The High Cost of Governance Deficits:

A Case For Modern Governance

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Introduction

At a time when digital disruption, complexities in the geopolitical landscape, and the speed of information are all increasing, companies are under an incredible amount of pressure to perform well for shareholders and stakeholders alike. Corporate governance, at its best, serves as the guardrail that keep companies and their boards of directors on track while they move full speed ahead. But in the wake of a corporate crisis or scandal, public and media attention increasingly focuses on directors, asking: “How could the board let this happen?”

This Diligent Institute report begins to quantify the material cost of governance crises, and more importantly, the competitive advantage that comes with strong corporate governance practices. The report indicates the advantages companies can realize by practicing modern governance: empowering leaders with technology, insights, and processes to fuel good governance.

The report employs two approaches to examine the relationship between corporate governance and company performance:

1. **A composite measure of strong corporate governance was created and then applied to the S&P 500. Then, the equity returns for 2017 and 2018 of the top 20% of S&P 500 companies exhibiting strong corporate governance and the bottom 20% were compared.**
2. **A series of companies that underwent corporate crises fueled by governance deficits was assembled. Their performance one or two years down the line was then compared to the industry average.**

The report’s key findings include:

1. **Companies with strong corporate governance (the top 20%) outperformed the bottom 20% by 15% in the most recent two-year period.**
2. **Companies with corporate crises fueled by governance deficits underperformed their sectors by 35%, on average, a year after the incident, losing approximately $490 billion in shareholder value.**
3. **Two years after experiencing the corporate crisis, companies lost approximately $250 billion of shareholder value, and underperformed in their sectors by 45%, on average.**

Measuring the Benefits of Strong Corporate Governance

METHODOLOGY

In order to establish definitions of strong corporate governance vs. deficient corporate governance, a new composite measure was created. The report relies on 14 specific board characteristics derived from existing literature on what defines strong corporate governance.[1] The 14 measures were then divided into three broader categories:

- Board Composition/Director Independence
- Shareholder Rights
- Executive & Director Compensation

Each category was assigned equal weight for the composite score. The top 20% and the bottom 20% of companies were established based on performance in the S&P 500 and analyzed against the equity return for each group.

The table below lays out which measures were included under each category.[2]

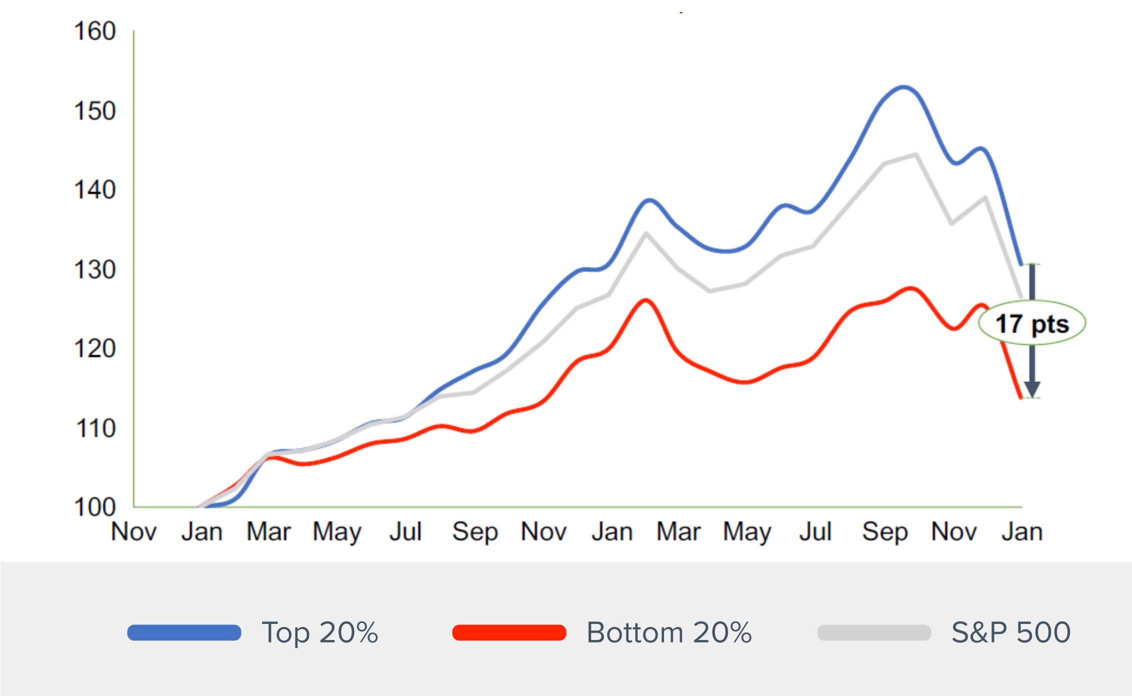
Categories	Measures	Implications to corporate governance
A) Board composition/ independence	**CEO/ Chairman same person?**	**Good governance** when the CEO and the Chairman responsibilities are performed by different persons
	Risk Committee (exist or not?)	**Importance** of risk committee is ever increasing
	Board size (>15 or not)	Bigger boards tend to be **less efficient**
	Interlock (Total Interlocks, number of competing and overlapping directorships)	Interlocking directorships **weaken governance**
	Average Tenure	Boards with too long or too short tenures correlate with **weak governance**
B) Shareholder Rights	**Antitakeover provisions: golden parachute, poison pill**	Anti-takeover provisions deter takeovers and indicate management entrenchment—**weak governance**
	Governance provisions (staggered board, limitation or change of charter, limitation on change of bylow, supermajority requirement for merger)	These provisions limit shareholder rights—**weak governance**
	Majority voting required for director elections	**Good governance** if directors are elected by majority votes since most of elections are uncontested
C) Corporate Compensation	**CEO cash pay vs. bonuses**	Higher percentage of performance-based pay correlates to **stronger governance**
	Director equity grants	Director equity ownership correlates to **stronger governance**

