referee in mitigating the agency problems has been studied widely also in Europe. However, all the studies have in common the fact that none of them does a cross country analysis to see the impact of independent directors as a potential mechanism of good corporate governance. Peasnell et al.,(2005) for a sample of UK firms find that firms with higher outside independent directors are associated with less income-increasing earning management consistent with the hypothesis that earnings management is negatively related with the presence of independent directors. Same results are found by Benkraiem, (2011) for France suggesting that their presence can moderate earning management and the role of independent directors becomes more effective when they represent at least one third of the board. However, these associations are not the same for other European countries. Chalevas and Tzovas

(2010) for example, analyzing a Greek sample of firms find that there is no relation between the increased number of independent members in the board and earnings manipulation. The authors find an inverse relationship between independent directors and the weighted average cost of capital.

Studies have been controversial in relation to the role of independent directors with the firm performance and there is not a clear idea of the role of independent directors with the performance of the company. Block (1999) finds that the market reacts positively on the announcements of the appointment of outside directors on the board. Other studies mainly focusing in US do not find any relation between the presence of independent members in the board and the firm performance. While Dahya et al., (2008) in a cross-country analysis suggests that the performance of the firms increases with the presence of independent members on the board, Bhagat and Bolton (2008) for a US sample do not find significant relation between outside members and firm performance.

A substantial number of studies analyses the role of the audit committee and in particular the audit committee independence in relation to the agency problems. The presence of independent directors is important also for the well-functioning of the audit committee. The primary role of the audit committee is to assist the board in matters regarding the financial statements of the company, the audit quality or in reviewing the external auditing process. The audit committee has also the possibility to choose the external auditor. As the primary role of the audit committee is to control the financial reporting system of the company this committee is important in preventing the agency problems and so limit the self-interest behaviors of the insiders and having independent members in the audit committee will improve this effectiveness. Studies have analyzed the proportion of independent members in the audit committee and their role in improving the financial reporting quality (Peasnell et al., 2005;Abbott et al, 2004; Klein, 2002). Klein (2002) finds

that when audit committees are composed of a majority of independent directors companies engage in less earnings management as measured by abnormal accruals. These results according to her study are more pronounced when the number of independent members decreases. However the author do not find any significant relation between an audit committee comprised exclusively of independent directors and earnings management suggesting that audit committees fully independent are not effective in mitigating the agency problems. Abbott et al., (2004) for a sample of US firms during the years 1991-1999 find that the financial statements restatements occur less when the companies have an audit committee comprised only of independent directors. However not all the studies support the hypothesis that independent members in the audit committee limit the agency problems. Xie et al., (2003) do not find a significant relation between the percentage of outside members on the board and the discretionary current accruals. Same results suggested by Agrawal and Chadha (2005) who do not find any significant relation between the audit committee independence and the probability of earning restatements from the firms. For France Piot and Janin (2007) suggest that only the existence of an audit committee is related to with less earnings management but the authors do not find any significant relation between an independent audit committee and earnings management.

Finally, independent directors are also important for companies operating in countries with weak investor protection. Countries with weak investor protection do not ensure a strong protection for the minority shareholders and having independent directors on the board may be important for the minority shareholders in order to protect their investment in the company. Kim et al., (2007) analyzing a sample of firms for 14 European countries found that when the minority shareholder's rights are strong there is a significant presence of independent members in the board suggesting that in these countries the minority shareholders have more legal power to affect the board of directors and so to nominate

more independent members. They suggest that for these countries the minority shareholder law and board independence are complements for the governance of these firms.

2.2.2 Differences in the classification of independent directors

Other studies focus on the recommendations of the codes of best practices on the role and the functions of the independent members on the board. Examining the independence of the non-executive directors, Zattoni and Cuomo (2010) find that almost all the codes of governance in 2005 recommend the independence but the definitions and the criteria of independence are very different. Examining a sample of 60 countries, they argue that the independence criteria is commonly accepted by all the best practices but the meaning of it differs significantly in most of these countries. The main differences are related to the civil law countries who present a weak definition of the independence. Johanson and Østergren (2010), in their descriptive study for the governance codes of UK and Sweden, compare the recommendations of the codes on board independence. Although there are some similarities in these recommendations, they also find important differences between the two countries. The main difference is that in Sweden, major shareholders are defined as independent whereas, in the UK best practices, they are not. Another important difference is that the UK is a shareholder oriented country and Sweden a stakeholder oriented one. The similarities between the codes of these countries are influenced by the global best practices of corporate governance.

Of particular interests are the studies of Crespi and Pascal Fuster, 2013 and Santella et al., 2006, who analyze the misclassification of the proportion of independent members declared by the board. Crespi and Pascal Fuster (2013) analyze a sample of Spanish listed firms find that the proportion of independent directors disclosed in the firms' corporate governance reports is higher compared to the filter they used to measure the degree of

independent directors. They develop a stricter definition of independence that takes into account the best practices of Uk code of corporate governance, NYSE and EU Commission recommendations and by applying this definition to the companies of their sample report a misclassification of the independent director by the firms. This misclassification according to the authors is higher for the members of the committees such as the audit committee and also for firms controlled by managers.

Santella et al., (2006) analyze the degree of independent directors on a sample of Italian companies, by using the independence requirements of the EC Recommendation (2005) on the non-executive and supervisory directors. Using the independence criteria suggested by the EU recommendations, the authors find that the proportion of independent director on the board is very low. One particular requirement that is not applied by the companies when determining independence, is the one suggesting that directors should not have any business relationship with the firm to be qualified as independent.

2.3 Studies analyzing the convergence

In Europe, with the creation of a unique capital market and also with the international organisms that are pushing to minimize the divergences of the corporate practices across the European countries, convergence is becoming of particular interests for researchers. The literature analyzing the convergence of the corporate governance for European countries or companies located in Europe is divided in two research methodologies. One part of the studies focuses in explaining the convergence by analyzing the corporate governance codes of each country and define the convergence degree according to similarities or differences in these practices (Cicon et al., 2012; Collier and Zaman, 2005). The other studies using data of corporate governance of listed companies in a cross country analysis defines the convergence as the degree of similarities or differences among the

practices of corporate governance that these companies adopt (Markarian et al., 2007; Wojcik, 2006).

The first empirical paper to provide an explanation of the convergence is the study of Markarian et al., (2007). The authors analyzing a sample of 75 large firms from different countries all over the world for the years 1995-2002 examine the governance and also the disclosure practices of the sample selected. They find that the governance practices for the sample firms are moving towards more independent organisms of corporate governance, mechanisms that are similar to those of Anglo-Saxon countries. However, regarding the disclosure practices the authors conclude that both Anglo-Saxon and non Anglo-Saxon firms are improving their disclosure practices but there is no convergence towards an Anglo-Saxon model. One limit of this study may be related to the sample the authors choose to analyze. As the sample is a set of large companies it is easy to think that for reasons such as cross-listing or the existence of large international investors these companies are more interested to adopt corporate governance mechanisms that are widely accepted.

