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A CONCEPTUAL STUDY OF CORPORATE GOVERNANCE AND FIRM FINANCIAL PERFORMANCE OF LISTED COMPANIES

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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. In this 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 comparative method used in presenting the results of different studies mentioned in our paper. The results of the studies are inconclusive, some studies founded a strong positive relation, and others founded a negative correlation between corporate governance and firm performance, while a third category of studies didn't find 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, reforms

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INTRODUCTION

Corporate governance is defined as the process carried out by the board of directors, and its related committees, On behalf of and for the benefit of the company's Shareholders and the other Stakeholders, to provide direction, authority, and oversights to management, “It means how to make the balance between the board members and their benefits and the benefits of the shareholders and the other stakeholders” (M.Tarek Youssef, 2007).

The origin of corporate governance can be traced to the creation of registered company under the joint stock companies Act of 1844 (UK). This marked the beginning of the modern corporations that separates control from ownership (Berle & Means, 1967).

Corporate governance framework began developing to protect firms from the actions of professional managers with the passage of limited liability Act of 1855 (UK) to protect shareholders from debt beyond their investment (Parker et al. 2002).

Corporate governance gains prominence in the 1980’s due to stock market crashes across the world and inability of corporate governance framework to prevent corporate failure (Francis, 2000).

The King’s committee report and code of practice for corporate governance in South Africa published in 1994 stimulates corporate governance In Africa.

In Kenya the private sector initiative for corporate governance continues to liase with Uganda and Tanzania towards the establishment of Regional center of excellence in corporate governance. Over the past few decades, the issue of corporate governance has given rise to much debate regarding its efficiency (Kiel & Nicholson, 2003) due to the failure of businesses such as Enron and World Com (Du Plessis et al., 2011). As a result, the practice of corporate governance has been dominated by developments in Western countries. For instance, the United States (US) established the Sarbanes–Oxley Act in 2002, which required major changes to the corporate governance rules adopted by the New York Stock Exchange (NYSE) (Dragomir, 2008); the United Kingdom (UK) Combined Code (2003) reviewed the report of Turnbull, Higgs and Smith (Mallin, 2011); and the Australian Stock Exchange (ASX, 2003) formed the ASX Corporate Governance Principles after crises in several large companies, such as HIH Insurance in 2002 (Farrar, 2008; Habib & Azim, 2008).

Many international organisations, such as the World Bank and the OECD, have encouraged all countries to implement international standards of corporate governance. They have also developed guidelines for corporate governance (Aguilera & Cuervo-Cazurra, 2009).

Clearly, less developed countries need to adopt an effective corporate governance structure to solve these problems and encourage new practices for implementing the different features of corporate governance in developing economies (Mulili & Wong, 2011). In emerging-market

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countries, enhancing corporate governance could provide many essential public policy objectives. For example, good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital, improves firm performance, and enhances the capital market (Al-Matari et al., 2012).

Much research has been conducted on the relationship between good corporate governance and firm performance (Klapper & Love, 2004; Wang & Sami, 2011; Ikäheimoa, Puttonen & Ratilainen, 2011; Bauer et al., 2008; Brown & Caylor, 2004; Farag, Mallin & Ow-Yong, 2014; Al-Najjar, 2014). However, few investigations have focused on corporate governance and firm performance in the context of a developing country such Kenya.

The concept of corporate governance in developed economies has been explained using various theories (Solomon, 2010). According to the agency theory, the purpose of corporate governance is to reduce potential conflicts between managers and the interests of the shareholders (Jensen & Meckling, 1976). The stakeholder theory also plays an essential role in explaining governance structures because companies are made aware of all stakeholders rather than only the shareholders (Freeman, 1984). Donaldson and Preston (1995) have argued that the stakeholder theory can help to maximise firm performance and the combined benefits of all stakeholders by considering the interests of all stakeholders.

Research studies on corporate governance are limited to studying what occurs in developed economies or large emerging economies. It seems, therefore, that less developed and emerging economies are very much under-investigated in the literature. Therefore, this research will try to fill this gap by looking at the corporate governance principles, the internal corporate governance mechanisms and their impact on firm performance

In the framework, corporate governance principles are represented by the rights and equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board. The corporate governance mechanism variables are board size, leadership structure, board composition and audit committee independence. The dependent variable of firm performance will be assessed by measuring financial performance (return on assets and return on equity) and market value (Tobin's Q).

