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Corporate Governance: The Value of Corporate Governance on Firm Value

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What is the Impact of Corporate Governance on a Firm's Value?

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ABSTRACT

Corporate Governance can be seen as a ripple effect, as it impacts not just the employees, and managers of a company, but also the directors, capital providers, the industry, and most importantly, shareholders. Most companies strive to have a high level of corporate governance, which is the harmonization of goals and their means to achieve the goals for shareholders, directors, and officers. On the other side, a lack of good corporate governance can hurt a company's integrity and reliability in the views of stakeholders. This paper will discuss the background and history of corporate governance, the importance of corporate governance, the impact it has on firm value, and then briefly discuss some examples of corporate governance in the work place today.

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Introduction

The term corporate governance refers to the framework of rules, procedures, and practices that the board of directors utilizes to safeguard clarity, equality, and responsibility in the company's relationships with shareholders. This includes consumers, employees, managers, providers of capital, and society. The framework is comprised of definite and implied contracts between the corporation and shareholders for the allocation of duties, entitlements, and remunerations, practices for settling shareholders conflict of interests, and methods for appropriate control, movement of information, and regulation that functions as a checks and balances system. This structure is created with the intention to ensure the long-term prosperity of companies, while managing relationships between shareholders and management (Cheffins, 2011). The focus on the long-term is not only essential for shareholders, who've invested into the company, but also for managers and employees. This is because without looking forward, they could find the company under water, and liquidating operations, leaving them without a job. As a whole, corporate governance has the ability to impact the value of a firm either positively, or negatively depending on if the rules are adhered too, and if the policies are enforced.

History of Corporate Governance

The concept of corporate governance goes back to the when the first conflicts of interest emerged between management and shareholders, to the early days of the East India Company, the Hudson's Bay Company, and other companies that charted during the sixteenth and seventeenth century. Corporate Governance really began picking up traction after World War II, when the United States began seeing a significant increase in the formation of new companies. It was during this time that the board of directors and stakeholders "took the back seat" and let the managers drive the companies to success of failure (Cheffins, 2011). This meant that they had to be supportive of management and their decisions, even if they disagreed. There was a serious disconnection between the board of directors, management, and shareholders, and the lack of communication of duties led to shareholders to be apathetic, and focus specifically on the return on their investments.

It wasn't until the late seventies, when the Securities and Exchange Commission (SEC) started to classify issues related to the accountability of management as regulatory issues, that the Securities and Exchange Commission (SEC) decided to add corporate governance to there official agenda. It was also during the 1970's that the Securities and Exchange Commission (SEC) learned about the extensive bribes disbursed to foreign politicians by United States corporations, further propelling the need to add corporate governance to the reform agenda. The Chairman of the SEC, William Proxmire, released a statement in May of 1976 pertaining to the dubious actions of companies that was touted as the frustration of the corporate accountability system. In the report, Chairman Proxmire pointed out that the system was in place to ensure the correct accounting for, and utilization of capital resources, and that there was no misrepresentation in the financial statements submitted to the SEC. However, the system was failing, and corporations were inappropriately entering money, that enabled the corporate bribery to happen ("United States: Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices", 1976).

The SEC responded to this by proposing a solution that had two key factors. The first was to certify that stakeholders received the required material details that enabled them to gauge management decisions and practices, and to make well informed decisions about their investments. The second element of the proposal ensured that boards of directors were not only aware of the potential issues, but established appropriate and efficient solutions to them. This proposed solution held executives and management more accountable, eliminating the lassie-fair approach that directors and shareholders previously shared ("United States: Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices", 1976). However, this solution didn't solve the corporate governance issues entirely, but was the start of the reform of corporate governance.

As time progressed, the board of directors, and shareholders started getting more involved with the establishment of company policies, procedures, and elections of board members. This was because more and more investors emerged, looking to invest, and others increased their holdings in specific companies.

Literature Review

The research began by finding three literature articles from the library's journals that related to corporate governance and the impact on firm value. The three articles were "Corporate Governance Mechanisms and Firm Performance", "Corporate Governance, Board Characteristics, and Firm Performance: Evidence from Sri Lanka", and an editorial, "Corporate Governance, Board of Directors, and Firm Performance". The articles all related in a sense of describing corporate governance as having an impact on firm value whether good or bad. The idea was to pull evidence from each of the articles to emphasis how corporate governance ultimately encompasses positive consequences to a firm's value.

Previously published literature has addressed the relationship between corporate governance and firm value. One research study looked at (Roy, 2016) research consisting of 58 Indian firms over a five-year period, from 2007-2012, using Return on Asset (ROA) and Market to Book Value (MTBV), as measures of firm performance. It was found that these two factors were notably affected by several different corporate governance factors. They concluded that firm performance and firm value are greatly influenced by the corporate governance of the firm.

