

# Codes of Good Governance

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## ABSTRACT

**Manuscript Type:** Review

**Research Question/Issue:** We review the recent developments in the area of codes of good governance, a set of best practice recommendations regarding the behavior and structure of the board of directors.

**Research Findings/Results:** Our review of the literature on codes of good governance highlights their rapid spread around the world and how academic research has lagged behind in analyzing this topic. Despite the criticism that the codes' voluntary nature limits their ability to improve governance practices, codes of good governance appear to have generally improved the governance of countries that have adopted them, although there is need for additional reforms.

**Theoretical Implications:** Unfortunately, research on codes of good governance has developed in isolation with little cross-fertilization across the different disciplines. We propose a multi-level framework to discuss three main topics that have emerged within the codes literature: the motivations behind the diffusion of codes across countries and its implications for convergence of corporate governance practices; the content of the codes and their "comply or explain" dimension; and the relationship between code compliance and firm performance. We conclude by proposing four areas of future research.

**Practical Implications:** Code development, adoption, and compliance are directly related to issues surrounding the governance of the firm, and in particular to all the interactions that a director has inside and outside the firm. Codes are regulations that emerge from policy-making negotiations between multiple stakeholders, such as the state (via the stock market regulators) and the investors.

**Keywords:** Corporate Governance, Codes of Good Governance

## INTRODUCTION

We review the state of information on the topic of codes of good governance, a set of best practice recommendations regarding the behavior and structure of the board of directors. An important debate in the international corporate governance world is whether countries should develop hard laws, such as the United States with the Sarbanes-Oxley Act 2002, or whether soft regulation, such as codes of good governance, are sufficiently effective to improve existing corporate governance practices across countries, as well as to address the pressing issues of corporate accountability and disclosure.

Although the first country to issue a code of good governance was the United States in 1978 and the second country was Hong Kong in 1989, the pace of issuance has gathered speed ever since, particularly after 1992 when the United

Kingdom's Cadbury Report was issued (Cuervo-Cazurra and Aguilera, 2004). By mid 2008, 64 countries had issued 196 distinct codes of good governance. Additionally, there is a large variety of issuers of codes, which include not only stock markets or its regulators, but also investor associations, employer associations, professional associations, and even governments.

The explosion in the issuance of codes of good governance has been accompanied by an increase in the number of articles in academic publications. For example, since 1997, *Corporate Governance: An International Review* has published 14 papers that explicitly discuss the nature of codes in a given country and 59 papers that have the phrase "governance code" in their abstract. Obviously, this shows that the topic of codes of good governance is central to the field and that there is plenty to take stock from.

However, there is little systematic analysis of how codes of good governance have affected how corporations are structured or how managers behave across different corporate governance systems. For instance, a recent review of the literature on corporate governance published in the *Handbook of the Economics of Finance* (Becht, Bolton and Roell, 2003)

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briefly discusses codes of good governance and highlights how the existence of a "striking schism between firmly held beliefs of business people and academic research calls for an explanation" (p. 49).

Despite the importance and increasing interest in codes of good governance, there are no reviews of what we know and do not know about this topic, which is central to international corporate governance. In fact, the existing literature seems to have moved in two directions. One tends to focus on the influence that a particular code has on firms in a given country and the other tends to describe the existence and content of codes in multiple countries. However, the current state of knowledge appears to be at an impasse as there is some conflicting evidence on the effectiveness of codes of good governance, and there are few analytical, rather than descriptive, studies of codes across countries. All this is resulting in an apparent divergence in development between the real world, where codes continue to be developed and revised, and the academic world, where there is limited theoretical advancement on the topic.

Therefore, this paper takes stock of where we stand regarding codes of good governance, identifying what we currently know about the topic, the theoretical and empirical debates that are raging, but have not been settled, and the areas of research that have not been explored yet. Such a review will help researchers better understand the current state of knowledge and direct attention and effort to those areas of research that are more promising in terms of impact.

To do this, we first empirically describe the worldwide diffusion of codes up to the middle of 2008. We then systematically review the existing research on how effective codes have been in different countries and how the variance is explained. We conclude with a critical analysis of what needs to be done next in this area of research.

## CODES OF GOOD GOVERNANCE WORLDWIDE

Codes of good governance have risen to prominence in the last decade as they have spread around the world. In the 30 years since the first code was issued in the US and the middle of 2008, codes of good governance have been created in 64 developed, transition, and developing countries. Although it was not until 1989 that a second country issued a code of good governance, in the 1990s codes were quickly developed in many countries, partly inspired by the Cadbury Code that had been created in the United Kingdom in 1992. The spread of codes of good governance around the world was aided by the push from international entities, such as the World Bank and the Organization for Economic Cooperation and Development (OECD), which started highlighting the need to improve institutions in general and corporate governance in particular to help countries grow and develop.

Codes of good governance have some key universal principles for effective corporate governance that are common to most countries. O'Shea (2005) shows that most codes have some recommendations on the following six

