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An Analysis of Corporate Governance Development and Prior Studies IN THE FIRM VALUE CONTEXT

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ABSTRACT

This study aims to review the key corporate governance proxies that provide incremental information on firm value. A brief analysis is also conducted on significant prior research studies. Documentary review was used for data collection. The analysis starts with the definition of corporate governance. Then, a review of the corporate governance index was carried out. It was found that the first corporate governance index was that initially introduced by Gompers, Ishii and Metric (2003). The study used shareholder rights to indicate a firm's corporate governance level using the G-Index. The results showed that strict shareholder rights increased firm value. Later studies replicated Gompers, Ishii and Metric (2003) and introduced new corporate governance proxies. Many studies have successfully added more corporate governance proxies to increase firm value. Although prior studies have highlighted some successful corporate governance proxies, these have proven controversial regarding their judgmental and qualitative manner. Furthermore, data collection on these corporate governance proxies is somewhat problematic. Therefore, future studies should develop simple corporate governance proxies and means of data collection using publicly available databases that are stress-free.

Keywords: Firm value, corporate governance, OECD

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Introduction

The ultimate goal of an organization is to create firm value with a firm taking into account the long-term impact of managerial decisions on profits. Bay (2006) reviewed prior studies and concluded that this value depends on various factors such as size, financial operation results, and the economy among others. As a result, firms have tended to look for vehicles to increase their value in various ways. Over the past two decades, corporate governance has been taken into consideration as regards increasing firm value. Recent research (e.g. Samaha et al., 2012 and Chou et al., 2013) still shows that good corporate governance guarantees firm success and economic growth, lower costs of capital, and positive impacts on share prices. Furthermore, corporate governance can minimize wastage, corruption, risk and mismanagement. Besides, Bushman and Smith (2001) suggested that in addition to financial information, firms should help instill confidence among investors by presenting control mechanisms using corporate governance themes and also alleviate the agency problem. In addition, the degree to which corporations observe the basic principles of good corporate governance is an increasingly important factor for investment decisions. Good corporate governance practices help enhance the reliability of investments, demote the cost of capital, underpin the good functioning of financial markets, and ultimately influence more stable sources of financing. Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation (OECD, 2004). In the academic world, interest in corporate governance has been truly interdisciplinary, with much work being undertaken by researchers not only from economics and finance but also from law, management and accounting (Bebchuk and Weisbach, 2010). The main objective of this article is to indicate the development of corporate governance in the firm value context. This is to summarize the vital corporate governance proxies that provide incremental information on firm value. In addition, the work briefly analyzes significant prior research studies.

Definition of Corporate Governance

The definition of corporate governance differs depending on one's view of the world (Gillan, 2006). Shleifer and Vishny (1997) identified corporate governance as the ways in which suppliers of finance to corporations reassure themselves of getting a return on their investment. Zingales (1998) views governance systems as the complicated set of constraints that shape the ex post bargaining over the quasi-rents generated by the firm. In 1999, the Organization for Economic Co-operation and Development (OECD) provided the following definition: Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation-the board, managers, employees, shareholders and other stakeholders. It also spells out the rules and procedures for making decisions on corporate affairs. In so doing, corporate governance also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance." OECD, 1999). The OECD later broadened the definition: "Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs on one hand, and those who invest resources in corporations, on the other" (OECD, 2001). Middlemist (2004) concluded that corporate governance is a relationship among stakeholders used to determine and control the strategic direction and performance of organizations, it is concerned with making strategic decisions more effectively, and is used to establish order between a firm's owners and its top-level managers whose interests may be in conflict.

