Implementing Governance Practices

Industry competitiveness proves to be a key factor in determining boards' initiatives

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IT IS AXIOMATIC TO SAY THAT GOOD corporate governance prevents corporate malpractice, enhances a company's image, and simply increases firm value. Why, then, aren't all firms guided by the same strong corporate-governance principles?

Firms in some industries have similar governance practices, whereas firms in other industries differ greatly in their governance structures. As they decide whether to implement certain governance practices and reforms, it is important for directors to understand how other firms make these decisions. Thus, it becomes essential to recognize the factors that drive the quality and diversity of firms' governance practices.

Among most practitioners, it is widely believed that industry factors are important in determining how firms structure their governance practices; leading governance solutions providers such as Institutional Shareholder Services Inc. (ISS) offer all the relevant data for competitive benchmarking.

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When adopting governance structures, however, not all firms take into account the practices of their industry peers. Many consider governance an independent choice. It may come naturally to directors to make governance decisions by employing practices that best suit their firms' own dynamics. In certain industries, though, common factors force firms to improve upon the required minimum standards while aligning governance practices within the industry. For these cases, firms that ignore the governance of industry peers may lose out in the long run. The challenge lies in deciding when to consider peer governance.

To determine when and how peers' governance practices should be closely considered or adopted, during my doctoral studies at McGill University I conducted an extensive study. The study uses the survey data provided by ISS on governance characteristics that are audit-, board-, antitakeover- and compensation-related and translates them into governance scores. Using these scores as indicators of governance quality, the research question is first explored on some 5,000 U.S. and 190 Canadian firms. It is then extended to include additional 2,000 international firms.

Industry competition matters

The results of the study conducted on U.S. and Canadian firms reveal that product market competition plays an important role in determining the quality of firm governance. Firms that operate in competitive industries are bound by industry forces to eliminate inefficiencies. This also requires operating with governance standards that do not allow for any managerial slack. It is therefore not surprising to see firms in more competitive industries adopt more stringent governance practices.

Product market competition is also an important determinant of the diversity of corporate governance within industries. As most firms choose to implement more stringent governance rules, those companies in industries with strong competition tend to adopt similar governance structures. The diversity of governance practices, however, increases with industry concentration. In concentrated (i.e., less competitive) industries, firms can implement stronger regulations as they consider appropriate; high costs may leave their competitors unable to follow suit. This results in more diverse governance structures.

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Recognizing the importance of a broader equilibrium force, such as industry competition, has several substantial implications. If industry competition helps shape governance practices, then efforts to improve corporate governance tend to provide the greatest benefit in non-competitive industries.

When firms adopt more stringent governance practices, this often reduces the CEO's discretion. Depending on the industry, the benefits and costs associated with this will vary. Giving the CEO more authority makes much less difference for the shareholders of a firm that operates in a competitive industry. This is because competitive forces have usually wrung out much of the company's flexibility.

Adopting more stringent governance standards in a concentrated industry, therefore, has different implications than adopting those standards in a competitive industry. The results of this study, combined with those of earlier studies even suggest further consequences related to firm value. In a related study, Giroud and Mueller (2010) show that the passage of business combination laws that weaken governance results in a significant drop in operating performance for firms in non-competitive industries. Firms in competitive industries, on the other hand, do not experience any significant effect.

Therefore, improving or deteriorating governance can have different effects on the operating performance of the firms in competitive and non-competitive industries.

It is thus essential for directors to take into account their firm's industry structure when making governance-related decisions in the boardroom. Depending on the firm's industry dynamics, there may be little value in implementing further costly and complicated procedures.

Given the importance of the factor of industry competition, the implications can also be extended to other policy decisions. Efforts to improve corporate governance can easily be broadened to include policy measures aimed at improving industry competitiveness, such as deregulation and antitrust

laws. By improving industry competitiveness, policy makers can effectively improve the governance quality of firms, as competitive pressures will leave no room for firms to choose otherwise.

Acknowledging that peer governance is essential

It is hard to isolate a firm from its industry, and from its industry counterparts. Most firms' decisions take into account those by industry rivals. Decisions regarding corporate governance should not be an exception.

When companies make governance-related decisions, the words "competitor," "peer" and "rival" most commonly come up in the context of executive compensation, specifically in cases where the company uses Relative Performance Evaluations as part of its contracts. This concern for competitors should essentially spill over to the other governance decisions – not just those dealing with executive compensation, but everything that is board- or audit-related.

As governance decisions affect firm value and operating performance, the consequences of these decisions ultimately affect the firm's position in its industry relative to its peers. Similarly, the governance decisions of the peers affect not only the peers' position but also, indirectly, the firm's own.

Since the benefits and costs of governance-related decisions are shared by all industry participants, understanding which governance principles your competitors are implementing becomes essential.

Peer governance matters more in competitive industries

Industry structure also determines when peer governance matters the most. For those firms that are operating in industries with intense competitive pressures, those firms that do not consider the governance decisions of their competitors stand a smaller chance of survival in the long run.

In industries marked by intense competition, firms that ignore competitors' governance decisions stand a smaller chance of survival.

Acknowledging industry factors is necessary but not sufficient; the external legal environment still matters.

There will still be certain outside factors, such as country-specific regulations, which will determine the minimally accepted governance standards a firm has to meet. These rules also help align the governance practices of firms.

To examine firms in a more global setting, the study was extended to include those from 21 other countries.[1] Consequently, the differences in diversity of firm governance practices within countries appear striking. In some countries, such as Australia, Singapore and Japan, most firms operate with similar standards. Yet, in others, such as Switzerland and the Netherlands, governance practices are much more diverse.

The legal environment of a country is an important determinant of governance diversity. In countries with a stronger legal environment, firms adopt not only more stringent rules but also more similar governance standards. The external legal environment is the main factor in aligning governance practices, even after accounting for industry factors.

Country regulations fundamentally set the minimum standards a firm has to adopt. The decision to improve upon what is legally required (or not) is then determined by the dynamics of firms and their industries. While looking at it from a global perspective, the directors should never ignore the industry factors; but they must not leave out the fact that firm governance decisions are ultimately a byproduct of the country's legal environment.

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1. The additional countries studied were Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the U.K.