

## **Corporate governance, the perception of corporate governance and the connection to firm performance; Evidence from Romania**

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### **Non-technical summary**

This article employs an in-depth study of Romania to offer evidence not previously available for this country on the relationship between corporate governance and different metrics of firm performance for exchange-listed companies.

We make additional contributions to the literature.

First, we construct two corporate governance indices: the Reported Corporate Governance Index (RCGI) was developed based on a 2011 survey of corporate governance practices among listed companies supplemented by hand collection of data (the index covers 21 companies), and the Perceived Corporate Governance (PCG), an index of “perceived” corporate governance constructed by collecting questionnaire answers from 87 active investors on the Romanian capital market (this index is estimated for 85 listed companies). The two indices represent the first metrics of corporate governance for Romania.

Second, we construct a wide database containing financial ratios for Romanian companies (annual ratios for a six years period, i.e. 2006-2011) which are not publicly available and are scarce or even inexistent in the previous literature.

Third, we report for the first time actual statistics on the relationship between corporate governance and performance: perhaps counterintuitive, we report that corporate governance is negatively correlated with contemporaneous firm performance for Romanian companies and the Management and the Board of Directors (sub-index 4) and Auditing (sub-index 5) are both significant risk factors that decrease firm performance as reflected by Tobin’s Q. In addition, a 1-point increase in the overall RCGI predicts a 2.2 decrease in price/sales ratio. The subjective index of perceived corporate governance - PCG is positive and statistically significant when it alone is used to explain Tobin’s Q. This time a 10 point increase in the investors’ perception of corporate governance produces a 0.098 increase in the firm performance. No statistically significant relationship is found between PCG and P/E or the contemporaneous stock return which implies that there doesn’t seem to be a corporate governance premium on the Romanian stock market and good CG stocks are neither overvalued nor have higher stock returns. Other results show that company size seems to be positively correlated with both corporate governance metrics and with firm performance and also that the inclusion of a company in the first category of the Bucharest Stock Exchange has the largest correlation coefficient with the corporate governance index, since the inclusion itself is directly related to complying with some CG conditions.

We conduct robustness checks by considering alternate dependent variables (price/sales for Tobin’s Q) and an extensive set of control variables, which provide consistent results and

increase our confidence in the performance-governance relationships. We acknowledge as a weakness of this research that, despite these extensive control variables firm heterogeneity that is not captured by our control set could correlate with both Tobin's q and RCGI and therefore affect the results. One response to this risk is to use panel data in a firm-fixed-effects model (Black et al., 2006), which could not be implemented because we have only cross-sectional data on both RCGI and PCG (both indices are constructed in 2011). For the same reason we could only estimate contemporaneous relationships between corporate governance and performance, therefore we have no estimations on causality (or antecedence) between the variables.

Overall, our results are in line with other studies which found there is no connection between corporate governance ratings and firm performance/valuation (i.e. Epps and Cereola, 2008 for the S&P500 companies), and contrary to others (Black, 2001 for Russia, Bauer et al., 2004 for companies included in the FTSE Eurotop 300 or Klapper and Love, 2004 for 25 emerging markets). However, as mentioned earlier, a global theory of corporate governance is still in a developing stage and studies which cover countries more prone to comparison with Romania (i.e. countries from the former Eastern European communist block) are still to be accomplished.

The negative relationship between the company reported index RCGI and firm performance (Tobin Q) and the positive relationship between the index reflecting investors' perception PCG and the same metric of firm performance (therefore suggesting a peculiar negative relation between the two CG indices) can be interpreted in the following way: our proposed scorecard assessing the companies CG mechanism, as the Bucharest Stock Exchange CG Code (used by us to supplement companies' answers and construct RCGI), are to a certain limit opened to interpretation; at the same time, managers with poor performance lately (reflected in Tobin Q and other metrics) are more motivated (and subjected to pressure by stockholders) to do anything to improve the image of the company, including interpreting questions in their favor (first, they are more prone to participate in the survey and to answer the voluntary BSE code and second, they participate in these surveys only to answer as much "Yes" as they can, therefore contributing to a high and "unfair" RCGI for their company); concomitantly, the companies which achieved a better operating performance have not the same incentives to participate to these surveys or to artificially create for themselves a better image by trying to score a higher RCGI. For these reasons, we expect that RCGI could be biased towards poor performers (companies with small Tobin Q) which report for themselves artificially high CG scores, while the index assigned by the market (investors) grades CG practices more realistically and therefore PCG reflects the "normal" positive relationship between company corporate governance and its performance. Other strongpoints of PCG that make it the better CG metric in our opinion consist in its broadness (85 companies comprised in the index as compared to only 21 in RCGI) and the fact that companies' participation was not voluntary (the entire list with the 85 companies was given to investors who were then asked to rate assign ratings). Consequently no unilateral retraction from this analysis of companies that didn't feel confident in their image was possible, so PCG is not based on a biased sample, as opposed to RCGI.

The current legislative environment on the Romanian equity market (i.e. a new and stricter CG Code, media scrutiny etc.) could raise the activism of institutional and individual investors and

draw more attention to governance provisions; thus, we might expect to see some changing relationships between CG metrics and at least market valuations (P/E ratio) as investors begin to purposely search for good CG companies for inclusion in their portfolios.

Finally, we notice after performing an in-depth analysis of the related literature that, while the first direction of studies is extensively covered in the literature (but even here some markets are not yet looked at), the second one still needs investigation, especially for emerging and transition markets. We find that for countries which are not covered by public providers of governance ratings, academic studies on the relationship between corporate governance and firm performance lack almost entirely. These are usually countries with weak legal systems which neglect the subject of corporate governance and with companies and executives most likely reluctant to assist an academic endeavor which attempts to evaluate corporate governance practices and to construct governance indices. Consequently, a research attempt in this direction could prove to be a challenging task. Still, such studies are essential for the development of a global theory of corporate governance, as governance mechanisms and the institutional environment in which they are embedded are strongly influenced by forces developed at the national level, and for this reason it is difficult to extend the result of a one country study to other national setting (Zattoni and Van Ees, 2012). The current research attempts to fill some of the gap in this area in the case of Romania.