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Investigating the Evidence of Correlation between Corporate Governance and Financial Performance: a Literature Review

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***Abstract*—corporate governance can play a significant role in the stability of financial markets and their resilience. However, in the light of subprime crisis, there is an ever increasing attention from academicians as well as policymakers on governance issues and the relevance of its best practices. More importantly, corporate governance scholars have, to date, provided controversial results on the relationship between corporate governance and financial performance of a firm.**

Thus, this article aims to outline the conceptual and empirical scope of the increasingly evolving topic of corporate governance. We attempt by this paper to present the findings of major empirical works, underway during the last five years, that study the nature of link between corporate governance and financial performance.

Keywords*—Corporate Governance, Financial Performance, Shareholders' Model, Stakeholder's Model, Cognitive Model, and Agency Theory.

I. Introduction

The belief that good corporate governance leads to superior performance is, still as of today, widespread in the corporate world and even regarded by senior management as a panacea.[1] Moreover, for more than two decades, the American model of corporate governance was heralded as being the most successful system at creating value. However, the recent financial scandals lead us to question the relevance of the existing best practices of corporate governance. [2] Oddly enough, some control mechanisms of corporate governance have had perverse effects encouraging executives to adopt deviant behaviors and thus result in poor financial performances. [3]

Therefore, it seems sensible to revisit major conceptual and empirical frameworks conducted by researchers in this field and to provide an orientation in corporate governance for both new scholars and specialists in disciplines which intersect with the topic.

This article summarizes the results of recent empirical studies which investigate the existence of correlation between corporate governance and firm performance.

For this purpose, we will organize this paper in two parts. The first one will tackle the main theories and models related to corporate governance and financial performance. Then, we will present, in the second part of this article, major findings of recent empirical studies which explore the existence of any correlation between two concepts.

II. Corporate governance

A. *Definition of Corporate Governance*

There are several definitions of corporate governance. However, the most widely used one is given by the Organization for Economic Co-operation and Development, which states: "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." [4]. Shleifer and Vishny have given a financial perspective to corporate governance's definition and state that: "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." [5].

B. *The Two Paradigms of Corporate Governance*

Whilst the literature review of corporate governance is abundant, only two paradigms exist in this field. The first one is based on the contractual theories of management sciences. Its main objective is to solve the problem of conflict of

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interests through disciplinary governance systems. According to this paradigm, the economic agent is a passive, rational and selfish [6]. His/her only motivation is to maximize his/her utility in terms of risk and expected return. Two models are proposed in this paradigm namely: the shareholder and stakeholder models [7].

In contrast to the disciplinary approach, the cognitive approach to corporate governance gives a central role to human capital and knowledge creation [8]. The cognitive theory states that value creation comes from accumulating knowledge and know-how. The source of value creation is linked to acquiring competencies that are difficult to imitate and which provide a significant competitive advantage and sustainability to the enterprise.

C. *Fundamental Corporate Governance Theories*

According to Charreaux's classification, theories explaining the concept and role of corporate governance can be classified into micro-level and macro-level theories. Micro theories of corporate governance propose models of how a firm and its executives are governed whereas macro theories look into the specificities in the governance systems found across different nations. [9]

For the purpose of this paper, we will focus on the micro theories which are all founded from and around the "agency theory". This latter, is defined as "the relationship between the principals, such as shareholders, and agents such as the company's executives and managers". In this theory, shareholders who are the owners or principals of the company, hire the agents to manage the company. This theory prescribes that employees are held accountable for their tasks and responsibilities through two mechanisms which are executive compensation and stock options and threat of firing and takeovers. [10]

Over the past three decades, a number of researchers have tried to explore further the nature of interaction between the "principal" and the "agent". As a result, five theories came to light to solve the agency problem.

1) The 'stewardship theory' has its roots from psychology and sociology and is defined by Davis, Schoorman and Donaldson as: "… a steward protects and maximizes shareholders wealth through performance, because by doing so, the steward's utility functions are maximized". Furthermore, the stewardship theory suggests unifying the role of the Chief Executive Officer (CEO) and the chairman so that to reduce the agency costs. As a matter of fact, it has been empirically found that the returns of a company have improved by having both these two functions combined rather than separated [11].