KEY FINDINGS ON THE BENEFITS OF STRONG CORPORATE GOVERNANCE

This report provides strong evidence for the importance of strong corporate governance. By applying the composite measure of corporate governance characteristics to the S&P 500, the report found that the companies in the top 20% outperformed those in the bottom 20% by 17 points. This demonstrates a strong difference between those companies that embrace modern governance practices and those that do not.

In fact, for the bottom 20%, it's important to note that there is a large difference not only as compared to companies with strong corporate governance, but also compared to the overall S&P 500 average. Companies with governance deficits perform less well, and companies with strong governance outperform the average.

S&P 500 Equity Return by Governance Ranking



While this finding does not establish whether good governance causes stronger financial growth, there is a clear correlation between strong corporate governance and positive equity return. It is possible that companies with stronger financial performance are in the best position to enact strong corporate governance practices. However, even in that case, it is still notable that strong corporate governance is an indicator of organizational health, as revealed by this analysis. Furthermore, as illustrated in the next section, failing to uphold strong corporate governance can lead to bad outcomes, including the erosion of shareholder value.

Measuring the Impact of Governance Deficits

METHODOLOGY

In order to further validate the findings above, the report examined a series of known examples of corporate crises involving governance deficits (e.g., situations in which corporate governance was insufficient) and compared the performance of those companies against industry averages one year and two years after the crises, respectively.

The cases selected for this review were chosen because the companies' crises were widely reported and well-established through media coverage, regulatory reports, legal reviews, investor reports, and other publicly-accessible sources.

The following criteria were used to determine which crises were included:

1. **The crisis needed to have occurred relatively recently in order to speak sufficiently to current best practices, but not so recently that there might be insufficient data available. The cases included all occurred sometime between 2012 and 2017.**
2. **The crisis had to have a strong corporate governance component.**
3. **The review was limited to large, public companies to ensure that sufficient publicly-accessible data sources were available.**
4. **Finally, unlike many companies that experienced crises on this scale in the past several years, the companies included needed to still be in existence, and to have not gone bankrupt.**

Fourteen companies were included in this review. Those with two years of subsequent equity performance data included Chipotle, Lululemon, Mylan, Olympus, Toshiba, Valeant, Volkswagen, and Wells Fargo. Companies with only one year of such data included Equifax, ExxonMobil, Facebook, Kobelco, Perrigo, and United Airlines.

