

Corporate governance and company performance

A proven link between effective corporate governance and value creation

Research findings

2019



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Foreword

The role of governance

Governance and the decision-making frameworks it underpins are the foundations of trust companies and stakeholders need for capital markets to function efficiently. Evidence of the importance of governance is widely seen. Recently, a set of governance principles has been developed for large private companies in the UK, while codes for the listed markets continue to evolve.

But is it true that strong governance practices contribute to a company's ability to create sustainable value?

Intuitively, most of the business community would see some form of governance as critical to growth. Embedded within decision-making structures, governance can bring sharper focus to strategic objectives. It can also prevent the development of micro-cultures where misaligned and/or inconsistent decision-making results in the inefficient use of capital. However, many companies only give governance the attention it deserves once something has gone wrong.

Governance – a short history

The first formal code of governance was introduced in the UK in 1992 following the Cadbury Report. The UK Corporate Governance Code¹ (the Code) sought to capture best practice and establish guidance and principles for listed companies, on a comply or explain basis. Globally, there are now more than 100 different corporate governance codes, many of which originate from the principles and approach adopted in the UK.

In the period since, investors, lenders, corporates and academics have debated the long-term benefits of applying strong corporate governance principles. Some argue that these principles now tend to be applied only to demonstrate compliance rather than to achieve any practical benefits for stakeholders. Equally, there is limited practical academic evidence of a tangible definition of strong governance and its consequential impact on corporate performance.

Purpose of this white paper

With the new Code taking effect from the beginning of 2019, this paper explores whether:

- the application of the Code provides a reliable blueprint for a governance framework which supports sustainable value creation
- applying a stronger governance approach creates sustainable value.

This paper provides corporates, lenders, investors and other stakeholders with practical evidence of the benefit of intentionally framing and understanding an organisation's approach to governance. It also highlights key governance characteristics demonstrated by top-performing companies.



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¹ For the purposes of this research, we have used the UK Corporate Governance Code 2016

Abstract

Two sides to the debate

Supporters of corporate governance believe that strong governance establishes corporate structures that improve leadership, accountability and effectiveness, and ultimately translate into better decision-making which drives corporate performance.

Meanwhile, sceptics view corporate governance as a red-tape exercise that detracts from decision making and ultimately adds little value to corporate performance. It is merely a question of compliance being tolerated rather than embraced.

This paper aims to answer the question: does strong corporate governance, as outlined by the Code, have a proven impact on creating sustainable value?

About our research

Our research has two parts:

- a review of academic studies between the period 1996 to 2012 from across the globe and a summary of the prevailing consensus
- analysis of our own data gathered for the Grant Thornton UK Corporate Governance Index (CG Index) over a 10-year period. The CG Index captures how FTSE 350 companies have applied the principles and provisions of the Code in their annual reports, and incorporates both qualitative and quantitative measures.

Key findings

Our review of selected academic studies found that:

- companies with strong governance operationally outperform those with weak governance
- companies with strong governance generate more value for the company, shareholders and lenders.

Our own primary research adds to this, finding that:

- applying the Code drives value across a number of financial indicators all of which have a probability of occurring greater than 70%
- companies with strong governance both create more value and retain value compared to companies with weak governance
- an increased trajectory of improvements in operational and financial performance follows improvements in corporate governance.

Conclusion and implications

Our primary research shows that:

- corporate governance should not be treated as a compliance exercise, since it can genuinely add value for business
- the application of the Code provides a valuable blueprint for enhancing governance practices.

These findings should be of strategic importance to corporate boards and business leaders, lenders, investors and regulators.

Key findings

Creates value



Companies with strong governance are **29% more** efficient at generating profits with the financial resources allocated to them



Companies with strong governance are **43% more** efficient at making and selling products/services



Companies with strong governance generate **3.4 x more** cashflow from their operations



Top performing governance companies generate **double** the return for shareholders



Companies that progressively improve their governance score to the next quartile generate **44% more** operating cashflow, a **46% increase** in free cash flow and **10% higher** operating efficiency

Retains value



Top performing governance companies are **15% less** financially leveraged, suggesting better ability to pay off long-term debts



Companies with strong governance have **25% more** liquidity and are therefore better able to pay off short-term debts



Companies with strong governance have **3.4 x more** cash remaining to pay off lenders and investors (after investing in operations)



Companies with strong governance are **more than twice** as resilient to operational failure

About this research

What is the purpose of this research?

This research investigates whether there is a proven link between strong corporate governance performance and consequently, value creation. This paper is a summary of our research, which comprises two elements:

- our own analysis using data from the CG Index (the primary research)
- a selective review of existing literature in order to frame our unique insight to the debate.

How did we conduct our primary research?

The primary research is based on the CG Index, which captures the corporate governance practices of the FTSE 350, excluding around 40-55 investment trusts as they follow the AIC Code of Corporate Governance. The CG Index provides an overall annual governance score using a proprietary methodology developed over 17 years of assessing the application of the Code. This study focuses on the 10 year period, 2007- 2017. Findings from the CG Index over this period have been widely referenced by the Financial Reporting Council (the FRC) and others.

