

Chapter 82

Reducing Risk Through Governance:

Impact of Compensation, Defense, and Accounting Practices

I-Jan Yeh

Shih Hsin University, Taiwan

Ching-Liang Chang

Yuan Ze University, Taiwan

Joe Ueng

University of St. Thomas, USA

Vinita Ramaswamy

University of St. Thomas, USA

ABSTRACT

The main purpose of this study is to investigate the determinants of formal governance policy. Many firms have a formal governance policy. Others, however, have no such a policy. This study examines what kind of firm's characteristics that encourage companies to adopt a formal governance policy. Data were collected from Corporate Library. A sample of 3,068 firms from the database of 2010 Corporate Library was analyzed. Results show that when firms have a better financial performance and better corporate governance practice, they are more likely to have a formal governance policy. Specifically, when firms have a better board rating, compensation policy, takeover defense strategy, and accounting practice, firms are more likely to have a formal governance policy.

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INTRODUCTION

Prior research has attempted to investigate the relationship between governance mechanisms and the market valuation of publicly traded firms (Bai et al., 2004). In general, the research has documented the importance of corporate governance to protect the shareholders and to enhance the firm's value. Many firms have a formal governance policy to guide their financial decisions and corporate strategies. Others, however, have no such a policy.

The main purpose of this study is to investigate the determinants of formal governance policy. This study examines the firm's characteristics that encourage companies to adopt a formal governance policy. A key reason to underlying the motivation for this study was to investigate how corporate structure and governance has impacted the survival of public listed companies in the USA since the financial crises of 2008. Prior empirical research the financial and economics literature was out dated with respect to 'applied' practices that have emerged since the global financial crisis (Strang, 2012). This study makes a contribution to the literature by investigating a large sample (N=3068) of public companies to determine how their governance impacted their profitability from 2001 through to 2010.

LITERATURE REVIEW

Prior studies, in general, have documented that the adoption of a formal corporate governance policy has a positive impact on the firm's value. Having a formal corporate governance also enhances shareholders' value. Ashbaugh-Skaife et al. (2006) investigated whether firms with strong corporate governance will result in higher credit ratings relative to firms with weaker governance. They documented that credit ratings are negatively related to the quality of corporate governance, proxied by the number of block holders and CEO power, and positively related to takeover defenses, accrual quality, earnings timeliness, board independence, board stock ownership, and board expertise.

Bai et al. (2004) investigated the relationship between governance mechanisms and the market valuation of publicly listed firms in China. They examine the effect of corporate governance variables on market valuation after controlling for factors commonly used in market-valuation analysis. Their results indicated that both high concentration of non-controlling shareholding and issuing shares to foreign investors have positive impact on the firm's market valuation, while a large holding by the largest shareholder, the CEO being the chairman or vice chairman of the board of directors, and the largest shareholder being the government have negative effects.

Black et al. (2006) provide evidence that an overall corporate governance index is an important and likely causal factor in explaining the market value of Korean public companies. Evidence from his study differs from what Bai documented in their study.

Gompers et al. (2003) used the incidence of 24 governance rules and constructed a "Governance Index" to proxy for the level of shareholder rights at about 1,500 large firms during the 1990s. They find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. Their study suggests a positive relationship between the power of shareholders and the firm's financial performance.

Bauer et al. (2003) analyzed whether good corporate governance leads to higher common stock returns and improves firm value in Europe. Surprisingly, and contrary to Gompers, et al., Ishii and Met-

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