

**How independent, competent and incentivized should non-executive directors be? An empirical investigation of good governance codes.**

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# **How independent, competent and incentivized should non-executive directors be? An empirical investigation of good governance codes.**

## **Abstract**

There is a commonly-held conviction among governance scholars and practitioners that increasing the number of non-executive directors may have beneficial effects on board practices. This view has gained momentum after each wave of scandals. Given the relevance of the issue in governance studies and practices, the aim of this article is to investigate how independent, competent and incentivized non-executive directors should be according to governance scholars and board best practices. To answer this question, we conducted a review of the literature on non-executive directors. We then collected corporate governance codes developed worldwide at the end of 2005, and made a comparative analysis of their recommendations about the independence, the competencies, and the incentives of non-executive directors. Our results show that (i) non-executive directors' independence is a commonly recommended governance practice, the meaning of which differs widely among countries; (ii) non-executives directors' competencies and incentives are not considered a governance issue to be regulated in detail; (iii) agency theory and the search for appropriate board demography tend to dominate the recommendations of governance literature and codes. Our findings have implications for both research and practice.

Keywords: board of directors, non-executive directors, codes of good governance.

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## **Introduction**

In the last few decades, recommendations on how to increase board effectiveness and corporate governance centred on the role of non-executive directors, considered one of the most important mechanisms to ensure corporate accountability (Daily et al., 2003; Dalton et al., 1998). After the recent worldwide wave of scandals, policymakers reacted to managers' misappropriation both by attacking the conflicts of interest in and around large public companies, and by demanding an increase of board independence from powerful subjects inside and outside the firm (Aguilera, 2005; Dalton and Dalton, 2005).

As a consequence, codes and rules relating to non-executive directors have been reinforced. In the US, the Sarbanes Oxley Act (2002) and the new NYSE listing rules (2003) require that the board of a publicly traded company be composed of a majority of independent directors and that the audit committee be made up entirely of independent directors – at least one of which needs to have financial expertise (Agarwal and Chadha, 2005). In the UK, building on the review undertaken by Sir Higgs, the recommendations on board composition were tightened up in 2003. The Combined Code recommends nominating independent non-executives for at least half the seats on the board, separating the positions of chairperson and CEO, having a majority of independent directors in the nomination committee, and totally independent membership of the audit and the remuneration committees. Other countries followed the examples of the US and the UK and strengthened recommendations on board composition and independence (Aguilera, 2005; Huse, 2005).

In line with codes and rules, the empirical evidence on the effectiveness of non-executive directors supports some recognition of their relevance to safeguard corporate

accountability. The findings of these studies are consistent with the idea that (i) non-executive (mostly independent) directors (especially those with financial expertise) are valuable in providing oversight of a firm's financial reporting practices (e.g. Agarwal and Chadha, 2005; Beasley, 1996; Persons, 2006); (ii) non-executive directors may protect shareholders' interests affecting important board outcomes, such as CEO substitution, the reaction to potential takeovers, the introduction of anti-takeover mechanisms, and top management's compensation (e.g. Hermalin and Weisbach, 2003; Kosnik, 1987 and 1990; Weisbach, 1988).

That being said, this paper aims to contribute to the ongoing debate on the effectiveness of non-executive directors as powerful safeguards of shareholders' interests by reviewing the extant literature and analyzing good governance code recommendations. In particular, we first reviewed literature on the characteristics of non-executive directors. We then analyzed good governance codes developed around the world to understand the characteristics of non-executive directors in terms of independence, competencies and incentives. Our findings show that (i) non-executive directors' independence is a common governance practice, however, the meaning of "independent director" differs widely among countries; (ii) non-executives directors' competencies and incentives are not considered a governance issue to be regulated in detail; (iii) agency theory and the search for appropriate board demography tend to dominate the recommendations of governance literature and codes.

The paper is divided in four sections. In the first section, we summarize literature on non-executive directors' characteristics and we introduce good governance codes. In section two, we describe the research method: the sample, data collection, and data analysis. In the third section we present our main results. Finally, we discuss the implications of our findings for theory and practice.

## **Theoretical background**

### *Board tasks and non-executive directors*

Board tasks have been categorized in several ways, but the most common distinction is between board control and service tasks (Forbes and Milliken, 1999) that are respectively founded on agency and resource dependence theory (Huse, 2005).

According to agency theory, rooted in economics and finance, agents are opportunistic and are strongly motivated to take profit from the information asymmetry between them and their principals (Fama, 1980; Fama and Jensen, 1983). Following this premise, agency scholars conceive boards of directors as groups of independent people that have the duty to actively control top management behaviours and decisions in order to secure the shareholders' value maximization (Fama and Jensen, 1983). The monitoring task includes a set of related activities, such as the control of firm performance, the monitoring of firm's activities, the assessment of CEO behaviours, and so on (Huse, 2005; Johnson, Daily and Ellstrand, 1996; Stiles and Taylor, 2001).

According to the resource dependence theory (Pfeffer and Salancik, 1978), boards of directors constitute a resource on which managers may call for advice (Daily and Dalton 1994; Huse 2005). Boards of directors participate in the strategic decision-making process, support top management in defining the strategic context of the firm, and provide external legitimacy and networking (Stiles and Taylor, 2001). The board service task includes a set of related activities, such as evaluating and selecting strategic alternatives that have been developed by top managers, providing advice to improve the quality of strategic decisions, and so on (Demb and Neubauer, 1992; Huse, 2005; Lorsch and MacIver, 1989; Styles and Taylor, 2001).