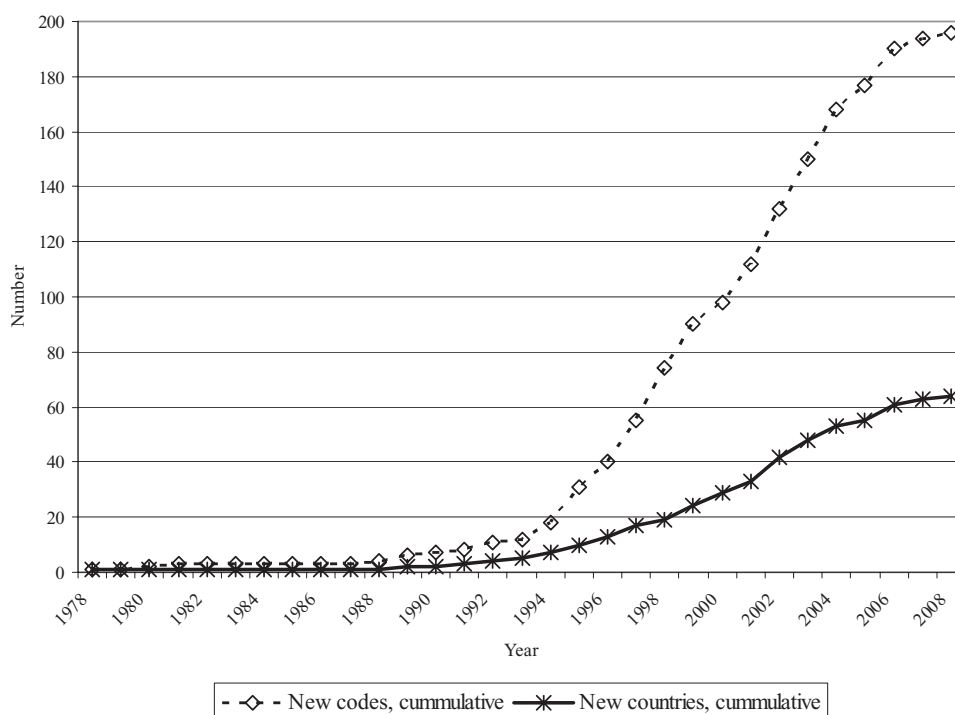
governance practices, explicitly or implicitly: (1) a balance of executive and non-executive directors, such as independent non-executive directors; (2) a clear division of responsibilities between the chairman and the chief executive officer; (3) the need for timely and quality information provided to the board; (4) formal and transparent procedures for the appointment of new directors; (5) balanced and understandable financial reporting; and (6) maintenance of a sound system of internal control. Furthermore, detailed descriptions, as well as systematic summaries, of the content of codes have appeared in Gregory (1998; 1999), who reviews the content of codes in developed and developing countries, and in Van den Berghe and de Ridder (1999). Later, Gregory and Simmelkjaer (2002) integrate these studies on the content of codes in a report on codes of good governance that served as the base for the European Union's recommendation on codes of good governance for its member states.

To better understand the importance and worldwide diffusion of codes of good governance, we compiled a database with all unique codes of good governance issued until the middle of 2008. We include in the database all unique documents that have been issued that propose a set of best practices for the behavior of the board of directors and the better functioning of corporate governance in firms.

We exclude three sets of corporate governance documents from this database. First, we exclude laws that have been issued by governments, because these are legal requirements to operate in the country rather than a set of voluntary best practices like codes; all countries except those that follow a communist economic system (e.g., North Korea) have laws that define private firms and the corporate governance mechanisms that these firms have to implement. However, we do include codes issued by governments when the codes are voluntary in nature and do not have the force of law; in this case, the issuer is not only the government, but also tends to include the stock exchange, employer association, and director association as part of a national commission to improve corporate governance. Second, we exclude codes of good governance developed by a firm that only apply to the firm in question, because they are not best practices for firms in the country, but only address the needs of one firm. Third, we include only one version of each code in the count, excluding initial drafts and updates of codes to avoid double-counting codes that provide in essence the same set of recommendations. Many codes of good governance are first circulated in draft form to receive comments and are later issued in a final version. When this is the case, we only include the final version in the count of codes. Additionally, some codes have been issued multiple times to update certain recommendations. When this is the case, we only include the initial version in the count of codes.<sup>1</sup>

We identified the codes using the database of codes of good governance that was analyzed in Aguilera and Cuervo-Cazurra (2004) and Cuervo-Cazurra and Aguilera (2004), and updated it with information from the European Corporate Governance Institute (ECGI, 2008), as well as did searches of the academic literature and financial press using Lexis/Nexis, Econlit, and BusinessSourcePremier.

**FIGURE 1**  
Worldwide Creation of Codes of Good Governance by Countries, 1978–Middle of 2008



### Worldwide Diffusion of Codes of Good Governance

The first code of good governance was issued in 1978 in the United States, but it was not until 1989 that a second country code of good governance appeared in another country, Hong Kong. Ireland was the third country to issue a code, in 1991, and the United Kingdom was the fourth, in 1992, with the influential Cadbury Report. This report sparked a debate on good governance that resulted in the rapid introduction of codes in other countries. Additionally, the spread of codes around the world was encouraged by transnational institutions, such as the World Bank and the OECD. In the mid-1990s, these transnational institutions started to look at good governance as a condition necessary for the development of countries and suggested to their member countries to adopt best governance practices; these included not only good governance at the country level, in the form of control of corruption and efficient state bureaucracies (e.g., Cuervo-Cazurra, 2008), but also good governance at the firm level in the form of best practices for publicly traded firms. As a result, by the middle of 2008, 64 countries have issued at least one code of good governance.

Figure 1 illustrates the number of codes and countries that have issued codes. Some countries have had more than one code of good governance created since the first one, most notable are the United Kingdom and the United States with 25 codes each, while in others only one code has been issued, like in Argentina or Austria. The figure highlights the importance of the phenomenon, and how the creation of codes took some time to gain momentum. After the creation of the