Using a recent sample of only European listed companies for the years 2000 and 2004 Wojcik (2006) finds that the companies have improved their corporate governance rating during the years. By using corporate governance ratings developed by a professional rating agency such as Deminor Rating SA the author measures the governance ratings for Anglo-Saxon and non Anglo-Saxon. He finds that non Anglo-Saxon companies have reduced the differences between the ratings suggesting that a convergence is in act. The governance mechanisms that improved significantly were the board structure and functioning and also the disclosure practices of the firms. Wojcik (2006) study is of particular interest because is the first study to use a sample of only European firms to measure the convergence between the two types of cultures, Anglo-Saxon and non. However, one limit of the study

could be the fact that the author is using a governance rating developed by a professional agency. As Daines et al ., (2010) suggests, the professional governance ratings may not provide useful information to the shareholders and they also have limits in predicting companies' performance or other outcomes.

The other two studies (Cicon et al., 2012; Collier and Zaman, 2005) focus on the corporate governance codes of the European countries. Collier and Zaman (2005) analyze the recommendations of the codes of corporate governance related to the structure and the functioning of the audit committee. The objective is to demonstrate any degree of convergence between the European codes of corporate governance and the Anglo-Saxon model of corporate governance being the audit committee a structure adopted from the Anglo-Saxon countries. The authors find a convergence towards the Anglo-Saxon principles of corporate governance as the audit committee is widely recommended in the codes of governance of the European countries.

Cicon et al., (2012), as opposed to the previous studies, fail to find evidence of convergence between the corporate governance codes for 23 EU nations only few codes are converging towards the Anglo-Saxon models while other are diverging. The authors divide by using Latent Semantic Analysis techniques divide the codes by themes that the codes emphasize and find no convergence of the governance codes analyzed according to the themes. By developing a new classification of the codes by country according to the themes contained in the codes they find that their classification is different from the legal regimes classification developed by La Porta et al., (1997).

In the next section we describe the sample of European firms object of this study and also the definition of independence used to determine the proportion of independent members in the board. We also measure the level of compliance of the firms of the sample with their countries' best practices and the Anglo-Saxon best practices. Finally we also measure the

relation between the level of independence and the country's legal regime and with the anti-director rights index developed by La Porta et al., (1999).

Chapter III

Sample selection and research model

3.1 Data collection and description of the sample

In the previous section, we described the European corporate governance codes, we observed that the recommendations on the number of independent members differ significantly among countries. For different reasons, we noted that the best practices are significantly related to country specific characteristics and there is not a unique degree of independence recommended by most of the corporate governance codes. In the empirical part we will measure the degree of independent members in the company boards and how the best practices of every country are adopted by the companies. We will also measure the degree of compliance of the companies with the global best practices. To do so, we collect firm-level data on the level of independent board members and audit committees and on the division of duties between the Chairman and the CEO.

In Table 2, we present the description of our sample. The companies are part of the **STOXX** Europe 600 Index, a subset of STOXX Global 1800 Index and represent 600 European listed companies with large, medium and small capitalization across seventeen countries. The sample is from seventeen different European countries and in this analysis we included also the Irish companies present in the index. According to the Irish Stock Exchange, Irish listed companies are required to apply on a *comply or explain* basis with UK corporate governance code (June 2010). In this study we excluded 137 financial companies due to their different accounting rules. We also excluded 3 firms for which corporate governance information with regard to the independence criteria of boards and audit committee are unavailable or doubtful and our final sample is composed of 463

companies distributed in seventeen countries. The distribution of our sample among the countries is explained in the Table 2 below.

Table 2

						INDUSTRY				
	N	OIL & GAS	BASIC MATERIALS	INDUSTRIALS	CONSUMER GOODS	HEALTHCARE	CONSUMER SERVICES	TELECOMMUNICATIONS	UTILITIES	TECHNOLOGY
UK	**143**	13	18	37	18	5	31	4	8	9
Denmark	**12**	1	0	3	2	5	0	1	0	0
Netherlands	**26**	3	2	10	4	1	3	1	0	2
France	**67**	5	3	17	12	3	15	1	4	7
Greece	**2**	0	0	0	1	0	1	0	0	0
Spain	**21**	1	1	7	2	1	3	1	5	0
Belgium	**10**	0	3	0	2	1	3	1	0	0
Finland	**17**	1	3	6	2	1	1	1	1	1
Sweden	**28**	1	3	12	4	3	2	2	0	1
Norway	**10**	4	2	1	1	0	1	1	0	0
Austria	**6**	1	1	2	0	0	0	1	1	0
Portugal	**4**	1	0	0	0	0	1	1	1	0
Luxembourg	**3**	0	2	0	0	0	1	0	0	0
Germany	**59**	0	12	13	12	6	6	2	2	6
Switzerland	**27**	0	3	9	6	5	2	1	0	1
Italy	**18**	2	0	4	4	0	2	1	5	0
Ireland	**10**	0	0	3	1	2	4	0	0	0
Total	**463**	33	53	124	71	33	76	19	27	27

As we may observe in the Table 2 our sample is not equally distributed among the countries. There are countries that have a significant number of companies and others that

have only a minimum. Uk is the country most represented in the sample with 143 companies while for Greece we have only two companies. Other countries such as Austria, Luxembourg and Portugal have also a minimum number of companies compared to the other countries. In table 3 we also divided the sample according to their sectors. To divide the sample into sectors we used the classification provided from the ICB (Industry Classification Benchmark)[5]. The ICB makes a classification between ten sectors but as we mentioned above, we excluded the financial firms so our sample is divided in nine sectors. Companies are well represented for each sector. The largest number of companies by sector is related to the Industrial companies while for the other sectors the distribution is quite the same for all the companies. Other sectors that have a large number of companies are those related to the Consumer goods and Consumer services. The sector that has a small number of companies is the Telecommunications.

To collect the data on governance we analyzed the corporate governance reports and the annual reports for the companies of the sample for the year 2011. Having the three types of companies in our sample allows us to generalize the results for all the listed companies since one can expect that the large corporations are more predisposed to adopt international corporate governance principles, due to their widely held ownership structure.