Non-executive directors may contribute to board control and service tasks with varying degrees of effectiveness (e.g. Lorsch and MacIver, 1989; Stiles and Taylor, 2001). According to the literature, the key antecedents of non-executive directors' effectiveness are: a) the

degree of independence (Fama, 1980; Fama and Jensen, 1983; Monks and Minow, 2004), b) the level of knowledge and skills (Charan, 1998; Carter and Lorsch, 2004; Hendry, 2005), and c) the economic incentives to behave properly (Mace, 1971; Shen, 2005).

*The independence of non-executive directors.*

Independence is considered an important element of good governance, because it is assumed that non-executive directors who are independent from management effectively represent the shareholders' interests (Fama, 1980; Fama and Jensen, 1983). American fund managers cite an independent board as a critical element of a successful corporate governance system (Monks and Minow, 2004; Useem et al., 1993). Agency scholars (e.g. Fama, 1980; Fama and Jensen, 1983) contend that non-executive independent directors are usually expert monitors, as performing poorly in this area may undermine their reputation and future career.

Despite the large emphasis on their governance role, there is not a common definition of "independent directors" (Brudney, 1982). In the narrowest terms, we can consider "independent" a director who does not have any business or family relationship with top managers of the firm. In broader terms, directors are independent if they do not have any business or family relationship with subjects that can influence their accountability towards the firm. The most common approach defines independent directors as persons without a business or family relationship that may determine a conflict of interests with the corporation (Borowski, 1984; Brudney, 1982). Following this approach, independent directors are neither employees of the company, nor outsiders who have a significant economic relationship with the company (such as bankers, lawyers, suppliers, service providers, etc.) or family ties with its management or shareholders (Dalton et al., 1998).

Directors' independence is seen primarily as a necessary prerequisite for one board task: the unbiased oversight of management (e.g. Carter and Lorsch, 2004). However,

independence may have a second meaning that is also relevant in the accountability process. Independence implies the ability of non-executive directors to see things differently (e.g. Roberts, McNulty and Stiles, 2005). Non-executive directors should bring to the board their past experience which, together with their distance from the day-to-day running of the company, allows them to offer different perspectives from executives on strategic decisions (Roberts et al., 2005). The interplay of a variety of skills and perspectives amongst different board members increases the likelihood of creative and innovative solutions to problems and improves the quality of the strategic decision process (e.g. Carter and Lorsch, 2004; Roberts et al., 2005).

*The knowledge and skills of non-executive directors.*

Boards of directors are “large, elite, and episodic decision-making groups that face complex tasks pertaining to strategic-issue processing” (Forbes and Milliken, 1999: 492). If we consider the enormous difficulties faced by executive and non-executive directors in their job, we realize that problems of honest incompetence may be even more dangerous than problems of self-seeking behaviour (Hendry, 2005). Thus, a second ingredient to board effectiveness is a good mix of experiences and competencies of board members (Roberts et al., 2005).

Management literature indicates that directors – to be effective – should have both functional and firm-specific knowledge and skills (Charan, 1998; Carter and Lorsch, 2004). Functional knowledge and skills include not only the traditional areas of management, such as finance, marketing and accounting, but also some other areas (such as law) useful for managing the relationship with the environment (Forbes and Milliken, 1999). The competencies and skills of non-executive directors are crucial for their effectiveness (Hendry, 2005). Non-executive directors who are top executives of another public company are

perceived to be more responsible and higher quality than other classes of directors (Fairchild and Li, 2005).

Firm-specific knowledge and skills are important because without an intimate understanding of the company and its functioning, it is difficult for directors to deal with issues presented in the board meetings. To be active in board discussions, non-executive directors should analyze information provided by management in detail, and take initiatives to find further information on the company and the industry (Charan, 1998). A recent survey questioned the quality of the firm-specific knowledge of non-executive directors. Most of the CEOs agreed, in fact, that board members need a clear understanding of what drives the firm's strategic success, but at the same time they complained that non-executive directors don't spend sufficient time to gain this knowledge (Carter and Lorsch, 2004). In sum, both competencies and specific information are key ingredients for the effectiveness of non-executive directors.

#### *The incentives of non-executive directors.*

To be effective, non-executive directors should be engaged in carrying out their responsibilities (Roberts et al., 2005), i.e. they should invest time and effort to become knowledgeable about the firm, and involved and intimate with the firm's problems. However, some studies show that non-executive directors do not devote enough attention to their board responsibilities (e.g. Mace, 1971; Carter and Lorsch, 2004; Lorsch and MacIver, 1989), mainly due to the fact that they are busy people facing time constraints to perform their duties (Lorsch and MacIver, 1989). Thus, incentives and pay may be important antecedents to their effectiveness (Jensen, 1989).

Directors' pay structure is a controversial issue regarding both the amount and the form of remuneration (Shen, 2005). If non-executive directors are well-paid, they have little



incentive to oppose the policies of the CEO and top management, because in some way they are dependent on management. Alternatively, if they are not well-paid, non-executive directors may be insufficiently incentivised to devote the time and effort required for the fulfilment of their responsibilities. In sum, even if there is a consensus that excessive pay is undesirable, it is not clear how much non-executive directors should receive to be motivated to contribute to the board effectively (Shen, 2005).

The form of payment is the most controversial issue about directors' pay, as equity incentive schemes are the principal determinant of excessive pay (Frey and Osterloh, 2005) and at the same time, due to the possibility of creating a link with firm's results, their presence can align directors' behaviour with shareholders' interests (Shen, 2005). Concerning this issue, some scholars believe that companies should offer directors share-based payments, e.g. restricted stocks with lock provisions, so that their interests would be aligned with those of shareholders (Hambrick and Jackson, 2000; Mace, 1971; Tosi, Shen and Gentry, 2003). Other scholars believe instead that a strong relationship between directors' wealth and share price may create the perverse incentive for directors not to discourage management to "cook the books" so as to inflate the share price and their wealth (Dalton and Daily, 2001; Frey and Osterloh, 2005).

