Chapter 9
Corporate Governance and Performance

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ABSTRACT

The purpose of the present study is to evaluate the current state of the linkage between corporate governance and performance. Corporate governance is by far the most important subject that should be studied due to its role and significance. Accordingly, there is intensive literature on corporate governance and its possible impact on performance. By conducting a systematic literature review, the authors provide the results of frequently used variables that supposed to reflect the character of corporate governance on firm performance. The study covers the findings of empirical papers that analyze the impact of "board size," "percentage of independent directors," "CEO duality," "ownership concentration," "audit committee and auditor reputation," "board meetings," and "firm size." The examination of the reviewed studies indicates that there is a need to explain the competing findings observed among firms, markets, and countries by developing a theoretical explanation.

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INTRODUCTION

The delegation of one's powers to their subordinates is considered a problematic process in any social structure. In a corporate structure, this delegation of power process is most significant between shareholders and managers who are being paid to represent the interests of shareholders. The conflict of interest between shareholders and managers has been an influential topic in the literature ever since the foundation of the first share company. Even in the 18^{th} century, this conflict of interest was considered one of the main issues concerning joint-stock companies. In his masterpiece book named "Wealth of Nations" (Smith, 1776), Adam Smith states this issue to be one of the most important elements in the field of business management. One thing that is certain is that humans strive to maximize their utility. Highly debated behavior "Homo-Economicus", shows a deviation from a fixed behavioral algorithm due to the difference between the utility functions of individuals.

Another early argument in the field of corporate governance is the difference between theory and the reality of the business and environment. In the start of 20^{th} century, it was often argued that economics as of theorized back in the day, were influenced by mechanisms that are either untraceable or that mechanism that exist only in the theory but not in the real world. Factors that are considered to measure the effectiveness of corporate governance has been discussed in length. A widely recognized and cited study in this regard has been added to the literature by Coase (1937). In this scope, Properties such as measurability and relevance to corporate governance element has been taken to account when determining the factors to use in this study as representatives and indicators of the success of corporate governance.

One of the most comprehensive attempts to create a standard measurement basis for the success of corporate governance was published by Brown & Caylor (2004). Using dataset provided by Institutional Shareholder Services, a composite measure consisting of 51 subfactors under 8 categories was presented. Main categories are listed as audit, the board of directors, charter by-laws, education, executive compensation, ownership, progression, and level of incorporation. Measurement from the end results of these factors is named "Gov-Score". The study then uses its measurement system for determining the relationship between operating performance, valuation and shareholder payout in a dataset consisting of 2327 firms. According to the findings of the analysis, companies that have a higher Gov-Score value are relatively more profitable, has higher shareholder value, and pay out more dividends. Overall higher "Gov-Score"s are associated with higher firm performance. In addition to this, the study also reports interesting and meaningful facts, such as the relationship between consulting fees and audit fees paid to auditors. Firms that pay their auditors more than what they pay to their consultants have generally worse performance than those that do the reverse.

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