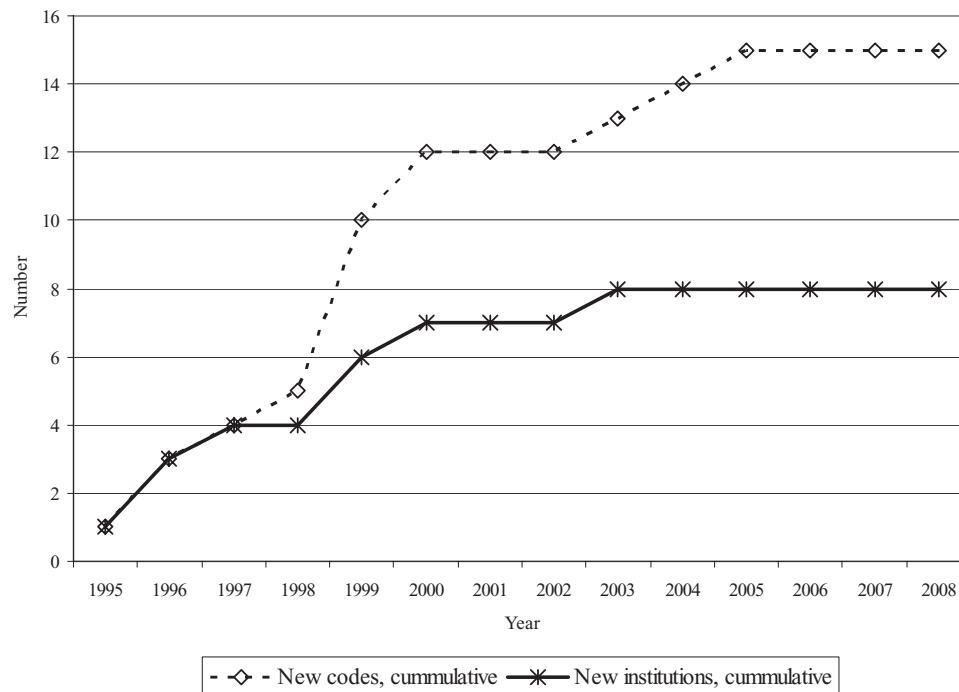
first code, very few new codes were created and very few new countries issued codes. However, the Cadbury Report of 1992 accelerated the worldwide diffusion of codes, with a rapid number of new codes and new countries issuing codes after the mid-1990s and continuing into the 2000s.

Codes have also been created by transnational institutions to address the need for better corporate governance of multiple countries, not just the needs of a country in particular, as is generally the case with national codes of good governance. These codes of good governance issued by transnational institutions are important for two reasons. First, they signal the importance of corporate governance and help establish sets of best practices that address common corporate governance problems of firms around the world. Second, they serve, in some cases, as the basis for the creation of codes of good governance in individual countries. Figure 2 illustrates the development of such codes over time. They started in 1996 and were rapidly developed in the late 1990s, but slowed in the 2000s with no new codes being issued after 2005.

### Creation of Codes by Country

The worldwide diffusion of codes is impressive, but a more detailed explanation of the creation of codes in each country shows the wide differences across countries. Table 1 summarizes the number of codes created by country; there are two differences worth noting. First, as we mentioned before, countries vary in the year in which the first code was created. The United States was the country with the first code, fol-

**FIGURE 2**  
Worldwide Creation of Codes of Good Governance by Transnational Institutions, 1995–Middle of 2008



lowed by Hong Kong, Ireland, the United Kingdom, and Canada. All these countries share in common a common-law, or English-based, legal system. This legal system, in contrast to the civil-law system, has a more flexible legislation, with common practices and previous judicial interpretations of laws and regulations having applicability in disputes. In the civil-law system, of which there are three types (French, Scandinavian, and Germanic), laws are issued by the national parliaments and assemblies and applied by judges, with limited enforceability of accepted practices. It was not until 1994 that a country with a civil-law legal system, Sweden, created a code of good governance. This same year, the first developing country, South Africa, created a code of good governance. However, it was not until 1997 that other developing countries (e.g., Brazil, Thailand) and transition countries (e.g., Kyrgyz Republic) created codes.

Second, countries vary significantly in the number of codes that have been created. At one extreme are the United States and United Kingdom, where 25 distinct codes have been issued. After these two, the countries with the highest number of codes are Hong Kong with nine; Belgium and France with eight each; Canada with seven; Australia, Spain, and Sweden with six each; and Denmark, Germany, Italy, Netherlands, and Portugal with five each. The rest of the countries have four or fewer codes. There appears to be a connection between the development of capital markets and the number of codes issued. Countries with not only larger, but also deeper, capital markets have more codes of good governance; the need for good governance increases as the number of public firms grows because agency problems between disperse owners and managers, or between majority and minority shareholders emerge.

### Creation of Codes by Transnational Institutions

Codes of good governance by transnational entities also vary. Table 2 summarizes the codes created by transnational institutions. These codes are designed to improve corporate governance of multiple countries and as such are more general than the codes developed in each country, which focus only on issues that need to be addressed there. Transnational institutions started issuing codes of good governance in 1996. Among them, the International Corporate Governance Network has become a repository of the texts of codes of good governance worldwide. Its website (<http://www.icgn.org>) contains a list of recent codes of good governance. The OECD, on its part, issued its highly influential Principles of Corporate Governance in 1999, which has become the basis not only for the evaluation of corporate governance practices in developing countries by the World Bank, but also for the development of codes of good governance by countries.

In addition to these transnational institutions the World Bank has taken an active role in promoting good corporate governance around the world, helping developing and transition countries evaluate their current corporate governance practices and upgrade them to international levels. In collaboration with the International Monetary Fund on some occasions, the World Bank has issued a Corporate Governance Country Assessment or a Report on the Observance of Standards and Codes (ROSC) for 44 countries.<sup>2</sup> These reports evaluate the corporate governance practices prevailing in the country against the benchmark of the OECD Principles for Corporate Governance. However, the reports are not codes of good governance per se.