In this study, the CG Index overall governance score for each year has been broken down into 10 industry sectors and each ranked sequentially based on governance score. The 10 sectors were then individually ranked into quartiles and amalgamated to produce a representative FTSE 350* top and bottom quartile, allowing us to compare their respective financial performance in the following year.

The results have also been separately analysed according to market capitalisation bandings of 50 to confirm there is no undue influence based on size (see Appendix C for further details).

How did we conduct the literature review?

For the literature review, we used Google Scholar to search for articles with the terms 'corporate governance' AND 'financial performance'. As this query returned a large number of academic studies (183,000), we distilled the studies using two criteria, namely studies:

1. done in G7, G20, BRICS and APEC economies, for the period 1996 - 2012.
2. which looked at corporate governance using four or more governance data points (eg board composition and board skills and board diversity and/or other governance elements) rather than studies that focus on a single governance factor (eg board diversity only).

We consider that composite measures are a more accurate proxy for corporate governance.

* For the purpose of the GT CGI and this research, this excludes around 40 investment trusts as they follow the AIC Code of Corporate Governance.

What is the Grant Thornton UK Corporate Governance Index?

The CG Index is a comprehensive database founded in 2002 to capture the corporate governance practices of the FTSE 350 market. The CG Index is based on the Code and captures how FTSE 350 companies apply and adhere to all the provisions of the Code.

Specifically, the CG Index captures:

- compliance with and application of the principles and provisions of the Code (as set out in the Code and Listing Rules)
- quality and detail of narrative reporting requirements (as set out in S414c of the Companies Act 2006).

The CG Index is used in this research as a proxy to measure the strength of governance practices.

Our research takes the view that an annual report is the window into a company as it is the one consistent source of 'assured' information for all stakeholders. Our findings have informally been tested with corporates by sharing outputs with company secretaries, non-executive directors and/or members of the financial function.

Why did we use the Code as a proxy for strong governance?

There is no single recognised definition for what constitutes 'strong corporate governance'. However, the Code is widely seen as a blueprint for promoting stronger governance. In addition, all premium listed companies are required to comply with the Code or explain their non-compliance.

As the Code represents the distillation of best practices evolved by the UK's largest listed companies, we believe the Code is a good proxy for measuring underlying corporate governance.

What governance measures does the Code use?

The Code is made up of a number of provisions spanning five main categories of corporate governance: leadership, effectiveness, accountability, remuneration and shareholder relations. We capture all these elements and apply a weighted average to derive an organisation's overall corporate governance score.

A higher corporate governance score implies better overall corporate governance practices.

How is the CG Index compiled?

The CG Index is compiled annually through a documentary review of companies' annual reports. Annually, every listed company in the UK is required to make certain disclosures on their corporate governance practices as stipulated by the following regulatory requirements:

- Listing Rules
- Companies Act (section 414C)
- UK Corporate Governance Code 2016.

Where there is a requirement for more than a binary 'yes' or 'no' (for example, in relation to the annual election of directors) we assess the quality of disclosure using five grades, ranging from 'none' to 'detailed'.

Introduction

Context

The rate of change in the UK corporate governance landscape (and the proliferation of governance codes across the globe) aligns with the assumption that improving an organisation's governance will increase the levels of trust between the corporate and stakeholders needed for capital markets to operate efficiently. Strong corporate governance is considered to improve performance because it:

- creates a corporate environment with a clearer purpose, and strategic and cultural intent. As a result, managers make more strategically aligned decisions, trust between stakeholders is higher, and investment is made in more value-adding projects
- reduces the diversion of company financial and non-financial capital, delivering higher value as a result
- improves risk management capacity by ensuring risk-adjusted decision-making is in line with strategy. This translates into more predictable operating performance and therefore lower cost of capital.

But is there any evidence for this?

Hypothesis

The hypothesis for this paper is that strong governance, as defined by the application of the Code, has a proven link to creating sustainable value.

Background to corporate governance

In the UK, the first governance code was established in 1992 following a series of corporate failures and scandals. Since then, the Code has evolved through at least 30 updates (see The evolution of UK corporate governance page 7).

These updates are the result of an evolutionary process that seeks to capture what most successful companies already do and share it for all rather than apply regulation based on failure. Often, revisions or the introduction of new codes appear to come about as a result of much publicised corporate failures. However, it would be a mistake to interpret this as 'more compliance', when in fact it is simply the capture of existing best practice.

