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WHAT IS GOOD CORPORATE GOVERNANCE?

A STUDY OF CORPORATE GOVERNANCE QUALITY AND ITS METRICS

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Abstract:

One of the questions that more divergences has posed in the study of corporate governance is determining what is understood as "good" corporate governance and how this "quality" is measured. In order to address the question of what good corporate governance is we have undertaken an exploratory and comparative study of the way different theories conceptualise corporate governance quality. We have also identified the different metrics of corporate governance quality and have assessed their limitations.

We conclude that the mainstream theoretical approach in defining corporate governance quality is agency theory. We also conclude that, despite its limitations, practitioners take advantage of agency theory premises. Driven by their own business purposes, they suggest a definition of corporate governance quality based on the company's financial performance. Furthermore, the endogeneity between corporate governance quality and firm performance reveals that the agency conception of corporate governance quality provides a misleading understanding of what good corporate governance is and how it is measured. Thus, we propose the behavioural approach as the methodology to enhance a better understanding of governance practices and their impact on stakeholders, i.e., as a more effective way to understand what good governance is.

Keywords: *Corporate governance quality, agency theory, stewardship theory, behavioural approach, corporate governance indices*.

Proposed thematic area: Corporate Governance

Alternative thematic area: Groups of interest management

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1. INTRODUCTION

The study of corporate governance as part of the business management discipline began in the 1970s, but it was not until 1992 when regulators took the first steps towards a corporate governance reform with the Cadbury Report (Cheffins, 2012). In the following years, the irruption of relevant corporate scandals warned investors and other stakeholders on the serious deficiencies companies showed in their governance practices. These deficiencies are still noticed today in the “long taken-for granted models of ‘good’ corporate governance” (Raelin & Bondy, 2013). Since the Cadbury Report, scholars’ interest has grown considerably as inadequate corporate governance practices have triggered society to demand more strict controls over companies’ management (Cheffins, 2012). Consequently, corporate governance quality has become a subject of great relevance in the agenda of both regulators and scholars (Chan et al., 2014; Ettredge et al., 2011; Hugill & Siegel, 2014; Jiraporn et al., 2011; Zaman et al., 2011).

Despite the great amount of corporate governance studies, those specifically discussing the concept of corporate governance quality are recent and rare (Aguilera et al., 2015; Daines et al., 2010; Djokić & Duh, 2016; Huse, 2005; Iwu-Egwuonwu, 2011; Mousavi & Moridipour, 2013; Renders et al., 2010; Zattoni & Van Ees, 2012); and those studies defining a way to measure corporate governance quality are even fewer (Bebchuk et al., 2005; Cremers & Nair, 2005; Gompers, Ishii, & Metrick, 2003) and have not found the “right” and unique way to measure and assess it (Romano et al., 2008; Schnyder, 2012; Tipurić et al., 2014).

The numerous agency theory-based studies dominate the research on corporate governance. Their economic focus has made them very popular for practitioners to interpret the quality of governance practices (Raelin & Bondy, 2013). However, their results have been very inconsistent due to two main reasons. First, scholars do not agree on a best way to measure the company's financial performance (Bebchuk et al., 2005; Shabbir & Padgett, 2008) as the company's value is a complex construct itself (Romano et al., 2008). Second, the history of business management presents a variety of governance patterns that do not work well for all companies as different systems fit with different cultural and legal contexts (Aguilera & Jackson, 2010; Daniel et al., 2012; Filatotchev et al., 2013). As a result, corporate governance metrics have been inconsistent in different settings which has impeded their validation (Larcker et al., 2007). Therefore, searching for the "perfect and unique" metrics of corporate governance quality is likely to fail.

Given the limitations of agency theory, alternative theoretical lenses have emerged and have also worked on defining and measuring corporate governance quality (Arora & Dharwadkar, 2011; Huse et al., 2011; Matsa & Miller, 2013; Raelin & Bondy, 2013), but they also have been "marginalised" (Raelin & Bondy, 2013). Despite these new attempts, no comparative research has been done with the aim of understanding how the definition and measurement of corporate governance quality is imbued and also restricted by the fundamentals of the theories that have approached the understanding of corporate governance.

We therefore address the following questions: *What is good corporate governance? How is it measured?* Through an exploratory and comparative study of the literature on corporate governance theory, quality and metrics, we search to question the mainstream agency-based belief that corporate governance quality and corporate financial performance have a direct, unidirectional and causal link. We also intend to study if alternative theories have reached

valid definitions and metrics of corporate governance quality. In essence, we aim at enlarging and reinterpreting the concept of quality applied to corporate governance practices.

Our study fits into the comparative research methodology as it explicitly contrasts to each other some theories and metrics in order to identify similarities and differences regards to the way they approach the concept of corporate governance quality (Azarian, 2011). A number of studies on corporate governance have adopted the comparative research methodology, mainly with the purpose of building cross-cultural and cross-national corporate governance knowledge (Aguilera, 2005; Aguilera & Jackson, 2003, 2010; Filatotchev et al., 2013). In our case, the comparative methodology will help us parameterize what "good" corporate governance means. Thus we expect to provide regulators with insights capable of stimulating and supervising the so-called corporate governance "best practices" that until now have proved to be unable to avoid "worst practices" deriving in companies' harming behaviours (du Plessis & Low, 2017; Primbs & Wang, 2016).

