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*Jean-Paul Page, CFA*  
University of Sherbrooke

# Corporate Governance and Value Creation



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# **Corporate Governance and Value Creation**

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## **Statement of Purpose**

*The Research Foundation of CFA  
Institute is a not-for-profit organization  
established to promote the development  
and dissemination of relevant research for  
investment practitioners worldwide.*

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## Biography

**Jean-Paul Page, CFA**, is professor of finance in the Faculty of Administration, University of Sherbrooke, Quebec, Canada. Previously, he was head of the Department of Finance, where he helped set up a master's program in finance that is recognized as one of the best worldwide.

His research focuses on the minimum rate of return (cost of capital), business valuation, and corporate governance. His books include *Corporate Finance and Economic Value Creation*, *Investment Decisions in the Canadian Context*, and *The Interest Factor in Decision Making*. In addition, he is the author of the monograph *The Practical Aspect of Business Financing* as well as a substantial amount of course material. Professor Page is a frequent presenter at professional association conferences and international congresses.

Professor Page is the recipient of numerous honors, including being named a Fellow by the Certified General Accountants Association of Canada and receiving a Leaders in Management Education prize from *National Post* and PricewaterhouseCoopers, an Outstanding University Award for Innovation and Excellence in Teaching from the University of Sherbrooke, and a Mérite Estrien award from the newspaper *La Tribune*.

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# Foreword

The well-publicized scandals at Enron Corporation, Tyco International, and WorldCom/MCI, together with transgressions within the asset management, insurance, and securities industries, have shined a bright light on the issue of corporate governance. It is now well understood that corporate misconduct has very unpleasant consequences, not only for those who perpetrate the misdeeds but also for employees and shareholders whose jobs and wealth are destroyed. This latter point forms the underpinning of this outstanding monograph by Jean-Paul Page, CFA. Corporate leaders should practice good corporate citizenship not merely for the sake of complying with rules and regulations in order to avoid fines—or worse, prison—but to create value for their shareholders.

Page begins by defining corporate governance, and he does so broadly, arguing that its impact should extend beyond the boardroom to managerial decisions throughout the organization. He then links corporate governance to resource allocation.

Page next promotes the thesis that society demands good corporate governance in order to create economic value, which leads to his argument for the primacy of shareholder interests. He then discusses the delegation of shareholder power to the board of directors and presents a variety of standards by which to evaluate the performance of the board.

Although Page is quite clear about the primacy of shareholders' interests, he acknowledges that other parties also have stakes in the corporation. He presents their claims as constraints on shareholder rights.

In the final section of the monograph, Page presents a framework by which security analysts can evaluate corporate governance systems.

Page also includes several appendixes, in which he reviews many of the practical issues of corporate governance, including laws and regulations, activities of institutional investors, the position of CFA Institute, and corporate governance evaluation.

I find this monograph especially appealing because it extends beyond a litany of good practices and bad practices. Page approaches the subject from a theoretical perspective by establishing the connections between governance, value creation, resource allocation, and shareholder priority. This theoretical foundation facilitates Page's thorough discussion of the practice of corporate governance.

The silver lining in the dark cloud of corporate misconduct is the intense focus on corporate governance by board members, corporate managers, policymakers, and especially, investors. The Research Foundation of CFA Institute is especially pleased to contribute to this critical topic with this excellent monograph.

Mark Kritzman, CFA  
*Research Director*  
*The Research Foundation of*  
*CFA Institute*



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# Preface

Governments and regulatory agencies (the U.S. Securities and Exchange Commission, the provincial Securities Commissioners in Canada, stock exchanges, and others) have intervened substantially in the past three years to reestablish society's confidence in the financial markets and corporate governance. The myriad laws, regulations, and directives have kept the legal aspects of corporate governance in the forefront. Legislators have strengthened the normative framework for conduct and established stiffer penalties for noncompliance in hopes of preventing a recurrence of past abuses. The purpose of these governmental actions was to show that elected officials take their responsibilities for maintaining a fair and efficient market to heart and, at the same time, to put the financial world on notice that society will henceforth demand more transparency, honesty, and integrity.

Although strengthening the laws and regulations was necessary, if only to facilitate legal action, I believe these measures alone are not sufficient to reestablish confidence on the part of investors or, perhaps more importantly, to ensure that companies achieve their purpose: value creation. History has shown that sweeping legislation and severe penalties alone do not motivate people to fulfill their roles in society or to always behave honestly and with integrity. Regardless of the scope of the legislation, liars, cheaters, and thieves will continue to swear they are as pure as the driven snow.

I suggest that, in addition to complying with rules and regulations, companies themselves rectify the problems that have shaken the financial world—problems of managers' lackadaisical commitment to real value creation, the overemphasis on short-term results, and a mind-set that believes wealth can be created without due regard to the rights and privileges of those who contribute to the process. I believe that companies can be made to understand that successful companies are those that set up governance rules that truly favor value creation and that go well beyond the regulations imposed by the State and other agencies.

In the realm of governance, companies have a primary responsibility to comply with laws and regulations—the rules of the game. I assume that the rules are well known and sufficiently explicit to be understood. The purpose of this study is not to propose changes to the rules of the game or to justify or criticize them. To borrow an expression from competitive sports, now that the rules have been established, we must learn how to win the game. My purpose is to describe what a value-creating corporate governance system should be like, establish the standards on which criteria can be based to allow financial analysts to study the governance system in a particular company, and suggest how analysts can go about analyzing a company's corporate governance system. Without explicit, justifiable standards, the evaluation of a complex issue such as corporate governance would be arbitrary and analysts could fail to identify the real sources of the company's success and longevity.

Of course, when describing a perfect world, one runs the risk of overlooking certain conventions and being labeled utopian. In light of the recent events that have shaken investor confidence, however, it is as unrealistic to believe that current corporate governance models need no improvement.

Chapter 1 offers a broad definition of corporate governance and shows its impact on resource allocation and, by extension, on value creation. It also shows that governance is not limited to the structure and operating rules of boards of directors but encompasses all the decisions that managers at all levels of the organization may make.

Chapter 2 explains what society asks of the company (i.e., to create economic value). I begin here because, to use a sports analogy, to win the match, you must first understand the point of the game. Achieving this objective requires that the interests of shareholders, the owners, be given priority when making decisions. The first 3 of the 15 standards proposed in the monograph are discussed in this chapter. (Exhibit 1 in Chapter 6 provides an overview of the 15 standards.)

Chapter 3 discusses the delegation of shareholder power to the board of directors and defines the roles the board must fill for the company to create value. The board must add value for the company, and to this end, it cannot get bogged down in the typical management control and monitoring function. Instead, the board needs to help define strategy and participate in the innovation process. I state and discuss five standards of governance that apply to the board of directors.

The subject of Chapter 4 is the constraints within which companies must operate to achieve their value-creation objectives. Although this aspect of governance is often overlooked, I believe all corporate governance systems implicitly include a number of mechanisms that define the rights of all the stakeholders and that, consequently, restrict the discretionary power of the owners. The remaining seven standards suggested are discussed in this chapter.

The standards listed and discussed in Chapters 2–4 are intended to facilitate the analysis of underlying structural strengths and weaknesses through an analysis of a company’s governance system. For each standard, I suggest “indicators” and explain their usefulness. I believe that the compliance or noncompliance of a company with respect to any one standard means little; rather, overall compliance should be considered.

Chapter 5 is intended to help financial analysts determine the real value of a company by describing how to analyze a corporate governance system in light of the 15 standards. Just as an evaluation of managerial competence is essential to analyzing and projecting financial results, an evaluation of the governance system will reveal whether the conditions for wealth creation are present. The 15 standards make it possible to verify whether the ultimate power belongs to shareholders, whether the board of directors and managers give precedence to efficient allocation of resources, and whether the rights and privileges of each stakeholder are respected. These three conditions form the foundation of the process that leads to real value creation and, by extension, offers the best guarantee of a company’s survival.

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# 1. The Big Picture: Major Issues of Corporate Governance

For practitioners and academics, governance often boils down to the rules prescribing how boards of directors operate. At most, the concept may extend to the control mechanisms used to reconcile company managers' interests and shareholders' interests. In their excellent literature review of this topic, Shleifer and Vishny (1997) offered a definition that encompasses these elements: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (p. 737).

Although not fundamentally wrong, this notion of governance seems rather simplistic. First, it is limited to the sole control exercised by shareholders and overlooks the rights and privileges of all the other stakeholders in the company—creditors, suppliers, customers, employees, and ultimately, the State and society in general. Indeed, in addition to the shareholders, all these parties exercise some form of power and impose limits in varying degrees that affect value creation.

Second, the traditional definition of governance fails to take into account the implicit rules, standards, and agreements that, in addition to legislation, regulations, and contracts, actually have an influence on decision making. By their very nature, contracts, regulations, and laws are incomplete because they cannot foresee every eventuality. If they were comprehensive, there would be no disputes or *ex post* negotiation on the sharing of gains created. Because all the aspects of the agreement would be covered before signing, the contracts, market mechanisms, and price systems would be sufficient to clarify any situation that might arise. The role of corporate governance is justified and important precisely because of the incomplete nature of contracts, laws, and regulations.

## **Broad Definition of Corporate Governance**

Corporate governance begins with power—who holds the power in an organization, how it is delegated and exercised, its purpose, and what control mechanisms the power holders use. With power comes the responsibility of decision making, the right to choose, and the option to delegate. Power in a company is not absolute because it is always exercised within guidelines or constraints. In public corporations, the purpose of power is the creation of value, and the structure of shareholder-owned corporations means that the value created must be shared. Therefore, a comprehensive definition of corporate governance will cover all the activities involved in creating and sharing value. Corporate governance encompasses all the

activities associated with exercising power, sharing rights and responsibilities, and organizing the various functions of a company. It may be defined as follows:

*Corporate governance consists of the legal, contractual, and implicit frameworks that define the exercise of power within a company, that influence decision making, that allow the stakeholders to assume their responsibilities, and that ensure that their rights and privileges are respected.*

A corporation exercises the ultimate power when it allocates resources, which it must do efficiently if it hopes to create value or wealth. To be successful in this regard, the organization must acquire the best resources—financial, material, and human—at the best possible price and must use them as productively as possible.

## **Legal Framework of Governance**

Governance is exercised within a legal or juridical framework that clearly sets out the latitude managers have when making decisions. First, and according to the traditional definition of governance, the power is delegated by the board of directors, which acts on behalf of and in the interest of the shareholders. Because shareholders usually do not have the requisite skills to manage the company, however, they delegate the responsibility to people who can. It is at this point that legal and regulatory constraints intervene to reconcile the interests of the agents and the principals. For example, corporate law is founded on the director's obligation to act as a "prudent administrator," which requires him or her to act with prudence and diligence so as not to expose the company to unnecessary risks.

A variety of laws and regulations complete this general rule, including, in the United States, the Securities Act of 1933 (see Appendix A) and the more recent Sarbanes–Oxley Act, which contains strict guidelines on conflicts of interest, the communication of financial information, and the integrity of the audit process. Enacted in response to the Enron Corporation, WorldCom/MCI, and other accounting scandals, this act is aimed at preventing wrongdoing by managers.

The existence of laws and regulations is clearly not enough to guarantee sound corporate management. Compliance must be assured. To this end, account-rendering obligations for managers and various control mechanisms have been instituted to ensure compliance with legal and regulatory requirements. The obligations consist of financial audits (with penalties for noncompliance), the obligation to disclose information to regulatory authorities, and the obligation to create an audit committee.<sup>1</sup>

Laws and regulations do not guarantee that the economic system will run smoothly, that corporate power will be exercised wisely, and that opportunities for value creation will be fully leveraged. At best, these mechanisms protect society

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<sup>1</sup>CFA Institute requires that member investment practitioners also follow a Code of Ethics and Standards of Professional Conduct (see [www.cfainstitute.org/standards/ethics/](http://www.cfainstitute.org/standards/ethics/)).

from the most flagrant abuses and prevent the most extreme wrongdoing. Accounting rules and financial audits also cannot guarantee that every single problem will be identified or protect against fraud and abuse, but they can at least help expose the most dangerous situations.

One of the major flaws of laws and regulations is that they do not evolve in step with business. For instance, various accounting rules for derivative products are still under study, even though many companies have been using these risk management tools for at least 20 years.

Another shortcoming is that anything not expressly forbidden is considered acceptable. The rules for recording financial information are a telling example in this regard: Anything goes as long as it does not contravene the rules set out by the accounting regulatory bodies (the Financial Accounting Standards Board and American Institute of Certified Public Accountants in the United States). Therefore, for example, Enron's financial statements did not have to show the company's loan-related liabilities, even though the liabilities were real and known; no rule existed in this regard.

Finally, laws and regulations are by nature general orders and their application must be placed in various contexts (as illustrated by the numerous interpretation bulletins issued by the Canada Revenue Agency and by the U.S. Internal Revenue Service). It is precisely to resolve this lack of precision that the courts exist and that jurisprudence has taken on such importance.

Notwithstanding the solid legal foundation on which it is based and the fact that a company's first responsibility is to respect the laws and regulations in effect, corporate governance cannot be limited to a series of explicit orders and rules. Its field of application is far vaster and encompasses both the contractual framework and a host of implicit rules.

## **Contractual Framework of Governance**

The contractual framework is an important component of any governance system. Contracts are governance mechanisms that affect the freedom of the stakeholders in an organization by stating how they agree to act under foreseeable circumstances. Contracts govern many types of business behavior and are thus important mechanisms for defining the powers of the stakeholders.

Another reason contracts are justified is that the markets are not perfect. A case in point is the existence of information asymmetry. Some parties in possession of information that others do not have may be tempted to profit from that knowledge to the detriment of others. The likelihood of this asymmetry is very real indeed in the relationship between managers and shareholders because shareholders cannot constantly monitor the behavior of those to whom they have delegated decision-making authority. And this situation is exacerbated by shareholders and managers interacting at a distance and through the intermediary of a board of directors.

Incentive contracts were introduced to counteract these deficiencies. These contracts outline specific parameters designed to encourage managers to act in the interest of the shareholders. Thus, the design limits inappropriate and opportunistic behavior. This same strategy can be applied to employee–employer relationships; employers can include incentives in contracts to motivate employees to create value for the organization, to encourage behavior in line with the company’s objectives, and to ensure that everyone acts in the best interests of the company.

The effectiveness of incentive contracts as governance mechanisms depends largely on how complete they are. If managers could anticipate every possible event and its consequences, they could negotiate the sharing of the gains *ex ante* and minimize any form of abuse. Because it is impossible to foresee every eventuality, however, contracts are generally incomplete and have weaknesses. Consequently, decisions must be made about who will have the decision-making power when situations arise that were not provided for either in the contract or in the prevailing laws and regulations. Moreover, although a contract may appear to provide enough incentive at the time it is signed, the incentive may turn out to be insufficient to ensure optimal behavior by the parties in new or unexpected situations. Under these circumstances, the *rights* of the parties take on their full importance and alternative governance mechanisms find their justification.

In short, legal and contractual frameworks alone cannot ensure optimal behavior in the complex corporate world. These solutions do, however, constantly evolve; the law and contracts gradually integrate information and solutions from past cases.

In light of the incomplete character of the legal and contractual frameworks, other governance mechanisms are worth examining that could help individuals agree on how to act and that could have an impact on the powers delegated when unexpected circumstances arise.

## **Implicit Framework of Governance**

Serving to complete the legal and contractual frameworks, the implicit framework makes it possible to explain many of the distinct behaviors of employees or other individuals who interact with companies. This framework involves a complex set of rules, tacit agreements, and vague principles concerning the sharing of various responsibilities.

The company’s social role and the resulting obligation to be a good corporate citizen are a good example. How does one explain corporate charitable donations when they are required neither by law nor by contract? The answer is simply that such behavior, although it may start as public relations, gradually evolves into the norm.

Implicit rules in the form of principles and abstract statements of corporate values are, in fact, decision-making tools that act as benchmarks when unpredictable circumstances arise. Over time, the rules lead people to behave in “acceptable” ways. For instance, observers have noted that when a telephone call is interrupted, 8 times

out of 10, the person who calls back will be the one who made the call in the first place. Similarly, in business, office size and job importance are understood to be directly related, employees “know” that a Christmas party is held each year, the boss’s secretary enjoys special status, and so on. Although not explicitly defined, all these tacit agreements and customs explain many managerial decisions that have an impact on value creation.

Implicit rules underpin corporate culture. Although they are difficult to identify because they are not expressly outlined in any agreement, their importance as governance mechanisms must not be underestimated. They clearly limit the discretionary power of managers and help coordinate behavior, thereby minimizing friction within the organization. In fact, given the complexity of a manager’s tasks, the absence of such rules could result in incoherent actions. For all, the rules are reassuring because they set the boundary between acceptable and unacceptable behavior.

In summary, when evaluating the efficiency of a governance system, all the elements that can limit the actions of managers must be included. In this regard, implicit rules are important elements. They often directly affect how resources are allocated and value is created.

## **Governance and Value Creation**

In a capitalist system, the ultimate business objective is to maximize resource allocation to create as much economic value as possible and, in so doing, improve social well-being and quality of life. Offering society the best products and services at prices consumers consider reasonable is, therefore, the overriding goal of companies operating in any given economic system.

Creating economic value is associated with creating wealth. There is a direct connection between the two concepts insofar as those responsible for creating value can also benefit from some of the wealth created. Wealth is measured by the value of the products on the market and, in the case of shareholders, the market value of their stock. Recall that market value is determined by the price buyers are prepared to pay for a product, a real or financial asset, or a service. Therefore, a company will see its prices and value rise as demand for its goods and services rises. The corporate objective can, therefore, be expressed as follows:

- Creation of economic value
- ≈ Creation of wealth
- ≈ Increase in company value
- ≈ Increase in share price.

That is, in governance systems focused on the creation of economic value, decisions consistent with the company objective are those that tend to maximize share price. This way of translating the wealth-creation objective into tangible results has been a determining factor in the evolution of corporate governance systems and the implementation of decision-making criteria and resulting management procedures.

