The Inter-conditioning between Corporate Governance and Financial Performance

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Abstract

The current economic context, as well as previous research, highlights the importance of corporate governance over the financial performance expected by companies. Therefore, the study of the current practices in the field of corporate governance, the impact that it has on the results of the companies, but also vice versa – the identification if the financial performance achieved puts its mark on the degree of compliance with the requirements established for good corporate governance – is a representative approach in opening new priorities for the interests of companies. This is the objective of the present research in which, applying quantitative research methods, the authors tested some hypotheses that demonstrate the corporate governance and the financial performance causality of companies on the Romanian capital market.

Keywords: *emerging markets; corporate governance conformity; Corporate Governance Code; financial performance; Bucharest Stock Exchange*

JEL Classification: *G34, M40*

1. Introduction

The financial scandals of the last decades, the increasingly sophisticated expectations regarding the quantitative, as well as the qualitative, global performance, have led to new ways of corporate governance. Evidence in this regard provides us with the evolution of corporate governance regulations, but also the remarkable advances in research from this point of view. The Organization for Economic Cooperation (OECD) has developed principles of corporate governance, and in the United States (US), in 2002, the Sarbanes-Oxley Act (SOX) was introduced.

Multiple researches have investigated the effectiveness of corporate governance regulations. Some researchers have studied the relationship between corporate governance and financial performance. Bhagat & Bolton, in 2009, studied this relationship for the pre- and post-adoption period of SOX law for a sample of US companies, demonstrating the existence of a positive influence between the independence of the Board of Directors and the financial performance after the adoption of the SOX law. They also found that there is a significant positive relationship between the financial performance indicator expressed by the return on assets (ROA) and the corporate governance index (G-index) after implementing the SOX law. The positive relationship between financial performance and corporate governance indicators is also demonstrated by researchers Orazalin & Mahmood (2018), Mishra & Mohanty (2018), Wessels et al. (2017), Chen & Chen (2011), Cremes & Nair (2005) et al.

In other studies, conducted in developed countries, the relationship between a strong board structure and the high degree of compliance with the requirements of the Corporate Governance Codes has been demonstrated by Zhang& Erasmus (2016); Switzer (2007); Boone et al. (2007); Gillen et al. (2007). Moreover, nowadays, powerful companies disclose to the public both financial and non-financial reporting, whose purpose is to increase the transparency and credibility of reporting (Marinescu, 2020).

However, the transition and emerging economies represent a vast area of research in this topic, due to the particularities of these types of economies (Svejnar, 2002). Moreover, Svejnar believes that in emerging economies there are particularities of governance that can influence decision makers. Studies on this topic

were conducted on emerging economies of Asia (China, India) and Central and Eastern Europe. Romania, a country with an emerging economy, is facing various problems of governance of companies with effects both in the public and private sectors. The Bucharest Stock Exchange (BVB) has developed, over time, several versions of the Corporate Governance Code. In 2015, BVB drafted the new Corporate Governance Code (the Code), applicable to all companies listed on the Romanian capital market on the Main segment as of January 2016. The Code contains 41 corporate governance requirements. Its purpose is to create an attractive capital market for foreign investors by increasing transparency and trust in companies through good corporate governance.

Previous studies carried out on Romanian companies indicate the existence of a dependency relationship between corporate governance and financial performance (Dănescu & Popa, 2019; Avram et al., 2017; Spătăcean et al., 2017; Dănescu et al., 2015; Lupu & Nichitean, 2011).

2. Data and methodology

Starting from the previous demonstrations regarding the influence of governance on financial performance, in the current economic context, we consider the development of new research to highlight other representative aspects. The purpose of this research is to highlight the role of the Corporate Governance Code (CGC) on financial performance for the companies listed on the Bucharest Stock Exchange (BSE).

We have based the research on the hypothesis that ensuring the companies' compliance with the requirements of the CGC positively influences the financial performance, in the case of the companies listed on the BSE, and vice versa.

To test the hypothesis using econometric models, we used quantitative data published by companies during the listing period on BVB (ln_age), but also annual financial indicators (total assets, total debt, total equity) based on which we calculated the rate of return on assets (ROA) and the ratio between debt and equity (DE_ratio). Also, using the qualitative data published in the Corporate Governance Statements, we calculated the degree of compliance of companies (CGDI) with the requirements of the Corporate Governance Code issued by BVB in 2015, with incidence from 2016. The data

were taken from the base data of BVB, as well as from the websites of the analyzed companies and are expressed in absolute or relative values. We used natural logarithm from numerical data to avoid heteroscedasticity. In **Table no. 1** we present the descriptive statistics of the data used.

For the return on assets (ROA) we use a financial performance indicator by which the net profit is related to the total assets of a company in a financial year. This indicator shows us how efficiently the assets of a company are used for profit.

The Debt / Equity ratio, often used in corporate finance, indicates the degree to which a company finances its economic operations through debt. This indicator indicates the possibility of the companies to cover the outstanding debts of their own assets in case of unfavorable events.

