

The Corporate Governance and Firm Performance: A Review of Existing Empirical Evidence

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Abstract

The study aims to review and expand general understanding on the relationship between corporate governance and firm performance. The study is motivated by the current debate on the role of corporate governance on firm performance and sustainability and an assertion that corporate failure is a result of failures in corporate governance mechanisms. Prior studies have confirmed notable roles played by corporate governance on firm performance. The study has analysed and comprehended key issues of corporate governance and key factors affecting its general mechanism in protecting shareholders' interest. It further analyses and presents key players of corporate governance which in one way or other have strong influence on the effectiveness of the corporate governance. The study adds on the existing debate and widens stock of literature relating to roles of corporate governance in maximising shareholders' value. It is considerably of usefulness to investors, practitioners and other stakeholders who are interested with firm's operations performance in particular.

Key words: Corporate governance, firm's performance.

1. Introduction

Corporate governance continues to be a focus of research due to its perceived role and contribution to the firm's performance. Notwithstanding its historical background is very exciting and mainly linked with corporate scandals in US and UK as well as traced in the agency theory. Principally, corporate governance background is aligned on the agency problem between shareholders (principal) and managers (agents). It was brought to wider attention by the Enron scandal, Asian financial crisis and the fall of WorldCom. Correspondingly; (John and Senbert (1998); Shleifer and Vishny (1997) contend that the historical background of corporate governance is explained by the agency problem between the suppliers of the fund and organizer of the investments (managers). It is thus clearly to note that the main factor that led to the emerging of corporate governance is the conflict of interest between directors and owners of the business (shareholders). Accordingly the main objective of corporate governance is to ensure that directors run a business for the shareholders' interests of the value maximisation. This study aims to explore the existing empirical studies which link the corporate governance practices with the firm performance and emphasis to the maximisation of the shareholder value. It further, makes an assessment of the factors affecting corporate governance effectiveness.

The study is motivated by the current debate on the role of corporate governance on firm's performance and sustainability and an assertion that corporate failure is a result of failures in corporate governance mechanisms. The study is expected to add on the existing debate and widen stock of literature relating to roles of corporate governance in maximising shareholder value. The study is of paramount usefulness to investors, practitioners and other stakeholders who may need such information to make informed decisions regarding business firms. The rest of this paper is organised as follows; data and methodology; key issues on corporate governance and firm performance including empirical review, discussion of main findings and conclusion.

2. Data and Methodology

In undertaking this study the author conducted a rigorous literature review including the use of library and e-Journals. The paper is thus purely based on desktop and library research methodology. In this regard various journals and research papers and paper articles germane to corporate governance and firms' performance have been surveyed extremely in making this study.

3. Studies on Governance and Firm Performance

This section is exclusive and bestowed for reviewing the extant empirical or otherwise literature on the role of corporate governance on the performance of the business firms, vide, maximization of shareholders value. It documents the explication of key terms in relevant to this study; key players of corporate governance, measures of firm performance, factors affecting corporate governance effectiveness and empirical works on corporate governance and firm performance.

3.1 Corporate Governance Concept, an elucidation and measurement

Corporate governance is a multifaceted concept which has attracted multiple understanding and interpretations, accordingly, no generally single acceptable definition of corporate governance. Different authors have explained corporate governance differently and associate it with quite a range of corporate issues. Their explanations surround agency relationship and link between corporate governance and the governance of the corporations, paying little attention on the shareholders' interests.

McConomy and Bujaki (2000); Robert et al (2005); Grahamling and Hermanson (2006) for example define corporate governance as the system in which companies are directed and controlled in conducting businesses. It is a 'set of mechanisms with the aim of protecting shareholders' interests' (Shleifer and Vishny (1997); Tirole (2001). From the definition; we deduce that corporate governance focus on the point of running companies in a proper way in order to maximize shareholders' value. In effect it is considered as bridge that connects shareholders and company's managers. Corroboratively; Pass (2004) considers corporate governance as the system that sets out the roles of the board of directors in managing the company and in maintaining relationship with the company's shareholders. His ideas are not different from what other authors think about corporate governance. Generally; all authors consider corporate governance as the "engine" of the corporation that helps to make sure that companies are run for the shareholders' interest and also helps to bridge the gap between shareholders and company managers.

