Does Good Governance And Ethics Translate Into Better Business Sense?

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Corporate governance has become an emotive issue largely because it has attracted a lot of political attention, mostly originating from the world's largest economy—the US and later trickling to Europe and the rest of the world. High profile corporate scandals, bringing into spotlight tales of executive greed and malpractices, have made the rather staid subject of governance suddenly very glamorous. It has caught the imagination of lawmakers and laymen alike. Suddenly, corporate governance is a topic that has as many experts as critics.

Be that as it may, the manner in which corporations are run sooner or later affect a large number of people and even whole economies. Today, Exxon Mobil or Walmart's turnover is higher than the GDP of Sweden or Austria. The sphere of influence corporations have today is immense and their governance principles, values and ethics embodied in their fabric is so critical to the whole world. Corporate governance is all about systems, processes, ethics and values.

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Once the concept is de-linked from political rhetoric, corporate governance makes eminent business sense. Ethical behaviour is a maturation process of a society where ethical and voluntary practices get codified into law. This then sets the minimum acceptable standards of behaviour by corporates and citizens alike.

Simply put, governance is the nuts and bolts of how a company or a country is run. Logically, a well-oiled piece of machinery will always deliver better results.

That corporate governance translates into good business sense is something we all know intuitively but is there empirical evidence to support this hypothesis?

DO COMPANIES WITH HIGHER CORPORATE GOVERNANCE PERCEPTION GET CONSISTENTLY REWARDED?

In 2004-2005, PricewaterhouseCoopers and Financial Times did a survey on World's Most Respected Companies and some of the results are as follows:

	Top ten most respected companies	Companies that create the most value for their shareholders	Top ten companies that best demonstrate their commitment to corporate social responsibility	Companies that have the most effective corporate governance
1.	General Electric	Microsoft	Microsoft	Microsoft
2.	Microsoft	General Electric	Toyota	General Electric
3.	Toyota	Toyota	BP	Toyota
4.	IBM	Berkshire-Hathaway	General Electric	Daimler-Chrysler
5.	Coca-Cola	Wal-Mart	IBM	Coca-Cola
6.	Dell	IBM	Royal Dutch/Shell	IBM
7.	Wal-Mart	Coca-Cola	Johnson & Johnson	Wal-Mart
8.	Citigroup	Citigroup	Honda	McDonald's
9.	Procter & Gamble	BP	McDonald's	General Motors
10.	Hewlett-Packard	Exxon-Mobil	Wal-Mart	Virgin

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Value creation activities by enterprises move within different value drivers - both financial or GAAP related and non-financial measures. Irrespective of how the measurement parameters on this grid change, companies that create value are respected and also have effective corporate governance along with high social responsibilities.

But do high levels of Corporate Governance pay? What would make the elephant dance?

A path breaking study by Paul Gompers, Lizzi & Metrick of Harvard Business School titled "Corporate Governance and Equity Prices", concludes that an investor that sold shares in publicly traded United States companies with the weakest shareholder rights and bought those with the strongest would have earned "abnormal" returns of 8.5% a year during the sample period. The study analyzes 1,500 companies and ranks them in deciles based on twenty-four distinct corporate governance provisions. The most "dictatorial" firms were less profitable, had lower sales growth and the returns on such firms not surprisingly trailed those of the "democratic" portfolio by an average of 8.5% a year.

Similar studies by Rob Bauer and Nadja Guenster showed empirical evidence of positive correlation of better performance in the stock markets by better governed companies in the Euro zone. In fact, they go on to say that companies that increase 1% in Deminor Rating (a European Corporate Governance rating agency) translates to 0.47% increase in their market value.

GovernanceMetrics International said its data in 2006 on 2,588 global companies found that 26 companies receiving the highest score of 10.0 outperformed the Standard & Poor's 500 stock index total return by 10 percent over the last five years.

In the Asian markets, CLSA's (Credit Lyonnais Securities Asia) report entitled 'Saints and Sinners - Who Has Got Religion' analysed results of over 495 companies in the emerging markets and these studies showed that in many markets, companies with good corporate governance have outperformed their indices in recent years and move to valuation premia. Companies with governance are also those with high ROEs (return on equity) and the largest value creators on an EVA (Economic Value Added) analysis. The report further states that of the 100 largest companies, firms that garnered the top five scores for corporate governance were HSBC (Hong Kong), Infosys (India), Singapore Airlines (Singapore), Li & Fung (Hong Kong) and Richemont (South Africa).

