

Understanding the Corporate Governance Score: Are Some Components of Corporate Governance Overrated? Evidence from a Developing Country

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Abstract

The corporate governance structure of companies has been subjected to intense examination in recent time due mainly to recent corporate collapses and other financial mis-conduct by management. The benefits of an effective corporate governance structure are well documented, ranging from reduce cost of capital to improved transparency in ethics, morality and financial disclosure. Evaluating the effectiveness of a company's corporate governance structure normally involves the use of a corporate governance score. This study investigates the appropriateness of some of the more commonly used components in compiling the corporate governance score. The study found that the presence of both an audit committee and a compensation committee along with effect of CEO duality had significant statistical effect on the corporate governance score. However, the results also showed that the size of the board and the number of independent directors were not statistically significant components of the corporate governance score.

Keywords: audit committee, board size, corporate governance score, CEO duality

1. Introduction

Corporate governance is viewed as a mechanism of resolving conflicts between management and shareholders and to prevent the abuse of minority shareholders by majority shareholders. The essence of corporate governance is therefore to mitigate agency costs. The corporate governance framework explains the distribution of rights and responsibilities among the actors within corporations and explains the rules and procedures for making decisions on matters affecting corporations.

The OECD defines corporate governance as follows “...the procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.”

Interestingly, the World Bank provides a different view of corporate governance as “...Corporate governance is about promoting corporate fairness, transparency and accountability.” Which ever definition of corporate governance is embraced, the underlying assumption is that firms with good corporate governance structures should enjoy better performance when measured using accounting metrics. Strong corporate governance results in the reduction of risk, better access to capital at a lower cost and ultimately improved firm performance.

There have been numerous studies that have examined varying aspects of firm performance, in terms of using a corporate governance score to assess the strength of the firm's corporate governance structure. The corporate governance score is then use to predict or evaluate the dependent variable. Researchers have used different components on corporate governance in order to develop the corporate governance score or index. The problem with those prior studies is that, we do not have any empirical evidence to determine the statistical significance of the individual components comprising the corporate governance score or index.

This study is the first one that provides the basis for testing the statistical significance of some of the more popular components that are normally used to evaluate the corporate governance structure of corporations. This study examines the following five components that are generally accepted as good indicators in assessing the quality of corporate governance in corporations, these are: CEO duality, the board size (number of directors on the board),

board composition (the presence of independent directors), the presence of a compensation/remuneration committee and the presence of an audit committee. The results of this study will determine the extent to which reliance should be placed on these widely used corporate governance components in developing a corporate governance score or index.

2. Theories and Literature Review

The main theoretical framework for this study is one that is grounded in agency theory and corporate governance. The basic premise is that, the separation of ownership from management results in agency costs to the principals. Principals are concerned that the interests of agents are not generally in alignment with the interest of the owners and resulting from this non-alignment or divergence of interests, shareholders incur agency costs. Therefore, to control and monitor self-serving agents, the need for effective corporate governance structures become an imperative.

The agents who are the CEOs are employed to manage the firms on behalf of the shareholders with the sole purpose of maximizing shareholders' wealth and in return CEOs receive a compensation package which should be reflective of their performance and contribution to shareholder wealth maximization. However, in most cases this simple depiction of what should be a straightforward model does not work. The result is distrust between principals and agents and the attempt by principals to implement punishment and monitoring system to bring agents behavior in line with the interests of shareholders. To achieve this, corporate governance and control structures are normally implemented through the board of directors.

