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1 THE SCOPE AND NATURE OF CORPORATE GOVERNANCE

LEARNING OBJECTIVES

- To appreciate why different definitions of corporate governance have emerged since it was first recognised as an academic subject
- To understand why specific governance systems may be appropriate in some geographical areas but not in others
- To understand how global markets and competitive pressures can lead to the dissemination of governance practices around the world
- To appreciate why academic researchers and corporate information providers are so interested in measuring the strength of corporate governance within countries and individual companies

INTRODUCTION

Companies are an important part of our daily lives. Every purchase we make has been influenced by a company and in turn influences it. Even if we do not buy its products each business we encounter has an impact. We may appreciate the architecture of its headquarters building or cover our faces to avoid inhaling its pollutants. Advertising billboards may make us smile or frown. The news that a company's share price has risen has a positive impact if our pension fund or unit trust is holding it, or may cause concern if we know that the company is profitable because it exploits child labour.

In today's economy we are bound together through a myriad of relationships with companies. We are their customers, their employees and their shareholders and in addition our bank deposits become their loans. We are their *stakeholders* with the power to augment or reduce their profits through our purchasing decisions, to improve or diminish their efficiency by the way we work, to change their boards of directors through our votes and to increase or curtail their supply of funds through our savings.

We are all important to companies. For this reason every company strives to find the best way to manage its relationships with its stakeholders, or to put it another way, to find the best methods of corporate governance. This definition of corporate governance as a way of managing relationships between corporate stakeholders would not be recognised by everyone. In the next section we will consider

how the study of corporate governance has changed over the years and why some people choose to define governance as we have here, while others prefer to narrow down the list of stakeholders, in some cases so that it includes only shareholders. While definitions of governance are influenced by theory emanating from a variety of academic disciplines, the practice of governance is affected by national characteristics including, law, politics and culture. The section on corporate governance systems will discuss why different countries have different views of governance and therefore why corporate governance systems vary between nations. The answer is based on *path-dependency*, the idea that on any journey your destination is affected by your starting point.

We live in a global economy in which companies are linked through international *supply chains* and global markets. This can have the effect of diluting national culture and making countries more and more alike. Some authors argue that for these reasons corporate governance systems are converging. We will examine this idea in the next section of this chapter. We then go on to offer a plan of the book explaining how the themes already introduced will be developed later. The conclusion summarises the chapter, highlighting why governance has become so important to investors and to companies. This theme is taken up in the case study at the end of the chapter. It considers how the strength of corporate governance is measured by information providers who sell their measures to investors. Academic research which uses these metrics shows that they are not perfect substitutes for each other, so must be handled with care.

THE DEFINITION AND SCOPE OF CORPORATE GOVERNANCE

In 2001 Diane Denis published a paper entitled 'Twenty-five Years of Corporate Governance Research ... and Counting'. That title marks 1976, if not as the year in which corporate governance was born, at least as the year when it became a subject for serious academic study. For students of finance 1976 is significant in that it was the year when Jensen and Meckling published their seminal paper on *agency theory*. In their paper they look at the problems that arise when an individual who owns all the shares in a business and is its chief decision-maker sells a proportion of those shares to an outsider who cannot influence day-to-day decision-making within the firm. They show that this changes the manager's spending habits, making them less likely to invest in projects that increase the value of the firm. If this can happen in a situation involving one owner-manager and one external owner, the likelihood of sub-optimal decision-making becomes much higher in real-world situations where companies are owned by many absentee shareholders and run by a small team of professional managers. These observations have led to the idea that corporate governance is about finding solutions to this problem, that is, ensuring that management teams act so as to improve the wealth of shareholders.

According to this shareholder-centred view of corporate governance, it is important to find effective ways of monitoring the actions of management teams or of aligning their incentives with those of the shareholders on whose behalf they work. This can be done in a variety of ways; monitoring can be undertaken by *boards of directors* and by *auditors*. Boards can align the interests of managers and shareholders by paying managers in ways that encourage them to pursue profitable proj-

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ects, since the pursuit of profit leads to improvements in shareholder value. The stock market can punish errant managers by acting as a market for corporate control, facilitating the takeover of poorly performing companies by others which are better run. Like the other mechanisms already mentioned, the threat of takeover should encourage managers to act in the best interests of shareholders.