The companies' performance one or two years after their crises was compared with the overall performance of their sectors. Sector performance excluded the firms being analyzed. Additionally, the report assumed the same relative performance to sector in the 24 months leading up to the crises.

KEY FINDINGS ON THE IMPACT OF GOVERNANCE DEFICITS

RESULTS ONE-YEAR POST-CRISIS

From the 14 companies examined, the report found that the corporate crises fueled by **governance deficits destroyed a total of approximately $490 billion in shareholder value one year after the crisis occurred. The companies in question underperformed their sectors by 35%, on average.**

Each of the examples studied warrants further analysis and consideration, much of which has already been done thoroughly in the media. However, in order to contextualize the findings, the report examines a few examples in greater detail below.

GOVERNANCE DEFICIT: FALSIFIED INFORMATION SUPPLIED TO CUSTOMERS

Kobe Steel is a 112-year-old supplier of steel to manufacturers of cars, planes, and trains around the world. In September 2017, an external committee concluded that Kobe Steel had falsified quality data to 605 customers.[3] It was revealed that this practice had been occurring for five decades, with the knowledge and involvement of management.

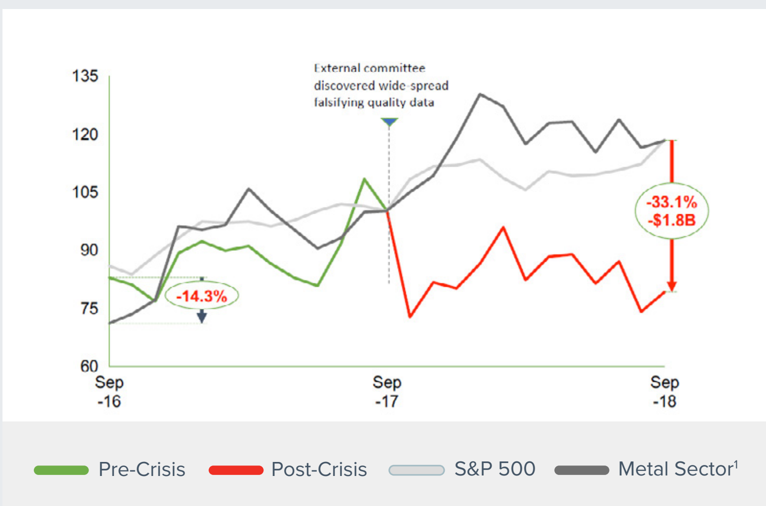
This was not the first scandal associated with Kobe Steel, and in the year leading up to the 2017 revelations, the company's stock had underperformed the industry benchmark by 14%. However, 12 months after the news was published, Kobe Steel underperformed the metals sector by 33%, or $2 billion.

There are several ways in which stronger corporate governance could have prevented this crisis from occurring. A Kobe Steel report in the wake of the incident noted "a management style that overemphasized profitability and had inadequate corporate governance."[4]

The board is responsible for incentivizing and overseeing management, and, in this case, the board's oversight was insufficient. It was also revealed that at least two directors were aware of the practices prior to the committee's report – demonstrating a clear governance deficit.

Further, the board was unaware of the deep flaws in corporate culture that motivated and permitted the inappropriate actions. Kobe Steel's report described, "a culture that prioritized winning purchase orders and meeting delivery deadlines, over ensuring quality," as well as, "an insular organization where personnel were rarely exchanged or transferred between different divisions."

In companies with modern governance practices, the board might be expected to raise concerns and to ask probing questions when the corporate culture seems unhealthy or out of balance.



