# Corporate governance and firms' financial performance

Sekhar Muni Amba
New York Institute of Technology, Bahrain

**ABSTRACT**

In the light of corporate financial scandals, there is an ever increasing attention on corporate governance issues. As the investors look for emerging economies to diversify their investment portfolios to maximize returns they are equally concerned about governance factors to minimize risks in these economies. This paper examines the impact of corporate governance variables on firms' financial performance. Influence of corporate governance variables CEO duality, Chairman of Audit Committee, Proportion of Non-executive Directors, Concentrated Ownership structure, Institutional Investors, Gearing Ratio on firms' financial performance "Return on Assets" is researched using the firms traded in Bahrain bourse. This research finds that corporate governance variables do influence firms' performance. CEO duality, proportion of non-executive directors and leverage has negative influence and board member as chair of audit committee, proportion of institutional ownership has positive influence on firms' financial performance

Keywords: Corporate governance, financial performance, Bahrain

## INTRODUCTION

At the culmination of every financial crisis academicians, regulators, governments tend to focus on the corporate governance more vigorously in order to enhance investors' confidence that would attract investments. The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly state the division of responsibilities among different supervisory, regulatory and enforcement authorities.

Corporate governance describes the structure of rights and responsibilities among the parties that have a stake in a firm (Aguilera and Jackson, 2003). A corporate governance system can be a set of processes and structures used to direct a corporation's business. A key objective of a corporate governance system should be the enhancement of shareholder wealth. Once implemented, an effective corporate governance system can help to ensure an appropriate division of power among shareholders, the board of directors, and management (Mcconomy et al. 2000). According to Bairathi, V. (2009). "Corporate governance is not just corporate management; it is something much broader to include a fair, efficient and transparent administration to meet certain well-defined objectives. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. When it is practiced under a well-laid out system, it leads to the building of a legal, commercial and institutional framework and demarcates the boundaries within which these functions are performed." Well-functioning corporate governance mechanisms in developing economies are crucial for both local firms and foreign investors interested in the tremendous opportunities that such economies provide.

Evidence suggests that firms in emerging economies (compared with their counterparts in developed countries) are discounted in financial markets because of weak governance (LaPorta, Lopez-de-Silanes, Shleifer, and Vishny, 1999). As such, improvements in corporate governance can enhance investor confidence and increase these firms' access to capital (Rajagopalan and Zhang, 2009). In this context, from the time when the Kingdom of Bahrain signed Free Trade Agreement with USA in 2004 followed by substantial foreign investment in Kingdom of Bahrain, firms would demand greater transparency and internationally recognized sound corporate practices in Kingdom of Bahrain. To this effect Central Bank of Bahrain has released Corporate Governance code 2010 that is to be followed by companies and business establishments in Kingdom of Bahrain. Central Bank of Bahrain perceived that the new paradigm of governance to bring about quality corporate governance is not only a necessity to serve the diverse corporate interests, but it is also a key requirement in the best interests of the corporates themselves. Corporate practices in the matter of disclosure, transparency, group accounting, role of directors, degree of accountability to the shareholders, lenders and overall public good are some of the critical issues which require a continues modification to suit to the changing dynamic business environment (Central bank of Bahrain 2010) .Governments can play a major role in creating the environment for quality governance through an appropriate regulatory frame work.

## RESEARCH OBJECTIVES

The objective of this research is to study the impact of corporate governance variables: CEO as board of director CEO as Chairman of the board, Chairman of Audit Committee, Proportion of Non-executive Directors, Concentrated Ownership structure, Institutional Investors, and Gearing Ratio on firm's profitability ratios Return on Assets and Return on Equity.

## LITERATURE REVIEW

There has been wide variety of interest among researchers, scholars and governments, including global agencies in the realm of corporate governance especially after the financial crisis 2008 that lead collapse of many financial institutions and virtually brought many industries to bankruptcy.

