Appraisal of Corporate Governance: Configurationally Approach

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Abstract: The assessment is one of the major challenges of corporate governance (CG) from its beginning and now measures it good corporate governance but how its mechanisms which leads to financial competence, social legality and or other motives which they want to attain. Recent investigations, analyses and criticize existing academic and commercial corporate governance indices. Most of these 'rating of ratings' papers conclude that surrounding composite measures of the corporate governance are unproductive and purpose therefore to return to simpler measures. This paper throws light on the 'configurationally approach' to CG and argue that, while the criticisms made by the 'rating of ratings' papers are acceptable, their recommendations are misguided. Based on four central insights derived from the 'configurationally approach' the paper shows that reverting to simpler measures of firm level CG practices is a step in the wrong direction, in that it eliminates information about interactions between different corporate governance mechanisms. This is particularly consequential for comparative CG research that aims to identify differences in country specific CG systems. Alternative solutions are developed to improve corporate governance measures, which take into account insights from the configurationally approach.

Key Words: Configurationally approach, Unproductive, Corporate governance

Introduction :

One of the major challenges of corporate governance (CG) research since its inception has been the definition of measures of 'good corporate governance ',i.e. of corporate governance mechanisms that lead to financial efficiency, social legitimacy or more generally goal attainment. In order to analyse the impact that CG has on different measures of corporate performance, academics and commercial providers have either used individual variables (such as board independence and ownership structure) or have attempted to construct composite measures of corporate governance practices. Despite considerable efforts and despite considerable sophistication of measures and methods, the results so far are surprisingly ambiguous and contradictory.

In particular, it has proven very difficult to show that even sophisticated professional measures of the quality of a company's corporate governance system produced by different commercial providers are indeed able to predict future performance. This situation has led to a series of studies that review the existing rating schemes and corporate governance indices. The main finding of these 'rating the ratings' papers is that composite measures of CG practices are ineffective in so far as they do not predict

performance outcomes better than single measures. More worryingly, different measures from different providers that purport to measure the same underlying phenomenon (i.e. the quality of corporate governance) are only weakly correlated with each other. Some authors explain the weak evidence for a link between CG and performance as a limitation of the methods used. Others, however, focus on a more fundamental problem regarding measurement errors and index construction. Two criticisms can be distinguished within the latter group: firstly, there is a lack of theoretical justifications for the composition of these indicators (what to include and what not); secondly, a convincing method or a theory to determine the weighting of different variables included in the index is lacking. This paper reviews the existing 'rating the ratings' and related papers and argues that while methodological efforts and innovations are laudable, they will remain pointless as long as these new methodological approaches are applied to fundamentally flawed measurements.2 Indeed, the weak correlation among different ratings indicates that the problem is a fundamental one of defining and measuring 'good' governance, rather than a problem that can be solved2'downstream', i.e. at the stage of data analysis (cf. Larcker *et al.* 2007).

Ratherthan further seeking to improve statistical methods, the focus should shift towards the 'upstream' problem of how we conceptualize and measure CG in the first place .One common suggestion derived from the observed limitations of composite CG indices is to return to simpler measures of corporate governance in order to avoid the problems associated with measurement errors and index construction. Yet, this suggestion seems problematic in view of recent developments in the CG literature. Different recent contributions show that different CG mechanisms may appear ineffective if investigated individually, but may have an important impact on outcomes in combination with other CG mechanisms. Also, certain firm-level CG mechanisms may have an impact on outcomes only in a given environment, i.e.in combination with certain institutional factors. This has led to an increased attention to combinations-,or 'bundles' of corporate governance practices at the firm level and how they may relate to different organisation-level and contextual contingencies. Based on these insights, the claim that simpler measure of corporate governance at firm level should be used appears like a step in the wrong direction. Even if a single variable may strengthen the predictive power of a model, it seems likely that using such a simple measure for the complex construct of corporate governance will lead us to miss potentially important interactions between CG mechanisms. This shortcoming is particularly important in comparative research, because it leads us to neglect important functionally equivalent CG mechanisms across countries and to overlook contextual contingencies.

