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# **The Impact of Corporate Governance on Firm Performance: An Agency Theory-Based Appraisal**

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# INDEX

<b>CHAPTER I: INTRODUCTION.....</b>	<b>9</b>
-------------------------------------	----------

<b>CHAPTER II: THEORETICAL FRAMEWORK AND LITERATURE REVIEW...11</b>	
---	--

1. The Concept of Corporate Governance.....	11
2. Two Competing Views of Firms.....	12
2.1.Shareholder Theory.....	13
2.2.Stakeholder Theory.....	16
3. The Agency Problem.....	19
3.1.The Contractual View of the Firm.....	21
3.2.Agency Costs.....	22
3.3.Sources of Agency Conflicts.....	23
4. Corporate Governance Devices and Firm Performance.....	25
4.1.Board of Directors.....	27
4.2.Executive Compensation.....	30
4.3.Shareholder Rights.....	34
4.4.Market for Corporate Control.....	36
4.5.External Audit.....	38

<b>CHAPTER III: CROSS-REGION CORPORATE GOVERNANCE</b>	
---	--

<b>APPRAISAL.....</b>	<b>41</b>
-----------------------	-----------

1. Regional Regulatory Environments, Agency Theory and Ownership Structure.....	42
1.1. Insider Model and Outsider Model .....	42
1.2. Ownership Power and Voting Power.....	45
1.3. Agency Problem and Large Shareholders.....	47
2. Region Specific Corporate Governance Frameworks.....	48
2.1. Hong Kong.....	48
2.2. Italy.....	51

2.3. United States.....	54
<b>CHAPTER IV: HYPOTHESES DEVELOPMENT.....</b>	<b>58</b>
<b>CHAPTER V: EMPIRICAL ANALYSIS.....</b>	<b>62</b>
1. Data and Methodology Description.....	63
2. Sample Description.....	63
3. Corporate Governance Evaluation Tool: Quickscore.....	64
3.1. Evaluation Process.....	68
3.2. Evaluation Criteria and the Four Corporate Governance “Pillars”.....	69
3.2.1. Board of Directors’ Structure.....	69
3.2.2. Executive Compensation.....	73
3.2.3. Shareholder Rights .....	77
3.2.4. External Audit.....	80
4. Performance Proxies.....	82
4.1. Return on Assets.....	82
4.2. Return on Equity.....	83
4.3. Tobin’s Q.....	83
5. Model Specification.....	84
5.1. Relationship between Overall Score and Performance.....	85
5.2. Relationship between Corporate Governance Pillars and Performance.....	85
6. Results and Findings.....	87
6.1. Sample of Companies Listed in Hong Kong.....	87
6.2. Sample of Companies Listed in Italy.....	87
6.3. Sample of Companies Listed in United States.....	91
<b>CHAPTER VI: CONCLUSIONS.....</b>	<b>97</b>

<b>REFERENCES.....</b>	<b>99</b>
------------------------	-----------

<b>APPENDIX.....</b>	<b>108</b>
----------------------	------------

1. Descriptive Statistics of Variables	
1.1. Table 1: Descriptive Statistics of Corporate Governance Scores.....	108
1.2. Table 2: Descriptive Statistics of Performance Indicators.....	109
2. Empirical Analysis Results.....	110
2.1. Hong Kong	
Table 3: Regressions' Coefficients for year 2013.....	110
Table 4: Regressions' Coefficients for year 2014.....	111
Table 5: Regressions' Coefficients for year 2015.....	112
2.2. Italy	
Table 6: Regressions' Coefficients for year 2013.....	114
Table 7: Regressions' Coefficients for year 2014.....	115
Table 8: Regressions' Coefficients for year 2015.....	117
2.3. United States	
Table 9: Regressions' Coefficients for year 2014.....	118
Table 10: Regressions' Coefficients for year 2015.....	119
Table 11: Regressions' Coefficients for year 2016.....	121

## **GRAPHS AND TABLES:**

1. Taxonomy of Ownership and Voting Power.....	47
2. Ownership Structure, Law Provisions and Corporate Governance Practices of Analyzed Regions.....	57
3. Sample Description.....	63
4. Quickscore Evaluation Criteria.....	67
5. Quickscore Evaluation Process.....	69
6. Frequency of Shareholder Rights Scores in Italy, year 2015.....	89
7. Graphical Explanation of the Inverse Relationship between Overall Score and Performance in United States.....	94

<b><i>SUMMARY</i></b> .....	<b><i>124</i></b>
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## **ABSTRACT**

This thesis examines the potential impact that corporate governance has on firm's operating performance. The theoretical framework according to which firm-specific corporate governance practices are evaluated is the agency theory.

I employed an evaluation tool developed by Institutional Shareholder Services to assess the goodness of firm-specific corporate governance practices, and investigated whether exists a connection between the scores awarded to each company and its operating performance, measured using Return on Equity, Return on Assets and Tobin's Q. The sample is composed of firms listed in Hong Kong, United States and Italy stock exchanges. The data refers to the three-year period 2013-2015.

The empirical analysis found evidence of a negative relationship between Tobin's Q and overall corporate governance goodness for US-based firms and a connection between all the performance indicators and the level of shareholder rights for Italian companies, limitedly to the year 2015.



## CHAPTER I - INTRODUCTION

In modern corporations, a group of shareholders, which ultimately owns the authority, demands to a group of managers the responsibility and the power to make decisions concerning their interests. Managers guide the organization and deploy the firm's resources (financial, human and physical) in order to create value for the owners. However, managers, in light of their decision-making power, have an incentive in pursuing their self-interests rather than those of the owners.

As Gompers et al. (2001) noted, modern corporations do not differ very much from democracies. Managers are shareholders' representatives and are entitled by them to manage their resources pursuing the enhancement of their wealth, as politicians are expression of citizens and have the obligation of managing the resources of the state concentrating on people's welfare. Like in sovereign states the power can entirely rest in people's hands or could be concentrated in the figure of a dictator, in modern corporations the authority can be balanced to give shareholders a complete control over the company's direction and management's action or might be balanced in favor of managers, who might enjoy a high degree of freedom in their choices and objectives. Both these relationships, the between shareholders and managers and the one between people and rulers are characterized by the presence of an agency problem, which is inherent in any rapport in which one party is supposed to act in the other's interest. The negative effect that might emerge from this condition is likely to affect substantially the welfare of the *principal*, i.e. the shareholder. Corporate governance provides instruments for mitigating this problem, through a complex and wide system of mechanisms, processes and relations that regulate the relationships between these groups, the owners and the decision-makers, and among the owners themselves.

The debate over corporate governance has been renewed in the public opinion following to the wave of corporate scandals occurred since the past decade, which shed a light over the weaknesses suffered by the system and over its preponderance in ensuring an effective functioning of markets. Following to the bankruptcies of multi-national companies such

as Enron in the US (\$70 billions of shareholder value were wiped out (Ackman 2002) and Parmalat in Italy (\$12 billion in corporate assets vanished (Edmondson and Cohn 2004)), or the Volkswagen scandal in Germany (which caused the market capitalization of the firm to plummet by 40%, worth \$30 billion (Karaian 2015)), the goodness of corporate governance has become a prominent issue in the decisions of investors. According to a survey conducted by McKinsey and Company (2002), 14% of the investors in the U.S. say they are willing to pay a premium for a well-governed company.

The purpose of this thesis is to investigate the extant relation between firm-specific corporate governance practices and firms' actual performance. I try to provide an answer to the long-debated question: "Does corporate governance have a substantial impact on firm's results?"

The thesis starts by the theoretical framework, which is necessary to understand which is the point of connection between corporate governance and performance. In the first section, the concept of corporate governance is outlined and different views are assessed. Then, the agency theory, which is the theoretical paradigm upon which this work is based, is explained. The corporate governance instruments which are employed to reduce the negative effects of the agency problem are described. Consequently, a description of the cross-regional differences in corporate governance and ownership structure is performed. Following to this literature review, the empirical analysis is explained and carried out. The hypotheses are listed, and the statistical model used to test the significance of the relationship between corporate governance and performance is developed. The evaluation criteria of corporate governance practices are defined, as well as the indicators used to proxy firm's performance. Eventually, a description of the findings in carried out and conclusions are drawn.

## **CHAPTER II - THEORETICAL FRAMEWORK AND LITERATURE REVIEW**

### **The Corporate Governance Concept**

Studying the potential impact of corporate governance on firm's performance would not be meaningful without firstly defining the boundaries of the concept of corporate governance. It is necessary to shape the concept accurately in order to provide the work with a solid theoretical framework, since the concept of corporate governance does not have a univocal and unambiguous meaning. Moreover, the exploration of the impact of corporate governance on performance requires the definition of a set of observable traits according to which the goodness of the governance system can be assessed.

The concept of corporate governance, despite the attention received by scholars, has not received a universally accepted definition. It has been defined in numerous ways highlighting different aspects. With regard to the various definitions, scholars and researchers classify corporate governance in either narrow or broad terms. The narrow view is based on the satisfaction of shareholders. Broader definitions extend the objective of corporate governance to the satisfaction of stakeholders (i.e. suppliers, employees and government) (Gillan 2006). I will deepen this issue later on when dealing with competing views of the firms.

The definition of the concept essentially relates to the theoretical viewpoint involved (Gillan 2006). For example, corporate governance can be seen from a shareholder perspective, which entails the methods employed for maximizing owners' value, or from the organizational perspective, in terms of controlling mechanisms to regulate and maintain business operations (Zingales, 1997). The latter viewpoint finds substance in the definition provided by Cadbury (2000), which defines corporate governance as "the system by which corporations are directed and controlled". This broad definition does not emphasize in any way who is responsible for each role, on behalf of who, and what is the ultimate scope that has to be pursued when directing the company.

According to Schleifer and Vishny (1997), corporate governance is “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. This definition assigns to governance the primary role of mediating between finance providers (i.e. shareholders and stakeholders) and employers (i.e. managers), stating that, since resource owners demand their control to management, they need to be assured to receive a reward for their activity. Specifically, shareholders need to be shielded from the negative effects that derive from the conflict of interest suffered by managers, who are hired to act in shareholder’s behalf but have an incentive in acting selfishly. This definition is much narrower with respect to the former, and encompasses one of the elements that have traditionally been associated with corporate governance, namely the mediation between managers and shareholders. Principals must weigh the costs of monitoring and controlling agents (agency costs) against the costs they are likely to incur from negative managerial behaviors in the absence of efficient monitoring and control.

Thus, corporate governance issues arise due to the necessity of counteracting *agency problems* (Hart, 1995), and fundamentally from shareholders' attempts to protect themselves from the expropriation of their wealth (Shleifer and Vishny, 1997).

## **Two Competing Views on Firm’s Nature**

The lack of consensus regarding the role of corporate governance is a consequence of the multiplicity of views regarding the nature and the purpose of firms. Contingently on the viewpoint taken to analyze corporations, corporate governance boundaries can vary widely. In fact, given that corporate governance relates to the way in which firms are controlled and directed, is essential to define what are the purposes of a firm, which subjects have to be prioritized when running a company and which objectives have to be pursued in order to fulfill its role.

In this regard, there are two perspectives according to which we can look to a company. The first one is the shareholder perspective (Friedman 1962), which prioritizes the figure of the shareholder and set the main objective of the firm as the pursuit of profit maximization for the benefit of the owners. The other viewpoint, known as stakeholder perspective (Freeman 1984), takes a broader view of the firm and considers in the objectives the other subjects who have an interest in the company, e.g. all the stakeholders, which includes suppliers, employees, communities etc.

I now describe briefly these two models in order to define the corporate governance concept that is used in this work, which is essential to establish a linkage between corporate governance and performance and to provide a better understanding of the following paragraphs.

### **1. The Shareholder View of The Corporation**

According to the shareholder theory, as it was put forth by Milton Friedman (1962), the purpose of the corporation is the maximization of the wealth of its shareholders through productive, allocative and dynamic efficiency. In this narrow perspective, the firm is responsible for its shareholders, and seek to maximize its profits to grant a return to the finance providers. In this regard, the performance of the firm can be simply evaluated by measuring its market value and the increase in wealth that it provides to its shareholders under the form of a return for their risk-bearing activity.

Since the purpose of the corporation is set clear under this viewpoint, and there is solid basis upon which to evaluate the corporations' performance, this model provides an unambiguous and clear goal to the management's decision-making activity. Consequently, directors and officers have an implicit obligation to run the company concentrating on profitability, while respecting the constraints posed by laws. In turn, the profit created by the company is assigned to the stockholders proportionally to their stake.

This theory, which is markedly oriented towards the protection of the investors, emerged following to the birth of the modern business corporation, in the twentieth century (Maher and Andersson 2000). The ownership of the firms became more dispersed as capital was raised from banks, shareholders and other institutions. Indeed, the management of the firm became separated from the ownership of the firm. The relationship that links managers and shareholder is characterized by a mutual need, since the owners need specialized human capital to run the company on their behalf, and managers need stockholders to raise the capital they could not provide on their own.

The division of power which characterizes the modern corporation, although it allows the counterparties to have access to the resources they lack to operate (respectively, the human capital for shareholders and the funds for managers), raises problems since it is the basis of the principal-agent problem, or agency problem, which exists between shareholder and managers (Berle and Means 1932). The separation of beneficial ownership and executive decision-making may lead the management's behavior to diverge from the profit-maximization ideal that guides the firm's operations in the shareholder theory viewpoint. This happens because the interests and objectives of the principal (the shareholders) and the agent (the managers) might be different when there is a separation of ownership and control. Managers, being not the owners, are not directly exposed to the costs and benefits that derive from their actions. Therefore, although shareholders are interested in the maximization of their wealth, managers may have other objectives such as, for example, the maximization of their salaries, growth in market share, or an attachment to particular investment projects (Maher, Andersson 2000). We will go through the agency problem afterwards in a dedicated chapter. This condition of separation underlies the corporate governance problem in the shareholder theory. In this light, the mediation between shareholder and managers is the purpose of corporate governance, which fulfills this commitment by providing rules, mechanisms and processes that ensure shareholders against the detrimental actions of the managers who act on their behalf.

The conflict with managers is not the only threat that concerns stockholders. As we stated before, the shareholder theory is concerned with the creation of wealth for company's owners. The more the investment is large, the more risk is born by the individual shareholder, who demands to be repaid accordingly. The ownership structure of a company might be characterized by the presence of a strong shareholder, who is able to exert a relevant pressure on the management in lieu of the magnitude of its investment. This large shareholders, or block-holders, are awarded with an advantage that stems from their control (Demsetz 1986). A large stake corresponds to a large voting power, which puts block-holders in the position to influence management directly. Furthermore, since the cost of monitoring decreases as the ownership stake increases, block-holders have a great incentive to monitor the management's behavior closely, which can turn up as an advantage also for the owners of the remaining stake. Managerial opportunism is likely to diminish in presence of concentrated ownership structure, since the close monitoring performed by the blockholder decreases sensibly the management's freedom and power. However, controlling shareholders "also have the incentive to use their voting power to consume corporate resources or to enjoy corporate benefits that are not shared with minority shareholders" (Holderness 2003). If discrepancies between the objective of majority and minority shareholders exist, blockholders might have the tendency to project their personal preferences onto organizational actions, even if these are against the company goals as a whole (Holderness and Sheehan, 1998).

The power that comes from a controlling stake might allow the block-holder to seize returns that does not belong to him at the expense of the minority shareholders. Accordingly, if the corporation goal is to create wealth for the entirety of its owners is such a way that the returns awarded to each of them corresponds to his ownership share, and so to the risk that the shareholder bears, corporate governance should include mechanisms to protect weak minority shareholders against the potential expropriation of rents by the large shareholders.

The absence of mechanisms of shareholder protection against the action of managers or controlling shareholders can discourage potential investors to provide resources to the

firm, a problem known as hold-up (Grossman and Hart, 1986). The possibility that rents would be reaped by managers or larger shareholders can lead to suboptimal levels of investment, which in turn have a negative impact on economic prosperity. In a shareholder model light, corporate governance is primarily concerned with the alignment of interests between shareholders and managers, so to ensure that the corporation gets external funding and that the financiers receive a proper return.

## **2. The Stakeholder View of Corporation**

The stakeholder view of the firm is relatively recent if compared to the shareholder theory, as it has been introduced by the work of Edward R. Freeman in 1984. According to this view, corporations should not be run exclusively in the very best interests of those who provide financing for its operations; conversely, the corporation is responsible for the welfare of several classes of stakeholders.

The stakeholder concept widens the understanding of corporation to embed in its boundaries not only the finance providers, who have an evident interest in the fate of a firm, but also all the other parties “without whose support the organization would cease to exist” (Freeman 1983). More pragmatically, the stakeholders include all the subjects who are involved with an organization and who are affected by its success or failure. The interest held in a company does not derive only from the direct investment. This group includes investors and contractual partners such as employees, customers, suppliers, but also governments, political groups, trade associations and communities, which may indirectly be affected by the company’s circumstances, not just economically but also socially and environmentally. (Donaldson, Preston 1995). According to these view, the corporation is a “socially responsible” institution that should aim at the maximization of the welfare of its stakeholders. The stakeholder theory lays emphasis more on moral values rather than only on profit-maximization tenet, like shareholder theory asserts. The scope of the corporation is not limited to the deployment of resources so to increase the wealth of those who have provided the funding, but focusses on the creation of long-term relationship with all the company stakeholders so to create benefit for all of them.



Here the problem emerges with respect to the fulfillment of its social objectives. It is in fact difficult to establish mechanisms that could ensure the achievement of the purposes of all the stakeholders simultaneously. Most of these aspects are impossible to measure or only indirectly affected by the company's actions. This model fails in helping managers and directors to set priorities and to make decision regarding the deployment of corporate resources. Moreover, it is difficult to establish enforcement mechanisms to ensure that the corporation satisfy its obligations toward stakeholders (Blair 1995).

If we define the scope of the corporation as the fulfilment of its social responsibilities, then corporate governance, being the way in which firms are controlled and directed, should provide mechanisms to conduct managers towards these objectives and to evaluate them accordingly. When the objectives of the corporations are narrowed down to the satisfaction of its owners, it is simpler to gather observable information about its performance to reward the management, and the prioritization of one subject with respect to the other gives clear guidance to management's actions. However, this could lead to undesirable outcomes for other stakeholders. A clear example can be the layoff of employees to optimize the human capital deployment. This move can be easily justified by cost and efficiency constraints, but if we take into account the loss of welfare suffered by the employees (who are company's stakeholders) the gains of this decision can vary. Another corporation's behavior that might explain the potential conflict between the shareholder and the stakeholder model is the exploitation of taxation loopholes in order to reduce the taxes owed to the government. These operations are legal and completely understandable under a profit-maximizing perspective, but can be considered unethical and can harm economically the community.

For what has been stated before, it would be desirable to have a corporate governance system which considers the interests of all the involved parties and tries to balance them. According to the stakeholder model, corporate governance is concerned with the promotion of long-term investment and commitment of the various stakeholders (Williamson 1985). Blair (1995) also defines corporate governance in this broader

context and argues that corporate governance should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders that contribute firm specific assets, introducing a refined stakeholder perspective which defines stakeholders as asset providers.

The lack of measurement mechanisms and the blurred definition of stakeholders' objectives makes the stakeholder model scarcely actionable in providing boundaries to the concept of corporate governance (Andersson and Maher 2010). The resolution of the potential conflicts existing among all the stakeholders of a corporation would be the role of corporate governance in this framework, which however would need a clear definition of the objectives of the various stakeholders and a determined performance monitoring system.

Both the shareholder and stakeholder theories are normative theories of *corporate social responsibility*, dictating what a corporation's role ought to be (Smith 2003). The two views differ in the definition of the responsibilities and purposes that characterize the nature of the corporation. In a shareholder perspective, "there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it engages in open and free competition, without deception or fraud." (Friedman 1962, p. 133). On the other hand, the stakeholder perspective argues that the firm has a duty not only towards its stockholders, but also vis-à-vis "individuals and constituencies that contribute, either voluntarily or involuntarily, to a company's wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers. (James, Preston and Sachs, 2002).

Defining what is "good" and what it is "bad" when dealing with corporate governance practices is a difficult task. Although, being the scope of this thesis to explore the connection between the quality of corporate governance and the firm's performance, it is essential to define rigorously which elements impact positively the assessment of corporate governance, and which negatively. To this end, it is necessary to define which the ultimate purpose of corporate governance is.

This work adopts a shareholder-based view of corporate governance, according to which its ultimate goal is to align the interests of shareholders and managers and ensuring an equal treatment for all shareholders. To evaluate the ability of corporate governance to fulfill this task, I adopted an evaluation tool developed by Institutional Shareholder Services (ISS). It subdivides the corporate governance into four different sub-areas, which altogether, and in different manners, contribute to the alignment of interests between the principal and the agent, in this way ensuring that the company operates in a way coherent with its purpose. After having defined the boundaries of the corporate governance as it is adopted in this work, I now provide a theoretical explanation of the principal agent problem and the various measures taken in order to prevent the manifestation of its negative effects.

## **The Agency Problem**

A widely used framework to conceptualize the relationship between firm performance and corporate governance is *agency theory*, which was described by Denis and McConnell (2003) in terms of being an expression of property rights in corporate governance by principals; any understanding of firm structure must start with the provision that shareholders are the principals (i.e. owners) in the organization.

This thesis relies on the agency theory as the primary paradigm to explore the effect of corporate governance on firm's performance. In this light, corporate governance deals with the maximization of shareholders' value by reducing the agency problem. The theory provides a powerful theoretical basis for explaining the relationship and suggesting solutions for the agency problem: when the agency problem is mitigated, agency conflicts are reduced and shareholders' returns are enhanced, thus boosting firm performance (Fama and Jensen 1983, Jensen and Meckling 1976).

The agency problem, or principal-agent problem, is a conflict of interest inherent in any relationship in which one party is expected to act in another's best interest, while being

delegated of some decision-making authority by the agent (Eisenhardt 1989): the relationship between shareholders and managers is one of the clearest examples (Agrawal and Knoeber 1996). The conflict of interests that might exist between the principal (in this case, the shareholders) and the agent (i.e. the managers) may lead to costly inefficiencies which impact negatively on the welfare of the principal. Agents are individuals naturally oriented towards the maximization of their own welfare rather than that of principals, therefore control and incentive mechanisms are necessary to align the interests of the counterparties.

As noted above, investors seek to capture a return on their investment, and due their reliance on management, must bear the residual risk over the company's operations. Managers, on the other hand, are responsible for the daily management of the company and deploy the firm's resources (financial, human and physical) in order to create value for the owners. The consequences of manager's conduct revert ultimately on the principal. Hence, the agency theory paradigm is substantiated by the presence of one party (the managers) who are expected to act in the other party's (the shareholders) best interest.

The agency problem in modern corporations descends from the division between ownership, represented by the shareholders who provide funding for the company, and the control, i.e. the managers who employ that funding (Berle and Means 1932). Their relationship is characterized by the presence of an information asymmetry: managers are better informed for what concerns the allocations of capital that can lead to the best outcome for shareholders, in lieu of their superior knowledge and competence and privileged access to companies' information.

Rational shareholders, who are apt to bear a reasonable risk with the promise of a return, are presumably concerned with dividends and rising stock prices, whereas managers may prefer growth to profits (so- called "empire building" which can increase the manager's prestige), may be lazy or fraudulent ("shirk"), may maintain costly labor or product standards above the necessary competitive minimum, or may be guided by hubris. (Aguilera and Jackson 2003). The conflict between the objectives of the counterparties can arise problems as it may lead to inefficiencies related to firm's investment decisions, thus leading to suboptimal conditions.

## **The Contractual View of the Firm**

The agency problem is the essential element of the contractual view of the firm, as developed by Coase (1937) and Jensen and Meckling (1976). This view argues that the corporation can be represented as a “nexus of contracts” (Coase 1937), in which all the involved parties are linked by a network of contracts that specifies their mutual obligations. The contract that links shareholders and managers would, ideally, specify how the management employs the funding and how the returns are allocated. The contract would determine specifically what the duties of the managers are in every conceivable situation, and which the actions to undertake in order to satisfy the counterparties’ obligation are. Unfortunately, such a complete contract is “technologically unfeasible” (Schleifer and Vishny, 1997). Future circumstances are impossible to foresee, and so it is impossible to specify ex-ante a contract that can dictate to managers how to act in any different situation. Because of the problem shareholders and managers face in the design of the contract, they have to decide how to allocate residual rights, namely the rights to make decisions in contingencies not contemplated by the initial contract. Shareholders would find desirable to hold the residual rights so to intervene directly when the managers face decisions which are not object of the contract, avoiding the emergence of the principal-agent problem. However, shareholders are not prepared nor informed to take this responsibility, which is the reason why they hire managers in the first place. This information asymmetry causes the allocation of residual rights to shift towards the managers, who ultimately are entitled to manage the company also in conditions of uncertainty.