According to Johnson et al., (1996) the board of directors has three major responsibilities to accomplish namely: monitoring management actions, advising the CEO, and getting external resources that are vital to build corporate capabilities. An effective board is therefore vital to ensure that agents/CEOs do not enrich themselves at the expense of the shareholders. The effectiveness of the board is dependent on its structure. However, managerial power theory contends that board structure arrangements are important boundary conditions for board monitoring and for aligning CEO pay to firm performance. Boards dominated by executive insiders are assumed to be problematic monitors and compromised compensation decision-makers, given that the CEO can influence fellow executive rewards' and career advancement (Beatty and Zajac, 1994). In addition, managerial power theory proposes that CEOs who are also board chairpersons have the power to influence board decisions in general, but especially in the setting of CEO pay (Boyd, 1994). Combining the role of board chairperson and CEO is said to render directors beholden to the CEO and hence, to create the conditions for board complicity or board capture (Bebchuk and Fried, 2004; Cadbury, 2002; Gumbel, 2006; Huse, 2007).

Arising from this concern, an effective governance mechanism would be one in which the percentage of independent directors on the board exceed that of the executive directors. The directors are the moderating force between the opportunistic CEOs and the shareholders and thus board integrity must be maintained at all times, especially because shareholders are normally dispersed and lack the power to directly monitor the actions of the CEOs.

This study also incorporates some aspects of stewardship theory. Stewardship theory presents a view that is contrary to that of agency theory, while agency theory sees agents as opportunistic and self-serving; stewardship theory sees agents as loyal, committed individuals who want to do a good job and therefore see shareholder wealth maximization as being in their best interest. The study therefore gives extensive coverage to the agency and corporate governance issues.

2.1 Overview of Corporate Governance

Agency conflicts in organizations results from the separation of ownership and control, the conflicting objectives of owners and managers, and information asymmetry between owners and managers (Fama and Jensen, 1983). As a result of these agency conflicts, and given that managers have sufficient latitude in applying acceptable accounting procedures, they are likely to have incentives to take actions that maximize their utility, even when those actions do not maximize shareholder wealth (Watts and Zimmerman, 1986).

Daily, Dalton, and Cannella (2003) view governance as the determination board uses as to which organizational resources will be deployed and the resolution of conflicts among the numerous participants in organizations. They argue that the definition stands in some contrast to the many decades of governance research, in which researchers have focused mainly on the control of executive self-interest and the protection of shareholder interest in settings where organizational ownership and control are separated. It is further argued that the overwhelming emphasis in governance research has been on the ability of the various mechanisms available to protect shareholders from the self-interested whims of executives (Daily, Dalton, and Cannella 2003).

There is considerable debate in corporate governance literature on the role of board in disciplining the firm management (Rashid, et al. 2012). The board's ability to exercise the governance function depends on a number of board attributes, such as the distribution of power between the board Chair and the Chief Executive Officer (CEO) (Pearce and Zahra 1991; Finkelstein and Hambrick 1996; Kakabdse et al. 2006); board size (Hermalin and Weisbach 2003; Zahra and Pearce 1989); boards of directors' ability to choose CEO with standard managerial competencies who may demonstrate integrity, provide meanings, generate trust, and communicate values (Bennis and O'Toole 2000); board independence (Rosenstein and Wyatt 1990; Gopinath et al. 1994; Maassen 2002; Raheja 2005), and the extent of influence of external environment (Pfeffer and Salancik 1978).

The board's ability to monitor management attracted attention following the collapse of Maxwell Publishing Group, BCCI and Poly Peck in the United Kingdom (Rashid, 2013). The Cadbury Code developed and published in response to these collapses (Jonsson, 2005), made recommendations for board reforms, including the structural independence of the board (Rashid, 2013).

Similarly, the board's ability to monitor management, also attracted attention following the wave of mega corporate collapses in the early 2000s, such as the collapse of Enron, WorldCom and HIH insurance (Brick et al. 2006; Braun and Sharma, 2007). It is alleged that, board's inability to monitor management within these corporations was due to insufficient monitoring as the management had a consolidation of power (Rose, 2005). The Sarbanes-Oxley Act in 2002, following the corporate scandals in the United States (such as Enron and WorldCom), recommends a number of additional checks and balance to monitor the CEOs (Dey et al. 2009)

The corporate governance mechanisms provide shareholders some assurance that managers will strive to achieve outcomes that are in the shareholders' interests (Shleifer and Vishny, 1997). Shareholders have available to them, both internal and external governance mechanisms to help bring the interests of managers in line with their own (Walsh and Seward, 1990). Internal mechanisms include an effectively structured board, compensation contract developed by a compensation or remuneration committee, that encourage a shareholder orientation, and concentrated ownership holdings that lead to active monitoring of executives. The market for corporate control, serves as an external mechanism that is normally activated when internal mechanisms for controlling managerial opportunism have failed (Daily, Dalton, and Cannella 2003).