The evolution of UK corporate governance



2018	FRC Guidance on Board Effectiveness
2018	UK Corporate Governance Code
2018	Wates Corporate Governance Principles for Large Private Companies
2016	FRC Guidance on Audit Committees
2016	UK Corporate Governance Code (2016 update)
2014	FRC Risk Guidance
2014	UK Corporate Governance Code (2014 update)
2012	FRC Guidance on Audit Committees
2012	UK Stewardship Code (2012 update)
2012	UK Corporate Governance Code (2012 update)
2011	Women on Boards
2011	FRC Guidance on Board Effectiveness
2010	FRC Guidance on Audit Committees
2010	UK Stewardship Code
2010	UK Corporate Governance Code
2009	Walker Report: A review of corporate governance in UK banks and other financial industry entities
2008	The Combined Code on Corporate Governance (2008 update)
2008	FRC Guidance on Audit Committees
2006	The Combined Code on Corporate Governance (2006 update)
2005	Internal Control: Guidance for Directors on the Combined Code
2003	Higgs Report: Independent Review of Non-Executive Directors
2003	Smith Report: Audit Committees - Combined Code Guidance
2003	Tyson Report: Recruitment and Development of Non-Executive Directors
2003	The Combined Code on Corporate Governance (2003 update)
2001	Institutional Investment in the United Kingdom (The Myners Report)
1999	Turnbull Report: Internal Control - Guidance for Directors on the Combined Code ¹⁹⁹
1998	Hampel Report: Final report - Committee on Corporate Governance
1998	The Combined Code on Corporate Governance
1995	Greenbury Report: Directors' remuneration - report of a study group chaired by Sir Richard Greenbury
1994	Rutterman Report: Internal control and financial reporting- guidance for directors of listed companies registered in the UK
1992	Cadbury Report: Financial Aspects of Corporate Governance

Grant Thornton corporate governance study

The rationale

Having undertaken a meta-analysis of academic research between 1999 to 2012, we consider our own study brings a fresh perspective to the existing academic research in three key ways.

- Our research measures strong governance based on a recognised independent blueprint for companies (namely the Code). In contrast, academic research tends to take a theoretical basket of measures and/or use the researcher's interpretation of 'good governance drivers' rather than building a methodology against any recognised guidance or principles. Conversely, by using the Code as the archetypal definition of strong governance and assessing how it has been applied across almost all its metrics over a 10-year period, we aimed to make the assessment of strong governance as objective and practical as possible.
- The governance score for each company, from the CG Index, goes beyond capturing whether a company is compliant or not. It also assesses the application of governance practices, adding a qualitative, objective assessment of governance that has been captured in a consistent way over 17 years.
- Our study provides a more comprehensive set of governance indicators – 74 in total – compared with an average of 31 in the academic papers. It also uses a wider base of financial metrics, measuring the relationship between governance and performance against 20 financial indicators, which have a greater than 70% probability of occurring. These financial metrics are further broken down in this research into those we felt are most relevant insights for companies, lenders and investors. The academic research uses, on average, four financial indicators.

Key findings

Value creation

We found that, compared with companies in the bottom quartile of the CG Index, companies in the top quartile perform better across a range of indicators associated with value creation. Top-quartile companies:

- generate **3.4 x more cash flow** from their operations
- are **43% more efficient** at making and selling products/services looking at EBIT
- are **29% more efficient at generating profits**² with the financial resources allocated to them
- generate **double the return** for shareholders.

These findings hold across all ten sectors covered by the research.

² Does not apply in Basic materials, Financials, Oil and Gas and Utilities

³ Does not apply in Consumer services and Financials

⁴ Does not apply in Consumer services, Healthcare and Utilities

Value retention

We found that, compared with companies in the bottom quartile of the CG Index, companies in the top quartile perform better across a range of indicators associated with retaining value. Top-quartile companies:

- are **15% more solvent**³ and are therefore better able to pay off long-term debts
- have **25% more liquidity**⁴ and are therefore better able to pay off short-term debts.
- have **3.4 x more cash** remaining (after investment in operations) to pay off lenders and investors
- are more than **twice as likely to stay in the FTSE 350**.

In each case, these findings hold for most of the ten sectors covered by the research.

Continuous improvement adds value

Our research provides important evidence for organisations looking to understand the potential additional value they can generate from investing in improving their governance approach in line with the Code.

When we investigated the financial performance of companies that progressively improve their corporate governance score – moving from the bottom quartile in the CG Index – we identified a strong link between improved governance and subsequent financial performance.

Each step up between quartiles is associated with an average:

- **44% increase** in operating cashflow
- **46% increase** in free cashflow
- **10% increase** in EBIT margin.

Key governance aspects

We did not find a 'one size fits all' set of strong governance practices being applied across the top-performing companies. However, we did find that strong governance supports the board and the organisation in its decision making in six key areas:

- business model clarity and connectivity
- culture and value integration
- risk management
- internal controls
- board effectiveness
- succession planning.

Further insight

We provide further insight on these findings below and illustrate the financial impact of strong governance from three perspectives: the corporate, the investor and the lender.



