

THE RELATIONSHIP BETWEEN THE DEGREE OF COMPLIANCE WITH THE CORPORATE GOVERNANCE CODE AND ORGANIZATIONAL PERFORMANCE: A STUDY ON ROMANIAN FIRMS

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ABSTRACT. The companies listed on the Bucharest Stock Exchange (BSE) are required to adopt the BSE Corporate Governance Code on comply or explain basis. Previous studies of the relationship between the compliance and organizational performance have found a weak link. In this study we constructed a Corporate Governance Index based on the “Apply or Explain” reports of the listed companies on the BSE. We showed that the Index is significant and negatively correlated with firm performance measured using ROA and ROE as dependent variables. Also the index proved to be significantly correlated with the size of the board of directors.

Keywords: *organizational performance, corporate governance, board duality, gender diversity, board structure.*

JEL Classification: G30, M10

I. Introduction

Corporate governance has become an important topic in practice and academic literature in recent years.

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By 1990s, corporate governance had become a major issue in all of the advanced economies and, increasingly, in developing countries as well. International organizations, including the OECD, the World Bank, and the IMF, have devoted increasing attention to corporate governance as a topic of global concern (O'Sullivan, 2001)

According to Monks and Minow (2004) the importance of corporate governance has increased dramatically in 2002 when a series of events led to the bankruptcies of large U.S. companies and the loss of thousands of jobs. The way companies are governed determined their fate as well as that of the economy in general. Failure to attract adequate levels of capital threatens the existence of firms which can have serious consequences for the entire economy. Firms that are unable to attract capital may remain outside of international markets entirely, while economies may not benefit from globalization.

The investors are interested in those companies with good corporate governance because, according to OECD (1999), Corporate governance specifies the distribution of rights and responsibilities among different participants in the company, such as managers, shareholders and other interested parties, specifying the rules and procedures for making decisions on company's affairs. In this way, it also provides the structure through which company's objectives are set, the means of attaining those objectives and monitoring performance. Thus deficiencies in corporate governance can have as a consequence not only scandals and corporate liquidations but also financial crises and economic instability.

The Center for International Private Enterprise (2002) lists some of the main advantages of a strong corporate governance. These include:

- improved access to capital and financial markets;
- higher accountability and transparency;
- stimulation of performance;
- protection of shareholders and their investment;
- reduces the incidence of corruption;
- enhancement of marketability of goods and services

The list illustrated above gives a general image of the most important benefits of a good corporate governance.

According to agency theory, (Jensen and Meckling, 1976) we can talk about a positive relationship between corporate governance and company performance. Even though there are many studies that suggest

a positive link between corporate governance and organizational performance, many companies still remained unconvinced by them. For this reason we are convinced that this paper can be of real help because it includes a detailed literature review on the above relationship with the purpose of identifying whether there is a significant and positive relationship between CG and organizational performance.

Based on this relationship between corporate governance and performance the remainder of this paper is organized as follows: section II includes a brief discussion on the concepts of governance and performance, section III presents a detailed literature review of the relationship between corporate governance and organizational performance, including also a summary of the caveats of such studies, section IV offers information regarding the sample, data collection and the construction of the CG index, section V includes the analysis of the link between compliance and organizational performance and section VI presents the concluding remarks.

II. Corporate governance and organizational performance – An overview of definitions

Corporate governance

The literature on corporate governance is extremely broad. Only in recent years hundreds of articles and dozens of books have been oriented toward corporate governance.

The concept of corporate governance began to take shape more clearly after 1997, in the European Union, when most countries have adopted codes of corporate governance, which were optional.

The impulse of adopting these codes has been the financial scandals related to the failure of British companies quoted on the stock market. On the other hand, the Asian economic crisis of 1997 and the withdrawal of investors from Asia and Russia have created problems for the international business community regarding the consequences of the investors' lack of trust in corporate management.

Corporate governance principles developed by the OECD (Organization for Economic Cooperation and Development) provide specific indications, meant to improve legal regulations. They formulate practical proposals to the attention of stock market authorities, investors

and other pillars that have intervened in the governance of the company. Adapting corporate governance principles for the purposes of ensuring transparency, accountability and fair treatment of shareholders has resulted in the development of the OECD Principles of Corporate Governance. The principles underlying corporate governance should ensure the strategic direction of the company. Rules and practices governing the relationships between management and shareholders of companies, employees and creditors are a guarantee of economic growth and financial stability. This allows for confidence building, capital market integrity and economic efficiency.