The concept of reducing the value-creation objective to maximizing share price has met with some opposition. Some critics argue that equating real economic value with stock price presupposes highly efficient financial markets, which they dispute. They further contend that value creation is not always recognized or is underestimated by the financial markets. Conversely, financial markets sometimes also recognize value that does not exist by overestimating the stock price. Such a situation can affect decision making and lead to less-than-optimal resource allocation in the long term.

Because the intention of this study is not to debate market efficiency, I worked with the premise that the markets are efficient enough to make real economic growth possible. Consequently, companies that create the most value see their stock price increase, providing them with access to the financing they need to grow. The financial markets evaluate companies that do not create value accordingly, making it difficult for them to expand.

## **Supremacy of Shareholder Interests**

A corporate governance system based on value creation places shareholder interests above those of the other stakeholders (i.e., creditors, employees, suppliers, customers, and society as a whole). As a result, shareholders wield absolute power. By delegating this power to the members of the board of directors, the shareholders have the last word over all the company's activities and can reap the wealth resulting from the value creation. With few exceptions, creditors, employees, and other stakeholders receive the compensation agreed on at the start of the relationship regardless of the company's success later on and benefit only indirectly from the value created.

Although the power of shareholders is clearly defined by the legal and contractual environment and limited by many informal rules, a fundamental question remains:

Does the supremacy of shareholder interests allow a company to maximize value creation and achieve its full economic potential?

The answer to this question is essential because it will allow us to evaluate and understand the various corporate governance models currently in use. I turn to this question in the next chapter.

## **Summary**

Evaluating corporate governance necessarily involves analyzing the power structure (shareholders, board of directors, top executives, and other managers) and how the structure affects the behavior of decision makers and stakeholders. The real economic wealth a company can create hinges on an effective allocation of its resources, which is only possible when the interests of all the parties involved are taken into



account. Generating profits for shareholders to the detriment of employees or any other stakeholder is not profitable in the long term and could well foil the core objective of value creation.

Corporate governance is a complex issue, the focal point of which is the exercise of power. The power has limits, however, imposed by both legislation and contracts. Also, even if the overarching power belongs to the shareholders, residual power cannot be exercised to the detriment of the rights of the other stakeholders. Because the governance system and resulting structures have a major influence on the decision-making processes within a company, financial analysts must understand the governance mechanisms. Moreover, in the business world today, corporate governance is a factor in competitiveness that is as important as the quality of a company's human resources, its know-how, and its innovation capacity.

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## 2. Shareholder Power

Chapter 1 established that corporate governance involves exercising power to create true economic value within certain limits and constraints. Making an informed assessment of the various governance models in existence and their effectiveness requires an understanding of what underpins the exercise of corporate power. Otherwise, we cannot determine whether the conditions for value-creating decision making truly exist. As an analogy, a physician cannot diagnose the cause of an illness without understanding how the human body works. A financial analyst cannot correctly identify the factors affecting a company's long-term success and survival without first understanding the critical role businesses play in our economic system.

### **Fundamental Principle of Resource Allocation**

The discipline of economics studies the use of scarce resources to satisfy unlimited wants. Indeed, the question is how to fulfill all the wants in the face of limited resources. To solve this problem, economists propose the market mechanism and its corollary, the price system. The market mechanism allows individuals to freely participate in trade in order to satisfy their needs under the best possible conditions (i.e., the best prices). Prices indicate the relative value of a resource/product, and the more people are willing to pay for a scarce resource/product, the more efficiently it will fulfill needs and increase satisfaction. In this sense, capitalism is founded on the principle that people are born to be free.<sup>2</sup> Freedom is first and foremost an *individual* right that, as a general rule, supersedes collective freedom.

In other economic systems, such as command or planned systems, the State, usually through a highly centralized planning system, decides how to allocate resources. Because the State determines and attempts to fulfill the needs of society, the markets play a minor role in coordinating trade and resource allocation.

My purpose here is not to expound on the value of these two systems, which are fundamentally and diametrically opposed. I know full well that no economy is purely capitalist or communist and that some countries lean more right and others left. The current trend is toward an economic system based on freedom of choice, one in which resources are allocated primarily according to the market mechanism and price system. This philosophy underpins the capitalist system, and I certainly do not intend to question an economic system that has created so much wealth and

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<sup>2</sup>The correlations between freedom, democracy, and economic development can easily be demonstrated, although these connections are not the topic of discussion.

vastly improved standards of living. I fully endorse the system and its institutions, but I do see room for improvement.

## **Value or Wealth Creation**

The economy is made up of three major sectors—households (i.e., consumers of goods and services); companies, whose primary mission is to produce and offer goods and services; and governments, whose main role is to ensure that the system runs smoothly. Each entity within each sector can acquire resources, which exist in limited quantity, and the market mechanism is such that they are all competing against each other.<sup>3</sup> How does such a system ensure that when private companies acquire resources, they truly create wealth or value and thereby improve the standard of living of citizens?

To create value, companies that acquire resources must first produce goods and services whose value is greater than the acquisition, production, and financing costs involved. So, first, a close look at the resource allocation process is in order. Because resources are limited, they command a certain price. To acquire these resources—in other words, to invest—companies must have the funds required or obtain financing.

The savings of economic entities that choose to defer their consumption (i.e., investors) provide a major part of these funds. To obtain the funds, companies must offer the investors competitive returns commensurate with the risks the entities are taking. Because they are free to invest their money in the vehicles that offer the best returns, these investors will choose to finance a company only if it offers competitive returns not only in relation to other companies but also in relation to all the other investment options available.<sup>4</sup>

To offer competitive returns, a company must be well managed, have or be able to acquire the right resources, and above all, be able to use the resources effectively. Using resources effectively means converting them into the quantity and quality of goods and services society desires, offering them at appropriate prices, and generating sufficient profits or gains to both offset the cost of the resources and adequately compensate the lenders. Only companies that succeed in this regard create true economic value, generate wealth, and contribute to the well-being of society, thereby ensuring their long-term survival.

A market based on freedom of choice makes for better resource allocation than a managed market because a free market channels savings to the most efficient and profitable companies. More specifically, by giving savers the freedom to choose the companies in which to invest, the economic system, through the market mechanism

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<sup>3</sup>Resources are raw material (land, wood, water, oil, etc.), processed material (equipment, machines, furniture, etc.), or factors of production (labor, technology, know-how, etc.).

<sup>4</sup>There are many choices for investors—business financing, government financing, and household financing.

and price system, creates the conditions required for good resource allocation and, by extension, value creation.

Put another way, the process by which savings are channeled to companies that offer the best return-to-risk ratio tends to create efficient resource allocation and the likelihood that society's desires will be fulfilled. Jensen (2001) justified the value-maximization objective as follows:

Given that a firm must have a single objective that tells us what is better and what is worse, we must face the issue of what that definition of better is. Even though the single objective will always be a complicated function of many different goods or bads, the short answer to the question is that 200 years' worth of work in economics and finance indicate that social welfare is maximized when all firms in an economy attempt to maximize their own total firm value. The intuition behind this criterion is simple: that value is created—and when I say “value” I mean “social” value—whenever a company produces an output, or set of outputs, that is valued by its customers at more than the value of the inputs it consumes (as valued by their suppliers) in the production of the outputs. Firm value is simply the long-term market value of this expected stream of benefits. (p. 11)

In the next sections, I discuss three standards that depend for their justification on the value-creation objective—the standards for the supremacy of shareholder interests, equality among shareholders, and oversight of executive compensation.

## **Supremacy of Shareholder Interests**

To acquire the physical resources required to create and build a business, its owners must have capital to invest or access to financing. Some initial equity or venture capital is a necessary prerequisite for finding other forms of financing. Indeed, a business cannot be created or grow without an investor or investors willing to take over the majority of the risk because, without that safety net, no other backers will be prepared to contribute financing.

Consequently, a company's very existence hinges on the commitment of its shareholders and their ability to back most of the risk inherent in any business, which is the residual risk. When shareholders assume the residual risk, it means that the shareholders must have lost everything before others lose a dime. In this way, the system ensures that if shareholder interests are satisfied, the financial requirements of the other stakeholders are also fulfilled.

The greater the capital injected by the owners, the stronger the company and the better its prospects for growth. Equity or venture capital is, therefore, the foundation of a business. A company belongs to the shareholders because they are responsible for its very presence. Indeed, because they shoulder most of the risk, shareholders have every right—within the law—to exclusively enjoy, benefit from, and dispose of the entity they created. To deny this right would be tantamount to

annihilating ownership privileges and would deal a severe blow to individual liberties, something no democratic regime would tolerate.

In the case of a company, this ownership right is obviously not absolute, yet the ultimate right to act (and the associated responsibility to control) belongs to the shareholders. As a result, they are fully entitled to enjoy the profits generated by the company and to benefit from any increase in the company's value. Just as homeowners are entitled to the gains realized on the sale of their homes, shareholders are entitled to sell their stock and reap any gains.

Like all other suppliers of funds, shareholders are entitled to compensation proportional to the risk they assume. This compensation ranges from potentially losing their entire investment (if the company fails) to anywhere between a negative to a disproportionately high return (if the company's success exceeds expectations). Even if the returns are scandalously high, anyone who entertains the idea of imposing a ceiling on the compensation demonstrates a complete lack of understanding of the nature of risk and the vital role venture capital plays in the economy. No more than one newly created business out of ten enjoys real success—that is, creates real value and adequately compensates the owners. So, to deprive shareholders of their full right to the gains generated, be it in the form of dividends or capital gains, would be unfair.

Society benefits from a company's success. First, a successful company creates jobs and pays more taxes, which are used to fulfill other needs. Second, the goods and services produced may improve society's standard of living. Therefore, corporate gains are merely fair compensation to which entrepreneurs are entitled for their contribution to society.

To fully assume their role in society, pursue their growth, and adequately compensate their shareholders for the risk they assume, companies must allocate the resources they acquire to wealth-creating projects. Given that shareholder compensation is residual (i.e., distributed after all the other stakeholders have been compensated), corporate decision making can be shaped by shareholder interests while at the same time ensuring that the interests of the other stakeholders are satisfied.

No company can achieve its value-creation objective without the help of individuals or other companies, which become nothing short of partners. In the context of corporate governance, these partners are referred to as stakeholders, and because they are essential to the value-creation process, they acquire power and possess rights. A stakeholder can be a person or a private or public legal entity. Because they reap financial profits or other advantages, the stakeholders have a vested interest in cooperating with the company and participating in the value-creation process.

Stakeholders are divided into two categories. The first group obtains its power by virtue of laws and regulations and comprises the financial markets, the State, and society. This category also includes creditors because their rights and privileges are

protected by standard contracts. The other category includes all those who hold little power or few statutory rights and consequently must constantly negotiate with the company (i.e., employees, customers, and suppliers).

These partners generally have diverging interests that are difficult for the company to reconcile. Moreover, the power and advantages are different for each category. For example, it is difficult for a company to pay employees the highest salaries in the industry while at the same time guaranteeing consumers the lowest prices. The task of managing entities with different interests is fraught with tension, which is exacerbated by the fact that making shareholder interests a priority depends on first satisfying all the rights and privileges of the stakeholders.

The complexity of the task has prompted some economists to propose a corporate governance system that removes the primacy of shareholder interests from the decision-making process. They suggest that, instead, the interests of all the stakeholders be taken into account. In this way, they reason, everyone would work harder to create value and everyone's interests would be satisfied—provided they all reaped their share of the rewards. In this system, the objective of maximizing shareholder wealth would be superseded by the goal of satisfying each and every stakeholder. Prosperity would come from each person's commitment to help the company succeed. To ensure consumer loyalty, the company would sell its goods or services at the lowest prices in the industry and offer the best after-sales service. To ensure that employees were diligent, the company would pay the highest salaries and offer the best working conditions. To please its suppliers, the company would pay top dollar for its raw materials. And so forth. The result would be that the company would create even more value for its shareholders than in the present system.

Clearly, however, giving the best to everyone is simply not possible in the real world. When resources are scarce, the competition and its impact on value creation and on people's motivation to work harder cannot be ignored. Making the competition disappear does not set up the best conditions for optimal resource allocation and value creation. Societies that have adopted economic systems that spread the wealth equally, regardless of the risks people assume and their contribution to wealth creation, suffer from poverty and major social imbalances.

Critics of a governance system that places shareholder interests at the forefront to guarantee optimal resource allocation are right, however, when they contend that companies of the 21st century must be able to count on committed employees, loyal customers, and reliable suppliers. Competitive advantages come from these stakeholders, particularly for companies of the so-called New Economy, whose most important assets are intangible (i.e., experience, know-how, and reputation). Concerned with the threats weighing on these new companies, the well-known researchers Rajan and Zingales (1998) stated:

... the nature of the enterprise has changed greatly: human capital has replaced physical capital as the main source of value and vertically integrated firms have given way to more competition in the intermediate product markets. . . . [T]hese changes require also a change in the focus of the corporate governance debate. We should spend less time discussing how to strengthen the rights of dispersed owners and more time on mechanisms to control and retain human capital. (p. 35)

Reducing the stakeholders' need to negotiate by promising them a share of the gains does not resolve the problem raised by Rajan and Zingales. Similarly, reducing the priority of shareholder interests in no way guarantees a better distribution of wealth. To the contrary, only competition and freedom of choice create good working conditions for employees while allowing consumers to obtain the best products at the fairest prices, because it is the market mechanism and price system that ensure an optimal balance, optimal resource allocation, and by extension, optimal wealth.

The proponents of maintaining the supremacy of shareholder interests do not, however, dismiss the valuable role stakeholders play in the value-creation process. Indeed, these proponents fully acknowledge that stakeholders have real rights and that stripping them of their privileges or depriving them of the advantages and benefits to which they are entitled under freely negotiated agreements cannot maximize shareholder interests. Consequently, no corporate governance system implemented to promote value creation can be limited to making sure the company respects laws, regulations, and creditor contracts. It must also ensure that the rights and privileges of all those who participate in the value-creation process are not only recognized and respected but also integrated into the company's mission.

**Standard #1.** Because optimal resource allocation implies pursuit of the value-creation objective, which companies can achieve by placing shareholder interests at the forefront of decision making, I propose the first and most important standard for corporate governance:

Standard #1. The ultimate power in a company must rest with the shareholders.

A corporate governance system that ensures the presence of conditions conducive to value creation must necessarily influence decision making at all levels of the company. Whether a chief executive officer who sees to the organization's future or a supervisor in charge of a team of workers, each one has day-to-day choices to make that ultimately improve (or worsen) the company's efficiency and allow it to create (or destroy) value. The measurement of the contribution of each decision to the value-creation objective is net present value. The use of this criterion throughout the company allows evaluation of whether the company's governance system favors an optimal allocation of resources and whether it is actually oriented toward value creation.

**Indicators.** The role of this standard in a company is shown by

- the existence of value-creation-driven investment and financing policies and
- the use of a decision-making criterion that measures value creation—net present value.

## Equality in Shareholder Structure

Because different classes of shareholders exercise different voting rights and varying degrees of control, the shareholder structure—shareholder concentration or dispersion—is an important factor to consider when analyzing a company’s governance system.

Shareholder concentration exists when one shareholder or a homogenous group of shareholders holds effective control of a company and can influence decisions and the composition of the board of directors.<sup>5</sup> Such a scenario is typical in the case of subsidiaries that are not wholly owned by the parent company or the case of family businesses where relatives have effective control or at least control the majority of the votes.<sup>6</sup>

In this type of structure, the investors who own a small number of shares and are not part of the controlling group are very much minority shareholders, meaning that on an individual basis, they have little say in decision making and, more importantly, have no influence on executive appointments. Consequently, they have a hard time exercising any kind of control, and should they have to defend their rights, the courts are often their only recourse, unless, obviously, they decide to sell their stock.

The main problem such holders of small numbers of shares have when it comes to exercising power lies in coordinating themselves so they can directly or indirectly exercise influence on the company’s important decisions.<sup>7</sup> Moreover, because of the costs involved, coordinating efforts for only a small measure of decision-making control does not pay. Therefore, they tend to rely on the significant shareholders to discipline the managers. Indeed, institutional investors, notably, major pension

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<sup>5</sup>This statement excludes small businesses where the owner and owner’s relatives are simultaneously shareholders, directors, and principal managers.

<sup>6</sup>Shares with multiple voting rights concentrate power in the hands of a limited number of people even if there are many shareholders. The main result is that the percentage sharing of profits and gains does not correspond to the power held. The problems discussed in this section are, therefore, much more acute in such situations.

<sup>7</sup>Even if they hold little power individually, small shareholders can band together to express a common point of view. They can, for example, launch a proxy fight, which involves collecting a significant number of votes held by many small shareholders to elect (or oppose the appointment of) one or more board members. This procedure can have a disciplinary effect but involves considerable cost and effort. Moreover, unless a cumulative voting procedure exists, the proxy fight is ineffective when the control group already holds most of the voting rights.



funds, are much better placed to exercise control of a company and ensure compliance with the value-creation objective.

Even holders of significant numbers of shares that are still in the minority suffer from the same control problems of any minority—particularly where information asymmetry is concerned. This problem exists because, usually, the farther one is from the power, the farther one is also from information. In this regard, the regulatory agencies play a vital role by requiring that all relevant information be transmitted at the same time to all shareholders and that no privileges be accorded to controlling shareholders. This mechanism is still insufficient, however, to ensure full respect of minority shareholder rights.

Subsidiaries and family-owned businesses can also experience other types of problems, such as when the controlling shareholders do not share the same risk tolerance as the other owners. Such diverging points of view can lead to conflicts and potential disinvestment by some of the shareholders.

**Standard #2.** A company cannot come into being without venture capital (i.e., equity capital). In the same way, the company cannot undertake any major project without an equity contribution by the shareholders, be it through retained earnings or a share issue. Access to funds is facilitated by a diversified shareholder base—pension funds, investment funds, and individual investors. Therefore, participation by as many shareholders as possible in the company's capital base is highly desirable.

Participation by minority shareholders, however, largely depends on whether they believe their rights will be respected and the company is capable of undertaking value-creating projects. So, to achieve diversification, the company must respect all of its shareholders and conduct itself in such a way as to earn their confidence.