Problem Specification

Globally, the concept of Corporate Governance originated in the Private Sector, with a focus on high profile failures in the US, the Treadway Commission constituted in 1985 highlighted the need of putting in place a proper control environment, desirability of constituting independent boards and its committees and objective internal audit function. As a consequence, the

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Committee of Sponsoring Organizations was formed which prescribed a control framework in 1992. After the Enron debacle of 2001, came other Scandals involving large US Companies such as WorldCom, Owest, Global Crossing and the auditing lacunae that eventually led to the collapse of Andersen

A spate of scandals and financial collapses in the UK in the late 1980s and early 1990s made the shareholders and banks worry about their investments. This led the UK Government to recognize insufficiency of existing legislation and role of self regulation as a measure of controlling scandals and financial collapses. Some of the corporate disasters took place primarily due to insufficiency of implementable governance practices. To prevent the recurrence of such business failures, the Cadbury Committee was set up by the London Stock Exchange in May 1991 *inter alia* to help raise standards of corporate governance

Due to outcome of 1997 economic and financial setback, Asian countries too became intensely involved in the subject of corporate governance. Challenges facing corporate governance reform in East Africa are corruption, weak regulatory enforcement, inactive shareholders, board weaknesses and predictable leadership.

Kenya enacted a new Constitution in 2010 that seeks to promote among others promotion of good governance through transparency, effective leadership and integrity. The Institute of Certified Public Secretaries of Kenya (ICPSK) established through an Act of Parliament CAP 534 is in the frontline of promoting good governance.

Firstly, due to the few studies regarding corporate governance in developing countries, and specifically in Kenya, compared with developed countries, this paper presents evidence concerning corporate governance practices. Secondly, it investigates the relationship between corporate governance practices and firm performance of listed companies.

In light of the issues raised above, the main aim of this research is to examine the perceptions of corporate governance practice in developing countries and the effect of corporate governance on firm performance.

Many empirical studies on corporate governance use a single variable in investigating the relationship between corporate governance and performance. The results are mixed with positive, negative and no correlation for both developed and developing countries

Other empirical studies use a corporate governance index but the results are different when different measures of performance is used

Specific Research Objectives

The specific objectives of the study are as follows:

(i) To determine the effect of the Board committee independence on Return on Assets.

(ii) To determine the relationship between equitable treatment of shareholders and Return on Assets.
(iii) To establish the effect of Board Size on Return on Assets.
(iv) To determine how Equity Holding affect Returns on Assets
(v) To determine how Board Meetings affect Return on asset

Significance of the Study

The findings of this study will provide a significant contribution to understanding the issues and the current state of corporate governance practices in the Kenya for many stakeholders, including policy makers and listed companies in NSE. This study will develop a Corporate Governance Index (CGI). The index can be used as an indicator by future researchers to continue research into corporate governance and decision-making.

In general, this study provides a comprehensive representation of corporate governance to practitioners with a clear view of the relationship between corporate governance principles, corporate governance mechanisms and firm performance.

Benefits of Good Corporate Governance are Investor confidence, Access to cheaper capital leading to growth Access to the best human capital, & improved Staff motivation and retention Better operational performance Infusion of new experience and ideas brought in by Independent directors Good management and constant monitoring of risks Reduced fraud Assuring the integrity of financial reports.

Scope of the Study

The paper summaries reviews of journals and articles for a five year period and making conclusions on the findings.

The study seeks to investigate the key issues associated with corporate governance of listed companies. A range of research methodologies used in previous research and review of empirical literature on corporate governance and performance nationally and internationally will be performed

Organization of the paper

The paper explores the nature and role of corporate governance and its effect on performance

Board size, Equity Holding, Board meetings, proportion of non executive directors and board committees are the measures of corporate governance while ROE, ROA and Tobin Q are the measures of performance.

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A review of conceptual literature follows the introduction. In particular, the literature discusses the subject of governance in the context of firms listed in various securities' exchange. Chapter three considers a review of empirical literature. The section presents key empirical studies conducted on corporate governance and performance, arising methodological weaknesses in terms of research design, target population, respondents, research setting, sample designs and inherent knowledge gaps. Chapter four considers conclusion and recommendation. A discussion of future research, potential policy implication and the limiting factors of the study

REVIEW OF CONCEPTUAL LITERATURE

La Porta et al. (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders, i.e. the managers and controlling shareholders. They then give specific examples of the different forms of expropriation. The insiders may simply steal the p rofits; sell the output, the assets or securities in the firm they control to another firm they own at below market prices; divert corporate opportunities from firms; put unqualified family members in managerial positions; or overpay managers. This expropriation is central to the agency problem described by Jensen and Meckling (1976).

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 main corporate governance theories upon which this study is based are the agency and stakeholder theories Jensen & Meckling (1976) further define agency relationship and identify agency costs. Agency relationship is a contract under which "*one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent*". Conflict of interests between managers or controlling shareholder, and outside or minority shareholders refer to the tendency that the former may extract "*perquisites* " (or perks) out of a firm's resources and less interested to pursue new profitable ventures. Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. The share price that shareholders (principal) pay reflects such agency costs. To increase firm value, one must therefore reduce agency costs. This is one way to view the linkage between corporate governance and corporate performance. Fama (1980) aptly comments that

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separation of ownership and control can be explained as a result of "*efficient form of economic organization*".