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Global Investor Opinion Survey 2002: In 2002, McKinsey conducted their second study in collaboration with Global Corporate Governance Forum to study the relationship between corporate governance and shareholder returns. The survey found that investors still put corporate governance on a par with financial indicators when evaluating investment decisions.

(a) Premiums that investors were willing to pay for well-governed companies averaged 12-14 per cent in North America and Western Europe.
(b) Premiums went up 20-25 per cent in Asia and Latin America.
(c) Eastern Europe and Africa had the highest premium at over 30 per cent.

The survey of 2002 showed a decline in premiums as compared to the one in 2000 (when it was at 80 per cent) mainly because many countries had implemented governance related reforms. Lower premiums indicate that investors feel that companies in such countries have already addressed many fundamental governance issues.

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More than 60 per cent of investors say that governance considerations might lead them to avoid individual companies with poor governance and 33 per cent investors say they may avoid whole countries.

PricewaterhouseCoopers (PwC)/ Economist Intelligence Unit: 'From Compliance to Strategic Advantage': A study by PwC and Economist Intelligence Unit in February-March 2004 of more than 200 senior executives in financial institutions globally has reinforced the strategic advantages of good corporate governance at financial institutions.

Some financial institutions may have equated good corporate governance with meeting the demands of regulators rather than the benefits of improving the quality of management and controls. Such companies may be falling short of reaping the potential strategic advantages of improved corporate governance.

(a) Sixty nine per cent global respondents said their company had become more focused on compliance and governance.
(b) Seventy five per cent global respondents said that the tone at the top of their organisation had changed to reflect a greater emphasis on governance.

However, the survey found that, apparently, change has occurred by the desire to comply with regulations rather than to improve the institution's management tools. The survey concludes that those firms whose governance processes enable them to anticipate emergent risks, spot under performing products and engage with their key stakeholders, stand to reap reputational advantages in the marketplace.

'Countries which require higher corporate transparency tend to have a lower country risk premium, a lower cost of capital and higher trading volume and liquidity in their financial markets.'

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'Companies with better governance tend to perform better, in the sense that they have a higher return on assets and higher market valuation, which makes it easier for them to fund their operations.'

Investors are willing to pay a premium for well-governed companies because:

(i) some believe that a company with good governance will perform better over time leading to higher stock prices and higher long-term rewards;
(ii) others see it as a means of reducing risk since good governance decreases the likelihood of bad things happening to a company.

Companies voluntarily installing good corporate governance practices rely on market forces to reward them in the form of higher share prices in the medium to long term. A company in a country with weak legal or regulatory systems can lower its cost of capital and improve access to markets by taking specific action to depict itself as a 'good company'. Giving detailed financial information not mandated by law, disclosing future plans, etc are some examples.

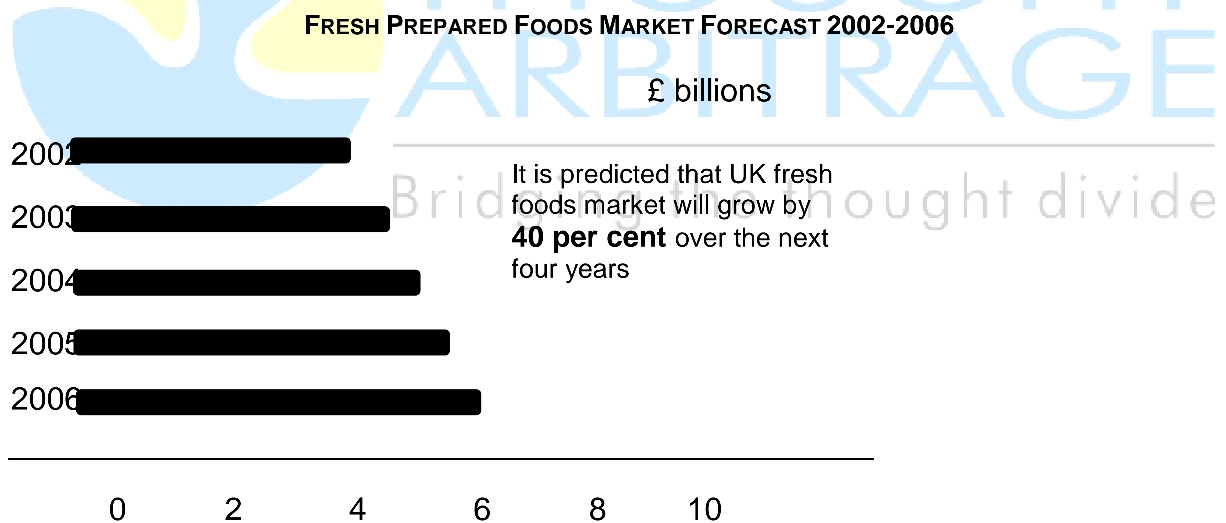
It goes on to give a detailed account including financial computation of the item