Consequently; it can be concluded that the need for corporate governance came to be very important due to the separation of ownership and management. Separation of ownership appears due to the fact that the owners of the business (shareholders) employ experts (managers) to run the business on their behalf. However, it came to be well known after the fall of some corporations in the US and UK. These led to US and UK governments to conduct various studies in order to strengthen the role of corporate governance. As a result, various codes have been established with the same objective of making corporate governance more effective. In US, the Sarbanes-Oxley Act 2002 has been reported to have made sweeping changes that affects corporate governance (Valenti, 2008). The UK also made some changes to their corporate governance after the report of the Cadbury committee in 1992. Above all; nowadays stock exchanges have been engaging in producing corporate governance codes in line with their registration requirements for the companies that seek to be listed.

3.2 Corporate Governance and Firm's Performance- a measurement outlook

Many researchers have tried to assess the relevance of corporate governance on the firm's performance through examining relationship between the two using different indicators. Some researches focus on the contribution of the independent directors to the firm's performance while others have concentrated on the relevance of committee structure and board diversity to the firm's performance. In general, we can group research conducted on the relationship between corporate governance and firm's performance in two groups; those which have analysed the effect of single component of corporate governance on the firm's performance and those that have considered the effect of more than one factor of corporate governance on the firm's performance.

The authors who have considered single factor in researching the link of corporate governance and firm performance include (Peng (2004); Lam and Lee (2008); Baysinger and Butler (1985); Cotter et al (1997); Francoeur et al (2008). Most of these authors have examined the contribution of independent directors to the firm performance and few of them assessed the role of women in the board of directors. Considering one actor/factor in assessing the relationship between corporate governance and firm's performance can be challenged. For example, evaluating the role of the women in the board of directors as being linked with firm performance is somehow confusing. The contribution of the board of directors needs to be assessed as a whole and not as individual contributions. It is very difficult to separate the roles of individual members of the board of directors.

In addressing the above problem; some authors have suggested that corporate governance effectiveness need to be assessed on its size, independence and composition (John and Senbert; 1998). The proponents of this point argue that size, independence and composition help to give general picture of the corporate governance and its contribution to the firm performance. Some of the authors such as: Raja and Kumar (2007), Hutchinson and Gul (2004), Eli Mir and Seboui (2008) and Weir and Lang (2008) researched the board composition, independence, ownership and board size component. It is a researcher belief that these factors can demonstrate the actual contribution of the corporate governance and also can help to draw the general idea about the roles of corporate governance. This does not mean that the researcher disregards the authors who assess only one actor or factor but it importantly to think and consider that the inclusion of these factors are more realistic.

Corporate governance is very wide and sometimes to address all factors that affect it is difficult. The problem of assessing all factors that are considered to have influence on the corporate governance might be availability of data. Some of the factors are not common in all countries which make it difficult to generalize the findings of corporate governance. Also, it has been reported that corporate governance is influenced by cultural differences.

If this is true then, it will be as difficult to get consensus on the usefulness of corporate governance as on accounting standards. In conducting research, researchers consider availability of data that can suit the proposed area of investigation. Therefore, researching one factor or multiple factors that affect corporate governance depends on the types of data available on the hands of researchers.

3.3 Corporate Governance- the roles of key players

There are many players of corporate governance that work together in order to maximize shareholders' value. Most literature links corporate governance with quality of financial reporting. Generally, known actors of corporate governance are board of directors, audit committee (internal and external auditors), shareholders, management and regulators. The main focus of corporate governance is directed to the board composition with the aim of determining the number of independent directors included in the board.

In effect, the effectiveness of corporate governance depends on 'independent directors (non-executive directors)' who are not employees of the company but they contribute enormously in business decisions (Peng (2004); Murphy (2006); and expected to give balanced strategic planning in regards with company's investment opportunities. However, in general, the roles of the independent directors are remarkable and will continue to reflect the interests of the shareholders by connecting them with managers (directors). Independent directors form three key committees in corporate governance; such committees are nomination committee, audit committee and remuneration committee that determine director's remuneration and other related benefits.

