How corporate governance factors can influence financial performance

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- New research by Calvert establishes that corporate governance factors can be positively linked to financial performance.
- Calvert examined how 10 governance factors, ranging from accounting risk to shareholder rights, materially affected financial performance of companies in 49 countries.
- Calvert found that the impact the factors had on corporate performance differed depending on the relative strength of governance practices and rules in its country of domicile.
- The research offers guidance for investors in assessing the impact of governance factors in four country "clusters": Strong practices/strong rules; strong practices/weak rules; weak practices/strong rules; weak practices/weak rules.

Corporate governance overview

At Calvert, we have long considered corporate governance assessments an integral part of company research because they can be an indicator of how well a company identifies material environmental and social factors and manages associated risks and opportunities. Identifying those issues can be the first step in mitigating risk or unlocking long-term value.

However, incorporating governance information into investment decision-making poses challenges. There is an abundance of publicly available data, including measures of board and committee independence, director equity policies, internal pay equity, director elections and shareholder rights to convene meetings. But there is little clarity on which of those measures may be linked to performance, or the impact the rules and practices of different countries may have on those links. The latter is especially relevant as responsible investing becomes an increasingly global phenomenon.

Prior Calvert research suggested that this is a fertile area for study. For example, historically, we have stressed the importance of board diversity when making investment decisions because of the link we found between this factor and corporate performance. This insight suggested that it would be fruitful to look for other differentiating factors in corporate governance.

The research summarized in this paper is designed to improve our understanding of the link between governance factors and performance. We believe it can provide meaningful insights when making investment and engagement decisions.

Framework for analysis

Corporate governance is the overarching framework that sets the direction of a business, including its purpose, goals and strategy. A company's governance structure determines who has the legal power to make decisions within the business and how that power is checked and balanced, including the consideration of stakeholder interests.

Our research found that certain factors within a company's governance structure are linked to corporate performance. However, as we discuss more fully below, the strength of the links varied, depending on both corporate practices and country-level rules within a given country.

Our analysis showed that the state of corporate governance in the universe of 49 countries examined could best be categorized in four clusters:

- Strong corporate practices/strong country rules
- Strong corporate practices/weak country rules
- Weak corporate practices/strong country rules
- Weak corporate practices/weak country rules[1]

Country clusters

The screened section below explains how we developed two indexes, based on practices and rules, to populate the four clusters. Exhibit A shows the results:

Exhibit A

Governance clusters: Sorting countries on practices and rules.

Sources: Calvert Research and Management, OECD, MSCI, as of September 2020. A universe of 72 countries in the OECD governance database was narrowed to 58 that have MSCI governance data; this was reduced to 49 by including only countries with five or more companies.

As we shall see, these distinctions can serve as a guide for investors that allows them to focus on the subset of governance factors that are likely to be financially material within a country context.

Gauging practices and rules

To assign a country to its proper cluster among the four described above, we evaluated its strength along two proprietary indexes for measuring governance:

- **A practices index** designed to classify overall governance practices as "strong" or "weak" based on a bottom-up survey of companies with each country. We examined more than 8,500 companies within 49 countries surveyed by the OECD, using MSCI governance data, across a range of about 100 metrics applicable to 10 broad governance factors (e.g., board effectiveness, accounting risk, pay figures, etc.). Every company received a grade on each factor and we assessed those factor grades at the country-level to assign "strong" or "weak" designations for practices.
- **A rules index** designed to classify a country's overall governance rules as "strong" or "weak," based on a top-down survey of its laws, exchange listing requirements and corporate governance codes. We examined 49 countries and used OECD data across a range of about 34 metrics applicable to accounting, board, ownership and control, and pay. Each governance rules metric received a grade, and we used the aggregate of those scores to assign each country a "strong" or "weak" designation for rules.

[1]For sake of brevity, subsequent references will be to strong practices / strong rules, etc.

Next, we looked at 10 governance factors to determine their relationship between financial performance of all of the companies in the 49 countries. The factors were:

1. Accounting Risk
2. Audit Oversight
3. Board Effectiveness
4. Board Independence
5. Director Elections
6. Ownership Structure
7. Pay Figures
8. Pay Oversight
9. Pay Performance Alignment
10. Shareholder Rights

For each company in the 49-country universe, we regressed these factors on return on assets (ROA), return on invested capital (ROIC), natural log of price-to-equity ratio (P/E) and the natural log of price-to-book ratio (P/B), controlling for country, market capitalization and industry classification.

