

## Corporate Governance and shareholder value<sup>1</sup>

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*The recent bankruptcy of the Parmalat group underlines the importance of effective corporate governance practices in creating and preserving shareholder value.*

Although the company involved was much smaller<sup>3</sup>, the Parmalat stock market debacle and the repercussions it has had are just as serious as those provoked by the Enron and Worldcom scandals.

The collapse of Parmalat is quite obviously a waste from both an economic and human perspective. It is also a bad sign for the global financial community on the eve of the enlargement of the European market, as it highlights the weaknesses of corporate governance practices in Europe.

European accounting standards have long been considered superior to those applied by US companies. Furthermore, the presence of majority shareholders or influential bankers on Boards has always been thought to make our corporate governance systems more robust. However, it is time to wake up to the truth: accounting can do little to prevent organized fraud.

In practice, only a strict adherence to corporate governance principles can limit this type of behavior (although unfortunately, it cannot stamp it out completely).

However, the situation should not be misjudged: what is needed is not merely for companies to ensure compliance with the regulation or follow marketplace recommendations which are often too vague or are not strict enough. Too many companies consider that they have fulfilled their corporate governance “obligations” once they have set up one or two committees, appointed high-profile “independent” directors or arranged for Board of Directors’ meetings to be held more frequently.

This attitude is not only futile but also fatal in the medium-term as it fails to take account of a well-known fact: effective corporate governance practices are essential to value creation, and investors will be increasingly able to separate the wheat from the chaff.

### *Corporate Governance and Performance*

There are a large number of studies pointing to a strong correlation between corporate governance practices and the financial results and market performances of companies.

Based on a corporate governance index including over 20 provisions, many of which relate to shareholder protection, researchers in the US have demonstrated that in terms of market performance, companies with effective corporate governance practices

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<sup>1</sup> Parts of this article have been published in “Le Nouvel Economiste” (January 16, 2004), “Business Digest” (February 2004), and “Option Finance” (March 2004).

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<sup>3</sup> Parmalat, Italy’s leading food group with sales of EUR 7.5 billion, traded at EUR 1.8 billion at the end of November 2003. Following revelations of its true financial position in December, its value fell by more than 95% to EUR 90 million.

consistently outperform (+ 8.5% over the 1990s) those without an efficient corporate governance system<sup>4</sup>. Many studies confirm that in general, the independence, competencies, organizational abilities and motivation of directors are key factors in value creation. The alignment of managers' interests with shareholders' interests through a system of compensation linked to company performance can also help to increase shareholder value (even though the spate of abuses recently witnessed has prompted the conditions in which such compensation should be granted to be reconsidered).

These analyses of the impact of certain components of good corporate governance practices are supported by a smaller number of global studies. In this regard, a survey of institutional investors conducted by McKinsey in 2002 confirmed that the issue of corporate governance is at the very heart of investment decisions. Most of the investors surveyed were willing to pay a substantial premium for companies that had adopted strict corporate governance standards: between 12% and 14% in Western Europe and the US, between 20% and 25% in Asia and Latin America and around 30% in Eastern Europe and Africa.

Most of the studies conducted on this topic thus corroborate what financial theory has been saying for several decades<sup>5</sup>. A company is fraught with many conflicts of interest: firstly, between professional managers and shareholders, but also between shareholders and bankers and even between shareholders themselves (majority/minority shareholders). These conflicts of interest are the source of a number of problems: non-optimal investment or financing policies, exorbitant personal benefits. They also generate information costs (reporting and communication policy), audits cost , as well as transaction costs that are ultimately borne by the shareholders.

Effective corporate governance practices are one of the ways in which conflicts of this kind can be resolved. The aim of such practices is to protect the interests of shareholders by monitoring management more closely, either directly, by specifically reserving a certain number of powers for the General Meeting of shareholders, or indirectly, through a Board of Directors intended to represent shareholders' interests. The costs of a good corporate governance system should be largely offset by the costs that would result from poor governance practices.

### *Competitive advantage and value*

Serving as an interface between the financial markets and the company, good corporate governance practices are essential for forging and maintaining shareholder confidence.

Historically, shareholder confidence was primarily based on the concept of competitive advantage, a critical component in measuring company value. By strategically justifying the existence of a positive difference between economic returns and the cost of capital, this concept is synonymous with value creation. Faced with a competitive advantage that was generally sustainable over time, investors would base their expectations of returns or risk assessments on historic or current results that reflected the competitive advantage held.