2. DEFINING CORPORATE GOVERNANCE QUALITY

During the last decades, different definitions of corporate governance quality have been proposed across different disciplines such as economics, business management, law and sociology. This variety has proved to be challenging for the study of corporate governance (Aguilera & Jackson, 2010). The definition of good corporate governance differs depending on how the concept is theoretically approached.

According to agency theory, corporate governance is the set of instruments that owners deploy to make sure the company is managed according to their interest (Huse et al., 2007). These instruments are consequently directed to align managers' goals with owners' goals (Daily et al., 2003; Romano et al., 2008). Not so long ago, this corporate governance

conceptualization was accepted almost universally. However, the incapability of agency theory to empirically prove one of its main premises – that a better corporate governance causes a better financial return for the company's owners – has fostered the emergence of alternative theories and, with them, of new definitions of what "good" corporate governance is. In contrast with agency theory, these alternative definitions deal with the practices and means to resolve the conflicts among the different stakeholders (Daily et al., 2003).

2.1 The dominant paradigm of agency theory: corporate governance quality is a matter of costs and financial returns

Misalignment between the interests of a company's owners and managers has been studied for decades. Jensen & Meckling (1976) suggested that owners wish to maximize the return of their participation in the company, i.e., they expect managers to maximize the capacity of the company to generate profits in a sustainable manner. Managers are not necessarily driven by this goal but by their own interests. If both counterparts search for maximising their utility function, there is enough empirical evidence to believe that the agent – the manager – will not always act according to the principal's – the owner's – best interests. Agency theory assumes two premises to explain this. First, agents are opportunistic by nature and fully rational (*homo economicus*), thus their sole goal is to maximize their utility function regardless of principals' utility, and their actions are driven by this goal (Lubatkin et al., 2007). Second, agency theory is based on the information asymmetry premise: because of their assigned tasks and responsibilities, managers possess more information on the company and business than owners do; it is possible then to expect agents to use this better access to information for their own benefit. Thus, owners need to exert control over the management behaviours. This makes them incur in the so-called agency costs, that is, supervision costs and incentives given to managers in search of their goals alignment with the owners' ones (Gomez-Mejia &

Wiseman, 2007). According to agency theory, quality of corporate governance is defined by the capacity of the company's government system to minimize these agency costs (Shleifer & Vishny, 1997). Regulations based on this approach seek this economic efficiency for both owners and companies.

How can the quality of corporate governance be improved? In other words, how can agency costs be minimized? Scholars have been studying the various levers that can be used to reach this goal. These include compensation packages for managers that align their interests with those of the owners (Deutsch, Keil, & Laamanen, 2011; Hayes, Lemmon, & Qiu, 2012; Sanders & Hambrick, 2007; Williams & Rao, 2006), organizational and ownership structures that maximize the value of companies – measuring this value with financial metrics such as Total Shareholder Return or Tobin's Q (Larcker et al., 2007; Shabbir & Padgett, 2008; Weir & Laing, 2000), and the regulatory frameworks that prevent the abuse on behalf of the managers and guarantee a "good" corporate governance of the corporations (Cheffins, 2012; Enriques & Volpin, 2007; Shabbir & Padgett, 2008).

In summary, agency theory presumes that better corporate governance provides better company performance in purely economic metrics: lower costs and better financial performance.

Two main reasons explain why agency theory has been the dominant theoretical framework in the study of corporate governance (Daily et al., 2003; Zattoni & van Ees, 2012). First, this theory reduces the complexity of corporate governance to a manager-owner relationship matter in which the interests and goals of both counterparts are clear and consistent throughout the time. Second, because the idea that human beings are selfish and little prone to sacrifice their individual interests on behalf of others' interests is very attached to the study of economic agents' behaviour within the classical economic approach, i.e. to the mainstream in business management (Bosse & Phillips, 2016).

However, managerialism and opportunism produce costly negative externalities such as an increase in bureaucracy, cronyism and lobbying within the firm, and the proliferation of blockholders and short-term investors seeking to control the company. Also, an excessive reliance on monitoring mechanisms causes additional surveillance costs and more information asymmetry in managers' favour leading to an imperfect ability to avoid managerialism (Raelin & Bondy, 2013).

Based on these externalities, agency theory adepts recognise that opportunistic behaviours of both principals and agents potentially constitute dysfunctions in corporate governance structures resulting in serious harm for the firm (Jensen, 2012). Thus, new contributions from fields such as behavioural economics have reshaped agency theory assumptions, introducing the premises of bounded rationality (Foss & Weber, 2016; Pepper & Gore, 2015) and bounded self-interest (Bosse & Phillips, 2016; Hahn, 2015).

2.2 Psychology and sociology make their appearance: stewardship theory

One of the first studies to propose an alternative approach to the study of corporate governance set the ground for the theory known as stewardship theory (Donaldson & Davis, 1991). Like agency theory, stewardship theory is focused on the principal-agent relationship, and the alignment of the two parties' interests. However, stewardship theory refutes the basic economic assumptions of agency theory and is constructed with different assumptions based on organisational psychology and organisational sociology (Donaldson & Davis, 1991; Sundaramurthy & Lewis, 2003; van Puyvelde et al., 2012). Some see stewardship theory "more as a limiting case of agency theory than as an opposing framework" (Caers et al., 2006 cited by van Puyvelde et al., 2012), some see it as a complement (van Puyvelde et al., 2012).

