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Corporate Governance Standards:
The Importance of Compliance and Main Issues in Germany

by

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I. Reasons for a Corporate Governance Code – the German experience

Efforts to advance good governance in corporate Germany were not very successful until 1995. Many large companies were still de facto run by management boards with little outside control. The hitherto considerable influence of financial institutions (represented in the supervisory boards as major lenders and often significant shareholders) had receded over the years. The main reasons for the acceleration in German corporate governance matters were:

1) Well publicized failures in erstwhile 'blue chip companies' like Metallgesellschaft and Holzmann contributed to the urgency of governance improvements and attracted increased political attention, eventiually evidenced by the formation of a Government Commission by the German Chancellor.
2) The success of the equity markets in the late 90ies led to broad share distribution in public hands. With the privatization of the 'Deutsche Telekom' the number of German shareholders increased to some 13 million (5.7 million direct and 7.2 million indirect through equity funds, as per December 2001).
3) Increased competition in the asset management sector. There are today some 8.2 million Germans who save regularly in equity funds for their retirement or education of their children. To win clients, opportunities for

increased performance were sought and a key element was found in the pursuit of corporate governance.

Empirical research confirms that companies with demanding governance standards show significantly higher market valuations:

- A recent study by McKinsey and the World Bank shows that large international institutions are willing to pay a 13 % premium for German companies with good corporate governance.[1]
- In an empirical study by authors of the business schools of 'Harvard' and 'Wharton' 24 corporate governance criteria with 1.500 companies were analysed during a period of 10 years until 1999. Companies with excellent governance performed on average 8.5 % p.a. better than companies with poor governance.[2]
- A governance index consisting of 91 companies from the German stock exchange has shown an average additional return of 12 % p.a. between the best and poorest performing companies in the period 1998 – 2002.[3]

The acceleration of German corporate governance development coincided with the increasing complexity of governance issues. This presented new challenges 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 the detailed elements of good governance and their effective application. The evaluation of corporate governance by investors and analysts as part of their investment decision process was seen as complex, also due to the many 'soft factor' issues not covered expressly by law or other regulations. Thus practical efforts to install a code and other tools were needed to achieve the implementation of good governance.

II. Practical development efforts

1) A 'Code of Best Practice' – a model governance catalogue as a private initiative

The first step was the drafting of a 'Code of Best Practice'[4] for corporate governance by German corporations. In September 1999, a panel of ten experts representing listed companies, auditors, investors and legal practitioners

[1] MCKINSEY (2002): 'Global Investor Opinion Survey', undertaken in cooperation with the OECD / World Bank 'GLOBAL CORPORATE GOVERNANCE FORUM'. Internet: http://www.gcgf.org /.
[2] GOMPERS / ISHII / METRICK (2003): Corporate Governance and Equity Prices, in: The Quarterly Journal of Economics, Issue 118, No. 1.
[3] DROBETZ / SCHILLHOFER / ZIMMERMANN (2004): Corporate Governance and Expected Stock Returns: Evidence from Germany, in: European Financial Management (forthcoming).
[4] Available in the Internet: http://www.corgov.de/.

started working on the establishment of a 'Code of Best Practice' as a ‘model catalogue’ for listed German companies. As a private initiative, no time was wasted on lengthy policy matters like political mandates or resolution of chairmanship issues. Consequentially, less than four months were needed to present the Code in early January 2000. The basis were the relevant German laws and regulations, international governance standards (particularly the OECD Principles on Corporate Governance from 1999) 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 content and understandability before its publication. The principal goal was to give German companies a market oriented guideline for the drafting of their governance principles. Accordingly companies no longer had an excuse to avoid the description of their governance scenario.

2) The publication of a scorecard for analysts and investors

To encourage a wider understanding through the application of good governance in the financial markets, a working group of the 'German Society of Financial Analysts' (DVFA) developed a ‘Scorecard for German Corporate Governance‘[5] based on the ‘Code of Best Practice’ which was presented in June 2000. The scorecard model found good reception also in other countries, including Russia and some Asian states.

3) The official 'German Corporate Governance Code' – a combination of public and private sector work

Particularly after the Holzmann corporate crisis in late 1999, the German government realized the practical importance of better governance for the development of German companies in the competitive international context. In July 2000, the German Chancellor convened the first ‘Government Commission on Corporate Governance’ to develop official standards for German governance and to draft recommendations for future company law developments. The commission consisted of high-level experts from politics, quoted companies (midcap to large companies of different industries), unions, the German stock exchange, private shareholder association, institutional investors, university (i.e. economic law), auditing and consulting firms. In June 2001, a nearly 400 page report with detailed proposals was presented to the German Chancellor.

5 First published, also in the Internet, by the 'GERMAN SOCIETY OF FINANCIAL ANALYSTS' (DVFA) in June 2000. The current version of December 2003 is available in German and English at: http://www.dvfa.com/.