The allocation of residual controlling rights to the managers creates opportunities for them to extract the rents that pertain to shareholders or to entrench. This troubles arising from the division of roles and from the incompleteness of contracts are solved by the application of governance systems, a complex structure of rules which seek to mitigate the agency problem.

When the ownership structure is characterized by the presence of a controlling stake, the agency problem between managers and shareholders is mitigated, because the blockholder has an incentive and a greater ability to monitor the managerial conduct closely, in light of the magnitude of his investment. (La Porta et al. 1999). Relying on the power that comes from his voting power, the blockholder might also be able to influence the management directly. In this case, an agency problem emerges between large and small shareholders, as a consequence of the relevant control that the blockholder is able to exert on the company. Minority shareholders have the opportunity to “free-ride” on the control that the large blockholder perform on managers. However, if the blockholders’ objectives are not aligned with those of the company as a whole, i.e. the other shareholders, minority shareholders may suffer losses, which derives from the inefficiency of investments (Jensen and Meckling 1976). The agency problem in this situation occurs between large and small shareholders. Large shareholders influence management, and have the power to shape the investment decision of the company and to deploy minority shareholders’ resources. As such, the blockholder acts as an agent, which controls the resources of the principal (i.e. minority shareholders).

Corporate governance, in this sense, shapes the relationship between large and small shareholders by providing minorities with means to safeguard their interests, if they are different from those of majority shareholders.

### **Agency Costs**

Investors in publicly traded corporations incur in costs for monitoring and bonding managers so that they best serve the company’s owners. Jensen and Meckling (1976) define agency costs as the sum of the cost of monitoring management, bonding the agent to the principal, and residual losses. In this light, corporate governance can be viewed as a mechanism to reduce the conflict of interest that derives from the separation of roles while minimizing the associated agency costs that are bear by the principal. The objective of corporate governance is to shape manager’s behavior so that they make decisions that

shareholders would have made themselves, such as investing in projects with positive net present value (Lei 2007).

### **Sources of Agency Conflicts**

There are four basic sources of conflicts between shareholders and managers, namely moral hazard, earnings retention, time horizon and risk aversion (Lei 2007).

- *Moral hazard:*

The moral hazard is represented by the managers' incentive to consume firm's private resources to increase their own welfare and by the lack of managerial effort. It is a direct consequence of the fact that managers are not owners of the firm's assets (Jensen and Meckling 1976), and they do not bear the risk of their decision-making activity. Shleifer and Vishny (1989) demonstrate that managers might be apt to undertake projects which best suit their personal skills without concentrating in shareholder wealth maximization. As a consequence, moral hazard ultimately results in investment inefficiency. The enforcement of incentive-based pay, such as option-based and stock-based compensation is a useful tool to avoid the insurgence of moral hazard and improve managerial performance (Chloe and Yin 2004).

- *Earnings retention:*

If free cash flow is paid out as dividends, managers are less likely to invest in projects with suboptimal outcomes. Managers may concentrate on increasing firm size rather than shareholder value, since their compensation is usually tied to firm's size, and not to shareholder returns (Jensen and Murphy 1990). Brennan (1995) found evidence that a managerial desire for corporate power may cause losses for shareholders. Jensen (1983) argues that managers prefer earnings retention and can decide to invest for diversification purposes.

- *Time Horizon:*

Shareholders and managers may have different preferences for what regards the timing of cash flows. Shareholders concern themselves with future cash flows over a long time horizon, whereas managers might seek to increase cash flows within their employment term, thus leading to a bias in favor of short-term projects at the expense of long-term projects, even if the latter have a positive net present value (Shleifer and Vishny 1990). Consistently with this affirmation, Dechow and Sloan (1991) found that investment in R&D decreases sharply in the CEO's final year of term. The discrepancy between shareholders' long-termism and managers' short-termism can be reduced with the introduction of long-term stock option plans.

- *Managerial Risk Aversion:*

Since their human capital is tied to the firm, managers cannot diversify their investments at a low cost, like shareholders do. Therefore, as affirmed by Jensen (1986), manager may prefer to diversify the firm's investments in order to branch out the firm activities and reduce the risk. Diversifying the activities of the firm could be desirable for managers as it can decrease the firm's risk, but it can result in shareholders' losses if the common ownership of different business does not increase the firm's value (Lang and Stultz 1993). In fact, although diversification reduces the risk of the firm's activities, it is not desirable for shareholders since they can readily diversify by themselves using capital markets.

The misalignment between the managers and shareholders' risk tolerance might be damaging for shareholder, since it can result in an allocation of resources that is not efficient in a shareholder's point of view.

To sum up, the principal-agent problem arises in modern corporations because of the co-existence of four elements:

- Agent's self-interest attitude
- Division of ownership and control



- Information asymmetry between agent and principal
- Residual decision rights allocated to agent

Corporate governance relates to the set of rules and mechanisms that ensure shareholders that the company is being ran in their best interests. As a consequence, it deals with measures to solve the agency problem, since it creates opportunities for managers to act pursuing the maximization of their own wealth instead that the one of shareholders.

In the following section, we go through the methods that are employed in corporations to solve the agency problem.

## **Corporate Governance Devices and Firm's Performance**

Hoskisson, Castleton and Withers (2009) defined the two broad mechanisms that are employed in order to solve the issues that are connected to the agency problem: they are monitoring, which entails the control practices that are put in place directly by shareholders or by the Board of Directors on their behalf in order to oversee the managerial conduct, and bonding (i.e. incentive-based compensation) which is used to tie the interests of the counterparts and to put them into a risk-sharing situation. The enforcement of this mechanism is costly for shareholders, but they help to lower the losses which derive from managerial misbehavior. When these mechanisms are well designed, the cost of enforcement are optimized and the losses associated to selfish employment of resources are minimized.

Andersson and Maher (1999) take a broader view of the means that are used to mitigate the conflict of interests between agent and principal. They delineate three governance-related methods that are employed in order to reduce the negative effects that stem from the agency problem:

- The first method seeks to bring the interests of managers and shareholders directly into congruence, by means of direct controlling by the Board of Directors and by stock options and compensation plans. The enforcement of this method result in

an efficient management achieved by providing financial incentives to managers to act in the best interest of shareholders or by discouraging the emergence of opportunistic behavior using close monitoring.

- Another method consists in the award of strong rights to shareholders (among others, right to convene meetings, right to express the opinion through voting, right to inspect the company's documents), so to provide them both with a greater incentive and greater ability to control the actions of managers.
- The last method relies on external sources of control such as market for corporate control or capital markets, often referred as takeover markets, in which poor-performing or non-shareholder oriented managers are replaced by alternative management teams who believe they can achieve a better resource utilization (Jensen and Ruback 1983).

The corporate governance assessment used in this work evaluates, directly or indirectly, all these methods. Aside from these three governance-related mechanisms, I include among the corporate governance instruments also the financial control performed by external auditors.

The enforcement of these instruments is paramount for companies. Firms need to build shareholders' confidence in order to collect funds for their operations. In absence of governance controls, managers are more likely to deviate from the interests of shareholders (Fama and Jansen, 1983).

In the following paragraphs, an explanation of how the aforementioned devices work in order to minimize the agency problem is provided. Since all these measures altogether form the corporate governance system, their understanding is essential to provide a linkage between corporate governance and performance.

### ***Board Of Directors***

The Board of Directors, the main authority for what concerns manager monitoring, is appointed by the shareholders and act in their behalf in order to monitor the decision-making activity of the managers to ensure their good faith and their shareholder value-creation attitude. Directors participate in the economic life of the company and have the responsibility to monitor the managers' action and to ratify them. They might or might not held executive roles within the organization. Managers must report periodically to the Board of Directors, and the latter have to evaluate the proposals and approve them.

The Board Of Directors is provided by corporate law with the exclusive right to administer the corporation. As such, according to several theorists it is argued to be an important element of corporate governance, given its legal authority to reward, hire and fire managers (Williamson 1984). It represents the point of connection between finance providers and finance employers. Their aim is, consequently, to safeguard shareholders' investment against potential misbehaviors of management. Aside from their "watchdog" role, they are generally supposed to provide knowledge, advice, and business networks to assist managers. (Pugliese et al., 2009; Zahra and Pearce, 1989).

Shareholders can individually protect themselves by selling their companies' stakes, but this opportunity is not available to the entire group of shareholders, except in the cases of leveraged buyouts (Baysinger and Hoskisson 1990). As Fama and Jansen (1983) stated, "the separation of residual risk bearing and decision management leads to decision systems that separate decision management from decision control". Decision management is responsibility of the company's managers, while the decision control role is covered by the Board of Directors. In their control role, they allow the shareholders to apply a continuous monitoring to the management. Shareholders hold most of the time ownerships in different organizations, for diversifying purposes, therefore it is not always desirable for them to bear the cost of controlling and monitoring the behavior of the people responsible for the daily management. Specifically, the more fragmented their ownership stakes, the more would not be optimal for them to bear the high costs of

controlling the managers. To do so, they rely on the Board of Directors, which, as a direct representation of the owners, ensure the control while minimizing the associated individual shareholders' costs. Moreover, the control responsibility is demanded to directors as they are able to perform it more efficiently than how shareholders could do thanks to their direct relationship with the firm that could diminish the information asymmetry. They stand near the management, receive information and have the opportunity to ask the managers. In light of that, the Board of Directors is the most important authority responsible for internal control. It acts as a safeguard for the individuals and organizations who have decided to invest in the company's stake, ensuring that their returns are not eroded by bad strategies or by the selfish behavior of managers and officers.

The Board of Directors is responsible for the evaluation management's performance. Managerial performance usually is appraised and rewarded by a combination of independent outsiders and inside directors who act as auditors (Herman, 1981). The presence of both kinds of directors is necessary in order to find an effective balance between evaluation impartiality and validity. Insider directors participate in the decision-making process, and so have access to information that is relevant for evaluating manager's competence and strategic choices' desirability. The presence of insiders on the board is aimed at preventing information process problems, and hence to enhance the effectiveness of the decision control (Hoskisson and Baysinger 1990). Outsiders, conversely, assure the independence and autonomy of judgment, given their lack of personal connection with the company or the management. The balance between the two kinds of directors permits an unbiased and informed evaluation of performance. The composition of the board is also argued to affect the control systems that are put in place to monitor strategic business units (SBUs) within a corporation (Hoskisson and Baysinger 1990). Outsiders rely much more on objective evaluation criteria given their lack of understanding of businesses and firm practices, thus enabling ex post financial controls (evaluating the outcome of manager's conduct). Insiders, on the other hand, adopt more subjective criteria, based on the business and firm's knowledge which descend from their

past experiences. Hence, Insiders can establish ex ante strategic controls on managers' decisions (evaluating of the managers' behavior).

The inherent risks that could hinder the capacity of the Board of Directors to monitor the company's operations are the lack of independent oversight and the muddled nature of its activity, which can impede an effective supervising. In fact, the Board of Directors can be dominated by CEOs, who can influence directors' inclination leveraging on their de facto power over the company's operations or on their personal ties with directors (Allen 1974). As a consequence, the Board of Directors must be structured in such a way to avoid the supremacy of managers over their activities. To reach its objective, the Board of Directors must be comprised of a number of independent directors, who do not have any connection with the company and can provide in this way an effective oversight on management actions.

The effectiveness of the management's monitoring has been often ascribed to the presence of independent directors on the board. The absence of personal or economic ties with the company should grant an objective supervision. The results of the researches focusing on this matter are often conflicting or inconclusive: Fosberg (1989) find no relationship between the proportion of outside directors and various performance measures, Hermalin and Weisbach (1991) and Baghat and Black (2002) find no association between a firm's Tobin's Q and the proportion of outside directors, with the latter finding no linkage neither with Return on Assets and Stock Returns. On the other hand, Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) demonstrate that the market values more firms which appoint a large share of outside directors; Anderson, Mansi and Reeb (2004) show that firms with a higher proportion of outside directors are likely to finance themselves at smaller cost of debt.

In this dissertation, I will test whether board structures affect firm's operating performance. A well-structured Board of Directors which is able to monitor effectively the management's conduct should induce the management not to appropriate of the firm's

resources: ex ante controls (ratification of managers' proposals) ensure that projects which are not expected to result in a shareholders' value increase are not undertaken, and ex post controls on managerial conduct increase management's accountability and decrease the probability that detrimental behaviors occur. Monitoring increases the probability that any managerial malfeasance is detected, thus reducing the managers' incentive in appropriating resources. (Baysinger and Butler 1985). The more the management receives an independent oversight, the more is likely that a misaligned action is spotted and the responsible manager fired. According to that, a management that is closely controlled should perform better than a management which is free in its choices. Basing on these elements, I hypothesize that an adequate board structure has a positive effect on firm's performance.

### ***Executive Compensation***

Managers' compensation comprises both the financial and non-financial benefits that are awarded to managers in return for their service for the organization, and it is exploited by companies as one of the most important devices to solve the agency problem existing between shareholders and managers. In fact, the conflict of interests of managers provides the basis for the enforcement of performance-based compensation plans to managers (Grossman and Hart, 1986). The compensation device is employed largely by firms to harmonize the counterparts' interests, and, as several researches suggest, rather than the absolute level, is the structure of the compensation which have the strongest effects on interest alignment and firm performance (Meheran 1994). The amount of money received by executives in return for their service is not important in solving the agency problem, but it is the balance between fixed and variable pay that plays a crucial role. Executives' pay is usually composed by a combination of fixed salary, bonuses, options on company's shares and benefits (Ellig 2001).

Remuneration plans are designed in order to consider the short and long-term objectives of the company and its performance, in this way rewarding executives for the achievement of objectives that are desirable for shareholder. Compensation has been

argued to be an efficiency maximization factor under a shareholder-welfare point of view, but also to be the source of the governance malfeasance demonstrated by the increasing deviation of managers and average worker pay (Zattoni and Khumar 2016). Some argue that this outcome is a result of the increased competition for grabbing up the scarce business talent present on the market, thus being value adding for shareholders, while others underline the harmfulness of this phenomenon and its likely connection with the increased control of executives over their own pay (Rodgers and Gago 2003). Several academic works (e.g. Jansen and Mackling 1976) posits that variable compensation plans change the risk attitude of managers, encouraging them to undertake riskier projects than they would do in absence of such unsettled pay plans. Executives, like most individuals, are described by theory as risk averse agents. Consequently, managers prefer compensation policies that minimize their personal risk, and so they would promote fixed compensation plans rather than equity based remuneration because the latter is strictly linked to variables that are somehow beyond managers' control. If fixed compensation would be applied, executives would have an incentive to reduce the firm's risk in order to minimize their compensation risk (Jansen and Meckling 1976). This outcome is likely to have negative impact on shareholders' wealth. So to say, executives tend to be less risk averse when they know that their reward would be a function of the performance of the projects they undertake. Executives' pay attached to performance enables risk sharing between principal and agent: shareholders are not anymore the only residual risk-bearing subject in the organization, but also managers are personally exposed to the outcome of their decision-making activity. The application of variable remuneration plans tends to weaken this risk-based conflict between shareholders and managers by fostering managerial risk taking.

Managers pay is composed by both a fixed and a variable part. Agency theory suggests that the choice between fixed and variable pay is selected according to how easy is to monitor performance (Stroh, Brett, Baumann, Reilly 1996). In organizations, shareholders return can be computed using objective and measurable factors, such as Return on Equity, Return on Assets, Share Price, and so variable compensation can be attached to such measures. However, poor board functioning has been argued to facilitate

rent extraction by managers (e.g., Kumar and Zattoni 2014). Variable compensation needs an effective monitoring and evaluation to be effective, since the incoherency of measurements and quantifications may lead to incongruity between pay and performance level, thus invalidating the scope for which such variable-compensation plans has been designed.

Agency theory assumes that economic agents are motivated by self-interest, are rational actors, and are risk averse. Therefore, principals can ensure themselves against detrimental agent's behavior by controlling agent's incentives. A sound compensation plan is able to bring shareholders and managers' interests into congruence, in this way achieving the principal objective of governance. This purpose is reached by designing remunerations plans related to performance indicators. The salary that is granted to managers is determined proportionally to some pre-determined criteria that are relevant for finance providers. They can receive an amount of cash which is quantified relatively to stock price, or they can receive directly stocks as a reward for their work. In this way, managers and shareholders are brought into a risk-sharing situation, in which the actions undertaken by managers for the maximization of their own wealth are contextually in the best interest of shareholders.

Since variable compensation plans' effectiveness is strictly linked to the one of monitoring, and because directors are responsible for building compensation strategies, board structure is closely intertwined with compensation. Setting the level and the structure of the executives' pay is one of the most important task of the Board of Directors. Moreover, theorists have long investigated the relationship between the two control mechanisms, monitoring and bonding, where the latter is the term associated with the role played by compensation plans. While some argue that the two work as substitutes, others, (e.g. Hoskisson, Castleton and Withers 2009) suggest that the two act as complements. The close relationship between monitoring and bonding is witnessed by the link between monitoring intensity and compensation level. The increased intensity of monitoring resulted in an increment of managerial risk, which in turn caused an upsurge of the required executives' remuneration.



An extensive body of literature explores the relationship between executive compensation and firm's performance. Summarizing the massive stream of researches addressing pay-for-performance is not an easy task. Leonard (1990) examined the effects of the introduction of long-term incentive pay, and found that companies with long-term incentive plans enjoyed significantly greater increases in ROE (return on equity) than did companies without such plan. Mehran (1994) studied the compensation structures of 153 manufacturing firms in 1979-80 and discovered that firm performance is positively related to the percentage of equity held by managers and to the percentage of their compensation that is equity-based, that equity-based compensation is used more extensively in firms with more outside directors, and that firms in which a higher percentage of the shares are held by insiders or outside blockholders use less equity-based compensation. This evidence supported the adoption of performance-based pay as a performance-enhancing instrument.

Performance-based compensation provides a great incentive to managers to concentrate on maximizing profitability and to act in the very best interest of shareholders. Every action that would not be oriented towards profitability could reduce their compensation. It is an instrument which, differently from monitoring, is not aimed at detecting management's malfeasances, but rather in making those malfeasances financially unattractive for managers. Therefore, performance-based compensation plans create an adherence between the actions that maximize the welfare of shareholders and those that maximize the welfare of managers. In this way, the principal agent problem is drastically reduced.

The minimization of the losses arising from the agency problem has a clear positive effect on firm's operating performance, as it prevents the occurrence of waste of capital. Furthermore, it lowers the moral hazard of managers: strategic decision makers are incentivized to perform as good as they can since they are put in a risk-sharing situation with the owners.

Thus, my hypothesis expects a positive relation between effectiveness of executive compensation plans and firm's performance.

### ***Shareholders' Rights***

The division of powers and the unfeasibility of complete contracts have awarded managers with a great authority for what concerns the company's life. However, corporate laws provide shareholders, in light of their owner's role, with the power to have a say about the company's management. This power is fragmented into minor separate rights, which shareholders can enforce against executives and managers. The existence of a set of rights which are awarded to every shareholder indiscriminately, proportionally to the size of its stake, aims at ensuring not only the protection of owners against their agents, e.g. the managers, but also against larger controlling shareholders who are able to exert a great pressure on management to pursue their private interests, who might be different from those of minorities. The exercise of these rights can protect themselves from managerial misbehavior and from the supremacy of large blockholders.

Chugh (2010) studied the relationship between shareholder rights and corporate performance in US corporations. Defining shareholders' rights, he highlighted several provisions that are associated with this concept, on the basis that the corporate governance ideal embodies the concept that stockholders own the corporation (Bebchuk 2006). In accordance, they are entitled to share in the profits and the future of the company through their voting rights. Every national legal framework prescribes the presence of a shareholder meeting, which is called to ratify some resolutions of primary importance for the company. These matters are the ones of crucial importance for the life of the company: Mergers and acquisitions, financial statement approval, election of the board members, and so forth. The circumstances in which the decision power is awarded to shareholders are defined by law. To this extent, shareholder rights are characteristic of a given legal framework rather than of a single company. However, the company can put in place some lawful measures that indirectly impede the exercise of these rights. These could include

takeover defenses that might entrench management or the introduction of misalignment between ownership and voting power in the bylaws.

Chugh (2010) described the shareholder rights' which standard, which prescribes equal voting rights for all shareholders (without dual/multi-classes) and absence of takeover defenses, and restrictions on changing corporations' by-laws or limiting shareholder proposals. The shareholders should have the right to elect the full board each year, without the limitation of staggered terms. The shareholders should have the right to an independent nominating committee. Essentially, the standard implies that the firm's management is not entrenched and can be replaced. Moreover, shareholders are free to sell the firm to outside parties without any limitation.

Shareholders should have the power to influence the direction of the firm they own, but it will not make any sense to divide the ownership from the decision making, and thus to appoint managers, if all of their decisions should have been approved by shareholders after having been put forth by executives. However, while managers remain exclusively responsible for the day-to-day management of the company, shareholders are called to express their opinion on some non-recurring, extraordinary proposals. In shareholders meeting, so, owners reunite and vote to decide about propositions, hence expressing directly their power to orientate the company strategy which descends from their holding.

It is generally asserted in the literature that greater shareholder rights have a positive impact on firm's value (Chugh 2010). There are several reasons that support this hypothesis. The conferment of greater rights to shareholders would result in fewer litigation costs, as transparency and protection of minority shareholders reduce conflicts. The conflict of interest is minimized, due to the effective management's monitoring, and the increased supervision puts in place a strong incentive for enhancing managerial performance. Eventually, a corporate governance system which is oriented towards shareholders may be regarded as a positive signal by investors, resulting in a higher credit rating and in turn in a lower cost of debt (Ashbaugh-Staife, Collins and LaFonde, 2006).

Gompers, Ishii and Metrick (2003) evaluated shareholder rights at about 1500 large US-based firms during the 1990s, and found that firms with strongest rights would have earned abnormal returns of 8,5% per year. Furthermore, they proved that the same companies had higher firm value, higher profits, higher sales growth, lower capital expenditures and made fewer acquisitions. Chugh, Meador J. and Meador M. (2010) investigated the financial performance of firms with greater shareholder rights and contrasted it with that of firm with lower shareholder rights. They found that firms with greater shareholder rights performed better in absolute terms, but when adjusted for volatility firms with lower shareholder rights performed better. Other streams of empirical literature demonstrate that greater shareholder rights generally are associated with higher share prices, higher growth rates, higher profitability and lower volatility in share prices (Bebchuk, Cohen, and Ferrell, 2004). However, contrasting evidences exist: Core, Guay and Rusticus (2005) demonstrated that share returns of companies with strong shareholder rights do not outperform those with weak shareholder rights.

The empirical analysis that will be described later on will seek to demonstrate that a high level of shareholder rights is associated with better performance. According to the theoretical framework, shareholder activism shall reduce waste of capital descending from the selfish attitude of the powerful subject (which might be managers or blockholders).

### ***Market for Corporate Control***

The market for corporate control is a disciplinary device that, contrarily from the other instruments, stems from the external environment in which the company operates, namely the equity market. Its functioning is strictly related to that of the stock market. When a company is directed by a poor-performing management team, the price of the company's stocks is likely to drop. Then, the lower the price of the stocks compared to the value that it could reach in the presence of an efficient management, the more the take-over of the company gets attractive for those who believe they can manage the company more efficiently (Manne 1965). A price discount justified by poor-management is attractive for investors, who can seek to acquire the corporate control, defined as the right to determine

the managers of corporate resources, that is, to hire, fire and set management's compensation (Fama and Jansen 1983). Therefore, an efficient market for corporate control can enhance the accountability of managers, who are threatened to be replaced if the stock price (which varies consequently to their choices) falls under a certain threshold. The market for corporate control can be seen as an arena in which managers compete for the command of the firm, on the basis of observable factors such as the stock price. In this perspective, it is counter-productive for them to engage in opportunistic behavior if it will have a negative effect on share's price. (Grossman and Hart 1986) Since the price of shares is directly linked with shareholders' wealth, in presence of a well-functioning market for corporate control managers would have an incentive to act in favor of shareholders, putting aside their personal objectives that could lower the stock's price. This mechanism is particularly effective in jurisdictions with an active market for corporate control (typically United States and United Kingdom) and in situations in which the ownership structure makes take-over bids relatively simple, i.e. when the ownership rights and voting rights are aligned (OECD). In regard, hostile takeovers (the ones that are opposed by management) are an effective method of curbing managerial opportunism to the benefit of shareholders. However, managers could implement some measures to make hostile takeovers more difficult for the acquirer, so to discourage him and keep the control of the company. Thus, it is true that the market for corporate control is an external corporate governance device which is not under company's control (it is much more a region-specific characteristic rather than a firm-specific characteristic) the potentially damaging measures undertaken in order to insulate the company's managers from the market for corporate control are developed and implemented by each firm individually. Hence, firm-level anti-takeover provisions must be taken into account when assessing a company's corporate governance, since they are likely to diminish the effectiveness of the region-level market for corporate control. It is clear that in jurisdictions with an active market for corporate control both managers and shareholders are more concerned with anti-takeover measures than if the market for corporate control is stagnant and unmoving. The evaluation method employed in this thesis takes into account the market for corporate control by assessing the firm-specific provision that might hinder its utilization.