Stewardship theory refutes the agency theory assumption that agents always seek the optimal solution according to their economic utility function. Instead, they settle with a solution that sufficiently satisfies them (van Rooij, 2011). According to this assumption, agents face decisions uncertainty by simplifying the available information and adopting courses of action that produce an acceptable enough result (Ees et al., 2009). Consequently, inefficiencies in companies management do not have their origin in in a struggle for power between owners and managers and the derived costs of it, but in the agents' limited competence and capacity to collect and process the available information (Ees et al., 2009).

Stewardship theory does not assume that managers are opportunistic agents that need to be extrinsically motivated to be aligned with owners' interests. Instead agents' motivation to behave aligned to principal's interests depends on psychological aspects such as professional self-fulfilment, contribution to society and the company, improvement of their personal prestige, CEO's personal traits (social ties, work experience and demographics) and the level of trust principals have on agents. Stewardship theory identifies this level of trust as the absence of control mechanisms implemented by principals (Davis et al., 1997; van Puyvelde et al., 2012).

This intrinsic motivation explains that goals of both counterparts are compatible or aligned, which means that agents wish to collaborate with principals (Donaldson & Davis, 1991; van Puyvelde et al., 2012). Managing the company in order to improve its performance is the way managers have to increment owners' utility and also theirs. Consequently, stewardship theory measures corporate governance quality through the company's financial performance achievements (Davis et al., 1997): the better the company's financial performance is, the more psychologically and socially satisfied managers are with their job, and at the same time the more owners' wealth increases.

Stewardship theory claims that the company's organisational structure and decision-making processes cause financial performance variations (Donaldson & Davis, 1991): whereas for agency theory good governance practices are those directed to align goals of both principal and agent goals and to minimise agency costs, stewardship theory sees executives' location, role, and access to information as the governance parameters that enhance or destroy the financial results of the company.

Stewardship theory highlights the contradictory findings of the agency theory-based studies of corporate governance. These contradictions exist due to the complexity of board decision-making processes and the highly specific nature of governance traits determined by the company's organisational structure. This organisation-centred theory contrasts with the universalist approach adopted by agency theory in which a determined set of norms applies equally to very diverse companies and expects homogenous results (Ees et al., 2009).

2.3 A new corporate governance paradigm: the behavioural approach

The behavioural approach emerges as a new corporate governance discipline focusing on the psychological study of agents' behaviour and relationship with their social context (Huse et al., 2012). It was Pettigrew's initiative of a behavioural perspective that initially attracted scholars' attention (Huse et al., 2012; McDonald & Westphal, 2011; Westphal & Zajac, 2013). Pettigrew (1992) suggested that the study of corporate governance should focus on corporate boards' internal functioning. Rather than examining the boards' formal characteristics and their relation with the company's financial performance – as suggested by agency and stewardship approaches –, the behavioural lens views corporate boards as "organizational teams that deal with complex issues under potentially ambiguous task and role situations" (Murphy & McIntyre, 2007).

According to the behavioural approach, corporate governance quality is determined by the efficiency in the accomplishment of the board control and strategic advice tasks. In other words, good corporate governance means that board internal functioning relying on its decision-making processes results in an efficient exertion of its duties. The approach "is mechanism-based, socially informed and yet actor-centric" (Westphal & Zajac, 2013). Thus, quality metrics proposed by behavioural scholars involve three different governance elements:

1. Psychosocial mechanisms within the governing group and in a given context. Managers and directors interact among them conditioned to their own individual past experiences and socialization processes, because this past social life has shaped the way they understand and conceptualise their current social world (Forbes & Milliken, 1999; Huse et al., 2012; McDonald & Westphal, 2011; Westphal & Zajac, 2013). As a matter of fact, agents and principals' sense of belonging to a same social or cultural group is differently interpreted by economic and behavioural approaches. Whereas for agency theory this sense of belonging causes certain relaxation in the implementation and reinforcement of control mechanisms and therefore a weaker supervision over managers, the behavioural approach understands that this sense of belonging promotes the exchange of information between both counterparts, fostering a better control of managers by board members even when managers are not formal members of the board (Hoitash, 2010; McDonald & Westphal, 2011).
2. Social, cultural and national context in which managers and board members' actions take place. Managers and directors interact among them conditioned to the set of social norms and parameters that lead them to exert socially accepted behaviours (Huse et al., 2012; Westphal & Zajac, 2013).
3. Psychological profile of individuals forming the governance groups of companies – members of the board and top managers. Economic theories have also brought variables

such as directors' gender or cultural background into the analysis of corporate governance quality but they have considered them as formal determinants of the company's financial performance. In contrast, the behavioural approach explains how group diversity influences the behaviours, interactions and decisions of board members as ways to increase the effectiveness of board tasks; thus the behavioural approach has seen board deep- and surface-level diversity as a key parameter of corporate governance quality (Adams & Ferreira, 2009; Carter et al., 2003; Francoeur et al., 2008; Hambrick et al., 2015; McDonald & Westphal, 2011).

Table 1 summarises the differences found in the interpretation of corporate governance quality. In the next section we will analyse and assess the variety of metrics proposed to measure corporate governance quality.

3. MEASURING CORPORATE GOVERNANCE QUALITY

The attempts to measure corporate governance quality have taken three different paths: standards and principles of good corporate governance, corporate governance ratings and corporate governance indices (Djokić & Duh, 2016).