**TABLE 1**  
**Creation of Codes of Good Governance by Countries**

| Country         | Year of first code | Number of unique codes until the middle of 2008 | Country             | Year of first code | Number of unique codes until the middle of 2008 |
|-----------------|--------------------|---|---------------------|--------------------|---|
| Argentina       | 2004               | 1   | Luxembourg          | 2006               | 1   |
| Australia       | 1995               | 6   | Macedonia           | 2003               | 1   |
| Austria         | 2002               | 1   | Malaysia            | 2000               | 1   |
| Bangladesh      | 2004               | 1   | Malta               | 2001               | 1   |
| Belgium         | 1995               | 8   | Mexico              | 1999               | 2   |
| Brazil          | 1997               | 2   | Morocco             | 2008               | 1   |
| Bulgaria        | 2007               | 1   | Netherlands         | 1996               | 5   |
| Canada          | 1993               | 7   | New Zealand         | 2003               | 2   |
| China           | 2001               | 2   | Nigeria             | 2006               | 1   |
| Cyprus          | 2002               | 1   | Norway              | 2004               | 1   |
| Czech Republic  | 2001               | 2   | Pakistan            | 2002               | 1   |
| Denmark         | 2000               | 5   | Peru                | 2001               | 2   |
| Estonia         | 2006               | 1   | Philippines         | 2000               | 1   |
| Finland         | 2003               | 2   | Poland              | 2002               | 2   |
| France          | 1995               | 8   | Portugal            | 1999               | 5   |
| Germany         | 1996               | 5   | Romania             | 2000               | 1   |
| Greece          | 1999               | 2   | Russia              | 2002               | 1   |
| Hong Kong       | 1989               | 9   | Singapore           | 1998               | 3   |
| Hungary         | 2002               | 1   | Slovakia            | 2002               | 1   |
| Iceland         | 2004               | 1   | Slovenia            | 2004               | 1   |
| India           | 1998               | 2   | South Africa        | 1994               | 1   |
| Indonesia       | 2000               | 1   | Spain               | 1996               | 6   |
| Ireland         | 1991               | 3   | Sri Lanka           | 2006               | 1   |
| Italy           | 1999               | 5   | Sweden              | 1994               | 6   |
| Jamaica         | 2005               | 1   | Switzerland         | 2002               | 2   |
| Japan           | 1997               | 4   | Taiwan              | 2002               | 1   |
| Kenya           | 2002               | 1   | Thailand            | 1997               | 4   |
| Korea           | 1999               | 1   | Trinidad and Tobago | 2006               | 1   |
| Kyrgyz Republic | 1997               | 1   | Turkey              | 2003               | 1   |
| Latvia          | 2005               | 1   | UK                  | 1992               | 25  |
| Lebanon         | 2006               | 1   | Ukraine             | 2003               | 1   |
| Lithuania       | 2003               | 1   | USA                 | 1978               | 25  |

### EXISTING LITERATURE ON CODES OF GOOD GOVERNANCE<sup>3</sup>

The literature on codes of good governance has expanded a great deal since the issuance of the UK Cadbury Report in 1992, and particularly since the early 2000s. Codes have also become more relevant and have moved to the center stage of policy and business strategy. Companies, as well as countries, seek to make their corporate governance practices more effective, in part as a consequence of corporate governance scandals, but also to attract investors. Even though codes of good governance refer to the behavior and structure of the board of directors, the area of study is broader, because directors are at the core of the firm and inevitably interact with other actors inside and outside the firm. Hence, codes of good governance include not only recommenda-

tions on the structure of the board, but also on the relationship of the board with executives in the firm and directors from other firms.

In this section, we review and discuss three main topics that have emerged within the codes literature: the motivations behind the diffusion of codes across countries and its implications for convergence of corporate governance practices; the content of the codes and their "comply or explain" dimension; and the relationship between code compliance and firm performance.

#### Cross-Country Level: Diffusion of Codes and Governance Convergence

The emergence of codes of good governance around the world and by transnational organizations is noticeable, as



**TABLE 2**  
**Creation of Codes of Good Governance by**  
**Transnational Institutions**

| Transnational issuer   | Year of first code | Number of unique codes until the middle of 2008 |
|--|--------------------|---|
| Commonwealth Association for Corporate Governance            | 1999               | 1   |
| European Association of Securities Dealers (now APCIMS-EADS) | 1996               | 2   |
| European Bank for Reconstruction and Development (EBRD)      | 1997               | 1   |
| European Shareholders Group (Euroshareholders)               | 2000               | 1   |
| ICGN   | 1996               | 3   |
| OECD   | 1999               | 2   |
| The Latin American Corporate Governance Roundtable           | 2003               | 1   |

Note: This list does not include the Corporate Governance Country Assessment or the Report on the Observance of Standards and Codes (ROSC) that the World Bank and International Monetary Fund have created for 44 countries because these are evaluations of corporate governance in the country against the OECD Principles of Corporate Governance rather than distinct codes.

we have seen in the above section. In addition to when codes emerge, it is also important to study the patterns of diffusion across countries and the reasons for such patterns. Aguilera and Cuervo-Cazurra (2004) was probably the first empirical study to examine the determinants of the diffusion of codes of good governance across countries. They argue that a combination of efficiency and legitimacy reasons trigger countries to issue codes of good governance. Their analysis of the adoption of codes of good governance in 49 countries reveals that codes are more likely to emerge in countries with a common-law legal system, a lack of strong shareholders' protection rights, high government liberalization, and a strong presence of foreign institutional investors. Cuervo-Cazurra and Aguilera (2004) also explored the speed of adoption of the codes, finding that codes are more likely to develop faster in countries with greater foreign investment exposure. Zattoni and Cuomo (2008) in a follow-up article examine the main drivers, such as efficiency and legitimacy, behind code adoption in different countries' legal systems. Using a sample of 60 countries, they conduct a comparative analysis of scope, coverage, and strictness of recommendations of codes in civil- and common-law systems. Their findings show that, for the most part, civil-law countries (such as France) issue codes of good governance later than common-law countries (such as the UK or the US), issue fewer codes, and state more lenient and ambiguous recommendations. Finally, Enrione, Mazza and Zerboni (2006) have looked at

the stages of diffusion in the context of the institutionalization process. They study 150 codes in 78 countries from 1978 to 2004 and relate the rate of code adoption to firm organizational structure. They discuss and empirically show the institutional life-cycle of codes from adoption to fully institutionalized (i.e., taken for granted) practices. For example, they indicate that the initial codes emerged as a reaction to the 1980s organizational shift from conglomerate strategies to core strategies in firms.