In the thesis, the takeover defenses applied by each firm will be taken into consideration when evaluating firm-specific governance structure. I hypothesize that strong takeover defenses insulate management from external pressure which orient them toward the creation of shareholders' wealth, therefore impact negatively on firm's performance. Takeover defenses' assessment is embedded into the appraisal of shareholder rights.

### ***External Audit***

Audit embeds all the activities that are undertaken in order to examine and verify company's records and statements. While there are several internal controls that are put in place to monitor the appropriateness of the company's practices, external controls are required in order to ensure independence of judgment and veracity. Most of the external audit practices are mandated by law provisions, but still differences can emerge among companies. In past years, external audit has attracted attention due to the occurrence of scandals regarding the independence and good faith of external auditors, like the Enron scandal, which eventually led to the bankruptcy of the company and of its external auditor, Arthur Andersen.

External auditors exercise a *gatekeeping role*, since they provide an independent judgment and assure the market that the financial condition of the company is portrayed truthfully (Palmrose 2006). As such, external auditing reduces the agency problem relying on an independent and objective supervision performed by competent subjects without any linkage to the organization.

My analysis includes the external audit as an additional corporate governance instrument to follow the categorization proposed by Institutional Shareholder Services.

In this thesis, the effectiveness of all the above described tools is evaluated in order to grade corporate governance. However, these are classified differently. I classified the instruments that are used within companies to reduce the magnitude of the agency problem according to the classification that is provided by Institutional Shareholder Services. This categorization allows to evaluate and judge the firm-specific corporate

governance practices in order to compare them within a particular context. In accordance, the adopted categorization includes four instruments:

- Board of Directors
- Executive Compensation
- Shareholder Rights
- External Audit

The market for corporate control is not evaluated directly, since, as aforementioned, it is a characteristic of the economic and legal environment in which the firm operates, rather than a firm-specific peculiarity. The effect of the external market for corporate control is, in this categorization, embedded in the shareholder rights pillar. The evaluation of shareholder rights comprises the assessment of the existence of firm-specific provisions that may hinder the influence of the market for corporate control. This grouping is coherent because the measures taken in order to insulate the company from the external pressure simultaneously put limits to the rights of shareholders.

The combined action of these instruments prevent managers or block-holders to undertake conducts that might be damaging for the wealth of shareholders.

In most developed markets, governance systems have reached a high level of development (Schleifer and Vishny, 1997). Companies can attract sound capital amounts by ensuring the investors that their money will be deployed in their best interests. The mitigation of the agency problems, and the subsequent allocation of responsibilities, allow shareholders to “trust” the company. For sure, the poor economic results of any company are not entirely dependent on the existence of the good faith of managers. They can well act to satisfy their shareholders, but can still take bad decisions which diminish owners’ wealth. Organization operates in a competitive field, and the uncertainty that is systemically associated with their actions creates the risks to shareholders. Corporate Governance assure shareholders that the rewards that they receive for their residual claim are the outcome of a set of informed decisions which are taken in their best interests. Their finance provider role has to be rewarded in light of their investments, which are essential to allow the corporation to grow.

In the section below, I will highlight some differences that exist among countries regarding to ownership structure and corporate governance practices, and explain why they have important effects on the understanding of agency theory.



# **CHAPTER III – CROSS-REGION CORPORATE GOVERNANCE APPRAISAL**

## **Regional Regulatory Environments, Agency Theory and Ownership Structure**

This work aims at exploring the relation between corporate governance and firm performance. In the previous chapters, we defined the concept of corporate governance adopted in this work and its objectives. However, since this work addresses the relationship between corporate governance and performance across various territories, it is necessary to identify the differences that exist among different regions concerning the corporate governance frameworks.

The differences among several factors related to ownership at a territorial level have stark consequences on corporate governance. Despite corporate governance universally refers to the mechanisms that help to avoid conflicts of interest within corporations, the discrepancies that characterize the territory-specific ownership and control structures have substantial effects in shaping the magnitude of each of the two conflicts that characterize corporate governance, i.e. the one between management and shareholders and the one between small and large shareholders. We will see later on that different ownership configurations vary the magnitude of the contrasts between the different counterparties.

Aside from ownership-related matters, dramatic differences in corporate governance emerge from varying regulations and legal environments (Shleifer and Vishny 1997). Furthermore, the development of the corporate governance frameworks themselves can be deeply different according to the economic development. In the majority of developing countries, corporate governance systems are non-existent or largely ineffective (Gibson

2003). However, not only developing countries have been deemed to have inappropriate governance frameworks. Pagano, Panetta and Zingales (1995) proved that corporate governance in Italy performed so bad to obstruct the flow of external financing to the firms.

When comparing corporate governance models, scholars usually counter-pose the two dichotomous Anglo-American and Continental European corporate governance models. (Hall and Soskice 2001, de Silanes, Lopez et al. 1998). Hall and Soskice (2001) characterize the Anglo-American model with financing through equity, fragmented and dispersed ownership, active markets for corporate control and flexible labor markets. On the other hand, according to their view, the Continental-European corporate governance is typified by financing through debt, concentrated ownership in the hand of large block-holders, weak markets for corporate control and rigid labor markets.

### **Insider System Countries and Outsider System Countries**

The most noteworthy difference concerning corporate governance relates to the degree of ownership concentration and identity of the controlling shareholder (OECD 2015). In this regard, some countries are characterized by a high degree of dispersion of the ownership, in which a large group of small shareholders owns each one a small fraction of the firm's stake. These countries conform to the so-called *Outsider System*. On the other hand, the regions that are traditionally characterized by high ownership concentration (i.e. Continental Europe and Japan) are called *Insider Systems* (Franks and Mayer 1997). Here, the powerful controlling shareholder is able to influence the management dramatically, adding other facets to the agency problem analyzed previously. These country-level differences are mainly a consequence of the protection that is granted to small investors by corporate law. In jurisdictions in which regulation is oriented toward the protection of small shareholders, the ownership tends to be diffused. Contrarily, legal frameworks biased for the maintenance of control and governability foster the concentration of shareholdings.

The Outsider System is typical of the United States and the United Kingdom, where laws and regulations tend to place a strong emphasis on the protection of investors. In turn, the high level of protection that is granted to shareholders, and in particular small shareholders, results in an absence of concentration of ownership. Investors are discouraged in engaging in “active” corporate governance. These systems are also associated with an active stock market, which promotes the turnover of owners. The smallness of the stakes and the high turnover enhance the possibility that is given to investors to diversify their risks.

On the other side of the continuum, in Insider System countries the ownership tends to be concentrated in the hands of a blockholder, who might be an individual, a family, an institution or another firm. Here, the blockholder is able to control *de facto* the firm in light of the superiority of his shareholding. The Insider System is typical of Europe (except UK), Japan and Korea.

Berle and Means (1932), in their seminal work, argued that ownership structure affects firm performance. According to their view, concentrated ownership alleviates agency problems, mitigating the division between control and ownership, and so has to be preferred. However, Demsetz and Villalonga (2011) found no evidence of that. Adding other facets to their analysis, from these two opposed ownership configurations are likely to derive different typologies of conflicts between internal parties. As such, concentrated ownership does reduce the agency costs that stems from the division between ownership and control, but may cause the emergence of other kinds agency costs: the ones suffered by minority shareholders in their relationship with the controlling owner. Although the two basic contrasts inherent to corporate governance, the one between shareholders and managers and the other between minority shareholders and controlling blockholders, might exist in both systems in relation to the firm-specific ownership structure, the different grade of ownership concentration affects the predominance of one of them over another markedly. As to say, each ownership structure is associated with a different probability that one of the two misbehaviors will occur.

In the Outsider System, frictions between management and shareholders are more likely to happen, because of the great deal of freedom that is enjoyed by managers in their activities. The fragmentation of ownership reduces the incentive to monitor the management's behavior for every individual shareholder, due to free riding problems associated with individual monitoring (Easterbrook and Fishel 1983). As to say, a small shareholder who wants to perform a close monitoring of managements, supposed that he has the competences to do so, incur in the whole cost of monitoring, while the benefits of its activity are shared among all shareholders. This lead to a condition in which small shareholders tend to "free-ride" in the hope that another subject will do the monitoring on their behalf. In this situation, managers end up with a relevant discretion and could easily run the company according to their interests instead of the shareholder's ones. As an example, they could pursue the maximization of the company's size or of their salaries. That is why, in this system, corporate governance would intervene mainly to limit the scope of managerial discretion, fostering the alignment of the interests of the counterparties so to avoid any expropriation of rent made by managers. Corporate governance, legal and regulatory framework are designed not only to address the separation between ownership and control, but also in response of the diffused nature of share ownership. Governance practices aim at addressing weaknesses in monitoring, at strengthening managerial accountability, and at aligning the interests of managers closely with ones of shareholders mainly through monitoring, shareholder activism and executive compensation packages designed to encourage managers to pursue shareholders' wealth maximization.

Conversely, in Insider Systems, the presence of a large shareholder ensures a proper direct monitoring of the management, since the large investment of the block-holder allows him to internalize the costs associated with monitoring. The discretion enjoyed by managers in their decisions is much smaller in these systems. In the case in which the ownership structure of the firm is characterized by the presence of an individual shareholder who owns the majority of the voting power (which is not always correspondent with ownership, as I will explain afterwards), the management would be directly chosen by

the blockholder, who will have the control of the firm. Small shareholders could benefit from this situation by relying on the direct monitoring of the large blockholder, as the two groups have the same final objective, namely the increase of shareholders' wealth. In this light, minority shareholders might consider the concentrated structure as an advantage. However, despite the controlling shareholder creates shared benefits with its monitoring, he also has an incentive to extract private benefits that stems from his control. Concentrated ownership creates the possibility that the controlling shareholder collude with the managers with the objective of pursuing its interests at the expense of the minorities. In this case, the concentration of ownership can be seen as detrimental, since it can act as an impediment to the flow of external capital from small investors in controlled firms. This problem can be particularly acute when small investors do not have adequate rights to secure their investment (Shleifer and Vishny 1997, Barca 1995). Management could be forced to pursue the interests of the blockholder, which may not be equivalent with those of minorities. For example, blockholders may force management to divert resources to other companies they own, in this way damaging in this way the minority shareholders (Becht 1997).

In insider systems, corporate governance and regulations are less concerned with shaping managerial behavior so to orient it toward shareholder wealth maximization, but rather with the protection of minority shareholders against the power enjoyed by the blockholder, which has an incentive to concentrate on its private benefits, reducing the returns awarded to minority shareholders.

## **Ownership power and Voting Power**

In dealing with the two systems, we used as distinguishing parameter the ownership concentration. Though, the effects that we described as associated with different degrees of ownership concentration can be best explained referring to voting power concentration. In fact, despite in most cases ownership rights are commensurate to voting power, it is not always so. Ownership might not be equivalent to control in the presence of dual-class shares, ownership pyramids, voting coalitions or clauses, which award long-term shareholders with additional voting power. Ownership and voting power are different

concepts which relates to the presence of difference rights held by shareholders: the former gives right to receive the cash-flow that derives from the firm's operation, while voting power refers to the right to "have a say" on how the firm is managed (Goergen 2012). In outsider systems, the dispersed ownership can be counterbalanced by the presence of dual-class shares, golden shares, proxy voting, which ultimately causes the voting power to be concentrated in the hands of a single block-holder. In the absence of such devices, when the principle of "one share- one vote" is enforced, dispersed ownership corresponds to the absence of a controlling shareholder. Similarly, in insider systems, the voting power of large blockholders can be diluted via capped voting. In this case, despite the presence of a large owner, the corporation is not controlled. That happens because of the presence of instruments that limit the control that can be awarded to a single shareholder, breaking the proportionality between ownership rights and voting rights.

As we can see from the table below, the discrepancies between ownership and voting power can have significant effects on the balance of power between the different subjects involved.

### Box 1. Taxonomy of Ownership and Voting Power

	Dispersed Voting Power	Concentrated Voting Power
<b>Dispersed Ownership</b>	<p>Many small shareholders</p> <p>One share/One vote</p> <p>Implications: “Strong Managers, Weak Owners” Takeovers are possible</p>	<p>Many small shareholders</p> <p>Voting power concentrated in the hands of blockholders via dual class shares, golden shares, proxy votes, voting trusts, etc.</p> <p>Implications: “Strong Voting Blockholders, Weak Minority Owners” Takeovers are impossible</p>
<b>Concentrated Ownership</b>	<p>Large shareholders</p> <p>Voting power of ownership diluted via capped voting</p> <p>Implications: “Strong Managers, Weak Owners” Takeovers are difficult</p>	<p>Large Shareholders</p> <p>Voting rights aligned with ownership rights via one share/one vote, or concentrated via separation devices.</p> <p>Implications: “Weak Managers, Weak Minority Owners, Strong Majority Owners” Takeovers are possible</p>

source: Oecd

## Ownership Concentration and Agency Problem

In this thesis, I study the impact of corporate governance on firm’s performance using a sample of firms listed in both Insider and Outsider Systems (as it is explained later on, Hong Kong and Italy represent insider system regions, while the United States is used as the archetype of Outsider System country).

The consideration of shareholding concentration adds other facets to the agency problem that I described before. When there are many small shareholders, managers represent the powerful subject in the organization, thanks to the discretion they enjoy in making decisions. When a majority shareholding exists, managers have less freedom because of the blockholder’s pressure and direct control. The concentration of ownership mitigates

the agency problem existing between managers and shareholders. However, in the latter case the agency problem arises between small and large shareholders. The control that is awarded to the blockholder gives him both the incentive and the authority to participate directly in the company's management. As a consequence, the blockholder is not anymore the "principal" that is described in agency theory, because he does not entirely demand its power to managers. Ownership and control are less divided. Under a small shareholder viewpoint, the blockholder represents the "agent" described in agency theory, because he is responsible for the deployment of firm's resources that belongs to minority shareholders. The fact that the blockholder is an owner of the firm can turn out to be an advantage, but he may have the opportunity to expropriate the wealth of other shareholders. I will investigate whether the magnitude of the governance impact is different contingently upon the ownership structure.

Now that we have outlined the different ownership patterns and their effects on corporate governance matters, we provide a brief description of the corporate governance frameworks and ownership structures of the three regions included in our sample, namely Italy, Hong Kong and US. This characterization is key for understanding the different priorities of each corporate governance and regulatory framework, and how the different methods employed for avoiding shareholder's rent-extraction are designed in order to fulfil their role, contingently upon the region-specific environment.

## **Examination of Region-Specific Corporate Governance Frameworks**

### **Insider System Regions:**

#### **Hong Kong, China:**

Hong Kong returned to Chinese rule in 1997 after 155 years of United Kingdom's influence. The British legacy provided Hong Kong with a strong financial market



regulation and developed financial market institutions, which made Hong Kong the most important financial hub of Southeast Asia. Hong Kong's attractiveness is built upon the strong and well-functioning institutions that govern its market and on its geographic proximity with China. While direct government ownership is rare (save for PRC companies listed in Hong Kong), as with many Asian jurisdictions, the largest shareholders of corporate groups are in many cases families (although in some cases wealthy individuals or conglomerates are apparent), with family representation on boards common (ISS Hong Kong Market IQ 2015). About 75% of issuers have a dominant shareholder, for example, an individual/family or state-owned entity, who owns 30% or more of the issued shares (OECD corporate governance Fact-book, 2015).

In dealing with corporate governance issues, many jurisdictions have used various combinations of legal and regulatory instruments on the one hand, and codes and principles on the other. In Hong Kong, specifically, the source of corporate law is the *Companies Ordinance*, updated in 2014. Securities market is regulated by the *Securities And Futures Ordinance*, updated in 2012. Moreover, Hong Kong Stock Exchange provides *Listing Rules*, to which companies must adhere before listing in equity markets. Implementation mechanisms for the national codes and principles vary among jurisdictions, ranging from: no basis in regulatory or listing requirement; “comply or explain” system; to fully or partially binding. A comply or explain system is ensured either by laws and regulations or by contracts between the listed companies and the stock exchange. The key corporate governance regulation in Hong Kong is the *Corporate Governance Code*, which might be adopted by firms according to a comply-or-explain basis. In 2015, the 40% of listed companies were fully compliant with the code (BDO Corporate Governance Academy, 2015). Mandatory disclosure to the market regarding adherence to the codes is prevalent and has become a part of the annual reporting requirements for listed companies in most jurisdictions. Hong Kong makes no exception, as the disclosure in the annual report is mandatory. The main stock exchange of the region is the Hong Kong Stock Exchange (SEKH), which holds also the role of custodian. In most jurisdictions, public regulators, which supervise and enforce the corporate governance practices, play a key role (in 75% of OECD countries) (OECD 2015

Corporate Governance Fact-book), whereas in Hong Kong and a few other regions (China, Sweden, Czech Republic and Netherlands) the role of public regulators is limited only to the issues related to disclosure or the securities law, as in principle civil rules on corporate governance are mainly supervised and enforced privately. The public regulator responsible for Hong Kong is *Securities and Futures Commission*, which, as stated before, is concerned only for securities law.

Another facet that has to be explored in order to understand the corporate governance framework is the existence of rules allowing the misalignment between ownership rights and voting rights. Almost all jurisdictions allow companies to issue shares with limited voting rights. In this respect, In Hong Kong, while the Listing Rules do not require one-share, one-vote, a company cannot list with shares whose “voting power does not bear a reasonable relationship to the equity interest of such shares when fully paid”, other than “exceptional circumstances” agreed with the Exchange (No exception has been permitted to date) (OECD fact book 2015).

For what concerns takeover bid rules, Hong Kong and China are the only two regions in which takeovers are regulated in voluntary codes, rather than through hard law. A mandatory takeover bid is triggered when an individual shareholder overcomes the 30% of the total ownership stake.

Hong Kong companies have a one-tier board structure, which comprises the chairperson of the board, executive directors, non-independent non-executive directors, and independent non-executive directors (ISS Hong Kong Market IQ 2015). The one-tier system provides for a Board of Directors appointed by the shareholders’ meeting and a management control committee made up of non-executive independent members of the board chosen within the board. The Hong Kong Code recommends that the roles of chair and chief executive be separated although this recommendation is often not followed (ISS Hong Kong Market IQ, 2015; BDO Corporate Governance Academy, 2015). For the election of the board, shareholders are called to vote for each individual director, who has to be supported by the majority of voters to be appointed. The name, qualifications and relationship with the firm of each candidate must be made available in order to accept the

candidacy. For what concerns executive compensation, in Hong Kong the Code recommends that a significant portion of executive directors' remuneration be linked to corporate and individual performance. The regulation dictates that both the aggregate and individual remuneration of directors and managers have to be disclosed, but not approved directly by shareholders.

External audit matters are regulated by law, which aims at ensuring an independent supervision of the firm's financial conditions. To this end, it is paramount that the third-party auditor does not have any tie with the audited firm. Hong Kong law requires the rotation of the engagement partner of the audit firm every 5 years, in order to avoid the birth of personal or economic ties that may hinder the auditor's integrity.

In light of the concentrated ownership structure of its companies, Hong Kong is considered an example of insider system region. Despite the presence of controlling shareholders shall reduce the probability that managers act opportunistically, investors seeking to invest in these companies should be concerned with the negative side of investing in a controlled company. The blockholder is able to exert a substantial pressure on management. For this reason, the mechanisms that work to protect minorities from the potentially negative effects that are associated concentrated ownership are considered paramount. The objectives of the blockholder may be different from those of minority shareholders, and shareholders' rights can be crucial in ensuring that the blockholder does not expropriate returns that pertain to other shareholders.

## **Italy**

In EU, the corporate governance system has often been characterized as a relationship-based system rather than as a market-based system. In turn, countries belonging to this system can be split into two main groups: the Latin and the Germanic Systems. The Italian Corporate Governance System belongs to the Latin group, despite it retains some peculiar characteristics that distance it from the international standard models (Melis, 2000). The Italian company law has probably favored excessively the certainty of control at the

expenses of shareholders' protection (Bianchi et al., 1997). For this reason, many potential small investors have avoided to invest on the stock exchange in the past. In Italy, nearly 2/3 of listed companies are controlled by a single shareholder. The presence of widely held companies is still limited (4% of the total number of firms and 22% of total market capitalization). There is a sharp decline of the pyramid structure and non-voting shares in the last decade, possibly as a reaction to increasing market pressure (Consob, 2014). The *Company Law* is the source of companies' regulation, and the *Consolidated Law on Finance* provides a legal framework to securities. Companies can adhere to the *Corporate Governance Code*, issued by the Corporate Governance Committee, which contains the basic principles and suggested practices, although its enforcement is not mandatory and can be adopted according to a comply-or-explain basis. The main public regulator of corporate governance matters is the *Commissione Nazionale per la Società e la Borsa* (CONSOB). The largest stock exchange is *Borsa Italiana*, which is a part of the *London Stock Exchange Group*.

Like the great majority of jurisdiction, Italy introduced in its legal system the opportunity for firms to issue preferred shares or voting caps. Specifically, companies can decide to issue shares with limited voting rights for a fraction of capital no larger than 50%, and can issue shares with no voting rights. Multiple voting rights can be awarded to shares that have been held by the same shareholder for at least two years, up to double-voting shares (Loyalty Shares). Capped voting is allowed for privatized state owned companies and cooperatives, in which, specifically, is applied the one-head-one-vote principle instead of the common one-share-one-vote. In Italy, the regulator is in charge for takeover bids matters. In Italy, as a result of 2014 amendments to the Consolidated Law on Finance, the mandatory triggering threshold is differentiated according to the size of companies: small and medium sized enterprises may establish in the bylaws a threshold in the range 25%-40% of voting rights, while for larger companies the threshold is 25% of voting rights provided that no other shareholder holds a higher stake. Italian companies are normally governed by a Board of Directors elected by shareholders, supported by an additional statutory body that has mainly audit purposes and is also elected directly by shareholders (Collegio Sindacale). Italy, along with Portugal and Japan, are the only countries that are characterized by this peculiar corporate bodies' configuration. In spite

of that, both Italy and Portugal provides companies with the opportunity of establishing a one-tiered or two-tiered Board of Directors, in addition to the “traditional” model with a board of statutory auditors. However, in Italy the vast majority of companies use the traditional model. The mandate of the Board of Directors is maximum 3 years long, whereas the statutory body is charge mandatorily for 3 years. In Italy, shareholders are called to elect the Board of Directors with a very peculiar voting arrangement aimed at facilitating an effective participation by minority shareholders. Each shareholder must vote for a list of candidates, instead that for a single candidate. The slate that is awarded with the majority of votes will take all the seats on the board, except for at least one seat, which is reserved to a minority slate. In this way, the regulator ensured the presence of a representative of minority shareholders. In the case in which only one slate is proposed, that slate will take all the seats. Companies must disclose in advance of the meeting the name and the qualifications of the candidates included in the slates. For what concerns the remuneration of directors and managers, the corporate governance recommends the general criteria that should be followed by companies in the design of the compensation plan, with particular attention to long term incentive mechanism for variable remuneration (LTIM).

For what concerns external audit requirements, the Italian law had been the first one to introduce the mandatory rotation of the external auditor in 1974. The auditor must be replaced every 9 years.

Italy is clearly an insider system country. Controlling shareholders are very common in the market’s ownership structure. Consequently, the managerial behavior can be controlled by those large shareholders, who might, however, act individualistically to increase their wealth at the expense of small shareholder. As we stated for Hong Kong, in this landscape shareholders rely on the presence of their representatives on the Board of Directors and on shareholder rights to protect themselves against blockholder’s misbehaviors. Investor should value the firm-specific shareholders’ rights protection mechanisms to ensure they receive a proper return.

## **Outsider System Region:**

### **United States**

In the United States, being the outsider system country par excellence, the ownership of public companies is usually characterized by dispersed shareholdings. Listed companies are united rarely under the control of a major shareholder but rather subject to managerial control (OECD, 2012). One States study describes how most public corporations in the United States have large shareholders, by taking into account the ownership of both directors and officers and all large shareholders (Holderness, 2010). US is often described as the paradigmatic case of shareholder-oriented or market based model to corporate governance. However, scandals surrounding Enron's bankruptcy in 2001 and other corporate scandals occurred in the same period led to the introduction of the Sarbanes-Oxley Act in July 30, 2002, a corporate governance reform that sought to create a reporting system that makes corporate governance more transparent to the public and increase management accountability (Epps and Cereola 2008).