National corporate governance codes of best practices represent changes in corporate governance regulation that most countries have undertaken since the 1990s. In most countries' stock markets, both investors and proxy advisors use reports on codes compliance as a way to assess the quality of the governance practices of listed companies (Larcker et al., 2013). However, this measurement of corporate governance quality is exposed to a regulatory bias, being each regulation intrinsic to the environment in which it is enacted, thus not allowing an unbiased classification of companies that operate under different regulatory settings.

The purpose behind corporate governance ratings is to rank companies by applying predetermined criteria of corporate governance quality. According to this methodology, those companies with higher ratings are considered to better comply with corporate governance best practices and more likely to increase the value of their investments for shareholders (Djokić & Duh, 2016).

Djokić and Duh (2016) show that ratings do not help investors make accurate predictions on governance practices of an individual company and their impact on the company's performance. Both corporate governance codes and ratings work more as "compliance checker" methods than single-case-analysis methods – like indices – allowing to connect governance structures and financial performance of a specific company (Djokić & Duh, 2016). Thus, we will focus our analysis of corporate governance quality metrics on indices developed both by scholars and consultants.

3.1 Agency-based metrics of corporate governance quality

Contribution from scholars

Indices are ways to incorporate, for one particular company, some of the formal governance traits that could reflect well the company's good corporate governance practices (Larcker & Tayan, 2011; Romano et al., 2008). Indices motivate companies to individually benchmark with regulations and recommendations of good governance, and therefore to adopt better practices (Djokić & Duh, 2016). They also contribute to larger transparency helping investors and other stakeholders be well informed about companies' behaviours, and helping companies build better reputation as a competitive advantage basis (Tipurić et al., 2014).

The first studies pursuing the measurement of corporate governance quality through indices were done in order to prove the hypothesis stated by agency theory according to which those

corporations with better corporate governance quality demonstrate higher economic and financial performance (Daily et al., 2003).

In these first studies, metrics of corporate governance quality were very simple given the short number of considered variables. Daines (2001) used the establishment of IPOs protection clauses as an indicator of corporate governance quality; Fich and Shivdasani (2006) assessed quality through board members' level of occupation measuring this as the proportion of members belonging to three or more corporate boards; Larcker et al. (2007) used a combination of variables related to corporate boards such as directors' stock ownership; and Coles et al., (2008) based governance quality on board size.

Table 2 shows the main agency-based indices proposed by scholars. Most of these indices are country-specific. Some of them have been built under the premise that all corporate governance dimensions contribute equally to firm performance, some of them weight each dimension's contribution (Pillai & Al-Malkawi, 2016; Zitouni, 2016).

Table 2 indices reduce corporate governance complexity to only a few dimensions. This can be explained by the fact that index construction entails errors and problems in its calculation, thus scholar have often searched for simplicity (Bebchuk & Hamdani, 2009; Romano et al., 2008). However, the proliferation of indices has revealed important inconsistencies in showing a direct and positive relation between corporate governance quality and company financial performance (Romano et al., 2008). In order to tackle this limitation, three agency-based studies opted to develop more complex and more sophisticated corporate governance indices (Bebchuck et al., 2005; Brown & Caylor, 2006; Gompers et al., 2003): *Governance Index*, *Entrenchment Index* and *Gov-score*. Because of this complexity and the richness of used data, these studies have become seminal (Beekes et al., 2010; Brown & Caylor, 2006).

Governance Index. Gompers et al. (2003) proposed the *Governance Index* – or G-Index – based on the 24 corporate governance provisions developed by the *Investor Responsibility Research Center (IRRC)* [1]. These provisions reflect the power balance between shareholders and managers.

G-index groups provisions into four categories: (1) provisions to delay hostile takeover bids, (2) provisions affecting internal norms for shareholder voting, (3) provisions to protect managers from any responsibility derived of their actions and (4) other provisions comprising those that managers can develop to reduce shareholders' power.

According to their study, firms with lower G-Index value were those supposed to show better corporate governance practices, and to outperform those with higher G-Index. In companies with better corporate governance, owners replace managers with ease, thus agency costs are low. In companies with higher G-Index, owners face important restrictions to replace managers who do not act in the shareholders' best interest, raising the agency costs. Gompers et al. (2003) also found that an investment strategy based on the highest decile of best-rated companies according to G-Index provides an 8.5 per cent positive return over the average of the sampled companies.

G-index has also been used in other corporate governance academic studies. Boone et al. (2007) found a positive correlation between G-Index and board size and independence; Francis et al. (2011) found a positive correlation between corporate governance quality according to G-Index and capital expenditure and innovation; and Fracassi and Tate (2012) found a positive correlation between higher values of G-Index and value destruction measured by Tobin's Q which matches what the agency theory declares.

[1] IRRC is a non-for profit organisation established with the proceeds of the sale of its commercial division to Institutional Shareholder Services, the main corporate governance consulting services firm in the world (Taub, 2005).

Entrechment Index. The Entrenchment Index (or E-Index) measures the enforcement of provisions aimed to protect managers from shareholders' efforts to replace them. These provisions increase the agency costs for the principals, something that will lead to a worse corporate governance quality according to the agency approach. E-Index focuses mainly on the anti-takeover measures adopted by the board and causing power transference to managers in shareholders' detriment.

