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Corporate Governance and Firm Performance: A Theoretical Review

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Abstract: This paper is a review of the empirical literature evidence on whether corporate governance actually enhances firm performance. The concept of corporate governance has attracted considerable attention, domestically and internationally, in recent years. Previous research, largely conducted using international data, has suggested that better governed firms outperform poorer governed firms in a number of key areas. Issues and Significance: It is widely believed that good corporate governance is an important factor in improving the value of a firm in both developing and developed financial markets. However, the relationship between corporate governance and the value of a firm differs in developing and developed financial markets due to disparate corporate governance structures in these markets resulting from the dissimilar social, economic and regulatory conditions in these countries.

Keyword: corporate governance, global performances, indicators system, value of a firm.

I. INTRODUCTION

What is Corporate Governance? The 1992 U.K Cadbury Committee defines corporate governance as the system by which organizations are directed and controlled. The Federal Reserve Bank of Richmond defines the subject as "... the framework by which a company's board of directors and senior management establishes and pursues objectives while providing effective separation of ownership and control. It includes the establishment and maintenance of independent validation mechanisms within the organization that ensure the reliability of the system of controls used by the board of directors to monitor compliance with the adopted strategies and risk tolerance."

What is Firm Performance?

Performance can be seen here as the success in meeting pre-defined objectives, targets and goals. Firm performance is thus the effectiveness of a firm in achieving the outcomes it intends to achieve within specified time targets. These outcomes can be explained as the measures by which the firm is evaluated, and broadly include the quality of governance.

The issue of governance performance is more and more present in the field literature.

Regarded as a finality of a complex public management process, the governance performance, we refer either to the central, or to the local government, acquires systemic characteristics and, according to their level, the governors establish the feedback that is carried put through new public decisions meant to lead towards a performance improvement.

II. LITERATURE EVIDENCE ON THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FIRM PERFORMANCE

The relationship between corporate governance and economic performance incited both academic world and policymakers in recent years.

There exists a well number of anecdotal evidence of a link between corporate governance practices and firm performance. But the empirical studies mainly focus on specific dimensions or attributes of corporate governance like board structure and composition; the role of non-executive directors; other control mechanisms such as director and managerial stockholdings, ownership concentration, debt financing, executive labour market and corporate control market; top management and compensation; capital market pressure and short-termism; social responsibilities and internationalization.

Coles et. al (2001) states that much of the academic work in the corporate governance field has focused on how to design corporate governance mechanisms that will motivate managers to make choices for the firm that will improve performance. However these researches indicate mixed findings. Coles classified governance mechanisms into two broad categories namely organizational monitoring mechanisms (including leadership structure and board structure) and CEO incentive alignment mechanisms (including CEO compensation and ownership structure).

Better corporate governance is likely to improve the performance of firms, through more efficient management, better asset allocation, better labour practices, or similar other efficiency improvements (Claessens, 2006). Drobetz et al. (2004) argue that agency problem, the foundation of agency theory, is likely to exert impact on a firm's stock price by influencing expected cash flows accruing to investors and the cost of capital. Firstly, low stock price result from the investors' anticipation of possible diversion of corporate resources. Theoretical models by La Porta, Lopez- de-Silanes, Shleifer and Vishny (2002) and Shleifer and Wolfenzon (2002) also predict that in the existence of better legal protection, investors become more assured of less expropriation by controlling bodies and hence, they pay more for the stocks. Secondly, through reducing shareholders' monitoring and auditing costs, good corporate governance is likely to reduce the expected return on equity which should ultimately lead to higher firm valuation.

A more recent study by Rhoades et. al (2001) conducted a meta-analysis of 22 samples and found a weak but significant relationship between leadership structure and firm performance. They found that firms with a separated structure have higher accounting returns compared to companies with CEO duality.

Dehaene et. al (2001) analysed 122 Belgian companies to verify whether a relationship exist between board composition (number of directors, percentage of outside director, CEO duality) and company performance (ROA and ROE). Their findings indicate a significant positive relationship between percentage of outside director and ROE i.e. the more external director a company has, the better is its performance. They also found a significant positive relationship between CEO duality and ROA i.e if the CEO is also the Chairman of BOD, the company would show higher ROA.

Brown and Caylor (2004) took another approach in evaluating corporate governance and firm performance. They created a broad measure of corporate governance;

Gov-score comprising of 51 factors in eight corporate governance categories based on a dataset provided by Institutional Shareholder Services. They then relate Gov-score to operating performance (ROE, profit margin and sales growth), valuation (Tobin Q) and shareholder payout (dividend yield and share repurchases) for 2,327 US firms and found that better governed firms are relatively more profitable, more valuable and pay out more cash to their shareholders. They also showed that good governance as measured using executive and director compensation is associated with good operating performance. On the other hand, they provide evidence that good governance as measured by charter and bylaws (that focuses on anti-take over measures) is most highly associated with bad operating performance. They however put a caveat in their conclusion saying that although the results indicate association between good corporate governance and performance, it does not necessarily imply causality.

In another study Bernard S. Black, Inessa Love and Andrei Rachinsky in 2005 examined the connection between firm-level governance of Russian firms and their market values from 1999 to 2004, which was a period of dramatic change in Russian corporate governance. Drawing on all six indices of Russian corporate governance in the study titled “Corporate Governance and Firm’s Market Values: Time Series Evidence from Russia”, the authors note that their finding strengthens the case for a causal association between firm-level governance and firm market value. In fact, the present study by Black and his team “finds an economically important and statistically strong correlation between governance and market value in OLS with firm clusters and in firm random effects and firm fixed effects regressions.”

Carlos Pineda analyzes the relationship between firm performance, as measured by Tobin’s Q, and the Corporate Governance Index published by The Globe and Mail Report on Business for a sample of Canadian firms over a three-year period running from 2002 to 2004. The result of the study structured under the topic: “Do Corporate Governance Standards Impact on Firm Performance? Evidence from Canadian Businesses”, suggests that few measured governance variables are important and that the effects depend to some degree on firm ownership. In general, Pineda finds no evidence that a comprehensive measure of governance affects firm performance.

In contrary to the above findings, somewhat different result is reported by Bauer, Guenster and Otten (2004) for Europe and the United Kingdom. Their empirical results suggest a negative relationship between governance standards and earnings based performance ratios (net profit margin and return on equity). In an event study, De Jong, DeJong, Mertens and Wasley (2005) do not detect any price effects following actions taken by the Netherlands’ private sector self-regulation initiative (“The Peters Committee”). In a recent study, Cheung, Jiang, Limpaphayom and Lu (2008) also find no statistically significant correlation between corporate governance practices and market valuation in China in the year 2004.

III. CONCLUSION

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

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.

There appears not to be a consensus on whether corporate governance, as a cluster of values, does indeed positively affect firm performance. What is certain is that some values of corporate governance have individually been associated with high firm performance by some studies.

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