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Research Article

CORPORATE GOVERNANCE MAKES COMPANY PERFORM BETTER, DOESN`T IT?

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ABSTRACT

The need for corporate governance comes from separation of powers between ownership and control in large corporations which are built on each other to protect investors` rights by reducing managerial discretion over business decisions. Business flourishment is a basis for countries` proper development in terms of capitalism providing that such prosperity is based on a rational legal system. Affluent nations who were able to form strong institutions to protect property rights and enforce contracts are far too ahead of developing countries that fail to set up such legal instruments to eliminate loopholes in their systems thus not being able to enjoy world market opportunities. The legal systems of the nations, especially those courts who implement law and order among the persons, are said to play an important role in availing or restricting business activities. In the formation of good corporate governance in the developed world, historically common law and civil law practices had a lot to say. This article will discover some peculiarities of both systems.

KEYWORDS

Corporate governance, legal systems, pre-determined goals.

INTRODUCTION

Corporate governance is a tool for handling the separation of roles between the major players of business for the sake of long term value creation. There is ongoing debate over the absence of sufficient incentives for managers to act in the best interests of their shareholders who may well lead to low economic performance through pursuing short term goals. Performance as the evaluation indicator in this context is generally defined as achievement of pre-determined goals and meeting firm`s objectives within the time limits pre-defined earlier.[1] Managers acting as agents of the firm`s shareholders assume the responsibility to balance priority of different stakeholders of the company, and sometimes have conflicting interests with the shareholders. Theoretically, best corporate governance should align expectations of all stakeholders enabling their voices to be heard and providing cooperation toward a common goal which together forms the dynamics of corporate governance.[2]

THE MAIN RESULTS AND FINDINGS

However, in most studies the existence of correlation between the firm`s performance and managerial behavior has gained momentum, and in the new millennia the importance of corporate governance did not receive enough attention leading to so called crisis of confidence remarked by the Conference Board's Commission on Public Trust and Private Enterprise in January 2003.[3] Such correlation has contributed to the emergence of two ambivalent views, more specifically the lesser is the board size the better is financial success of the enterprise, meanwhile, better economic progress is the fruit of boards comprising a lot of members; both assumptions offer that board size is the determinant of level of control in the firm.[4] Independence of the directors means there is bigger proportion of outsiders[5] (Anglo-American model) which is advised to be strengthened by the New York Stock Exchange and Nasdaq standards.[6] At the same time one research indicated that inside directors have a priority over outsiders since they have day-to-day

[1] DUCA F, "Does Corporate Governance Enhance Firm Performance?: An Empirical Literature Evidence" <https://pdfs.semanticscholar.org/1e28/edab3e9fa94ceadf449be18f8130405b7d25.pdf> (accessed 20 February 2020) 53

[2] Deloitte – Nyenrode Research Program, 'Good Governance driving Corporate Performance?' 2016 <https://www2.deloitte.com/content/dam/Deloitte/nl/Documents/risk/deloitte-nl-risk-good-governance-driving-corporate-performance.pdf > (accessed 20 February 2020) 6

[3] Young B, 'CORPORATE GOVERNANCE AND FIRM PERFORMANCE: IS THERE A RELATIONSHIP?' (IVEY Business Journal 2003) <https://iveybusinessjournal.com/publication/corporate-governance-and-firm-performance-is-there-a-relationship/> accessed April 3, 2020.

[4] Zahroh Naimah and Hamidah, 'The Role of Corporate Governance In Firm Performance' (2017) 34 SHS Web of Conferences <http://repo.uum.edu.my/21077/1/shsconf_four2017%201%206ivv.pdf> accessed 1 April 2020. 2-3

[5] Ibid

[6] Young B, 'CORPORATE GOVERNANCE AND FIRM PERFORMANCE: IS THERE A RELATIONSHIP?' (IVEY Business Journal 2003) <https://iveybusinessjournal.com/publication/corporate-governance-and-firm-performance-is-there-a-relationship/> accessed April 3, 2020

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operations of the firm which is why are capable of increasing firm performance.[7]

Having analyzed 22 samples, Rhoades et.al testified considerable correlation between the board structure and firm performance which demonstrated better performance in two-tier boards (German model) compared to that of Anglo-American companies with CEOs interwoven responsibilities.[8] The companies with better corporate practices tend to pay out relatively higher dividends to the shareholders with more valued shares.

Research conducted with 312 quoted companies of the UK demonstrated that there were only 41.6% of non-executive members of the UK boards, and only 16% of the companies had the same person as CEO and chairman after this had been recommended by the Cadbury Report to avoid collecting too much power in the same hands. But this study failed to prove the positive interrelation between the CG mechanisms and company`s financial performance since such performance is dependent on different variables other than CG.