The concept of corporate governance encountered many definitions, depending on their perspective different authors define this concept in different ways. Thus corporate governance definitions can be groups in two categories: narrow and broad definitions. These two categories are illustrated below.

In a narrow sense, corporate governance can be defined as the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the board of directors (Monks and Minow, 2004).

A broader definition was given by Cadbury Committee, 1992. Thus corporate governance was defined as the system by which companies are directed and controlled.

Claessens, 2003 identified another way to group corporate governance definitions. The first set of definitions deal with a set of behavioral patterns: more specifically the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders.

The second set deals with the normative framework: more specifically the rules under which firms are operating—with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets.

According to the Center for International Private Enterprise (CIPE), which has pioneered corporate governance projects worldwide as part of its mission to combat corruption and strengthen democratic, market-based economies, corporate governance can be defined as “a means whereby society can be sure that large corporations are well-run institutions to which investors and lenders can confidently commit their funds”.

Organizational performance

Organizations have an important role in our daily lives and therefore, successful organizations represent a key ingredient for developing nations. Thus, many economists consider organizations and institutions similar to an engine in determining the economic, social and political progress. Precisely for this reason, in the last 22 years, there were 6 Nobel prizes awarded to researchers who have focused on the analysis of organizations and institutions. Continuous performance is the focus of any organization because only through performance organizations are able to grow and progress. Thus, organizational performance is one of the most important variables in the management research and arguably the most important indicator of an organizational success.

Although the concept of organizational performance is very common in the academic literature, its definition is difficult because of its many meanings. For this reason, there isn't a universally accepted definition of this concept in the academic literature.

In the '50s organizational performance was defined as the extent to which the organizations, viewed as a social system fulfilled their objectives (Georgopoulos and Tannenbaum, 1957:535). Performance evaluation during this time was focused on work, people and organizational structure. Later in the 60s and 70s, organizations have begun to explore new ways to evaluate their performance so performance was defined as "an organization's ability to exploit their environment for accessing and using the limited resources (Yuchtman and Seashore, 1967:379).

The years 80s and 90s were marked by the realization that the identification of organizational objectives is more complex than initially considered. Managers began to understand that an organization is successful if it accomplishes its goals (effectiveness) using a minimum of resources (efficiency). Thus, organizational theories that followed supported the idea of an organization that achieves its performance objectives based on constraints imposed by limited resources (Lusthaus and Adrien, 1998 after Campbell, 1970). In this context, profit became one of the many indicators of performance.

III. Literature review: The relationship between corporate governance and organizational performance

According to Wilkes (2004), “good corporate governance is increasingly being seen as the hallmark of a well run company”.

The theory that underlines the role of corporate governance on organizational performance widely referred to is agency theory. Based on this theory, a potential governance problem is built into corporate system because of the separation of ownership from control. Agency problems emerge when the manager (agent) with the responsibility of representing the owners’ best interests, pursues self-interest instead that of the owner (Khongmalai et al. 2009).

The quality of corporate governance depends on the institutional environment represented by the political economy factors, legal and regulatory standards, competition, and regulatory agents. On its turn, the quality of corporate governance has a positive impact on investors’ confidence, more specifically, the higher the quality of corporate governance the higher the confidence and optimism regarding the future cash-flow. Many shareholders believe that with improved governance practices more of the firm’s free cash flow will be returned to them as dividends rather than being expropriated by the managers who control the firm (Reddy et al. 2010, *after* La Porta et al., 2002). Investors seek out companies that have sound corporate governance structures (CIPE, 2002).

Also, better corporate governance has a positive impact on firm performance through better asset allocation, a more efficient management, better labor practices of other efficiency improvements (Claessens, 2006).

In other words, good governance minimises the possibility of poor organisational performance (Edwards & Clough, 2005).

