

**CORPORATE GOVERNANCE,  
ACCOUNTING AND PERFORMANCE: IS  
THERE AN EFFECT?**

**UTS**

THINK.CHANGE.DO

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# OVERVIE OF PRESENTATION

- **What is corporate governance? – contrasting perspectives**
- **Corporate governance as economic phenomena**
- **Does “better” governance result in better performance?**
- **Does “better” governance result in higher quality accounting?**
- **Does “better” governance result in better disclosure/transparency?**
- **The growth of commercial governance “ratings”**
- **Is auditing part of broader corporate governance?**
- **Has regulation gone too far?**



# WHAT IS CORPORATE GOVERNANCE?

- **Best adaptation of the Greek and Latin is “government of a body”**
  - **The body is the owners (a somewhat controversial view I will defend)**
  - **The “government” are the elected representatives**
- **This suggests (to me) that corporate governance is about oversight and “rule setting/enforcing”**
- **It suggests that governance (i.e., oversight and rule setting) is likely to have an impact on managerial behaviour and organizational performance (all other things equal).**
- **It also suggests that the board of directors is absolutely central in describing “corporate governance”**
  - **Hence, much of my discussion will focus on the “effects” of corporate board characteristics on performance and transparency (financial reporting)**
  - **It also reflects a view of governance (and the board) that needs some justification**
- **One way of contrasting alternative explanations/definitions of corporate governance is to recognize the underlying perspective. Let’s start with two that I want to criticize!**



# WHAT IS CORPORATE GOVERNANCE? (continued)

- **Legal: “corporate governance is essentially a product of legal intervention.”**
  - Too much of the governance debate (and especially what is good and bad) is dominated by lawyers. This is unfortunate, as governance attributes existed long before laws that in any way addressed or required them.
  - A classic UK mistake is to focus on the start of governance as the 1720 Bubble Act.
  - Wider issue is whether additional regulation can address so-called ‘problems, and how we collect evidence thereon.
  - Much of what “proxy advisory’ services produce reflects a legalistic view of governance.
- **Management: “corporate governance is about the relationships between a company’s management, its board, its shareholders and other stakeholders” (OECD 2004).**
  - In other words, its pretty much about “everything”
  - Too much emphasis on broad notions about what governance is and what purpose it serves. Terms like “stakeholder” are popular.
  - This perspective also suffers from a “naivety” when it comes to testing populist claims about so called ‘performance effects” (much of what is published in so-called “management journals” would be bounced immediately by economics and finance outlets)
- **My approach has (I believe) more “focus”. Sometimes a narrow approach actually gets an outcome more efficiently!**



# CORPORATE GOVERNANCE AS ECONOMIC PHENOMENA

- **The demand for corporate governance arises from the separation of ownership and control**
  - **Usually attributed to Berle and Means (1932), but well explained by Adam Smith (1776): “The directors of such (joint stock) companies, however, being the managers of other people’s money than of their own, it cannot be well expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.”**
  - **The separation of ownership and control had already been hundreds of years in the making (Watts and Zimmerman 1983 JLE)**
- **An economic perspective on corporate governance draws on the following:**
  - **Property rights**
  - **Agency**
  - **Finance**
- **Helps link operating, financing and investing decisions**
- **Also suggests the board as a pre-eminent part of corporate governance.**



# CORPORATE GOVERNANCE AS ECONOMIC PHENOMENA (cont)

- The role of the board reflects the separation of decision management and decision control (Fama and Jensen 1983). In a word the role is one of “monitoring”
- So what drives the demand for monitoring?
  - Diversity of ownership
  - Business activity
  - Method of financing
- How much does the board reflect economic versus regulatory influences?
  - Hard to test the economic role where much of what we see is influenced by regulations/guidelines
  - Over time it is harder to defend a simple economic model of board composition/leadership (i.e., key characteristics that shape the governance role of the board)
  - We can’t really address “what boards do”, unless we first understand “how do they get to be the way they are”.



