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Impact of corporate governance on firm's performance The case of the Portuguese Listed Firms.

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ABSTRACT

Purpose: Corporate governance issues have been particular important in the last years because of diverse international scandals (e.g. Enron e a WorldCom in the US, Parmalt in Italy, and Banco Português de Negócios in Portugal, among others). This calls for the need for a reformulation of governance mechanisms to minimize agency conflicts and restore confidence in capital markets as well as transparency of the company's economic and financial situation. The choice of some corporate governance issues may have impact in the company's performance, as it may influence agency costs between the principal and managers and between type of investors and may impact the firm's financial decision. In this sense, this paper aims to analyze the impact of corporate governance' characteristics on the financial performance of Portuguese listed firms.

Design/methodology/approach: A panel data of listed companies on Euronext Lisbon, between 2012 and 2016, and the multiple linear regression model, was used.

Findings: We find that results depend on the performance ratio used. The main results suggest that the size and independence of the board of directors have impact on the company's performance. Moreover, we find that financial investors give relevance to best corporate governance practices.

Originality: Most studies analyzing this thematic focus on major countries. This work focuses on a small-size country, where corporate governance mechanisms were questioned due to diverse bankruptcies and financial scandals. Moreover, accounting and market-based performance are addressed to see the main differences and similarities.

Keywords: Performance, Corporate governance, ownership, listed firms.

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1. Introduction

The financial scandals of some companies, as Enron and WorldCom in the U.S.A, and Parmalat in Italy, called the attention of unethical corporate governance practices. Therefore, diverse countries have change corporate governance recommendations to give confidence to financial markets and to promote the company's financial information transparency.

Portugal was not an exception. In 2015, after the financial scandal of Banco Português de Negócios and Banco Popular Português in 2008, and Banco Espírito Santo in 2014, the CMVM (Comissão de Mercado de Valores Mobiliários – Security Market Commission) admitted a lack of self-regulation about corporate governance, and, assigned the IPCG (Instituto Português de Corporate Governance – Portuguese Institute of Corporate Governance) with the responsibility to create a new corporate governance code, which was published in May 2016, and revised in 2018.

Different practices of corporate governance may impact company's performance. All companies want to increase profits and its value, but this can be limited due to some firm's characteristics. Studies analyzing which determinants impact company's performance are diverse (e.g. Anderson and Reeb, 2003, Villalonga and Amit, 2006, Miralles-Marcelo, Miralles-Quirós and Lisboa, 2014). Although, it does not exist a unique model, neither a unique way to measure performance. Moreover, studies considering the impact of corporate governance characteristics in company's performance are more scarce (e.g. Bhagat and Black, 1999, Black, Jang and Kim, 2006, Cunha and Martins, 2007).

This paper aims to study the impact of corporate governance determinants in the company's performance. For that, Portuguese listed firms, from 2012 till 2016 were analyzed.

Following previous researchers, three alternative proxies of performance were used, two related with accounting performance: ROA (Return on Assets) and ROE (Return on Equity), and one related with financial performance: Tobin's Q. ROA measures the return of the investments made by the company, while ROE measures the return of the firm's owners. Tobin's Q allows to analyze if the company' shares are under or over-valuated by the financial market.

To analyze the impact of corporate governance characteristics five different variables were selected: dimension and composition of the board of directors, ownership concentration, managers' remuneration and the type of auditor (one of the big4 companies or other). Control measures were also considered: company' size, leverage, growth opportunities and age.

The main results show that the board of directors' composition, namely the presence of independent directors, impact the company's performance. Moreover, opportunity growth, and the company' age also impact it. Although the impact depends on the performance proxy used. Financial investors are more worried with corporate governance practices, since they want to invest in ethical companies to assure that their investments are secure. Thus, they prefer companies with more independent members on the board of directors, new companies and with less growth opportunities, to avoid opportunistic behaviors and expropriation of the company's value. For another size, the company's profits and accounting performance increases with the dimension of the board of directors, with less independent members, more growth opportunities, to companies with less leverage and older. In this case, the possible to growth, the accumulate knowledge and the convergence in the moment of the decision making are relevant factors to increase the company's net income, and thus return.