### *The good governance codes: objectives, content and diffusion*

Codes of good governance are sets of best practices regarding the board of directors and other governance mechanisms. These codes have been designed to address deficiencies in the corporate governance system by recommending a set of norms aimed at improving the transparency and accountability of managers and directors (Fernandez-Rodriguez et al., 2004). The core of good governance codes lies in the recommendations on the board of directors (Zattoni and Cuomo, 2008). In particular, following recommendations from scholars

and practitioners (e.g. Charan, 1998; Demb and Neubauer, 1992; Lorsch and MacIver, 1989), codes encourage the quest for an increasing number of non-executive and independent directors, the separation of Chairman and CEO roles, and the creation of board committees (nomination, remuneration, and the audit committee). The introduction of these practices is considered a necessary factor in order to avoid governance problems and to increase board and firm performance (Aguilera and Cuervo-Cazurra, 2004).

The adoption of codes has been encouraged by different institutions (such as national stock exchanges, government institutions, and industry associations) to increase the accountability of listed companies' governance processes to outside investors (Aguilera and Cuervo-Cazurra, 2004). The first code of good governance was developed at the end of the '70s in the United States in the midst of great corporate debate fuelled by the publication of a seminal book on board practices (Mace, 1971) and the failure of some large companies (Aguilera and Cuervo-Cazurra, 2004). The development of corporate governance codes in European countries dates to the early '90s in the UK, when a series of financial scandals and related failures of listed companies (e.g. BCCI and Maxwell) led to the formation of the Cadbury Committee. Code activity accelerated after an influential report was issued by the OECD Business Sector Advisory Group on Corporate Governance ("The Millstein Report"), and the related OECD Principles of Corporate Governance, published in 1998. Since then there has been a proliferation of codes around the world. By the middle of 2003, 35 countries had issued at least one code of good governance and 141 codes had been developed globally (Cuervo-Cazurra and Aguilera, 2004).

The empirical evidence supports the idea that good governance codes exert – at least formally – a large influence on governance practices at national level. Previous studies show that companies tend to comply with code's recommendations (e.g. Akkermans et al., 2007; Conyon and Mallin, 1997; Dedman, 2002; Fernandez et al., 2004; Gregory and Simmelkjaer,

2002; Werder et al., 2005), and that financial markets appreciate compliance (e.g. Del Brio et al., 2006; Fernandez et al., 2004; Goncharov et al., 2006). However, we still do not know if best practices developed at national levels are similar or different across countries, as previous studies investigated codes' recommendations and compliance mostly at country level (e.g. Akkermans et al., 2007; Conyon and Mallin, 1997; Dedman, 2002; Del Brio et al., 2006; Fernandez et al., 2004; Goncharov et al., 2006; Werder et al., 2005). With that in mind, the aim of article is to explore differences and similarities in codes with regard to the characteristics of non-executive directors, as they are considered by both literature and codes one of the most important mechanisms to fulfil corporate accountability (e.g. Daily et al., 2003; Roberts et al., 2005).

## **Methods**

### *Sample*

Our sample includes most recent codes of good governance developed worldwide at the end of 2005. We considered 60 countries: the 49 countries included in the data set of La Porta et al. (1998) and all EU member states at the end of 2005. Our main sources of information are the “Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States” (Gregory and Simmelkjaer, 2002), the “Survey of Corporate Governance Developments in OECD Countries” (OECD, 2003), and the “Code and Principles” section on the European Corporate Governance Institute web site ([www.ecgi.org](http://www.ecgi.org)). For reasons of consistency, our database includes only codes of good corporate governance. We excluded laws and legal regulation, reports on compliance with codes already issued, codes on the behaviour of top management, consulting-firm reports, and individual or specific company codes. By the end of 2005, 44 out of the 60 countries examined had issued at least one code of good governance (Zattoni and Cuomo, 2008).

We classified countries according to their legal tradition, their membership of the EU, and their board model. The legal tradition of a country is considered a good predictor of the deficiencies in the corporate governance systems (La Porta et al., 1998; Reynolds and Flores, 1989). The anti-director rights index and the distinction between common law and civil law countries (La Porta et al., 1997 and 1998) have been routinely used as measures of legal shareholder protection in cross-country quantitative studies. We assigned a dummy variable to each legal tradition: 0 for civil law, and 1 for common law. Moreover, we considered EU membership to take into account the potential effect of harmonization induced by EU regulations (e.g. Lannoo and Khachatryan, 2004). We defined EU countries (1=yes, 0=otherwise) as those that had full membership in 2005. Finally, we discriminated between countries with one-tier boards (1=yes, 0=otherwise) and countries with two-tier boards because the role of non-executive directors may differ in the two governance models (Hopt and Leyens, 2004). To this end, we rely on both literature (e.g. Hopt, 1998; Vutt, 2006) and the definition of board structure in the codes.

### *Data collection*

We collected archival data on the content of codes. In particular, for each code we collected data and created a number of dummy variables to measure the presence of some requisites related to non-executive directors' independence, competencies, and incentives: 1 present, 0 otherwise.

We compared and contrasted (Maxwell, 1996) the definition of independent directors in terms of subjects and relationships to avoid. The definitions of independent directors included in the codes of good governance preclude various types of relationships with a number of subjects. Beyond (and sometimes instead of) specific requirements, some codes also require a general independence criterion, stating that non-executive directors should avoid any

relationship that may potentially undermine their independence. Table 1 contains the final categorization.