Cheffins (2011) said corporate governance first came into vogue in the 1970s in the United States. With the collapse of Enron and Arthur Andersen in the U.S and similar disasters in the U.K such as Marconi, corporate governance has become increasingly important. As a result, international organizations have shown concerns about governance issues. The international monetary fund has demanded that governance improvements be included in its debt relief program (Khanchel, 2007).In 1999, the Organization of Economic and Development (OECD) issued its influential OECD principle of corporate governance, intended to assist member and non-member countries in their efforts to evaluate and improve the legal, institutional and regulatory framework for better corporate governance (Nestor, S., & Thompson, J. 2001).

### CEO duality

CEO duality means that the CEO is also holding a position as a chairman of the board of directors. Agency theorists argue that when a board chairman is also a CEO, he will gain sufficient controlling power to gain more private benefits (Finkelstein and D'Aveni, 1994). Chugh, L. C., Meador, J. & Meador, M. (2010) found that CEO-duality describes a situation in which the CEO and the board chair is one and the same person. It is argued that situations in which the CEO is also the chair may enhance the performance of the firm as there is one responsible and accountable steward. This means that one person has the full power to take any decision. Brickley, J. A., Coles, J. L., & Jarrell, G. (1997) said that separating a chairman and a CEO of the board yields both costs and benefits, and larger firms seem to experience higher costs than smaller firms in this situation. To examine the effect of duality of CEO on firm value multiple studies have found that the existence of with a weak legal system encourages companies its CEO acts as a chairman of the board.On the contrary Ehikioya, B. I. (2009) at their study said CEO duality has a way of influencing the overall performance of the firm. However, research also supports the idea that combining the positions of CEO and chair in one person may prevent the board from effectively exercising its monitoring and oversight duties (creating agency costs) and will result in lower performance (Coles, J.W., McWilliams, V.B. & Sen, N. 2001).Core, J.E., Holthausen, R.W. and Larcker, (1999) found that high CEO compensation is associated with weak governance structures including CEO duality.

**Independent and non-executive directors**

The primary role of the executive directors is to implement the strategy agreed by the board, the chief executive is the main interface with the board and, indeed, in North America is often the only executive member of the board, the executives are the full time managers of the business and it is they, not the non-executives, who are the true custodians of the business. If the executives choose they can blind and deceive until they are caught, the hope is, as is the case in most of our businesses, that they are honest and direct and seek to run the enterprise morally, ethically and within the law. If they do not the full weight of the law should be used against them Treadwell, D. (2006).

Mak and Kusnadi (2005) reveal that a higher fraction of independent directors on the board is linked to greater firm value.Vafeas and Theodorou (1998) suggest that “the relationship between non-executive directors (including independent directors and grey directors) and firm valuation is not significant. Yammeesri, J., & Herath, S. K. (2010) said at their research that it is still debatable whether non-executive directors will perform well in monitoring firm management and whether their performance could reflect an increase or decrease in corporate performance. In the case of Thai firms, there is no evidence to confirm that independent directors are significantly related to firm value.

As per the study of Rashid, A., De Zoysa, A., Lodh, S., & Rudkin, K. (2010). the Independent non-executive directors are appointed from outside and they should not have any material interest in the firm. Arguments have been presented challenging the limitations of outside independent directors. Nicholson and Kiel (2007) argue that inside directors live in the company they govern, they better understand the business than outside directors and so can make better decisions. As per Rashid et al. (2010) their argument is one of information asymmetry between inside directors and outside independent directors, they argue that a lack of day to day inside knowledge may reduce the control role of the independent directors in the firm, and that the independent directors may fail to perform because lack of appropriate support by the inside directors. Cho and Kim (2007) and Brennan, N. M., & Solomon, J. (2008). also questions the value of outside independent directors, as they may not be competent to perform their assigned tasks in that they are part-timers and do not have inside information of the firm.