# CORPORATE GOVERNANCE AS ECONOMIC PHENOMENA (cont)

- **Hermalin and Weisbach (AER 1998):** assume the board and the CEO negotiate over both the CEO's wage and the identity of new directors. Leads to several predictions:
  - **Poor performing CEOs more likely to be replaced**
  - **Sensitivity of CEO turnover to performance increases with board independence**
  - **Probability of independent directors being added rises following poor performance**
  - **Board independence declines over the CEO's tenure**
  - **Accounting measures predict CEO turnover better than stock returns**
- **Evidence supports these predictions, especially the role of CEO tenure (boards become less independent – (Arthur 1998 JCF). Also applies to board leadership (powerful CEOs more likely to hold dual role)**
- **The model recognizes that there is a degree of self-serving behaviour on the part of those monitoring as well as those who are supposed to be monitored. Is this really a surprise?**



# TESTING THE EFFECT OF BETTER GOVERNANCE: SOME PRELIMINARIES

- Tests of the effects of better governance are essentially an attempt to establish causality
- Such tests need the following:
- A sound theoretical basis
  - A defensible measure of what constitutes “better” governance
  - An appropriate measure of what better governance is expected to impact on
  - Suitable procedures to control for other factors influencing the “effect” and which might be correlated with the governance attribute in question
- A simple example:  $\text{Stock return} = f(\text{number of independent directors, other controls})$
- Why would this fail the tests above:
  - Stock prices reflect “obvious” differences in governance characteristics, so difference in expected return is zero
  - Bigger boards are not necessarily better boards
  - Weak economic logic





# DOES BETTER GOVERNANCE RESULT IN BETTER PERFORMANCE?

- **Characteristics examined include:**
  - **Board size**
  - **Number of independents**
  - **Board leadership**
  - **Board committee existence/composition (audit committee, compensation committee, etc)**
  - **Auditor**
  - **Governance “indexes” – these often go far beyond the simple attributes I have listed above. Do they reflect the nuanced influences of specific attributes?**
  - **Are these complements or substitutes?**
- **What is the horizon over which performance effects should be measured? Are these specific to different governance attributes**
- **What is an appropriate performance measure? Is this constant across firms?**
- **How can we explain the relative stability of governance attributes?**



# THE GROWTH OF COMMERCIAL AND ACADEMIC GOVERNANCE RATINGS

- **Popularity premised on alleged link to performance (not clear!)**
- **Much of the governance advisory (proxy advisory) industry doesn't seem to have any rigorous foundations**
- **More and more competing indexes**
- **Researchers are attracted to “all inclusive” measures because it avoids the issue of “what did you leave out”**
- **However, do we fully understand these measures, and do the factors most responsible for variation have any clear, theoretically defensible link with the variable/s they are expected to influence (e.g., stock returns, accounting quality, disclosure etc)?**
- **These indexes are best described as comprising board independence, distribution of ownership and other structural characteristics (e.g., voting rights). Are they additive in the way the creators assume?**



# RESEARCH EVIDENCE

- **Gompers, Ishii and Metrick (2003 QJE):** use G-Score and show that it is associated with superior future stock returns
- However, **Core, Guay and Rusticus (2006 JF)** show the Gompers et al. result appears to be period specific.
- **Larcker, Richardson and Tuna (2007 TAR)** try to identify what the important ‘dimensions’ are of corporate governance. They measure 39 attributes reflecting
  - **Board variables**
  - **Ownership variables**
  - **Activist variables**
  - **Debt variables**
  - **Compensation mix variables**
  - **Anti-takeover variables**
- They decompose the 39 structural measures of governance into 14 “factors”
  - **Research limited to a single year (2002)** which coincides with a lot of other events – (e.g. SOX)
  - **Some of these factors are associated with future two year stock returns, others are associated with operating performance**
  - **Evidence of effect on accounting quality is mixed (accruals, conservatism)**
  - **No evidence of impact on likelihood of accounting restatements**
- **Larcker et al. conclude:** We believe that these mixed results are particularly attributable to the difficulty in generating reliable and valid measures for the complex construct that is called “corporate governance”

