Interaction between financial performance and corporate governance

Student: Cernătescu Loredana
Coordinator: Prof.Univ.Dr. Ion STANCU

Abstract

This paper examines the impact of corporate governance mechanisms and CEO characteristics on Romania listed companies' performance. The corporate governance mechanisms are: board size and the number of independent directors in the board. I used as performance measures the following: return on assets and return on equity. Additionally, we considered the impact of CEOs characteristics on companies' performance. These characteristics are: CEO status regarding the possibility of holding multiple functions, the sex of the CEO, age and tenure in CEO position. Also we controlled for firm size, firm age and gearing. My findings suggest mixed results between corporate governance and firm performance. The investigation is performed on a sample of 64 companies listed on the Bucharest Stock Exchange during 2013. I did a secondary study which is not described in the main paper, I only presented the results. The study is focused on 82 companies listed on London Stock Exchange. This was done in order to spot some differences between the two models of corporate governance and to see if we can improve some aspects regarding the way we do things.

Key words: corporate governance, financial performance, board of directors, CEO, return on equity, return on assets

Introduction

In the past two decades, rapid globalization has highlighted the existence of different national corporate governance systems to investors, policymakers, and researchers alike. In the developed world, one of the most prominent distinctions has been made between the shareholder model, which characterizes the US and UK, and the stakeholder model, which characterizes Japan and Germany. The former features dispersed ownership, a separation between ownership and control, and external market-based financing and discipline, while the latter features concentrated ownership, insider control, and coordinated networks of firms and financial institutions. All these are conclusions from studies made by authors like: Shleifer, A., Vishny, R. W. (1997), Stuart L. Gillan (2006), Schwartz, M.S. (2012), Kaptein, M. (2004), Svensson, G., Wood, G., Callaghan, M. (2010), Ştefãnescu, C.A, (2011), Ungureanu, M. (2012) and others.

Jensen and Meckling (1976) apply agency theory to the modern corporation and model the agency costs of outside equity. In doing so, they formalize an idea that dates back at least as far as Adam Smith (1776): when ownership and control of corporations are not fully coincident, there is potential for conflicts of interest between owners and controllers. There are also benefits to separating ownership and control; otherwise such a structure is highly unlikely to have persisted as it has.' The conflicts of interest, however, combined with the inability to costless write perfect contracts or monitor the controllers, ultimately reduce the value of the firm, ceteris paribus. These ideas form the basis for research on corporate governance. How do entrepreneurs, shareholders and managers minimize the loss of value that results from the separation of ownership and control?

In Romania, the requirements of corporate governance occurred recently comparing to other European countries. Romanian companies have begun to meet the corporate governance requirements, especially in the context of voluntary corporate governance requests developed by Bucharest Stock Exchange for listed companies.

1. Literature review

In the following we will briefly give the results of various studies in the international literature that analyzed the link between corporate governance mechanisms listed above and reported financial performance.

The studies conducted until now mentions the fact that both market mechanisms and internal mechanisms of the companies, could be used in order to harmonize the interest between managers and stakeholders. Both managerial labor market and market for corporate control are

exerting pressure in and out of the companies, in order to harmonize the interests. According to Fama (1980), “the firm is viewed as a team whose members act from self-interest but realize that their destinies depend to some extent on the survival of the team in its competition with other teams”, the productivity of each member manifesting a direct effect on the team and on the other members. Thus, through the team, every manager has stimulants in order to monitor the behaviour of the other managers, being subordinates or superiors.

However, the studies regarding the relationship between corporate governance and firm performance are wide, but the results are not convergent. We distinguish streams which sustain a positive relationship between corporate governance and firm performance, while others sustain a negative relationship or a lack of association between corporate governance and firm performance. The positive correlation is based on the theory that an efficient board of directors could reduce significantly the agency costs (Mashayekhi & Bazaz, 2008). Besides, the legal systems, the political stability, the reduced size of the markets, the corporate ownership and the type of the individual financial systems, are the differences manifested through the institutional dispositions, between developed and developing countries. Corporate governance considers the mechanisms that reduce the agency costs, controlling the freedom of action from the manager’s perspective and aligning the interests of the owners and managers. According to Shleifer and Vishny (1997), “corporate governance mechanisms are economic and legal institutions that can be altered through political process”.

