LITERATURE REVIEW ON CORPORATE GOVERNANCE - FIRM PERFORMANCE RELATIONSHIP

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Abstract: *In the matter of corporate governance reforms, an important aspect is whether the implementation of corporate governance principles and codes has a positive impact on firm performance. The literature testing the relationship between different corporate governance mechanisms and firm performance is extensive. Over time, a lot of corporate governances mechanisms were studied in relation to firm performance and the most used are: CEO duality, board size, proportion of non- executive directors, board committees, ownership structure and concentration, managers' compensation and incentives schemes. With time, different authors began to use more comprehensive measures for corporate governance rather than a single variable or a single governance mechanism, the so called corporate governance indexes. Regarding performance there are three main approaches to firm performance in social science research: research based on market prices, accounting ratios and total factor profitability.The most used performance measures are: Tobin's Q, return on equity, return on asset and economic value added. In our paper, we present the studies undertaken since the 1990's regarding the relationship between different mechanisms of corporate governance and firm performance and between corporate governance index and performance for both developed and developing countries around the world. Regarding the working tools used in this theoretical research we can mention the longitudinal method, by presenting the evolution in time of empirical studies on the research topic and the comparative method used in presenting the resulys of different studies mentioned in our paper. The results of the studies are inconclusive, some studies founded a strog positive relation, others founded a negative correlation between corporate governance and firm performance, while a third category of studies didn't found any relationship at all. We used participative observation method by issuing conclusions on the potential causes of the inconclusive results on the existence and nature of the relationship between corporate governance and firm performance.*

Keywords: corporate governance, firm performance, corporate governance index.

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1. Introduction

Corporate governance knows many definitions. Some authors define it as a mix of different mechanisms that direct and control the company (Kim et al. (2005); Hassan (2008)). There are two major sides of corporate governance (CG): conformance and performance. The first one consist of monitoring, supervising and being accountable to different stakeholders (Hassan and Halbouni, 2013:120), while performance measures the contributions of managers (those who govern the company) in obtaining performance.
In the matter of corporate governance reforms, an important aspect is whether the implementation of corporate governance principles and codes has a positive impact on firm

performance. In recent years, the aspect of causality determination has become increasingly important in the research regarding corporate governance.
After studying the literature on this regard we found that many empirical studies use a single governance variable or mechanism in investigating the relationship between firm value or performance (Yermack (1996); Bhagat and Black (2002)). But due to the fact that corporate governance is a complex phenomenon other authors (Gompers et al. (2003); Core *et al.* (2006); Brown and Caylor (2006)) consider that is should be measured using a corporate governance index (CGI - a multidimensional variable). In our opinion, in order to surprise all the aspects of corporate governance mechanism in studying its link to firm performance (firm value) it is appropriate to use an index to measure all dimensions related to corporate governance.
One of the widespread beliefs regarding corporate governance is that good corporate governance leads to increasing performance. But there are studies that suggest no correlation between a mechanism or an index of corporate covernance and firm performance. Although in the '90 the American model of corporate governance was the most successful and appreciated in the matter of creating value, the financial scandals from 2001 a decrease of the public and investors in corporate governance systems. The results of this decrease were new corporate governance requirements and also investors approached it more seriously.
Regarding performance there are three main approaches to firm performance in social science research: research based on market prices, accounting ratios and total factor profitability (Bocean and Barbu, 2007). One of the most used ratio in the research regarding corporate governance is Tobin's Q, while among the accounting ratios, the most common ones return on equity (ROE), return on asset (ROA) and economic value added (EVA) can be used to assess the total profitability of a company.
The information from our research is structured as follows: in section 2 we will present the studies regarding the relationship between different elements that describe CG and firm performance and in section 3 we state our conclusions.