Shareholders are the owners of the company, and each one has the right to demand to be treated as such and to benefit from the advantages associated with ownership. Accordingly, the governance system must guarantee that all shareholders benefit from the same advantages and, moreover, that they develop a sense of belonging. In addition to the protection provided by various laws and regulations, minority shareholders count on the company's governance system to ensure that all the players have the same rights and are treated equitably—that is, that no shareholders enjoy special advantages, particularly with regard to access to information. This principle brings us to the second standard for a governance system that creates the conditions required for value creation.

Standard #2. No shareholder should benefit from special advantages.

**Indicators.** The way in which this standard is met in a company is shown by

- the number of shareholders,
- the percentage of voting rights held by the principal shareholders,

- the presence or absence of a controlling shareholder, and
- the treatment and consideration accorded to shareholders—in particular, in terms of access to information.

## **Executive Compensation**

The traditional way of analyzing corporate governance is to assume that the significant shareholders are not the company's managers and that no one holds a significant percentage of the voting shares. For example, the shareholder base of U.S. companies is highly dispersed, and most corporate governance recommendations reflect this ownership structure. Berle and Means (1933) were among the first to analyze the effects of shareholder dispersion on power and control. The conclusion they drew is that in such a case, shareholders have little power; instead, power is concentrated in the hands of the company managers.

Because of this situation, delegation of power is at the core of corporate governance; the main questions revolve around accountability, control, divergent objectives, and of course, information asymmetry. The finance and economics literature addresses these issues primarily from two angles: (1) alignment of shareholder and management interests and (2) how laws and regulations can ensure the smooth operation of the system by avoiding abuses. These aspects of corporate governance are important, of course, because they foster investor confidence in the financial markets. But a governance arrangement that is truly focused on creating value must go beyond these aspects and take into account the conditions under which decisions are made within the company and the major strategies the company pursues to ensure that the power held by the stakeholders is properly used.

The problem of power delegation revolves around the divergence of interests between the principals (shareholders) and their agents (managers). How can shareholders make sure that the managers are not placing their own interests ahead of the company's? Beyond that issue, how can the principals ensure that value creation always drives their agents' decisions and that the agents do not use corporate resources for their own benefit?

These questions are particularly relevant when one considers the vastly different positions managers and shareholders hold in regard to the company's taking on risk. Shareholders are at one end of the spectrum because they typically have a diversified portfolio whose performance depends on the results of various securities held in a variety of companies. As a result, for shareholders, losses incurred in one place can be offset by successes elsewhere. Managers are at the other end of the spectrum because they cannot hold more than one position in more than one company at a time. Consequently, if the company that employs them fails, their compensation, and possibly even their job, is jeopardized. Managers are, therefore, typically more risk averse than shareholders, which can lead them to base their decisions solely on ensuring the company's stability, at the expense of value creation.

Because it varies greatly from one person to another, risk tolerance necessarily affects behavior. Whereas the shareholder typically considers the nondiversifiable, systemic part of the company's risk, the manager tends to look at risk as a whole. Although both have the company's success at heart, the manager will lean toward job and income security. Faced with a risky choice that may create considerable economic value, the manager will not necessarily always choose the economic rationale.

Beyond the disparity of objectives, another problem arises when managers use the company's resources for personal gain—for example, by padding an expense allowance. The shortfall and/or costs resulting from such behavior by corporate managers can have a negative impact on shareholder return. For this reason, control measures, and especially incentive mechanisms, must be implemented to improve alignment between management and shareholder interests.

To ensure that managers will act in the best interests of the company, managers' compensation is usually tied to corporate performance so as to induce the managers to make the same kinds of decisions that the owners would make. The intention is that the managers be able to benefit as much as the shareholders from the company's success, at least in the case of compensation.

The most common types of incentive in use today are profit-sharing and stock option plans. Although these partnership plans generally produce good results, they can lead to abuse if too much of the compensation is tied to stock performance, as evidenced by the Enron Corporation, WorldCom/MCI, and Parmalat scandals (among others). Focusing too exclusively on stock performance can lead managers to focus on a shorter horizon than the one normally contemplated by shareholders. Thus, striving for immediate gain can result in actions that destroy value—manipulation of results, biased projections to mislead analysts and investors, and in some cases, dishonesty and fraud.

Although the shareholders are the obvious big losers in such situations, society is also adversely affected by the ensuing poor allocation of resources. Moreover, investors in general lose confidence in the value-creation system and consequently invest less.<sup>8</sup>

The negative consequences can also extend to other entities connected with the company. For example, in the infamous Enron case, thousands of employees lost their jobs and much of their pension plan. In other cases, suppliers and customers have paid the price for the company's inability to honor its commitments.

Another major drawback of stock option plans is that they are not tax deductible for the company or the shareholders. Therefore, shareholders bear the full cost of the plans. When the options are exercised, share capital is diluted, which reduces the shareholders' share in the profits.

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<sup>8</sup>Investors perceive a greater risk in the stock market and, therefore, demand higher returns, which increases the obstacles to implementing value-creating projects.

This discussion should not be construed as an argument for doing away with stock option incentives, but it does mean that the shareholders should vet their use.

**Standard #3.** The shareholders ask that the managers be dedicated, that they place the company's interests before all else, and most importantly, that they adopt a long-term vision. Because they do not themselves select the managers, they cannot control them directly. Consequently, the only way to ensure that shareholder and manager objectives coincide is to retain a right of oversight over compensation. This, of course, means that the executives must be evaluated and shareholders must have access to the information in this regard.

To deal with these issues, I suggest the following standard:

Standard #3. The shareholders must approve executive compensation.

“Executive compensation” must be interpreted in a broad sense to include all the benefits granted to managers, such as stock options, golden parachutes, pension plans, and profit-sharing plans.

The shareholders must decide on any and all benefits granted to executives and ensure that the benefits are tied to the company's long-term performance. The goal is to make senior managers accountable to the shareholders, who are the ones financing the remuneration. The principle is simply that employees, regardless of their rank, should always answer to those with the power to set their salary.

Compensation should be approved but not be set by the shareholders because, first, the shareholders are not experts in compensation matters and, second, salaries and benefits should, first and foremost, respond to market forces. For this reason, shareholders delegate the responsibility of fixing senior managers' compensation to the board of directors, which performs this function through a compensation committee.

This delegation does not mean shareholders have no legal right in this regard or have no interest in this issue. In fact, they are paying the compensation, and they will be the first to endure the fallout if the managers consider themselves poorly compensated.

**Indicators.** Whether Standard #3 is being observed is indicated by

- whether shareholders have the right to exercise power over executive compensation, notably, the right to rule on compensation matters at general meetings, and
- the type of incentive mechanisms used, the exercise conditions involved, and (especially) the quality of information provided to shareholders concerning these privileges.

## Summary

The ultimate purpose of corporate governance is to improve the decision-making process so as to achieve the company's primary objective of creating value for its shareholders. Decisions that are consistent with this objective will maximize shareholder wealth.

Corporate governance must flow from this same objective. A recent study by Gompers, Ishii, and Metrick (2003) analyzed the relationship between corporate performance and the balance of power between shareholders and managers. The authors used 24 distinct corporate governance provisions for a sample of about 1,500 companies per year during the 1990s. They built a Governance Index, G, to proxy the balance of power between managers and shareholders. They then analyzed the empirical relationship of the index with corporate performance. They concluded that the more power shareholders have vis-à-vis management, the better the company's performance. They reported:

An investment strategy that purchased shares in the lowest-G firms ("Democracy" firms with strong shareholder rights), and sold shares in the highest-G firms ("Dictatorship" firms with weak shareholder rights), earned abnormal returns of 8.5 percent per year.

The value-creation objective legitimizes the first three standards for good corporate governance:

- The ultimate power in a company must rest with the shareholders.
- No shareholder should benefit from special advantages.
- The shareholders must approve executive compensation.

These three standards orient corporate governance toward the value-creation objective and define the relationships among shareholders and between them and the company. The standards are particularly relevant in cases of extensive shareholder dispersion, which characterizes most shareholder structures and which is used as a frame of reference in most governance studies.

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### 3. Delegation of Shareholder Power to the Board of Directors

Now that we have established that the ultimate power in a company belongs to the shareholders—mainly because of their right of ownership—the next question is how this power should be exercised so that the company creates value. As a general rule, except in the case of small and medium enterprises (SMEs), shareholders do not exercise power themselves but delegate it, through a board of directors, to business managers.<sup>9</sup> Thus, the board of directors exercises the legal and practical control that belongs to the shareholders.

The questions surrounding the delegation of power pertain chiefly to accountability, control, the divergence of objectives, and information asymmetry. The first researchers to propose explanations of and solutions to these problems were Jensen and Meckling (1976), whose agency theory explains the behavior of managers, who have power but no ownership, and the dilemma of shareholders, who must delegate control to these managers. Agency theory, which involves the costs of resolving conflicts between principals and agents (i.e., shareholders versus the board and the board versus managers), is the theoretical foundation underpinning most recommendations about the roles and constitution of boards of directors.

Agency theory puts forward a number of concepts that shed light on power delegation in the corporate organization. According to Jensen and Meckling, the company constitutes a nexus of contracts that ensure that all the stakeholders, with the exception of the shareholders, are satisfied insofar as they receive compensation set out in a negotiated contract:

The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. (p. 311)

Shareholders are entitled to a residual benefit that cannot be established in advance and that is affected by the behavior of the managers to whom the decision-making power is delegated. Given that they are usually geographically dispersed,

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<sup>9</sup>In SMEs, the shareholders are usually the principal managers. Because managers and shareholders are one and the same, there are no issues of power delegation.

shareholders of major corporations are hard-pressed to exercise direct control over managers' actions. Therefore, some of the governance mechanisms they implement are designed to control the managers and orient the company's decisions toward value creation.

To evaluate the efficiency of a corporate governance system, the analyst must look beyond structural problems and evaluate the way the board fulfills its responsibilities. More than a body that exercises control, the board of directors is the company's supreme decision-making authority. The board holds most of the power on behalf of the shareholders and monitors managers to ensure that they fulfill their primary mandate to manage the company as if it were their own. According to this fundamental principle of power delegation, the board has five major responsibilities or objectives, which to be fulfilled must respect the standards dictated by the value-creation objective:

1. To align management and shareholder interests.
2. To ensure the reliability of financial information.
3. To help define broad strategic orientations.
4. To safeguard the company's reputation.
5. To ensure respect of fundamental social values.

This chapter provides five standards related to various aspects of the power exercised by the board of directors on behalf of the shareholders.

## **Respecting Shareholder Interests**

The greatest responsibility shareholders impose on the board of directors is to ensure that managers adopt policies and make decisions in line with the value-creation objective, that shareholder interests prevail, and that the costs of power delegation are minimized.<sup>10</sup> The board's task of controlling and monitoring managerial behavior is essential, particularly when the shareholder base is dispersed, because in such a situation, no one shareholder wields enough power to assume this role directly. To fully discharge this responsibility, the board of directors must select the executives, fix their compensation, and resolve any disputes that may arise within the executive team.<sup>11</sup> In the interest of efficiency, the board usually sets up compensation, nominating, and governance committees to assist with these tasks. To avoid conflicts of interest, managers should not be part of these committees.

The compensation committee evaluates the compensation terms and conditions of senior managers and suggests modifications based on market conditions and the company's growth. A number of compensation combinations are possible,

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<sup>10</sup>Jensen and Meckling observed, "It is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's view point" (p. 308).

<sup>11</sup>The shareholders must be able to express their opinion, however, on the compensation of senior management at annual meetings.

all of which seek to align management and shareholder interests and to encourage the managers to keep the value-creation objective in mind when making decisions. The evaluation of manager performance and incentive programs is a complex, important task, and no universal method of carrying it out exists. As Core, Guay, and Larcker (2003) concluded from a survey of equity compensation and executive incentive practices:

. . . simple normative prescriptions, such as “repriceings are an indication of poor governance” or “more equity ownership by executives is always better than less ownership” are inappropriate. It is almost always necessary to understand the objectives of shareholders, the characteristics of managers, and other elements of the decision-making setting before drawing any conclusions about the desirability of observed equity-based incentive plans or the level of equity ownership by managers. Sweeping statements about governance and compensation, without a detailed contextual analysis, are almost always misleading.

**Standard #4.** The fact that control and ownership are separate often precipitates conflict and costs that reduce the company’s value and hinder value creation. The board of directors must, therefore, anticipate potential conflicts between executives and shareholders, try to avoid such conflicts, and attempt to minimize the costs should they arise. To this end, the members of the board, as trustees of shareholder rights, must act and conduct themselves as if they themselves owned the company. They are, in fact, the managers’ bosses, and in this capacity, they are responsible for setting manager compensation, evaluating manager performance, and ensuring management succession. For a corporate governance system to favor value creation, the board of directors must respect the following standard:

Standard #4. The board of directors must ensure alignment between executive and shareholder interests.
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The board of directors’ primary responsibility is to ensure that the company is managed in such a way as to create value, and to this end, shareholders’ interests must prevail over all else. The degree of control the board exercises over executives determines its ability to adequately fulfill its fiduciary role.

Because true control cannot be exercised when conflicts of interest exist, for the board of directors to adequately discharge its responsibilities and (above all) to effectively represent the shareholders, it must be able to act and behave independently. This independence is not possible if the managers directly or indirectly hold the majority of votes.

Obviously, executives cannot conduct their own performance evaluations or set their own compensation. To avoid all appearance of conflict of interest, the board of directors typically establishes that only so-called outside directors are eligible for the committees that perform executive evaluation and compensation setting. Ques-



tions arise, however, about how to assure director independence. Is being the executive of another company sufficient, or is a person in such a position likely to be swayed to favor other executives no matter what the company? Because the independence of board members is a major issue in corporate governance, it deserves an in-depth discussion.

**Independence of the Board of Directors.** A board must be independent primarily because it must be able to discipline managers and ensure that they place shareholder interests ahead of their own. A vast literature has developed on what is needed to make a board independent. The advice can be summarized as follows: The fewer the inside managers and related directors serving on the board, the greater its independence. (Although the definition of “related” is not always clear, it generally means an individual who does business with the company—for example, a consultant, banker, or legal counsel. Executives from other companies and social or economic leaders would be considered unrelated members.) Moreover, the chief executive officer (CEO) should never hold the position of board chair.

The issue of independence has been the subject of serious study by governments, regulatory agencies, and stock exchanges.<sup>12</sup> The rules that managers should not make up the majority of the board and that the chief executive, as the senior manager, should not control the agenda of board meetings require no explanation. Studies conducted on the correlation between board independence and corporate performance (and, by extension, value creation) have not been conclusive, however, that these rules promote company performance. In this regard, the conclusions of Bhagat and Black (2002) are revealing. They found that independence alone does not guarantee satisfactory performance:

Firms with more independent boards (proxied by the fraction of independent directors minus the fraction of inside directors) do not achieve improved profitability, and there are hints in our data that they perform worse than other firms. This evidence suggests that the conventional wisdom on the importance of board independence lacks empirical support. (p. 233)

In short, independence alone does not guarantee good governance, because the duties of boards of directors are not limited to disciplining and supervising managers; they also include advising the company and safeguarding its reputation. This function requires access to information that only managers have and that no regulation or system obliges the managers to provide. The risk of information asymmetry between managers and board members increases with board independence, which in turn, reduces the board’s power. Thus, aiming for total independence and trying to completely eliminate information asymmetry are incompatible.

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<sup>12</sup>The California Public Employees’ Retirement System (CalPERS) provides a chart in an appendix to its corporate governance principles that summarizes the main legal and regulatory provisions about independence (available at [www.calpers-governance.org](http://www.calpers-governance.org)).

Each company's situation must be considered on a case-by-case basis, and in most cases, striving for balance is preferable. This balance is achieved when managers are a minority on the board and do not serve on the committees responsible for their appointment, compensation, and evaluation.

The best way to ensure that the board of directors aligns management and shareholder interests is for the board to consist of the largest possible number of independent members who are capable of asking hard questions and insisting on obtaining satisfactory answers. Unfortunately, no rule or standard will guarantee these qualities. The most one can hope for is that the board can rely on available, competent, and courageous directors. The rules requiring board members to take an equity position in the company so they will take shareholder interests to heart does not necessarily lead to more vigilance.

In fact, no standard or rule about independence will necessarily guarantee board quality. As Bhagat and Black explained:

Some types of independent directors may be valuable, while others are not. Maybe CEOs of companies in other industries (who are, by number, the majority of independent directors) are too busy with their own business, know too little about a different business, and are overly generous in compensating another CEO. Maybe "visibility" directors—well-known persons with limited business experience, often holding multiple directorships and adding gender or racial diversity to a board—are not effective on average. But this explanation suggests that to push for greater board independence may be fruitless or even counterproductive, unless independent directors have particular attributes, which are currently unknown. (p. 267)

The analyst must understand that total independence does not exist and that too much as well as too little independence can be damaging. Each company is unique, and the need to discipline managers depends on, among other things, the competition, the control exercised by company creditors, and the shareholder structure. Because a rule that would apply to all companies in all industries and in all countries is impossible, the analyst has no choice but to conduct an independent assessment of corporate governance.

**Indicators.** Indications of whether the board of directors is properly aligning shareholder and management interests may be found in

- the degree of the board's independence (i.e., how many members are unrelated),
- separation of the CEO position from that of the board chair,
- the number of board members who are also shareholders,
- the presence of protective mechanisms that benefit managers and reduce the control exercised by the board of directors, and
- equity ownership by board members and executives.

## **Quality of Information and Audit Committee**

Any delegation of power and responsibilities entails information asymmetry. The reason is that those who perform the tasks—in the case of companies, its managers—are the ones who hold the information and hence the power. Any information the board, shareholders, or financial markets receive essentially depends on the goodwill of the managers.

Although many laws, standards, and directives govern the accuracy, timing, and form of company communications, these laws and standards pertain almost exclusively to information that must be made public or that is financial in nature. The main purpose of this type of information is reporting and involves past decisions. The board of directors, however, in addition to making sure the company complies with laws and regulations pertaining to the disclosure of information, must also have the information it needs to make informed decisions about the future—strategic orientation and likely sources of value creation. Because of its fiduciary duty to safeguard shareholder interests, the board of directors must ensure that it has access to all the pertinent information on the past and for decision making.