Therefore, rather than reverting to simpler or even univariate measures of CG, this paper constitutes an attempt to integrate insights from the 'bundles approach' to the question of index construction for comparative CG research. Based on this discussion, an alternative approach to index construction is developed. The paper is structured as follows. Section 2 reviews the recent literature criticizing widely-used CG ratings and indices. Next I present recent insights from the 'bundles approach' to corporate governance. Section four provides suggestions regarding the development of more meaningful comparative measures of firm-level CG.

Configurationally approach:

It has become increasingly common in financial economics research to use commercially provided corporate governance ratings to measure the quality of a given companies CG. The great appeal of such commercial ratings is that they are provided by professionals who have better access to firms and more resources than the average academic researcher. Yet, the different commercial indices do not generate consistent or robust results when used in studies investigating the link between the quality of CG and firm performance or valuation. The critics find that most existing ratings either arbitrarily sum up many dimensions into one measure who speak of 'check-and-sum measures' used by

most academics or use sophisticated but completely opaque algorithms. Indeed, there is a lack of theoretical justification of the composition of indicators and the weighting of different variables. In this section, after briefly presenting the most important findings of several‘ rating the ratings papers, I discuss both problems in some detail.

The most extensive and detailed review of existing CG ratings by Daines*et al.*(2010) compares four different methodologies measuring the quality of firm level CG arrangements; namely, the Corporate Governance Quotient (CGQ)developed by Risk Metrics/ISS, the GMI metric produced by Governance Metrics International, the rating used by The Corporate Library(TCL), and the Accounting & Governance Risk (AGR) score developed by Audit Integrity. Their statistical analyses show that these widely-used commercial governance ratings do not predict different measures of corporate performance in any4reliable way. For all dependent variables (DVs) that they use (accounting restatements, shareholder litigation, operating performance, stock returns and cost of debt) the predictive power of the four CG metrics are weak with some of them even showing negative correlations, i.e. ‘*worse*’ corporate governance leads to better performance. 4 The most reliable measure appears to be the AGR,which tellingly is different from the other ratings in that it is exclusively based on accounting practices. It measures the quality of a firm’s accounting practices, which is in some respects an output of its corporate governance system, not a direct measure of it. Contrary to what some authors suggest sometimes implicitly the absence of predictive power of CG ratings regarding future performance does not automatically imply that there is something wrong with the ratings. Indeed, it might be that the theory that there is a link between CG and firm performance is5incorrect. However, provide evidence that there is indeed something wrong with the ratings. They show that all but two ratings are very weakly correlated, i.e. they assess the quality of the same firms’ corporate governance system very differently.

The weaknesses of CG indices are often attributed to their complexity and unselective nature. Among academics, Gompers, Ishii & Metrick (GIM) (2003) were among the first ones to suggest a measure for the quality of CG governance based on a composite index. Their ‘management entrenchment index’ (the G-Index) used the Investor Responsibility Research Centre (IRRC) data on anti-takeover provisions in companies’ charters (17 items in total) as well as several other shareholder-relevant provisions. The indicator contains a total of 24 items with higher scores indicating stronger ‘management entrenchment’. It is hence hypothesized to correlate with worse performance. They find support for this hypothesis in so far as the G-Index is significantly related to stock returns and Tobin’s Q (but not to accounting performance).Second, it constitutes a way around the critical problem of weighting different items. Third, it avoids the thorny question of interaction effects between different CG mechanisms (are they substitutes or complements?). Avoiding the two latter problems is crucial according to them, because we lack a theoretical model that would allow us to understand the interaction between CG mechanisms .

The problem of a lack of theory that could guide us in our choices regarding what to include in an index and what not, is even more important regarding the weighting of different variables once they are included. attempt to solve the ‘kitchen-sink problem’ by constructing indicators of the quality of corporate governance that only contain ‘relevant’ variables. However, they do not address the second problem according to which corporate governance indices are problematic, because they simply sum up different dimensions of corporate governance without any theoretical justification of the equal weighting of each variable. more radical solution, on the other hand, avoids the problem altogether by suggesting the use of a single variable. Yet, this solution avoids the problem rather than solving it. There are few references to explicit weightings of different CG mechanisms based on any conceptual or theoretical arguments. As mentioned above consider voting rights to be more important CG mechanism than other

mechanisms, because they are conceptualized as the most fundamental shareholder rights. Thus, an indicator may contain more items measuring anti-takeover provisions than variables measuring the structure and nature of the board of directors. This would imply that anti-takeover provisions are given more weight. Indeed, observe that academic indicators tend to weight takeover defences more strongly than do the commercial datasets. This is particularly the case of the widely-used G-Index, which is practically an antitakeover index. These algorithms are considered professional secrets by the index providers. One obvious drawback for academic research is therefore that the weightings are not replicable for academics.