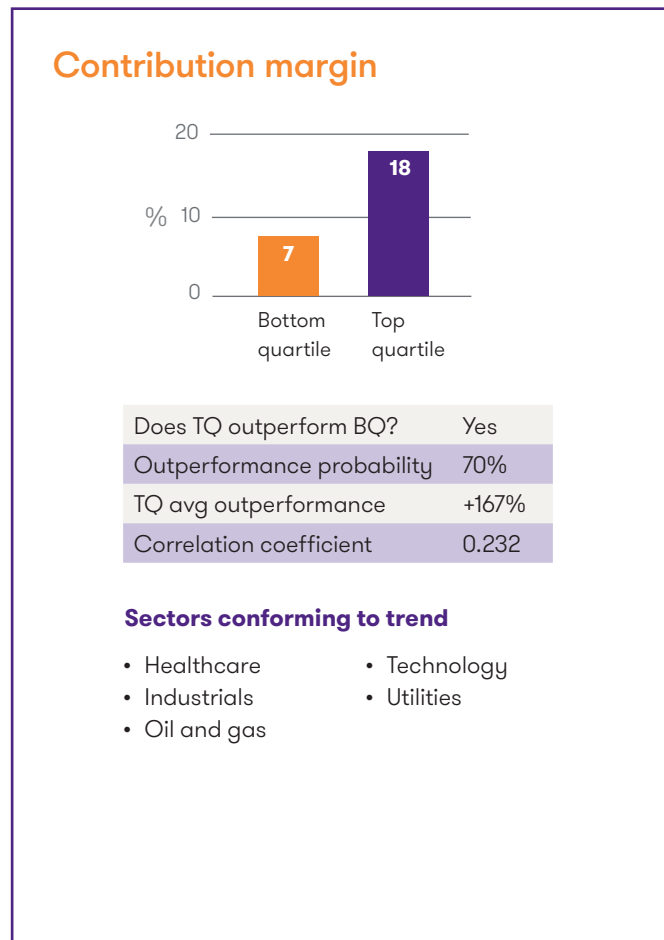
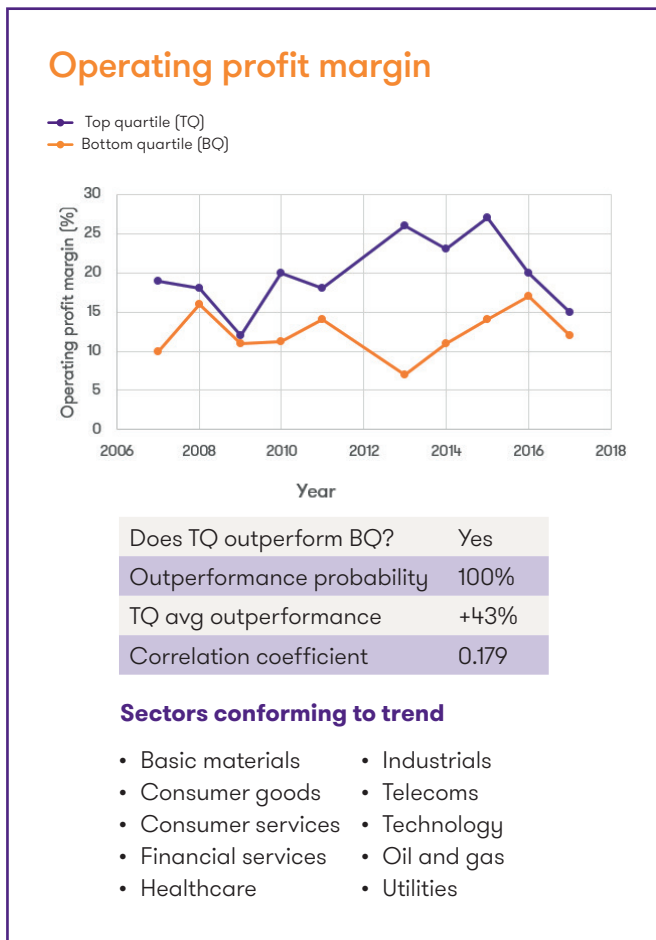
Insights

Insights for companies

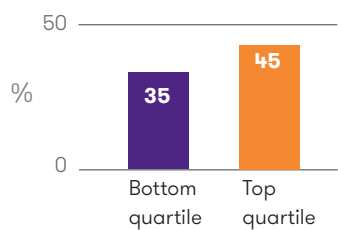
Companies with strong governance operationally outperform those with weak governance

Like the academic studies refer to page 18, our review of UK corporate governance practices finds that companies with strong governance financially outperform those with weak governance.

After normalisation, to take into account company size and sector, we found a positive correlation between strong governance and the following year's operating performance measures: operating profit margin, contribution margin, return on capital employed and operating cashflow.



Return on capital employed

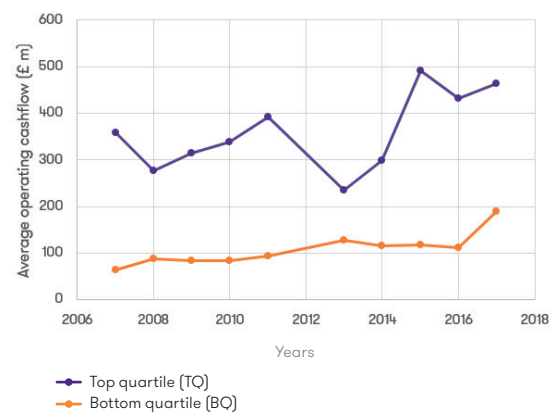


Does TQ outperform BQ?	Yes
Outperformance probability	80%
TQ avg outperformance	+29%
Correlation coefficient	0.221

Sectors conforming to trend

- Basic materials
- Consumer goods
- Consumer services
- Financial services
- Healthcare
- Industrials
- Telecoms
- Technology
- Oil and gas
- Utilities