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<sup>4</sup> Corporate Governance and Equity Prices, Gompers, Paul A. - Ishii, Joy L. - Metrick, Andrew, 2001.

<sup>5</sup> Agency theory: Bearle and Means (1932); Coase (1937); Jensen and Meckling (1976)

This simple relationship has become far more complex in the new economy,<sup>6</sup> which is characterized by incessant change. With the advent of new technologies and development models based on the creation of future options, the emergence of networks of companies where the value created is collective rather than individual, and the shortening of product life cycles and the life of production processes, competitive advantages have become both easier to create and more difficult to sustain.

Accordingly, investors take a number of different factors into account in their analyses. They no longer seek to obtain assurance that a company's competitive advantage can be sustained, but endeavor to assess the company's ability to renew its advantage on an ongoing basis. More importance is placed on the ability to effectively execute a modest, and undoubtedly opportunist strategy, than on the ability to design a grand, faultless strategy which proves unworkable in practice.

This obvious remark has been widely confirmed over the past few years and it has prompted repeated calls from across the board for an overhaul of financial reporting to include more qualitative data reflecting the company's capabilities.

In addition to a company's potential for value creation in the long-term, investors must also consider any possible abuses that may creep into the way in which the value created is distributed among the stakeholders involved (majority and minority shareholders, corporate officers and creditors). Transfers of value in favor of one of these categories can occur. These personal benefits may be either pecuniary (such as transfer prices, preferential agreements or exorbitant compensation), or non-pecuniary (access to privileged information, capacity to wield political or social influence, etc.).

While such cases of value transfer are often carried out in full compliance with the law (or, even if they are not, are carried out under wholly legitimate or equitable conditions), this is not the case with misappropriations of funds, which have been observed in a number of stock market fiascos, including, it now appears, Parmalat. These misappropriations are made possible due to a lack of internal controls or to the inefficiency of such controls, for which the Board of Directors is generally held ultimately responsible. The complex structure of multinationals from both a tax and legal standpoint only serves to make matters worse.

### *Corporate governance, the cornerstone of value*

In light of the uncertainties surrounding the decisive factors underlying value creation, and the risks associated with the complexity of organizations, it is no surprise that investors' analyses are placing more and more importance on companies' corporate governance practices.

Institutional investors have firmly embarked on this route. Institutional investors in the US are currently required to inform the market of the corporate governance principles underpinning their votes at general meetings of shareholders. This practice, which will gradually spread to Europe, will require companies to take a clear stance on how their corporate governance systems should be organized.

Best corporate governance practices are well-known. However, companies need to focus on the extent to which such practices are adapted to their particular situation,

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<sup>6</sup> "Value creation in a connected economy", J.-F. Rérolle, *Analyse Financière*, September 1998

and in particular, their size, maturity and industry, the market on which they trade, their legal structure, the geographical distribution of their capital, and the size of their floating capital, etc. It is obvious that a group listed on the New York and Paris stock markets whose stock ownership is widely dispersed across the international spectrum cannot have the same corporate governance system as a family-controlled company listed on the Paris *second marché*. Each company must pursue its own individual course by deciding which governance structure is best adapted to its internal and external needs: there is no size fits all in Corporate governance.

At the center of all decision-making and control functions, the Board of Directors is a key component in value creation and distribution. It is responsible for approving the company's major strategic decisions, identifying any risks to which the company is exposed and ensuring that these risks are managed appropriately. The Board must also appoint, evaluate and monitor its management executives. Finally, it acts as a guarantor of quality for the information provided to shareholders. The company has the burden of proof in terms of the competencies, independence and commitment of its directors.

A system to protect shareholders' interests must also be put in place and, in this regard, actions often speak louder than words: for example, the practice of using a bank acting as an advisor for a given transaction to certify the fairness of said transaction, even though the remuneration paid to the bank is linked to the success of this transaction, should be forbidden.

Above and beyond the corporate governance systems adopted, companies should also bear in mind that they are ultimately seeking to regain market confidence. Whether or not they succeed in this will depend on the ability of their governance systems to comply with a number of simple rules which underpin the policies pursued by institutional investors: equitable business practices, efficiency, accountability and transparency.

The means serve the ends. It is vital for management to behave in an exemplary manner and to ensure that the methods it deploys with respect to decision-making and control are transparent. The stance adopted in the French Law on Financial Security, by requiring a report by the Chairman on the preparation and organization of the Board of Directors and the internal control procedures put in place by the company, can only serve to strengthen corporate governance practices in France. Yet once again, this is easier said than done, and the new practices will need to prove their worth before they ultimately win the day.