The paper is organized as follows: after this introduction topic, is presented a literature revision of corporate governance, and its impact on company's performance. After the sample, variables and methodology followed are explained. Results and its discussion are shown afterwards. To finish, the main conclusions of this study and suggestions for future researches are enlightened.

2. Literature Review

Corporate governance is the processes and structures companies adopted to protect stakeholders' interests and control the company's performance. It may promote transparence, fairness and responsibility (IPCG, 2018).

The more relevant corporate governance code mas created in 1992 by the Cadbury Committee (Cadbury, 1992). Later, other institutions also create some corporate governance codes as for example OECD (Organization for Economic Co-operation and Development) that created principles in 1999, Sarbanes-Oxley Act in 2002, Principles of Good Corporate Governance and Best Practice Recommendations, among others. In Portugal, the CMVM approved its first corporate governance code in 1999 with 17 practices of corporate governance (CMVM, 2007). After 2015 the IPCG was designed to be responsible for this thematic, who published the first code in May 2016, which was revised in 2018 not only to complement the legal system but also to be a guide of a good corporate governance practices.

Corporate governance recommendations should be followed by listed firms but are recommended to all companies. Since 2006, European listed firms must publish an annual report about corporate practices with the philosophy of comply or explain (IFC, 2015). When recommendations are not followed, companies must justify their decision. Although Heidrick & Struggles (2014) show that Portugal still far from some best practices of corporate governance already followed by other European countries.

A good corporate governance system will attract more investment to the company and increase its performance. The link between corporate governance and performance was suggested by Baysinger, Kosnik and Turk (1991), Bhagat and Black (1999), Alves and Mendes (2001), Black et al. (2006), Cunha and Martins (2007), Marques (2015), among others. This relation can be detected using corporate governance characteristics as determinants to explain companies' performance. The most common are: board of directors' dimension and composition, ownership composition, remuneration practices and type of auditing. Following we will explain the impact suggested by previous researcher.

3. Hypothesis development

Board size may impact company's performance as board members play a relevant key role in monitoring management and in aligning the interests of shareholders and managers. Moreover, they also give guidelines to managers that may increase the company's performance (Fama and Jensen, 1983).

Portuguese corporate governance recommendations did not establish an ideal number of board of directors' members. Anderson, Mansi and Reeb (2004) argue that it may be proportional to the firm' size. Although, its dimension may impact the company's performance.

A large board of directors have more problems of communication and organization which make it difficult to find a consensus in the decision making (Jensen, 1993, Yermack, 1996, Eisenberg, Sundgren and Wells, 1998, Bennedsen, Kongsted and Nielsen, 2004, Cunha and Martins, 2007). A small board of directors usually have less agency conflicts and work more in group in the way to increase the company's performance (Rodrigues, 2012). This leads to our first hypothesis:

Hypothesis 1: Board of directors size negatively impacts the company's performance.

Board composition, namely, the number of independent members on the board of directors may also impact the company's performance. Corporate governance recommendations argue that board of directors should have at least on third of independent members, but always plural (recommendation III.4, IPCG 2018). Although, not all companies follow this recommendation.

The impact of independent members on company's performance is not consensual. Some researchers found a positive relation as more independent members may protect investors and the company's interests. These members work as monitoring mechanisms to control managers from expropriations, ameliorating the principal-agent problem (Esperança, Sousa, Soares and Pereira, 2011).

Although, Agrawal and Knoeber (1996), Yermack (1996) and Cunha and Martins (2007) argue that a high percentage of independent board members may have a negative impact on the company's performance. Independent members may not be really independent and may have relations with some members of the company or they may not be compensated by the effort made and thus will not be motivated to defend the company's interests. Moreover, insiders have more information about the company and if they are also owners, they may take decisions that increase the company's value.

This work analyzes Portuguese companies as the one of Cunha and Martins (2007), so we expect to find a similar conclusion. The second hypothesis is the followed:

Hypothesis 2: The independence of the board of directors negatively impacts the company's performance.

