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More on the relationship between corporate governance and firm performance in the UK: Evidence from the application of generalized method of moments estimation

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ABSTRACT

This study examines the relationship between corporate governance compliance and firm performance in the UK. We develop a Governance Index and investigate its impact on corporate performance after controlling for potential endogeneity through the use of a more robust methodology, Generalized Method of Moments (GMM) Estimation. Our evidence is based on a sample of 435 non-financial publicly listed firms over the period 1999–2009. In contrast to earlier findings in the UK literature, our results suggest that compliance with corporate governance regulations is not a determinant of corporate performance in the UK. We argue that results from prior studies showing a positive impact of corporate governance on firms' performance may be biased as they fail to control for potential endogeneity. There may be a possibility of reverse causality in the results of prior studies due to which changes in the internal characteristics of firms may be responsible for the corporate governance compliance and performance relationship. Our findings are based on GMM, which controls for the effects of unobservable heterogeneity, simultaneity and dynamic endogeneity and thus present more robust conclusions as compared to the findings of previously published studies in this area.

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1. Introduction

The impact of corporate governance on corporate performance has been the main theme of many research projects in accounting, finance and management literature. While considering governance regulation, it is expected that protection of shareholders' rights is given by firms' compliance with corporate governance recommendations. Thus the theoretical aim of complying with the UK Combined Code on Corporate Governance (2003) provisions is to reduce agency costs and improve corporate performance. This is consistent with agency theory as described in Fama and Jensen (1983) and Jensen (1986). Managerial signalling theory also indicates that complying with the code of corporate governance is a primary signal to markets that the management follows better governance structure. This can lead to an increased demand for shares by

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investors, which will increase share prices and the shareholders' wealth (Beiner et al., 2006; La Porta et al., 2002). It is thus expected that companies which adopt recommendations of the Governance Code are likely to enhance their corporate performance.

However, if compliance with corporate governance is endogenously chosen by firms, then each firm will reach the level of compliance in an optimal manner. In such a situation, no relationship between equilibrium levels of governance and corporate performance should be expected (Love, 2011). More specifically, better compliance with the corporate governance practices might improve the redistribution of rents between shareholders and managers, but not necessarily increase firms' performance. Thus better compliance might reduce agency costs for minority shareholders by disciplining managers and controlling shareholders more effectively.

In this regard, results of previous studies on the relationship between firms' performance and compliance with the corporate governance recommendations are inconclusive. For instance, Conyon and Mallin (1997) and Peasnell et al. (1998) indicate improvements in corporate performance after issuance of the Cadbury Report in 1992 (which recommends the adoption of some internal monitoring mechanisms with the aim of promoting shareholder interests). By contrast, Weir and Laing (2000) and Weir et al. (2002) do not find a significant relationship between complete compliance with corporate governance as contained in the Cadbury Report and firms' performance. They however, reported an increase in the number of firms which follow good corporate governance practices after the Cadbury Report. Similarly, Gompers et al. (2003), Brown and Caylor (2006), Bozec et al., (2008) and O'Connor (2012) indicate a positive association between governance and firms' performance. Moreover, other studies, such as, Core et al. (2006), Gupta et al. (2009) and Pandeya et al. (2015) report an insignificant relationship between governance and firms' performance.

The rationale for an association between corporate governance compliance and firms' performance arises because better governance enhances efficiency in the monitoring of managerial activities. This in turn, encourages managers to pursue value-maximizing projects and to avoid expropriation of firms' resources such as perquisites consumption (Love, 2011). In addition, better governance increases investors' protection by limiting expropriation of firms' resources from the majority shareholders (La Porta et al., 2002; Lemmon and Lins, 2003). There is also evidence of a decrease in the likelihood of corporate insolvency as a function of corporate governance characteristics because governance compliance improves the prospects for greater access to external funding (Claessens et al., 2003; Fich and Slezak, 2008; Amana and Nguyen, 2013). In contrast, firms might comply to an optimal level of corporate governance practices, which would not have a causal effect on performance since corporate governance compliance could be endogenously determined. In such a case there would be no observable relationship between governance and firms' performance (Love, 2011).

Keeping all the above mentioned points in mind, this study specifically controls for the effects of endogeneity and examines the impact of corporate governance compliance on firms' performance in the UK. We choose the UK for this investigation because it offers an environment where corporate governance regulations are optional, unlike the US where compliance is required by the US corporate law. Our findings contribute to the existing literature in at least two different ways. First, we address aspects of endogeneity that have been ignored or treated with arbitrary assumptions in previous research. While doing this we apply a dynamic generalised method of moments (GMM) estimator.[1] More specifically, we control for endogeneity that arises from: (i) unobservable heterogeneity – firm fixed effects; (ii) simultaneity – better corporate governance compliance leads to better performance, or alternatively, better performance leads to better corporate governance compliance; and, (iii) dynamic endogeneity – the possibility that contemporaneous compliance with the Governance Code is a function of past performance.

Second, we develop a governance index with fifteen provisions based on the UK Combined Code of Corporate Governance (2003), which is more comprehensive than prior UK studies (such as, Padgett and Shabbir, 2005; Arcot and Bruno, 2007; Clacher et al., 2008; Renders et al., 2010; Mouselli et al., 2014). We also include further aspects of compliance with respect to audit committees with different measures, such as, the number of meetings held and participation of a financial expert in the committees and believe that the use of all the additional measures would help in identifying and explaining the governance compliance – performance relationship.

We find no significant evidence to suggest that current or past compliance with good corporate governance practices leads to improvements in firms' performance. We arrive at similar conclusions whether we use accounting or market-based measures of firms' performance (i.e., ROA and Tobin's Q). We therefore report two major implications of our results. First, our results show the importance of considering the possibility of an endogenous relationship between governance and performance. Second, our results suggest that the causal link found in previous research, in which good corporate governance practices enhance firm performance, might be reversed in the sense that firms with low levels of performance might improve corporate governance compliance to signal the market about future performance. This effect is also more likely to arise as a result of the increase in institutional investments in firms with high level of compliance. This would mean that improvement in corporate governance compliance by firms is the result of greater monitoring by institutional investors which select high performing firms in their portfolios. We therefore argue that our findings have implications for the regulators and policy makers.

[1] See Roodman (2009) for a description and details of dynamic generalised method of moments (GMM) estimator.

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