'brand earnings' in the income statement, besides quantifying the group's brand value for the previous three years.

Infosys has won many awards, national and international, and is considered a leader in corporate governance in India.

However, intensive regulation that absorbs many discretionary actions may well rob companies of gains markets perceive for voluntary improvement in governance. This is reflected in the McKinsey study of 2002 where the premiums investors were willing to pay for well-governed companies went down dramatically as compared to the earlier study of 2000 primarily because many countries had adopted governance-related reforms.

Therefore, in countries where fundamental governance issues have been addressed, individual companies can benefit at the stock market by fine-tuning current business practices and raise governance standards voluntarily.



Source: Geest Plc Annual Report and Accounts.

Eight reasons why we believe the fresh prepared foods market will continue to grow:

1. People are likely to cook if they eat on their own. One and two person households account for sixty four per cent of all households and the single

person household will continue to grow. Seventy Eight per cent of all meals have only one or two people present and this number is increasing.

2. The number of full-time working females is due to continue to increase over the five years.
3. Fresh prepared foods are starting to have a universal appeal and the next generation are already fans.
4. Less than one per cent of all meals served are ready meals—there is huge potential to increase the number of times people buy and to encourage eating outside evening mealtimes.
5. The amount of time spent on food preparation continues to fall. Thirteen minutes is the average amount of time spent on 'hands-on-meal preparation at home. (Thirty Four per cent of all meals take less than five minutes to prepare.
6. Using Taylor Nelson Sofres figures, we predict that consumers will spend an additional £ 3.6 billion on fresh prepared foods over the next five years.
7. There were over 400 convenience stores, run by the large supermarket chain in 2002. This number is expected to increase.
8. Celebrity chefs raise awareness but not the game. According to Mentel, 'basic culinary skills have been lost among some younger generations, engendering a 'can cook won't cook' 'cycle which will be very difficult to break'.

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Who will Reward Companies for Good Governance?

