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Research Article

Corporate Governance System and Firm Financial Performance

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Abstract

This study review the systematic understanding between the link between corporate governance system and companies' financial performance from theoretical and practical perspective based on dealing with the concepts, theories and evidence that done in the previous studies in the literature review regarding corporate governance and its mechanisms as internal control system and its impact on firm financial performance. The current research brings about many explanations regarding the mechanisms role of corporate governance like the size of board of directors, independency and CEO duality and their impact on the firm financial performance. The present study recommended that the internal controls mechanisms and board features are crucial for reaching good corporate governance. Previous studies in the literature revealed admit that corporate governance's mechanisms improve firm financial performance. Thus, the current study revealed the significance role of internal controls mechanisms for the success of companies.

Keywords: Corporate Governance Mechanisms; Firm Performance; Related Theories

Introduction

Explanation of corporate governance (CG)

Corporate governance (CG) in recent year has become a key element that provides managers to make effective decision making. Appropriate control in a vital way to increases medium/long term company valuation, maintaining, creating, and enhancing firm's success and its financial performance. CG aims at ensuring a balanced economic and transparent it that the stockholders' interests and wealth are safeguarded and this will be leaded to a high sustainable for the companies and minimizing potential risks loses. CG contains a set of internal control mechanisms like procedures, approved rules, policies, and should be utilized by company's managements to guarantee that their companies are functioning more regarding to the prearranged aims of the company. Because of the several financial crisis, like these mechanisms that were created in the US and Europe, appeared important regulations and low to improve entities' internal control mechanisms. Yet, the poor of efficient and weakness of CG as internal control mechanisms (ICM) makes companies weak and might face a risks, including unsuitable losses and uncertainty risks and recording of accounting transactions. Carrying out control and technological innovations is key to the development of manipulation and unauthorised transactions, impacting firms' competitiveness and therefore a financial performance [15-20].

The failure of countless corporations across the globe due to a lack of effective CG in the previous few decades has made it evident that businesses must adjust their CG to develop and improve [34,35,37]. Thus, new researches are needed and important to enhance CG and also to safeguard stockholders' wealth. CG has practised widely in many countries around the world, it is not officially bonded. It just epitomizes more or less recommendations for good CG. Nonetheless, there has recently been a surge in interest in using CG in public companies to manage stakeholder–management relationships and improve management processes. The ideal roles and distributions among parties, including auditors, shareholders, creditors, as well as regulators, should be defined by the structure of CG, which should also cover the policies, procedures, as well as regulations for successful decision-making in corporate affairs. Within the context of regulatory, social, as well as market settings, the firm's objectives are effectively pursued. Effective CG systems encourage companies to introduce values through entrepreneurship, innovation, advancement, as well as exploration while also providing ICM, transparency, as well as responsibility. ICM are viewed as essential component of a firm's corporate governance framework, with efficient organisations having strong internal control and CG.

Concepts and Related Literature Review

The importance of board features and internal control mechanisms (ICM) achieve sound corporate governance (CG) by summarising the important points in previous studies. First, the descriptions of CG and the theories of good CG, ICM, the board characteristics, audit committee, and the financial performance are presented. Next, the empirical findings from previous case studies are presented [20,34,44,50,52,53].

A huge amount of previous studies in the literature in testing internal control system on firm financial performance such as [20,31,34,41,44,50], and other studies' evidences such as [14-34]. Furthermore, see for example [7,18,23,50].

In recent decades, CG has evolved into a key mechanism for enhancing firm performance as a result of the recent global financial crisis, which highlighted the importance of excellent CG practices and structures. The framework of excellent CG is critical for improving the long-term performance and sustainability of businesses. Good CG improves an organisation's image, increases shareholder confidence, and lowers the chance of fraud. The board of directors (BoD), external and internal audits, management, audit committee, as well as ICM are all important components of good CG that help uncover abnormalities early in the project life cycle. Even though CG differs by company and country, the key objectives are similar, which is to achieve profitability, excellent performance, as well as to oversee managers in order to protect shareholders' interests [4,6,10]. It is worth noting that inadequate or inappropriate CG might lead to abuses, fraud, and bad results.

