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CORPORATE GOVERNANCE INFLUENCE ON FIRMS' FINANCIAL PERFORMANCE IN CEE COUNTRIES

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Abstract. According to the previous authors' research on the trade-off between investor's long and short-term goals, plausible corporate governance of the company is one of the key factors for the company to generate sustainable shareholder value, which is especially important in the current uncertain marke environment (Bistrova, Lace 2011). The present study looks into the corporate governance systems employed by the listed Central and Eastern European enterprises to find out whether the qualitative corporate governance succeeds better firm's financial performance, which is mainly profitability. The study results provide an overview of the most important attributes of the efficient coporate governance structure and allow authors to develop the model for sustainable shareholder value creation.

Keywords: corporate governance, financial performance, profitability, CEE countries.

Jel classification: G30, G34, G35

1. Introduction

The research of the Baltic Institute of Corporate Governance in 2010 showed that if the corporate governance quality of the state-owned companies was increased than the government as the major shareholder would earn up to 500 million Lats (~ 1 bn USD) more as the value and efficiency of the enterprises would significantly improve (Akopova 2011).

The importance of the corporate governance (CG) and its influence on the corporate value was further proved in the research on Central and Eastern European companies (Bistrova, Lace 2011). The results showed that the companies with the highest CG quality (top 25%) outperformed companies with the worst CG quality (bottom 25%) by 0.98% on a monthly basis during the period of 2008 - 2010. Furthermore, the study demonstrates that the companies with the good CG quality were able to offer lower risk.

Indeed, high corporate governance standards commonly accepted within the corporate structure help investor to escape such failures as Enron, Parmalat, Worldcom as well as very recent Chinese "bubble-companies" such as Sino-Forest, Orient Paper, China MediaExpress Holdings etc.

Establishment of the quality corporate governance ensures significant limitation of the agency problem and is intended to maximize shareholders' as well as other interested parties' wealth. High quality of the corporate governance (CG) is a guarantee of the long-term trust between shareholders and the management of the company.

The evidence of corporate governance positive influence on company's value and stock return was proved by the various researchers (Gompers *et al.* 2003; Drobetz *et al.* 2003; Aman, Nguyen 2007). It would be also logical to assume that the efficient corporate governance system is able to improve also the financial performance of the enterprises, which results in higher company valuation later.

Thus, the study's principal hypothesis was that the company demonstrates better financial performance if its corporate governance system exhibits high quality compared to the company, which fails to establish plausible and transparent corporate governance structure. The authors also checked the influence on financial ratios of the CG constituents such as independency of Board of Directors, transparency of the disclosed information, qualityof investor relations, efficiency of management team etc. The aim of the study is to find an evidence that it is worth investing money in establishing good corporate governance in order to improve financial performance of the Central and Eatern European listed companies.

In the course of the study to find the evidence the autors used qualitative methods, which are mainly statistical ones: correlation, quartile analysis, regression running, etc.

2. Is good corporate governance able to drive financial performance?

The study on the US companies discloses certain relationship between the corporate governance and company's operating performance as measured by the return on assets (ROA): better governance measured by the GIM and BCF indices, stock ownership of board members, and CEO-Chair separation is significantly positively correlated with better contemporaneous and subsequent operating performance. Also, interestingly, board independence is negatively correlated with contemporaneous and subsequent operating performance (Bhagat, Bolton 2008).

Similar study was also done on the 300 European companies comprising FTSE Eurotop, where the authors examined the relationship between corporate governance and firm performance, as approximated by net profit margin and return on equity. Surprisingly, and contrary to Gompers *et al.* (2003), a negative relationship is found between governance standards and earnings-based performance ratios (Bauer *et al.* 2003).

Better governance as measured by Brown and Caylor (2004), and The Corporate Library is also not significantly correlated with better contemporaneous or subsequent operating performance. And board independence is negatively correlated with contemporaneous and subsequent operating performance.