Ownership concentration may impact company's performance as major owners may control managers and influence their decisions. For one side, ownership concentration reduces agency conflicts between the principal and managers, as major owners are the company managers or highly control them, avoiding opportunistic behaviors that may lead to the expropriation of the company's wealth (Jensen and Meckling, 1976). Agrawal and Mandelker (1990) found a positive relationship between ownership concentration and firm performance as major owners make all the efforts to maximize the company's wealth and in turn their own one. Moreover, due to the monitoring effect, information asymmetries reduce leading to a better performance. Thus, hypothesis 3 naturally follows:

Hypothesis 3: Ownership concentration positively impacts the company's performance.

To guarantee an alignment of interests between managers and owners, Portuguese corporate governance recommendations argue that managers may receive a variable remuneration that reflects manager's performance (recommendation V.3.1, IPCG 2018).

When managers can increase their personal wealth, they may do all the efforts to increase the company's value. Cunha (2005), Cunha and Martins (2007), Rodrigues (2014) and Marques (2015) found that managers remuneration has a positive effect on company's performance. The following hypothesis is developed:

Hypothesis 4: Variable remuneration positively impacts the company's performance.

The auditor is another relevant factor that may impact company's performance, as the auditor may analyze the effectiveness of the internal control mechanisms and report all detected problem (recommendation VII.2.4, IPCG 2018). Previous researchers (Hallak and Silva, 2012) found that companies audit by one of the big4 companies have information more transparent and more reliable, which may give more confidence to stakeholders, specially minority investors. Moreover Marques (2015) found that companies audited by one of the big4 have higher performance, as these companies may be more independent when monitoring the company. The next hypothesis follows:

Hypothesis 5: A big4 auditor positively impacts the company's performance.

Not only corporate governance characteristics may impact the company's performance. The company's size may also influence it. Large-size companies may benefit from economies of scale, reducing some costs (Miralles-Marcelo et al., 2014). Moreover, these companies have greater presence on the market and thus may use their full capacity, which is translate in more profits. These companies also have less costs of bankruptcy (Rajan and Zingales, 1995). Thus, it is expected the following relationship:

Hypothesis 6: Company' size positively impacts its performance.

The company's indebtedness may also impact its performance. Debt, specially bank debt, is an extern mechanism to control managers opportunistic behaviors, as it reduced the company free cash flow (Jensen and Meckling, 1976). Cunha (2005) found that debt increases the firm performance as to comply debt covenants, companies should increase their performance, being more efficient in the decision making to avoid bankruptcy risk. Although, for another side, debt may increase the company's costs and bring more instability and uncertainty, leading to a reduce of the company's profits (Miralles-Marcelo et al., 2014). Therefore, we expect that leverage impacts the company's performance, but we cannot predict the sign. The next hypothesis is stablished:

Hypothesis 7: Indebtedness impacts the company's performance.

Company's growth opportunities may also impact its performance. Companies with more growth opportunities may do new and innovative investments, increasing its efficiency (Villalonga and Amit, 2006). Although, these companies also have more free cash flow available and so managers may have more opportunistic behaviors, expropriating the company's wealth (Vogt, Degenhart, Kaveski and Fank, 2013). Moreover, new investments usually increase the company's risk. Miralles-Marcelo et al. (2014) found a positive relationship between growth opportunities and performance when analyzing the Portuguese market. Thus, the next hypothesis naturally appears:

Hypothesis 8: Growth opportunities positively impact the company's performance.

Finally, the company's age may also impact its performance. Old companies may benefit from economies of scale, accumulated knowledge about the market, reputation and more consolidated market quote, and thus may have greater performance (Miralles-Marcelo et al., 2014, Coad, Segarra and Teruel, 2016). Although, older companies may be at a maturity stage, with difficulties to growth and to increase their profits and the market expectation about the future of these companies may be of declining instead of growth (Black et al., 2006). As results found to the Portuguese market had a positive relationship, our last hypothesis is the following:

Hypothesis 9: Company's age positively impacts its performance.

4. Empirical Work

4.1. Sample

The sample includes Portuguese listed companies from 2012 till 2016. Portugal is a small-dimension country almost unexplored not only due to its dimension but also because of the difficulty to find available data. The choice for listed companies was due these are the only companies that have the obligation to produce and publish corporate governance report, that is the thematic analyzed in this work.

From the total sample we exclude companies without corporate governance reports, and companies from football clubs and from financial sector as these companies have specific accounting system which limit the calculation of measures proxies of performance.