This classic interpretation of Jensen and Meckling (1976) is over-simplistic because in addition to discussing the tensions that exist between managers and shareholders, they also examine the potential for conflicts between shareholders and lenders. This prompted later authors like Shleifer and Vishny (1997) to expand the definition of corporate governance to include practices that protect all suppliers of finance, not just shareholders. Once we think of governance as a process that supports lenders, we have to consider the rating agencies that quantify the risk of corporate debt, together with the legal protection offered to lenders as part of the corporate governance system.

While finance theorists tend to think of firms as coalitions of providers of finance and people who make decisions about how that finance is used, other subject specialists consider broader coalitions. Sociologists, organisation theorists and management specialists include employees as an important interest group within the firm. Ethicists are concerned that companies can affect wider society and the environment. This has led to an even broader approach espoused by the OECD (1999) which characterises corporate governance as a set of mechanisms designed to regulate the relationship between a company and all its stakeholders. This approach to corporate governance leads us to consider the legal rights of employees, the relationships between companies in a supply chain and corporate communications with customers as part of the governance system.

Some readers may be dismayed at the lack of a single, agreed definition of the subject matter of this book. Others will be excited at the idea of exploring different approaches and deciding for themselves which is more useful. The author hopes that most readers will fall into the second category, because in this book we will consider a variety of theories from different disciplines, each of which can add something to our understanding of the nature of the problems that exist when we start to think about companies as coalitions of interest groups rather than as single decision-makers, as economists traditionally do.

CORPORATE GOVERNANCE SYSTEMS

In the previous section we saw that different approaches to corporate governance lead us to include various different activities and institutions as part of the corporate governance system. Over the years a variety of different taxonomies of governance systems have been offered. These include shareholder and stakeholder, inside ownership and outside ownership, market-based and bank-based and market and network systems. Regardless of which of these we look at, each classification puts English-speaking countries into one category and continental European countries into another, which they often share with Japan.

The shareholder/stakeholder distinction characterises countries according to whether their laws and practices tend to favour shareholders or a broader group of stakeholders in the company. One key indicator of this is the composition of

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the *board of directors*. If the board includes representatives of the company's employees or its bank, then it is deemed to have a stakeholder orientation. Given that boards in continental Europe may include both these groups, and Japanese boards may include bankers, these two regions are deemed to have a stakeholder orientation. The UK, US, Australia and New Zealand, on the other hand, are classified as being shareholder-oriented because in those countries boards are deemed to represent the interests of shareholders only.

The inside-ownership and outside-ownership classification distinguishes between countries in which shareholders are involved in the running of the business and those in which shareholders cannot take control. A shareholder may be classified as an insider because they sit on the board or hold a large proportion of equity, otherwise known as a blockholding, which gives them easy access to board members. An outside shareholder cannot influence management thinking because they hold little equity and therefore have few votes. Blockholdings of equity are common in continental Europe and some Asian countries, which means that they can be characterised as inside systems, while share ownership is more widely dispersed in English-speaking countries, which are therefore known as outside systems.

The bank/market distinction refers to the way in which companies are financed. In a bank-based system companies tend to borrow in order to expand their activities. This may involve a close relationship with a particular bank which may even offer personnel to sit on the boards of the companies to which they lend. This type of relationship gives the bank a key monitoring role which is beneficial for any minority shareholders who do not have the time, expertise or incentive to monitor the company's activities. Germany and Japan are often described as bank-based governance systems. In a market-based system companies choose to issue securities on the stock market when they need funds. This means that the stock market monitors their behaviour through the mechanism of the hostile takeover which is almost exclusively associated with the UK and the US.

