
Current Topics in Corporate Governance: Code Compliance and Corporate Performance

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Abstract. The German Corporate Governance Code follows the comply-or-explain principle. We revisit the academic discussion of code compliance and its impact on firm performance for German corporations. Code compliance is defined here as the extent of compliance with the German Corporate Governance Code. While initial analyses did not always show a significant correlation between code compliance and performance, recent studies provide convincing empirical evidence of a positive performance effect.

Keywords: Corporate Governance, German Corporate Governance Code, Compliance, Performance

1. Introduction

It is generally accepted that corporate governance mechanisms are established to ensure a satisfactory return on investment for shareholders (Shleifer and Vishny, 1997). However, the well-known corporate failures in the nineties of the last century have raised serious concerns about whether the corporate governance environment of firms is sufficiently transparent and whether dispersed shareholders have the necessary information and power to insist on good governance mechanisms. In response to these concerns, several governance codes have been established around the world and in particular in Europe (Aguilera and Cuervo-Cazurra, 2004). These codes aim to provide guidelines for satisfactory shareholder rights and transparency standards.

Codes that adopt the comply-or-explain principle require that firms either fulfill the particular recommendations or that they explain why they do not follow these recommendations. Thus, the comply-or-explain principle provides a framework that allows firms to deviate in individual cases from the best practice established by the Code. However, the reasons for a deviation

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have to be made transparent to investors. Not only from a regulatory perspective two questions are of interest: (1) Which firms do comply fully with the codes, i.e. what are the determinants of code compliance? and (2) Are firms rewarded for code compliance by higher stock market valuations?

The remainder of the paper is organized as follows: In section 2 we evaluate Compliance Statements as a measure for good corporate governance and depict the general level of compliance in Germany. Section 3 gives a summary about recent national and international studies developing the link of corporate governance and firm value. The paper closes with a brief outlook in section 4 on upcoming research challenges in corporate governance and code compliance.

2. Code Compliance as a Measure of Good Corporate Governance

The following chapter gives a brief introduction into the German Corporate Governance Code and evaluates the general compliance level in Germany.

2.1. General remarks

Beginning with the 1990s and their well-known corporate scandals, governments in most developed countries around the world established corporate governance codes or laws. These codes differ in respect of their legal bases and their compliance mechanisms: They range from non-binding practice recommendations to restrictive legal requirements. Well-known international examples of the former respective categories are the UK Corporate Governance Code (originally based on the Cadbury Committee recommendations) and the US Sarbanes-Oxley Act.¹

Besides the relevant statutory provisions and legal requirements, the German Corporate Governance Code includes two types of best-practice-guidelines: recommendations (so called “Shall-Recommendations”) and suggestions (so called “Should-Suggestions”). The German Corporate Governance Code covers six topics: Shareholders and the General Meeting (1), Cooperation between Management Board and Supervisory Board (2), Management Board (3), Supervisory Board (4), Transparency (5) and Reporting and Audit of the Annual Financial Statements (6).

¹ For a description of international code releases see Aguilera/Cuervo-Cazurra 2009; for information about UK Code and Cadbury Committee see Dedman 2002 and <http://www.ecgi.org/codes/documents/cadbury.pdf>. Full text of US Sarbanes-Oxley Act is available via <http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf>; For a general worldwide code overview please visit: http://www.ecgi.org/codes/all_codes.php.