Numbers prove existence of casual link between the performance and good governance

The importance of corporate governance as a crucial blueprint for the enhancement of corporate management rather than a mere compliance code has found its empirical base in one of the recent findings that included 350 companies operating in 10 sectors in 10 sectors namely, Basic materials, Consumer goods, Consumer services, Financial services, Healthcare, Industrials, Telecoms, Technology, Oil and gas and Utilities in the time frame from 1996-2012. This study testified that proper code of corporate governance implemented in the business adds value to financial indicators occurring not less than 70%. The UK Code of CG as a mother of more than 100 similar codes across the Globe, when complied with helps enterprises to become 29% efficient at making profits and 43% better at selling products, with top companies doubling share returns to their shareholders. These outcomes are of strategic importance to those who earlier criticized CG as something to be tolerated with. It was also identified that low-performing companies had better financial performance as they improved their CG. When compared with companies that had poor corporate management systems, top quartile companies showed 90% of probability of outperforming the former in generating value for stockholders in terms of free cash flow. The research concluded that when corporate governance is applied in key areas (business model clarity and connectivity, culture and value integration, risk management, internal controls, board effectiveness and succession planning) there is a stronger likelihood of creating a dynamic atmosphere with subsequent improved decision making in the business.[9]

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7 Stanwick, Peter A., and Sarah D. Stanwick. "The Relationship between Corporate Governance and Financial Performance: An Empirical Study." (*The Journal of Corporate Citizenship*, 8 2002): 35-48. accessed April 3, 2020. <www.jstor.org/stable/jcorpciti.8.35.>

8 DUCA F, "Does Corporate Governance Enhance Firm Performance?: An Empirical Literature Evidence" <https://pdfs.semanticscholar.org/1e28/edab3e9fa94ceadf449be18f8130405b7d25.pdf> (accessed 20 February 2020).

9 Bell S, '**Corporate governance and company performance** A proven link between effective corporate governance and value creation', (Grant Thornton 2019) <https://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/documents/corporate-governance-and-company-performance.pdf > accessed 10 March 2020. 10-14

Meanwhile, the sample of 270 companies of German origin for the period from 2000-2006 years was studied in terms of their performance measures, ownership structure and board characteristics, ownership structure instruments and control. The study revealed that concentrated ownership does not itself impact on the level of performance due to its having various types. As insider ownership firms, German companies incur higher level of agency costs since outside minority shareholders face difficulties monitoring insiders resulting in negative effect on performance. One of the profound findings of the research was to prove the positive link between the presence of institutional shareholders in the company and its performance pushing companies there to promote cross listing to attract investors. It also re-supported the earlier view that companies with few outsiders in their supervisory boards are significantly more likely to outperform those with higher portion of outsiders in the boards.[10]

Apparently, corporate governance system is not an only indicator of firm`s success in financial terms. But many scholars have proved the existence of the link between corporate governance and firm performance. When shareholders are positive about laws that can make their directors to work in good faith[11] they will invest more, also managers who are assured that there will not be litigation abuse against them can pursue company goals more efficiently.

English directors are satisfied with their codes, but are Germans?

In order to explore the attitudes of companies to corporate governance and it being codified, 48 interviews conducted with legal advisors as well as senior directors of German companies and secretaries of the UK companies are analyzed. Codes taken to regulate corporate behavior are UK Corporate Governance Code 2018 (developed from the original Cadbury Report every time with some additions[12]) for the UK and Cromme Code for Germany. The former is said to be voluntary comply-or-explain provided that proper justification is provided for non-compliance, while the latter contains both soft law and hard law as well as aspirations which is not either binding or requires explanation for not being complied with[13]. Based on the extracts from the interviews appended in the research many UK companies are assured that code of corporate behavior reflects best practices evolved within the companies.[14] Each development of

[10] Ivashkovskaya Irina and Zinkevich Nadezhda, 'The relationship between corporate governance and company performance in concentrated ownership systems: The case of Germany' (Journal Korporativniye Finansi 12 2009) <file:///C:/Users/My%20Pc/Downloads/1650-%D0%A2%D0%B5%D0%BA%D1%81%D1%82%20%D1%80%D1%83%D0%BA%D0%BE%D0%BF%D0%B8%D1%81%D0%B8-3096-1-1-20161221.pdf> accessed 15 March 2020 15-18

[11] Hans-Bernd Schäfer and Hüseyin Can Aksoy, 'Good Faith' [2015] Encyclopedia of Law and Economics <http://file:///C:/Users/My%20Pc/Downloads/Encyclopediagoodfaith.pdf> accessed 5 February 2020.

