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CORPORATE GOVERNANCE QUALITY

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Abstract

Corporate governance quality in most countries has overall improved, although to varying degrees and with a few notable exceptions. Corporate governance issues are especially important in emerging countries, since these countries do not have the long-established financial institution infrastructure to deal with corporate governance issues. This paper discusses how emerging countries are dealing with corporate governance quality issues. In emerging countries the impact of improvements in corporate governance quality on traditional measures of real economic activity was positive, significant, and quantitatively relevant, and the growth effect is particularly pronounced for industries that implemented principles and codes of corporate governance.

Key words: corporate governance quality, corporate governance principles, emerging commerce
JEL classification: G30, G38

1. Introduction

The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has therefore become a necessary prerequisite for any corporation to manage effectively in the globalized market.

The term "corporate governance" is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle&Means (1932) and the even earlier Smith (1776).In the last two decades, however, corporate governance issues have become important not only in the academic literature, but also in public policy debates. During this period, corporate governance has been identified with takeovers, financial restructuring, and institutional investors' activism. One can talk about the governance of a transaction, of a club, and, in general, of any economic organization. In a narrow sense, corporate governance is simply the governance of a particular organizational form - a corporation.

Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan assert that governance determines how the firm's top decision makers actually administer such contracts [Garvey and Swan, 1994].

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Shleifer&Vishny define corporate governance by stating that it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment [Shleifer&Vishny, 1997]. A similar concept is suggested by Caramanolis-Cötelli, who regards corporate governance as being determined by the equity allocation among insiders and outside investors [Caramanolis-Cötelli, 1995].

John and Senbet propose the more comprehensive definition that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected [John&Senbet, 1998]. They include as stakeholders not just shareholders, but also debt holders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart closely shares this view as he suggests that corporate governance issues arise in an organization whenever two conditions are present [Hart, 1995]. First, there is an agency problem, or conflict of interest, involving members of the organization – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract.

Zingales defines corporate governance as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm [Zingales, 1997]. He considers that all the governance mechanisms discussed in the literature can be reinterpreted in light of this definition.

An OECD study considers that corporate governance is the system by which business corporations are directed and controlled (1999). The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

Roe define corporate governance as the relationships at the top of the firm - the board of directors, the senior managers, and the stockholders (2004). In his opinion institutions of corporate governance are those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm.

Core corporate governance institutions respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders).

A few studies have examined corporate governance in emerging markets. Researchers [Claessens&al, 1999; La Porta&al, 1999; Lins, 2000] have studied the implications of the concentrated corporate ownership that is common in many emerging and developed markets and conclude that the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders.

2. Improving corporate governance

Corporate governance is receiving substantial attention in developed countries. Think tanks and business associations throughout the developing world and in the transitional economies are also focusing resources on corporate governance.

In order for corporate governance measures to have a meaningful impact in any economy, a set of core democratic, market institutions, including a legal system to enforce contracts and property rights, needs to be up and running. Yet, in most developing economies, even the most basic democratic, market institutions may be weak. Given these circumstances, instituting corporate governance in developing and emerging markets requires more than merely exporting well-established models of corporate governance that function within the developed economies. Special attention needs to be given to establishing the necessary political and economic institutions that are tailored to a country's specific needs and that give corporate governance effectiveness.

Each region is in a different stage of establishing a democratic, market-based framework and a corporate governance system. Hence, each nation has its own particular set of challenges. Some of the general challenges confronting developed and emerging economies include [Adegbie-Quaynor, 2007]:

Table 1: Corporate Governance Problems

Developed country	**Developing countries**
■ Dispersed ownership: agency problems between shareholders and managers ■ Empire building of CEOs ■ Excessive remuneration (stock options) ■ Insider trading ■ Defense mechanisms (poison pills, staggered boards) ■ Non-disclosure of information ■ Internal control problems (independence of auditor)	■ Concentrated ownership: agency problems between controlling and minority shareholders ■ Ineffective Boards – Poor Capacity – Passive Approach – Low independence ■ Conflicts of Interest; ■ Minority Shareholder mistreatment, especially in change of control situations ■ Succession / Family Business Issues ■ Transparency / Internal Controls / Audit Function

Although instituting corporate governance is clearly beneficial for firms and countries, the rapid pace of globalization has made the need urgent. Doing so requires that firms and national governments make some fundamental changes. Companies must change the way they operate, while national governments must establish and maintain the appropriate institutional framework.

Efforts to improve corporate governance by establishing international standards began roughly 15 years ago and have recently gained enormous momentum.

In Table 2 are presented the main countries which develop full texts of corporate governance codes, principles of corporate governance and corporate governance reforms both in developed countries and developing countries. CGRI (corporate governance regulation index) is the product between years of development and number of acts.

Table 2: Corporate governance regulation index

Countries	**Development period**	**Number of acts**	**CGRI**
Developed countries			
Australia	1995-2007	9	117
Austria	2002-2007	4	24
Canada	1994-2007	7	98
Denmark	2000-2007	4	32
Finland	2003-2007	2	10
France	1995-2007	6	78
Germany	1998-2007	11	110