Development of Corporate Governance Mechanisms

G-Index

First introduced by Gompers, Ishii and Metric (2003), the main objective of the G-Index is to measure

shareholder rights and its relationship to firm value. They examined the effect of shareholder rights on firm value by constructing a firm-level G-Index that equals the number of governance provisions a firm has. The study found that more governance provisions indicated more restricted shareholder rights, with firm value subsequently being high. This index was based on 24 anti-takeover provisions across five broad anti-takeover provision categories: (1) the delay group comprises four provision designed to slow down a hostile bidder; (2) The voting group contains six provisions, all related to shareholders' rights in elections or charter/bylaw amendments; (3) the protection group contains six provisions designed to insure officers and directors against job-related liability or to compensate them following a termination; (4) the other group includes the six remaining firm-level provisions; and 5) the state group covers the state takeover laws. The study used empirical evidence using cross-sectional data and concluded that firm value was higher when shareholder rights are strong. Later, Cremers and Nair (2005) measured external governance (takeover vulnerability) and antitakeover protection in the Investor Responsibility Research Center (IRRC) database. The study duplicated that of Gompers, Ishii and Metric (2003) using 24 different provisions, and confirming its findings. Also, Chi (2005) explored the relationship between firm value and shareholder rights based on the G-Index. The result shows that the change in the G-Index negatively related to the future change in firm value, but had no relationship to the past change in firm value. In addition, using fixed effects models, the study showed that when a firm increased its G-Index by placing more restrictions on its shareholder rights, its firm value decreased. Jiraporn et al. (2006) also employed the G-Index developed by Gompers Ishii and Metric (2003). The results revealed that the estimated coefficient for the G-Index was negative and significantly related to firm value. This negative sign suggested that weak shareholder rights may aggravate the agency problem and it is associated with reduced firm value. Chong et al. (2009) used a firm-level G-Index for the Mexican Stock Exchange. They found a positive relationship between the index and the market-to-book ratio and Tobin's Q; however, the index had no relationship to the measures of firm performance such as return on assets and return of equity. Ding (2009) investigated the interaction between the G-Index and executive ownership. The results showed both substitution and complementary relationships between the G-Index and executive ownership. Furthermore, the G-Index negatively affected firm performance. Bowen et al. (2010) tested the relationship between the G-Index and accounting discretion. They found associations between poor governance quality and accounting discretion.

Entrenchment-Index

The Entrenchment Index, or E-Index, was devised by Bebchuk, Cohen, and Ferrell (2004) (BCF). They extended the twenty-four G-Index provisions by adding the index recommended by the Investor Responsibility Research Center (IRRC). The E-Index recognized two types of provisions. First, provisions are the constitutional limitations on shareholder voting power. The structural provisions constraining the ability majority of the shareholders are an important factor in the fundamental allocation of power between management and shareholders. They identified four such constitutional limitations on shareholder voting power: staggered boards, limits and amended bylaws, limits and amended charters, supermajority requirements for mergers and charter amendments. Second, the provisions were the key hostile takeover readiness measures. The two provisions that best reflected management's defensive posture and its inclination to protect from a hostile bid or its consequences were the poison pill and golden parachutes, both of which the board has the power to approve at any time with no need for a shareholder vote of approval. The results showed that the increases in the level of this index were monotonically associated with economically significant reductions in firm valuation as measured by Tobin's Q.

Bhagat and Bolton (2008) examined corporate governance, capital structure, ownership structure and firm value using the G-Index and BCF-Index

from the Investor Responsibility Research Center (IRRC). The index ranged from a feasible low of 0 to a high of 24; a high score was associated with weak shareholder rights. They concluded that better governance as measured by the Gompers, Ishii and Metric (2003) and BCF indices, stock ownership of board members, and CEO-Chair separation significantly correlated with better contemporaneous and subsequent operating performance in a positive manner. Dittmar and Smith (2007) used complicated measures of internal and external corporate governance comprising the degree of managerial entrenchment due to takeover defense and the presence of large shareholder monitoring. They used both the G-index and E-Index for governance proxies, and found that firms with poor corporate governance dissipated cash quickly in ways that significantly reduce operating performance.

