Australian Journal of Basic and Applied Sciences, 10(9) May 2016, Pages: 120-126

AUSTRALIAN JOURNAL OF BASIC AND APPLIED SCIENCES

ISSN:1991-8178 EISSN: 2309-8414
Journal home page: www.ajbasweb.com

On the effect of Corporate Governance Mechanisms on Firms Performance

Mohammed Abdelshakour Shehata

Assistant Professor Dept. of Accounting, Faculty of Business and Economic, Qassim University, KSA Minofia University, Egypt.

Address For Correspondence:
Mohammed Abdelshakour Shehata, Assistant Professor Dept. of Accounting, Faculty of Business and Economic, Qassim University, KSA Minofia University, Egypt.

ARTICLE INFO
Article history:
Received 3 March 2016; accepted 2 May 2016; published 26 May 2016

Keywords:
corporate governance, board of directors, ownership structure, firms performance.

ABSTRACT
In this paper we aim to discuss the effect of corporate governance mechanisms on firm performance. Using a panel data of 69 American firms publicly traded in the USA between 2004 and 2010, and OLS regressions, our results indicates that corporate governance mechanisms especially the board characteristics, the ownership concentration, CEOs age and his/her education nature can largely affect the ROA measure of firms performance.

INTRODUCTION

Corporate governance is a set of rules and behaviors which determine how companies are managed and controlled (Zingales, 1998). Good corporate governance will achieve its goal by establishing a proper balance between leadership, entrepreneurship and performance, on the one hand, and monitoring and compliance with those rules, on the other. Good governance should be integrated into the company's values. It provides mechanisms to ensure leadership, integrity and transparency in decision-making. It must help to set the objectives of the company, how to reach them and how to evaluate the performance. "

As defined by the principles of the OECD, "the corporate governance structure specifies the distribution of rights and responsibilities among the various players in the life of the company, such as the board, managers, shareholders and other steckeholders "

So the corporate governance ensures sustainable and effective process of value creation in compliance with all internal and external parties involved, and compliance with legal regulations, internal rules and ethical principles. Its objective is to improve the performance and profitability of transactions entered into by the company by making decisions in a cooperative, transparent and above all controlled by different organs of society.

Corporate governance is characterized by internal mechanisms aimed to influence and monitor the behavior of the leader. These mechanisms, including one distinguishes the disciplinary role assumed by the board and ownership structure.

The rest of paper is organized as follow: section 1 reviews the appropriate literature around the relationship between corporate governance and firm performance. Section 2 presents the model, describes our methodology and variables measurement. Section 3 gives details about our data. Section 4 discusses our results. Section 5 concludes the study.

To Cite This Article: Mohammed Abdelshakour Shehata., On the effect of Corporate Governance Mechanisms on Firms Performance. ***Aust. J. Basic & Appl. Sci.,*** *10(9): 120-126, 2016*

1. *Literature review and hypothesis development:*

The agency problem between shareholders and managers are also in the business. Poor management of relations between the partners, including shareholders and directors may be the cause of the inefficiency of the firm even if it is privatized. It thus appears that the leaders are at the heart of attention because they are the main decision centers. Strategic commitments, organizational or financial are responsible for the creation or destruction of shareholder value.

As in any managerial business interests of bank executives and owners of capital may differ. Encouraging managers to risk taking depends on the degree of alignment of their interests with those of shareholders. Under the assumption of control, managers can monitor banks and take excessive risks not aligned with the will of the shareholders. In this vein, the concentration of ownership is an effective means of control of management decisions.

Two contracts models can build the agency relationship: the contract based on behavior, whereby the agent agrees on actions that will make on behalf of the principal (and not results) and the contract based on the result, for which the agent commits the result of the actions it will perform on behalf of the principal (and not the means to achieve them).

In this spirit, corporate governance is based on the idea that it is important to establish a system to minimize conflicts between the principal and the agent to maximize wealth creation for the firm. This can be done by establishing an effective governance system. In general, the firm's managers have opportunistic behavior, allowing them to increase the benefits they derive from their job and do not honor their commitments faith the signed contract.

The behavior of a manager depends on the amount of capital it holds. Over this share is, the more it has to manage interest seeking to maximize the value of the firm.

A firm is said to be well governed if it meets a certain equity among its stakeholders, its efficiency will strengthen the long term. It must then apply a governance system that assesses performance and punishes leaders of the firm.