3.2 Defining independence

The objective of the empirical part of our study is to find out how the best practices are adopted by the companies. To do so we first define the independence criteria necessary to measure the degree of independence on boards. We examined the independence criteria used in the codes of corporate governance for the countries of our sample and observed

[5] The Industry Classification Benchmark categorizes over 70,000 companies and 75,000 securities all over the world to enable the comparison between the companies. Their website is http://www.icbenchmark.com/.

that the definition of independence is significantly different among countries. Countries adopt different measures with regard to whom the director should be independent. This means that the definitions of independence are not clear enough to determine how a board member should be qualified as independent. So although almost all the bests practices recommend that a board member is independent when he is independent from the management, from the company and not having a material business relationship the main difference among the best practices is related to the major shareholders where it is not specified how a member is qualified independent form the major shareholder. In most of the best practices it is not determined the percentage of the shares that the board member may own to be qualified as being a shareholder representative. Countries such as Uk, Italy, Denmark and Norway recommend that a member of the board should be also independent from the major shareholders to be qualified as independent but the percentage of the major shareholder it is not specified. In the Uk corporate governance code (2010) among other criteria for determining the independence of a board member it is specified that a member is dependent when he "represents a major shareholder" but the degree of significant shareholding is not specified.

In the German best practices of 2010 it is specified that a member of the supervisory board is "considered independent if he/she has no business or personal relations with the company or its Management Board which cause a conflict of interests". This definition does not specify if a member should or should not be a major shareholder representative to be qualified as independent. We think that according to this definition a major shareholder representative may be qualified as independent in Germany when he is not. For Switzerland and Austria we observed the same limits in the definition of independence and for these countries as for Germany a member of the board may be qualified as independent even though he is a major shareholder representative.

For most of the countries of our sample, the degree of independence from the major shareholder required to determine the independence of e board member is 10% or more of the shares (voting rights) of the company which is in line with the SEC (OECD 2004). Spain and Portugal have lower percentages to assess the independence from the major shareholders which are 5% for Spain and 2 % for Portugal.

As the definition of independence is different among the countries of our sample to use the same definition of independence we developed our own measure of independence. To compare the different mechanisms of governance regarding the proportion of independent members we first need to use the same measure. Our measure of independence is developed taking into account the recommendations provided by the SEC rules, corporate governance codes of European countries, the OECD and the EU commission recommendations.

To begin with, we refer to independent director as the director who is a non-executive and independent member of the board. In this case neither an employee nor a member of the management may be qualified as an independent director. Our definition is in line with most of the codes of governance of Europe that use the definition of “independent non-executive directors” as the independent members on the board. In different studies the independent members are also defined as outsiders, or non-executives or independent members. According to our definition a director is not independent if he or she:

a) ***is or has been an employee of the company or its group or an executive member of the board within the past three years;***
b) ***is an external auditor of the company or has a relationship with the external auditor of the company;***

c) ***receives directly or as a partner a significant remuneration from the company or any other related company or person for services or advices not connected with his duties as director of the board;***
d) ***has significant business relationship with the company or a related company, directly or as a partner, shareholder, member of the board of directors or management of another company who has such relationship;***
e) ***the director holds cross-directorship or has relationships with other directors of other companies that have links with the company;***
f) ***the director is not a major shareholder[6] of the company or represents a major shareholder of the company;***
g) ***holds shares that together with shareholder rights that he owns in the same company as a result of the control that he exercises in other companies are more than 10% in the company where he is classified as an independent director.***
h) ***has close family ties with persons that fulfill any of the points above***

This definition of independence is stricter compared to the definition of the codes of best practice of the European countries. Using a stricter definition of independence allows us to be sure that the directors qualified as independent according to our definition is really independent as so he acts independently in all the matters of the board of directors or the other committees. In this definition to qualify a member as independent he should be independent from the company, the management and he must not be a major shareholder representative. He also should not have any material business relationship with the company.

[6] A major shareholder is a shareholder who holds more than 10% of the shares or voting rights of the company.

The source we used for the corporate governance codes is the European Corporate Governance Institute (ECGI) an international scientific non-profit association seeking to improve corporate governance in Europe and elsewhere. We only analyzed the English translations of the codes and in the case that for some countries we didn’t find the corporate governance code in the ECGI, we made a web research to obtain it.

Chapter IV

Results

4.1 Descriptive statistic on the proportion of independent members on the Board of Directors and the Audit Committee

We start the analysis by identifying the degree of independent members in the board of directors, audit committee and the separation of duties between the CEO/ Chairman. More specifically the variables used in our analysis are: the proportion and the number of independent members on the board of directors, the proportion and the number of independent members in the audit committee, the size of the board of directors and the audit committee and the division of roles between the CEO and the Chairman of the board of directors. We analyzed the corporate governance reports of our sample firms and according to our definition of independence we measured the number of directors that may be qualified as independent according to this definition. When the corporate governance report did not offer all the information we needed to determine the independence of the directors, we also performed a web research to see the different links that directors may have with the company or its' shareholders in order to better assess the independence of the directors. We constructed dummy variables to identify the CEO/ Chairman duality, the majority of independent members in the board of director and audit committee. We also measured the number of companies that adopted a fully independent audit committee to measure the degree of compliance of our sample firms with the Anglo-Saxon principles of governance. In Table 3 we report the list and the description of the variables used in the study.

Table 3

List and description of the corporate governance variables

VARIABLES	DEFINITION
propBOD indep	proportion of independent members in the board of directors
propAUD indep	proportion of independent members in the audit committee
BOD size	number of members in the board of directors
Num Indep	number of independent members in the board of directors
AuditCom size	number of members in the audit committee
NumAudit indep	number of independent members in the audit committee
Audit Full Ind	=1, if the audit committee is fully independent; =0, otherwise
CEO /Chair	=1 if the CEO is also chairman of the BOD; =0, otherwise
% BOD Independence	=1, if the Board of directors (BOD) has a majority of independent directors; =0, otherwise
% Audit Committee independence	=1, if the audit committee has a majority of independent directors; =0, otherwise

Table 4 presents descriptive statistics on the level of independence of the board, audit committee and the independence of the Chairman, for all the firms in the study. We divided the sample of companies by country and measured the value for all the variables identified. As shown in Table 4, there is a variation in the value of the proportion of independence across countries, consistent with the prior section's descriptive analyses of the best practices.

With regard to the proportion of independence of the board of directors, we note that the results are very different among the analyzed countries. Countries such as Finland and Netherlands present the highest proportion of independent members. It seems that for the

Netherlands, the best practices are widely accepted by the companies. Finish companies tend to follow the international best practices by adopting a higher degree of independence compared to their national corporate governance recommendations. The Anglo-Saxon countries, Uk and Ireland tend to also have a high degree of independence in their board of directors and this is in line with their best practices. The result observed for Switzerland and Austria are particularly interesting. As described in the sections above, these countries do not have a strict definition of independence and the independence from the major shareholder is not required at all in their best practices. Although we use a stricter measure of independence compared to their best practices, these two countries present a high degree of independence for their board of directors. Other countries such as Norway, France Luxembourg and Sweden also tend to have, on average, a high proportion of independence in their board of directors. This is interesting to note because in their best practices a majority of independence is not recommended but a lower proportion is suggested.