Operating cashflow



Does TQ outperform BQ?	Yes
Outperformance probability	100%
TQ avg outperformance	+238%
Correlation coefficient	0.337

Sectors conforming to trend

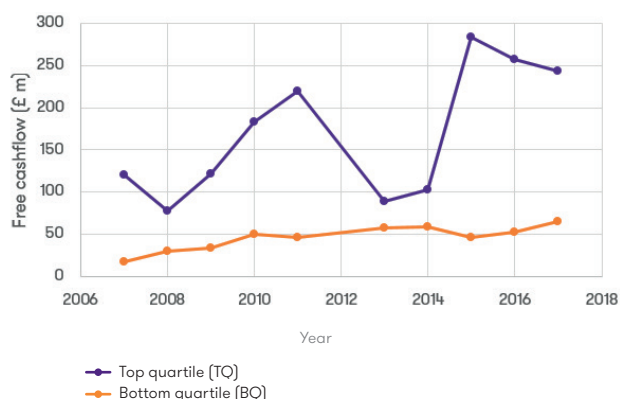
- Basic materials
- Consumer goods
- Consumer services
- Financial services
- Healthcare
- Industrials
- Telecoms
- Technology
- Oil and gas
- Utilities

Insights for investors

Companies with strong governance deliver superior return to shareholders and have more cash to reinvest in the business

After normalising the data to take into account company size and sector, we found that companies with strong governance generate more value for shareholders in terms of free cashflow. This translates into more cashflow per share, more dividends per share and stronger total shareholder returns.

Free cashflow

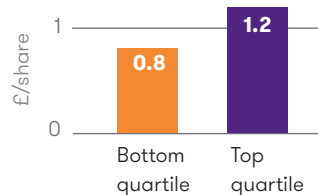


Does TQ outperform BQ?	Yes
Outperformance probability	100%
TQ avg outperformance	+236%
Correlation coefficient	0.231

Sectors conforming to trend

- Basic materials
- Consumer goods
- Consumer services
- Financial services
- Healthcare
- Industrials
- Telecoms
- Technology
- Oil and gas
- Utilities

Cashflow per share

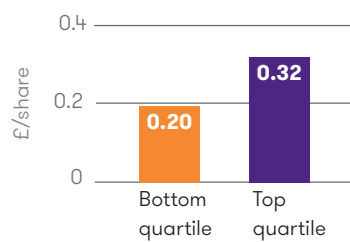


Does TQ outperform BQ?	Yes
Outperformance probability	90%
TQ avg outperformance	+50%
Correlation coefficient	0.221

Sectors conforming to trend

- Basic materials
- Consumer goods
- Consumer services
- Financial services
- Healthcare
- Industrials
- Telecoms
- Technology
- Oil and gas
- Utilities

Dividend per share

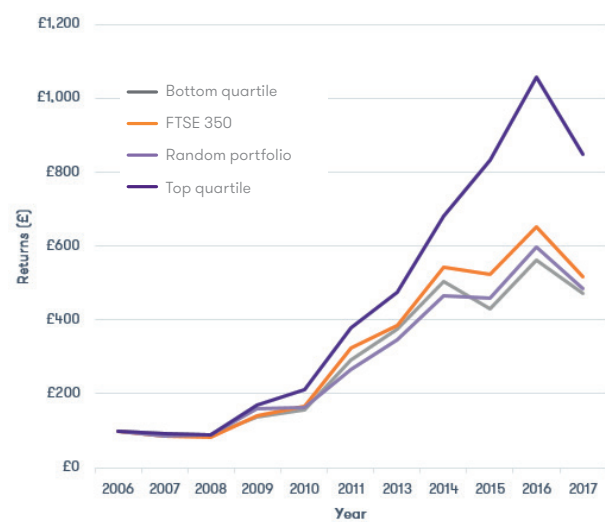


Does TQ outperform BQ?	Yes
Outperformance probability	90%
TQ avg outperformance	+60%
Correlation coefficient	0.232

Sectors conforming to trend

- Healthcare
- Industrials
- Oil and gas
- Technology
- Utilities

Total shareholder return



	Sharpe ratio	Standard deviation
Top quartile	11.6	179.51
FTSE 350	9.6	173.71
Random portfolio	10.9	164.92
Bottom quartile	9.8	163.01

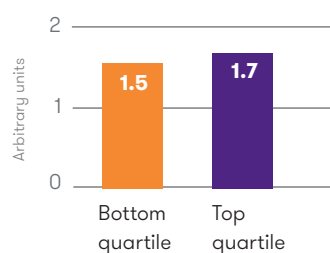
Insights for lenders

Companies with strong governance are more financially prudent and have better financial management

An understanding how corporate governance influenced risk-taking behaviour when it comes to financial management we used indicators that measure liquidity and solvency. After normalising the data to take into account company size and sector, companies with strong governance have better liquidity (quick ratio) and better solvency (financial leverage). They also have a better current ratio but the probability is below 70%. This suggests that top performing governance companies are more financially prudent and better able to pay off debts as they fall due.

Additionally, we found that companies with strong governance generate more free cashflow and therefore, are in a good position to be able to pay off debts.