The main elements of the regulatory framework are *State Corporate Laws* for what concerns company law, and the *Securities Act* of 1933 and the *Securities Exchange Act* of 1934 regarding securities law, which had been updated in 2012. The two key codes related to corporate governance are the *NASDAQ Listing Rules* and the *NYSE Listed Companies Manual*, which are binding for listed companies and are enforced by the regulator and by the stock exchange. Their implementation must be disclosed annually by companies in the annual company report. The primary source of corporate governance law is the state law, although the public regulator for corporate governance, the *Securities Exchange Commission* (SEC), is responsible for some specific matters. The American jurisdiction is particularly unrestrained for what regards the unbinding of ownership rights and voting rights. It allows the issuance of shares without voting rights, with limited voting rights, and allows multiple voting rights and capped voting, although voting rights cannot be altered subsequently to the listing. Differently from most other countries, in US rules do not impose a mandatory tender offer, leaving it up to the bidder to deal with shareholders, whether on an unsolicited basis without the prior approval of the target, or

pursuant to a private agreement between the bidder and the target. In US, like in most jurisdictions, the corporate Board of Directors is structured in to a one-tier system. For the election of the Board of Directors, shareholders express their preference for each individual candidate, which can be elected without the necessity of a majority. Cumulative voting is allowed.

A majority of the jurisdictions have introduced general criteria for board and key executive remuneration, whereas United States do not require any obligation concerning executive compensation, except the mandatory disclosure of individual and aggregate amount of salaries.

United States-based firms are required to have their financial statements inspected and certified by an external third-party auditor. As in Hong Kong, American firms are obliged to rotate the engagement partner of the external audit company every 5 years in order to safeguard the objectiveness of its activity.

United States is characterized by a markedly active market for managerial talent. The replacement of management teams is a common practice. During 1995-2006, CEO turnover in North America ranged mostly between 10- 15%, with a peak of 18% reached in 2000. CEO turnover in North America declined slightly in both 2007 and 2008, which coincided with the global economic recession. This declining trend continued in 2009 and into 2010 as well, possibly reflecting concern about the strength of economic recovery (OECD). This data agrees with the characterization of United States as a country with a developed and functioning market for corporate control.

As we stated before, the presence of a controlling shareholder is rather infrequent in the American market landscape. For this reason, the probability that blockholders expropriates minorities' rents is minimal. Investors should value the presence of firm-specific mechanisms that increase management's accountability and bring the interests of the counterparts into congruence, such as board of director's monitoring and performance-based compensation plans. The effectiveness of these two instruments is

paramount to ensure shareholder's confidence in a system in which controlling shareholder's monitoring is not available.

Having highlighted the potential impact that corporate governance can have on firm's performance, and having outlined the region-specific corporate governance frameworks, I now describe the empirical analysis that has been performed in order to test the significance of the link between corporate governance and performance.

The table below highlights the main characteristics and legal requirements of each region. It is paramount to define these elements, because the analysis requires the evaluation of firm-level corporate governance practices that are benchmarked to each region's regulation, best practices and recommendations.



		Hong Kong	Italy	United States
Corporate Governance Instruments	Ownership Structure	Concentrated Ownership. 75% of listed companies have a dominant shareholder who owns more than 30% of the capital stake. Hong Kong is an <i>insider system</i> region.	Concentrated Ownership. 83% of listed companies are controlled, either by a majority shareholder (49% of companies) or by a dominant shareholder (21% of companies). Italy is an <i>insider system</i> country.	The ownership is diffused. An individual shareholder does not overcome the 5% of capital in the 13% of listed companies, and 57% of firms have at least one shareholder which owns the 5% of the outstanding capital. Blockholders control 20% of the issuers. United States is an <i>outsider system</i> country.
	BoD Structure	One-tiered BoD elected by shareholders. The <i>Corporate Governance Code</i> recommends that at least 3 or one third of directors be independent. The appointment of the audit and remuneration committees is mandatory, and the committees have to be at least 50% independent. After 9 years of tenure, directors must prove to have maintained their independence.	All models allowed; the more common is the "traditional" model, composed of a BoD and a Board of Statutory Auditors, both directly appointed by shareholders. The mandate lasts maximum 3 years. At least one independent director must be appointed, and at least one director must be chosen by minority shareholders. The establishment of a wholly independent audit committee is mandatory. After 9 years of tenure directors lose irrevocably their independent status.	One-tiered BoD elected by shareholders. At least the 50% of directors must be independent, but this clause vary contingently upon the ownership structure. At the end of the mandate, the board might be renewed completely or in a staggered manner. The establishment of a wholly independent audit committee is mandatory. An independent director maintains his status independently from his tenure.
	Executive Compensation	The <i>Corporate Governance Code</i> recommends that a significant portion of executive remuneration be linked to performance. The amount must be disclosed, as mandated by law, but not directly approved by shareholders.	The <i>Corporate Governance Code</i> recommends the general criteria that should be followed by companies in the design of the compensation plan, with particular attention to long-term incentive mechanism for variable remuneration (LTIM). Total amounts must be disclosed and remuneration plans are subject to shareholders' non-binding vote.	There are no recommendations nor obligations concerning executive compensation, except for the mandatory disclosure of the total compensation.
	Shareholder Rights	Meetings can be convened under request of shareholders owning 5% of capital. Items can be put in agenda under request of 2,5% of capital, or 50 shareholders. The meeting must be convened within 49 days from the request. A mandatory takeover bid is triggered when an individual overcome the 30% of ownership. The misalignment between ownership and voting power is allowed, but only in special circumstances.	Meetings can be convened under request of shareholders owning 5% of capital. Items can be put in agenda under request of 2,5% of capital. The meeting must be convened within 30 days from the request. The threshold for mandatory takeover bid is set according to the firm's size, and spans from 25% to 40%. The issuance of loyalty shares is permitted, shares with no voting rights can be issued for a maximum of 50% of capital. Capped voting is allowed for specific group of companies.	The request for convening a shareholders' meeting can be asked by shareholders owning at least the 10% of the capital, while the minimum shareholding for placing items on the agenda is 1%, or \$2000 of market value held for at least one year. The requests can be rejected according to certain criteria. There is no compulsory deadline for companies for convening a meeting requested by shareholders. Law does not impose a mandatory tender offer. There are no constraints for what concerns the unbinding of ownership and voting rights
	External Audit	Companies are obliged to rotate the engagement partner every 5 years. The audited firms cannot hire an auditor who has inspected its financial statements.	Companies are obliged to rotate the external auditor every 9 years.	Companies are obliged to rotate the engagement partner of the external auditor every 5 years.

## **CHAPTER IV: HYPOTHESES DEVELOPMENT**

According to what I stated in the theoretical part of this work, there are reasonable elements that support the belief that an effective corporate governance influence positively firms' performance. Contingently upon the ownership structure of the company, the shareholder-protecting devices which made up the corporate governance work differently but are aimed towards the same objective: the assurance of shareholders against the potential expropriation by the figures who holds the controlling power in the firm.

A clear definition of the causal relationship between corporate governance and firm's performance is difficult to establish. To summarize the matters that I addressed so far, it can be stated that an effective corporate governance system prevents managers and blockholders to engage in projects that result in destruction of shareholders' value for the maximization of their own welfare. To this end, it seeks to mitigate the agency problem, which derive from the division of ownership and control by aligning the interests of the involved parties.

Corporate Governance instruments such as performance-based executive compensation are aimed at making opportunistic behavior financially unattractive for managers. Moreover, pay-for-performance ties the performance of the firm to the returns that are gained by managers, motivating managers to make their best effort in selecting the strategies that are most favorable for themselves, and in turn for shareholders. The monitoring performed by the Board of Directors ensure an adequate evaluation of managerial conduct and impede the occurrence of shareholder value destroying actions. In presence of a proper control, the incentive that managers have in expropriating firm's resources drops since the probability that their malfeasances would be discovered increases. In this situation, the management team would be replaced, an event that it is highly undesirable for managers. Furthermore, an impartial and objective control performed by the Board of Directors is necessary to ensure minority shareholders that their returns would not be diminished by the presence of a controlling shareholder. The

award of rights to shareholders increase their ability to participate in the fate of the company, thus allowing them to protect themselves from objectionable outcomes. The ex-post monitoring performed by external auditors certifies the truthfulness of the company's financial disclosure, informing investors about the financial conditions of the firm. All these instruments work together to ensure that the firm's operations are oriented towards shareholder-value creation, by focusing on profitability.

In this work, I argue that better governed firms are more profitable than worse governed firms are. In previous chapters, I described how corporate governance instruments work differently contingently upon the ownership structure of the firm (precisely, concentrated ownership affect negatively the probability that managers undertake value destroying projects for their own sake, but can still result in reduced profitability if the controlling shareholder and minority shareholders have different objectives).

When the ownership of a company is dispersed, the basic conflict that can arise is between powerful managers and weak shareholders. Shareholders need instruments to control managerial conduct. Executive compensation plans, board monitoring and shareholder rights work to ensure shareholders against the misbehavior of the people who are in charge of controlling their resources, thus reducing the agency costs which stems from the division of ownership and control. This conflict is likely to happen in outsider system countries (in my sample, US).

On the other hand, the concentration of the voting power in the hands of a strong shareholder diminish sensibly the need for a managerial monitoring device, since the blockholder is able to internalize the costs associated with management's monitoring. In spite of that, this situation can still turn out to be negative for minorities since the controlling shareholder can rely on the power that derives from control to increase its welfare at the expense of minority shareholders. In this scenario, the Board of Directors act as an uphold body for small shareholders, and shareholder rights provide minorities with an instrument to express their will against the blockholder. Agency costs arise from the relationship between large and small shareholders: small shareholders demand the

responsibility of deploying their resources to the blockholder (who has control of the company), who have the incentive of focusing on his own welfare rather than sharing the benefits of control with minorities. The expropriation of small shareholders by a controlling shareholder is likely to happen in insider countries, since they are characterized by concentrated ownership (in the sample, insider systems are represented by Italy and Hong Kong).

In light of that, I establish the linkages between corporate governance and performance. Shleifer and Vishny (1997) and Jensen and Meckling (1986) stated that an effective corporate governance system is able to impede the waste of capital that is associated with managerial or blockholder expropriation, and increase the firm's efficiency by inducing the firm's leadership to undertake projects with positive net present value. Moreover, an effective corporate governance optimizes the cost of monitoring bear by investors (Agency Costs) (Jensen and Meckling 1976) and reduces the risk that value-destroying operations are undertaken: as a consequence, the establishment of a compelling corporate governance is associated with lower cost of capital (Lei 2007).

In the empirical analysis, I will investigate whether these performance-enhancing factors are sufficient to explain different performance levels of firms characterized by different corporate governance effectiveness.

In light of what affirmed previously in this work, I developed the following hypotheses:

*H1: the quality of firm-specific corporate governance practices is positively related with firm's operating performance.*

This general hypothesis is tested using the overall score received by each company as a proxy for the quality of corporate governance practices. The availability of the four sub-scores allows to investigate the impact of each of them individually on firm's performance. All the governance "pillars" on which Quickscore is based participate to the overall quality of a firm's corporate governance system. In the theoretical framework of this thesis are explained the reasons according to which each corporate governance

device contributes to the avoidance of capital waste and to incentivize managers to engage in value-creating operations. Hence, I developed a set of four sub-hypotheses that relates to each of the four sub-areas.

H1.1: *the quality of firm-specific board structure is positively related with firm's operating performance.*

H1.2: *the quality of firm-specific executive compensation plans is positively related with firm's operating performance.*

H1.3: *the quality of firm-specific shareholder rights' practices is positively related with firm's operating performance.*

H1.4: *the quality of firm-specific audit practices is positively related with firm's operating performance.*

## **CHAPTER V: EMPIRICAL ANALYSIS**

### **Data And Methodology Description**

The impact of corporate governance of performance is appraised by analyzing the relationship between firm specific corporate governance practices and its operating performance.

The research is based upon a set of scores that rates the company's governance risk. Governance risk scores can be used as a proxy for governance quality, since we can meaningfully assume that there exists a robust negative correlation between governance risk and governance quality. In turn, an effective corporate governance system should mitigate the agency problem existing within the corporation, minimizing investment inefficiencies. As a consequence, effectiveness of corporate governance should affect firm performance. I measured firm performance and governance effectiveness, and analyzed the potential existence of a relation between the two variables.

Corporate governance has been assessed using an index which aggregates and evaluates the corporate governance provisions of each firm. The employment of a scoring system to appraise corporate governance is not news in the research landscape. The often-cited Gompers, Ishii and Metrick (2001) constructed a "Corporate Governance Index" to proxy for the level of shareholder rights in 1500 firms during the 1990s and investigate their impact on performance using data of the Institutional Responsibility Research Center (IRRC). This index included 24 measures. Brown and Caylor (2004) employed a dataset provided by Institutional Shareholder Services to create Gov-score, a composite measure of 51 factors encompassing eight corporate governance categories. Using the index, they demonstrated that better-governed firms are relatively more profitable, more valuable and paid out more to their shareholders. Epps and Cereola (2008) took the same approach of this work by studying the relationship between the ISS' corporate governance rating and actual firm's performance, but found no statistical evidence that the ratings reflect firm's

operating performance, measured with ROA and ROE. However, they measured corporate governance using the aggregate Corporate Governance Quotient (CGQ), which is a cumulative and synthetic expression of all corporate governance's criteria. Instead, in this thesis, I study the relationship between four scores awarded to each corporate governance sub-part and the performance proxies, as well as between the overall score, which is obtained aggregating the four sub-scores, and performance.

## Sample Description

For the scope of the research, I have employed a set of corporate governance ratings and performance proxies referring to 650 listed companies from Italy, United States and Hong Kong stock exchanges. Governance risk has been evaluated on a yearly basis, and the data covers a three-year timeframe spanning from 2013 to 2015. Specifically, the dataset comprises ratings for:

- 21 companies listed in Italy, 38 companies listed in Hong Kong and 498 companies listed in US for the year 2013;
- 27 companies listed in Italy, 38 companies listed in Hong Kong and 498 companies listed in US for the year 2014;
- 88 companies listed in Italy, 38 companies listed in Hong Kong and 489 companies listed in US for the year 2015.
- 

Regions	Years				
	2013	2014	2015	Total	
	Hong Kong	38	38	38	114
	Italy	21	27	88	136
	US	498	498	489	1485
	Total	557	563	615	

Before describing the statistical model, I provide a description of the evaluation tool employed for scoring corporate governance, namely Quickscore.

### **Corporate Governance Evaluation Tool: ISS' Quickscore:**

Our understanding of the relationship between corporate governance practices and firm performance necessitates a definition of the criteria according to which the two elements are evaluated. In order to assess the “goodness” of firm-specific corporate governance systems, I relied on the assessment of the mechanisms put in place at a company level to reduce the agency problems and the conflict that may arise within companies as a consequence of the division of powers. To this end, I employed a grading instrument called Quickscore.

ISS Governance Quickscore is an evaluating tool developed by Institutional Shareholder Services, the global leader firm in the proxy advisory industry. The score that is attributed to every individual firm is aimed at providing to institutional investors a synthetic evaluation tool, which embed comprehensive data and quality scores to identify governance risk and support investor's decisions. Quickscore delivers a snapshot of management quality and governance risk. In other words, Quickscore is a factor-level data supported instrument which provides a meaningful insight about every firms' governance quality. Quickscore helps investing funds to assess governance practices and compliance in their risk mitigation analysis. Quickscore ordinales firms according to the quality of the governance measures put in place. To do so, it uses a numeric decile-based score that indicates a company governance risk relative to the other companies listed in the same stock exchange. A score of one means relative lower governance risk (and so better quality of corporate governance), whereas a score of ten indicates relatively high governance risk (and consequently the presence of poor governance).

Quickscore does not necessarily assigns firms different values to respect the decile-based form. If a group of companies performs equally in terms of shareholder rights, for example, and they all respect the legal and best-practice provisions, they will all be awarded with a score of 1, even if they represent more than the 10% of the total number of companies in the market. The mean of the scores differs from 5.5, as one would expect



from a decile-based evaluation tool. This is because the objective of Quickscore is to provide a snapshot of the potential differences that exist among firms: if those discrepancies are non-existent, Quickscore assigns the same score.

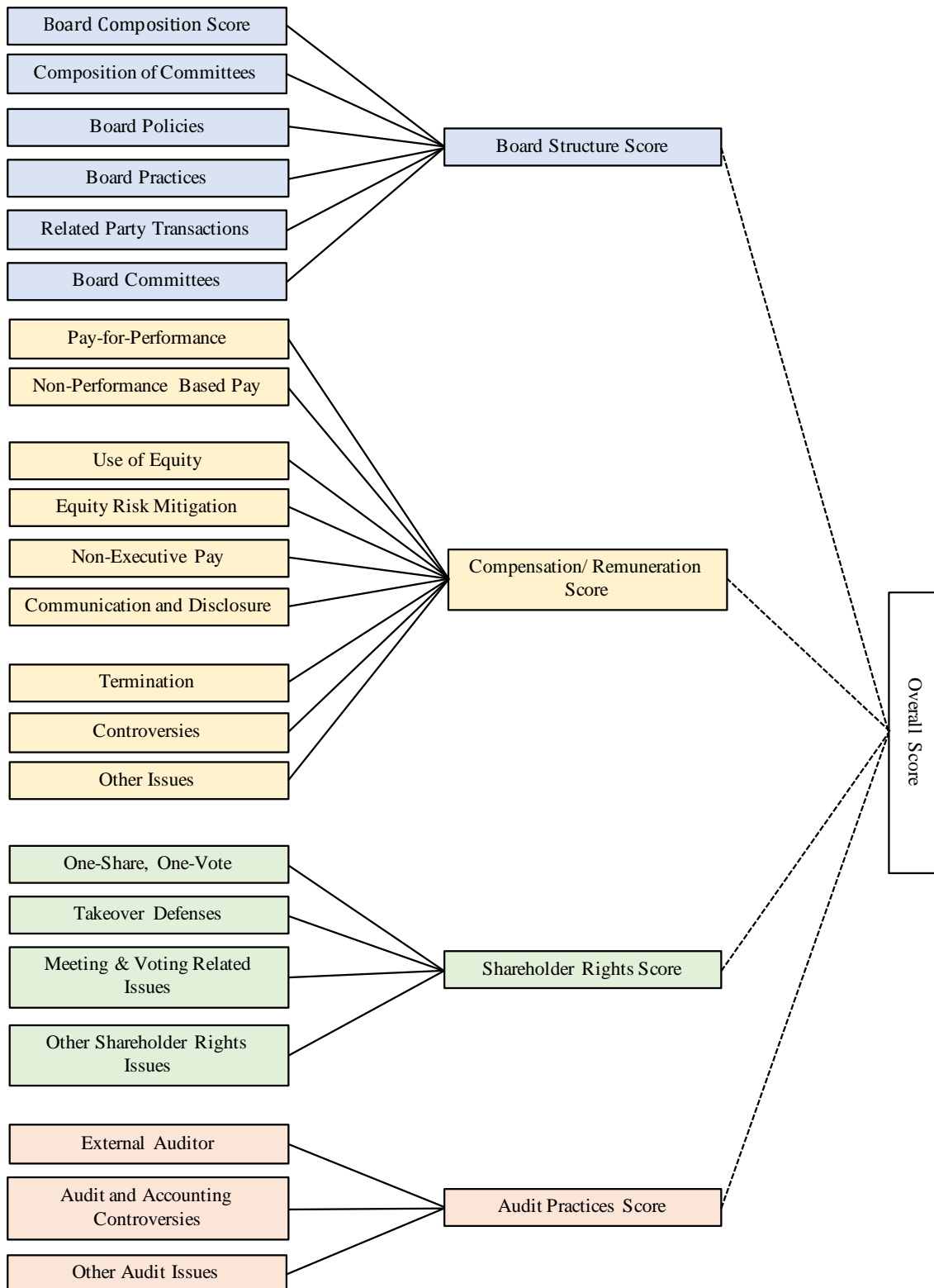
The relative nature of Quickscore, which ordinales firms based on a combination of governance practices, instead of evaluating them on an absolute basis, is useful to investors because it allows them to compare firms, although the comparability is granted only among companies that are listed in the same stock exchange. The individual factor breakdown takes a regional approach in evaluating and scoring companies, to allow for company-level comparisons within markets where corporate governance practices are similar. The regionalized scoring approach is tailored to local governance dynamics, with attention paid to best practices identified for that region.

The cross comparability of governance would be only possible taking into account the average quality of governance structures in the environment of reference. Developed markets are characterized by far stricter governance rules to which market participants have to comply, and, on average, the quality of governance systems is much higher in those regions. According to a joint study by ACCA Singapore and KPMG Singapore reveals a wide divergence between Corporate Governance requirements of different countries. Among the top ten highest scoring markets in terms of corporate governance requirements clarity, degree of enforceability and number of instruments used, six are developed economies. These results indicate that the maturity of the economy and capital markets influences, to some extent, the need for well-defined corporate governance requirements. In this sense, advanced governance systems are both cause and consequence of the high level of development of these economies: the good functioning of markets would not be possible without refined governance practices and legal requirements that protects investors and build confidence in the market. According to that, the best Quickscore performer of an emerging economy, belonging to the first decile, would easily be characterized by poorer governance with respect to an average performer of an advanced economy. Quickscore comparability is only granted within the market of reference, and not across markets.

The overall score received by a company is the result of the aggregation of four sub-scores attributed to different pillars of governance: board structure, compensation/remuneration of managers and directors with strategic responsibilities, shareholder rights, and audit and risk oversight. Each element is evaluated according to ISS own policies and global best practices. The factors embedded and synthesized by the index are nearly 200, and vary across countries and regions. Each pillar is evaluated taking into consideration different elements that affect its “quality” and could be relevant for shareholders. Therefore, the board structure score embeds the evaluation of each company’s board compensation, committee’s composition, board practices, board policies and related party transactions. The compensation practices are assessed by focusing on pay for performance, non-performance based pay, use of equity, equity risk mitigation, non-executive pay, communication and disclosure, termination and controversies. Shareholder rights are evaluated according to the application of the one-share, one-vote principle, takeover defenses, voting issues and formalities, and other shareholder right issues. The audit practices are assessed using criteria related to external auditors, accounting controversies and other minor audit issues. The appraisal of all these elements is conducted under a regionalized approach, which considers local government dynamics and different legal systems requirements.

The graph below summarizes the criteria according to which corporate governance is graded.

Quickscore Evaluation Criteria:



As Quickscore embeds governance practices assessments, and governance should serve to protect investors ensuring a shareholder oriented management, we can say that the lower the score reached by a company, the more its governance risk would be low, and the interests of managers aligned with those of shareholders. Quickscore is a simple though complete method of governance practices' evaluation, and could be used to investigate about the relation between governance and firm's performance (Epps and Cereola 2008). If we look beyond the grades and evaluations that compose the index, we can say that Quickscore is a good proxy for the quality of governance. Borrowing from the definition proposed by Shleifer and Vishny (1997), corporate governance is "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment", a company which performs well in Quickscore should have taken the necessary measures to align the interests of principal and agent, so to encourage the managers to act in favor of shareholders, putting aside their individual desires and hubris, thus avoiding waste of resources.

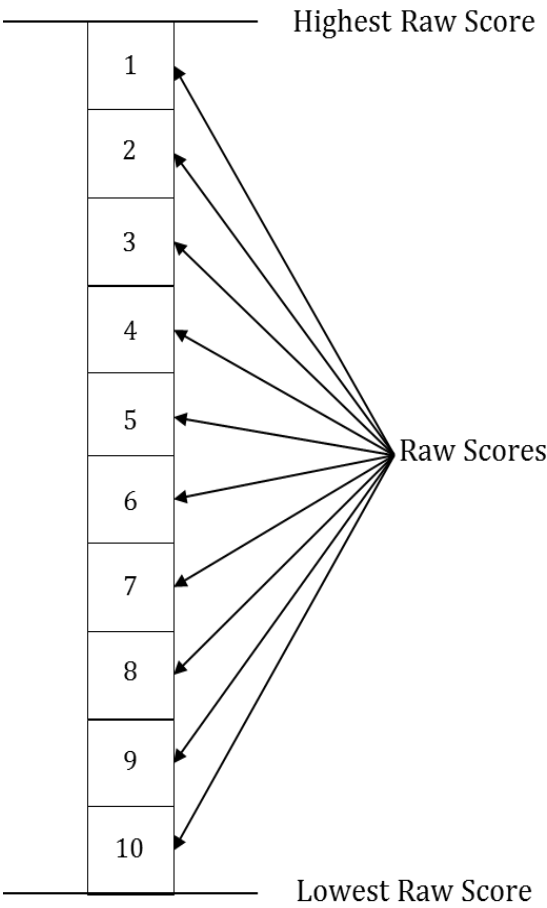
### **Evaluation Process**

The evaluation process begins with a series of corporate governance-related questions that have to be answered according to firm-specific practices. A positive response awards the company with a positive score which increases the company's grade, while negative answers cause the score to decrease. As such, all the answers, which map the company-specific corporate governance practices, are mirrored into a raw score which is awarded to every company. Subsequently, the Quickscore evaluation process continues with the normalization of the raw scores. The highest raw score received by a company in the market and in the year of reference is normalized into a score corresponding to 1. The lowest score (which can be negative) corresponds to a normalized score of 10. Then, the numerical raw score difference is divided into 10 slots. The raw scores are then transformed into a score spanning from one to 10 according to the range in which they fall. According to that, it is more precise to say that Quickscore evaluates the differences

existing in corporate practices within a given environment rather than the corporate practices itself.