E-Index calculation is based on the 6 provisions - out of the G-Index 24 provisions- statistically significant in the prediction of a higher Tobin's Q as an indicator of company performance (Bebchuk et al., 2005): shareholders' limited capacity to election of board members; shareholders' limited capacity to carry out statutory modifications; establishment of clauses that decrease the value of stocks in case of hostile takeover (poison pills); establishment of any type of financial compensation to executives in case of dismissing as a result of a merger or takeover (golden parachutes); requirement of over a 51 per cent of favourable votes in shareholders' general meetings for approving merging agreements; requirement of over a 51 per cent of favourable votes in shareholders' general meetings for statutory changes.

Just like showed by the G-Index study, the average yield of a portfolio composed by companies better ranked according to E-Index was statistically higher than a portfolio composed by companies worse ranked (Bebchuk et al., 2005).

G-Index and E-Index use proxies of external governance mechanisms, i.e. of how stock market reacts towards the company's performance and its management behaviour, and of the corresponding regulatory body. Both indices leave internal governance mechanisms outside of the analysis. To address this limitation, Cremers and Nair (2005) brought both governance mechanisms – external and internal – into their research of whether a better quality of corporate governance increases the company's financial performance measured as the Tobin's

Q. They used the G-Index as external governance proxy. Additionally, they included two proxies for internal mechanisms: the company's ownership proportion held by pension funds and by institutional blockholders – institutional shareholders with equity ownership above 5 per cent – considering that these 2 types of owners tend to foster better control over executives and thus improve corporate governance quality.

Cremers and Nair's empirical evidence shows that prioritising investment in companies with better corporate governance, i.e. with a power balance more favourable for principals than for agents, improves between 10 and 15 per cent the yield of average portfolios (Cremers and Nair, 2005). Also, Cremers et al., (2008) showed a negative correlation between takeover defences – measured with the E-Index – and net profit margin.

Gov-score. Continuing with Cremers and Nair's approach, Brown and Caylor (2006) developed an index measuring both external and internal governance mechanisms, called Gov-score. This index is founded on the corporate governance proxies developed by Institutional Shareholders Services (ISS)[2]. Out of the 51 ISS corporate governance proxies, Brown and Caylor (2006) identified seven holding a positive significant correlation with company's financial performance measured by the Tobin's Q. Two reflect external governance mechanisms: "board members are elected annually" and "the company does not arrange poison pills"[3]. Five are internal governance provisions:

- In the last three years there was not an adjustment in the price of the executives' stock options
- The stock options delivered to the executives during the last three years did not exceed the three per cent threshold of the floating common shares.

[2] *Institutional Shareholders Services* (ISS) is a for-profit company with more than 1.700 clients – mainly institutional investors – and 20.000 companies subject to analysis, that leads the corporate governance consulting and services market (Institutional Shareholders Services, 2017).

[3] These two provisions are included in the E-Index (Bebchuk et al, 2005).

– All the board members attended to, at least, 75 per cent of the board meetings or had a valid excuse not to attend.
– The board regulations are information available for the shareholders.
– The board members are subject to the rules about ownership of shares.

Brown and Caylor (2006) found a statistically significant positive correlation between Gov-score values and Tobin's Q values.

Further studies have supported Gov-score validity as an agency-based measurement of governance quality. Alali et al. (2012) showed a positive correlation between corporate governance quality measured with Gov-score and credit ratings; and Peni and Vähämaa (2012) reported that banks with better corporate governance according to Gov-score provided higher stock returns.

Despite the number of studies, it cannot be stated that a refinement in the agency-based methodologies to measure corporate governance quality has led to an improvement in the correlation between governance practices and structures, and companies' financial performance. In some cases, more simple metrics of corporate governance such as "CEO-Chairman duality" or "CEO's stock ownership" have proved to be better predictors of company financial performance than indices, more complex in their reach and calculation (Romano et al., 2008).

Additionally, all of these indices pose the so-called problem of endogeneity (Adams et al., 2010): they consider proxies of corporate governance mechanisms as exogenous variables explaining company financial performance. However, company financial performance influences the board's composition and decisions on the company's governance mechanisms. Consequently, endogeneity raises questions about the validity of such methodologies to assess corporate governance quality (Romano et al., 2008).

Contributions from consultants

Corporate governance consulting firms have shown a conceptual and methodological alignment with agency theory. Given that their main clients are investment institutions and given that their clients' main goal is to maximize their investments yield, consulting firms rely on the agency theory assumption that better quality of corporate governance translates into better company financial performance and, therefore, higher return value for investors.

In the vast majority of national regulations, investment institutions with large positions in traded corporations are compelled to attend shareholder meetings and vote in them (Yermack, 2010). Given the high number of companies in which these institutions invest, the detailed analysis of these companies' management and governance is a vast task to fulfil and hardly approachable. This poses a problem regarding the supervision of investees' managers. The solution consists in buying this information from consulting firms specialized in corporate governance analysis.

Within the corporate governance consulting universe, proxy advisors (PA) have gained special relevance. PA provide institutional investors with investment advice and voting recommendations for or against each of the points subject to voting in shareholders general meetings (Hitz & Lehmann, 2017). Evidence shows that, in most cases, institutional investors follow recommendations issued by PA, and in some cases they directly delegate their vote in them (Hitz & Lehmann, 2017; Larcker et al., 2013). Considering that managers search for approval regarding each of the points discussed in the shareholders general meetings, PA effectively exert supervision over managers of companies in which their clients invest. Furthermore, the international reach of proxy advisory firms makes them use international standards when evaluating the corporate governance of firms. It often occurs that international standards are stricter than the standards and regulations each of these companies apply,

increasing the likelihood of negative votes despite firms complying with the legal obligations of their jurisdictions (Iliev et al., 2015).