Another key player is 'Audit committee' which plays an important role in governance (Fleming (2002)). This is the integral part of the corporate governance which ensures that managers make use of the available investment opportunities in appropriate manner. Audit committee consist internal and external members that help to balance opinions in regards to company's operations. Therefore, we can conclude that the audit committee helps to improve firm's performance due to their monitoring roles.

'Shareholders' is another player of corporate governance, on the other side they are known as owners of the business. The role of shareholders that qualify them to form part of the corporate governance is their involvement in the appointment (Pass (2004) of directors and external auditors in the Annual General Meeting (AGM) and that they are supposed to use their voting power effectively (Hemraj, 2003).

'Executive directors' executive directors and non-executive directors together form board of directors that is responsible for the whole governance of the corporation. Executive directors are key players of corporate governance in teamwork with non-executive directors. According to Pass (2004) and Hemraj (2003), executive directors are responsible for managing daily businesses of the company and they also determine the company's strategic objectives.

3.4 Factors affecting Corporate Governance effectiveness

Corporate governance effectiveness is influenced by many factors including their component which also influences firms' performance. Factors already reported in the literature that have a high influence on the corporate governance are discussed below:

'Board composition' traced onto independence, size and composition (Senbert 1998) has influence on its effectiveness in ensuring that companies are run for shareholders' interests. Independence and composition as the measure of the board effectiveness are all focused on the inclusion of outside directors in the board of directors (Hutchinson and Gul 2004) as such the independence of the board increases with number of outside director's increases. The presence of independent directors in the board of directors is argued to protect shareholders interest and enhance involvement in the decision making hence improved transparency.

'Concentration of ownership' basically referred to as internal and external equity holdings influence corporate governance effectiveness. Robert et al (2005) contend that ownership concentration affects the way in which corporate governance is put into application. Wear and Laing (2000) and Hutchinson and Gul (2004) have exposed that internal shareholdings help to solve the agency problem and struggle for firm performance. As a result, we expect that internal equity ownership will make the board more effective. In order to promote this factor, however, companies encourage executive and non-executive directors to hold shares in order to align their interest more closely with those of external shareholders (Pass, 2004). This will stress the management to work strongly for their best interest as well as shareholders' interests.

'Committee structure' corporate governance effectiveness can be traced as well on the committee structure. John and Senbert (1998) exposed that corporate governance effectiveness can be affected by the committee structure. They argue that internal and external directors need to be included in the committees in which they can work successfully. They explained that outside directors are more effective in the monitoring committees. Based on the appreciated work of outside directors, it is advised to include them in the monitoring committees such as audit committee, remuneration committee and nomination committee.

'Board diversity' Board diversity focuses on the consideration of gender in the board of directors and their impact on the board effectiveness. The involvement of women in the board of directors is said to enhance board

effectiveness as well as company performance. This thought is supported by Erhardt et al (2003), Smith et al (2006) and Francoeur et al (2008) who have documented a positive relationship between women's involvement in the board of directors and performance of the companies. They argue that women are very strategic and help to make a board of directors more effective in making decisions.

'External shareholding structure' corporate governance effectiveness can also be explained by the types of the shareholders of the company. Basically, there are two types of investors/shareholders; there are individual investors and institutional investors. Institutional investors refer to pension funds, insurance funds and other related funds with the same objectives. Institutional investors have incentive to stress components of corporate governance and hence make them more effective as compared with individual investors (David and Kochhar; 1996). Most institutional investors employ experts in running their funds; they can use their experts to raise a number of issues in relation to company performance.

'Corporate governance code' A corporate governance code also has high incentive on the effectiveness of the corporate governance. Robert et al (2005) argue that corporate governance code sets the minimum number of internal and outside directors that need to be included in the board. In order to enhance corporate governance effectiveness, some countries' regulations require a "dual board" system. Dual board is formed by supervisory board and executive board of directors. The role of supervisory board is to supervise executive board of directors in running business.

3.5 Firm's Performance and Measure of Performance

The study evaluates the relationship between corporate governance and firm performance. The problem is what a firm performance actually means and also what constitutes this performance. Many authors have evaluated the link between corporate governance and firm performance using different measures. Some of them have employed return on asset as measure of performance while others have used sales growth. Also, other researchers have employed return on equity as the measure of the company performance. El Mir and Seboui (2008) argued that corporate governance is mostly believed to be the main driver of the company performance. However, the measures of company performance employed by the researchers are not the same which may be accounted as the source of mixed findings on the relevance of corporate governance on firm performance.