1. SIC code 3312, 3356, 3365, 3460 (metal industries)

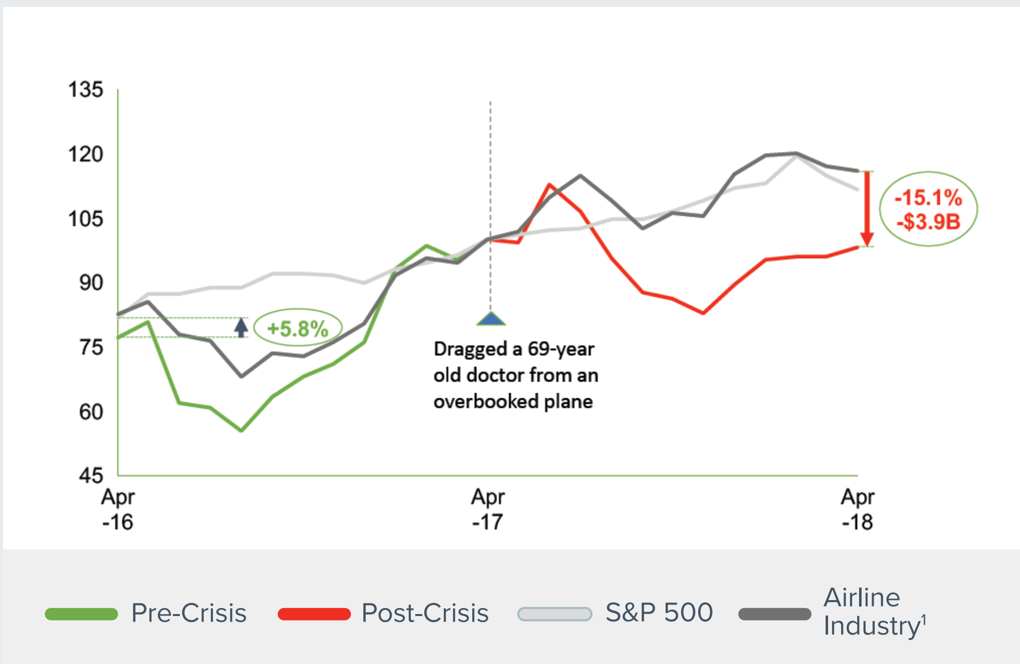
GOVERNANCE DEFICIT: REPUTATIONAL DAMAGE AT THE SPEED OF A TWEET

United Airlines is the third-largest airline in the United States. In April 2017, a 69-year-old doctor was dragged off an overbooked United plane. A video surfaced on social media and very quickly went viral. The company issued a series of responses that were widely received as tone-deaf, insincere, insufficient, and not fast enough to adequately contain public outrage.[5] The incident was an indication of a much deeper cultural issue, underscored by a series of customer service scandals that followed.[6]

In the 12 months leading up to the incident, United Airlines had actually overperformed the industry benchmark by 6%. However, 12 months after the incident, United Airlines underperformed by 14%.

Modern governance could have helped United in two significant ways. First, better oversight of corporate culture by the board might have revealed underlying issues needing to be addressed, potentially preventing the incident from occurring at all. Second, the public relations disaster after the incident occurred could have been mitigated by greater board oversight of the crisis response plan, ensuring that the plan was solid and included provisions for handling social media.

Additionally, companies with modern governance practices would have ensured that board members in the room had the necessary crisis response experience, and that the CEO had the right skillset to respond effectively.[7]