Weimer and Pape (1999) offer a variant of this taxonomy in their classification of countries as either market-oriented or network-oriented. As we have already seen, in a market-oriented company shareholders are the key stakeholding group to which the company is accountable. The stock market is important as a conduit of funds and also acts to discipline companies through the threat of a hostile takeover. They go on to argue that in a system like this managers are likely to be rewarded in a way that is highly sensitive to corporate performance. You have probably already guessed that this is the category into which the English-speaking countries fall. In countries which are network-oriented lenders and blockholders are the key stakeholders, which means that the stock market does not have a corporate control function and there is little pressure to reward managers according to shareholder wealth. Weimer and Pape (1999) go on to make distinctions between three geographical regions which it includes within the board grouping of network-centred countries. The Germanic group[1] is distinct from the other regions in that banks and employees are the key stakeholders. This is in contrast to the Latin group,[2] where families and the state are key blockholders, and Japan, where city banks, other financial institutions and employees are the most important stakeholders.

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In a series of influential papers La Porta *et al.*, often known as LLSV, offer a rather different classification of countries according to their legal tradition. Legal systems are often classified according to their basis in either common or civil law. In a *common law* system tradition and precedent are very important. Judges make rulings based on the outcome of earlier cases with similar facts. In contrast, *civil law* systems, based on Roman law, rely far more on the content of written laws and codes. Each case is judged in relation to statute rather than in relation to previous rulings by judges. La Porta *et al.* (1996) offer a finer classification of civil law countries according to whether they have French, German or Scandinavian origins. As you can imagine, these legal systems, along with the common law that is associated with the UK, have spread across the world thanks to colonisation. The French commercial code dates back to 1807 and was developed under Napoleon. The Germanic code came rather later, in 1897, when Bismarck reunited Germany. The Scandinavian codes originated earlier than the others but were subject to more change. La Porta *et al.* (1996) show that investors enjoy the greatest protection under common law, so it is not surprising that equity finance is so important in English-speaking countries (La Porta *et al.*, 1997). Civil law countries offer less protection to investors, with the French system offering the least legal protection, and therefore being associated with the least developed stock markets.

Other authors have used the LLSV classification to make connections between political systems (Pagano and Volpin, 2005) and cultural influences (Licht *et al.*, 2005) on corporate governance. Pagano and Volpin (2005) argue that the legal system is not exogenously given; instead it develops from political processes, and specifically from the voting system. They examine two types of voting systems, the proportional system, in which seats are awarded on the basis of the proportion of all votes cast in favour of each party, and the *majoritarian system*, in which candidates are elected according to the votes cast in a particular region. In the proportional approach all votes are important, so political outcomes are determined by groups with similar preferences. Pagano and Volpin (2005) argue that this is a good description of entrepreneurs and employees, since each of these two groups is associated with specific aims. In contrast, when voting is regional, particular geographic areas can tip the national balance between parties. This means that voters in specific regions are important, and within this group of voters those with unusual preferences can hold the balance of power and encourage the passing of laws that are of less benefit to other groups like employees and entrepreneurs. When they apply their model to data from 45 countries they find that proportional voting systems lead to strong protection of employees' rights, while shareholders are better protected in majoritarian systems like the one in the UK.

Licht *et al.* (2005) question the importance of legal tradition as a determinant of corporate governance on the grounds that recent attempts to implement laws on investor protection in some former communist countries have not improved financing in those countries. This leads them to suggest that a legal system can be successfully transplanted in another country only when it is consistent with that country's culture. This explains why both culture and law are similar in Australia, Canada, New Zealand and the US. When the British colonised these countries, significant numbers of British people settled in them, affecting their culture and easing the adoption of UK legal norms. Those former communist countries that

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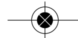

adopted western laws on investor protection found they made no difference because the existing culture was at odds with those new laws, so day-to-day practices did not change. This discussion implies that corporate governance systems are path-dependent. In other words, they evolve from a set of pre-existing conditions; given that each country has its own starting point, it will move towards its own governance system. However, some authors have argued that the forces of competition and globalisation are leading to a convergence of governance systems, an argument to which we turn in the next section.

ARE GOVERNANCE SYSTEMS CONVERGING?

