

LEADERSHIP AT THE VERY TOP: Governance Makes a Difference

Company governance can make a difference, but precisely how remains a source of policy and academic debate. The Sarbanes-Oxley Act of 2002 and the revised New York Stock Exchange listing requirements of 2003 mandated greater board independence, and in the wake of Enron's failure in 2001 and other company scandals, many companies have instituted a host of improvements in their governance policies and practices.

Drawing on data on 2,327 companies as of February 2003, Researchers Lawrence D. Brown and Marcus L. Caylor examined company governance in several areas, including audit, board composition, charter and bylaws, director education, executive and director compensation, ownership, and state of incorporation. Institutional Shareholder Services, an independent appraiser of proxy voting and company governance, compiled data on 51 measures of governance, and the researchers found that some but not all of the measures were associated with greater company profitability, value, and cash to shareholders.

The better governance predictors of company performance included whether 1) all directors attended at least three-quarters of the board's meetings; 2) more than half of board is comprised by independent non-executive directors; 3) the nominations committee is entirely composed of independent non-executive directors; 4) the governance committee meets at least annually; 5) board policies are published in the proxy statement, 6) option re-pricing is prohibited, 7) directors and executives are required to own stock, and 8) board performance is annually reviewed. However, contrary to expectations, several measures normally considered indicative of good governance actually correlated with adverse performance, including whether the 1) consulting fees paid to the auditor exceeded the auditing fees paid to the auditor, and 2) directors are elected annually, 3) company has no poison pill or one that was shareholder approved.

Overall, better governed companies are found to have better performance. Firms with relatively poor governance are less profitable, less valuable, and pay out less to stockholders than those with relatively good governance. The average rate of return on equity for companies ranked in the top decile, for instance, stood at 9.2 percent, while the rate in the bottom decile was -6.8 percent. Governance does make a difference.

Source: Lawrence D. Brown and Marcus L. Caylor, "Corporate Governance and Firm Performance," Georgia State University, 2004.