Corporate Governance and Company Performance: Evidence from the Czech Republic

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Abstract: - The purpose of this paper is to investigate the impact of corporate governance on financial performance in the Czech Republic. The relationships between board demographics and corporate performance were examined for a sample composed of 200 largest joint-stock companies from the processing and the construction industry. Correlation analysis and multivariate regression analysis were employed to test the sample on five hypotheses whose definition was based on similar studies from other countries. A weak correlation between the company size and the size of its board was identified. Otherwise no potential link between any of the corporate governance demographic variables and the company performance was found in the Czech Republic.

Key-Words: Corporate Governance; Company Performance; Czech Republic

1 Introduction
Corporate governance gained attention especially after the series of financial reporting scandals such as Enron, World.com in the United States or Parmalat in Europe. Since then, this issue has been analyzed in a number of theoretical and empirical studies.

One of the fundamental questions is whether there is a relationship between good corporate governance and financial performance. This relationship has been proven by many empirical studies (e.g. [1],[10] and [19]).

The research was conducted mainly in developed countries where companies are listed on the stock exchange and are obligated to follow an extensive set of rules and to disclose various information and reports. In the past several years the focus of academics has shifted to corporate governance issues in emerging economies around the world in order to explore and describe characteristics of partial countries. The objective of this paper is to proceed with this research and to evaluate corporate governance practice in the Czech Republic.

Companies in the Czech Republic are not required to publish any report concerning corporate governance and it is at their own discretion to follow the Czech Code of Corporate Governance based on the OECD Principles. Moreover, a number of public companies listed on the Czech capital market, represented by Prague Stock Exchange, are still insufficient to create a data sample for statistical analysis.

2 Literature Review
Numerous empirical studies have described statistically significant positive relationship between corporate governance and financial performance in developed countries. Over the past years, international corporate governance has been expanded on a perspective of emerging markets.

In the Central and Eastern European countries, that share a major transition of state-owned enterprises into private companies in the last two decades of the twentieth century, issues of corporate governance are starting to be gradually addressed.

Gruszczynski [9] examines the relationship between the corporate governance rating and the financial performance of listed companies in Poland. The study confirms that the level of corporate governance of listed companies is to some extent correlated with their financial performance. However, there is no strong evidence that the governance of Polish listed companies relies on their financial performance.

At the end of twentieth century, the privatization process in Central and Eastern Europe has attracted an attention of scholars, who have analyzed the
transformation of state-owned enterprises to private companies and examined the influence of ownership concentration and structure.

There is a lack of studies regarding the relationship between board structure and company performance, but on the other hand there are several studies conducted on the ownership issues ([7], [22], [3] and [14]).

3 Independent Variables
Our overall research objective is to review the empirical evidence concerning board characteristics and corporate performance in the Czech Republic in the light of alternative theories on the relationship between the board composition and corporate performance. The Czech Republic represents an interesting case study as it is an emerging market with the two-tier corporate governance system. It is challenging to design adequate methods to measure the relationship between the corporate governance and financial performance of companies. Four independent variables have been identified to carry out this task.

3.1 Board Size and Financial Performance
It is a generally accepted fact that board size is growing with the company size. According to the resource dependence theory ([17] and [8]), the larger companies will have the greater need for resources and for that reason will require a larger board. Therefore, we hypothesize that:

Hypothesis 1: The size of the company is positively correlated with its board size.

A larger board does not necessarily mean a better financial performance. Jensen [11] suggested that boards of directors with more than 8 directors will not perform effectively. Mintzberg [16] suggests that large and diverse boards are more easily manipulated by CEO.

Yermack [23] found a strong inverse association between the board size and the company value measured by Tobin’s Q in a sample of U.S. companies. Conyon and Peck [5] tested this inverse association in five European countries and evidence demonstrates generally negative effect of the board size on corporate performance. Coles et al. [4] confirms the existence of a U-shaped relation between Tobin’s Q and the board size, suggesting that either very small or very large boards are optimal. Thus large board size may be optimal for large or complex companies.

On the other hand, Dalton et al. [6] reports nonzero, positive relationship between the size of the board and financial performance.

Theoretically, every new board member may bring new connections and skills thus increasing the company performance, until a point is reached, where an oversized board is unable to communicate efficiently. This results in decision-making problems. Managing boards in two-tier system are generally much smaller than boards of directors in predominantly analyzed one-tier system. In order to maintain a comparative perspective, we combined a number of both board members in the manner of one-tier board. Thus we hypothesize that:

Hypothesis 2: The size of the managing and supervisory board is positively correlated with the company performance.

3.2 CEO and the Managing Board
The theory is not unified in terms of whether the same person should hold simultaneously both the CEO and the chairman role. According to the agency theory, such situation leads to a reduction of board monitoring effectiveness, because the CEO as the board chairman are controlling themselves. This is not an issue in two-tier system, in which the executive and non-executive roles are divided between managing and supervisory board. The question is whether a CEO should also be the chairman of the managing board. In the past, the common practice used to be that the managing board had a meeting once or twice a year and the CEO was delegated to appoint the top management. The membership of the CEO within the managing board improves the effectiveness of company governance, because the board is aware of the top management’s activities. Therefore we hypothesize that:

Hypothesis 3: CEO being also a chairman of the Managing board has a positive influence on the company performance.