From the literature review above, it emerges that using simpler measures of CG has become the main solution to the problems associated with measuring firm level CG. such an approach is problematic for two reasons. Firstly, single measures create a risk of substantial measurement errors. Secondly, the focus on one single or a limited number of measures to capture the complex construct of CG creates very substantial risks of correlated omitted variables bias. Cremers andNair (2005) find that the absence of takeover defences leads to abnormal returns only in cases where at the same time there is an active block holder. This indicates that ‘good’ external governance (exposure to hostile takeover threat)leads to ‘good outcomes’ only if a *complementary* internal element of good governance (shareholder activism) is present at the same time. Other scholars find relationships of *substitutability*. One of the first analyses of CG bundles by Rediker and Seth (1995) – who coined the term bundles of CG mechanisms investigated three practices: monitoring by the board of directors, monitoring by external shareholders, and managerial share ownership. This claim is not directly related to the idea of bundles, but derives from insights in organization studies regarding partial implementation of organizational practices. However, it holds important lessons for the bundles approach as well, because the actual effects of a given bundle may depend not just on organizational and environmental contingencies, but also on the strength of the different CG mechanisms that form a bundle themselves. These four ‘claims’ of the ‘bundles’ approach, have far-reaching implications for the notion of ‘best practice’ in corporate governance. Indeed, whether a given practice can be considered best practice may depend on the presence, absence, or strength of another practice. The next section turns to explore what implications this has for corporate governance indices and the definition of good CG.

Few previous attempts to create meaningful measures of firm level CG have taken into account insights from the bundles perspective. Different authors acknowledge the importance of interaction effects between CG practices, but they either seek to avoid the problem by using simpler measure or by choosing ‘downstream’ methodological solutions to deal with it. One notable exception is Bebchuk and Hamdani (2009). As mentioned above, they argue that two different CG indices are required to measure the quality of CG of widely-held companies and in companies with controlling shareholders. However, while the contingency of CG mechanisms on ownership structures is certainly a very important one. Indeed, the distinction between the principal agent problem in widely-held firms and the principal-principal problem in firms with block holders is increasingly acknowledged and well understood in the literature, notably in emerging markets where block holding is dominant. Yet, the scholarly attention to the difference between closely held companies and widely-held ones does not provide a sufficient justification why this particular contingency should be more important than other contingencies. Thus, it could be argued that industry differences or16differences in size may affect the effect of CG mechanisms in quite similar ways than ownership, even though they are currently less well-researched than ownership-related contingencies.

Two ways to deal with the main claims of the bundles approach regarding interaction effects and functional equivalence can be identified. One is empirical, the other is theoretical. Firstly, the empirical solution is to choose the research design in a way that minimizes the risk of missing interactions

between corporate governance mechanisms. In configurational research, different methods have been used to account for interaction effects. For instance, researchers have simply added two ways or three-ways interaction terms to linear regression models or used a theoretically informed 'ideal typical' configuration to calculate 'deviation17scores'. Also inductive research approaches, such as cluster- or principal component analysis, can be used to identifying CG bundles. Finally, explicitly configurational methods such as crisp set or fuzzy set qualitative comparative analysis (QCA) constitute promising approaches to identify configurations of CG mechanisms.