The final sample is an unbalanced sample of 37 companies with a total of 178 observations.

4.2. Variables

The company's financial information was collected from SABI database. Information regarding corporate governance characteristics was collected from corporate governance reports that are published in the webpage of CMVM.

Three alternative measures of performance are used: ROA (Return on Assets), ROE (Return on Equity) and Tobin's Q. ROA is the ratio between net profit and total assets. ROE is the ratio between net profit and total equity. Finally, Tobin's Q was calculated using the formula proposed by Chung and Pruitt (1994):

$$\text{Q de Tobin (Q\_TOBIN)} = \frac{\text{Valor de Mercado dos Capitais Próprios} + \text{Dívida}}{\text{Ativo Total}}$$

Five variables to analyze corporate governance characteristics are considered. The first one: board of directors' dimension (BOD size) is the ratio between the total number of board of directors and the natural logarithmic of total assets. We followed the study of Anderson et al. (2004). The board of directors' composition (BOD comp) is the ratio between independent members over total board of directors' members. Similar variable was used by Bhagat and Black (1999) and Cunha (2005). Ownership concentration of qualified owners (Own Conc) is the total percentage in the hands of qualified owners. Remuneration (Rem) is a dummy variable which equals to one when manager's remuneration is variable, depending on the company's performance, and zero otherwise. Finally, auditor is also a dummy variable which equals to one when one of the big4 (PricewaterhouseCooper, Delloitte, Ernest and Young and KPMG) is the auditor of the company and zero otherwise.

Some control variables regarding the company characteristics were also used. The company' size (Size) is the natural logarithm of total assets, as Agrawal and Knober (1996), Yermack (1996), Bhagat and Black (1999). Leverage (Lev) is the ratio between total liabilities and total assets. Growth opportunities (GO) is the ratio between total asset of year t divided by total asset of previous year. Finally, age is the total number of years the company is in activity.

The descriptive statistics of the variables are presented in table 1.

Table 1. Descriptive statistics

	Mean	Median	Maximum	Minimum	Std. Deviation
ROA	0.0247	0.0183	1.4367	-0.5619	0.1423
ROE	0.0118	0.0409	1.0594	-4.3920	0.4286
Q	1.8354	0.7781	38.7970	-0.1421	4.1821
BOD size	0.4360	0.3918	0.9411	0.1442	0.1877
BOD comp	0.1932	0.2000	0.7800	0.0000	0.1889
Own Com	0.7793	0.7770	0.9974	0.5144	0.1255
Rem	0.9101	1.0000	1.0000	0.0000	0.2868
Auditor	0.7921	1.0000	1.0000	0.0000	0.4069
Size	19.8405	19.6689	23.8499	15.0724	1.5761
LEV	0.4986	0.4826	2.5173	0.0012	0.3363
GO	1.0063	1.0017	1.7526	0.4592	0.1717
Age	30.7528	24.0000	105.0000	3.0000	21.7488

ROA – Return on assets, ROE – Return on equity, Q – Tobin's Q, BOD size – board of directors' size, BOD com – board of directors' composition; Own Con – ownership concentration, Rem – remuneration, Auditor – big4 company, Size – company' size, LEV – leverage, GO – growth opportunities, Age – company's age

Source: Researchers (2020)

4.3. Model

The proposed model is the following. It was created based on the literature review and the aims of the work.

$$\begin{aligned}\text{Performance}_{i,t} &= \propto_{i,t} + \beta_1 \times \text{BOD size}_{i,t} + \beta_2 \times \text{BOD comp}_{i,t} + \beta_3 \times \text{Own Conc}_{i,t} \\ &+ \beta_4 \times \text{Rem}_{i,t} + \beta_5 \times \text{Auditor}_{i,t} + \beta_6 \times \text{Size}_{i,t} + \beta_7 \times \text{Lev}_{i,t} + \beta_8 \times \text{GO}_{i,t} \\ &+ \beta_9 \times \text{Age}_{i,t}\end{aligned}$$

Performance is one of the three alternative measures defined. The model will be estimated using the ordinary least square methodology.

4.4. Results

Table 2 shows the results obtained after estimating the proposed model.

