

Corporate governance

A premium for **good** governance



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In emerging as in developed markets, companies that adopt strict corporate-governance practices are being rewarded by institutional investors.

Does good governance pay? In theory, it should increase the market valuation of companies by improving their financial performance, reducing the risk that boards will make self-serving decisions, and generally raising investor confidence. Indeed, surveys suggest that institutional investors will pay as much as 28 percent more for the shares of well-governed companies in emerging markets.¹ Do such investors practice what they preach? To find out, we looked at 188 companies from six emerging markets—India, Malaysia, Mexico, South Korea, Taiwan, and Turkey—and tested the link between the market valuation and the corporate-governance practices of these companies in 2001.

We rated the performance of each company against some key components of corporate governance (Exhibit 1) and used explicit, objective criteria for every component to ensure consistent ratings. The information on which we based the ratings came from public and proprietary sources as well as annual reports. If, for example, half of the members of the board of a company were truly independent—that is, if they had no business connections to it—the company rated a top mark of 2 on our scorecard. By contrast, companies with fewer independent directors scored either a 1 or a 0.

After we aggregated the ratings for each company into a single metric of governance, we tested the relationship of this score with the market valuation of the company as measured by its price-to-book ratio on the local stock exchange at the end of its 1999 fiscal year (the most recent when

¹See Paul Coombes and Mark Watson, "Three surveys on corporate governance," *The McKinsey Quarterly*, 2000 Number 4 special edition: Asia revalued, pp. 74–7.

EXHIBIT 1

The corporate-governance top ten

Many factors contribute to good governance; some (such as the relationship between the CEO and the chair) are difficult to quantify. Nevertheless, several useful indicators of a well-governed company are available to shareholders. 10 widely recognized principles are summarized here.

Accountability

Transparent ownership: identify major shareholders, director and management shareholdings, and cross-holdings.

Board size: establish an appropriate number of board seats; studies suggest that optimal number is 5 to 9.

Board accountability: define board's role and responsibilities in published guidelines, and make them basis for board compensation.

Ownership neutrality: eschew antitakeover defenses that shield management from accountability. Notify shareholders at least 28 days before shareholder meetings and allow them to participate on-line.

Independence

Dispersed ownership: deny any single shareholder or group privileged access to or excessive influence over decision making.

Independent audits and oversight: perform annual audit using independent and reputable auditor. Insist that independent committees oversee auditing, internal controls, and top-management compensation and development.

Independent directors: allow no more than half of directors to be executives of company; at least half of nonexecutive directors should have no other ties to company.

Disclosure and transparency

Broad, timely, and accurate disclosure: fully disclose information on financial and operating performance, competitive position, and relevant details (such as board member backgrounds) in timely manner. Offer multiple channels of access to information and full access to shareholders.

Accounting standards: use internationally recognized accounting standards¹ for both annual and quarterly reporting.

Shareholder equality

One share, one vote: assign all shares equal voting rights and equal rights to distributed profit.

¹Generally accepted accounting principles (GAAP), such as US GAAP, UK GAAP, or International Accounting Standard (IAS). Source: Organisation for Economic Co-operation and Development; McKinsey analysis

figures were available for all companies in our sample).² To account for systematic differences in corporate valuations and governance among nations, we expressed the price-to-book ratio and corporate-governance score of each company as the percentage by which they differed from its national and industry averages.

Even after allowing for the effect of characteristics such as financial performance (measured by returns on equity) and size on valuations,³ we found that companies with better corporate governance did have higher price-to-book ratios, indicating that investors will pay a premium for shares in a well-governed company.⁴

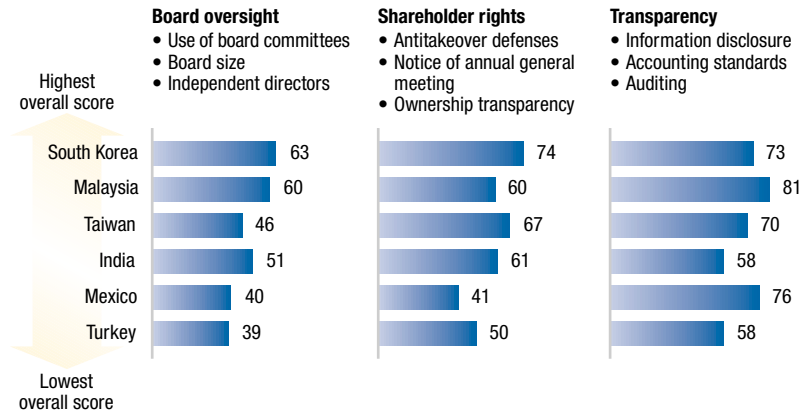
²We used least-squares regressions, with the company's price-to-book ratio as the dependent variable and the corporate-governance score as the independent variable.

³We tested alternative specifications, including dependent variables for a company's size (using revenue) and performance (using return on equity) as well as measures of adherence to legal and financial standards. None changed the character of the results described here. Our final specification was limited to corporate governance because we were interested in its total effect, not only in the premium that can't be explained by financial performance.