A critical debate in the varieties of capitalism literature, as well as more generally in comparative political economy, is to what degree corporate governance systems and business systems in general are converging toward the Anglo-Saxon model of corporate governance, or the so called shareholder-value model (Hall and Soskice, 2001; Aguilera and Jackson, 2003; Morgan, Whitley and Moen, 2005; Yoshikawa, Tsui-Auch and McGuire, 2007). This question arises also in the context of codes, because, despite a high level of difference in the adoption of corporate governance codes across countries, both Cuervo (2002) and Reid (2003) note that increasing external forces, such as globalization, market liberalization, emergence of powerful foreign investors, and recommendations on global best practices by transnational institutions such as the World Bank, appear to facilitate increasing confluence.

The second question in the convergence debate is to what degree codes of good governance are enabling mechanisms to facilitate further governance convergence across countries, or whether, on the contrary, codes are mechanisms to highlight and reinforce the unique national governance characteristics. Collier and Zaman's (2005) study of codes of good governance in 20 European countries address this question as to whether codes push convergence towards the Anglo-Saxon model in corporate governance systems. This convergence in governance practices is particularly salient, they find, in areas such as the audit committee, which is a strategic governance practice in the Anglo-Saxon corporate governance systems, but was rather uncommon within Continental Europe before the early 1990s (Birkett, 1986; Collier, 1996).

Convergence of governance practices is certainly encouraged by transnational institutions that seek to regulate markets and protect investors. Two illustrative examples are the European Commission (EC) and the OECD. The European unification has been an important trigger for governance convergence (Reid, 2003; Hermes, Postma and Zivkov, 2007), particularly through their Communication 284 (COM-284) report of 2003. This is an EC report that discusses how to enhance corporate governance in the European Union and provides specific governance recommendations, such as reinforcement of shareholder's rights, greater disclosure and accountability, and modernization of the board of directors. There is some research evidence to suggest that the European-level governance guidelines are highly aligned with country codes (Cromme, 2005). Part of the explanation is that, in general, issues such as stakeholder rights and responsibilities are taken more seriously across Continental Europe, as their former weak capital markets are strengthened and institutional investors become more assertive in promoting more effective governance measures, such as higher accountability and better disclosure.

There have also been significant efforts by transnational institutions, such as the World Bank or the OECD, to encourage the adoption of global standards of governance practices, which are generally drafted more in line with the Anglo-Saxon model (Roberts, 2004). In particular, the attempts have been prominent in developing countries, as their firms are being privatized and seek to attract and retain foreign capital investments. To help developing economies to create and adopt codes of good governance, the OECD developed in 1999 the "OECD Principles of Corporate Governance," which has been serving as a guiding rule for much of the corporate governance reforms (Coombes and Watson, 2001; Krambia-Kapardis and Psaros, 2006). For example, the new Russian code of good governance issued in 2002 is seen as an attempt to impose an Anglo-Saxon model of governance on Russian domestic businesses by emphasizing the principle of shareholder protection (Roberts, 2004). Likewise, Krambia-Kapardis and Psaros (2006) argue that the code of good corporate governance in Cyprus, a developing country, largely draws on Anglo-Saxon principles of corporate governance. But even, Germany, a well-established country within the stakeholder model of corporate governance, has also included some governance practices in its codes that are more typical of the Anglo-Saxon corporate governance system, such as disclosure of individual executive compensation which was controversial given the two-tier system board system and co-determination legislation (Cromme, 2005; Chizema, 2008).

There is another side to this debate that argues that country characteristics are the main drivers of code adoption, as well as code content. For example, using the contents of codes in seven Eastern European countries, Hermes *et al.* (2007) assess whether external forces are the main drivers of the content of codes in these countries relative to the recommendations of the EC principles. Their findings show that Eastern European codes of good governance cover only about half of the recommendations of the EC principles. Hungary and Poland especially have greatly deviated from the EC recommendations. Hermes *et al.* (2007) study shows the influence of domestic forces in shaping the contents of codes of good governance. In fact, there are strong views among corporate governance scholars that "the one rule fits all" is flawed and that consequently a wide diversity of approaches to corporate governance should be expected due to the very different national contexts where firms are embedded (Sargent, 1997; Cuervo, 2002; Reid 2003; Okike, 2007; Reaz and Hossain, 2007; Balgobin, 2008). From this perspective, Reaz and Hossain (2007) argue that more careful attention should be paid to the developing and transition economies, as they are less advanced in areas of corporate governance, Western models are difficult to implement by the latter, and instead some translation into a hybrid model is necessary. In sum, this perspective claims that for a code of good governance to be effective it must capture the socio-political and economic environment in which firms operate (Cuervo, 2002; Roberts, 2004; Okike, 2007; Reaz and Hossain, 2007).

In sum, the dramatic diffusion of codes of good governance has generated a heated debate on its effects on the convergence of corporate governance systems, mostly towards the shareholder-oriented model. Examining the

existing literature, we think that the outcomes are not as straightforward as one might think and hence it is important to move the debate beyond the convergence/divergence dichotomy and pay more attention to the dynamics of how firms apply certain aspects of the codes and not others, or how issuers follow the transnational code for one dimension of the specific practice, but not fully adopt the entire recommendation. For example, Yoshikawa *et al.* (2007) conduct a study using a sample of Japanese firms and discover intriguing results of the diffusion of governance innovation. According to their findings, Japan's corporate governance system neither fully converges to, nor completely diverges from the Anglo-Saxon model. Instead they argue that pressure from foreign capital and product markets may not always lead to convergence to international standards. It seems that when innovating governance practices, Japanese companies decoupled from the original context and customized their governance practices to their particular circumstances. Thus, well-governed firms exposed to foreign product and capital markets, such as Toyota, Honda, and Canon, rejected the straight forward adoption of the Anglo-Saxon model, and eventually the government was forced to revise the Commercial code to adjust to the Japanese reality and local demands. In this instance, the firm-level interaction with the code issuers and enforcers is a dimension that should not be overlooked. According to Yoshikawa *et al.* (2007), firm financial performance, positioning in the business community and organizational culture play important roles in shaping corporate governance reforms. In sum, as codes diffuse around the world it is important to understand why and how they fit in the overall corporate governance system, as well as in the institutional environment.