Table no. 1. Descriptive statistics

	Mean	Median	Standard deviation	Max	Min	N
ROA	0,06085	0,0438	0,0703	0,337	1,3E-10	67
CGDI	0,61744	0,6	0,2421	1	0	67
DE _ratio	0,9961	0,3958	1,8763	9,864	0	67
Ln_Age	2,8726	3,091	0,4677	3,219	0,6931	67

Source: Authors' calculation and projection. Data were processed using Eviews software.

The degree of compliance with the requirements of the Corporate Governance Code is mathematically determined according to previous research by Dănescu & Popa (2019). It indicates whether the corporate governance of the analyzed companies meets 40, respectively 41 requirements of the CGCelaborated by the Bucharest Stock Exchange. To calculate the degree of compliance with the CGC, we assigned a degree of importance to each requirement of the Code. Based on the companies' responses to these requirements, found in the corporate governance statements (the "Apply or Explain" Statement), we assigned a score to each requirement (1 when the requirement is fully met, 0.5 when the requirement is partially met and 0 when the requirement is unfulfilled), and we determined the degree of compliance according to formula (1):

$$CGDI_m = \Sigma(s_{im} * w_i) \qquad (1)$$

Where:

- s_{im} is the score assigned to each requirement i of the Code (it values 0; 0.5 or 1) for company m in the year 2018;

- w_i is the importance attributed to requirement i.

In the study we included all the companies listed on the Romanian capital market that trade shares on the Main segment, regardless of the category they belong to. From the sample we excluded the companies whose transaction is suspended, or which are in insolvency proceedings. Thus, our sample consists of 67 companies of different sizes. Our study aims to analyze the compliance of corporate governance with the requirements of the Code of each company and its influence on the financial performance (ROA). We have studied this phenomenon for the year 2018, for the data published in the final situations of 2019.

We used the Ordinary Least Squares (OLS) method to determine the influence of the degree of compliance with the Financial Performance Code expressed by ROA. Based on the hypothesis that there is a positive reciprocal causality between financial performance indicators and the degree of compliance of corporate governance (previously assumed by other researchers, i.e. Kanduki et al., 2015), we tested both the influence of compliance on financial performance and the reverse causality – that is, the influence of financial performance on compliance with the requirements of the Code – based on two equations. The first equation investigates the influence of the degree of compliance with the requirements of the Code on the financial performance expressed by ROA, and the second one investigates the influence of the financial performance (ROA) on the degree of compliance (CGDI):

$$ROA_i = \beta_0 + \beta_1 CGDI_i + \beta_2 DE\_ratio_i + \beta_3 ln\_age_i + \varepsilon_i \quad (2)$$

$$CGDI_i = \beta_0 + \beta_1 ROA_i + \beta_2 DE\_ratio_i + \beta_3 ln\_age_i + \varepsilon_i \quad (3)$$

For the accuracy of the results, we included in the study control variables, such as the financial leverage and the age of listing the company on the capital market.

3. Results and discussion

In the study we included control variables (size variable or age on the capital market variable), expecting us to identify a positive influence between the company's age on the BSE and the degree of compliance with the requirements of the Code (due to the experience gained over the period of listing) and a statistically insignificant influence (positive or negative) between the degree of compliance of the corporate governance and the financial leverage (because we do not consider that a company with large debts will not register a high degree of compliance with the Code). These expectations were confirmed by performing the correlation test of the variables and by establishing the Pearson coefficients (according to **Table no. 2**).

Between the financial performance expressed through the profitability of the assets and the degree of compliance with the requirements of the Code, we observe a positive correlation of low intensity. On the one hand, we identify a negative correlation between the return on assets and DE_ratio. On the other hand, contrary to our expectations, a negative correlation was determined between ROA and the age on the capital market of the analyzed companies.

Table no. 2. Variable correlation matrix				
	ROA	**CGCDI**	**DE_ratio**	**Ln_age**
ROA	1			
CGCDI	0,2489	1		
DE_ratio	-0,2272	0,1628	1	
Ln_age	-0,2062	-0,1335	0,0324	1

Source: Authors' calculation and projection. Data were processed using Eviews software.

Using the Durbin-Watson test, we tested the autocorrelation of the variables using regression. The value of the test is 1.87, respectively 1.86, which means that the variables are not self-correlated. To avoid the heteroscedasticity phenomenon, we decided to log the data. Also, for the same reason, we performed the Breusch-Pagan-Godfrey test for the two models tested using equations 2 and 3. The significance threshold exceeded the accepted level of 0.05, which means that the null hypothesis of the Breusch-Pagan-Godfrey test it is accepted, rejecting the alternative hypothesis of heteroscedasticity (**Table no. 3**).