Poor corporate governance is still a major issue within many companies today. Through extensive research not only did we find poor corporate governance causes a decline in firm value, we also found some of the key reasons that lead firms to having poor corporate governance. In the journal "The Nature of Corporate Board Structure and Its Impact on the Performance of USA Listed Firms," Shweta Mehrotra talks about some of the key issues that lead to a weak corporate governance. One of the issues we deal with is board size. Mehrotra talks about how the perfect board size of 8 to 10 members can lead to a strong corporate governance, but anything less or more than that number can cause many issues. Mehrotra also talks about voting power within a company, and how if one person has too much power poor corporate governance will not only affect the company externally, but internally as well.

Rationale

We chose corporate governance as a topic because of the number of individuals that affected by it. Recently, there have been numerous examples of poor corporate governance in the news, and this impacts the consumers, but the employees, managers, directors, and more importantly the community. Companies with poor corporate governance typically have a disconnection between the directors and either employees, management, or shareholders. This negatively impacts the firm by decreasing the value of the company, and leads to a lack a trust amongst shareholders. Without the confidence from stakeholders, companies can find themselves losing shareholders, and more importantly not gaining any new or future investors.

Research Question

The research question we chose is “What is the impact of corporate governance on firm value?”

Methodology

Our methodology included various online database searches for specific key terms and phrases, including but not limited too, corporate governance, impact on firm value, history of corporate governance, good corporate governance, and bad corporate governance. The databases we used to search for those terms and phrases were Google Scholar and Business Source Premier. These databases were extremely helpful in conducting our research, as we could limit our search results to specific parameters that we determined.

Research Findings

Corporate Governance is an important component to evaluate when considering the success or failure of an organization. The responsibility of the board is not only reduced to the monitoring role of the boards, but also the anticipation that the members of the board will offer knowledge, advice, and networking to guide management in improving the firm’s performance and assist shareholders in constructing management earnings (Kumar and Zattoni, 2013). The purpose of creating effective organizational functions is to maintain structure within an organization, and it is the primary responsibility of the board members to protect, direct, and control the firm's environment. Additionally, providing transparency and accountability of the firm's activities is also crucial. With the assurance that all reporting, policies, and procedures are disclosed, and are available for all stakeholders to review, the firm develops trust and reliability, both within and outside of the organization. Another important element is that corporate governance helps establish positive relationships among shareholders, executives, non-executives, and customers. By welcoming different perspectives, the firm develops a stronger urgency to satisfy the needs of all members involved and builds up a unique structure that will act like a resource for the firm (Gill, Vijay, Jha, 2009).

Impact on Firm Value

There are several ways Corporate Governance can impact a firm's value. To give us a broader sense of what this means, we've researched several journals that described how the reduction of uncertainty, implementation of strategic policies, and recognition on the importance of sharing the interest of all participating parties might ultimately affect the firm's value.

To help reduce uncertainty, the Board of Directors can investigate and evaluate both internal and external environments, which impacts the endurance of the firm. Although companies may refrain from using external sources, several authors hypothesized and proved though supporting data, that independent (or external), dependable, and expert directors will notice a higher value of information, which helps justify the associated agency costs of quality reporting (Kumar and Zattoni, 2013). Also, boards with more independent directors lean more towards effective controls due to their expertise from numerous sources outside the firm. They essentially enhance the legitimacy of the organization by ensuring balanced decision making, specifically to protect stakeholders (Dharmadasa, Gamage, Herath, 2014). We find that encompassing both internal and external resources provide a competitive advantage that positions the organization in a superior state against its rivals.

Providing guidance towards the success of an organization is also instrumental to the firm's value. The idea of creating strategic policies through the Board of Directors can help shape the framework, influence decision-making, and construct the firm to use best practices. With corporate governance in place, managers can make optimal strategic policies, which may lead to competitive advantage (Gill, Vijay, Jha, 2009). Many companies, which are governed by the board of directors, are typically assigned two roles. The first is an advisory role towards the management team and the second is a monitoring and controlling role that may extend to the board itself (Dharmadasa, Gamage, Herath, 2014). Depending on the characteristics of the board, whether size, diversity, and/or composition of the individual who serve on the board of directors, the ability to advise, monitor, and control will be influenced, which will have an impact on firm performance. A comprehensive understanding of these characteristics should be measured for implementing effective corporate management and public policies (Dharmadasa, Gamage, Herath, 2014).

