An analysis of the EU governance framework

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Prepared for the European Contacts Group

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oxera

Why is good corporate reporting economically meaningful?

Higher-quality financial and non-financial reporting leads to:

- better security pricing and capital market efficiency;
- higher capital investment efficiency;
- a long-term increase in corporate valuation.

Economic profits are better related to outcomes for *all* stakeholders

Higher-quality corporate reporting also creates positive externalities by aligning the interests of shareholders and other stakeholder groups

European Commission consultation on the quality of corporate reporting

The Commission has developed an EU framework involving three pillars of financial reporting:

Corporate governance
Statutory audit
Supervision of statutory auditors and audit firms

The Oxera report focuses on Pillar I, which is important as it addresses the ‘agency problem’:

Whenever a management team is entrusted with the funds of investors, the potential for mismanagement arises.
The likelihood of mismanagements can be reduced through improvement in governance.

An overview of the Oxera report

Qualitative assessment

Case studies of four historic corporate governance reforms in different jurisdictions

All reforms studied have a similar broad focus on management responsibility for financial reporting, and creating, maintaining and testing an effective internal controls system.

Holistic summary of the current status of corporate governance frameworks across EU countries

The corporate governance framework underpinning corporate reporting varies considerably across the EU, providing support for the DG FISMA initiative to consult on the quality of corporate reporting in the EU.

Quantitative analysis

Empirical analysis on the impact of corporate governance reforms in the USA and Italy on investor risk (the company-level cost of equity, CoE), accruals quality, and corporate governance rating

Improvements were found in all three metrics post-reform, which suggests that such reforms lead to better corporate governance and better financial reporting quality and are therefore expected to lower the investor risk.

‘Quasi-natural’ experiment that compares Italian companies after the reform in Italy with comparable non-Italian companies in the EU

Benefits were found for Italian companies following the governance reform relative to matched EU non-Italian companies, in the form of lower investor risk and improved financial reporting quality.

Current EU corporate governance framework

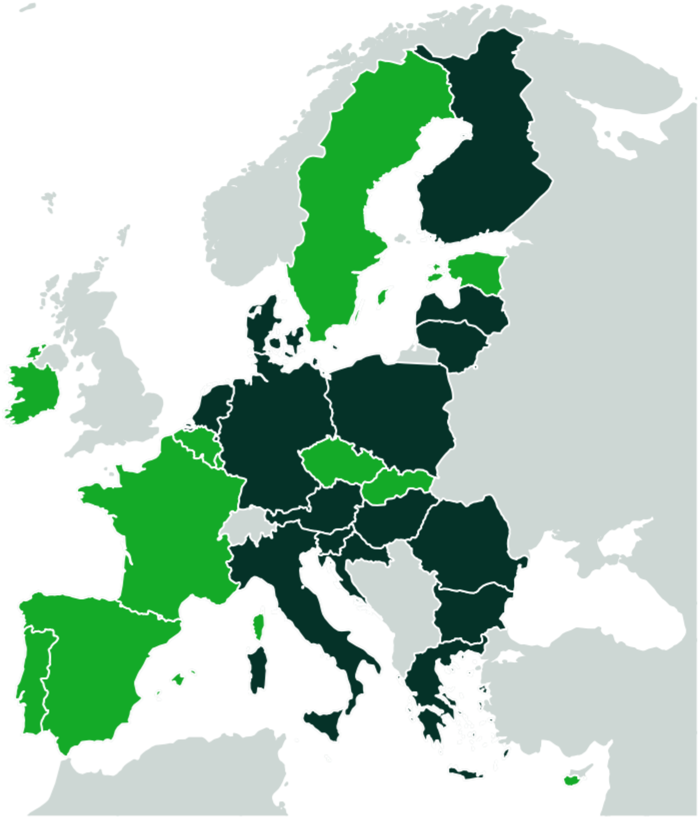
Summary

We found a striking pattern of many EU member states exhibiting a patchwork of guidance coming from legislation, securities regulators (including stock exchanges), corporate governance codes, and central banks.