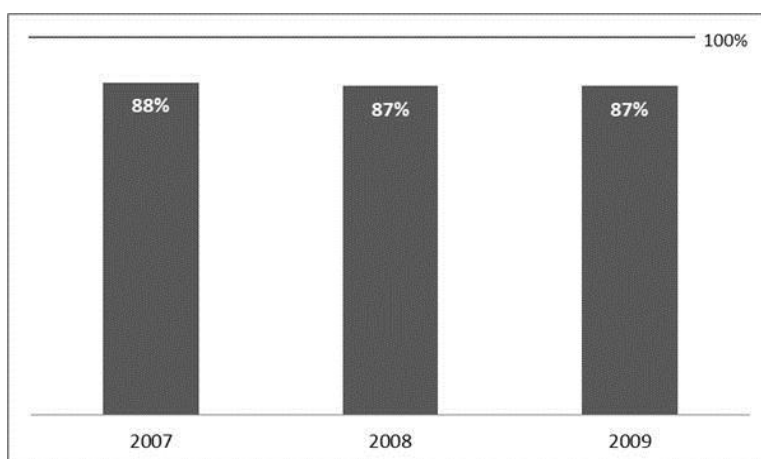
Similar to the UK Code the German Code also follows the comply-or-explain principle regarding the 'Shall-Recommendations'. The Code primarily addresses listed corporations and has its legal basis in § 161 of the German company law (AktG), requiring an annual declaration of conformity with the 'Shall-Recommendations' of the Code.² Compliance is thus measured by the extent of conformity by the corporation's governance system to the 'Shall-Recommendations' of the Code.

For the evaluation of code compliance two questions are of major interest: (1) what is the general level of code compliance and (2) what are the characteristics of firms which comply or do not comply with the code.

2.2. Compliance levels

Several studies provide evidence for a high level of code compliance in Germany. For instance examining a large sample of firms covering 345 German Prime Standard firms for the years of 2007 to 2009, Deubel/Rapp/Wolff (2010) find that the average level of compliance amounts to 88 percent in 2007 and 87 percent in 2008 and 2009 (see figure 1).

Figure 1: General level of compliance in German Prime Standard companies in 2007-2009



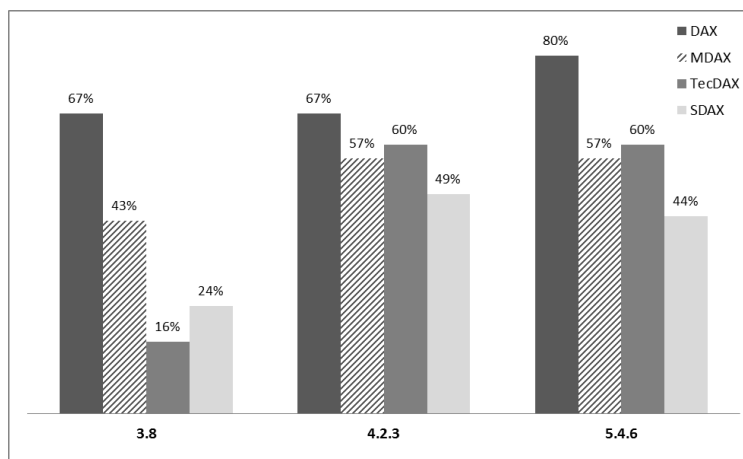
This figure illustrates the level of code compliance in German Prime Standard firms as reported by Deubel/Rapp/Wolff (2010). Code compliance is defined as the extent of compliance with the German Corporate Governance Code.

It is interesting, which specific code stipulations firms usually do or do not comply with. The common approach is to identify "neuralgic" norms, meaning norms which a specific number of firms do not follow (v. Werder/Talaulicar/Kolat 2005). Typically the neuralgic norms account

² For full script of the German corporate Governance Code please visit: http://www.corporate-governance-code.de/eng/download/kodex_2010/German-Corporate-Governance-Code-2010.pdf.

for much of the variation in the compliance level. Studying all non-financial German Prime Standard firms from 2002 to 2007, Jahn et al (2010) for instance find that 89 percent of all compliance level variations can be explained by variations in compliance with “neuralgic” norms. They define this by norms, that more than 10 percent of all firms do not comply with.³ Figure 2 shows the index specific compliance rates with three significantly neuralgic code recommendations.

Figure 2: Norm specific compliance rates 2009 (in percent)



This illustration focuses on three specific norms, showing the highest rates of non-compliance as reported by Deubel/Rapp/Wolff (2010). Norm 3.8 contains the implementation and design of directors&officers insurances. Norm 4.2.3 covers the commission’s recommendations of executive remuneration systems. Norm 5.4.6 comprehends recommendations of supervisory board compensation systems.