Measure: A dummy variable equals to 1 if a CEO is also a chairman of the Managing board, and vice versa.

3.3 Ownership Concentration
The ownership structure in the Czech Republic is similar to the German model, which is characterized
by a concentrated ownership. Since there is no active market for corporate control, concentrated ownership plays an important role in the corporate governance mechanism. Blockholders are able to monitor the company management more efficiently than a group of minor shareholders, to reduce informational asymmetry thus lowering agency costs. Shleifer and Vishny [21] state that ownership concentration and performance are positively correlated.

The results of the empirical studies are divergent when the majority of evidence is supporting the positive effect of concentrated ownership. For instance, Lehmann and Weigand [13] in their study of German companies conclude that a large shareholder does not necessarily improve the corporate performance, but ownership concentration significantly improves the ROA of listed companies. According to the meta-analysis of 33 studies by Sánchez-Ballesta and García-Meca [20], the effect is stronger in continental countries than in Anglo-Saxon countries, which is in accordance with the claim that the relation between ownership and financial performance is stronger in countries with lower levels of investor protection.

Claessens and Djankov [3] in their study of 706 Czech companies over the period between the years 1992-1997 conclude that more concentrated ownership is linked to higher company profitability. Therefore, we hypothesize that:

**Hypothesis 4:** The ownership concentration is positively correlated with financial performance.

Measure: The percentage of shares held by a controlling shareholder.

### 3.4 Ownership Structure

The ownership structure may be as important as the ownership concentration regarding company performance. Frydman [7] examines the ownership effects on corporate performance of mid-sized companies in the Czech Republic, Hungary and Poland, and concludes that a foreign ownership brings a significant improvement of revenue performance, although its impact is no more significant than the one of domestic outsiders. A reason could be the sample period between the years 1990-1993, which was in the middle of the privatization process when the transfer of technological and managerial know-how from foreign owners may have required more time. Frydman [7] does not investigate ownership concentration, because all the companies in the sample were characterized by a single dominant shareholder. Pivovarsky [18] found that the concentration of ownership by foreign companies and banks in Ukraine is associated with better performance than that of domestic owners.

Overall, the foreign shareholder may improve the company corporate governance practice and therefore we hypothesize that:

**Hypothesis 5:** Foreign ownership is positively correlated with financial performance.

Following frequencies were identified in the underlying data set:
- Municipality (4)
- Domestic corporate entity (77)
- Domestic individual owner (30)
- Foreign corporate entity (89)

For the regression analysis purpose, scores were used in order to approximate the expected level of corporate governance quality with various types of majority owners. We expect the foreign corporate owners to demand higher quality of Corporate Governance. On the other hand we expect domestic individual owners to be the worst performers in the Corporate Governance practices. Based on these assumptions following scores were assigned:
- Domestic individual owner – 0
- Municipality – 1
- Domestic corporate entity – 1
- Foreign corporate entity – 2

### 4 Control Variables

In order to properly analyze the relationship between corporate governance and financial performance, it is necessary to involve the control variables which could strongly influence ROA, which was selected as the dependent variable. Since the data set consisted of only two industries, we preferred two commonly used company factors to industry related variables (e.g.[2], [12], [15] and [10]).

#### 4.1 CompanySize

The company size has an impact on financial performance and is controlled in most studies (e.g.[12] and[10]). As long as companies in the Czech Republic are mostly not listed, it is not possible to use market capitalization as a measure of
the company size. For this reason the revenues were used as the most appropriate proxy.

Since correlations aim to find linear relationships, the heavy skew in the distribution of revenues justify the use of the natural log of this variable for all analysis.

### 4.2 Debt/equity ratio

Debt may represent an important corporate governance mechanism, because creditors monitor the manager’s activities and managers are therefore discouraged to accept excessive debt financing for investments with high risk. Overall, debt financing may reduce agency costs and may improve company performance.

### 5 Dependent Variable

Company performance is measured as the return on assets ratio (ROA) defined as earnings before interest and taxes (EBIT) divided by the book value of assets. ROA is an indicator of accounting-based measures which are generally criticized since they are based on historical data and so the results do not reflect the actual situation. For that reason, the majority of empirical studies involve also Tobin’s Q as a dependent variable. Tobin’s Q is a market-based measure of the company performance, related to its market value. This indicator is however not applicable in the Czech Republic as the vast majority of the companies in the data sample are not listed on the Prague Stock Exchange.

### 6 Data Sample

Our hypotheses are examined on 200 largest joint-stock companies (sorted by revenues) from the two most significant industries in the Czech Republic, that means the processing and the construction industry. The two industries combined accounted for more than 45% of the national gross domestic product in 2011 [24].

Focus on a limited number of industries was preferred as it enables the comparison of variables. Different industries usually exhibit different levels of ROA for example.