We have already seen that corporate governance systems are heavily influenced by financial markets and institutions, law and culture as well as by the type of tensions that exist between the stakeholders in companies. Stock markets are increasingly seen as global rather than local marketplaces. Neither investors nor companies restrict their activities to their local markets. Investors increasingly seek to diversify their portfolios by including the shares of overseas companies, and companies themselves 'shop around' to find the best exchange on which to list, rather than simply listing on their domestic exchange. An *institutional investor* that maintains close relationships with investee companies in one country will attempt to do the same thing with investee companies abroad. In this way it will encourage convergence in reporting and governance practice around the world. Similarly if a company decides to list its shares overseas, it will have to meet listing and reporting requirements that are different from those to which its local competitors are subject. This will affect the way it collects and processes data, which may in turn affect the way that it communicates with other stakeholding groups. If it is able to provide more useful information to customers as a result of this, it will gain a competitive advantage in its product market. If other companies are to compete with this one, they may have to change their own practices so that they become consistent with overseas regulation, despite the fact that they are not bound by it.

For multinational companies the idea of a local market is hazy at best. Multinational companies may be listed on more than one exchange; they certainly operate in many countries and so are subject to a range of different laws and regulations in financial, labour and product markets. In such a case it is easiest to stick to the strictest regulations encountered. If this means offering product information and guarantees that are better than those offered by rivals in some markets, those competing companies will have to change their own practices in order to retain market share. In this way they find themselves behaving as if they were subject to stricter regulation than in fact applies.

In cases such as these practices are diffused across national boundaries without any interference by regulators. Some corporate governance practices may be disseminated by more explicit intervention by regulators. Three examples spring to mind, all of which will be discussed in more detail later in this book. In the UK the Financial Reporting Council recently published a Stewardship Code (Financial Reporting Council, 2010) designed to encourage institutional investors to use their votes and to engage in other forms of dialogue with the companies whose shares they hold. The Code explicitly states that it expects British institutions to

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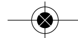
take the same approach to dealing with all investee companies regardless of where they are domiciled. This implies that British investors may encourage overseas companies to change their practices in line with what is done in the UK.

Earlier in this chapter we saw that the OECD takes a broad view of corporate governance as the means by which relationships between a company and all its stakeholders are managed. It issued a set of Principles of Corporate Governance in 1999, which it then updated in 2004. It encourages countries to adopt their own set of governance rules based on the guidelines. While the OECD is at pains to say that each country should adopt rules that are consistent with its own situation, it is inevitable that some convergence will occur as countries implement a single set of principles.

We have already seen that legal systems have a significant effect on the rights of investors and so can encourage or discourage the growth of stock markets as a means of financing companies. Legal systems have also affected the way in which companies report their activities to shareholders, so countries developed their own generally accepted accounting principles. As globalisation developed it became increasingly important for investors to have access to comparable information on all the companies in their now global investment universe. This prompted the development of International Financial Reporting Standards which are now mandatory within the European Union, gaining ground in the US and recommended by the World Bank for use in developing nations.

Developments like these add to the pressure for companies around the world to adopt practices that originated outside their own economy. We can see this in the way that certain features of board organisation and structure have become established as best practice in countries as diverse as the UK, Sweden, Turkey, South Korea, Bahrain and South Africa. Regulators in each of these countries, and many more besides, have introduced codes of corporate governance which lay down an ideal standard for governance practices at the level of the firm. Companies are required to either comply with the content of the code or to explain to their investors why they choose to use an alternative practice. In each of these countries, it has become normal to organise the board of directors so that the chair of the board is not the most senior management figure within the company. This has been done so as to avoid concentrating too much power in the hands of a single person. This wariness of power is also seen in the way in which companies in all these countries are encouraged to ensure that the majority of directors are *non-executives*, that is, they are not employed in the companies on whose boards they sit. Instead they work in other businesses and bring an independent perspective to bear on the issues faced by other companies. In addition certain key board functions such as succession planning, board remuneration, management of the audit process and relationships with auditors are being considered in small board sub-committees staffed by non-executive directors. This both recognises the importance of these functions and ensures that they do not become mired in company-specific norms.