The highest compliance rates are observed in the following areas: Shareholders and the General Meeting (95,2%), Transparency (97,9%) and Reporting and Auditing of the Annual Financial Statements (93,4%). The topics Management Board (85,6%) as well as Supervisory Board (82,7%) showed generally lower rates. Especially the category Cooperation between Management and Supervisory Board (73,8%) showed surprisingly low rates (e.g. Deubel/Rapp/Wolff 2010).

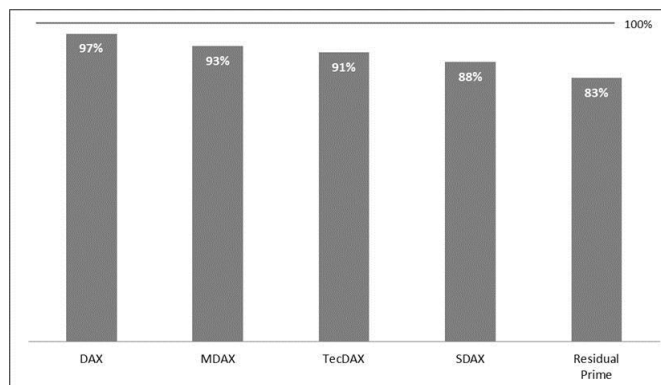
2.3. Determinants of compliance levels

In the current academic literature two major determinants of code compliance in German firms are identified: firm size and ownership concentration. The correlation between code compliance and firm size is positive as illustrated in figure 3 for the year 2009: While DAX firms show

³ For further details about neuralgic norms and general compliance to the German Corporate Governance Code see v.Werder/Talaulicar/ Kolat (2005); v. Werder/Talaulicar/Kolat (2006) and especially the yearly Code-Report Studies by v. Werder.

the highest level of code compliance (97 percent), SDAX corporations have a clearly lower rate of 88 percent and companies not included in the indices a rate of only 83 percent. The positive relation between firm size and level of code compliance is remarkably stable over time as the analysis in Rapp/Schmid/Wolff (2011) reveals.

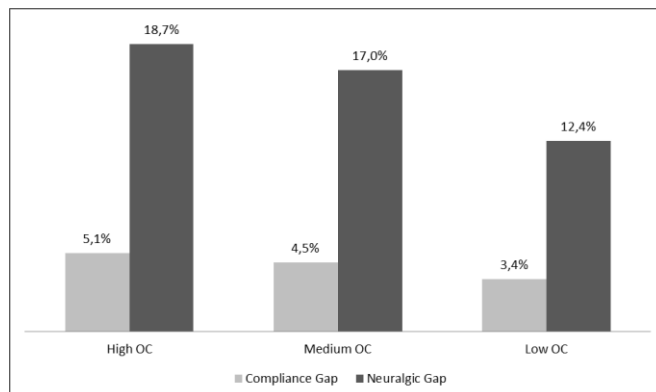
Figure 3: Index specific compliance rate in 2009



The figure illustrates the index specific level of code compliance in 2009 for DAX, MDAX, TecDAX, SDAX firms as reported by Deubel/Rapp/Wolff (2010)

In contrast, the correlation between ownership concentration and compliance level is negative (Jahn et al., 2010). Firms with large blockholders and thus strong external control comply less with the governance code, which goes along with *ceteris paribus* lower agency costs. This empirical pattern is documented in figure 4: Examining *compliance gaps*, defined as the extent of non-compliance with the German Corporate Governance Code, the figure illustrates that firms with higher ownership concentration reveal higher compliance gaps. This pattern is independent of, whether we measure the compliance gap with respect to overall compliance or with respect to neuralgic compliance.

Figure 4: Non-compliance with the code related to firm's ownership concentration



This figure illustrates non-compliance in terms of overall compliance (compliance gap) and compliance with neuralgic norms (neuralgic gap) related to firms with high, medium and low ownership concentration (OC) as reported by Jahn et al. (2010).