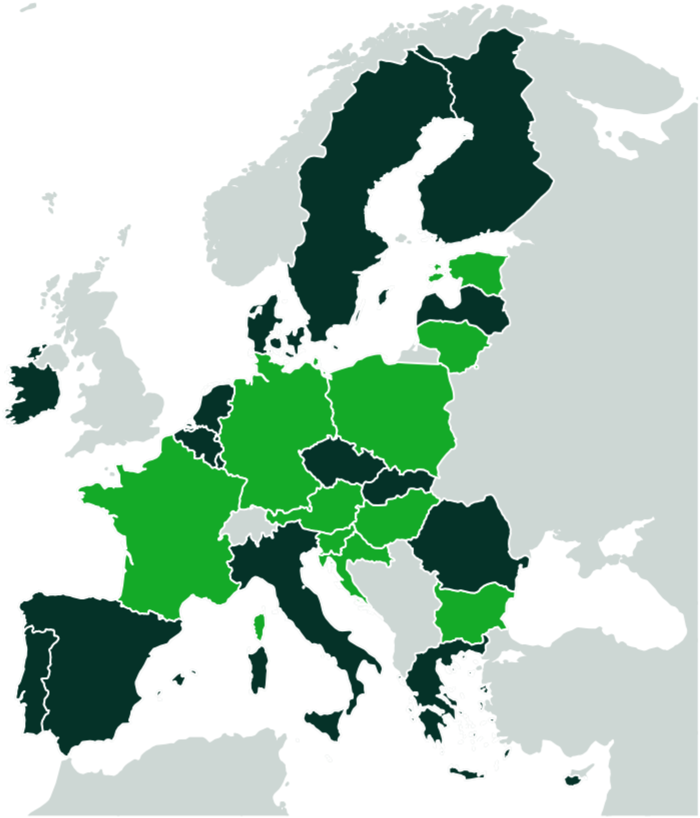
Some of these rules are required by law and others are considered ‘best practice’.