Although most of the countries of our sample tend to have companies that present a high degree of independence, for countries such as Germany, Denmark, Belgium, Italy or Spain this proportion is lower. The companies of these countries have on average less than a majority of the board of directors' independence. For some of these countries, such as Germany or Denmark, having employee representatives in the board decreases the proportion of independence being the employee representatives not independent according to our definition of independence and also according to most best practices of the European countries.

Table 4

Descriptive statistics of Board Audit committee Chairman Independence

Country		propBOD indep	propAUD indep	BoD SIZE	NUM INDEP	ADITCOM SIZE	NUMAUDIT INDEP	AUDIT FULLIND	CEO CHAIR
Denmark	N	12	12	12	12	12	12	12	12
	Average	,4812	,7321	10,17	4,83	3,42	2,33	,33	,08
Finland	N	17	16	17	17	16	16	16	17
	Average	,8553	,9635	7,47	6,35	3,31	3,19	,93	,00
France	N	68	68	68	68	68	68	68	68
	Average	,5350	,6978	12,97	6,82	4,03	2,79	,26	,62
Germany	N	59	58	59	59	58	58	58	59
	Average	,4296	,4879	13,78	5,61	4,57	2,22	,05	,00
UK	N	143	143	143	143	143	143	143	143
	Average	,6427	,9866	9,63	6,15	3,79	3,74	,96	,03
Greece	N	2	2	2	2	2	2	2	2
	Average	,3447	,6667	11,50	4,00	3,00	2,00	,50	,50
Ireland	N	10	10	10	10	10	10	10	10
	Average	,6861	,9714	11,60	8,00	3,70	3,50	,90	,00
Italy	N	18	18	18	18	18	18	18	18
	Average	,4534	,9995	11,67	5,17	3,61	3,05	,61	,22
Luxembourg	N	3	3	3	3	3	3	3	3
	Average	,5852	,8889	12,67	7,33	4,33	3,67	,67	,67
Netherland	N	26	26	26	26	26	26	26	26
	Average	,8347	,9071	7,54	6,15	3,46	3,12	,77	,00
Norway	N	10	10	10	10	10	10	10	10
	Average	,6526	,8750	9,10	5,70	3,20	2,80	,60	,10
Portugal	N	4	3	4	4	3	3	3	4
	Average	,3284	,8889	16,75	5,50	3,33	3,00	,67	,00
Spain	N	21	21	21	21	21	21	21	21
	Average	,4512	,6587	12,90	5,67	3,95	2,57	,24	,43
Sweden	N	28	28	28	28	28	28	28	28
	Average	,5159	,7048	11,00	5,46	3,68	2,50	,36	,04
Switzerland	N	27	27	27	27	27	27	27	27
	Average	,7120	,7340	9,26	6,59	3,48	2,67	,48	,15
Austria	N	6	6	6	6	6	6	6	6
	Average	,6537	,5556	11,67	7,33	5,17	2,83	0	,00
Belgium	N	10	10	10	10	10	10	10	10
	Average	,4947	,7600	11,60	5,60	3,70	2,80	,40	,10

With regard to the size of the board of directors, there are no significant differences among the countries of the sample. The range of the board size is between 7 and 13 members. Finland, Netherlands and Switzerland have on average smaller boards compared to the other countries. Portugal is the country that has the biggest size for the board of directors. However, having a small number of Portuguese firms in our sample, we are not able to determine if this proportion is representative for all the listed firms of this country.

For the audit committees, we observe a high compliance with the respective codes and also with the best practice recommendations. We find a high degree of independence in the European companies showing that the EU recommendations and the international best practices are being widely accepted. For the Italian listed companies we analyzed the Internal risk and control committee which according to Melis (2004) has a similar role with the UK audit committee. In fact for some Italian listed companies of our sample we found that they named “audit committee” the internal risk and control committee.

There is a high proportion of independence in the audit committees of the European companies as we reported in Table 4. As we may expect, the Anglo-Saxon countries show a high degree of independence which is also in line with the best practices. However, interesting are the results for Italy, which show the highest degree of independence compared to other countries. The only country that, on average, does not present a majority of independent members on the audit committee, is Germany. We think that having employee representatives in the audit committee for the German listed companies significantly decreases the proportion of independence in these committees.

For the audit committee’s size as for the board of director’s size we do not observe significant differences among the countries. The average size of the audit committees ranges between 3 and 6 board members. Germany, Luxembourg and Austria have more

members in the audit committee compared to the other countries. The Anglo-Saxon countries present the same size on average for the audit committee in line with our expectations.

We also used the fully independent audit committee variable to observe how the companies do comply with this principle. The objective is to see if there is a compliance of the companies of our sample with the Anglo-Saxon principles of governance being the audit committee full independence required by law in the US. With regard to the fully independent audit committee variable, as we could expect we observe that the Anglo-Saxon countries such as UK and Ireland tend to have a high number of companies adopting this principle. However what seems interesting to note is that a relevant number of companies from Italy, Finland, Netherlands, Luxembourg, Portugal and Norway tend to adopt a fully independent audit committee following the US best practices recommendations. For Germany and Austria this degree is lower respect the other countries.

Most of the companies of our sample divide the functions of the CEO and Chairman. As we may observe even though not all the best practices recommend a division of duties between the CEO and Chairman there is a low degree of companies that have as CEO and Chairman the same person. The country that has the highest proportion of companies having the same person as CEO and Chairman is France. For France the best practices have no indications regarding the CEO duality and so most of the French companies prefer to have the same person. Taking into account that the number of observation for French companies is high we may conclude that most of the companies in France have the same person as CEO and chairman of the board of directors. We observe a high proportion of CEO duality also for countries such as Italy, Luxembourg, Spain, Switzerland and Greece. However, except Luxembourg in which the best practices of the country recommend a

division of duties between CEO/ Chairman for the other countries, for the other countries the best practices of do not recommend a division of duties between the CEO and Chairman. As expected the Anglo-Saxon countries present a low percentage of companies that do not divide the roles between the CEO and Chairman.

In the Table 4 we observe that countries differ significantly among them regarding the proportions of independence their companies adopt. For the companies of the sample contrary to their best practices we did not find similarities among countries regarding the proportion of independence they adopt.

To better understand the proportion of independence in the board of directors and the audit committee in the appendix we show descriptive statistic of the level of independence for each company of the sample. For all the countries of the sample we show the proportion of independence of the companies regarding the board of directors and the audit committee independence.