2. Empirical Studies on Corporate Governance – Firm Performance Relationship

2.1. Studies regarding different corporate governance mechanisms and firm performance relationship

The literature testing the relationship between different corporate governance mechanisms and firm performance is extensive. Studies use different variables to assess corporate governance such as: CEO duality, board size, proportion of non- executive directors, board committees, ownership structure and concentration, managers' compensation and incentives schemes and others. In this part of our paper, we will present only some of the empirical studies.
The first corporate governance mechanism that we will consider is the board committees. If Main and Johnson (1993) found that the presence of remuneration committee is associated with higher levels of executive pay that determines a profitability decrease (negative correlation) for US companies, Klein (1998) found that remuneration committee has a positive link with performance (measured by ROA, productivity and market returns) for the US economy. Weir and Laing (2000) obtained the same results using ROA as a measure of performance. For the audit committee the results are also mixed: if Laing and Weir (1999) establish a positive correlation between firm performance and audit committee using ROA, in 2002 Weir et al. (2002) concluded that the existence of audit committee doesn't influence the firm performance (Tobin's Q). The research period for the first study is from 1992 till 1995, while for the second is 1994-1996. The studies were done for the UK companies.

Black and Kim (2012), using Tobin's Q as a measure of performance found that audit committee is positively correlated with firm performance (Tobin's Q) in large Korean companies, while in the smaller firms they didn't found any correlation. This result wasn't confirmed for Nigerian firms, in Kajola (2008) study. The author used ROE and profit margin as measures for performance and 7 years as study period (2000-2006), and the result suggested no impact of the audit committee on firm performance.
Other variable characterizing corporate governance used in such studies is size board. Board size differs from one country to another according to Corporate Governance Codes. Kajola (2008) found a positive significant correlation between board size and firm performance (measured by ROA). In 2009, the same positive correlation was found between large firm boards and firm performance measured by Tobin's Q and ROA by Jackling and Johl (2009). These results were partial sustained by the research of Adams and Mehran (2012). They used a sample of 35 listed banks on the US capital market for a period from 1986 till 1999 and concluded that board size has a positive impact on firm performance measured by Tobin's Q, but no correlation with ROA.
Empirical studies that found negative correlation between board size and firm performance are both for developed economies (Cheng, 2008; Guest, 2009) and developing economies (Guo and Kga, 2012; Ujunwa, 2012), using as performance measures ROA, ROE, Tobin's Q and share returns.
Regarding the representation of non-executive directors on the board, the evidence from the empirical studies conducted is mixed, although it is expected to have a positive influence on firm performance. There as studies that found a positive correlation between the proportion of non-executive directors and firm performance (Weir et al., 2002; Gupta and Fields, 2009), while there are authors that found a negative correlation (Bozec, 2005; Guest, 2009) and others that didn't found a link between the two (Klein, 1998; Laing and Weir, 1999; Kajola, 2008). The measures of performance used in these studies were Tobin's Q, ROA, ROE, market returns and market value.
The structure of board determines board independence. A reasonable proportion between inside and outside managers gives the independence of the board that assures the protection of stakeholders' interests. Authors like Bhagat and Black (2002), Adams and Mehran (1995) and John and Senbet (1998) offer empirical confirmation that supports the hypothesis that the right mix of internal and external managers can enhance performance.
Another board characteristic that was studied in relation to firm performance is board meetings. Empirical studies support the idea that firm with good attendance at board meetings perform better than firms with low attendance (Ntim and Oser, 2011), while Johl (2006) in his study on the FTSE 100 companies found a negative correlation between the two elements.
Another issue approached in the literature on this theme is the one regarding managerial ownership and firm performance. While there are some studies that suggest no correlation between the two (Cho, 1998; Brick et al., 2005), there are studies that support the idea of a positive link (Kaserer and Moldenhauer, 2005; Welch, 2003). One of the first studies regarding this correlation was made by Morck, Shleifer and Vishny (1988). According to their results, managers having stake between 0 and 5% take decisions that are in the interest of both while an ownership stake between 5% and 25% influences the managerial decisions.
Voluntarily disclosure can be considered as one of corporate governance mechanism that enhances performance (Zaman et al., 2014). Transparency and disclosure of information are considered to be an essential element of corporate governance. When talking about disclosure there are different aspects such as board and management structure disclosure, ownership structure disclosure and financial transparency and information disclosure. Regarding the last one different author suggest the idea that disclosure through annual reports leads to high profitability (Henry, 2008; Iatridis, 2008). Toksal (2004) found that

corporate governance reporting reduces the cost of capital, while Habib (2008) doesn't find any correlation between economic profit and corporate disclosure.
As we can see, the results are mixed for all the individual mechanisms of corporate governance taken into account. These inconclusive results are due to different used methodologies, different time frames, different samples and different economies, and legislative framework.
The results of the studies support the fact that not all the elements of corporate governance have a positive impact on firm performance, so the integration of all corporate governance mechanism into an index seems to be more effective in having a correlation with firm performance.

