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Relationship between good corporate governance and financial performance

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Abstract

Good corporate governance has multiple impacts on stakeholders, the environment, and society. There are many ways to define good corporate governance. In this study, we try to define good corporate governance in Mongolian listed companies and find that companies with good governance led to good financial performance. An empirical analysis is made based on the 2016-2020 audited reports regarding some of the corporate governance and financial performance indicators of the first and second classification joint stock companies of the Mongolian Stock Exchange. The result of this study concludes that good corporate governance has a positive effect on financial performance.

Key words: corporate governance, financial performance, good governance

I. Introduction

The global political, economic, technological, and social environment is changing rapidly, and companies are facing unprecedented challenges in how to survive, work more efficiently, and manage their impact on society, the economy, and the environment. Companies are becoming more open to shareholding rather than sole ownership or traditional family businesses. They have been directed towards a form and system where any organization and individual can be the owners and directors. The benefits of open companies are limitless in term of shared knowledge, skills, assets, and resources. At the same time, it is difficult to balance and manage their stakeholders' conflicts of interest. Therefore, good corporate governance becomes imperative. On the other hand, companies are becoming large-scale, sophisticated systemic and capital- financed which has a strong impact on society, the economy, technology, and the environment, both positively and negatively.

Mongolian companies cannot stay away from these new trends and challenges, and in a rapidly changing world, we can develop companies with good governance by improving the best practices of corporate governance in accordance with Mongolia's characteristics. Therefore, there is a need to study the concepts, methodology and best practices of corporate governance, how to determine the quality of corporate governance, and its importance. Thus, studying of how the performance of companies with good governance differs from the others is essential to this paper. Which factors of good governance have a greater impact on financial performance for Mongolian companies are the main questions of this study. In order to do that, we considered some factors of corporate governance of top listed companies and it was determined how these affect the financial performance of those companies.

This paper consists of the following section: Section II explains a good corporate governance approach. Section III shows a relationship model between corporate governance and performance. Section IV discusses empirical results. Finally, we provide a conclusion.

II. Literature review

Academics and major institutions have been trying to define and explain corporate governance from various perspectives. For instance, Corporate governance is the system by which companies are directed and controlled[1]. Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders[2]

Institutions and academics have done numbers of general studies on corporate governance, but they have not yet come to a clear and common understanding of how to define good corporate governance and what its most important components are. Cheffins (2012) identified that the Cadbury Report in 1992 marked the first major step in the next phase of corporate governance development. Since the Cadbury Report, there has been an increased interest in the study of corporate governance by scholars. Since then, the society, those who owns shares began to focus more on the management of their companies in order to control them. As a result, issues of the quality of corporate governance and good corporate governance practices, have been discussed. Not only of scholars and researchers but also policymakers followed public demand in these attraction (Chan, 2014: Sigal, 2014; Zaman, 2011).

There are even fewer studies on how to measure corporate governance (Bebchuk, 2005; Cremers et al., 2005; Ishii et al., 2003). Dynes (2010) and Schneider (2012) have identified that these studies have conflicting findings or very little correlation. Bondi (2013) explained that it is very common for researchers to look at the quality of corporate governance in terms of its economic efficiency. However, scholars do not agree on the best way to measure a company's

[1] Cadbury Committee, 1992
[2] OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris

financial performance (Bebchuk et al., 2005), which creates the problem of finding a "perfect" measure of corporate governance quality. So the question of how to measure the quality of universally accepted corporate governance is controversial. But there have been similar principles of corporate governance such as transparency, accountability, responsibility and fairness in the concept, and those are important for good governance, and taken together, corporate governance "best practices" have been used by a number of scholars and policy makers. Determining indicators of good governance through the implementation of shareholders' rights, the responsibilities of stakeholders, and the board of directors.

III. Model

We set up our model to evaluate whether corporate governance is related to financial performance results as follows:

$$FP_{it} = \beta_0 + \beta_1 MS_{it} + \beta_2 NOS_{it} + \beta_3 NSM_{it} + \beta_4 DD_{it} + \beta_5 FS_{it} + \beta_6 NBM_{it} + \beta_7 NIB_{it} + \varepsilon_{it} \tag{1}$$

where FP_{it} is the financial performance indicators of the i-th company in the t-th period under Table 1. The explanatory variables (corporate governance factors) are denoted by MS, NOS, NSM, DD, FS, NBM, and NIB in Table 2.

Table 1
Financial performance indicators.