In their analysis, Raja and Kumar (2007) employed Tobin's Q being formed by the summation of market value of equity, liquidation value of preference share and book value of debt divided by book value of total assets as the measure of firm performance against corporate governance. Also in assessing the significance of corporate governance; Hutchinson and Gul (2004) measured firm performance by considering return on equity. In this case, return on equity is measured as profit after interest and tax divided by equity. This seems to be a reasonable measure of the performance as the main objective of corporate governance is to maximise shareholders' value. The measure is directly linked with the shareholders' welfare (Baysinger and Butler; 1985).

Moreover, in evaluating firm performance Weir and Lang (2000) and Erhardt et al (2003) employed return on asset as the measure of performance. Francoeur et al (2008) employed abnormal return (excess return) as the measure of performance. In the same process, Smith et al (2006) employed four measures; gross profit margin, contribution margin divided by net sales, operating income divided by net sales and net income after tax divided by net sales. This proves that different accounting measures have been employed in assessing the contribution of corporate governance to the firm performance. However, the analysis shows that different accounting measures have been employed based on the variables investigated. We have seen that internal directors and outside directors perform well in different committees. This may suggest the use of different measures when investigating effectiveness of corporate governance when considering internal and outside directors.

3.6 Empirical Reviews; Corporate Governance and Firm Performance

In assessing the role of corporate governance in the firm's performance; Cotter, et al (1997), Baysinger and Butler (1985) and Peng (2004) evaluated the role of independent directors. They established that independent directors play important roles towards firm performance. They concluded that boards with a high proportion of outside directors will be in a better position of meeting shareholders' interests as compared with boards with low proportion of outside directors. Cotter et al (1997) examined the roles of independent directors for the target firms during their takeover by tender offer. They argue that tender offer has different impacts on the target shareholders and managers. Target shareholders have a high chance of gaining while for target managers are somehow difficult. Managers tend to maximize their utility at the expense of the shareholders. It is expected that outside directors will diffuse the effect and force managers to act on the shareholders' interest.

Also, McIntyre et al (2007) and Klein (1998) assessed the relationship between firm performance and board composition by focusing on the different aspects of the board composition. Klein (1998) focused on committee structure of the board and directors roles within the committees. In his findings, he documented insignificant association between firm performance and overall composition. However, he documented a positive relationship between firm performance and board structure. In contrast with other researchers on corporate governance, Klein

(1998) considered the role of internal directors on the finance and investment committees. Higher proportion of internal directors in these committees is positively related with accounting stock market performance. In the same vein, McIntyre et al (2007) reported positive relationship between board composition and firm performance. They concluded that high level of experience, appropriate team size, moderate level variation in age and team tenure correlates with firm performance. Also, Lam and Lee (2008) examined the association between Chief Executive Officer (CEO) duality and firm performance on family controlled businesses in china. In this case CEO duality means Chief Executive Officer and Chairperson of the Board. They established that CEO duality contributes much to the firm performance for non-family firms and is not relevant for family controlled firms. In the same analysis, Francoeur et al (2008) and Smith et al (2006) examined the involvement of women in top management. They documented the same findings that women make a remarkable contribution to firm performance. They argue that a high proportion of women on the board of directors have positive impact on the firm performance. Francoeur et al (2008) argue that women are very effective in a complex business environment due to their working life and non-working life experiences. They contend that the inclusion of women in the complex business environment signifies future prospects of the company that result in significant abnormal returns. Moreover, Erhardt et al (2003) and Carter et al (2003) examined the relationship between board diversity and firm value. According to Carter et al (2003) board diversity includes the percentage of women, African Americans, Asians and Hispanics on the board of directors. Both documented a positive relationship between board diversity and firm value. Board diversity improves decision making by considering different opinions from various members of the board of directors.

