CGC مركز حوكمة الشركات

Corporate Governance Center

Alfaisal University - College of Business

Impact of Good Corporate Governance on Company Profitability and Sustainability

Research Paper

جامعة الفيصل
Alfaisal University

Second Annual
Corporate Governance Conference
22nd of April, 2018

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Impact of Good Corporate Governance on Company Profitability and Sustainability

Study Objective

- This study looks to investigate the relationship between corporate governance and firm performance in 92 listed companies in Saudi Arabia.

- Present empirical evidence to promote the adoption of good corporate governance practices.

Impact of Good Governance

Maintaining high cash flow expectations (La Porta, Lopez-de-Manes, Shleifer, & Vishny, 2002)

Lowering the cost of capital (Hail & Leuz, 2006; Wu, Lin, & Yang, 2016)

Corporate Governance and Performance in Literature

- A large body of research examined the relationship between corporate governance and corporate performance in developed and emerging economies.
- Many have reported improved corporate governance practices are positively associated with firm performance (Chen, 2001; Grompers, Ishii, & Metrick, 2003; Black, Kim, & Jang, 2006).
- The variation from country to country can be explained by different economic and regulatory environment found in different nations across the world (Doidge, Karolyi, & Stulz, 2007).

Corporate Governance and Performance in Literature

- A small number of literature addresses the relationship between governance and performance in the context of Saudi Arabia.
- Fallatah and Dickens (2009) find that corporate governance and firm value have a positive relationship, but corporate governance was not a statistically significant predictor for return on assets.
- Al-Sahafi, Rodrigs, and Barnes (2015) reveal that board size is positively related to return on assets, return on equity, and firm value in the Saudi banking sector.

Research Hypothesis

Hypothesis:

Good corporate governance practices are positively associated with better firm performance.

Sector	Number of firms
Consumer Staples	8
Consumers Discretionary	9
Materials	25
Financials	19
Healthcare	6
Energy	3
Real Estate	9
Industrials	8
Telecommunication Services	3
Utilities	2
Total	**92**

Methodology

- ROE and Tobin's Q are used extensively in corporate governance empirical literature (Pintea & Fulop, 2015).
- A common practice is to control for asset size and years since listing (Chen, 2001; Black, Kim, & Jang, 2006).
- Leverage can impact profitability, so a control variable is introduced (Chen, 2001; Black, Kim, & Jang, 2006; Fallatah and Dickens, 2009).
- To account for industry characteristics, dummy variables are often used (Black, Kim, & Jang, 2006; Fallatah and Dickens, 2009).

Methodology

Variables	Exp. Sign	Description
Dependent variables		
Return on equity		Net income / Shareholder's equity
Tobin's Q		(Market capitalization + BV of debt) / BV of total assets
Independent variable		
Corporate Governance Index	+	Includes BoD, SHR, T&PD, and SHR scores for the year 2015
Control variables		
Firm size	-	Natural log of total assets
Firm age	-	Years since listing
Leverage	-	Debt to total assets ratio
Sector		Belonging to one of 11 GICS sectors (dummy variable)

$$Performance = \beta_0 + \beta_1 CG + \beta_2 \ln(assets) + \beta_3\, age + \beta_4\, leverage + \beta_5\, sector + \varepsilon$$

Methodology

Variables	Exp. Sign	Description
Dependent variables		
Return on equity		Net income / Shareholder's equity
Tobin's Q		(Market capitalization + BV of debt) / total assets
Independent variable		
Board of directors	+	
Shareholders' rights	+	
Transparency and public disclosure	+	
Stakeholders' rights	+	
Control variables		
Firm size	-	Natural log of total assets
Firm age	-	Years since listing
Leverage	-	Debt to total assets ratio
Sector		Belonging to one of Tadawul's GICS sectors (dummy variable)

$$Performance = \beta_0 + \beta_1 BoD + \beta_2 SHR + \beta_3 PD + \beta_4 STR + \beta_5 \ln(assets) + \beta_6\, age + \beta_7\, leverage + \beta_8 sector + \varepsilon$$

Results: Composite Index

	Model 1: Return on Equity (R^2 =21.9)		
Independent variables	Unstandardized coefficient	Standardized coefficient	Significance
Corporate Governance Index	.006	.351	.000***
Leverage	-.165	-.282	.004***
Telecommunication services (sector)	-.175	-.216	.025**

	Model 2: Tobin's Q (R^2 =22.2)		
Independent variables	Unstandardized coefficient	Standardized coefficient	Significance
Corporate Governance Index	.039	.313	.003***
Firm size	-.273	-.502	.000***

*, **, *** indicates significance at the 10%, 5%, 1%, levels

Results: Subindices

	Model 1: Return on Equity (R^2 =22.2)		
Independent variables	Unstandardized coefficient	Standardized coefficient	Significance
Transparency and public disclosure	.003	.264	.007***
Leverage	-.186	-.317	.002***
Telecommunication services (sector)	-.172	-.212	.028**
Real estate (sector)	-.098	-.202	.045**

	Model 2: Tobin's Q (R^2 =20.8)		
Independent variables	Unstandardized coefficient	Standardized coefficient	Significance
Transparency and public disclosure	.022	.277	.007***
Firm size	-.256	-.470	.000***

*, **, *** indicates significance at the 10%, 5%, 1%, levels

Robustness Checks

- Using alternate construction of CG score and different performance indicators (Black, Kim, & Jang, 2006) to check robustness.
- An equally weighted index had a minimal effect on coefficients of the significant variables.
- CG score is statistically significant (p-value = 0.012) when using market-to-book ratio as an additional measure of firm performance.

Limitations and Future Research

- Regression models may suffer from omitted variables bias and endogeneity.
- Another limitation is that the relatively small sample size, which covers a single year, 2015.
- Future research to focus on increasing sample size to cover more companies and multiple years to allow for more accurate estimates.

Conclusion

- A positive relationship exists between corporate governance and firm performance, proxied by return on equity and Tobin's Q.
- Out of the four subindices, transparency and public disclosure is found to be statistically significant.
- Future studies are recommended refine the model by introducing other control variables, addressing limitations such as endogeneity, and increasing sample size.

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Thank You