

## Does Superior Governance Still Lead to Better Financial Performance?

**ALTHOUGH THE MESSAGE HAS BEEN OVER-**looked by some, the reforms triggered by the ethical scandals of Enron, WorldCom, Andersen, and others have strongly underscored the need for improved attention to the importance of an organization's governance, particularly its ethical culture. An organization's ethics and compliance programs have also been put under the spotlight because of the revised guidelines issued in 2004 by the U.S. Sentencing Commission. One of the evolving conclusions from the increased emphasis being put on superior governance is that public corporations have responsibilities to a much wider group of stakeholders than just shareowners. Effective ethics and compliance programs are essential for organizations to achieve this goal.

Prior research by this editor and others has shown that well-managed companies that take their ethical, social, and environmental responsibilities seriously—in other words, companies that act as good corporate citizens—have stronger long-term financial performance than the remaining companies in the S&P 500 Index. The current study expands the scope of this research to investigate the strength of the linkage between companies that emphasize superior governance practices and their long-term financial performance. A number of consulting organizations have made public statements that Sarbanes-Oxley

reforms and other governance improvements should be considered best business practices and should result in better financial returns to shareholders. Yet few studies have been published that actually demonstrate for U.S. corporations the size of the benefits, if any, that are associated with superior governance attributes.

In a new study addressing this issue, the governance attribute that was selected for analysis is whether the leadership of a company's internal ethics and compliance programs met the standards for membership in the Ethics Officer Association (EOA). The EOA is the professional organization exclusively for managers of ethics, compliance, and business conduct

programs. According to the EOA, its members are "individuals who are recognized by their organization as having the assigned role and responsibility for devising, implementing, or administering ethics, compliance, or business conduct programs."

As part of their mission, ethics officers are expected to integrate their organization's ethics and values initiatives, compliance activities, and business conduct practices into the decision-making processes at all levels of their organization. Although all listed corporations are required by stock exchange rules to have a code of ethics and business conduct, only one-third of the S&P 500 companies have a

*"The surest way to  
live with honor in the world  
is to be in reality what  
we appear to be."*

—Socrates

qualifying ethics and compliance program that is managed by an individual having membership in the EOA. Because of the increasing importance of ethics and compliance programs to corporate governance, EOA membership was selected as one of the best available attributes of superior corporate governance.

The metric used to measure long-term financial performance was Market Value Added (MVA). This is a concept developed by prominent financial consultants Stern Stewart & Co., who annually calculate the financial performance of the companies included in the Russell 3000® Index. MVA is related to the more widely known Economic Value Added™ (EVA). MVA measures the amount of shareowner wealth created by a company since its inception and is believed to be the best available measure of long-term returns to investors.

Specifically, MVA is the difference between the market value of a company (both equity and debt) and the capital that lenders and shareholders have entrusted to it over the years in the form of loans, retained earnings, and paid-in capital. As such, MVA is a measure of the difference between “cash in” (what investors have contributed) and “cash out” (what they could get by selling at today’s prices). If MVA is positive, it means the company has increased the value of the capital entrusted to it and thus created shareholder wealth. If negative, the company has destroyed investor wealth.

Operating information used to calculate MVA considers the cost of all capital and includes a considerable number of adjustments to the accounting information that companies report. Operating data is based on a company’s latest fiscal year-end,

while the market value is as of March 31. As it does each year, Stern Stewart recalculates historical MVA for companies to reflect the latest enhancements in its calculation methodology.

The current study uses the MVA amount reported for each corporation in the current S&P 500 Index for the years 2000 through 2004. The mean MVA for the companies classified as having superior governance was compared in each year with the mean MVA of the remaining S&P 500 companies without weighting for size of revenue or market cap. The number of superior governance companies selected by means of EOA membership ranged from 150 to 160, depending on the year, representing about one-third of the total.

Analysis of the results of the study showed that, in each of the five years, the mean MVA financial performance of companies with the designated superior governance attribute was consistently and substantially higher than that of the remaining S&P 500 companies. The mean difference was statistically significant at the .000 level, meaning that the probability that the results could occur by chance is less than one in 1,000, or 0.1%.

Using EOA membership as a criterion for differentiating good governance, the mean MVA or additional value or bonus wealth created for shareowners ranged from a high of \$28.6 billion per company in 2000 to a low of \$5.8 billion in 2003. The 2004 mean difference amount increased to \$9.4 billion per company. The increase for 2004 is an indication that a rising stock market does value an attribute of good corporate governance.

To determine that the average additional wealth created for share-

owners didn’t result from the performance of only a few companies, a comparison of median MVAs by year showed that the middle companies also returned substantially more to shareowners than the remaining S&P 500 companies in each of the five years. The median difference also increased in 2004 from the low point in 2003.

This study provides powerful new evidence supporting the belief of many investors that firms having attributes of strong corporate governance, including better-quality ethics and compliance programs (programs that are based on core values that permeate the organization) actually deliver superior financial returns to their shareowners. Corporate management and boards of directors should also recognize the value the market is placing on attributes of good corporate governance, especially a well-managed program of ethics and compliance.

Additionally, a survey by Stanford University professors David Montgomery and Catherine Ramus of 800 MBA graduates showed that “97% were willing to forgo financial benefits to work for an organization with a better reputation for corporate social responsibility and ethics.” This is additional evidence to support the contention that good corporate citizenship helps attract superior management talent.

Does the ethics and compliance program in your organization make the grade? ■

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