Of course, it is one thing to introduce regulations of the kind described in the previous paragraph, and quite another to observe that the regulations are being implemented. Companies can choose whether or not to act in accordance with the regulations, so these examples of best practice may differ markedly from



observed practice. Khanna *et al.* (2006) examine the extent to which governance systems are converging by looking at the relationships between firm-level governance measures supplied by Crédit Lyonnais Securities Asia, and the LLSV legal origins data. They find that countries that are trading partners adopt very similar corporate governance laws, supporting the idea that globalisation and competition lead to convergence. However, when they examine the relationship between corporate practices used in countries that trade less frequently, they find that the similarities disappear. In other words, the regulation has changed the appearance of governance but not the practices chosen by companies.

This supports an argument put forward by Gilson (2001). He distinguishes between form and function in corporate governance, where form is the mechanisms chosen, and function is the activity facilitated by those mechanisms. He argues that forms are path-dependent and therefore unlikely to converge rapidly, while functions are more likely to be similar in different parts of the world. For example monitoring is a function that all shareholders would agree is necessary, so we would expect to see monitoring all over the world. This is a convergence of function. However, in some countries monitoring may be done by banks, in others by boards and in others by a controlling shareholder, so the forms remain very different.

PLAN OF THE BOOK

The rest of the book will elaborate on the themes we have identified in this chapter. The next four chapters will consider the implications for governance of certain features that are specific to a company. These are its owners, its board, its stakeholders and the way it rewards its management team. We have already seen that shareholders are at the centre of some governance systems, but not others. While we often think of shareholders as the owners of companies, in fact they own a particular class of security issued by companies. This is a subtle yet important distinction which, as we will see in chapter 2, is important in defining the rights and responsibilities of shareholders in comparison to the rights and responsibilities of the owners of other assets. Finance theory is based on the assumption that all shareholders are rational and risk-averse. That is, they want to get the best possible return available given the level of risk they are willing to bear. This description may be accurate for some types of shareholders but not for others. We will consider the motivations of different types of shareholders and the extent to which they see themselves as owners of companies or owners of securities. Their viewpoint is likely to affect their relationship with the company's management team and therefore the extent to which they allow the managers to take control of the company. When managers take control they may, as we have already seen, make decisions that are not in the shareholders' best interests. When a dominant shareholder is able to maintain control of a company they may act in a self-serving way, using the company to fulfil their own ambitions rather than to create wealth for the other shareholders whose holdings are not large enough to give them control over decision-making. By examining the rather different shareholding patterns observed in different countries we will see that corporate governance problems and therefore systems vary in line with the idea of path-dependency introduced earlier in this

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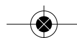

chapter. In addition we will look at a range of empirical evidence on the relationship between corporate value and share ownership by different groups to see if some ownership structures encourage greater value creation than others.

Voting is one of the key ways in which shareholders can exercise control over the company. Perhaps the most important issue on which shareholders vote is the election of directors. The board of directors has a unique role in both setting corporate strategy and in monitoring decisions so as to ensure that they are beneficial for shareholders. In chapter 3 we will consider the tensions between the two roles and look at how they can be relieved through the addition of *independent directors* to a *unitary board* or through the *dual board* system in which each company has two boards: one in charge of strategy and the other which has a specific monitoring function. We will also consider an increasingly important feature of board organisation, the use of subcommittees to oversee particular functions; again we will consider a range of empirical evidence that attempts to find out whether particular board structures are associated with better value creation than are other structures.

Just as the organisation of the board varies between countries, so does its role, depending on the extent to which the company acknowledges a responsibility to stakeholders as well as to shareholders. In chapter 4 we will consider what it means to be a stakeholder in a company and how companies might change their behaviour in response to pressure from stakeholders. We will specifically consider the ways in which lenders, employees, customers and other companies become involved in governance. In considering the role of employees there will be some overlap with chapter 3, because employees and their representatives sit on *supervisory boards* in some continental European countries.