No single member of the board can be an expert in legal and accounting standards, so boards need audit committees made up of those board members most familiar with the systems and rules of information communication and knowledgeable about finance and accounting.

The primary mandate of the audit committee is to ensure that information about major projects and the company's results are intelligible and available to all the members of the board. In addition, the audit committee must ensure that the laws and regulations enacted by the State about the disclosure of information are strictly observed. To fulfill all these functions, the audit committee should have the power to:

- recommend the external auditor,
- approve the audit plan submitted by the external auditor and make any changes deemed appropriate,
- ensure that the recommendations of the external auditor are implemented, and
- directly access the internal auditor to obtain all the relevant information and to request that certain studies be conducted.

**Standard #5.** Because the exercise of power is so dependent on information, the following standard is paramount when evaluating a corporate governance system:

Standard #5. The board of directors must have access to all the information it requires to fully discharge its responsibilities.
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The board has a fiduciary role vis-à-vis the shareholders and must ensure that information made public meets the requirements of all laws and regulations. This standard states that the board must have access to the information it needs to fulfill

these duties. The board is not *legally* responsible, however, for the content of the information. By law, this responsibility lies with the CEO and the vice president of finance. The board's role is essentially to implement strict control procedures to ensure the integrity of the information.

Decisions are only as good as the quality of the information available to the decision maker. Without relevant information, one cannot correctly assess a situation and understand the effects and consequences of the choices that must be made. One of the main responsibilities of the board of directors is to discipline managers to ensure that they give precedence to the interests of the shareholders and the company. This responsibility is impossible to carry out without some control over information. Although this task is clearly complex, the board of directors is vested with all the powers it needs to discharge this responsibility, and it should be committed in this regard.

The task of ensuring the merit of the information delivered by managers is not simple. Indeed, because managers have always understood that their power largely depends on the information they control, they are not naturally prone to information transparency or objectively delivering all the information the board needs to execute its responsibilities. One way to help the board receive comprehensive information on time is to include a certain number of managers on the board. Although the presence of managers can jeopardize independence, it will also reduce information asymmetry and usually improve the board's efficiency. In this case, again, a balance must be struck.

**Indicators.** The quality of information that a board of directors, particularly its audit committee, is receiving and the quality it is disseminating are indicated by

- the composition of the audit committee, its specific roles, and its method of operation,
- the audit committee minutes—what files are submitted, when, and the follow-up of questions raised—and
- the difference between the information managers have and the information provided to board members.

## **Broad Strategic Orientation**

Corporate governance is not defined solely by the composition of the board of directors and the control it exercises. Governance depends on how the board helps create the company strategy and oversees its implementation.

The board of directors is typically characterized by extensive expertise, objectivity, and pragmatism. Traditionally, its consulting role within the company has been limited to analyzing strategies for the acquisition of major assets and their financing. However, although these tasks are important, the limitation deprives the

company of invaluable advice on employees, customers, suppliers, and of course, relations with the State and civil society.

Regardless of their competence, executives need advice. Because they are responsible for the company's day-to-day operations, they have only a partial view of the company's situation in its economic, social, political, and competitive environment. In addition, even if their intention is to remain objective, executives are by their nature and role generally optimistic about their organization. When the company needs to adopt broad strategies and evaluate the risk objectively, however, it needs individuals who are more detached than executives, who know the company well, and who have diversified expertise.

Outside consultants are not well placed to fulfill this advisory role because they often have ties to management, so their suggestions and vision may not differ materially from the vision driving managers' own proposals and plans. Therefore, the board of directors must play the advisory role.

Directors should be prepared to contribute, through their expertise, to the broad strategic orientations of the company and, by extension, to value creation. To fulfill its role as a major decision-making authority, the board must have the requisite competencies to grasp the company's competitive position and challenges. To counsel the company on important decisions and on broad strategic orientations, the board of directors must be made up of dedicated individuals with diversified expertise.

**Standard #6.** As the only body that provides the company with the expertise of experienced and totally dedicated advisors, the board of directors has a mandate to ensure that the company's direction and strategy will create value. This responsibility leads to the following standard:

Standard #6. The board of directors must participate in the definition of the company's broad strategic orientations and have the requisite competencies in this regard.
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The responsibility of the board of directors cannot be limited to controlling and disciplining managers' actions and vetting financial statements. A team of seasoned, fully independent professionals could replace a board that performs only these functions.<sup>13</sup> Any person who agrees to become a director must desire first and foremost, besides the prestige and financial advantages membership may entail, to help develop an organization that will endure.

Analysts should be aware that an active, competent board of directors that is not limited to rubber-stamping decisions is an important strategic advantage for a company. Indeed, board members give company managers access to seasoned

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<sup>13</sup>If the board were limited in this way, the laws and regulations could be changed to expand the role of external auditors to include these functions.

advisors who have extensive knowledge of the company's outside environment and who, because they are not involved in the company's day-to-day operations, have an objective vision.

For board members to be able to dispense advice on important strategic matters, they must have credibility and legitimacy. Allaire and Firsirotu (2003) established this condition as the first pillar on which a value-creating governance system is founded. According to these authors, legitimacy is acquired not only by being independent; the directors must also demonstrate that they give priority to shareholder interests. However, although legitimacy is necessary for a director to be effective, it is not sufficient without credibility. Therefore, directors must have the required competencies and must demonstrate knowledge of the industry and the company. According to Allaire and Firsirotu:

Achieving a reasonable level of credibility requires an important investment of time and intellect early on to acquire a good understanding of the company's strategic and competitive issues, the sources of its economic value, the quality of its leadership at various levels, its managerial values, its key drivers of share value, and so on. (p. 21)

Once someone has consented to become a member of a board of directors, that person is supposed to possess the required skills and independence of thought together with availability to fully assume his or her responsibilities. The first and most important of these responsibilities is to serve the interests of the company and, consequently, those of the shareholders. On this issue, state laws and the regulations of a number of government agencies clearly outline the duties of the directors of the board: a fiduciary duty, a duty of loyalty, and above all, a duty of care.

To ensure compliance with the spirit of the law, board members must make informed votes on all proposals submitted to the board of directors for approval. Members must, therefore, become comfortable with what they are discussing, take part in the discussions and contribute to them, and gain understanding of each situation. To accomplish these aims and also grasp the industrial, economic, and social environment in which the company operates, board members must be diligent in keeping apprised of the company's affairs—through analyses of historical results, assessments of forecasted performance, and understanding of key strategic issues.

The quality of the board of directors, therefore, depends heavily on the members' availability—having the time to devote to the company's affairs. To make a significant contribution, members must do more than simply attend the requisite meetings. To comprehend the agenda items (matters that must be decided by them), they must prepare for meetings by being well briefed on the issues. Two days of availability per meeting would seem to be a bare minimum. Although the frequency of meetings varies from one enterprise to another, largely depending on circumstances (because events may arise at any time), at least five meetings should be held per year—one meeting per quarter and one annual

planning meeting. The problem is that attractive board candidates generally have full calendars and must prioritize competing time demands.

**Indicators.** Three aspects will indicate to analysts whether the company's board of directors is meeting Standard #6:

- the expertise and experience of the board's members,
- the legitimacy, credibility, and availability of the members of the board, and
- the agendas of the board of directors.

## **Company Reputation**

Companies interact with many organizations and people who, to varying degrees, participate in and benefit from its success—employees, customers, suppliers, and ultimately, society. How a company behaves with these stakeholders has a direct impact on its survival and success. Moreover, its commitment is a major competitive advantage. This commitment depends primarily, however, on how the company is perceived. The company with the best reputation as an employer will attract the best employees. Similarly, the company perceived to offer the best quality/price will attract the most customers.

According to recent research by Pharoah (2003), the importance of corporate reputation has never been higher than it is today. This study showed that a solid reputation helps increase sales, facilitates strategic alliances, and affords the company a major edge when it comes to attracting and keeping talented employees.

A direct correlation exists between a company's reputation and its behavior with its stakeholders. The company would do well to treat everyone fairly because doing otherwise threatens value creation. The board of directors plays a role in preserving a company's reputation because executives are not always as aware as board members are of how their actions affect all the company's stakeholders.

Corporate reputation is more than a matter of public relations. It is built by adopting a responsible attitude and respectful behavior to all. The example of reputation-enhancing behavior must be set at the top—with the board ensuring that the legitimate interests of all the parties involved in the value-creation process are respected.

**Standard #7.** A company's good reputation in society and among social, political, and economic decision makers provides a major competitive edge. Some would argue that a good reputation unquestionably forms the most precious and most fragile asset of a company. It is an asset that cannot be purchased but must be built by investing the necessary resources. As the senior decision-making authority, the board of directors must safeguard the company's reputation. In addition, it must

ensure that the company's managers always conduct themselves in such a way as to inspire confidence. Hence, the following standard:

Standard #7. The board of directors must safeguard the company's reputation and ensure that managers act in a manner consistent with its preservation.

The value placed on a company depends not only on its financial performance but also on the perception investors, markets, and society have of the company. These perceptions are often based on the company's past actions and may not correspond entirely (or even at all) to reality. Nevertheless, perceptions often drive people's actions. For example, a product's brand image may prompt consumers to pay more for the product even if its quality and value are identical to those of another product. Similarly, a good reputation can boost product sales, attract competent employees, and facilitate securing of financing.

Although closely tied to the corporate image, a company's reputation is not limited to the image it projects. Image is, above all, a public relations matter; it depends on how information is conveyed and on the strength of the company's advertising program. Reputation encompasses much more (i.e., everything that can be done for people to develop a favorable opinion of the company). Therefore, how the company treats its employees and how it acts toward its customers are as important as image. Moreover, when considering image and reputation, analysts should remember that people evaluate with their eyes, hearts, and value systems.

The media's attitude toward the company is, of course, critical. When the name of the company makes the headlines, whether the news is good or bad, opinions are always swayed. Moreover, the development of information networks and the democratization of communication as a result of the Internet have expanded what are considered to be "media" and rendered corporate reputations even more fragile.

**Indicators.** The analyst does not evaluate a company's reputation by asking managers what they think of themselves or their company. Indeed, the analyst has no choice but to go directly to the people concerned. Items of interest in this search are the opinions of

- employees,
- customers,
- suppliers, and
- social and economic leaders.

## **Fundamental Social Values**

The most formidable challenge facing companies today involves regaining the confidence of society and the financial markets. To this end, companies must behave transparently, equitably, and with integrity in a manner consistent with society's fundamental values.



Where morals and ethics are concerned, the example must once again be set at the top, and the board of directors' behavior must set the tone for the entire organization. Speeches are meaningless unless the company walks the talk. Respect of fundamental values must translate into concrete action, not be used only as fodder for speeches. Accordingly, the board of directors must be beyond reproach, set high standards of conduct for its members (notably, with respect to conflicts of interest), and implement the means to have them respected. The same applies to management. The more senior the position, the more irreproachable the manager's behavior must be. The employee who sees the boss bending the rules will naturally find it difficult to resist the temptation to do the same.

**Standard #8.** As with the creation of economic value, respect of basic social values must be a part of the corporate culture. Accordingly, it is up to the board of directors to ensure that these values shape not only the company's decision-making process but also the ensuing policies that orient its actions.

Moreover, because executives are entrusted with complex tasks, must frequently make decisions without all the information they need, and must act in accord with society's values even without clearly defined rules, a value *system* is needed to limit and guide their choices. Thus, the board of directors must set up evaluation and monitoring mechanisms to ensure that everyone in the company acts honestly, fairly, and with integrity. These social values underlie the next standard:

Standard #8. The board of directors must ensure that the company respects fundamental social values.
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The enormous loss of confidence in companies and the bodies mandated to regulate them has raised society's suspicions about managers and companies. Although laws and sanctions have become more severe than in the past and the laws encompass a broader range of improper actions, society is demanding that companies and their managers go beyond following certain rules, which by their nature cannot cover everything, and respect fundamental values of honesty, fairness, and integrity.

Managers are responsible for an endless number of decisions. Despite the managers' extensive skills and all the decision-making tools at their disposal, unforeseen situations invariably arise that require on-the-spot decisions. It is at these times that the fundamental values of society to which the company fully subscribes become the managers' best guide.

A code of ethics is helpful at such times, but although a code of ethics to guide behavior is not difficult to draft, implementing it and ensuring compliance are quite another matter. Assigning the responsibility to an individual, an advisor, or an ethics committee can help achieve compliance as long as the person or entity is

not serving merely as window dressing. Whatever title this individual or committee has, those responsible for ethical behavior in the company must report directly to the board of directors.

**Indicators.** Analysts can gain an indication of whether the company is serious about complying with societal values by considering

- the existence of a code of ethics or professional conduct,
- the values on which the code is based,
- the existence of mechanisms to ensure that rules of ethics are known and respected, and
- the penalties for violating the standards.

## Summary

The board of directors must play an active role in pursuing the value-creation objective for the company it oversees not only by aligning manager and shareholder interests and ensuring the reliability of financial information. Although essential to preserving investor confidence, these responsibilities are not enough.

If the board of directors hopes to make a material contribution to wealth creation, it must be made up of a group of experienced advisors who can bring new ideas and timely advice to the table—that is, have credibility and legitimacy—and it must be sufficiently independent to objectively evaluate managers' project proposals. To this end, board members must inspire confidence, have the company's success at heart, and above all, be prepared to devote time and energy to the company they are overseeing.

The board of directors must also safeguard the company's reputation by helping create a corporate culture that respects the rights and privileges of all the stakeholders. Reputation is primarily a matter of perception and is the company's most fragile asset.

Finally, the board of directors must ensure that the company respects basic social values. To this end, the company must do more than keep up appearances. There is no substitute for honesty and integrity. Board members must behave ethically—in the same way they would like other members of the company to behave.

I have not proposed any standards with regard to board structure and operation because it is difficult to find a common denominator in this regard. Each company must decide the size of its board of directors and define its evaluation procedures and work rules. The boards must follow the rules established by the law, of course, and they are responsible for creating the committees they need to better discharge their responsibilities.<sup>14</sup> In addition, a number of guidelines exist to help with board-related decisions.<sup>15</sup>

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<sup>14</sup>The applicable laws are discussed in Appendix A.

<sup>15</sup>A summary of recommendations put forward by institutional investors is provided in Appendix B. Appendix C presents the position of CFA Institute.

The board of directors will add value for the company and participate in the creation of value, regardless of the board's structure or method of operation, if the standards discussed in this chapter are respected:

- The board of directors must ensure alignment between manager and shareholder interests.
- The board of directors must have access to all the information it requires to fully discharge its responsibilities.
- The board of directors must participate in the definition of the company's broad strategic orientations and have the requisite competencies in this regard.
- The board of directors must safeguard the company's reputation and ensure that managers act in a manner consistent with its preservation.
- The board of directors must ensure that the company respects fundamental social values.

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## 4. Stakeholder Power

For companies to create value, they must efficiently use the resources they acquire, and to this end, the shareholders, as owners, must hold the ultimate decision-making power. This power must be well structured, however, to respect the rights and privileges of the stakeholders in the company. Indeed, taking what belongs to others cannot create true value. The standards concerning stakeholder power discussed in this chapter ensure that shareholder power is used wisely, that the company conducts itself as a good corporate citizen, and that the managers effectively discharge their management responsibilities. These standards complement the previous standards on shareholder power and on delegation of shareholder power to the board of directors.

### The Financial Markets

Contrary to popular belief, financial markets do not actually create wealth. Instead, the markets set the conditions that companies need to create wealth. They allow individuals and other economic entities to negotiate to cash in on the value of what they own and to choose investment vehicles in line with their risk tolerances and return objectives. Wealth derived from the financial markets thus comes from only two sources—the revenues generated by companies and the losses suffered by other investors. Beyond the wealth generated by companies, what one investor wins, another necessarily loses. Nothing is lost and nothing is created in the financial markets. All that is involved is a transfer of wealth.

Companies wish to secure financing at the best possible cost, and savers wish to obtain the best return on their investment. This twofold objective can be reconciled if the financial markets make it possible for savers to fairly evaluate the assets traded and accurately recognize the gains created. To this end, the price of the assets traded (predominantly corporate securities) must reflect their true value; return on the investment and the cost paid by the companies to secure the financing will then be reasonable and fair.

From the standpoint of society, recall that in a capitalist system, the allocation of financial and other resources is made through a price system. To optimize allocation, prices must reflect the real value of the resources; if the prices are fair, the prices of various financial instruments (stocks, bonds, etc.) make it possible to allocate funds to the projects that will be most productive for a nation's economic development.

If a company is high risk, an efficient market will set the price of its stock to offer potentially high returns. Some investors will be interested by the prospect of

such returns, and the company can obtain the funds to undertake its projects. If a company is deemed low risk, the price of its stock will be set accordingly and it will find investors suitable to its riskiness.

In this way, only companies able to efficiently produce goods and services in demand by the population will survive because they will be the only ones able to offer investors adequate returns. The companies that cannot secure financing will gradually disappear because of their inability to finance profitable projects. The more efficient a company, the more money it makes and the higher its stock price.

**Standard #9.** To be effective, the value-creation process must allow the companies with the “best” projects to secure financing, which means that savers must be able to identify these companies. Without an organized financial market, savers could not find the best investment—just as companies could not obtain the best financing—because individual savers cannot negotiate with each company, no more than each company can negotiate with each saver. Therefore, well-functioning financial markets that provide an efficient price-setting mechanism are a prerequisite for economic development and wealth creation. The commitment of certain countries to creating a well-organized financial market or to improving the market’s operation is an essential step in maintaining or improving society’s standard of living.

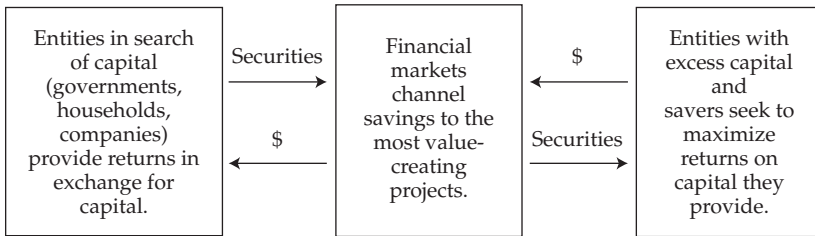
For a company to obtain the funds it needs for value-creating projects at the best possible rate, the price of the company’s stock must correspond to its true value. For the price to be true, the company must win and keep the confidence of financial markets. To this end, in addition to obeying the laws and regulations of the bodies governing financial markets, the company must adopt behavior consistent with the conditions for market efficiency.

