THE EMPIRICAL APPROACH

RECENT RESEARCH PROVIDES A GREATER UNDERSTANDING OF WHETHER AN OPTIMAL GOVERNANCE STRUCTURE CAN BE APPLIED TO COMPANIES. **GRANT FLEMING** EXAMINES THE EVIDENCE.

Hardly a week goes by without a financial reporter attributing a change in a company's share price to issues associated with corporate governance – the BBC reports that a 4% fall in the company's value was due to institutional investor dissatisfaction with new anti-takeover provisions, or a CNN story states that a new top-gun CEO is appointed sparking a 5% rise in stock value. The judgment made in many of these instances is that the nature of the corporate governance structure makes a real difference to the future cash flows and value of the company.

While it is easy to offer a correlation between changes in market value and corporate governance for a particular case, the empirical research on corporate governance is much less clear on what types of systems lead to superior financial performance. Indeed, the inter-disciplinary area of empirical corporate governance research by accountants, lawyers, economists, and social scientists indicates that there are very few governance factors that unambiguously can be described as beneficial in terms of helping a company maintain a competitive advantage over its rivals.

Differences in legal and economic institutions and business environments are important determinants of the composition, role and legal responsibilities of the board of directors and board committees.

Given this, one can see that each discipline listed above plays an important complementary role in investigating what factors may help or hinder a company analyse strategic options, make decisions, supervise and monitor management. Corporate finance contributes to governance research by focusing on large samples of firms from which to draw inferences about management behaviour and financial performance. These results provide a view as to what happens *on average* for companies undertaking a particular type of governance change and is very often consistent with other work that might provide case studies of 'best' or 'worst' practice. In this article, we provide a brief review of recent empirical corporate finance literature with emphasis on what large sample statistical studies tell us about corporate governance and the role of the board of directors.

TYPES OF CORPORATE GOVERNANCE SYSTEMS. Corporate governance systems are often separated into stylised forms that we can describe as outsider and insider systems. Outsider systems tend to be market oriented where there is a competitive market for directors, independence of the board is regarded as an important issue when determining board and committee composition, and monitoring and incentives are constructed in such a way as to align shareholders' (primary stakeholders) and managers' interests. Broadly speaking, economies such as the UK, the US, Australia, Canada and New Zealand are viewed as outsider systems.

Insider systems involve a dominant player or group in the corporate governance process – a bank providing a supervisory role, a business grouping where cross-shareholdings lead to large shareholders possessing board positions, or a family exercising control and cashflow rights over a group of companies. Insider systems by definition involve less dispersed share ownership and are therefore less market oriented. Roles and responsibilities on the board, or tier of boards, range from day-to-day monitoring of management to long term planning and advice. European and Asian companies tend to fall into the insider governance form.

The terms outsider and insider, like many simple categorisations, hide as much as they reveal about the differences in governance practices across countries. Certainly, insider systems might be characterised by cross-shareholdings (eg in France, Germany and Korea) but the dynamics of the corporate economy as well as legal rules and business culture and norms can lead to substantial differences in outcomes. Similarly, outsider systems such as the UK and Australia may differ in outcomes: we need only look at the size of the labour market for directors to see that the UK presents a more competitive environment than Australia in that area. Nevertheless, researchers tend towards categories and both stylised systems have been extensively researched in corporate finance over the last twenty years. Further, these empirical findings have been used to support a number of government reviews of corporate governance in the UK, Europe and Australia. We are now at a stage where we can draw out some regularities from this research. But first, a few words on method and techniques of analysis.

MEASURING THE EFFECTIVENESS OF CORPORATE GOVERNANCE SYSTEMS. Corporate finance studies use a range of statistical

'THE EMPIRICAL RESEARCH ON CORPORATE GOVERNANCE IS MUCH LESS CLEAR ON WHAT TYPES OF SYSTEMS LEAD TO SUPERIOR FINANCIAL PERFORMANCE'

techniques to analyse the average experience of a company under different governance and legal and economic regimes. These studies can be summarized by the following relationships:

1. Action = f(Composition of the board)
2. Performance = f(Action)
3. Composition = f(Performance).

The first relationship states that board composition is likely to be associated with actions that are seen as good corporate governance practices. Actions that look after shareholder and other stakeholder interests might be the adequate review of management, the setting of remuneration, or the replacement of top executives. The second relationship states that good corporate governance actions should be associated with good company financial performance. For example, a study might examine whether board composition such as having an active institutional investor is more likely to be associated with higher return on assets. In fact, such a study is a combination of 1 and 2 above because it looks at whether boards with active block-holders are likely to monitor management who then perform better than industry rivals. Composition leads to Action which leads to better Performance. The third relationship attempts to explain what factors determine board composition – is there something about the governance of high or low performers that makes them succeed or fail?

Empirical methods also vary according to the particular study. The simplest statistical technique is to provide estimation of the features of various governance systems around the world; for example, ownership concentration or shareholding relationships. This technique is popular in analysing relationship 3 where performance and other factors can determine composition. The data collection is extremely difficult in practice as insider systems in particular can involve a complex web of ownership and control rights over a company's cashflows. Tracing inter-firm relationships and cross-shareholdings is a task that leads to new concepts and understanding of whether regime differences matter.

A more elaborate technique is to investigate the relationship between company performance (using contemporaneous and lagged variables such as return on assets, change in earnings per share, or share market performance) or company value (using market-to-book values) and particular features of a company's governance system: ownership structure, board size, board committees, number and proportion of non-executive directors. These relationships are usually determined by regression analysis and the models control for other factors that might otherwise determine performance. A third approach is to focus on how the share market reacts to an event associated with a company's internal governance. Here an expected or normal share price return is estimated and the share price behaviour around a price sensitive event (eg CEO resignation) is analysed for any abnormal change in firm value. This technique relies upon the information processing features of the stock market and assumes that markets reasonably accurately alter expected future cashflows of the company after governance changes. As we know, a change in expected future cashflows for the company results in a change in the share price.