Table 2. Corporate governance characteristics impact on performance

	ROA	ROE	Q
C	-0.1480	-1.0542*	9.8990
BOD size	0.1104*	0.5274***	-1.1073
BOD com	-0.1191**	-0.1425	5.3211***
Own Con	-0.0416	-0.1392	-4.6120
Rem	0.0284	-0.0809	0.0835
Auditor	0.0368	0.0510	0.9847
Size	0.0038	0.0267	0.0232
Lev	-0.0087	-0.1538*	0.2648
GO	0.1700***	0.5102***	-5.6826***
Age	0.0011**	0.0013	-0.0242*
Adjusted R2	**4.31%**	**9.62%**	**12.68%**
F-statistic	1.8862*	3.0921***	3.8548***

ROA – Return on assets, ROE – Return on equity, Q – Tobin's Q, BOD size – board of directors' size, BOD com – board of directors' composition; Own Con – ownership concentration, Rem – remuneration, Auditor – big4 company, Size – company' size, LEV – leverage, GO – growth opportunities, Age – company's age

Source: Researchers (2020)

Our conclusions depend on the performance proxy used, especially if it is an accounting measure or a market-based measure. Bhagat and Bolton (2008: 264) suggest that "stock market-based performance measures are susceptible to investor anticipation" justifying the difference in results using accounting or market-based measures of performance.

Board of directors' size positively impacts the company's performance, but only measured by accounting variables, contrary to hypothesis 1. It was supposed that a large board of directors may have problems of communication, which may impact the decision-making process. Although, to the Portuguese market results are the opposite may be because, in mean, the number of board of directors' members is less than 9, and if the board is to small may be there are some problems of expropriation of the company's wealth. Cunha and Martins (2007) found that companies with 5 to 9 members have more performance than companies with more members. As in this case the mean number of members is 9 it may justify this finding. Similar results were found by Rodrigues (2012) and Marques (2015) to the same market and using ROA to measure the company's performance.

Regarding the independence of the board of directors, results are mixed: using accounting variables to measure the performance the impact is negative as expected in hypothesis 2 but using a market-based variable the impact is positive. It seems that companies with more independent members have less profits, may be due to more costs to pay these members or even because independent members may have different strategy to the company and the divergence of ideas may cause a negative impact in the company. Board members with stock ownership may have personal incentive to take effective decisions to the company. Similar results were found by Bhagat and Bolton (2008). Although, financial investors prefer companies with more independent members to protect their rights and avoid expropriation of the company's wealth. Esperança et al. (2011) and Marques (2015) argue that independent members are a substitute of monitoring mechanisms.

Ownership concentration is insignificant to explain the performance of companies in this sample. Although this result may be related with the high percentage of ownership of the qualified owners of this sample, as less than 22% of the ownership (in mean) is dispersed. Hypothesis 3 is not validated.

Regarding managers remuneration, the existence of variable remuneration did not impact company's performance as expected, may be because almost all companies of the sample have the practice of variable remuneration to managers, following corporate governance recommendations. The type of the audit company has also no impact on the company's performance may be because most of the companies in the sample have a big4 company as auditor.

Hypothesis 6 is not validated since company' size do not impact its performance. Although, companies in the sample are all listed companies, with medium and large size and according to Anderson and Reeb (2003) in this case the size may not be a relevant variable.

Results prove that an increase in debt has a negative impact on ROE, since net profit decreases and shareholders risk increase. Similar results were found by Miralles-Marcelo et al. (2014).

Growth opportunities positively impact the company's performance when measured by accounting variables, but has the opposite relationship using the market perspective. It seems that companies with more opportunities can do new investments, increasing their sales and incomes, and in turn, increasing profits. Similar results were found by Miralles-Marcelo et al. (2014). Although, using the market perspective of performance: Tobin's Q, an increase in growth opportunities deals with a decrease in the company's performance may be because financial investors are less protected from managers opportunistic behaviors that may damage the company's value. This result was also found by Vogt et al. (2013).