Gov-Score

Gov-Score includes important governance measures for firm valuation using different databases from the Institutional Shareholder Service (ISS) data. Brown and Caylor (2006) initially developed the index based on seven factors and showed that it fully drives the relationship between Gov-Score and firm value. Gov-Score is a modified version of the Entrenchment Index providing incremental explanatory power for firm valuation. Gov-Score measures both internal and external governance. In the study, the summary governance measure was significantly and positively related to firm valuation. The seven governance measures Brown and Caylor (2006) identified as key drivers of this link are: (1) board members are elected annually; (2) the company either has no poison pill or one approved by shareholders; (3) option re-pricing did not occur within the last three years; (4) the average options granted in the past three years as a percentage of basic shares outstanding did not exceed 3%; (5) all directors attended at least 75% of board meetings or had a valid excuse for non-attendance; (6) board guidelines are in each proxy statement; and (7) directors are subject to stock ownership guidelines. The first two of the measures represent external governance and are also part of the entrenchment index devised by Bubchuk et al. (2005). The other five are internal governance factors, none of which were considered by prior literature linking governance to firm value. The results agreed with prior studies.

OECD's Corporate Governance

Previous studies have been carried out by introducing corporate governance proxies. However, it is somewhat difficult to justify which index should be used to measure the corporate governance of firms. The OECD principles were initially issued in 1999 and have since become the international benchmark for corporate governance, forming the basis for a number of initiatives, both in government and the private sector. The principles were revised in 2004. The OECD principles of Corporate Governance have transformed the internal benchmarks for policymakers, investors, corporations and other stakeholders worldwide. Its guidelines on corporate governance provide specific guidance for policymakers, regulators and market participants in improving the legal, institutional and regulatory framework that underpins corporate governance, with the focus on publicly traded companies, while also providing practical suggestion for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance. In addition, the principles are recognized by the Financial Stability Board as one of the twelve key standards for international financial stability and form the basis of the corporate governance component of the World Bank Report on the Observance of Standards and Codes (OECD, 2004). The Stock Exchange of Thailand (SET) has adopted the OECD principles as the principles of good corporate governance for listed companies and defines corporate governance as set of structures and processes covering the relationships between a company's board of directors, its management, and its shareholders to encourage the company's competitiveness, growth and long-term shareholder value, taking into account the interests of other company stakeholders. The principles cover five key areas of corporate governance:

Rights of Shareholders: The corporate governance framework should protect and facilitate the exercise of shareholders' rights. Equity investors have certain

property rights. For example, an equity share in a publicly traded company can bought, sold, or transferred. Also, an equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment.

Equitable Treatment of Shareholders: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Disclosure and Transparency: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. A strong disclosure regime that promotes real transparency is a pivotal feature of the market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis.

Responsibilities of Board: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation.

Transparency Index

The Transparency Index was introduced by Cheung et al. (2010). They developed the index to measure the quality of the disclosure of corporate governance practices of Chinese listed companies by examining the relationship between company disclosure and market valuation of the companies. The transparency index was based on the five OECD Principles of Corporate Governance (OECD, 2004). The study utilized 56 criteria related to information disclosure and used a quantitative dimension to measure companies' degree of disclosure. Companies that omitted or did not comply with a specific scoring criterion received a 'poor' score (score=1). Meeting the minimum compliance standard earned a score of 'fair' (score=2), and a firm that exceeded the minimum requirements and/or met international standards received a higher score (score=3). Then, they calculated the index as the equally weighted score of all 56 criteria. Firms with a better quality of disclosure had higher scores. They used Tobin's Q and market-to-book ratio as proxies for firm value. The results showed that the Transparency Index had a positive and significant relationship between company transparency and market value.

CGI Index

CGI is a corporate governance index constructed by Connelly et al. (2012). The study aimed to assess the quality of corporate governance practices among Thai listed firms. The criteria of CGI were based on the OECD corporate governance principles (OECD, 2004). The study also introduced checklists to measure the corporate governance levels of the firms. The results revealed that firms with effective corporate governance were significantly and positively associated with firm value for the full sample of family firms.