Taking seriously insights from the 'bundles approach' implies that the question of contingencies needs to be tackled too. As mentioned above, three different types can be distinguished: organizational, environmental, and temporal contingencies. Dealing with organizational contingencies does not necessarily have to be done through the measurement of CG. Rather, the research design could be chosen in order to allow for the identification of bundles depending for instance on industry-level contingencies. Thus, the sample of firms analysed could be split according to these possible contingencies and results from either regression analysis or inductive techniques could then be compared across groups. The second type of contingencies concerns how the firm's external environment shapes the nature and/or effectiveness of specific corporate governance mechanisms. Laws and regulations play an important role in determining what bundles may (or may not) emerge at the firm level. In order to account for this type of contingencies, composite measures that distinguish legally required CG mechanism from others constitute one possible solution. The inclusion of both legally-required and voluntary dimensions of CG in a composite measure would capture important information regarding the determinants of firm-level CG bundles. It would become possible to analyse whether a given 'bundle' is mainly the result of legal requirements or whether companies complement legally required practices with voluntary ones. In longitudinal studies, this would also permit a more fine-grained analysis of the patterns of change, e.g. by distinguishing firms which simply comply with CG practices as they become legally required, from firms that adopt 'best practices' that go beyond the legally required minimum. The main implication of the 'degrees of implementation' claim is that corporate governance mechanisms cannot be captured simply by recording the presence or absence of a given mechanism. Indeed, note that a practice can be either fully endorsed or the firm can merely comply with minimum requirements. It is even possible that a firm only complies symbolically with a given practice or refuses to comply at all.

Put simply, the insights from the bundles approach suggest that we need more sophisticated measures rather than simpler ones in order to be able to quantify firm level CG practices in meaningful ways. Yet, clearly, developing more22sophisticated measures also raise new issues or indeed aggravates existing ones that may make some of the suggestions problematic or impracticable. Partly, this is inevitable and simply due to the complexity of the task at hand. Kogut and Ragin (2006)state that the logic of complementarities and configurational analysis is confronted with an irreducible problem of causal complexity. This extends to metrics to be used in configurational analysis. However, different ways forward exist to address at least some of the problems related to complexity. Two promising approaches are 'modular indices' and 'contingent indices, which I briefly review here. As I argued above one of the problems of existing indicators is that they include non-correlated variables in a single index. This problem is possibly further increased with the approach suggested in this paper. Indeed, 'casting the net wider' is likely to lead to a situation where many variables do not strongly correlate. How to deal with this problem? Certain precautions would have to be taken to make the index statistically sound. Another recent attempt to develop more reliable CG measures is a study by Ferreira *et al.* (2012), which proposes an indicator for bank governance in the US that accounts both for contingencies and the problem of equifinality. The23paper constructs a contingent index of management

insulation (MII), which aims at measuring the degree of mangers exposure to potential strategic intervention, by activist shareholders'. They acknowledge explicitly the existence of interaction effects, whereby the functioning/effectiveness of a given shareholder right may depend on the presence or absence of others rights. The outcome of interest to their research question is the ease with which shareholders can take control over the bank board. Different corporate governance mechanisms are relevant to this question: Whether the board is staggered or not, whether shareholders have the right to call an extraordinary general meeting or to act by written consent, what rules for the nomination and removal of directors apply and whether shareholders have the right to declassify the board and/or increase its size. To be sure, this index also has limitations notably that it is deliberately a measure of management entrenchment not a general shareholder rights index. However, the way in which equifinal paths to manager entrenchment are measured constitutes a promising first step that could be applied to other aspects of corporate governance such as disclosure, pay, and ownership structures.

Conclusion:

This paper reviewed different recent attempts in the literature to assess the quality of commercial and academic firm-level corporate governance measures. I showed that the most common solution to improve existing measures is to create simpler indices that are composed of variables which strongly correlate with the outcome of interest or indeed use just the variable which most strongly correlates with these outcomes. Based on four main claims from the 'bundles approach', I argued that this solution has severe shortcomings in particular for comparative corporate governance research. The paper sought to discuss the major implications of the bundles approach for the way in which we measure CG at the firm level and across countries. The main argument was that it seems unlikely that ever simpler measures for firm-level corporate governance are able to account for the complex and multiple interactions that exist between corporate governance mechanisms and between these and environmental factors. Indeed, for comparative corporate governance research, simplistic measures of corporate governance practices are likely to fail to contain sufficient information in order to capture functional equivalents and equifinal paths to effective governance. The task at hand is complex and poses different challenges. However, besides creating theoretically sounder measures, composite corporate governance measures based on insights from the 'bundles approach', taking into account contingencies, functional equivalents and degrees of implementation, will also constitute an important step towards linking the firm- and the national, institutional level, thus contributing to closing the macro-micro gap in CG25research between national institutional environments and organization-level characteristics.

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