Corporate governance may affect both the company's performance and its ability to attract cheap capital (Shleifer and Vishny, 1997). The tendency to develop guidance on corporate governance began in the United States in the early 90s. The guidelines cover, in principle, the following topics: the general objectives of the company, responsibilities and composition of the board, disclosure issues, performance evaluations of management and the board

Svensson et al. (2010, p.337) states that "Our great concern has been corporate governance That, for example, has become Just another checklist to be completed and filed and forgotten until the next time the specific legislative Requirement Needs to be met."

According to the theory of agent, CEOs are interested in maximizing their own profit and thus their actions do not demonstrate ethical behavior of companies they represent. As a result, corporate governance, through the process of supervision and control exercised by the Board, is designed to ensure that the management company acts ethically in accordance with the interests of shareholders..

Georgeta Vintilă and Ştefan Cristian Gherghina (2011) have a research paper named “An Empirical Investigation of the Relationship between Corporate Governance Mechanisms, CEO Characteristics and Listed Companies’ Performance”. The research consist in the examination of the relationship between corporate governance mechanisms, CEO characteristics and the

performance of the U.S. listed companies. Authors of the study formulated 9 hypothesis which contain various relationship between financial performance of the companies and corporate governance variables. The process regarding the creation of the database, in order to investigate the relationship between corporate governance mechanisms, CEO characteristics and firm performance, consisted in using a random sample of 155 U.S companies, provided by Institutional Shareholder Services (ISS).

The results of this research are as follows:

- No significant relationship between the number of the independent directors from the board of directors and firm performance;
- a negative relationship between the size of the board of directors and Tobin's Q, but a positive relationship between the size of the board and return on assets;
- a positive relationship between the shareholdings of the institutional investors and mutual funds and return on assets, but until a threshold of 26.02% of the shares held by institutional investors and mutual funds, beyond the relationship becomes negative.
- there is not any relationship regarding firm performance between the companies where the CEO and Chairman are the same person and the companies where the CEO and Chairman are different persons;
- a negative relationship between the age of the CEO and PER, while there resulted a positive relationship between the tenure of the CEO and ROA and between the tenure of the CEO and PER;

The authors of "Does Good Governance Matter to Institutional Investors? Evidence from the enactment of Corporate Governance Guidelines", Armand Picou and Michael J. Rubach argue that if a company has a large number of shares in circulation, it is possible that many institutions and individuals, take different positions on shares (stock positions). So they conducted a study analyzing reactions of institutional investors to issuing regulations on corporate governance. Their conclusions stipulated that for those companies that have made public the existence of corporate governance rules, but did not provide any content, the results indicate a delayed response (two days). Thus, it supports the hypothesis that suggested a delayed reaction but a positive following the announcement. The results support the idea that good governance has a positive effect on corporate performance. For firms that have provided content of the corporate governance rules, the number of outstanding shares is significantly related to yield. There is evidence that the notice of adoption of codes of corporate governance will positively influence performance

2. Empirical review

The global objective of my research consist in the examination of the relationship between corporate governance mechanisms, CEO characteristics and the performance of the Romanian listed companies.

I set the following hypotheses which will be tested afterwards, in accordance with the studies mentioned previously:

Hypothesis 1: There is a positive relationship between the number of the independent directors from the board of directors and firm performance.

Hypothesis 2: There is a negative relationship between the size of the board of directors and firm performance.

Hypothesis 3: There is a negative relationship between the age of the CEO and firm performance.

Hypothesis 4: There is a positive relationship between the CEO tenure as Chief Executive Officer and firm performance.

Hypothesis 5: There is a positive relationship between the number of years since the companies are listed to BSE and firm performance.

Hypothesis 6: There is a negative relationship between the size of the firms and their performance.

Description of the Database and Research Methodology

This case study investigates the impact and role of corporate governance on the performance of a total of 64 listed companies listed to Bucharest Stock Exchange. Corporate governance mechanisms considered are the following: the size of the board, the number of independent directors who are part of this board, the age of the Chief Executive Officer (CEO), CEO tenure as Chief Executive Officer, its gender and number of years of listing on the stock exchange.