Countries explicitly requiring a signature attesting to the accuracy of accounts

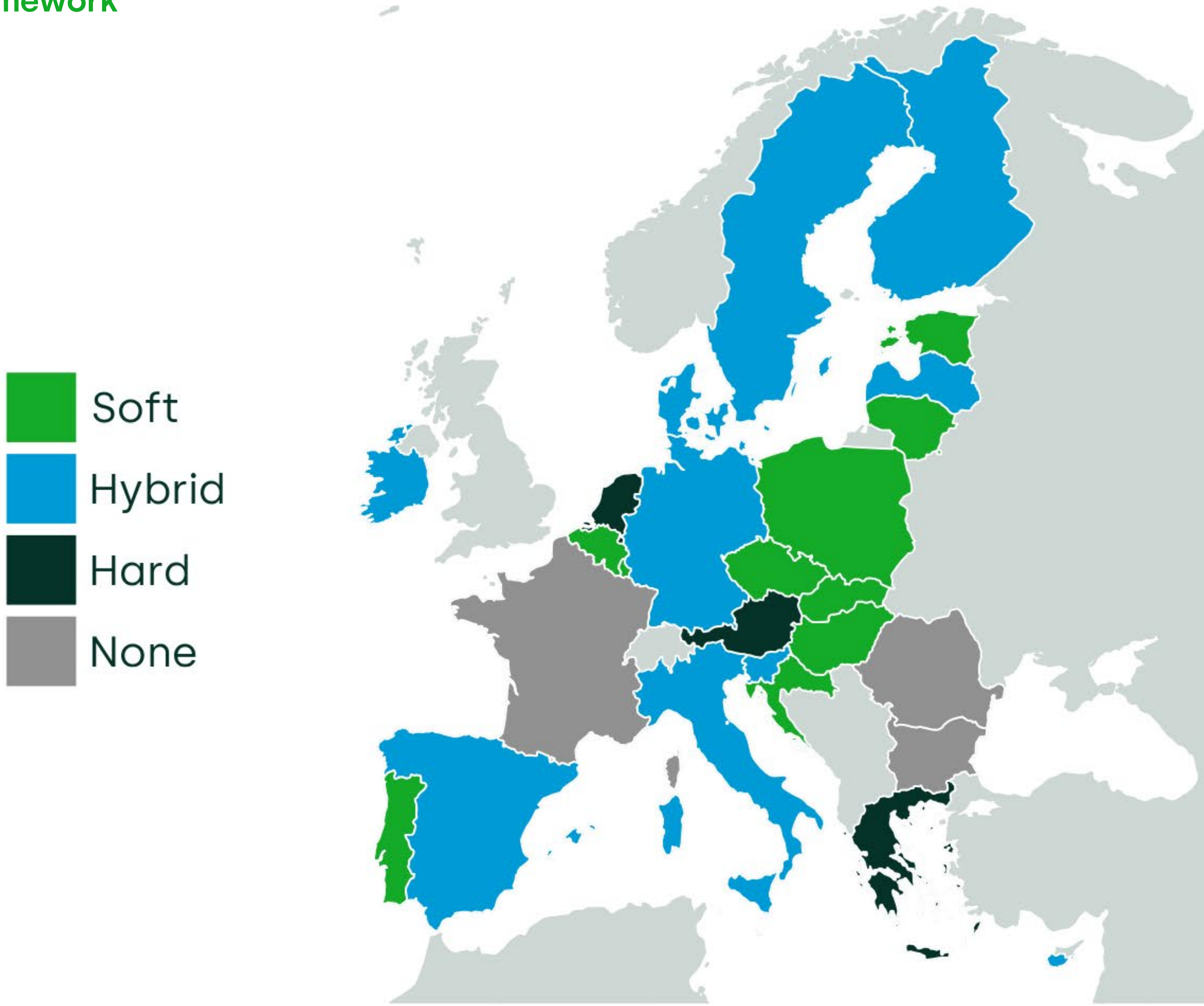
Management signs



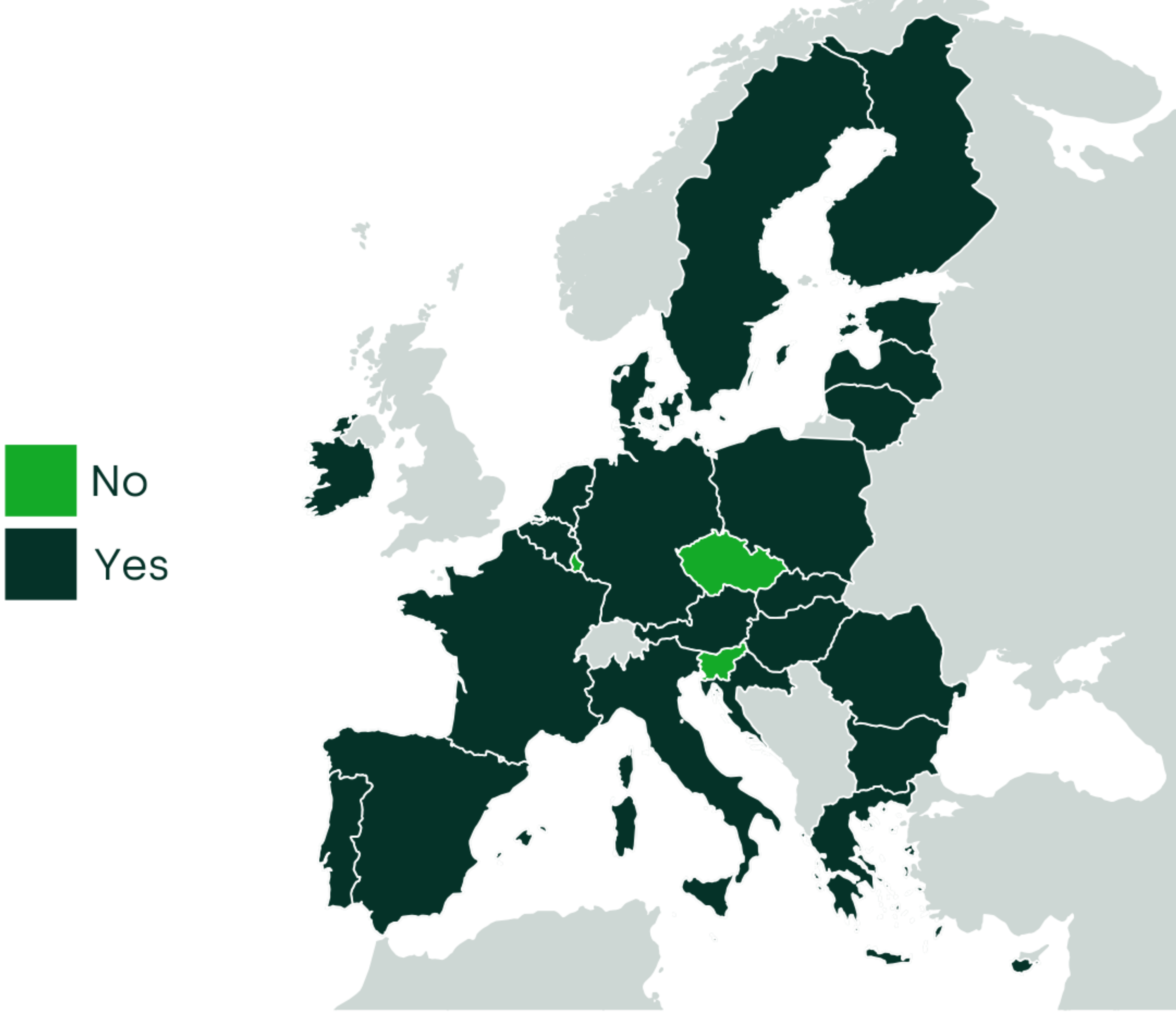
Board signs



Legal status of corporate governance framework