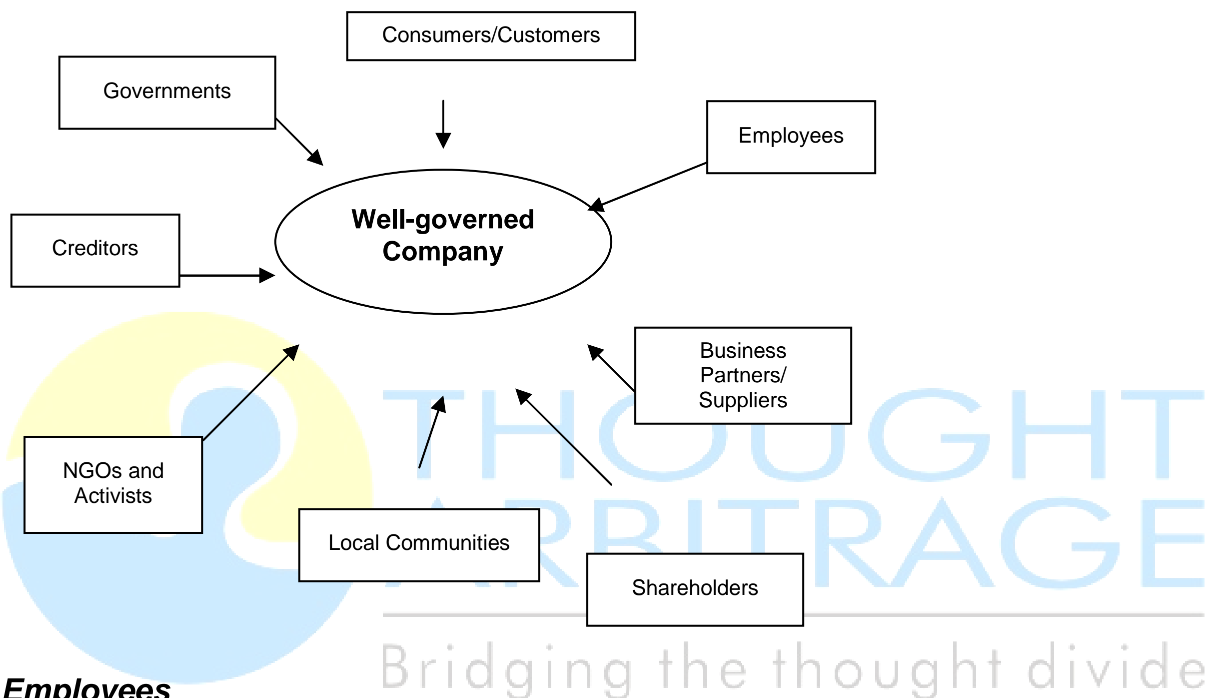
Whether companies get consistently higher rewards for playing by the rules is a function of many complex issues. Modern business is no longer only about profits. Increasingly, interests of 'stakeholders' are gaining over mere interests of 'shareholders'. As many more interest groups try and have a say in how businesses ought to be run, business leaders are compelled to demonstrate that they are a part of society—as they withdraw resources from society, they must be seen to add value to such resources before returning them back to society.

Corporate governance compels a company to be out-ward looking and aware of its ties to people outside the entity—customers, suppliers, social activists and the

community at large. If the company seeks good results for all the components of that wider network of relationships, it will surely optimise its achievements.

After all, a company cannot exist in a vacuum.

Rewards to well-governed companies come from many constituencies, some of which are:



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Employees

In 1997, John Browne, CEO of oil, natural gas and petrochemical giant BP caused a stir when he broke ranks with the rest of the oil companies in a public statement at Stanford University. He said, ‘We actually think global climate change is a very serious problem and we are going to reduce our own emissions by 10 per cent using a system of internal checks and balances.’ The statement led to much speculation about BP’s intentions for making the statement but according to HBS Professor Forest Reinhardt, the best explanation was that BP thought it could build a stronger and better culture for the future within its own organisation. ‘Young people are increasingly worried about these problems of the environment…They want to work at companies whose values are similar to their own… [BP] can have people who bring more energy and passion to their jobs if the firm for which they work is consonant with their own values’.

NGOs, Consumers and Governments

In 1995, the well-known apparel and shoe company, Nike, tied up with factories in Sialkot, Pakistan to manufacture well-made footballs. The work was sub-contracted around local villages and children as young as 10 years old were drawn into the production process. June 1996 issue of Life magazine carried an article about child labour in Pakistan with a picture of 12-year old Tariq surrounded by pieces of leather that he will spend the day sewing up for as little as 80 cents.

In a matter of weeks, activists all across the US and Canada were standing in front of Nike outlets holding up Tariq's picture. Consumers, including children, returned used Nike shoes to stores as a symbolic form of protest. Sustained strong criticism from customers and NGOs/ activists:

(i) Prompted Nike in 1998 to accept periodic inspection visits to factories in Pakistan. The company also promised to root out underage workers and require overseas manufacturers of its wares to meet strict US health and safety standards.

(ii) In February 1997, representatives of the soccer ball industry signed a partnership agreement with UNICEF and International Labour Organisation to address the issue of child labour in factories of south-east Asia where soccer balls are sewn.

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Concerted action by NGOs, activists, consumers, governments and international agencies compelled Nike to not 'just do it' but 'do it right'.