In chapter 5 we will turn to the question of how boards of directors are rewarded for their work. The area of executive pay is a controversial one, especially in the wake of the recent banking crisis. While the Walker Review (HM Treasury, 2009) has introduced new rules concerning the disclosure of the earnings of what they term 'high-end' employees, in non-banking companies the only information that must be revealed relates to the remuneration of board members. For this reason the discussion of remuneration will be limited to the payments received by directors. One key role of the remuneration system is to motivate directors, so we will begin by considering three rather different theoretical approaches to motivation. Maslow's hierarchy of needs implies that money should not be important to board members; in contrast, according to equity theory, people decide how much effort to expend based on how much money they earn relative to their peers. This approach gains some credibility given that in practice salaries are based on industry norms. However, it is the agency-theoretic view that holds sway in determining how remuneration packages are constructed. According to this view directors must be paid in ways which align their interests with those of shareholders. This means that compensation packages include several elements related in sometimes complicated ways to the gains received by shareholders. An examination of the evidence will help to establish whether or not these packages do lead to greater value creation.

In the next three chapters we will turn to external influences on corporate governance. In chapter 6 we will see how an active stock market can trade control of companies through takeovers. This is important if we accept that corporate gover-

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nance is about protecting the interests of shareholders. In theory the threat of a takeover should be enough to encourage directors to make decisions in the best interests of their shareholders and therefore substitute for monitoring by the board or for remuneration schemes that align managerial and shareholders' interests. However, we must recognise path-dependency again here. In some countries ownership patterns and legal systems discourage takeovers, so we will use empirical evidence on the takeover market to consider whether or not it works as theory suggests it should.

It would be impossible to write a book on corporate governance without mentioning regulation. The last 20 years have witnessed a proliferation of corporate governance regulation around the world. Much of it has been in the form of codes which require companies to either comply with a set of rules or explain why they have adopted a different procedure. This approach has the advantage that it lays down a clear set of expectations but still allows companies to choose alternative practices if they are better suited to their situation. We will look in some detail at the development of codes in the UK. The Cadbury Code was one of the earliest corporate governance codes and was also highly influential. In a comparison of codes of corporate governance around the world we will see that many of the prominent features of UK regulation can also be found in other codes. Of course we must recall the work of Khanna *et al.* (2006), who show that while it may appear that governance systems are converging, companies do not always choose to adopt what regulators recommend. While directors' associations in the US have been writing codes for years, the legislature has shown a preference for law over voluntary codes in passing the Sarbanes-Oxley Act in 2002. We will consider the costs and benefits associated with this wide-ranging piece of legislation and look at the evidence on its effect on American companies.

A common feature of regulation around the world is an emphasis on transparency so that shareholders and stakeholders can easily see what the company is doing and appreciate its implications for them. In chapter 8 we will look at the many ways in which companies communicate with both shareholders and stakeholders. Before the advent of the internet it made more sense that in does now to differentiate between communications with shareholders and communications with stakeholders. Today anyone can gain access to the investor relations section of a corporate website and see the annual reports of companies, which were previously sent only to shareholders, although they were available on request to others. In addition they can see other reports and presentations given to analysts and other stakeholders. In this chapter we will consider how reporting has changed over time and look at companies' incentives to both disclose additional information not required by regulation, yet also to manipulate some information so as to mask or amplify its significance. This leads into a discussion of why auditors do not always recognise the kind of manipulation that characterises fraud cases. We will also look at forms of communication that target specific groups of stakeholders and consider how certain forms of communication can enable companies to gain or enhance a good reputation.

Chapter 9 is rather different from the earlier chapters in that it focuses on a particular governance context. It looks at the issues faced in emerging or developing markets. While western economies have become interested in corporate

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governance many years after industrialisation has been achieved and they have gained the status of 'developed nations', emerging markets are being encouraged to consider governance issues as they develop. The World Bank and the OECD see corporate governance as part of the development process because it has the potential to attract foreign investors whose activities will encourage stock market development which will, in turn, facilitate economic growth. In chapter 9 we will see how initiatives by the World Bank and the OECD have influenced corporate governance in emerging markets, looking in particular at the OECD's 'Principles of Corporate Governance'. Finally we will summarise the empirical evidence which shows that improvements in corporate governance are having a beneficial effect on shareholder wealth, and thereby encouraging growth in emerging markets.