Countries explicitly requiring discrete corporate governance report

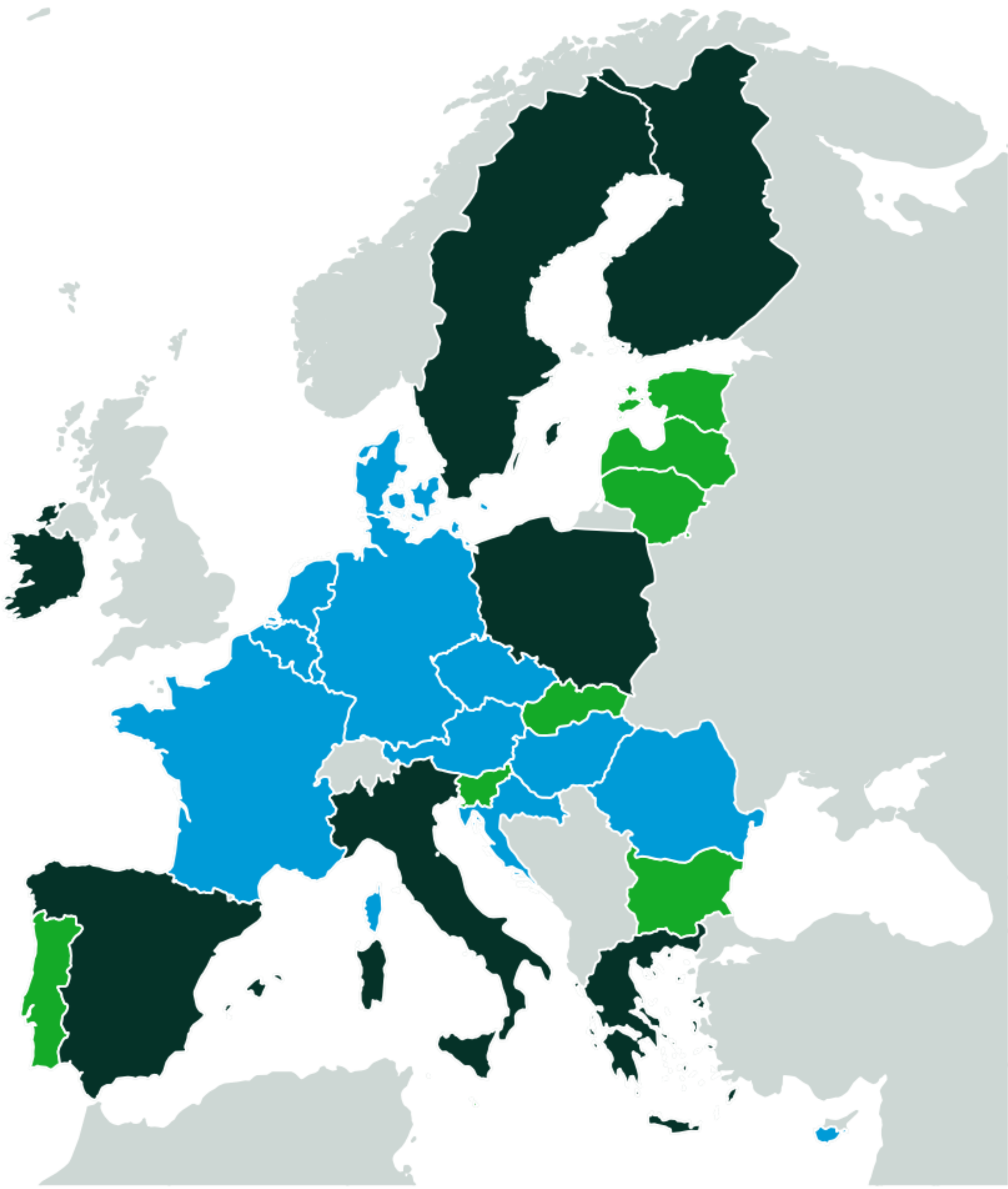


Requirement on internal controls

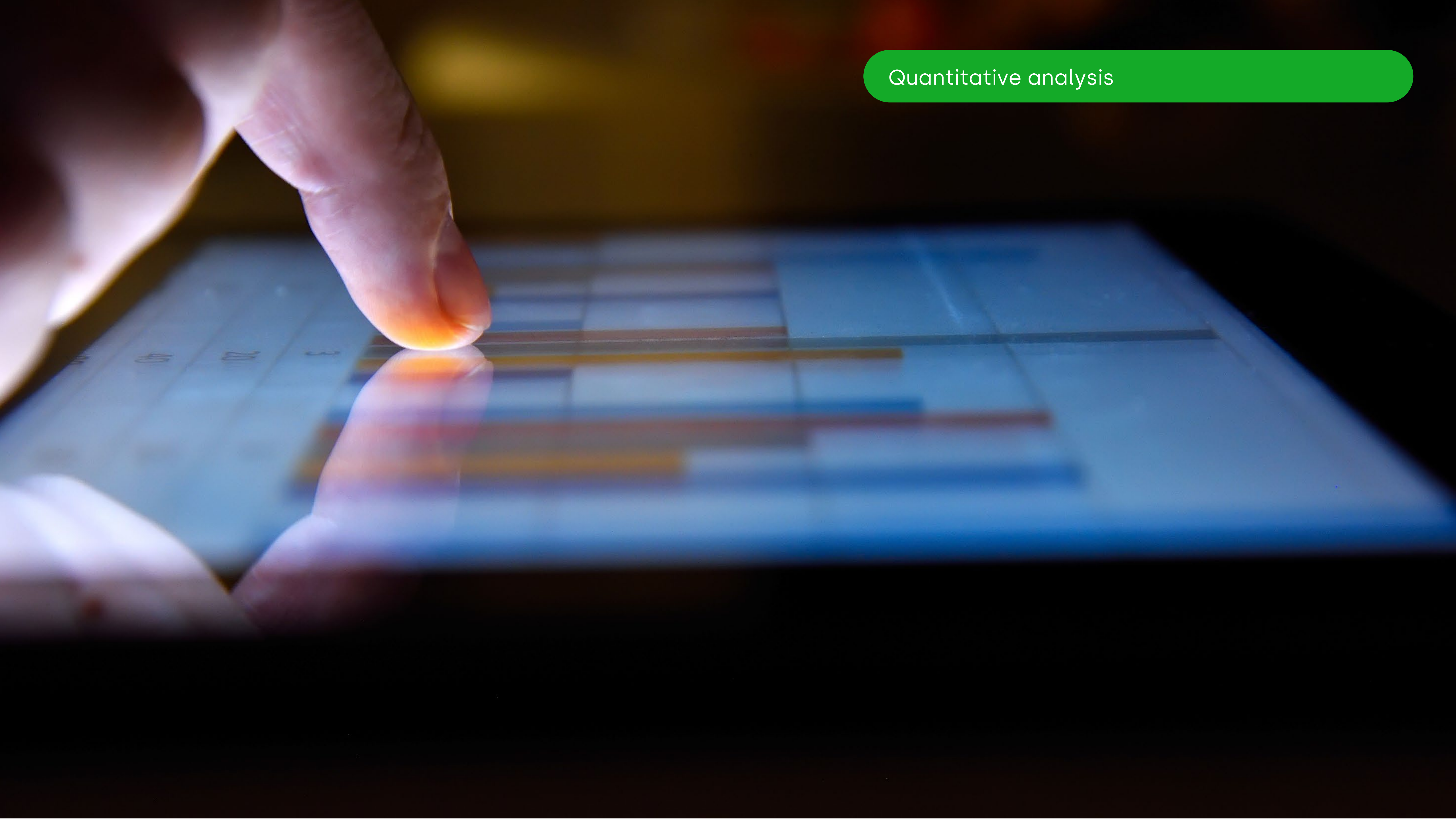
No requirement or ill-defined

Monitoring only

Monitoring and reporting required



Quantitative analysis



Summary

We study the impact of the corporate governance reforms in the USA and Italy.
The findings can be used to highlight the potential future outcomes if the EU were to adopt similar corporate governance reforms.

