A Study on the Effect of Governance Adequacy on the Corporate Performance

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Abstract

The paper analyzes the effects of governance adequacy on the corporate performance among Korean manufacturing firms. Most existing governance literature have adopted agency theory and investigated the control role of governance structure on the basis of the stockholder perspective, testing the hypothesis that the better the governance structure, the lesser the agency cost and the greater the stockholders' wealth. In contrast to this hypothesis based on the stockholder perspective, this paper sees governance structure through the lens of stakeholders surrounding a firm's activities and argues that a firm's ultimate goal must be the maximization of the stakeholder value rather than the simple maximization of stockholders' wealth. In this paper, we focus on the governance adequacy, examining the relationship between governance structure's change and corporate performance. Using the multiple regression analysis, we find that the relationship between governance adequacy and corporate performance is statistically significant. In addition, when dividing the corporate governance Index into stockholders' wealth, board of directors, disclosure, audit committee, and dividend policy are significantly related to the corporate performance.

Keywords: governance; governance adequacy; corporate performance

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1. Introduction

Corporate governance is a mechanism for selecting the CEO of a corporation and deciding upon how and where to allocate its assets, which has an influence on corporate performance. Using internal control devices (such as distribution of ownership shares, the board of directors and outside directors, and incentive system) and external control devices (such as M&A and labor market of executives); both of which have a decisive effect on governance structure, a corporation can minimize agency cost between executives and stockholders, and improve corporate performance. Shleifer (1997) asserted that the economic significance of corporate governance lies in ensuring that the funds invested in a corporation from capital market should not be used for private gain of executives, but for enhancement of corporate value so that the investors can retrieve the investment, and get its proper rewards. The board of directors, an important axis of corporate governance, acts as an intermediary to mediate the conflicting interest between executives and stockholders and also plays the role of reducing the agency cost. But it is true in South Korea that a corporation is under the essential control of a CEO as the founder or major shareholder so that appropriate checks have not been acted on the corporate decision-making process. The studies of corporate governance at home and abroad have so far tended to focus mainly on governance structure, which is considered to be a major factor of determining agency cost. Governance structure as conducting the role of a resource provider for a corporation has been neglected in the literature of corporate governance. However, the studies of resource dependence theory suggested that the reformed governance structure can lead the board of directors to provide a corporation with valuable information by enhancing the effectiveness of its strategic decision-making or to boost resource efficiency by reforming its role and can eventually improve corporate performance. The studies of these aspects of corporate governance have been relatively wanting in reality.

This paper is aimed at observing the relation between the degree of reformation of governance structure and corporate performance, and then at analyzing what aspect of governance structure closely influences corporate performance. If reformation of corporate governance is in considerable connection with corporate profit and corporate value, a corporation needs to reform its governance structure strategically and stockholders may reflect the result more in their investment decisions based on the evaluation of how much governance structure has been reformed. Also, various interested parties such as the government authorities, markets, and stockholders may request reformation of governance structure more strongly.

2. Literature Review

It may be said that one of the greatest changes Chaebeols or conglomerates of South Korea have gone through since the Asian economic crisis in 1997 is related to their governance structures. As a result, a wide variety of studies have been dedicated to the governance structure since 2000. From the perspective of the agency theory, these studies have focused on a controlling function of the board of directors, the corporate governance to minimize agency cost, and the causal relationship between corporate performance or corporate value, which has been represented in a variety of forms and governance structures. Most of them have dealt with the controlling roles of the board of directors, ignoring other kinds of roles comparatively.