Table no. 3. Research results							
Variable	**ROA**			**Variable**	**CGCDI**		
	Coefficient	**Std. deviation**	**T test**		**Coefficient**	**Std. deviation**	**T test**
Constant	0.0919	0.0575	1,5971	Constant	0.6508***	0.1902	3,4204
CGCDI	0.0786**	0.0343	2,2913	ROA	0.9782**	0.4269	2,2913
DE_ratio	-0.0099**	0.0043	-2,2707	DE_ratio	0.0297*	0.0156	1,8945
ln_age	-0.0242	0.0175	-1,3842	ln_age	-0.0426	0.0625	-0,6812
F test	0.0109			F test	0.0448		
R^2	0.1611			R^2	0.1218		
Durbin-Watson test	1.8761			Durbin-Watson test	1.8636		
Breusch-Pagan-Godfrey test	0.7264			Breusch-Pagan-Godfrey test	0.1221		
N	67			N	67		

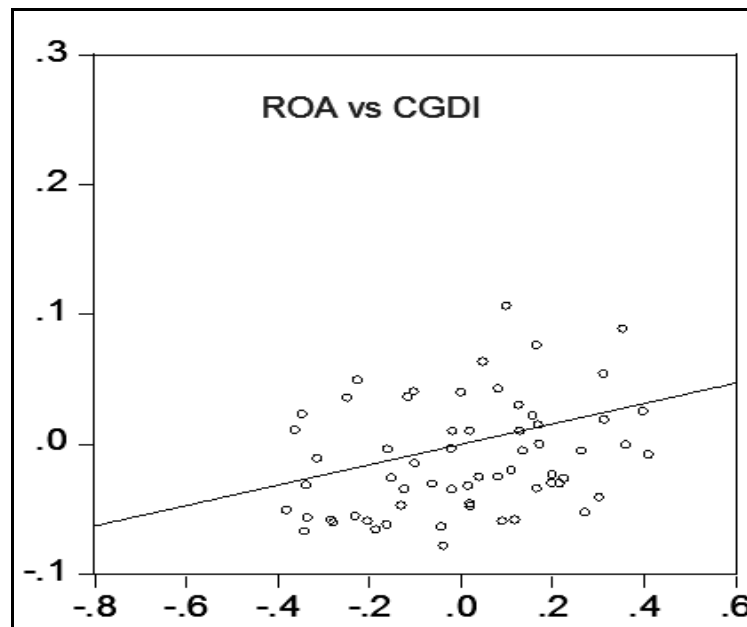*Source*: Authors' calculation and projection. Data were processed using Eviews software.

The coefficient of determination (R^2), specific to the regression analysis, measures the percentage of the variation of the independent variables according to the deviation of the dependent variable. Test F shows that the equations are statistically significant, because its value is below the significance threshold set at 0.05.

By testing Equation 2, we observe the degree of compliance with the requirements of the Code, which has a statistically significant positive impact on the financial performance expressed by the ROA indicator, with a coefficient of 0.0786. The graphical representation of this equation is transposed in

Figure no. 1. We also observe a statistically significant negative influence of the financial leverage on the financial performance. Although the influence of seniority on the corporate capital market (ln_age) on ROA is negative, the result is not statistically significant.

Figure no. 1. Graphic representation of ROA according to CGDI

Source: Authors' projection using EViews

The results are similar to those obtained by Kandukuri et al (2015), even though they calculated the degree of compliance by scoring method. They tested the influence of the degree of compliance with the requirements of the Code on the Tobin Q indicator, another important indicator considered when evaluating a company, being calculated as a ratio between the market value of the company and its intrinsic value.

Testing Equation 3, we notice that the results obtained are statistically significant. We identify a significant positive influence of the financial performance on the degree of compliance with the requirements of the Code. Therefore, companies that register a higher financial performance, tend to register a higher degree of compliance of the corporate governance with the requirements of the Code elaborated by the BSE. The financial leverage positively influences the degree of

compliance. However, even if the result is statistically significant, we cannot affirm that it has a solid economic value.

4. Conclusions

The Bucharest Stock Exchange is guided by the "Apply or explain" principle, requesting companies listed on the capital market to report a corporate governance statement that responds to all the requirements and recommendations of the Code. Through this statement, important information about the corporate governance of a listed company is transmitted. In our research, we used the responses of the companies listed on BVB in 2018 from the corporate governance statement in order to determine a degree of compliance with the requirements of the Code. Moreover, we tracked the

influence of this degree of compliance on the ROA financial performance indicator, but also the influence of ROA on the degree of compliance.

In this study, we identified a positive influence between the ROA indicator and the degree of compliance of the corporate governance for the companies listed on the BSE in 2018. We also identified a moderate negative relationship between ROA and financial leverage. We did not observe any significant connection between the financial performance and the seniority of listing the company on the capital market, as well as between the degree of compliance with the requirements of the Code and the seniority of the listing.

The results of this research applied to the Romanian capital market are similar to those of other previous research applied to other capital markets. The limits of our research are mainly related to the small number of variables included in the study. We aim to develop a stronger research on international capital markets, comparing several European capital markets, as well as extending the existing database for several years and applying specific econometric models for observing phenomena in time and space.

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