These conditions include transparency and accuracy. The greater the transparency the company demonstrates and the more credible the information it delivers to investors and analysts, the more confidence it will earn from the financial markets and the better its evaluation will be.

Because both society and companies benefit from market efficiency and because market efficiency depends on publicly traded companies respecting the conditions that promote market efficiency, the following corporate governance standard is proposed:

Standard #9. The company must behave in such a way as to earn the confidence of financial markets.

**Role of financial markets in value creation.** The primary role of the financial markets is to channel savings into the economy’s most productive activities. In this way, the most profitable companies—the ones with the best projects—will be able to obtain the most funds and, because they have the best projects, create the most value. **Figure 1** illustrates this idea.

**Figure 1. Value-Creation Process**

Projects require financing. To obtain outside financing, a company must offer or promise competitive returns (i.e., compensation that, given the project's risk, is at least on a par with the returns offered by other companies and other economic entities). For the company, the returns gained by investors or creditors are the cost of financing. The cost of using a resource is not only its price but also the compensation paid to those who provide the funds to purchase the resource. To create real value, the acquired resources must allow the company to produce goods and services with enough value to offset the price paid for the resources and to compensate the financial backers.

To achieve economic prosperity and improve society's standard of living, financial resources must be invested in successful projects. If the resources are so invested, savers obtain the best returns for the risks they choose to take and companies can finance their most promising ideas and undertake expansion projects at the lowest cost. The first condition needed for this result is a liquid, efficient financial market.

Because self-regulation seems insufficient to guarantee real efficiency, however, regulatory agencies institute formal rules for how companies must behave in the financial markets and for disciplining companies that break the rules (see Appendix A).

**Disciplining companies.** The financial markets regulate the behavior of companies to ensure that they act in accordance with the value-creation objective. Thus, when a company creates wealth, its stock market price goes up. In the long term, only well-managed companies see a sustainable increase in their market value. Companies with incompetent managers and companies that use the wrong decision-making criteria will be penalized for their poor performance by seeing their stock price drop.

The consequences of such financial market regulation for companies are obvious: A successful company has easier access to capital, its stock is in demand, and it is in a better position to undertake new projects to sustain its growth. A struggling company becomes a potential target for takeover because its stock price is low.

Hostile takeovers are a way for potential buyers to sanction inefficient executives and improve a company's performance, often by replacing incompetent managers.

The growing concentration of savings in the hands of institutional investors—notably, pension funds in the private and public sectors and mutual funds—has placed them in a position to exert significant power over companies.<sup>16</sup> Given the role institutional investors play in business financing and the number of shares they control, one would expect them to be active and demand that executives give top priority to the company's interests. They could seek to impose corporate governance rules and standards in their favor. At first blush, this situation would be no cause for concern because these investors would be pursuing the same objectives as any other investor and should demand that companies create the maximum value while respecting the rules.

There is little evidence, however, that institutional investors (with the exception of certain public pension funds, as noted in Appendix B) successfully contribute to improving corporate governance. To the contrary, institutional investors are often accused of short-term vision and of wearing blinders, particularly where manager compensation is concerned. This accusation stems from the performance criteria institutional investors use to evaluate fund managers. The criticism is that the criteria prompt funds to exert pressure on company managers to strive for short-term performance at any price, even to the detriment of real value creation. If this accusation is true, institutional investors would do well to review their own governance rules and standards in light of their purposes.

The primary role of institutional investors, however, is to build savings over the long term, and such an investment objective is incongruent with a high turnover of assets under management. Therefore, institutional investors should not be accused of forcing companies to take actions that run counter to the company's interests solely to generate quick returns. I see no relationship between the activism of institutional investors and the value-damaging actions taken by some executives. Rather, the involvement of institutional investors can actually improve management by obliging executives to render accounts and disciplining them for subpar performance and foolish compensation.

In addition to the market and institutional investors, other forces play their roles in disciplining companies. The labor market can act so that incompetent managers find themselves out of a job. The customers for the company's goods and

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<sup>16</sup>Most pension funds and mutual funds are in a position to exercise considerable power over companies because they can exercise voting rights through the proxy process. Such delegation of power can lead to a conflict between the interests of the institution (the agent) and the savers/fund beneficiaries (the principals). Governance in the institutional investment sector thus also raises many questions, but these questions do not pertain to the corporate governance discussed in this monograph.

services can reject them, resulting in long-term financial problems that invariably lead to a drop in the company's stock price. Ultimately, however, financial markets have the greatest and, more importantly, the most immediate disciplinary power.

**Degrees of market efficiency.** For financial markets to effectively sanction companies, the price of the traded securities must accurately reflect their value. In a condition of perfect correspondence between market price and true economic value, investors pay fair prices for the securities they purchase and companies obtain fair prices for the securities they issue. This ideal of a perfectly efficient market does not, of course, exist.<sup>17</sup>

Fortunately, efficient resource allocation does not require the markets to be perfectly efficient. Rather, the market price must be close enough to the real value that investors have confidence in the price-setting mechanism. People have confidence in the market as long as no one can systematically and consistently take advantage of the spreads between the price and the real value. This type of efficiency occurs when everyone has the same information at the same time and the information is sufficiently clear that all the players can correctly interpret it.

When people have confidence in the financial system's price-setting mechanism, they agree to invest, companies obtain financing at fair prices, and they, in turn, invest. The end result is increased economic prosperity (see Page 2003).

If prices in the financial markets do not reflect the true value of the securities, investors lose confidence in the price-setting system and refuse to invest, thereby depriving companies of the financing required to grow. The consequences are clear: job losses, fewer goods and services, and a lower standard of living for everyone.

The outcome is similar for an individual company that loses the confidence of the financial markets. It will no longer be able to obtain financing at a reasonable cost and will eventually disappear. Therefore, a company that cheats (i.e., manipulates its information or fails to act in accordance with the conditions of market efficiency) causes itself great harm. Inevitably, the real information will reach the markets and the share price will be adjusted to reflect the real value. In the meantime, investors will have lost confidence.

Financial markets are obviously not 100 percent efficient, although it is in their best interests to aim for efficiency. Similarly, the primary objective of the regulatory organizations (securities commissions, stock exchanges, and others) should be to ensure maximum efficiency.

**Market regulations.** The purpose of market regulations and of the agencies created to enforce them is to improve market efficiency. For market efficiency

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<sup>17</sup>The conditions for a perfectly efficient market are (1) that transactions be carried out without transaction fees and (2) that all the participants have perfect, free information at all times.



to exist, accounting and financial information must be reliable and available at all times and no investor, no matter how important, should be able to benefit from special advantages.<sup>18</sup>

Each country has its own regulatory agencies, but the most important and influential in the world is the U.S. Securities and Exchange Commission. The jurisdiction of the SEC extends to stock markets, brokerages, financial advisors, and mutual funds.

The most recent action taken in the United States to protect investors and maintain market integrity is the Sarbanes–Oxley Act of 2002 (see Appendix A), which is enforced by the SEC. Past experiences that led to Sarbanes–Oxley clearly showed that the financial markets sometimes needed supervision.

No regulation, however, no matter how comprehensive, and no structure, for that matter, can prevent all abuses that interfere with market efficiency. Economic development requires that the market be able to discipline companies itself. Consequently, a fine balance between formal rules and market mechanisms is always preferable.

**Indicators.** Whether the company is behaving in such a way as to earn the confidence of financial markets can be analyzed by noting

- the quantity and relevance of information communicated by the company,
- the speed with which information becomes available, and
- the clarity of the information.

## **Society and the State**

Regardless of the prevailing ideological trend, governments are stakeholders in any business and are, consequently, key players in corporate governance systems. Society requires that governments define the rights and privileges of companies and their owners. Governments fulfill this requirement, either directly or indirectly, through the laws and regulations they create and the agencies they establish to implement the laws.

As corporate citizens of society and the State, companies must respect the laws and regulations of the State and its agencies and must pay attention to its responsibilities to society, or the companies will face failure. Without knowledge of all the applicable business laws and regulations and without ensuring that it complies with them, the company risks sanctions, complaints, and even prosecution.

**Standard #10.** Through democratically elected governments, society has erected various safeguards that restrict the exercise of corporate power. A good corporate governance system requires the company to respect a wide variety of constraints and boundaries imposed by the State.

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<sup>18</sup>See Appendix A for applicable laws and regulations.

Legislation has a major impact on economic activities because it defines the power held by each entity and sets the boundaries of what can and cannot be done. The legal framework, therefore, establishes all the formal rules with which the company must comply. The company that fails to comply will be penalized and could cease to exist.

The principle that businesses are bound to respect the laws and regulations of the State is quite clear. Applying the laws to day-to-day realities is not so clear. Bending the rules may be necessary to keep a company in the game. Highway speed limits provide a good analogy. Although drivers know the speed limits, they also know that they can exceed those limits by a certain amount without penalty. When everyone is driving at greater speeds, it creates a new norm. Because companies tend to take the same view, those that follow the letter of the law may fall behind in the short term. So, although businesses are to blame for bending the rules, society is also at fault for its tolerance of “speeders.”

The following corporate governance standard reinforces that companies must respect government laws and regulations and fulfill their social responsibilities:

Standard #10. The company must behave in such a way as to earn the respect of society.
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**Wealth distribution through taxes.** An inherent limitation of a system based on value creation and shareholder primacy is that gaps inevitably arise between the rich and the poor, between the haves and have-nots. As a company becomes successful, it becomes more powerful and capable of acquiring more and more resources. Its shareholders or owners become wealthier, its employees are better compensated, and its suppliers become more profitable. Those who are not helping create wealth in this manner will not prosper in the system.

A democratic society, unlike a totalitarian regime, cannot allow the gaps to become too big, however, or affect too many people. Thus, one of a democratic government’s tasks is to distribute a part of the wealth created to the have-nots, and the tool of choice for this distribution is the tax system. The more successful a business and the greater its profits, the more taxes it will pay to contribute to the lot of the less advantaged.

Governments must act carefully when redistributing wealth, however, because as taxes go up, entrepreneurs become less motivated to undertake projects. In an increasingly globalized economy, the issue of a heavy tax burden takes on even more importance because it can dissuade businesses from starting up or expanding in a given location. Consequently, although a fair allocation of wealth is essential to society’s well-being, abuses in this regard can destroy economic value.

Gaps between the investors in wealth creation and others are normal and inherent in a price system–based value-creation process. If the gaps are deemed abnormal, it is more appropriate to question how the wealth is distributed than to blame the companies that create it.

Through corporate income taxes, governments can be a company's biggest stakeholder. If a government imposes a corporate tax rate of 40 percent, the government is taking 40 percent of the profits before shareholders get their share. Therefore, 40 percent of the company's pretax value belongs to the government and, by extension, to society.

**Preserving freedoms.** Society asks governments not only to distribute wealth but also to legislate and regulate businesses to ensure the efficiency of the price system, which allows for optimal resource allocation. Efficiency in the price system requires freedom and requires that all costs be accounted for in the price.

Most economists agree that one situation that justifies State intervention in the market system is when a company becomes so powerful that it controls an entire sector of the economy. Once a company has a monopoly, it controls prices; free competition, a key element in an efficient price system, ceases to exist, and consumers are deprived of choice.

Another situation in which the State must intervene to preserve freedom is when the use of a resource entails implicit or collateral costs. Such use usually involves long-term damages that are not necessarily reflected in the price but that limit society's future choices—for example, mining exploration, which can cause irreparable environmental damage.

In summary, a government's power to legislate is justified by the fact that to run smoothly, society and the economic system need safeguards to prevent abuse and ensure the preservation of existing and future individual rights and freedoms. Governments must define the rights of each person and entity by enacting laws and regulations, ensuring compliance, and imposing sanctions as needed.

**Goods and services provided by the State.** In addition to distributing wealth and enforcing fair play, the State may be asked by society to offer goods and services when people have no confidence in the private sector's ability to do so effectively. Examples are building roads, the management of national parks, and a large portion of health care. In some societies, the effect is that governments become the main engine of the economy; in others, the private sector drives growth.<sup>19</sup>

A trend toward privatization has endured worldwide for some 20 years, but in some circumstances, the free market and the market price system clearly cannot

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<sup>19</sup>How big a place government occupies in the economy can be calculated by dividing the total market value of all final goods and services in a country by its gross domestic product. If this percentage exceeds 50, resources in that country are no longer considered to be allocated according to the price system.

fulfill all of society's needs. In those cases, goods and services and the value they provide should be the responsibility of the State.

**Indicators.** Analysts can discover to what extent a company is meeting the standard to obtain the respect of society by examining

- the managers' knowledge of and respect for the company's legal and regulatory environment and
- the existence of lawsuits or complaints, whether founded or not, launched against the company or its managers.

## Respecting Democratic Institutions

When it comes time to legislate and regulate, the legislator must clearly understand business reality so that the value-creating conditions can be preserved. The company must, therefore, make sure it is heard and, to this end, must be able to communicate with the elected officials responsible for governing society. Consequently, in addition to the official mechanisms provided for communication (e.g., parliamentary commissions, hearings), companies have the responsibility and right, as do all citizens, to express their point of view on legislation that will affect them. They do not, however, have the right to interfere with the legislator's work.

**Standard #11.** The company's responsibility to create wealth, combined with the taxes paid to the State, fully justifies the right of each company to be heard by the representatives of democratically elected governments. The way in which companies carry out this right and duty, however, must not undermine the rights of others or the workings of democratic institutions. Therefore, the following standard must be respected:

Standard #11. The company must behave in such a way as to earn the respect of democratic institutions.
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This standard needs explanation to guide companies in their communications and other relationships with the State. The issue is lobbying: How far can a company go to make sure it is heard? No one can clearly answer this question, and opinions on this issue vary widely. Any rules instituted by governments to structure lobbying activities must, of course, be respected. But in my opinion, the right of companies to make themselves heard by the government should have few limits. The guidelines are: Communications should be transparent; comply at all times with applicable laws, regulations, and directives; and respect fundamental social values.

Within the issue of general lobbying is the issue of contributions to political parties and campaigns. Although expressing the company's point of view improves value-creating conditions, whether corporate financing of political parties or politicians achieves the same objective is not at all clear. Ultimately, only individuals

should be authorized, using their own funds, to contribute to political campaigns. When enterprises or organizations make political contributions, they are, in effect, using funds provided by investors, even though the executives may not necessarily share the opinions (beliefs and ideologies) of these investors. Public companies should remain neutral.

To maintain the quality of the democratic process, some States have legislated to structure these practices. In any case, in making campaign contributions, good governance requires that companies remain transparent, obey laws, and respect social values.

Even if a company's business is dependent on the State (through military supplies, for example, or government assistance for their financing needs), the company is certainly not ensured survival. Politicians and political parties must be accountable to the population if they wish to be elected or reelected. Therefore, their time frame is often limited to the next election. They also are not known for self-sacrifice in the interests of supporting a business venture.

**Indicators.** Whether the company is making its voice heard appropriately to the relevant legislators and institutions and is displaying respect for democratic institutions can be discovered by examining

- participation of the company in the State consultation process (e.g., commission of inquiry, parliamentary commission),
- how dependent the company is on government assistance programs, and
- the company's political neutrality.

## Creditors

Companies are generally unable to meet all their financing needs through internal growth and selling shares, so shareholders must count on creditors to make up the shortfall. Whether short-term financing in the form of credit lines or medium- or long-term capital financing, suppliers of credit enable businesses to acquire a large proportion of the resources they use. Moreover, companies can gain advantages by using debt in their financial structure. Thus, creditors are important partners with the shareholders.

Among all the stakeholders, creditors enjoy a special status. In exchange for their contribution, they acquire, through contracts, a priority right over the revenues and assets of the company. Therefore, at least in terms of respect of their interests, they acquire many of the privileges typically reserved for owners.

**Standard #12.** The importance of creditors to the company and its shareholders suggests the following corporate governance evaluation standard:

Standard #12. The company must behave in such a way as to preserve its credibility with creditors.

Shareholders and companies must be aware that debtholders' interests are not necessarily the same as the interests of shareholders and companies; adding debt can create agency costs.

**Fiscal advantages of debt.** An important advantage of using debt to finance a portion of a company's assets is the special tax treatment accorded to interest expense. Unlike profits paid to shareholders, compensation paid to creditors is deductible from revenue for calculating corporate taxes (in most advanced economies). Debt is thus a financing method that, for all intents and purposes, is subsidized by the State. For example, at a tax rate of 40 percent, a return rate of 10 percent required by the creditors translates into a financing cost of only 6 percent for the company.

This reduction in the cost of funds obtained through debt does not directly create wealth for society because what the company gains is lost by the State.<sup>20</sup> The debt advantage, however, becomes an incentive for shareholders to back the additional risk created when a company uses a method of financing involving fixed payments.

Without direct or indirect subsidies granted by the State, securing financing in the markets does not increase a company's value. Only the efficient use of assets (i.e., resources) makes it possible to truly create value. Therefore, without counting the tax savings generated because interest expense is tax deductible, the total value of a business is based on the value of the assets; the equity value is obtained by deducting the amount of the debt. Be it in the form of debt or equity, financing is intended to allow the company to carry out value-creating projects and does not, in and of itself, create value.

**Shareholder vs. creditor objectives.** Creditors and shareholders benefit from a company's success to varying degrees. Because their situations and objectives tend to vary widely, conflicts can arise in case of financial distress.

Creditors achieve their primary objective if the company performs well enough to make its interest payments and repay the principal on the debt on time. An exceptional performance in no way changes the compensation the creditors receive. Consequently, for them, stability and continuity take precedence over exceptional success.

Shareholders are looking for maximum success and are prepared to assume greater risk than creditors assume to achieve it. They are willing to withstand some instability, which may not sit well with the creditors. These conflicting interests can result in a loss of value for the company because any conflict, regardless of its nature, entails agency costs.

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<sup>20</sup>Governments compensate for shortfalls by imposing a heavier tax on the interest income earned by savers.