### Country-Level: Implementation of Codes of Good Governance

We now turn to the question that has been asked in the literature of how codes get implemented once they are developed and adopted as a guiding governance principle. There are two mechanisms for code implementation – mandatory or voluntary regulation. The classic examples of the two alternative approaches to implement codes are legislation (e.g., the US Sarbanes-Oxley Act of 2002) and a "comply or explain" approach (e.g., the UK Combined Code of 2003) as suggested by Balgobin (2008).

One mechanism to implement codes is through the development of stringent corporate legislation. However, such a compulsory approach is rarely found in codes of good governance and is more commonly associated with laws. The most well known example is the 2002 Sarbanes-Oxley Act (SOX). After several accounting scandals rocked financial markets in the US, the Accounting Industry Reform Act of 2002, known as the Sarbanes-Oxley Act was enacted to prevent further corporate failure (Maassen, van den Bosch and Volberda, 2004). The federal SOX in 2002 and new listing requirements have a form of mandatory rules, and companies have no other alternative than to comply with them (MacNeil and Li, 2006). Under the New York Stock Exchange (NYSE) rules, Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) are required to certify

quarterly and annual reports for their legal compliance (O'Shea, 2005; Balgobin, 2008). The underlying philosophy of SOX is that corporate governance practices need to be mandated, rather than be left to self-regulation of companies and markets, to prevent devastating corporate governance failures such as Enron (Taylor, 2003; MacNeil and Li, 2006).

Voluntary firm compliance is the other mechanism used to implement the codes, as it was originally done in the British Cadbury Report. It is based on the rule of "comply or explain," where it is not required for listed companies to comply with all code recommendations, but companies are required to state how they have applied the principles in the code and in the cases of non-compliance, they must explain the reasons. According to MacNeil and Li (2006), this approach has two underlying considerations—flexibility to adjust the characteristics of different firms and an assumption that the capital markets will monitor and assess value to compliance. Maassen *et al.* (2004) claim that the voluntary self-regulation principle has had a significant impact on the development of corporate governance codes around the globe. They note that codes have been favored by most international financial markets in adjusting to modern corporate governance standards.

There have however been some changes in the "comply or explain" principle over time. Although the "comply or explain" principle is based on self-regulation, O'Shea (2005) argues that as codes get revised, the requirements have become more prescriptive and stringent. Dewing and Russell (2004) show that code self-regulation had a characteristic of informal self-regulation during 1990s, but more recently the implementation of codes has progressed to formal and direct self-regulation in response to public concerns. For example, while the previous UK Cadbury report in 1992 recommends the separation of the role of Chairman and CEO, the revised Combined Code in 2003 requires that the CEO should not become Chairman of the same company.

Despite the greater specificity of the governance recommendations in the codes, the debate on the need for regulation of corporate governance is still very much alive. Dewing and Russell (2004), MacNeil and Li (2006), and Maassen *et al.* (2004) note that some scholars and organizations have expressed their concerns about weak monitoring and enforcement mechanisms of corporate governance codes. As a monitor for effective voluntary disclosure, MacNeil and Li (2006) argue that the market does not seem to play its role. Originally, the market is supposed to penalize unjustified non-compliance with a lower share price. However, as indicated by the MacNeil and Li (2006) study, financial performance appears to excuse non-compliance, casting a doubt that compliance does not necessarily lead to positive financial performance. As a contribution to this debate on formal versus informal self-regulation, Dewing and Russell (2004) suggest that an appropriate structure of regulations of corporate governance may be better based on regulation of financial services. In addition, Cuervo (2002) proposes that, for countries characterized by a large shareholder-oriented system, it is necessary to expand formal market control mechanisms to compensate for deficiencies in the legal system, rather than developing codes of good governance.

In sum, although most codes of good governance share similar issues, the specific content of the codes of good governance does vary significantly across countries, capturing the different needs across corporate governance systems. The implementation of the codes has increased over time, with country-level studies showing that firms tend to increasingly adopt a higher percentage of code recommendations despite their voluntary nature. This voluntary nature and the associated "comply or explain" principle has given rise to a heated debate as to whether codes are an effective governance tool, or whether more stringent governance rules with mandatory implementation are needed to increase compliance, especially in countries that have weak institutions and underdeveloped governance systems.

### Firm-Level: Compliance and Effectiveness

Although codes of good governance have been developed around the world for more than a decade, the degree to which firms adopt codes varies across countries, and the decision to adopt a given code does not automatically guarantee effective corporate governance. In this section, we discuss the literature on code compliance and then review the relationship with firm performance.

The level of compliance with codes has varied significantly across countries. For example, in the UK, Conyon and Mallin (1997) and Weir and Laing (2000) show that British firms listed in the London Stock Exchange (LSE) to a large extent complied with the Cadbury Report's recommendations. MacNeil and Li (2006) note that the scale of compliance with the UK Combined code has increased over time. Similarly, in terms of increasing compliance over time, O'Shea (2005) reports that only two-thirds of the top 100 UK listed companies had audit committees in 1992, prior to the Cadbury report, while by June 1995, every single FTSE 100 company (the 100 most capitalized firms in the LSE) had an audit committee and almost 98 per cent of mid 250 UK companies also be counted with them. However, there is also evidence in the codes research for the other side of the story. For example, MacNeil and Li (2006) find significant evidence of non-compliance. They show that compliance is not properly monitored and argue that investors' tolerance of non-compliance is related to a great degree to superior financial performance. Investors seem to rely on financial performance as a proxy for non-compliance rather than engaging in the tedious task of evaluating merits of corporate provisions. MacNeil and Li (2006)'s study clearly claims that financial performance has influence over excusing non-compliance in reverse.