Current ratio

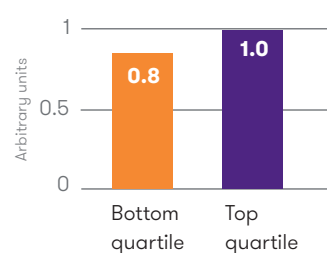


Does TQ outperform BQ?	Yes
Outperformance probability	50%
TQ avg outperformance	+13%
Correlation coefficient	0.041

Sectors conforming to trend

- Basic materials
- Consumer goods
- Financial services
- Industrials
- Telecoms
- Technology
- Oil and gas

Quick ratio

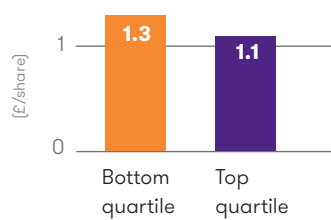


Does TQ outperform BQ?	Yes
Outperformance probability	90%
TQ avg outperformance	+25%
Correlation coefficient	0.106

Sectors conforming to trend

- Basic materials
- Consumer goods
- Financial services
- Industrials
- Telecoms
- Technology
- Oil and gas

Financial leverage

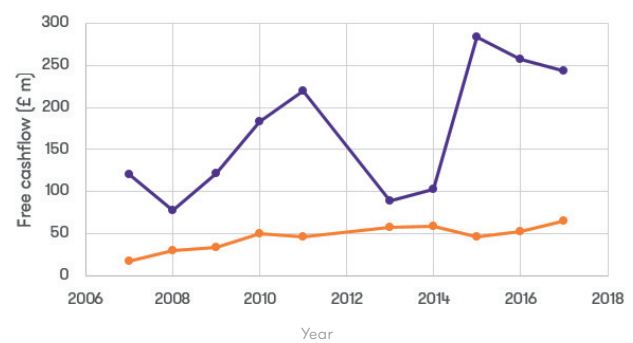


Does TQ outperform BQ?	Yes
Outperformance probability	70%
TQ avg outperformance	-15%
Correlation coefficient	-0.318

Sectors conforming to trend

- Basic materials
- Consumer goods
- Healthcare
- Industrials
- Telecoms
- Technology
- Oil and gas
- Utilities

Free cashflow



— Top quartile (TQ)
— Bottom quartile (BQ)

Does TQ outperform BQ?	Yes
Outperformance probability	100%
TQ avg outperformance	+236%
Correlation coefficient	0.231

Sectors conforming to trend

- Basic materials
- Consumer goods
- Consumer services
- Financial services
- Healthcare
- Industrials
- Telecoms
- Technology
- Oil and gas
- Utilities

Findings from the literature review

A vast body of academic research seeks to identify a causal relationship between corporate governance and financial performance. Despite this, the empirical evidence for such a relationship is still inconclusive and/or limited.

Part of the reason for this ambiguity is that it is hard to provide 100% correlation, as financial outcomes are subject to a wide range of variables. As a result, studies tend to limit the number of governance and financial measures they cover in order to provide more conclusive correlations.

In addition, the financial metrics chosen by academics reviewed as part of this study may not have practical relevance. The common primary metrics chosen in the academic studies tend to be shareholder based. For example: Tobin's Q, return on assets, return on equity, market to book value, and market value of equity to sales.

Finally, strong governance can be interpreted in many ways depending on the size, nature and purpose of an organisation. Measuring it is notoriously difficult. Equally, qualitative data on governance practices is limited, so studies often rely on binary (or compliance based) outputs to measure governance and are absent on the value of application.

The selection of academic studies

To eliminate some of this noise, the studies we selected for review:

- come from countries with relatively mature regulatory frameworks
- use a basket of governance measures (four or more) rather than that simply looking at one governance element.

The value of corporate governance

To understand the impact of governance on financial performance, academic studies generally aim to answer two fundamental questions:

- Is there a link between corporate governance and corporate performance?
- Is the association causal?

On the first question, we found most of the research shows a positive correlation between corporate governance and various measures of corporate performance (see Appendix A).

In terms of the second question – causality is more difficult to prove given the number of variables that influence corporate performance.

That said our literature review still found a number of studies that demonstrate to some degree a causal relationship between strong governance practices and improved financial performance.

Literature review



Covers **40** pieces of research from **34** different countries.



Each study used an average of **31** governance indicators against an average of **4** financial metrics.



Average population per study was **3,250** typically over a period of **5** years.

Grant Thornton UK Corporate Governance Index



Uses **74** governance measures (based on the Code) against **20** financial metrics.



Study population of over **2,300** listed company entries over a **10**-year period.



Tracks **506** individual listed companies over the period.

Key findings of academic literature review

The literature supported our primary research and highlighted three main financial benefits of strong governance.

1. Companies with strong governance practices show better operating performance

The academic research provides abundant and robust evidence that well-governed companies operationally outperform companies with weak governance.

One common reason provided is that strong corporate governance creates a corporate environment with better oversight. As a result, managers make better decisions.

The second reason is that well-governed companies are more efficient (see next point).