Table 1 shows a review of the literature aimed at studying the relationship between corporate governance and organizational performance. Even though there are a few exceptions (Yurtoglu, 2000; Gugler et al., 2001 and Bauer et al., 2004; Ghazali, 2010) the vast majorities of studies described in table 1 show a positive and significant link between corporate governance and firm performance.

According to our synthesis of the literature the empirical studies on the relationship between corporate governance and organizational performance can be divided into two groups: the first group includes

the studies that analyze differences among different firms within a country and the second group includes studies that analyze differences among countries and their impact on performance or firm valuation. Each of these two groups are illustrated in detail in Table 1 through many studies. Among all these studies, the most prominent and cited ones from the former group belong to: Gompers et al. (2003) for the U.S., Drobetz et al. (2004) for Germany, Black (2001a, 2001b) for Russia, Odegaard and Bohren (2003) for Norway and from the latter group to La Porta et al. (2002) who analyzed 539 large firms from 27 developed economies. All these studies were no exception from the assumptions made during this paper, more specifically the positive relationship between corporate governance and firm performance. The mixed results of the studies oriented toward the relationship corporate governance performance may be attributable to several types of errors, mostly statistical errors that generally occur in such empirical studies.

Thus, a first explanation for the lack of significant results can be attributed to sample selection errors. Most of the studies have been concentrated on large companies (essentially due to the constraints of data availability, the vast majority of corporate governance data are available for large firms). Using such samples may result in sample characteristics different from those of the general population (Vella, 2000). Thus, the relationship between corporate governance and performance will not be studied properly because the impact of corporate governance can be confused with the impact of parameters that led to this selection.

Insignificant relationship between the two variables or the mixed results can be also determined by not controlling for endogeneity. A key aspect in studying the relationship between two variables refers to reverse causality, i.e. where the company's performance in turn influences the corporate governance (Bhagat and Black, 2002; Drobetz et al, 2003). In these cases, the method of ordinary least squares (OLS) will lead to inconsistent results.

Another justification for the negative results of studies focused on the relationship between corporate governance and performance refers to the time horizon. Thus, a longer time horizon is necessary to demonstrate good corporate governance impact on performance. However many studies are not based on time series to eliminate this problem.

One last point to mention in the category of possible errors in the study of corporate governance is related to the quantification of this variable. Many studies are focused on a single dimension to quantify corporate governance. Therefore it is possible that the results of these studies not incorporate the overall effect of corporate governance. Thus, it is necessary to construct a variable that provides a more comprehensive view of corporate governance.

Table 1.

Author(s)	Sample (Time period)	Corporate Governance (CG) measures	Focus of the study	Key findings
Country level studies				
Alba et al. (1998)	375 Thailand firms (1994-1997)	CG measure: ownership concentration	CG and financial performance	Firms with concentrated ownership show a deteriorating financial performance (profitability) relative to firms with less concentrated ownership.
Farrer and Ramsay (1998)	180 Australian firms (1995)	Single measure- director's ownership	Director's ownership and performance	Positive relationship between director's shareholding and performance
Yurtoglu (2000)	126 Turkish non-financial firms (1998)	CG measure: ownership concentration	Ownership, control and performance	Negative relationship between ownership concentration and pyramidal shareholding and profitability and firm value
Black (2001a, 2001b)	21 Russian firms (1999)	CG Ratings from a Russian investment bank	CG and firm value	Through a determined effort to improve the CG practices firms can improve their share values and reduce the cost of raising equity capital
Gedajlovic and Shapiro (2002)	334 Japanese firms (1986-1991)	CG measure: ownership concentration	CG and financial performance	Positive relationship between ownership concentration and profitability
Gompers et al. (2003)	1500 US listed firms (1990-1999)	Governance Index	CG and performance and firm valuation	Firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions
Hovey et al. (2003)	100 Chinese firms (1997-1999)	CG measures: ownership structure and concentration	Ownership and firm value	No significant relationship between ownership concentration and firm value; Positive relationship between institutional shareholding and firm value

