Corporate Governance and Performance of Firm: A Literature Survey

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Abstract

This study aims to investigate the relationship between corporate governance and firm performance through previous studies. We find that previous studies are indicator of significant relationship between Board Size and firm performance, Board Composition and firms performance, CEO duality and firms performance while insignificant relationship between financial leverage and firm performance.

Key worlds: Corporate Governance; Performance; Board Composition; Financial Leverage; Board Size

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1. Introduction

The Corporate sector and ICAP are the main controller of capital market secretarial profession of Pakistan. SECP is responsible for the monitoring of the profession. IFRS foundation declares statements, which are used to take help in case of other requirements related to the economic reportage. In 2002, there were major frauds in WorldCom and Enron after that Sarbanes-Oxley act was issued, then there was made a code of conduct regarding the corporate governance in Pakistan by SECP and that code was mentioned compulsory to be adopted within the identical year 2002. Later on review of code was taken and revision of the code took place during 2012.A current issue of discussion in business is corporate governance. Shareholders/investors always try to get information that can be helpful for them to earn as much interest return as they can. Then a study (Fama, 1965) that is counted as an important study related to effective marketing. The results of study imposed a twist in the research and changed the focus of research studies to ultimate determination of issues such as prospective caring economic information related to industry strength, forecast profits, management ability, supply and demand, and different domestic affairs which can carry any kind of impact in the production ability or the value in stock market (Thomsett, 1998). Corporate governance can be counted among the most effecting aspects of firm governance, this area is studied at a large scale and here research is made in it to get best firm performance. A common mindset is that as better the corporate governance will be; better will be the firm performance. Corporate governance consists of different areas such as ownership structure, board size, Chief Executive Officer Compensation, CEO duality, audit committee and ratio of board conferences etc. The basic purpose of this study is to provide pit falls of most important pillars of corporate governance through literature. On the basis of previous studies we find the following main elements that contributes towards good corporate governance system.

1.1. Board Size

It is recommended in Corporate Governance Codes that board size should not be too big nor too small; here an ideal size of board may be 5-16 members according to the firm's diversification. According to Jensen (1993) in larger boards of bigger groups, there can be more element of gentility and graciousness. He also has focused upon smaller board size that it forms technical and structural changes which results as rationalizing of cost. As a result, these factors can lead to lack of truth and frankness. As here also a kind of board members, which do have some problems with the boardroom decisions but those, remain unable to speak out that problem, they are just compelled to agree the taken decision. Due to larger number of members in board, there exist different type of diverse opinions, which lead to a sort of agency problems. Here also an element of free-riding in bigger boards that some of the directors just put their burden, controlling and monitoring work to their colleagues on the board, hence neglecting of duties also increases. (David, 1996) Quote the organization with smaller sized boards hold higher stock market value as compared to groups with larger board. (Yermack, 1996) examine 452 larger units of U.S industrial corporations during period 1984-91 and got a simple negative effect of board size upon firm value even in cases of firm's **reversion.** According to the study of (Scott, 1998) corporations having a lesser executives on board are able to achieve even much better then firms having a larger board size. (Dan et al., 1998) find inverse correlation of board size with the firm value but (Catherine & Dalton, 2005) find opposite to them as they conducted an analysis of 131 studies and found that bigger boards are directly associated with better firm performance and value. Many authors have stated that, when the powers of the chairperson and CEO are given in a single hand, he gains complete authority and power of decision, by that latent conflict between board and management is decreased, which provides a way towards better firm performance (Khaled Elsayed, 2007; James & Davis, 1991; James, 1997)