The variables used are the following ones:

Variable Name	Description	Data Source
1. Data regarding corporate governance		
BoardSize	The number of members which compose the board of directors	Thomson Reuters
No_IndependentDir	The number of the independent directors from the board of directors	Thomson Reuters
CEO_Age	The age of the Chief Executive Officer	Thomson Reuters
Dummy_Age	If the CEO age is less than 51 years old = 0 If the CEO age is more than 51 years old = 1	Thomson Reuters
CEO_Tenure	The tenure of Chief Executive Officer as CEO	Thomson Reuters
Log_Tenure	Logarithm of CEO_Tenure	Own calculations with data

		from Thomson Reuters
Dummy_Sex_CEO	If the CEO is male = 1 If the CEO is female = 0	Own processing
Dummy_CEOvsChaiman	Daca CEO ≠ Chairman = 1 Daca CEO = Chairman = 0	Own processing
2. Variabile ce evidenţiază performanţa firmei		
ROE (%)	Return on Equity measures the rate of return on the ownership interest (shareholders' equity) of the common stock owners. ROE is equal to a fiscal year's net income (after preferred stock dividends but before common stock dividends) divided by total equity (excluding preferred shares), expressed as a percentage.	Thomson Reuters
ROA (%)	Return on Assets shows how profitable a company is relative to its total assets. It is calculated by dividing a company's annual earnings by its total assets, expressed as a percentage.	Thomson Reuters
3. Variabile ce înregistrează mărimea firmei		
Log_Active	Logarithm of Total Assets	Thomson Reuters
4. Variabile ce arata vârsta companiei		
NrAniListare	The number of years of listing at a Stock Exchange	www.kmarket.ro
5. Variabile ce arată structura capitalului		
Years_Listing	Financial leverage (calculated as the ratio of total debt to equity).	Thomson Reuters
6. Variabile ce arată creşterea cifrei de afaceri a companiei		
Economic_growth	This is calculated using the following formula: (Turnover1-Turnover0) /Turnover0.	Own calculations with data from Thomson Reuters

Regression models:

Model 1: Firm_performance = β_0 + β_1* No_IndependentDir + β_2* Log_Tenure + β_3* Financial_leverage + ε_i

Model 2: Firm_performance = β_0 + β_1* Log_Tenure + β_2* BoardSize + β_3* Financial_leverage + ε_i

Model 3: Firm_performance = β_0 + β1* BoardSize + β_3*Dummy_Age + β_4*Dummy_SexCEO + β_4* Financial_leverage + ε_i

Model 4: Firm_performance = α + β_1*CEO_Age + β_2*Log_Asstes + β_3* Financial_leverage + ε_i

Model 5: Firm_performance = α + β_1* Log_Tenure + β_2*Assets + β_3* Financial_leverage + β_4*Economic_growth + ε_i

Model 6: Firm_performance = α + β_1* Log_Tenure + β_2* Years_Listing + β_3* Financial_leverage + ε_i

The results of the model presented above are summed in the next table:

Nr.	R^2	Dependent Variable	Independent Variable	Value of the coeff.	Probability
1	40.09%	ROE	Log_Tenure	0.1044	0.0080
			Assets	1.7E-08	0.0369
			Financial_Leverage	-0.0210	0.0000
			Economic_Growth	0.1058	0.0341
2	35.44%	ROE	Log_Tenure	0.1083	0.0068
			BoardSize	0.0055	0.0379
			Financial_Leverage	-0.0184	0.0001
3	35.03%	ROE	No_IndependentDir	0.0082	0.0473
			Log_Tenure	0.1157	0.0039
			Financial_Leverage	-0.0180	0.0001
4	34.81%	ROE	Log_Tenure	0.1408	0.0009
			Years_Listing	-0.0061	0.0532
			Financial_Leverage	-0.0178	0.0001
5	31.13%	ROE	BoardSize	0.0065	0.0203
			Dummy_Age	0.0315	0.3342
			Dummy_Sex_CEO	-0.0965	0.0852
			Financial_Leverage	-0.0181	0.0002
6	27.20%	ROE	CEO_Age	0.0012	0.5390
			Log_Assets	0.0466	0.0311
			Financial_Leverage	-0.0225	0.0000
7	25.31%	ROA	Log_Tenure	0.0397	0.0247
			Assets	3.64E-09	0.3172
			Financial_Leverage	-0.0057	0.0060
			Economic_Growth	0.0487	0.0316
8	23.85%	ROA	Log_Tenure	0.0535	0.0046
			Years_Listing	-0.0027	0.0481