Stewardship theorists assume that managers are good *stewards* of the firms. They are trustworthy and work diligently to attain high corporate profit and shareholders' returns (Donaldson & Davis 1994). These *stewards* can cooperate and work closely with the principal to achieve a "*goal alignment*" (Davis et al. 1997).

This paper examines the relationship between corporate governance practice and firm performance in the context of companies listed. It includes corporate governance as the independent variable, and it shows corporate governance principles and corporate governance mechanisms. Firm performance is the dependent variable measured using return on assets (ROA) and Tobin's Q ratio

Emerging Issues

Female board members Smith etal (2006) shows that female board members have a better understanding of the market, they bring a better image, motivate junior female staff in business thus shows a positive relationship between female board members and firm performance.

Other emerging issues in corporate governance globally are corporate social responsibility and investment, leadership and strategic management, technology and identifying and managing risk Impact on corporate governance on SMEs.

REVIEW OF EMPIRICAL LITERATURE

Empirical models are used to identify the relationship between corporate governance and firm performance. The corporate governance measures are correlated with measures of firm performance, implying that corporate governance practice is linked to firm performance such that corporate performance is enhanced by good corporate governance practice (Jensen, 1993; Dao, 2008; Chan & Li, 2008; Rashid et al., 2010; Cheung et al., 2011).

Board Size

There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. However, recent thinking has leaned towards smaller boards. Jensen (1993) and Lipton & Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by, and increase the accountability of individual directors. Empirical research supports this. For example,Yermack (1996) documents

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that for large U.S.industrial corporations, the market values firms with smaller boards more highly.

Eisenberg et al. (1998) also find negative correlation between board size and profitability when using sample of small and midsize Finnish firms, which suggests that board-size effects can exist even when there is less separation of ownership and control in these smaller firms. Mak and Yuanto (2003) echo the above findings in firms listed in Singapore and Malaysia when they found that firm valuation is highest when board has five directors, a number considered relatively small in those markets.

Klein (1998) found positive correlation between board size and profitability. Large board size improve performance. And, 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).

Board Independent Directors

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. Duc VO and Thuy pan found no link between independent directors and firm performance.

Board Meetings

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.

Equity Holding

The cost of large shareholdings and entrenchment are formalized in the model of (Stulz 1988), which predicts a concave relationship between managerial ownership and firm value. In the model, as managerial ownership and control increase, the negative effect on firm value associated with the entrenchment of manager-owners starts to exceed the incentive benefits of managerial ownership. The entrenchment costs of manager ownership relate to a managers'

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ability to block value –enhancing takeovers. McConnell & Servaes (1990) provide empirical support for this relationship among U.S. firms.

In Asian economies, control by single shareholder is a common sight in firms (Claessens et al. 2000). Claessens et al. (2002b) find that firm value increases with the cash-flow ownership (right to receive dividends) of the largest and controlling shareholder, consistent with “incentive” effects. But when the control rights (arising from pyramid structure, cross-holding and dual-class shares) of the controlling shareholder exceed its cash-flow rights, firm value falls, which is consistent with “entrenchment” effects. La Porta et al. (2002), using samples in 27 wealthy countries, find evidence in firms with higher cash flow ownership by controlling shareholder improves firm valuation, especially in countries with poor legal investor protection. Baek et al. (2004) find evidence that Korean listed firms with concentrated ownership by controlling family shareholders experienced a larger drop in stock value during the 1997 financial crisis.

Using listed firms in eight East Asian economies to study the effect of ownership structure on firm value during the 1997 Asian crisis, Lemmon and Lins (2003) also find evidence that stock returns of firms in which ownership is concentrated in top managers and their family members were significantly lower than those of other firms

Board Committees

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.

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Emerging issues

There is also evidence that board size, together with other features of a board, is endogenously determined by other variables, such as firm size and performance, ownership structure, and CEO's preferences and bargaining power (Hermalin & Weisbach 2001).

Instead of looking at individual components, there are some recent attempts to construct index encompassing several corporate governance components and measure corporate performance against the index. For example, in U.S., Gompers et al. (2001) construct a "Governance Index" consisting of provisions related to takeover defenses and shareholder rights, and find that the index is highly correlated with firm value, measured by Tobin's Q.