1.1 The board of directors:

The board of directors is no longer a mechanism contributing to the creation of value, but a tool of power, domination, annuity research, creation of social norms. In the financial contract theory of governance: the Board is involved in encouraging leaders to be effective, either by compensation systems, is threatening to evict them. Its disciplinary role is lower in companies whose capital is dominated by the family of the leader, the discipline being provided by the majority shareholder. In addition, the board of directors has the power in its disciplinary function to span other stakeholders of the firm.

In partnership theory of governance: the board of directors is considered instrument facilitating the creation of value for all stakeholders of the company. Indeed, the board of directors acts as a hierarchical body which, in addition to its role of arbiter in the rent sharing, should encourage teamwork.

In the strategic theory of governance: the board of directors is considered a cognitive instrument to assist in the creation of skills. Indeed, the board of directors is required to facilitate the development of skills and help build new strategic options.

The Board of Directors has a right of oversight on risk management as a whole and through the Committee Risk Committee and the Audit and Compliance Committee. This is a crucial mechanism of the internal control system that allows to discipline and set the rules with the leader.

In a complex sector such as banking, the Board of Directors plays a key role. Given the opacity of the banking activities and the existence of deposit insurance, the control exercised by the board is much more important than that of other stakeholders.

1.1.1 The board independence:

First, the definition of independence of board members requires more details in the case of a banking firm.

The IND variable measures the proportion of independent directors on the board. Based on the best practices guide for corporate governance, an independent director we mean a director who is not employed or linked, directly or indirectly, to an entity having trade links, financial or significant business with the bank or with one of the majority shareholders.

The board includes two types of administrators: dependent and independent. Dependent directors who are members of the management team serve on the Board for information purposes while independent control it. The independent directors have more incentive to monitor management and ensure that they pursue policies consistent with the interests of shareholders.

External independent directors exercise more effective control and internal and external directors affiliates. Dependent internal directors do not have the authority to control and especially challenge the decisions of leaders to the extent they are answerable to the people they must control.

A director is called internal if he works for the bank. It is said affiliate, if he has or had a business relationship with it or a kinship or other relationship with his managers. Any other director is considered by the authors as external or independent. However, the credit relationship between the directors and / or their employers and the bank are not explicit. It is therefore difficult to consider them as the criterion of independence. Furthermore, studies addressing the impact of the degree of independence of the board on the performance of banks are not abundant and found different results. Thus, Griffith (1999) states that boards dominated by outside directors more control bank managers from those dominated by inside directors.

The theoretical impact of the independent directors on the credit risk is under debate. The independent director can better control managerial decisions. Nevertheless, it may encourage excessive risk taking credit of the leaders when deposits are insured in an implicit or explicit. Empirical results are also controversial.

H_1: the board independence is positively associated with firm performance.

1.1.2 The board size:

The size of the board can influence decision-bank risk. According to the agency theory, the effectiveness of the Board as a control mechanism, depends on its size. The disciplinary function is better served by a smaller board of directors, composed of 7 to 8 board (Jensen, 1993). A small size of the board has a more effective internal control. It can reduce the agency conflict between shareholders and managers: administrators control officers and thus maximize the return on investment of shareholders.

As part of the agency theory, the small size of the board allows better communication and cooperation among administrators to control managerial decisions.

Within banks, a restricted Management Board is associated with excessive risk taking. The shareholders interested in maximizing their return on equity are prone to risk-taking at the expense of depositors.

When the board is restricted in size, shareholders can exercise direct control, through the directors on managerial decisions. In a small board, coordination of views of Executive Directors is easier and the decision making is faster.

The Board is thus a body which can reduce conflicts of interest between different stakeholders. According to the agency theory, the large size of the Board promotes its domination by the leader and eventually creates conflicts of interest between directors and managers. This creates a fragmented board, inefficient and with difficulties to reach a consensus on important decisions.

H_2: the board size is negatively associated with firm performance.

1.1.3 The duality:

Duality means the appointment of the same person, over the same period, the two posts of CEO and chairman. She has significant costs that offset its potential benefits to most large firms.

Supporters of the agency theory argue for the separation between the function of Chairman of the Board of Directors and the CEO (Fama and Jensen, 1983; Jensen 1993).

Some researcher assumes the dual focuses the power of information and decision-making in the hands of the leader only. This monopoly of power accentuates the conflict of interest and is also a source of the impartiality of the control exercised by the board, it promotes rooting the President and confused management and control board. While another researcher assumes that duality improves the strategic vision of the firm that facilitates strategic decision making.

Duality allows a concentration of power in the hands of one person who will at the same time judge and party. Therefore, there is consolidation of the control and decision-making within the bank. The board of directors will be under the control of leaders and thus cannot assume its disciplinary role.

The CEO, control of the board, can act so that his interests are aligned with shareholders' interests at the expense of other stakeholders by adopting risky strategies.