For the sake of clarity, I now provide an example of the evaluation process.

Let us suppose that in a given market, in a given year, the company that performs better according to questions posed by Quickscore reaches a raw score of 120. The lowest raw score is -40. The difference between the high and the low is 160. The difference is divided into ten ranges which covers 16 raw score points each. Then, the firms which have been graded from -40 to -25 receive a score of 10, the ones awarded with a raw score between -24 and -9 receive a score of 9, the ones awarded with a raw score between -8 and 7 receive a score of 8, and so on.



**Governance Pillars and Evaluation Criteria**

Quickscore divides its governance evaluation into four subcategories, to which is awarded an individual rating. The four “pillars” represent different aspects of governance systems are graded separately, and the scores received by each pillar are then aggregated to form the overall score received by a company.

**I. Board Structure**

The board structure is the first “pillar” of the Quickscore evaluation method. There are several aspects of the Board of Directors that are assessed in order to identify potential

sources of governance risk. The criteria according to which a parameter is considered acceptable or not are established following the prescriptions of legal systems of reference and global best practices.

The six aspects that are evaluated in order to grade the board structure are:

1. *Board composition*
2. *Composition of committees*
3. *Board practices*
4. *Board policies*
5. *Related party transactions*
6. *Board controversies*

For a Board of Directors to have an adequate structure, several requirements have to be respected. All of them are posed in order to allow it to undertake effectively its monitoring and ratifying role. The board structure must be designed to enhance the board's decision-making efficiency and to hinder the risk that relationships with the company could prevent the directors to undertake their controlling role fairly.

#### *1. Board Composition*

The first element that is assessed is the composition of the board. The criteria are, among others, board size, percentage of women on the board, percentage of independent director, director's tenure, independency of the chairman, and presence of a Lead Independent Director (LID: whose role is to coordinate the activities of independent directors and to mediate between them and non-independent ones (Self-Discipline Code of Italy Stock Exchange)). The size of the board must be set in order to pursue decision-making efficiency and avoid intricate criticalities. The proportion of women among directors is evaluated as gender diversity is considered as a performance-enhancing element when assessing boards. More in general, board diversity is deemed to be a crucial element to evaluate, since research demonstrates that increased diversity is associated with better firm's performance (Carter, Simkins and Simpson 2003). Granting a proper level of board independence is paramount to ensure an unbiased and autonomous judgment of the

company's strategy and performance. The presence of ties with the company may weaken the directors will and ability to control management actions effectively. Moreover, an adequate proportion on board independence may prevent the arise of potential conflict of interest within the board.

The Board of Directors is in charge for the monitoring of management's actions, and so its responsibility in granting adequacy to the governance system is preeminent. The governance risks associated with Board of Directors' poor functioning could be mitigated respecting these set of prerequisites. As we stated times before, management's actions are taken in a condition of uncertainty, and so poor performance can occur even if the Board of Directors perform a compelling monitoring. Nonetheless, the enforcement of controls disincentives the managers to act selfishly, and knowing that they actions are subject to a strict monitoring might lead to better decisions. Thus, the Board of Directors harmonize the manager-shareholder conflicts arising from the division of powers by performing a strict supervision on managers' behavior and by punishing shareholder-value destroying conducts. The monitor role of the Board of Directors is strictly tied to its power to compensate managers. In fact, managers are compensated according to their performance, that is measured according to the criteria that are relevant for shareholders. Consequently, the level of remuneration awarded to managers corresponds to the level of their performance. Since remuneration's amount needs to be evaluated according to performance, compensation and evaluation are closely interdependent.

## *2. Composition of Committees*

Another point of view under which board of director structure is evaluated is the composition of committees. In the great majority of law jurisdictions regulations call for the existence of committees within the Board of Directors. These are formed by the directors themselves, and each of them is assigned of a specific task. Usually, directors establish three committees: the nominating committee, the remuneration committee and the audit committee. The first one is responsible for developing a clear policy for what concerns the size and the composition of the boards, as well as for identifying and approving nominees for vacant director's positions. The compensation committee makes recommendations and set guidelines which help to design the executives compensation

plans. Since this committee holds a significant power over the executives' pay, global best practices indicates that it should be composed entirely by independent directors, according to each law systems criteria, to avoid conflict of interest. The last one, the audit committee, is charged for the formal oversight of financial reporting and disclosure, as well as for checking the validity of the internal controls and risk management systems and for the compliance to regulations. Its responsibility is to ensure shareholders and stakeholders regarding the truthfulness, validity and accuracy of the financial information of the company that are spread across the economic system and which serve to agents to evaluate and take investment decisions. To do so, it revises the financial statements and selects the external auditor who is in charge for independent audit. Moreover, it oversees over the Board of Directors' activities, ensuring that its governance role is fulfilled effectively. Analogously to the compensation committee, audit committee's members must be necessarily independent, to safeguard the judgment impartiality which is paramount for the audit task. The existence of these three committees within the board foster efficiency by dividing tasks and responsibilities, and provide additional protection and warranties to shareholders regarding the effective fulfillment of the monitoring role of the Board of Directors. According to that, the composition of committees is appraised by firstly acknowledging the presence of such committees, and then by controlling the presence of executives sitting in any of them, which can nullify its efforts due to the arising of potential conflict of interest. Then, the level of independence of committees' members is assessed.

### *3. Board practices*

Following to the considerations related to committees, Quickscore evaluates the board structure by assessing the board practices and policies. Board practices embeds the total number of outside board memberships held by each directors and the attendance rate of board meetings. The number of outside boards is taken into account considering that an excessive board membership number reduces the time that each director can devote to the fulfillment of its role for each company, thus weakening the effectiveness of the board. The attendance rate is considered for the same reason: for obvious reasons, poor



attendance to board meetings is considered to be harmful for the performance of the board. Within the evaluation of board practices, also the remuneration of directors is appraised relatively to the one of their peers, to check that it is aligned with market practice.

#### *4. Board Policies*

Board policies deal with the presence of self-evaluation projects of Board of Directors, a practice that is considered positive for the board itself, and with the existence of stock ownership guidelines referred to directors.

#### *5. Related Party Transactions*

Related-party transactions refer to business deals between two parties who are joined by a special relationship prior to the transaction. In the corporate governance field, it deals with the mechanisms of approval by the Board of Directors, which have as an object the transactions between the company and another party who holds any interest in the company. Related-party transactions can lead to conflicts of interest that may compromise independence, particularly in instances where participation or ties to transactions are not fully disclosed (Quickscore Methodology 3.0).

#### *6. Board Controversies*

Finally, “board controversies” evaluation is aimed at measuring the responsiveness of the board to shareholder resolutions, and to ensuring that the board is not undertaking any action that could be harmful for shareholder rights.

## **II. Compensation**

Executive compensation is the second pillar approached by Quickscore to identify and measure governance risk within an organization. Quickscore considers the evaluation of the compensation pillar as the aggregation of nine compensation sub-aspects grades. The aspects that are assessed in order to evaluate the compensation are:

### *1. Pay-for-performance*

2. *Non-performance based pay*
3. *Use of equity*
4. *Equity risk mitigation*
5. *Non-executive pay*
6. *Communications and disclosure*
7. *Termination*
8. *Controversies*
9. *Other issues*

The adherence to this set of guidelines in designing executive pay mitigates the agency problem inherent in the managers-shareholders relationship, inducing managers to focus on shareholders' wealth maximization.

#### *1. Pay for performance*

Pay for performance is the mechanism by which managers are rewarded with a pay that is quantified according to the achievement of some predetermined objectives and is set taking into account performance criteria. The amount received by executives is in this way related to their performance and, in turn, to the corporation's one. The evaluation method considers the existence of a cap over the variable pay as desirable for the organization and for its shareholder, defined as a multiple of the base pay. Another important facet that has to be contemplated is the level of deferral of compensation. According to Institutional Shareholder Service voting guidelines, "Deferred compensation is used by companies to reduce long-term risk and better align executive compensation with company performance over the long term. Holdbacks or deferrals on compensation are recommended best practice in many markets, particularly in the wake of the financial crisis and the sharpened focus on tying pay to long-term company performance" (Quickscore methodology 3.0.). Eventually, pay for performance is evaluated comparing past executives' remuneration with those of market peers, to check the existence of congruency between the pay opportunity that is delivered to company's executives with that of shareholders, relatively to market peers.

## *2. Non-performance based pay*

Quickscore takes into account also the remuneration that is not connected to performance. Executives receive a compensation which is not completely variable, and is composed of a fixed part which is paid independently from their results. Quickscore evaluates the ratio between fixed and variable compensation to in order to maintain the bonding role of pay. If the variable part of the salary is a small fraction of the fixed salary, the bonding role of executive pay is largely compromised. The evaluation method considers also other cash flows untied to performance that could be granted to the management, like rewards in terms of privileged access to loans or on-off payments, which are discretionary payments that could be granted for a range of various reasons.

## *3. Use of Equity*

After having assessed the quality of non-performance pay provisions, Quickscore evaluates the compensation plans' components which involve the use of equity as a reward for managerial system. Executives are rewarded with company's shares or options in return for their services, thus making themselves shareholders. For this reason, use of equity entails a strong linkage between pay and performance, since the value of the stocks awarded to managers is contingent upon the company's performance. Quickscore appraises the presence of such equity-based plan, then if the plans include prohibition of share recycling, options repricing and option cash buyouts. Speaking generally, the tool rates all the provisions including use of equity using as criteria the compliance to regulations and international best practices.

## *4. Equity Risk Mitigation*

"Equity risk mitigation" involves the control of all the provisions that ensure shareholders about the effectiveness of equity plans. The presence of claw back provision is checked (claw back ensure that the real pay is not given for fictitious performance, referring to the opportunity given to the company to recoup bonuses or other incentive compensation at the occurrence of fraud or errors in the determination of results), along with the vesting period compliance with minimum requirements (the vesting period is the timeframe existing between the moment in which the executive is granted with the right to be

awarded with shares or option and the moment in which he or she is able to actually exercise the right). Quickscore considers also the existence of clauses regarding the mandatory shares' holding period for managers.

#### *5. Non-Executive Pay*

Quickscore takes into account also the salary awarded to non-executive directors, by appraising the presence of equity-based compensation plans for non-executives or any other form of performance-based pay and the existence of loans granted to directors by the company. These evaluations are aimed at ensuring that the remuneration paid to directors is not excessively high if compared to market peers.

#### *6. Communication and disclosure*

Another important facet dealing with compensation is the disclosure and communication of the remuneration received and the details of the plans. Disclosing relevant information regarding such matters is central to build shareholder confidence, since any ambiguity could result in the emergence of suspects and doubts regarding the applied governance practices. Poor disclosure lead governance risk to increase dramatically, since investors and shareholders do not know which are the compensation plans that are being applied and so there is no opportunity to evaluate their effectiveness.

#### *7. Termination*

Termination and severance payments refer to the compensation received by a director when he or she part ways with the company and they are usually conceded at the occurrence of specific events. These packages are evaluated to check their congruence with market levels and to prevent the payment of inadequate amounts which would eventually result in diminished resource availability for the company.

#### *8. Controversies*

Under “controversies” Quickscore will evaluate whether there is a significant misalignment in pay for performance that has been identified according to qualitative criteria. ISS' qualitative analysis of executive compensation identifies pay practices and

design features that may strengthen or weaken the linkage between executive pay and company performance. Features and practices to be examined in ISS' qualitative analysis may include (but are not limited to): the rigor of performance conditions on incentive plans, the proportion of performance-based equity pay, whether termination provisions may enable "pay for failure," the presence of retention or other discretionary awards, "realizable" pay relative to granted pay, and other features of the pay design as deemed appropriate to the company's specific circumstances.

### **III. Shareholder Rights & Takeover Defenses**

Corporate laws grant shareholders with the power to have a say about the company's management, descending from their owners' role.

Whereas Board of Directors and executives' compensation are argued to be the two predominant elements of corporate governance, shareholder rights protection and takeover defenses also plays a crucial role in sheltering owners from unwanted events.

The elements that judged in order to evaluate the third pillar of governance, as considered by Quickscore, are:

1. *One-vote, one-share*
2. *Takeover defenses*
3. *Meeting & voting related issues*
4. *Other shareholder right issues*

#### *1. One-vote, one-share*

Firstly, Quickscore address the existence of specific classes of shares which awards the holders with multiple voting rights. They are deemed to be damaging, since they can serve to entrench shareholders or managers, insulating them from external influences or actions. The objectives of shareholders who can exercise a disproportioned influence through multiple voting rights can be different from those of shareholders who own the majority of shares. The issuance of stocks with multiple voting rights can reshape the controlling

structure of the company, causing a deviation from the proportionality between ownership and influence. Since shareholders are exposed to the risk of the company's operations, their voting power should be commensurate with their investment. Stockholders who own larger stakes in a company are more exposed to the related uncertainty, and so have to be compensated with a proportional larger voting power. Dual class stocks can cause deviation from this proportionality. Additionally, "research suggests that companies with dual-class capital structures or other antitakeover mechanisms often trade at a discount to similar companies without such structures" (Quickscore Methodology 3.0). For the same scope, the existence of non-voting shares is checked. In the case in which such dual class stocks are participating to the capital structure, the percentage of capital that they represent is taken into account, to measure the magnitude of the disproportionality between risk-bearing and voting power.

## *2. Takeover Defenses*

"Takeover defenses include all actions by managers to resist having their firms acquired. Attempts by target managers to defeat outstanding takeover proposals are overt forms of takeover defenses. Resistance also includes actions that occur before a takeover offer is made which make the firm more difficult to acquire" (Ruback 1987). Among takeover defense practices we can include targeted stock placement, preemptive rights granted at the occurrence of a takeover bid, share repurchase plans, some specific ownership factors (e.g. ownership ceilings), shareholder's priority rights and poison pills (strategy which makes the company's own stocks less attractive for the acquiring firm, in this way discouraging hostile takeovers. This may include agreements to sell target's company shares to shareholders at a discount, as well as agreements to sell acquirer's shares at a discounted rate following to a merger). All of these practices enables mechanisms that can prevent hostile takeovers. Quickscore evaluates the likely presence of takeover defenses in assessing company's governance practices. This is because takeover defenses make acquisitions much costlier for the acquirer, thus insulating the target's managers from the discipline of the market for corporate control (Casares Field and Karpoff 2002). The market for corporate control, where corporate control is defined as the power to control the majority of the seats in a company's Board of Directors (Jensen and Ruback

1983), acts in a complementary manner with regard to corporate governance. In fact, while corporate governance disciplines executives through an internal system of monitoring and bonding, external market forces intervene through the possibility for the managers of being replaced following to a shift in corporate control. If a potential acquirer thinks a company in being managed poorly, and that consequently it is not expressing its entire potential, it might have an incentive to acquire the control of the company, so to replace its management and extracting the gains that the company it is not realizing due to poor management. The market for corporate control is thus an important disciplining mechanisms for executives, and takeover defenses may weaken it by making acquisition costlier for the acquirer, and hence discourage him.

Under this perspective, takeover defenses are damaging for shareholder welfare, since they can maintain in charge executives who would have been replaced if they takeover defenses were absent. Given their potential shareholder welfare-diminishing role, Quickscore appraise the existence of takeover defenses and their fortitude.

### *3. Meeting And Voting Related Issues*

Under the shareholders' rights and takeover defenses pillar, Quickscore addresses also the Meeting & Voting related issues in order to evaluate the shareholders' meetings practices and rules. Shareholders meetings allow shareholder to express themselves directly without mediation. They are the only situation in which the decision-making power is not demanded to managers, and so the effectiveness of their mechanisms must be insured and appraised.

Among others, Quickscore assesses the majorities and quorums that are needed to approve management proposals, the restrictions that might be posed to call a meeting regarding timing, topics or ownership levels, as well as the presence of procedures to allow shareholders to vote by proxy and the disclosure of meeting materials. The requirements of a supermajority to approve specific matters of primary importance, such as amendments to the company's bylaws or mergers, is evaluated contingently to the ownership structure of the company. In fact, supermajority provisions violate the tenet according to which a simple majority should be sufficient to effect change regarding a company and its corporate governance system. Requiring more than a simple majority

can allow management to entrench itself by blocking amendments that are in best interest of shareholders. However, for companies that are controlled by a shareholder owning the majority of the stakes, supermajority provisions can be favorable to minority shareholders since they can prevent the controlling shareholder to unilaterally force a resolution despite the opposition of minority shareholders.

#### *4. Other Shareholder Rights Issues*

As a last evaluation factor, Quickscore considers the existence related-party transactions with significant shareholders and the characteristics of the mandate awarded to management to issue shares, under “other shareholder rights issues”. Related-party transactions with significant shareholders can, according to ISS, “represent guaranteed business which can help to justify significant investments, but can also “crowd out” transactions with unrelated parties which may be more profitable for the company”. The characteristics of the mandate to issue shares are evaluated according to the dilution limit and to the discount limit that can be set in the authorization approved by shareholders in the general meeting.

### **IV. Audit Practices**

Under this pillar, Quickscore grades the audit practices established by a company. Quickscore subdivides the audit practices into three sub-groups of elements that are evaluated separately:

1. *External Auditor*
2. *Audit And Accounting Controversies*
3. *Other Audit Issues*

External audit is an additional safeguard provision aimed at ensuring investors about the validity of the financial information disclosed by the company. Aside from internal controls, performed by audit committees and internal supervisory authorities, external auditing is mandated by law and provides an independent and autonomous judgment over the company’s financial statements, by being performed by subjects free from any tie



with the company. External auditors inspect financial statements and certify their truthfulness and coherency. According to that, granting their independence is paramount to ensure their impartiality and objectivity

### *1. External Auditors*

Quickscore then approached to external auditing by evaluating the elements that could weaken the independence of external auditors. In fact, the practice of auditors providing non-audit services to companies can prove problematic. Larger companies providing external audit services may have effective internal barriers that protect the independence of their judgment preventing conflict of interest to arise. Nonetheless, when the majority of fees paid to the company is in return for non-audit services, such as management consulting, the ability of the auditor to remain impartial is questionable at best. Consequently, Quickscore assess whether non-audit fees constitute the majority of the fees paid by the company to the auditor, since in that circumstance risks stemming from lack of independence can emerge.

Quickscore checks also the existence of an adverse opinion of the external auditor regarding the soundness of financial statements in past years.

### *2. Audit And Accounting Controversies*

Under “Audit and accounting controversies”, the evaluation tool considers the presence of misrepresentations or accounting irregularities regarding the past financial statements of the company. To do so, Quickscore assess whether the company has restated its financial statements in past years, if it has disclosed financial information untimely, if it has shown material weaknesses in internal controls, or if the regulator has taken an enforcement action against the company in past years. The presence of these weaknesses can pose risks to shareholders and stakeholder, since they can result in reputational, financial or legal risks for the company.

### *3. Other Audit Issues*

Eventually, Quickscore evaluates the existence of other kinds of shareholder safeguards, such as the presence of financial experts sitting on the audit committee who can provide

the company with the expertise necessary to avoid financial misrepresentations or irregularities.

The “audit practices” pillar measurement is addressed differently from the others: it is not graded according to a decimal system but rather the existence of audit-related troubles in the past corresponds to a score of 10, whereas the complete absence of issues is scored as 1. Therefore, this sub-area companies’ performance is not ordered in deciles. In our model, we transformed the scores awarded to companies in dummy variables, which value is either 0, if the score is 1, or 1, if the score is 10.

The statistical characteristics of the sample are displayed in the appendix of the dissertation (p. 108).

## **Performance Proxies**

The statistical investigation of the impact of corporate governance on performance requires the definition of some observable aspects, which provide the basis for an objective evaluation of firm’s performance. In the following paragraphs, I describe briefly the performance indices that are used to proxy firm’s operating performance.

### **Return on Assets:**

ROA is one of the most used measures of firms’ operating performance (Klapper and Love 2004; Core, Holthausen and Larcker 1999). The value is obtained calculating the ratio of the income pertaining to a given fiscal period and the value of the total assets employed by the company in the same period. Since the company’s assets are under management’s control, the ROA indicates to investors the return that managers were able to achieve relatively to the assets they had available, and so how efficient they were in employing the firm’s resources.

### **Return on Equity:**

ROE represents the net income of a firm as a percentage of shareholders' equity. The index is one of the most well-known measures of profitability and it has been employed largely by scholars to investigate the relationship between performance and corporate governance (Gompers, Ishii and Metrick 2003, Baysinger and Butler 1985), since it shows how much profit a company has generated relatively to the capital invested by its owners. It is calculated dividing the net income relative to a fiscal period by the amount of equity of the firm in the same period. Companies showing a positive ROE are creating wealth for its shareholders, whereas a negative ROE implies shareholders' wealth destruction. Hence, ROE is often used a proxy for firm's performance under a shareholder's viewpoint and measures how effectively managers are employing the capital that shareholders entrust to them.

### **Tobin's Q:**

Like the two previous performance measures, Tobin's Q is one of the most used indicators in the academic world for what concerns the measurement of the impact of corporate governance on performance (Gompers, Ishii and Metrick 2001; Yermack 1996; Bahgat and Bolton 2008). It was introduced at the end of the 1960s by James Tobin and William Brainard (1968). The value is obtained from a ratio: the factor at the numerator is the market valuation (the price for exchanging the firm's assets in the market); at the denominator lies the replacement cost of the same assets, namely the price that would be paid by the firm to buy newly produced assets. The index reflects the difference between the market value and the accounting value of the firm: the discrepancies between the two (that cause the Q to fluctuate around the value 1) are caused by the market expectations about the company and by the unmeasured assets that contribute to the firm's valuation but are not recorded by accountants, e.g. intellectual capital and knowledge. In this work, we can assume that corporate governance is a valuable element which brings value to a firm, but as it is not acknowledged in the bookkeeping, it should create a gap between market and accounting value of the firm. More precisely, corporate governance

mechanisms decrease the governance risk of a company, and so, *ceteris paribus*, firms with a relatively better corporate governance should be valued more than the sum of the accounting value of their assets.

A description of the performance dataset's statistical characteristics is provided in the appendix of the thesis (p.108 ).

## **Model Specification**

The statistical models test whether there is a direct link between corporate governance effectiveness and firm's performance. As stated times before, an efficacious corporate governance system is able to mitigate the agency problem, thus reducing the waste of capital, diminishing risk, and providing incentives to focus on shareholders' wealth maximization. I will seek to determine if the performance-enhancing effect of corporate governance is so substantial to influence directly the corporate results.

To this end, I developed a set of statistical models, in which the dependent variables are the return on equity of company  $i$  in the year  $t$  ( $ROE_{it}$ ) the return on assets of company  $i$  on year  $t$  ( $ROA_{it}$ ), and the Tobin's  $Q$  of company  $i$  in year  $t$  ( $T\_Q_{it}$ ). The companies are grouped according to the region they belong, since the corporate governance scores are not comparable across countries. The independent variables that act as regressors are the company-specific scores achieved in each of the four sub-areas of corporate governance in the first set of equations, and the overall score in the second set.

In the models,  $BSS_{it}$  represents the score awarded to the company  $i$  regarding its Board Structure in year  $t$ ,  $SRS_{it}$  represents the score awarded to  $i$  regarding the Shareholder Rights in year  $t$ ,  $CS_{it}$  represents the score for the company  $i$ 's Compensation Practices in year  $t$ ,  $AS_{it}$  represents the score received for the company  $i$ 's Audit Practices in year  $t$ , and  $OS_{it}$  represents the overall score received by the company  $i$  in year  $t$ .

### **Relationship between Overall Score and Performance:**

The research is performed using two sets of models. The first three regression models include the three performance indicators as dependent variables, and the overall score received by each company as independent variable, i.e. regressor. According to that, the three equations are:

$$\text{MODEL 1.1: } ROE_{it} = \beta_0 + \beta_1 OS_{it} + \varepsilon$$

$$\text{MODEL 1.2: } ROA_{it} = \beta_0 + \beta_1 OS_{it} + \varepsilon$$

$$\text{MODEL 1.3: } T\_Q_{it} = \beta_0 + \beta_1 OS_{it} + \varepsilon$$

I regressed the dependent variables on the regressors using the Ordinary Least Squares method (OLS) and observed the resulting coefficients. The regression has been performed for each year and region separately. As such, the results will show coefficients related to each region included in the sample for each year.

The results of this regressions will expound the relationship between a firm's overall governance effectiveness and firm's performance.

### **Relationship between Corporate Governance Pillars and Performance**

The second set of models investigates the relationship between the performance indicators and the scores awarded to each company for each of the four corporate governance pillars. Again, the performance indicators are the dependent variables and the overall score is the regressor.