The controversies surrounding corporate governance originate in the problem with the basic assumption of the agency theory, a theoretical ground of the controlling role. Roberts, McNulty and Stiles (2005) pointed out that the assumptions of the agency theory (such as opportunism and pursuit of personal gain of executives), a theoretical basis of established studies, simplified human nature so much that the studies recognized humankind as a being pursuing only pecuniary profit. They indicated that the collaboration between a CEO and directors should be taken into account, too. Hendry (2005) found that the agency
theory makes a basic supposition that executives pursue private gain than profits of shareholders and may maximize their own utility when directors make a decision, and that the supposition includes the problem that it regards an executive as a thorough being pursuing only pecuniary self-interest. Still, most of governance studies have been conducted from the viewpoint of the agency theory, and have not dealt with the different functions of the board of directors.

Therefore, there have emerged the studies to grasp the functions of the board of directors by means of the stewardship theory, which explains the role of service, or the resource-dependency theory, which emphasizes the role as a resource provider, aside from the perspective of the agency theory. They refer to a series of attempts to recognize the governance structure to help corporate activities in a positive manner and its role as a resource provider which has been unnoticed so far, and then to look at the relation between this type of governance structure and corporate performance or corporate value. As part of the studies to grasp the functions of the board of directors, first, Muth and Donaldson (1989) elucidated board structure through the stewardship theory. They stressed that the function of corporate governance was not limited to the controlling role and asserted that the board of directors could have an influence on corporate performance by presenting the CEO with situational advice and consultation. Meanwhile, Hillman, Cannellar and Paetzold (2000) highlighted the role of resource-providing from the viewpoint of resource dependency. They further criticizing those studies on the board of directors’ function, which had leaned towards the agency theory. They classified directors into four categories with regard to the organization of the board of directors on the basis of the resource dependency theory. They also examined the effects and the changed of the external environment of a corporation such as deregulation has on the organization of the board of directors. In addition, an attempt has been made to explain the function of the board of directors in reference to the role of service. But these studies had some limitations. First, while Hillman, Cannellar and Paetzold (2000) made use of deregulation as a proxy variable for the changed external environment of a corporation, their study has a limit in that the deregulation, a relative concept, depends upon a researcher's opinion, and the study has not addressed the environment directly. Because regulation plays the role of restricting the discretion of executives in the process of decision-making and so may be used as a means substituting the controlling role, the environment of a corporation needs to be studied more directly than the proxy variable of deregulation. The studies concerning the role of service of the board of directors, however, are restricted to explaining particular issues (like rewards for a CEO) through the stewardship theory.

Zahra and Pearce (1989) suggested an integrated model after reviewing the existing studies about the relation between the board of directors and corporate performance, and they looked upon the uncertainty of the environment and the degree of resource availability as the important variables to influence the attributes of the board of directors (such as organization, characteristics, structure, and process), asserting that the contingencies of a corporation could have an effect on the board of directors, too. The study of Daily and Dalton (1993) insisted that it depended on the degree of resource availability, and whether the role of the board of directors succeeds or not. That is to say, the degree of resource availability has an influence on the role of the board of directors to provide the resource. In the study of Young, Ahlstrom, Bruton and Chan (2001) which compared the roles of the board of directors of corporations in Hong Kong and Taiwan and those in the West, the role of service and controlling is relatively less important in the former than in the latter, while the role of resource-providing is relatively more important in the former than in the latter.

Studies on corporate governance in South Korea revealed that the role of the board of directors has attracted bigger attention particularly with the introduction of the effective outside-director systems by the 1998 regulation for listing securities. The regulations aimed at raising corporate transparency and improving corporate governance after the crisis of foreign exchange. However, many of the studies in South Korea have emphasized only the controlling role of the board of directors for monitoring
executives. Hence, limited studies yet to look into how important the roles such as resource-providing and strategic advice are. From the necessity to approach, the role of the board of directors, this study observes governance structure around the role of resource-providing, and of service of corporate governance, and examines in a strategic manner how its improvement can have an influence on corporate performance.