There is also a fair amount of research around compliance surrounding the German code of good governance. This finds, for example, that company size is positively associated with a relatively higher level of compliance (Bebenroth, 2005; Werder, Talaulicar and Kolat, 2005), but assessments on the degree of compliance are mixed. On the one hand, Pellens, Hillebrandt and Ulmer (2001) survey companies in the DAX100 and find that 95.6 per cent of the firms comply with the provisions in the German code of good governance and 48.5 per cent have already fully implemented the German code as a company guideline. More recently, Werder *et al.* (2005) examined the overall acceptance of the



code recommendations, including critical recommendations that generated non-compliance. They nevertheless identify a high degree of acceptance of the code as well as willingness to comply in the future. On the other hand, the literature also reveals that the German code of good governance includes some controversial, and not so popular, recommendations that are not followed by the majority of companies, such as personal liability and compensation of the management and/or supervisory board (Bebenroth, 2005). It seems like German firms have not made up their minds yet on whether all code recommendations are helpful for firms.

The institutional environment and, in particular, the development of the stock market determines a great deal the degree of monitoring of code compliance, even if it is simply informal and for legitimization purposes. As it is to be expected, in developing countries, compliance with codes is scarce. For example, research on the Cyprus code of good governance by Krambia-Kapardis and Psaros (2006) finds a low level of compliance with all significant aspects of the code. This is in the context of Cyprus, which not only has weak capital markets and legal support, but also a low degree of free market controls, with highly concentrated ownership, and unreliable information flow. Their findings suggest that corporate governance codes in other developing economies might need to be strengthened by explicit institutional initiatives.

In sum, the "comply or explain" approach allows for the possibility of non-compliance, with examples of market tolerance on non-compliance and of institutional resistance. Regarding non-compliance, it seems critical as research moves forward to study the link between a firm's governance structures and firm performance, mostly because research shows that financial performance can justify non-compliance. In emerging economies, on the other hand, it appears to be important that complementary institutions are strengthened in order to increase the effectiveness of codes.

We now turn to discussing the literature examining the relationship between codes of good governance and firm performance. Since compliance with codes of good governance entails significant implementation costs (Aguilera, Filatotchev, Gospel and Jackson, 2008), it is reasonable for companies to expect benefits from compliance in the form of improved firm performance and eventually positive market reactions. Once again, the literature shows for the most part inconclusive results, suggesting the need for additional research. Thus a key puzzle that needs to be resolved in research on codes of good governance is whether they do have an impact on firm performance, or whether they merely serve to assuage investors' complaints.

The first step in reviewing the relationship between code compliance and firm performance is to differentiate how scholars conceptualize and measure performance. Below we describe the existing studies clustered by performance measures. The first group of studies reveals a positive relationship between code compliance and earnings management. For example, Benkel, Mather and Ramsay (2006) analyze whether independent directors on the board and audit committee are related to lower levels of earnings management. Using a sample of the top 300 Australian firms, they find that a higher proportion of independent directors on the board and in the audit committee is associated with reduced levels

of earnings management. Their finding is consistent with those of previous US and UK research that illustrate the critical monitoring role of independent directors in corporate governance practices (Weir and Laing, 2000). Finally, based on a variety of earnings quality characteristics of Mexican firms, such as income smoothing, timely loss recognition, and abnormal accruals, Machuga and Teitel (2007) show that the quality of earnings improve after implementation of the codes.

Other studies find positive associations between codes of good governance and more traditional measures of performance, such as returns and market value. For example, Fernández-Rodríguez, Gómez-Ansón and Cuervo-García (2004) find abnormal positive returns associated with Spanish firms' announcements of compliance with the Olivencia Code; Del Brio, Maia-Ramires and Perote (2006) indicate that the degree of compliance increases Spanish firms' value; and Alves and Mendes (2004) also uncover a positive relationship with equity returns among Portuguese firms. Moreover, codes of good governance also affect other performance variables more broadly defined. For example, Dahya, McConnell and Travlos (2002) illustrate that the adoption of the Cadbury report in 1992 increased CEO turnover in the UK, triggered by the need for the separation of Chairman and CEO positions. At the same time, this UK code recommendation also heightened the sensitivity of the CEO turnover to poor performance.

However, many other studies show either an inconsistent or negative relationship between code compliance and firm performance. For example, Park and Shin (2001) do not find that compliance with the Toronto Stock Exchange's Corporate Governance Guidelines is associated with reductions in accruals management, and Nowak, Rott and Mahr (2004) find no association with the impact on the German capital market performance. There are also other studies that show, at a more general level, that universal code recommendations, such as board independence, is not systematically linked to financial performance (Dalton, Daily, Ellstrand and Johnson, 1998; Bhagat and Black, 2002).

Several factors might account for the mixed and inconclusive findings. First, other factors related to governance and broader than governance may affect the relationship between code compliance and firm performance. In other words, as pointed out by Mura (2007), many studies fail to control for the endogeneity of the explanatory variables due to unobserved firm heterogeneity. It indicates that if the studies have not controlled for this condition, the results may generate biased and inconsistent estimates. Second, firm-specific characteristics are very likely to influence this relationship. For example, Fernández-Rodríguez *et al.* (2004) find that the wealth effects are greater for firms with lower leverage rates and where managers dominate the board. Along similar lines, Benkel *et al.* (2006) also show that reduced levels of earnings management through the monitoring role of independent directors are mostly associated with large firms, but rarely with small firms. They suggest that it may be the result from higher public scrutiny of large firms that provide independent directors with more incentives to better monitor and from more resources to recruit more experienced and knowledgeable directors. These results illustrate that relative benefits and costs of compli-

ance may rest on companies' pre-governance structures and firm-level characteristics. Third, an important issue is the concept of independent directors. Although most corporate governance codes underscore the independence of boards of directors, Maassen *et al.* (2004) question whether independent directors are truly independent enough to be effective monitors. This is particularly the case because the definition of director independence varies across countries and even firms. Moreover, depending on their expertise, experience, and given incentives, some boards may be more motivated to be more effective monitors. In sum, although investors value positively firm's compliance with recommendations on board structure, there has been mixed results of the codes' impact on firm performance. Other factors and firm characteristics seem to affect the relationship, requiring more careful analyses to distill the value of codes of good governance on firms.