Allan Chang Aik Leng (2004) made an analysis on the Malaysian companies' corporate governance structure and its influence on the return on equity (ROE). The three variables which were found to be significant in influencing the rate of return on equity were: the degree of ownership of shares in a company by institutional investors, the gearing ratio or the level of debts, and the size of the company. There have been also indentified the factors which did not have any influence on the profitability as measured by ROE: the proportion of non-executive directors in the company, the degree of ownership of the firm attributed to the largest shareholder, the role of the CEO as both the chief executive officer and the chairman of the board of directors, and finally the role of the chairman of the audit committee as a non-executive director.

The study "Corporate Governance and Wealth Creation" (Moxey 2004) disclosed the results of the questionnaire on corporate governance system's influence on operating performance (ROE). The response was clearly skewed towards the view that corporate governance has little influence on profitability: 12 % of respondents were of the opinion that corporate governance has no influence at all on profitability and only 2 % viewed the effect as very influential. The results showed that those, who said the main purpose of corporate governance is to 'optimise ability to create wealth' believed that the corporate governance has more influence on the profitability than those who said that the main purpose is to 'protect shareholders' or those who said that both are 'equally important'.

There have been several studies on CEE stock markets, but the studies were done rather on macro level or considered separate factor which determine CG quality. Besides, the vast majority of them is trying to find the relationship between the quality of corporate governance and corporate performance.

Research made on 151 CEE companies by Mueller and Peev (2005) indicates that the firms' which are controlled mainly by foreign shareholders are overdoing their counterparts with mainly locals represented in the ownership structure. Another study on ownership influence on CEE companies' performance considered mainly the type of ownership structure: strategic, state, financial, founder/family (Bistrova 2010). The results of the study indicated that the best-performing companies have state representation in their ownership, which were followed by the family/founder controlling.

Pajuste (2002) has been also researching ownership and shareholders' rights in CEE stock markets for the period of 1994–2001. Her findings provide the evidence of significant controlling shareholder influence on the performance of the company and that minority shareholders' rights are often abused making the market absolutely inefficient and risks are not justified by the returns, which are lower.

3. Research design

The main aim of the research is to discover whether by improving corporate governance quality the operating performance and overall financial profitability of the company improves as well. Besides, one of the objectives is to consider the capital structure of the company and discover a relationship between the corporate governance and the stability of balance sheet if there is any.

The authors employed the same Corporate Governance assessment model, which was developed in 2011 and tested on the CEE listed companies (Bistrova, Lace 2011). The model was developed based on the CG best practices recommended by the CEE stock exchanges. The model consists of 21 criteria which are grouped into 4 major categories: Supervisory Board, Management team, Investor Relations/AGM and Information Transparency. The authors assessed Corporate Governance quality of 118 CEE companies according to the developed methodology for the period of 2010. The companies were selected from the stock main indices of each country (Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Poland, Slovakia, and Slovenia).

The authors selected 5 financial ratios (Table 1), which are commonly used to assess firm's profitability, operating efficiency and financial stability.

Table 1. Y Variables used in the regression equation

Y	Ratio Name	Measurement
ROE	Return on equity	Profitability
ROCF	Return on operating cash flow	Profitability
PM	Profit margin	Profitability
ER	Equity ratio	Financial Stability
AT	Asset turnover	Efficiency

As X variables the authors took the following CG indicators, which were based on the CG assessment model:

where:

TR – total CG rating,
SB – supervidory board,
MT – management team,
IR – investor relations,
DI – disclosure of information

As a result the authors of the study the equation, which was tested for all five financial idnicators, looked as follows:

$$Y = \alpha + \beta_1 TR + \beta_2 SB + \beta_3 MT + \beta_4 IR + \beta_5 DI \quad , (1)$$

Y variable was tested for the 3 types of each financial ratio: based on 2010 annual figures, average for the last 4 years (2007–2010) and its 4 year (from 2007 to 2010) dynamics or compound annual growth rate.

Correlation coefficients as well as other most important regression coefficients were calculated in order to test the validity of the relationship.