Companies and creditors sign contracts that explicitly set out the rights and responsibilities of both parties with regard to the loans and establish the dates on which the funds will become available. Loan contracts have repayment terms and conditions that reflect the nature of the assets acquired by the company and that fix the returns on the loans; that is, the returns on the lenders' funds are in no way tied to the company's performance. These contracts may also include clauses designed to ensure that the company respects its commitments, such as guarantees and restrictions.

Shareholder–creditor conflicts reduce the value of the company and can reduce opportunities for value creation. The company has no choice but to take into consideration the legitimate interests of its creditors, even if this choice means limiting its growth prospects (which is a cost) over the short run. In cases of strong shareholder concentration, the creditors, particularly if they are banks, to counter-balance the power held by the majority shareholder, will attempt to secure the right to approve major decisions made by the company.

The first level on which companies can meet this standard is to have an effective communication system with lenders that minimizes information asymmetry between the company and the lenders. Creditors have different objectives from shareholders. And creditors are usually seeking to protect themselves in case opinions diverge about the actions a company can take in the event of financial distress, such as accepting riskier projects. This protection entails costs to the company that should be minimized because they hinder value creation. Accurate, complete information provided to creditors as well as shareholders will not entirely eliminate all potential disagreements, but it will certainly minimize them.

When negotiating loan contracts, shareholders and creditors have a vested interest in identifying, and thus possibly avoiding, potential sources of conflict. Uncertainty can never be eliminated entirely, however, because regardless of the good faith of the parties at the time of negotiation, it is impossible to foresee every eventuality.

For the same reasons as shareholders, creditors attempt to make sure that managers do not make decisions that will cause the creditors harm. When negotiating debt contracts, creditors often thus add various clauses to guarantee that the commitments are respected. The goal is to protect themselves against an increase in the risk they agreed to back at the outset. Analysts need to be aware, therefore, that the cost of the funds obtained from creditors is not limited to the rate charged but also includes all the clauses that restrict the company's choices. Creditors require guarantees and usually impose restrictions that severely limit managers' freedom of action. These limits obviously come at a cost. The legal costs created by disputes are also a type of agency cost.

All sources of financing entail agency costs, however, and financing a business solely with equity does not eliminate potential conflict because diverging interests

can also exist among shareholders. For example, consider the point of view of institutional investors versus individual investors or the perspective of minority versus majority shareholders. The less debt financing a company uses, the more equity it must have and the more diverse the shareholder base will be. Consequently, the agency costs must be considered marginally (i.e., the costs generated by debt financing minus the costs of equity financing).

Most of the agency costs related to financing arise from information asymmetry. However, this greatest source of conflict disappears when each stakeholder has the same information at the time of contract negotiation and at the time the contract is executed.

**Indicators.** Analysts can decide whether the company is preserving its credibility with creditors by examining

- the quality of the information communicated to creditors and
- the number and the severity of restrictions imposed by the creditors.

## Human Resources

Employee quality and commitment constitute a company's most important competitive advantage. Because a good company cannot exist without good employees, it must win their loyalty. To this end, the company should adopt a strategy for the treatment of employees that recognizes their major role in creating value and that is rooted in the principles of fairness (particularly in compensation) and transparency.

**Standard #13.** Given the competitive advantage linked with employee loyalty, the following standard is proposed:

Standard #13. The company must act in such a way as to earn the loyalty of its employees.
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This standard requires companies to develop a strategy that identifies each employee's role in value creation and that demonstrates principles of equity and transparency. When an economy has a balance between labor supply and demand, market forces ensure that employees receive fair treatment.

**Balance between labor supply and demand.** The labor force in an economy is considered to be "in balance" when employees are paid proportionately to their contribution to society's well-being. Unfortunately, because the labor force can never be perfectly balanced, the work force may be poorly allocated and employees may give less than their best efforts.

An imbalance between labor supply and demand can have two consequences: Employees may acquire too much power, or employers may have the upper hand. Employees can acquire too much power when a sector is experiencing a labor shortage or scarcity. In such a situation, which is usually short-lived, supply cannot satisfy demand and the lack of human resources may cause companies to miss opportunities



to create value. A union that acquires too much power and ends up imposing its will on a company has the same effect. Conversely, when unemployment is high, companies acquire too much power and can impose work conditions that employees would otherwise find unacceptable. Although this action may seem profitable in the short term, the long-term effect on productivity and efficiency can be negative.

**Effort.** Another issue companies face is how to measure and control employees' efforts. Consider the example of an entrepreneur who creates a company with two managers. The entrepreneur provides the funds, one employee is responsible for production, and the other is responsible for marketing. The managers' compensation will be as follows: \$100,000 base salary plus 5 percent of the profits, leaving 90 percent of the profits for the entrepreneur. The entrepreneur's idea works well, and the company soon flourishes. The agreement negotiated at the outset is fully respected. The entrepreneur (the venture capitalist), however, reaps almost all the rewards (90 percent of the profits), even though the two managers make a considerable contribution to the company's success. Clearly, this situation cannot persist indefinitely, and if the contract is not renegotiated, the two managers may well stop working as hard as they had worked. They may even decide to quit the company.

**Need for a human resources strategy.** To deal with imbalances in labor, fairness in performance measurement and compensation, and other employee issues, a company needs, first and foremost, a strategy that recognizes the importance of its employees, gives them the attention they need, and treats them fairly. This approach is needed before the company undertakes any initiatives to improve employee satisfaction at work. All the efforts to validate and train employees are for naught if the employees believe, rightly or wrongly, that they are poorly paid or treated unfairly or that the boss has no confidence in them. An important point in this regard is that human resources are vital to more than the knowledge-based companies of the New Economy. To the contrary, few sectors are immune to shortages of qualified labor at some time.

In the past, access to physical resources, raw materials, equipment, or other materials was a major competitive advantage because companies could count on a widely available work force. Today, the labor market has changed. Tasks have become more complex, and employees are not interchangeable or easily replaced. Moreover, training costs have soared. The company must consider these changes in its human resources strategy.

Developing a human resources strategy involves recruiting the most talented people, investing in their training to make them competent, and learning how to retain them in the face of competition for experienced workers. Because of potential labor imbalances, companies must adopt a strategy to gain and maintain the loyalty of the greatest number of employees. Loyalty on the part of employees is defined

as employees who are committed to doing their jobs well and apply the required effort. Companies with loyal employees enjoy a major competitive edge.

Loyalty cannot be taken for granted. It takes more than a statement in the annual report affirming that the company “takes care of” its employees. To secure a commitment from its employees, a company must have a clear strategy that is implemented through policies and concrete actions. In this regard, it is in a company’s best interest to

- treat all its employees fairly by avoiding arbitrary conduct, unfairness, and bias,
- interact and negotiate with employees transparently,
- continuously provide employees with information, and
- compensate employees on the basis of their contribution while retaining the company’s competitiveness.

**Indicators.** A company’s corporate governance in regard to employees is shown by

- employee turnover,
- average number of years of service for employees, and
- payroll as a percentage of sales (see Meyer and Allen 1997).

## Consumers

Value creation hinges on the production and supply of goods and services that meet the needs of society—that is, the consumers or customers of the company. Consequently, consumers exercise an enormous power over companies. To create value, a company must recognize the value of its clientele, know it well, anticipate its needs, and above all, offer a product or service with a good price-to-value ratio.

Today, a satisfied customer will not necessarily buy again from the same company. Driven simply by the desire to try something different or by curiosity, the customer may change brands or try a substitute product. Because of this growing consumer independence, it is not easy for companies to win customer loyalty. The best time-tested way to keep them coming back is to offer the best value for the price. Product value depends on quality, after-sales service, and the brand image or prestige associated with the product. And no company can offer all three elements at the same price.

**Standard #14.** Because value can be created only when consumers are satisfied and because customers are an asset that must be built, the next standard is as follows:

Standard #14. The company must behave in such a way as to deserve its customers’ loyalty.
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To meet this standard while creating value, companies must recognize the power of consumers and deal with the increased competition in today's marketplace.

**Magnitude of consumer power.** In retail businesses, consumers have the last word. In many cases, they can dictate the products and services they want, the quality, and even the price. Companies that refuse to acknowledge the power of consumers or that simply cannot fulfill their customers' desires quickly run into major difficulties.

In addition to being well protected by various laws, consumers have learned to organize—at the national level and in a general manner (e.g., consumer associations), by industry (e.g., the Automobile Protection Association), or by forming purchasing groups whose main objective is to inform members (by way of publications, websites, conferences, and the media) of prices, features, and quality. This organizing has had two results: A poor report by one of the groups can neutralize the most aggressive marketing efforts, and a strong recommendation can send demand soaring to such an extent that it rapidly outstrips supply.

In addition to relying on consumer associations, many consumers have become adept at obtaining information themselves. The Internet has piqued consumer curiosity and become a treasure trove of information. Consumers have also become more discerning. Consequently, today's consumers are well educated about products and services and well placed to assess and compare products and services.

For businesses, the issue raised by these trends has nothing to do with whether the business agrees or disagrees with the assessment of their products, the tests conducted, or the criteria used; the issue is to contend with the reality of consumer power.

**Democratization of supply.** Increased supply and competition is the second major reason consumers have acquired so much power over business. Trade liberalization and the development of communication networks provide consumers with access to a broader variety of products than ever before, with the result that consumers can use competition to their favor. Companies can no longer take the continued patronage of customers for granted.

Urging companies to "put consumers first" is nothing new, as is attested to by the "total quality management" concept and the movement spurred by the book *In Search of Excellence* (Peters and Waterman 2004). Customer commitment and attachment are what give a company a true competitive edge. To this end, the customer must first be satisfied, then be convinced that he is getting his money's worth, and finally, have confidence in the company he patronizes.

Customer satisfaction may no longer be a guarantee of loyalty, however, because customers leave not only when they are dissatisfied but also when they are lured away by the vast selection of goods and services available in the market—which leads to the next subsection.

**Difficulty in meeting Standard #14.** This governance standard is not easy to achieve within the value-creation objective, but the following three steps will help secure customer loyalty.

First, before any other steps are taken, the company must know its current customers; the company must be able to anticipate their desires, their tastes, and (especially) their needs. To this end, a sophisticated information system is vital.

Second, the company must optimize the price/quality/feature combination, including post-sales service. Consumers are not necessarily looking for the lowest prices, nor are they prepared to pay simply any price for a specific feature. Informed and educated, they know full well that quality comes at a price and are also quick to recognize superfluous product features. Companies must, therefore, offer products and services that give consumers their money's worth. Success at this step depends on the company's efficiency.

The third step is to treat customers as the assets that are truly at the core of the value-creation process. As with any other asset, companies should look for ways to increase the value of its customers by increasing their number and loyalty; in particular, companies should not shy away from investing to retain customers and meet their needs through, for example, quality postsales service. In the long term, the strategy of investing in current customers will lead to the creation of as much value as a strategy of winning new customers. Many companies invest massive amounts of money to acquire new customers but neglect their existing clientele. Consumers are increasingly being solicited by all kinds of means, however, so a company that can rely on a loyal customer base has a precious asset. As in the case of the company's human resources, however, it is an asset that requires tremendous maintenance (Reichheld 1966).

**Indicators.** Whether a company is striving for customer satisfaction can be assessed by discovering

- the existence of a customer database to identify consumer needs,
- the opinions of customers with regard to price/quality, and
- the reputation of the company with the competition's customers.

## Suppliers

Suppliers are all the sources of inputs used for production of the company's goods and services, including the important field of outsourcing. Moreover, given the level of consumer power and competition, a company can often make more money in the acquiring of resources than when selling them in a final form. Because the buyer has the last word, overpaying for a resource makes the task of creating value very difficult. Any purchase by a company necessarily involves a relationship with a supplier because making a "good" purchase (i.e., not overpaying) is essential to value creation.

In the matter of provisioning, buyers have the upper hand—so much so that the fate of many suppliers depends on the willingness of their customers to continue buying from them. The company often exercises sufficient power to dictate the rules of the game and to benefit from important advantages when acquiring resources.

Companies in all sectors of the economy have operated from a position of strength for a long time in relation to their suppliers. “Just-in-time” and similar measures clearly illustrate the power of buyers, who have been in a position to negotiate good prices, dictate their own manufacturing standards, and even have a part of their inventory financed. Free trade and multilateral trade agreements are other factors that exert enormous pressure on suppliers.

Increased competition has forced supply companies to continuously improve efficiency and become more creative, failing which they can find themselves out of business. This business environment, which has resulted in closures and job losses, is sometimes referred to as “rampant capitalism.” It is, in a sense, the “collateral damage” caused by economic progress. Ultimately, the big winners are consumers, who obtain better products and services at lower prices.

If the company uses its resources efficiently and its suppliers use their resources efficiently, the result is greater economic development and social well-being.

Many companies, however, fail to realize that value creation is nearly impossible without a continuous supply of quality goods and services at a fair price. These companies do not place enough importance on purchasing systems and long-term relationships with suppliers. When it comes to their suppliers, companies are in the same situation as customers are vis-à-vis the companies. In other words, companies should treat their suppliers in the same way they would like to be treated by their customers. Companies have the advantage in promoting competition among suppliers. The company must adopt a strategy that recognizes the importance of its suppliers while allowing the company to benefit from the advantages of competition among suppliers.

**Standard #15.** Because companies generally operate from a position of strength vis-à-vis their suppliers, it is important that they play by the rules. Hence, the following standard is recommended:

Standard #15. The company must have a sound business relationship with its suppliers.

**Indicators.** Analysts can check the soundness of a company’s relationships with suppliers by noting

- the amount of diversification in supply sources and the dependence of the company on certain suppliers,
- the dependence of suppliers on the company, and
- the longevity of relationships with suppliers.

## Summary

Financial market participants, the State, creditors, employees, consumers, and suppliers—all rely on economic prosperity to achieve their objectives. In our economic system, there can be no prosperity without value creation. And to achieve value creation and prosperity, financial markets must be efficient and robust, the State must legislate wisely, and creditors must have confidence in companies. Furthermore, companies must fulfill consumer needs, and to do so, companies need loyal employees and must be able to count on their suppliers.

These interests—sometimes mutual and sometimes in conflict—define and constrain management policies and practices.

Observance of laws and regulations and respect for stakeholder rights do not mean that the ultimate power in a company belongs to everyone and that the overriding objective of governance is wealth distribution. Just as value cannot be created by taking what rightfully belongs to others, giving precedence to shareholder interests is essential to efficiently allocating resources and is, therefore, a fundamental condition to value creation. Because the numerous limits and constraints imposed on the primacy of shareholder interests make decision making so complex, strategies must be developed to ensure that the managers who make the day-to-day decisions do not lose sight of the value-creation objective.

No company can operate outside the law or exist without customers, employees, and suppliers. Corporate governance evaluation must, therefore, include an analysis of the principal strategies used to ensure the participation of all the stakeholders in the value-creation process.

To this end, this chapter set out the following seven standards:

- The company must behave in such a way as to earn the confidence of financial markets.
- The company must behave in such a way as to earn the respect of society.
- The company must behave in such a way as to earn the respect of democratic institutions.
- The company must behave in such a way as to preserve its credibility with creditors.
- The company must act in a such way as to earn the loyalty of its employees.
- The company must behave in such a way as to deserve its customers' loyalty.
- The company must have a sound business relationship with its suppliers.

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## 5. Analysis of the Corporate Governance System

The purpose of analyzing a company's corporate governance system is to assess (1) whether the organization and exercise of power truly enable value creation and (2) to what extent investors can be assured of the company's survival. In fact, the way power is exercised within an organization not only affects the behavior of all the parties involved but also determines the company's economic efficiency, which is the only way to create wealth and guarantee the company's long-term survival.

Unlike traditional financial analysis, whose purpose is to evaluate and forecast financial results, governance analysis involves determining whether the factors *behind* the projected performance are present. Among these factors are the quality of the decision-making process, the integrity of the organization and the people within it, and the commitment of the various stakeholders involved in value-creating activities. Therefore, rather than trying to forecast results, governance analysis attempts to determine whether the conditions required to achieve the results exist.

Financial analysis is a complex task for which there is no magic recipe. Only judgment, education, knowledge, and effort allow the analyst to become truly competent. Governance analysis is simply another aspect of the work that allows the analyst to accurately evaluate a company's value.

### Survival and Governance

A company with a good governance system can strike a balance between the ultimate power held by the shareholders, the fiduciary role exercised by the board of directors, the authority managers have to allocate resources, and the rights stakeholders enjoy. The “more calibrated” the balance, the better the decision making and the more efficient the resource allocation—which leads to value creation.

Resource allocation based on sound decision making is critical to a company's survival. The 15 standards I have proposed are indispensable to good governance and, consequently, to sound decision making and, if respected, will ensure the company's continued ability to offer society the goods or services it wishes at fair prices. These standards are the pillars that should underpin the company's broad orientations, strategies, and policies concerning asset acquisition, market exploitation, human resource management, and innovation.

When making decisions, managers must respect the value-creation objective and give priority to shareholder interests while at the same time respecting the rights

of the various stakeholders. If these fundamental elements of a good governance system are disregarded, managers run the risk of adopting the wrong decision-making criteria and taking action that could cause the company harm. Suppose, for instance, that a company makes decisions aimed at improving short-term performance by disregarding employee rights or by canceling a research and development program. Such actions mortgage the future because they harm the company's medium- and long-term competitiveness and could ultimately jeopardize its survival.

A good governance system begins with the company winning the confidence of society by complying with the laws and regulations enacted by the State and by the agencies that see to the proper functioning of financial markets. But the company must do more if it wishes to fulfill its primary role of creating value to contribute to society's well-being. A good governance system also requires that the board of directors add value and that the managers administer the company as if it were their own. A governance arrangement allows the company to identify and pursue value-creating strategies and, more importantly, helps it establish a reputation for strength, credibility, and responsibility. The confidence of stakeholders in the company and the credibility of the company allow it to obtain the funds it needs to undertake value-creating projects, to recruit the best employees in order to develop competitive advantages, to retain and acquire new customers, and to win the ear of society's leaders. Confidence and trust must exist at all levels of the company and its stakeholders:

- between society, including the financial markets, and the company,
- between the shareholders, board of directors, and managers, and
- between the company and its creditors, customers, employees, and suppliers.