In addition to the above authors; Weir and Lang (2000) also researched the relationship between corporate governance and firm performance by considering duality, outside directors, and the remuneration committee. They concluded that remuneration committee has a positive effect on the firm performance while outside directors have a negative impact on the performance. However, they argue that there is a positive link between outside directors and firm performance after the period of poor performance. Also, Weir and Lang (2000) conducted their research in order to assess the proposals of the Cadbury report in modifying corporate governance practices. In their analysis, they argue that Cadbury variables can be impacted by the type of performance measure selected. Also, Raja and Kumar (2007) documented strong positive association between committee component and firm performance.

Also, Bonn (2004) joined other authors by considering the effect of board structure on the firm performance. The author revealed that outside directors' ratio and female directors' ratio are positively related with firm performance. However, author established that board size and director's age have no influence on the firm performance. Hutchinson and Gul (2004) also aimed to examine the roles of the corporate governance on the firm performance. Their results show that higher level of non-executive directors on the board, management share ownership and management remuneration weaken the negative relationship between firm investment opportunities and performance.

In their analysis; Hutchinson and Gul (2004) suggest that the contribution of corporate governance components to the firm performance need to be assessed in the light of the firm's external environment (growth opportunities). They argue that, it is not likely for corporate governance to affect all firms equally due to different business environments. The environment in which firm operates has influence on the operating efficiency. This seems to be new area of research for corporate governance-related issues. The firm performance depends in most cases on the macroeconomic factors but researchers may encounter a lot of problems in researching the relationship between business environment and corporate governance effectiveness. However, business environment contributes in large extent to the success or failure of the firms and thus it is reasonable to link corporate governance, business environment and firm performance as a whole.

4. Discussion of Main Findings from Review

Most studies recognize the usefulness of corporate governance and its components to firm performance. However, there are no studies that have managed to assess all components of corporate governance. Corporate governance does not exist as a single body; it is formed by some bodies and committees that include internal directors and independent directors. Due to the complexity of evaluating corporate governance as a whole most researchers focus on the key players and determinants of corporate governance.

Prior researches on corporate governance and firm's performance focused on the role of outside director, internal directors, board composition (team size, different experiences, team tenure and age) and the contribution of women in top management. Also, they researched committee components, board diversity, CEO duality, board size, management share ownership and management remuneration.

Many researchers have concluded that independent directors' ratio and women directors' ratio are positively related with firm performance. In contrast with other researchers, Weir and Lang (2000) concluded that independent directors are negatively related with firm performance. However, they argue that independent directors have notable contribution to the firm performance after a period of poor performance. Also, there are

mixed findings on the relationship between board composition (age) and firm performance. Klein (1998) documented insignificant relationship while McIntyre, et al (2007) have documented strong association between board composition (age) and firm performance. In his findings, Bonn (2004) concluded that directors' age has no influence on firm performance.

In summary, prior researchers have noted the contributions of corporate governance to firm performance. In addition to that, most authors have pointed out the importance of independent directors and women on the board of directors and related committees. This gives an impression of good governance which is the main issue for the policy makers and regulators. It is hoped that these findings helped and will continue to help regulators and policy makers to focus on the area of improvement in order to make corporate governance more fruitful and strengthen stewardship mechanisms.

5. Concluding Remarks

This paper uses the desktop and library research to explore and present the extant literature on the relationship between corporate governance and firm performance. The study has reviewed in greater detail the roles of corporate governance and its contribution to firm value as well as exploring the key players of corporate governance and factors affecting its effectiveness. The results from empirical review report mixed association of corporate governance and firm performance such that others find negative contributions and others otherwise and hard to generalise on basis of specific components.

The study has revealed that corporate governance has been put into application due to the agency problem and accordingly it is principally aimed to narrow the gap between shareholders (fund suppliers) and managers. It further presents that studies on corporate governance are of two categories; those which use single component and which use multiple components but all focusing on the relevance of corporate governance in firm performance. The existing studies conclude that corporate governance plays significant role in contributing the firm's performance.

This paper concludes that the corporate governance is the main driver of firm performance and that it is an important concept which need not be overemphasised. The review has further exposed some limitations of the prior research being mainly linked with the data and measure of performance employed in the general analysis. Data used by the prior researches focused on listed companies and ignored a large number of unlisted companies in the business. The study implies the need of more empirical studies on this area which overcomes the limited identified in the analysis of existing empirical studies with particular emphasis on the use of multiple components of corporate governance on firm performance.

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