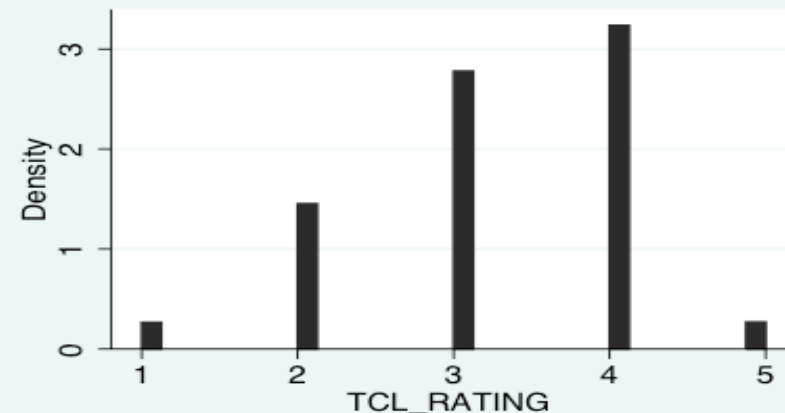
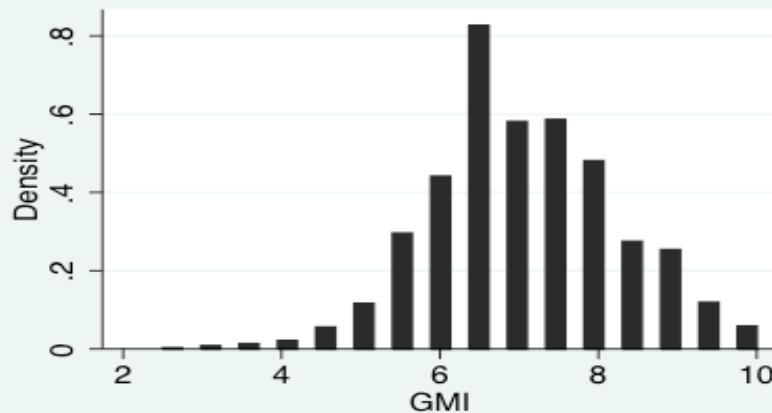
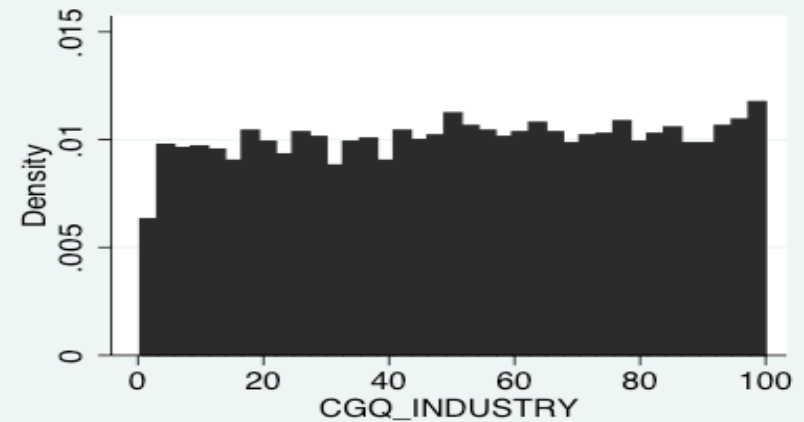
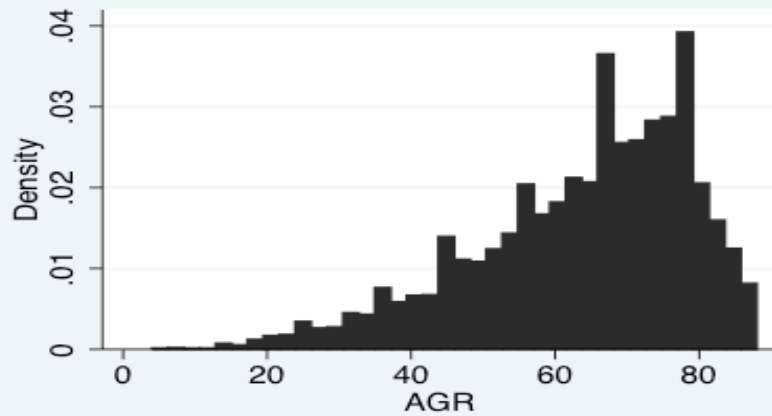


# RESEARCH EVIDENCE (cont)

- **Daines, Gow and Larcker (2008 Stanford WP) subject multiple indexes of governance to multiple tests. They look at (US) metrics for 2005 from;**
  - **Audit Integrity**
  - **Risk metrics (previously ISS)**
  - **GovernanceMetrics International**
  - **The Corporate Library**
- **DGL test relation between governance indexes and the following:**
  - **Financial restatements**
  - **Class-action lawsuits**
  - **Operating performance**
  - **Tobin's Q**
  - **Stock returns**