In summary, governance is not limited to the structure of the company; it concerns how power is exercised and decisions are made. A good governance system is a major asset that, at all levels, sets the conditions for using resources efficiently and creating value.

## **Governance Analysis in the Financial Analysis Process**

The purpose of fundamental stock analysis is to establish a stock's real or intrinsic value in order to determine whether the company is over- or undervalued by the market. Based on this determination, the analyst recommends whether to buy or sell the stock. So, whatever form the analyst uses for the final recommendation (a point system, a target price, etc.), the decision must be based on the stock's intrinsic value.

Usually, intrinsic value is established by discounting at the present time all future cash flows from time zero to infinity. Discounting places more weight on recent cash flows, but few analysts can distinguish between overvalued and undervalued shares without assigning a value to medium- and long-term cash flows. Unfortunately, traditional analysis and forecasting methods are poor predictors of performance beyond five years. Thus, analysts do not extend their projections



beyond a three-year horizon. Medium- and long-term forecasts are frequently only extrapolations of short-term forecasts; the premise is that observed trends will continue indefinitely. Doing otherwise is difficult because forecasts are based on analysis of historical results (corporate, industry, and economic data) and the information provided by companies about their futures is also typically based on observable trends. Moreover, not many reliable methods exist to forecast trend reversals or changes in direction.

Still, business conditions do change rapidly, and the 21st century has experienced the need for and emergence of new approaches to valuation—particularly for rapidly growing companies and companies operating in a changing environment. For these entities, extrapolating and forecasting a linear pattern for the medium and long term is not realistic. This conclusion is convincingly attested to by the value placed on many high-technology companies at the end of the 1990s. For example, projections for fiber-optic manufacturers were such that the entire planet would have had to be wired several times over to achieve the projected long-term volume and to justify the stock prices. Similarly, the projected sales required to support the total value assigned to e-commerce companies implied the disappearance of all “bricks and mortar” businesses.

Much of medium- and long-term forecasting involves determining which businesses will be able to overcome the inevitable difficulties they will encounter in the future. For this determination, an analyst must scratch beneath the surface and assess the company’s decision-making structure and the nontraditional competitive advantages provided by its reputation, integrity, and commitment to stakeholders—in other words, the quality of its governance. We can draw an analogy from the world of disaster analysis: When considering which buildings will be least affected by a flood, a tornado, or an earthquake, the engineer looks to the better-built buildings with sound maintenance. In deciding which buildings fit those criteria, the engineer recognizes that not all the aspects of a good building are immediately apparent. Similarly, when it comes to evaluating a company, the analyst must recognize that the extent to which conditions for value creation exist may not be obvious.

The standards listed and discussed in the previous chapters are intended to facilitate the analysis of underlying structural strengths and weaknesses by analyzing a company’s governance system. In the next sections, we consider five principles that can aid an analyst in this exploration.

## **Principles of Corporate Governance Analysis**

Analysis of governance is based on an assessment of qualitative factors; thus, it differs greatly from a quantitative analysis, which typically relies on data-based calculations. When it comes to governance, the analyst’s work involves evaluating what is not directly observable and making an assessment based on qualitative indicators. Although the principles of governance analysis are similar to those

governing traditional financial analysis, they have a different importance because the information is not easily available and benchmarking is difficult.

**Principle #1: Think Critically.** Some of the elements needed to evaluate a company's governance are found in official declarations and documents. Analysts must be vigilant, however, because as soon as a standard is made the least bit explicit and is recognized as an evaluation criterion by the markets and analysts, senior managers and boards of directors tend to adjust their discourse to address it, whether their actions are truly addressing it or not. For this reason, the major statements of principle found in annual reports generally reflect the trend of the day.<sup>21</sup> Companies have claimed at some point or another to espouse such management philosophies as "the search for excellence," "total quality," "consumer sovereignty," and of course, "value creation." History has shown, however, that these words do not necessarily translate into action.

Analyze the facts and the decisions the company has made. Individuals who hold positions of responsibility within an organization have a natural bias toward the organization. Indeed, they should. Therefore, their point of view, albeit totally honest, will be somewhat tainted with optimism. Analysts must approach a company's written discussion of governance principles with caution.

**Principle #2: Understand the Company's Context.** The 15 proposed standards do not apply in the same manner to all companies. They must be adapted to the specific characteristics of each company, or at least placed in context to take into account important factors, such as the laws and regulations constraining the company, the degree of national and international competition, shareholder dispersion, the presence of institutional investors who play an active role in monitoring management, and the complexity of the administrative structure. For example, the greater the company's competition is, the more the market will discipline the managers and the less will be the need for direct control by shareholders or other constraints on the company.

**Principle #3: Focus on Qualitative Elements.** Even if the analyst uses an effective chart based on an ordinal scale for analyzing corporate governance, the analyst must always keep in mind that the analysis is *qualitative* and, as such, will always be subjective. The efforts the analyst makes to arrive at an accurate score may be so great that they prevent the analyst from recognizing that the score is still based on subjective judgments.

Similarly, using a questionnaire that managers or board members answer with a yes or a no or by checking a figure on a given scale does not guarantee accuracy. Although a questionnaire makes it possible to take the pulse of a group or sample of companies, it does not allow the analyst to draw conclusions about particular

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<sup>21</sup>The presentation of annual reports is in large part the work of public relations specialists.

respondents. This warning is all the more important now that people have become extremely aware of governance-related issues. To avoid compromising themselves, they may even forward the questionnaire to the legal department, which will make sure the information provided coincides with the company's written documents and shows that the company is in compliance with formal rules and standards.

Rather than traditional survey tools, I suggest using semi-structured interviews. After reading the company's official documents and understanding the company's context, the analyst can talk informally with managers and employees to ascertain the extent to which the company is meeting the standards stated here that are generally found in companies that create value.

The indicators I listed can be used as guideposts. They are not exhaustive, however, and I have not suggested any "weightings." Their purpose is to help the analyst assess the company's ability and willingness to respect governance standards. Keep in mind also that the indicators are a way to check whether the *conditions* for achieving a certain level of corporate governance are present, not for forecasting governance performance. Even if the analyst's conclusions can be translated into a rating or ranking, a governance evaluation is not truly quantifiable. It requires discernment and intelligence.

**Principle #4: Talk to Stakeholders and Others.** Because intangible elements such as integrity, reputation, and loyalty are associated with perception, it is important that the analyst talk to shareholders, creditors, employees, and competitors. For example, asking a boss if her employees considered her fair and transparent is pointless. When the goal is to scratch beneath the surface and find out the real facts, analysts must look at the day-to-day operations and meet with employees directly. Analysts must go beyond the answers provided by the managers in charge of investor relations and meet with customers, employees, and suppliers. If necessary and possible, the products and services offered by the company can be tested.

**Principle #5: Be Tenacious and Dig Deep.** To evaluate a company's performance accurately, the financial analyst must do more than interpret balance sheets, income statements, and cash flow statements. The analyst must look at the notes to the financial statements, must measure the impact of accounting choices on the results obtained, and beyond that, must perform an independent audit. In the same way, to understand how power is exercised and to evaluate whether the conditions for value creation are present, the analyst must do more than look at the composition of the company's board, shareholder structure, corporate organization chart, and executive compensation system. The analyst must be tenacious and dig deeper. For governance analysis, the analyst has nothing equivalent to the notes to financial statements, and important strategic choices concerning employees, customers, and suppliers do not always coincide with the official company line.

To determine whether a stock should be sold, held, or bought, the analyst must reach the correct conclusion on whether the stock is overvalued, valued correctly, or undervalued. And the analyst must be right before everyone else because the recommendation will be good only if other investors are slower in coming to the same conclusion. Simply analyzing what is apparent and accessible to everybody is not sufficient. The analyst must delve deep to explore the factors that actually contribute to value creation. Analysts who do their homework increase their odds of making good recommendations.

## **Governance Evaluation by Rating Agencies**

As a result of the increasing attention being paid to governance in this decade, a number of agencies have begun to offer fund managers a corporate governance evaluation service.<sup>22</sup> The first initiatives in 2000 were aimed primarily at meeting the demand of institutional investors that governance be included as a selection criterion for stocks and a basis for corporate risk evaluation.

The services take the form of ratings or scores in reports that, although similar to credit evaluations, focus on governance (which is only one of the elements taken into account in a credit analysis). These scores provide a quick way to find out the opinion of well-informed, impartial people on the relative quality of a company's governance.

For financial analysts trying to determine the value of a company, however, the usefulness of governance scores is limited. One reason is that the interpretation of such scores is complex. What does a rating of 8 out of 10 mean for a company in a given industry on a given date and subject to specific regulations? Moreover, because governance evaluation is still a novelty, no scientific study has demonstrated a significant link between scores and financial performance, much less a link to value creation.

In general, the information collected by the providers of governance scores concerns only one aspect of governance—namely, the structure of power in the form of shareholder composition, independence of board members, and separation of the chief executive and chair positions. Moreover, the information, whether obtained by questionnaire or directly through interviews with a company's representatives, typically takes the form of ready-made formulas. The information the services provide rarely differs from public records—in the company's annual report, in filings with regulatory bodies, or on its website. Companies know that governance is a highly sensitive issue and that any differences between what they say and what they do can be damaging. For this reason, companies often call on their legal departments to provide information on governance.

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<sup>22</sup>Appendix D provides the main agencies offering governance evaluation services.

Whereas the usefulness of governance scores for the financial analyst is limited, the story is quite different for the companies under evaluation. If the company is willing to participate in the process, the evaluation criteria used by rating agencies allow it to compare itself with others and identify actions it should take to improve its score—which should, of course, raise the quality of its governance.

## **Summary**

The financial analyst's work is ultimately to determine the intrinsic value of a stock, and to this end, the analyst must go beyond the information found in the company's annual report and quantitative or easily observable information, such as market share or management experience. The real value of a company rarely corresponds to the figures on the balance sheet, so the analyst must use other indicators to ascertain whether the conditions for survival and value creation are actually present. This analysis of qualitative factors differs substantially from traditional financial analysis. The analyst's work with qualitative factors involves measuring what is not directly observable and then forming an opinion. To help with this work, I proposed 15 standards and various indicators the analyst can use to judge a company's corporate governance. In this chapter, I have discussed how the analyst should go about evaluating corporate governance—in particular, through following five principles of analysis.

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## 6. Conclusion

The scandals that recently shook various large corporations have pushed the study of corporate governance to the forefront in a number of disciplines. Each expert approaches the topic from the perspective specific to that field; therefore, to compile a unified body of knowledge about corporate governance is difficult. In the field of corporate governance evaluation, for example, *The Patterson Report* (2003), which presents some of the most important and up-to-date research published in the scientific literature, lists more than 500 articles on the relationship between corporate governance and corporate performance.<sup>23</sup>

Even agreeing on a generally accepted definition of governance has proven to be difficult. Because experts in different disciplines are notorious for not communicating with each other, corporate governance concepts have evolved simultaneously in various directions and there is a dearth of well-established concepts in this field. For example, legal experts approach governance predominantly from the angle of conflict of interest, economists tend to address agency costs and information asymmetry, accountants propose measures aimed at improving the reliability of information, and ethicists are concerned with morals. Financial managers have offered their own definition, one that links governance and value creation. The issue is: If a company wishes to create value, how does it reconcile shareholder power with the responsibilities delegated to directors and managers and with stakeholder rights?

Although a number of experts have referred to the financial approach to corporate governance in their analyses, no one as yet has explored the links between the foundations of power, the role society asks companies to fulfill, and decision making. Who should hold the ultimate power so that companies can create maximum value? How should this power be exercised? To what extent should it be constrained? The starting point of this approach is the fundamental role companies fulfill in society.

I chose to take this approach. This perspective also has limitations, however, because it precludes a comprehensive study of all governance-related aspects. For example, in this perspective, it is the State's responsibility, not the responsibility of companies, to ensure a balance between corporate power and the power exercised by regulatory agencies on behalf of society. Similarly, companies are not responsible for ensuring a balance between economic and social development. In both cases, the issues are much too important to be entrusted to companies. Therefore, the analysis

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<sup>23</sup>Patterson classified the research on the link between governance and performance into 14 categories and presented the main conclusions of some 100 studies.

presented here started with the assumption that laws and regulations exist to constrain corporate activities that would harm society and the economy and that corporate compliance is expected. This initial assumption was essential to focus the exploration on an in-depth analysis of the links between governance and value creation.

I also believe that the managers and directors of companies generally have the necessary judgment to discharge their value-creation responsibility. Therefore, the State and regulatory agencies would do well to avoid imposing too rigid a structure on decision making. Our economic system is based on freedom and, as a result, is open to abuse, but the desire to eradicate all abuses must not lead to excessive constraints that would end up having worse consequences for society's standard of living than freedom has.

By proposing standards rather than rules, codes, or laws, I am somewhat bucking today's trend. Whereas rules command or prevent certain acts, standards, which are necessarily more general in nature, seek to change attitudes and behavior. By being less specific than laws, standards are more flexible and have a broader reach or coverage.

**Exhibit 1** summarizes the 15 standards proposed as the essential elements of a corporate governance system truly focused on the efficient use of resources that will allow the company to create value and, ultimately, ensure the company's survival. The standards relate to three factors: the foundation of power, the exercise of power (i.e., decision making), and constraints on power. These standards should be viewed as parts of a whole. Applied individually, they will have limited usefulness for good governance. Indeed, the standards complement each other, and in a sound corporate governance system, emphasis should not be placed on one to the detriment of the others.

The standards must be adapted to the regulatory environment and economic context in which the company operates. The exercise of power, or the governance system, is specific to each company and depends on

- the degree of shareholder confidence in its managers,
- the control shareholders can exercise over executives,
- the constraints imposed by the goods and services market as a result of competition,
- the power held by the creditors, and
- the laws and regulations in force.

The fact that governance systems must be tailored to each company makes benchmarking or ranking scores difficult to interpret and largely explains why financial analysts make little mention of evaluation of the corporate governance system in their reports. Although analysts may believe they should address this issue seriously, they find "governance" an abstract and difficult subject to evaluate. They are also sometimes not familiar with the subject, which they tend to associate with the law or management studies.

**Exhibit 1. Proposed Corporate Governance Standards**

Standard	Link with Value Creation	Rationale
<i>The foundation of power</i>		
1. The ultimate power in a company must rest with the shareholders.	A decision-making criterion that gives precedence to shareholder interests allows for efficient allocation of resources and, ultimately, value creation.	By creating value, companies contribute to economic development and, by extension, to the well-being of society.
2. No shareholder should benefit from special advantages.	The way shareholders are treated facilitates access to equity capital, enabling the company to undertake value-creating projects.	By according all shareholders the same rights and privileges, companies earn investor confidence.
3. The shareholders must approve executive compensation.	Incentive compensation for executives motivates them to focus on value creation only insofar as it is tied to the company's long-term performance.	By retaining the right to approve executive compensation, the board holds managers accountable to the shareholders.
<i>The exercise of power</i>		
4. The board of directors must ensure alignment between executive and shareholder interests.	The decrease in costs arising from power delegation favors value creation.	Encouraging executives to act like shareholders reduces sources of conflict.
5. The board of directors must have access to all the information it requires to fully discharge its responsibilities.	A decrease in information asymmetry that results from power delegation makes it possible to improve the conditions for value creation.	By having full access to information, the board of directors can more effectively exercise the powers delegated to it by the shareholders.
6. The board of directors must participate in the definition of the company's broad strategic orientations and have the requisite competencies in this regard.	Informed boards and objective advice from dedicated, competent people favor value creation.	The ability to count on a team of seasoned advisors allows the company to implement better strategies.
7. The board of directors must safeguard the company's reputation and ensure that managers act in a manner consistent with its preservation.	A good reputation is a major competitive advantage when the company negotiates to acquire resources.	Reputation is the company's most precious and fragile asset and the most difficult to acquire.
8. The board of directors must ensure that the company respects fundamental social values.	True value cannot be created unless the company behaves honestly, fairly, and with integrity.	Respect for society's fundamental values is the first requirement with which any company must comply.



**Exhibit 1. Proposed Corporate Governance Standards (continued)**

Standard	Link with Value Creation	Rationale
<i>Constraints related to the exercise of power</i>		
9. The company must behave in such a way as to earn the confidence of financial markets.	A company's behavior in line with the conditions for market efficiency allows the company's stock to reflect the value created.	By earning the confidence of financial markets, the company can obtain the funds required to undertake value-creating projects at the lowest cost.
10. The company must behave in such a way as to earn the respect of society.	Compliance with laws and regulations is a prerequisite for the company to fulfill its value-creation role.	In a democratic system, no one can live outside society.
11. The company must behave in such a way as to earn the respect of democratic institutions.	When the State understands business realities, companies can create value under the best conditions.	The company is a full citizen of society and must express its point of view on legislation that affects it.
12. The company must behave in such a way as to preserve its credibility with creditors.	Creditors are invaluable partners for value creation; therefore, the company must respect its agreements with them.	Creditors must be able to count on quality information that allows them to correctly interpret managers' decisions.
13. The company must act in such a way as to earn the loyalty of its employees.	Value creation is impossible without the active and enthusiastic participation of employees.	Truly committed employees are a company's number one competitive advantage.
14. The company must behave in such a way as to deserve its customers' loyalty.	To create value, the company must fulfill consumer needs.	A company cannot exist without customers, and its success is directly related to the size of its customer base.
15. The company must have a sound business relationship with its suppliers.	The value-creation process begins the moment the company obtains resources.	Sound business practice allows the company to acquire resources at the best price to create the maximum value.

Empirical verifications of governance-related proposals encounter some of the same difficulties. Most of the information required to analyze a governance system is not made available by companies, which forces researchers to proceed by approximation. Consider one of the topics that has been researched, the link between director independence and corporate performance. Various definitions and criteria have been used to define "independence," but people cannot avoid biases and researchers cannot prove that certain types of so-called independent directors are objective. Indeed, when group decisions are involved, each member's independence of mind is the only guarantee that the choices will be in line with the company's objectives and devoid of conflict of interest. And only by being a witness to board deliberations can a researcher observe the true degree of independence.

