The Corporate Governance Scorecard –

a Tool for the Implementation of Corporate Governance

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Abstract

Recent empirical research confirms that companies with demanding governance standards achieve higher market valuations. Due to the complexity of specific corporate governance matters there is a rising need for a systematic and quantitative evaluation approach for corporate governance. In Germany, a Corporate Governance Scorecard has been developed that fulfills the key goals defined by analysts and investors: It has a standardized format, can be applied efficiently, is available at no cost and enables self-assessments by companies as well as sector-specific comparisons. The German Scorecard has not only found good reception at the national financial community, but has also been adapted around the world especially in emerging countries.

Reasons for the Scorecard approach – the German example

Until the early 1990ies, efforts to advance good governance in Germany were not very successful. Many large companies were still de facto run by management boards with little outside control. Although the considerable influence of financial institutions represented in the supervisory boards as major lenders and in many cases significant shareholders had gradually receded over some years, the main reasons for the acceleration in German corporate governance matters were:

Firstly, large institutional investors[1] actively pursued the shareholder value concept by asking for concentration on core competencies and longer term profit orientation. Secondly, the success of the equity markets on a world-wide basis saw a prolonged rise also in German equities. With the privatization of the 'Deutsche Telekom' the number of German shareholders increased to some 13 million (4 million direct and 9 million indirect through investment funds, as per December 2001). This led to increased competition in the asset management sector. To win clients, opportunities for increased performance were sought and a key element was found in the pursuit of corporate governance. Recent empirical research (Gompers 2001; McKinsey 2002) confirms that companies with demanding governance standards show higher market valuations.

Thus, German investors joined international institutions (mainly: US and UK pension funds) in an active drive for corporate governance. Thirdly, the new German 'KonTraG' law of 1998 was an important sign of more capital market oriented legislation and led to clearer lines of demarcation inside the companies as well as increased duties and rights for auditors. Finally, well publicized

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failures in erstwhile 'blue chip companies' like Metallgesellschaft and Holzmann, but also large 'Neue Markt' companies, contributed to the urgency of governance improvements. This also led to increased political attention, evidenced by the formation of a Government Commission by the German Chancellor.

The acceleration of German corporate governance matters went along with a generally higher complexity of governance issues. Therefore new challenges arose for companies and investors concerning the practical implementation and pursuit of good governance principles. A former lack of interest turned into a lack of knowledge about detailed elements of good governance and their effective application. The evaluation of corporate governance by investors and analysts to facilitate their investment decisions was seen as complex due to many 'soft factor' issues not covered by law. Thus it became evident that practical tools were needed to achieve the implementation of good governance principles.

Practical development efforts

The German response to this situation was provided by market practitioners in a twofold approach:

A 'Code of Best Practice' – a model catalogue for companies:

The first step was the drafting of a 'Code of Best Practice' for Corporate Governance by German corporations. In September 1999 a panel of ten experts representing the relevant fields of academia, corporations, auditors, investors and legal practitioners started working on the establishment of a 'Code of Best Practice' (German Panel 2000) as a ‘model catalogue’ for listed German companies.

The ‘Code of Best Practice’ presented in January 2000 was based on the relevant German laws and the international governance standards and expectations expressed by national and international investors.

International institutions leading in the governance field like Calpers and Hermes were invited to comment on the their governance content and understandability before its publication. The principal goal was to give German companies a market oriented guideline for the drafting of principles. Accordingly they no longer had an excuse to avoid the formulation of their governance scenario.

The publication of Scorecards for analysts and investors:

As the second step, a working group of the 'German Society of Financial Analysts' (DVFA) developed a ‘Scorecard for German Corporate Governance‘

(DVFA 2000) based on the 'Code of Best Practice' which was updated in June 2000.

Because the first issue of the Scorecard found good reception in Germany as well as in other countries[2], an updated version of the Scorecard (DVFA 2002) was issued to follow the official 'German Corporate Governance Code' that had been published by the German Government Commission on Corporate Governance in February 2002.

Main goals of the Scorecard approach

The Scorecard should:

- Facilitate the work of analysts and investors through a systematic and easy overview of all relevant issues of good governance.
- Enable companies to easily assess the 'reach' and the quality of their own governance situation.
- Allow to set minimum scores by investors for governance as part of general investment politics.
- Enable comparisons across industries and countries.
- Be readily available to all interested parties via the internet.
- Ensure high degrees of usage: the completion of the Scorecard via programmed tools (MS Excel) should therefore be possible.