[12] *Corporate Governance In Commonwealth Countries:* Corporate Governance in the United Kingdom Chapter 16 (International Centre for Research in Accountability and Governance 2019). <https://www.researchgate.net/publication/332694263_Corporate_Governance_in_the_United_Kingdom> accessed 15 February 2020

[13] Sanderson and others, (Centre for Business Research, University of Cambridge, Working paper No. 407, 2010) <https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp407.pdf> accessed 15 February 2020. 2-3

[14] Ibid 5

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the rules was highly in response to the changes in corporate needs of the time where domination was taken by major players not the government. German firms, on the other hand, do not feel their ownership over the Code since they believe that German code of good management was developed in response to recourse by foreign needs. One of the interviewees stated that the main concern of the governmental commission was to demonstrate Germany as a better place for foreign investors which made the code unattainable for some. Government in its term failed to provide cross-section participation in drafting for it was under pressure from Anglo-Saxon media that propagated Germany as a developing country in terms of corporate governance.[15] When entities do not feel involved in the adoption of laws that directly influence them they will not feel a degree of appreciation to the legal framework surrounding them. So is the case with Germany which passed such regulation in a relatively shorter time and letting small companies feel under-represented as well as putting bureaucracy on bigger businesses. Small companies simply see corporate governance as something not designed for them but rather as a marketing tool to push Germany into financial market. While top companies commented it as not democratic and drawn by someone who has never been inside the business. Moreover, new millennium recorded 300 percent more turnover of CEOs in North America, Europe and Asia which was claimed to have a strong link with shareholders being dissatisfied with comparatively low returns on shares. Because, when these forced dismissals happened performance rate was 7.7% lower compared with the years when CEOs left with usual reasons such as retirement, poor health or other conditions. This period has been described as short-termism with frequent changes in CEO position. Also, formers CEOs are blamed for dragging the company back when appointed as chairman.[16]

Deviations from rules are not always justifiable

Numbers demonstrated supporting results for the views mentioned about the UK and Germany. With 257 listed companies studied, there were 750 deviations from the rules established in those codes in 2006. The success of the application of the Codes is dependent on the integrity between the shareholders and managers who should understand importance but keep in mind that one does not fit all and there is always room for reasonable non-compliance. To study the compliance rate in maximum equal terms only recommendations part of the Cromme Code was taken excluding those parts of full compliance and parts that are merely suggested without insistence on explanation in case of non-compliance. According to research UK companies with high performing characteristics were on top quartile of compliance; FTSE top 30 recorded 66.67 conformance with the Code, and 20 of which were in 100 percent conformity with the recommendations. German companies listed on Dax 30, MDax and SDax 50 each were studied based on their annual reports which showed only 18 full-compliance (14.06%) with 4.40 average number of deviations (in the UK it was 0.60).[17] The provisions with which UK companies least complied was regarding not

[15] ibid

[16] Lucier and others, 'CEO Succession 2004 The World`s Most Prominent Temp Workers', (Booz & Company 39 2005) < https://www.strategy-business.com/media/file/sb39_05204.pdf > accessed 15 February 2020. 5

[17] Seidl and others, 'Applying "comply-or-explain": Conformance with Codes of Corporate Governance in the UK and Germany' < https://www.researchgate.net/publication/228429847> accessed 10 January 2020. 14-15, 20-21

having the same person on positions of CEO and Chairman which was said to threaten independence of the Board.[18] Even though above study demonstrated significant differences in compliance rates of the two countries, there are some points to consider. German code of good governance is relatively new adopted a decade later than its British fellow which means German companies may be in the process of adoption. Moreover, the huge gap between the numbers of provisions complied in the UK and Germany can be accounted for the difference between total numbers (82 provisons in Cromme code while only 48 in the UK, almost twice less). However, most intriguing feature in the study is that whether such numbers of non-compliance is showing flexibility of the code that was initially intended or it is just the mask under which managers are pursuing their own interests. Since, the main target behind the composition of the codes was to protect shareholders` interests, the only way seems to explore into what was indicated in the reports as explanation for deviations which still may not correspond to actual motives of the directors. This has been indicated as the limitation of the research. We are only able to make approximate assumptions based on the numbers to choose a better code for compliance from experienced practitioners of the sphere. When Oxera conducted research on behalf of London Stock Exchange the UK corporate governance code was one of the factors encouraging companies to choose the UK over the US.[19] This reinforces the view that the UK corporate mechanisms are comparatively favoured regardless of possible dishonest deviations by directors.

CONCLUSION

This paper is only a shallow analysis of the topic. There are many factors surrounding and influencing this phenomenon worldwide. Corporate governance based on international standards is effective tool for transition countries to step toward a market based economy. Therefore, corporate governance has strong ties with the development of business strategy in a right way considering the interests of main participants. I want to finish my work with the famous quote by **Alexander Pope**:

> *For forms of Governance let fools contest,*
>
> *Whatever is best administered is best.*

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[18] Maassen, 2002. Corporate governance UK p5. Indeed, studies have shown that in terms of return of equity, ROI and profit margin, the firms with independent leadership clearly outperformed the once with CEO-duality.

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