CHANGES IN U.K. CORPORATE GOVERNANCE AND FIRM PERFORMANCE

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ABSTRACT

The changes in UK corporate governance codes had initiated the change in board structure and composition. The belief in Cadbury Report is that good corporate governance results in better firm performance. Contrary to this expectation, many studies have shown a negative relationship between board changes and firm performance. This paper investigates and provides an alternative explanation on the corporate governance changes and firm performance relationship. This research asserts that the strong corporate governance has increased monitoring roles and, in order to reduce default risk, firms choose conservative reporting practice which requires a higher verification for recording revenues than recording expenses. Hence strong governance firms seem to report lower profit as compared to weaker governance firms. The results of this paper seem to confirm the assertions.

INTRODUCTION

The UK corporate governance codes have encouraged separation of CEO and Chairman and have attempted to enhance the monitoring roles by increasing Non-executive directors in board. The changes in board structure and composition impacted risk management, and subsequently financial reporting practices. The 1990s were a critical point in term of corporate governance changes in UK. The UK Financial Reporting Council, the London Stock Exchange and the accountancy professions were concerned about investor's lack of confidence owing to the corporate scandals. This situation had led to build the Cadbury Committee and the Report of the Committee on the Financial Aspect of Corporate Governance (the Cadbury Report) was issued in 1992. On the recommendation of the Cadbury Committee, Greenbury Report (1995) and Hampel Report (1998) were published. Following the suggestion of Hampel Report, the Combined Code (1988) was drawn from Cadbury report, Greenbury Report and Hampel Report. The Cadbury Report provided an opportunity to study the relationship between board changes and firm performance. The belief in Cadbury Report is that good governance results in better firm performance. Contrary to expectation, most researches documented negative relationship between corporate governance changes and performance (Vafeas and Theodorou, 1998; Laing and Weir, 1999; Weir and Laing, 2000). Heracleous (2001), after reviewing the causes of the research results, asked for the further studies.

The primary purpose of this study is to examine the connection between changes in corporate governance and firm financial performance. This paper postulates that the accounting conservatism can be one of the reasons in the negative relationship between strong corporate governance companies and their performance. There are no previous study examined the relationship between corporate governance and performance based on the accounting conservatism. Therefore this study can fill a gap of corporate governance studies.

HYPOTHESIS

H1: Firms with separation of CEO and Chairman are likely to show lower firm performance than firms with duality.

H2: Firms with a higher percentage (> 30%) of NEDs are likely to show lower firm performance than firms with lower percentage (<30%) of NEDs.

METHODOLOGY

The samples are drawn from UK manufacturing firms including both listed and de-listed companies. Initially 436 firms for the period of 1990-1998 are retrieved from OSIRIS database. Governance data were taken from the several Corporate Registers: The Hambro corporate register (1989-1991), The Corporate register (1991), The Arthur Anderson corporate register(1992-1994), The Price Waterhouse corporate register (1995- 1996 & 1998). For the performance measure, Net income is used. Net income is the bottom line of the Income/Loss statement. The association between performance and corporate governance variables is analyzed using Ordinary least square regression (OLS). NI/TA will be explored using regression expressions by examining Structure (STR), Composition (COMP), Size and Current Ratio (CL/CA). The regression equation is as follows:

$$NI/TA = \beta_0 + \beta_1 STR + \beta_2 COMP + \beta_3 SIZE + \beta_4 CLCA + \varepsilon$$

RESULTS AND ANALYSIS

Table 3 to 5 shows descriptive statistics and correlation matrices for the 1990-92, 1993-95 and 1996-98 showing Number of data, Mean, Standard deviation and Pearson correlation. The mean of Separation (STR) and Percentage of Non-executive office (COMP) are increasing during these periods. This indicates that companies have gradually adopted the recommendation of the Cadbury Report. For example, companies have separated the role of CEO and chairman; from 62.5 percent in 1990-1992 periods to 82 percent in 1996-1998 periods. In addition more companies have elected non-executive directors. The percentage of firms which elected more than 30% of non executive directors increased to 45.2% in 1996-98 period from 34.1% in 1990-92 period.

Table 6 shows the results of the regression of NI on board changes. The F-value for each model is significant at the 5% level. The explanatory power of each model is between 8% and 11%. Table 6 shows that the association between board structure and net income are significantly negative while in pre-Cadbury, the sign is insignificant. Firms with more than 30 % NEDs show significantly negative coefficient throughout the 1990s. These results seem to contradict the expectation of Cadbury Report.

DISCUSSIONS

This paper's findings are consistent with previous results. Weir and Laing (2000) study confirm that firms with separation do not perform better than firms with duality. Firms with at least three non-executive directors have shown negative and significant relationship with firm performance in 1995. Shin & Shim (2007) has shown that firms with separation are more conservative in reporting than those with duality, and that firms with more than 30% NEDs are more conservative in reporting than those with less than 30% NEDS. These results can be interpreted as risk-averse behavior of shareholders by increasing monitoring by the board. With Separation of the chairman and CEO, the check and balance seemed to work during the 93-98 periods. Also the increases in new NEDs were another force to increase monitoring. From these results, it can be inferred that the firms with strong board structure tend to adopt conservative financial reporting practice and therefore this leads to negative relationship between board changes and performance.

LITERATURE REVIEW, TABLES AND REFERENCES

[Omitted but Available Upon Request]