In September 2001, a second Government Commission was put in charge to develop the official ‘German Corporate Governance Code‘[6]. Its mission was to develop a code that would be broadly accepted and supported by all relevant interest groups. The members of the commission were recruited from: Listed companies representing different industries, institutional and private investors, audit firms as well as academic experts of law and finance and the unions. For selected issues the commission consulted further experts e.g. from executive search or law firms. After five months of intensive work with a draft for public comment, the Code was published in February 2002.

Following the principle ‘comply or explain‘, German companies have to comply at least annually with the Code or explain deviations. The Code is meant to give a full picture of all governance elements and therefore comprises three layers of governance issues:

- A description of the legal stipulations relating to key governance points.
- ‘Shall Recommendations’ which also reflect basic international governance standards. Companies that do not comply with these Recommendations have to state this in their annual report and/or their website.
- ‘Should Suggestions’ that represent additional international elements of good governance. These ‘Suggestions’ do not require an obligatory statement in case of non-compliance (but the Code encourages a detailed description of the application and any deviation from the 'Suggestions').

III. The implementation experience

- The political environment: The German experience shows that to achieve full application of the Code the building of a legal requirement for its application (but not in terms of content) was necessary. With the 'comply or explain'-provision companies can decide individually about each individual 'Recommendation' of the Code. However, it is obvious that any deviation particularly from the 'Shall Recommendations' will negatively impact the standing of the company in the capital market. Companies therefore have a clear interest to keep these deviations to the absolute minimum.

  Another advantage of the 'comply or explain'-principle is the flexibility to adjust the Code to new best practice developments. Especially the latter is important for quality adjustments and to prevent over-regulation. While

[6] Available in German and English in the Internet: http://www.corporate-governance-code.de/.

the German Government Commission on Corporate Governance has an official mandate, it has no legislative powers. All members are non-political representatives. Any adjustments to the Code generally do not require new legislation, thus allowing fast response to major changes in German corporate governance. This framework helps to ensure a high degree of fast adjustment of the Code.

- The international influences: The OECD Corporate Governance Principles had considerable influence on the official German Code and its privately compiled predecessor. Other influence was exercised by leading Anglo-Saxon institutions like Calpers, TIAA-CREF and Hermes. Private organizations like 'The Conference Board' and an increasing amount of comparative studies also played a meaningful role in the drafting process.

  In Europe, the EU Commission's role in corporate governance has increased in the last years but is limited due to major differences in national securities and company laws. The EU Action Plan was set up in May 2003 to set minimum governance standards for European companies. The idea of the EU Action Plan is not to legislate for all EU member states, but to achieve convergence of the many different governance regimes over a well defined timeframe.

  Especially legal differences impose a 'natural' barrier towards globally harmonized corporate governance standards. Therefore, it remains crucial to make country-specific governance situations more transparent. This has also been one of the main objectives in the development effort of the German Code.

- Compliance by companies: In the early development period, only a few companies were really interested to actively engage in the promotion of governance. Intensive resistance had to be overcome particularly by the chief lawyers who generally have a strong position in German companies and reacted negatively to new obligations of a non binding legal nature. Even after the introduction of the official Code in 2002, some major corporations are only willing to do the absolute necessary rather than seeing the opportunity to promote the company image to all stakeholders.

  As mandated by law, listed German companies had to explain deviations from the recommendations of the Code for the first time at year end 2002. A June 2003 survey showed that the vast majority (> 90 %) of all

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companies had published their 'comply or explain'-statement in time.[7] More interesting, however, is the content of the statements. The survey reveals that only few companies comply with all recommendations. Most reported deviations concern: individual board remuneration, board qualification, implementation of audit committees, deductibles for D&O insurance, and timely financial reporting. More improvement are even required in terms of application of the voluntary 'Should Suggestions' of the Code. Only close monitoring by investors, analysts and the media will ensure an ongoing improvement in quality terms.

- The importance of the media: National and international media involvement has played an increasing role in the broader perception of governance issues. In the early phases, the investors had to engage the relevant media actively to interest them in an issue that was less spectacular than the dramatic rise of the stock market. After the publication of the Code in February 2002, the media helped to create a good understanding about the new requirements, not only for companies but for all stakeholders. Today, a lively debate on the further development issues of German governance supports the further reviews of the Code.

IV. Major issues in Germany in relation to the current corporate governance challenges in the Ukraine and Eurasia

- Many of the remaining critical issues in Germany are also of concern in Eurasian countries (although on a different implementation level):
  - Improving the efficiency of the annual general meeting (up to 10 hours for large companies)
  - Strengthening the legal rights for redress by minority shareholders
  - Improving board efficiency, especially regarding board structures (size reduction, introduction of committees, co-determination)
  - Increasing the liabilities of management and supervisory board members for incorrect capital market information
  - Substantial deficits in the current takeover law
  - Strengthening auditor independence and introduction of a private accounting oversight board (in progress)

[7] VON WERDER ET AL.: 'Kodex Report 2003' (a study of the 'Berlin Center of Corporate Governance') published in: Der Betrieb, Volume 56, No. 35, August 29, 2003, 1857 – 1863.

