CORPORATE GOVERNANCE AND FIRM PERFORMANCE

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Abstract:
Good corporate governance plays a crucial role in obtaining market confidence in supporting and facilitating the long-term international investment. Governments of many countries believe that the existence of best practices of corporate governance is a way to boost the economy and thus improve the performance of the national economy. In this article we intend to increase the understanding regarding corporate governance and the effects that good corporate governance has on company performance and on economic performance in general. In this paper we investigated which factors determine effective corporate governance. Also, we tried to provide a framework for understanding how a good or a bad corporate governance can affect corporate performance. After a literature review, we find that corporate governance matters for economic performance, insider ownership matters the most, outside ownership concentration destroys market value, direct ownership being superior to indirect.

Keywords: corporate governance, principles for corporate governance, firm performance,

Introduction

Compatibility of corporate governance practices with existing global standards, has become, today, a crucial factor for the success of corporations, especially multinational corporations, amid increasingly more pronounced globalization. It can be said that the existence of good corporate governance is an essential precondition for any corporation to conduct an efficient activity in a globalized market.

The concept of "corporate governance" is relatively recent, the last decades, both in public and academic debate and in the practice of companies.However, certain aspects which form the concept of corporate governance have been addressed much earlier in the economic theory, by Berle and Means in 1932 and we can say that perhaps earlier by Adam Smith in 1776. In the last two decades, corporate governance issues have become significate identifying with major takeovers corporations, financial restructuring of corporations and institutional investors activism. With time it crystallized the idea that corporate governance is a way to administer some form of organization - a corporation.

Garvey and Swan, from the idea that the corporation operates based on contracts (commercial, employment contracts, social, property contracts, etc.), believes that governance is the management of these contracts by the top management of organization. [7].

Shleifer and Vishny believes that corporate governance represent the way how capital owners ensure that they receive in return for their capital use optimal value of their investments [21]. The same view is shared by Caramanolis-Côtelli, showing that corporate governance is influenced by the allocation of capital among investors within the organization and those outside of the organization [4].

John and Senbet propose the more comprehensive definition that ”corporate governance deals with mechanisms by

which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected" [13]. They included among stakeholders not only shareholders but also creditors, employees, suppliers, customers, state institutions, representatives of local communities. Hart closely shares this view as he suggests that "corporate governance issues arise in an organization whenever two conditions are present (agency problem and transaction costs)" [10].

Zingales defines corporate governance "as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm" [24]. He shows that all the instruments of governance can be reinterpreted in the light of this definition.

An OECD study defines corporate governance as the instrument by which corporations are managed and controlled [19]. Corporate governance is one that ensures the allocation of rights and responsibilities among those involved in the distribution of value added generated by corporate (management board, managers, shareholders, employees and other stakeholders). Corporate governance is one that establish rules and sets procedures for conducting business effectively and optimal decision making approach. Through corporate governance it ensure also setting targets, the means of attaining those objectives and monitoring performance. Roe define corporate governance as "the relationships at the top of the firm - the board of directors, the senior managers, and the stockholders" [20].

In his opinion, corporate governance means those instruments that establish the balance of power between the board of directors, managers and shareholders. This balance is the one that influence and modulate strategic decisions addressed by senior management of the organization. He also believes that corporate governance should answer two separate questions, one that manifests itself in the vertical plane (the conflict between minority shareholders and managers) and another that occurs horizontally (the conflict between minority shareholders and shareholders who hold corporate control).

In this paper we propose, based on conclusions of other researchers [5,14,15], to approach the issue of the relationship between corporate governance and organizational performance. In this exploratory research we considered the balance of power established between the board of directors, managers and shareholders, given that their objectives may differ sometimes. If in the second section we expose the corporate governing principles, generally accepted, in the third section we review some of the ways to measure performance. The fourth section is devoted to identifying the links between corporate governance and firm performance. The final part summarizes the conclusions from the research.

Principles for corporate governance

Corporate governance is only one of the factors that influence the general economic context in which firms operate. In addition to corporate governance an essential role have macroeconomic policy, competitiveness and market type. In addition the governance way depends on the legal environment, power regulators, institutional environment. Other factors such as business ethics, corporate responsibility in relation to environmental issues and social problems of communities in which it operates, also can influence decisively the long-term reputation and market value of the company.

Based on his vast experience OECD has created a generic framework for corporate governance by defining a set of principles that aim to improve the legal, institutional and regulatory framework

regarding corporate governance, providing a set of useful suggestions for stock exchanges, investors, corporations and stakeholders who wish to contribute to the development of good corporate governance. The principles cover five areas (Figure 1).