# RESEARCH EVIDENCE (cont)

## DISTRIBUTION OF RATINGS (DGL):





# RESEARCH EVIDENCE (cont)

## DGL: SUMMARY OF RESULTS

Table 8: Summary of Primary Results

Dependent variable		Primary Ratings				CGQ Sub-scores				TCL Sub-scores				
		AGR	CGQ	GMI	TCL_ RATING	CGQ_ AUDIT	CGQ_ BOARD	CGQ_ COMP	CGQ_ TKOVER	TCL_ ACCTG	TCL_ BP	TCL_ BOARD	TCL_ COMP	TCL_ TKOVER
Restatements	No controls	***		***						***	**			
	Controls	***		***			*			***	*			
Class-action Lawsuits	No controls	***	xxx		**		xxx						***	
	Controls	***		***				**			*			
Operating performance	No lag	***		x	**	xxx	xxx			*		***		
	Lagged ROA	***				xxx	xxx							
Tobin's Q	No lag	xxx	xxx		***	x	xxx	***		***				
	Lagged Q			***		*		*						
Stock performance		***			*		xx							

\*, \*\*, \*\*\* Indicates significance with the expected sign at the 10 percent, 5 percent, and 1 percent levels, respectively.

x, xx, xxx Indicates significance but with the unexpected sign at the 10 percent, 5 percent, and 1 percent levels, respectively.

- Level of predictive ability well below threshold to support claims made for them
- No relation for Risk Metrics with either their own voting recommendations or the actual votes by shareholders on proxy proposals!



# RESEARCH EVIDENCE – AN AUSTRALIAN PERSPECTIVE

- **Small number of Australian studies that look at corporate governance effects. Some use the Horwath Index, which is proprietary, but accepted to be more narrowly focussed on board characteristics (like ASX Guidelines)**
- **Linden and Matolcsy (2004 AAR) find no evidence of better stock returns or operating performance effects where Horwath Index is higher.**
- **Matolcsy, Stokes and Wright (2004 AAR) find no evidence that adding external directors improve valuations.**
- **Coulton, James and Taylor (2005 WP) find no evidence that board characteristics are associated with more transparent CEO compensation disclosures**



# RESEARCH EVIDENCE – AN AUSTRALIAN PERSPECTIVE

- **Brown and Beekes (2006 JBFA) test Horwarth Index effect on disclosure ‘informativeness’.**  
They look at:
  - **Disclosure of documents designated as “price sensitive” by ASX**
  - **Properties of analysts forecasts (accuracy, bias, consensus and extent of following)**
  - **Timeliness of overall disclosures**
- **Beekes, Brown and Chin (2006 WP) conduct a similar study on Canadian firms using Clarkson Centre Board Shareholder Confidence Index**
- **Results for both countries show that higher governance rating is associated with:**
  - **More frequent disclosures**
  - **Less biased EPS forecasts**
  - **More accurate forecasts**
  - **More timely price discovery**
- **Does this mean that better governance “causes” these effects, or that better governance is “associated with” these outcomes?**
- **Hard to know when we don’t really know exactly what the measure of governance quality is!**





# CORPORATE GOVERNANCE AND ACCOUNTING QUALITY

- **Once again, we need a sound theory and we also need to be able to measure accounting quality. Neither is especially straightforward.**
- **Possible indicators are measures of earnings manipulation (should we just focus on aggressive accounting?), measures of accounting volatility (what is innate, what is manipulation?), measures of financial reporting transparency (which disclosures are voluntary?), credit ratings, analysts' forecasts, what else?**
- **A good “theory” would link the attribute studied to the accounting/disclosure/rating effect. This means that evidence on multi-factor indexes leading to better accounting quality would raise more questions than they would answer**
- **Should we concentrate on instances of egregious accounting (fraud) or do we expect a link with more general measures of accounting manipulation?**



