Manuel Ammann
Professor of Finance, University of St. Gallen, and Director, Swiss Institute of Banking and Finance

David Oesch
Asst. Professor of Finance, University of St. Gallen

Markus Schmid
Professor of Finance, University of Mannheim

Are better governed companies rewarded by capital markets?

It's always beneficial for a firm to implement better corporate governance as a means to align management's interest with those of shareholders. In fact, corporate governance should be understood as an opportunity rather than an obligation and pure cost factor

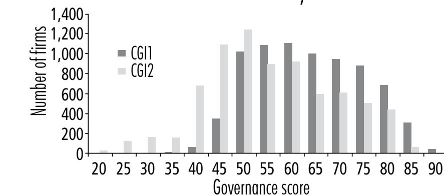
The separation of ownership and control is a fundamental problem present in all large companies. By giving control over day-to-day business matters to management, the owners of the company (*the shareholders*) run the risk that a company is not managed in a way that is consistent with the maximisation of their interest. A prominent example of the agency problem is the consumption of perquisites by managers. While it may be beneficial for a manager to use company resources to pay for a lavish office or a company aircraft, shareholders would perhaps prefer a more productive use of the firm's resources. There are a number of measures that shareholders can take to either exert effective control over the managers' activities or to align management's interests with those of shareholders. The combination of all these measures is usually subsumed by the term "corporate governance". However beneficial better corporate governance may be, its implementation is often accompanied by considerable costs for a firm as evidenced by the costs that governance improvements mandated by the Sarbanes-Oxley Act of 2002 imposed, especially on smaller firms. It thus remains an empirical question whether the implementation of corporate governance measures can benefit a company overall or the costs outweigh the benefits. The question is remarkably timely with many governments around the world putting in place more stringent corporate governance laws in the wake of the financial crisis, most notably the US, where the Dodd-Frank Act passed in 2010 includes several governance-related items.

If a company's board does not consist of more than 50% of independent directors, it is interpreted as a sign of bad corporate governance since one mechanism to control the CEO is potentially weakened.

Recent evidence on the beneficial effect of corporate governance is reported in our paper "Corporate Governance and Firm Value: International Evidence", published in the Journal of Empirical Finance in January 2011. In this paper, we investigate whether companies that implement better corporate governance are rewarded by capital markets by means of a higher firm valuation. To construct a measure of corporate governance on the firm level, we use a database compiled by Governance Metrics International (*GMI*), which assembles information on 64 individual corporate governance attributes for roughly 2,000 companies from 22 countries for the time period from 2003 until 2007. The 64 attributes are classified into six different categories, namely board accountability, financial disclosure and internal control, shareholder rights, remuneration, market for control, and corporate behaviour. As an example, one attribute in the category "board accountability" indicates if a board consists of more than 50% of independent directors. If this is not the case, it is interpreted as a sign of bad corporate governance since one mechanism to control the CEO is potentially weakened. Combining the 64 individual measures into a corporate governance index, we empirically test if companies with a higher governance index have a higher firm value. Using many different statistical tests, we find a positive effect of better corporate governance on firm value. Therefore, if a company implements more