Chapter 10 concludes the book by summarising the important developments in corporate governance since 1976 and by looking in a little more detail at some of the technical issues involved in interpreting the empirical evidence on those developments. You must have noticed that the phrase 'empirical evidence' has appeared many times in this section. There is a vast empirical literature on the relationship between governance mechanisms and corporate performance. Much of it is based on the underlying view that corporate performance is determined by governance, or to use a more technical phrase, that governance is given *exogenously*. However, this is not necessarily the case. Given that companies can choose which governance mechanisms to adopt they may make the choice based on performance. For example a company might react to falling profitability by inviting non-executive directors to join the board and offer a fresh viewpoint on strategy. If the new members join during a year in which profitability falls, a conventional model would treat the new directors as the cause of the falling profit. In fact they may be a reaction to it, in other words, the board structure is determined *endogenously* rather than given exogenously. This and similar modelling problems will be considered in the final chapter.

CONCLUSION

We have seen in this introductory chapter that corporate governance is a relatively new field of academic study. It attracts interest from scholars from many disciplines including finance, sociology, management and ethics. Each offers a distinct theoretical perspective on how to solve the problems that arise due to conflicts between the various stakeholders who make up the company. Regulators too are keen to find solutions to governance problems. They are inevitably informed by existing laws and practices, so it is not surprising that different systems have evolved in different countries. Yet we must not forget that today economies are bound together by strong trade and financing links, which encourage the spread of good practice across national boundaries. Some practices can be adopted worldwide, but others rely on a specific set of national characteristics to work properly. Regulators and companies must think carefully before recommending or implementing practices that work well in other contexts.

While every type of organisation has its own governance structures the emphasis in this book will be on the governance of companies that are listed on

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stock markets. This is due in the main to the fact that listed companies have to produce more information than private ones, so their governance practices are more transparent and therefore offer the possibility of being tested for their effectiveness. In addition, regulators are keen to introduce new codes and laws to affect corporate governance in listed companies, and it is important to consider the effects this has on the companies themselves as well as on the economies in which they operate.

KEY POINTS

- Corporate governance is a relatively new area of academic study which searches for solutions to the problems that arise in companies made up of stakeholders whose objectives differ. Its development has been shaped by theoretical insights from a variety of disciplines, including finance, sociology, management and ethics.
- The corporate governance system found in any particular country must be compatible with that country's existing laws, culture and political system.
- Some governance practices can and have been transplanted from one county to others through competitive forces and the operation of the global capital market.
- There is widespread interest in measuring the effectiveness of corporate governance systems at both the corporate and the country level. Academic researchers and information providers have contributed to this endeavour, and throughout this book we will use their metrics to consider the usefulness of specific aspects of corporate governance.

CASE STUDY Measuring the strength of corporate governance

Around the world regulators are encouraging better corporate governance through the publication of codes and laws, companies are providing more information on their own practices and investors are showing a willingness to pay more for equity in companies that have sound governance practices (McKinsey & Co., 2002). With such an interest in what constitutes good governance, it is not surprising that academics have attempted to quantify governance practices in order to undertake empirical research into its relationship with corporate performance and information providers have developed their own proprietary measures for sale to clients.

Corporate governance ratings are calculated by awarding points to companies which display certain governance characteristics, such as independent boards and remuneration packages based on stock market performance. Academic measures like the Gompers *et al.* (2003) G-score based on 24 indicators of shareholder rights and the slimmed-down version including just six indicators, the E-index created by Bebchuk *et al.* (2009), usually treat all characteristics equally, while commercial measures may weight certain types of characteristic more heavily than others. The fact that Yahoo! Finance includes one such rating (CGQ®, provided by RiskMetrics) in its corporate profiles indicates just how mainstream corporate governance rankings have become.

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The Corporate Governance Quotient CGQ® is based on eight categories of information, each of which can be used to calculate a sub-index as well as the overall measure. The sub-indices are based on the characteristics of the board, the audit, the company's bylaws or charter, its anti-takeover provisions, director compensation scheme, progressive practices, ownership and director education. Clearly some of these characteristics are based on local laws and regulation, so the precise components vary according to where the company is based. RiskMetrics takes a rather broad-brush approach by listing one set of characteristics for American companies and another set for the rest of the world. The major differences are in the way that anti-takeover and charter provisions are handled.