Three analyses were designed to cross-validate the findings:
EU quasi-natural experiment
US analysis
Italian analysis

Three hypotheses are tested in our quantitative analyses:
Better corporate reporting:

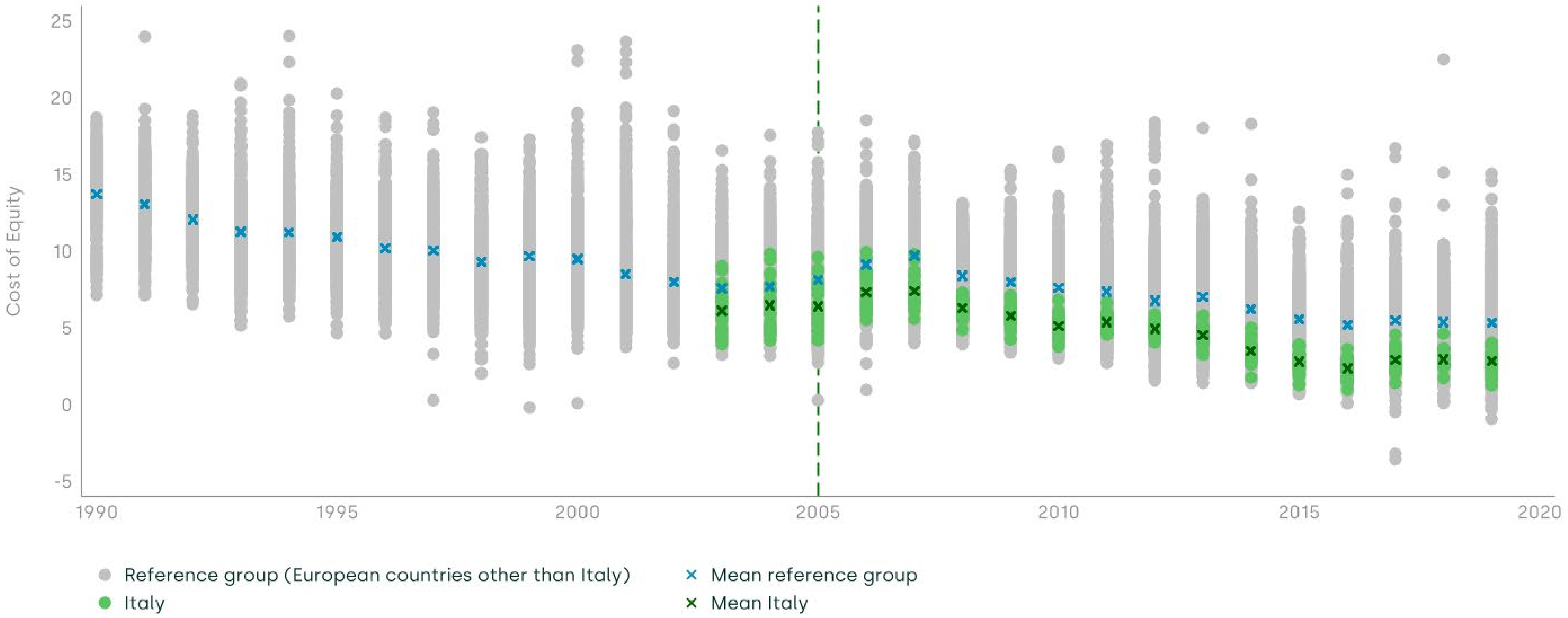
- reduces investor risk
- improves reporting quality
- strengthens corporate governance

Variables used in the quantitative analysis

	Proxy variable	Explanations
Investor risk	Cost of equity	Reduction in investor risk measured by cost of equity
Reporting quality	Abnormal accrual	Abnormal accruals are unrelated to cash flow realisations, and include the estimation errors and their reversals. Higher abnormal accrual points to poorer reporting quality
Corporate governance	The G-Index	The G-Index measures the level of takeover protection and managerial entrenchment. A higher index value is correlated with worse governance