**Ownership structure**

Salami, K. A. (2011) investigated how ownership structure and existence of conflicts of interests among shareholders operating within a poor governance system, impacted on company profitability. His paper, using panel data and regression models, concluded that firms with low ownership concentration showed low firm profitability. This stand was supported by Sørensen, R. J. (2007). who examined the effects of ownership dispersion on cost efficiency, using empirical evidence, and concluded that corporate governance failure suggested that dispersion and indirect ownership weakened incentives to control the company, leading to agency losses and inferior performance, the study presented an empirical analysis that suggested that fragmented ownership induced cost-inefficiency relative to companies owned by a single entity's, Chen, I. J., Lai, J. H., & Chen, C. C. (2012) indicated that higher equity concentration is positively associated with corporate performances to reduces agency costs.

**Audit committee**

According to Siagian and Tresnaningsih (2011) Directors and audit committees that are independent from management should improve the firms' reporting system and the quality of reported earnings because they are not subject to potential conflicts of interest that reduce their monitoring capacity. Usually, independent directors also serve as experienced professionals in other firms or large organizations and therefore, care about their reputation (Nguyen and Nielsen, 2010).The committee should contains independent board of director along with other members. Islam, M. Z., Islam, M. N., Bhattacharjee, S., & Islam, A. Z. (2009) posited that an independent audit committee is one of the important mechanisms in this respect. It is expected to satisfy the need of both internal and external users of financial statements, and prior studies have documented the importance of the independence of audit committee members for maintaining the integrity and quality of the corporate financial reporting process. Some study reports a negative association between the percentage of independent directors on the audit committee and earnings management, does not observe a significant effect for audit committees comprising 100 percent independent directors. Xie, B, Davidson, W.N., DaDalt, and P.J (2003) report that audit committees comprising members with some corporate or investment banking background are negatively associated with earnings management.

**LEVERAGE**

Essentially, it involves borrowing money to invest in securities over and above the money contributed by shareholders.According to Weill (2003) who carried out new empirical evidence on a major corporate governance issue: the relationship between leverage and corporate performance found mixed evidence depending on the country: while significantly negative for firms in Italy, the relationship between leverage and corporate performance is significantly positive for firms in France and Germany. This tends to support the influence of some institutional characteristics on this link. Majumdar and Chhibber (1999) tested the relationship between leverage and corporate performance on a sample of Indian companies. Adopting an accounting measure of profitability, return on net worth, to evaluate performance, they observe a significant negative link between leverage and corporate performance. Weill, L. (2003). use various measures of performance on this issue on a sample of US firms, based on accounting or ownership information (firm value, cash-flow, liquidity, earnings, institutional ownership and managerial ownership). They perform regressions of leverage on this set of performance measure;

their conclusion is the existence of robust relationships between leverage and some of the measures of performance such as a negative link with firm value and cash-flow.

**Corporate governance in the Kingdom of Bahrain**

Bahrain's banking sector has remained to be a basis for growth of the domestic economy. From the official web site of the Central Bank of Bahrain (Banking Sector, 2012) after the oil and gas sector, the financial service sector remains the highest contributor to the country's GDP. Central Bank of Bahrain is responsible for licensing, supervising and regulating the financial sector and its new supervisory and regulatory framework has played a significant role in liberalizing the sector to international banks.

According to Corporate Governance code 2010 as introduced by Central Bank of Bahrain, following corporate governance principles are emphasized:

Principle1: The Company shall be headed by an effective, collegial and informed board.
Principle2: The directors and officers shall have full loyalty to the company.
Principle3: The board shall have rigorous controls for financial audit, internal control and compliance with law.
Principle4: The Company shall have rigorous procedures for appointment, training and evaluation of the board.
Principle5: The Company shall remunerate directors and officers fairly and responsibly.
Principle6: The board shall establish a clear and efficient management structure.
Principle7: The board shall communicate with shareholders and encourage their participation.
Principle8: Company shall disclose its corporate governance.
Principle9: Companies which refer to them as "Islamic" must follow the principles of Islamic sharia.