Author(s)	Sample (Time period)	Corporate Governance (CG) measures	Focus of the study	Key findings
Odegaard and Bohren (2006)	1057 Norway firms (1989-1997)	Different variables were used to quantify CG: ownership concentration, owner type, insider ownership, board characteristics, security design (fraction of voting shares), financial policy.	CG and economic performance	Corporate governance matters for economic performance; Insiders ownership matters the most while outside ownership destroys market value; Direct ownership is superior to indirect ownership; Performance is inversely related to board size, leverage, payout and the fraction of non-voting shares
Drobets et al. (2003)	91 German listed companies (1998-2002)	Corporate governance ratings (CGR)	CG and firm value; CG and expected stock returns	Positive relationship between corporate governance and firm value Negative correlation between expected returns and corporate governance
Khanchel El Mehdi (2007)	24 listed Tunisian firms (2000-2005)	8 different variables to measure CG	CG and market value	Positive relationship between CG and marginal market value
Mashayekhi and Bazaz (2008)	240 listed Iranian firms from the TSE(2005-2006)	3 variables used to measure CG (board independence, board leadership and institutional investors on the board)	CG and firm performance	Negative relationship between board size and firm performance. The presence of outside directors strengthens the firms' performance. No significant relationship between leadership structure and firm performance. The presence of institutional investors on the board of directors is not positively correlated with firm performance.
Reddy, Locke and Scrimgeour (2010)	top 50 publicly-listed companies on the NZX50 from New Zealand (1999-2007)	Different variables used to quantify different CG principles	CG and firm performance	Board independence and board size do not have any significant effect on firm performance Compliance with NZSC corporate governance requirements has a positive influence on company performance
Ghazali (2010)	87 non-financial listed Malaysian firms (2001)	2 variables used to measure CG (board size and independence)	CG and firm performance	No significant relationship between corporate governance variables and corporate performance

Author(s)	Sample (Time period)	Corporate Governance (CG) measures	Focus of the study	Key findings
Cross country studies				
Claessens (1997)	Czech and Slovak firms (1992-1993)	CG measure: ownership concentration	CG and equity prices	Positive relationship between ownership concentration and domestic shareholding firm value
La Porta et al. (2002)	539 large firms from 27 developed economies	CG measure: shareholder protection		Better shareholder protection is associated with higher valuation of corporate assets.
Klapper and Love (2004)	374 firms from 14 emerging markets (1999)	CG ratings from CLSA Asia-Pacific Markets	CG and firm performance	Strong correlation between the quality of CG and profitability and firm value – better CG leads to higher profitability and firm valuation
Bauer et al.(2004)	250 firms included in FTSEurofirst 300 (2000-2001)	Deminor ratings	CG and stock returns CG and firm performance CG and firm value	Positive relationship between stock returns and firm valuation on one side and corporate governance on the other. This relationship weakens substantially after adjusting for country differences. Negative relationship between CG and firm performance
Durnev and Kim (2005)	859 firms from 27 countries (1999-2001)	CG ratings from CLSA CLSA Asia-Pacific Markets	CG and firm value	Positive relationship between CG and firm value
Renders, Gaeremynch and Sercu (2010)	938 firm-year observations from FTSEurofirst 300 (1999-2003)	Deminor ratings	CG and firm performance	Significant and positive relationship between CG ratings and firm performance. The strength of the relationship depends on the quality of the institutional environment.

Source: Own compilation based on a literature review

IV. Data, sample and index construction

The sample of this research study is composed of the tier I, II and III listed companies on the Bucharest Stock Exchange. We excluded from our sample the financial companies due to the special regulatory environment in which they operate.

The data sources - information regarding the firm's financial performance, board characteristics and CG index - were the annual reports from 2010 of the sampled firms collected for each firm individually

from their web page or the database with the financial information available from the BSE.

The index of CG used in this study was constructed by assigning one point for each principle of non-compliance and zero for each principle of compliance. The BSE Code of CG has a total of 19 principles and 51 recommendations. Thus, a score equal to 51 shows a full non-compliance with the BSE Code of CG.

It is important to mention that this research is in line with previous works by assigning equal weight (1 point for non compliance) without making distinction in compliance with different recommendations.

V. Data analysis

Table 2 below shows the descriptive statistics of the Index of CG in 2010 and 2011.