Ensuring that everyone's best interest is at hand is also essential in adding towards the firm's value. To avoid entrenchment, the board of directors should consider adding multiple constituents to the decision making process. An example to describe how an organization could potentially harm a firm's value is through CEO duality. This refers to the same person on the board serving two functions; that of the CEO, and the chairperson on the board (Dharmadasa, Gamage, Herath, 2014). Although some may view this as positively impacting corporate governance because it provides a focused objective by one leader, some may believe this would reduce the effectiveness of having a board, who's responsibility is to monitor and control. By performing governance through non-duality, an organization will make certain to share the interest of all participating parties, providing equal treatment for its stakeholders in as much as its shareholders.

Good Corporate Governance

For several decades, corporate governance has been an important topic for corporations. Examples of major failures in the business world are that of Lehman Brothers and Enron, caused by several factors including poor corporate governance policy and practices. Therefore, corporations must institute and implement strong corporate governance policies in order to have the trust of all stakeholders involved. (Samra, 2016)

There are many different aspects that contribute to a corporate environment of good corporate governance. These traits include having a clear strategy for the organization, having an effective risk management policy in place, stringent discipline policies, fairness, transparency, corporate social responsibility, employee and customer evaluations, a strong and qualified Board of Directors, clearly defined roles, integrity, and ethical behavior. (Mack, 2017) (Blackman, 2015)

It is imperative to have a straightforward strategy for any corporation. For example, a company might research new areas of business to move into, create new products, and market them to a new target audience. Knowing the strategy will also help a company to stay focused on its plans or objectives for the future. (Mack, 2017)

Effective risk management is also an important component of a healthy corporate governance policy. In any company and in every industry, risk is a factor. (Mack, 2017) Formulating a plan, judging how to handle each risk, and watching out for risk is imperative to corporation. A corporation may also diversify business operations into other areas so that revenue may be sourced from multiple locations. (Mack, 2017)

Another key to corporations having a strong corporate governance policy is Discipline. A company's disciplinary policies are only effective if they are being carried out fully. A company may have great strategies and plans for the future, but if its employees are not correctly carrying out their duties, the plans will be ineffective. Management must fully carry out disciplinary procedures to help the company to be effective. (Mack, 2017)

Fairness is also imperative to a successful management team. Employees should be challenged to reach their goals, but goals should be realistic and attainable.(Mack, 2017)In the Wells Fargo scandal that came to light in 2016, management had set unrealistic expectations for their employees, which led to employees lying, cheating, and stealing just to make the sales quotas.(Balter, NOVEMBER 13, 2007) Employees should be pushed to a point, but not to where there is high turnover and low morale. A corporation must also be fair and just with employees and customers. This will make for long-term success. (Mack, 2017)

Corporate social responsibility is also important to any company's success. It is important for corporations to portray a positive image to the community and be a good member of society. (Karim, Suh, Carter, & Zhang, 2015) By reducing waste, becoming 'green', reducing pollution, and recycling, a company can practice good CSR. A company may also come up with ways to improve themselves and reinvest in the local economy. (Mack, 2017)

Transparency in a corporation is one of the many traits of good corporate governance. Transparency can help to unify an organization. This does not mean sharing confidential company information. This means having policies in place to let all stakeholders involved, feel as though they are being made aware of what decisions are being made and how it may help investors or consumers make their decisions.(Balter, NOVEMBER 13, 2007) If employees are allowed to understand managerial decisions and goals, and the company's financial performance, it permits the employees to better understand their role in the firm. Transparency also gives a greater deal of accountability and trust to all stakeholders involved.

Employee self-evaluations can be helpful in managing the company and to assess if any issues or policies need to be addressed. Consumer and employee surveys may also help to give beneficial feedback about policies that are being used. Another great management tool that can be very beneficial to a corporation is to hire an outside consulting firm to evaluate company and employee performance and give guidance on any improvements that may be helpful. (Mack, 2017)

Another important aspect of corporate governance is to construct a powerful and qualified board of directors for the firm and regularly assess the board mandates to check performance. Boards should be comprised of individuals that are qualified, educated, have pertinent experience, act ethically, honestly, and have the time to take care of their commitments. They should also be challenging management and their decisions. Education of board expectations, roles in the company, and governance policies may be helpful also. Team (September 16, 2014)

Additionally, establishing policies, duties, clear responsibilities, and definitive lines of accountability between managers, executives, board members, and directors, policies, duties, and clear responsibilities is another valuable corporate governance strategy. By stressing the importance of ethical and honesty in business dealings, employees begin to adopt the right mindset of how to conduct everyday business. Policies should be put into place for non-compliance and whistleblowing, as well. An ethical person should be appointed to oversee these policies and procedures. (Team, September 16, 2014)

Coca-Cola

One example of a corporation that follows good corporate governance strategies is Coca-Cola. The shareholders of the company elect the board of directors, and the board of directors establishes the corporate governance guidelines for the company to follow. These directions make clear the role of the board, directors, CEO performance evaluation, and management succession. The board regularly reviews their corporate governance policies, and they are updated as necessary. Their policy is to be a leader in the community and they are committed to transparency, accountability, and strong ethical conduct (Corporate Governance Guidelines).