(Insert here Table 1)

Then, we compared and contrasted code content to understand if good governance codes include some requisites (in terms of competencies and knowledge) non-executive directors should have to be elected to the board or to some of its committees. In particular, we considered non-executive directors' (i) competencies to be board members, (ii) competencies to be members of nomination or remuneration committees, (iii) basic competencies to be members of the audit committee, and (iv) advanced competencies to be members of the audit committee. Table 2 contains the final categorization of competencies.

Finally, we analyzed the content of code recommendations on non-executive directors' economic incentives. In particular, we checked if codes recommend or allow non-executive directors to receive (i) stocks or (ii) stock options. See Table 2 for final categorization.

(Insert here Table 2)

### *Data analysis*

Data analysis of the content of codes followed generic prescriptions for analyzing qualitative data and involved various applications of sorting, organizing and coding data (Lee, 1999). This was done through the use of theoretical memos (Maxwell, 1996).

We started coding two governance codes from each country-origin legal system: the UK and the US codes for Anglo-American legal systems, the Norwegian and the Swedish codes for Scandinavian legal systems, the German and the Japanese codes for German origin, and

the French and the Italian codes for French origin. Both researchers coded all items independently. After this test of the coding system, we measured consistency among coders and defined coding rules according to the differences we encountered. Then the entire coding process was repeated for all codes of good governance.

Each code was independently analyzed by both researchers and interpreted on a continual and evolving basis in order to decompose and reduce data (Coffey and Atkinson, 1996). Following the prescription for qualitative research, we analyzed data quantitatively using nominal and categorical variables (Marshall and Rossman, 1995). At the end of the independent analysis, we matched the two sets of data and found a high degree of overlap. Only 133 out of 2,684 measures of the codes' recommendations on non-executive directors' independence, competencies, and incentives were coded differently by the researchers. We measured inter-rater reliability using both percent agreement and Cohen's Kappa (e.g. Cohen, 1960; Dewey, 1983). The results of the analysis of inter-rater reliability are high, and above appropriate minimum acceptable level of reliability. The percent agreement equals .950 and Cohen's Kappa is .834.

Then, we identified the few cases that were the subject of disagreement and analyzed each in detail. Disagreements were mostly caused by misinterpretation of the meaning of code recommendations due to differences among national systems of governance. To reconcile disagreements we analyzed the information collected on the national governance systems in detail (Gregory and Simmelkjaer, 2002). Then we re-read the codes of good governance, and discussed non-matched cases. The deeper knowledge of governance practices of various countries allowed us to reach an agreement without prolonged discussion.

To compare code recommendations on non-executive directors' independence, competencies, and incentives, we used a t-test for difference-of-means. We conducted the

analyses for common law versus civil law legal systems, EU versus non-EU countries, and one-tier versus two-tier countries.

## **Results**

### *The independence of non-executive directors*

The analysis shows that codes use different labels for non-executive independent directors. A large majority of codes of good governance use the term “independent directors”, but in a few cases they are given different labels such as “outside” directors (Indonesia, Mexico, Japan, and Korea) or “unrelated” directors (Canada).

Our results show that only two codes (Austria and Germany) do not provide a formal and detailed definition of independent directors. The other codes of good governance provide a quasi-legal definition of independent directors stating the relationships with specific subjects that the director must avoid to be considered independent. Seventeen codes (twelve from English-origin legal systems) reinforce the specific definition by including a general requirement of independence, stating for example that “the board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the directors’ judgment” (Combined Code, p.7).

The most commonly cited subjects with whom independent directors should not have a relationship are the focal firm itself (73 per cent of codes) and subjects able to influence the focal firms’ decisions, namely executives (73 per cent) and shareholders (68 per cent). Company directors may not be considered independent if they have a relationship with subsidiaries and other group companies (50 per cent), external companies related to the focal firm (45 per cent) – e.g. a bank or a main supplier or customer – or audit and consulting firms

(34 per cent). In fewer cases (18 per cent), independent directors should avoid having a significant relationship with other company directors.

Proscribed relationships differ for corporate bodies and individual persons (see Figure 1). In relation to the focal firm, directors are not considered independent if they have a business (50 per cent) or an employment (41 per cent) relationship, if they are executive officers (41 per cent), or receive additional compensation for services (34 per cent). When defining director independence from related companies, codes emphasize similar relationships. Where the code defines director independence from individuals (managers, shareholders or directors) who exert a strong influence on the focal firm, the proscribed relationships differ. Specifically, in the case of managers (39 per cent), shareholders (27 per cent), and directors (11 per cent), the most commonly proscribed relationship is a familial one. Beyond that, directors may lose their independence if they are representatives of majority shareholders (23 per cent) or if they have a business relationship with these shareholders (14 per cent).

(Insert here Figure 1)

We tested differences between common law and civil law countries in defining independence of non-executive directors using a t-test (see Table 3). Our findings show that both independence from directors (.73 versus .21,  $p < .05$ ) and management (1.40 versus .86,  $p < .05$ ), and above all the general requirement of independence (.80 versus .17,  $p < .001$ ) are significantly stronger in common law than in civil law codes. These results are consistent with the characteristics of Anglo-Saxon countries, where the risk of misappropriation is principally related to management abuse, while in other countries this risk is mainly related to abuse by majority shareholders (Aguilera and Jackson, 2003; Weimer and Pape, 1999). These data also



support the “law matters” approach showing that common law countries in general have a more stringent definition of independence than civil law ones, and thus a stronger protection of investors rights (La Porta et al., 1997 and 1998).