4. Overview of the corporate governance in CEE region

The financial markets in CEE are yet in the development phase and so is the attitude towards corporate governance and best practice implementation. The level of corporate governance is very different from country to country (Fig. 1). Highest overall score was received by Estonian, Lithuanian and Slovenian companies, which have very good information disclosure and excellent investor relations. The lowest score was obtained by the Romanian companies, which are very weak in providing the information, thus making it almost impossible to consider the company as an investment target for a foreign investor.

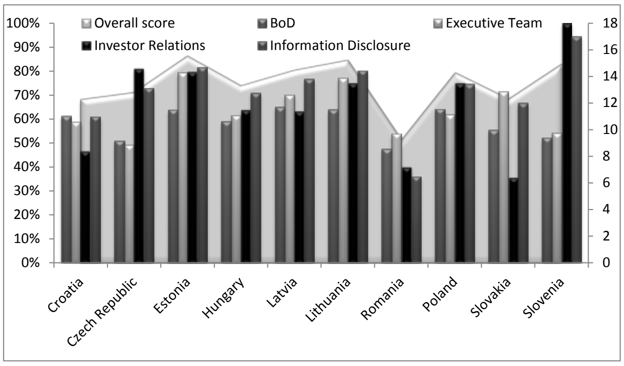

Fig.1. Average CG assessment of CEE companies by countries (Source: authors' developed)

It is interesting that in majority of cases Board of Directors (BoD) scores were the lowest compared to other categories. Partial explanation is found in the frequency of elections, where almost all companies were penalized due to not having annual elections (as considered in the best practice standards). BoD is being elected once in 3–4–5 years, which makes the assessment of each BoD member's activity and contribution inefficient.

Highest scores in executive team evaluation were obtained by the companies from Estonia, Latvia, Lithuania and Slovakia mainly thanks to the high stability of the management team and to its logical organization structure. Surprisingly, Czech and Slovenian companies, though having high overall scores, have rather weak ratings of the executive teams. The reason for that is unclear executive structure, which often does not correspond with the reporting structure (e.g. regional management organization, while reporting is by divisions). Moreover, CEO education and experience often is not relevant to the business essence of the company.

Besides, the quality of corporate governance to a great extent depends on shareholding structure. If the company has strategic shareholding of Western European origin (e.g. 51 % of Magyar Telekom held by Deutsche Telekom, 62 % of TEO LT held by Swedish Teliasonera), then the company is significantly influenced by its shareholders and is forced to implement also Western European CG standards. The companies, which have as controlling shareholder local individuals, usually do not bother about complying with recommendations of the local stock exchanges.

Fig. 2 chart shows the assigned ratings across the categories. Almost 90 % of the companies are disclosing shareholder's structure and have separated roles of CEO and Chairman. The companies are very active in publishing the minimum set of documents (annual and quarterly reports) required by investors, but are not very willing to make additional reporting: presentations, webcasts, CSR reports.

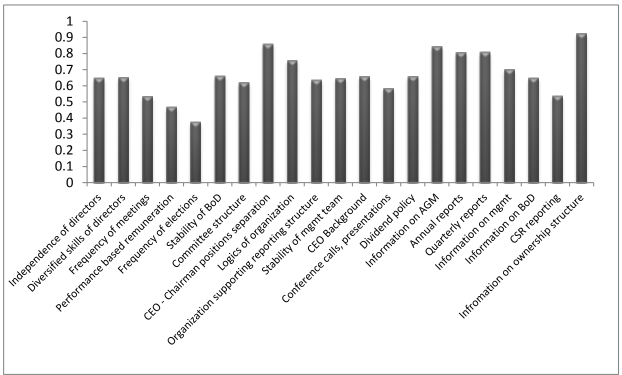

Fig.2. Average CG assessment of CEE companies by criteria (Source: authors' developed)

5. Corporate governance influence on financial performance

5.1. Best and worst companies according to CG quality

The authors selected the best and the worst companies according to the CG quartiles. The difference in rating of the best and worst was not too large: companies with the best results in CG assessment earned more than 26.5 points while, companies with the worst results in CG assessment had ratings below 22 points. At the same time the market median was 24 points.