Empirical distribution of governance scores for CGI1 and CGI2

The means of both sets indicate a symmetric distribution

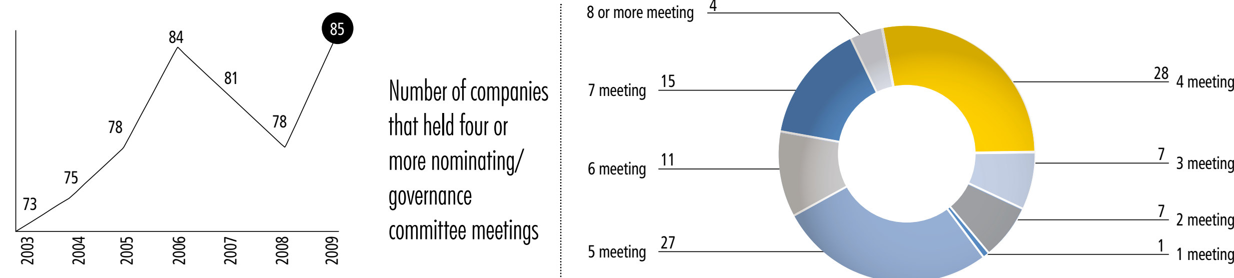


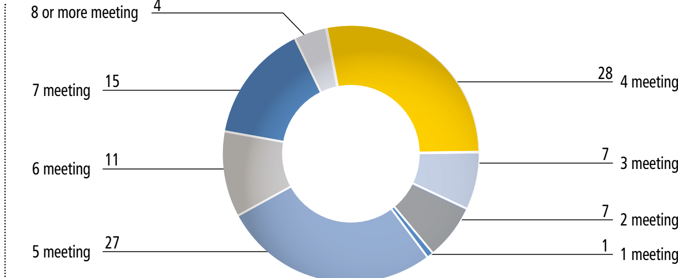
Source: Corporate Governance & Firm Value: International Evidence

The positive valuation effect of CSR is restricted to firms with a good corporate governance structure.

Number of nominating/governance committee meetings by top 100 US public companies

During 2009, 85 of the top 100 companies held four or more nominating/governance committee meetings





Source: Shearman & Sterling LLP

Global top 10 in corporate governance

Good governance results in higher firm value

Score	Company	Score
1.	Royal Dutch Shell	82.0
2.	Bursa Malayasia Berhad	79.0
3.	Nexen	79.0
4.	Infosys Technologies	78.5
5.	Cisco Systems	77.0
6.	Life Technologies	77.0
7.	Pacific Basin Shipping Limited	76.3
8.	Fedex	75.5
9.	Novartis	75.5
10.	Intel	75.0

Source: IR Global Rankings

Statistical tests indicate that better corporate governance indeed causes higher firm valuations and that causality does not run the other way.

measures to strengthen the quality of its corporate governance, it can expect a reward by capital markets in the form of a higher firm valuation. This finding holds for our whole time period as well as for individual years and also for all sample countries combined as well as for the majority of individual countries.

Over the last few years, there has been much debate about companies' corporate social responsibility. The richness of the GMI dataset allows us to investigate whether this particular aspect of corporate governance also has an effect on firm valuation. As indicators of corporate social responsibility we use variables that indicate, for example, if a company has a policy addressing workplace safety, if a company discloses its environmental performance, or if a company discloses its policy regarding corporate level political donations. Combining these attributes to a measure of corporate social responsibility, we find that companies with better corporate social responsibility are more highly valued than companies with comparatively worse corporate social responsibility. The value relevance of these attributes is also robust to controlling for the effect of standard corporate governance attributes. Moreover, we find that the positive valuation effect of corporate social responsibility is restricted to firms with a good corporate governance structure. Hence, good corporate governance seems to assure that corporate social responsibility expenditures are profit-oriented rather than serving the managers' personal ambitions, for example to improve their reputation as good global citizens.

Establishing a statistical relationship between corporate governance and firm value leaves an important question unanswered: Does corporate governance actually cause higher firm valuations or could it be the case that causality runs the other way and more highly valued firms implement better corporate governance? One potential explanation for such reverse causality could be that higher valued firms are more likely to have the financial and managerial resources necessary to put better corporate governance in place. If such an alternative explanation was true, the results of our study would not allow the conclusion that firms can actively increase their valuation by improving corporate governance. In our study, we are able to account for this so-called "endogeneity problem" by applying various statistical techniques that allow us to determine in which direction causality runs. The results of our statistical tests indicate that better corporate governance indeed causes higher firm valuations and that causality does not run the other way.

Overall, the results of our research suggest that it's always beneficial for a firm to implement better corporate governance as a means to align management's interest with those of shareholders. For the average firm in our sample, the costs of implementing corporate governance mechanisms seem to be smaller than the resulting monitoring benefits. Thus, from the companies' perspective, corporate governance should be understood as an opportunity rather than an obligation and pure cost factor. BFM