Journal of Corporate Finance 43 (2017) 193–216

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Internal governance and performance: Evidence from when external discipline is weak

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ARTICLE INFO

Article history:
Received 13 April 2016
Received in revised form 4 January 2017
Accepted 11 January 2017
Available online 13 January 2017

JEL classification:
G30
G34
L31
I10

Keywords:
Corporate governance
Nonprofit organizations
Hospitals

ABSTRACT

The effect of internal governance on performance is potentially economically significant but may be difficult to identify because of confounding external disciplinary mechanisms and the endogenous choice of internal governance. This study addresses those difficulties by using nonprofit hospitals as an economic environment with muted external disciplinary mechanisms and instrumenting for internal governance using governance spillovers of geographically local public firms. Using patient heart attack survival as a measure of performance, a one standard deviation increase in strength of internal governance reduces the probability of death by 0.89 percentage points after controlling for patient characteristics.

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1. Introduction

Internal governance is a set of policies put in place to align managerial interests with claimants' interests. Estimating the effect of internal governance on performance is notoriously difficult. A firm's strength of internal governance is likely co-determined with unobserved firm characteristics and imperfectly observed external disciplinary mechanisms. In light of these difficulties, this study estimates the marginal effect of internal governance on performance in an economic environment with weakened external disciplinary mechanisms, and uses governance spillovers as an instrument to identify the relationship.

It is well known that imperfectly observed external disciplinary mechanisms confound estimating the linkage between internal governance and performance. This study uses nonprofit hospitals as an economic environment to study governance because in this setting many of the traditional external disciplinary mechanisms are muted. In the nonprofit universe there is a weakened market for corporate control, which can reduce managerial slack through the threat of takeover (Bertrand and Mullainathan, 2003) and has been found to have a large impact on the effect of governance (Cremers and Ferrell, 2014). Further, in the nonprofit universe there are no institutional investors to discipline management (Holderness, 2003) or do the Wall Street walk and divest their shares; there are no activist investors or blockholders to petition for a seat on the board of directors in order to change the operating performance of the organization; and there is limited product market competition, which can offset the deleterious effects of weak governance (Giroud and Mueller, 2011). Potentially offsetting these muted market based external disciplinary

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http://dx.doi.org/10.1016/j.jcorpfin.2017.01.005
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mechanisms is a heightened regulatory environment, which may limit the scope for managerial malfeasance, but unlike market based disciplinary mechanisms, regulation may be a blunt instrument, poorly tailored for a particular nonprofit hospital's situation. With many external disciplinary mechanisms weakened or missing, the effect of internal governance on performance may be more prominent thereby facilitating identification of the linkage between internal governance and performance.

The presence of imperfectly observed external disciplinary mechanisms presents a classic correlated omitted variables problem, as it is likely that the strength of internal governance is affected by the firm's exposure to external discipline. Estimating the effect of internal governance on performance is further confounded by simultaneity, as it is likely that the board's expectations of future performance affects its choice of strength of internal governance, and its choice of strength of internal governance affects the expected future performance. This study addresses these complications by using governance spillovers of geographically local public firms to instrument for nonprofit hospital governance. It is the nonprofit economic environment that allows me to argue that the direction of the spillovers is from public firms to nonprofit hospitals, not from nonprofit hospitals to public firms. These governance spillovers act as a source of exogenous variation in a hospital's strength of governance, which in turn is used to identify the effect of internal governance on performance.

While the weakened external disciplinary mechanisms in the nonprofit universe isolates the effect of internal governance, it comes at a cost — many traditional measures of governance are not applicable. I remedy this by constructing a measure of the strength of internal governance based on the involvement of the board in the compensation setting process of the CEO. This measure uses the presence or absence of pertinent policies to measure the board's involvement in setting the CEO's compensation package.

Measures of performance that are commonly used in the for-profit universe either don't exist in the nonprofit universe (stock returns) or do not have clear interpretations (Tobin's *Q* or return on assets) because of the lack of a clear objective function of a nonprofit. This study uses patient survival of an acute myocardial infarction (AMI), commonly known as a heart attack, to measure performance. In particular the effect of internal governance on performance is estimated using patient level medical records for 85,881 AMI patients at 62 hospitals in Arizona and Florida. This measure of performance in conjunction with the micro-level data has a number of benefits. In these data the disposition of all patients that are admitted to the hospital is reported. This limits the scope that managers can manipulate reported performance metrics. Further these data capture the demand for a firm's services (in this case demand for AMI treatment) and the characteristics of the firm's customers (in this case patient characteristics). Under the assumption that demand for AMI treatment is exogenous, the effect of internal governance on performance documented in this study comes from supply side improvements in the delivery of services. Further, this measure of performance compliments the existing literature by documenting internal governance affects operational performance, which could be one of the channels through which governance affects performance as measured by Tobin's *Q* or ROA in the broader literature.

In this economic setting I am able to consistently estimate the effect of internal governance on performance using an estimation technique that explicitly addresses endogeneity. The effect is non-trivial in magnitude. A one standard deviation increase in internal governance corresponds to a 0.89 percentage point increase in the probability of a patient surviving three days. One channel identified by these data is through more effective medicinal treatment of AMIs as measured by a reduction in adverse drug reactions. This is consistent with hospitals with stronger internal governance providing a higher quality of care, which in turn increases the probability of a patient surviving an AMI. I interpret these results as demonstrating that internal governance affects performance, and providing direct evidence that strong governance at the top of an organization substantively affects the performance of the organization at the operational level. This direct evidence of operational improvement is only possible through a detailed assessment of the workings of a uniform population of firms.

This study makes contributions to two distinct strands of literature. The first contribution is to the corporate governance literature. This study consistently estimates the effect of internal governance on performance. While the literature has provided evidence that corporate governance affects financial and accounting performance, this study emphasizes the breadth of the importance of corporate governance by demonstrating that governance has an economically significant effect on performance at the operational level. This evidence supports and extends the existing corporate governance literature by demonstrating a clear link between corporate governance and performance; and documenting that corporate governance improves performance at the operational level, which is one possible source of the value creation that other studies have documented.

The second contribution of this study is to the nonprofit finance literature, and in particular to the nascent literature on governance in nonprofit organizations. In 2010 the nonprofit organizational form controlled $4.5 trillion dollars in assets and recognized $2.1 trillion dollars in revenue in the United States. Nonprofit hospitals alone controlled $926 billion dollars in assets and recognized $773 billion dollars in revenue (Blackwood et al., 2012). The magnitude of the assets under control are economically significant, yet the nonprofit organizational form has received limited attention from the finance literature (Brickley and Horn, 2002; Eldenburg et al., 2004; Adelino et al., 2015; Newton, 2015). This study advances our understanding of the magnitude of the agency costs in nonprofit organizations and documents that effective board monitoring is crucial to the provision of high quality healthcare. Further, this study demonstrates that despite nonprofit organizations having an unclear objective function, the costs of agency conflicts are mitigated in a similar fashion to those at traditional for-profit firms.

2. Prior literature

Research on the effects of corporate governance falls in two primary categories. The first category is the effect of corporate governance on a firm's stock return or market value. Gompers et al. (2003) construct an index of shareholder's rights, referred

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