WHAT DO RECENT FINDINGS TELL US ABOUT CORPORATE GOVERNANCE? Let us turn to the first relationship: Action = *f*(Composition of the board). On the whole, board composition affects the ability of the board to monitor and supervise management in public companies. This is evidenced by the following findings:

- high quality non-executives are more likely to negotiate better terms for target shareholders in takeover situations, and more likely to make better acquisitions;
- CEO and CFO turnover in poorly performing companies is more likely when non-executive directors dominate the board, and when boards are smaller;
- poison pills (the issuance of additional shares of preferred stock during takeovers) and other takeover defenses are positively reacted to by the market when boards have a majority of non-executive directors;
- firms with weaker governance structures (for example, less non-executives or institutional board members, more busy many board position directors) tend to pay their CEOs more than other companies, and more than labour demand dictates;
- the appointment of a new active block-holder (especially an institution owning a substantial block of shares) receives a positive share price reaction; and
- firms with active institutional board members (for example, a pension fund or bank that takes an active role in the governance of the company) are more likely to be involved in restructuring such as divestitures, share buybacks and CEO turnover.

The work on whether composition influences performance involves relationships 1 and 2: Performance = *f*(Action, Composition of the board). Here we know that:

- board composition is not related to company performance;
- smaller boards are associated with higher firm value. Furthermore, when a company is restructured, managers and institutional investors prefer smaller to larger boards;
- the market reacts positively when CEOs and CFOs resign from poor performing companies, and reacts negatively when directors (especially non-executives) leave good performing companies; and
- active block-holders are associated with improvements in industry-adjusted performance after about two years.

Finally, relationship 3 involves investigation into what factors determine board composition: Composition = *f*(Performance):

- tightly held firms (where the founder or family are still active) tend to have executive dominated boards;
- poor performing companies are more likely to have executives leave and non-executives appointed to the board;
- company restructuring often leads to institutional shareowners taking a more active role in governance; and
- CEO power in nominating and selecting board composition increases when the firm is performing well, and decreases when CEO voting stakes decline and when dealing with institutions such as venture capitalists.

DOES THE UK/US SYSTEM PROVIDE THE BEST CORPORATE GOVERNANCE? Much of the research described above (especially relationships 1 and 2) is undertaken on outsider systems and tends to adopt an agency framework which assumes that utility maximising managers (the agents) may be in positions of power and decision making that allows them to undertake actions that increase their welfare at the expense of shareholders (the principals).

Agency costs are said to be higher in systems where a large shareholder can more easily expropriate value from smaller shareholders – in insider systems. However research on insider systems in Europe, and increasingly in Asia, shows that under appropriate circumstances the results from outsider systems are quite robust. Agency costs are not always higher in European insider systems. Furthermore, there are advantages to insider systems that deserve periodic review when deciding upon a corporate governance regime. The findings are:

- insider systems offer higher degrees of managerial stability and autonomy which may permit the fostering of long term relationships with customers, suppliers and employees;
- CEO and executive turnover is lower in insider systems permitting long term horizons to be adopted in strategic planning;
- dual board structures provide checks and balances in monitoring and strategic advice;
- large levels of reciprocal ownership of shares leads to takeovers being friendly, rather than hostile, and more likely to be funded by equity rather than cash;
- large cross-ownership does not reduce the wealth increasing nature of takeovers;
- banks as large shareholders effectively monitor and perform many of the governance tasks as in outsider systems – turnover, restructuring and likelihood of better company performance; and
- the possibility of large block-holders (especially family shareholders) expropriating other shareholders' funds decreases in countries where there is a quality banking system, legal and judicial protection of individual shareholders and a high level of financial disclosure.

This research shows that market oriented or outsider systems are not necessarily best practice to be applied around the world without modification. Indeed, the insider system research has formed the basis of the more recent World Bank and International Monetary Fund views on financial and corporate governance reform in financial crisis regions such as South East Asia and Eastern Europe.

In summary, recent findings on outsider and insider systems show us that BBC and CNN could well be getting it right when they offer a rationale for a change in the company's value following a governance change. In addition, the recommendations on optimal or best practice corporate governance in the UK (for example, the Cadbury, Greenbury and Hampel Committee Reports) are also consistent with the empirical literature. Specifically, we can point to recommendations such as:

- boards should have an 'appropriate mix' of executive and non-executive directors;
- a nomination committee should be the primary structure to deal with director selection and appointment;
- the separation of the chair of the board of directors from the CEO is desirable;
- CEO pay should be set relatively independent of the CEO;
- board committees should uphold a duty of care to a range of stakeholders;
- more information is better than less on internal decision making processes; and
- there is an important role for legal and judicial support for shareholders when governance systems fail.

These are laudable guidelines for practice. But empirical corporate governance shows that much work is left in measuring whether such recommendations will alter company performance. Indeed, we could say that the board is still to decide.

Grant Fleming is Vice President, Wilshire Australia and a Senior Lecturer in finance at the School of Finance and Applied Statistics, Australian National University. He performs investment research on Asia Pacific private equity funds, and teaches corporate finance, international finance, multinational financing and corporate strategy.
Grant.Fleming@anu.edu.au

**These views are those of the author and do not represent those of Wilshire Australia.*

This article first appeared in *The Finance and Teasury Professional*, the official journal of the Finance and Treasury Association of Australia. www.fta.asn.au