The example of the German Scorecard: Structure and content

The structure:

To allow an easy understanding and application of the Scorecard by the user, a concise structure has been sought. It contains on five pages a main body dedicated to the individual scoring process followed by a summary page which gives an overview by showing the partial scores achieved for each criterion as well as the total score.

The main body of the Scorecard is divided into seven relevant criteria, which comply with the structure of the official 'German Corporate Governance Code'(Cromme 2002).

Every criterion comprises relevant points not exceeding a number of ten. All points directly relating to the 'German Corporate Governance Code' show the corresponding references in brackets.

As the Scorecard is in the first instance devised for analysts and investors, additional important issues of corporate governance not yet covered by the Code are also included. Thus current deficits from the investor's point of view in the 'German Corporate Governance Code' are being dealt with by the Scorecard (such points are clearly identifiable as they have no reference to the Code).

Content of the main criteria:

<u>'Corporate Governance-Commitment':</u> This checks the extent how basic principles of good governance are anchored in the company, that its realization

is achieved by a sufficiently neutral corporate governance officer and that there is an ongoing commitment for adjusting to new developments and advances in governance standards.

<u>'Shareholders and the General Meeting':</u> The criterion reviews all relevant issues related to the equal treatment of shareholders, focussing on the existence of full voting rights and pre-emptive rights for shareholders in most circumstances of capital increases.

<u>'Cooperation between Management Board and Supervisory Board':</u> This sets the communication arrangements between Management Board and Supervisory Board.

It suggests an appropriate deductible for any D&O Insurance of Board members to avoid a 'full insurance mentality' and puts particular weight on the question of asking the shareholders for their approval in case of takeover offers. This is of particular relevance for investors as the new German takeover law permits the Boards to resolve far reaching poison pill defenses without prior shareholder approval.

<u>'Management Board':</u> The emphasis is on details of the compensation elements rewarding shareholder value orientation and excluding i.a. option repricing. The criterion also deals with practical conflicts of interest and own-account share dealing.

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'Supervisory Board': Besides introducing a compensation element, depending on longer term profitability, it concentrates on conflicts of interest, qualification standards for Supervisory Board members and expert committees for complex tasks (particularly the audit committee) are the focus here.

'Transparency': Equal and regular information for all shareholders ('fair disclosure'), also via the internet, as well as detailed analysis of deviations from previous targets, are key points here.

'Reporting and Audit of the Annual Financial Statements': Apart from demanding international accounting- and auditing standards and full information on stock options, the criterion focuses particularly on sufficient independence of the Auditor and his appropriate compensation, different accounting standards and internal and external information matters like maximum periods for publishing reports.

The Scorecard methodology

The approach:

The Scorecard should enable the user to evaluate corporate governance principles and practices in a quick but systematic fashion with a concise structure of the major criteria with relevant individual points.

In the case of the German Scorecard, the user assesses the degree of fulfillment of each point by marking the corresponding field in the column

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‘Fulfillment’. Three choices (yes, partially, no) exist for every point giving full, half or zero marks for each point.

Especially for debatable items, the source of information for the particular point is to be given in the column ‘Information Source’. If a specific point cannot be dealt with due to binding company specifics, the point can be marked with ‘yes’, but this evidently does not apply if it conflicts with principles of good governance.

Calculation and weighting of the Scorecard:

The calculation and weighting of the Scorecard should follow an easy path that gives standard weightings but also allows the reflection of individual weighting differences. The calculation should be menu-driven and follow proven methods like MS Excel standard software.

In the German example, each point is weighted by a suggested 'standard weighting' following its deemed importance. The percentages appear in the second column of the Scorecard.

In order to allow an individual approach, an individual weighting can be assigned to every point (third column). This allows the Scorecard to reflect individual experiences and preferences avoiding the usual 'box-ticking' problem of a too schematic approach.

The Scorecard then calculates the ‘Partial Scores’ in the fourth and fifth columns by weighting the achieved points of each item.

The last step, also automatically achieved by the Scorecard, is the calculation of the ‘Total Score’. All partial scores assigned to each of the seven criteria are weighted by the set percentage numbers and then added up for the 'Total Score' in the overview page 'Summary of Results'.

Governance evaluation criteria for the Scorecard:

The conceptual approach to the evaluation question should reward the fulfillment of a good standard of governance and an active commitment with a possible score of 65% - 75%. The remaining percentage should be achievable if additional important governance items are fulfilled.