Corporate governance (CG)

Following the 1929 Wall Street Crash, economic and legal experts such as Eugene, Adolf Berle, Fama, and Kathleen Eisenhardt attempted to study the notions of corporate governance (CG). Nevertheless, the 1990s saw a breakthrough in the use of CG in a number of emerging economies. As previously said, CG refers to the process through which the board of directors (BoD) governs, establishes, and manages interactions between external and internal stakeholders for the benefit of the firm's stakeholders. CG refers to the traditions, rules, and procedures in place to help a company achieve its objectives. Internal control mechanisms (ICM), in particular, are used to remove or diminish concerns involving principal agents (for instance, disputes and mismanagement), such as stakeholders, management, the BoD, regulators, suppliers, employees, partners, the general public, constituents, as well as consumers. Several internal mechanisms have impact on firm performance. [24,27,35], discovered evidence that financially strapped firms adopt AEM to improve their financial standing. Nonetheless, a significant number of research [1,2,9,14,16-18,21-23,25,28,29,32-36,44-46,49,50], have found a negative link between firm performance and earnings management, suggesting an opportunistic strategy to income management.

A board size for example consists of selective directors by stockholders to run the company's affairs. These managers run the company based on company policies, and then make decisions on the company's finances and control the operational company. This mechanism is one of the core internal control mechanisms that have been used to control top management activities for the purpose of protecting the stockholder's interests [25,46,47]. Based on previous studies we predict the hypothesis below:

- **Hypothesis 1:** A negative link between board size and ROA.

To guarantee that firms operate more effectively, improve capital access, assure the effectiveness of supervisory activities, manage risk, and protect stakeholders, good CG is required. It also enables firms to be accountable and transparent to investors, reducing expropriation and unfairness for shareholders while promoting strong and balanced economic growth. Different corporate governance structures could be implemented for different companies.

Theories and corporate governance theories

Agency theory

Agency theory is an essential theory, it is a main economic theory persuading the corporate governance framework, and attracts several researches on corporate governance. The agency theory was first introduced. The agency theory is important because it provides a contractual relationship between firm managers and shareholders. Three firms' challenges or problems were found based on the agency theory. The effort problem (which is concerned with whether managers make an effort to manage the corporation in order to maximise shareholder wealth), the differential risk problem (which is concerned with the differing perspectives of principal and managers), and the asset situation (concerns on insiders who control corporate assets) are all issues that need to be addressed. According to agency theory, CG mechanisms are needed to reduce agency costs by coordinating the financial interests of executives with respect to stakeholders by fixing their compensations and benefits, appointing an independent board of directors (BoD) to monitor managerial behaviour, and appointing an independent BoD to monitor managerial behaviour.

CG, from the standpoint of agency theory, is a process in which the BoD of the CG play a critical role in monitoring managers to ratify their actions, minimises disputes between shareholders and agents, and helps the firm achieve its goals. A number of researchers have looked into this role. Furthermore, the agency theory claims that board directors must be independent in order to protect shareholders' wealth by decreasing agency conflicts, enhancing profitability, ensuring the long-term viability of businesses, and improving disclosure and information quality. According to several studies, the independent BoD has a considerable favourable link with increased financial performance of companies.

Resource dependence theory (RDT)

Pfeffer (1973) was the first to introduce this hypothesis into CG's work. Here, RDT emphasises the critical role of the BoD, particularly independent boards, in providing access to resources, improving organisational functions and external connectivity, and improving the company's performance. As a result, RDT implies that environmental connectivity between outside resources and firms is necessary. To reduce transaction costs associated with environmental interdependency, BoD must integrate important parts of environmental risks into a corporation. Organisations need to understand RDT in order to increase their directors' advice quality. For the board structure and role, the independent BoD can appoint other resourceful specialists, particularly those with great talents and specialties.

The key tasks of the independent board provide arguments for developing connectivity between organisations and their external contexts, according to RDT [24-30]. Furthermore, due to the diverse information, skills, and expertise shared among audit committee members, the audit committee may work more resourcefully and efficiently to improve audit quality under the RDT. Companies can extract valuable resources, gain highly effective audit quality and financial reporting, a higher degree of CG and ICM, and greater benefits and interests of firms and stakeholders' values through an excellent audit committee.