			Financial_Leverage	-0.0050	0.0097
9	**21.85%**	**ROA**	BoardSize	0.0016	0.1719
			Dummy_Age	0.0162	0.2526
			Dummy_Sex_CEO	-0.0618	0.0120
			Financial_Leverage	-0.0047	0.0187
10	**19.19%**	**ROA**	Log_Tenure	0.0400	0.0263
			BoardSize	0.0012	0.3194
			Financial_Leverage	-0.0051	0.0105
11	**18.86%**	**ROA**	No_IndependentDir	0.0016	0.3860
			Log_Tenure	0.0416	0.0206
			Financial_Leverage	-0.0050	0.0121

Conclusions

Hypothesis number 1 states that there is a positive relationship between the number of the independent directors from the board of directors and firm performance. The results from the table presented above show that, indeed, the relationship between the two variables is positive. This means that the higher the percentage of independent directors of the board, the more company's performance improves. The result is consistent with results obtained by authors such as Bita Bazaz Mushuyekhi and Mohammad S. (2008) but contradicts the results of the authors Udaya Kumara and Guo Zhaoyang KGA (2012) in "Corporate Governance and Firm Performance of Listed Firms in Sri Lanka ".

As in the case of independent directors, in terms of board size regression models led to same results: a positive correlation between company performance and the total number of directors being part of the board. These results allowed me to not accept the hypothesis number 2, whereby the connection between the two variables is negative. The positive relationship between the size of the board of directors and corporate performance means that to get a higher performance you need a board of directors consisting of a higher number of members, in order to be able to manage the company effectively. From my point of view it should be considered not so much the number of members, but their skills and the ability to track more than his own interests, because when a company have a good performance, most likely members will be rewarded. On the other hand, with increased capacity to monitor the firm's activities, new directors are brought which may increase the costs resulting from the possible existence of bad communications and decisions associated with larger groups. Keeping in mind this last idea, there are scientists who claim that a board of directors consisting of a smaller number of members has a better defined control function, while one consisting of a large number of members will have problems with interaction and communication thereby increasing the power exerted by the CEO. Researchers Bita Mashayekhi and Mohammad S. Bazaz (2008) states that the most important function of the board is to control costs resulting from ownership and control. A positive aspect of a bigger board of directors

is that it benefits from a large number of experiences brought by directors.

Following the results of the regression equations I failed to find any significant relationship between the age of the CEO and firm performance (this leads to rejection of the hypothesis number 3 which states that there is a negative relationship between firm performance and the age of Chief Executive Officer). From my point of view, in terms of director's age, there might be benefits on both sides. Those with an age above average, let's say 50 years, have the experiences as an advantage and they can make decisions based on them. On the other hand, slightly younger principals can have the enthusiasm and can lead to higher risk appetite, which can bring significant gains for firm. Eventually, it all depends on context, the intentions and abilities of the person who runs the company.

The results for hypothesis number 4 show a positive relationship between the tenure of Chief Executive Officer as CEO and performance of companies in Romania. The same outcome was demonstrated by authors Raymond K. Van Ness, Paul Miesing and Jaeyoung Kang in "Board of Directors Composition and Financial Performance in the Sarbanes-Oxley World" (2010). Although corporate governance rules don't recommend the CEO to hold this position for a long time, however it seems that research results suggest otherwise. Increase performance by keeping the company's CEO over several years can be explained by the fact that a CEO who seeks the welfare of the company, will use the experience to make decisions that will lead to superior performance.

Regarding the relationship between the number of years of listing on the stock exchange and company performance, results showed a negative relationship with financial performance of romanian companies. These results suggest precisely the main difference between the Anglo-Saxon model orientation towards capital market and to the European banking sector. Due to the relationships obtained, it rejects the hypothesis number 5. From my point of view companies in Romania are still reluctant regarding implementation of corporate governance rules. One reason may be that BSE has just implemented a new code of corporate governance (25 February 2015), a code that wants to be in compliance with the European Union.

Last hypothesis formulated stipulates a negative relationship between firm size and its financial performance. The results for Romania in this case showed a positive relationship between the two variables.

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