The results show (Fig. 3) that the companies which were classified as the leaders according to the CG rating showed below average profitability ratios, which is seen in both cases – profit margin and return on equity. The only positive example is that the average for 4 years profit margin of the 'Best CG companies' seems to be higher than the average profit margin of the 'Worst CG companies'.

Undoubtedly, one of the explanations is the additional costs coming from the excellent corporate governance system maintenance. On the other hand, the companies, which cannot deliver good financial and business performance, try to be attractive for investors at least from the window-dressing their corporate governance structure. Another point to check regarding the worst companies is definitely the earnings quality and financial results plausibility.

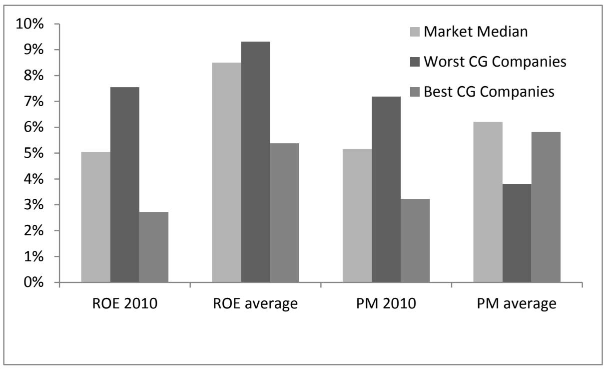

Fig.3. Profitability ratios (ROE and Profit margin) according to the CG rating (Source: authors' developed)

Checking the business efficiency of the CEE companies provides an evidence that again the enterprises with the best CG ratings lose to the whole market as well to the companies with weak CG standards and the difference is rather substantial (Fig. 4).

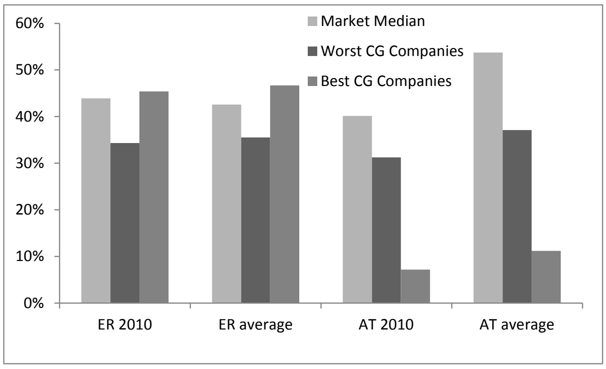

Fig.4. Equity ratio and asset turnover according to the CG rating (Source: authors' developed)

The picture changes totally if one considers the stability of the balance sheet which is measures by the equity capital (Fig. 4). In this case the companies with the best CG ratings obviously are the most conservative compared to the market as well as to the companies showing weak CG ratings. The latter have rather risky balance sheets as their equity ratio does not exceed 35 % of the total assets.

Such situation can be in a certain way explained by the conservativeness of the shareholders in every respect – sticking to the Best CG practice and keeping stable balance sheets.

5.2. Regression results

The data provided in the Table 3 demonstrates that the correlation between the financial ratios and the quality of corporate governance does not show a very tight relationship, which is non-existent in the case of return on equity and asset turnover.

Table 2. Correlation coefficients of CG regression equation at different y variables

	2010	Average 2007-2010	CAGR 2007-2010
ROE	23.1 %	12.5 %	12.2 %
ROCF	20.9 %	16.5 %	34.9 %
PM	34.6 %	8.0 %	39.1 %
ER	38.0 %	38.6 %	-
AT	22.7 %	18.6 %	18.9 %

Moderate correlation still can be seen in the several cases such as growth dynamics of return on operating cash flow as well as in case of profit margin, where 2010 results moderately correlate with the quality of corporate governance. It is interesting that the correlation coefficient is relatively high if we consider equity ratio as the main financial variable.