3. Research Methodology

3.1. Research Model and Hypothesis

This study examines whether the improvement of corporate governance can reinforce the role of service-providing and of resource-providing of the board of directors, and in turn, buildup of corporate performance eventually. For such a purpose, Tobin’s Q, a variable of corporate performance, was used as an equation related to corporate performance and the year-on-year degree of improvement of corporate governance score (CGS). Corporate governance score be set as an independent variable to reflect the improvement of governance structure. The size of business, debt ratio, return on assets (ROA) and the others were considered as the control variables, which are recognized significant in the existing studies. A model and hypothesis of the positive analysis is as follows:

\[
Tobin\ Q_t = \beta_0 + \beta_1 CG_t + \beta_2 Size_t + \beta_3 DR_t + \beta_4 ROA_t + \epsilon_t, \\
\Delta CG_t = CG_t - CG_{t-1}
\]

Hypothesis 1. The degree of improvement of governance structure will have a plus effect (+) on the business performance of a corporation (Tobin’s Q).

Another model and hypothesis of the positive analysis is presented in order to look at the relationship between corporate performance and the evaluation scores in reference to protection of shareholders’ right, the board of directors, public disclosure, audit institutions, and distribution of management negligence, which are sub-indicators of corporate governance, as follows:

\[
Tobin\ Q_t = \beta_0 + \beta_1 SH_t + \beta_2 BOD_t + \beta_3 DIS_t + \beta_4 AUD_t + \beta_5 DIV_t + \beta_6 Size_t + \beta_7 ROA_t + \epsilon_t
\]

Hypothesis 2-5. The optimum level of shareholders’ right (H2), the board of directors (H3), public disclosure (H4), audit institutions (H5) will have a plus effect (+) on the business performance of a corporation (Tobin’s Q).

Hypothesis 6. The distribution of management negligence will have a plus effect (+) on the business performance of a corporation (Tobin’s Q).

3.2. Data

The samples of this study are based on indexes of the corporations, whose scores of corporate governance had been measured for three straight years from 2005 to 2007. This is in line with the objectives of this paper in examining the relationship between the optimum level of corporate governance and the business performance of a corporation and the relation between the improvement of corporate governance and the business performance of a corporation. Among these corporations, only the corporations keeping operating at present have been analyzed but non-manufacturing businesses are not included. The corporations are excluded, too, that do not offer any one of the items (such as total assets, debt, capital,
share outstanding, prices of common stock and preferred stock, and net profits) to estimate the variables necessary for hypothesis testing. As a result of that, the ultimate samples amount to 398 corporations.

3.3. Definition and Measurement of Variables

This study makes use of Tobin's Q to estimate the enterprise value of a dependent variable. Tobin's Q is the ratio between the market value of a corporation and the replacement value of its asset. The value of Tobin's Q tends to rise when a corporation holds an investment opportunity to increase net present value or is engaged in the development with future value, or the value of intangible assets is elevated. The market to book ratio of a corporation has been estimated by Tobin's Q in the same way of Smith and Watts (1992). In other words, the market to book ratio of a corporation means the result of dividing the sum of the total market value of its issued shares, and the debt book value by the book value of the total assets. If an item does not have any one of the variables above, it is excluded.

In this study, the evaluation score of governance structure, an independent variable set to estimate the relation between governance structure and corporate performance, is the CG data measured at the Corporate Governance Service of Korea, which consist of five items such as protection of shareholders' right (68 points), the board of directors (34 points), public disclosure (32 points), audit institutions (20 points) and distribution of management negligence (13 points), whose total score is 167 points.

