



Corporate governance and financial performance: The role of ownership and board structure[☆]

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ABSTRACT

This study examines how corporate governance and ownership structure relate to the financial performance of firms. We estimated this relationship using fsQCA. We enhanced our analysis using complementary linear and non-linear multiple regression analysis. The panel data used in this study covered 1207 companies from 59 countries across 19 sectors for the period 2013 to 2015. The study makes two main contributions. First, the multiple empirical techniques employed in this study offer a broader approach to the empirical analysis of financial performance. Second, the study aids our understanding of the role of corporate governance and ownership in the financial performance of firms.

1. Introduction

This study explores the determinants of financial performance. Corporate governance, firm size, and ownership are analyzed as antecedents of financial performance. This novel study combines fuzzy-set qualitative comparative analysis (fsQCA) of a large panel of firms (1207 companies from 59 countries for the period 2013 to 2015) with linear and non-linear multiple regression analysis (MRA). It thus overcomes the known limitations of linear regression analysis (Woodside, 2013) by using a comprehensive approach that embraces Poisson regression and fsQCA.

The study has two salient features. First, from a methodological perspective, the study combines the use of three empirical techniques. Second, the study provides some useful hints for practitioners and managers regarding the controversial relationship between corporate governance and financial performance.

The academic debate on the link between corporate governance and financial performance is open. For example, do high stock dividends negatively impact future returns? Does a high capitalization ratio affect return on equity (ROE)? And what is the optimal board size? Certain scholars suggest that corporate governance and firm performance are complex (Hermalin & Weisbach, 1991; Dalton & Dalton, 2011; McGuire, Dow, & Ibrahim, 2012a; Fogel & Geier, 2007). These scholars have found multiple contradictory linkages including outside directors,

compensation, and board size. Furthermore, the empirical findings in this area are not conclusive (Bhagat & Black, 2001; Klein, 2015). Yet, studies have failed to jointly control for board size, compensation, and ownership dispersion. Research has shown that ownership dispersion is relevant to financial performance (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 2002; Maury & Pajuste, 2005; Konijn, Kräussl, & Lucas, 2011). This study uses board size and ownership dispersion to provide a new perspective on previous studies (Bhagat & Black, 1999; Eisenberg, Sundgren, & Wells, 1998; Jensen, 1993; Hermalin & Weisbach, 2001). Additionally there is no clear consensus on the most suitable way to measure financial performance (Dalton & Dalton, 2011). This study uses ROE as a direct measure of financial performance (Bhagat & Black, 1997).

The rest of the study is structured as follows: Section 2 presents the research hypotheses. Section 3 introduces the data set and empirical method. Section 4 presents and discusses the results. Section 5 concludes by providing research limitations, managerial implications, and avenues for future research.

2. Conceptual framework

Corporate governance is a popular target of academic research because of its substantial effect on the firm. Relevant research topics include shareholders, the board of directors, management remuneration,

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corporate governance policies, and social media (Bebchuk & Weisbach, 2010; Paniagua, Korzynski, & Mas-Tur, 2017; Paniagua & Sapena, 2014a, 2014b; Shleifer & Vishny, 1997). This study's conceptual framework and hypotheses are based on agency theory, which is the most widely used conceptual framework to analyze corporate governance (Fama & Jensen, 1983; Jensen & Meckling, 1976). According to this theory, multiple ownership represents a challenge to the firm because of a lack of incentives to control asset management (Grossman & Hart, 1986). While corporate governance through a board of directors partially solves this problem, it introduces new issues such as information asymmetries, which give rise to the classic agency problem between owners and managers. This study identifies two key areas of corporate governance that affect financial performance: board members and ownership.

2.1. Board members and financial performance

Scholars have confirmed that the board structure is a relevant aspect of agency theory (Jensen & Meckling, 1976; Eisenberg, 1976; Fama, 1980; Fama & Jensen, 1983; Dalton & Dalton, 2011; Dey, 2008; Bhagat & Bolton, 2008). Studies have shown that external board members play a crucial role in monitoring the firm's activities (Brickley, Coles, & Terry, 1994; Shivdasani, 1993; Bebchuk & Weisbach, 2010). Much of the existing literature confirms that the most efficient boards of directors have a larger proportion of outside directors than insider directors (Mizruchi, 1983; Lorsch & MacIver, 1989; Zahra & Pearce, 1989; Dalton, Daily, Ellstrand, & Johnson, 1998; Rosenstein & Wyatt, 1990; Denis, 1999; Bhagat & Black, 2001).

Several theories explain the advantages of smaller boards. One is cohesiveness, which is helped by smaller boards. Evans and Dion (2012) report a positive association between group cohesion and performance. Another is strategic management. Large boards limit the members' ability to initiate strategic interactions (Goodstein, Gautam, & Boeker, 1994). Moreover, board members' assessments of top management are more easily manipulated when boards are large (Mintzberg & Mintzberg, 1983).