By aligning the results of these regression analyses within their countries, in their respective clusters, we could identify which governance factors had the most impact on performance of companies with each quadrant. For example, if a factor like board effectiveness showed a significant positive relationship with performance in countries with strong practices and strong rules, would that also be the case in countries with weak practices and weak rules? Or which, if any, of the factors were material across the most clusters?

Each factor represents a composite of indicators to which we typically assign scores as part of our ongoing overall company-level governance assessments and includes information that is broadly comparable between companies. (Note that the factors are substantially similar to the metrics used to construct the practices and rules indexes, but the methodology was tailored specifically for each application.)

Research findings

Exhibit B provides an overview of the material issues we found within each of the four clusters, along with the five largest countries in each cluster, by total market capitalization of listed equities. Within each cluster, we found two to five governance factors to be financially material, with accounting risk and ownership structure most broadly represented across countries.

Interpretations of findings

Our goal in analyzing the results was to determine how the distribution of material factors within the four-cluster organization of Exhibit A could guide investor decision-making. To that end, we observed that the material governance factors fell into three main categories: broadly material factors, basic governance factors, quality governance factors. We discuss each below.

Exhibit B

The materiality of governance factors varies with country practices and rules

	Strong Practices Strong Rules	Strong Practices Weak Rules	Weak Practices Strong Rules	Weak Practices Weak Rules
	Australia Germany Netherlands United Kingdom United States*	Canada* France Sweden Singapore Switzerland	Brazil China Hong Kong India Japan	Mexico South Korea Taiwan Thailand UAE
Accounting Risk	●	●	●	
Audit Oversight				
Board Effectiveness	●			
Board Independence			●	
Director Elections				
Pay Figures		●		●
Pay Oversight		●		
Pay Performance Alignment	●	●		
Ownership Structure		●	●	●
Shareholder Rights			●	

Source: Calvert Research and Management, August 2020. The above classifications are for illustrative purposes and represent the five largest countries by market capitalization in each classification; in total, we classified 49 countries for this research. *To correct for an observed North American bias in disclosure data, companies in the US and Canada are separated from their clusters to calculate scores. Our materiality assessment remains the same.

Broadly material factors

Accounting risk and ownership structure are gateway factors in most countries.

Accounting risk and ownership structure were both found to be material in three of four of our country clusters. As such, we consider these "gateway factors" for investors in almost any country, with a few notable exceptions discussed below.

In some ways, the finding that accounting risk and ownership structure are broadly material is intuitive. Weak performance on either measure would be a flag for most investors. For example, our measure of accounting risk identifies companies for anomalies in financial reporting, e.g., revenues, expenses and asset-liability valuations. These anomalies can signal problems with how a business is run or indicate if there are potential problems with internal controls.

Similarly, weak performance on the ownership structure composite can be an indication of imbalances between share ownership and decision-making power. These imbalances may pose a risk for minority shareholders, who often have limited control or recourse. Our research supports investor caution for companies that lag on these composites with the following two exceptions:

1. Accounting risk was not found to be material in the "weak practices/weak rules" cluster. These countries tend to have weaker enforcement mechanisms, which may result in cover-ups and could be one reason why it is not a point of differentiation as it is elsewhere.
2. Ownership structure was not found to be material in our "strong practices/strong rules" cluster. Investors in these countries tend to be already protected by several layers — i.e., strong conventions and adequate enforcement.

Basic governance factors

Board independence, pay figures and shareholder rights are basic measures of governance performance that emerge as material factors in both "weak practices" clusters.

For instance, fewer than 40% of companies in "weak practices" markets had an independent board majority, compared with 85% in "strong practices" jurisdictions.

In "weak practices/strong rules" jurisdictions like Brazil, China, Hong Kong, India and Japan, the governance basics of board independence and shareholder rights are material to corporate performance, in addition to the gateway factors of accounting risk and ownership structure. These are markets where getting the basics right can make a difference in corporate performance. This means focusing on companies with credibly independent boards and clear respect for minority shareholder rights, which includes "say-on-pay" provisions.

These are markets where policymakers have responded to widespread weak practices by strengthening rules in an attempt to improve governance practices. For instance, in response to corruption scandals, Brazil recently strengthened its regulatory framework to improve disclosure and independence standards. It also added rules aiming to address bribery and create awareness of corruption.

However, our research indicates that it may take a long time for stronger practices to work their way through the system and produce widespread improvement at the aggregate company level. This can be due to ineffective rules or inconsistent — and sometimes weak — enforcement.