However, the main leader can oppose strong incentives of shareholders and uphold their own interests. In wanting to preserve its human capital in the bank, it will tend to reduce bank risk. The combination of these two functions thus enables better decision-making through better communication between the management team and the board of directors.

The President of the Council, as being the principal officer of the bank, tends to take less risk to protect its human capital. Besides that the leader is more risk-averse nature and when he also chairs the Board of Directors, it will be less aligned with shareholder interests. If the CEO of the bank holds more power and ability to control the decisions of the board, the firm will be exposed to less risk and it will be more effective.

In their prior works Fama and Jensen (1983) and Jensen (1993) argue that the duality can reduce a board supervision of the management company a thing that reduce firm performance.

H_3: the duality is negatively associated with firm performance.

1.2 The ownership concentration:

The relationship between ownership concentration and firm performance seems to be theoretically complex and empirically ambiguous (Earle et al. 2004). The prior work of Shleifer and Vishny (1986) theoretically demonstrate that ownership concentration can improve the firm performance by increasing monitoring and alleviating the free-rider problem in takeover. The agency theory frame work can be also used in order to predict the positive effect of ownership concentration on reducing agency costs and so increasing the firm performance levels (Jensen and Meckling, 1976).

Empirical studies show that results around the potential effect of ownership concentration on firm performance are mitigated. In fact, a wave of research papers shows that there is a negative relationship between these variables. We can refer to the studies of Demstez and Lehn (1985) and that of McConnell and Servaes (1990) who report a negative effect between ownership structure and firm performance level. In the other hand, some other studies show that this relationship is positive. Regarding the fact that the positive effect is reported by both theory and empirical findings we will suppose that there is a positive effect of ownership concentration on firm performance.

H_4: Ownership structure can positively affect firm performance.

1.3 CEOs personal characteristics:

In this study we aim also to control for the possible effect of CEOs personal characteristics in explaining firm performance. We focus on the effect of CEOs age and his/her education nature.

1.3.1 CEOs age:

The effect of CEOs age on corporate policies is for interest since the existing of an extensive number of studies that document that this variable can largely affect CEOs decision making process. In fact, prior results from Taylor (1975) show that the age of CEOs can affect their decision making. Especially, CEOs who are older can make optimal decisions because they have the ability to analyze in depth the environment changes and more generally information. They so can be more effective in managing their firms and this will positively affect firm performance.

Another important empirical finding is reported by Shefrin (2001) who demonstrates that the risk aversion is increases with CEOs age. This means that older CEOs will do not make risky decisions regarding their risk aversion caused by their ages, a thing that can help firm to be more effective.

More recently, results by Malmendier and Tate (2005) show that CEOs age can reduce corporate investment distortions and this will help increasing firm performance.

H_5: CEOs age can positively affect firm performance

1.3.2 CEOs education:

According to Bhagat et al. (2010) CEO ability is the composition of observable and quantifiable characteristics such as education and work experience, as well as unobservable and potentially non-quantifiable characteristics such as leadership and team-building skills.

Using a small sample of approximately 500 firms from the year 2002, Gottesman and Morey (2006) find that school quality is not systematically related to firm performance. They also find that a CEO having a law degree or an MBA is not associated with better firm performance, but they do find limited evidence that a CEO having a non-MBA master‟s degree is associated with superior operating performance.

Bertrand and Schoar (2003) consider managerial style more generally and find that CEO specific fixed effects are important determinants of firm decisions and firm performance, as measured by Return on Assets and Tobin‟s Q. Bertrand and Schoar (2003) consider a dummy variable for whether or not the CEO has an MBA. In further tests, they find that CEOs who have an MBA degree are associated with Return on Assets levels on the order of 1% higher than for non-MBA graduates, and that CEOs with an MBA are, in general, more aggressive managers.

Fligstein (1990) suggested that the educational background of CEOs may affect the way they perceive organizational challenges and the cognitive process they use in the decision making process.

Xiaowei & Zhang (2010) use a high level of CEO education to measure a good capacity to process information and flexibility to openness, innovation and development of strategic decisions.

Ayaba (2012) examined the impact of CEOs' educational background on firm performance by using listed firms in the Stockholm stock exchange as evidence, particularly in manufacturing and IT sectors. The results of this study suggested that CEO educational background and educational level have a limited impact in accounting for differences in firm performance.

Koyuncu et al. (2010), examined how CEO educational background affects firm performance based on a sample of 437 CEOs of firms selected from S&P 500 for the period from 1992-2005. The results indicated that those firms led by a CEO with an educational background in operation related issues such as engineering outperformed firms managed by CEOs with other functional background.

