

## 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.<sup>1</sup> 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

<sup>1</sup>See 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 standards<sup>1</sup> for both annual and quarterly reporting.

**Shareholder equality**

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

<sup>1</sup>Generally 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).<sup>2</sup> 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,<sup>3</sup> 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.<sup>4</sup>

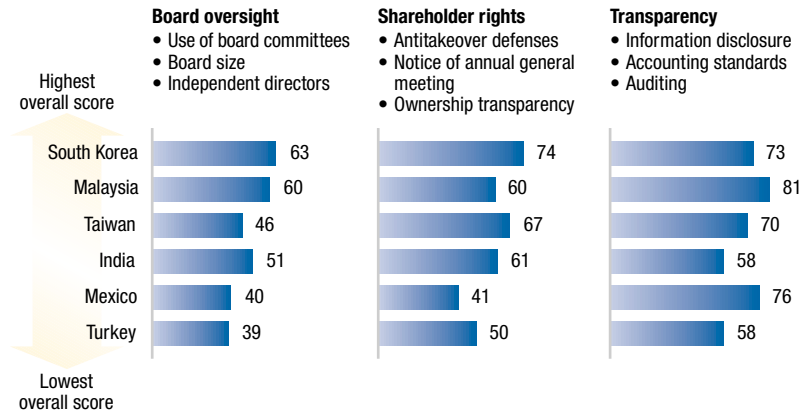
<sup>2</sup>We used least-squares regressions, with the company's price-to-book ratio as the dependent variable and the corporate-governance score as the independent variable.

<sup>3</sup>We 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.

<sup>4</sup>This result was statistically significant at the 95 percent confidence level.

## EXHIBIT 2

## Ratings race

Aggregate corporate-governance score,<sup>1</sup> percent

<sup>1</sup>Includes 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> Among other things, the country's government required major

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

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

<sup>7</sup>For 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 revealed, 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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Applications are now open for Good Governance Awards 2019 which is an initiative that recognises and encourages adherence to good governance practice by nonprofits in Ireland.Â Premium NGO Management Resources. How NGOs can Develop the Perfect Pitch Deck for their Projects? How to Organize Nonprofit Fundraising Events? 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?Â @inproceedings{Newell2002APF, title={A Premium for Good Governance. (Corporate Governance)}, author={Roberto Newell and Gregory Wilson}, year={2002} }. Good Governance - What is Good Governance? Click to read an essay on good governance, 8 characteristics of good governance, World Bank definition, etc. for the UPSC IAS Exam. Download good governance notes PDF for IAS 2020 and other competitive exams.Â Good Governance - Introduction, Definition & Characteristics [UPSC GS-II]. The actions that a government takes to manage its affairs in a state or a country are to be called as governance. It can be positive or negative; good or bad keeping in note the outcomes of the governance and how the citizens/public receive them. Good governance is a term of increasing importance in today's world order.