2. Companies with strong governance are more efficient at using financial resources and utilising assets

The research suggests that well-governed companies operationally outperform those with weak governance because companies with strong governance are more efficient at managing their financial resources and maximising asset utilisation.

The evidence goes further, suggesting that companies with weak governance tend to underperform because of inefficient use of financial resources due to:

- managerial motivation (tendency to do less work when returns are smaller) and/or lack of clarity minimising risk based decisions
- over-investment
- perquisite consumption (managers lack motivation due to abundance of managerial perks).

3. Companies with strong governance generate more value

Given that well-governed companies are run more efficiently, it is perhaps unsurprising that the research indicates that companies that are well governed create more overall value for the company itself as well as for shareholders and lenders.

There are several ways to measure the total value created by a company. The research indicates that those companies with strong governance practices generate more value in several ways.

• Better cashflow generation

Companies with strong governance are more efficient at using financial resources to generate profit and this translates into improved cashflow generation.

Positive cashflow, and the ability to generate it consistently, is critical for sustained operations since this cash is used to fund day-to-day operations as well as pay off debts and dividends. This suggests that strong governance practices not only beneficial to companies but also to shareholders and lenders.

• Better stock market performance and returns

A number of studies show that companies that demonstrate strong governance outperform those with weak governance on the stock market and therefore yield higher shareholder returns.

The studies go further to conclude that portfolios comprised of companies with weak corporate governance constantly underperform passive investment portfolios.

This suggests that companies with strong governance deliver significantly higher return. Accordingly, investors can therefore maximise their returns by investing in companies that demonstrate strong governance practices.

• Better value added

Using Economic Value Added (EVA) and Market Value Added (MVA) as indicators of true economic profit produced and wealth created by a company over time, the literature shows that companies with strong governance practices create more economic value and true wealth.

Conclusion

While some pieces of research show contradictory findings, the majority indicate a positive and causal relationship between strong corporate governance and improved corporate performance, albeit on a limited basket of measures and no recognised or independent definition of strong governance.

Conclusions

The findings of our research confirms the hypothesis that there is a proven link between strong governance and the creation of sustainable value.

While the overall governance score consists of variables that interact to influence company performance, the positive relationship, proven through this study, shows that governance is integral to the sustainability of an organisation. It also indicates that the principles from the Code provide a reliable platform for shaping an approach to governance.

Of course, success is not guaranteed, even for a well-governed business – events can change the course of any company. However, our research indicates that top performing governance companies that apply governance principles in the following six areas have a far greater chance of creating a dynamic environment that drives better decision making and success than organisations where decision-making is poorly supported:

- business model clarity and connectivity
- culture and value integration
- risk management
- internal controls
- board effectiveness
- succession planning

While many question the purpose of the annual accounts, it is the one consistent point of contact for stakeholders that provides a reliable window into a company. It highlights how the business frames, takes and monitors the decisions that drive financial outcomes.

With new governance codes coming into effect, we hope that this research will encourage organisations globally to refresh their attitude to their governance approach. Further, we hope it will encourage investors, lenders and stakeholders to be clearer about the role governance should play in their engagement with companies and in their investment decisions.



Appendices

Appendix A: Studies covered by our review

Country	Years covered	Period	Population	Findings	Ref*
Argentina	2	2003-2004	65	Well-governed companies show better operational performance	1
Australia	1	1996	460	Strong corporate governance correlates with higher firm value	2
Austria	5	1999-2003	649	Strong positive correlation between strong governance and performance	16
Belgium	5	1999-2003	659	Strong positive correlation between strong governance and performance	16
Brazil	4	2002-2005	60	Companies with strong governance have higher market valuations, better cash flow rights and greater need for external funding	3
Canada	4	2002-2005	289	Strong corporate governance correlated with higher firm value and better operating performance	4
China	3	2004-2006	100	Positive correlation between strong corporate governance and higher market valuations	5
China (Hong Kong)	4	2002-2005	170	Improvements in corporate governance over time result in an increase in corporate value (and vice versa)	8
Denmark	5	1999-2003	1,115	Strong positive correlation between strong governance and performance	16
Finland	5	1999-2003	865	Strong positive correlation between strong governance and performance	16
France	5	1999-2003	5,138	Strong positive correlation between strong governance and performance	16
Germany	5	1999-2003	5,199	Strong positive correlation between strong governance and performance	16
Ghana	5	1997-2001	22	Elements of corporate governance are associated with enhanced corporate performance	7
Greece	5	1999-2003	1,970	Strong positive correlation between strong governance and performance	16
India	4	2002-2005	120	Companies with strong governance have better cash flow rights, greater need for external funding and higher market valuations	3
India	4	-	141	Strong corporate governance is a good predictor of better corporate performance	9
Indonesia	3	2002-2004	46	Corporate governance has a significant impact on company performance	10
Ireland	5	1999-2003	380	Strong positive correlation between strong governance and performance	16
Italy	1	2012	215	Strong governance leads to better operating performance	11
Italy	5	1999-2003	1,822	Strong positive correlation between strong governance and performance	16
Japan	6	1999-2004	315	Companies with strong governance outperform those with weak governance on the stock market	12