  - Establish centralized expertise of state prosecutors and improve capital market know how of the judiciary

- Which recommendations can be derived from the German governance development experience for Eurasian countries?
  - Significant legal and practical differences between all countries make it mandatory to develop a country-specific code. Based on its country code, each company can then define, explain and upgrade its specific governance situation.
  - The OECD Corporate Governance Principles, the UK Combined Code and other national codes as well as governance guidelines from international investors (Hermes[8], TIAA-CREF[9]) are the basis for a good code.
  - A key success factor for the acceptance by all parties is the involvement of local experts from all sectors.
  - The right development approach, i.e. a bottom up, private sector initiative versus a top down policy decision, depends on the specific national situation. In Germany, the initiative for practical governance work came from the private side. Historically, however, legally binding frameworks have proven more powerful than voluntary initiatives. This is exemplified by the voluntary German Takeover Code, which was not widely enough followed so that a takeover law had to be enacted. This is in contrast to the UK, where voluntary codes are very successful. For the German Corporate Governance Code, the combination of a law prescribing the application of the key Code elements through a 'comply or explain'-provision evolved as the suitable way to achieve sufficient acceptance and pragmatic flexibility at the same time.

V. Fostering the implementation of good corporate governance with a scorecard

The best governance framework does not guarantee acceptance and implementation if the companies are not complying with the spirit of the code. Practical ways of making companies do more than the minimum are therefore essential. One of the proven ways to achieve this is the systematic analysis and publication of the governance situation via a scorecard.

[8] Hermes Pension Management Limited: 'The Hermes Principles – What shareholders expect from public companies – and what companies should expect of their investors', London 2002, available in the Internet: http://www.hermes.co.uk.

[9] TIAA-CREF: Policy Statement on Corporate Governance, New York 2004, available in the Internet: http://www.tiaa-cref.org.

1) **What should a scorecard achieve?**
   - 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.
   - 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 also enable active dialoguing.
   - Allow investors to set minimum scores for governance as part of their general investment policy.

2) **The example of the German Scorecard: Structure and content based on the German Corporate Governance Code**

   The main body of the Scorecard for German Corporate Governance is divided into seven relevant criteria, which comply with the structure of the official German Code. Every criterion comprises relevant points not exceeding a number of ten. All points directly relating to the 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 some of the current deficits from the investor’s point of view in the German Code are being dealt with by the Scorecard (such points are clearly identifiable as they have no reference to the Code).

3) **The scorecard methodology**

   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.

   The <u>calculation and weighting of the scorecard</u> 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. This allows the Scorecard to reflect individual experiences and preferences avoiding the usual 'box-ticking' problem of a too schematic approach.

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 an overview page ‘Summary of Results’.

Conceptually, the evaluation 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. The 25% gap over the fulfillment of the ‘Shall Recommendations’ of the German Corporate Governance Code is clearly meant to incentivise companies to pursue higher standards than just the ‘Recommendations’. German companies with demanding governance standards nowadays easily reach scores between 80% and 95%.

4) International application of the scorecard approach – an encouraging picture[10]

Since it was first published in June 2000, the scorecard model 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 have to develop a comprehensive legal and transparent basis for corporate governance. The general method of the German Scorecard, after suitable local adaptations, is now utilized inter alia in Croatia, Indonesia and the Philippines. This underlines the applicability and usefulness of the scorecard method for assessing governance practices of companies and provides the opportunity to systematically improve governance practices.

In Russia, a corporate governance scorecard has been presented in autumn 2003 by a working group led by GIFA with representatives of other relevant parties.

Other scorecard or rating efforts show substantial differences of the approach: a limited transparency of the evaluation process, high costs for companies or investors. 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. And finally, the German Scorecard can easily be adapted to the circumstances of non-listed companies.

[10] For further details see STRENGER: 'The Corporate Governance Scorecard: A tool for the implementation of corporate governance', in: Corporate Governance – An International Review, Volume 12, No. 1, January 2004, 11 – 15.

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VI. Outlook: A good framework is not enough – governance quality is what matters

The publication of the official 'German Corporate Governance Code' in early 2002 marked a milestone in the development of good governance in Germany. The German approach serves as a good practical way for crafting a practical corporate governance code. Nevertheless, it is crucial to note that this can only serve as a general methodological example. The detailed work to structure a code (as any subsequent implementation steps) can only be successfully achieved if a broad group of national experts expressly tailors the code to the specific country needs.

The next step to achieve better corporate governance standards should be focused on improvements in governance quality. This is helped by the use of practical tools to promote the implementation of good governance with investors, analysts and companies and to facilitate the understanding of its complex nature. As such a tool, the German Scorecard has found good reception and international application. It enables analysts, investors and companies to evaluate systematically varying governance scenarios of companies and also copes with the rising complexity of corporate governance matters. Obviously, better governance quality cannot be achieved by prescription only. Company executives and their boards must accept that an active and positive pursuit of good governance is paramount for success in this discipline.