According to the Corporate Governance code in Bahrain 2010, this code goes beyond the company law's requirements on several points. Examples are this code's recommends that the chairman of the board and the CEO should not be the same person, and at least 50% of the board of directors should be non-executive directors. Those are not required by the law but they are strong recommendations which should be considered in evaluating the quality of a company's corporate governance, and which company should follow unless it has good reasons not to follow them and it discloses those reasons under 'comply or explain' principles. All companies listed in Bahrain Stock Exchange are following the corporate governance code.

**SAMPLE DATA AND VARIABLES**

The research has been conducted on firms listed in Bahrain bourse in the Kingdom of Bahrain. Ten companies have been removed from 49 companies listed at Bahrain bourse due to insufficient and unavailability of data required to do this research. Thus a sample of 39 companies was selected from 49 companies to collect the data for independent variables CEO duality ( as board of director / Chairman of board),Chairman of Audit Committee, Proportion of Non-executive Directors, Concentrated Ownership structure, Institutional Investors, Gearing Ratio and dependent variable Return on Assets (ROA). Researcher used the Investors Guide published by Bahrain bourse for the years 2010, 2011 and 2012 to collect the data. Since this study uses eight variables of which seven independent variables and one dependent variable for all the three years. Thus this research has utilized 39x3x8 = 936 data points.

## METHODOLOGY, EMPIRICAL RESULTS AND CONCLUSION

Statistical technique multiple regression analysis had been employed to test the relationship between firms financial performance measured by Return on Assets and corporate governance variables.

Hypothesis: Corporate governance has a significant impact on Firms financial performance.

Regression model

$ROA=b_0+b_1*CEOBOD+b_2*CHAIRAC+b_3*NED+b_4*INST+b_5*GEAR+b_6*CONCEN$

**Where**

CEO duality:

CEOBOD=1 if CEO is also BOD else 0 is awarded

CEOCHR= 1 if CEO is chairman of the board else 0 is awarded

CHAIRAC = 1 if company has chairman audit committee else 0 is awarded

NED = Number of non-executive directors/ Total number of Directors

INST = Proportion of large institutional investors owning shares

GEAR (leverage) = Proportion of assets invested in a business that are financed by long-term borrowing.

CONCEN = Proportion of concentrated ownership of the firm.

ROA= (Net Income excluding minority interest & extraordinary income / Total Assets)*100

From table 2 Regression equation is :

$$ROA= 80.25-6.80*CEOBOD - 6.57*CEOCHR + 5.61*CHAIRAC - 80.25*NED + 0.12*INST -0.09 *GEAR-0.06*CONCEN$$

From table 1 ,F statistic = 4.18, Sig.Value =0.00.Regression model is significant at 5% level.

Durbin-Watson statistic measure of this model is 1.96 confirms the absence of autocorrelation. CEOBOD (CEO also a board of director) variable is significant at 5% level and CEOCHR (CEO as chairman of the board) is not significant at 5% but these two variables have negative impact on ROA. Thus in general CEO-duality has a negative impact on ROA and creates additional agency costs and impairs performance. As dual power solely rests with CEO may impede the ability of board of directors in evaluation the management of the company for which board exists. On the contrary excessive board autonomy may affect board financial performance by limiting operational business tactics of the management. Thus a careful rethinking may be needed as far as CEO duality is concerned. CHAIRAC (board of director being the chair of audit committee) has positive effect on performance and contributes to transparent and well audited financial reports though this variable is not statistically significant. NED (proportion of non-executive directors) is statistically significant at 5% level but effectively has a negative influence on return on assets signaling higher the proportion of NED lower the firm’s financial performance. This indicates the need of optimum proportion of non-executive directors in board for effective governance impacting performance of the firm positively. INST, the variable representing proportion of institutional ownership in the capital structure positively affects the firm’s financial performance though this variable is statistically not significant. As institutional owners are more concerned about returns on their investments they perceived to contribute for effective corporate governance of the firm which enhances firms’ financial performance. GEAR (leverage) gearing ratio is statistically significant to corporate governance with a negative relationship with firms’ financial performance. As debt holders control corporations with covenants in their contracts may impair the aggressive strategies of the management in pursuit of financial excellence. Apart from this, result also supports financial theory that the presence of optimality of debt ratio in firms’ capital structure beyond which this ratio shows negative impact on firms’ financial performance. CONCERN variable representing proportion of concentrated ownership, though this variable is not statistically significant at 5% level but has a negative relationship with firms’ financial performance. Higher the concentrated ownership thus dominating minority shareholders affects the firm negatively. These owners may pursue policies that would effectively support their goals rather than the common goals of the corporation that would effectively benefit all stakeholders including minority shareholders. This emphasizes the need for controlling concentrated ownership in the equity ownership of the firm.