4.2 Level of compliance of the companies with the best practices recommendations and the independence criteria developed in this study

Having analyzed the recommendations of the codes of best practices for the countries of the sample and also the proportion of independence in the boards we are now able to determine the degree of compliance of the companies of our sample with the respective country codes and also with our measure of independence. The objective is to determine by using a stricter criteria of independence compared to that recommended by the best practices how the level of compliance differs in the sample. This analysis will be useful also to determine the degree of convergence of the companies of the sample with the Anglo-Saxon best practices being our definition of independence related to the Anglo-Saxon best practices.

Table 5 is divided in two sections. The left section presents descriptive statistics on the level of compliance of the companies with the respective countries' best practices. The section in the right presents descriptive statistics regarding the level of compliance with the measures of independence used in this study. We measured the level of compliance for the companies of the sample according to their respective corporate governance codes and then with our best practices. We observe that the level of compliance of the companies with the respective country codes of corporate governance is significantly higher compared to the compliance with the best practices suggested in this study. This is related to the fact that the definition and the degree of independence that we used is very strict compared with the different country's best practices.

For the board of directors we observe a high level of compliance of the companies with their respective country codes of best practices. As we may observe the second part of the sample starting from Finland all the companies fully comply with their respective codes. However, if we compare these results with the independence measure that we developed, the compliance decreases significantly and the values remain the same only for Finland, Austria and Luxembourg. The German sample fully complies with their respective codes but the level of compliance is very low in the right section for the board of directors. This because only few companies in Germany have a majority of independent members in the board of directors which is the condition of our measure of independence. Low degree of compliance with our measure of independence but high compliance with the respective country codes is seen also for other countries such as Spain, Italy, Portugal and France. For Ireland, Finland and Austria the level of compliance do not change between the two sections. For these countries the best practices do not recommend a majority of independent members in the board of directors. The companies listed in these countries for different reasons tend to comply with the Anglo-Saxon best practices of corporate

governance. Interesting results are observed for Netherlands where this is the only country of the sample in which the level of compliance with the respective best practices is lower compared to the stricter criteria we used. The Dutch best practices require that in the board of directors should be all except one independent directors while for our measure we require only a majority of the board of directors to be independent. For the board of director independence we observe a low level of compliance of companies from Denmark, Netherlands, France, and Spain with their respective country codes.

For the audit committee we observe the same results as for the board of director's independence. Companies tend to comply more with their local best practices compared to the independence criteria developed in this study. For countries such as Germany, Sweden and Spain there is an important difference between the level of compliance with their local best practices and those of the study. We observe a high degree of compliance of the companies with their local best practices except for France and Greece for which the compliance is lower compared to the other countries. French companies tend to comply more with the definition of independence developed in this study compared to their local best practices. This because French best practices recommend at least two third of the members of the audit committee to be independent while in this study we require only a majority of independence. Same results are observed for Uk as their code of best practices recommends at least three independent members in the board. Being the Uk board composed of only three independent and sometimes not all of them independent changes the degree of compliance of the companies with their respective best practices. For the audit committee we observe a high degree of compliance of the companies with our measure of independence compared with the board of directors. However, companies listed in Spain, Sweden, Germany, and Greece as for the board of directors, present a low degree of compliance with the independence criteria developed in this study.

Table 5

Descriptive statistics on the level of compliance to the corporate governance guidelines of independence of our European sample firms

		% of Compliance with local country codes of best practices			% of Compliance according to independence criteria developed in this study		
Country	**N**	**% Independent BOD**	**%Audit committee independence**	**CEO not Chairman**	**% BOD Independence**	**%Audit committee independence**	**CEO not Chairman**
UK	143	94	96	97	94	100	97
Ireland	10	100	100	100	100	100	100
Denmark	12	50	92	100	50	92	92
Netherland	26	58	100	100	92	100	100
France	68	77[7]	68	100	60	90	38
Spain	21	71	100	100	48	76	57
Greece	2	50	50	100	0	50	50
Belgium	10	90	90	90	70	90	90
Finland	17	100	100	100	100	100	100
Sweden	28	100	100	96	61	79	96
Norway	10	100	100	90	80	100	90
Austria	6	100	100	100	100	100	100
Portugal	4	100	100	100	25	100	100
Luxembourg	3	100	100	67	100	100	67
Germany	59	100	100	100	41	79	100
Switzerland	31	100	100	100	90	93	87
Italy	18	100	100	100	50	100	78

Significant differences we observe also for the CEO/ Chairman compliance. As for the audit committee and the board of directors we observe that companies tend to comply more with their local best practices rather than the independence criteria of this study. For the CEO duality the question is if companies of the sample have the same person as CEO of the company and Chairman of the board of directors. As we observed many countries of the sample do not specify any recommendation regarding the division of duties between

[7] widely held= 79; controlled= 77

the CEO and Chairman so an explanation for the companies that fully comply with their best practices is because their best practices do not recommend the division of duties. Even though we observe a high degree of compliance of the companies with the local best practices, companies listed in countries such as Luxembourg, Norway and Belgium present a low degree of compliance compared to the other countries. This degree of compliance is lower for these countries if we observe the right section of the table. France, Spain and Greece have the lowest rate of CEO not being Chairman compared to other countries while companies listed in countries such as Ireland, Netherlands, Finland Austria, Portugal and Germany are fully compliant with the independence criteria developed in this study.

Overall, we observe that Denmark and Netherlands have the lowest rate of compliance to their respective country codes. As for Germany, Spain, Portugal and Italy, they have the lowest rate of independence according to the best practices of our model. If we compare this results with the classification of Table 1, except for Spain for the other three countries the result are also in line with the classification that we made, where we noted that the local best practices for these countries differ significantly with the best practices recommendations.

Overall, the level of compliance of all our sample firms of all countries combines is 69 % for BOD independence, 91% for audit committee independence, 56% for the audit committee fully independent and 85 % for the Chairman's independence as measured by the distinction (non-duality) of BOD Chair and CEO. These results are not reported in our Tables.

These results are important to discuss the convergence of the corporate governance models for the European companies with the Anglo-Saxon best practices. According to these results we may say that at a firm level we observe that the corporate governance practices

of the European companies are converging towards a more independent mechanism of governance that is related to the Anglo-Saxon model. The level of compliance of the companies with our measures of independence is high suggesting that convergence in the firm level of governance is actually occurring. Of particular interest is the audit committee fully independence. Although the best practices that we analyzed do not recommend it more than a half of the companies of our sample have a full independent audit committee. This contributes to our results suggesting that a convergence towards the Anglo-Saxon best practices is actually occurring.