3. Code Compliance and Firm Performance

This chapter will give a short roundup of empirical studies evaluating the link between compliance with good governance and firm performance respectively firm value.

3.1. *International Evidence*

Probably, the most influential study on corporate governance and firm performance is the study of Gompers/Ishii/Metrick (2003). By constructing a “governance index” for some 1500 firms during the 1990s, the authors evaluated the level of shareholder rights and their influence on performance and firm value. They find that corporate governance is strongly correlated with stock returns. For instance firms with strong shareholder rights have a higher firm value, higher profits, lower capital expenditures and make more corporate acquisitions.

In international settings, Bruno/Claessens (2009) analyze the effects of corporate governance and legal environment on firm performance through a large international sample of 2350 corporations from 23 countries. They find evidence that companies adopting good governance (e.g. independent boards, high transparency level) perform best in any legal environment. Thereby they figure out that the effects of stringent country specific legal corporate governance requirements are neutral or negative.⁴

Renders/Gaeremynck/Sercu (2010) show *inter alia* in a cross-European panel analysis a clear association between higher corporate governance ratings and better performance. Moreover they suggest that, although corporate governance in Europe is mostly based on a voluntary system, governance ratings increase over time. These results are also relevant for the discussion whether governance should be regulated by law and contribute therefore to the findings of Aguilera/Cuervo-Cazurra (2009).

For a large Governance Metrics International (*GMI*) dataset consisting of roughly 2300 firms in 22 countries Ammann/Oesch/Schmid (2011) investigate the relation between firm level corporate governance and firm value. Their results indicate that better corporate governance practices are reflected in significantly higher market valuations. They point out that the costs of implementing governance mechanisms seem to be smaller than the monitoring benefits for the average firm in their sample.

⁴ For research on performance-relevance of good governance and compliance in US please also refer to Larcker/Richardson/Tuna (2007).

3.2. German Evidence

In Germany there is still an intensive debate about the link between code compliance and firm performance. This is most probably due to the fact that so far most German studies rely on rather small samples and thus suffer from a lack of discriminatory power.

In a study of Nowak/Rott/Mahr (2004; 2006) the authors try to identify the short-term effects of Code compliance announcements on firm value. Their results suggest that firm value is unaffected by the announcements and that regulatory corporate governance initiatives, that rely on mandatory disclosure without monitoring and enforcement, are inefficient in civil law countries.⁵

In contrast Goncharov/Werner/Zimmermann (2004) stated that firms with a higher compliance level were priced with an average premium of about nine percent of their sample's average price per share, which they considered consistent with their hypothesis that capital market incentives suggest a broad adoption of the code. They further concluded that a stronger enforcement by the code could increase the valuation effect. Stiglbauer (2010) confirmed the value relevance of compliance disclosure with a positive impact on the market-to-book ratio and total-shareholder return. However, an influence of transparency disclosure on operating performance and vice versa was not evidential. Jahn et al. (2010) showed in an analysis of 364 firms over six years that for corporations with a high free-float factor compliance with the code increases firm value. Therefore the comply-or-explain principle has to be evaluated as it allows corporations to maintain individual governance structures while at the same time assuring necessary transparency standards.

In a recent working paper Rapp/Schmid/Wolff (2011) also evaluate the level of code compliance and implications for firm value. Similar to Jahn et al (2010) the authors find that firms with high agency costs comply more with the German Corporate Governance Code and that the stock market rewards code compliance for firms with limited ownership concentration.

4. Summary

This paper gives a short overview about current trends in academic research on code compliance and firm performance. While we observe generally high levels of code compliance in Germany, there are some interesting analyses that identify specific determinants of code compliance. A major source of code compliance seems to exist in the ownership structure of firms.

⁵ For further research on performance-relevance of corporate governance in Germany please also refer to Bassen et al. (2006).

With regard to firm performance, we demonstrate that despite the international evidence on the correlation between levels of governance and firm performance, in Germany there is still an intensive debate whether high levels of code compliance correspond positively with firm performance. However, recent large sample studies provide reasonable evidence in favor for the argument.

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