Table 2. Descriptive statistics of the CG Index

Index	2010	2011
Mean	13.17	10.29
Minimum	3	34
Maximum	3	34
Count	30	17

As we can observe from Table 2 the index has a higher mean in 2010 compared to 2011, which suggests that the sampled firms have become more compliant with the BSE Code of CG over time.

Relationship between corporate governance and organizational performance: empirical analysis

In order to analyze the relationship between corporate governance and organizational performance we constructed the following model:

$$\text{CorpPerf} = \beta_0 + \beta_1 \text{Index} + \beta_2 \text{BoardSize} + \beta_3 \text{BoardDuality} + \beta_4 \text{GenderDiversity} + \varepsilon$$

Besides using the CG index as an explanatory variable we included in our model, based on previous studies other variables such as: board size (number of members in the board of directors), Board

duality (dummy variable with the value of 1 if the chairman of the board is also the CEO and 0 otherwise) and gender diversity (number of women on the board).

As a dependent variable we used the performance of the firm. The studies that examine the impact of board characteristics on organizational performance used a variety of financial measures: Tobin's Q or its proxy (Weir et al., 2002; Kiel and Nicholson, 2003; Dwivedi and Jain, 2005), return on investment (Boyd, 1995; Adjaoud, et al., 2007), return on assets (Zajac & Westphal, 1996; Shrader, et al., 1997; Kiel & Nicholson, 2003; Carter et al., 2003), return on equity (Bhagat and Black, 1999; Adjaoud et al., 2007), stock returns (Bhagat and Black, 1999), earnings per share (Adjaoud et al., 2007) and economic value added (Adjaoud et al., 2007).

In our present study we used as performance measures of the firm two variables: ROA (return on assets) and ROE (return on equity). We decided to use ROA as one illustration of organizational performance for the following reasons:

- ROA is directly related to management's ability to efficiently utilise the assets, which ultimately belong to shareholders. A lower return on assets will indicate inefficiency.
- ROA is significant in explaining Tobin's Q and the firm value (Carter et al., 2003).

Table 3 below shows the results of the initial analysis.

Table 3. Regression estimates

Explanatory variables	Model 1 – Dependent variable ROA	Model 2 – Dependent variable ROE
Index	-0.003 (-1.02)*	-0.008 (-2.216)**
lnBoard size	-0.112 (-1.912)*	-0.158 (-1.677)*
Board duality	0.018 (0.626)	-0.86 (-1.828)*
Gender diversity	0.001 (0.057)	0.013 (0.444)
R-Squared	0.374	0.689

* and **: significant at 10% and 5% level; t-statistic in brackets. We used natural logarithm of Board Size as in previous studies which show that the relationship between board size and firm performance is convex rather than linear (Yermak, 1995; Guest, 2009)

As table 3 shows, the Index is significant and negatively correlated with ROE and ROA. This results are in line with previous findings which mean that a higher compliance with the CG Code will have as a result an increase in investors' confidence which in turn will have a positive impact on firm performance.

Regarding the other explanatory variables, we can observe that the variable board size is negatively correlated with the organizational performance and significant 10% for both models. The negative correlation means that smaller boards are associated with higher organizational performance. The board duality is significant having a negative impact on firm performance only when ROE is used as a dependent variable, this means that splitting the titles of chairman and CEO will lead to better performance in the future.

Table 4 below, shows the regression results using as a dependent variable the CG index. The only variable that appear to have a significant impact on the degree of compliance is the board size. This means that smaller board are associated with a lower degree of compliance with the BVB Corporate Governance Code.

Table 4. OLS regression of the Index on its explanatory variables

Explanatory variables	Dependent variable - Index
Board size	-2.268 (-2.195)**
Board duality	2.489 (0.703)
Gender diversity	0.088 (0.038)
% Non-executives	0.005 (0.043)
R-Squared	0.194

* and **: significant at 10% and 5% level; t-statistic in brackets.

VI. Conclusions

In this paper we have constructed an Index based on the level of non-compliance with the Bucharest Stock Exchange Corporate Governance Code of the tier I, II and III listed companies. We have studied whether compliance matters for organizational performance using accounting

measures such as ROA and ROE as means of quantifying firms' performance. We found that there is a significant link between compliance and both measures used to quantify performance. We also showed that the degree of compliance with the CG code is linked with the size of the board of directors.

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