Table 1 Summary of Corporate Governance Variables Affecting Firm Value

OECD Principles	Dependent Variables	Authors	Significant Variables to firm value
1. Rights of shareholder			
1.1 Basic rights	Stock Option	Lambert et al., (1989)	Dividend payment
	Growth	LaPorta et al., (2000)	Dividend payment
	Dividend payer	Trung and Heaney (2007)	1) Total cash dividends paid to common shares 2) Ratio of total dividends to net earnings after tax before extraordinary items 3) Ratio of total dividends to net sales
	Firm value	Cheung et al., (2010), Connelly et al. (2012)	Dividend policy
	Firm value	SET and Thai Institute of Directors (2012)	Dividend policy
	Dividend policy	Thanatawee (2013)	Dividend payout ratio: dividends/net income
1.2 Right to participate	Trusts	Hodges et al. (2004)	Questionnaire from the Annual General Meetings of UK National Health Service Trusts.
	Board of director	Apostolides (2010)	AGM score card
1.3 Opportunity to participate effectively and vote	Firm value	SE T and Thai Institute of Directors (2012)	1) How many days in advance does the company send out the notice to call the general shareholders' meeting? 2) Did the company post the notice to call the shareholders' meeting more than 30 days in advance on its website?
2. Equitable treatment			
2.1 Treat equally	Shareholder voting	Bethel and Billan (2002)	Vote results of shareholders at companies' annual meetings and at special shareholder meetings
	Firm value	Connelly et al.(2012)	Only one class of share with one-share, one-vote
2.2 Insider trading	Firm value	Connelly et al. (2012)	Is there a system established to prevent the use of material inside information and inform all employees, managers, and board members
2.3 Opportunity to participate effectively and vote	Firm value	SET Thai Institute of Directors (2012)	1) How many days in advance does the company send out the notice to call the general shareholders' meeting? Did the company post the notice to call the shareholders' meeting more than 30 days in advance on its web site?

OECD Principles	Dependent Variables	Authors	Significant Variables to firm value
3. Role of stakeholders			
3.1 Right of stakeholders	Firm value	SET and Thai Institute of Directors (2012)	Remuneration for its executive directors and CEO
4. Disclosure and transparency			
Disclosure and transparency	Voting right Cash flow right	LaPorta et al (1999)	Aggregate market value of common equity of firms controlled by widely held financial firms divided by the aggregate market value of the common equity of the 20 largest firms in a given country
	Firm performance	Demsetz and Villagonga (2001)	1) Percentage of shares owned by management 2) Percentage of shares owned by the five largest shareholders
	Firm value	Claessens et al.(2002)	Percentage of firms with dispersed control
	Dividend policy	Thanatawee (2013)	Percent of shares held by the five largest shareholders
5. Responsibilities of the board			
5.1 Board members	Firm value	Kusnadi (2005)	Board size is defined as the number of directors on each firm's board
5.2 Board responsibility	Firm value	SET and Thai Institute of Directors (2012)	Is the attendance of members at the Nomination Committee, Remuneration Committee, and Audit Committee meeting disclosed?
	Firm value	Connelly et al., 2012	Board meeting frequency 1) Met more than four times during the past 12 months 2) Board attendance greater than 80 percent average attendance during the past 12 months

Conclusion

Corporate governance mechanisms have long been considered to add incremental value to firms. Well-known and widely-used indices to measure corporate governance have been developed in the early 21st century. In 2003, the G-Index was introduced by Gompers, Ishii and Metric (2003) to measure firm value using shareholder rights. This was followed by the E-index by Bebchuk, Cohen, Ferrell (2004) which introduced two types of provisions: constitutional limitations on shareholder voting power and key hostile takeover readiness measures. Later, the Gov-Score was devised by Brown and Caylor (2006) to measure both internal and external corporate governance. Substantial changes in corporate governance measurements were recommended by OECD in 1999 and 2004. Corporate governance mechanisms have been classified into five main categories. These five principles have been used in academic research until present. Following this, the Transparency Index introduced by Cheung et al. (2010) measured the quality of disclosure of corporate governance

practices to examine the relationship between company disclosure and market valuation. More recently, the corporate governance index (CGI) was constructed by Connelly et al. (2012) in order to assess the quality of corporate governance based on the OECD framework. Although prior studies have indicated that some corporate governance proxies have value relevance to firm value, these corporate governance proxies are controversial regarding their judgmental and qualitative manner. In addition, the means of data collection of these corporate governance proxies is somewhat problematic. Therefore, future studies should develop simple corporate governance proxies and data collection should be easily performed using publicly available databases.

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