In summary the regression model depicting the effect of corporate governance variables on firms’ financial performance is statistically highly significant, it should be left to the regulators, corporate governance thinkers and policy makers in deciding the range of optimum levels for these variables for the effective governance of the firms which is good for all stakeholders.

## REFERENCES


Aguilera, R. V., & Jackson, G. (2003). The cross-national diversity of corporate governance: Dimensions and determinants. *The Academy of Management Review*, 447-465.

Bairathi, V. (2009). Corporate governance: A suggestive code. *International Research Journal*, *11*(6), 753-754.

Brennan, N. M., & Solomon, J. (2008). Corporate governance, accountability and mechanisms of accountability: an overview. *Accounting, Auditing & Accountability Journal*, *21*(7), 885-906.

Brickley, J. A., Coles, J. L., & Jarrell, G. (1997). Leadership structure: Separating the CEO and chairman of the board. *Journal of corporate Finance*, *3*(3), 189-220.

Cheffins, B. (2011). *The History of Corporate Governance*.

Chen, I. J., Lai, J. H., & Chen, C. C. (2012). Industrial Concentration, Innovation and Corporate Layoff Announcements. *International Research Journal of Finance and Economics*, (87).

Cho, D. S., & Kim, J. (2007). Outside directors, ownership structure and firm profitability in Korea. *Corporate Governance: An International Review*, *15*(2), 239-250.

Chugh, L. C., Meador, J. & Meador, M. (2010) "Corporate Governance and Firm Performance: 1990-2006." *Journal of Business and Economics Research"* 8 (9): 1-11

Coles, J. W., McWilliams, V. B., & Sen, N. (2001). An examination of the relationship of governance mechanisms to performance. *Journal of Management*, *27*(1), 23-50

Core, J. E., Holthausen, R. W., & Larcker, D. F. (1999). Corporate governance, chief executive officer compensation, and firm performance. *Journal of financial economics*, *51*(3), 371-406.

Ehikioya, B. I. (2009). Corporate governance structure and firm performance in developing economies: evidence from Nigeria. *Corporate Governance*, *9*(3), 231-243.

Finkelstein, S., & D'Aveni, R. A. (1994). CEO duality as a double-edged sword: How boards of directors balance entrenchment avoidance and unity of command. *Academy of Management Journal*, 1079-1108.

Islam, M. Z., Islam, M. N., Bhattacharjee, S., & Islam, A. Z. (2009). Agency Problem and the Role of Audit Committee: Implications for Corporate Sector in Bangladesh. *International Journal of Economics and Finance*, *2*(3), P177.

Khanchel, I. (2007). Corporate governance: measurement and determinant analysis. *Managerial Auditing Journal*, *22*(8), 740-760.

La Porta, R., Lopez de Silanes, F., Shleifer, A., & Vishny, R. (1999). Investor protection and corporate valuation. *NBER Working Paper Series*, *7403*.

Majumdar, S. K., & Chhibber, P. (1999). Capital structure and performance: Evidence from a transition economy on an aspect of corporate governance. *Public Choice*, *98*(3-4), 287-305.

Mak, Y. T., & Kusnadi, Y. (2005). Size really matters: further evidence on the negative relationship between board size and firm value. *Pacific-Basin Finance Journal*, *13*(3), 301-318.

