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Effects of corporate governance practices on firm performance

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Abstract: Corporate governance is mainly focused on ensuring that managers act in shareholders' interest. Therefore, this concept has emerged as essential to minimize conflicts in the company and to discourage managers to take leverage decisions that enhance their own benefits, to the detriment of shareholders. The degree to which managers can deviate from optimal behavior critically depends on the strength of corporate governance. Therefore, one can hypothesize that there must be a relationship between leverage financial performance of the enterprise and corporate governance quality. The aim of this paper is precisely to test this hypothesis and support the idea that firms with better governance system are more profitable and with a higher market value. It is also concerned the link between business results, quality of governance, costs of accumulating experience by managers and therefore the degree of performance and market value.

Keywords: corporate governance, performance, management, evaluation, mechamism

JEL Classification: G32, G34, O16, L25

1. Introduction

Corporate governance seeks, primarily, how investors leads managers to provide an adequate return on invested capital. This problem is reflected by agency theory which proposes disciplining a inefficient management team, so that the managerial activities to provide a return on the measure of the capital brought by investors. Experience already suggests that managers with poor performance are facing disciplinary pressures from from internal and also external mechanisms of corporate control.

Corporate governance is defined as all processes and structures through which the economic activities of enterprises are directed towards increasing long-term shareholders' benefits by improving performance and responsibility policies, taking into account the interests of other stakeholders.

The motivation to investigate the link between corporate governance system and performance of an enterprise can be seen from a dual perspective. First, in accordance with theories of costs, managers have an incentive to choose a level of governance to ensure compliance with all regulations for investors protection. Second, should be considered that the best governance practices, such as improved communication and a low level of vulnerability may cause investors to demand a lower risk premium, and managers can obtain an incentive to increase the efficiency, on a voluntary basis, of the company's governance practices, with some low implementation costs.

Business performance is significantly influenced by the form of implemented governance, respectively the decision makers ability to identify and harmonize the interests of the most significant social partners. For developing the activity under high competitiveness, management should avoid potential conflicts between all

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these partners and, moreover, to consider and to harmonize them. Ability of managers and other decision makers, such as shareholders, Board of Directors, auditors to harmonize and prioritize these interests, directly influences the risks and gains arising from investments in shares company.

2. Concept and Mechanisms of Corporate Governance

Corporate governance describes the methods and systems used for managing organizations of all types and sizes, public and non-profit and also private companies and partnerships built form. In this respect, Sir Adrian Cadbury has defined corporate governance as a system by which companies are guided and controlled. This concept came into the literature and the good practice in the field in the last two decades.

Corporate governance is seen as actual demarcation of rights and responsibilities of each group of stakeholders within the company. Transparency is a major indicator of governance standards in an economy. Thus was developed a series of recommended practices (ISA) that focus on separate managers of board and the existence of an audit committee and a remuneration committee. Currently, the concept is used to describe the action of government, the manner of managing, administering, including states, world bodies and businesses.

Corporate governance can be seen from two perspectives: the behavioral one, referring to the interaction of managers, shareholders, employees, creditors, customers and suppliers, state and other interest groups within the overall strategy of the company and the normative one related to the set of regulations falling these relationships and behaviors, respectively company law, securities law and capital markets, bankruptcy law, competition law, stock exchange listing requirements, etc.

In some European countries (Belgium, Spain, Portugal, Italy etc.), as well as the international organizations (OECD), the objective of developing governance mechanisms is improving the information on governance provided on the capital market and improving company performance, competitiveness and/or access to capital. For countries with tradition in the field and liquid capital markets (UK, France, Germany etc.), the main objective of these mechanisms concerns the activity of board, respectively improving its quality and the quality of information about corporate governance.

Business practice has shown that there is no ideal system of corporate governance. Empirical evidence suggests that the choice of governance mechanisms by the company is not random, but is done according to characteristics such as: sector, size, concentration of ownership, shareholders' power to influence the nature of performance measures and board structure. In each enterprise system consists of individual elements, which are interdependent and interact to determine a governance environment.