Taking the German Scorecard as the example: A company displaying an active 'Corporate Governance Commitment' (first criterion) and fulfilling all 'Recommendations'[3] of the 'German Corporate Governance Code', reaches a score of 75%. If the additional 'Suggestions' of the Code[4] and additional 'best practice standards' are fulfilled, the maximum 'Total Score' of 100% can be achieved.

This 25% gap over the fulfillment of the 'Recommendations' is clearly meant to incentivise companies to pursue more than the 'Recommendations'. German companies with demanding governance standards reach scores between 80% and 95%.

International application of the Scorecard approach – an encouraging picture

Since it was first published in June 2000, the Scorecard has found good reception, also on an international level. The Scorecard itself, but also its basic approach are now applied in many countries outside Germany. This particularly applies to countries which still have to develop a comprehensive legal and transparent basis for corporate governance.

In East Asia, for instance, the Scorecard is well known as a tool for the improvement of corporate governance. Besides changing the legal background after the crisis of 1997, an additional instrument was sought to foster the implementation of ‘best practice’ governance principles and to promote the link between legal and voluntary changes towards good governance. Therefore the original version of the German Scorecard, after suitable local adaptations, is now utilized inter alia in Indonesia (FCGI 2001) and the Philippines (Saldaña 2000). This confirms the applicability and usefulness of the Scorecard for assessing governance practices of companies and provides the opportunity to systematically improve governance practices across the Asian region. Although not applying the Scorecard in its original design, other Scorecard-related approaches have emerged. Mainly two approaches have been followed in Latin America and Europe: To assess the quality of governance in Latin America, a Scorecard approach was developed to conduct a rating for corporate governance in 72 companies (Grandmont 2001). The degree of detail of the rating is not as expansive for the German Scorecard: the questionnaire comprises four main criteria with two to ten points. Partial scores are assigned, using the following weighting: The majority of the points can achieve a score between one and five, while for particularly important items a deduction of up to five points is possible if the point is not covered satisfactorily or even not at all.

In Europe, Deminor Rating, a commercial rating agency for corporate governance on behalf of client companies uses a Scorecard-related approach to compile a detailed internal ‘Corporate Governance Profile’. It is then the choice of the company to use this profile as basis for a publicly disseminated ‘Corporate Governance Rating and Investor Report’. This report is seen by Deminor as ‘a quality certificate awarded by an independent agency’ helping to attract investors (Deminor 2000).

The structure of the Deminor approach consists of four main criteria comprising a wide amplitude of sub points enabling a detailed analysis of corporate governance. Similar to the German Scorecard, the rating process delivers a total score.

In comparison with the German Scorecard, two substantial differences of both approaches exist: Whereas the concept of the Deutsche Bank has a limited transparency of the evaluation process, the detailed concept of the Deminor rating is not accessible to external parties. Furthermore, none of the approaches enables the user to verify the rating by conducting the process himself – an important feature of the German Scorecard approach.

Resume

Since first published, the Scorecard has found good reception and international application. The key to this result is the approach itself, which enables analysts, investors and companies to successfully apply and evaluate varying governance scenarios of companies, coping also with a rising complexity of corporate governance matters.

Its easy and no-cost availability as well as good application features are important factors for its broader usage. Its reasonable degree of individualization to company- and sector-specific requirements and its adaptability to different legal frameworks and new governance developments have made it an important implementation tool also for many countries beyond Germany. This particularly applies to emerging countries that are not having a broad distribution of relevant expertise in this field. Thus many bodies, also in the public sector, that are interested in an efficient implementation of good governance principles, could be seen to apply this instrument.

NOTE

1 DWS Investment GmbH, a Deutsche Bank group entity and the largest mutual fund company in Germany and Europe with assets over Euro 90 billion and Union Investment, the third largest German fund manager mostly owned by the cooperative banks.

2 The DVFA Scorecard served as model for Scorecards issued inter alia by bodies in Indonesia and the Philippines.

3 ‘Recommendations’ of the ‘German Corporate Governance Code’ that companies do not comply with, need to be explained (according to the German ‘Law of Transparency and Publicity’ as of July 19, 2002).

4 ‘Suggestions’ of the ‘German Corporate Governance Code’ represent further international standards of good governance. These ‘Suggestions’ do not have to be published in case of non-compliance.

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