Despite the supervision support PA provide to institutional investors over their investees, they also distort the effectiveness of this supervision in two ways. First, institutional investors' managers often hire PA services as a sort of alibi that allows them to justify their investment decisions in case there is a supervision failure in the corporate governance of one of their investees (Gallagher, 2014). Second, PA do not bear any legal responsibility for the damages or prejudices they may cause to shareholders due to the recommendations they issue (Hitz & Lehmann, 2017). Both facts dilute responsibility in case of investees' bad governance which, after all, harms individual investors' interests (Eckstein, 2016).

Consequently, reaching a better understanding of how PAs influence corporate governance quality allows managers to anticipate to possible conflicts between the actions implemented in accordance with the local regulations and the corporate governance standards demanded by PAs. Furthermore, understanding what methodologies consulting firms apply to evaluate companies' governance and to issue vote recommendations clarifies how they define corporate governance quality and how they spread this definition within the financial investment community.

The ISS methodologies. The corporate governance consulting market is vastly dominated by Institutional Shareholders Services (ISS), which has produced a series of corporate governance quality indices. However, in its web page the company does not reveal explicitly what is understood as quality of corporate governance (ISS, 2018).

Until 2010, ISS used an index called Corporate Governance Quotient (CGQ) to measure corporate governance quality (Brockway, 2010). CGQ is calculated based on 64 corporate governance provisions from eight categories (audit, internal statutes, hostile takeover

protection, executives' compensation, performance evaluation, executives' ownership in the company and CEO qualifications). Each provision is assigned a specific relevance weight according to 16 measurements of risk and performance.

In 2010, ISS launched the *Governance Risk Indicator* (GRId) assessing corporate governance quality at three possible levels – low, medium and high – applied to four categories: audit, board composition, executives' compensation and shareholders' rights (Larcker et al., 2015).

In 2013, ISS set the rating called QuickScore consisting in an algorithm that classifies companies in deciles based on more than 200 corporate governance factors and financial metrics, and providing each factor with a weight and a score. Each factor belongs to one of the four governance categories ISS already used in previous metrics (Brownstein, 2013). QuickScore was rebranded QualityScore in 2016 (ISS, 2016).

ISS metrics hold some limitations. First, the distribution of factors computing for QualityScore of any given company depend on the company regional context (corporate governance regulation, and corporate culture) and the judgment of ISS experts in each of these regions. Also, the weight assigned to each factor also depends on the ISS experts' judgement in each region and sector of the analysed company (ISS, 2015). A second problem is that ISS does not disclose aspects determining what provisions are included in QualityScore calculation and what are their specific weights. This opacity does not allow analysed companies to anticipate to the ISS evaluation and adapt to the demanded quality standards.

Generally speaking, corporate governance metrics used by consulting firms vary greatly due to their necessity to launch new "products" to maximize their revenues, although consulting firms may argue that behind this lies their intention to develop more effective tools. As for ISS, every 3-5 years the firm launches a new methodology. The high frequency in the change of metrics implies more uncertainty both for investees' managers and shareholders. This

produces suspicion of these instruments reliability in determining if any given company's governance is "good".

Although recently corporate governance consulting firms have recognized the relevance of qualitative aspects in their analysis of corporate governance and have adapted their evaluation criteria to the regional context of analysed companies (ISS, 2015), the focus of their metrics remains distinctly quantitative and universalist.

Consulting firms' proposal of a definition for corporate governance quality relies on the minimization of the agency costs owners bear. As corporate governance consulting firms find support on the agency theory, they establish a causal relationship between corporate governance quality and financial performance that allows them to add value for their clients, mostly owners – principals – of the companies, and thus reach their prime goal, which is for-profit.

3.2 Behavioural metrics of corporate governance quality

During the last years the analysis of the personal traits of board members and managers in order to determine the quality of corporate governance has gained scholars' attention (Adams & Ferreira, 2009; Ferreira, 2014; Francoeur et al., 2008; Humphries & Whelan, 2017). Gabrielsson and Huse (2004) analysed the methodologies used in studies on the relationship between board traits and corporate governance. 72 per cent of these studies used directors' and managers' demographic data. Also, most of the analysed works addressed the characteristics of the board (independence board members, board size, stock ownership of board members, CEO duality) but did not address the internal functioning of the board because most of them followed an agency theory approach.

Alternatively, other studies have attempted define metrics for corporate governance quality through the behavioural lens highlighting the effectiveness in the accomplishment of the board supervision and advisory tasks.

First, some studies have found that face to face contact among directors is the main driver of all board behaviour dynamics, positive and negative, from attitudes – such as trust or sociability – to cognitive biases – such as groupthink – and power relations inside the boardroom. Both the monitoring task and the advisory task require good communication and constructive critical trust between board members in order to lead to effective board functioning (Bebchuk & Hamdani, 2009; Forbes & Milliken, 1999; Roberts et al., 2005). Consequently, board meetings (in number and level of attendance) and away-days have been found as key parameters determining an effective board task performance (Forbes & Milliken, 1999; Huse et al., 2012; Sundaramurthy & Lewis, 2003), and therefore are good indicators of the quality of companies' governance practices.