Regarding the analyses of EU and non-EU countries, our results do not show significant differences between the two samples. The codes of countries with one-tier boards, however, have higher standards of independence than those of two-tier boards, even if the difference is significant only for the general requirement of independence (.48 versus .09,  $p < .01$ ). This result may be explained considering that in two-tier boards there is a separation between members of the supervisory board and members of the management board, while in one-tier boards the same persons are responsible for managing and monitoring the company (e.g. Hopt and Leyens, 2004).

(Insert here Table 3)

#### *The competencies and skills of non-executive directors*

Our results show that twenty-one codes include a general requisite of competence for non-executive directors, e.g. they require that non-executive directors have “sufficient abilities, knowledge and experience” (Cyprus) or are selected for “their personal prestige, experience and capacity” (Mexico). This requisite is more frequently found in recently industrialized countries – especially in the Far East (India, Malaysia, Indonesia, Taiwan, South Korea) and Eastern Europe (Hungary, Lithuania, Poland, Slovakia, and Slovenia) – than in nations with an older industrial tradition. This recommendation is particularly valuable in such emerging economies because institutional and market forces are too weak to regulate governance matters (North, 1990).

Only a few codes recommend that the non-executive directors who sit on nomination and remuneration committees have specific competencies. This is the case of the Slovenian code which requests that at least one “company law expert” and one “expert in management” sit on the remuneration committee. The Polish code also requests that one member of the remuneration committee possesses “the relevant qualifications and experience in accounting and finance”. In addition, the codes of Hungary and Lithuania recommend that non-executive directors sitting in board committees have “the capabilities, professional skills and experience” or possess “qualifications and expertise” required to perform their role.

The recommendations on competencies of non-executive members of the audit committee are more frequent due to the important role of this committee in avoiding fraudulent and illegal acts (Collier and Zaman, 2005). In particular, seventeen codes recommend the financial literacy of members of the audit committee (i.e. the ability to read and understand financial statements), and the same number of codes recommend the presence of at least one member with accounting or related financial management expertise (i.e. a qualified accountant or a professional with experience in financial and accounting matters). Only nine codes recommend both, and the majority of these originate from common law countries (Ireland, Australia, Canada, USA, and UK).

We tested differences between common law and civil law countries in non-executive directors’ competencies using a t-test (see Table 4). Our findings show that common law codes, more often than civil law codes, recommend that at least one non-executive member of the audit committee has advanced accounting and financial competencies (.67 versus .24,  $p < .01$ ). This result is consistent with the Anglo-Saxon governance system that is characterized by higher investor protection than other governance systems (e.g. La Porta et al., 1997 and 1998). Our findings also show that a general requirement of competence is more often present in civil law codes than in common law codes (.59 versus .26,  $p < .10$ ). As we observed before,

this is due to the larger presence (within civil law legal systems) of recently industrialized countries which are characterized by weak institutional and market forces regulating governance issues (North, 1990).

Our results also show that EU codes, more often than non-EU codes, recommend the presence of qualified non-executive members on the nomination and compensation committees (.18 versus .00,  $p < .05$ ). This is due, as we have seen, to the characteristics of Eastern European codes. Moreover, our results show that the codes of countries with one-tier boards recommend competent non-executive directors less often than the codes of two-tier boards (.36 versus .82,  $p < .01$ ) and recommend highly qualified non-executive members of the audit committee more often (.45 versus .18,  $p < .10$ ). This result is understandable if we consider that French and common law countries traditionally adopt the one-tier model, while German and Scandinavian countries use the two-tier one (Hopt, 1998).

(Insert here Table 4)

#### *The incentives of non-executive directors*

The issue of share-based incentives offered to non-executive directors is explicitly considered in only fifteen codes. Lacking an explicit prohibition, we presume that all other codes allow companies to assign share-based payments to directors. Specifically, only five codes explicitly proscribe assigning shares or any other share-based payment to non-executive directors, while a larger number of codes (thirteen) discourage companies from offering share-option pay to non-executive directors. These numbers may underestimate the disfavour versus share-based payments because some codes (i.e. Singapore, Malaysia, New Zealand, Austria, and Turkey) do not take a clear position on the issue, stating for example that non-executive directors' remuneration "should be appropriate to the level of contribution, taking

into account factors such as effort and time spent, and responsibilities of directors” (Singapore).

We tested differences between common law and civil law countries in non-executive directors’ equity incentives using a t-test (see Table 4). Our findings show that common law codes more often than civil law codes allow companies to offer shares to non-executive directors (1.00 versus .83,  $p < .10$ ). This result is consistent with the Anglo-Saxon governance system which is characterized by more developed financial markets and a stronger equity culture (e.g. La Porta, et al. 1997; Weimer and Pape, 1999; Zattoni and Minichilli, 2009; Zattoni, 2007). Our results also show that share-option payments (i) are less common than share-based payments in both legal systems, and (ii) are allowed more often in common law than in civil law codes (but with no statistically significant difference). The lower possibility to offer share option payments (instead of share-based payments) may be explained considering the higher volatility and risk associated with stock option mechanisms (Hall, 2000).

Our results show also that EU codes recommend less often than non-EU codes both the offer of shares (.77 versus 1.00,  $p < .05$ ) and of share-options (.50 versus .91,  $p < .01$ ). This difference is due to the cautious use of these instruments by continental European companies. Moreover, our results show that one-tier board codes more often than two-tier board codes allow shares to be offered to non-executive directors (.96 versus .63,  $p < .10$ ). This is mainly due to the large presence of common law codes in the first sample.