Corporate governance mechanisms are introduced to control problems within the company and to ensure that managers are working in the interests of shareholders. In theory, the impact of internal governance on corporate information may be complementary or substitutive. In the first case, agency theory shows that when there is a large flow of information, adopting some governance mechanisms will strengthen the company's internal control and will provide a package of intensive

monitoring to reduce opportunistic behavior and asymmetric information. Managers are not likely to retain information for their benefits under such intensive monitoring environment, leading to improving quality of financial statements. In the second case, companies will not provide information for more governance mechanisms because a mechanism can substitute another one. If information asymmetry can be reduced through internal monitoring packages, the need to implement additional governance devices is reduced. Agency theory argues that, in a diffuse ownership, the companies will provide more information to reduce information costs and the asymmetry degree.

Governance mechanisms can be classified into those that are specific to the enterprise and those specific to the country in which it operates. The first ones include ownership structure, board composition and competition for corporate control. Country-specific mechanisms include the legal environment, cultural environment, accounting standards and accounting practice field.

Divergent interests of shareholders and managers constitutes a dominant element in agency theory applied in the enterprise. Such conflict may be the consideration of income claims in terms of the contract. Agency theorists argue that one of the reasons why shareholders may remain passive in the activities of corporate governance is the existence of some effective mechanisms to protect their interests, such as monitoring managerial process. Thus, owners should reduce costs and agency managers to control opportunism. Changes in corporate governance systems, following the financial scandals have led regulators to seek new ways to control the relationship between board and shareholders and to strengthen controls in the preparation of financial statements.

Corporate governance mechanisms have an impact on business performance in a different ways, depending on financial and legal structure, which, in turn, exerts a differential influence on entities' results. Following the Enron and WorldCom financial scandals, concerns have been intensified both theoretically and practically to elucidate the relationship between a firm's governance practices and operational performance, its financial market.

3. Monitoring Managerial Activities and Firm Performance

Monitoring practices that align the interests of owners and managers to prevent or hinder the managers to act only in self interest, preventing strategic objectives should be positively associated with firm performance. Thus, a high degree of monitoring should promote increased performance by preventing opportunistic management behavior. A higher level of monitoring should lead to achieving the upper limits of performance that can be achieved by deliberate actions of managers.

CEOs are increasingly criticized for focusing on targets unrelated to company performance or to attempt to achieve short-term rather than long term profits as large. This behavior is often called "bounded" and is, in turn, often accused of damaging a company's competitive position. Thus, when a company's performance is poor or declining is expected as rational measure from the owners to replace executives, especially the key people in the decision making. However, according to recent agency theory, separating the owner of control device is weaken its power. The basic premise of this theory is that managers and owners have different

motivations, and if there is no mechanism by which the first ones to be deterred from acting in their own interest, they will be free to maximize benefits directed towards themselves, in detriment of owners' objectives. If, however, managers are prevented from acting against the interests of owners, regardless of conflicting motivations, theory of executive discretion is compromised. Therefore, owners of the companies should establish the best retention system that encourages managers to meet their interests.

Without independence between "internal" and "external" market, managers' remuneration may be largely determined by the cost of their services and not necessarily related to firm performance. Moreover, if the pay range is determined by supply and demand on external labor market, the primary means by which a manager is rewarded or whether prosecuted for higer or inadequate performance is renewal, respectively cancellation of his contract and not changing its compensation beyond market driven. In such cases, the turnover and/or turnure are better indicators of performance of managers than actual pay.

According to the literature, board composition is another factor affecting firm performance and corporate decisions. Such a council could play an important role in limiting the power of a shareholder who would like to expropriate minority shareholders' interests, so it is expected that the decision making process being a rational one. But members of the board is likely to be influenced by shareholders who are able to elect Board of Directors and to appoint managers. Independent directors and supervisory authorities can improve efficiency and performance of an enterprise, if the independent directors take rational decisions, reducing the likelihood of irrational investment capital.

On the other hand, more independent managers was related to improved financial performance improvement, reduced fraud and deterring income manipulation. Recent research on the business environment in a continuously modernization, indicates that an independent manager with a wide range of responsibilities acquires the necessary knowledge to increase financial performance. However, practice has shown that too much independence from the board may harm performance and monitoring process, which may damage the interests of shareholders.

Revision of corporate governance code recommends that, within a company, assessing the performance of managers and board to improve overall efficiency of the company by maximizing the strengths and reduce weaknesses, even by proposing new members. Good practices recommend that colective evaluation to be presented to whole council, and the individual ones to be kept confidential and be comunicated to every manager in question. The main aspects covered are considering, in relation to corporate objectives, the effectiveness of the council's work, each manager's contribution and performance achived.