This difficulty helps explain why governance studies are fragmented. Some researchers are studying the link between form of compensation and performance; others are examining the relationship between director participation in the company's capital stock and performance. Although highly useful, such narrow studies do not allow us to evaluate corporate governance systems as a whole.

Since 2000, researchers have faced another major challenge because governance rules and practices have been transformed in the United States by the Sarbanes–Oxley Act and increased focus on governance by the Securities and Exchange Commission and New York Stock Exchange. The images of even the most transparent and ethical companies (all of them) were tarnished by accounting or trading scandals, and companies have been compelled to change the way they transmit information, prevent and address conflicts of interest, and fulfill the criterion of director independence. Many companies are now also realizing that their governance systems can improve their competitiveness, long-term profitability, and even odds of survival. The relationships between governance and survival were discussed in the section “Survival and Governance” in Chapter 5. I hope this newfound realization on the part of corporate executives will lead to a change in attitudes and behavior.

These changes—those related to the legal and regulatory framework as well as those pertaining to how governance is understood—will not necessarily bear fruit immediately. The real effect of governance on operations and results is measurable only in the medium and long term. What is certain at this point is that the change is in the right direction.

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# Appendix A. Applicable Laws and Regulations

The legal and regulatory framework has greatly influenced the evolution of corporate governance, particularly with respect to the delegation of shareholder power to the board of directors.<sup>24</sup> The goal of the State and organizations dedicated to ensuring well-functioning financial markets is to stimulate investor confidence. As has happened in the past, following the recent scandals that shook the business world, legislators quickly realized the need to beef up laws and their enforcement. They also realized that the financial information disclosure process and the quality of the audit process had to be improved.

**New York Stock Exchange** ([www.nyse.com](http://www.nyse.com)): The NYSE regulates the activities of its members, and its rules, like those of other self-regulatory organizations, define the scope of certain legislative aspects concerning companies and the trading of securities. The NYSE's corporate governance rules cover independence, the integrity of control procedures, and the responsibilities of board members and senior managers with respect to the accuracy and quality of information transmitted to investors. The rules are as follows:<sup>25</sup>

- Listed companies must have a majority of independent directors.
- An independent director is one who has no material relationship with the company.
- Independent directors must meet regularly without the presence of management.
- Listed companies must have a nominating committee and a corporate governance committee composed entirely of independent directors, and each committee must have a written charter addressing its purpose, goals, and responsibilities; an annual performance evaluation of the committee must be carried out.
- Listed companies must have a compensation committee composed mostly of independent directors and a written charter that sets out the performance objectives and compensation-setting and performance measurement mechanisms for the president and chief executive officer (CEO).

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<sup>24</sup>The various rules and regulations are easily accessible on the University of Cincinnati College of Law website at [www.law.uc.edu/CCL](http://www.law.uc.edu/CCL).

<sup>25</sup>The rules of the NYSE have served as a model for other stock exchanges in the United States and elsewhere in the world ([www.amex.com](http://www.amex.com), [www.nasdaq.com](http://www.nasdaq.com), and [www.tsx.com](http://www.tsx.com)).

- Listed companies must have an audit committee that satisfies the legal requirements of the U.S. Securities and Exchange Commission (SEC); notably, it should be composed of at least three members, all of whom are independent, and have a written charter setting out their responsibilities.
- Listed companies must adopt and disclose corporate governance guidelines.
- Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers, and employees and must promptly disclose any noncompliance with the code for directors or executive officers.

**Public Company Accounting Oversight Board** ([www.pcaobus.org](http://www.pcaobus.org)):

The mandate of the U.S. PCAOB, established by the Sarbanes–Oxley Act of 2002, is to supervise operations in connection with the preparation of financial statements and to see that financial information is complete, disclosed in a timely fashion, and the object of a truly independent audit. The PCAOB is also vested with investigation and sanction powers.

Answering to the SEC, the PCAOB has the following main responsibilities:

- to register public accounting firms that prepare audit reports for issuers,
- to conduct inspections of registered public accounting firms,
- to establish or adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers,
- to conduct investigations and disciplinary proceedings and impose sanctions on offenders, and
- to define new standards or rules when needed to improve the quality of auditing services, protect investors, or further the public interest.

**Sarbanes–Oxley Act of 2002** ([www.pcaobus.org/About\\_Us/Sarbanes\\_Oxley\\_Act\\_of\\_2002.pdf](http://www.pcaobus.org/About_Us/Sarbanes_Oxley_Act_of_2002.pdf)):

Enacted in July 2002 following the Enron Corporation and WorldCom/MCI debacles, Sarbanes–Oxley is definitely the most sweeping reform of U.S. securities law since 1933. Threatened by the potential economic impact of a broad-based crisis in confidence on the part of investors and society in general, the U.S. government implemented a new legal framework with stricter provisions than the Securities Act as well as more severe penalties, particularly in cases of insider trading and conflicts of interest.

The primary goal of Sarbanes–Oxley is to protect investor interests. In fact, most of the measures it instituted seek to align management and shareholder interests and to

- increase the powers of the audit committee, particularly in terms of supervising the work of outside auditors,
- increase the independence of outside auditors, mainly by separating audit and consulting services,

- increase the responsibilities of senior executives by obliging the president, CEO, and chief financial officer to certify the veracity of information in the company's reports, and
- increase the independence of the board of directors and the audit committee.<sup>26</sup>

Sarbanes–Oxley thus addresses three key principles underpinning power delegation: the independence of individuals in positions of authority when exercising their judgment, the responsibility of boards to monitor senior management, and the importance of auditor integrity. These new legal constraints give managers less room to maneuver in ways the board does not desire, specify the responsibilities of auditors, and ensure the integrity of control and information reporting procedures. The scope of this statute is vast, and its provisions are gradually becoming recognized as standards around the world.

Sarbanes–Oxley also provided for the establishment of the PCAOB (Sections 103–105), which is charged with overseeing the audit of public companies.

**Securities Act of 1933** ([www.sec.gov/about/laws.shtml](http://www.sec.gov/about/laws.shtml)): The Securities Act of 1933 was the first securities legislation to be enacted in the United States. One of its main objectives was to ensure that investors receive financial information sufficient to allow them to make an informed judgment on the value of securities being offered for public sale.<sup>27</sup>

**Securities and Exchange Commission** ([www.sec.gov](http://www.sec.gov)): The most important outcome of the Securities Act of 1933 was the creation of the SEC. Working closely with the New York and American stock exchanges and the National Association of Securities Dealers (NASD), the SEC's first and foremost mandate is to protect investors and maintain the integrity of the securities markets. It is also responsible for seeing that companies, through their boards of directors, respect the interests of shareholders—notably, by ensuring that investors have access to reliable, comprehensible financial information. The SEC exercises major power in the markets, including regulating the financial services industry, defining the registration conditions for publicly traded companies, supervising self-regulating organizations, and imposing disciplinary actions on companies that do not comply with information disclosure requirements.

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<sup>26</sup>The Sarbanes–Oxley Act did not, however, institute a rule about separating the positions of president and CEO from chair of the board.

<sup>27</sup>See also the Securities Exchange Act of 1934 and the 1975 amendments to it ([www.sec.gov/about/laws.shtml](http://www.sec.gov/about/laws.shtml)).

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## **Appendix B. Actions and Activism of Institutional Investors**

Institutional investors have a fiduciary duty to place their clients' interests above their own. Their first obligation is to add value to their clients' assets; they must invest in companies that create value. Institutional investors must, therefore, ensure that interventions in the companies in their portfolios reflect this objective. They must act to ensure that corporate policies serve the best interests of the institution's investor/owners.

Although institutional investors are not expected to become involved in the day-to-day operations of the companies in which they invest, they should recognize the need for diligent oversight of and input into management decisions that may affect a company's value. Institutional investors should adhere to clear, transparent general voting guidelines, but in voting their proxies, they must also recognize the need to review all votes individually and ensure that minority shareholders are treated fairly.

Institutional investors and other financial market participants do not have the power to legislate or impose sanctions, but they do exert considerable influence that has a visible effect on certain corporate governance practices—notably, the structure of the board of directors and its method of operation (e.g., size; evaluation system for members; director education; nomination and election of members, president, CEO, and board chair; and shareholder communication).

The most active institutional investors in the United States are the California Public Employees' Retirement System and the Teachers Insurance and Annuity Association—College Retirement Equities Fund; in Canada, the most active institutional investor is the Canadian Coalition for Good Governance, which represents a multitude of institutional investors (with more than \$400 billion under management).

**California Public Employees' Retirement System** ([www.calpers-governance.org](http://www.calpers-governance.org)): CalPERS is a recognized leader among institutional investors in regard to corporate governance. The pension's philosophy states that investors (broadly, the financial markets) should regulate corporate behavior:

CalPERS strongly believes that each market throughout the world should adopt corporate governance principles that are appropriate for that market. Ideally, these principles should be developed by the market's participants themselves, through cooperative action and consensus.<sup>28</sup>

Given CalPERS' tremendous influence (it represents 1.4 million public employees, retirees, and their families and more than 2,500 employers), its guidelines can be considered representative of the recommendations of many institutional investors. CalPERS' standards contain the following elements:

***Board independence and leadership***

- definition of independence,
- director nomination, and
- combination of the CEO and chair positions.

***Board process and evaluation***

- succession plan,
- access to senior managers, and
- board size.

***Individual director characteristics***

- performance criteria,
- evaluation, and
- nomination.

***Shareowner rights***

- proxies,
- poison pill,
- greenmail, and
- other.

**Canadian Coalition for Good Governance** ([www.ccg.ca](http://www.ccg.ca)): The CCGG seeks to promote best corporate governance practices and to align board and management interests with shareholder interests. Shareholder concentration is much greater in Canada than in the United States,<sup>29</sup> and the CCGG's mission takes this point into account:

We are committed to considering carefully the balance between financial performance and appropriate corporate governance definitions, structures and processes to judge whether the interests of minority shareholders are appropri-

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<sup>28</sup>From [www.calpers-governance.org/principles/](http://www.calpers-governance.org/principles/).

<sup>29</sup>Many studies highlight this point; an example is Halpern (1966).

ately recognized and protected. There are few easy governance solutions that apply to all companies or all situations.<sup>30</sup>

The CCGG's recommendations address the following elements:

***Individual directors***

- quality motivation of board members,
- director share ownership, and
- appointment of majority of independent directors.

***Board structure***

- separation of chair and CEO,
- independence and mandates of board committees, and
- requirements for the audit committees.

***Board processes***

- performance evaluation of boards and committees,
- performance evaluation of individual board members,
- access to CEO and planned succession,
- management oversight and strategic planning,
- management evaluation and compensation, and
- report of governance policies to shareholders.

**Teachers Insurance and Annuity Association-College Retirement Equities Fund** ([www.tiaa-cref.org](http://www.tiaa-cref.org)):

The corporate governance proposals of TIAA-CREF are among the most comprehensive and detailed in the institutional investment sector. Based on a fine balance between shareholder rights and the need for effective company management, TIAA-CREF seeks to correct what it considers to be three main deficiencies of corporate governance systems:

We place particular priority on these areas that were generally recognized as sources of significant and continuing corporate governance deficiencies: 1) the failure of boards of directors to play their required oversight role; 2) the failure of some professional advisors, including public accountants, law firms, investment bankers and consultants, to discharge their responsibilities properly, and 3) the failure of many investors, particularly institutional investors, to exercise effectively their rights and responsibilities or even to be heard on matters of corporate governance importantly affecting them.<sup>31</sup>

TIAA-CREF's principles address the following elements:

***Board of directors***

- Board membership:

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<sup>30</sup>From "Corporate Governance Guidelines for Building High Performance Boards" (available at [www.ccg.ca](http://www.ccg.ca)).

<sup>31</sup>"TIAA-CREF Policy Statement on Corporate Governance" (available at [www.tiaa-cref.org/bookstore](http://www.tiaa-cref.org/bookstore)).



- director independence,
- director qualifications,
- board alignment with shareholders, and
- director education.
- Board responsibilities:
  - fiduciary oversight,
  - CEO selection and succession planning,
  - strategic planning, and
  - equity policy.
- Board structure and processes:
  - role of chairperson,
  - committee structure (audit, compensation, governance/nominating),
  - executive sessions,
  - board evaluation,
  - annual elections,
  - board schedule and meeting agendas,
  - indemnification and liability,
  - board size, and
  - director retirement policy.

### ***Shareholder rights and responsibilities***

- director representation of shareholders,
- support of one share = one vote,
- confidential voting,
- majority requirements,
- abstention votes,
- authorization of stock,
- fair-price provisions,
- antitakeover provisions,
- incorporation site,
- shareholder access to the board, and
- bundled issues.

### ***Executive compensation***

- equity-based compensation and
- fringe benefits and severance agreements.

### ***Role of independent advisors***

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# Appendix C. Position of CFA Institute

(as corrected May 2005)

Among its various activities, CFA Institute, formerly known as the Association for Investment Management and Research (AIMR), addresses issues of corporate governance. The CFA Institute Code of Ethics and Standards of Professional Conduct have become a benchmark in the financial world, making CFA Institute one of the most influential organizations in the field.<sup>32</sup> In the past few years, the advocacy efforts of CFA Institute have focused on such issues as the independence of financial analysts, the governance of pension plans, financial statement audits, accounting standards, financial market regulation, and corporate governance. Most recently, the organization, through its CFA Centre for Financial Market Integrity and its Global Corporate Governance Task Force of volunteers, published *The Corporate Governance of Listed Companies: A Manual for Investors*.<sup>33</sup>

The foundation of all CFA Institute recommendations is respect for and protection of investor rights. Investor interests must always come first (i.e., before those of the investment manager or analyst, before the employer's, and before the interests of any public company or its managers). Applying this principle to corporate governance, the Global Corporate Governance Task Force stated:

The Task Force believes that corporate directors have a fiduciary duty to shareholders—that is, they have a duty of loyalty to shareholders and must work for their best interests. Directors do not work for the company or for the company's management—they work for the shareholders and are their representatives charged with overseeing management. Directors are stewards of the corporate assets and are responsible for overseeing management's allocation of those assets so as to maximize shareholder value.<sup>34</sup>

As noted in *The Corporate Governance of Listed Companies*, the CFA Centre and its Corporate Governance Task Force recognize that corporate governance issues pose specific risks for investors that investors need to understand. Through this manual, the Centre intends to provide the tools needed to recognize the governance risks created by investing in public companies, how those risks may affect investments, and indications of where to find information about those risks. When applied appropriately, *The Corporate Governance of Listed Companies* should enable individuals and institutions to make better investment decisions.

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<sup>32</sup>The CFA Institute Code of Ethics and Standards of Professional Conduct are available at [www.cfainstitute.org/standards/ethics/](http://www.cfainstitute.org/standards/ethics/).

<sup>33</sup>Available at [www.cfainstitute.org/cfacentre/cmp/pdf/cfa\\_corp\\_governance.pdf](http://www.cfainstitute.org/cfacentre/cmp/pdf/cfa_corp_governance.pdf).

<sup>34</sup>CFA Institute Advocacy, 2004 Comment Letter: Proposed Revisions to OECD Corporate Governance Principles (available at [www.cfainstitute.org/advocacy/04commltr.html](http://www.cfainstitute.org/advocacy/04commltr.html)).

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# Appendix D. Corporate Governance Evaluation

Various organizations conduct studies of corporate governance and provide ratings or scores.

**Corporate Library** ([thecorporatelibrary.com](http://thecorporatelibrary.com)): The Corporate Library provides a Board Effectiveness Rating and board analysis.

### *Companies included*

- 2,000 U.S. companies (with particular emphasis on the 500 largest) and
- 500 of the largest international companies.

### *Main evaluation criteria*

- CEO compensation,
- outside director shareholdings,
- board structure and makeup,
- accounting and audit oversight, and
- board decision making.

**Governance Metrics International** ([www.gmiratings.com](http://www.gmiratings.com)): GMI provides the GMI Ratings.

### *Companies included*

- North American companies included in the following indexes: TSX 60, S&P 500, S&P MidCap 400, and Russell 1000,
- more than 625 European companies,
- Japanese companies that make up the NIKKEI 225, and
- Australian and New Zealand companies that make up the ASX 50 Index.

### *Main evaluation criteria*

- board accountability,
- financial disclosure and internal controls,
- shareholder rights,
- executive compensation,
- processes for control (e.g., poison pills, single shareholder controlling majority of the voting power),
- ownership base and potential dilution, and
- corporate behavior.

**Institutional Shareholder Services** ([www.issproxy.com](http://www.issproxy.com)): ISS provides the Corporate Governance Quotient (CGQ) and Governance Analytics.

*Companies included*

More than 5,500 U.S. companies and nearly 2,000 other companies around the world, including those that make up the MSCI, EAFE, and S&P/TSX Composite indexes.

*Main evaluation criteria*

- board of directors,
- audit committee,
- charter and bylaw provisions,
- antitakeover provisions and director compensation,
- progressive practices,
- ownership, and
- director education.

**Rotman School of Management at the University of Toronto**

([rotman.utoronto.ca/ccbe/criteria.htm](http://rotman.utoronto.ca/ccbe/criteria.htm)): The Rotman School provides a Board Shareholder Confidence Index.

*Companies included*

Companies listed on the Toronto Stock Exchange and in the S&P Composite Index.

*Main evaluation criteria*

- Individual potential:
  - independence of a director and
  - stock ownership.
- Board potential:
  - board structure and
  - board systems.
- Past practices, effect of board decisions:
  - dilution,
  - option repricing, and
  - CEO compensation.

**Standard & Poor's** ([www.governance.standardandpoors.com](http://www.governance.standardandpoors.com)): S&P provides Corporate Governance Scores and Corporate Governance Evaluations.

*Main evaluation criteria*

- Ownership structure and external influences:
  - transparency of ownership,
  - ownership concentration and influence, and
  - influence of external stakeholders.

- Transparency, disclosure, and audit:
  - content of public disclosures,
  - timing of and access to public disclosures, and
  - audit process.
- Shareholder rights and stakeholder relations:
  - shareholder meeting and voting procedures,
  - ownership rights and takeover defenses, and
  - stakeholder relations.
- Board structure and effectiveness:
  - board structure and independence and
  - role and effectiveness of board.

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