Sage

Another example of a company that has exceptional policies in corporate governance is the Sage. This company adheres to ethical trade and business practices, following all laws and regulations. Employees are expected to conduct themselves fairly in all dealings. They also have policies set in place for employees to voice non-compliance or other questionable behavior. They also have a strict remuneration and anti-slavery codes of conduct for their corporation, as well as strong policies for risk management and internal controls (Corporate Governance).

Bad Corporate Governance

When dealing with a company that has strong corporate governance, potential investors will see a set of rules and controls that shareholders, directors, and employees all agree with. Companies today strive for the highest level of corporate governance they can have in order to gain more shareholders. For almost all shareholders today it's not appealing enough to just invest in a company that is very profitable. Shareholders also want to see a company demonstrating good corporate citizenship, ethical behavior, and of course corporate governance.

However, regardless of what shareholders want, there are still companies today that operate with poor corporate governance. Shareholders tend to call companies with a weak corporate governance "Eyes closed, hands out" companies. This means that directors and upper management would rather see profits within the company and their pockets continue to grow, rather than having any care for their customers or shareholders. According the journal "The Nature of Corporate Board Structure and Its Impact on the Performance of USA Listed Firms," the size of the board plays a very big role determining whether a company has strong or weak corporate governance. The board should have a size of 8 to 10 members. Efficiency tends to be reduced if there are too many members because there is an increase in difficulty when it comes to agreement concerning important decisions. On the other hand, with not enough members on the board decision-making is reduced because there will not be an adequate discussion of certain issues involved in the company. Overall, with the perfect size of board members we tend to see the board be more aware in their performance towards monitoring and control functions, and be more engaged to decision or potential future plans made by upper management (Mehrotra, Shweta).

Wells Fargo

One example where the board of directors is almost nonexistent and approved of poorly executed upper management decisions occurred at Wells Fargo. Top managers asked employers to meet aggressive, and unrealistic goals. Due to the tough measures that upper management brought on their employees, a lot of them weren't able to meet their goals. Therefore, managers gave their employees the approval to create fake accounts. Almost all of the employees at Wells Fargo participated in fraudulently opening bank and credit card accounts, and they also created fake e-mail addresses to sign customers up for these bank accounts. All of this was done without the knowledge or approval from the customer. In just five years of these fake accounts being created millions of fake accounts were created, and all throughout this process the board was nonexistent. This proves that an ineffective board does have a major impact on poor corporate governance. Another issue that leads to poor corporate governance is the lack of voting power from shareholders. Instead of a company having voting power from multiple shareholders, which proves to produce strong corporate governance, there are some companies where one individual owns more than 50% of the company, which allows him/her to be in control of all the voting power.

Viacom

We see this exact situation go on at Viacom. Viacom's controlling shareholder is National Amusements. A man by the name of Sumner Redstone owns 80% of National Amusements. Therefore, that makes Redstone the leading controller and voter of Viacom as well. With this excessive power Redstone was able to change members on the board when he felt necessary, even if the current members weren't doing anything wrong. On top of that, there were a number of employees who were receiving private benefits, who were hand selected by Redstone himself. Not only did he give himself a thirty-six million-dollar bonus, but he also gave large bonuses to others as well. Mr. Dauman, who is the CEO of Viacom, also received just over half a billion dollars in compensation over the past few years. Excessive voting power from one individual can cause many problems within a company (Solomon,Steven). With the lack of voting power from other shareholders and fighting between the board and management, Viacom is a perfect example of what can happen not only outside, but also inside the company as well with poor corporate governance.

Conclusion

Corporate Governance has a greater impact on the value of firms than the eye can see. As the framework of rules, procedures, and practices that the board of directors utilizes to preserve transparency, equality, and responsibility in the company's relationships with shareholders, it is clear that corporate governance not only affects shareholders, companies and their employees, but also the industry, consumers, and society as a whole. Companies that have a strong sense of corporate governance have built trust amongst their shareholders by reducing uncertainties, taking into consideration shareholders and managements interests, and through the creation of strategic plans. When shareholders are happy with the performance of their investment, they are more likely to provide more capital and resources, which directly benefits the company, the directors, and management, and is passed along to consumers through their actions and decisions, is what most companies desire. However, companies that are lacking good corporate governance are more likely to be seen as unreliable and deceitful in the views of stakeholders. In this instance, companies are likely to see stakeholders remove their investments, as there are plenty of other trustworthy, and reliable options for them and their resources.

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