2) In defining the "Stakeholder Theory" Clarkson states: "an enterprise is a system of stake holders operating within a larger system that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stake holders by converting their stakes into goods and services"[12]

3) Whilst, the stakeholder theory focuses on the interactions among stakeholders, the "resource dependency theory" concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. [13]

4) "Transaction cost theory" was first initiated by Cyert in 1963 and was an interdisciplinary alliance of law, economics and organizations. This theory comes as an alternative to the agency theory. It describes governance frameworks as being based on the net effects of internal and external transactions, rather than as contractual relationships outside the firm.[14]

5) "Political theory" states that the allocation of corporate power, privileges and profits between owners, managers and other stakeholders is determined by how governments favor their various constituencies. The ability of corporate stakeholders to influence allocations between themselves at the micro level is subject to the macro framework, which is interactively subjected to the influence of the corporate sector. [15]

D. *Best Practices of Corporate Governance*

In their attempt to help corporations implementing this concept, a number of supranational entities have proposed different guidelines of best practices of corporate governance. Nevertheless, the OECD offers a holistic approach to implementing corporate governance and states: " A good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders. It should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth."[4].

Understandably, the key objective of good corporate governance should be then to improve and maximize stakeholders' wealth and welfare. Thus once implemented, an effective corporate governance system can help to insure an appropriate division of power among shareholders, the board of directors, and management and to warrant a sound financial performance.

III. Financial Performance

One of the emerging and most controversial issues in the field of management is the mechanisms of corporate governance and their influence on the value of a firm. Various studies in diverse domains like accounting, economics, finance, law and management were conducted to understand the nature of relationship between the two concepts. [16], [17], [18], [19], and [20].

The assessment of financial performance of a company, in general, is done through its financial ratios. Over the past three decades, researchers have tried to prove the relevance and the usefulness of these proposed ratios in portraying a true reflection of a firm financial situation. Using principal component factorial analyses, researchers such as Chen and Shimerda and Zeller and Al have found that financial performance could be measured by five types of ratios namely: profitability, liquidity, productivity, growth analysis and capacity of financing [21].

However, financial performance, as it is viewed by the majority of governance scholars, has been limited to stock value performance. According to Brennan [22], the measurement criterion of a stock value can be grouped into two categories. The first category is the so-called ex-ante or provisional measures that include the Tobin's Q ratio and the ratio of Marris. The second category includes measures derived from the portfolio theory such as the Sharpe ratio, Treynor ratio and the Alpha of Jensen. These measures are called ex-post ratios because of their capability to evaluate the performance achieved over time. Nevertheless in the past decade, a third category of measures emerges from more recent literature. Founded by Anglo-Saxon consulting firms, corporate performance can be measured by another type of ratios called "Value Creation Ratios" namely: market value added (MVA) and the Economic Value Added (EVA).

A. *Financial Performance According to the Shareholder Model*

Chatelin and Trébucq indicate that capital markets estimate the stock price of a company, if the information is transmitted and made public, through discounting its future cash flows. They summarize these measures of valuation model to the followings: the discounted cash flow model, the return on investment (ROI) and the measures presented by the consulting firms such as: economic value added (EVA), the return on assets (ROA) [23].

B. *Financial Performance According to the Stakeholder Model*

Charreaux and Desbrières propose a comprehensive measurement of profit generated by the company in connection with its different stakeholders. This value is equal to the difference between the opportunity price and the opportunity cost of all stakeholders. The distribution of the value creation depends on the bargaining power of each party [24].

C. *Financial Performance According to the Cognitive Model*

Mariri and Chipunza indicate that value creation can be modeled by a flowchart showing the interactions between the three types of business capital namely: financial, human and intellectual capital. Furthermore, they explain that this "extended" conception of performance allows sustainable performance to be in line with the current motivations of firm's employees. As a matter of fact, several studies have shown the contribution of employees to create sustainable corporate performance. Employee expectations are, therefore, an essential factor to be taken into consideration in the implementation of sustainable performance systems [26].

IV. Impact of Corporate Governance on Financial Performance

To this date, it is still difficult to identify the major empirical trends or even a shared consensus among scientific community related to corporate governance and its impact on financial performance.

Nonetheless, previous empirical studies came to a consensus upon the common mechanisms used to implement and improve corporate governance within organizations. The majority of researchers have identified the following measures of good corporate governance namely: (a) board size; (b) presence of female board members; (c) duality of the CEO; (d) education level of board members; (e) board working experience; (f) independent directors; (g) board compensation; (h) board ownership; and (i) block holders.