The governance structure of a firm involves mechanisms to maximize agency conflicts. The demand for these control mechanisms is likely to be higher for firms with greater need for oversight, or with higher degrees of agency conflicts. In other words, agency conflicts and governance mechanisms in a firm are likely to be complementary, that is, higher levels of agency conflicts will result in stronger governance structures (Dey, 2008).

While agency theory dominates corporate governance research (Dalton, Daily, Certo, and Roengpitya, 2003), part of the governance literature stem from a wider range of theoretical perspectives (Daily, Dalton, and Cannella 2003), it is said that, many of these theoretical perspectives are intended as complements to agency theory. Daily, Dalton, and Cannella (2003) argue that, a multitheoretical approach to corporate governance is essential for recognizing the many mechanisms and structures that might reasonably enhance organizational functioning. For example, it is claimed that the board of directors is perhaps the most central internal governance mechanism. However, whereas agency theory is appropriate for conceptualizing the control and or monitoring role of directors, additional perspectives are needed to explain directors' resource, service, and strategy roles (Johnson, Daily, and Ellstrand, 1996).

Resource dependency theory provides a theoretical foundation for directors' resource role (Daily, Dalton, and Cannella 2003). Advocates of this theory, see board members' contributions as boundary spanners of the organization and the environment (Dalton, Daily, Johnson, and Ellstrand, 1999; Hillman, Cannella, and Paetzold, 2000). In these roles, outside directors provide access to resources needed by the firm. For example, outside directors who are also executives of financial institutions may assist in securing favorable lines of credit (Stearns and Mizruchi, 1993) also outside directors who are partners in a law firm, provide legal advice, either in board meetings or in private communications with firm executives, which may otherwise be more costly for the firm to secure. The provisions of these resources enhance organizational functioning, firm performance, and survival (Daily, Dalton, and Cannella 2003).

Executives have reputations that are interwoven with the financial performance of their firms (Baysinger and Hoskisson, 1990). In order to protect their reputations as expert decision makers, executives and directors are inclined to operate the firm in a manner that maximize financial performance measures, including shareholder returns. For example, directors, whether insiders or outsiders, concern themselves with the effectiveness of their firm's strategy, because they recognize that the firm's performance directly impacts perceptions of their individual

performance. Therefore, in being effective stewards of the organization, executives and directors are also effectively managing their careers (Fama, 1980).

The power perspective, as applied to corporate governance studies addresses the potential conflict of interest among executives, directors, and shareholders (Jensen and Werner, 1988). The power relationship between CEOs and board of directors has been of particular interest in corporate governance research (Daily, Dalton, and Cannella 2003). Although the board is legally the more powerful entity in the CEO/board relationship, there are a number of factors that operate to reduce board power vis-à-vis the CEO. For example, CEO can exercise influence over the succession process by dismissing viable successor candidates (Cannella and Shen, 2001). Also, the timing of a director's appointment to the board might also impact the power relations between board members and CEOs, because directors appointed during the tenures of current CEOs may be loyal to them and may be less likely to challenge them (Monks and Minow, 1991).

2.2 CEO Duality

Boards of directors are charged with ensuring that chief executive officers (CEOs) carry out their duties in a way that serves the best interests of shareholders. Thus, boards can be seen as monitoring devices that help align CEO and shareholder interests (Fama and Jensen, 1983). CEO duality occurs when the same person holds both the CEO and board chairperson in a corporation (Rechner and Dalton, 1991). CEO duality has opposing effects that boards must attempt to balance. On the one hand, duality can firmly entrench a CEO at the top of an organization, thus challenging a board's ability to effectively monitor and discipline (Mallette and Fowler, 1992). On the other hand, the consolidation of the two most senior management positions establishes a unity of command at the top of the firm, with unambiguous leadership clarifying decision-making authority and sending reassuring signals to shareholders (Finkelstein and D'Aveni, 1994).