## **Discussion**

We believe that our findings contribute to our understanding of characteristics of non-executive directors in that our results show that (a) almost all codes recommend the independence of non-executive directors, albeit with differences in labels and definitions; (b)

codes do not consider non-executive directors' competencies and incentives as a detail for regulation; (c) code recommendations are strongly influenced by agency theory and the search for appropriate board composition and structure.

#### *Independence of non-executive directors*

Governance codes are encouraging boards to increase the number of non-executive independent directors, in the conviction that they may play an invaluable role in the accountability process (e.g. Agarwal and Chadha, 2005). There are at least two good reasons why the primary focus of governance reforms has been placed on independent directors (Borowski, 1984). First, almost all the other potential sources of accountability (such as the market for corporate control or the courts) come into play only after allegations of management misconduct have been made, while independent directors may act in a preventative capacity to avoid bad or illegal decisions being made in the first instance (Borowski, 1984). Second, independent directors, by keeping informed and ensuring that the disclosure process is functioning properly, may guarantee the efficiency of other governance mechanisms based on public information (Roberts et al., 2005).

Consistent with this view, our results show that non-executive directors' independence is recommended by almost all codes of good governance. Our findings also show that civil law codes adopt a weaker definition of independence, with particular reference to directors, managers, and general requirements. These results support the "law matters" approach (e.g. La Porta et al., 1997 and 1998), as common law countries adopt a more stringent definition of independent directors in accordance with their stronger protection of investor rights. An important feature of common law codes is the presence of a general requirement of independence, as simply adopting quasi-legal measures of independence may not produce the desired objectives, i.e. having directors with an independent character and judgment. Our

results encourage civil law countries to strengthen their measures of independence, and above all to adopt a general requirement of independence which emphasizes the substantial aspects of independence over the formal legalistic ones.

At the core of code recommendations is the basic proposition that boards must be empowered to govern well, and that the best way to reach this objective is to ensure that boards are controlled by independent directors (Carter and Lorsch, 2004). Despite its soundness, this assumption cannot translate into practice as intended. First, board independence comes at a cost. For example, a board dominated by independent directors is likely to know little about the industry and the business (Roberts et al., 2005). This lack of knowledge may create difficulties both in setting strategy and monitoring performance, since a solid understanding of the business is a critical prerequisite of board effectiveness (e.g. Carter and Lorsch, 2004). Second, independence should be considered not only in a quasi-legal sense as a protection against the potential collusion between executives and non-executives, but also (and above all) as independence of mind (Carter and Lorsch, 2004). Non-executive directors should bring to the board their past experiences and their actual competencies which, together with their distance from the day-to-day running of the company, allow them to offer different perspectives on strategic decision-making (Roberts et al., 2005). Ideally, the entire board should develop practices and culture emphasizing independence, which encompass non-executive directors being able to access company documents and managers, whilst having direct channels to independent sources of information (Carter and Lorsch, 2004; McCabe and Nowak, 2008; OECD, 2004: 66).

#### *Competencies and incentives of non-executive directors*

The competencies and incentives of non-executive directors are debated issues in the governance literature. In particular, governance scholars and practitioners (e.g. Carter and

Lorsch, 2004; Charan, 1998; Hendry, 2005; Roberts et al., 2005; Shen, 2005) question the quality of non-executive directors' competencies and experiences, and whether and what kind of incentives may encourage active behaviour. Despite this heated debate, our findings show that few codes recommend electing non-executive directors with strong competencies and experiences. This is also true in the case of the audit committee where it is not yet common practice to require the financial literacy of all members and the presence of at least one member with experience in finance or accounting. Moreover, few codes consider the issue of financial incentives to non-executive directors. Almost all codes implicitly allow companies to assign share-options or share-based payments to non-executive directors.

Our findings show that codes of good governance unanimously recommend increasing board independence, often to elect competent non-executive directors, and rarely to avoid assigning shares-based payments to non-executive directors. The neglect of competency and incentive issues may be due to the conviction that market forces may both manage the selection of non-executive directors properly, and provide them with the right incentive to behave effectively (e.g. Gilson, 1990; Kaplan and Reishus, 1990). Our results support this view as they indicate that the codes of recently industrialized countries, compared to the codes of older industrialized nations, contain more frequently a general requirement of competence of non-executive directors. The effectiveness of market forces is, however, questioned by scholars who believe that the selection process of directors may be guided by top managers (e.g. Davis and Thompson, 1994; Singh and Harianto, 1989). The development of certain board practices, such as a strong presence of independent directors on the nomination committee, may support market forces and facilitate the selection of appropriate candidates to the board (e.g. Carter and Lorsch, 2004). Furthermore, the development of induction programs and training activities at firm level may help non-executive directors to

collect relevant information about the company and to develop a more precise view of their responsibilities (e.g. Stiles and Taylor, 2001).

A large majority of codes seems to ignore the fact that substantial share-based incentives may undermine non-executive directors' independence. A priori, it is not obvious if independence (without knowledge and incentives) may lead to better board performance than knowledge and incentives (without independence) (Baghat and Black, 1998; Peng, 2004). Inside the boardroom, there is a trade-off between independence on the one hand, and knowledge and incentives on the other (e.g. Demb and Neubauer, 1992). Non-executive directors are deemed not to have conflicts of interest, but are seen to be relatively ignorant about the company and they have limited incentives to act carefully. Executive directors have a conflict of interest, but they are well informed and have their human capital, and possibly their financial capital, committed to their company. Probably, the optimal board has some knowledgeable and incentivized executive directors, and some independent directors (Baysinger and Butler, 1985). Finding an appropriate balance among non-executive directors' independence, competencies, and incentives is still an open issue. However, many governance scholars and practitioners agree that both non-executive and executive directors should be involved in the performance of board tasks, and that board processes should encourage open and collaborative behaviour by board members (e.g. Carter and Lorsch, 2004; Charan, 1998; Huse, 2005; Minichilli, Zattoni and Zona, 2009; Robert et al., 2005; Shen, 2005; Stiles and Taylor, 2001).