The company's age has a positive impact on ROA but a negative impact on Tobin's Q. Older companies, due to their knowledge and reputation have possibilities to increase its profits, leading to an increase in the company's performance, as expected in hypothesis 9. Similar results were found by Miralles-Marcelo et al. (2014), Coad, Segarra and Teruel (2016). Although, from the market perspective the results are the opposite as financial investors may have few perspectives of growth to these companies. Moreover, older companies may have more free cash flows and thus managers may expropriate the company's wealth, in detriment of investor's wealth maximization.

The expected results and the real one founds are synthesized in table 3.

Table 3. Synthesis of expected and found results

	Hypothesis	Expected Sign	Result found		
			ROA	ROE	Tobin's Q
BOD size	H1	-	+	+	NS
BOD independence	H2	-	-	NS	+
Ownership concentration	H3	+	NS	NS	NS
Managers remuneration	H4	+	NS	NS	NS
Auditor	H5	+	NS	NS	NS
Size	H6	+	NS	NS	NS
Leverage	H7	?	NS	-	NS
Growth Opportunities	H8	+	+	+	-
Age	H9	+	+	NS	-

NS – not significant

Source: Researchers (2020)

Analyzing table 3 we can see that not all the expected results were found, and results are also different analyzing performance using an accounting or a market perspective. It seems that the board of directors' composition, growth opportunities and age are relevant variables to explain the performance, although their significance is the opposite using ROA and ROE or using Tobin's Q. This fact can be explained as the accounting perspective of performance is focused on past information, whether Tobin's Q depends on the perceptions of financial investors of the company's future. Although, to both perspectives board of directors' characteristic has a relevant impact on performance, justifying the need to consider corporate governance in the moment to take decisions.

5. Conclusion

There is a growing concern over corporate governance practices to protect stakeholders' interests and promote company's transparency. Therefore, this work aims to analyze the impact of corporate governance characteristics on its performance.

A sample of Portuguese listed firms and during the period from 2012 till 2016 was analyzed. Three different measures of performance were used: two accounting variables: ROA and ROE and one market-based variable: Tobin's Q. Moreover, we take into consideration five characteristics of corporate governance: dimension and composition of the board of directors (following most of the works in this area), ownership concentration in the hands of qualified owners, the type of manager's remuneration (if it is variable or not), and the type of auditor company (if it is one of the big4 or no).

The results of this study reveal that only board of directors' composition is relevant to explain company's performance. In an accounting perspective a larger dimension of the board of directors but with few independent members cause an impact on performance. These may be explained since insiders are more effective directors as they have more information about the company that may lead to increase incomes and thus profits. In a market perspective, more independent members on the board lead to superior performance may be because financial investors want to be protected from expropriations.

Moreover, growth opportunities also impact the company performance but has a positive impact on return, as firms with more opportunities to invest can increase incomes and thus increase profits; to a market perspective has a negative impact since managers have more free cash flow and more opportunity for opportunistic behaviors. Age has also impact on performance but again two opposite signs. Older firms have more profits, but for another side as these companies may have more difficult to growth in the future and thus exhibit smaller performance when measured by Tobin's Q.

This study contributes to the literature since it shows that to Portugal the accounting perspective differs from the market-based one. Small investors want to be protected from expropriations and thus increase the market value of companies that assure it. Although, in terms of actual returns it may have a negative impact. This also can be explained due to the information asymmetries between insider and outsider owners, since the first group has more information about the company.

The above findings are relevant not only for researchers, but also to policy makers and corporate boards as they may understand how they can improve the company's performance.

To future research another perspective of performance could be used: The Economic Value Added (EVA) to see which corporate governance characteristics impact this new measure. This variable considers the profits of the company but see if it is generating (or no) additional value, it means, if that returns are enough to pay the cost of finance the company's investments.

Moreover, Portugal is a small-dimension country and all companies have similar size and corporate governance characteristics. Thus, it could be relevant not only to analyze other countries but also to compare between small-size and large-size countries to see which the main differences.

As the dimension and composition are the more relevant variables to explain the company's performance it could be interesting to see the impact when the president of the board and the CEO are the same person and the impact of family members in the board.

Finally, the Portuguese corporate governance recommendation had a big change in 2016. Thus, it could be interesting to see if the practice of the companies has changed after that year, and which practices have changed to see if this modification was relevant to cause impact in the company's performance.

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