Ratios	Indicators and Abbreviations
Solvency ratio	Current ratio (CUR) Quick ratio (QR)
Financial stability ratio	Tangible worth to total assets (TAR) Debt to equity ratio (DER)
Profitability analysis	Gross profit margin (GP) Return on assets (ROA) Return on equity (ROE)
Cash Flow analysis	Cash receipts from operations to sales ratio (CRO) Cash paid for operations to cost of sales ratio (CPO)

Table 2
Corporate governance indicators.

Abbreviations	Explanations
MS	Major shareholder's share
NOS	Numbers of shareholders
NSM	Numbers of shareholder meeting
DD	Dividend distributed or not
FS	Financial statement submitted within due dates
NBM	Number of board directors
NIB	Number of independent directors

IV. Data

In order to study the relationship between financial performance and corporate governance, we selected 23 joint-stock companies with registration of Mongolian Stock Exchange, in which their activities were stable, and shares were actively traded. The relative data was collected from the audited financial statements of the period of 2016-2020. Table 3 displays to the summary statistics.

Table 3. Summary statistics

	MS	NOS	DD	NBM	NIB	NSM	FS
Mean	**0.4774**	**3790**.078	0.5130	9.2260	**3**.1652	1.0956	0.9652
Median	0.4490	924.0000	1.0000	9.0000	3.0000	1.0000	1.0000
Max	**0.9750**	**51881**.00	1.0000	**11**.000	**5**.0000	2.0000	1.0000
Min	**0.1970**	**94**.00000	0.0000	**9**.0000	**2**.0000	1.0000	0.0000
St D.	0.2026	10527.64	0.5020	0.6360	0.5450	0.2954	0.1840
n	115	115	115	115	115	115	115

Source: Mongolian Stock Exchange (2016-2020)

According to Table 2, the largest shareholder owns a maximum of 97.5%, a minimum of 19.7%, and an average of 47.7%; the number of shareholders is a maximum of 51,881, a minimum of 94, and an average of 3,790; the number of board members is a maximum of 11, a minimum of 9, the number of independent directors is a maximum of 5 and a minimum of 2, and an average of 3.

Table 4 shows the result of a Panel Least Square estimation. The solvency ratio outcomes show that dividend distribution (DD) and the numbers of independent directors (NIB) have a positive effect on current ratio (CUR) and quick ratio (QR). In other words, if dividends timely distribute or having more independent directors on the board, it could improve the current and quick ratio. If the number of independent directors on the board is large, it is observed that the solvency ratio comes into good effect.

The financial stability results show that the number of shareholders (NOS) has a positive effect on financial stability. However, the percentage of the largest shareholder (MS) and whether financial statements were reported not on time (FS) had a negative effect. In conclusion, the financial stability of companies with a large number of shareholders is good. In contrast, the largest shareholder's share is high, and companies that do not report their financial statements on time are poor in terms of financial stability.

According to the profitability results, the number of independent directors (NIB) has a positive effect on the company's profitability. In other words, the greater the number of independent directors is the better the profitability.

According to the cash flow results, the number of directors (NBM) and the number of board meetings (NSM) have a positive effect on the company's cash flow, while the number of independent directors (NIB) has a negative effect.

Taken together, the adjusted R-squared of selected corporate governance factors on financial performance indicators is at most 92 percent and at least 12 percent.

Table 4
Relationship between corporate governance and financial performance

Explanatory variables	MS	NOS	DD	NBM	NIB	NSM	FS	$Adj.R^2$
CUR			2.621** (1.173)	-2.640** (1.068)	5.277* (1.464)			0.361
QR			2.315* (1.175)	-2.616** (1.069)	5.605* (1.331)			0.372
TAR	-0.421** (0.178)						-0.105* (0.054)	0.924
DER		0.002** (0.001)						0.861
GP					0.179** (0.081)			0.690
ROA			-0.070** (0.035)					0.549
ROE			0.102* (0.047)					0.572
CRO				1.170** (0.335)	-2.586** (0.391)			0.522
CPO						0.775** (0.366)		0.116

Notes: Standard errors clustered at the province level are reported in parentheses. ***, **, and * denote statistical significance at 1%, 5%, and 10%, respectively.

V. Conclusion

In order to study the relationship between financial performance and corporate governance, we collected 5 years data of top 44 joint stock companies and 16 indicators have been used as dependent variables from financial part. From governance part we used 7 factors of corporate governance indicators as explanatory variables. Selected seven indicators of corporate governance have a different relationship on financial performance. Among the best explanatory indicators are the major shareholder's share, the number of shareholders, financial statement submitted within due dates, and the number of independent directors. We concluded that not every corporate governance numerical indicators are necessarily correlated with financial performance.

Selected corporate governance indicators have a greater impact on financial stability and profitability than other financial performance. In general, it can be concluded that good corporate governance has a positive effect on financial performance.

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