Investors, Community and Government

Public image of Royal Dutch Shell, the global oil giant, had been badly tarnished as a company that damages the environment and supports corrupt regimes with atrocious human rights record, particularly in its Nigerian operations. Shell relies on Nigerian oil and gas for about 10 per cent of production; Nigeria is also home to some of its most promising reserves.

However, proximity of Shell to the ruling regime and its silence or connivance in the country's terrible human rights abuses sparked off protests and boycotts worldwide by NGOs and international campaigners. In 1997, more than 10 per cent of its investors voted in favour of a shareholders' resolution that called on the company to

improve its corporate responsibility policies. A further 6.5 per cent of shareholders abstained, marking a record lack of support for Shell's board.

Honest soul-searching by senior Shell executives led them to conclude that successful businesses in the modern world are not built around the pursuit of profits alone. Care of environment, human rights and 'sustainable development' are equally important issues. It led chairman of Shell in Nigeria to admit '…we recognise that our development activities in the past have been less than perfect.'

In an example of good corporate governance, in 2003, Shell commissioned an independent report to help it understand better how its activities are affected by and inadvertently contribute to conflict. Although the report was not made public, Shell is supporting the creation of a working group made up of Nigerian and international experts and representatives of local communities to explore ways to stem the conflict.

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In 2003, Shell also contributed $54.5 million to the government-backed Niger Delta Development Commission as well as $30 million for its own community development programme.

VALUE REPORTING AND HIGHER MARKET RETURNS

Such a wide spectrum of stakeholders will logically face different information needs. Traditional reporting tools applied by companies and accepted by regulators deal with historical facts, that is, reporting after the event is over and a bulk of it has to be broken down into financial figures.

This leaves out many key value drivers of a company—brands, knowledge, and people, to name a few.

Traditional financial reporting can be frightening in its complexity and many 'financially literate' people have confessed being unable to understand the real import of reported information. Suppose there are two companies, Company A and Company B similar in size, market capitalisation, market standing and also

financials. The difference is that Company A is a single-business company with easy-to-understand financials whereas Company B is a multi-business, multi-national company with complex reporting.

Chances are that Company A will have better market valuation than Company B. That is because investors crave transperancy and Company B's opaque and complex reports make investors perceive it as risky and hence less valuable.

More information means more certainty. Complex holding—subsidiary company relationships, cross-holding investments in group companies, off-balance sheet items or Enron's much-maligned Special Purpose Vehicles (SPVs) hide from view a company's real performance. Opaqueness may range from actual inaccurate reporting to defraud investors to information that is misleading but technically correct.

The South African corporate governance framework, King II says, investors deserve a forward-looking approach to reporting…While financial reporting provides a valuable record of where a company has been, non-financial information provides an indication of where a company is going and how it will get there.

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Progressive companies the world over are trying to deal with this in a number of innovative ways and provide new types of information that goes beyond the minimum required by regulation. Much of such reporting is at an experimental stage with companies voluntarily providing forward-looking statements, with inevitable assumptions, projections and forecasts.

PricewaterhouseCoopers has carried out a study to explore how this experimentation can be consolidated into a proper framework that the corporate sector may use to create lasting value. The research effort, which covered over three thousand CFOs, investors and analysts globally, is codified into the ValueReporting Framework.

The ValueReporting Framework has identified four critical blocks of information that are common to all industries.

These are:

Market Overview	Strategy	Value Creating Activities	Financial Performance
Competitive Environment Performance	Goals and Objectives	Customers	Financial Position
Regulatory Analysis Environment Policies	Organisational Design	People	Risk Profile
Macro-economic Environment	Governance	Innovation	Economic
		Brands	Segmental Analysis
		Supply Chain	Accounting Polices
		Environment, Social and Ethical	

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These four blocks of information proceed in a cascading manner starting from market overview through other blocks.

(i) A logical start to assessment of any business is to appreciate the environment in which it operates. Factors affecting the market place have a decisive impact on a company's present and future aspects. For instance, when the regulatory environment in India regarding quality of ground water was revised, it had an immediate effect on the fortunes of cola giants Pepsi and Coca-Cola. When companies effectively communicate critical factors about the environment in which they function, readers are better able to analyse the company's performance.