Mcconomy, Bruce J; Bujaki, Merridee L. (2000). Corporate governance: enhancing shareholder value [Includes overview of TSE guidelines], *CMA Management*, 47.8. 10-13

Nestor, S., & Thompson, J. (2001). Corporate governance patterns in OECD economies: Is convergence under way. *Corporate governance in Asia: A comparative perspective*, 19-43.

Nguyen, B. D., & Nielsen, K. M. (2010). The value of independent directors: Evidence from sudden deaths. *Journal of Financial Economics*, *98*(3), 550-567.

Nicholson, G. J., & Kiel, G. C. (2007). Can Directors Impact Performance? A case-based test of three theories of corporate governance. *Corporate Governance: An International Review*, *15*(4), 585-608.

Rajagopalan, N., & Zhang, Y. (2009). Recurring failures in corporate governance: A global disease?. *Business Horizons*, *52*(6), 545.

Rashid, A., De Zoysa, A., Lodh, S., & Rudkin, K. (2010). Board composition and firm performance: evidence from Bangladesh. *Australasian Accounting Business and Finance Journal*, *4*(1), 76-95.

Rashid, A., De Zoysa, A., Lodh, S., & Rudkin, K. (2010). Board composition and firm performance: evidence from Bangladesh. *Australasian Accounting Business and Finance Journal*, *4*(1), 76-95.

Salami, K. A. (2011). Analysis of the Relationship between Share Ownership Structure, Corporate Governance Structure, and Corporate Investment Efficiency, using GSE Market Data (2005-9). *Journal of Accounting and Finance*, *11*(4), 111-118.

Siagian, F. T., & Tresnaningsih, E. (2011). The impact of independent directors and independent audit committees on earnings quality reported by Indonesian firms. *Asian Review of Accounting*, *19*(3), 192-207.

Sørensen, R. J. (2007). Does dispersed public ownership impair efficiency? The case of refuse collection in Norway. *Public administration*, *85*(4), 1045-1058.

Treadwell, D. (2006). The role of the non-executive director: A personal view. *Corporate Governance*, *6*(1), 64-68.

Vafeas, N., & Theodorou, E. (1998). The relationship between board structure and firm performance in the UK. *The British Accounting Review*, *30*(4), 383-407.

Weill, L. (2003). Banking efficiency in transition economies. *Economics of transition*, *11*(3), 569-592.

Weill, L. (2003). Leverage and corporate performance: A frontier Efficiency Analysis on European Countries.

Xie, B., Davidson, W. N., & DaDalt, P. J. (2003). Earnings management and corporate governance: the role of the board and the audit committee. *Journal of corporate finance*, *9*(3), 295-316.

Yammeesri, J., & Herath, S. K. (2010). Board characteristics and corporate value: evidence from Thailand. *Corporate Governance*, *10*(3), 279-292.

Table 1 Regression result

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 3686.339 | 7 | 526.620 | 4.177 | .000[b] |
| | Residual | 13742.536 | 109 | 126.078 | | |
| | Total | 17428.874 | 116 | | | |

a. Dependent Variable: ROA

b. Predictors: (Constant), CONCERN, CHAIRAC, CEOCHR, NED, GEAR, CEOBOD, INST

Table 2 Regression coefficients

| | | Coefficient | Std. Error | Beta | t value | Sig. |
|---|---|---|---|---|---|---|
| 1 | (Constant) | 80.254 | 23.503 | | 3.415 | .001 |
| | CEOBOD | -6.796 | 3.313 | -.231 | -2.051 | .043 |
| | CEOCHR | -6.566 | 11.531 | -.050 | -.569 | .570 |
| | CHAIRAC | 5.610 | 6.682 | .073 | .840 | .403 |
| | NED | -80.252 | 22.296 | -.380 | -3.599 | .000 |
| | INST | .118 | .079 | .193 | 1.488 | .140 |
| | GEAR | -.091 | .037 | -.246 | -2.487 | .014 |
| | CONCERN | -.062 | .066 | -.124 | -.947 | .346 |

a. Dependent Variable: ROA