Separation of ownership and management in modern corporations has led to different arguments regarding the relationship between the principal and agent. According to agency theory, the agent in this relationship will be a self-interest optimizer. In other words, executive managers will take decisions with the aim of optimizing their wealth and or minimizing their risks at the expense of the shareholders' value (Elsayed, 2007). Therefore, it has been argued that internal and external monitoring mechanisms need to be implemented to lessen the divergence in interest between shareholders and the management (Jensen and Meckling, 1976).

However, other researchers argue against the hypothesis of agency theory and propose stewardship theory (Elsayed, 2007). For example, Donaldson and Davis (1991) claim that the executive manager under stewardship theory is far from being an opportunistic shirker, and essentially wants to do a good job, that is, he wants to be a good steward of the company's assets. The basic premise of stewardship theory is that, the structure of the firm is the main determinant that can assist the executive manager to implement his or her plans effectively (Elsayed, 2007).

According to Johnson et al., (1996) the board of directors has three major responsibilities to accomplish: monitoring management actions, advising the CEO and getting external resources that are vital to build corporate capabilities. One fundamental question that has received growing attention in the literature is whether there is a relationship between board leadership structure and corporate performance. Or to put it another way, is it better to have one person to fulfil the CEO and at the same time to be the chairman of the board of directors, or it is preferred to give the job to two different persons? (Elsayed, 2007).

The board of directors is at the apex of the internal control system and has responsibility for the functioning of the firm (Jensen, 1993). However, when the board chairman is also the CEO, the board intensity to monitor and oversee management is reduced as a result of a lack of independence and a conflict of interest (Dobryznski, 1991; Millstein, 1992). The issue that arises when companies practice CEO duality is, "Who monitors management?" (Abdullah, 2004). Unlike in a two-tier system, the unitary system has the board at the highest internal control system, as argued by Jensen (1993). It has been argued that the firms' managers' influence in setting the board agenda and controlling information flow, could impede the board's ability to perform its duties effectively (Solomon, 1993; Aram and Cowan, 1983). The firm's managers' ability to determine the board agenda and the flow of information is predicted to be much stronger when the board chairman is also CEO than when the firm adopts a non-dual structure (Abdullah, 2004). Dayton (1984) asserts that the board is the primary force pushing the company towards realizing the opportunities and meeting the obligations of the shareholders and other stakeholders. He argues that, it is the CEO who allows the board to play the primary force.

In a similar vein, dual leadership structure indicates the absence of separation of the decision management and decision control (Fama and Jensen, 1983). Rechner (1989) argued that the ideal corporate governance structure is

one in which the board is composed of a majority of outside directors and a chairman who is an outside director. Hence, the weakest corporate governance is one where the board is dominated by inside directors and the CEO holds the chairmanship of the board. Where one person dominates a firm, the role of independent director becomes hypothetical (Rechner, 1989; Dayton, 1984). A structure of this type, is likely to lead to the board being incapable of protecting the interests of the shareholders. The board with the high influence of the management, will not be able to discipline the management appropriately as the management who controls the board will over-rule such initiatives (Abdullah, 2004). Miller and Friesen (1977) argue that the non-executive chairman promotes a higher level of corporate openness.

Different theoretical arguments have been used to either support or challenge CEO duality. Drawing on agency theory, the opponents (e.g. Levy, 1981; Dayton, 1984) suggest that CEO duality diminishes the monitoring role of the board of directors over the executive manager, and thus in term may have a negative effect on corporate governance. On the other hand, advocates of CEO duality (e.g. Anderson and Anthony, 1986; Donaldson and Davis, 1991) assert that corporate performance is enhanced when executive manager has the full authority over his corporation by serving also as the chairman, as less conflict is likely to happen. Others such as Brickley et al., (1997) argue that there is no one optimal leadership structure, as both duality and separation perspectives have related costs and benefits. Hence, duality will benefit some firms while separation will likely be advantageous for others.