It is a common practice that data sample for an empirical investigation of corporate governance consists of listed companies. There are, however, only 28 listed companies at the Prague Stock Exchange which would not be considered as a representative data sample. Nevertheless, there are no obligations related to corporate governance requested by the Prague Stock Exchange. Hence, it is fully in competence of companies whether they comply with good governance practices.

For investigation purpose publicly disclosed information in two local information sources in the Czech Republic were used: Official government website www.justice.cz and database Magnus maintained by ČEKIA (www.cekia.cz).

### 7 Empirical Results

At a simple correlation level of analysis shown in Table 1, there is no significant relationship between any of the four corporate governance demographic variables: the size of board, CEO being the chairman of the managing board, ownership concentration and ownership structure. Neither there is any correlation between monitored variables (ROA, Revenues and Debt/Equity ratio) or with board demographic variables.

It is, however, possible to see a weak correlation of 0.310 between the board size and revenues that serve in the context of this paper as a proxy for the company size. This would imply that larger companies tend to have larger board size and so Hypothesis 1 is supported.

Further notable is the correlation of 0.397 between the ownership concentration and its

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>7.21%</td>
<td>15.25%</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues (ln)</td>
<td>21.5</td>
<td>0.72</td>
<td>-0.009</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt/Equity</td>
<td>3.30</td>
<td>19.90</td>
<td>-0.111</td>
<td>-0.042</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board Size</td>
<td>7.23</td>
<td>2.23</td>
<td>0.006</td>
<td>0.310**</td>
<td>-0.078</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CEO as Chairman</td>
<td>0.42</td>
<td>0.50</td>
<td>0.051</td>
<td>0.112</td>
<td>-0.051</td>
<td>-0.036</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ownership concentr.</td>
<td>91.98</td>
<td>17.89</td>
<td>0.040</td>
<td>0.121*</td>
<td>-0.173**</td>
<td>-0.070</td>
<td>-0.042</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Ownership structure</td>
<td>1.29</td>
<td>0.73</td>
<td>0.020</td>
<td>0.209**</td>
<td>-0.127*</td>
<td>0.109</td>
<td>0.035</td>
<td>0.397**</td>
<td>1</td>
</tr>
</tbody>
</table>

* p < 0.05 (one-tailed); ** p < 0.01 (one-tailed)

Source: authors’ analysis
structure. This represents the link between the share of the majority owner and the type of the owner. Foreign corporate entities tend to have larger share when being a majority owner than municipality or domestic corporate owner in the same position. Domestic individual owner then tends to have the smallest share if majority owner.

Furthermore, the multivariate regression analysis was performed with ROA as the dependent variable. Its output is displayed in Table 2. The four independent variables used in the regression analysis were the Board size (BOS), the Ownership concentration (OWC), the CEO being in the Board of Directors (CEO), and the Ownership structure (OWS).

<table>
<thead>
<tr>
<th>Dependent: ROA</th>
<th>Std. β</th>
<th>Std. Error</th>
<th>t Stat</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.026</td>
<td>0.071</td>
<td>0.371</td>
<td>0.711</td>
</tr>
<tr>
<td>BOS</td>
<td>0.001</td>
<td>0.005</td>
<td>0.145</td>
<td>0.885</td>
</tr>
<tr>
<td>OWC</td>
<td>0.000</td>
<td>0.001</td>
<td>0.546</td>
<td>0.586</td>
</tr>
<tr>
<td>CEO</td>
<td>0.016</td>
<td>0.022</td>
<td>0.739</td>
<td>0.461</td>
</tr>
<tr>
<td>OWS</td>
<td>0.000</td>
<td>0.016</td>
<td>0.000</td>
<td>1.000</td>
</tr>
</tbody>
</table>

Source: authors’ analysis

R square equals 0.46% which supports low values of β coefficients in the suggestion that selected variables do not describe the variability in ROA.

8 Conclusion
Because of the lack of empirical studies addressing corporate governance in the Czech Republic, one of fundamental objectives of this paper was to locally test the corporate governance variables employed in the empirical studies from other countries.

However, the findings of this study do not fully support the hypotheses based on prior empirical evidences from other countries. Neither correlation analysis nor multivariate regression analysis could indicate any potential link between any of the corporate governance demographic variables to company performance. It is an important finding as it provides a potential for a further research in the area of its reasoning.

Only Hypothesis 1, stating that the company size is positively correlated with its board size, has been supported. This hypothesis implies that larger companies tend to have larger board size.

It is necessary to stress that a majority of prior studies are not applicable in this case, as the conditions in the Czech Republic differ in two aspects.

First, the analyzed foreign countries have an active capital market and the data sample usually consists of listed public companies. The Czech private joint-stock companies are not obligated to disclose more than annual reports. It is therefore difficult to extract many important variables (such as the independency of board members) from publicly disclosed information.

Second, the company governance is based on one-tier board system. This raises the question whether the employed board demographic variables are suitable for the two-tier system existing in the Czech Republic.

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