(ii) Once market overview is clearly articulated, company strategy can be properly understood to compete within that environment. Strategy is the blueprint that guides company actions towards achieving desired goals, of identifying areas of competitive advantage and how the company proposes to capitalise on those advantages.

(iii) Having established and communicated the company's strategy to operate in a given environment, management must then link corporate efforts towards specific value creating activities to deliver on that strategy. Most value creating activities are common to companies, like, value of its human capital and brand equity, retaining or winning anew the loyalty of its customer base, strength of its supply chain or the advantage of innovation. The relative importance of each element will depend on individual corporate strategy. (See example of Infosys in giving information about its brands mentioned above.) Such depth of information provides a balanced scorecard for investors and management to accurately assess the direction in which the company is headed and whether its strategy is workable. Financials, usually historical in nature, alone do not give management critical information to take corrective action at an optimal time.

(iv) Finally, all these activities are measured in terms of economic outcome that shareholders look for. Of course, traditional financial reporting provides most of the information needed by management and investors. For instance, detailed segmental analysis over and above what is required by regulation, clear communication of accounting policies adopted and candid reasons for changeover, if any, economic performance that directly measures increases to shareholder value, etc.

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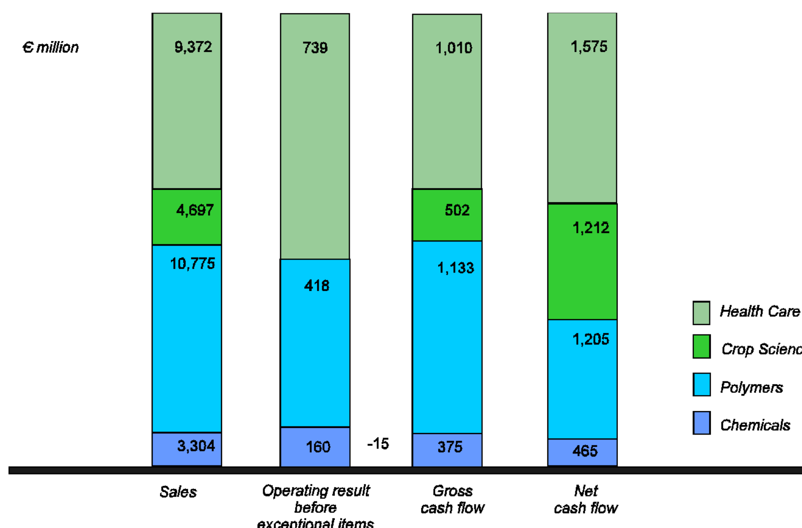
BAYER- Financial Report : Performance by Business Area



Source: Trends in Corporate Reporting 2004-2005, Towards Value Reporting, PricewaterhouseCoopers,p 148

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This reporting provides clear analysis of each business segment and graphically illustrates performance of each segment.

Linking these information elements in a coherent manner allows evaluation of companies' performance and comparisons between companies. It helps to assess performance in the context of total corporate activity. Although to the outsider a company presents a composite entity, anyone who has worked in a large corporation knows that individual business units or even departments in a unit generally co-exist like feudal fiefdoms bound in a loose alliance.

When information is reported in a structured manner, it makes assessment of inter and intra company dealings much more meaningful.

The more companies say about where they are making money and how they are spending their resources, the more confident investors can be about the company's fundamentals.

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According to Robert G Eccles, author of *Building Public Trust—A Value Reporting Revolution*, transperancy pays. Companies with fuller disclosure win more trust from investors. Relevant and reliable information means less risk to investors and thus, a lower cost of capital, which naturally translates into higher valuations. Eccles' key finding is that companies that share key metrics and performance indicators that investors consider important are more valuable than those companies that keep information to themselves.

STATUS QUO IS NOT AN OPTION

With every major corporate scandal, investor confidence takes a beating and exerts a downward pressure on the economy. For instance, Brookings Institution estimated that the problems arising out of corporate governance in the US from December 2001 to July 2002 alone directly cost the US economy between 0.2 per cent and 0.5 per cent of GDP ($US20 to 50 billion) in the year.