# CORPORATE GOVERNANCE AND ACCOUNTING QUALITY (cont)

- **Klein (2002 JAE): audit committee, board of director characteristics and earnings management**
  - **Absolute unexpected accruals are lower where the audit committee is independent.**
  - **Is it appropriate to look at the absolute value of an earnings management measure?**
  - **What are the consequences of lower quality reporting?**
- **Several other studies of similar type – i.e., an attempt to correlate aspects of governance with measures of accounting manipulation/quality**
- **Interesting “twist” on this is examination of the link between the extent to which accounting is conservative and board of director characteristics (Ahmed and Duellman 2007 JAE)**



# CORPORATE GOVERNANCE AND ACCOUNTING QUALITY (cont)

- **A few general observations:**
- **Where the test is to look at the effect on earnings quality, it has become far more common to use multiple measures of earnings quality**
- **We need to ask what governance attributes are expected to be associated with variation in accounting quality**
- **How can we control effectively for the fact that accounting attributes and governance mechanisms are simultaneously determined by other factors (i.e., endogeneity)**
- **Accounting quality measures fluctuate significantly from one period to the next. Can we find the same results in other years, and do we find significant effects when (unusually) there is a material change in relevant governance characteristics?**
- **In my view, this would make academic research which claims to show a link far more convincing**
- **Most fundamentally, where the measure of accounting quality is effectively a measure of managerial manipulation, is this necessarily bad?**



# CORPORATE GOVERNANCE AND ACCOUNTING QUALITY (cont)

- **Bowen, Rajgopal and Venkatachalam (2008 CAR):** extend the argument to consider if that portion of earnings manipulation correlated with variation in governance structures is associated with poor subsequent performance.
  - **This still really assumes that earnings manipulation “allowed” by “poor governance” is opportunistic. Is it?**
- **Step 1: Examine the link between governance and accounting quality**
  - **Accounting discretion measured as abnormal accruals, earnings smoothing and small positive earnings surprises**
  - **Also control for economic determinants influencing accounting choices**
  - **Governance characteristics captured by G-Score (Gompers et al. and specific attributes such as board characteristics and ownership structure**
  - **Conclude weak governance is associated with greater accounting discretion**
- **Step 2: Examine extent of association between predicted amount of accounting discretion and future performance.**
  - **Performance proxies are stock returns, operating cash flow and earnings**
  - **Basically find no evidence of a negative link with performance**
  - **Not clear whether this means accounting discretion is used for “good” purposes or firms understand the extent to which it is used for “bad” purposes.**



# CORPORATE GOVERNANCE AND THE AUDITOR

- **Many studies include measure/s of audit quality as part of their focus on governance.**
- **It is not clear to me that auditors play a governance role, as governance implies a broader input than just monitoring/assurance of accounting output! Auditors are at pains to limit the scope of their role!**
- **Small number of studies claim a link between audit quality and governance via a link between audit fees and a proxy for governance problems (free cash flow)**
- **Best known examples are Gul and Tsui (1998 JAE) – a direct link between audit risk and free cash flow**
- **Results are for a small sample of HK firm-years**
- **Gul and Tsui (2001 AF) present related evidence for Australian firm-years. Problematic measure of free cash flows**



# CORPORATE GOVERNANCE AND THE AUDITOR (cont)

- **Ferguson and Taylor (2008 WP)**
  - **Large sample test of audit fees for 1998 and 2002 (2006 in progress)**
  - **Careful measure of free cash flows**
  - **Look for interaction between FCF and measures of growth opportunities (FCF is only a problem if growth opportunities are low)**
  - **Also look at possible effect on FCF of high debt**
  - **All the “usual” controls for audit fee determinants**
- **FT results don't support the view that audit fees are systematically higher where free cash flow “abuse” is (potentially) an issue**
- **The significance of the result is that it puts the auditors role back in a proper perspective**



# CONCLUDING COMMENTS

- **When it comes to the definition of “good” corporate governance, let alone its precise effects, there is much more that we do not know than what we do know**
- **Research on performance effects (as well as accounting quality) is best described as mixed**
- **Too much research without strong theoretical linkages**
- **Researchers are too concerned with trying to capture “every” governance aspect**
- **Maybe the term “governance” is overused – role of the auditor is a good example**
- **Governance is an area where there are strongly held beliefs. However, much of what is “believed” has not been convincingly demonstrated!**
- **Lack of clear evidence should be a cautionary note for ever-increasing legislative intervention.**