#### *The dominance of agency theory and the emphasis on board composition and structure*

Mainstream research and practice in corporate governance is dominated by agency theory and the emphasis on board monitoring task (Daily et al., 2003; Huse, 2005; Roberts et al., 2005; Shen, 2005). Following agency theory, good governance code recommendations focus on



boards' compositional and structural characteristics, and emphasize non-executive directors' independence as an appropriate and adequate proxy for board effectiveness (Roberts et al., 2005).

The emphasis that investors place on board composition and structure is due to the fact that these characteristics are visible from a distance (Carter and Lorsch, 2004; Roberts et al., 2005). However, recent governance studies indicate that board composition and structure do not automatically lead to more effective boards, and underline that board effectiveness is strongly influenced by group-level processes such as open and critical debate, directors' commitment to fulfil their roles, and the coordination of directors' contributions (e.g. Dalton and Dalton, 2005; Finkelstein and Mooney, 2003; Forbes and Milliken, 1999; Pettigrew, 1992; Pye and Pettigrew, 2005; Zona and Zattoni, 2007). The emerging view in governance studies underlines that to create well-functioning boards it is not sufficient to add more independent directors, as the codes of good governance recommend (e.g. Huse, 2005; Shen, 2005). On the contrary, boards wanting to improve their task performance must establish governance practices, such as the introduction of training activities for non-executives or peer-evaluation of board practices, that encourage active and open behaviour by directors and dramatically increase the board's contribution to firm performance (Huse, 2005; McNulty and Pettigrew, 1999; Stiles and Taylor, 2001).

An appropriate board composition and structure is still considered important, because it creates the condition for board effectiveness and increases investor confidence in corporate governance (Carter and Lorsch, 2004; Roberts et al., 2005). But an effective board is created through both appropriate board composition and structure, and board processes encouraging a culture of openness and constructive dialogue between executives and non-executives (Carter and Lorsch, 2004; Roberts et al., 2005; Shen, 2005). Board processes should encourage directors to devote time and effort to obtain relevant information, to apply their knowledge

and skills in board decision-making, and to frankly manifest their opinion even when is in contrast with the CEO's or top managers' view (Finkelstein and Mooney, 2003; Forbes and Milliken, 1999; Pye and Pettigrew, 2005). The key to the working of the board lies in the development of trust relationships within the board, aimed at encouraging board members' creativity and participation to board decision-making (Stiles and Taylor, 2001). In sum, board composition, structure and processes should be designed to motivate non-executive directors both to support executives in strategic decision making, and to monitor their conduct (Roberts et al., 2005).

#### *Limitations of the study*

We acknowledge that our study has some limitations. First, we focused on non-executive directors, while it is clear that a number of governance mechanisms contribute to create proper checks and balances inside a firm (Aguilera and Jackson, 2003). The existence and use by firms of alternative mechanisms of accountability imply that these mechanisms are substitutable, or that the relatively less frequent use of one mechanism need not adversely affect corporate governance (Agarwal and Knoeber, 1996). Furthermore, there is growing evidence that issues of performance, board independence, ownership structure, and top management characteristics and compensation are strictly interrelated (Agarwal and Knoeber, 1996; Loderer and Martin, 1997). In other words, only in abstract terms it is possible to analyze one governance mechanism without considering the others.

Second, we focused on good governance codes and not on legal regulation or corporate practices around the world. This decision is based on the following considerations. The regulation of matters pertaining to boards of directors is usually left to codes of good governance, whereas company law is silent on the types and roles of directors, the mix or balance between different types of directors or the qualifications directors must possess

(Goulding, Miles and Schall, 2005). Furthermore, codes of good governance exert (at least formally) a large influence on the corporate governance of listed companies. Even if compliance with code recommendations is voluntary and based on the “comply or explain” principle, empirical evidence shows that publicly traded companies tend to respond to the main code recommendations (e.g. Conyon and Mallin, 1997; Gregory and Simmelkjaer, 2002). In sum, our study focuses on code recommendations, whereas the analysis of actual board practices or of the interplay between legal rules and codes of good governance is beyond the scope of this article.

## **Conclusion**

Our review of literature and codes of good governance investigated non-executive directors’ independence, competencies, and incentives across countries. Our results show that literature and codes give more emphasis to non-executive directors’ formal independence than to their competencies and incentives. Our study indicates that this view may have some limitations. First, a definition of “independent” directors based on quasi-legal independence is easily administrable, but does not distinguish between formal and actual independence. Second, competencies and incentives may also contribute to explain the effectiveness of non-executive directors in fulfilling their governance role. Third, beyond board composition and structure, board processes may also have an impact on the effectiveness and the accountability of non-executive directors. Future studies investigating non-executive directors’ role in corporate governance should appropriately acknowledge these issues.