The three equations are:

$$\text{MODEL 2.1: } ROE_{it} = \beta_0 + \beta_1 BSS_{it} + \beta_2 SRS_{it} + \beta_3 CS_{it} + \beta_4 AS_{it} + \varepsilon$$

$$\text{MODEL 2.2: } ROA_{it} = \beta_0 + \beta_1 BSS_{it} + \beta_2 SRS_{it} + \beta_3 CS_{it} + \beta_4 AS_{it} + \varepsilon$$

$$\text{MODEL 2.3: } T\_Q_{it} = \beta_0 + \beta_1 BSS_{it} + \beta_2 SRS_{it} + \beta_3 CS_{it} + \beta_4 AS_{it} + \varepsilon$$

As before, I regressed the dependent variables on the regressors using the Ordinary Least Squares method (OLS) and observed the resulting coefficients.

This second set of models allows to understand the effect that each corporate governance sub-element has on profitability.

In the last chapter of this work, the findings of my analysis are described and conclusions are drawn.

## **RESULTS AND FINDINGS:**

The results of the statistical analysis I performed demonstrates that differences in corporate governance's overall scores mirror differences in performance, although in a very limited manner. The numerical outcomes of the statistical regressions are displayed in the appendix (p. 110).

### **Sample of Companies Listed in Hong Kong**

The analysis of the relationship between corporate governance overall score and performance of Hong Kong-based companies is mostly inconclusive. It shows that corporate governance practices affected significantly Tobin's Q, but limitedly to the year 2014 (Table 4c). The relationship is negative as hypothesized (the coefficient is -0.078) but the model shows a very low level of explanatory power, meaning that the model poorly predicts the correlation between the variables.

For what concerns the relationship between corporate governance pillars' scores and performance, the empirical analysis found no relationship among the variables for what concerns the Hong Kong sample. All the tested models have proved to be not significant, except for the one studying the relationship between compensation score and Tobin's Q for the year 2014 (Table 4f; positive correlation, with coefficient amounting to 0.12), which despite being significant is of very low explanatory power and not consistent across the three sampled years. The relationship between the variables in this sample is completely random and not explained by the model I developed.

The complete results of the regressions are displayed in tables 3, 4, and 5.

### **Sample of Companies Listed in Italy**

The Italian sample do not show any connection between overall score and performance. None of the tested models is significant.

However, the results of the second set of regressions (those studying governance sub-areas' scores and performance) show a strong and significant negative relationship between performance proxies and shareholders' rights score for the year 2015 (Tables 8d, 8e and 8f) as it was envisaged by the hypothesis. The relationship is negative because, since Quickscore is decile-based, 1 is awarded to best performers, and 10 to the worst ones. The resulting coefficients amount to, respectively, -0.56 for the model testing the relationship between ROA and governance sub-scores ( $R^2$  equal to 0.20), -2.09 for the model in which ROE is the independent variable ( $R^2$  equal to 0.18), and -0.07 for the model including Tobin's Q ( $R^2$  equal to 0.13).

This means that Italian firms that bestow strong rights to their owners are more profitable and more valuable than those which limit shareholder rights. The fact that the relationship holds only for the last year analyzed (2015), could be a consequence of the smallness of the sample for the other two years (for the years 2013 and 2014 the sample is composed, respectively, of 21 and 27 companies, increasing to 88 for the year 2015). Although the consistency of the results achieved for the year 2015 is not replicated in the other two years, the empirical analysis found a negative relationship between shareholder rights score and Tobin's Q for the year 2013 (Table 6f; coefficient amounting to -0.072) and a negative relationship between shareholder rights score and ROA for the year 2014 (Table 7d; coefficient of -0.03).

The complete results of the regressions are displayed in tables 6,7 and 8.

The frequency of each shareholder rights' score in the year 2015 is shown in the graph below. The x-axis reports the scores, spanning from 1 to 10. The y-axis refers to the number of firms awarded with each score.



Frequency of Shareholder Rights Scores in Italy, year 2015:



As we can see from the graph above, the majority of Italian firms are clustered in the first decile. This means that there is no relevant discrepancy regarding shareholder rights among these firms, and the best performer in terms of shareholder rights confer to shareholders similar rights with respect of the other firms in the same cluster. However, at the other extreme, we can see a cluster of firms in the lowest four deciles. The clustering is not homogeneous, as all firms are either very close to the best performer or to the worst performer. There are no firms in the middle between the two extreme points. My analysis shows that the firms belonging to the first decile performed better than the ones belonging to deciles 7, 8, 9 and 10.

My analysis report evidence that shareholder rights are an important factor in explaining the operating performance of Italian firms. In Italy the 83% of listed companies are controlled, either by a majority shareholder who owns more than 50% of the company's shares (116 companies out of 238), or by a shareholder who is able to exert a dominant

influence (51 cases) (Consob corporate governance yearly report, 2015). As we stated before, and in accordance with this data, Italy is an Insider System country. Blockholders are able to dominate the management, and the greater governance-related risk for shareholders is to be expropriated by larger stockholders. In the section dealing with cross-region corporate governance differences, I stated that the majority shareholder is able to monitor the management efficiently, in light of its large shareholding. Moreover, the controlling shareholder is able to gather information from the inside of the company, reducing substantially the information asymmetry which is inherent in any principal-agent relationship. However, despite the probability that shareholders' wealth is reduced by managerial misbehavior is diminished by the presence of the blockholder, the latter has the possibility to manage the firm's resources to increase its personal welfare at the expense of minority shareholders. Shareholder rights, which are conferred to all shareholders independently from the magnitude of the investments, provide minorities with a device to protect themselves from the blockholder's malfeasances. The result I achieved can be interpreted in this viewpoint: the award of strong rights to shareholders limit the ability of the majority shareholders to deploy the firm's assets for his own sake, in this way increasing the profitability of the firms. On the other hand, firms that limit shareholder rights may have their profitability lowered by the damaging conduct of the blockholder. If the controlling shareholder finds ways to employ the firm's assets which provides him with a personal gain that is larger than the loss he suffers from the drop of profitability, then he will have an advantage in influencing the management to pursue this objective. Minority shareholders will see their returns decrease as a consequence of this behavior. However, if minority shareholders are provided with instruments to express their will, then the probability that the resources would be deployed seeking for profit will increase. The conferment of shareholder rights mitigates the agency problem that exist between controlling and minority shareholders, thus boosting firm's performance. A reduction in shareholder rights causes an increase in agency costs through some combination of inefficient investment and reduced operational efficiency.

The results obtained from the Italian sample are coherent with those reached by Gompers, Ishii and Metrick (2001) and Bebchuk, Cohen and Ferrel (2004), which demonstrated the

existence of a positive correlation between the magnitude of shareholder rights and firm's operating performance for American firms. According to their findings, firms that award shareholders with strong rights are relatively more profitable and valuable. The result of my analysis agrees with this view, for what concerns Italian firms. In Italy, firms that confer a great deal of rights to their shareholders shows a higher level of profitability (reflected by the Return on Equity), a higher level of operating efficiency (represented by the Return on Assets). Furthermore, these firms are considered by the market as more valuable (Tobin's Q represents the firm's market valuation with respect to the accounting value of its assets).

### **Sample of Companies Listed in United States:**

For what concerns US-based companies, I found no relationship between the firms' overall score and ROA and ROE. However, the empirical analysis witnessed the presence of a significant relationship between the firms' overall score and Tobin's Q for all the three years analyzed. The evidence contrasts with the hypothesis, since the results show a positive relationship between the variables (Tables 9c, 10c and 11c; the three coefficients are, respectively, 0.083 for 2013, 0.070 for 2014 and 0.061 for 2015). The  $R^2$ , which determines the "goodness" of the model, is relatively low, amounting to 0.02521 in 2013, 0.01769 in 2014 and 0.01479 in 2015. This means that, even if the relationship between the variables is not fortuitous, the model has a very limited capacity of predicting the value of the dependent variable, despite the tests demonstrates that the relationship is significant.

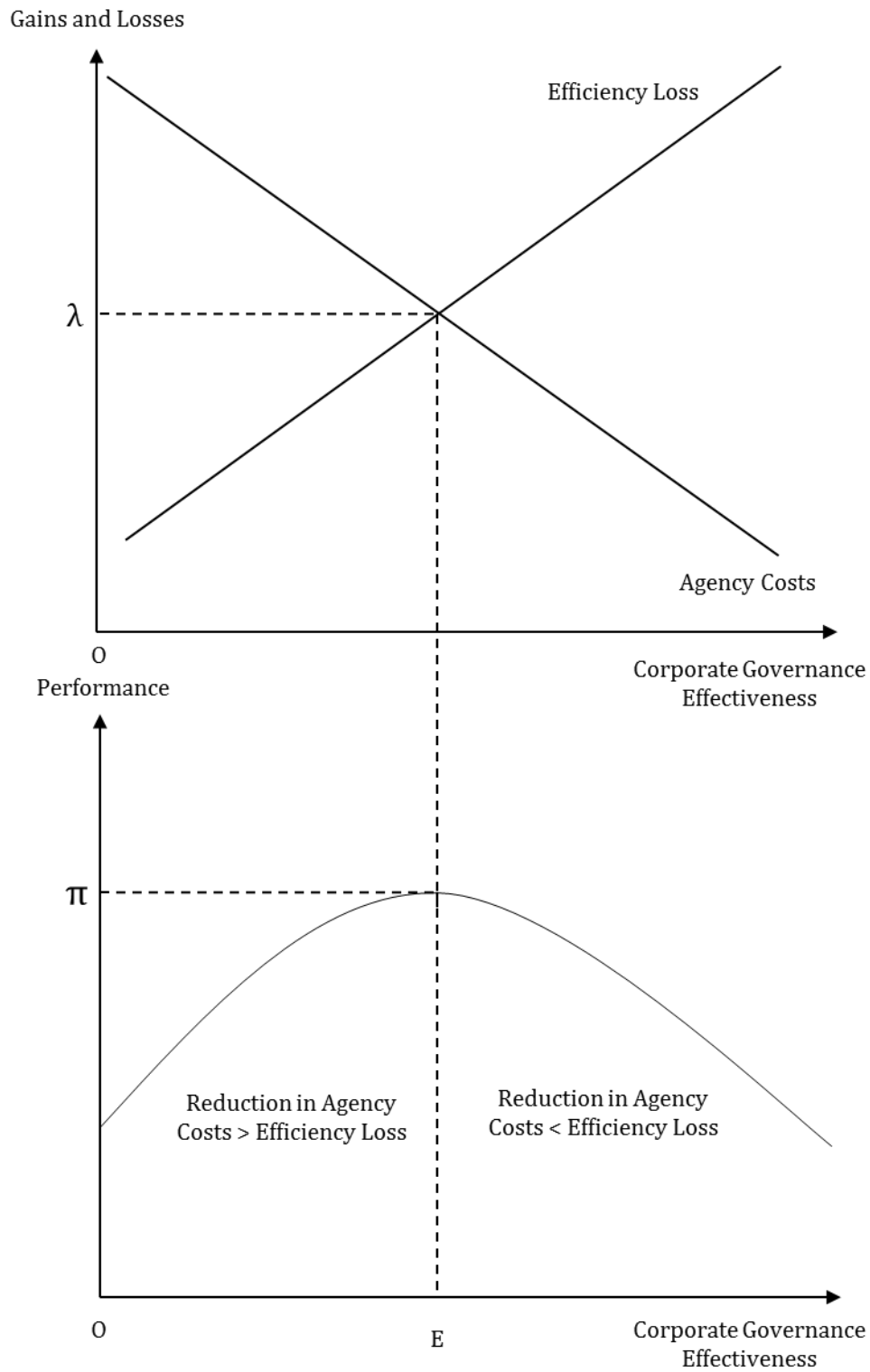
The complete results are displayed in tables 9, 10, and 11.

In United States, better corporate governance practices are associated with a lower Tobin's Q. This is surprising, as the index captures the discrepancy between firm's accounting value and market value. According to theory, the market should value more firms with better governance, as it decreases and the risks that the company's resources are consumed pursuing objectives that differs from the shareholder-value creation.

Contrary to the conventional wisdom, my results demonstrate that better corporate governance is not always associated with a relative higher market valuation.

This unexpected relation between corporate governance effectiveness could be a signal that pursuing corporate governance effectiveness can lead to efficiency loss. This fall can be so large to overcome the agency costs that are associated with managerial opportunism. The enforcement of strict corporate governance practices adds costs and constraints to the firm's activity. The restraint of management discretion is a direct consequence of the implementation of corporate governance controls, which in turn are necessary to ensure the fulfillment of their role, i.e. the assurance of shareholders to receive adequate returns on their investments. If management activity has to be monitored and ratified, constraints to managerial activity emerge. Managerial discretion can be *excessively* restricted, thus causing the firm to lose efficiency: decision-making and directive activity can become cumbersome and clumsy, resulting in lack of agility and stiffness. There exists a stream of literature that analyzes the negative side of corporate controls. The implementation of performance-based remuneration policies can lead to reduced risk-taking by managers, which can curtail the opportunities to engage in positive net present value projects, if they are judged too risky (Coles, Daniel, and Naveen 2006). Meddlesome Board of Directors can wreak havoc to managerial activity, especially in case of unstable environments, or following to events that needs a timely reaction by the company (Van Essen, Engeren and Carney 2013). Enhanced managers' monitoring increase the risk born by management, which requires to be paid more, therefore consuming company's financial resources (Hoskisson, Castleton and Withers, 2009). For what concerns the exercise of shareholder rights, Priluck (2013) argued that "sparring with management is popular sport for short-termists seeking to maximize the value of their assets". That suggests that often shareholder activism is the expression of institutional Shareholders which push for dividends and buyback shares, thus reducing the availability of liquidity to invest in economic growth, This short-term thinking, even if associated with the disciplinarian role of shareholders, might result in a wealth-destructive behavior. The graph below describes one of the possible interpretations of the unexpected negative relationship that I have found between corporate governance quality and performance.

Graphical explanation of the inverse relationship between corporate governance and performance:



If the effectiveness of corporate governance falls in the interval within O and E, the reduction of agency costs associated with control practices is larger than the loss of efficiency that derives from the restraint posed on firm's operations. Shareholders are protected from the expropriation of their returns, while simultaneously granting to managers a degree of freedom that helps the corporation to operate with efficacy. On the other hand, if the effectiveness of corporate governance (in lowering agency costs) overcomes the threshold represented by the point E on the X-axis, the strictness of controls makes decision-making activity so rigid and cumbersome that the increase in welfare which derives from the reduction of agency costs is not large enough to counterbalance the loss of efficiency. In this situation, the possibility that shareholders' resources would be employed in a manner not consistent with their interest is minimal, but this does not have positive effect on performance; conversely, profitability is depressed by the additional complexity posed by corporate governance.

According to the results of the empirical analysis, American best-performing firms in terms of corporate governance are an example of this latter scenario. Quickscore takes the highest-scoring and lowest-scoring firms as a benchmarks, and evaluates the others subsequently; the negative relationship between the analyzed variables could be due to the fact that the best-performer taken as benchmark of corporate governance effectiveness falls within the second interval, the one in which an increase in corporate governance effectiveness decrease performance rather than boosting it. Agency theory predicts that governance measures foster firm performance by optimizing agency costs and reducing waste of capital: my findings suggest that it is not always the case. Excessive strictness in governance practices can decrease firm's performance. This evidences suggest that enhancing corporate governance is not always the optimal choice, as controls entails costs that may impact negatively on the firm's result; instead, the design of a corporate governance structure that counterbalances the positive and negative effects associated with that is the strategy that lead to the best possible outcome (represented by the point  $\lambda$ ). In the graph above, the optimum level of governance effectiveness is the point E: at this level, the reduction of agency costs equals the loss of efficiency, hence leading to the

best possible outcome in terms of performance (in correspondence of the point  $\pi$  on the y-axis).

Although, this interpretation is best suited to mirror a negative relation between corporate governance effectiveness and operating performance indicators such as ROA and ROE; the negative relationship between governance quality and Tobin's Q means that the market, *ceteris paribus*, values less a firm that enforces strict governance measures. The non-existence of a correlation between ROA, ROE, and performance put forth a different explanation: the above-presented interpretation may be a market belief, and hence is reflected in the relationship between Tobin's Q and corporate governance overall effectiveness.

The results of my analysis contrast with those achieved by Epps and Cereola (2008), who did not find any evidence of the existence of a relationship between Institutional Shareholder Services' corporate governance ratings and actual firms' performance. They analyzed a sample of United States-based firms over the years 2001-2004, and investigated the relation between the Corporate Governance Quotient developed by Institutional Shareholder Services (forerunner of Quickscore) and operating performance. They concluded that the corporate governance rating does not mirror firm's performance in any way. Conversely, I proved that corporate governance scores of American firms are correlated with Tobin's Q, even though the resulting relationship is opposed with respect to the one I was expecting.

## **CHAPTER VI: CONCLUSIONS**

This thesis analyzed the impact of corporate governance practices on firm's performance. To reach this objective, I collected a set of ratings to mirror the effectiveness of firm-specific corporate governance practices and a set of performance indicators. I investigated the relationship between this group of variables. The results show that differences in corporate governance practices are reflected in the actual performance of companies, although the impact is rather tenuous. Furthermore, the existence of a relationship between the variables has not been consistent throughout all the analyzed samples.

The theoretical paradigm used to establish a linkage between the analyzed elements is the agency theory. According to that, a compelling and efficient corporate governance structure shall improve firm's performance by optimizing the agency costs that emerge from the division of ownership and control. I sampled companies listed in three different regions, which differ dramatically in terms of regulation and ownership structure. I extended the understanding of agency theory by considering the effects of different ownership structures on the agency problem: in case of diffused ownership, the management is the dominant subject in the corporation, and corporate governance seeks to mitigate the risk that managers would exploit their power pursuing their self-interests; on the other hand, when the ownership is concentrated in the figure of a blockholder, the control gives him the opportunity to manipulate the management to accomplish personal objectives at the expense of minority shareholders, and corporate governance works to alleviate the agency problem between the two classes of shareholders.

The analysis provided useful insights to the long-debated question regarding the relevance of corporate governance. By employing an evaluation instrument actually utilized by investors to grade corporate governance, I took a pragmatic approach to assess the relationship between governance and performance. Despite my results prove that corporate governance influences firm's performance, the understanding of the connection between the variables is far from being comprehensive. I tested the relationship between the factors in a direct manner, whereas there are a multitude of aspects that eventually



shape firms' performance, aside from corporate governance, that must be taken into account. By directly linking the factors I explored whether differences in corporate governance alone are so relevant to justify differences in performance. However, performance is the outcome of a multitude of factors, e.g. industry characteristics, strategy, economic conjuncture and so on. To assess thoroughly the impact of corporate governance on performance all these elements should be considered in the empirical analysis: in that way, the results would be decontaminated from the effects of these factors, allowing a better understanding of the impact of corporate governance on performance.

Another point of weakness is represented by the non-comparability of samples. The relative nature of the evaluation tool does not allow to scrutinize all the sampled companies simultaneously, in this way constraining the consistency of the analysis.

Eventually, the proposed analysis does not consider the possible existence of a lag between the implementation of governance practices and the actual manifestation of their effects.

Despite all the undeniable limits that weaken the validity of the model, I demonstrate that corporate governance practices substantially influences firm's performance. The empirical analysis proves the existence of a negative relationship between corporate governance effectiveness and Tobin's Q relatively to United States- based companies. Moreover, I have found evidence of a positive connection between the strength of shareholder rights and performance (measured by ROA, ROE and Tobin's Q) for Italian companies, even though only in one of the three years sampled, namely 2015.

The achieved results underline the preponderance of corporate governance. The demonstration that, in some cases, the goodness of corporate governance allows to reach an outstanding performance is a crucial result for investors and policymakers. The best-performing governance structure might be considered as a source of competitive advantage, as it allows firms to achieve better results than its competitors; however, a firm-specific corporate governance may be easily replicated by competitors, in this way nullifying the advantage granted to the firm that implemented it first. Corporate

Governance best practices are not scarce: this means that all the market participants can reduce their disadvantage by enforcing the best-performing corporate governance structure. In this situation, Better governance could result in better performance for the economy as a whole. Although this would be a desirable outcome, it is unlikely that there exists a unique corporate governance structure that can be considered “better” in absolute terms. Ownership structure, industry, economic conditions are likely to influence the corporate governance system that may allow the achievement of the best performance. The analysis proved that corporate governance effectiveness is not always desirable, as it has been found to be negatively correlated with performance in some circumstances. In accordance, this thesis fails in adding clarity to the corporate governance-performance issue, and adds to the extensive group of researches that yielded to mixed results (Saravia 2014).

There is still a multitude of aspects that have to be explored concerning the administration of corporations. This thesis demonstrated that governance is an element that must not be underestimated, as different levels of corporate governance effectiveness translate substantially into different levels of performance. Research is still required to outline the pattern of the relationship between corporate governance and firm’s performance. The results of my analysis provide food for thought to researchers: the proposed interpretation of the inversed relationship between governance effectiveness and performance in United States and the positive correlation between shareholder rights’ strength and performance witnessed in Italy still need to be explained with clarity; finally, the reasons of the temporal inconsistency of the results are to be explored.

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## APPENDIX

**Table 1: Descriptive Statistics of Corporate Governance Scores**

		Hong Kong			Italy			United States		
		AVG	MED	SD	AVG	MED	SD	AVG	MED	SD
<b>2013</b>	AUDIT_SCORE	1,7	1	2	2,3	1	3.355	1,8	1	2.618
	BOARD_STRUCTURE_SCORE	6,8	7	2.511	4,0	4	1.633	5,5	5	2.896
	SHAREHOLDER_RIGHTS_SCORE	5,2	6	2.449	5,8	7	3.555	5,2	5	2.950
	COMPENSATION_SCORE	4,4	4	3.279	5,3	5	2.532	5,4	5	2.833
	OVERALL_SCORE	6,1	7	2.985	5,4	6	3.278	5,4	5	2.857
<b>2014</b>	AUDIT_SCORE	2,2	1	3.032	3,2	5	2.042	2,0	1	2.122
	BOARD_STRUCTURE_SCORE	7,1	9	3.095	4,1	4	2.964	5,4	5	2.891
	SHAREHOLDER_RIGHTS_SCORE	6,4	8	3.873	4,9	6	3.810	5,2	5	2.966
	COMPENSATION_SCORE	5,3	4	3.035	4,3	3	3.466	5,4	5	2.833
	OVERALL_SCORE	6,5	8	3.380	5,1	5	3.177	5,4	5	2.866
<b>2015</b>	AUDIT_SCORE	3,0	1	3.796	3,3	1	2.715	2,1	1	2.298
	BOARD_STRUCTURE_SCORE	6,7	7	3.069	4,8	5	2.708	5,5	5	2.870
	SHAREHOLDER_RIGHTS_SCORE	5,9	8	3.554	3,1	1	3.595	5,1	5	2.918
	COMPENSATION_SCORE	5,7	5	2.880	6,1	7	3.030	5,5	5	2.852
	OVERALL_SCORE	6,6	7	3.217	5,4	5	2.702	5,5	5	2.878

**Table 2: Descriptive Statistics of Performance indicators**

		Hong Kong					Italy					United States				
		AVG	MED	SD	MAX	MIN	AVG	MED	SD	MAX	MIN	AVG	MED	SD	MAX	MIN
2013	ROA	7,54	5,60	6.364	25,37	1,00	3,08	3,45	2.466	7,35	-0,93	7,74	6,61	6.068	40,76	-16,94
	ROE	14,46	10,81	9.493	37,03	4,41	7,39	12,88	14.653	31,79	-25,76	20,88	15,00	30.286	417,58	-37,78
	TOBIN'S Q	1,37	1,02	1.313	6,72	0,60	1,26	1,04	0,498	2,81	0,25	2,25	1,80	1.493	12,91	0,97
2014	ROA	8,31	6,60	9.997	50,89	0,93	2,56	2,21	2.429	8,10	-1,35	7,81	6,76	6.241	43,54	-29,71
	ROE	15,66	12,30	12.586	63,37	5,04	6,77	6,68	9.954	21,27	-24,02	23,74	15,61	68.503	1325,34	-60,75
	TOBIN'S Q	1,20	1,04	0,682	3,87	0,60	1,22	1,04	0,410	2,79	0,95	2,31	1,85	1.521	12,95	0,74
2015	ROA	4,78	4,96	2.239	8,97	0,73	3,85	3,02	4.981	18,81	-12,05	6,09	5,98	8.829	43,18	-61,37
	ROE	11,25	10,25	6.533	31,40	3,90	10,24	9,64	17.996	53,33	-95,39	20,46	14,93	47.801	426,47	-230,02
	TOBIN'S Q	1,11	1,03	0,458	2,15	0,54	1,53	1,17	0,823	4,20	0,71	2,15	1,72	1.437	13,81	0,61

**Legend:**

**AVG:** Mean average of the observed variables.

**MED:** Median of the observed variables.

**SD:** Standard Deviation of the observed variables.

**MAX:** Maximum value of the variables observed.

**MIN:** Minimum value of the variables observed

## Empirical Analysis Results: Regressions' Coefficients

This section of the appendix describes the numerical results of the regressions.