4.3 Measuring (T-test) how the proportion of independence is affected by the country's legal regime and by the anti-director rights index (LaPorta et al., 1999)

The last analysis consists in verifying whether our developed measure of independence criteria is consistent enough to capture corporate governance quality. To do this we use two different measures of classification to identify firms qualified as having strong or weak corporate governance systems; the legal regime and the level of anti-director rights (LaPorta et al. 1999) of the country in which they operate. Numerous empirical studies have shown that an economy's legal regime has a significant impact on its corporate governance practices and that common law countries have better corporate governance systems than civil law countries (Daske et al., 2006; Leuz et al., 2003; LaPorta et al., 1998). According to La Porta et al.,1998 common low countries have strong investor protection compared to civil law countries and so also better corporate governance mechanisms. From this point of view we would expect that common law countries will also present more independent corporate governance board compared to the civil law countries. The authors also suggest that ownership concentration is negatively related to the level of investor protection of a country and civil law countries have more concentrated ownership structures compared to common law countries. Most of the European countries

are civil law and according to Enriques and Volpin (2007) most of the companies in Europe have a concentrated ownership structure. At this point being the independence a quality of strong corporate governance mechanism would be interesting to observe how the independence is related to the civil law countries of our study. As Kim et al., (2007) suggests in companies with large shareholders they can use their powers to expropriate the minority shareholders by appointing members to the board that are in line with their interests rather than independent members. In line with these studies we expect a small number of independent directors in the boards with concentrated ownership structure.

The anti-director rights index developed in La Porta et al., (1998) represents an index of different variables that measure the shareholders' rights. This index is used to determine the corporate governance quality of a firm according to the different variables of corporate governance that the index uses. In the other study La Porta et al.,(1999) classify countries according to the values of anti-director index. We use that classification in this study to see if our results also corroborate with the results of La Porta et al., (1999).

Hence to validate our independence model, we classify our sample according to the countries' legal regime and level of anti-director rights. We then perform T-tests on each of our three corporate governance measures (BOD independence, audit committee independence, and Chairman independence) according to these classifications to verify if there are significant differences found in the independence levels of the BOS, audit committee and the Chairman's status. We report these results in Table 6.

As seen in Table 6, the level of compliance to our independence measure is significantly higher for common law and High anti-director rights endowed firms for all three of our corporate governance variables. Common law countries present a more independent structure of corporate governance compared to the civil law countries. As other studies

suggest the ownership concentration and the level of investor protection may be some of the reason for these results. Our results are also in line with the anti-director index suggesting that strong corporate governance implies more independent members in the boards. Hence our developed measure of independence criteria is robust and corroborates with other metrics to capture the quality of corporate governance systems.

Table 6

Mean Comparison (T-test) analysis of the proportion of BOD, audit committee and chairman's independence according to the legal regime and anti-director rights.

Legal Regime	CIVIL LAW	COMMOM LAW	t	Sig
Prop BOD Independence	,58	,93	**-8,094**	**,000**
Prop AUDIT COMMITTEE independence	,87	,99	**-4,542**	**,000**
% CEO $\neq$ CHAIR	,79	,97	**-6,928**	**,000**
La Porta et al.'s (1999) ranking of anti-director rights	**HIGH**	**LOW**	**t**	**Sig**
Prop BOD Independence	0,59	0,85	**-6,014**	**0**
Prop AUDIT COMMITTEE independence	0,86	0,97	**-4,017**	**0**
% CEO $\neq$ CHAIR	0,81	0,92	**-3,502**	**0**

Conclusions

In this study, we explore and review the corporate governance mechanisms in Europe. We analyze the corporate governance best practices for 17 European countries. We focus our attention on the recommendations of the European corporate governance codes regarding the independence criteria. In particular we analyze the recommendations regarding the proportion of independent members in the board of directors, audit committee and the division of duties between the CEO and Chairman. Using a definition of independence developed by analyzing several national and international recent best practices we found useful results with regard to the country best practices recommendations and firm-level compliance with these recommendations.

There are differences in the recommendations of the European corporate governance codes among the countries observed. We found that there are no countries using the same best practices among the sample. With regard to the CEO duality most of the countries recommend the division of duties between the CEO and Chairman. However, there are countries in which it is not recommended the division of duties between CEO and Chairman.

When classifying the countries according to their corporate governance quality we observed that Anglo-Saxon countries such as Uk have a strong corporate governance compared to the other countries. For our classification Italy is the country with the weakest governance mechanisms followed by Switzerland. Comparing these results with La Porta et al., (1999) study we observe that our result are in line with their findings excluding Spain and Norway which in our classification they are not counted as having strong corporate governance.

By analyzing the recommendations of the corporate governance codes we observed that the definition of independence is different among the countries. Most of the countries adopt a definition that does not take into consideration the recommendations of international organisms such as the OECD or the EU commission. The main differences are related to the independence from the major shareholders for which most of the best practices do not recommend the proportion of a major shareholder or this principle is not recognized as a condition to determine the independence of a board member. For some European companies there was a misclassification of the board members as independent. According to the companies' corporate governance reports these directors are classified as independent while according to our definition they are not.

When analyzing the proportion of independent members in the board, audit committees and the division of duties between the CEO and Chairman we observed a high degree of independence for the companies of the sample. We show that companies tend to have more independent mechanisms of corporate governance than their best practices recommend. In line with our expectations Anglo-Saxon countries have more independent structures compared to the other countries. Interesting results we observed for the board of directors of Finish companies representing the highest degree of independence among the other countries, although their best practices do not recommend a majority of independent members in the board of directors. Germany is the country that presents less independent boards and audit committees compared to the other countries. A great incidence of these results is related to the presence of the employee representatives elected as members of these boards and not qualified as independent.

Our findings show a high level of compliance of our sample firms to their respective corporate governance codes. When we measure the compliance with our definition of

independence, we note different results and the degree of compliance decreases significantly for some countries of our sample.

Nevertheless, in general, our sample firms exhibit a high level of compliance to our developed independence criteria. This is interesting to note because although the measure of independence that we used to determine the independence of the members is stricter compared to the countries' best practices we observe that most of the companies tend to comply with these recommendations. It seems that in order to increase the number of investors and also the financing from new international investors, European companies have adopted principles that are widely accepted by international investors. Interesting to note is the audit committee fully independence. Even though the best practices do not recommend a fully independent audit committee more than a half of the sample tend to comply with this principle.

Classifying our sample between common and civil law countries and with LaPorta et al.'s (1999) ranking of countries according to the level of anti-director rights, we find that firms operating in common law countries and having high anti-director rights exhibit a significantly higher degree of independence compared to firms in civil law countries and with low anti-director rights.

The overall results of our sample of firms suggest a high compliance of the companies with the Anglo-Saxon best practices. This is documented by the number of companies with fully independent audit committee but also the high degree of independent audit committees and the CEO not being a Chairman. As the measure of independence that we used has similarities with the Anglo-Saxon countries this brings us to the conclusion that civil law countries are adopting more shareholder oriented structures similar to Anglo-Saxon best

practices. Thus we document that corporate governance practices are converging and this convergence is moving towards the Anglo-Saxon best practices of corporate governance.