H_6: CEOs education can positively affect firm performance.

2. The model and variables definition and measures:

The independence of directors (Bind) : this variable measures the proportion of independent directors on the board. An independent director is a director who is not employed or linked, directly or indirectly, to an entity having trade links, financial or significant business with the bank, or with one of the majority shareholders. Finally, an independent director should not have any relationship with the bank executives.

The size of the board (Bsize): size is a control variable for detecting the effect of bank risk characteristics. The board size is measured by the total number of directors.

The duality (DUAL) combine the functions at the head of the board is measured by a binary variable that takes the value of 1 if the board is chaired by the CEO and 0 otherwise.

The ownership concentration (Own) is defined as the percentage of the block holders who own more than five percent in the firm. The CEOs age is measured by (Age) which reflects the manager age. Finally, the financial education of CEOs is a dummy variable that indicates if a CEO have a financial education or not. This variable will take 1 if a CEO already have a financial education and 0 elswere.

3. Data description:

Our data set consists of 69 American firms that are publicly traded between 2004 and 2010. However, only a total of 378 is included in our estimation because in some years some data are missed. All data are presented after an LN transformation. The descriptive statistics is given by Table 1.

Table 1:

	ROA	Bind	Bsize	Dual	Own	Age	Fineduc
Mean	0.131265	2.813987	1.988681	0.753968	0.247679	4.002214	0.796296
Median	0.128970	2.833213	2.079442	1.000000	0.226100	3.988984	1.000000
Maximum	0.336836	3.526361	2.708050	1.000000	0.999900	4.553877	1.000000
Minimum	-0.181019	2.079442	0.693147	0.000000	0.000000	3.663562	0.000000
Std. Dev.	0.069721	0.304936	0.366393	0.431268	0.155451	0.139584	0.403285
Skewness	-0.202160	-0.146610	-0.891607	-1.179335	2.135687	0.799244	-1.471362
Kurtosis	4.924549	2.839268	4.305899	2.390832	11.05849	5.178132	3.164905
Jarque-Bera	60.91095	1.761056	76.94232	93.46701	1310.146	114.9660	136.8173
Probability	0.000000	0.414564	0.000000	0.000000	0.000000	0.000000	0.000000
Sum	49.61830	1063.687	751.7215	285.0000	93.62280	1512.837	301.0000
Sum Sq. Dev.	1.832588	35.05567	50.60988	70.11905	9.110239	7.345311	61.31481
Observations	378	378	378	378	378	378	378

RESULTS AND DISCUSSION

Table 2 shows the estimation results of our model. We regress the dependent variable which represents a proxy of firm performance on some corporate governance mechanisms. Namely, we test the effect of ownership concentrations, the board size, board independence, the duality which represents the accumulation of the functions and the board independence on firm performance proxy. We also test the effect of two special CEOs personal characteristics. In fact, we test the effect of CEOs age and if they have a financial education.

We use the panel data approach with OLS regressions in order to estimate the parameter of our model. Our results highlight that the majority of our hypothesis are validated. In fact, the effect of board independence on firm performance seems to be positive since the coefficient β_2 =0.021 and this result is significant at the 10% level. This positive effect is due to the fact that the board independence is one of the board decisions efficiency according to Jensen (1993).

The board size as it is predicted has a negative impact on firm performance. The coefficient β_2 =-0.04 and it is significant at the one 1% level. It is clear that the board size has a negative effect on firm performance. This means that when the board size increases this can reduce the quality of the control of managerial decisions and so CEOs can take suboptimal decisions which can destruct firm value and decrease the firm performance. Our empirical finding corroborates previous results in the financial literature.

The ownership structure seems also having an influence on firm performance β_3 =0.02 and P-value =0.006. In fact, the ownership concentration has a positive and significant correlation with the return on assets variable. Our empirical finding is in harmony with the work of Earle et al. 2004 who find that ownership concentration increases the profitability and the efficiency of firms.

This positive effect corroborates also previous results by Wruck 1989 who documents that ownership concentration can have a positive effect on firm performance as it was measured by the market return. Morck, Shleifer and Vishny 1988 report that there is a positive effect of ownership concentration at low levels of concentration, then, it decrease at moderate level and again increased at higher levels of ownership concentration.

We find also that the duality can reduce firm performance hence the coefficient β_4 =-0.08 and p-value= 0.0004 which means that the result is significant at the one percent level. Our results corroborate those of Pi and Timme (1993) who find a higher return for banks where there is no association with the post of the chairman of the board and the CEO function in the US context. Similar results are documented by Brickley et al. (1997) and Palmon and Wald (2002).