Significance codes: 0 '\*\*\*' 0.001 '\*\*' 0.01 '\*' 0.05 '.' 0.1 ' ' 1

The symbol that may be assigned to each coefficients represents its level of significance. The coefficients to which is not assigned any symbol are randomly related to the independent variable, meaning that there is no meaningful relationship between the factors.

### Hong Kong

**Table 3: Results relative to the year 2013**

Table 3a: Regression of Overall Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	6.2517	2.9847	2.095	0.0474	*
OVERALL_SCORE	0.2120	0.4424	0.479	0.6363	

Table 3b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	16.8857	4.4387	3.804	0.000914	***
OVERALL_SCORE	-0.3984	0.6579	-0.606	0.550760	

Table 3c: Regression of Overall Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.343312	0.618823	2.171	0.0405	*
OVERALL_SCORE	0.004289	0.091720	0.047	0.9631	

Table 3d: Regression of Governance Pillars' Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	2.18685	4.80177	0.455	0.654	
AUDIT_SCORE	0.67990	0.52117	1.305	0.207	
BOARD_STRUCTURE_SCORE	0.37293	0.53045	0.703	0.490	
SHAREHOLDER_RIGHTS_SCORE	-0.07103	0.55209	-0.129	0.899	
COMPENSATION_SCORE	0.45523	0.41556	1.095	0.286	

Table 3e: Regression of Governance Pillars' Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	16.0078	7.4335	2.153	0.0437	*
AUDIT_SCORE	0.3887	0.8068	0.482	0.6352	
BOARD_STRUCTURE_SCORE	-0.5973	0.8212	-0.727	0.4754	
SHAREHOLDER_RIGHTS_SCORE	-0.2770	0.8547	-0.324	0.7492	
COMPENSATION_SCORE	0.7530	0.6433	1.170	0.2556	

Table 3f: Regression of Governance Pillars' Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )
(Intercept)	1.69285	1.076521	1.571	0.132
AUDIT_SCORE	-0.070403	0.116843	-0.603	0.554
BOARD_STRUCTURE_SCORE	-0.046767	0.118923	-0.393	0.698
SHAREHOLDER_RIGHTS_SCORE	0.001748	0.123776	0.014	0.989
COMPENSATION_SCORE	0.024998	0.093167	0.268	0.791

**Table 4: Results relative to the year 2014**

Table 4a: Regression of Overall Score on ROA:

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )
(Intercept)	6.7395	4.4727	1.507	0.145
OVERALL_SCORE	0.2426	0.6146	0.395	0.697

Table 4b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	16.7095	5.6445	2.96	0.00701	**
OVERALL_SCORE	-0.1625	0.7756	-0.21	0.83589	

Table 4c: Regression of Overall Score on Tobin's Q:

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.70542	0.28231	6.041	3.68e-06	***
OVERALL_SCORE	-0.07801	0.03879	-2.011	0.0562	.



Table 4d: Regression of Governance Pillars' Score on ROA:

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )
(Intercept)	2.2467	65.515	0.343	0.735
AUDIT_SCORE	-0.3844	0.8409	-0.457	0.652
BOARD_STRUCTURE_SCORE	0.9630	0.8469	1.137	0.269
SHAREHOLDER_RIGHTS_SCORE	0.1016	0.6064	0.167	0.869
COMPENSATION_SCORE	-0.1027	10.134	-0.101	0.920

Table 4e: Regression of Governance Pillars' Score on ROE:

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )
(Intercept)	12.50209	8.55672	1.461	0.160
AUDIT_SCORE	-0.09775	1.09820	-0.089	0.930
BOARD_STRUCTURE_SCORE	0.57073	1.10613	0.516	0.612
SHAREHOLDER_RIGHTS_SCORE	-0.18342	0.79200	-0.232	0.819
COMPENSATION_SCORE	0.09591	132.353	0.072	0.943

Table 4f: Regression of Governance Pillars' Score on Tobin's Q:

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.14328	0.39812	2.872	0.00943	**
AUDIT_SCORE	-0.06650	0.05110	-1.301	0.20791	
BOARD_STRUCTURE_SCORE	-0.03817	0.05147	-0.742	0.46693	
SHAREHOLDER_RIGHTS_SCORE	-0.03179	0.03685	-0.863	0.39848	
COMPENSATION_SCORE	0.12865	0.06158	2.089	0.04968	*

**Table 5: Results relative to the year 2015:**

Table 5a: Regression of Overall Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	3.9614	1.0878	3.642	0.00153	**
OVERALL_SCORE	0.1251	0.1494	0.837	0.41196	

Table 5b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	14.8368	3.1073	4.775	0.000102	***
OVERALL_SCORE	-0.5468	0.4268	-1.281	0.214129	

Table 5c: Regression of Overall Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.27226	0.22290	5.708	1.15e-05	***
OVERALL_SCORE	-0.02424	0.03062	-0.792	0.437	

Table 5d: Regression of Governance Pillars' Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	3.11928	1.49823	2.082	0.0519	.
AUDIT_SCORE	-0.05428	0.14245	-0.381	0.7076	
BOARD_STRUCTURE_SCORE	0.10569	0.21765	0.486	0.6331	
SHAREHOLDER_RIGHTS_SCORE	0.07074	0.15022	0.471	0.6434	
COMPENSATION_SCORE	0.12239	0.21666	0.565	0.5791	

Table 5e: Regression of Governance Pillars' Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	16.482163	4.354731	3.785	0.00136	**
AUDIT_SCORE	0.007957	0.414048	0.019	0.98488	
BOARD_STRUCTURE_SCORE	-0.375158	0.632621	-0.593	0.56054	
SHAREHOLDER_RIGHTS_SCORE	-0.312171	0.436626	-0.715	0.48380	
COMPENSATION_SCORE	-0.159821	0.629735	-0.254	0.80253	

Table 5f: Regression of Governance Pillars' Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.12835	0.299965	3.743	0.00149	**
AUDIT_SCORE	0.005472	0.028521	0.192	0.84999	
BOARD_STRUCTURE_SCORE	-0.047887	0.043577	-1.099	0.28628	
SHAREHOLDER_RIGHTS_SCORE	-0.007519	0.030076	-0.250	0.80542	
COMPENSATION_SCORE	0.058737	0.043378	1.354	0.19247	

## Italy

Table 6: Results relative to the year 2013

Table 6a: Regression of Overall Score on ROA:

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	3.612	1.21880	2.964	0.0118	*
OVERALL_SCORE	-0.09892	0.18903	-0.523	0.6103	

Table 6b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.00219	72.059	1.391	0.190	*
OVERALL_SCORE	-0.4842	11.176	-0.433	0.673	

Table 6c: Regression of Overall Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.48112	0.23999	6.172	4.79e-05	***
OVERALL_SCORE	-0.04078	0.03722	-1.096	0.295	

Table 6d: Regression of Governance Pillars' Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	4.145396	2.108.317	1.966	0.0808	.
AUDIT_SCORE	0.159639	0.221111	0.722	0.4886	
BOARD_STRUCTURE_SCORE	0.114175	0.360823	0.316	0.7589	
SHAREHOLDER_RIGHTS_SCORE	-0.325218	0.190025	-1.711	0.1212	
COMPENSATION_SCORE	-0.001961	0.292076	-0.007	0.9948	

Table 6e: Regression of Governance Pillars' Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	13.98524	13.32362	1.050	0.321	
AUDIT_SCORE	0.07559	139.732	0.054	0.958	
BOARD_STRUCTURE_SCORE	0.09509	228.024	0.042	0.968	
SHAREHOLDER_RIGHTS_SCORE	-1.46253	120.087	-1.218	0.254	
COMPENSATION_SCORE	0.24916	184.579	0.135	0.896	

Table 6f: Regression of Governance Pillars' Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.20486	0.40812	2.952	0.0162	*
AUDIT_SCORE	0.01679	0.04280	0.392	0.7040	
BOARD_STRUCTURE_SCORE	0.07041	0.06985	1.008	0.3397	
SHAREHOLDER_RIGHTS_SCORE	-0.07256	0.03678	-1.973	0.0800	.
COMPENSATION_SCORE	0.02927	0.05654	0.518	0.6172	

**Table 7: Results relative to the year 2014**

Table 7a: Regression of Overall Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	2.598816	1.074936	2.418	0.0265	*
OVERALL_SCORE	-0.007513	0.180160	-0.042	0.9672	

Table 7b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	6.2228	4.4034	1.413	0.175	*
OVERALL_SCORE	0.1075	0.7380	0.146	0.886	

Table 7c: Regression of Overall Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.23389	0.18121	6.809	2.24e-06	***
OVERALL_SCORE	-0.00330	0.03037	-0.109	0.915	

Table 7d: Regression of Governance Pillars' Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	5.0028	1.8690	2.677	0.0172	*
AUDIT_SCORE	-0.3989	0.2708	-1.473	0.1614	
BOARD_STRUCTURE_SCORE	-0.1459	0.2190	-0.666	0.5153	
SHAREHOLDER_RIGHTS_SCORE	-0.3085	0.1671	-1.846	0.0848	.
COMPENSATION_SCORE	0.2178	0.1660	1.312	0.2092	

Table 7e: Regression of Governance Pillars' Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )
(Intercept)	7.1371	8.0691	0.884	0.390
AUDIT_SCORE	0.8049	11.691	0.688	0.502
BOARD_STRUCTURE_SCORE	-0.6545	0.9454	-0.692	0.499
SHAREHOLDER_RIGHTS_SCORE	-0.8020	0.7216	-1.111	0.284
COMPENSATION_SCORE	0.8462	0.7166	1.181	0.256

Table 7f: Regression of Governance Pillars' Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.47795	0.30796	4.799	0.000234	***
AUDIT_SCORE	-0.06107	0.04462	-1.369	0.191231	
BOARD_STRUCTURE_SCORE	0.01230	0.03608	0.341	0.737905	
SHAREHOLDER_RIGHTS_SCORE	-0.04660	0.02754	-1.692	0.111280	
COMPENSATION_SCORE	0.02629	0.02735	0.961	0.351604	

**Table 8: Results relative to the year 2015**

Table 8a: Regression of Overall Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	4.05093	1.28575	3.151	0.00235	**
OVERALL_SCORE	-0.03674	0.21421	-0.172	0.86428	

Table 8b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	14.7728	4.6091	3.205	0.00199	**
OVERALL_SCORE	-0.8442	0.7679	-1.099	0.27519	

Table 8c: Regression of Overall Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.60126	0.21220	7.546	9.31e-11	***
OVERALL_SCORE	-0.01285	0.03535	-0.363	0.717	

**Table 8d: Regression of Governance Pillars' Score on ROA**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	<b>3.91579</b>	<b>1.69559</b>	<b>2.309</b>	<b>0.023834</b>	*
AUDIT_SCORE	<b>0.23161</b>	<b>0.19768</b>	<b>1.172</b>	<b>0.245246</b>	
BOARD_STRUCTURE_SCORE	<b>0.28001</b>	<b>0.21012</b>	<b>1.333</b>	<b>0.186920</b>	
SHAREHOLDER_RIGHTS_SCORE	<b>-0.56250</b>	<b>0.15825</b>	<b>-3.555</b>	<b>0.000678</b>	***
COMPENSATION_SCORE	<b>-0.07078</b>	<b>0.19139</b>	<b>-0.370</b>	<b>0.712622</b>	

**Multiple R-squared: 0.2019**

**Adjusted R-squared: 0.157**

**Table 8e: Regression of Governance Pillars' Score on ROE**

**Coefficients:**

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	19.4790	6.2242	3.130	0.002540	**
AUDIT_SCORE	0.1395	0.7256	0.192	0.848092	
BOARD_STRUCTURE_SCORE	0.7034	0.7713	0.912	0.364856	
SHAREHOLDER_RIGHTS_SCORE	-2.0785	0.5809	-3.578	0.000629	***
COMPENSATION_SCORE	-1.0877	0.7026	-1.548	0.126002	

**Multiple R-squared: 0.1763**

**Adjusted R-squared: 0.1299**

**Table 8f: Regression of Governance Pillars' Score on Tobin's Q**

**Coefficients:**

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.573332	0.292650	5.376	9.23e-07	***
AUDIT_SCORE	0.005479	0.034118	0.161	0.87286	
BOARD_STRUCTURE_SCORE	0.009975	0.036266	0.275	0.78408	
SHAREHOLDER_RIGHTS_SCORE	-0.073431	0.027312	-2.689	0.00894	**
COMPENSATION_SCORE	0.019835	0.033033	0.600	0.55011	

**Multiple R-squared: 0.1284**

**Adjusted R-squared: 0.07927**

## **United States**

**Table 9: Results relative to the year 2013**

**Table 9a: Regression of Overall Score on ROA**

**Coefficients:**

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	7.41593	0.63539	11.671	<2e-16	***
OVERALL_SCORE	0.05988	0.10394	0.576	0.565	

**Table 9b: Regression of Overall Score on ROE**

**Coefficients:**

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	40.3819	53.2124	0.759	0.448	***
OVERALL_SCORE	0.9371	87.049	0.108	0.914	

**Table 9c: Regression of Overall Score on Tobin's Q**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.79911	0.15445	11.649	2,00E-16	***
OVERALL_SCORE	0.08297	0.02527	3.284	0.00111	**

**Multiple R-squared: 0.02521    Adjusted R-squared: 0.02287****Table 9d: Regression of Governance Pillars' Score on ROA**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	7.3355	0.9157	8.011	1.17e-14	***
AUDIT_SCORE	-0.1579	0.1135	-1.391	0.165	
BOARD_STRUCTURE_SCORE	0.1237	0.1056	1.171	0.242	
SHAREHOLDER_RIGHTS_SCORE	0.1257	0.1015	1.238	0.216	
COMPENSATION_SCORE	-0.1189	0.1069	-1.112	0.267	

**Table 9e: Regression of Governance Pillars' Score on ROE**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	62.804	76.881	0.817	0.4145	
AUDIT_SCORE	-2.817	9.532	-0.296	0.7678	
BOARD_STRUCTURE_SCORE	-15.646	8.868	-1.764	0.0784	.
SHAREHOLDER_RIGHTS_SCORE	7.007	8.519	0.822	0.4113	
COMPENSATION_SCORE	6.832	8.978	0.761	0.4471	

**Table 9f: Regression of Governance Pillars' Score on Tobin's Q**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.50242	0.22208	6.765	4.56e-11	***
AUDIT_SCORE	-0.03247	0.02753	-1.179	0.23901	
BOARD_STRUCTURE_SCORE	0.06658	0.02562	2.599	0.00968	**
SHAREHOLDER_RIGHTS_SCORE	0.06365	0.02461	2.586	0.01004	*
COMPENSATION_SCORE	0.01977	0.02594	0.762	0.44621	



**Table 10: Results relative to the year 2014**

Table 10a: Regression of Overall Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	7.6808	0.6421	11.963	<2e-16	***
OVERALL_SCORE	0.0243	0.1049	0.232	0.817	

Table 10b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	28.104	7.044	3.990	7.76e-05	***
OVERALL_SCORE	-0.806	1.151	-0.701	0.484	

**Table 10c: Regression of Overall Score on Tobin's Q**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.92858	0.15575	12.382	2,00E-16	***
OVERALL_SCORE	0.07061	0.02540	2.779	0.00568	**

**Multiple R-squared: 0.01769      Adjusted R-squared: 0.0154**

Table 10d: Regression of Governance Pillars' Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	8.28644	0.94151	8.801	<2e-16	***
AUDIT_SCORE	-0.35360	0.14129	-2.503	0.0127	*
BOARD_STRUCTURE_SCORE	0.02035	0.10785	0.189	0.8504	
SHAREHOLDER_RIGHTS_SCORE	0.03028	0.10271	0.295	0.7683	
COMPENSATION_SCORE	-0.00671	0.10847	-0.062	0.9507	

Table 10e: Regression of Governance Pillars' Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	37.601	10.331	3.64	0.000306	***
AUDIT_SCORE	-1.599	1.550	-1.032	0.302795	
BOARD_STRUCTURE_SCORE	-1.318	1.183	-1.114	0.265931	
SHAREHOLDER_RIGHTS_SCORE	1.286	1.127	1.141	0.254331	
COMPENSATION_SCORE	-1.886	1.190	-1.584	0.113836	

Table 10f: Regression of Governance Pillars' Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.79425	0.23014	7.797	4.93e-14	***
AUDIT_SCORE	-0.01204	0.03498	-0.344	0.7308	
BOARD_STRUCTURE_SCORE	0.02088	0.02631	0.794	0.4279	
SHAREHOLDER_RIGHTS_SCORE	0.02590	0.02500	1.036	0.3010	
COMPENSATION_SCORE	0.05359	0.02646	2.025	0.0435	*

**Table 11: Results relative to the year 2015**

Table 11a: Regression of Overall Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	6.59579	0.88199	7.478	3.83e-13	***
OVERALL_SCORE	-0.09296	0.14280	-0.651	0.515	

Table 11b: Regression of Overall Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	27.9878	4.7611	5.878	7.96e-09	***
OVERALL_SCORE	-13.773	0.7708	-1.787	0.0746	.

**Table 11c: Regression of Overall Score on Tobin's Q**

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	<b>1.81824</b>	<b>0.14256</b>	<b>12.754</b>	<b>2,00E-16</b>	<b>***</b>
OVERALL_SCORE	<b>0.06072</b>	<b>0.02308</b>	<b>2.631</b>	<b>0.00881</b>	<b>**</b>

**Multiple R-squared: 0.01479**

**Adjusted R-squared: 0.01265**

Table 11d: Regression of Governance Pillars' Score on ROA

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	5.86622	1.32041	4.443	1.12e-05	***
AUDIT_SCORE	-0.09432	0.18048	-0.523	0.601	
BOARD_STRUCTURE_SCORE	0.15452	0.14741	1.048	0.295	
SHAREHOLDER_RIGHTS_SCORE	0.06150	0.14321	0.429	0.668	
COMPENSATION_SCORE	-0.13437	0.14682	-0.915	0.361	

Table 11e: Regression of Governance Pillars' Score on ROE

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	31.1442	7.1008	4.386	1.43e-05	***
AUDIT_SCORE	0.5499	0.9706	0.567	0.5713	
BOARD_STRUCTURE_SCORE	-11.603	0.7927	-1.464	0.1440	
SHAREHOLDER_RIGHTS_SCORE	0.7788	0.7701	1.011	0.3124	
COMPENSATION_SCORE	-17.283	0.7896	-2.189	0.0291	*

Table 11f: Regression of Governance Pillars' Score on Tobin's Q

Coefficients:

	Estimate	Std. Error	t value	Pr(> t )	
(Intercept)	1.52650	0.21270	7.177	2.9e-12	***
AUDIT_SCORE	-0.01571	0.02907	-0.540	0.5893	
BOARD_STRUCTURE_SCORE	0.04446	0.02375	1.872	0.0618	.
SHAREHOLDER_RIGHTS_SCORE	0.03429	0.02307	1.486	0.1379	
COMPENSATION_SCORE	0.04345	0.02365	1.837	0.0668	.

# SUMMARY

## ABSTRACT

This thesis examines the potential impact of corporate governance on firm's operating performance. The theoretical framework according to which firm-specific corporate governance practices are evaluated is the agency theory. I employed an evaluation tool developed by Institutional Shareholder Services (ISS) to assess the goodness of firm-specific corporate governance practices, and investigated whether exists a connection between the scores awarded to each company and its operating performance, measured using Return on Equity, Return on Assets and Tobin's Q. The sample is composed of firms listed in Hong Kong, United States and Italy stock exchanges. The data refers to the three-year period 2013-2015.

The empirical analysis found evidence of a negative relationship between Tobin's Q and overall corporate governance goodness for US-based firms and a connection between all the performance indicators and the level of shareholder rights for Italian companies, limitedly to the year 2015.

## INTRODUCTION

In modern corporations, a group of shareholders demands to a group of managers the responsibility and the power to make decisions concerning their interests. Managers guide the organization and deploy the firm's resources (financial, human and physical) in order to create value for the owners. However, managers, in light of their decision-making power, have an incentive in pursuing their self-interests rather than those of the owners.

The relationship between shareholders and managers is characterized by the presence of an *agency problem*, which is inherent in any rapport in which one party is supposed to act in the other's interest. Corporate governance provides instruments for mitigating this problem, through a complex and wide system of mechanisms, processes and relations that regulate the relationships between these groups, the owners and the decision-makers, and among the owners themselves. The purpose of this thesis is to investigate the extant relation between firm-specific corporate governance practices and firms' actual

performance. I try to provide an answer to the long-debated question: “Does corporate governance have a substantial impact on firm’s results?”

## **THEORETICAL FRAMEWORK AND LITERATURE REVIEW**

Assessing the quality of corporate governance would not be meaningful without firstly defining its ultimate objective. With regard to the various definitions, scholars classify corporate governance in either narrow or broad terms. The narrow view is based on the satisfaction of shareholders. Broader definitions extend the objective of corporate governance to the satisfaction of stakeholders (i.e. suppliers, employees and government) (Gillan 2006). The definition of the concept essentially relates to the theoretical viewpoint involved (Gillan 2006). According to Schleifer and Vishny (1997), corporate governance is “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. This definition assigns to governance the primary role of mediating between finance providers (i.e. shareholders and stakeholders) and employers (i.e. managers), stating that, since resource owners demand their control to management, they need to be assured to receive a reward for their activity. Specifically, shareholders need to be shielded from the negative effects that derive from the conflict of interest suffered by managers, who are hired to act in shareholder’s behalf but have an incentive in acting selfishly. Thus, corporate governance issues arise due to the necessity of counteracting *agency problems* (Hart, 1995), and fundamentally from shareholders' attempts to protect themselves from the expropriation of their wealth (Shleifer and Vishny, 1997).

The lack of consensus regarding the role of corporate governance is a consequence of the multiplicity of views regarding the nature and the purpose of firms. In this regard, there are two perspectives according to which we can look to a company. The first one is the shareholder perspective (Friedman 1962), which prioritizes the figure of the shareholder and set the main objective of the firm as the pursuit of profit maximization for the benefit of the owners. The other viewpoint, known as stakeholder perspective (Freeman 1984), takes a broader view of the firm and considers in the objectives the other subjects who have an interest in the company, e.g. all the stakeholders, which includes suppliers, employees, communities etc. This work adopts a shareholder-based view of corporate

governance, according to which its ultimate goal is to align the interests of shareholders and managers and ensuring an equal treatment for all shareholders.

### **The Agency Problem**

A widely used framework to conceptualize the relationship between firm performance and corporate governance is *agency theory* (Denis and McConnell 2003).

The *agency problem*, or *principal-agent problem*, is a conflict of interest inherent in any relationship in which one party is expected to act in another's best interest, while being delegated of some decision-making authority by the agent (Eisenhardt 1989): the relationship between shareholders and managers is one of the clearest examples (Agrawal and Knoeber 1996). The conflict of interests that might exist between the principal (in this case, the shareholders) and the agent (i.e. the managers) may lead to costly inefficiencies which impact negatively on the welfare of the principal. Agents are individuals naturally oriented towards the maximization of their own welfare rather than that of principals, therefore control and incentive mechanisms are necessary to align the interests of the counterparties. The agency problem in modern corporations descends from the division between ownership, represented by the shareholders who provide funding for the company, and the control, i.e. the managers who employ that funding (Berle and Means 1932). Their relationship is characterized by the presence of an information asymmetry: managers are better informed for what concerns the allocations of capital that can lead to the best outcome for shareholders, in lieu of their superior knowledge and competence and privileged access to companies' information. According to the contractual view of the firm, developed by Coase (1937), the opportunity that is given to managers to expropriate shareholders descends from the allocation of residual control rights to them. Specifically, the technological unfeasibility of a "complete contract" results in the necessary allocation of the decision-making authority in situations not conceived by the contract. As this authority is awarded to management, the latter enjoys a high degree of freedom in making decisions, reducing shareholders in a condition of subjection.

This thesis relies on the agency theory as the primary paradigm to explore the effect of corporate governance on firm's performance. It provides a powerful theoretical basis for explaining the relationship between corporate governance and performance: when the agency problem is mitigated, agency conflicts are reduced and shareholders' returns are enhanced, thus boosting firm performance (Fama and Jensen 1983, Jensen and Meckling 1976).

### **Agency Costs**

Investors in publicly traded corporations incur in costs for monitoring and bonding managers so that they best serve the company's owners. Jensen and Meckling (1976) define agency costs as the sum of the cost of monitoring management, bonding the agent to the principal, and residual losses. In this light, corporate governance can be viewed as a mechanism to reduce the conflict of interest that derives from the separation of roles while minimizing the associated agency costs that are borne by the principal.

There are four basic sources of conflicts between shareholders and managers, namely moral hazard, earnings retention, time horizon and risk aversion (Lei 2007).