Closer home, during the East Asian financial crisis, stock prices of firms in crisis affected countries generally did not fall as much when they had better corporate governance as measured by higher level of disclosure (for example, whether they issued ADRS in the US markets or had one of the then 'big 6' firms as auditors) and more outside share ownership.

Despite suffering major shocks in the crisis, Singapore and Australia fared relatively well, partly because their companies, banks, public institutions and domestic economies were governed well and in good shape.

Governance mechanisms are not a guarantee that companies will not fail—capital markets absorb and discard companies in the normal course. The main objective of installing good governance mechanisms is to reduce the likelihood that companies fail because of management failure or breakdown of ethics. Better governance also reduces the risk of macroeconomic instability by containing the types of shocks to which an economy is exposed and to deal effectively with negative shocks when they occur.

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Edward D Breen, who was appointed CEO of Tyco following allegations of fraudulent financial reporting, commented on the state of the quality of corporate governance at Tyco:

The most important thing in my opinion, when I came into the company and I've stated this many times, was *fixing* (emphasis added) corporate governance…

Market forces have sent out a powerful message—that there is a heavy price to pay for failing to meet corporate governance standards of the day. Someday abuses will be uncovered and the price must be paid.

Broken down into bare essentials, corporate governance regulations merely strengthen the role of directors as agents of the real owners and reinforce the role of management as 'delivery boys' of the owners' interests. Of course, for corporate governance to bear results, focus has to move from the CEO and boards and move to all components of the market including regulators, banks, analysts and also private companies.

The biggest advantage of instituting a formal process of governance is that it makes the company and its employees examine each process critically. Review of processes may evoke responses like, 'we've always done it this way' but as any experienced manager will vouch, somewhere along the way, executives will tend to gloss over details or leave some corners uncovered.

Yes, documenting processes sometimes does expose to the danger of over-simplifying things—adopting a check-the-box approach—yet it is still the most proven way of stitching up processes.

The McKinsey Investor Opinion survey questionnaire very boldly adopts check-the-box and easy-to-verify approach to quantify good governance with very successful results. Some parameters for judging good governance were: majority of outside directors, stock holding of directors, formal director evaluation process, responsiveness to investor requests, etc. Skeptics may argue that these pointers end up trivialising the governance process but results of the survey prove that complying with norms is a useful step towards institutionalising governance processes.

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For example, the first step in the process of implementing or improvement of governance practices is to have a formal code of conduct. Companies are compelled to distill noble corporate resolutions and intentions into a few clearly defined and easily understandable statements. Codes help to focus attention and ground promises to achievements.

While codes of conduct are a good starting point, it is crucial to translate good intentions into practice—into a bigger strategy of competitive business.

It is a dangerous trend when companies promote mission statements without organisational commitments and reorganisation to implement these ideas.
Consider the case of Starbucks, a niche coffee retailer that started in the US. In 1994, Starbucks suffered embarrassing grassroots protests because it was sourcing coffee beans from export houses that exploited slave labour in the coffee farms of

Guatemala. It prompted Starbucks to adopt a code of ethics and it cost the company little. However, it could not change the labour conditions in Guatemala—the prime reason for facing protests—because it was a small player in international coffee business. Enforcement of the code was also very slow as it depended on review of plantation conditions by Guatemalan coffee growers' association—the very organisation that was accused of promoting exploitative working conditions. Ironically, Starbucks won a prestigious award for its code of ethics.

There are many reasons why Enron went down but absence of an excellent code of governance was not one of them. Only, that excellent code was not practiced.
Corporate governance is an ongoing process of conduct and should not be seen as a compliance tool for setting right ethical misdeeds or bad corporate decision-making. As the introduction to Narayan Murthy Committee Report on corporate governance states, '…failure to implement good governance can have a heavy cost beyond regulatory problems. The evidence suggests that companies that do not employ meaningful governance procedures can pay a significant risk premium when competing for scarce capital in public markets.'

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Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of communities within which they operate.

Modern businesses are moving from companies' *mantra* of '*trust me'* to consumers' demands of '*show me*'—public demands for companies to be more transparent and more accountable for a wide range of actions.

A corporation, like a democracy, may not be the best but is still the most viable mechanism that modern civilisation has, to make great improvements in living standards of a large number of people. We must all work towards making this workhorse of modern life deliver efficiently.

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