Contributions and limitations

This research contributes to the literature in many ways. It documents the recent corporate governance practices in Europe and in particular their recommendations on the independence criteria of the board members. We gather firm level statistics on the independence of boards, audit committees and the chairman's independence from management, on a large sample of European firms from 17 different countries, to understand how the firms comply with their respective governance guidelines and also with the measure of independence that we developed in this study. Because many differences are observed in the definition of independence from one country to another, we developed our own definition of independence inspired by the strictest criteria found in the governance code of the countries studied as well as by the SEC, OECD and European commission recommendations. The independence criteria developed in this study allows us to contribute to the existing studies by proposing a new set of standardized guidelines in defining the independence criteria for board members and audit committees.

Using our definition of independence we show that countries tend to comply with their respective country codes but also show a high level of compliance with the measures of independence that we used in this study. Because the study shows that the level of compliance of firms in terms of BOD and audit committee independence as well as Chairman's independence is higher in Common Law countries with stronger enforced corporate governance systems, corporate governance standards and codes setters of Civil Law countries can be inspired by this research to enforce their actual guidelines in regards to the independence criteria, and therefore attract more international investors.

The sample we used composed of small, medium and large firms allows us to better generalize the results as most of the studies use only large firms. Using only large firms may have negative impact on the sample as large firms are more oriented towards adopting more international best practices of corporate governance.

In this study we also contribute to the existing literature analyzing the convergence of the European corporate governance practices. Analyzing the corporate governance codes but also the corporate governance reports of the companies of the sample we are able to determine the degree of convergence of the European corporate governance practices in a firm-level and country-level. We document a high degree of adoption of the governance practices in a firm-level but still differences in a country-level corporate governance practices suggesting convergence in the firm-level. This suggests a convergence of the European corporate governance practices towards the Anglo-Saxon practices of corporate governance.

However, this study presents some limits. The sample is large enough to analyze the convergence and the corporate governance practices of the European companies but the sample is not equally distributed among the countries. For some countries the number of companies is very low and this makes difficult to generalize the results on the governance practices of these countries.

Another limit of the study is related to the proportion of cross-listed companies and their incidence in the sample selected. Cross-listed companies may be more willing to adopt governance practices that are commonly accepted in all the countries they are cross-listed and this may play an important role in their improvements of corporate governance or in their degree of adoption of the Anglo-Saxon best practices being this best practices commonly accepted worldwide.

We focused our attention in explaining the convergence of the corporate governance practices but also the quality of the governance by only using the independence criteria. Analyzing all the recommendations of the codes of best practices may be more useful to compare the governance quality of the countries and also more important in determining convergence.

Future research venues

As we documented in this study there is a high level of compliance of the companies of the sample with the Anglo-Saxon best practices. We suggest that future research should be focused in explaining the reasons of the high compliance of the European companies with the Anglo-Saxon best practices even though their best practices do not recommend a high level of independence. Studies should be focusing in the incidence of the international investors on improving the corporate governance systems and so moving towards a more shareholder oriented mechanism such as the Anglo-Saxon model. As Zattoni and Cuomo (2008) suggest the Anglo-Saxon investors may put pressure to the firms to adopt more shareholder oriented mechanisms of governance and so more independent structures that are important in protecting the shareholders' interests. At this point would be interesting to analyze the incidence that these investors may have in improving corporate governance mechanisms in the European companies.

When analyzing the governance practices among the European countries we found that their best practices are different in the recommendations of the proportion of independence in the board and the division of duties between the CEO and Chairman. We documented convergence in the firm level and this convergence according to Gilson (2001) is in form rather than functional. The convergence is in form because we noted that companies tend to follow the Anglo-Saxon principles of governance. However, we didn't analyze if this

new practices improve the governance of the companies. The main objective of corporate governance is to mitigate the agency problems and also improve the company performance. New studies may focus on these results and analyze their impact in mitigating the agency problems and increasing the value of the firm.

Studies have been controversial in analyzing the relationship between corporate governance and firm performance. We found that the number of independent members differs from that disclosed by the companies. Using these results to analyze the role of independent directors in improving company performance may bring new results and so contribute to the existing literature on firm performance by suggesting new measures to determine the independence of the board members.

Finally, we hope our study inspires future research in corporate governance to further develop corporate governance quality measures.

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Appendix

Table 1

Proportion of independent members in the Board of directors for each company

Country	Prop BOD indep	Number of companies	Percentage
Denmark	.29	1	8.3
	.33	2	16.7
	.42	1	8.3
	.44	2	16.7
	.56	2	16.7
	.57	1	8.3
	.58	2	16.7
	.67	1	8.3
	Total	12	100.0
Finland	.57	1	5.9
	.67	2	11.8
	.75	1	5.9
	.82	1	5.9
	.86	4	23.5
	.88	2	11.8
	.89	1	5.9
	1.00	5	29.4
	Total	17	100.0
France	.17	1	1.5
	.19	1	1.5
	.22	1	1.5
	.23	1	1.5
	.25	3	4.4
	.27	1	1.5
	.28	1	1.5
	.30	1	1.5
	.31	1	1.5
	.33	3	4.4
	.36	1	1.5

	.40	4	5.9
	.42	2	2.9
	.42	1	1.5
	.43	1	1.5
	.44	2	2.9
	.45	1	1.5
	.47	1	1.5
	.50	5	7.4
	.53	1	1.5
	.53	1	1.5
	.55	2	2.9
	.56	1	1.5
	.57	1	1.5
	.58	3	4.4
	.59	1	1.5
	.60	1	1.5
	.62	1	1.5
	.63	1	1.5
	.64	2	2.9
	.64	4	5.9
	.67	1	1.5
	.71	1	1.5
	.73	1	1.5
	.75	4	5.9
	.77	1	1.5
	.80	2	2.9
	.81	1	1.5
	.82	3	4.4
	.83	1	1.5
	.86	1	1.5
	1.00	1	1.5
	Total	68	100.0
Germany	.00	1	1.7
	.10	2	3.4
	.11	1	1.7
	.13	1	1.7
	.15	1	1.7
	.22	1	1.7
	.25	4	6.8

	.30	1	1.7
	.33	1	1.7
	.35	1	1.7
	.38	1	1.7
	.40	5	8.5
	.42	10	16.9
	.43	1	1.7
	.44	4	6.8
	.50	17	28.8
	.67	4	6.8
	.83	2	3.4
	1.00	1	1.7
	Total	59	100.0
Uk	.38	1	.7
	.40	2	1.4
	.43	1	.7
	.44	1	.7
	.45	1	.7
	.46	2	1.4
	.50	9	6.3
	.53	1	.7
	.54	1	.7
	.55	4	2.8
	.56	8	5.6
	.57	12	8.4
	.58	4	2.8
	.60	7	4.9
	.62	1	.7
	.63	13	9.1
	.64	3	2.1
	.64	1	.7
	.67	22	15.4
	.69	1	.7
	.69	1	.7
	.70	8	5.6
	.71	9	6.3
	.73	5	3.5
	.73	1	.7
	.75	5	3.5