⁴This result was statistically significant at the 95 percent confidence level.

EXHIBIT 2

Ratings race

Aggregate corporate-governance score,¹ percent

¹Includes 188 companies from countries represented; performance of each company rated on alignment with key components of corporate governance (see Exhibit 1).

Moreover, the reward for good corporate governance is large.⁵ By moving from worst to best in corporate governance, companies in our sample could expect, on average, to experience roughly a 10 to 12 percent increase in their market valuation—a result underscoring the importance investors attach to these attributes. The market value of a Mexican food processor, for example, stood at \$158 million on December 31, 1999. Onerous antitakeover rules gave the company the lowest score on one measure of governance. If the company adopted less onerous defenses, our model predicts that capital markets would raise its valuation by close to 12 percent.⁶ Thus, improving corporate governance could be a strategy for leapfrogging competitors in financial markets.

Average scores on various components of corporate governance diverged among countries—a fact suggesting that companies in different ones should focus on different components. For example, Malaysian, South Korean, and Taiwanese companies, reflecting the concerted effort to improve their corporate governance after the 1997 Asian crisis, had the highest average scores for board oversight and shareholder rights (Exhibit 2). In many ways, South Korea led the governance-reform efforts.⁷ Among other things, the country's government required major


⁵Our small sample precluded us from determining whether the size of the good-governance premium varies by country.

⁶In practice, the increase could be higher or lower, as the model shows only an average statistical inference.

⁷For more on the South Korean effort, see Dominic Barton, Robert F. Felton, and Ryan Song, "Building Asian boards," *The McKinsey Quarterly*, 2000 Number 4 special edition: Asia revalued, pp. 64–73.

banks and conglomerates to appoint a majority of outside directors, to define transparent board responsibilities, and to establish committees ensuring the independent oversight of board activities. It also removed ceilings on foreign ownership, thus intensifying competition, and lowered the size threshold for any group of shareholders seeking to sue a board they believe has failed to protect their interests. A South Korean organization, People's Solidarity for Participatory Democracy, subsequently challenged major companies, such as Samsung Electronics and SK Telecom.

Although Mexican companies had generally poor scores on board responsibilities and shareholder rights, they had among the highest average scores on transparency, which includes accounting standards, disclosure, and auditing. In our sample, Mexican companies were the most likely to be cross-listed on US exchanges and thus obliged to comply with tough US Securities and Exchange Commission regulations on financial reporting—a standard that most other companies in emerging markets have yet to meet. Moreover, recent reforms in Mexican capital-markets legislation will likely promote higher standards of corporate governance in precisely those areas in which Mexico had previously lagged behind.

Companies in emerging markets often claim that Western corporate-governance standards don't apply to them. Our results, however, show that investors the world over are looking for high standards of good governance and will pay a premium for shares in companies that meet them. Enron's collapse is a worrisome sign that some US companies too fail to meet those standards. But high standards of corporate governance are crucial to the value of companies, especially in emerging markets. 

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Good corporate governance means that the processes of disclosure and transparency are followed so as to provide regulators and shareholders as well as the general public with precise and accurate information about the financial, operational and other aspects of the company. As has been mentioned elsewhere in this article, corporate governance is a term that means many things and the bottom line for good corporate governance is the dual aim of pursuing profits and doing so in a transparent and accountable manner. The subsequent articles in this module introduce the readers to various aspects of A Premium for Good Governance - Free download as PDF File (.pdf), Text File (.txt) or read online for free. The McKinsey quarterly 2002 number 3. A premium for good governance Does good governance pay? In theory, it should increase the market valuation of companies by improving their financial performance, reducing the risk that boards will make self-serving decisions, and generally raising investor confidence. Indeed, surveys suggest that institutional investors will pay as much as 28 percent more for the shares of well-governed companies in emerging markets.' Do such investors practice what they preach? About good governance and human rights. Good governance is the process whereby public institutions conduct public affairs, manage public resources and guarantee the realization of human rights in a manner essentially free of abuse and corruption, and with due regard for the rule of law. The true test of 'good' governance is the degree to which it delivers on the promise of human rights: civil, cultural, economic, political and social rights. Read more about good governance and human rights. The cost of corruption. Every year \$1 trillion is paid in bribes while an estimated \$2.6 trillion is lost to corruption. Recently the terms "governance" and "good governance" are being increasingly used in development literature. Bad governance is being increasingly regarded as one of the root causes of all evil within our societies. Major donors and international financial institutions are increasingly basing their aid and loans on the condition that reforms that ensure "good governance" are undertaken. This article tries to explain, as simply as possible, what "governance" and "good governance" means. Governance. The concept of "governance" is not new Good Corporate Governance as documented in the ACCA AA (F8) textbook. Free sign up for extra features! Download all ACCA course notes, track your progress, option to buy premium content and subscribe to eNewsletters and recaps. FREE Sign up. Home Our purpose The science How it works.