### **Corporate Governance Devices**

There are several methods which are designed in order to mitigate the agency problem that, put together, compose the corporate governance of the firm. These are, according to Maher and Andersson (2000), board of directors, executive compensation, shareholder rights and market for corporate control. In this work they are grouped differently in order to follow the categorization used by Quickscore, the corporate governance evaluation tool developed by ISS. The market for corporate control is embedded in the shareholder rights' evaluation, since the isolation of management from external pressures that weaken the disciplinarian power of the market for corporate control also reduces the rights that are conferred to shareholders. Moreover, I add the external audit as a corporate governance instrument.

The Board of Directors, the main authority for what concerns manager monitoring, is appointed by the shareholders and act in their behalf in order to monitor the decision-making activity of the managers to ensure their good faith and their shareholder value-

creation attitude. A well-structured and independent Board of Directors which is able to monitor effectively the management's conduct should induce the management not to appropriate of the firm's resources. Thus a management that is closely controlled should perform better than a management which is free in its choices.

Managers' compensation comprises both the financial and non-financial benefits that are awarded to managers in return for their service for the organization, and it is exploited by companies as one of the most important devices to solve the agency problem existing between shareholders and managers. Managers pay is composed by both a fixed and a variable part. Executives' pay attached to performance enables risk sharing between principal and agent: shareholders are not anymore the only residual risk-bearing subject in the organization, but also managers are personally exposed to the outcome of their decision-making activity. Agency theory assumes that economic agents are motivated by self-interest, are rational actors, and are risk averse. Therefore, principals can ensure themselves against detrimental agent's behavior by controlling agent's incentives. A sound compensation plan is able to bring shareholders and managers' interests into congruence, in this way achieving the principal objective of governance. It is an instrument which, differently from monitoring, is not aimed at detecting management's malfeasances, but rather in making those malfeasances financially unattractive for managers. The minimization of the losses arising from the agency problem has a clear positive effect on firm's operating performance, as it prevents the occurrence of waste of capital.

Corporate laws provide shareholders with the power to have a say about the company's management, which is substantiated into a set of minor rights that can be enforced against managers and large shareholders, who are able to exert a substantial pressure on managers in light their investment: all these prerogatives altogether compose the shareholder rights. Aside from the right to participate in the firm's profit, shareholders are entitled with the power to vote in shareholders' meetings to express their will, that might differ from that of managers or blockholders. shareholder rights are characteristic of a given legal framework rather than of a single company. However, the company can put in place some lawful measures that indirectly impede the exercise of these rights. These could include



takeover defenses that might entrench management or the introduction of misalignment between ownership and voting power in the bylaws. It is generally asserted in the literature that greater shareholder rights have a positive impact on firm's value (Chugh 2010), due to reduced litigation costs and increased confidence of investors.

The market for corporate control is a disciplinary device that, contrarily from the other instruments, stems from the external environment in which the company operates. When a company is directed by a poor-performing management team, the price of the company's stocks is likely to drop. Then, the lower the price of the stocks compared to the value that it could reach in the presence of an efficient management, the more the take-over of the company gets attractive for those who believe they can manage the company more efficiently (Manne 1965). Therefore, an efficient market for corporate control can enhance the accountability of managers, who are threatened to be replaced if the stock price (which varies consequently to their choices) falls under a certain threshold.

Audit embeds all the activities that are undertaken in order to examine and verify company's records and statements. Most of the external audit practices are mandated by law provisions, but still differences can emerge among companies. External auditors exercise a *gatekeeping role*, since they provide an independent judgment and assure the market that the financial condition of the company is portrayed truthfully (Palmrose 2006). As such, external auditing reduces the agency problem relying on an independent and objective supervision performed by competent subjects without any linkage to the organization.

## **CROSS-REGION DIFFERENCES IN CORPORATE GOVERNANCE**

The differences among several factors related to ownership at a territorial level have stark consequences on corporate governance. The discrepancies that characterize the territory-specific ownership and control structures have substantial effects in shaping the magnitude of each of the two conflicts that characterize corporate governance, i.e. the one between management and shareholders and the one between small and large shareholders.

The most noteworthy difference concerning corporate governance relates to the degree of ownership concentration and identity of the controlling shareholder (OECD 2015). In this

regard, some countries (i.e. USA and UK) are characterized by a high degree of dispersion of the ownership, in which a large group of small shareholders owns each one a small fraction of the firm's stake. These countries conform to the so-called *Outsider System*. On the other hand, the regions that are traditionally characterized by high ownership concentration (i.e. Continental Europe and Japan) are called *Insider Systems* (Franks and Mayer 1997). Here, the powerful controlling shareholder is able to influence the management dramatically, adding other facets to the agency problem analyzed previously.

Berle and Means (1932), in their seminal work, argued that ownership structure affects firm performance. According to their view, concentrated ownership alleviates agency problems, mitigating the division between control and ownership, and so has to be preferred. However, Demsetz and Villalonga (2011) found no evidence of that. Adding other facets to their analysis, from these two opposed ownership configurations are likely to derive different typologies of conflicts between internal parties. As such, concentrated ownership does reduce the agency costs that stems from the division between ownership and control, but may cause the emergence of other kinds agency costs: the ones suffered by minority shareholders in their relationship with the controlling owner.

In the Outsider System, frictions between management and shareholders are more likely to happen, because of the great deal of freedom that is enjoyed by managers in their activities. The fragmentation of ownership reduces the incentive to monitor the management's behavior for every individual shareholder, due to free riding problems associated with individual monitoring (Easterbrook and Fishel 1983).

Conversely, in Insider Systems, the presence of a large shareholder ensures a proper direct monitoring of the management, since the large investment of the blockholder allows him to internalize the costs associated with monitoring. Small shareholders could benefit from this situation by relying on the direct monitoring of the large blockholder. However, despite the controlling shareholder creates shared benefits with its monitoring, he also has an incentive to extract private benefits that stems from his control, by colluding with management. In Insider Systems, corporate governance and regulations are less concerned with shaping managerial behavior so to orient it toward shareholder wealth

maximization, but rather with the protection of minority shareholders against the power enjoyed by the blockholder. Thus, even though the concentration of ownership mitigates the agency problem existing between managers and shareholders, agency problems may arise between small and large shareholders. The control that is awarded to the blockholder gives him both the incentive and the authority to participate directly in the company's management. As a consequence, the blockholder is not anymore the "principal" that is described in agency theory, because he does not entirely demand its power to managers. Ownership and control are less divided. Under a small shareholder viewpoint, the blockholder represents the "agent" described in agency theory, because he is responsible for the deployment of firm's resources that belongs to minority shareholders. The fact that the blockholder is an owner of the firm can turn out to be an advantage, but he may have the opportunity to expropriate the wealth of other shareholders. I will investigate whether the magnitude of the governance impact is different contingently upon the ownership structure.

According to what I stated in the theoretical part of this work, there are reasonable elements that support the belief that an effective corporate governance influence positively firms' performance. Contingently upon the ownership structure of the company, the shareholder-protecting devices which made up corporate governance work differently but are aimed towards the same objective: the assurance of shareholders against the potential expropriation by the figures who holds the controlling power in the firm.

In this work, I argue that better governed firms are more profitable than worse governed firms. When the ownership of a company is dispersed, the basic conflict that can arise is between powerful managers and weak shareholders. Shareholders need instruments to control managerial conduct. Executive compensation plans, board monitoring and shareholder rights work to ensure shareholders against the misbehavior of the people who are in charge of controlling their resources, thus reducing the agency costs which stems from the division of ownership and control. This conflict is likely to happen in outsider system countries (in my sample, US).

On the other hand, the concentration of the voting power in the hands of a strong shareholder diminish sensibly the need for a managerial monitoring device, since the

blockholder is able to internalize the costs associated with management's monitoring. In spite of that, this situation can still turn out to be negative for minorities since the controlling shareholder can rely on the power that derives from control to increase its welfare at the expense of minority shareholders. In this scenario, the Board of Directors act as an uphold body for small shareholders, and shareholder rights provide minorities with an instrument to express their will against the blockholder. Agency costs arise from the relationship between large and small shareholders: small shareholders demand the responsibility of deploying their resources to the blockholder (who has control of the company), who have the incentive of focusing on his own welfare rather than sharing the benefits of control with minorities. The expropriation of small shareholders by a controlling shareholder is likely to happen in insider countries, since they are characterized by concentrated ownership (in the sample, insider systems are represented by Italy and Hong Kong).

Details concerning the specific ownership structure and corporate governance practices of each sampled region are provided in the table at page 57.

## **HYPOTHESES DEVELOPMENT**

In light of what stated before, I establish the linkages between corporate governance and performance. Shleifer and Vishny (1997) and Jensen and Meckling (1986) stated that an effective corporate governance system is able to impede the waste of capital that is associated with managerial or blockholder expropriation, and increase the firm's efficiency by inducing the firm's leadership to undertake projects with positive net present value. Moreover, an effective corporate governance optimizes the cost of monitoring bear by investors (Agency Costs) (Jensen and Meckling 1976) and reduces the risk that value-destroying operations are undertaken: as a consequence, the establishment of a compelling corporate governance is associated with lower cost of capital (Lei 2007).

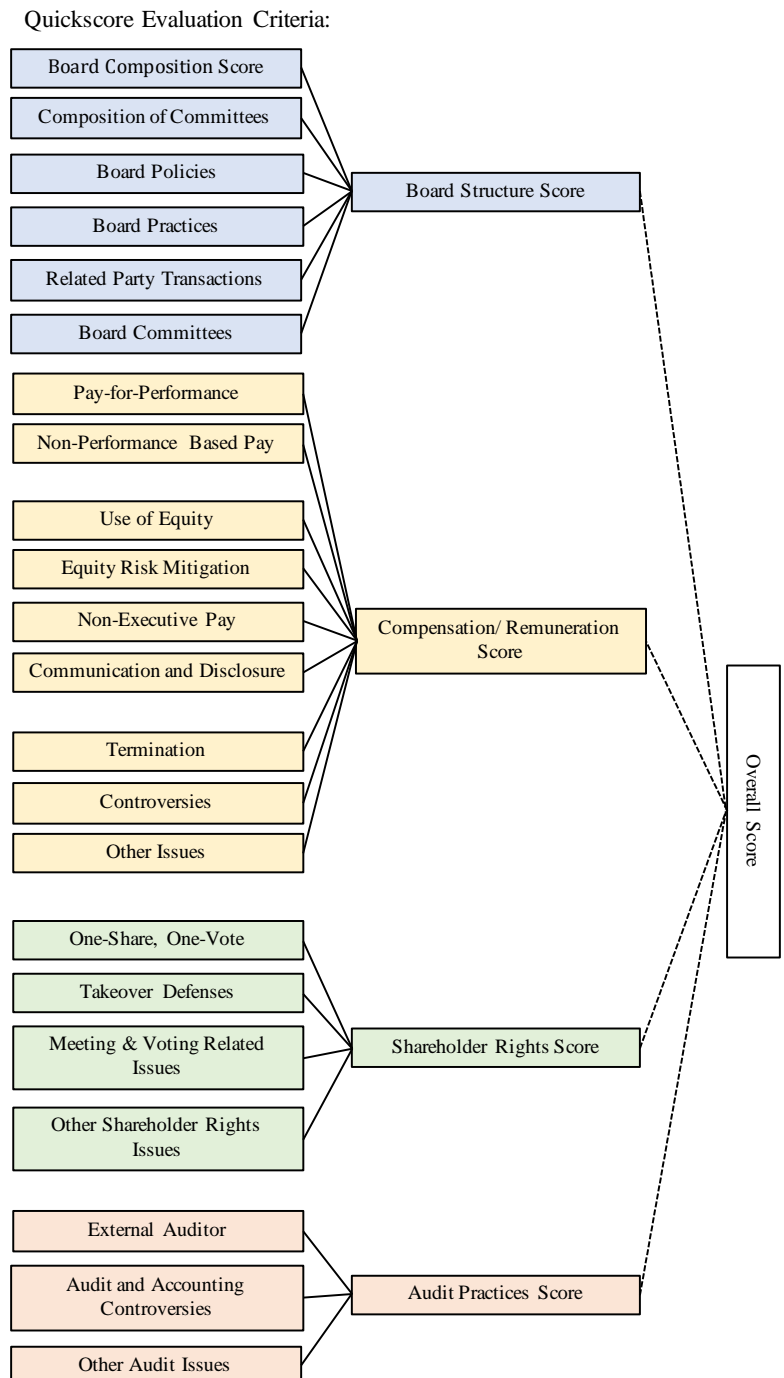
My hypothesis states that the quality of firm-specific corporate governance practices is positively associated with operating performance. This general hypothesis is tested using the overall score received by each company as a proxy for the quality of corporate governance practices. The availability of the four sub-scores allows to investigate the

impact of each of them individually on firm's performance. The quality of firm-specific board structure, compensation practices, shareholder rights practices and audit practices, measured by the sub-scores, is expected to be positively related to operating performance.

## EMPIRICAL ANALYSIS

The impact of corporate governance on firm's performance is appraised by studying the relationship between a set of corporate governance ratings and performance indicators referring to 650 listed companies from Italy, United States and Hong Kong stock exchanges. Governance risk has been evaluated on a yearly basis, and the data covers a three-year timeframe spanning from 2013 to 2015.

In order to assess the “goodness” of firm-specific corporate governance systems I employed a grading instrument called Quickscore. It ordinales firms according to a numeric decile-based score that indicates a company governance risk relative to the other companies listed in the same stock exchange. A score of one means relative governance lower governance risk (and so



better quality of corporate governance), whereas a score of ten indicates relatively high governance risk (and consequently the presence of poor governance).

It adopts a regionalized scoring approach tailored to local governance dynamics. The evaluation criteria considered by Quickscore in the appraisal of every corporate governance “pillar” are summarized in the table in the previous page.

The indicators employed to proxy performance are the three most commonly used performance indices, namely ROA, ROE and Tobin’s Q. The first one, ROA, indicates to investors the return that managers were able to achieve relatively to the assets they had available. ROE represents the profits of the company as a percentage of the company’s shareholders’ equity. Thus, companies showing a positive ROE are creating wealth for its shareholders, whereas a negative ROE implies shareholders’ wealth destruction. Hence, ROE is often used a proxy for firm’s performance under a shareholder’s viewpoint. Tobin’s Q reflects the difference between the market value and the accounting value of the firm: the discrepancies between the two are caused by the market expectations about the company and by the unmeasured assets that contribute to the firm’s valuation but are not recorded by accountants, e.g. intellectual capital and knowledge. In this work, we can assume that corporate governance is a valuable element for a firm, but as it is not acknowledged in the bookkeeping, it should create a gap between market and accounting value of the firm.

For the scope of the research, I developed a set of statistical models in which the dependent variables are the return on equity of company *i* in the year *t* ( $ROE_{it}$ ) the return on assets of company *i* on year *t* ( $ROA_{it}$ ), and the Tobin’s Q of company *i* in year *t* ( $T\_Q_{it}$ ). In the models,  $BSS_{it}$  represents the score awarded to the company *i* regarding its Board Structure in year *t*,  $SRS_{it}$  represents the score awarded to *i* regarding the Shareholder Rights in year *t*,  $CS_{it}$  represents the score for the company *i*’s Compensation Practices in year *t*,  $AS_{it}$  represents the score received for the company *i*’s Audit Practices in year *t*, and  $OS_{it}$  represents the overall score received by the company *i* in year *t*.

#### **Relationship between Overall Score and Performance:**

$$\text{MODEL 1.1: } ROE_{it} = \beta_0 + \beta_1 OS_{it} + \varepsilon$$

$$\text{MODEL 1.2: } ROA_{it} = \beta_0 + \beta_1 OS_{it} + \varepsilon$$

$$\text{MODEL 1.3: } T\_Q_{it} = \beta_0 + \beta_1 OS_{it} + \varepsilon$$

### **Relationship between Corporate Governance Pillars and Performance**

$$\text{MODEL 2.1: } ROE_{it} = \beta_0 + \beta_1 BSS_{it} + \beta_2 SRS_{it} + \beta_3 CS_{it} + \beta_4 AS_{it} + \varepsilon$$

$$\text{MODEL 2.2: } ROA_{it} = \beta_0 + \beta_1 BSS_{it} + \beta_2 SRS_{it} + \beta_3 CS_{it} + \beta_4 AS_{it} + \varepsilon$$

$$\text{MODEL 2.3: } T\_Q_{it} = \beta_0 + \beta_1 BSS_{it} + \beta_2 SRS_{it} + \beta_3 CS_{it} + \beta_4 AS_{it} + \varepsilon$$

I regressed the dependent variables on the regressors using the Ordinary Least Squares method (OLS) and observed the resulting coefficients. The results of the first set of regressions will expound the relationship between a firm's overall governance effectiveness and firm's performance. The second set of models allows to understand the effect that each corporate governance sub-element has on profitability.

### **Findings**

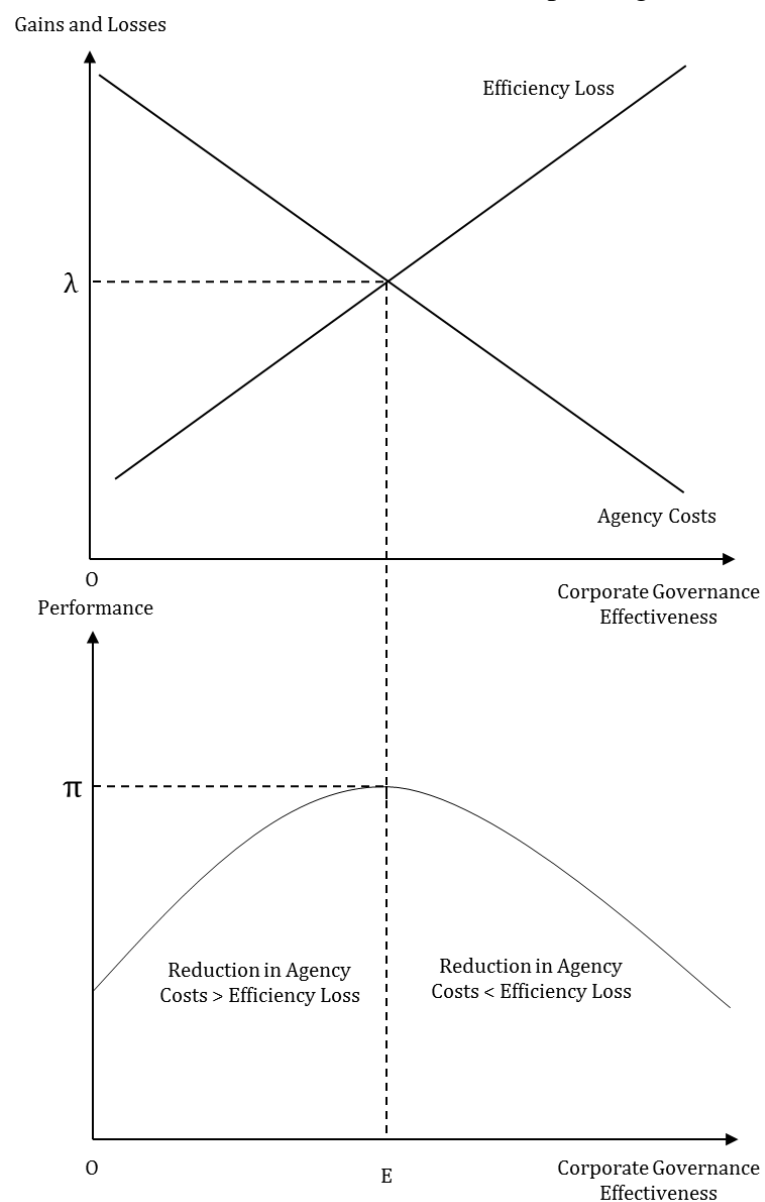
The analysis of the relationship between corporate governance overall score and performance of Hong Kong-based companies is mostly inconclusive. The relationship between the variables in this sample is completely random and not explained by the model I developed.

The Italian sample does not show any connection between overall score and performance. None of the tested models is significant. However, it shows a strong and significant negative relationship between performance proxies and shareholders' rights score for the year 2015, as it was envisaged by the hypothesis. This means that Italian firms that bestow strong rights to their owners are more profitable and more valuable than those which limit shareholder rights. The fact that the relationship holds only for the last year analyzed (2015), could be a consequence of the smallness of the sample for the other two years (for the years 2013 and 2014 the sample is composed, respectively, of 21 and 27 companies, increasing to 88 for the year 2015). My analysis reports evidence that shareholder rights are an important factor in explaining the operating performance of Italian firms. Being Italy an Insider System country, the result I achieved can be interpreted in this viewpoint: the award of strong rights to shareholders limits the ability of the majority shareholders to

deploy the firm's assets for his own sake, in this way increasing the profitability of the firms. On the other hand, firms that limit shareholder rights may have their profitability lowered by the damaging conduct of the blockholder.

For what concerns US-based companies, I found no relationship between the firms' overall score, ROA and ROE. However, the empirical analysis witnessed the presence of a significant relationship between the firms' overall score and Tobin's Q for all the three years analyzed. The evidence contrasts with the hypothesis, since the results show a positive relationship between the variables. In United States, better corporate governance

practices are associated with a lower Tobin's Q. This is surprising, as market should value more firms with better governance, Contrary to the conventional wisdom, my results demonstrate that better corporate governance is not always associated with a relative higher market valuation. This unexpected relation between corporate governance effectiveness could be a signal that pursuing corporate governance effectiveness can lead to efficiency loss. This fall can be so large to overcome the agency costs that are



associated with managerial opportunism. The enforcement of strict corporate governance



practices adds costs and constraints to the firm's activity. The restraint of management discretion is a direct consequence of the implementation of corporate governance controls, which in turn are necessary to ensure the fulfillment of their role, i.e. the assurance of shareholders to receive adequate returns on their investments. If management activity has to be monitored and ratified, constraints to managerial activity emerge. Managerial discretion can be excessively restricted, thus causing the firm to lose efficiency: decision-making and directive activity can become cumbersome and clumsy, resulting in lack of agility and stiffness.

Agency theory predicts that governance measures foster firm performance by optimizing agency costs and reducing waste of capital: my findings suggest that it is not always the case. Excessive strictness in governance practices can decrease firm's performance. This evidences suggest that enhancing corporate governance is not always the optimal choice, as controls entails costs that may impact negatively on the firm's result; instead, the design of a corporate governance structure that counterbalances the positive and negative effects associated with that is the strategy that lead to the best possible outcome (represented by the point  $\lambda$  in the graph). In the graph above, the optimum level of governance effectiveness is the point E: at this level, the reduction of agency costs equals the loss of efficiency, hence leading to the best possible outcome in terms of performance (in correspondence of the point  $\pi$  on the y-axis).

## CONCLUSION

This thesis analyzed the impact of corporate governance practices on firm's performance. To reach this objective, I collected a set of ratings to mirror the effectiveness of firm-specific corporate governance practices and a set of performance indicators. I investigated the relationship between this group of variables. The results show that differences in corporate governance practices are reflected in the actual performance of companies, although the impact is rather tenuous. Furthermore, the existence of a relationship between the variables has not been consistent throughout all the analyzed samples.

The analysis provided useful insights to the long-debated question regarding the relevance of corporate governance. By employing an evaluation instrument actually

utilized by investors to grade corporate governance, I took a pragmatic approach to assess the relationship between governance and performance. Despite my results prove that corporate governance influences firm's performance, the understanding of the connection between the variables is far from being comprehensive. By directly linking the factors I explored whether differences in corporate governance alone are so relevant to justify differences in performance. However, performance is the outcome of a multitude of factors, e.g. industry characteristics, strategy, economic conjuncture and so on. To assess thoroughly the impact of corporate governance on performance all these elements should be considered in the empirical analysis: in that way, the results would be decontaminated from the effects of these factors, allowing a better understanding of the impact of corporate governance on performance.

Despite all the undeniable limits that weaken the validity of the model, I demonstrate that corporate governance practices substantially influence firm's performance. The demonstration that, in some cases, the goodness of corporate governance allows to reach an outstanding performance is a crucial result for investors and policymakers. Since best-performing corporate governance structures are not scarce and are easily replicable, better governance could result in better performance for the economy as a whole. Although this would be a desirable outcome, it is unlikely that there exists a unique corporate governance structure that can be considered "better" in absolute terms. Ownership structure, industry, economic conditions are likely to influence the corporate governance system that may allow the achievement of the best performance. The analysis proved that corporate governance effectiveness is not always desirable, as it has been found to be negatively correlated with performance in some circumstances. In accordance, this thesis fails in adding clarity to the corporate governance-performance issue, and adds to the extensive group of researches that yielded to mixed results (Saravia 2014). Research is still required to outline the pattern of the relationship between corporate governance and firm's performance. The results of my analysis provide food for thought to researchers: the proposed interpretation of the inversed relationship between governance effectiveness and performance in United States and the positive correlation between shareholder rights' strength and performance witnessed in Italy still need to be explained with clarity; finally, the reasons of the temporal inconsistency of the results are to be explored.