	.77	1	.7
	.78	10	7.0
	.80	2	1.4
	.82	1	.7
	.83	2	1.4
	.86	1	.7
	.92	1	.7
	1.00	1	.7
	Total	143	100.0
Greece	.27	1	50.0
	.42	1	50.0
	Total	2	100.0
Ireland	.50	1	10.0
	.60	2	20.0
	.62	1	10.0
	.64	1	10.0
	.67	1	10.0
	.69	1	10.0
	.75	1	10.0
	.89	1	10.0
	.92	1	10.0
	Total	10	100.0
Italy	.00	1	5.6
	.20	1	5.6
	.23	1	5.6
	.33	3	16.7
	.40	1	5.6
	.44	1	5.6
	.47	1	5.6
	.50	1	5.6
	.53	1	5.6
	.55	1	5.6
	.56	1	5.6
	.60	2	11.1
	.64	1	5.6
	.67	1	5.6
	.78	1	5.6
	Total	18	100.0
Louxembourg	.50	1	33.3

	.56	1	33.3
	.70	1	33.3
	Total	3	100.0
Netherlands	.36	1	3.8
	.40	1	3.8
	.50	1	3.8
	.62	1	3.8
	.67	1	3.8
	.70	1	3.8
	.71	1	3.8
	.75	1	3.8
	.78	1	3.8
	.83	3	11.5
	.86	2	7.7
	1.00	12	46.2
	Total	26	100.0
Norway	.40	1	10.0
	.42	1	10.0
	.50	1	10.0
	.63	1	10.0
	.64	1	10.0
	.70	2	20.0
	.71	1	10.0
	.83	1	10.0
	1.00	1	10.0
	Total	10	100.0
Portugal	.12	1	25.0
	.33	2	50.0
	.53	1	25.0
	Total	4	100.0
Spain	.11	1	4.8
	.20	1	4.8
	.25	1	4.8
	.27	1	4.8
	.27	1	4.8
	.31	1	4.8
	.33	1	4.8
	.36	1	4.8
	.38	1	4.8

	.42	1	4.8
	.44	1	4.8
	.50	2	9.5
	.53	2	9.5
	.56	1	4.8
	.60	1	4.8
	.62	1	4.8
	.64	1	4.8
	.79	1	4.8
	.88	1	4.8
	Total	21	100.0
Sweden	.25	2	7.1
	.27	1	3.6
	.28	1	3.6
	.33	1	3.6
	.36	1	3.6
	.36	1	3.6
	.40	1	3.6
	.42	2	7.1
	.43	1	3.6
	.50	3	10.7
	.57	2	7.1
	.58	2	7.1
	.60	1	3.6
	.63	2	7.1
	.64	2	7.1
	.67	1	3.6
	.73	2	7.1
	.75	1	3.6
	.88	1	3.6
	Total	28	100.0
Switzerland	.29	1	3.2
	.38	1	3.2
	.43	1	3.2
	.50	1	3.2
	.55	2	6.5
	.57	1	3.2
	.60	2	6.5
	.63	2	6.5

	.67	2	6.5
	.70	1	3.2
	.75	3	9.7
	.78	3	3.2
	.79	1	3.2
	.80	1	3.2
	.83	1	3.2
	.87	1	3.2
	.90	1	3.2
	.91	2	6.5
	.92	1	3.2
	.92	1	3.2
	1.00	4	12.9
	Total	33	100.0
Austria	.53	1	16.7
	.54	1	16.7
	.58	1	16.7
	.62	1	16.7
	.82	1	16.7
	.83	1	16.7
	Total	6	100.0
Belgium	.22	1	10.0
	.33	1	10.0
	.36	1	10.0
	.50	3	30.0
	.56	1	10.0
	.56	1	10.0
	.58	1	10.0
	.83	1	10.0
	Total	10	100.0

Table 2

Proportion of independent members in the audit committee for each company

Contry	Prop AUD indep	Number of companies	Percentage
Denmark	.29	1	8.3
	.50	1	8.3
	.67	6	50.0
	1.00	4	33.3
	Total	12	100.0
Finland	.67	1	6.3
	.75	1	6.3
	1.00	15	87.5
	Total	17	100.0
France	.20	1	1.5
	.25	2	2.9
	.33	4	5.9
	.50	9	13.2
	.60	6	8.8
	.67	21	30.9
	.71	1	1.5
	.75	4	5.9
	.80	2	2.9
	1.00	18	26.5
	Total	68	100.0
Germany	.00	3	5.2
	.20	1	1.7
	.25	2	3.4
	.33	4	6.9
	.40	2	3.4
	.50	35	60.3
	.60	3	5.2
	.67	4	6.9
	.75	2	3.4
	1.00	3	3.4
	Total	59	100.0
Uk	.50	1	.7

	.67	3	2.1
	.75	1	.7
	.83	1	.7
	1.00	137	95.8
	Total	143	100.0
Greece	.33	1	50.0
	1.00	1	50.0
	Total	2	100.0
Ireland	.71	1	10.0
	1.00	9	90.0
	Total	10	100.0
Italy	.67	1	20.0
	1.00	17	80.0
	Total	18	100.0
Luxembourg	.67	1	33.3
	1.00	2	66.7
	Total	3	100.0
Netherlands	.50	3	11.5
	.67	2	7.7
	.75	1	3.8
	1.00	20	76.9
	Total	26	100.0
Norway	.67	3	30.0
	.75	1	10.0
	1.00	6	60.0
	Total	10	100.0
Portugal	.67	1	33.3
	1.00	3	66.7
	Total	4	100.0
Spain	.20	1	4.8
	.33	3	14.3
	.40	1	4.8
	.50	1	4.8
	.60	4	19.0
	.67	3	14.3
	.75	2	9.5
	.83	1	4.8
	1.00	5	23.8
	Total	21	100.0

Sweden	.25	1	3.6
	.33	5	17.9
	.50	2	7.1
	.60	1	3.6
	.67	7	25.0
	.75	1	3.6
	.80	1	3.6
	1.00	10	35.7
	Total	28	100.0
Switzerland	.25	1	3.4
	.33	1	3.4
	.50	5	17.2
	.67	5	24.1
	1.00	15	51.7
	Total	27	100.0
Austria	.50	4	66.7
	.67	2	33.3
	Total	6	100.0
Belgium	.33	1	10.0
	.50	1	10.0
	.60	1	10.0
	.67	1	10.0
	.75	2	20.0
	1.00	4	40.0
	Total	10	100.0