The issue of separation of the top two posts has been addressed in the Cadbury Committee (1992), which recommended that the roles of board chairman and CEO be separated. The Malaysian Code of Corporate Governance (2001) also recommended a similar board structure. The reason for the need for separations is that when both, monitoring roles and implementing roles are vested in a single person, monitoring roles of the board will be severely impaired (Abdullah, 2004). The impairment of the board's independence could affect the board incentives to ensure that management pursues value increasing activities (Abdullah, 2004).

2.3 Audit Committees

Audit committees have always been viewed as a significant source of improving corporate governance. The Cadbury Committee (1992) argues that well-constituted audit committees have the potential to improve the quality of financial reporting as well as ensuring the independence of the statutory audit. Studies have highlighted the benefits of audit committees. Turley and Zaman (2004) identified four effects namely: financial reporting quality, audit quality which deals with auditor independence and quality of internal control, structural effects which focus on the agency theory and finally, corporate performance.

Cohen *et al.* (2004) examined the role of audit committees with the emphasis on the overall corporate governance structure in-terms of the financial reporting and the monitoring of the board. Cohen *et al.* (2004) emphasized the governance role of audit committees in the context of its knowledge and expertise, composition, effectiveness, duties, responsibilities and power. Cohen *et al.* (2004) concluded that audit committees should have the requisite power to effectively monitor management's actions.

Following the collapse of Enron, the role of audit committees in relation to audit quality has been heavily researched. Chen and Zhou (2007) and Chen *et al* (2005) have looked the role of audit committees in the selection of the external auditor. Krishnan and Visvanathan (2009) studied the link between audit committee characteristics and the provision of audit and non-audit services. Other areas of importance relating to audit committees include its size, its independence and the frequency of meetings.

3. Sample Selection

The sample selected for this study was obtained from public listed companies of the Jamaican Stock Exchange (JSE). Sixty-eight (68) companies comprising various industries were selected and examined for the years 2014 to 2020. The annual reports provided to the JSE were examined for consistency in-terms of the directors' report for inclusion of information regarding the five (5) corporate governance components used in this study. The corporate governance components are information indicating the presence of CEO duality, information indicating the size of the board, board composition in-terms of independence directors, the presence of a compensation committee and whether an audit committee is present.

These five components were used to develop a corporate governance score similar to the one used by Sawicki (2009) in developing his corporate governance measure. The corporate governance score was developed by awarding one point to each company for the presence of a corporate governance component, and zero point if the component is not present. Thus, the maximum point a company can achieve is five (5) which represents the corporate governance for

the company. Some companies were excluded from the sample because their annual reports did not provide information to determine if all five components were present or absent over the 8-year period.

4. Analytical Tool and Hypotheses

The data analysis was done by using multiple regression. The corporate governance score was the dependent variable, and the five independent variables were:

- CEO duality
- board size
- presence of independent directors
- presence of compensation committee
- presence of audit committee

The regression equation is:

$$(CG \text{ Score}) = \beta_0 + \beta_1(\text{CEO duality}) + \beta_2(\text{board size}) + \beta_3(\text{independent directors}) + \beta_4(\text{compensation committee}) + \beta_5(\text{audit committee}) + \epsilon_j$$

The following five hypotheses were tested in the study:

H1: There is a positive relationship between the existence of CEO duality and a company's corporate governance score.

H2: There is a positive relationship between board size and a company's corporate governance score.

H3: There is a positive relationship between the presence of independent directors and a company's corporate governance score.

H4: There is a positive relationship between the presence of compensation committee and a company's corporate governance score.