(Chandra et al., 2001) emphasize that board size should be small by quoting that "Smaller size of board result to make a conclusion quickly". (Bernard et al., 2002) Also find no certain effect of board size upon firm value, but still in their study, there are hints about a negative effect of the board size upon firm value. Therefore, we can say that their study supports Yermark's statement. Whereas certain studies which show and state negative relations between firm value and board size such as (Y & Yuanto-Kusnadi, 2005; David, 1996; Carline & Scott, 2002; Martin & Theodore Eisenberg, 1998; Scott, 1998). According to (Hermalin & Michael, 2003) many firms also involve a representation for the minority shareholders, whose number are not merely increased by the changing board size (Stefan et al., 2004). In smaller board the element of expert advice and points around table remain missing which is found in larger boards. Moreover, larger board are also referred as having greater amount of skills, experience, nationality and gender. (Lawrence & Caylor, 2004) suggest that board size up to 6 – 15 members to attain an ideal performance of firm. (Nikos Vafeas, 2000) find firm having lesser members in board (at least five) are more effectively informed about the firm's earning and as a result they become able to have better control and monitoring (Morten Bennedsen, 2004) find in case of small and medium sized boards have negative impact upon firm value. (Catherine & Dalton, 2005) another point of view that by the increase of board size the performance of the firm increases directly but as a result, the presence of an additional board director identically reduces according to the increase of board's size (Vinish Kathuria , 1999). (Renee & Mehran, 2005) report contrary to (David, 1996; Wells & Stefan Sundgren, 1998) by showing a positive impact of corporate board size upon firm value. (Adams, 2005) states that this kind of performance may be in specific firms; that bigger board perform better in specific type of organizational structures. (Aggarwal, et al., 2007) argue no significant impact of board size upon firm value. All these authors have an idea of negative impact of board size upon the firm performance. In some studies, it has been seen that having greater quantity of outside executives simply reduces the hazard that any manager may deploy the finances and earning management (Beasley,1996; April Klein, 2002). (Laiba, 2011) investigate 12 various samples from Pakistani firms over six-year period (from 2004-10). In this study, researchers have determined a positive impact of board size upon firm value

1.2. Board Composition:

As a corporate board consists different number of outside executive [A member who is not directors in the firm, nor any investor, even any relative of the firm owner (Gallo & A, 2005), (Christopher Pass, 2004) defines outside directors as non-executive directors as persons who take on numerous responsibilities in the firm on a part-time based job. He may be the part of sitting for different type of firm committees such as audit committee, nominations committee and remuneration committee. For an effective corporate board sitting the board of directors must contain not less than 33% of outside executives (Mark, 1996).

As executive directors are supposed to play an active role as an authority agent to settle things between shareholders and firms' interest simultaneously (Oliver, 1987). At the same time, firms having greater number of outside directors have lesser firm performance as compared to other companies. To get ultimate suggestions and knowledge to board firm should have a board with proper mix of independent and dependent directors, this may lead to firm's profitability (Sanjai, 1999). In contradiction to (Sanjai, 1999) another study based on data taken from different companies of Bangladesh shows that the firms' performance is increased by effect of independent board directors (Afzalur et al., 2010). According to (Ali & Mohamma, 2011) more and effective non-executive board of directors boost the company performance. Results of study suggest a company should develop an independent board of directors as in that way firm performance can be increased due to effective independent directors. Study of (Dalton, 1998) employs a Meta-analysis which is conducted upon 69 sample trials of structure of board of directors and 159 sample trials of board composition. The study finds no impact of board composition upon corporate firm performance. Whereas, in a similar research study (Dawna & Paula, 2000) based upon Meta-analysis of 37 samples (all from the previous study) find a result of very small positive impact of board composition (ratio of outside directors in the board) upon corporate firm value. Study of (Khaled Elsayed, 2011) is based on 94 non-financial companies and proves there is no correlation between company performance and corporate boards. Researchers find more independent the board will be; greater will be the tendency of monitoring and firms need to hire an external Chief Executive Officer (CEO) for best efforts and performance (Benjamin, 2005; Adams et al., 2010). (Rashid, et al., 2010) Study the impact of the independent board composition upon the firm value with respect to reputed companies of Bangladesh. He determined that due to the presence of outside board directors there is an increase in the company progress. (Ali Safdar & Saeed, 2011) analyze the impact of ownership structure and corporate firm value with respect to companies of some developing markets of South Asia. They made a conclusion that in case of additional (outside, active) executives in the corporate board the firm value increases. By combining all effects, the conclusion is performance of the firm increases as the board is independent.