4. Results

4.1. Analysis of Correlation among Key Variables

Table 1. Correlation among Key Variables (2007)

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<tbody>
<tr>
<td>2007SH</td>
<td>1</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2007BOD</td>
<td>-0.057</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2007DIS</td>
<td>0.001</td>
<td>0.642**</td>
<td>1</td>
<td></td>
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<tr>
<td>2007AUD</td>
<td>-0.026</td>
<td>0.701**</td>
<td>0.572**</td>
<td>1</td>
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<tr>
<td>2007DIV</td>
<td>0.019</td>
<td>0.003</td>
<td>-0.015</td>
<td>-0.073</td>
<td>1</td>
<td></td>
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<tr>
<td>△2007CG</td>
<td>0.091</td>
<td>0.320**</td>
<td>0.377**</td>
<td>0.354**</td>
<td>-0.019</td>
<td>1</td>
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<tr>
<td>2007q</td>
<td>0.002</td>
<td>0.384**</td>
<td>0.352**</td>
<td>0.321**</td>
<td>-0.118*</td>
<td>0.248**</td>
<td>1</td>
<td></td>
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<tr>
<td>2007dra</td>
<td>-0.123*</td>
<td>0.039</td>
<td>-0.013</td>
<td>0.089</td>
<td>-0.210**</td>
<td>0.046</td>
<td>0.128*</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007roa</td>
<td>0.098</td>
<td>0.152**</td>
<td>0.127*</td>
<td>0.078</td>
<td>0.170**</td>
<td>0.031</td>
<td>0.217**</td>
<td>-0.295**</td>
<td>1</td>
<td></td>
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<tr>
<td>2007lna</td>
<td>-0.067</td>
<td>0.711**</td>
<td>0.594**</td>
<td>0.634**</td>
<td>0.034</td>
<td>0.259**</td>
<td>0.287**</td>
<td>0.060</td>
<td>0.184**</td>
<td>1</td>
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* Correlation coefficients are valid in level 0.05(both sides).
** Correlation coefficients are valid in level 0.01(both sides).

Table 1 shows Pearson correlation coefficients concerning variables used in 2007 data analysis. It was found that improvement of corporate governance, adequacy of board and public announcement, adequacy of audit committee, etc. had shown a positive correlation with Tobin's Q, and dividend policy displays a negative correlation with Tobin's Q. On the other hand, shareholder protection shows statistically no meaningful correlation in it. Statistic indicators such as size of business, debt rate and rate of return on asset reveal a positive correlation with Tobin's Q. According to the results, in both 2006 and 2007, the
Dependent variable of Tobin’s Q has a significant positive correlation with the degree of improvement of corporate governance, adequacy of board and audit committee, and adequacy of public announcement, and shows a negative correlation with distribution of dividends. Shareholder protection has statistically no valid correlation. The multicollinearity does not matter according to the results of checking the possible regression multicollinearity relevant to the correlation between independent and dependent variables.

4.2. Relation between Improvement of Corporate Governance and Corporate Performance

To verify the hypothesis 1 that improvement of corporate governance affects positively corporate performance (Tobin’s Q), we first conduct a regression analysis. The analyses use the stepwise model, and include only variables that have higher explanation power among variables on dependent variables. The results are shown in Table 2.

The regression analysis shows that the degree of improvement of corporate governance ($\beta=0.185$, $p<0.001$) has a positive effect on corporate performance by the level of $p<0.01$ when the degree is considered as an independent variable. The $R$ square shows that accounts for the effect of the degree of improvement of corporate governance on corporate performance ($R$ square = 0.163). The F value is 20.048 in the degree of freedom and $p$-value in the regression analysis is $p<0.001$, demonstrating the overall validity of this regression analysis model. Thus, the hypothesis 1 was supported that improvement of corporate governance have a positive effect on corporate performance.

Table 2. Regression Analysis on Corporate Performance (dependent variable: Tobin’s Q)

<table>
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<tr>
<th>Coefficient</th>
<th>p-value</th>
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<tr>
<td>$\Delta2007cg$: degree of improvement of corporate governance</td>
<td>.185</td>
</tr>
<tr>
<td>2007dra: debt ratio</td>
<td>.176</td>
</tr>
<tr>
<td>2007roa: rate of return on total assets</td>
<td>.229</td>
</tr>
<tr>
<td>2007lna: log value of total assets</td>
<td>.187</td>
</tr>
<tr>
<td>$R$ square 0.163, F=20.048, $p=0.001$</td>
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4.3. Connection between Corporate Performance and Other Factors

