CORPORATE GOVERNANCE AND FIRM PERFORMANCE

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Abstract:
Good corporate governance is an important step in building market confidence and encouraging more stable, long-term international investment flows. Many countries see better corporate governance practices as a way to improve economic dynamism and thus enhance overall economic performance. This paper sets out to further develop our understanding of corporate governance and its effects on corporate performance and economic performance. In doing so, it addresses some of the underlying factors that promote efficient corporate governance, and examines some of the economic implications associated with various corporate governance systems. I provide an framework for understanding how corporate governance can affect corporate performance. In the wake of a literature survey, I find that corporate governance matters for economic performance, insider ownership matters the most, outside ownership concentration destroys market value, direct ownership being superior to indirect.

Keywords: corporate governance, company performance

Introduction

The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has therefore become a necessary prerequisite for any corporation to manage effectively in the globalized market.

The term “corporate governance” is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776).In the last two decades, however, corporate governance issues have become important not only in the academic literature, but also in public policy debates. During this period, corporate governance has been identified with takeovers, financial restructuring, and institutional investors' activism. One can talk about the governance of a transaction, of a club, and, in general, of any economic organization. In a narrow sense, corporate governance is simply the governance of a particular organizational form - a corporation.

Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan assert that governance determines how the firm’s top decision makers actually administer such contracts [7].

Shleifer and Vishny define corporate governance by stating that it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment [21]. A similar concept is suggested by Caramanolis-Cötelli, who regards corporate governance as being determined by the equity allocation among insiders and outside investors [4].

John and Senbet propose the more comprehensive definition that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected [13]. They include as stakeholders not just shareholders, but also debtholders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart closely shares this view as he suggests that corporate governance issues arise in an organization whenever two conditions are present [10]. First, there is an agency problem, or conflict of interest, involving members of the organization – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract.

Zingales defines corporate governance as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm [24]. He considers that all the governance mechanisms discussed in the literature can be reinterpreted in light of this definition.

An OECD study considers that corporate governance is the system by which business corporations are directed and controlled [19]. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

Roe define corporate governance as the relationships at the top of the firm - the board of directors, the senior managers, and the stockholders [20]. In his opinion institutions of corporate governance are those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm.

Core corporate governance institutions respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders).

A few studies have examined corporate governance in emerging markets. Researchers [5,14,15] have studied the implications of the concentrated corporate ownership that is common in many emerging and developed markets and conclude that the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders.

Principles for corporate governance

Corporate governance is only part of the larger economic context in which firms operate, which includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long term success of a company.

OECD have assembled a system of principles that are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The principles cover five areas:

- the rights of shareholders;
- the equitable treatment of shareholders;
- the role of stakeholders;
- disclosure and transparency;
- the responsibilities of the board.

Briefly those principles are the following.

The corporate governance framework should protect shareholders' rights.

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

The principles are primarily intended to provide assistance to governments in creating a corporate governance framework. They can indeed be a useful point of reference for many emerging markets and economies in transition. Not only do the principles provide a benchmark for internationally accepted standards, they also offer a solid platform for analysis and practices in individual countries taking into account country specific circumstances, such as legal and cultural traditions.

Measuring firm performance

Three main approaches to firm level performance are found in social science research: research based on market prices, accounting ratios and total factor profitability. Market prices are readily obtained from national stock exchanges for all listed firms and are either in levels or first differences. These data are commonly used in the economics and finance literatures, whereas Tobin's Q is frequently the variable of choice in management and strategy research. Moreover, is it clear that not all markets are efficient, particularly in developing and emerging countries with emerging stock markets that are known to be illiquid and lacking in breadth and depth.

The popular Tobin's Q is a ratio comprised of a continuous time variable in the numerator and an annual, or semi-annual, value in the denominator. Neither ensures robustness or stability in an estimating equation; however a number of studies relating governance systems within the firm are modeled in this way.

Measuring firm performance using accounting ratios is also common in the corporate governance literature, in particular, return on capital employed, return on assets and return on equity. Similarly, economic value added can be used as an alternative to purely accounting-based methods to determine shareholder value by evaluating the profitability of a firm after the total cost of capital, both debt and equity, are taken into account.

Links between corporate governance and firm performance

The relationship between corporate governance and economic performance incited both academic world and policymakers in recent years. There is a special interest in the question whether capital market based systems in the US and the UK or the blockholder based systems in continental Europe and Japan are better appropriate to monitor corporate management. The Romanian system of corporate governance can be seen as a mixture of both the capital market-based system and the bank based system.