Table 1.Summary of literature review

Title	Methodology	Findings	Research Gap
Corporate governance and firm performance-Vietnam DUC VO and Thuy Phan	Flexible generalized Least squares Method T Test F test	**Board size**-Negative in line with Jensen 1993 but klein 1998 found Positive relationship **Female Board members** Positive in line with smith etal 2006 **Duality of CEO** Positive relationship in contrast with Jensen 1993 **Board education Level** Not concluded **Board experience** Positive relationship in line with wegge et al 2008 **Board independent Directors** No relationship **Board compensation** Positive relationship **Board ownership** Nonlinear relationship In line with farma and Jensen 1983.	Corporate governance index should be used

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Corporate governance and financial performance of banks in post consolidation era in Nigeria International journal of social science and humanity studies Ahmad Bawa Adul-Qadir & Mansur lubabah Kwanbo	• T-test • F-test • 12 Banks • 2000-2006 • Multiple Regressions (Analysis of variance [ANOVA])	**Equity Holding in banks** Positive relationship in line with James oka for 2011 but becht et al 2005 took a mixed position **Board size** Positive relationship in line with Adams & mehran 2010 but in contrast with Jensen 1993 **Appointment of Chief Compliance officer** No relationship	• Considers only Banks
The Impact of Board Size on Firm Performance: Evidence from the UK The European Journal of Finance, Volume 15, Issue 4, June 2009, Pages 385-404	1981-2002 large and long panel dataset variety of regression models FEM,GMM	board size has a strong negative impact on profitability, Tobin's Q and share returns	
Board Composition and Firm Performance: Evidence from Bangladesh In Australasian Accounting, Business and Finance Journal By A Rashid,S.lodh, k.Rudkin &A.DeZoysa	linear regression	No significant relationship	One variable used • Theories are not wide
Corporate Governance Structures and the Performance of Malaysian Public Listed Companies	Mann Whitney U Test T-test	No significant relationship between duality and board independence to company performance	• Considers only listed companies

CONCLUSION AND RECOMMENDATIONS

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

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inconclusive, the practical importance of governance in relation to performance is globally acknowledged, especially in aligning the interests of managers and shareholders.

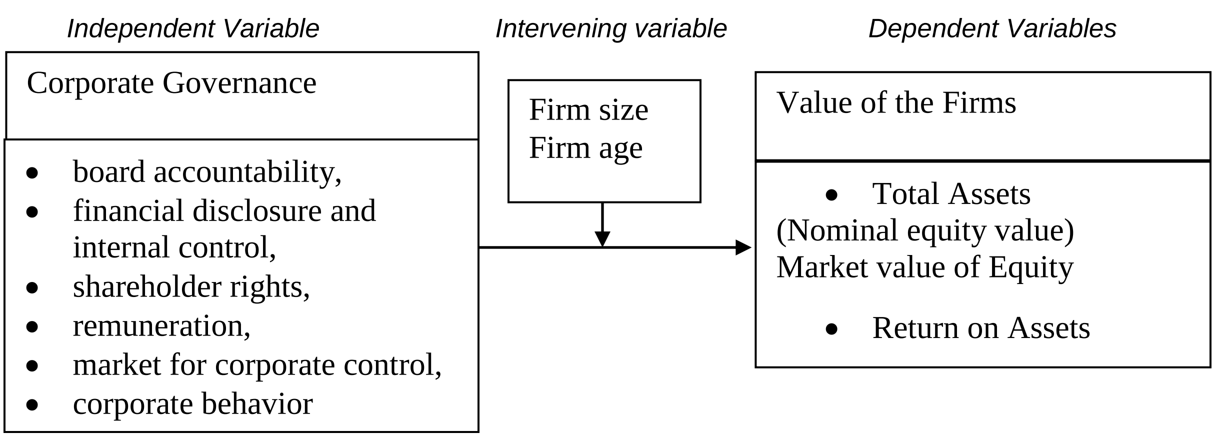
The inconclusive results of the empirical studies on this theme can be due to several factors. First, we can mention the choice of the variables used to measure both corporate governance and firm performance. While some studies use market-based performance measures like Tobin's Q, others use accounting-based performance measures (ROA, ROE, EVA). For measuring corporate governance in some studies only one mechanism of corporate governance is used, 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 the variation 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.

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.

Proposed Conceptual Framework

More comprehensive measures for corporate governance rather than a single governance mechanism should be used since all elements of corporate governance, in isolation, have effectiveness in aspects regarding performance and agency issues. A corporate governance index is used.

Figure 1: Relationship between corporate governance and value of the firms
(as conceptualized by the researcher)



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Recommendations on Further Research

Existing theories have not been sufficiently complete to include all major determinants of good corporate governance. Most of the empirical studies examined used agency and stewardship theories only More in-depth empirical study on the merits and demerits of family ownership structure and how has it impacted firm value. May be the resource dependency theory can better explain the success of these companies. If so, how corporate governance may evolve in these companies and what can be done to better align the interest of controlling family ownership and other shareholders.

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