2.2. Studies Regarding Corporate Governance Index and Firm Performance Relationship

With time, different authors began to use more comprehensive measures for corporate governance rather than a single governance mechanism. Studies mentioned before showed that not all elements of corporate governance, in isolation, have effectiveness in aspects regarding performance and agency issues. In what follows we will present some of the corporate governance indexes that were proposed by different authors in order to measure the quality of corporate governance system within the companies that applied them.
One of the first authors that examined the relationship between corporate governance and performance using multidimensional variable was Labelle (2002). The author used in his research the ratings from a statement of corporate governance practice (SCGP) developed by the Canadian Institute of Chartered Accountants (CICA) regarding disclosure quality of corporate governance, while performance was measured by ROE. The period of the study was 1996-1997. The results suggested no significant relationship between firm performance and disclosure quality of corporate governance.
The first authors to build a complex index regarding all corporate governance aspects are Gompers et al. (2003). Their index, G-index, is composed of 24 distinct Corporate Governance variables grouped in 5 categories. Their study regarding a 10 years period (1990-1999) found a strong correlation between G-index and the following financial indicators: stock performances, Tobin's Q, net profit margin and sales growth. In 2008 Bhagat and Bolton (2008) using G-index confirmed the results obtained by Gompers et al. (2003).
One of the first European studies regarding the relationship corporate governance-firm performance was conducted in Germany by Drobetz et al. (2004). The authors used a Corporate Governance Rating (CGR) (multidimensional answers to a questionnaire based on the Germany Corporate Governance Code (voluntarily adopted by the companies). The measures of performance used were Tobin's Q and market to book value, while CGR was structured into the following categories: shareholder rights, transparency, corporate governance commitment, management supervisory, board matters and auditing ant the period used in their study was 1998-2002. Their findings showed that there is a positive correlation between corporate governance and firm performance (better-operating performance, higher market valuation). In 2008 Bassen et al. (2008) found that between firm performance, measured by Tobin's Q, and compliance with Germany Corporate Governance Code is a negative correlation, for a period of one year and using publicly available date.
Bauer and Günster (2004) used in their analysis Deminor Corporate Governance Ratings (DCGR), an index formed by 300 criteria grouped into 4 categories: rights and duties of shareholders; range of takeover defenses; disclosure of corporate governance and board structure and functioning". The results of their study conducted for 2000-2001 showed an insignificant negative relation between firm performance (net profit margin, ROE) and corporate governance standards.

Beiner et al. (2005) using a CGI based on a set of 7 equations (6 with a corporate governance mechanism as a dependant variable, 1 with Tobin's Q as a dependant variable) found positive correlation between CG and Tobin's Q. Klein et al. (2005) uses the corporate governance score from ROB, testing its link to firm value and the results show that not all corporate governance dimensions are correlated with firm value (board composition and independence). The same ROB score is used by Gupta et al. (2009) and the results are the same: no significant correlation between firm value and performance and corporate governance index.

In 2006 Brown and Caylor designed the Gov-Score index that included variables grouped into 8 categories as follows: audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices and state of incorporation. Their results showed a positive correlation between the Gov-Score index and firm value measured through Tobin's Q. The period of the study was only one year (2002). Zheka (2006) found that, for a transitional economy (Ukraine in this case), corporate governance predicts firm performance. The author developed an index, Ukraine Corporate Governance Index (UCGI) with four dimensions: board independence, chairman independence, shareholders rights and information disclosure (transparency).