To verify hypotheses 2-6 that other details in corporate governance will have a positive effect on corporate performance (Tobin’s Q), we first conduct a regression analysis where shareholder protection, adequacy of board and audit committee, adequacy of public announcement and distribution of dividends are independent variables and corporate performance is an dependent variable, and then, carry out a regression analysis where details of corporate governance structure in 2007 are independent variables and corporate performance (Tobin’s Q) is a dependent variable. The analyses use the stepwise model, and include only variables that have higher explanation power among variables on dependent variables. The results are in the Table 3.
Table 3. Regression of Corporate Governance on Firm Performance (Dependent variable: Tobin Q)

<table>
<thead>
<tr>
<th>Regression Coefficient</th>
<th>P-value</th>
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<tbody>
<tr>
<td>2007BOD adequacy of board and audit committee</td>
<td>.245</td>
</tr>
<tr>
<td>2007DIS adequacy of public announcement</td>
<td>.180</td>
</tr>
<tr>
<td>2007DIV distribution of dividends</td>
<td>-.115</td>
</tr>
<tr>
<td>2007dra debt rate</td>
<td>.168</td>
</tr>
<tr>
<td>2007roa rate of return on total assets</td>
<td>.234</td>
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</table>

The result of regression analysis shows that the details of governance structure such as board of directors, adequacy of public announcement, distribution of dividends, positively affect firm performance at $p<0.001$. $R^2 = 0.221$. The rate of firm performance was accounted for by the board, public announcement, and distribution of dividends, which was at 0.221. The $F$ value calculated was 14.836. Considering $p<0.001$ in the estimated regression analysis model, the present regression analysis model is statistically significant. Hypothesis 2 was supported and that the shareholder protection had positively affected firm performance (Tobin Q). However, hypothesis 5 failed to support that adequacy of audit committee positively affects firm performance (Tobin Q). The hypotheses 3, 4, and 6 are statistically significant; hypothesis 3 argues positive effect of board of directors on firm performance, and hypothesis 4 argues positive effect of public announcement on firm performance, and hypothesis 6 argues positive effect of distribution of dividends on firm performance. According to the result of the above regression analysis, reformation of corporate governance gives a positive effect on corporate performance. This is indicated that the board, public announcement, and distribution of dividends out of reformation factors positively affect firm performance. However, it appears that shareholder protection, and adequacy of audit committee exhibited no significant effect on firm performance.

5. Conclusion

In this present paper, we empirically analyze how general modifications of corporate governance from 2005 to 2007 have influenced firm performance. This paper shows that reformation of corporate governance provides positive effects on firm performance. In addition, details of adequacy of corporate governance such as board of directors, public announcement, and distribution of dividends are influential factors in corporate performance. This paper is not examined the relationship between various characteristics of corporate ownership structure such as managers, controlling owners and firm performance, the studies of which are already rich in the related literature. This paper did not verify the cause and effect of the relationship between the characteristics of corporate governance (board, outside director, bond funds, foreign investor) and firm performance, either. As for fluctuation of annual evaluation score of corporate governance as a reformatory variable of corporate governance, we examine the effect of a reformatory variable on firm performance. It is necessary to reform corporate governance as a strategic position, as reformation of corporate governance is highly related to firm profit and value. This paper suggests that shareholders should also evaluate positively the improvement of corporate governance and then incorporate the result into the investment decision making.

The limitation of the paper is that it is rather difficult to replicate this study in other countries because the data of corporate governance used in this study are scored data estimated by a professional organization in South Korea, and the factors of corporate governance are probably not measured in the
same way in other countries. Future studies must be carried out for the standardization of measurement to make comparative studies across different nations and industries available.

Acknowledgements

This work was supported by Hankuk University of Foreign Studies Research Fund of 2012.

References