Internal control mechanisms (ICM)

ICM are a component of effective governance for businesses that monitor activities and provide corrective actions to guarantee that the firm's goals are met. ICM are defined as a process that influences the management, BoD, and other employees of an organisation. It gives substantial reassurance in terms of a firm's operational performance, audit quality, and compliance with applicable policies, laws, as well as regulations in order to meet the firm's goals [34,46,48,51,52]. Firms' actions and functions are overseen by the BoD, which includes subcommittees such as an audit. The audit committee, for instance, is in charge of delivering corporate assurance in accordance with applicable standards, regulations, and laws in order to maintain effective control over employee conflicts of interest and fraud.

Without an ICM, according to, good CG is impossible. As a result, there is a growing awareness that effective ICM are essential for strong CG. ICM have an impact on the organisation's overall governance and financial results. Thus, independent auditors' opinions on firm financial performance are critical for stakeholders to establish market value, build confidence and trust, and assure good performance in firms. ICM in CG make financial statements more reliable, according to demonstrated that corporations that lack ICM are vulnerable and doomed to fail [6]. ICM that are effective contributes to significant increases in financial performance. The importance of risk and ICM in strong CG was emphasised by. ICM protect the company from failing as a result of insufficient risk assessment and management. ICM that are effective help businesses achieves high levels of profitability and performance while also preventing resource waste. Control activities, risk assessments, control environments, communication, monitoring, and information are all components of an effective control system. Firms with ineffective ICM are riskier and perform poorly than their counterparts, confirming the critical role suggested by various academics to investigate the disclosure and importance of ICM for firm survival and performance. ICM have acquired a lot of momentum among public companies as a way to deal with failed organisations' inept risk management. Several businesses have failed, particularly during the 2008 economic downturn, which was mostly due to a lack of effective integration of ICM and risk management. ICM diagnose dangers in an organisation and investigate alternate solutions, thereby reducing risks. To fulfil stated corporate objectives, maintain conformity to regulations, avoid fraud and errors, and secure firm resources, ICM are critical in any dynamic business environment.

Methodology

Correlation analysis

The correlation between the dependent and independent variables is shown in table 1. The report showed that three independent variables have negative relationship with ROA, with values (BOD -0.0447), (INED -0.077). On the other hand, the another independent variables; CEO duality has a positive relationship with ROA, with value (CEO-duality 0.144). The report showed that BOD has highly negative relationship with ROA with value -.0447 as shown in table 1.

	BOD	INED	CEO-duality	ROA
BOD	1			
INED	0.191*	1		
CEO-duality	-0.108	-0.095	1	
ROA	-.0447**	-0.077	0.144	-0.435**

Table 1: Correlation Test.

Noting that the Level of significance is *p < .10 and **p < .05.

Regression analysis

The independent variables (BOD and INED) found to be negative but not all are significant related to ROA, that is BOD value (β = -0.142, p > 0.1), INED (β = -0.086, p < 0.1). Therefore, hypothesis that shows there is a negative relationship between board size and ROA is supported while hypothesis that shows there is a negative relationship between independent directors in the board and ROA is not supported as explained in table 2.

As for hypothesis that shows there is a negative relationship between the companies which do not have CEO duality and ROA, the result shows that CEO-duality (β = 0.006, p < 0.1) which indicates it is not supported.

ROA **Stand. Coeff.**			
Variables	**B**	**t- value**	**Sig.**
IVs:			
Board size	-0.142*	-1.477	0.144
Independent board	-0.086	-1.189	0.239
CEO-duality	-0.006	0.068	0.946

Table 2: Regression test: Link between corporate governance and ROA.

*p < .10, **p < .05, ***p < .01.

Conclusion

The purpose of corporate governance is reducing the extend of the gap among several parties that have interests in the company and enhance the investors' confidence and reduce the agency costs. In addition, it creates obliged environment among the company's stakeholders and their relation with the stakeholders. In that, applying good corporate governance in the companies is a core tool that ensures the productivity, profitability and the survival of the company. Several components have strong relationship are founded in case of existence of good mechanisms of corporate governance such as audit feature, size of the board of directors, independency and CEO duality under ICM to be as a core parties which aid irregularities detection in early time. We found that previous studies related to board independence is represented by the feature of corporate governance mechanisms that has the highest predictive importance on firm financial performance, followed by the size of the board of directors, and also with that CEO duality mechanism that is not always a significant with firm performance in several non-financial companies in both developed and developing countries. In general, in most of previous studies in the literature revealed good corporate governance mechanisms as good internal control mechanisms have positive relation with corporate performance. Nevertheless, some results also found mixed findings in the link between corporate governance mechanisms and firm performance.

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