Cheung et al. (2007) developed a Corporate Governance Index (CGI) based on publicly available information to appreciate corporate governance and found correlation between CGI and market to book value (firm value). The starting point for the test was the OECD 2004 revised corporate governance principles. Larcker et al. (2007) found a positive correlation between the CGI used and financial performance measured by sales growth, net profit margin and ROA, for a period of two years (2002-2003). Arcot and Bruno (2007) conducted a study based on a comply or explain index to test the influences of corporate governance and firm performance, in an environment with flexible regulatory, for the period from 1999 till 2004. Their findings suggested that compliance with a Code of Corporate Governance is not necessary correlated with an increase in firm performance.

Toudas and Karathanassis (2007) developed a governance index based on a questionnaire to test the effects of compliance with corporate governance on firm performance for a period of two years (2004-2005). The results suggested that good corporate governance (measured through shareholders rights) is correlated to firm performance (measured by Tobin's Q).

Padgett and Shabbir (2008) developed a non-compliance index for UK in order to test the link between companies' performance (measured by ROA, ROE, tota shareholder return (TSR) and Tobin's Q) and compliance with the UK code of corporate governance. Their results evidenced a reversed correlation between the non-compliance index and TSR. Garay and Gonzalez (2008) developed an index with the following dimensions: board composition and performance, transparency, ethics and conflict of interest and shareholders right, while the performance measures used were price to book value and Tobin's Q.

Bebchuk et al. (2009) developed an *Entrenchment index* (E-index) with 6 variables of the 24 used by G-Index, correlated with firm value for a period from 1990 until 2003. The results evidenced that the decrease of governance performance (an increase in the index value) is correlated with negative extra-returns.

Ntim (2009) developed the South African Corporate Governance Index (SACGI) with eleven dimension of corporate governance in order to asset the impact of South African Code on firm performance (measure by Tobin's Q and ROA) from 2002 to 2006. His results suggest a positive link between SACGI and firm performance.

Bozec et al. (2010) examined the governance index-performance relationship using the governance index developed by Global and Mail Report on Business and Tobin's Q, for a period of five years (2001-2005). Their findings suggested no relationship between the CGI and firm performance (Tobin's Q).

Price et al. (2011) developed a governance index with three dimensions: audit committee, board composition, and transparency, based on the compliance with the code of best practiced from Mexico and they found no correlation between firm performance and their CGI. Ammann et al.(2011) realized a cross-national study (22 countries) regarding corporate governance-performance link, using GMI corporate governance ratings and Tobin's Q and the results suggested a positive link between the two concepts. Cremers and Ferrell (2014) found a negative correlation between G - index and firm valuation for a large period (1978-2006).

After analyzing the result of the mentioned studies we found that there are mixed results: some of the studies show positive and significant correlation between CGI and firm performance/value, while others show the lack of such a correlation. This mixed results can be due to the way the indices used were developed (the construction of index are based on subjective judgments on the base of the expertise of the authors and the literature review), the period of time use in the studies, the lack of a code of best practices (many of the studies use periods from the '90).

3. Conclusion

The literature on corporate governance and firm performance relationship is extensive and got much attention. It can be characterized as being unable to reach a consensus regarding the nature of the relationship between the two concepts. Although the empirical evidence is inconclusive, the practical importance of governance in relation to performance is globally acknowledged, especially in aligning the interests of managers and shareholders.

The inconclusive results of the empirical studies on this theme can be due to several factors. First, we can mention the choice of the variables used to measure both corporate governance and firm performance. While some studies use market-based performance measures like Tobin's Q, others use accounting-based performance measures (ROA, ROE, EVA). For measuring corporate governance in some studies is used only one mechanism of corporate governance, while others use an index that captures the influence of several corporate governance mechanisms. Second, we consider that institutional differences among countries lead to different results of the empirical studies mentioned. The studies are conducted in both developed and developing economies, so this raises a question: Does corporate governance principles for developed countries are suitable for developing economies?

Although the results of the research regarding corporate governance – firm performance relationship are mixed, we consider that good corporate governance is an essential factor in achieving sustainable economic development due to the increase in the access to outside capital. Objectives like capital market development, decrease in transaction costs and cost of capital and also a reduction of financial crises vulnerability can be achieved by implementing corporate governance mechanisms.

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