In "weak practices/weak rules" jurisdictions, like Mexico, South Korea, Taiwan, Thailand and UAE, the basic issue of pay figures is material to corporate performance, in addition to the gateway factor of ownership structure. In these markets, policymakers have not yet responded to weak practices by strengthening rules. Consequently, without adequate rules, enforcement can become a moot point.

What differentiates one company from another in these markets are baseline measures of absolute pay, including disclosure. Approximately 20% of companies in these markets disclose executive pay, compared with 40% in the "weak practices/strong rules" cluster and more than 86% in the two "strong practices" jurisdictions. Therefore, investors should focus on pay disclosure and compare all-in CEO compensation to the size of the business.

Although South Korea has been regarded as an economic development success story, the quality of its corporate governance remains weak in our framework. The economy is dominated by large family-owned conglomerates ("chaebols"), which have been instrumental in the growth of South Korea's economy, aided by low interest loans and close government connections. Now, however, these firms are criticized for stifling innovation and competition, with minimal regulation by officials or oversight by shareholders.

Related party transactions, generational succession and board independence present risks for investors, but — from a governance perspective — there are opportunities among companies that separate themselves with more balanced ownership structures and disclosure of absolute pay and total compensation.

Our analysis finds that companies in the "weak practices/strong rules" cluster tend to have the highest rate of concerns on board independence compared to all other clusters. For example, 67% of companies did not have an independent board majority, compared with fewer than 46% in all other clusters. For shareholder rights, 83% of companies had not implemented regular "say-on-pay" votes, compared with at most 23% in countries where practices are strong.

Quality governance factors

Strong practices markets allow for further investor differentiation by quality governance.

In "'strong practices/strong rules" jurisdictions, like Australia, Netherlands, Germany, UK and US, the advanced governance quality factors of board effectiveness and pay performance alignment are material, in addition to the gateway factor of accounting risk. These are highly professional markets where board and pay basics are largely ironed out and quality separates the leaders from the laggards.

For example, board effectiveness moves beyond the basic measure of board independence and focuses on board expertise, skills, attendance and entrenchment. This is a proxy for the quality of inputs into corporate decision-making. We also find that pay performance alignment is a point of differentiation in these markets. This factor moves beyond pay disclosure and measures compensation incentives, including how those incentives align with broader shareholder interests.

Although compensation incentives are relatively rare globally, policymakers are increasingly putting incentive-based rules on the table. For example, the UK recently revised its Corporate Governance Code to include a stronger emphasis on culture, pay ratios and alignment of pay outcomes with performance.

In "strong practices/weak rules" jurisdictions, like Canada, France, Singapore, Sweden and Switzerland, we find that all three compensation factors are material to corporate performance, in addition to the gateway issues of accounting risk and ownership structure. While these are highly professional markets with strong customs, the absence of adequate enforcement creates challenges in and around executive pay, which is what separates one company from another.

From a performance perspective, investors should consider how pay decisions are governed, whether a company is transparent about internal pay equity, and whether the CEO pay makes sense for the size and performance of the business.

In Sweden, for example, corporate governance is characterized by strong practices on board independence, board effectiveness and ownership structure, even though written rules on these issues are relatively lenient. One likely reason for the "strong practices/weak rules" classification could be the general trust in public institutions and an emphasis on fairness and personal liberty. However, due to the trust afforded to the boards and the lack of official checks and balances, sound pay practices are what distinguishes one company from another.

Conclusion and further research

The country-level cluster classifications outlined in this paper serve as a foundation for further research that investigates the relationship between corporate governance and financial performance. Given the amount of publicly available information on the governance topic, this research guides company-level assessments toward those factors that are financially material depending upon where a company is domiciled. We think these findings can empower the broader investment community to more meaningfully integrate corporate governance assessments into investment and engagement decisions.

This research was conducted in partnership with George Serafeim and Christina Rehnberg

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Christina Rehnberg is Senior Associate at KKS Advisors. Experienced in econometric analysis and impact assessments, she works at the intersection of finance and sustainability, and helps clients understand the data driving their ESG strategy. Most recently, Christina supported Calvert Research and Management in developing new insights around the relationship between corporate governance factors and financial performance. Previously, Christina investigated capital market reactions to CEO corporate long-term plans at the CEO-Investor Forum, an annual event organized by the Strategic Investor Initiative (SII) of the CEO-led Chief Executives for Corporate Purpose (CECP) coalition.

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Source of all data: Calvert as of September 1, 2020, unless otherwise specified.

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