Iceland	2004-2007	2	8
Ireland	1999-2007	1	9
Italy	1998-2007	5	50
Japan	1997-2007	5	55
New Zealand	2003-2007	5	25
Norway	2004-2007	4	16
Portugal	1999-2007	6	54
Sweden	2001-2007	5	35
Switzerland	2002-2007	3	18
Netherlands	1997-2007	6	66
United Kingdom	1992-2007	21	357
USA	1997-2007	12	132
Emerging countries			
Bangladesh	2004-2007	1	4
Brasil	1999-2007	3	27
Bulgaria	2007	1	1
China	2001-2007	2	14
Cipru	2002-2007	3	18
Czech Republic	2001-2007	2	14
Estonia	2006-2007	1	2
Greece	1999-2007	2	18
Hungary	2002-2007	2	12
India	1998-2007	3	30
Indonesia	2000-2007	3	24
Jamaica	2005-2007	3	9
Latvia	2005-2007	1	3
Lithuania	2003-2007	1	5
Mexico	1999-2007	1	9
Peru	2001-2007	2	14
Poland	2002-2007	4	24
Romania	2000-2007	2	16
Russia	2002-2007	1	6
Turkey	2003-2007	1	5
Ukraine	2003-2007	1	5

Source: European Corporate Governance Institute, "Index of all codes", http://www.ecgi.org

There appear to have been improvements in establishing principles and codes that regularize corporate governance in a few emerging countries [Poland, Brasil, India etc]. This suggests a tendency toward convergence in corporate governance quality across emerging countries. Most of the emerging countries are at the beginning of the developing corporate governance framework process.

3. Corporate governance quality

For the analysis of comparative corporate governance quality I use the works of de Nicolo&al (2006) and Sudarat&Eichengreen (2007). First authors have constructed outcome-based measures of the quality of corporate governance for a wide sample of countries for the period 1994-2003. Last authors updated the corporate governance quality through 2005.

The Corporate Governance Quality index is a simple average of three indicators, called:

- accounting Standards (AS),
- Earning Smoothing (ES),
- Stock Price Synchronicity (SPS).

A. Accounting Standards

The first indicator is a simple measure of the amount of accounting information firms disclose, and is constructed similarly to the index reported by the Center for International Financial Analysis and Research (CIFAR) until 1993.

CIFAR uses information based on the top 8 to 40 companies (depending on data availability) and on 90 items selected by professional accountants CIFAR, 1993).

B. Earning Smoothing

The second indicator is a measure of "earnings opacity" proposed by Leuz&al (2003) and Bhattacharya&al (2003). It tracks the extent to which managers may conceal the true performance of firms using accruals to smooth fluctuations of annual profits. Specifically, it is the rank correlation between cash flows (before any accounting adjustments) and profits (after accounting adjustments) across a set of firms at each point in time. This indicator is an important complement to the first indicator, since a large number of reported accounting items may be meaningless if accounts are seriously manipulated or misrepresented.

C. Stock Price Synchronicity

The third indicator is a measure of stock price synchronicity proposed by Morck&al (2000), given by the average goodness-of-fit of regressions of each company's stock return on country-average return in each year. These authors show that after controlling for other drivers of co-movements in stock prices not necessarily related to corporate governance, more synchronous stock prices are found in countries in which corporate governance is poor and financial systems are less developed.

The overall index and its components are available for 41 countries, including 19 emerging markets, annually for the period 1995-2005.

The evolution of corporate governance for the full sample, individual regions, and emerging and advanced countries is shown in Table 3.

Table 2: Corporate governance quality index

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
All	58.7	60.2	58.0	58.9	60.7	61.1	61.0	63.2	63.9	64.7	65.2
Asia	57.0	58.8	57.7	58.2	59.7	60.7	59.9	60.7	62.2	61.3	61.7
Latin America	52.4	54.7	50.0	53.2	55.4	56.7	54.3	58.9	59.1	60.6	62.4
Europe	60.9	62.2	59.9	60.0	61.9	61.7	61.6	64.6	65.2	65.9	65.5
Others	62.8	63.3	62.9	63.6	65.3	65.7	69.0	68.6	69.0	72.0	74.0

Emerging	55.4	57.5	54.5	56.2	57.5	58.3	57.4	59.3	60.4	60.9	61.6
Advanced	61.0	62.1	60.5	60.8	63.0	63.2	63.5	65.9	66.4	67.3	67.8

Source: Corporate governance indices from 1995-2003 from De Nicolo&al (2006), extended through 2005 by Sudarat&Eichengreen (2007)

There appear to have been improvements in corporate governance both Asia and Latin America, although progress has been a bit slower in the Asian case. This suggests a tendency toward convergence in corporate governance quality across both emerging and developed regions.

4. Conclusion

The crusade to institute rigorous corporate governance is not over once these key political and economic institutions are in place. Well-designed, well-functioning institutions can only enforce existing corporate governance guidelines and codes. If these guidelines or codes fail to address key corporate governance issues, even the best institutions will be unable to offer solutions. Many codes, including the OECD principles, fail to address some corporate governance issues. A crucial weakness of existing guidelines is that the rules do not apply to all corporations equally.

In order to be effective, existing guidelines need to be supplemented to address these types of corporate governance issues as well.

During 1995-2005 there have been improvements in the quality of corporate governance in the last ten years Progress is apparent in a wide variety of emerging markets. At the same time, the comparison with advanced economies suggests that the process is incomplete. The question is whether emerging markets can eliminate this shortfall.

One view would be that effective corporate governance is an organic part of the larger process of economic and financial development and that emerging markets can close their corporate governance quality gap by adopting good corporate governance principles, maintain macroeconomic and political stability, opening to foreign investment is good for corporate governance.

One of the most important conclusions of this paper is that the extent of legal reform in these areas of the law has been impressive. In fact, many of the emerging countries can today boast higher levels of investor rights protection than some of the most developed market economies. Yet, the development of the law has not been matched so far by the development of financial markets. Improving the law in such an environment is at best a partial solution, but will not be rewarded unless a commitment to rule-based governance of markets is made credible.

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