4. Performance Evaluation based on Corporate Governance Practices

Contemporary economic activities are dominated by the internationalization of markets. This has as a direct effect a severe competition which obliges enterprises to innovate constantly and to restructure themselfs. Pace of change and adaptation to this rhythm have become the key of performance and survival of these entities.

In order to study the link between governance and performance, it is important to take into account the structure of the enterprise in accordance with the legal system in which it operates. As companies bearing the costs of implementing governance systems, they must understand how the financial system interacts with the law, since it is an key factor influencing the performance registered.

Performance measurement systems were introduced, initially for leadership and then for public responsbility, which put difficulties in implementation. Various reports show how the shortcomings of such systems can adversely affect performance monitoring and responsibility practices. In such circumstances, the corporate governance system should cover internal control systems, performance measurement and quality assurance. In other words, systems of responsibility and corporate governance need to manage any exposure of the company at risk.

Performance measures implemented in a company should act as references for investor perceptions to internal changes and financial situation. Agency theory, as well as some specialists in the field says that a company's financial performance is inversely proportional to the size of the management structure. Thus, the increased number of directors of a company is negatively related to its financial performance.

Performance evaluation was not included in the original code of corporate governance. There is only one principle which states that individual performance evaluation should show whether each manager continues to contribute effectively and if it is really commitment in this role. Good corporate governance provides improving efficiency and establish an interactive investment climate. Among the most important benefits of implementing high standards of companies management are: resource efficiency, lower cost of capital, increase investor confidence due to the reduction of sensitive discretionary attitude of managers and reducing corruption. Conversely, a weak corporate governance distorts the efficient allocation of capital in the economy, hinders investment, reduces the confidence of capital holders and favors corruption.

Thus, investors claim that they are given at least the same importance to the information about corporate governance as to financial information in their investment decisions. While in Western Europe 56% of investors attach an equal or additional importance to the information on the governance system, in the countries of South-East and Africa, the percentage is much higher, with 85% of investors, the rest relying in a larger extent on financial and accounting reports of firms.

Performance measurement should consider to capture the overall business, the following levels:

- financial and non-financial;
- strategic and operational;
- internal and external.

Performance management is based on tools and activities for each level: strategic planning, defining objectives, priorities and organizational values, using objectives and measures of performance adequate for the organization, key processes, functions and employees, evaluation, personal development plans, different payment systems related to the performance.

In accounting, but also finance are presented various associations between the different ways of presenting information – long time considered good governance practice – and reducing capital costs. Financial-accounting information have a direct, and also an indirect impact on control mechanisms for governance.

Company's accounting system provides information essential for: control of its current activities, planning strategies, tactics and future activities, ensuring optimal use of resources, measurement and performance evaluation, reduce the size of subjectivity in decision making, improving internal and external communication.
The ways of accounting archiving may be influenced by chosing accounting practices by each company individually and by exogenous events that can affect performance measures. Measurement problems are minimized by constructive reproducing which shows models relatively similar as well as the scale of relationships of performance monitoring process with other variables controlled.
Managers are evaluated directly in terms of accounting performance measures, but also of their effects, such as stock prices. For these reasons, managers may be tempted to manipulate financial information to serve their own interests. Firms with weak governance structures are more likely to manipulate earnings of a certain period.

5. Conclusion

Relevance for investors of information concerning quality and efficiency in governance and management of listed companies shows that improving corporate governance can be a strategy to increase their overall performance, respectively to increase the stock price of their shares on the capital market and hence to increase business value.
The relationship between leading characteristics and firm performance continues to be a fundamental problem in corporate governance literature. The association between board size and corporate performance level variation occurs when large boards have problems of communication/coordination and agency problems.
Companies with an effective system of governance are best placed to provide transparent information on decision and control activities which mainly concern the relationship between the firm and its investors, which also increases the confidence of investors and public. Therefore, in order that a better governance allows access to capital markets in the optimum conditions, the existence of good practices positively influences the market valuation and performance of an enterprise. Business practice shows that investors are willing to pay a certain premium for companies with good governance practices, being aware that financial performance is closely related to the managerial one.

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