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Table 1. Subjects and relationships used by codes to define directors' independence

<i>Subjects</i>	<i>Relationships to avoid</i>	<i>Specifications</i>
Shareholders	Representatives	Major shareholder or block-holder.
	Family relationship	Close family ties.
	Employment relationship	Actual, and sometimes past, employees.
	Business relationship	Actual, and sometimes past, contractual relationship.
	Additional compensation	For services offered to shareholders.
Directors	General relationships	Any other relationship that may undermine an independent judgment.
	Family relationship	Close family ties.
	Additional compensation	For services offered to directors.
Managers	Cross relationship	Cross directorships or significant link.
	General relationships	Any other relationship that may undermine an independent judgment.
	Family relationship	Close family ties.
	Employment relationship	Actual, and sometimes past, employees.
	Business relationship	Actual, or sometimes past, contractual relationship.
Company	Additional compensation	For services offered to managers.
	Cross relationship	Cross directorships or significant link.
	General relationships	Any other relationship that may undermine an independent judgment.
	Shareholder	Major shareholder or block-holder.
	Employment relationship	Actual, and sometimes past, employees.
	Executive officer	Actual, and usually past, executive officer.
	Board member	Service for a long period.
Subsidiaries and other group companies	Business relationship	Actual, or sometimes past, contractual relationship.
	Additional compensation	For services offered to the company.
	Performance compensation.	For share-option or performance-related pay schemes.
	General relationship	Any other relationship that may undermine an independent judgment.
	Shareholder	Major shareholder or block-holder.
	Partner	Partner of the company.
	Employment relationship	Actual, and sometimes past, employees.
Audit and consultant firms	Board member	Director of the company.
	Executive officer	Actual, and also past, executive officer.
	Family relationship	Close family ties.
	Business relationship	Actual, or sometimes past, contractual relationship.
	Additional compensation	For services offered to the company.
	General relationship	Any other relationship that may undermine an independent judgment.
	Shareholder	Major shareholder or block-holder.
Other related companies	Partner	Partner of the company.
	Employment relationship	Actual, and sometimes past, employees.
	Director	Director of the company.
	Executive officer	Actual, and also past, executive officer.
	Family relationship	Close family ties.
	Interlocking relationship	Cross directorships or significant link.
	General relationship	Any other relationship that may undermine an independent judgment.

*Table 2. Criteria used by codes of good governance to define directors' competencies and incentives*

<i>Subjects</i>	<i>Characteristics</i>	<i>Criteria</i>
Non-executive directors	Competencies	Requirement of certain abilities, knowledge, skills, personal qualification, experiences, professional prestige, capacities.
Nomination and remuneration committee	Competencies	Requirement of certain capabilities, professional skills, qualifications, experiences.
Audit committee	Basic competencies	Majority or all members should be financially or accounting literate.
	Advanced competencies	At least one member with accounting or related financial management expertise.
Non-executive directors	Share-based compensation	Granting shares is allowed.
	Option-based compensation	Granting share options is allowed.

Table 3. T-tests for difference-of-means on non-executive directors' independence

	Common law countries	Civil law countries	EU countries	Non-EU countries	One-tier countries	Two-tier countries
Number of relationships to avoid to be independent from:						
- shareholders	1.00 (.24)	1.10 (.20)	1.22 (.26)	.91 (.16)	1.21 (.18)	.63 (.24)
- directors	.73* (.28)	.21 (.09)	.32 (.15)	.45 (.18)	.45 (.15)	.18 (.12)
- managers	1.40* (.21)	.86 (.12)	1.00 (.17)	1.09 (.14)	1.09 (.13)	.91 (.21)
- company	2.47 (.50)	2.69 (.40)	2.77 (.47)	2.45 (.42)	2.87 (.35)	1.82 (.60)
- subsidiaries and other group companies	1.20 (.35)	1.55 (.40)	1.45 (.44)	1.41 (.38)	1.57 (.32)	1.00 (.62)
- audit and consultant firms	.67 (.33)	1.07 (.29)	.95 (.32)	.91 (.31)	1.00 (.26)	.73 (.41)
- other related companies	1.33 (.48)	1.31 (.34)	1.45 (.40)	1.18 (.37)	1.51 (.32)	.73 (.51)
General requirement	.80*** (.11)	.17 (.07)	.32 (.10)	.45 (.11)	.48** (.09)	.09 (.09)
Number of observations	15	29	22	22	33	11

†  $p < .10$ ; \*  $p < .05$ ; \*\*  $p < .01$ ; \*\*\*  $p < .001$ . Standard error in parentheses.

Table 4. T-tests for difference-of-means on non-executive directors' competencies and incentives

	Common law countries	Civil law countries	EU countries	Non-EU countries	One-tier countries	Two-tier countries
Competencies of non-executive directors	.26 <sup>†</sup> (.12)	.59 (.09)	.54 (.11)	.41 (.11)	.36** (.08)	.82 (.12)
Competencies of non-executive members of the nomination and compensation committees	.00 (.00)	.14 (.06)	.18* (.08)	.00 (.00)	.03 (.03)	.27 (.14)
Basic competencies of non-executive members of the audit committee	.40 (.13)	.38 (.09)	.41 (.11)	.36 (.10)	.39 (.08)	.36 (.15)
Advanced competencies of non-executive members of the audit committee	.67** (.12)	.24 (.08)	.27 (.10)	.50 (.11)	.45 <sup>†</sup> (.09)	.18 (.12)
Possibility to offer shares to non-executive directors	1.00 <sup>†</sup> (.00)	.83 (.07)	.77* (.09)	1.00 (.00)	.96 <sup>†</sup> (.03)	.63 (.15)
Possibility to offer share-options to non-executive directors	.73 (.12)	.69 (.09)	.50** (.11)	.91 (.06)	.75 (.07)	.54 (.16)
Number of observations	15	29	22	22	33	11

<sup>†</sup>  $p < .10$ ; \*  $p < .05$ ; \*\*  $p < .01$ ; \*\*\*  $p < .001$ . Standard error in parentheses.

Figure 1. The independence definition: subjects and relationships to avoid (percentage on the 38 codes with independent definition)