Concerning the effect of CEOs personal characteristics on ownership structure is supported here since we find that the CEOs age has a positive but no significant correlation with firm performance measure. While, the financial education of CEOs can largely has a positive and significant effect on increasing firm performance since the coefficient β_6=0.016 and P-value=0.066. Our results corroborate previous empirical findings by Malmendier and Tate (2005).

Finally, we can see that our hypothesis are partially validated and the corporate governance variables and CEOs personal characteristics can be considered as potential determinants of firms performance.

Table 2: Estimations results

Variable	Coefficient	t-Statistic	Prob.
C	0.0595	0.5297	0.5966
Bindep	0.0217	1.3917	0.1648
Bsize	-0.0495	-3.7001	0.0002
Dual	-0.0815	-3.5418	0.0004
Owner	0.0229	2.7259	0.0067
Age	0.0246	0.9284	0.3538
Fineduc	0.0168	1.8375	0.0669
R-squared	0.098610		
Adjusted R-squared	0.084032		

Conclusion:

In this study we study the relationship between corporate governance variables and some CEOs personal characteristics on firm performance as it measured by the return on assets index. We test the effect of the board size and independence on firm performance. The duality is also evoked. We finally, test the impact of CEOs age and his/her financial education on the firm performance measure.

In sum, our results indicate that the corporate governance mechanisms can increase firm performance if they are designed in a correct way. The independence of the board and a reduced number of the administrators in the board can positively affect firm performance. The separation between the function of general manager and chairman of the board can also positively affect the firm performance. The ownership concentration can increase also the firm performance because it will increase the degree of control exerted against CEOs so that he/she will take more rational decisions which are in interest of the firms.

Finally, the CEOs financial education seems having a positive effect on firm performance. CEOs with financial education can be more effective in managing firms a thing that can explain the increases of firm performance with the existence of CEOs with a financial education nature.

REFERENCES

Ayaba, H.O., 2012. Chief Executive Officer’s (CEO’s) Educational Background and Firm Performance: An empirical study on Manufacturing and IT listed firms in the Stockholm Stock Exchange.

Demsetz, Harold, and Kenneth Lehn, 1985. “The Structure of Corporate Ownership: Causes and Consequences.” Journal of Political Economy, 93(6): 1155-1177.

Earle, John S., Csaba Kucsera and Álmos Telegdy, 2004. "Ownership Concentration and Corporate Performance on the Budapest Stock Exchange: Do Too Many Cooks Spoil the Goulash?" Corporate Governance, 13(2): 254-264.

Fama, E.F., M.C. Jensen, 1983. "Separation of Ownership and Control", Journal of Law and Economics, 26: 301-325.

Fligstein, N., 1990. The transformation of corporate control. Cambridge, MA: Harvard University Press.

Jensen, M. and W. Meckling, 1976. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure Journal of Financial Economics, 3: 305-360.

Jensen, Michael, C., 1993, The modern industrial revolution, exit, and the failure of internal control systems, Journal of Finance, 48: 831-880.

Koyuncu, B., S. Firfiray, B. Claes and M. Hamori, 2010. CEOs with a functional background in operations: Reviewing their Performance and prevalence in the top post. Human resource management, 49(5): 869-88.

Malmendier, U., G. Tate, 2005. CEO overconfidence and corporate investment. Journal of Finance., 60(6): 2661-2700.

McConnell, J. John and Henri Servaes, 1990. “Additional Evidence on Equity Ownership and Corporate Value.” Journal of Financial Economics, 27: 595-612.

Morck, Randall, Andrei Shleifer, and Robert W. Vishny, 1988. “Management Ownership and Market Valuation: An Empirical Analysis.” Journal of Financial Economics, 20(1/2): 293-315.

Palmon, O., J. Wald, 2002. Are two heads better than one? The impact of changes in management structure on performance by firm size. Journal of Corporate Finance, 8: 213-226.

Pi, L., S. Timme, 1993. Corporate control and bank efficiency. Journal of Banking & Finance., 17: 515-530.

Taylor, R., 1975. Age and experience as determinants of managerial information processing and decision making performance. Acad. Manage. J. 18(1): 74-81.

Wruck, Karen H., 1989. “Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings.” Journal of Financial Economics, 23: 3-28.

Xiaowei, V.K. and J. Zhang, 2010. The effect of managerial Education and firm-ownership structure. Chinese Economy, 43(6): 34-53.

Zingales L.,1998.« Corporate Governance », in P. Newman (Ed.), The New Palgrave, Dictionary of Economics and the Law, London, Stockton Press.