Country	Years covered	Period	Population	Findings	Ref*
Kenya	5	1997-2001	23	Elements of corporate governance are associated with enhanced corporate performance	7
Korea	6	1998-2004	1,247	Improved corporate governance is causally related to higher market valuation, lower cashflow tunnelling, improved capital allocation and better growth decisions	13
Mexico	4	2002-2005	24	Companies with strong governance have better cash flow rights, greater need for external funding and higher market valuations	3
Netherlands	5	1999-2003	1,130	Strong positive correlation between strong governance and performance	16
Nigeria	5	1997-2001	16	Elements of corporate governance are associated with enhanced corporate performance	7
Pakistan	2	2008-2009	30	Elements of corporate governance are associated with better corporate performance	15
Portugal	5	1999-2003	556	Strong positive correlation between strong governance and performance	16
Russia	7	1999-2005	105	Strong corporate governance linked with higher market valuations	17
Saudi Arabia	4	2006-2009	94	Positive correlation between strong governance and higher firm value	18
South Africa	5	1997-2001	42	Elements of corporate governance are associated with enhanced corporate performance	7
Spain	5	1999-2003	746	Strong positive correlation between strong governance and performance	16
Sweden	5	1999-2003	2,241	Strong positive correlation between strong governance and performance	16
Turkey	4	2005-2008	100	Corporate governance has a positive influence on corporate performance	19
Turkey	2	1997-2008	41	Elements of strong corporate governance are associated with better EVA, MVA and CVA	25
Ukraine	4	2000-2003	5,000	Strong corporate governance is a good predictor of better corporate performance	21
UK	5	1999-2003	11,197	Strong positive correlation between strong governance and performance	16
UK	10	1999-2008	2,212	Strong governance is associated with better operating performance and higher stock-market returns	20
United States	15	1990-2004	68,497	Strong governance is highly correlated with better operating performance	22
United States	10	1990-1999	11,736	Clear correlation between strong governance and higher firm value and better stock-market returns	23

* See Appendix B

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Appendix C: Methodology

Governance data: The overall governance score for each company was taken from the CG Index. To build this index, data is collected annually from the front end of the FTSE 350 annual report. The score is based on the quality of disclosures and alignment to the principles and provisions of the Code.

Governance scoring and weighting: The overall governance score is derived using a proprietary weighting calculation between the five elements of the Code (leadership, accountability, effectiveness, remuneration, relations with shareholders). The score weighting is based on the emphasis placed by the FRC on each provision and on our experienced judgement on elements that are crucial to business performance. We have validated our methodology with several internal and external stakeholders, including the FRC.

Study design: The study uses data from a 10-year period from 2007–2017. Using the CG Index, we ranked the FTSE 350 study population according to their overall governance score. We then identified top-quartile companies and bottom-quartile companies in each of the years from 2007–2017 for each of 10 sectors (detailed below). The score was accumulated to provide a representative population across the quartiles. Once the top and bottom quartiles were identified, these companies' consequent years' financial performance were tracked using the financial indicators outlined in the main body of this report.

Our database represents the 10 industry classification benchmark (ICB) categories used in the UK namely: basic materials (7%), consumer goods (8%), consumer services (22%), financials (22%), healthcare (4%), industrials (21%), oil & gas (6%), technology (5%), telecommunications (2%) and utilities (3%). Numbers in brackets indicate the proportion of companies in the population.

Study population: While our analysis looks at the FTSE 350 market, we exclude investment trusts as they follow the AIC Code of Corporate Governance. As a consequence, from 2007–2017, we captured corporate governance data for an average 301 companies per year, giving us 3,018 total company entries.

In terms of individual companies, over the 10-year period, a total of 506 individual companies were incorporated into the CG Index and subsequently either stayed in, were acquired, merged or delisted. We tracked all these companies over their lifecycle in the CG Index.

Governance database stress testing: We referenced the dependability of the data by meeting with a selection of companies included in the dataset to confirm that the results reflected the company's approach to governance.

Data-screening: To remove anomalies and maintain the integrity of the data, the financial data was screened. Historical financial data for all the companies in our analysis was obtained from the FAME financial database. Once downloaded, the data was screened for missing data fields, anomalous data and extreme outliers (greater than two standard deviations from the mean). This cleansing process provided data for 77% of the original 3,018 company entries (ie a total population of 2,309 entries with reliable data).

Key points of note/limitations:

Key limitations to our study are as follows:

- It is based on the effective Code in operation over the study period.
- It assumes that disclosure equates to practice. Listed companies are subject to a variety of reporting requirements. Anecdotal testing over the 17-year period of the data collection has validated findings, however this is on an ad hoc basis. The data is also assessed and calibrated within the wider FTSE 350 population for accuracy each year.
- While a positive correlation exists between strong governance and a number of financial indicators, correlation does not automatically mean causation.
- While regression analysis also supports a positive association between strong governance and a number of financial and governance indicators, it is hard to isolate a variety of wider impacts. Reducing the population of measures would have improved correlation but affected our ability to comment on the value of strong governance being defined by the application of the Code.
- Only financial indicators were looked at as these are easily and reliably obtained from financial databases.



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