Table 3. F-test results of CG regression equation at different y variables (marked in grey if significant at 10% significance level)

	2010	Average 2007-2010	CAGR 2007-2010
ROE	0.73	0.21	0.20
ROCF	0.60	0.36	1.80
PM	1.76	0.08	2.34
ER	2.19	2.27	-
AT	0.71	0.46	0.48

F-test for all of the financial ratios the authors considered is showed in the Table 4. So, the regression turned out to be statistically significant only in three cases: dynamics of profit margin as well as average and current equity ratio.

So, by forcing the improvement of corporate governance the shareholders will not see an improvement in company's capital profitability as well as in business efficiency. However, with the improvement of CG, profit margin most probably will improve as well. Besides, the closer the company is to the Best Practice corporate governance standards, the more conservative is its balance sheet.

The results of the present study and the study made in summer 2011 on corporate governance partly correspond to the research on the fundamental analysis of the Baltic listed companies, which showed that the financial ratios with the exception of equity ratio and PE are not able to add value to the performance (Bistrova, Lace 2010). The logical chain with the corporate governance looks as follows: good corporate governance positively influences share performance, while it is not able to improve corporate financial performance. The only exception in this study is the equity ratio, which shows moderate correlation with the quality of corporate governance if considered both current level and historical average level.

Table 4. Correlation coefficients of CG regression equation at different y variables

	Coefficients	*Standard Error*	*t Stat*
Intercept	0.095	0.200	0.477
TR	0.406	0.202	2.012
SB	-0.722	0.399	-1.810
MT	-0.849	0.406	-2.089
IR	-0.761	0.424	-1.793
DI	-0.423	0.208	-2.036

Interestingly, if considering the statistical significance and the coefficients of the all x variables defined, one can notice the positive influence of the total CG rating, while negative influence of the other variables: supervisory board, management team, investor relations and disclosure of information. Partially it can be explained by the very low variability of these ratings from company to company, while the variability of the total rating significantly increases and, thus, provides more plausible result.

6. Conclusions

The hypothesis of the present study that good corporate governance quality is able to positively influence the financial performance of the company was refuted in the course of the study. The authors of the study based the hypothesis on the research conducted in other geographical regions and also on their own research, which proved firms' performance dependence on CG quality, speculated that the efficient management, plausible structure of the supervisory board, substantial transparency, minimization of agent-principal problem (Fama 1980; Grossman, Hart 1983) should also improve the financial results of the company.

However, the findings of the research showed that with the exception of the equity ratio no any other commonly used financial indicator can be improved. When describing 25 % best and 25 % worst companies from CG perspective according to their financial performance, it was discovered that the companies with the best CG ratings delivered below average profitability (Return on Equity, profit margin,operating cash flow to equity) and business efficieny (asset turnover). Interestingly, the opposite situation was seen with the worst companies, which outperformed the market with their financial performance. The only ratio, which made the 'Best CG companies' look good in comparison to the market, was equity ratio.

Basically, the same results were confirmed by the correlation coefficients, pointing to the consistently 'moderate' correlation of the corporate governance rating with the equity ratio. The regression results and F-test provided evidence that the regression is significant just in three y cases: profit margin 2007–2010 CAGR, equity ratio 2010 and equity ratio 2007–2010 average. Again the regression results proved that the companies trying to reach 'golden standard' in CG system are pursuing also rather conservative capital managemet policy having more than 45 % of equity ratio in total assets' structure as compared to 35 % equity ratio of the 'worst CG companies'.

The reasons for explaining poor financial performance of the well-managed companies can be several. One of the reasons might be that the companies, which cannot offer huge growth (e.g. telecoms, utilities), try to emphasize their excellent corporate governance and, thus, attract potential investors, which tend to rigorously check the corporate governance plausibility. Another reason, which appears to be rather plausible, is the possible risk of the earnings manipulations.

Therefore, the authors would continue researching this topic from the perspective of the earnings quality and the financial reporting result plausability.

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