The fundamental question in finance-based corporate governance research is whether economic value is driven by governance mechanisms, such as the legal protection of capitalists, the firm's competitive environment, its ownership structure, board composition, and financial policy. Research on the interaction between governance and economic performance has been rather limited, however, and the empirical evidence is mixed and inconclusive. This is both because corporate governance is a novel academic field and because high-quality data are hard to obtain.

Corporate governance systems can be distinguished according to the degree of ownership concentration and the identity of controlling shareholders. While some systems are characterized by wide dispersed ownership (outsider systems), others tend to be characterised by concentrated ownership (insider systems) where the controlling shareholder may be an individual, family holding, bloc alliance, financial institution or other corporations acting through a holding company or via cross shareholdings.

Based on a comprehensive survey primarily of studies from the US and UK, Gugler concludes that owner-controlled firms tend to significantly outperform manager-controlled firms [8]. For a sample of listed German manufacturing firms, Thonet and Poensgen found manager-controlled firms to significantly outperform owner-controlled firms in terms of profitability, but that owner-controlled firms had higher growth rates [22]. Jacquemin and Ghellinchk, using French firm data, found no differences between familial and non-familial controlled firms [12].

Whether or not owner-controlled firms outperform manager-controlled firms may also depend on the industry in question. Zeckhauser and Pound find that the superior performance of owner-controlled firms holds in industries with relatively low asset specificity (e.g. machinery and paper products), but there was no difference in industries with high asset specificity (e.g. computers) [23]. This suggests that the nature of the firm's investment and production decisions influence the asymmetry of information between principal and agent.

Agency theory argues that owner type matters. Direct principal - agent relationships represented by personal investors is considered better than indirect ownership, where widely held private corporations or the state invest on others' behalf.

Synthetically the papers mostly find either a positive or no link between outside concentration and performance. Morck et al., McConnell and Servaes, Belkaoui and Pavlik, Holderness et al. find a non-monotone relationship between insider holdings and firm performance. Two other studies: Agrawal and Knoeber and Cho cannot detect a significant link.

Conclusion

Corporate governance is a young academic field characterized by partial theories, limited access to high–quality data, inconsistent empirics, and unresolved methodological problems.

Corporate governance affects the development and functioning of capital markets and exerts a strong influence on resource allocation. In an era of increasing capital mobility and globalization, it has also become an important framework condition affecting the industrial competitiveness and economies.

Corporate governance mechanisms vary depending on industry sectors and type of productive activity. Corporate governance framework can influence upon the development of equity markets, R&D and innovative activity, and the development of an active SME sector, and thus influence upon economic growth.

Identifying what constitutes good corporate governance practice, and under what circumstances, is a difficult task. This is partly because the effectiveness of corporate governance systems is influenced by differences in countries' legal and regulatory frameworks, and historical and cultural factors, in addition to the structure of product and factor markets. The challenge, therefore, is not only to identify the strengths and weaknesses in each individual system or group of systems, but also to identify what are the underlying conditions upon which these strengths and weaknesses depend.

One of the main challenges facing policy makers is how to develop a good corporate governance framework which can secure the benefits associated with controlling shareholders acting as direct monitors, while at the same time, ensuring that they do not expropriate excessive rents at the expense of other stakeholders. The search for good corporate governance practices should be based on an identification of what works in developed countries, to discern what broad principles can be derived from these experiences, and to examine the conditions for transferability of these practices to other countries.

Corporate governance is a concern of great importance to owners of common stocks, because stockholder wealth depends in large part upon the goals of the people who set the strategy of the corporation. However the objectives of corporate managers often conflict with those of the shareholders who own their companies.

Mechanisms for controlling the dimension of corporate costs are necessary and they include external and internal disciplining devices. It was observed that due to important theoretical and practical limitations, external disciplining devices including takeover threat, the managerial labor market, and mutual monitoring by managers, reputation, competition in product factor markets and financial analysts cannot alone solve the corporate governance problem, although they may be important in some particular circumstances. Firms therefore have to adopt complementary internal disciplining devices in order to minimize their total agency costs. These internal devices include the composition of the board of directors, insider ownership, large shareholders, compensation packages and financial policies (dividends and debt).

Events of the last decade indicate that corporate internal control systems have failed to deal effectively with the globalization and informational era. Making the internal control systems of corporations work is the major challenge of our time.

This paper tries to improve the empirical insight into the relationship between governance and performance. In the wake of a literature survey, we discover that corporate governance matters for economic performance, insider ownership matters the most, outside ownership concentration destroys market value, direct ownership being superior to indirect.

Measuring performance by Tobin's Q and operationalizing it as market to book are consistent with agency theory. Large outside owners destroy market value, inside owners create it unless the stakes are unusually big, direct ownership is more beneficial than indirect. Although other performance measures generally produce more fuzzy relationships, Tobin's Q is rather consistent with long-term book return on assets, but not with stock returns.

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