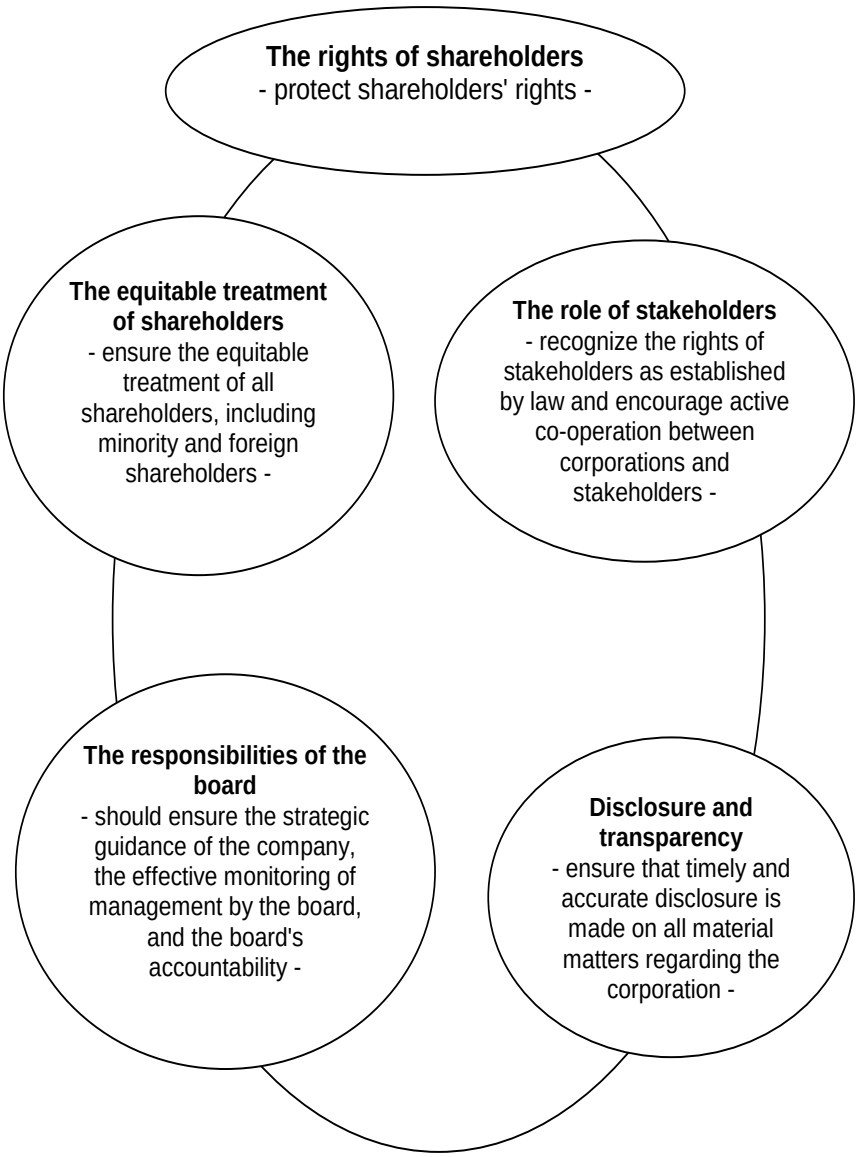

Figure 1. OECD principles for corporate governance
Source: OECD, 1999

The principles are intended to provide assistance to governments in creating a corporate governance framework, offering a platform for analysis of practices in corporate governance area.

Measuring firm performance

Three main approaches to firm level performance are found in social science research: research based on market prices, accounting ratios and total factor profitability (Table1).

Table 1 Measuring firm performance approaches

Measuring firm performance approach	Features	Most frequent indicator
based on market prices	readily obtained from national stock exchanges	Tobin's Q- a ratio comprised of a continuous time variable in the numerator and an annual, or semi-annual, value in the denominator
based on accounting ratios	readily obtained from accountancy of company	return on capital employed, return on assets and return on equity
based on total factor profitability	readily obtained from accountancy of company	economic value added, shareholder value

Source: Gugler, 1999; Maher and Andersson, 2000 and own considerations

For greater accuracy it is desirable to simultaneously use several methods to evaluate company performance.

Links between corporate governance and firm performance

The relationship between corporate governance and economic performance has been a concern ever higher for both academic and for experts in the field. This link has been linked to the degree of concentration of ownership and identity of controlling shareholders. There are two major categories of ownership concentration - outsider systems (widely dispersed ownership) and insider systems (ownership is highly concentrated).

Based on a comprehensive survey primarily of studies, Gugler concludes that “owner-controlled firms tend to significantly outperform manager-controlled firms” [8]. Thonet and Poensgen found “manager-controlled firms to significantly outperform owner-controlled firms in terms of profitability, but that owner-controlled firms had higher growth rates” [22]. Jacquemin and Ghellinchk, found “no differences between familial and non-familial controlled firms” [12].

Another factor that depends on the company's performance represents the type of industry that it is firm. Zeckhauser and Pound find that “the superior performance of owner-controlled firms holds in industries with relatively low asset specificity, but there was no difference in industries

with high asset specificity (ICT)" [23]. This suggests that the type of investment and the production process influence the choice of the method of performance evaluation firm.

Synthetically the papers mostly find either a positive or no link between outside concentration and performance. Morck et al., McConnell and Servaes, Belkaoui and Pavlik, Holderness et al. [2], [11], [18] find a non-monotone relationship between insider holdings and firm performance. Two other studies, Agrawal and Knoeber cannot detect a significant link.

Conclusion

Corporate governance is a relatively new area of study that is characterized by the existence of partial theories, some data insufficient, unclear or inconsistent, and methodology which is in a composition process. Corporate governance influences the degree of development of capital markets and their functioning, the allocation of resources. Due to economic globalization, information explosion, increased mobility of capital, good corporate governance can influence significantly the industrial competitiveness and economic performance. The investigations found that corporate governance mechanisms differ according to industrial sectors, type of activity productive and national and organizational culture.

Events of the last decade indicate that corporate internal control systems have failed to deal effectively with the globalization and informational era. This paper tried to provide a framework for understanding how a good or a bad corporate governance can affect corporate performance. After a literature review, we find that corporate governance matters for economic performance, insider ownership matters the most, outside ownership concentration destroys market value, direct ownership being superior to indirect.

Measuring performance by Tobin's Q is very often used, but it is desirable to use several methods simultaneously because other performance measures generally produce more fuzzy relationships.

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