However, the relationship between board composition and firm financial performance is inconclusive. Several studies present evidence of a negative correlation between board size and firm value (Bhagat & Black, 1997; Eisenberg et al., 1998; Jensen, 1993). For example, Yermack (1996) used a sample of 452 large US industrial corporations to show that small boards of directors are most effective. Eisenberg (1997) studied profitability for a sample of small and midsize Finnish firms and found a negative correlation. In contrast, Dalton et al. (1998) conclude that most studies provide scant evidence of the relationship between financial performance and board structure. Based on a sample of 20,620 observations from 131 studies, a meta-analysis by Dalton, Daily, Johnson, and Ellstrand (1999) suggests a positive correlation between board size and financial performance. Several scholars have also suggested a non-significant relationship (Fogel & Geier, 2007; Coles, Daniel, & Naveen, 2008; Dalton & Dalton, 2011). These findings led Dalton and Dalton (2011) to affirm that “there is virtually no evidence related to the financial performance of the firm about either of these fundamental elements of firms' governance structures”.

The linkages between the board and financial performance have been studied using a broad array of empirical approaches and data. He and Huang (2011) exploited the informal hierarchy dimension and showed a positive relationship with financial performance. Post and Byron (2015) examined the relationship between gender of the board members and financial performance, concluding that female board representation is positively related to financial returns. Some scholars, such as Conyon (2014); Kor and Mahoney (2005), and McGuire, Dow, and Ibrahim (2012b), have used the dimension of executive compensation, whereas others (Bear, Rahman, & Post, 2010; Marie McKendall, Carol Sánchez, & Paul Sicilian, 1999; Webb, 2004), have based their research on other characteristics such as diversity and social

responsibility.

Hypothesis 1. The number of board members is negatively related to the firm's financial performance.

2.2. Ownership and financial performance

Two key ownership-related features affect financial performance: ownership dispersion and ownership costs. Certain scholars argue that firm ownership dispersion is an important component of financial performance. The seminal research of Fama and Jensen (1983) discusses the concept of entrenchment, or the adverse effect of a high share of management ownership driven by short-term opportunism. Empirical evidence seems to support this argument. Booth and Chua (1996) showed that broad initial ownership increases secondary-market liquidity, which in turn reduces the required return to investors. Maury and Pajuste (2005) found evidence that the presence of a strong third substantial shareholder positively affects firm value, while a second large shareholder may negatively affect firm value. Konijn et al. (2011) investigated the effect of concentrated versus dispersed blockholder ownership on firm value, reporting a negative relationship between blockholder dispersion and financial performance. Similarly, Anderson and Reeb (2003) posit that family influence can also provide competitive advantages and that family firms outperform non-family firms. Other studies have failed to show a significant relationship between ownership concentration and company performance (Demsetz & Villalonga, 2001).

Hypothesis 2. Ownership dispersion is negatively related to the firm's financial performance.

The main sources of ownership financial costs are dividends. Easterbrook (1984) posits that dividends are a way of aligning managers' interests with those of investors. Dividends, which in the short run undermine prospective investment, therefore reduce agency costs. This is especially true in countries with weak institutions and poor shareholder protection (La Porta, Lopez-de Silanes, Shleifer, & Vishny, 2000; Pinkowitz, Stulz, & Williamson, 2006). In advanced economies, high dividends are associated with low growth companies (Gaver & Gaver, 1993). For example, Gugler (2003) reports that, in Austria, companies that are controlled by the state tend to pay higher dividends than private firms do. Additionally, Allen, Bernardo, and Welch (2000) indicate that firms use dividend policies to attract institutional investors.

Hypothesis 3. Ownership cost (dividend) is negatively related to the firm's financial performance.

3. Empirical methods and data

3.1. The data set

This study used panel data for a random sample of 1207 companies from 59 countries across 19 sectors for the period 2013 to 2015. These data were obtained from the Orbis database (Bureau van Dijk). The dependent variable was the annual growth rate of ROE. The variables of interest were measured as follows: The board members variable was measured by counting the number of members on the board. Ownership dispersion was measured using a composite index (0.1 to 1) where 0 indicated concentration of ownership and 1 indicated maximum dispersion. Property dispersion was calculated as follows: 1 for companies with six or more identified shareholders whose ownership percentage was known, and 0.1 for companies with a recorded shareholder with a direct stake of more than 50%. All other firms lay between these two cases. The dividends variable was measured as the annual dividend payout (in US dollars). All variables came from the same data source.

An important component of financial performance is firm size. Our estimates would be biased if we failed to control for firm size

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