1. SIC code 4512 (Air transportation, Scheduled), excluding United

RESULTS TWO YEARS POST-CRISIS

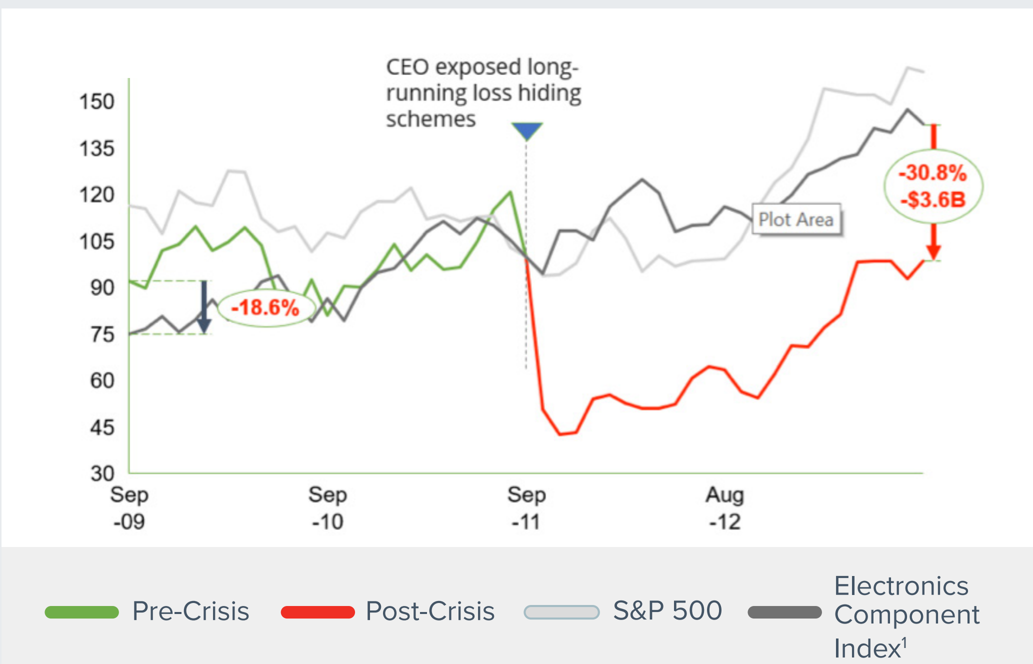
The effects of these crises in governance are not short-lived. At the two-year mark, for those companies with that much data available, approximately $250 billion of shareholder value had been destroyed. In fact, two years after the crisis had occurred, the companies examined had underperformed their sectors by 45%, on average.

That's an even higher differential than the one found in this study for companies one year after a crisis. This is likely due in part to the fact that once the crisis has occurred, there is a great amount of time, energy, effort, and resources that the board and the executive management team have to apportion to solving for and recovering from the crisis itself. Rather than planning for the company's growth or ensuring optimal operating conditions, leadership is forced to respond and to play defense. Companies that experience a crisis at this level take a long time to recover from the harm done, and some never do. A couple of brief examples provide some further illustration.

GOVERNANCE DEFICIT: FINANCIAL FRAUD

Olympus is a Japanese company that makes cameras and medical equipment. In September 2011, the then-CEO exposed "one of the longest-running loss-hiding arrangements in Japanese corporate history."[8] The complicated story that followed revealed board members, auditors, and high-level employees who were engaged in, complicit in, or at least aware of the fraud. Additionally, there was a perceived lack of awareness by the board's audit committee – an additional troubling issue. The story received ample press coverage and analysis of how the lack of governance controls contributed to this crisis.[9] It is quite clear that the board's failure to uncover the fraud and to respond appropriately cost the company – and its shareholders – billions of dollars.

In the 24 months leading up to the incident, Olympus had underperformed its sector by 19%. However, a full two years after the crisis, Olympus had underperformed by 31%, or $3.6 billion.



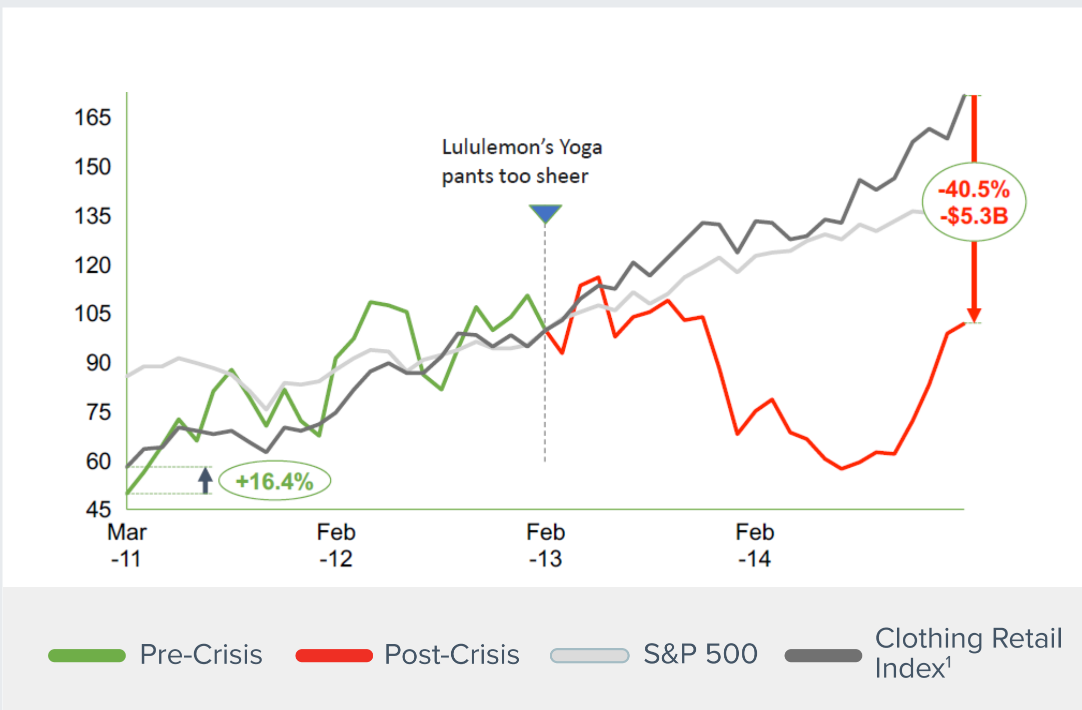
1. SIC code 36xx (consumer electronics, computer components), excluding Olympus