As per financial performance, most of the studies covered in this article have focused on corporate stock performance and more specifically on the ex-post and ex-ante ratios namely: (a) ROA, (b)ROE, (c)M/B, (d) Q of Tobin, (e) Sharpe ratio, (f) Treynor ratio and (g) alpha of Jensen

Furthermore, our targeted empirical works have focused mainly on emerging and frontier markets with an average sample size of 50 to 100 companies across all sectors and industries. Quantitative methods were used such as multiple regression methods and structural equation modeling.

A. *Strong Positive Correlation*

The general understanding of the first group of governance scholars is that corporate governance enhances the financial performance of a firm. It helps the enterprise creating and maintaining a business environment that motivates managers to maximize firm operational efficiency, returns on investment and long-term productivity. Love states in his study that the ultimate outcomes of corporate governance are higher cash flows and superior performance of the firm [13].

Wessels and Wansbeek confirm the findings of Love and affirm the existence of a noteworthy association between good corporate governance and the profitability of a firm [27].

Zaharia and Zaharia conducted an empirical investigation of Saudi listed companies and found that weak-governance companies have higher input costs, lower labor productivity, lower equity return, lower value, and lower operating performance than good-governance companies[28].

Further researches were conducted in a number of emerging and frontier markets and all have demonstrated a positive correlation between the best practices of governance and financial performance, as it is depicted in Table.1.

TABLE1

Country	Author	Year	Findings
Nigeria	Adekunle , Aghedo	2014	positive and significant relationship between composition of board member and firm performance [29]
Vietnam	Vo, Phan	2013	female board members, duality of the CEO, board's working experience, and board's compensation all have positive correlations with firm's performance [30]
India	Aggarwal	2013	governance rating of company has a significant positive impact on its financial performance [31]
Tunisia	Affes	2011	incentive schemes for executives has an indirect effect on financial performance through innovation[32]
Tunisia	Trabelsi	2010	a positive relationship between external administrators and performance[33]

Source: Researchers 'data

B. *Negative Correlation and Mitigated Results*

In contrast to the first trend of empirical work supportive of positive correlation between governance and financial performance, others studies have shown either negative correlation or mitigated results between the two concepts.

Qaemi and Shahryari concluded in their article of 2009 that there is no significant correlation between arrangement of board of directors and financial performance of Iranian listed firms. [34] Nikbakht and Al confirm in their study of 2010 that the board of directors has no significant influence on the performance of Iranian listed companies. [34]

The empirical work of Amba in 2013 of Bahraini listed companies shows this time a negative correlation between, high corporate governance index and financial performance [35].

Further evidence from other works conducted in countries like Nigeria, Turkey and the United Kingdom clearly show no significant correlation as it is depicted in table. 2.

TABLE2

Country	Author	Year	Findings
Nigeria	Peters	2014	no significant difference in the performance of firms with high performance quotient and from those that had low (CGV)[36]
Bahrain	Amba	2013	negative correlation between Corporate Governance and Financial Performance (ROA,ROE and Gearing ratio)[35]
Turkey	Coşkun, Sayilir	2012	the study do not seem to support that better corporate governance is associated with higher firm values and better performance[37]
U.K	Abdullah	2011	little evidence that companies with more independent boards perform better in terms of the market to book ratio (Q) or profitability (ROA). [38]

Source: Researchers 'data

V. CONCLUSION

We conclude from this study that it is evident there is no clear consensus among scholars as to establish any type of relationship between applying best practices of corporate governance and improving the financial performance of a firm.

These mitigated results could be explained by the fact that empirical research on corporate governance is relatively at its embryonic stage. That been said, the majority of empirical studies on the subject only tackles the relationship between certain disciplinary mechanisms and the corporate performance which leaves a room for potential future investigations and studies on that subject.

VI. LIMITATIONS OF THE STUDY

There are a number of limitations in the review conducted in this paper which can be associated with the lack of time.

Due to shorter period of time the study is only focusing on most recent studies.

Also, we did not investigate the macroeconomic level of corporate governance and how national systems of governance can influence the financial performance. Each country is located in separate region and the cultural aspect of different nations can influence the practices of the business and its corporate governance. Also, more attention should be focused on the practical aspect of the corporate governance and its practices in real business environment need to be studied closely.

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