H5: There is a positive relationship between the presence of an audit committee and a company's corporate governance score.

5. Results and Discussion

Multiple regression was used to evaluate the appropriateness of the corporate governance model. The data were tested for multicollinearity and the possibility of any serial correlation using tolerance statistic and the Durbin-Watson, respectively.

Table 1. Model Summary^b

R	R Square	Adjusted R ²	F Change	df	Sig. F Change	Durbin-Watson
.976 ^a	.953	.949	249.901	5	.000	2.162

a. Predictors: Audit committee, number of independent directors, CEO duality, Compensation committee, Board size

b. Dependent Variable: Corporate Governance score

Table 2. ANOVA^a

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	27.615	5	5.23	249.901	.000 ^b
Residual	1.370	62	.022		
Total	28.985	67			

a. Dependent Variable: Corporate Governance score

b. Predictors: Audit committee, number of independent directors, CEO duality, Compensation committee, Board size

Table 3. Coefficients^a

Model	Standardized Beta	Sig.	Tolerance
Constant		.000	
CEO Duality	.676	.000*	.970
Board Size	-.029	.373	.739
Number of independent directors	.052	.114	.715
Compensation committee	-.649	.000*	.862
Audit committee	-.139	.000*	.887

a. Dependent Variable: Corporate Governance score

.000* significant at 5%

Table 1 reports a Durbin Watson of 2.162, this tests the hypothesis of the existence of any serial correlation in the data. Generally, a Durbin Watson of 1.5 to 2.5 implies no meaningful serial correlation in the data. Whereas, a reading of less than 1.5 implies serial correlation in the data. The issues multicollinearity among the independent variables was examined by the collinearity statistic of tolerance. Multicollinearity generally exists when the tolerance is less than 0.2.

Table 3 provides the tolerance factor for the independent variables in the model and they are all above 0.2, which implies the absence of multicollinearity among the independent variables.

Based on the results shown in Table 1, ($R^2 = .953$) it shows that the independent variables explain 95.3% of the variation in corporate governance score. The test value $F = 249.901$ is statistically significant at the 0.05 significant level. This implies that all the independent variables contained in the regression model simultaneously had a significant effect on corporate governance score. Table 3 ANOVA results show that the regression model is statistically significant and is appropriate, to be used to evaluate the effect of the independent variables as components of the corporate governance score.

A closer look at Table 3, shows that there is not sufficient evidence to accept hypotheses 2 (H_2 , board size) and 3 (H_3 , number of independent directors) as there were not found to be statistically significant at the 5% level. However, there is sufficient evidence for the acceptance of H_1 , H_4 and H_5 (relating to CEO duality, compensation committee and audit committee respectively), which all had a statistically significant effect on the corporate governance score.

6. Summary and Conclusion

This paper has provided some very interesting observations regarding the issue of corporate governance and the compilation of a corporate governance score. One of the significant observations was that, the size of the board and the number of independent directors had little or no effect as components of the corporate governance score. Although this is interesting, the results should not be totally surprising, as these issues are yet to be settled in the corporate governance literature. There is currently disagreement as to what constitute an effective board size, with arguments for and against both large and small boards. Hence, the results of this study show that the absolute board size is not a significant component in evaluating a company's corporate governance structure. The other important observation was that the number of independent directors was not significant in determining an effective corporate governance score. Effective corporate governance has always been judged based on the number of independent directors on the board, however, we now have evidence showing that less emphasis needs to be placed on the component of number on independent directors. It could be that we need to evaluate the influence of independent directors on board and not focus so much on the number of independent directors.

The statistically significant components for the calculation of the corporate governance score were CEO duality, compensation committee and audit committee. This result supports the existing corporate governance literature, which highlights the effects that CEO duality, the presence of compensation and audit committees have on the evaluation of the effectiveness or strength of a firm's corporate governance structure. One of the implications of this study is that, it may be now time for researchers to start focusing less on the presence of independent directors on boards and direct their attention to measuring the influence that these directors have on the company's management.

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