Other corporate governance ratings like GMI and TCL are based on very similar information. Until 2010 these ratings were provided by GovernanceMetrics International and the Corporate Library, respectively. Then these two companies merged and were joined later that year by Audit Integrity. The merged company now operates as GovernanceMetrics International, Inc. At the time of the merger the company committed itself to continue to produce the full range of products previously offered by the three independent companies, but also unveiled plans for a new rating incorporating environmental social and governance factors, to be launched in July 2011.

GMI and TCL contain fewer categories than CGQ®, but use overlapping characteristics. GMI rates companies according to board accountability, financial disclosure and internal controls, shareholder rights, executive compensation, the market for control and ownership and corporate social responsibility. TCL includes board compensation and succession planning, CEO compensation, the takeover defences used and accounting concerns at board level. It then rates companies on a scale from A to F, where an A-rated company is free of any problems in all four areas and shows superior qualities in two areas while an F-rated firm is completely controlled by management, shows little or no regard for its shareholders and potentially faces bankruptcy.

As its name implied, Audit Integrity took a particular interest in accounting measurements in order to produce its measure of accounting and governance risk, AGR®. It is based on over one hundred accounting and governance variables and is used to give companies scores ranging from zero to 100. The companies are then classified along a spectrum ranging from very aggressive to conservative. A very aggressive company is one which is likely to face class action suits from investors and to have to restate its accounts at some time, while a conservative company has proved itself to be trustworthy.

Academic researchers have recently become interested in these commercial measures and have investigated the extent to which they can explain or predict corporate value. Daines *et al.* (2010) note the similarities between CGQ®, GMI and TCL but find no cross-sectional correlation between the three indices, indicating either that they are measuring rather different ideas of what constitutes good governance or that they are subject to measurement error. Certain indices have some predictive power in the case of firms that have to restate accounting earnings (AGR®, GMI and TCL) and are faced by class action lawsuits (AGR® and GMI). AGR® is also positively related to future operating performance and market outperformance and TCL is positively related to future company value. Only CGQ®

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has no predictive ability. Further Epps and Cereola (2008) find that it is not related to current accounting performance. Looking only at GMI, Bauer *et al.* (2008) find that GMI is a useful tool for portfolio selection, because companies which it labels as well-governed produce higher market returns that those it labels as poorly governed, while Spellman and Watson (2009) find that it can help to explain future returns.

These results indicate that investors should be careful when they choose among commercial governance ratings. Some ratings are useful as a negative screening device to identify companies that should be avoided because of their dubious accounting practices or vulnerability to litigation. Others can be used to predict performance. As companies realise that their governance scores are being taken seriously by investors they may change their governance practices in order to improve their ratings. On the face of it this is positive, but it can lead to what many people have called a 'box-ticking' mentality. In other words companies may introduce subcommittees, separate the role of CEO and chair of the board or drop their anti-takeover devices to improve their ranking on paper rather than because they believe it will improve their working practices or lead to greater investor protection (Sonnenfeld, 2004). In this case the companies will look stronger even though they are unchanged and the ratings will lose their association with performance or their ability to predict business failures. This highlights the fact that good governance is not just about introducing new procedures or doing what other successful companies do. It is about maintaining effective relationships with stakeholders that enable the company to attain its objectives.

Case-study questions

1 Why are investors willing to pay for corporate governance ratings given that they are based on publicly available information?
2 Why does RiskMetrics use different sets of characteristics for companies depending on their location?
3 Why might the use of commercial indices of corporate governance lead to a change in corporate behaviour?

REVISION QUESTIONS

1. Why might a country's laws affect the development of its corporate governance system?
2. Thinking about the culture of your own home country, which aspects of culture have affected your corporate governance system?
3. What factors could lead corporate governance systems around the world to become more similar?

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SUGGESTIONS FOR FURTHER READING

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http://www.icgn.org/ The website of the International Corporate Governance Network provides links to a useful publications, including advice on best practice.

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