Second, other behavioural studies have searched to assess the independence of board members, as independence improves the board supervision task. They have revealed that a number of directors' traits help measure the quality of the advisory task performance as they determine the sense of independence of mind directors hold when working within the board to question managers proposals and actions.

Some of these traits favour directors' independence. Non-executive directors bring into the board networks, wider views of the business and freshness. Studies have shown that formal independence – i.e. relevant weight of non-executive directors in the board – improves the effectiveness of the board control task (Bainbridge, 2008; Huse et al., 2012; Laster, 2012; Morck, 2008; Westphal & Bednar, 2005).

Gender diversity also boosts the effectiveness of the monitoring task. Women are effective monitors because their stronger emotional intelligence and ethical inclination allow them think critically and voice against the actions and decisions of the executive team (Adams & Ferreira, 2009; Groysberg & Bell, 2013; Kang & Payal, 2012).

Research on the effects of the directors' educational background on board tasks performance is quite rare compared to the one dedicated to other board members' demographic traits (Mahadeo et al., 2012). Furthermore, directors' educational background has been mostly addressed under the general framework of the board diversity-decision making relationship but hardly with the goal of revealing how it determines one specific board task effectiveness (Tseng & Jian, 2016). However, some evidences can be found. Directors with an educational background in law are claimed to be extremely effective where corporate norms have to be challenged as they bring critical views on the board making monitoring effective (Forbes & Milliken, 1999).

Other board traits impact negatively on the effectiveness of the control task performance. That is the case of board size: larger boards tend to harm independence from management team because in them conflict is more likely to emerge and sociability to diminish (Coles et al., 2008; Forbes & Milliken, 1999; Lipton & Lorsch, 1992). Independence is also negatively affected in case of CEO-Chairman duality because the important second power base that challenges the top management's proposals is missing (Morck, 2008).

Finally, behavioural studies have also proposed to assess the board members' involvement in the company's strategic formulation, as this enhances the advisory task performance.

Gender is the most studied parameter of corporate governance quality impacting on the strategy involvement of the board. The contribution of women board members on board tasks effectiveness is based on their capacity to foster the board know-how through creativity,

bringing their different and fresh ideas into the board discussions (Ees et al., 2009; Fondas, 2000; Huse et al., 2007; Mathisen et al., 2012; Matsa & Miller, 2013).

Age also plays an important role in the advisory task of board. Oldest directors have experience, know-how, wisdom and wide networks that help them be good strategy advisors (Kramer, 2011; Shaw, 2011).

Forbes & Milliken (1999) support the view that directors' educational background in economics and related areas is the most important area of expertise for the advisory task. Directors' training also strengthens the fulfilment of the board advisory task because it fosters know-how and reinforces directors' self-confidence and sense of legitimisation to voice their own stances (Errity & Stuckey, 2012; Maharaj, 2008).

Regarding the role of board size in the formulation and implementation of a business strategy, Yermack (1996) found that size and boards' efficiency are negatively correlated because conformity increases with board size. More recently, Coles et al. (2008) found that board size and efficiency actually follow a bell shaped function in which an optimal board size can be identified.

Tuggle et al., (2010) found that CEO-Chairman duality negatively affects board members' allocation of attention because duality contributes to create a corporate environment in which it is inappropriate to question the management performance, thus decreasing the level of attention the board members pay to the management actions.

To sum up, behavioural metrics of corporate governance quality are basically formal board traits and norms seen as drivers of positive or negative group dynamics that enhance and/or diminish the effectiveness of tasks implementation.

Behavioural metrics of corporate governance quality also have limitations. Behavioural studies have used data to describe directors' traits, behaviours and relationships to analyse the

internal functioning of the board (Hambrick et al., 2008). In many cases, accessing primary data was an unavoidable requirement. However, practice has shown the difficulty in obtaining reliable primary data due to low response rates and the bias respondents show when evaluating their own performance (Huse et al., 2007). Thus, some studies have surveyed CEOs exclusively (Huse et al., 2012; McDonald y Westphal, 2011; Zahra et al., 2000) excluding from their analysis of corporate governance quality the team performance of the board and the board members interactions.

We conclude this section with Table 3 summarizing the metrics of corporate governance quality according to their theoretical approach.

4. CONCLUSIONS

At the beginning of this paper we formulated the following research question: *what is good corporate governance?* Although initially it might seem to be a simple question, we have shown the complexity behind it. There is not a single and universal definition of what good corporate governance is; the deep meaning of this definition is anchored on the theoretical approach adopted.

We have found that agency theory is the mainstream in conceptualising and measuring corporate governance quality. For agency theory good corporate governance is founded on practices that lower agency costs. As a consequence, neither social nor individual behaviours are assessed, and the formal structures and norms that force such behaviours are in favour of owners' interests. Complementary to agency theory, stewardship theory brings elements from sociology and psychology into the study of corporate governance and bases corporate governance quality on the formal policies and structures that enhance agents' willingness to manage the company for the sake of owners' interests.

The behavioural approach sets itself apart and proposes an alternative evaluation of corporate governance practices that breaks with the legacy of the economic approaches. The behavioural approach defines corporate governance quality as the efficient performance of the board duties of advice and control. The economic focus is replaced by the socio-psychological study of individuals' – directors and management – traits and behaviours, their functioning and decision-making in a social group – the board and the company – and given a specific social and cultural context.