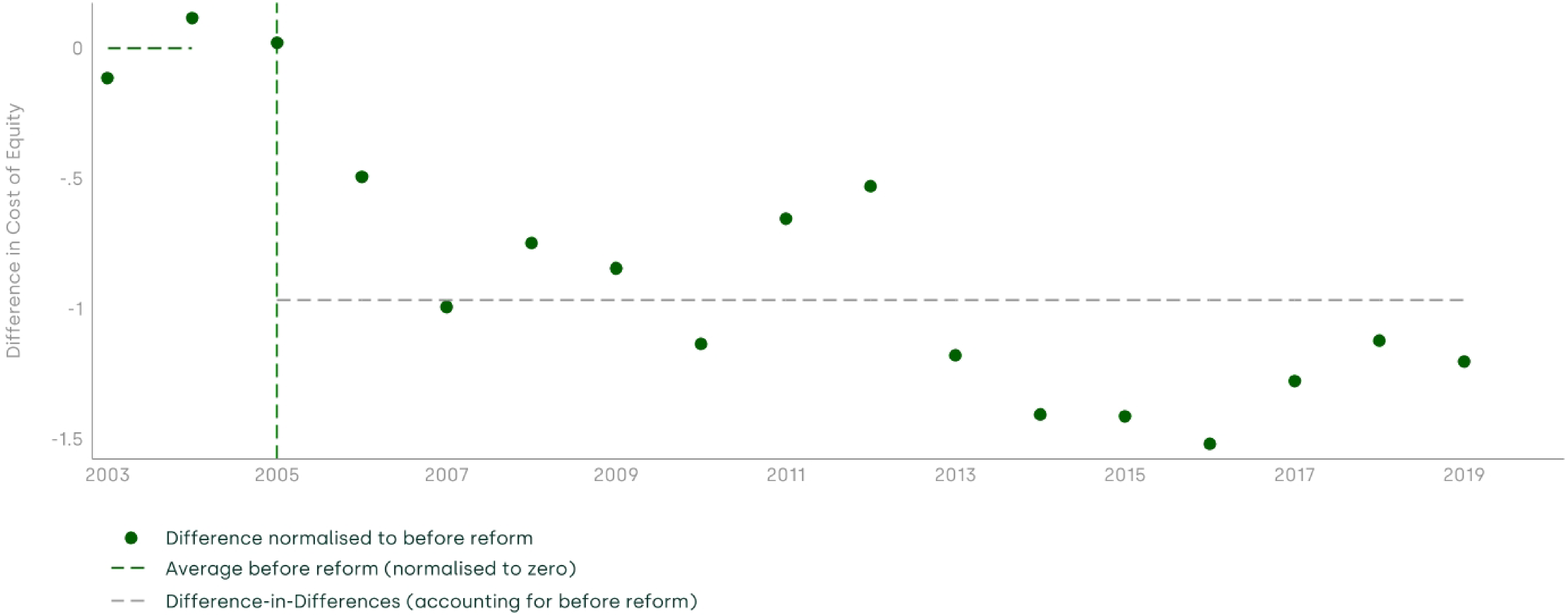
EU quasi-natural experiment—mean CoE

The mean CoE declined steadily for both Italian and non-Italian companies during the period examined, including following the Italian corporate governance reform in 2005.



EU quasi-natural experiment—difference-in-differences (DiD) I

The DiD analysis helps to answer the question: did the average CoE for Italian firms decline more than the average CoE of reference firms post 2005?



EU quasi-natural experiment—difference-in-differences (DiD) II

On average, following the Italian reforms, Italian companies experienced around a 1 p.p. extra reduction in CoE relative to non-Italian EU companies, with the DiD estimates ranging from 0.5 p.p. to 1.5 p.p. between 2006 and 2019.

Given that these non-Italian companies were matched to the Italian companies in terms of size and geography (i.e. they are all past and/or present constituents of the STOXX Europe 600 index), this finding suggests that the Italian reforms had a positive effect on investor risk.

Econometric tests confirmed the DiD results.

We found consistent results using a sample of US companies (S&P 500 constituents) and a larger sample of listed Italian companies.

Conclusions

Historical reforms in other jurisdictions have a strong focus on personal accountability for accurate financial reporting; and monitoring, testing and reporting internal controls structures.

The current EU situation is a patchwork, with inconsistencies in these two areas.

The benefits of a potential EU-wide reform on reporting extend beyond the improvements in investor and financial market outcomes.

Empirical analysis causally shows that prior reforms in Italy and the USA have reduced cost of equity, improved accruals quality, and improved governance, which reaffirms the findings of previous studies.

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