### AREAS FOR FUTURE RESEARCH ON CODES OF GOOD GOVERNANCE

Our review of the worldwide diffusion of codes of good governance and of the literature on codes highlights the importance of and interest in this governance topic. Codes of good governance have become a central issue in policy and in academia. Rather than a fad that would disappear as new ideas come along, codes of good governance have increased in relevance and continue spreading throughout the world. This importance of the topic is highlighted in the growing academic literature, but there is still an apparent lag between advances in the creation of codes and the studies analyzing them. Much progress has been made on our understanding of the diffusion of codes around the world, on the adoption of codes by firms, and on the impact of the codes on performance. However, our review also reveals large lacunae in our understanding of the topic. Four areas are noticeable in terms of the lack of research being done – the systematic analysis of the content of codes of good governance and of the issuers of the codes, a better understanding of the consequences of codes issued by transnational institutions, and finally the evolution in the recommendations of codes.

First, many studies take the codes as a black box and focus on the diffusion of codes or the impact of codes on performance. These analyses assume that codes are equivalent across countries and therefore can be analyzed as one common dependent variable or as a comparable independent variable. Although most of the codes tend to agree in the mechanisms that support more effective governance, such as a board of directors with independent members or the creation of committees, there are significant cross-national differences. For example, codes vary significantly because they are developed to address corporate governance issues that are specific to a given country. Moreover, the divergence in what is classified as a code across different studies, with some studies proposing different numbers of countries and codes that have been created, points to the need for a more careful examination of what each code contains to ensure their comparability and the soundness of the conclusions derived. Since the codes issued in different countries do in fact have different recommendations, the

comparison of their adoption and effectiveness in improving corporate governance across countries faces serious limitations because the standards used differ.

Second, studies have identified that the nature of the issuer of the codes can differ significantly, with codes being issued by the country's stock exchange, director associations, employer associations, investors and investors associations, professional associations, or the government. However, the literature has not systematically studied how the nature of the issuer affects not only the code content, but also its enforceability. These different types of issuers have different objectives and as a result the codes they create will have distinct aims. Thus, recommendations on what are considered best practices regarding the behavior of the board of directors are highly contingent on the issuer. However, once again, existing research has treated all codes as having similar underlying objectives, which a rigorous analysis by issuer may reveal as being a wrong assumption to hold. Additionally, the enforceability of the codes of good governance varies dramatically across issuers, speaking directly to the debate between the effectiveness of soft regulation versus hard legislation. The government and stock exchanges have the power to impose practices and penalties for non-compliance on all firms in the case of the former and publicly traded firms in the case of the latter. In contrast, investors and investor association only have the power of impose practices through activism in shareholder meetings, while other issuers – director associations, professional associations, and employer associations – have a limited ability to persuade firms to follow the recommendations of the codes. Although some studies touch upon the nature of the issuers, they do not analyze differences in the codes each type of issuer creates.

Third, the importance of transnational institutions in the creation and diffusion of codes of good governance has not been analyzed properly. Transnational institutions like the World Bank and OECD have been actively promoting good governance, helping developing countries understand how to improve their corporate governance practices. However, studies on codes of good governance have focused on the codes issued in each country rather than on codes issued by transnational institutions that have a wider applicability and speak to the important debate of global governance. These transnational issuers, by promoting a common set of practices regardless of country characteristics, may indirectly be contributing to the convergence of codes across national governance practices. In other words, they are not moving corporate governance toward a particular model (e.g., Anglo-Saxon or Continental), but toward a more general global governance model. This is a topic that has been rarely addressed in the academic literature of codes of good governance, despite its importance for understanding the drivers of the diffusion process.

Fourth, the recommendations contained in codes of good governance have evolved over time as some corporate governance problems are solved and others emerge, but there is limited research analyzing how codes change over time. This evolution in the issues that codes tackle has been dealt with revisions of previous codes and with new codes that address new and different governance problems. Hence, there is need for a better understanding of how corporate gover-

nance problems co-evolve over time with best governance practices and how codes are developed to tackle these rapidly changing issues. This co-evolution in corporate governance issues and the content of codes highlights another source of differences across countries and the codes developed in each country. Countries with more sophisticated capital markets would require codes with more advanced recommendations, while countries with simpler capital markets are likely to require codes that tackle more basic issues. Hence, adopting the latest thinking in corporate governance in countries that have underdeveloped capital markets may not only not be adequate but also be counterproductive.

In conclusion, there has been much discussion and research in the area of codes of good governance, particularly in understanding their diffusion, adoption, and impact on performance. However, there is need for additional research that goes deeper into the evolving content of the codes and analyzes differences across issuers, including transnational ones, to better understand how codes can help corporate governance practices become more effective around the world. Although the academic literature had initially lagged behind advances in the real world, fortunately it has gained momentum and is approaching the point where it makes direct relevant recommendations for better governance using these soft mechanisms. We hope that a future review of the topic finds that the gaps identified in the article have been properly addressed.

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## NOTES

1. This procedure ensures that we only include 196 unique documents in the count of the codes of good governance. If we were to include drafts and revised documents we would have 285 documents in the count. However, this would give some countries a false image of being active issuers of codes of good governance, when they are merely reissuing versions of an existing code. This procedure explains differences in the number of codes that we study and the number of codes that other researchers have analyzed. They include multiple versions of the same document in their count.
2. The countries are: Armenia, Azerbaijan, Bhutan, Bosnia and Herzegovina, Brazil, Bulgaria, Chile, Colombia, Croatia, Czech Republic, Egypt, FYR of Macedonia, Georgia, Ghana, Hong Kong, Hungary, India, Indonesia, Jordan, Korea, Latvia, Lithuania, Malaysia, Mauritius, Mexico, Moldova, Morocco, Nepal, Pakistan, Philippines, Panama, Peru, Poland, Romania, Senegal,

Slovakia, Slovenia, South Africa, Thailand, Turkey, Ukraine, Uruguay, Vietnam, and Zimbabwe.

3. A more detailed assessment of the literature appears in Aguilera, Cuervo-Cazurra and Kim (2009).

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