The theoretical conceptualisation of good corporate governance is of utmost relevance as it determines the corporate governance metrics proposed by both scholars and practitioners. Under the agency theory umbrella, governance metrics use items determining the power balance between managers and owners, being corporate governance better when power balance leans more towards owners. In contrast, the behavioural approach metrics do not seek to determine corporate governance quality as a means to explain company economic performance, but as an end itself. The behavioural approach rejects the classic economic hypothesis according to which owners are perfectly rational (*homo economicus*) whose utility function is determined, exclusively, by the market value of their stock ownership. The behavioural approach apprehends the complexity of human beings as individuals and as social beings, and therefore its metrics rely on the capacity of governing people to effectively undertake their duties. Behavioural metrics evaluate the board capacity to be independent to perform its supervision task, and to be involved and prepared to perform the strategy advising task.

The fact that the behavioural approach does not found its corporate governance quality definition on the economic performance of companies explains to some extent why consulting firms focus on metrics relying on agency theory. Linking corporate governance quality and company economic performance help consulting firms take advantage for their own business

purposes. However, metrics developed by consultants have been unable to show neither in an irrefutable manner nor in a universal manner that this link between corporate governance quality and company financial performance actually exists. The most solid explanation to this is the problem of endogeneity present in both the conceptualisation and the methodology of agency-based corporate governance metrics (Adams et al., 2010; Romano et al., 2008). Governance structures are eventually the result of decisions made to improve the governance of the company. This endogeneity of governance structures closes the circle, and biases the econometric calculations of studies supporting agency premises. Consequently, governance quality proposals cannot reach any general dimension.

Thus we must question the validity of agency-based studies that show, or intend to show, a positive and unidirectional link between governance structures and financial performance.

Defining good corporate governance holds significant implications on how shareholders measure the quality of companies' governance and base their investment decisions. In order to empower shareholders with the appropriate means to assess corporate governance, studies could follow the behavioural approach and strive to develop reliable and applicable methodologies that overcome its limitations, particularly in what refers to data collection and validation. Moving forward in this sense will allow scholars, practitioners and regulators to identify the problems associated to poor corporate governance practices in big corporations that, far from decreasing, still exist. Furthermore, improving the definition of what good corporate governance is and how it is measured allows all stakeholders to overcome the "long taken-for granted models of 'good' corporate governance" (Raelin & Bondy, 2013) and so better understand what governing a company means, and what is the impact of their role in it.

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Tables

Table 1: Theoretical differences in defining corporate governance quality

	Agency theory	**Stewardship theory**	**Behavioural approach**
Basis for corporate governance quality metrics	Company' s economic and financial performance	Company' s economic and financial performance	Board of directors' tasks performance
Practices that lead to good governance quality	Formal policies and structures that minimise agency costs	Formal policies and structures that facilitate agents' collaboration with principals	Formal and informal policies and structures that favour good internal functioning of the board of directors and its decision-making processes

Table 2: Agency-based indices

Authors	**Year**	**Context**
Campos and al.	2002	6 emerging countries
Alves & Mendes	2002	Portugal
Gompers et al.	2003	USA (IRRC data)
Bauer et al.	2004	UK
Drobetz, Schillhofer & Zimmermann	2004	Germany
Doidge & al.	2004	40 countries
Bebchuck et al.	2005	USA (IRRC data)
Durnev & Kim	2005	27 countries
Leal & Carvalhal-de Silva	2005	Brazil
Mintz	2005	23 countries
Beiner et al.	2006	Switzerland
Black, Jang & Kim	2006	Korea
Brown & Caylor	2006	USA (ISS data)
Zheka,	2006	Ukraine
Kanellos & George	2007	Greece
Khiari, Karaa & Omri	2007	USA
Ananchotikul,	2008	Thailand
Garay and Gonzalez	2008	Venezuela
Ntim	2009	South Africa
Darmadi	2011	Indonesia
Varshney, Kaul & Vasal	2012	India
Fallatah & Dickins	2012	Saudi Arabia
Hassan	2012	UAE
Samaha et al.	2012	Egypt

Source: Pillai & Al-Malkawi, 2016; Zitouni, 2016

Table 3: Metrics of corporate governance quality according to theoretical approach

			Metrics
Agency Theory	Scholars	*G-Index*	24 provisions reflecting the power balance between shareholders and managers
		E-Index	6 anti-takeover provisions adopted by the board and causing power transference to managers in shareholders' detriment
		Gov-Score	A combination of 7 internal and external CG provisions: directors election, poison pills, adjustment in stock options price, amount of delivered stock options, directors' attendance to board meetings, board regulations availability, board members subject to rules about ownership
	Practitioners	*Corporate Governance Quotient*	64 CG provisions assigned a specific relevance weight according to 16 measurements of risk and performance
		GRId	Assesses CG quality at three possible risk levels within four categories: audit, board composition, executives' compensation and shareholders' rights
		QualityScore	More than 200 CG factors and financial metrics; each factor with a weight and a score determined by the judgment of ISS experts
Behavioural Approach	Scholars	*Board Independence*	Board meetings, away-days, weight of non-executive directors, board gender diversity, board educational background in law, board size, CEO-Chairman duality
		Involvement in Strategy Formulation	Board meetings, away-days, board gender diversity, board age diversity, board educational background in economics, directors' training, board size, CEO-Chairman duality