1.3. CEO duality:

A manager stays in a state of knowing accurately about assess or can manage things in the best way whereas the principle cannot be in touch with information so deeply. These points make up a position to oppose CEO duality (Oliver, 1985). According to (Williamson, 1985) for the better interest it should be a fact that chairman should not be the Chief Executive Officer (CEO). The agency theory, the organizations' proprietor is alluded to as the "principal" though the director is the "agent" office expenses are brought about if the activities of the administrator are not to the greatest advantage of augmenting shareholders' benefits, however are attempted for self-interest duality reduces the controlling roles over the managers and this step may result as the negative impact upon the corporate (Michael & William, 1976). CEO duality is practiced in 80% of the corporations of USA, as the CEO and chairperson of board is a single man (A, Jeffrey & Jarrell, 1997). CEO duality focusses power in the CEO's post, in sum allowing the person to hold most of decision power in one hand. In that case, dual office structure also allows the chairperson to control the available information effectively then other directors in the board and that may result as effective management of firm (Jensen , 1993). If CEO duality does can effect as positive firm management, it would also be associated with better control of decision-making. Thus, effective decisions will improve firm performance. (Donaldson, 1991; Brickley, 1997) state the separation of CEO and chairperson as a perspective of benefits and costs, whereas CEO duality is the optimal management system. According to (Worrell, 1997) a firm announces CEO duality, the stock market badly responds to this affect, with an image of CEO duality negatively effects the management of the corporate board. Bad governance has a correlation with CEO duality as in cases of the use of "poison pills" or in cases of antagonistic takeovers (R & Shleifer, 1988). Different studies hold different arguments some are to favor and some to challenge the theory of CEO duality. "The stewardship theory, characterizes the supervisor as a steward who picks up a feeling of accomplishment by being high-performing and taking activities that are favorable to the investors benefits". (Muth & Donaldson, 1998) says that when the powers of the CEO and chairperson are in a single hand then he becomes empower to make definite and clear-cut decisions in the favor of firm, as a result taken decision and steps become effective for firm value. The correlation between firm performance and corporate governance is determined by (Yasser & Shazali Abu, 2011) utilizing two variables (Return on Equity and Net revenue) and four corporate administration variables (board size, audit committee, board composition and CEO Duality). The study finds distinctive relations among them. According to (Sheikh & Wang, 2012) CEO duality and concentrated ownership are linked directly with the firm performance. Moreover. CEO duality also have a direct relation with book-based measure of company performance. CEO duality is an element that can inversely effect observation of general manager by the corporate board members, which can result as an undesired state of the performance of firm (Leslie & Levy, 1981; Dayton & N, 1984).

1.4. Financial Leverage

(Rajni & Saini, 2012) investigate the impact of financial leverage upon market capitalization and stakeholder's profit in telecommunication sector companies of India. To determine this, financial data of seven firms gathered. Through t-test and correlation test, the study finds a negative relationship between market capitalization and financial leverage, while financial leverage and stakeholder's profit has a positive relation.

Impact of financial leverage upon firm performance and influences of company's economic condition is studied by (Cheng, 2010). To study the required field they got data from Taiwan Securities Exchange (TSE) of 645 listed firms based upon annual report of nine (09) years from 2000-2009 successively. For their study, financial leverage is taken as an independent variable whereas firm value is taken as dependent variable. The study concludes if firms do not consider bankruptcy possibilities then the values are greater for leveraged firm as compared to unleveraged ones. Moreover, if cost of debt is measured instantaneously, then leverage before reaching firm optimal capital structure is positively associated to the firm value. In corporate finance, there has been a vast research on the impact of debt in capital structure. Franco Modigliani and Merton Miller show a new face of corporate finance to the world during the year 1958. They show that there is no significant impact of the financial leverage upon the firm performance (Franco Modigliani & Miller, 1958). In their concept of the study, they do not involve the effect of taxes, bankruptcy costs, information symmetry and transaction cost. (Saini, 2012) investigates the impact of financial leverage on shareholder's profit and market capitalization. The research is based on data of different telecommunication sector companies from India and conclude that financial leverage has negative relationship with shareholder's return and market capitalization. (Akbarian, 2013) investigates impact of financial leverage and environment risk on firm performance in firms listed on Tehran stock exchange. The study concludes a positive relationship between economic risk and variable market risk (with free cash flow per share) and between cash flow per share and financial leverage. (Rataporn Deesomsak & Gioia Pescetto, 2004) use data of Malaysian firms and find negative relation between net profit margin and financial leverage. (Ivalina Kalcheva, 2007) use panel data gather from publicly held companies to examine impact of financial leverage upon the firm value to study the effective role of debt. The study develops different conclusions at higher and lower levels; as upon lower level study describes a positive impact of financial leverage on the firm value (employee productivity). However, in higher level study shows negative relationship between both variables.

2. Conclusion

Corporate governance maintains a fundamental portion in the firm performance. The decision about the corporate governance directly affects firm value. The aim of research work is to inspect the most important pillars of corporate governance and their impact on firm value through previous literature. From previous studies it is clear that Board size, Board composition, CEO duality and financial leverage are most important components of corporate Governance and considered as major contributing factors to profitability.

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