GOVERNANCE DEFICIT: CEO MISSTEPS

Lululemon made its name by providing high-quality yoga gear at a premium price. In February 2013, after receiving a number of complaints that picked up steam online, the company recalled 17% of its yoga pants for being too "sheer." In the wake of the recall, the powerful CEO and founder Chip Wilson made a series of offensive comments, provoking a great deal of outrage. He later apologized to employees, but not to customers, and the apology was not well received.[10] The company suffered as a result of his remarks and the ensuing public relations failings. This scandal and its governance implications have received ample media coverage.[11]

At the highest level, the board failed to effectively manage and track social media and public perception risk, even knowing that such perception was absolutely critical to the company's brand. The board also failed to manage supply chain risk, despite awareness of quality issues. Meanwhile, the crisis mitigation once the recall occurred was disastrous, in part because of the CEO's very public and offensive comments – and the board was unable to stem the public backlash effectively.

In the 12 months before the incident occurred, Lululemon had over-performed its industry by 16%. However, two years after, Lululemon underperformed its industry by 41% or $5 billion.



1. SIC code 56xx (retail clothing), excluding Lululemon

Conclusion: Modern Governance Matters

Modern governance is about more than meeting the structural requirements of the composite measure described above. Some of these cases are instances in which the structural standards in the composite measure were clearly not met, but others have to do with harder-to-measure governance issues. The way a board deals with crises, or how effectively a board can oversee culture, or how a board responds to risk, or who a board chooses to lead the company – all of these factors played crucial roles in their companies' success or failure.

Strong corporate governance is critical for companies that seek to maintain high performance and avoid devastating crises. The cost of poor governance practices is high. Consistently, companies with governance deficits perform worse than their peers who adhere to modern governance – and they underperform against their industry's average.

The good news is that even as corporate governance has become increasingly demanding, many boards are stepping up to the challenge. As the rate of change increases and the speed of information continues to change the business landscape, it is only becoming more important for boards of directors to have both the structural and cultural safeguards in place to detect and respond to issues. The report revealed that the companies with modern governance practices are outperforming the market and provided examples of how boards can deal with crises before they become catastrophes.

Endnotes

1. This methodology is based on: Renato Grandmont, Gavin Grant, and Flavia Silva, "Beyond the Numbers – Corporate Governance: Implication for Investors," Deutsche Bank AG, April 1, 2004.

Diligent Institute updated the methodology by altering the measures based on new research and using the most recent data on firm governance and performance.

2. The data for Board Composition (Category A) and Corporate Compensation (Category C) were provided by CGLytics, a research firm and governance analytics software platform. The data for Shareholder Rights (Category B) was pulled from company filings, news sources, and state corporate laws.

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6. Denise Lee Yohn, "How to Fix United Airlines' Culture Problem," Forbes, March 28, 2018, https://www.forbes.com/sites/deniselyohn/2018/03/28/how-to-fix-united-airlines-culture-problem/#16ebf91bfd3d.

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